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GLOBAL IDEAS

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Starbucks — One powerful coffee machine

Investment thesis

Despite a set-back to earnings during the 2008-09 financial crisis, Starbucks has an unusually impressive track-record: it has grown its earnings in dollar terms by a **29% CAGR** over the past *twenty* years. This is made more impressive by the fact that the business today still remains heavily US-focussed, despite its forays into other global markets.

Investors have seldom had an opportunity to buy this business at a bargain-basement P/E valuation, and today is no exception given it trades at a **12-month rolling forward P/E multiple of 24x**. However, in our view Starbucks' fundamentals are exceptionally strong and—if anything—improving given its shifting focus toward higher-return franchise stores and "channel development".

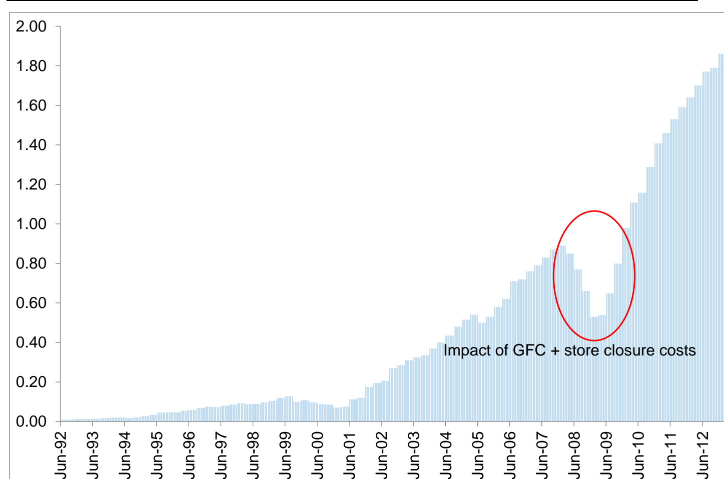
Starbucks Corporation				
September y/e	FY12	FY13	FY14	FY15
Diluted HEPS (cps)	179	207	251	289
% growth		*16%*	*21%*	*15%*
DPS	72	83	100	180
PE	30.7x	26.5x	21.9x	19.x
DY	1.3%	1.5%	1.8%	3.3%
Share price (US$'cps)	5487			
12-mnth fwd PE	24.3x			

Source: Bloomberg, Anchor Capital

In addition, poor levels of profitability in the EMEA operations appear to be an opportunity for improvement rather than a downside. As a result, we see little reason to expect a major de-rating, while at the same time investors can expect mid-upper teen EPS growth in dollar terms as well as increasing dividend payments (*Bloomberg* consensus estimates are more bullish, implying 20% p.a. EPS growth over FY12-15).

The key risk in the near term is the group's litigation risk with Kraft Foods, which could result in a substantial (>$1bn) liability for Starbucks.

Figure 1: Starbucks 20-year EPS track record ($/share)



Source: Bloomberg

Global Ideas is a newsletter published four times a week (Monday, Wednesday-Friday) and available only to clients of Investor Campus and Anchor Capital. Once a week we also feature an in-depth analysis of a company on our focus list. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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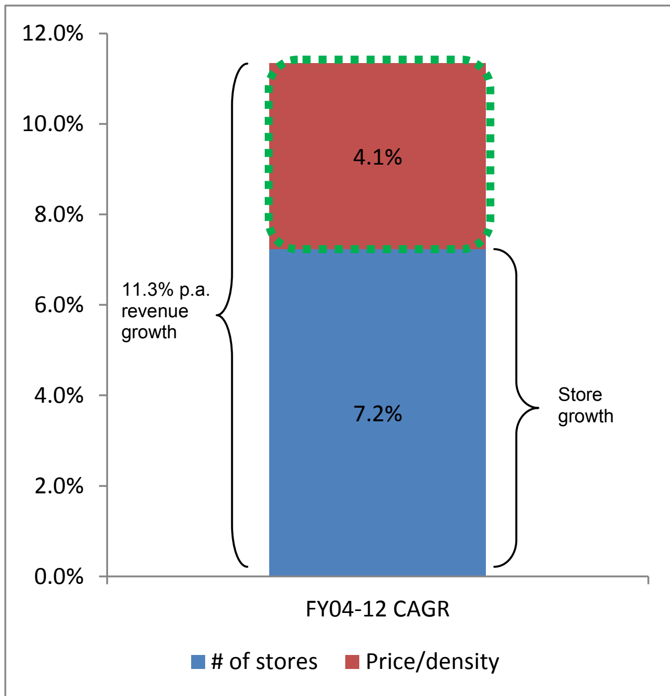
Why we like Starbucks:

