Starbucks Corp Conference Call to Discuss Fiscal 2015 Financial Modeling

Company Participants

- JoAnn DeGrande, VP IR
- Scott Maw, EVP, CFO

Other Participants

- Andrew Charles, Analyst, BofA Merrill Lynch
- David Palmer, Analyst, RBC Capital Markets
- Jeffrey Bernstein, Analyst, Barclays Capital
- John Glass, Analyst, Morgan Stanley
- John Ivankoe, Analyst, JPMorgan
- Jonathan Komp, Analyst, Robert W. Baird & Co. Inc.
- Katherine Heng, Analyst, Buckingham Research Group
- Nicole Miller, Analyst, Piper Jaffray & Co.
- Sara Senatore, Analyst, Sanford C. Bernstein & Co. Inc.

Presentation

Operator

Good morning. My name is Chrissy and I will be your conference operator today. At this time, I would like to welcome everyone to the Starbucks Coffee Company's FY 2015 P&L modeling 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.

Miss DeGrande, you may begin your conference.

JoAnn DeGrande {BIO 2134543 <GO>}

Thank you, Chrissy. Good morning. This is JoAnn DeGrande, Vice President of Investor Relations for Starbucks Coffee Company. And joining me today is Starbucks CFO Scott Maw. The purpose for today's call is to provide a high-level overview of the upcoming impact to Starbucks financial statements following the acquisition of Starbucks Japan to help you with your modeling. You will recall we announced the acquisition on September 23. I'll make a few remarks and we'll then open the call to your questions.

We recognize that the estimated financial impact of this acquisition on the China Asia-Pacific, or CAP segment. And on our consolidated results is significant and that it is a complex transaction from a modeling perspective.

To facilitate today's discussion, late yesterday, we posted a document that summarizes the accounting treatment as we transition the accounting at Starbucks Japan into Starbucks financials from a joint venture structure to full ownership in fiscal 2015. It may be helpful for you to refer to that document during this call.

Since we just announced Fourth Quarter fiscal year-end 2014 earnings last Thursday afternoon, this call will be solely focused on the Starbucks Japan impact and not on the broader business. We anticipate this call will last no longer than 30 minutes.

Before we get started, I'd like to remind you that this conference call may contain forward-looking statements. Forward-looking statements are subject to various risks and uncertainties that could cause our actual results to differ materially from these statements and 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. Please refer to our website at Investor.Starbucks.com to find the reconciliation of non-GAAP financial measures referenced in today's call with their corresponding GAAP measures.

With that, I will now turn the call over to Scott.

Scott Maw {BIO 18637895 <GO>}

Thanks, JoAnn. Good morning everyone. I'm going to summarize briefly certain points we made on the Japan acquisition call in September and in last week's earnings call. This is to ensure we all have the same starting point.

Before I get into the P&L impact and modeling discussion, let me reiterate the significant growth opportunities that we see in Japan as a result of this acquisition. Starbucks Japan has been a very important market to us for nearly 20 years. And we have grown this market with the excellent support of our joint venture partner, Sazaby. Starbucks Japan stores have some of the highest operating margins in our global portfolio. Additionally, under full ownership, Starbucks Japan will have the opportunity to leverage Starbucks existing infrastructure and expand to multiple channels, including consumer packaged goods, or CPG, licensing and food service as well as introduced concepts such as Teavana. The ready-to-drink market is a good example of what lies ahead for Starbucks Japan as Japan has one of the largest and most penetrated RTD markets in the world and Starbucks share in that market is a fraction of what it is in the US.

Another example of opportunity is mobile, digital. And loyalty as Starbucks has yet to fully leverage the capabilities and breadth of our social, digital. And loyalty assets in this market. With its deep customer loyalty, Starbucks Japan has developed its own approach to the space, catering to local preferences and Starbucks is very excited to build on that.

