Getting My Fix of Starbucks (SBUX)

scuttlebuttinvestor.com/blog/2017/12/30/getting-my-fix-of-starbucks-sbux

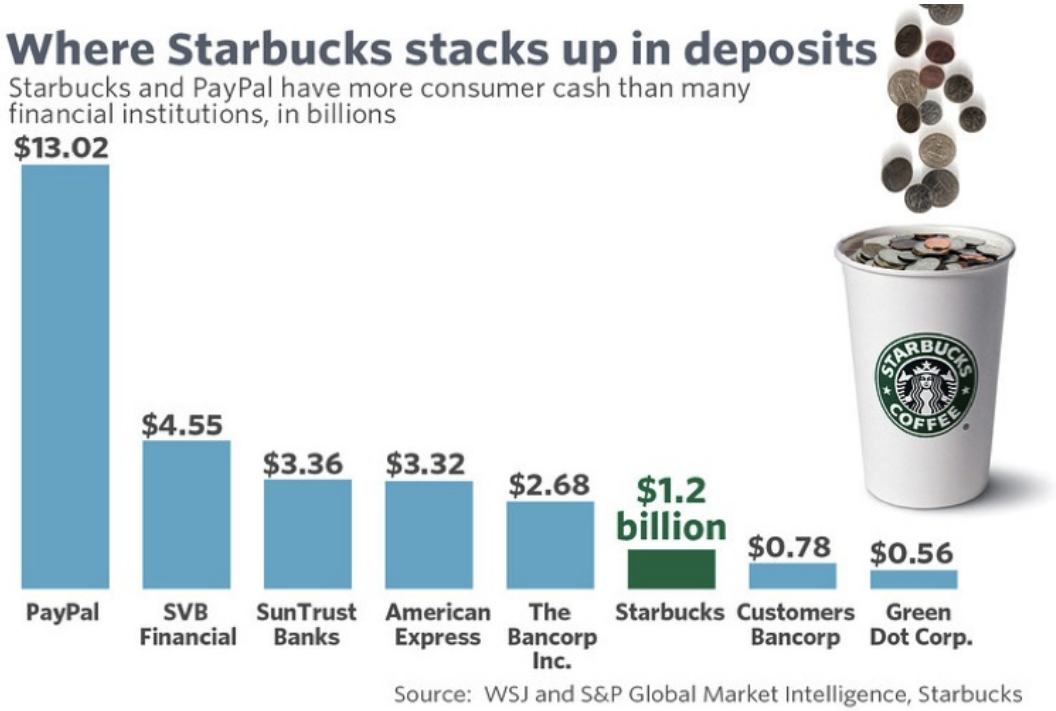
January 1, 2018

Happy Holidays

Happy holidays and happy new year! The pollyannas, the secret santas, the white elephant gift exchanges are all behind us. Did you stop to look around though and take notice? How many of those gifts that were exchanged were in some way related to Starbucks (SBUX)? Starbucks gift cards perhaps? The work of the lazy, creativity-lacking gift giver, sure. But the ubiquity of that Starbucks gift card this holiday season and probably at least the last ~5 years is undeniable. When you don't know what to buy or give, it's the ultimate fallback option. Surely the unknown recipient likes coffee or at least knows someone that does to whom they can re-gift it. And it's oh so easy to buy it at the Starbucks right down the street.

The Starbucks gift card is so popular in fact that the float on the Starbucks stored value program (the fancy word for prepaid gift cards) recently amounted to ~$1.3 billion (stored value card liability on B/S as of 10/1/17). So large in fact that it rivals the deposits of some small banks.

In the grand scheme of things, this stored value float isn't the crux to an investment thesis for Starbucks but it does demonstrate the important and central role that Starbucks plays in the lives of consumers across the US and the world. Starbucks locations are ubiquitous, their gift cards and stored value are a form of currency and a Starbucks gift card won't offend anyone and surely will make many of its loyal customers very happy.



