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Starbucks: Company update

Starbucks is a great quality business that we have liked for some time. But given the very strong recent share price performance it is worth considering whether it makes sense to sell this richly priced 35x P/E business and buy something else with which the market is less smitten. Starbucks has an extraordinary growth outlook and the company estimates that its revenue in FY19 will be almost double what it achieved in FY14. This would almost certainly translate into a more than doubling of profits over the 5-year period. The company has clearly been able to create and leverage a strong emotional and psychological connection with its predominantly Anglo-Saxon consumer base; whether and to what extent the brand will gain similar traction in China is a key risk, we feel, to the long-term growth outlook. We are inclined to back Starbucks to deliver on its colossal growth forecasts and we expect earnings to more than double over the next five years. However, a 35x P/E multiple is very demanding in our view and seems to imply that market-beating earnings growth, well beyond this five-year horizon, have already been reflected in the price.

Starbucks reported **2Q15 (March 2015) EPS** of $0.33, 18% up on the comparable 2Q14 EPS of $0.28. Revenues were also up 18% over the comparable quarter; the organic component of this growth involved a 7% 2Q/2Q increase in comparable store sales and revenues from an additional 1,511 net new stores (a 7% 2Q/2Q increase in the number of stores, taking the total to 22,088 stores worldwide – we note that the corresponding revenue increase from these new stores would be less than 7%); the effect of acquiring Starbucks Japan added additional revenue – material for the China/Asia Pacific business but not more than 5% of group revenue. The strength of the US dollar dampened the value of foreign earnings, although the company still derives the vast majority of its revenues and earnings from the US (69% of revenues during the quarter were from the Americas - predominantly the US, but including Canada and South America as well). Note that the immediate effect of the **Japan** acquisition was to “gross up” the income statement – revenue and costs are both higher but the bottom-line effect is much less substantial. The acquisition dragged the China/Asia Pacific operating margin down to 18.9% from its 32.8% level in the comparative quarter, and that in spite of an 80-bpt margin expansion due to sales leverage. This appears to be, principally, the result of changes in ownership structure, with the subsidiary now 100% owned, whereas at FY14 all 1,060 Japanese stores were higher-margin licensed stores. Given that Japan is a very mature market, one may wonder why Starbucks would make such an acquisition. We think the logic was principally driven by the consequent ability to cross sell products, previously unique to Starbucks Japan, into all its other stores. This process has already begun, and evidently with some success.

Management updated their **EPS guidance** for the upcoming quarters and full year as follows:

- A **3Q EPS** estimate of $0.39-$0.40 (GAAP); $0.40-$0.41 (non-GAAP); using the ‘cleaner’ non-GAAP number this implies EPS growth of 19% in 3Q (vs 3Q14).
- A **4Q EPS** estimate of $0.40-$0.41 (GAAP); $0.42-$0.43 (non-GAAP); implies 15% Q4/Q4 YoY EPS growth.
- **FY15 EPS** (September year-end) estimate of $1.77-$1.79 (GAAP); $1.55-$1.57 (non-GAAP); implies 17% YoY growth.

Non-GAAP EPS		1Q	2Q	3Q	4Q	FY
FY14A	Usc/share	0.34	0.28	0.34	0.37	1.33
FY15A/E	Usc/share	0.4	0.33	0.405	0.425	1.56
Change	%	18%	18%	19%	15%	17%

** numbers highlighted in gray are midpoint of company guidance*

Source: Company reports

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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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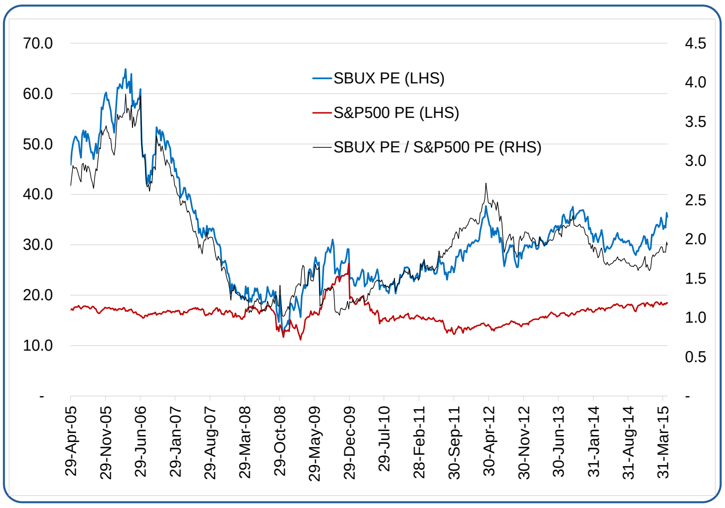
The full-year projected EPS number implies pretty strong EPS growth: 31%-33% at a GAAP level (reported FY14 *Diluted Net EPS* was $1.35), 17%-18% at the non-GAAP level. It is important to bear in mind that the GAAP EPS growth contains an 'accounting fiction' involving the recognition of fair value gains on Starbucks' prior interest in Starbucks Japan – clearly, for our purposes (determining the underlying earnings potential of the business), this should be stripped out of earnings, hence a preference for the non-GAAP EPS here.

Aspects of Starbucks' **European** business have, in the past, earned a very low margin and thus they represented optionality on these markets, given that a small increase in revenue would result in a large increase in profits. Given the recent increases in this region's operating margin (it went from 5.7% in 1Q14 to 10.4% in 1Q15), the potential leverage, which has often been used to justify Starbuck's high P/E, is less apparent. So, if the Europe, Middle East and Africa (EMEA) region was able to expand its margin from this 10.4% to the Americas level of 22.7%, this would indeed more than double operating profit for the region; but from a group perspective that would add only 4.4% to operating income. For this equation to really be exciting it would have to be combined with pretty substantial revenue growth in the EMEA region which, we think, will come rather slowly.