Let me now move on to some of the transaction details. Starbucks and Sazaby League each owned just under 40% of Starbucks Japan with the rest held by public shareholders. The acquisition has been structured as a two-step tender offer and in the first step, which was completed October 31, Sazaby tendered its entire ownership to Starbucks for $511 million. Therefore, now with 79% ownership, Starbucks Japan will be fully consolidated into Starbucks Corporation's financial statements effective with our Q1 fiscal 2015 results for roughly eight weeks of this quarter with the remaining time using the preacquisition JV accounting treatment. The second tender offer will be complete in the first half of the year and the expected purchase price is approximately $410 million. Until the remaining minority shareholders' interests are acquired, their share of Starbucks Japan's earnings will be excluded from our earnings per share calculations.

As we stated at the time of the acquisition announcement, the majority of the funding for this transaction will come from our substantial existing offshore cash and result in minimal additional leverage. We expect the transaction to be slightly accretive to earnings in the first year when excluding the following amounts: a gain on the acquisition for bringing our pre-existing ownership interest up to fair value, which is estimated to be in the range of $325 million to $375 million; and amortization a significant acquired intangible assets and transaction integration expenses of approximately $95 million to $105 million. These are all pretax estimates and we will firm up the final amounts related to the gain and the amortization of the intangible assets in Q1. The gain on the acquisition will be tax-free and reduce our annual tax rate by 4percentage points and it will be accounted for below the operating income line on the consolidated P&L.

Transaction and integration expenses will be recorded in unallocated corporate G&A expenses. The presentation of these items is shown in the middle column on the summary document we posted to our website. The amortization of the intangible assets will be reflected as part of the depreciation and amortization line on the CAP P&L.

From a modeling perspective, it is important to note that, under the joint venture structure that existed prior to the acquisition, royalties in product sales are part of revenue and COGS. And 39.5% of Starbucks Japan's profit is reflected on the income from equity investees line. These items are noted in the left-hand column on the summary document.

Following the acquisition, the CAP segment margin is estimated to be in the high teens on a GAAP basis. Under the JV structure, our share of Starbucks Japan's earnings added to CAP operating income and royalties and product sales were the only Japan related items reflected in CAP revenue, a small amount compared to the over $1 billion in annual revenue from Japan store sales which we will expect to recognize this year.

The relatively small amount of royalties of product sales in combination with the income from equity investees results in operating margin in the triple digits from Starbucks Japan under the JV structure. Under the full ownership model, CAP operating income as a % of CAP revenue will result in a lower but very healthy operating margin percentage initially in the high teens but growing to the low 20% range over time, including an approximately 2% to 3% unfavorable impact from the amortization of the intangible assets.

As we stated on the earnings call, on a total Company basis, we expect Japan to add 6 to 7 points to revenue growth and operating margin on a GAAP basis will decrease slightly in fiscal 2015. On a non-GAAP basis, we expect operating margin to be flat to up slightly. Again, this margin is impacted significantly by the change in ownership and the amortization of acquired intangibles. And we expect to return to strong margin growth in 2016.

Japan will be our second largest market in terms of retail revenues. And we are very pleased with the profitability of the Japan stores, the economics of the market. And the overall high IRR on the deal given a significant growth opportunities I highlighted earlier.

With that, let me turn the call back over to the operator to begin Q&A. Operator?

Questions And Answers

Operator

(Operator Instructions) Jeffrey Bernstein, Barclays.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Great. Thank you very much. A couple of clarifications. The 1,000 units that are currently I guess JV-ed in Japan, at this point in the First Quarter or Second Quarter of fiscal 2015, we should just be backing those out of the licensed line into the Company operated line. Is that just based on the ratio of the ownership structure in terms of the two components of the tender? Is that how we should think about it from a unit perspective?

A - Scott Maw {BIO 18637895 <GO>}

Yes.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Got it. Then the income line, which is obviously the big driver, I think it's income from equity investees, how much of that should we assume that's within the CAP income line today is specific to Japan in terms of how we adjust for that? Is that the majority to the entirety or how much should we think about in terms of backing that out starting over the next quarter or so?