Source: "Starbucks has more customer money on cards than many banks have in deposits", MarketWatch (6/11/16)

Background

I have a confession to make. I have lived in the San Francisco Bay Area for the last 6 years and living here has made me a big snob- a coffee snob to be exact. I never was much of a coffee drinker before I moved out to the Bay Area but once I did and I had my first taste of a Blue Bottle cappuccino, I was hooked. After that, I took on places like Ritual, Four Barrel, Verve, Stumptown, Sightglass and I was in love. No one had ever told me that coffee could be so good if the beans were roasted at just the right level and everything was made with careful precision. These so called Third Wave coffee shops had all kinds of fancy equipment and baristas that looked more like craftsmen than baristas. This led me to take home brewing classes so I could make beautiful concoctions at home. To my wife's dismay, I plunked down all kinds of money to buy a chemex, moka, French press and various other equipment that may be unfamiliar to the uninitiated. Making the perfect cappuccino is still out of reach for me until I buy my $15,000 La Marzocco espresso machine. I digress.

So what's a supposed coffee snob like me doing talking about Starbucks (SBUX)? Starbucks was the second wave. Before Starbucks, mostly everyone in America drank coffee one way - black drip coffee. Howard Schultz came upon the idea that Americans might actually like coffee based drinks like the Italians and imported some of the recipes over to the US. He singlehandedly changed Americans' relationship with coffee.

But even though I'm not a daily Starbucks customer and even though I wasn't pining for the Starbucks gift card at my workplace secret santa, I have been there many a time partly because it's a ubiquitous behemoth that sells a lot more than just coffee. It offers

a convenient meeting place (a “third place” as Howard Schultz coined it), a light lunch, a sweet treat, a cold drink and you likely already have a gift card in your wallet to pay for it.

Company Overview

Starbucks (SBUX) has 27,000+ shops that sell a product (coffee) with incredibly high repeat behavior to a very loyal group of consumers around the world. I would categorize SBUX in the bucket of reinvestment moat companies that can comfortably invest in their business to build out more stores in more locations to further “premiumize” the coffee experience. By doing so, they can continue to deliver strong returns of ~25% Return on Invested Capital (ROIC) that they have delivered in recent years. While concerns of slowing growth have weighed on the stock for some time, I continue to believe in SBUX’s ability to meaningfully increase free cash flow while making disciplined investments in Roasteries and Reserve stores to further elevate the coffee experience. There’s a lot to like about Starbucks:

Investment Merits

Customers with high frequency, repeat behavior and strong loyalty
I have a certain predisposition for businesses with recurring revenue streams. SBUX is not recurring the way a SAAS software company is, but coffee is a daily ritual for many- driving a reliable, repeating revenue stream. SBUX has been successful engendering loyalty from its customers as well- Starbucks Rewards has 13.3mm members in the US and an incredible 36% of all dollars tendered in the stores is transacted through the loyalty program (US Company operated stores). You would be hard pressed to find any other company loyalty program with this much engagement.

Stellar Unit Economics
SBUX benefits from strong unit economics that are best in class among quick service restaurants and other peers. In the US- the average new SBUX location generates revenue of $1.5mm (average unit volume or AUV) and generates a year 1 store profit margin of 34% or $510k. Based on an average store investment of $700k in the US, this results in an ROI of ~75%. Compare this to a McDonalds with an ROI of ~30%, an average fast casual operator at ~40% or even Chipotle (at its peak before the food illness issues) at ~70%. This means that the average SBUX store earns back its investment a third of the way into its second year – very compelling unit economics. The math likely changes with higher investments in Reserve stores and premium Roasteries in the coming years but if these seek to elevate the overall SBUX experience and thus drive pricing power through the entire system, it’s the right move for the long term.

> We look at the brand not as a piece of advertising, but everything we do communicates who Starbucks is. The place, the physical environment, really has become an extension of the brand and it's very important to the success of the company.

