

Starbucks Corp Loyalty Program Conference Call

Company Participants

- Aimee Johnson, SVP, Customer Relationship Management
- Durga Doraisamy, Director of IR
- Matt Ryan, Global Chief Strategy Officer
- Scott Maw, EVP and CFO

Other Participants

- David Palmer, Analyst, RBC Capital Markets
- David Tarantino, Analyst, Robert W. Baird & Co.
- Jason West, Analyst, Credit Suisse
- John Glass, Analyst, Morgan Stanley
- John Ivankoe, Analyst, JPMorgan
- Karen Holthouse, Analyst, Goldman Sachs
- Keith Siegner, Analyst, UBS
- Matthew DiFrisco, Analyst, Guggenheim Securities
- R.J. Hottovy, Analyst, Morningstar

Presentation

Operator

Good morning. My name is Shannon and I will be your conference operator today. At this time, I would like to welcome everyone to the Starbucks conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions) Thank you. Ms. Doraisamy, you may begin your conference.

Durga Doraisamy {BIO 19851420 <GO>}

Thank you, Shannon. Good morning, everyone. And thank you for joining us today. This is Durga Doraisamy, Director of Investor Relations for Starbucks Coffee Company.

The purpose for today's call is to discuss updates to Starbucks' loyalty program. Scott Maw, our CFO. And Matt Ryan, our Global Chief Strategy Officer, will lead the discussion and for the Q&A session, they will be joined by Aimee Johnson, Senior Vice President, Customer Relationship Management.

Before I turn the call over to Scott, I would like to remind you that this conference call will include forward-looking statements which are subject to various risks and uncertainties that could cause our actual results to differ materially from these statements. Any such statements should be considered in conjunction with cautionary statements and risk factor discussions in our filings with the SEC including our last annual report on Form 10-K. Starbucks assumes no obligation to update any of these forward-looking statements or information.

This conference call is being webcast and an archive of the webcast will be available on our website at investor.Starbucks.com.

And with that I will now turn the call over to Scott.

Scott Maw {BIO 18637895 <GO>}

Thanks Durga and good morning everyone. The purpose of today's call is to announce some exciting changes to our loyalty program to be called Starbucks Rewards for the US, Canada and Puerto Rico. Matt will go into details on the program changes which are based upon the number one customer requested update, more stars awarded based on what customers buy at Starbucks no matter how often they visit. That means giving stars for every dollar spent on everything, coffee, mugs, drinks, food and more.

Before I hand over to Matt, I just want to reiterate how important our loyalty program is today to both our customers and to our financial performance. Specifically, we have over 11 million active loyalty members, a number that has increased 50% over the past two years. Our members spend three times as much as nonmembers and they generate more profit driven by increased frequency of visits. And we continue to enhance the program by adding features and benefits such as integrating Spotify's music service and the convenience of ordering ahead via mobile order and pay. And we know that our loyalty program continues to add to the overall momentum of our US business.

This includes the cumulative effect of the incrementality associated with more members joining the program, 1-to-1 marketing to our existing members. And mobile order and pay. We also believe that the new Starbucks rewards program has the potential to further contribute to our comp store sales growth over time. In fact, the new program is one of the main reasons along with the launch of mobile order and pay that our fiscal 2016 comp store sales guidance is somewhat above our long-standing mid single-digit target.

Our recent trend of strong comp store sales over the past several quarters plus newer drivers such as mobile order and pay and these loyalty program changes give us confidence in our comp guidance for the year.

With that I will turn it over to Matt for more details. Matt?

Matt Ryan {BIO 18012513 <GO>}

Thanks, Scott. Before I go into the details of the program changes, let me provide some additional context for why we are making these changes.

As Scott mentioned, we are approaching this change to the program first and foremost through the lens of our customer as the number one request we receive from them, to tie the rewards to not only to how often you visit but also to what you buy. By designing in this way we are providing opportunities for our customers to earn more rewards each time they visit which will increase the value of the program to our customers and to us.