1. **Strong brand equity**—Starbucks is instantly recognisable everywhere it operates. This results in high levels of customer loyalty, allowing the group pricing power—a key attribute of a great business.

Figure 2: Estimated price/volume contribution to revenue growth (company-owned stores) - FY04-12



Source: Starbucks Form 10-K; Anchor Capital calculations

2. **Phenomenal return on equity and capital employed**—despite its US-centricity, Starbucks earns returns that would be the envy of any oligopoly operating in frontier markets. We believe the key to this is two-fold: 1) strong brand equity allows it to price its coffee at a premium, resulting in high gross margins at a store level, and 2) a rising proportion of franchised ("licensed") outlets, which require no incremental capital investment on the part of the group, as well as "channel development" (i.e. distribution of branded products).

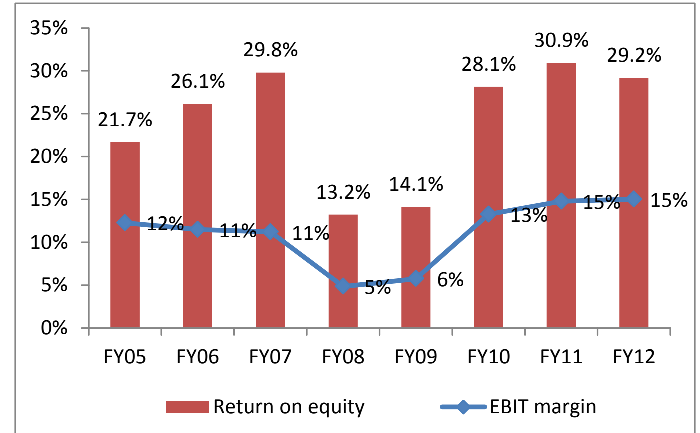
Figure 3: Income statement, balance sheet, returns on capital

Revenue	**100.0**
Gross profit	56.3
Operating expenses	41.3
Operating profit	**15.0**
Profit after tax	10.4
Shareholders' equity	**35.7**
Net cash	11.2
Capital employed	**24.5**
Return on equity	**29%**
Return on capital employed	**61%**

Source: Company data, Anchor Capital calculations

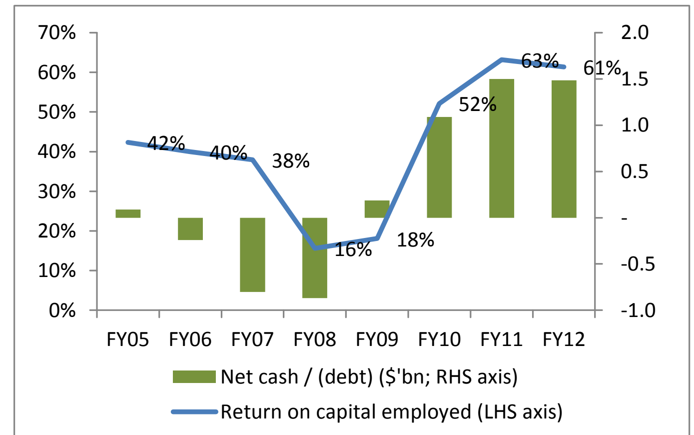
We think it is highly probable that the group's returns will continue rising as a result of this trend of incrementally more stores being franchised. As demonstrated in Figure 4, returns on equity have been rising—despite a rising proportion of cash held by the group. As a result, the rise in return on capital employed is even more impressive:

Figure 4: RoE + EBIT margin trend



Source: Company data, Anchor Capital calculations

Figure 5: Starbucks RoCE/ gearing levels

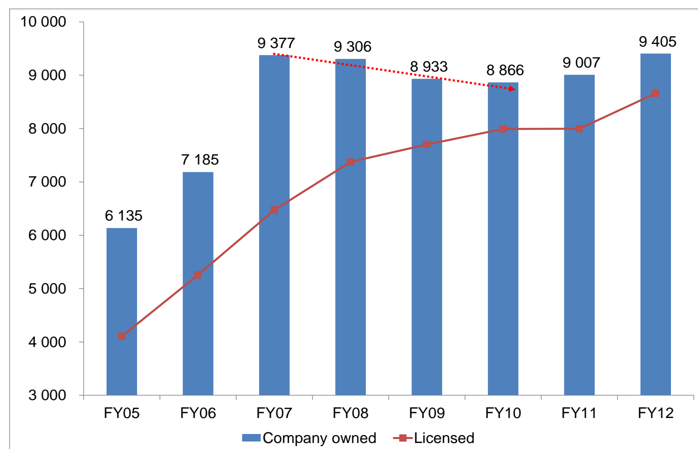


Source: Company data, Anchor Capital calculations

Investors will note that the group went through a large trough during the FY08/09 years—this coincided with the advent of the global financial crisis, coupled with the group having been too aggressive in opening new corporate stores in the "good" years leading up to this. As a result, Starbucks found itself "over-stored" going into a very weak period of consumer demand in many of their key markets (especially the UK and Canada).

The company took the decision to exit a number of unviable stores, resulting in lease termination restructuring charges taken during these years. Hence, margins and returns halved between FY07 and FY09. We believe the company probably learnt a painful lesson during this period and will likely be more circumspect in future with respect to aggressive new store openings at the top of an economic cycle.

Figure 6: Store numbers: Aggressive corporate store openings followed by rationalisation



Source: Starbucks

As previously indicated, we expect margins and return on capital to increase as the group steadily rolls out more franchised stores than corporate ones. The maths is fairly simple: the group earns a royalty on the sales of licensed stores, has only a head-office overhead to service and incurs zero capital outlay in opening these stores. While the group does not disclose the EBIT split between corporate and franchised stores, we estimate that EBIT margins on franchise, channel development and food service must be north of 30%, constituting the majority (>50%) of group profits. In turn, pure franchise profits will likely make up the vast majority of this.

Figure 7: Estimated profit split: corporate stores vs franchise/ other
<u>Key assumptions</u>:

$'m	FY12 - Group	Corporate stores	Franchise, CPG, other
Net revenues	**13 300**	10 535	2 765
Company owned stores	10 535	10 535	-
Licensed stores	1 210	-	1 210
CPG, Foodservice, other	1 555	-	1 555
COGS	-5 813	-4 651	-1 163
GP margin	**56.3%**	56%	58.0%
Total opex	-5 700	-5 001	-698
Store opex	-3 918	-3 918	-
Other opex	-430	-215	-215
Depreciation & amort	-550	-468	-83
G&A	-801	-401	-401
Restructuring charges	-	-	-
EBIT pre-associates	**1 787**	882	904
EBIT margin %	**13.4%**	**8.4%**	**32.7%**

1. We allocate 80% of COGS to company-owned stores, in line with its revenue contribution.
2. We allocate all store opex to company-owned stores, as well s 85% of depreciation (roughly 85% of PPE pertains to leasehold improvements)
3. We allocate 50% of all other expenses to corporate stores.

Had we performed this same exercise with the same assumptions for the group in FY10, we estimate the corporate store profit contribution to EBIT would have been closer to 75-80%, highlighting how quickly the shape of this business is evolving. This explains why returns on capital employed have been rising in recent years.