— Howard Schultz

Strong Brand
SBUX's moat or competitive advantage is derived primarily from its strong brand that is synonymous with premium coffee. The brand ranks high on all traditional measures of brand strength including awareness and consideration and is one of the most recognized and respected brands in the world. This brand strength is a powerful driver of pricing power – what enables the company to charge ~$4 or more for a coffee that consumers would have never paid more than a dollar for some years back. More importantly – the brand isn't only about coffee – it's about an elevated experience (often called "the Starbucks experience") that comes with the customer service and the ambiance of the store. In fact, Starbucks devised the idea of the "third place" – a place for consumers to go between home and work.

Smart management team making investments with a long-term focus
While Kevin Johnson (the current CEO) is relatively new and we've seen what's happened before when Schultz left the helm, Johnson seems focused on the right things. Management is focused on investing in the future and playing the long game in a few key ways: 1) Expanding the digital flywheel to increase digital relationships with customers by way of their loyalty program, which has been very successful; 2) Investing in meaningfully elevating the Starbucks experience through the Reserve stores across all markets and flagship Reserve Roasteries in major cities; 3) Investing in employees (partners) to increase wages/benefits that ultimately results in greater retention and thus drives a superior customer experience.

Johnson is also committed to rewarding shareholders in the form of dividend increases and share buybacks. In fiscal 2017, the Company returned $3.5bn to shareholders through repurchases and dividends and recently committed to returning $15bn (over 18% of the current market cap) over the next three years.

Multiple growth levers
Starbucks' management team has set robust long term targets of growing revenue in the high single digits, comparable sales in the 3-5% range and EPS at 12%+. Not too shabby for a company with 27,000+ stores. SBUX has a few different growth levers it can pull on to get there:

1) China and other geographic expansion – Growing the footprint of company owned stores in China is a major part of the story to get to a planned 37,000 locations by 2021. Chinese consumers have demonstrated a thirst for Starbucks coffee at premium price points and 600 or ~25% of SBUX's 2,300 new builds in 2018 will be in China. And it's

important to remember that Starbucks isn't a tech business like Google or Facebook that raises protectionist alarms for Chinese regulators. The government doesn't necessarily favor homegrown businesses when it comes to an industry like coffee.

2) Diversify product mix to include more food. Food comprises about 21% of total revenue but SBUX has ambitions to grow this to 25% by 2021. While food is margin dilutive, it helps expand the daypart from morning and also helps drive absolute profits and FCF

3) Drive more throughput – SBUX can drive growth simply by ensuring they are appropriately matching capacity to demand. Demand for coffee and caffeinated beverages tends to be more concentrated to the morning daypart. Expanding mobile order ahead and optimizing labor productivity are two ways that management intends to solve for this. As of Q4 2017, mobile transactions represented 30% of all transactions and mobile order ahead represented 10% of all transactions, an increase from 21% and 3% respectively less than two years prior (Q1 FY16).

4) Elevate the experience and product to drive a higher ticket – Starbucks is continuing to invest in the right places to drive pricing power. The investments in Princi (a premium Italian bakery that SBUX has partnered with), flagship Reserve Roastery in major cities, Reserve stores and Reserve bars in existing stores all seek to further premiumize and elevate the Starbucks coffee experience. While these require capital expenditures where they build out these experiences, they halo to the entire brand, reinforce pricing power and drive consumer willingness to pay for the product.