We are very proud that we have more than 75 million customers coming through our doors each month in the US but we estimate that fewer than one in six of those customers are a loyalty member, a rate of participation far lower than companies in other industries see. Naturally we think there is a lot of upside especially since we see significant revenue and profit incrementality associated with every customer who joins.

One of the other things we know is that some dissatisfaction with the current structure of the program manifests as transaction splitting in which customers ask baristas to ring up items they are buying separately in order to earn stars for each of those items. This is challenging for other customers who are forced to wait and to our baristas who have to perform extra work, a burden on them that adds cost to our P&L by extending the transaction time. We estimate that recently approximately 1% of our total transactions are from customers who request two or more separate transactions to get stars.

With the shift to the new program, we expect to see transaction comp go down by approximately 1 point while ticket comp will go up by the same amount simply as a result of avoiding transaction splitting. And while we are pleased that the new program will remove this distraction from our store operations, the real benefit will be to our customers as it increases customer satisfaction and motivates more customers to join our loyalty program.

Now let me get into some of the specifics because starting today we will be communicating the details of the new Starbucks rewards program through direct email to our customers. As I mentioned. And most importantly, stars will now be awarded based upon what you buy no matter how often you visit rather than on just frequency of visitation. Instead of awarding a star per visit customers will receive two stars for every dollar spent.

Under the current program, the customer who buys a tall cup of coffee, a round of beverages for the whole family or merchandise all get just one star. In the future, stars will be calculated on the total purchase which will provide more value to more customers. Because all customers will be earning many more stars per transaction, we have reset the number of stars you need for a reward at 125 stars. As always, you

can use reward earned on food or beverages. This choice of redemption is a cornerstone of the appeal of our program.

It is important to note that in aggregate the rate at which our customers earn rewards will not change and that the total % of revenue we provide back as rewards will remain constant.

To explain this in more quantitative terms, in the current program customers with gold status get a star for every transaction which averages a little over \$5. Most transactions are very close to that average so most customers earn a reward when they spend a little over \$60. In the new program, the math works the same way. At two stars per \$1 spent when a customer spends a little over \$60, they earn a reward.

This is a very important point as there are examples of companies in other industries who use changes in the loyalty program as a way to reduce the value of rewards at the expense of customers. As we switch the mechanics of the program, we are not using it as an opportunity to opaquely weaken the rewards proposition.

But we know that not all customers are alike and if these changes may affect them in different ways. If customers simply engage -- continue to engage as they currently do instead of engaging more as we believe they will, the vast majority of our customers will earn rewards just as fast or faster than they would today. A small portion of customers will experience a significant increase in the pace at which they earn rewards even without changing how they engage with us.

At the same time, there is a small minority of customers whose current purchase and redemption habits will result in earning rewards at a slower pace. For customers seeking to maximize the value of the program, the rewards structure still allows them to redeem for any item on the menu which we believe is a great way for customers to discover new products and establish new taste preferences.

An additional benefit of resetting how customers earn and redeem stars is that the unit cost of the star is now much lower than it is currently, more than 10 times lower. This will allow us significant flexibility as we find new ways of awarding stars to customers as whole stars can be awarded in the context of very small transactions, something that the unit price of stars has historically prohibited.

The potential this has for new ways customers can earn stars outside of our stores is tremendous. As our customers love additional ways to earn stars as evidenced by the success of our Stars Down the Aisle program in grocery. While we don't have new partnerships to announce today, we have begun to realize this idea with other like-minded companies such as Spotify, New York Times and Lift and this is just the beginning.

Reducing the unit price per star is a key part of the long-term strategy here and we have more news to share on this in the coming months.

We are also taking advantage of these program changes to simplify our membership tier structure. Currently we offer welcome, green and gold levels each with different tiers of benefits. In the Starbucks Rewards Program, we are simplifying to just two tiers, green and gold. When a customer signs up, they will now immediately become a green member with all the benefits that tier provides including a free drink on your birthday, free refills on brewed coffee, tea as well as mobile order and pay and more.