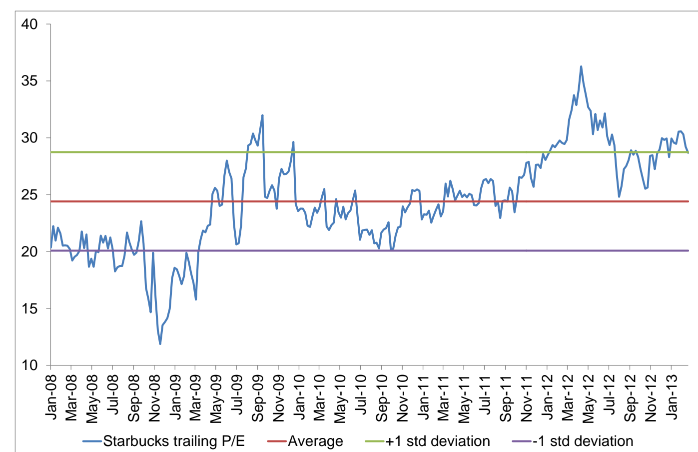
3. A rock-solid balance sheet, with potential for a return of cash to shareholders

Another reason to like Starbucks is its fortress-like balance sheet. As at 30 September 2012, the company had net cash and liquid securities of $1.6bn, amounting to 30% of shareholders' funds or 4% of market capitalisation.

4. A reasonable valuation, if not cheap—

At a 24x 12-month forward P/E multiple, it would be a stretch for us to call Starbucks an outright bargain. As shown in Figure 8, the current rating on a trailing basis is broadly one standard deviation above its average, but by no means at peak levels. We see no good reason why it should de-rate given the group's improving margin and return profile, which then leaves investors with the prospect of total returns equalling earnings growth plus dividends. In our view, this provides scope for mid-teen total dollar returns.

Figure 8: Starbucks historical trailing P/E multiple

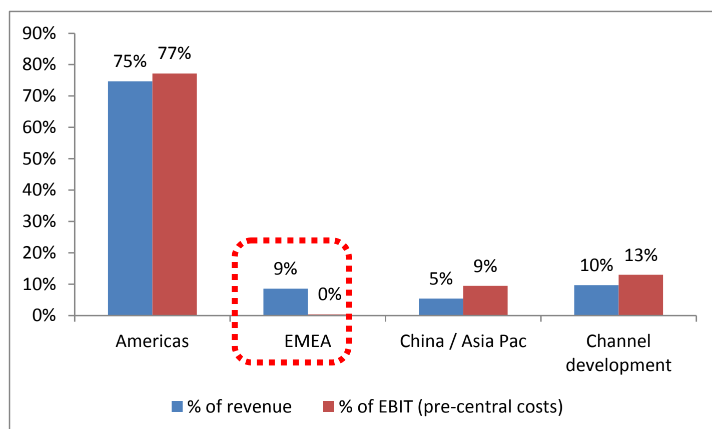


Source: Bloomberg

5. EMEA offers optionality

Starbucks makes very little money in its operations across the EMEA region. In FY12, the group reported revenue of $1.14bn in the region, while EBIT amounted to a mere $10m. By comparison, the group's operations in China / Asia Pacific delivered revenue and EBIT of $720m and $254m, respectively. This margin differential is partially explained by the higher proportion of franchised stores in Asia (80% vs 53% in EMEA), but we suspect that many of the group's corporate stores in EMEA (especially UK) are performing very poorly, possibly loss-making. As a result, this region's profitability is highly geared to an economic recovery.

