



Investment Research Center<sup>SM</sup>  
 Provided by Bloomfield Township Public Library - PO  
 #939393

End Session

Home	Companies	Funds	ETFs	Markets	Articles & Videos	Portfolio	Help & Education	Newsletters	Enter a Ticker or Name
------	-----------	-------	------	---------	-------------------	-----------	------------------	-------------	------------------------

**Starbucks Corp** SBUX |

Quote	Chart	<b>Stock Analysis</b>	Performance	Key Ratios	Financials	Valuation	Insiders	Shareholders	Transcripts	Filings	Bonds	Options
-------	-------	-----------------------	-------------	------------	------------	-----------	----------	--------------	-------------	---------	-------	---------

Analyst Research    Analyst Report Archive    Top Rated Stocks in Sector

**Starbucks' global brand, channel diversification and digital endeavors poised for long-term growth.**



by  
**R.J. Hottov**  
 Strategist

**Investment Thesis** 08/04/2015

We view Starbucks as one of the most compelling growth stories in the consumer space today, positioned for top-line growth and margin expansion through menu innovations, sustainable cost advantages, and an ongoing evolution into a diversified retail and consumer packaged goods platform. Although it is already the leading specialty coffee retailer in the U.S., we believe Starbucks still has meaningful domestic growth

potential, including new store formats (smaller-format express stores, drive-thrus, beverage trucks, and square footage reallocation for its premium Starbucks Reserve sub-brand), greater peak hour capacity, expanded food offerings, lunch/evening daypart expansion, game-changing Mobile Order & Pay and delivery platforms, and My Starbucks Rewards usage. At a time when most restaurant and retailers are struggling to stimulate traffic growth, Starbucks' recent transaction gains suggest that it remains a key consumer destination, reinforcing the strength of its brand intangible asset.

Starbucks is much more than retail story, however, and we believe the company is just starting to scratch the surface of its longer-term channel development, brand diversification, and geographic growth potential. Many of Starbucks' core retail competencies should facilitate these efforts, putting it in a unique position to capture retail and wholesale market share. Platforms like VIA instant coffee and K-Cups should support channel diversification efforts over the medium term, with nascent brands like Teavana becoming greater cash flow contributors over an extended horizon. We're also optimistic about mobile, digital, and loyalty program synergies across the various business lines and through new partnerships including Spotify, New York Times, and Lyft. Starbucks' international opportunities are undeniable-- particularly in China, India, Japan, and Brazil--and we believe best practices from the U.S. can be applied to these regions to accelerate growth. Competitive threats exist in both the retail and wholesale channels, but a wide moat built on strong brand equity, bargaining clout with suppliers of all kinds, and a leverageable model will help to stave off rivals.

**Economic Moat** 08/04/2015

Nonexistent switching costs, intense industry competition, and low barriers to entry make it difficult for restaurants and specialty retailers to establish durable competitive advantages, but with its wide economic moat based on a brand intangible asset that commands premium pricing and meaningful scale advantages, we expect Starbucks will maintain its specialty coffee leadership and successfully penetrate new growth avenues. Our confidence is supported by Starbucks' innovative mobile/digital/loyalty offerings (including the My Starbucks Rewards and Mobile Order & Pay platforms), channel development efforts (VIA, K-Cups, and other consumer packaged goods), geographic market expansion opportunities (China, India, Japan,

**Morningstar's Take** SBUX

<b>Analyst</b>		
<b>Price</b> 09-04-2015	<b>Fair Value Estimate</b>	<b>Uncertainty</b>
54.51 USD	60 USD	Medium
<b>Consider Buy</b>	<b>Consider Sell</b>	<b>Economic Moat</b>
42 USD	81 USD	Wide

**Stewardship Rating**  
 Exemplary

**Bulls Say**

- Starbucks can adapt to evolving consumer preferences thanks to a brand that transcends channels; digital, social media, mobile payment, and loyalty program investments (including the Mobile Order & Pay platform); and an unparalleled in-store experience.
- A reinvigorated food and beverage menu and store redesigns have improved the Starbucks customer experience, penetrated new dayparts, and improved unit-level productivity metrics.
- Despite its ambitious growth plans, we believe Starbucks can sustain a 40%-45% dividend payout, implying midteens dividend growth over the next decade.