A - Scott Maw {BIO 18637895 <GO>}

It's the majority. We haven't identified it specifically. Obviously, in the First Quarter, you will get a pretty good idea of the size. But it's the majority of that line in CAP.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Got it. But otherwise, from a modeling perspective, I think you said it adds like $1 billion to revenue. The tax rate on a non-GAAP basis, I know you said 31% GAAP but we should be assuming more like 35% to the overall non-GAAP P&L for Starbucks Corporation?

A - Scott Maw {BIO 18637895 <GO>}

Yes. It's 31% on a GAAP basis with 4 points of impact from the acquisition gain. So that should give you the math to get to what's a non-GAAP tax rate.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

And ultimately the accretion to the fiscal 2015 guidance, do you size up what that is from an EPS growth or EPS contribution perspective?

A - Scott Maw {BIO 18637895 <GO>}

Let me frame it a bit for you. So if you go back to the guidance we gave in the Third Quarter, I guided EPS growth 15% to 20% but towards the lower end. In the guidance last week, I moved that up to the middle end of the range. And so if you do that rough math, Japan is going to add 1 to 2 points to EPS growth this year.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Got it, very helpful. Thank you.

Operator

Matt DiFrisco, Buckingham Research.

Q - Katherine Heng

Katherine Heng in for Matt. I just want to ask what's the full revenue from Japan. And what percentage of flow-through that you guys -- that we should be expecting? Is it in line with the degree of purchase per quarter? Then also I have a follow-up.

A - Scott Maw {BIO 18637895 <GO>}

So Japan will add over $1 billion to consolidated and CAP revenues in fiscal 2015. And that's 6 to 7 points of total revenue growth for the Company.

Then as far as flow-through, I think what we have given guidance on is the operating margin at the CAP level, which as you know is about 30% today. That will move into the high teens for 2015 on a GAAP basis. That has 2 or 3 points of negative impact from the amortization. And so if you take that into account. And we know that will grow over the next handful of years, what will happen to CAP on an adjusted basis is we'll be approaching the margin of where the Americas is today.

So if you look at the Americas margin today and you look at what CAP will grow to on a GAAP basis over the next few years. And you add back the 2 or 3 points from the amortization of intangibles, you start to get into the rage of where the Americas business is today. And obviously that's a great, big, highly profitable business. So the CAP model and the CAP margin is a significant profit driver for us. And Japan is a big part of that going forward.

Q - Katherine Heng

Then what kind of breakdown of revenue is from stores and CPG? What's your goal to grow CPG channel in Japan and what's -- I guess should we assume that the CPGs in Japan have a higher margin than retail as it is in the US?

A - Scott Maw {BIO 18637895 <GO>}

I think what I would say is, today, licensed store, food service and CPG combined in Japan are relatively small. The CPG business is a nice business and it's a profitable business and we have been growing that. But compared to the great big retail business, it's a relatively small portion.

If you look at the growth opportunities that drove the deal and the cash flows that drive the return, we see significant opportunities in those channels to unlock those growth opportunities given 100% ownership. So I think as we get into investor day and as we get into more of the specifics of the Japan opportunity over the course of the year and beyond, we can give more specifics on the size of the opportunity. But that gives you some general understanding of where we sit today.

Q - Katherine Heng

All right. Thank you.

Operator

Sara Senatore, Sanford Bernstein.

Q - Sara Senatore {BIO 16508078 <GO>}

Thank you. Just trying to understand the unit economics a little bit here, about $1 billion for 1,000 stores. So am I thinking about it right, AUVs of $1 million? And that's a little bit lower than what we see in the US or some of your best European markets. So I guess I'm just trying to understand. Is there an opportunity there? Is that a difference in ticket or transaction? Both?

Then the follow-up question is could you just talk about the complexion of the margin changes? I know you have a cost of goods component related to when you sell products to licensees. I always thought that was sort of lower margin. So if we are thinking about how the different line items on your cost structure change, I guess how should we think about cost of sales versus store operating expenses versus other? Thanks.

A - Scott Maw {BIO 18637895 <GO>}

Okay. Thanks Sara. So on the first part, the thing that I would just highlight is we've said over $1 billion. So we expect at least $1 billion of accretion from Japan and realize that we'll have a portion of the year that's under the old ownership model. So that's over $1 billion doesn't reflect all the retail revenues for 2015. So when you take all of that into consideration, the AUVs in Japan are actually quite close to what we are seeing in the US. So we see really strong transactions. We see really strong ticket in Japan. It is a very good AUV and highly profitable model for us.

