

# Starbucks (NASDAQ: SBUX)



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## **Company Overview**

Starbucks is the premier roaster, marketer, and retailer of specialty coffee in the world, operating in 75 countries. Formed in 1985, the Starbucks Corporation currently operated more than 27,000 locations throughout the world and their stock trades on the NASDAQ under the symbol SBUX. They purchase and roast high-quality coffees that they sell, along with handcrafted coffee, tea and other beverages and a variety of high-quality food items, including snack offerings, through company-operated stores. They also sell a variety of coffee and tea products and license their trademarks through other channels such as licensed stores, grocery, and foodservice accounts. In addition to their flagship Starbucks Coffee brand, they sell goods and services under the following brands: Teavana, Tazo, Seattle's Best Coffee, Evolution Fresh, La Boulange and Ethos.

	Americas	As a % of Total Americas Stores	CAP	As a % of Total CAP Stores	EMEA	As a % of Total EMEA Stores	All Other Segments	As a % of Total All Other Segments Stores	Total	As a % of Total Stores
Company-operated stores	9,413	57 %	3,070	41 %	502	17 %	290	89 %	13,275	49 %
Licensed stores	7,146	43 %	4,409	59 %	2,472	83 %	37	11 %	14,064	51 %
<b>Total</b>	<b>16,559</b>	<b>100%</b>	<b>7,479</b>	<b>100%</b>	<b>2,974</b>	<b>100%</b>	<b>327</b>	<b>100%</b>	<b>27,339</b>	<b>100%</b>

The company's objective is to maintain the Starbucks brand as one of the most recognized and respected brands in the world. They are continuing the disciplined expansion of their global store base, both domestically as well as internationally, as well as optimizing the mix of company-operated and licensed stores in each market. In addition, by leveraging the experience gained through their traditional store model, they continue to offer consumers new coffee and other products in a variety of forms, across new categories, diverse channels, and alternative store formats. Furthermore, they also believe their Starbucks Global Social Impact strategy, commitments related to ethically sourcing high-quality coffee, contributing positively to the communities they do business in and being an employer of choice are important contributors to their overall objective.

## **Industry Outlook**

Global coffee production in 2017/18 is estimated at 159.66 million bags, 1.2% higher than 2016/17 with a 12.1% increase in Robusta output offsetting a 4.6% decline in Arabica production. The volume exported between October 2017 and February 2018 totaled 50.98 million bags, against 49.41 million bags for the same period in 2016/17, an increase of 3.2%.

Further, with advances in technology and trading platforms, more direct to consumer purchasing might occur, where growers are selling directly to customers, cutting out the intermediaries. This will put a greater emphasis on quality, sustainability, and experimentation of differing flavors.

Additionally, with the rise in competition from brick-and-mortar locations, you should expect to see a greater emphasis on the overall customer experience. Baristas will need to be constantly seeking feedback from the consumers and educating them on the story behind their coffee.

