William Blair Growth Stock Conference

Company Participants

- Scott Maw, CFO

Other Participants

- Sharon Zackfia, Analyst, William Blair & Company

Presentation

Sharon Zackfia {BIO 4804954 <GO>}

Hi. So we're going to go ahead and get started. My name is Sharon Zackfia and I'm pleased to have with us today from Starbucks Scott Maw, CFO. And JoAnn DeGrande, Vice President of Investor Relations.

With more than 20,000 worldwide locations, Starbucks remains very much a growth story with annual unit volumes now at all-time highs in the US even as development has reaccelerated and the company has posted 17 straight quarters of 5% or better comp gains.

Starbucks' international prospects are robust from over 6,000 locations today with China now Starbucks' second largest market outside of the US in store count. And the company remains fairly early in optimizing its acquisitions of Teavana, La Boulange and Evolution Fresh.

Before turning the podium over to Scott, I'm required to tell you we have a complete list of research disclosures and potential conflicts of interest on our website, williamblair.com.

Scott Maw {BIO 18637895 <GO>}

Thanks, Sharon. And good afternoon, everyone. And thanks for joining us as we talk a little bit about the Starbucks growth story this afternoon. First thing to point you to is just forward-looking statements. You can look at this on our website as well. And before I really dig into the growth drivers, just a little bit of historical perspective on Starbucks' performance. So as you can see, over the past several years we've had double digit revenue growth, we're on track for 10% plus this year. And that's really a long term target that we try to stick to. We're going to talk a little bit about the building blocks around that revenue growth.

Operating margin has consistently expanded over the past few years and I would point out particularly in FY12 we did see operating margin expansion despite a significant amount of coffee cost headwinds and we'll talk about that a little bit. And as we think about coffee pricing, obviously where coffee prices are today, we believe we have the ability to continue to earn through coffee price headwinds and we'll dig into that a little bit more.

Global comp sales growth, Sharon mentioned this. But we target mid-single digits. You can see we've been between 6% and 8% over the last few years and earnings per share growth, again, in the high teens to low 20s and we anticipate a similar number this year. And getting to that specifically. So for FY2014 we expect EPS growth in the neighborhood of 20% to 22%. Long term EPS growth we target at 15% to 20%. Long term revenue growth at over 10%, ROIC north of 20%. And we've done a number of things over the last few years, if you took a look at our balance sheet and cash flow statement, you would see a significant reduction in working capital and a significant contribution to operating cash flows for our working capital improvement. And total shareholder return, three consecutive years north of 30%. So very much a growth focused story for Starbucks.

You might ask yourself the question, Starbucks had $15 billion in revenues last year, will have over $16 billion in revenue this year, how do we keep the growth going? How is double digit growth and that kind of margin expansion and earnings growth possible? And the answer really is on this page. So in addition to all the efforts that happen every day, with our partners in the store, with what we do with coffee which is the foundation of everything we do, we have many layers of growth drivers. And I'm going to talk to some level of detail about each of these today. I won't read them now because we're going to go through them individually. But it's really these efforts. And again, the daily efforts of our partners in the stores, that drive that continued growth story and continue to drive the types of returns that we've all enjoyed.

So with that, I'll start with new store growth. We have 1,500 new stores targeted for this year. About half of those will be in China/Asia-Pacific. A significant number of those specifically in China and we're going to talk about China at some length. We have about 600 stores targeted in our Americas segment and 150 stores targeted in EMEA. Most of those EMEA stores are in the license store format. And we believe right now, we're talking about store growth. But we believe right now we're as confident as we've ever been about these new store growth numbers. There may be a chance for us to lean in a little bit given some of the new formats and the success that we've seen with those. But as we grow new stores, we just want you to make sure that you understand the level of discipline and investment we have in process and analysis behind these stores.