Source: Starbucks Investor Day Presentation 12/7/16; Growing and Elevating Our Stores- Andy Adams, SVP of Global Store Development

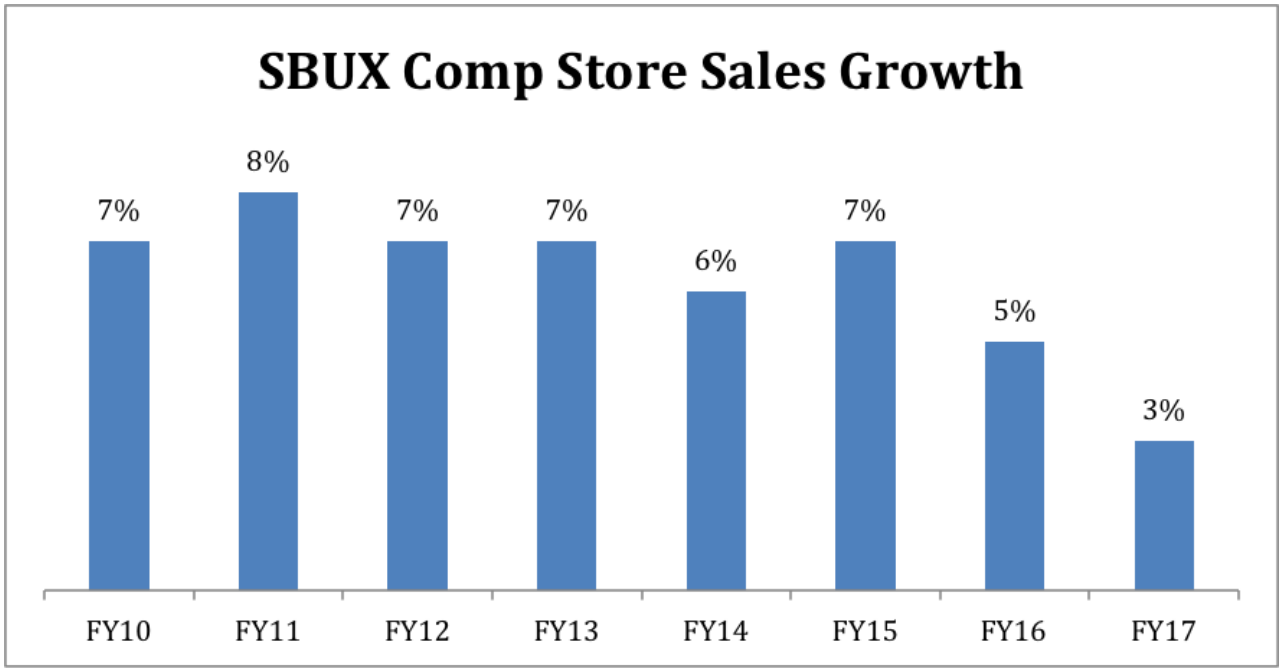
A tech savvy company that isn't in tech
Starbucks' has harnessed technology to meaningfully drive its business over the last few years. The success of a well-designed app and order ahead functionality has helped drive throughput and a more positive consumer experience, which engenders loyalty. Early on, order ahead was a victim of its own success as the physical operation wasn't quite set up to handle the increased demand but SBUX will iron out these kinks over time.

While helped by technology, Starbucks isn't at any risk of technological disruption. Consumers have consumed coffee for hundreds of years and while per capita consumption has ebbed and flowed (actually has increased over the last ~20 years - especially specialty coffee)– I don't see technology or anything else meaningfully changing the consumption of coffee.

Risks and Considerations (i.e. Why I'm Wrong)

Slowing growth especially in the more mature US market
Comparable store sales growth between 2010 and 2016 ranged from 5% to 8% on a consolidated basis and between 6 and 8% in the America's region. As shown in the chart below, growth in 2017 slowed down meaningfully to 3% both in the America's region and on a consolidated basis. Guidance for the long term and 2018 pegs comparable sales growth for the Company between 3 and 5%. Recessions and downturns in the business cycle will inevitably impact this in the intermediate term.

Growth will be slower than years past given increasing saturation in the US and the law of large numbers but: 1) this conservative target should be more achievable and beatable; 2) while the topline will be softer, moderate operating leverage in the business should help drive stronger growth in operating income, free cash flow and EPS.