## **Starbucks Performance:**

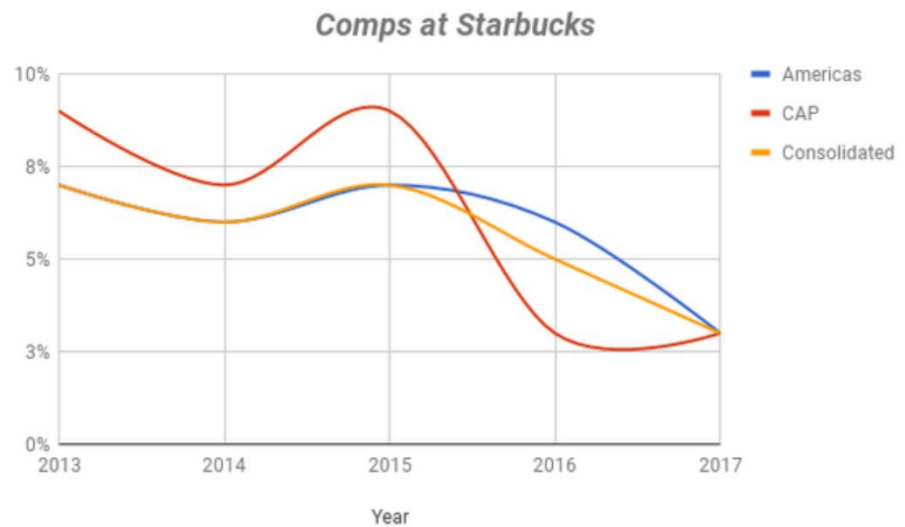


Starbucks Corp (SBUX US) - By Geography													
In Millions of USD except Per Share 12 Months Ending		FY 2012 09/30/2012		FY 2013 09/29/2013		FY 2014 09/28/2014		FY 2015 09/27/2015		FY 2016 10/02/2016		FY 2017 10/01/2017	
<b>Revenue</b>		<b>\$ 13,300</b>	<b>100.0%</b>	<b>\$ 14,867</b>	<b>100.0%</b>	<b>\$ 16,448</b>	<b>100.0%</b>	<b>\$ 19,163</b>	<b>100.0%</b>	<b>\$ 21,316</b>	<b>100.0%</b>	<b>\$22,386.8</b>	<b>100.0%</b>
Americas		\$ 9,936	75.9%	\$ 11,001	76.0%	\$ 11,981	75.1%	\$ 13,293	71.3%	\$ 14,795	71.2%	\$15,652.7	71.4%
China/Asia Pacific		\$ 721	5.5%	\$ 917	6.3%	\$ 1,130	7.1%	\$ 2,396	12.9%	\$ 2,939	14.1%	\$ 3,240.2	14.8%
EMEA		\$ 1,141	8.7%	\$ 1,160	8.0%	\$ 1,295	8.1%	\$ 1,217	6.5%	\$ 1,125	5.4%	\$ 1,013.7	4.6%
<b>Operating Margin</b>		—		—		—		—		—		—	
China/ Asia Pacific		35.10		35.00		16.00		20.90		21.50		23.60	
Americas		20.90		21.50		23.40		24.20		25.30		23.40	
EMEA		0.90		5.50		9.20		13.80		13.50		11.50	
Worldwide		15.00		-2.20		—		18.80		—		—	
<b>Number of Locations</b>		<b>18,066.00</b>	<b>100.00%</b>	<b>19,767.00</b>	<b>100.00%</b>	<b>21,366.00</b>	<b>100.00%</b>	<b>23,043.00</b>	<b>100.00%</b>	<b>25,085.00</b>	<b>100.00%</b>	<b>27,339.00</b>	<b>100.00%</b>
United States		11,128.00	61.60%	11,457.00	57.96%	11,962.00	55.99%	12,521.00	54.34%	13,172.00	52.51%	13,930.00	50.95%
International		6,938.00	38.40%	8,310.00	42.04%	9,404.00	44.01%	10,522.00	45.66%	11,913.00	47.49%	13,409.00	49.05%
Asia Pacific		2,628.00	14.55%	2,976.00	15.06%	3,492.00	16.34%	3,010.00	13.06%	3,632.00	14.48%	4,409.00	16.13%
China		292.00	1.62%	403.00	2.04%	544.00	2.55%	785.00	3.41%	1,110.00	4.42%	1,396.00	5.11%
South Korea		467.00	2.58%	559.00	2.83%	700.00	3.28%	831.00	3.61%	952.00	3.80%	1,108.00	4.05%
Other		—		501.00	2.53%	625.00	2.93%	361.00	1.57%	399.00	1.59%	596.00	2.18%
Taiwan		271.00	1.50%	297.00	1.50%	323.00	1.51%	356.00	1.54%	392.00	1.56%	420.00	1.54%
Philippines		201.00	1.11%	216.00	1.09%	240.00	1.12%	264.00	1.15%	293.00	1.17%	324.00	1.19%
Indonesia		133.00	0.74%	—		—		214.00	0.93%	260.00	1.04%	317.00	1.16%
Malaysia		134.00	0.74%	—		—		199.00	0.86%	226.00	0.90%	248.00	0.91%
Hong Kong		131.00	0.73%	—		—		—		—		—	
New Zealand		34.00	0.19%	—		—		—		—		—	
Japan		965.00	5.34%	1,000.00	5.06%	1,060.00	4.96%	—		—		—	
EMEA		987.00	5.46%	1,116.00	5.65%	1,323.00	6.19%	1,625.00	7.05%	2,119.00	8.45%	2,472.00	9.04%
Americas		784.00	4.34%	1,007.00	5.09%	1,137.00	5.32%	1,170.00	5.08%	1,296.00	5.17%	1,438.00	5.26%

## Risk Factors

The Starbucks brand is second to none in the restaurant industry. According to Forbes, the brand is the 35th most valuable in the country, worth \$15 billion. A major challenge in the food and beverage industry, however, is the very narrow moat. This means the company's brand is even more crucial for sustainable long-term growth and unfortunately, the brand only takes you so far. Behemoths like McDonald's and Dunkin' Donuts are becoming more aggressive with their growth strategies and could gain ground quickly with an economic downturn. Although SBUX has differentiated itself with its upscale instore experience, investors have to keep in mind that customers could opt for more inexpensive alternatives with a downturn, especially with low to no switching costs.