**Bears Say**

- With a lack of switching costs, there is little to prevent customers from trading to other specialty coffee chains including Dunkin' Brands, Tim Hortons, or McDonald's. Joh. A. Benckiser's consolidation of Mondelez's coffee assets, D.E. Master Blenders, Peet's, Caribou Coffee, and Einstein Noah could evolve into a formidable rival.
- Nascent brands such as Teavana, La Boulange, and Evolution Fresh could take management's attention from the core Starbucks brand and add layers of execution risk.
- Volatile commodity and foreign currency movements could affect quarter-to-quarter results.

**Competitors** SBUX

More...

Name	Price	% Chg	TTM Sales \$ mil
<b>Starbucks Corp</b>	<b>\$54.51</b>	<b>-0.33</b>	<b>18,429</b>
Compass Group PLC ADR	\$15.45	-1.34	26,702
Compass Group PLC	\$15.20	-1.94	26,702
McDonald's Corp	\$95.23	-0.81	26,016
Yum Brands Inc	\$79.38	-1.03	13,078
Chipotle Mexican Grill Inc Class A	\$726.66	0.29	4,441

and Brazil in particular), and its complementary brand portfolio (Teavana, La Boulange, and Evolution Fresh), which provide visibility for average annual revenue growth in the low double digits and cash flow growth in the mid- to high teens over the next decade. Although there are certainly execution and brand saturation risks tied to management's loaded agenda, we believe Starbucks' initiatives, if executed properly, could fortify its already wide economic moat.

With more than 12,300 company-owned and licensed locations in the U.S., Starbucks maintains a sizable lead over direct domestic rivals, including Dunkin' Donuts (8,200 U.S. points of distribution), Caribou Coffee, and Peet's Coffee (the last two chains, which account for a few hundred locations, are now owned by the Joh. A. Benckiser Group). With cafe-like environments and a brand that evokes a high-quality customer experience, Starbucks enjoys pricing power advantages over most specialty coffee peers, which we believe will only be augmented by the incubation of the Starbucks Reserve sub-brand to distribute exclusive, higher-end coffee blends. New product platforms such as smoothies and tea as well as a revamped food program have added diversity to the menu, allowing the firm to broaden its target audience, increase its average transaction size, and expand more into the lunch and evening daypart. Starbucks also wields considerable influence over arabica coffee bean suppliers, ensuring access to raw materials at competitive prices. In addition, retail landlords often grant Starbucks exclusive leases to prominent locations rife with consumer traffic, and we believe the company has a significant longer-term opportunity through the use of alternative store formats, including smaller-format express stores (400-600 limited service locations in high foot traffic locations), stand-alone drive-thrus, beverage trucks (which have been tested on college campuses), and kiosk locations. The company's strong landlord relationships and square footage creativity could accelerate the global growth aspirations of Starbucks' more nascent retail concepts over the next decade and make it more difficult for rivals to compete.

Many of Starbucks' competitive advantages also apply to international markets, which we view as a critical growth engine over the next several decades. With a widely recognized brand, Starbucks is among the few retail concepts to be successfully replicated across the globe. As such, we believe the firm will eventually exceed its domestic store count overseas. The chain is has more than 10,000 units outside the U.S. in more than 60 countries, including some well-established cafe cultures. Emerging-market prospects are also intriguing, including opportunities in markets such as mainland China (which already has over 1,500 units, on its way to 3,400 by 2019, and possibly 10,000 over a longer horizon), as well as Brazil and India (which offer potential for at least a thousand units apiece over the next decade, in our view). We view Starbucks' 2014 decision to buy the remaining 60.5% stake of Starbucks Japan that it didn't own favorably, as full ownership should help to accelerate inroads into new channels (with emphasis on the underpenetrated ready-to-drink market but also other licensing and food-service opportunities), roll out new brands (Teavana, in particular), and accelerate mobile/digital/loyalty efforts, which in turn should help to build on Starbucks Japan's already strong store-level profit metrics (low- to mid-20%).

