Morgan Stanley Global Consumer & Retail Conference

Company Participants

- Cliff Burrows, Group President, Americas, EMEA. And Teavana
- Troy Alstead, CFO & Group President, Global Business Services

Other Participants

- John Glass, Analyst, Morgan Stanley

Presentation

John Glass {BIO 2450459 <GO>}

Good morning, everyone. On behalf of the Morgan Stanley research team I would like to welcome you to this, our 16th Annual Global Consumer Conference.

My name is John Glass; I cover the restaurants. Over the next day and a half you are going to have an opportunity to meet many of my colleagues in research, as well as some of the leading consumer staples and discretionary companies in the world. In fact, just looking down today's schedule you will get a sense of the breadth of the conference starting with Starbucks this morning. But then quickly going to Procter & Gamble, luxury goods maker Michael Kors. And then Lorillard.

In between those presentations we are going to have a few of our own starting today at lunch our strategist, Adam Parker, is going to lead a panel including the analysts talking about best ideas as well as equity strategy. Later in the day there is going to be a panel on shareholder activism and finishing the day there is going to be a panel from our trading group talking about consumer trading.

We are going to end the entire day with a cocktail party at 5 o'clock somewhere out in the lobby out there. (Conference Instructions)

Let me quickly change hats and now make a quick introduction. I have had the pleasure of following Starbucks since nearly it's time as a public company. In fact, I keep still on my desk the initiation of coverage report that my predecessor wrote in 1992.

At the time, Starbucks at 140 stores in four states and one province of Canada. Had a market cap of $340 million and what was interesting was in that report it boldly stated that someday Starbucks would have 5,000 stores in the United States. One of the few times I think sell-side analysts have actually underestimated something like that.

Anyway, today we have got a couple of veterans of Starbucks speaking on behalf of the Company. Troy Alstead joined the Company in 1992 in finance. He was actually -- or 1991, 1991, early days. I think a very smart and wise move prior to the IPO and now is the Company's Chief Financial Officer.

In addition, we have got Cliff Burrows. He is the President for the Americas as well as Europe, Middle East. And Africa. And the Teavana brand which recently opened its first store in New York City. Cliff joined in 2001 and runs the UK business.

In addition, we have JoAnn DeGrande in the audience. She runs investor relations. As well as Greg Smith. So with that it is my pleasure to turn it over to Troy.

Troy Alstead {BIO 5724238 <GO>}

Thank you, John. Good morning, everybody. It is good to be here and, yes, I was hired in late 1991. So you are taking me back memory lane talking through that. I was either very smart or very lucky at the time. Hopefully, I was a little smart. But I think it was a lot of lucky to join the Company way back when I did.

Starbucks' heritage is in the Starbucks store. In fact, when I joined in the introduction you just heard that is really what Starbucks was all about was the store. Starting with a store like this in Seattle and a handful of other stores that back at the time, as you know, was only about the specialty coffees and fine teas and spices and coffee-making equipment from all over the world.

Today we have 20,000 stores in more than 60 countries all around the world, serving 70 million customers each week. And increasingly with a very strategic leadership position in at-home and away from the Starbucks store coffee.

Over the last four years in particular we been able to produce very strong and -- both strong and consistent levels of same-store sales growth quarter in and quarter out. That consistency of sales growth has been driven by product innovation, things like beverages.

Often new beverage platforms such as the Refreshers platform which we launched just a year ago. Hazelnut Macchiato, a new product innovation just earlier this year that was right in the heart of our espresso category and yet was highly innovative and highly incremental to the platform.

New product innovations which have been very hard-hitting and contributory to comp growth, as well as those returning favorites. Our best example that Cliff and I love to talk about is Pumpkin Spice Latte. We are celebrating its 10th year this year. It comes into the stores every year during the fall; goes back out again.

We are continually, frankly, even amazed internally at its ability to keep driving its proposition, comping over itself every year. And, frankly, how it has become one of those iconic products that many of our customers measure the seasons by.

When Pumpkin Spice Latte hits it is fall, when the red cup comes into Starbucks stores it is time to think Christmas. We have actually become, in many of our cases, some of those iconic products that really signal things in people's lives as we have become more pronounced.