We will also be introducing new benefits like monthly double star days where every month gold members can earn double stars on all the things they love, getting to their reward even faster.

As in the current program, our gold level allows customers to earn stars on every purchase they make at a rate of two stars per every dollar spent. As we convert to a spend-based program, the qualification requirement will convert accordingly. Now as soon as you accumulate 300 stars, you reach gold regardless of how often you come. Just spend \$150 or even less if you are taking advantage of our bonus star offers. With this transition in April, customers maintain their current status and any stars in the customer's account are converted to the new star system.

We have also made the decision that is part of the initial stars conversion in April, every individual star will convert to 11 stars representing their full value which reflects a slight adjustment up in the customers' favor.

Finally, one of the most exciting parts of these changes is coming mid-April where any customer making a transaction at the welcome or green level will be automatically awarded gold status for a full year and anyone making a transaction at gold status will also get their gold status extended for a year. This is not only assurance that anyone who is on their way to earning gold will get there. But that there has been no better time than right now to join our loyalty program.

As you can see, the changes we will be making are with our customers' best interest in mind which translates to increased customer loyalty and engagement as well as incrementality in both revenue and profit.

With that, I will hand it back over to Scott.

Scott Maw {BIO 18637895 <GO>}

Thank you, Matt. In closing, I would like to reiterate four key takeaways about our new Starbucks rewards program. Our new loyalty program should continue contributing to our comp store sales growth over time. We see the potential for deeper customer engagement because the new program is designed to incentivize through 1-to-1 marketing and personalization which will contribute to revenue growth and flow through to the bottom line.

The reduction in transaction splitting will speed transaction time for our customers and partners while increasing ticket which we estimate will cause an approximately 1

point switch between traffic and ticket within comp. Traffic will go down and ticket will increase by that same amount.

Our increased comp store guidance we gave at the beginning of fiscal 2016 includes the impact of the new program.

In summary, we were once again listening to our customers and elevating our digital ecosystem via a stronger and more relevant loyalty program. We will now take questions about the information discussed today so please limit your questions to these changes.

With that, I will turn the call back over to the operator for Q&A. Operator?

Questions And Answers

Operator

(Operator Instructions) Keith Siegner, UBS.

Q - Keith Siegner {BIO 6299571 <GO>}

Thank you very much. Just a question in terms of thinking about some of the technical aspects of this. Like for example, Stars Down the Aisle, great program. It is not the easiest program in that you have to take that little sticker off and enter the code. How does that evolve with this? Does that become a dollar spend, does it continue to be a certain amount of stars per transaction? Is there an easier way to get that reflected in your account? Any information along that would be helpful. Thanks.

A - Aimee Johnson {BIO 20799603 <GO>}

Sure. Thanks. Customers are still able to earn stars on grocery items. Stars earned on specially marked Starbucks products sold in grocery store will now vary depending on the item's suggested retail price.

A - Scott Maw {BIO 18637895 <GO>}

So what that means, Keith, is for slightly larger items, we will give more stars. The way to redeem those stars will be similar. Obviously we are always as we've discussed in the past looking for ways to make that easier. But the good news is you still earn Stars Down the Aisle and in this case based upon a little bit more about what you spend.

Q - Keith Siegner {BIO 6299571 <GO>}

Thanks.

Operator

David Palmer, RBC Capital Markets.

Q - David Palmer {BIO 6061984 <GO>}

Thanks. Good morning. Have you tested this change? And are you concerned at all that there might have been a simple elegance to the old system in that it was very easy to understand and therefore motivating and that you might be losing a little of that with this change? Thanks.

A - Matt Ryan {BIO 18012513 <GO>}

Yes, of course, we look very carefully at everything we do here. We don't do things haphazardly. What I can tell you is that there is an elegant simplicity to this new system and it is the number one most requested change we get across all those Starbucks to do it this way. It is what people are used to with loyalty programs right now and we think we will be matching what people want and expect.