Source: Data from Starbucks Investor Relations site; Consolidated Company operated stores open 13 months or longer

The decline of brick and mortar retail

The general decline of brick and mortar retail is a threat to traffic especially at locations in malls and adjacent to retail stores. SBUX depends on this retail foot traffic to drive traffic into its stores and it hasn't been immune to the decline. Long term though, they should fare ok as SBUX is often a destination in and of itself and they can shift out of leases to accommodate for shifting consumer trends in retail. Furthermore, they have continued to build out alternate locations with drive through or other locations (e.g. theme parks) that don't necessarily depend on retail traffic.

Store growth plans feel aggressive at first blush

Starbucks store growth plans do feel a bit aggressive with a plan to increase the store count to ~37,000 by 2021, a ~10,000 store increase over the current ~27,000 stores. That means adding about 2,500 stores per year for the next 4 years. To put that into context, that would put them close to the likes of McDonalds (~36,000 locations worldwide) and Subway (~45,000 locations worldwide). A focus on growth at the expense of quality can be detrimental or dilutive to the brand and Starbucks has been down this path before. The current management team is smarter and more experienced than the one that led to overgrowth some years ago. When you consider a habitual product coupled with new untapped markets and efforts to expand daypart to lunch and even dinner, the growth feels much more reasonable and sustainable.

Crux of the thesis highly predicated on China growth

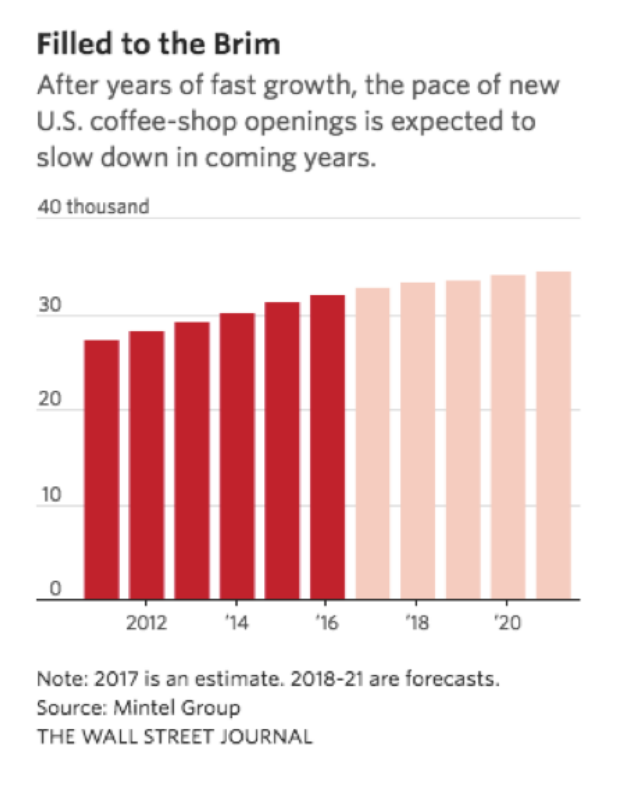
I'm highly skeptical of any company where the crux of the thesis is "China". This isn't the only growth lever in the case of Starbucks but it is a big part of the story. I am comforted by that fact that Starbucks has been quite successful in the China/Asia Pacific (CAP) Region and more specifically, China. Starbucks has nearly 3,000 company operated and licensed stores in China with roughly 600 more stores opening in 2018 including a premium flagship Reserve Roastery in Shanghai. CAP operating margins are on par and in fact, slightly ahead of the Americas region at 23.6% for 2017. Based on historical precedent and recent results, Starbucks seems to be well positioned to capture growth in China, especially as it repurchased its East China JV from a partner to make all of those properties company owned.