Food has been a significant contributor, particularly over the past year, toward quarterly comp growth. And that is, by the way, even prior to the La Boulange rollout which we are in the midst of rolling throughout the United States today. As we have up-leveled food in the last two years, as we have heavily focused on food offerings that are very relevant to the dayparts we have driven very significant and meaningful study contributions incrementally from food in the system.

Our loyalty program has been a great contributor as well, really an umbrella to everything we have done. We have found a way with loyalty to engage and resonate with our customers in ways that perhaps no other loyalty program really has, given the frequency of that customer transaction and I think the natural loyalty people have to that Starbucks experience every day. And there is no question the loyalty program has contributed to a consistency of comp growth throughout this period of time.

Daypart expansion; while we have had very enviable, I would say, comp growth in all dayparts, even during our busiest morning dayparts, the midday and the afternoon, very consciously, very deliberately. And very thankfully have been stronger even in the morning daypart as we are stretching those dayparts progressively over time.

All of that is in enabled by -- and you will hear Cliff talk a little bit about this in just a moment. All of that has been further enabled by work to drive productivity in those busy morning dayparts, to move that line faster through technology, through procedural work, through lean processes, through work routines.

Our ability to lift the lid on what used to be constrained, busiest half hours in the mornings progressively continues. It has allowed us to drive productivity higher every year recently and it has allowed us to raise average unit volumes in our stores to levels that we don't really know what that limit can be now over time as we continue to innovate across the store.

We delivered another strong result in fiscal 2013 as you heard us talk about in recent quarters -- or in recent weeks. Revenue growth of 12% up to $14.9 billion. And while we have been driving revenue growth very steadily over the last few years in particular, expanding operating margin. 150 basis points of operating margin to that non-GAAP 16.5% margin in fiscal 2013.

On the strength of that top-line growth and that margin expansion we drove 26% growth in earnings per share to $2.26. We have drove earnings fourfold over this span of time, as you can see. And we have found a way through the strength of revenue growth and through the heavy lifting of continually squeaking out tens of basis points throughout the middle of the P&L at every opportunity we can to drive earnings growth consistently. Effectively double the rate of our earnings growth.

And that revenue growth has become increasingly diverse. Diverse by geography, diverse by business channel, diverse by daypart as I mentioned. And diversify product category.

In the Americas, we have produced revenue growth of 11%. That is by far our biggest business unit that we have. It continues to grow very steadily and consistently. In the Americas this strength of very strong same-store sales growth and a moderate pace of new store development as we go.

EMEA, which has been a more challenged part of the world for us, has been improving and we moved into positive comp growth as we moved into the back half of the year. And it is contributing once again to revenue growth for the Company.

Our channel development business, which is the business we are really planting the seeds for that future growth going forward, as we continue to aspire to and strategically go after an out-of-store consumption pattern, where we have historically been underrepresented and we see a tremendous opportunity. And I'll come back to that in a moment.

Then our China/Asia Pacific business, our fastest growing revenue business, a very healthy 27% revenue growth. That is driven both by a healthy same-store sales growth similar to the level we see in the Americas and then also in China Asia-Pacific really significantly contributed by an acceleration of new store development. Very accretive, high profit, high return on capital new store development.

Now while we have driven revenue growth, we have expanded margin. Each of our four operating segments contributed to margin expansion over the past year.

Again, the Americas the most mature. Already high profit, high-returning business for us and continues to drive margin expansion. Again, contributed by the sales leverage from that very strong comp growth and those elevating average unit volumes that we have across the US system.

Then, also as I mentioned, the great work around continually looking for tens of basis points of efficiency and waste management in the cost of goods line and the labor line throughout the P&L.

EMEA, not unlike what we have done in the last few years around transforming the US business if we go back to 2008 and 2009 and even into 2010. We are now in the last 18 to 24 months approaching EMEA with that same kind of fever around transforming the business and it is clearly paying off for us now.

As we grew margins every single quarter of fiscal 2013 we have reached again -- granted it's starting from a lower base. But a good improvement over the course of the year. And we exited the year in that Fourth Quarter with a greater than 9% operating margin in EMEA.