Figure 9: Starbucks profitability by region—FY12

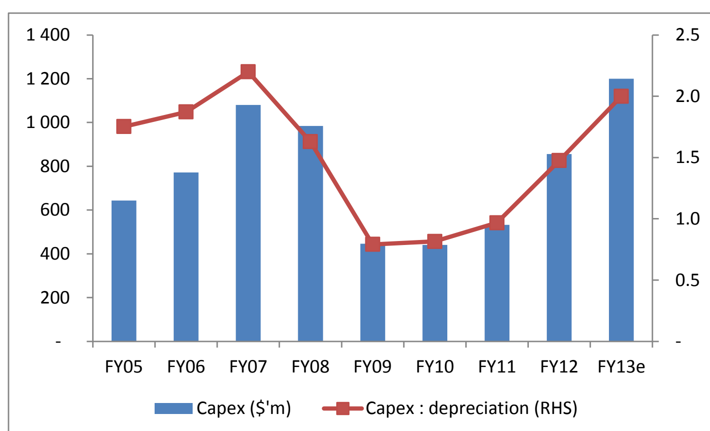


Source: Starbucks Form 10-K

6. Potential for greater dividend payments—

Aside from the potential for the group to distribute some of its cash hoard in the form of further share buybacks (the company has authorisation for 29m shares; 4% of shares in issue) or special dividends, we think the likelihood of higher ordinary dividend pay-outs is high. From not declaring dividends for a number of years, Starbucks again commenced paying in FY10. Since then, ordinary dividend cover has reduced from 3.4x to 2.5x in FY12. We also think capital expenditure could peak in FY13, resulting in stronger free cash flows beyond:

Figure 10: Capital expenditure & depreciation



Source: Company data, Anchor Capital estimates

Incidentally, the group has indicated capex for FY13 will be ~ $1.2bn—well above the levels in recent years. This will be utilised to drive new store growth (1,300 stores; 7% of FY12 base) as well as an increase in production capacity.

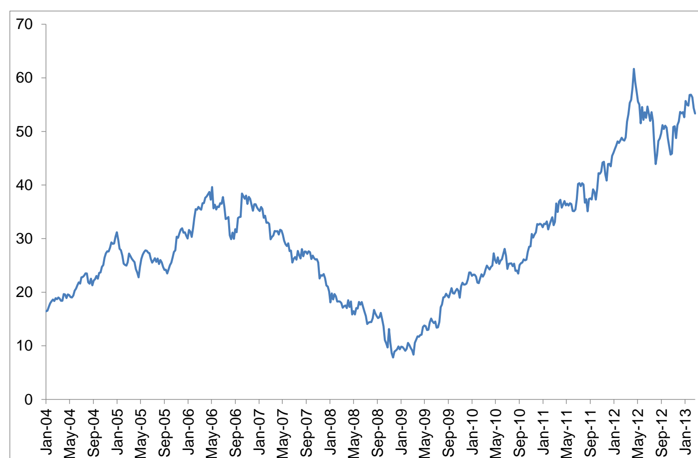
What we don't like about Starbucks:

1. Litigation risk with Kraft Foods—

Since 2004, Starbucks had a distribution arrangement with Kraft Foods whereby Kraft distributed a range of Starbucks and Seattle's Best Coffee branded packaged coffees in grocery and warehouse club stores throughout the US, Canada, the UK and certain other European countries. Under the agreement, Kraft was responsible for distribution, marketing, advertising and promotion of these products. In 1QFY11, Starbucks notified Kraft that it was discontinuing its distribution agreement with effect from 1 March 2011 due to "material breaches of its obligations."

Kraft denied it had breached any of its obligations, and has taken the matter to arbitration, seeking damages of up to $2.9bn plus attorney fees (~7% of current market cap). The arbitration hearing was completed on 3 August 2012, and Starbucks expects a decision from the arbitrator in the first half of FY13 (i.e. before end March 2013). While we believe the company can cope well with a worst-case outcome in this regard given its strong balance sheet and cash generating ability, we have little doubt that if the worst-case were to transpire it would result in downside for the stock in the short term.

Figure 11: Starbucks share price ($)



Source: Bloomberg

Sean Ashton

The business of money: Global asset management and stockbroking

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