So whether it's in the UK or in China or US or Canada, we take every store and we bump it up against a pro forma that meets all of our hurdle returns, has specific revenue and expense targets. And we look at that store every year to make sure it's marching along those return expectations. And we look at those stores and the distribution and we look at the stores that are over performing, what we call the greentail. And we try to understand what are the characteristics that those stores have? Is it geography? What happens with drive-throughs? What's the contribution in China by city, by vintage year? Do we see any deceleration or acceleration city by city, year by year? We pull that apart and spend more time than we ever have discussing and analyzing that store performance. And we also look at what we call the redtail. And there's not a lot of underperforming stores. But obviously in the normal distribution there are some stores that are meeting or just beating their hurdle. We look at those stores and try to understand are there things for us to learn there either in format or execution or staffing or how we open? And so we're constantly looking at this as we ramp the store growth to make sure that we learn from some of the bumps that we've had in the past and we take those learnings and infuse it into how we build new store growth. So we feel very confident both in our store growth and on our controls around the profitability of those stores as we expand.

So let's talk a little bit about -- oops, I'm a slide ahead, sorry. No. We're good. Let's talk a little bit about China. And I didn't really know where to put China in this presentation because it really draws on all those growth drivers. So I picked the new store segment. But I could have picked digital opportunities, I could have picked beverage innovation. Because really in China we're firing on all cylinders. And you can see some of the ROI numbers, you can see the growth numbers we're seeing in cap, very reflective of what we're seeing in China. We're at over 1,100 stores today and we'll be at over 1,500 stores by the end or around 1,500 stores by the end of next year.

It's a very dynamic market. It's a market where we continue to see traction around the Starbucks experience. And there are a number of things that are helping demographically and environmentally for Starbucks in China. Obviously there's a growing middle class in China. There's growing income within that middle class and I think importantly, something that's relatively transparent to us. But perhaps not to you all is we're seeing a growing adoption of a coffee experience and a coffee culture. So moving more towards that daily routine, we're seeing increased frequency. Moving a little bit less away from an occasion. Although that's still very much the China market, it's not reflective of the way it operates in the US. But we are seeing an adoption of the coffee culture and all of those environmental factors are definite new tailwinds for us.

But when we think about China, we think about that market very broadly and we think about it kind of carefully. So despite the fact we have significant store growth, we've been in China for 15 years. We're making significant investments in infrastructure in China and significant investments in our partners. Last week Howard and some of the leadership team spent most of the week in China and kind of -- there were several highlights of that event. But one of them was they invited 1,200 China store partners and their families to a China open partner family forum, which is kind of a mouthful. But basically they came, they met the senior leaders of the company, they got a chance to ask questions, they got a chance to interact with each other. And it was a big hit. And those are the types of investments we want to make as we grow China at the right level and at the right pace. So that level of investment, that level of infrastructure, that level of discipline, as well as investment in partners and building that coffee culture is absolutely critical.

We also have locally relevant products. So that includes things like chestnut macchiato. We have a Green Tea Red Bean Frappuccino, we'll show a picture of that in a minute. Local, relevant foods, things like our mood cakes for the Mid-Autumn Festival, all of those things targeted at the China market and locally relevant. The other thing that's important in China as in many of our markets, we also have specific and locally relevant inspired design within the stores.

So speaking of store design, stepping back and going a little bit more broadly. So we're really focused as we design Starbucks stores and as we ramp up a bit the store growth in making sure that we stay unique, that we make sure we stay consistent with the coffee forward Starbucks experience. And you can see that in some of the pictures here. So designs are locally relevant by country. We have stores in places where others really can't get into. We have a store on a train in Switzerland, we have a ski-up store. Here in the United States we have a number, an increasing number of drive-through stores that we're building. We see about a 25% lift as we build drive-throughs. Those are just a few examples of where we see opportunity.