The path forward in EMEA looks bright for us. It will be a bit lumpy as we go through various initiatives of improving that business over time. But we are very pleased with the trajectory we have. We see a clear path for us to execute to move that business into the mid-teens and then progressively toward the upper teens over time. Well within our grasp to reach that over the coming couple years.

Channel development, the business expanded margins in fiscal 2013. That is the segment that we have that most benefits from the coffee tailwind. Our retail geographic segments have progressively, or proportionately less benefit or impact from coffee costs. But channel development takes the full benefit or brunt of that over time. And that is some of the benefits that you see on that margin.

Then CAP not only the fastest revenue growing business that we have. But also the highest margin business that we have in the Company.

Now just another moment about channel development. There was, as I go back all the way to what I started the presentation with, a point in our history where we were very content to be the world's premium operator of Starbucks stores, starting first in the US and then rapidly expanding all around the world. In recent years in particular, we have strategically set our sights on all that consumption of our core products in coffee and tea and those things that surround the coffee and tea and the coffeehouse experience outside of the store where there huge amount of global consumption and where we've always been underrepresented and undershared.

We are very excited to now strategically be going after that. We have had great success in it in these early days. To have gained a 13% share of the US at-home coffee market and growing. And that is heavily fueled by the leadership position we have quickly taken in the rapidly growing premium single cup business.

Now, our ability to take the Starbucks brand and our products and what we do and extend those outside of the Starbucks store happens because we build the brand that we build those experiences and we create that environment first through the store in any geography that we may be in. The stores not only set us up for the opportunity to then extend it into consumption at home and in the office and when people are traveling. But the stores by themselves are also very powerful engines of growth and profitability with growing AUVs, growing four-wall profitability, strong incremental capital returns.

Now speaking of stores, I will pause for a moment. I'm going to turn it over to Cliff Burrows, who not only runs the majority of our stores globally and has responsibility for those in the Americas and now in EMEA. He has been with the Company for a long time as you know and I think is also the leader with the longest title within Starbucks.

Cliff Burrows {BIO 6993941 <GO>}

Thank you, Troy. Good morning, ladies and gentlemen. It is a great opportunity to be here.

I have been at Starbucks for 12 years. Started my career in the UK for five of those years, moved over to take responsibility for Europe, Middle East. And Africa. No sooner had I got there than I was requested to come to the US and run the US stores. I started that in the beginning of 2008 and it has been an amazing journey.

In recent years I took on and expanded role to cover the whole of the Americas and six months ago picked up EMEA again and our latest brand, Teavana. There are lots of similarities around the work. There is lots of points of leverage, particularly around the people and the operational approach to that work.

Delighted to be here today in New York. New York is one of those places that has been incredibly good for Starbucks, has been very kind to us over the years.

Now a lot of exciting things are happening in Starbucks today. And all the time when we are introducing this new ideas, new innovations, new programs my primary responsibility is to make sure that we can handle it in our store environment and also that it enhances the customer experience.

We have done a lot of work over recent years to simplify the work to make it much more consistent. And also invested a tremendous amount of money in our stores, hundreds of millions of dollars, to make sure they stay relevant and they can keep pace with all the things we are doing.

At the same time very, very focused that we need the people, we need the partners in the stores to be able to deliver and to manage all this change. So that has been my primary focus over that time.

We also know that the customer really appreciates and is very focused on the friendliness of the store partners; the taste of their beverage and it's made just the way they like it. And also it has to be fast enough for them. So respecting their time and focusing on speed is really important.

Just trying to get that whole balance, which is the Starbucks experience, for us. And we know the quality of everything we do has to match the quality of the beverage, which has been a driver of our business for so long.

We have also focused in recent times on our growth and we know it all starts with the stores. We know we have an opportunity for more stores and all the opportunities in the four walls with the new innovations make me really excited about the growth. They also make me not only confident about the four walls. But about the opportunity to continue to grow.

We always get asked the question, is the US near saturation. And the answer is very simple -- not at all; we are not even close. Last year we opened 512 new stores in the US.

The darker green dots are the stores without drive-throughs. So you can call them cafe-only. And you can see how widely they are distributed around the country. The light green dots are our drive-through. More than 65% of the new development last year was in drive-through and that has presented a big opportunity for us.