The most important metric in the food & beverage industry is comparable store sales (comps). Comps for Starbucks are headed in the wrong direction. As you can see from the graph below, comps in the China/Asia Pacific region are flattening out, and in the Americas, comps seem to be declining YOY. One cause could be the declining foot-traffic at brick and mortar retailers. This residual effect isn't going away anytime soon either with growth in e-commerce growing significantly YOY. In addition,



SBUX's goal of opening 12,000 additional locations (50% increase) in the next 3-5 years could be overly ambitious especially with the possibility of a US-China trade war, China being a key market.

Furthermore, Starbucks has tried multiple ways of fulfilling its mission. For example, it has made many attempts to expand its offering beyond caffeinated beverages. Unfortunately, both its recent endeavors, La Boulange Bakery and Teavana, have not panned out. Starbucks could be reaching the saturation level of its market and its heavy reliance on its brand as its competitive advantage is a strategy that could lead to only limited growth in the future.

### **Cost Efficiency**

Starbucks also has a very strong Operating and Net Profit Margin. Given that the company is consistently increasing the number of stores (around 500 stores per year), we expect more customers will be added into Starbucks' customer base and the total revenue and profit will increase steadily.

10383	9774.6	10707	11701	13300	14892	16448	19162.7	21315.9	22386.8	24850	26800	Sales (\$mill) <sup>A</sup>	33500
16.3%	18.0%	22.5%	23.9%	23.6%	25.3%	27.3%	28.7%	30.6%	29.9%	30.5%	31.0%	Gross Margin <sup>D</sup>	33.0%
11.9%	13.4%	17.1%	17.5%	17.6%	19.0%	21.3%	22.4%	24.5%	24.2%	24.5%	25.0%	Operating Margin	27.0%
9217	8832	8833	9031	9405	10194	10713	12235	12711	13275	15500	16200	Number of Stores <sup>E</sup>	18500
525.3	598.2	982.5	1173.6	1384.9	1721.4	2068.1	2393.9	2835.0	3011.0	3515	3960	Net Profit (\$mill) <sup>F</sup>	5740
30.9%	32.9%	34.1%	32.0%	32.8%	32.6%	34.6%	34.0%	33.0%	33.3%	26.0%	26.0%	Income Tax Rate	26.0%
5.1%	6.1%	9.2%	10.0%	10.4%	11.6%	12.6%	12.5%	13.3%	13.4%	14.1%	14.8%	Net Profit Margin	17.1%

### **Investment Efficiency**

Starbucks does an excellent job at increasing the percentage returned on their Capital. The company is expected to continue growing that percentage well into the future. Within the past 10 years, the return on total capital almost doubled from 18.2% to 34%. Furthermore, the Return on Equity has also benefited from consistent growth over the previous 10-year period. It



18.2%	17.2%	23.6%	24.1%	24.7%	23.2%	28.7%	29.7%	31.6%	32.6%	34.0%	34.5%	Return on Total Cap'l	33.0%
21.1%	19.6%	26.7%	26.8%	27.1%	27.8%	39.2%	41.1%	48.2%	55.2%	57.0%	54.5%	Return on Shr. Equity	45.0%

By estimating the growth rate of the two biggest revenue drivers Same-Store Sales Growth and Net New Store Growth, we have projected the Starbucks' future sales from 2018 to 2027. We expect the growth rates for the two drivers during 2018-2022 will be 3.5% and 7.0% respectively; 2023-2027 will be 3.0% and 5.0%; from the year 2028, both growth rates will remain at 2.5%.

After having the net income for Starbucks from 2018 to 2027, we have adjusted the net income to FCFE as formula below:

Then, we have calculated the cost of equity with the formula below to discount the FCFE to PV.

According to our model, the fair value of Starbuck is \$67 per share, and the current market price is \$59.