Starbucks' channel development aspirations underscore the power of its brand intangible asset. We view the company as one of the few food-service operators that could evolve into a world-class consumer packaged goods company due to its ability to connect with grocery and mass-channel customers through licensed on-premise stores. With its already strong bargaining clout with national retailers like Costco, Kroger, Whole Foods, and Trader Joe's, we expect Starbucks to develop national distribution of its entire consumer product portfolio over the next few years. With consumer packaged goods penetration in more than 40 countries (which has more than doubled the past three years), Starbucks should also have ample opportunities to expand its presence on grocery and mass-channel shelves across the globe. We've been impressed by Starbucks' efforts to expand its distribution beyond traditional outlets, including other restaurant chains, hotels, and airlines.

Continued market share gains in the \$8 billion-plus premium single-serve coffee category, including VIA and the company's K-Cup partnership with Green Mountain, will likely be the key near-term driver for the channel development segment. However, with Starbucks Refreshers energy drinks, cold carbonated Fizzio drinks, and the long-term potential of new food, juice, tea and products stemming from La Boulange, Evolution Fresh, and Teavana, respectively, we remain comfortable forecasting low-double-digit collective average annual revenue growth for the channel development and other segments over the next five years, especially when factoring

in the distribution infrastructure already in place. More important, we anticipate that the channel development segment will become an increasingly important free cash flow contributor. Even with the marketing and labor costs necessary to support new product launches, we anticipate that this segment will continue to see margin expansion in the years to come, with our model calling for gradual segment margins exceeding 40% by fiscal 2018.

**Valuation** 08/04/2015

We're raising our fair value estimate to \$60 per share from \$55 after the company's strong third-quarter results, a modest increase in our near-term revenue growth and margin assumptions stemming from the upcoming initiatives (Mobile Order & Pay, Starbucks Reserve, delivery, and international channel development partnerships), and a slight adjustment to our cost of capital assumption to account for recent debt issuances. Our fair value estimate still incorporates management's ambitious yet still achievable five-year targets and implies fiscal 2016 price/earnings of 31 times, enterprise value/EBITDA of 16 times, and free cash flow yield of 3%. Shares may appear lofty at 37 times the midpoint of management's adjusted fiscal 2015 EPS guidance (\$1.57-\$1.58), but we believe a premium is justified given the firm's unique growth and margin expansion story among large-cap consumer stocks. Despite an uneven consumer spending backdrop, we find most of management's 2015 guidance as realistic, including top-line growth of 16%-18%, mid-single-digit comps, 1,650 net new stores (8% unit growth), and flat to modest growth in adjusted operating margins (versus 18.6% in fiscal 2014). Our model assumes 17% top-line growth, driven by 7% consolidated comps (including 7% comps in the Americas, 3% in EMEA, and 11% in China/Asia Pacific), 1,650 net new locations globally, and 11% growth in the channel development segment. Our comp assumption is based on steady traffic improvement as well as a modest increase in the average transaction size due to new food offerings. Over the next 10 years, we anticipate average annual revenue growth of 11%, driven by new sales channels, geographic expansion, and licensed store openings. Our model assumes 2,000 annual net new store openings the next 10 years (including nascent brands), putting Starbucks on track for a global store base of 41,800 locations by the end of fiscal 2024 (7% annual unit growth). Recent profitability gains demonstrate the leverageable nature of Starbucks' model as well as supply chain efficiencies. Our model calls for mild adjusted operating margin contraction in fiscal 2015 as technology and marketing investments offset increased expense leverage and improved channel development margins. Longer term, we believe operating margins in the low to mid-20s are achievable through expense leverage, wholesale penetration, and licensing arrangements.