Starbucks is a great quality business and this is quite well reflected in its premium rating: its trailing 12m EPS of $1.44 puts it on a trailing P/E of 35x, roughly double that of the S&P 500. There is thus a risk that P/E compression will absorb future earnings growth (and that the company will simply disappoint these obviously optimistic expectations): if, hypothetically, the share went nowhere until FY18 (i.e. the next 3½ years) while the company continued to deliver EPS growth of 17% p.a. over that period (taking EPS all the way to $2.52), the P/E multiple would have only compressed to 20x. We think this degree of derating is unlikely but it does illustrate the risk at hand.

Starbucks vs S&P 500 P/E comparatives:



Source: Bloomberg, Anchor Capital

So, we know this is an excellent business and just the kind of share we would want to own. The point of tension is between the very high P/E multiple and the growth outlook.

The company has made some very attractive growth forecasts, including the projection at the December 2014 Investor Day that revenues should approach $30bn in FY19, almost double FY14's $16bn. To the extent that this new revenue would be attributable to their existing stores it would most likely come with extraordinary operating leverage and profit levels well ahead of *double* FY14 levels. And bear in mind that the growth trajectory doesn't necessarily stop in FY19 – if the company can maintain growth at anything like these levels beyond 2019, the share should deliver extraordinary returns. If you want to get a whiff of the bullish possibilities for Starbucks, here's something from their COO: "we believe the runway of opportunity for Starbucks inside and outside of our stores is both vast and unmatched by any other retailer on the planet."[1]

Let's consider how the growth outlook can be understood in terms of the company's different regions. First, the **Americas**, which is principally the US - their most mature market - accounted for 71% of operating income in the recent quarter. We believe the region can still show good earnings growth going forward, driven by operating leverage (a large portion of costs don't increase with increases in sales); the company's ability to leverage its "fixed asset," being its large network of stores, to sell additional products (teas, food, etc.); innovations in its product and technology (the Mobile Order and Pay App); opening in the evenings (by the end of FY19 they estimate that 20%-25% of their US stores will offer the "Starbucks Evening experience", adding [by their estimates] $1bn in revenue, a 6.3% revenue increase but likely to result in a way higher increase in profits because much of the underlying cost base won't increase), etc. And, while the store penetration in the US is advanced, the company still opened 636 net new stores in the Americas (including Canada and South America), a 4.6% YoY increase, during the 12 months ended March 2015. The Channel Development segment, which accounted for 16% of operating income in 2Q15, is expected to grow revenues by 60% and almost double its operating income by the end of FY19.

Second, in the recent quarter the China/ Asia Pacific segment contributed 11% to operating income, which includes Starbucks Japan - a mature market. So while this segment, especially the ex-Japan component, is still small, it represents Starbucks' greatest potential growth market where the company plans to double its store count in China, to over 3,000 stores, by 2019. It remains to be seen how this aggressive growth programme works out and there are noteworthy challenges, as we discuss below. However if it is successful, 3,000 stores in China could be just the beginning (by way of comparison, Starbucks had 14,399 stores in America in March 2015).

One significant risk to the growth trajectory is that the aspects of western culture into which Starbucks has so successfully tapped don't necessarily apply in other cultures. In Western countries the brand's power may have to do with a feeling of accessing the exotic, caring for rainforests, reversing some of the destructive legacy of western imperialism, etc.; in Asia many of these psychological legacies wouldn't even apply – yet the brand does still seem to have powerful leverage, which may have to do with a fetishisation of western brands and products.

[1] 4 December 2014, Starbucks Investor Day.

The key point to make is that the brand doesn't mean the same thing in these different contexts. This relates to the leverage the brand actually has on people: while Starbucks is partly or even largely about coffee (and increasingly about food and other speciality drinks) it's also more strange and complex than that. For a rather eccentric yet insightful take on the western aspect of Starbucks brand leverage, we could listen (briefly) to Slavoj Žižek, the popular contemporary Slovenian Marxist philosopher, who has this to say:

> *In the old days of pure simple consumerism, you bought a product and then you felt bad: 'my god I'm just a consumerist while people are starving in Africa.' So the idea was you had to do something to counteract your pure destructive consumerism, for example, you contribute to charity, and so on. What Starbucks enables you to do is be a consumerist without any bad conscience because the price for the countermeasure, for fighting consumerism, is already included in the price of the commodity; you pay a little bit more and you are not just a consumerist but you also do your duty towards the environment, the poor starving people in Africa, and so on and so on."*[2]

It is, in our view, quite important to take account of this impulse which Žižek has identified and which Starbucks has so successfully tapped into, and which seems to be a uniquely Western phenomenon, connected with a cultural legacy which, by definition, is not universally shared. It highlights the risk that what has made Starbucks successful in the US may have little if any traction in China.

At this stage, given the growth trajectory, Starbucks does not return a large amount of capital to shareholders. The dividend yield is c. 1.26% p.a.; share repurchases in 2Q were about 0.2% of shares outstanding (an annualised run-rate would provide a c. 0.8% EPS tailwind); the current authorisation allows for a further 23mn shares to be repurchased (1.5% of total shares outstanding).

Lastly, the company does have commodity price exposures, principally coffee and milk, which could put pressure on margins if, and when, these prices fluctuate. But commodity prices, barring any shocking moves, won't be what makes or breaks the investment case for Starbucks; what is most important to note is that Starbucks is **selling brands and buying commodities**, which tends to be a long-term winning formula.

Blake Allen

[2] *Transcribed from: https://www.youtube.com/watch?*

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