I think maybe some of the math is giving us a little bit of wiggle room on the exact growth in the Japan market. So it will be $1 billion or more. And the fact that we're not getting the full annualization has impacted some of the math you're doing on the AUVs but they approach pretty closely to where the US business is.

As far as the margin, I'll take a shot at answering it. And you can let me know how close I get. So again, on an operating margin standpoint, both from a topline and an overall profitability standpoint, the Japan stores stack up quite well with all of our large markets across the globe. And so a lot of the economics and the drivers that you see in Japan look, at least on a total store operating basis, very similar to the US model.

Some of what's happening in the math year-over-year. And I'm not sure if this is where your question is, is just that the revenue that we do pick up in the JV model is just that product sales revenue. And so, if you will, the numerator of the margin calculation is quite low. And the denominator. So it's much less than 40% of the income. But we are picking up 40% of the income. So you have a -- the accounting picks up a smaller percentage of the revenue but 40% of the income and the math gets skewed. It doesn't really reflect I would argue the economics.

The other thing that happens is that royalty line, if you will, that's in that revenue is basically all margin. That flow-through on that is quite high, whereas the product sales has COGS against it.

Q - Sara Senatore {BIO 16508078 <GO>}

Understood, thank you.

A - Scott Maw {BIO 18637895 <GO>}

Does that kind of get it?

Q - Sara Senatore {BIO 16508078 <GO>}

Yes. I guess just the one point of clarification of you confirm product sales has GOGS against it. Does that tend to be lower margin than what I would expect to see at retail. So your food costs -- your COGS as a percentage to revenues when you sell products to your licensees is higher than when I look at your retail business or your restaurant, the cafes?

A - Scott Maw {BIO 18637895 <GO>}

I think the overall math for everything we do in a country in a Company-operated store and the margin on that versus just the product sales, that product sale margin is a little bit lower.

Q - Sara Senatore {BIO 16508078 <GO>}

Okay. Thank you.

Operator

Joe Buckley, Bank of America Merrill Lynch.

Q - Andrew Charles {BIO 16591426 <GO>}

This is Andrew Charles filling in for Joe. You answered most of my questions with the last question just about the economics as well as the margin flow-through. So thank you.

A - Scott Maw {BIO 18637895 <GO>}

Thanks Andrew.

Operator

Nicole Miller, Piper Jaffray.

Q - Nicole Miller {BIO 5884270 <GO>}

Thank you. Good morning. Obviously, nothing changes from the way you account for these stores from a same-store sales or comp perspective. But can you just walk through how the Japan comps are. And then how it looks from a price mix traffic standpoint currently. And then where you see opportunity? Is it more traffic weighted? Is it more mix shift weighted? Is it more price weighted in the future? Thanks.

A - Scott Maw {BIO 18637895 <GO>}

First, with the performance of the Japan market, over the last three years, they have averaged 4 points of comp in Japan. And we haven't split that. But it's been quite healthy comp growth given a pretty uncertain and pretty difficult market environment. I think if you look at our performance stacked up with others in our space in Japan, that 4% over the last three years is actually quite strong. I think we see opportunities to continue that. We'll obviously be looking at ways to grow that. But I think we are really happy with what we have seen in the Japan market from a comp standpoint and perhaps there are things we can do to accelerate that a bit.

Just on the way the technical way, if you will, of how comps work in Japan, just so we're all clear, today, -- or sorry -- under the JV method that comps were not included in any of our comp reporting. So we just report comps on our Company-owned stores. Starting in the First Quarter of 2016, those stores will be comp store sales. So the first year, the way the accounting works is they are not in the comp store base. So the definition of comp stores is they have to be owned and open for a year. So the first year, they will not be in the comp store base. I'm sure we will be giving either directional or specific color on how those stores are doing in our earnings call, just given the significance to the market. But just so we're all clear, CAP comps and Company comps in the FY 2015 timeframe won't include Japan and they will going forward.