And when we think about unit growth opportunity, an alternative format, you can see in the upper middle picture there, we're building a number of stores that are effectively container stores. So there are a couple of railroad containers or boxes placed on top of each other and they're drive-up only. There's no place to sit. You can walk up to it. We're capturing traffic and in some of these stores, we have a couple dozen of these stores now, in some of them they're actually already approaching the unit volumes that we're seeing in the average Starbucks store that's a full cafe. And they're going in industrial areas, in commuter areas, in places where we can't take down a full footprint. But we know there's significant traffic. There's one down by Boeing Field in Seattle, it's a completely industrial neighborhood. There's no other retail anywhere around. But there's a high amount of office and worker traffic that we're able to pick up and intercept and that store's been open for a few years and it's doing great. So that's one place we know we can lead in. Smaller format stores. So we have a number of kind of walkthrough only stores in New York that are on commuter routes. Again, we try to do that right and get the Starbucks experience as right as we can. But customers want that experience and we see the opportunity to open more of those stores as we move forward.

The other thing I would point out is we've opened two stores recently in partnership with Disney. So one in California, one in Florida. These are big stores, they're really landmark stores for us. And while they're integrated and very consistent with the Disney theme, they are very coffee forward stores. So they're technology forward, coffee forward stores. They're beautiful stores. Quite stunning actually. The volumes are significant. And so, again, even in partnership with a place like Disney, we're able to keep the Starbucks experience relevant and keep coffee at the front of the store.

Moving onto beverage innovation. So we get one to two points a quarter and one to two points over the course of the year over the last few years from beverage innovation. This includes things in the past like our Refreshers beverage which has been a hit in the afternoon for us. It includes things around some of our seasonal offerings. So we've had pumpkin spice latte out in the market for 10 years now. We get significant comp growth from pumpkin spice latte every year, it's a big winner for us and with our customers. It includes things like innovation along the macchiato platform, vanilla macchiato is an example. And I think importantly and increasingly it includes innovation in our core coffee capability. So you can see, you now see on the picture here, Starbucks Reserve which we're putting in more stores, Clover, which is a high quality single serve brew coffee experience in the store. We're putting than in more stores.

So across all our innovation platforms we've had a significant pipeline. It's coming forward with drinks like Fizio which you can see in the bottom right which is a handcrafted, high quality, made-in-front-of-you soda that you'll be able to get in Starbucks stores aimed at a different day part for us. We introduced Teavana Oprah Chai in the last month or so and I talked about the Green Tea Red Bean Frappuccino in Asia Pac. So all of those things are examples of where we've seen significant lift and significant innovation. And someone asked me earlier today, is the pipeline more full or less full than it was a year ago when we came to the conference. And I think it's equally as full. If anything, it's more full. We have significant innovation on the docket. These are a few examples of things that are coming out now. We'll talk about food. But we're going to continue with the momentum that we have there.

It's not easy. But, I'm going to talk about this a bit later, what I would say about Starbucks is, innovation is a core competency for us. Again, it's been one to two points of comp growth for a long time. That takes a lot of work and a lot of effort. But I think we're really good at it. We're really good at innovating, we're really good at understanding what our customers want. And we're really good about quick development and execution of relevant products.

Moving onto food. So food is a significant opportunity for us and I think most of you know this. We only attach food on about a third of transactions, that makes up about 20% of our revenue in our US business. And we've been very focused recently on the La Boulange bakery rollout. But as the slide says, I think it's important to note that we've gotten one to two points of contribution in the US business from food for the past several years. So that was pre La Boulange and it was in day parts like lunch where we had bistro boxes, up level Panini. We did take -- we went all natural with our ingredients in our bakery platform even before La Boulange. And so those improvements drove significant food comps and drove significant growth. But in the last quarter, food was the largest contributor to comps in the US and La Boulange was the largest contributor to food comps. So as La Boulange is rolled out, it's rolled out in about, had been rolled out in about half the stores and about half the bakery platform, when we got to the Second Quarter we got to 75% of the stores and it kicked over to the most significant comp growth and we expect that to continue as we move forward.