Not everyone knows it -- we describe this as a company-owned market -- but we have a third of our stores are licensed. We obviously prefer to own and run and operate our stores. But we recognize that through channels, whether it is grocery or through captive channels such as airports, we have to partner with people. And more than 4,000 stores are in that licensed area and more than half of our stores opened last year were in the licensed business. But the customer really tells us that access and convenience is what is most important.

Now investing in the stores is not only in the new stores, it is about renovations. It is about investing in new technologies. And I will just talk for a moment about drive-through. We have focused on improving the experience.

The drive-through is something that we had. But it wasn't something we really focused on. We have seen from best to worst, a huge opportunity to improve it. To study what the best in the industry is doing has also helped us increase the experience, enhance that experience and increase the throughput.

Sure, drive-throughs are more expensive by the nature of the site. They cost us more. But we get a significant improvement in the profitability of drive-throughs. They are about 25% higher in average revenues and they produce a good margin for us.

We have now got a pretty major program going on over the next three years, which will be an investment in the physical space and technology to enhance that experience. What you will start to see is live. And I think the highlight of this is the live face-to-face video conversation that can take place between the customer in the car and our barista who is serving them. They will also be able to use their mobile devices to pay for the orders. And we think all of that helps enhance the experience for the customer.

So a lot of new opportunities for us. The focus on the remodels in our stores, as I say, we have focused on keeping those stores relevant. It has always been about location, it has always started with the stores but we have kept pace.

And I think you will see we have moved away very definitely from the historical cookie-cutter approach. Each store we make it locally relevant to the customer. We try and use local materials and all of that is designed to enhance the experience for the customer.

About 3,000 stores have been renovated, either minor or major, over the last two years. Now when we do a renovation we have already built in the cost of that renovation for a minor -- and a minor I would describe as a coat of paint, replacing damaged furniture, to repair just keeping the store in good order. And that happens usually every five years.

Every 10 years we do a major renovation, which is really putting the store back together to deal with the many hundreds of customers who come into the store every day. We don't expect to see a significant uplift by staying relevant. We do want to make sure as the portfolio ages it does not look like it is aging.

Where we do a significant enhancement, increased space; put in an extra number of seats. Where we change a configuration to improve flow, or where we are putting something like Clover as an addition then, sure enough, we see an improvement.

Now the store and focusing on what we offer the customer is really important. We have talked a lot about La Boulange. But food has been a growing part of significance over the last decade.

Our journey started with really enhancing and introducing breakfast sandwiches into our stores and they resonated with our customers. We have changed ingredients over time to be much more natural, cleaned up those ingredients. We have brought in oatmeal, which was a great addition, a very simple product to come into our stores. And it enhanced the ticket; it enhanced the opportunity for the customer.

Food is important and we have got to deliver great quality food. In recent months and over the last couple of years we have introduced salads, we have introduced lunch, which has given again a much greater opportunity for the customer to access the food they want. But just over 12 months ago we started to introduce La Boulange.

La Boulange starts with great quality ingredients. We have taken a point of view on food and so far we have rolled out over 3,500 stores. We have put in not only great food in the stores, we've also put the backend, which is manufacturing; we have put in the distribution; we have put in the logistics to be able to deliver those products to store in a way that they are freshest, in a way that they can be served with pride to the customers. And also help us control wastage while we grow our sales. So we see huge benefits there.

We do see that we can move this needle to the mid-20s over time. But you can appreciate we are not going to slow down the beverage sales to wait for food to catch up. So this is going to be a convergence over time.

Biggest single opportunity building up a quality bakery is lunch. We have a very, very small participation in the lunch market which is huge. So if we can introduce food that is relevant, start to build a reputation for it, that combined with the innovations around tea, the innovations around carbonation, around Refreshers, all helps us, hopefully, build a second peak to match our morning daypart.

Troy talked and I will just talk briefly about the productivity over time. If you look back to 2008, you would have seen this eight transactions per labor hour. We base it on transactions. So when you add food in it increases ticket. But we still expect and we still find ways to improve our productivity over time.