Q - Nicole Miller {BIO 5884270 <GO>}

Thank you.

Operator

John Ivankoe, JPMorgan.

Q - John Ivankoe {BIO 1556651 <GO>}

Thank you. I'm going to ask a really basic question. And I'm sorry if I've just missed the point here. Have you guided to a China Asia-Pacific operating income in dollars in 2015, or as a percentage change versus 2014? Obviously, there's a lot of moving pieces in terms of timing. Japan is not the only market in the overall segment. There's currency that has changed, especially related to the yen. I think we've kind of talked about a lot of different pieces. But at least I haven't heard in terms of like what that actual operating income dollar number or % change number is for 2015, if you could help eliminate that.

A - Scott Maw {BIO 18637895 <GO>}

We haven't. But maybe I can shine a couple lights on it for you. The first thing I would say is if you look at our guidance that we gave last quarter with 15% to 20% EPS growth, towards the lower end of that. And the 1 to 2 points coming from the Japan acquisition. And so if you wanted to get an idea, however you were modeling CAP operating margin dollars before, you can get a pretty good understanding with that range what the change is from Japan. So I think if you go and do that math, take your existing model and add that 1 to 2 points of EPS growth, you'll be in the ballpark.

We have not guided to specific dollars by operating segment for some obvious reasons. But I think that if you look at the margin guidance we have given, plus that increment from Japan, plus what you already know about the business before the Japan acquisition, you should be able to get pretty close.

Q - John Ivankoe {BIO 1556651 <GO>}

Okay. That's fine. Thank you.

Operator

David Palmer, RBC.

Q - David Palmer {BIO 6061984 <GO>}

Good morning, guys. Scott, just a question for you, a philosophical one about guidance. Just thinking about the earnings growth that you've had in the last couple of years and the guidance that you have for this year, excluding coffee, the growth was 22% in fiscal 2013. And in 2014 about 14%. And this year about 15% excluding coffee in Japan.

So the question might be -- and people are wondering if Starbucks is really settling into a growth rate that is really midteens, or philosophically do you think Starbucks is taking these boosts from coffee last year and Japan this year and essentially using that room to reinvest to make the middle and higher end of the guidance possible, or still possible, in fiscal 2016 and beyond? Thanks.

A - Scott Maw {BIO 18637895 <GO>}

Thanks David. I think the first thing I would say is if you look at the 2014 growth rate on a non-GAAP EPS, it was north of 20%. I think it was 21%. And if you take that growth rate percentage and you back out the 4 points that we got from commodities, that puts you right in the middle of our range. And so we did deliver above the range this year. But coffee was a piece of that. And so we start with roughly neutral commodities this year, we're pretty confident in that. And you add a little bit perhaps around the middle of the range for Japan. And then you look at some of the investments that I called out.

In the First Quarter, I called out specifically marketing and a leadership conference that we had. But if you look at the whole year, I really pointed to some significant and important long-term investments that have a little bit of impact of that growth rate. We are not talking about a big impact. But they are investments that we think are right so that we can perpetuate where we are and where we could be both within the range and perhaps beyond.

And so when I look at things like mobile order and pay, there are some upfront costs to that. We think that's a big deal for us. When we look at things like partner investments. And Troy talked about Food for Partners and some of the things that we are doing on paid, we know the partner experience in our stores and Starbucks is the key differentiator for what we do. And so it's really important that, from time to time and ongoing, we lean in on those investments. So when you add those things together, coffee favorability going away, partner investments, that's what really moves us down into the middle of the range. And I would argue, given all of that and the size and everything that we have going on, I think that's really actually quite strong EPS and operating income performance.

Q - David Palmer {BIO 6061984 <GO>}

Really helpful. Thanks Scott.

Operator

John Glass, Morgan Stanley.

Q - John Glass {BIO 2450459 <GO>}

Thanks. Scott, just going back to the equity income line, last year in CAP was $164 million. Either could you tell us either one of two things? One is what exactly of Japan was in that line historically, or what was Japan's net income net of taxes or whatever the thing you're measuring. And then we can take 39.5% of that.