And when you think about La Boulange, the way we think about is, we believe that we're an absolute leader in coffee quality and we continue to try to take that advantage from the supply chain, the way we source coffee, roast it, the variety we offer, the care we take in preparing it. It's really that same level of pride that we believe a La Boulange launch gives us in food. High quality ingredients, artisan crafted recipes in sandwiches. And we're starting to see that in the comp results in the stores.

We did see specifically in croissants and chocolate croissants that sales have doubled since the launch of La Boulange in those products. We launched a breakfast sandwich platform in March that was inspired by La Boulange which means the recipes, the way it was presented, everything was heavily influenced by La Boulange. And we saw 50% increase in sales in that platform once we launched it. So we know we have a winner and we know it's consistent with what we're trying to do in the stores.

Moving on. So I touched briefly on lunch. But let's talk about it a little bit more. So I've talked a fair bit about comp growth and one of thing things that we've done is we've decomposed our comp growth across two hour increments of the day. So 5:00 to 7:00, 7:00 to 9:00, 9:00 to 11:00, etc. And we've looked at one and two-year comps specifically by those two-hour increments. And the good news is, in every two-hour increment across the portfolio, we've seen comp growth. But the growth is most significant, highest, it spikes, around the 11:00 to 1:00 period and the 1:00 to 3:00 period. So around lunch and early afternoon. And this is all pre any La Boulange inspired or up leveled lunch program. It goes back to some things I mentioned around Bistro boxes and paninis. It goes back to things like Refreshers. And the thing that we're quite excited about is we're already becoming much more relevant in lunch, we're already seeing a significantly outsized comp growth in lunch and we haven't even gotten to the rollout of the up level lunch program. We haven't launched Fizio, we haven't really launched Teavana iced teas fully. We're done that somewhat. But there's more to come. So there's a lot of products and innovation and marketing and passion that's going to go into that lunch day part. And even before all of that, we're seeing outsized comp growth and showing that Starbucks is relevant around lunchtime.

Beyond that, we've talked a fair bit recently about the evenings program. So we've tested this in a couple of dozen stores over the last several years. So this has been a long test for us. We're now ready to roll the evening program, we'll be rolling it out over the next few years and ultimately getting up to as many as 1,000 stores. And there might be more opportunity. But that's our target now. And the evenings program is somewhat about beer and wine. And certainly we're going to have locally sourced and relevant beers and wines in Starbucks stores. But what we find in the stores that we've tested is the ticket is quite diverse. And so there's beer and wine sales in there, sure. But we've actually seen a lift in coffee beverage sales because people come in in small groups, half the people order coffee. The food platform that we've targeted with kind of a small bites plate you can see there has seen significant lift. So there's a broad diversity in that ticket across food, coffee and beer and wine. So we're pretty excited about that and we're moving forward.

Let's talk about tea a little bit. So I think the first thing I would say is, tea is a huge market, second most consumed beverage in the world after water. It's a bigger market than coffee and it's growing faster than coffee. And with the Teavana brand what we know is we have a brand that resonates with premium tea drinkers. And as we've started to roll it out in our Starbucks stores with Teavana Oprah Chai and some of the other Teavana products, we're encouraged by the early results. And what we also know is that tea in total in Starbucks stores is about 9% of our revenue. I was mentioning to someone earlier, I kind of have two feelings about 9%. First of all, our US revenues are a big number and so 9% of that number is a huge amount of sales for tea. So tea is a relevant product in Starbucks. People come in for Chai tea lattes, they come in for iced teas in the afternoon. We sell a lot of tea. But I also know, given how close tea is to our coffee offering. And we know that if we get the right quality and relevancy of offer there, tea can be much more than 9%. So we know there's opportunity there.

So when we think about the tea opportunity, it breaks down in several ways and I'll kind of give it to you a little bit chronologically how we see it. So first and foremost in Starbucks stores. So taking the Teavana learnings, the products, the recipes, all the great things that Teavana has built over the year with their mall based business and introducing that to our thousands and thousands of Starbucks stores across the US, is going to be a great lift, both for the Teavana at their end and I think for tea within Starbucks stores. So that's going on right now.