We will see this continue to grow. It is not only looking at how we do our work, how we construct the beverages, how we put in the back bar to help support the sale of food. All of that, plus lean principles and the investment we make in training our partners, is all helping us to grow that productivity.

I have a real passion for retail. I have a passion for service. I have a passion for merchandising. But I think one of the most significant changes over time has been our relationship with our customers through the Starbucks card program, through the My Starbucks Rewards. And more recently through the digital ability to pay and track the card and track the whole program.

We are seeing reloads on the card in the last 12 months, 3.7 billion on the My Starbucks Rewards and the Starbucks card program. We have also seen that reloads have grown 70% over the last few years.

More than 6 million people are active members on the card program and 4 million are at gold level, all of which bodes exceptionally well. One in three of our transactions is paid for by the card or My Starbucks Rewards. And we know in the US about 23% comes from our most loyal MSR customers. And I think that growth in digital is just the beginning.

The customer adoption; despite age, despite confidence with technology people are using it as their way into technology. So we have a lot of exciting stuff and not least is what happened on 85th and Madison. We opened just over four weeks ago -- just over three weeks ago, I should say, our first new store.

We acquired Teavana, which is a mall-based business based on retail teas and merchandise, that will carry on. This Teavana store is the first of many and it brings together the Teavana expertise around tea and merchandise, Starbucks' ability to create a fantastic environment and now start to create beverages which we hope will become a tea ritual to match our coffee ritual over time. Imagine what we could do in tea if it is anything like our coffee journey. And you heard the very early days how small we were.

So we are really excited about the opportunity that we have in tea. Tea today is only 8% of Starbucks' store business. Again, we think with Teavana in our portfolio it gives us a huge opportunity to grow that segment to complement what happens around coffee.

And I think finally just to wrap it up; we recognize we are adding more into the stores. We are so proud of the people who work for us, the 200,000 partners every day who put on the green apron. They are committed, they are passionate, they are dedicated to what they do. And without them it would not be possible. So we owe them an enormous gratitude of debt.

Thank you for your time today. I'm going to hand it back to Troy to finish off.

Troy Alstead {BIO 5724238 <GO>}

Thank you, Cliff. Back in 2008 and 2009 when we, under Cliff's leadership and particularly in the US, took a step back and restructured and transformed the business in many ways. And changed the Company from what had been a rapid growth company for many, many years to what again is a rapid growth company but in a very different way today.

Today we are rapidly growing and heavily focused on driving same-store sales throughout the stores by leveraging that existing asset we have, by growing through dayparts, by extending product offerings that still is relevant and core within that Starbucks experience. We are driving growth and geographies. We are driving growth in categories. We are driving growth in channels of distribution.

And while we have returned the Company now firmly into a growth mode, much more diverse and much healthier than ever before, we have also implemented all throughout the Company levels of financial discipline like we never had previously. That enhanced capability and financial discipline has allowed us to consistently deliver strong financial results in fiscal 2013 once again with revenue growth of 12% and 150 basis points of margin expansion and very strong earnings growth. It also gives us confidence in fiscal 2014 and the years ahead in our ability to drive continued, disciplined growth and enhanced bottom line.

Once again in 2014 we are expecting double-digit revenue growth driven by mid-single-digit comp growth and 1,500 net new stores around the world. We also expect at least as much margin expansion in 2014 than we just delivered in 2013. We delivered 150 basis points of expansion in 2013.

We anticipate somewhere between 150 and 200 basis points of margin expansion in fiscal 2014. That revenue growth and that margin expansion contributes to our EPS range of $2.55 to $2.65 with some offset in there a bit due to a higher tax rate that we anticipate in this current fiscal year as well as higher interest expense.

Now just a brief comment about coffee. Consistent with what we've been saying for quite some time, fiscal 2014 we expect another year of coffee tailwinds. We have virtually locked all of our coffee needs for 2014 at prices that will lead a net $0.09 to $0.10 benefit to the P&L this year.

It is a gross coffee benefit, less some investments in the business, part of which is and single biggest of which of those investments is the price reduction we took in our CPG channel this past year, passing along some of that coffee benefit along to the consumers.