[illegible]

<b><u>Income Statement</u></b>		
	2017	% of Revenue
Revenue	22,387	
Operating expense	18,036	80.6%
Operating income	4,351	19.4%
Earnings before income taxes	4,318	19.3%
Income tax expense	1,433	6.4%
Net earnings attributable to Starbucks	2,885	12.9%
<b>FCFE</b>	<b>2,728</b>	
Net earnings attributable to Starbucks	2,885	12.9%
Depreciation & Amortization	1,067.10	4.8%
Change in WC	-35.2	-0.2%
(Capex)	-1,519.40	-6.8%
Net Borrowing	330.5	1.5%

## **Risk Analysis**

**Potential Over Investment in Emerging Markets such as Chinese Market** – China is becoming the biggest market for Starbucks. It is true that such developing market carries more potential than that of the developed market. But customers are more caprice since they did not form a stable consuming habit.

From the early 1990s, coffee has become a popular export good in the Chinese market. Starbucks, the most popular American brand took advantage of the trend and succeeded in the Chinese market. It is easy to find a Starbucks store on every corner of almost any streets. However, there are more and more new local brands or other foreign brands competing in the same market, Maan Coffee, Coffee Bene, Dunkin Donuts, etc. Moreover, since Starbucks mainly concentrated in First-Tier Cities such as Beijing, Shanghai, Guangzhou, and Shenzhen, high operating costs are threatening their profit margin.

**Challenge of Starbucks' Flexibility in Strategy Repositioning** – Loss of foot traffic is challenging Starbucks' operations in the traditional shopping mall. The failure and closure of its Teavana stores proved the difficulties in expanding its product line. Although the failure may also attribute to difficulties of forming the new culture, it indicated a matter of fact: Starbucks is facing a bottleneck in expanding its culture since the existing one has been deeply cultivated in consumers' hearts. Moreover, not only in the U.S. but also in emerging markets like China, the commercial real estate is facing great challenge thanks to the fast-developing e-commerce. Lacking flexibility in its strategy, Starbucks has to find a way to cater to the fast-changing business environment. Otherwise, it may easily loss market share if there are new competitors, business models, or products.

**Incidents** involving food or beverage-borne illnesses, tampering, contamination or mislabeling, whether accurate, as well as adverse public or medical opinions about the health effects of consuming our products, could harm its business. Starbucks' success depends substantially on

the value of its brands, all of those incidents will be a disaster for Starbucks' business. It takes 10 years to build the Starbucks brand but only needs very few accidents to ruin it.

**Competition in premium coffee** will be a serious concern. Costa Coffee, McCafe, Dunkin' Donuts, Tim Hortons and all dependent premium coffee shop become the competitor of Starbucks. Let's take Dunkin' Donuts as an example, the company introduced its first specialty coffees and drinks in the early 2000s and slowly began making a name for itself. In 2016, Dunkin' Donuts came the 2<sup>nd</sup> position with a market share of 21.9%, Starbucks captured a market share of 39.8%.

**Coffee and commodity cost volatility can influence profitability.** According to International Coffee Organization (ICO), the average ICO composite indicator, an overall benchmark for the price of coffee of all major origins and type, was 114 US cents per pound in December 2017 as compared to 117.3 US cents per pound in November 2017 and 120 US cents per pound in October 2017. Volatility in prices of input products hinders effective pricing strategies to secure and retain business. If the company tries to bear the increased costs its margins may decrease affecting its profitability and long-term sustainability.

### **Summary**

Despite the current challenge, the Starbucks still growth steadily and its business model is very successful and cannot be duplicated. We believe its investment in international markets will pay off in following years. Considering it will benefit from lower tax rate, 2018 will be a good year for Starbucks.

Overall, with solid fundamentals, we believe the Starbucks stock is undervalued. Their earnings, revenue, and dividends per share are growing at a steady pace and its customer base is increasing. It is expanding the number of stores to accommodate it. Even with the increased number of stores, its return on total capital and equity can still keep an impressive rate. We believe it has a potential room for steady growth.

### **Fundamental Analysis**

Starbucks has shown in the last 6 years a solid growth within the region of ASIA and we believed that this tendency will continue. Regarding the USA market, its revenue has not grown at the rate that analysts were expecting, since the USA CAGR for the last 5 years has been of 7.26%, which is relatively low when compared with an ASIA CAGR of 29%.