A - Scott Maw {BIO 18637895 <GO>}

Yes. We haven't really broken that line down. As you can imagine, we could get into a situation where we're disclosing all of our JV income pick-ups. And just given how some of the movements can happen in that as we go through time, that is something that's difficult to guide to. So Japan was a large piece of that. I think I said the majority before, I think it's the largest piece but not the majority. And so I think, if you think about that. And, again, you understand that that ultimately is going to go to zero, you'll get a good read of the size of it year-over-year as we get into the First Quarter. I think that's about all we can say.

Q - John Glass {BIO 2450459 <GO>}

But if I were --

A - Scott Maw {BIO 18637895 <GO>}

There's just a lot of things -- go ahead.

Q - John Glass {BIO 2450459 <GO>}

But Japan publicly reported that number, right? So if we just took their net income and took 39.5% of it, with that be the right way to do it, or is there some adjustment you make as you take out your royalties or something like that or --?

A - Scott Maw {BIO 18637895 <GO>}

There's adjustments we make, both from an accounting standpoint and also understand that it's on a completely different GAAP basis. Japan GAAP and US GAAP have some significant differences. So you're going to get a number that's different than what's in our financials.

Q - John Glass {BIO 2450459 <GO>}

Okay. That's helpful. Can you just also remind us what's the unit growth in 2015 plan or what was it in 2014 in Japan? Are there any significant CapEx needs in that market? Do stores need to be upgraded to the current formats? Is there an IT upgrade cycle that needs to happen? Is it material?

A - Scott Maw {BIO 18637895 <GO>}

So in 2014, I think we added in the neighborhood of 50 stores in Japan. You can see probably the exact number on the website. We haven't really talked about the growth rate for next year. I think probably starting with something in that ballpark is a good place. But we will get more specific as we go further.

What I would say is whatever we expect to open in Japan is in the CAP guidance that I gave around store openings last week. And there's some IT work to do. What I would say is it's not a significant amount integration work in general that we need to do. The integration costs that are in the guidance I gave are not a major portion of that. And the team there is operating extremely effective. We know them; they know us. Mostly it's business as usual. But there is a little bit of integration work that we will do just around making sure systems are aligned, we can get the numbers reported and all that. But not significant.

Q - John Glass {BIO 2450459 <GO>}

Thank you.

Operator

Jonathan Komp, Baird.

Q - Jonathan Komp {BIO 19126079 <GO>}

(technical difficulty). Apologies for that. If I could just ask one more question, Scott, going back to the recent operating performance at Japan. And really I just ask in the context of the difficult macro environment and then also just looking at the equity investee line in the Fourth Quarter for the CAP segment, that number was only up about 1% year-over-year. So could you maybe just reconcile and provide a little more context on the recent performance for the business?

A - Scott Maw {BIO 18637895 <GO>}

Yes. So if you look at the comp numbers of the overall profitability over the course of the year in that JV line, I think the results are quite strong. What I would say, even looking at the guidance that I gave, is the emphasis I would place on how the math brings the margin down. I think it's highlighted by the fact -- and I said this in the earnings call -- but if you look at the Japan market margin. So just the market level margin, sort of ignoring the JV and all the accounting, that margin will actually expand in 2015 at the market level. So we continue to see really strong core profitability, really strong revenue growth. And also, in the Fourth Quarter of 2015. And I mentioned this at a macro level in the earnings call, we did have an adjustment for the asset retirement obligation on certain of our retail leases that went through and favorably impacted that JV line in the Fourth Quarter of 2013. And so that's affecting the compare. And it's a meaningful effect on that compare that you are doing.

Q - Jonathan Komp {BIO 19126079 <GO>}

Got it. Thank you.

A - JoAnn DeGrande {BIO 2134543 <GO>}

Great. Thank you, all for joining us today. This concludes our call. Have a great day.

Operator

Ladies and gentlemen, this does conclude the Starbucks Coffee Company's FY 2015 P&L modeling conference call. You may now disconnect.