**Risk** 08/04/2015

Starbucks faces increased competition on several fronts, including Dunkin' Brands' ambitious growth plans, McDonald's emphasis on the coffee and other beverage categories, increased competition from Jacobs Douwe Egberts (which combines the coffee assets of Mondelez, D.E Master Blenders, Peet's, Caribou Coffee, and the Einstein Noah Restaurant Group under the Joh. A. Benckiser Group umbrella), and an influx of specialty coffee programs at quick-service and fast-casual restaurant chains. Given its position as a more affluent consumer brand, discretionary spending headwinds could periodically create periods of top-line volatility. Coffee and dairy commodity cost volatility can influence profitability, as well as labor and occupancy cost inflation. Starbucks faces heightened economic, legal, and political risk associated with its international expansion efforts. The company has also taken on multiple layers of execution risk (including the further development of VIA Instant coffee and K-Cups; integration and further development of the Teavana, La Boulange, and Evolution Fresh brands; and the rollout of Mobile Order & Pay and delivery initiatives).

**Management** 08/04/2015

Starbucks Chairman Howard Schultz returned to the role of CEO in January 2008. Although we typically prefer the roles of chairman and CEO to be split for corporate-governance purposes, we believe the presence of Schultz, who previously served as CEO from 1987 to 2000, has helped reinvigorate the firm the past several years. In fiscal 2014, Schultz received \$1.5 million in base salary, which seems reasonable

given the firm's impressive fundamentals the past several years. However, Schultz also was given stock awards, option awards, and nonequity incentive plan compensation of \$20.0 million, which strikes us as moderately excessive relative to industry peers, even after factoring in the company's strong financial results. With a 3% stake of Starbucks' common shares, Schultz has sufficient incentive to increase shareholder value, in our opinion. Although we disapprove of certain takeover defenses, we assign Starbucks an Exemplary Stewardship Rating. We also remain impressed that, unlike many companies in the consumer cyclical space, Starbucks has shown a willingness to invest in high-growth potential projects like Evolution Fresh, La Boulange, Teavana, and the purchase of the remaining 60.5% stake of Starbucks Japan that it didn't own while still returning cash to shareholders through dividends and buybacks.

In January 2015, Starbucks announced that Kevin Johnson, current board member and former CEO of Juniper Networks, would assume the role of president and COO. He is replacing Troy Alstead. While we believe Alstead added stability to management's admittedly loaded strategic agenda when he assumed the post in January 2014, we're optimistic about Johnson's ability to support the company's current growth projects. In particular, we're encouraged by Johnson's consumer technology background, which we view as a key asset in expanding the company's already-leading digital platform across channels and geographies in the years to come. While Alstead's sabbatical and Johnson's appointment raise natural questions about eventual succession plans, we continue to view Starbucks as having one of the deepest benches in the consumer cyclical segment, with several innovative leaders capable of pushing forth the strategic priorities in the years to come.

## Overview

### Profile:

Through a global chain of more than 22,500 company-owned and licensed stores, Starbucks sells coffee, espresso, teas, cold blended beverages, food, and accessories. The company also distributes packaged and single-serve coffee, tea, juice, and pastries through its own stores, grocery store chains, and warehouse clubs under the Starbucks, Teavana, Tazo, Evolution Fresh, La Boulange, and Seattle's Best Coffee brands. In addition, Starbucks markets bottled beverages, ice creams, and liqueurs through various partnerships.

---

S&P 500 index data: S&P 500 Copyright © 2015

All data from Morningstar except U.S. intraday real-time exchange quotes, which are provided by BATS when available. End-of-day quotes for Nasdaq, NYSE, and Amex securities will appear 15 minutes after close. Graph times are Eastern Standard. © Copyright 2015 Morningstar, Inc.

**Contact us.** Please read our User's Agreement and Troubleshooting documents.  
©2015 Morningstar, Inc. All rights reserved.