Then second, we have four tea bars across the US. So this is a concept that has a tea forward offering. You can get all sorts of tea, bubble tea, iced tea, hot tea, it has a food offering, it has our wall of tea. Which if you've been in a Teavana mall store, has dozens of different teas that you can select from. It's got tea merchandise which, again, the Teavana mall store merchandise is really top notch. And we're testing and learning to see what might be from a tea bar based concept that we might be able to learn from and roll nationally over time. So those tea bars, there's one in Chicago, there's one in New York, one in Seattle. And one in L.A. and we're learning a lot about all aspects of it. How we brew tea, how quickly we brew tea. What the right food pairing and mix is. And we'll continue to learn from that.

Then mall based stores. So we'll continue to add some mall based stores, we'll continue to learn from the merchandising expertise, continuing to learn from the sourcing and recipe expertise from Teavana. Then down the line there could be an opportunity in CPG as we move further through time. So that's the tea opportunity.

Moving on. So let's talk about mobile, digital and loyalty. I think the first thing we can say with confidence is we have a position in this space that is unequaled by others, particularly in mobile payments. We know we're the number one mobile payment app out there. We don't know who number two is. But we know we have a significant portion of the total share. And the real power in these assets is how they work together. So we've got a really top notch loyalty program in My Starbucks Rewards. We have 8 million active members, it's growing rapidly. It's a loyalty program that drives increased frequency from our customers. If you're a loyalty member you know it's fair. If you come a lot you get a lot of rewards. It allows us to collect information about our customers so that we can offer them one to one marketing, digital marketing that's relevant to them, that provides them the right kind of offers, the right kind of updates of what's coming to the stores. And we're in the early days of building out that capability and that direct marketing capability and learnings.

Then we have the card program, which a third of all payments are on some form of card. 14% on the mobile app. And the gift card program for Starbucks is significant. So when we saw a bit of slowdown in the holiday timeframe, the gift card business really helped us sort of pick that up. Starbucks is relevant in a relatively low denomination of gift card and we're making it easier through e-gift and we continue to see loads and gifts growing over time.

And finally mobile. So the app is we think is the easiest way to pay. Customers think it's the easiest way to pay and it's really what gives us the confidence to test into an express order and pay concept. So that's something we'll be piloting in a market this fall. So you can, with your Starbucks app, if I can find my phone here, order in advance. You can confirm an order that you've done recently or a standard order, you can modify it, walk into the store and pick it up. Now what I will say, it's easy for me to say that. But the test market is really to iron out probably a dozen different things that we have to figure out. What's the customer experience? What's the wait time? What's the impact for people that have to stay in line? How do partners execute on it? What's the impact on the drive-through? All those questions we have hypotheses on. We're going to test this very significantly, learn from that. And then in the back half of next year we'll roll it nationally.

What we know is, given the ease of payment with that mobile app, we don't have to -- other people that are putting in express order and pay, they have to grapple a little bit with the pay piece of that, we've got that solved. But there are a lot of other things that we have to learn and we think it will help with throughput, we think it will help with customer service, giving them different options whether it's the drive-through, walkup, or order in advance to interact with Starbucks. So we're excited about that.

We've taken it down the aisle so we have five million stars registered down the aisle. If you buy a bag of coffee, there's a sticker on it. You can peel lit off and enter in your stars and now get loyalty in a couple of different channels. And we've seen a nice lift as a result in CPG in that. And I talked about the digital marketing which is very much early days. That's digital.

So let's talk a little bit about CPG specifically. And you can see here it's a pretty powerful portfolio of brands. So we have packaged coffee which has been a big -- we have a big market share in that. It's been a market share that we've held but obviously the category has been shrinking as single serve grows. We're fortunate to have a strong partnership with Green Mountain and that's allowed us to grow our share in K-Cups so we continue to work with them to bring more innovation, more SKUs, more capability to produce and get into additional doors around K-Cups. So that's a big growth opportunity for us.