Operator

John Ivankoe, JPMorgan.

Q - John Ivankoe {BIO 1556651 <GO>}

Thank you. Maybe a slightly different direction. Can we talk about where the usage is currently of mobile ordering and at what point Starbucks really starts to kind of look at that relative to the total transaction count and start to drive awareness whether using my Starbucks reward or through traditional marketing?

A - Scott Maw {BIO 18637895 <GO>}

Yes. Thanks for the question, John. As you know we have north of 20% of our transactions today on mobile payment. Mobile ordering is about 15% of that as we exited the quarter, about 3% of total transactions. And as we said at the earnings call, we saw that accelerate over the course of the quarter and we finished rolling that out in September. So we are really happy with what we are seeing. At our busiest times and our busiest stores, those percentages are much, much higher which we would expect.

And I think it is really important and we said it in the prepared remarks, mobile ordering is another benefit for MSR customers that we are adding to the program. So we continue to expand benefits, we continue to leverage things around offering bonus stars. And so one of the big things that we are focusing on both with MSR broadly and also specifically with mobile order and pay is getting awareness up in stores. And honestly as we roll this program out and as we get through the advertising and the notification process with our customers, that is a great chance for us to emphasize all of the benefits of MSR including and I would argue especially the benefits of having the ability to order ahead at the busiest times.

So that is all in the plan to continue to expand that awareness and drive more members into the program.

Q - John Ivankoe {BIO 1556651 <GO>}

Thank you.

Operator

Jason West, Credit Suisse.

Q - Jason West {BIO 4139501 <GO>}

Thanks. Sorry if you guys covered this but could you explain exactly again when customers will see this change happen on their phones I guess from what the stars conversion looks like? How are you dealing with if the transaction comes in at 250, are you going to round up to three stars at that point or do you have to go over the dollar per each star that you are going to get?

A - Aimee Johnson {BIO 20799603 <GO>}

So customers are going to see the changes as early as today. We are going to be sending emails out to our customer base as well and there will be some (inaudible) information on our website. We will actually start seeing the stars rolling to your individual account in April. That is when you will be able to log onto your phone and see the changes. In regards to star conversion, we are actually -- customers get stardust, they get credit for everything they are spending so there will be no rounding, customers will get exactly credit for what it is they spend with us.

Operator

David Tarantino, Robert W. Baird.

Q - David Tarantino {BIO 15144105 <GO>}

Good morning. My question relates to how this change will ultimately end up being a comps driver. I think you mentioned, Scott, that you expect it to drive comps yet the reward structure seems very similar just a change versus the value of the stars rather than the amount of benefits people are getting. So I guess maybe if you could at a high level talk about why this change ends up being a comps driver, that would be helpful.

A - Scott Maw {BIO 18637895 <GO>}

Thanks, David. The main reason is because it is the number one requested change and we hear about it a lot, we know that customers want more value based upon what they spend and so what we believe is given the significant capabilities we have around driving different behavior with 1-to-1 marketing and overall with the rewards program, we believe that customers because they earn more, they will spend more. And we have seen that as we have done bonus stars through 1-to-1 marketing, we have seen that across the entire history of the program that when we make the rewards easier to get, people spend more and they drive more activity.

And so it is really that simple. By giving customers more based upon what they spend we believe they will spend more and that will help with comps.

Q - David Tarantino {BIO 15144105 <GO>}

And if I am still on, Scott, is the idea then that this will benefit comps mainly through check growth or do you think it will also increase frequency?

A - Scott Maw {BIO 18637895 <GO>}

I think we believe we have the chance to do both. I think you will see most of it in ticket.

Q - David Tarantino {BIO 15144105 <GO>}

Great, that is helpful. Thank you.