Based on our analysis we estimate that Starbucks is heavily focused on the development of the Asian region, which accounts for 29% of its total revenue. We estimate that this is going to change therefore we expect that in the next 14 years the Asian region will represent 55% making China its biggest market worldwide.

Although the USA market is its biggest market as of today, we don't think that there is a lot of room to develop its brand in the USA, mainly because there is a shift in consumer preferences. Consumers are switching from Coffee chains to the local chain, making it harder for a franchise name like Starbucks to increase its presence and to solidify its customer loyalty.

One of the key successes from its expansion in China has been the development of the Roastery type store, which proved in its Shanghai opening to be a great hit. It was an impressive opening with record sales in all of the key metrics. For instance, USA stores do an average of \$32,000 a

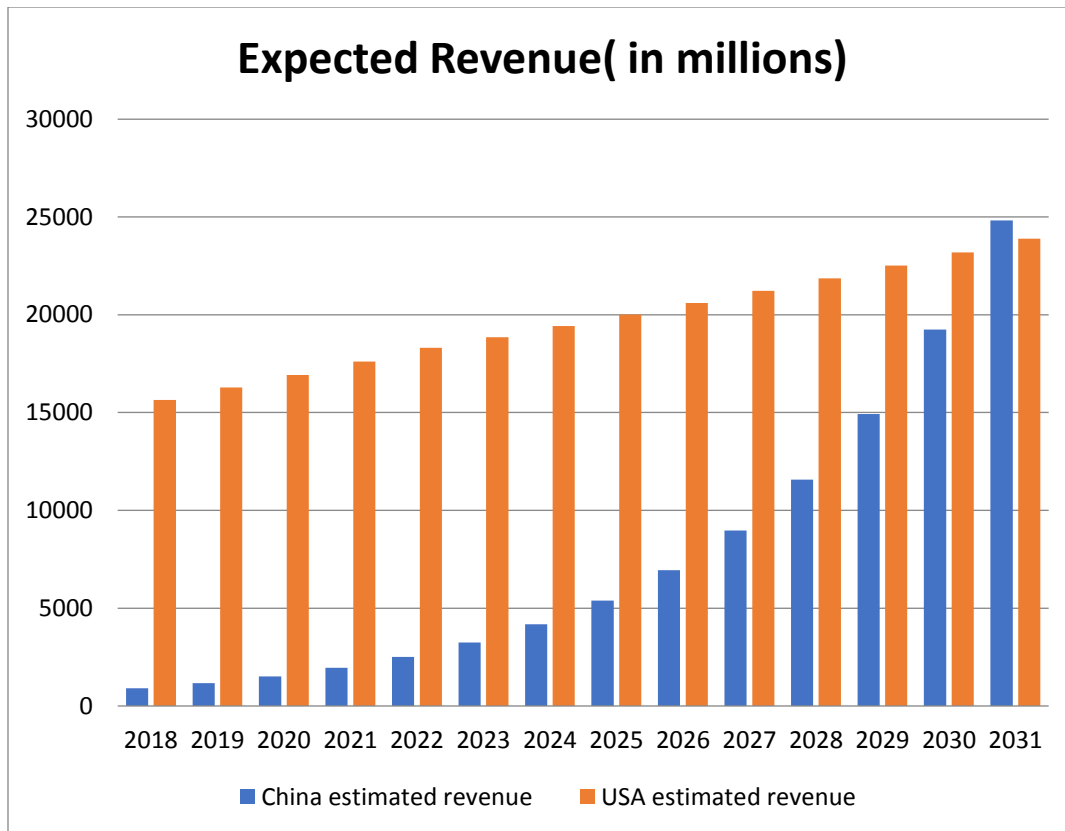


week while the Roastery in Shanghai, after 8 weeks of operations, made \$64,000 per day, this shows its unique success and big interest from customers in the Princi format, which as shown below is an artisanal bakery combined with an artisanal type roastery.



Based on this success Starbucks is planning to open around 1,000 Princi stores for the next year. These results are proof of the success of the business model implemented in Asia, the huge potential in China, the brand awareness and value that Starbucks has within Chinese customers. The Roastery type stores will open in Milan, New York, Tokyo, and Chicago.

Although Starbucks has made many developments such as the Nitro Cold Brew, Unicorn Frappuccino, etc.... we believe and as mentioned by Howard Schultz in the analyst call, that Starbucks big bet and big potential will be on the Chinese market. Our estimates put China with solid growth for the next 14 years.