In fiscal 2015 we do not have much buying at all having done yet into 2015. But given where the market is at today, we would anticipate another year of tailwind in 2015. It will not be as high as 2014. The peak, we believe, on our P&L is 2014. 2015 will be a tailwind. But not quite as high.

There is a couple of reasons I should point out for that that I think sometimes are lost, one of which is where the seed price is trading at today is, frankly, too low. It is below the cost of production in some of the growing regions and in some countries around the world. As we have done for decades, when coffee falls to that level we have got a commit to our farmers to pay them what it really takes for them to grow their coffee so that they can make a living and sustain what they are doing.

So as the seed price falls further we will benefit not at all from the seed price falling. In fact, we are not fully benefiting from where the seed is at today given that we will support our farmers with incremental payments to make sure they can do the right thing. We are in this for the long game. We are going to take care of our farmers and the process. It is something we have done for a long time and are committed to.

One other element that is important to recognize is, as we buy 300 or 400 million pounds of coffee every year and roast and sell that, a fair amount of that we roast and then sell on to licensees around the world who operate Starbucks stores and our food service partners. Where we do that, all that benefit of the seed price reduction passes along to the licensee. So on that 300 or 400 million pounds that we roast not all of that reduction in price that we generate from year to year shows up on our P&L, some of it goes to the benefit of our licensee or food service partner.

We have been committed to and remain committed to investing into the growth opportunities in the future and then balancing that at the same time with increasing returns to shareholders over time.

In the last handful of years in particular, while we have grown the top line, while we have expanded margins, while we driven earnings faster than revenue growth. And while, importantly, we have been investing into the business in heavy ways -- investing in our people, in our capability, in our infrastructure, in a few acquisitions here and there, investing in planting the seeds of growth for the future -- at the same time we have significantly increased our return on capital as a company, tripling that rate of ROIC over the last several years.

In fiscal 2013 reaching above 24% and we believe we can continue expanding ROIC from year to year as we go from here by virtue of driving growth. And in many cases a less capital intensive growth going forward.

We have also been committed to increasing returns to shareholders. We delivered $1.2 billion of cash back to shareholders in fiscal 2013.

With respect to dividends, we are committed to growing dividends over time, as we have in the past years. Dividends have grown as earnings have grown. But we have also recently expanded and elevated the top end of that targeted payout ratio range. And that elevation of that range just reflects the fact that we have a very strong balance sheet, strong predictable cash flow generation. We have got a business that can afford to continue to deliver consistent and growing dividends over time.

With respect to share repurchases, we think about repurchases in two ways. The first priority of our repurchase program is to offset the dilution that comes from our very broad-based equity programs. Since we are a privately-held company we had stock options that went out to part-time baristas in our stores and we continue to have that equity program today.

First target is to aim to buy enough back in a given year to offset that dilution and at least hold the share count even. Beyond that then, where market conditions are appropriate and where we think it is right, we will be in the market and take some additional shares off the table from time to time. In any event, I would anticipate that over time we will elevate both dividends and share repurchases.

We have a very strong, very healthy balance sheet. Healthy and predictable cash flow generation, both operating cash flow and free cash flow. A conservative balance sheet in the fact of relatively little debt.

We have recently completed a $750 million debt offering. We did that in advance of knowing the arbitrator's decision. But we wanted to take advantage of market conditions at the time. So that $750 million that we placed recently of 10-year notes was at the low end of our financing range that we were looking for. But we went there, again, wanting to take advantage of the conditions at the time.

We will now, as I discussed last week, issue another $750 million sometime soon to top off that recent round of financing. The next upcoming $750 million will be in the shorter end of maturities.

Then just to wrap it up, I would say I hope you have heard from Cliff, you have heard from me, we feel like we are phenomenally well positioned to move forward from here given our responsibility in the business, our coffee leadership, our global footprint, this powerful flywheel we have created between the brand experiences in the stores, enhancing that with the digital connection to the customer. And then leveraging that into the out-of-store huge opportunity that we have to build going forward.

We are positioned with a healthy balance sheet, a strong P&L. And an ability to continue to drive growth going forward.

With that I will stop. Thank you for your time this morning and we will go from here. Thank you very much.