A - Scott Maw {BIO 18637895 <GO>}

David, I'm going to use this opportunity just to talk a little bit and Matt touched upon this about personalization. So one of the things that we have been talking to you about for some time now is our increased investment in capabilities around 1-to-1 marketing and personalization. And you will recall that when we started the year we talked about partner and digital investments for this year in the neighborhood of about \$250 million to \$300 million on a run rate basis.

In the most recent quarter we took that up from \$275 million to \$300 million for the year and that step up was mostly driven by increased investment in personalization. And that has something to do with the change in this programming capability around that but it goes to what we are seeing from a return standpoint about investing in personalization, about understanding our customers better, about offering them more frequent ways to accrue value. And so that is associated with this program but also a really important part of what these changes mean for us.

Operator

John Glass, Morgan Stanley.

Q - John Glass {BIO 2450459 <GO>}

Thanks and good morning. I know, Scott you said most of the transactions are around \$5. But how is it distributed around it? There are a number of people including myself that are probably in the lower end of that. So how many customers are going to be negatively affected or are going to get less of a benefit from this? And if you know anything about their loyalty or do they tend to be more easily defectors for example to other brands because they tend to spend less?

Then also just the check splitting, how long has that been going on? Has that been embedded in traffic for as long as effectively as long as we have been able to see or has that been a more recent phenomenon that has actually been a driver of the traffic over the last four to eight quarters?

A - Matt Ryan {BIO 18012513 <GO>}

Sure, let me take both of those. The check splitting one is easy. That has been going on for quite some time. It is nothing new and it continues to be at around 1% of our total transactions.

As for the question of the distribution, what I can tell you is the vast majority of transactions are very close to that \$5 plus number that I referenced. We are not going to give out the very specific bell curve distributions or anything like that here in this call. But what I can tell you is there are a small minority of people who will either be advantaged or disadvantaged here. But I think it is worth pointing out that there are other benefits to the program besides just the star's back. For instance, if anybody is a brewed coffee drinker, there are free refills on brewed coffee or tea so those beverages that may be at the lower value end of the spectrum already come with a terrific benefit in the program.

A - Scott Maw {BIO 18637895 <GO>}

And just to build a little bit, John, when Matt says for some time, this transaction splitting has been an issue for years, not quarters but years and so it has been there in the underlying numbers for many years now.

Q - John Glass {BIO 2450459 <GO>}

Okay. But there is no incremental benefits for the low-end that you are getting with this new program, it is just you are pointing out the existing benefits for the free refills that have already been there?

A - Matt Ryan {BIO 18012513 <GO>}

That is right.

Q - John Glass {BIO 2450459 <GO>}

Okay. Thank you.

Operator

Karen Holthouse, Goldman Sachs.

Q - Karen Holthouse {BIO 17433865 <GO>}

Thank you for taking the question. When you look at international markets that have also rolled out a version of My Starbucks Rewards, have they all been also star-based or are there examples of where a dollar spend base has worked internationally? Are these also changes we can expect to roll to international markets that have been on the stars per transaction sort of base?

A - Matt Ryan {BIO 18012513 <GO>}

Sure, the changes that we are talking about today apply to the US, Canada and Puerto Rico. We are looking to do it in additional markets globally and we will announce them as the time comes. There are a couple of instances where we have linked to spend base and we have seen that to be tremendously successful. In fact that is part of the reason why we have moved in this way.

Q - Karen Holthouse {BIO 17433865 <GO>}

Great, thank you.

Operator

Matthew DiFrisco, Guggenheim Securities.

Q - Matthew DiFrisco {BIO 3948570 <GO>}

Thank you. I just have a question, a follow-up. I wonder -- it sounds like you are going to have more gold members when you switch over because you are going to be grandfathering in and then you are going to be promoting up some guys that are on the fringe about to earn that. I assume that is correct. If so, is there any risk of earnings implication as that gold customer -- there might be more people getting the refills, etc. and some of those benefits that might not be as high-margin as that person just paying for an extra drink?