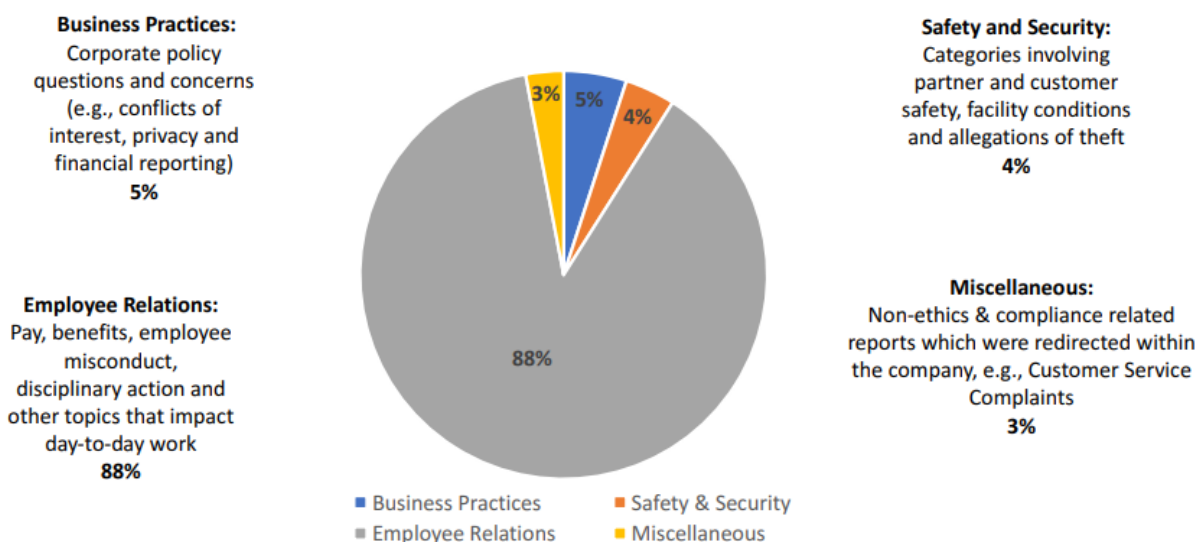


### **Corporate Governance:**

SBUX has a well-defined structure of corporate governance. The board has fourteen directors where a substantial majority have already met the requirements that are needed by NASDAQ and SEC. The Board of Directors has adopted governance principles and committee charters to lead Starbucks governance practices. For the 12th year in a row, Starbucks has been recognized as one of the world's most ethical companies by the Ethisphere Institute. Conducting business ethically, with integrity and transparency, is essential to preserving Starbucks culture and protecting their brand.

As a global company, Starbucks is subject to the highest standards of ethical conduct and behavior. There is a program whereby the shareholders and partners actively participate in the running process of the company. The Ethics & Compliance Helpline is a resource available to partners to ask questions or raise concerns. The corporate governance is based on four theoretical foundations which include; Agency theory, Transaction cost economics, Resource dependency theory and Stakeholder theory. Most of the reports that Starbucks receives involves employee relations issues. This trend is consistent with other companies – retail or otherwise – that provide alternative reporting mechanisms as part of a comprehensive ethics and compliance program.

## Categories of Employee (Partner) Concerns Reported to Starbucks Ethics & Compliance — Fiscal 2017



To help ensure the future supply of high-quality green coffee and to reinforce Starbucks' leadership role in the coffee industry, Starbucks operates eight farmer support centers. The farmer support centers are staffed with agronomists and sustainability experts who work with coffee farming communities to promote best practices in the coffee production designed to improve both coffee quality, yields and agronomy support to address climate and other impacts.

### Recommendation

Our recommendation is definitely a buy for Starbucks, with an estimated price target of \$67 per share for the next year. We believe it will keep showing strong results and its strategy transformation will pay off with future high growth.

<https://news.starbucks.com/press-releases/starbucks-first-reserve-store-opens-with-italian-principality-bakery>

[https://s22.q4cdn.com/869488222/files/doc\\_financials/quarterly/2018/q1/Q1-FY18-Transcript-Edited.pdf](https://s22.q4cdn.com/869488222/files/doc_financials/quarterly/2018/q1/Q1-FY18-Transcript-Edited.pdf)

<http://www.ico.org/documents/cy2017-18/cmr-0318-e.pdf>