Historic inability to integrate acquisitions

Starbucks' growth has primarily been driven organically but it has made several acquisitions along the way – Evolution Fresh, Teavana, La Boulange bakery - for millions of dollars each only to shut all these other businesses down. Maybe Starbucks' strategy is to buy these businesses for the brands/products to integrate them into SBUX shops but it feels like an expensive approach. Their inability to integrate acquisitions doesn't worry me that much because I see little future growth being derived from acquisitions. I believe that the Starbucks masterbrand has strong brand equity on its own that can be leveraged to launch new products and even services.

Intensifying competition including oversaturation from existing players and consolidating "third wave" coffee players. Low barriers to entry to open a coffee shop don't help the situation.
Coffee has had a good run over the last several years as consumers shift away from products like caffeinated soft drinks that are perceived to be unhealthy. As a result, large players and small players alike have continued to grow their retail store footprint. Major players like JAB Holding Company have gone on a buying spree with Keurig Green Mountain, Peet's, and third wave players like Stumptown and Intelligentsia. Nestle more recently bought a majority stake in another third wave coffee shop – Blue Bottle. And McDonald's continues to increase its coffee offerings at the lower end of the price spectrum.

Furthermore, the US seems to be pretty well saturated with 33,000 coffee shops, up 16% from five years ago as the chart below shows. Starbucks represents about 14,000 of these 33,000 shops. There exists some risk that Starbucks could get squeezed by more premium third wave shops at the high end and mass competitors like convenience stores and McDonald's at the low end.



Source: "Too Much Caffeine? Coffee Shops Face a Shakeout", Wall Street Journal (12/18/17)

The reality is that I am an outlier with my coffee snobbishness, and even with that, I often find my way into a Starbucks. There's a few things that provide some comfort here as the competition increases: 1) Starbucks is pushing into the super premium space with its Reserve stores and Roasteries to prevent it from getting squeezed from the top; 2)

Starbucks is looking to diversify its revenue mix by increasing the proportion of food so it isn't as reliant on only coffee; 3) Starbucks customers are a loyal bunch that enjoy its products with frequency with a very popular loyalty program (Starbucks Rewards) reinforcing this behavior.

Valuation

If Starbucks can deliver on somewhat aggressive store growth plans (37k stores by 2021) and drive operating leverage as it has described, the Company should be able to meaningfully increase free cash flow from ~$2.5bn currently to nearly $7bn over the next 10 years. This is all while continuing to generously invest in the business at capital expenditure levels north of $2bn that will support its efforts to maintain its existing stores and elevate the coffee experience through new, more premium stores.

While the valuation does appear to be on the rich side at 29x trailing earnings and 25x 2018 estimates, my DCF with more specific inputs on store growth and margin yields a valuation of $68 or about 19% upside from the current price ($57). This doesn't meet my hurdle for margin of safety at current prices. However, SBUX has frequently traded down to the $50 territory over the last year or so. If it revisits $50 or close to it in the near term, I would view this as an attractive entry point with 35%+ upside.

The Net Net

Starbucks is a well-positioned company led by a smart management team playing "the long game". While store growth in more mature markets and continuing competition in premium coffee may be a drag to future growth, Starbucks benefits from a moat in the form of a strong brand and a loyal, repeat customer that can be extended into more markets and into more than just coffee. And I believe that this moat is sustainable under the right leadership team that understands that Starbucks delivers an experience that extends far beyond just selling coffee. The sustainability of the moat is predicated on continued investment to elevate the store experience and thus drive pricing power. Management has demonstrated a willingness and enthusiasm to invest and has ample runway to do so while also rewarding shareholders with share repurchases.

As with most retail and QSR companies that trade in a short sighted stock market where it's all about "what comp sales have you done for me lately", an earnings or comp sales miss will inevitably provide the opportunity to acquire SBUX shares at a price (~$50 or below) that provides a rich and "frothy" upside (couldn't resist!). That's the time to strike and even gets a third-wave coffee snob like me excited.

Disclosure: I am currently long SBUX. I am not an investment advisor and this article presents my personal views. While I have conducted a fair bit of research to write this, you should also do your own research and come to your own conclusions.