And you can see in the upper, I guess it would be your upper left corner, ready to drink. So around our partnership with Pepsi, things like Frappuccino, canned Refreshers. And those businesses are all growing quite well. But if you look at the CPG business, the thing to remember is it's our second largest business. So this is a big business within Starbucks and it interacts in a very cohesive way with the stores. So the reason we're successful with packaged coffee, the reason we're successful with Refreshers in CPG is because of the success of those products in the store. So that's the leverage that we drive. CPG is growing at 10%. Chance for that to accelerate a bit maybe in the second half of the year as we lap some pricing that we took last year. And the two biggest growth drivers for CPG as you look forward are around single serve, primarily K-Cup. But some things that we're working on around Via as well. Then second would be international opportunities. So if you look at for example ready to drink in Korea and Japan, those are big businesses for us. They're nice, profitable ready to drink businesses.

They have three big aspects. Number one, Starbucks brand, which obviously we can bring to any partnership. The second thing that they have is locally relevant recipes and we've gotten good at that with our stores and with RTD in places like Japan and Korea. And they have the right distribution partner. And so we're looking in markets like China for that right distribution partner. We're in active discussions on that if you will or research on that. And when we get that right we think there's an unlock there for CPG RTD as well.

Okay. So let's talk a bit about coffee. So coffee prices have been volatile if you didn't know that. And this chart really shows on the gray line what's happened with the C price. Then if you look at the green line, it's really our all-in coffee costs in our P&L. So it includes a differential for quality, it includes the curve as you buy out further, But you can see there that because we have a long position, our coffee prices lags a bit where the market is. And what we've done is, if you go back to the last coffee price spike, we were a bit shorter, quite a bit shorter than we are now. We were probably about six months price protected. So as those coffee prices moved, we had some ability to wait that out. But ultimately we had to buy and you can see what happened a little bit to our coffee costs.

Now if you go to the right. And I mentioned this earlier, we had about 200 million of aggregation in our P&L in 2012 from coffee prices and we actually delivered slightly above our guidance to the street. So there's a lot of things, a lot of levers within our P&L that we can use to offset, both on the growth side and on the cost side. So just keep that in mind. Coffee is about 10% of our total costs, So it's meaningful. But just to keep it in perspective, it's 10%. And what we've done this year as we headed into that price increase is we had about 15 months priced. So over the last four months or so as coffee has been up above $1.50, $1.75, $2.00, we haven't priced a lot of coffee. We've done some. But it's been pretty limited as we wait to see what happens with the Brazil harvest this summer. So we'll continue to watch that. If prices come down, they were at $1.70 today, if they continue to come down, then we'll look at buying and pricing out more of next year's coffee costs. We have all of this year, almost all of this year priced and about 40% of next year.

Capital allocation, I'm running out of time a bit, the only thing I would say is, over the last couple of years, given some of the uncertainty around the Kraft litigation, we did not return as much capital to shareholders around buybacks as we anticipate this year. So no committals. But one of the things that we've done is, what we're targeting is offsetting the dilutive impact around our stock based compensation program. So our equity programs go well down into our store base. Our partners in our stores get stock in Starbucks. And we're targeting repurchases that offset that antidilutive impact. Now that will be impacted by timing and stock price and cash availability. So that isn't a guarantee. But that's certainly something that we're targeting. Then we may selectively go beyond that. So you can see just by the run rate, we're at half a billion through six months and it's been just over a billion the last two years. So we're on a run rate to return a little bit more capital to shareholders as a result.

In closing, I'd just remind that coffee and our partners are our foundation and we continue to make investments in coffee forward things like Clover, Reserves and other things. We have multiple layers of growth opportunities and innovation is a core competency for Starbucks. The pipeline is full. Strong EPS and revenue growth, good cash flow, balance sheet and additional working capital opportunities. And we're well positioned for both short term and long term growth. And that's it.