Then my follow-up question was with respect to I guess -- I think it was David that asked the question about the simple elegance of the first one, I personally -- I think a lot of people don't really think about the reward of spending \$60 but more so just 12 simple visits. So I wonder -- obviously you mentioned it was the number one request to change.

Have you really vetted -- can you give us confidence that you that you vetted this out, that there aren't a quiet majority that like the simple elegance of going for the 12 times and getting that reward, that you really do feel like you have a firm handle on how many people -- because you've done a great job -- it is a big loyalty program already and some of that I think is attributed to how easy it is to understand.

How much have you vetted that there isn't this quiet majority that really like it?

A - Scott Maw {BIO 18637895 <GO>}

Thanks, Matt. I will take both questions. On your first question, there is a small financial impact from the gold conversion in April but that is all in our guidance and it is not a big number.

On the second point, I think I would say a few things. First of all, because it is the number one requested item, it gives us a level of confidence just around how much activity and questions we have had around that and the fact that this is the right change.

The second thing as you can imagine is we did an extensive amount and I emphasize extensive of research and focus groups and surveys around different changes to the program before we launched this and so we are pretty confident that this is the right thing to do.

The third thing I will say and perhaps this is the most important, is there is a very small minority that is negatively impacted by this. Matt mentioned that. The vast majority of our customers will be equal to or better and we think that is going to help us as we work through these changes.

Operator

R.J. Hottovy, Morningstar.

Q - R.J. Hottovy {BIO 7448110 <GO>}

Thanks. Just had a question with respect to the stars partners and I appreciate you not wanting to give out any information about potential new partnerships that maybe in the works. But really just wanted to kind of figure out at this change who you might be going after in terms of partnerships in that regard? Just any kind of color to that regard if this program does change who you might be able to target really? Thanks.

A - Matt Ryan {BIO 18012513 <GO>}

It is actually quite exciting and I think that is one of the reasons why we have talked about this on guidance in the last few calls. The hold up has been the fact that we have not had the flexibility of a smaller unit value on stars. With this conversion you earn and burn at higher rates so that basically means the value of the star become lower and therefore the star becomes more useful in the context of more and more kinds of economic activity. So you can imagine that there are lots and lots of places where the value of the star priced as it is now all of a sudden become something that you can actually use whereas before you couldn't. That will open up a lot more categories.

I'm being a little bit coy about which ones at this point in time because I don't want to make an announcement before we make an announcement. But I can promise you that there is a lot in the works right now that will be very exciting in the months to come.

Operator

(Operator Instructions) Keith Siegner, UBS.

Q - Keith Siegner {BIO 6299571 <GO>}

Matt, just a follow-up, given that there are bunch of changes going on here in terms of what people have asked for, just a question about the actual redemption of the reward. Was there any thought given to maybe making that redemption a dollar-based reward as opposed to just get whatever drink or food that you want? And that

way making it even more a fungible currency to use across these different potential retail partners? How did you think through keeping it as whatever drink or food you want versus making it more like a dollar redemption? Thanks.

A - Matt Ryan {BIO 18012513 <GO>}

We certainly considered that. We looked at a lot of different possibilities and through extensive conversations with customers, we realized that one of the things that people really love about our program is the flexibility to use the reward on anything they want from our food and beverage menu. And we decided with all the changes that we are making we didn't want to layer on yet one more change and that that powerful anything on the menu reward will be something that will be very motivating and we wanted to keep it that way. And it is also something that we see as being a way for customers to sort of discover and experiment with different kinds of items on the menu. So it is valuable for us for people to use it as a tool to basically have the choice of anything that they would like to have on our menu.

Q - Keith Siegner {BIO 6299571 <GO>}

Okay. Thanks.

A - Scott Maw {BIO 18637895 <GO>}

Okay, everyone. Thanks so much for joining us this morning and we will speak to you next quarter.

Operator

This concludes the Starbucks conference call. You may now disconnect.

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