

Starbucks to Acquire Starbucks Coffee Japan, Ltd.

Company Participants

- Howard Schultz, Chairman, President and CEO
- JoAnn DeGrande, VP of IR
- John Culver, Group President, CAP, CD & Emerging Brands
- Scott Maw, CFO
- Troy Alstead, COO

Other Participants

- Brian Bittner, Analyst, Oppenheimer & Co.
- Jeffrey Bernstein, Analyst, Barclays Capital
- Jonathan Wing, Analyst, Sanford C. Bernstein & Company, Inc.
- Keith Siegner, Analyst, UBS

Presentation

Operator

Good afternoon, my name is Kyle. And I will be your conference operator today. At this time, I would like to welcome everyone to the Starbucks Coffee Company's call.

(Operator Instructions)

Thank you. Ms. DeGrande, you may begin your conference.

JoAnn DeGrande {BIO 2134543 <GO>}

Thank you, Kyle. Good afternoon, this is JoAnn DeGrande, Vice President of Investor Relations for Starbucks Coffee Company. And I would like to thank you for joining us to discuss Starbucks' announcement today on the agreement to acquire Starbucks Japan.

Here with me to discuss the announcement and the strategic rationale behind it are Howard Schultz, Chairman, President and CEO; and Troy Alstead, Starbucks' Chief Operating Officer. Also here with us for Q&A is Scott Maw, CFO; and joining us on the line from Tokyo, John Culver, Group President; China/Asia Pacific, Channel Development and Emerging Brands. Following prepared remarks, we will open the call to your questions.

Before we get started, I would like to remind you that this conference call may contain forward-looking statements. Forward-looking statements are subject to various risks and uncertainties. And 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 the Form 8-K filed today. And 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, or to the Starbucks newsroom at news.Starbucks.com for the related press release. Additional documents related to this acquisition will be posted this afternoon on the investor relations website. With that, I'd now like to turn the call over to Howard.

Howard Schultz {BIO 1432255 <GO>}

Thank you, JoAnn. This is an historic day, as we begin the process of acquiring full ownership of Starbucks Japan.

In so many ways, the history of Starbucks International's business and global footprint, which now extends to more than 21,000 stores in 65 countries, is tied to our first store in Japan. In the summer of 1996, I flew to Japan to join our new joint venture partner, Sazaby, to open our first store in Tokyo's gleaming Ginza District. I will never forget the lines around the block, that our very first customers formed in anticipation of their first taste of our coffee and the unique Starbucks experience, that until that day was limited to North America.

The importance of Japan to Starbucks in 1996 is even more impressive today, because the foundation of all of our partnerships is based on the trust, confidence, transparency and friendship that we have built with Sazaby and our Starbucks Japan partners. Our partnership began when Yuji San wrote me a handwritten note and delivered it in person to my office, about his vision for Starbucks in Japan, a letter which I still have. I am deeply grateful to Yuji San, Mori San. And (Jun) San, for their vision, partnership and their leadership.

Their efforts, along with the dedication and pride of tens of thousands of Starbucks partners in Japan over the past two decades have established an admired brand. And delivered the strong financial results that have made Starbucks Japan a meaningful contributor to Starbucks' growth and profitability in our China and Asia Pacific segment. All of us here at Starbucks are extremely grateful for the bedrock of values and loyalty that has been established with our partners and customers throughout the country of Japan.

In the coming months, we will continue to build on the foundation of trust we have achieved in Japan. We will continue to invest in our partners and enhance the experience we provide our customers, to facilitate enhanced growth and development. We will do this by staying true to our core values. And through the lens of taking care of our people, delivering the highest quality coffee and innovating in product store design. And the digital and mobile experience.

I'd like to thank our partners throughout Japan, who consistently have delivered the Starbucks experience for our customers each and every day. Through their hard work, passion and dedication they have helped to establish Starbucks as one of the most trusted and admired brands in Japan. To all of them, I say thank you.

Now let me turn the call over to Troy, to speak about the specifics around the transaction. Troy?

Troy Alstead {BIO 5724238 <GO>}

Thanks, Howard. We are extremely excited about expanding our ownership in Japan for many reasons. But there are two critically important points to underscore. First, this transaction will be immediately accretive, starting FY15 on a non-GAAP basis, when excluding a gain and certain expenses and amortization related to the acquisition.

Second, we will be positioned to accelerate growth in a market that offers tremendous opportunity for us. With this acquisition, Japan will become our second-largest market in terms of total annual retail store revenues, with approximately \$1.2 billion in revenues. And the fourth largest market in terms of store count. We will have approximately 25,000 partners. And we are excited to continue to build on strong positive comps, which have averaged approximately 4% annually over the past three years.

We believe this acquisition puts us in an even stronger position to elevate the Starbucks experience for customers and partners. We will also create a variety of growth opportunities to provide first-year earnings accretion for shareholders on a non-GAAP basis, which will also increase over time. I would like to take you through a quick recap of what led to this decision. And then I will discuss the key aspects of the transaction.

There were 1,051 Starbucks stores in Japan at the end of the Third Quarter, which currently operate under a joint venture agreement between Starbucks and Sazaby. Together, Starbucks and Sazaby introduced the coffeehouse experience to our customers in Japan. And we are very proud of what we have accomplished together. Sazaby has always recognized the importance of innovation and growth as key drivers of our ability to elevate the Starbucks experience.

We also recognize that to continue to position itself for future success, the business needs to keep pace with the dynamic nature of the Japanese market. Sazaby decided to exit the business ahead of the expiration of their rights under the joint venture agreement, in a manner that provides for a smooth and seamless transition for customers, partners and shareholders.

Full ownership in this market is the right approach for the future. We know this business deeply. And we have been involved in it at every turn, for nearly two decades.

The Starbucks Japan leadership team is very strong and stable. They know our brand, our business, our customers. And they have consistently and successfully tailored product and services to local tastes. We also know them well. And we have full confidence in their future performance.

Relative to our global portfolio, store-level profit margins in Japan are among the highest in the world, driven by high transaction counts and average ticket. Our business model in that market has been proven to be very resilient, even though Japan has had periods of macroeconomic difficulty. In addition to strong financial results, Japan has provided lasting benefits to the entire portfolio in a variety of ways, from playing a key role in our global expansion, to being a center of excellence for beverage innovation, store design. And an unparalleled store experience.

This is a key market for us, in terms of strong brand loyalty, deep trust. And local relevancy and presence. Our coffee leadership and expertise has an established position in this market. You may recall that we opened our first international Starbucks Reserve store in Japan.

But what we are most excited about is that with full ownership, we will be able to grow the business at a faster pace. And expand our business beyond our retail stores. This acquisition also provides us the opportunity to leverage our existing infrastructure and expand to multiple channels including CPG, licensing. And food service. Further, Japan has one of the largest and most penetrated ready-to-drink markets in the world. And today, our share in that market is a fraction of what it is in the US.

Additionally, the Japanese tea market is well-established and mature, which plays very well into our longer-term strategy for our Teavana brand. Tea is an important component in the Japanese culture. And we are excited to bring the full breadth of Teavana's premium teas and unique teahouse experience to our Japanese customers over time.

Another area of opportunity is mobile, digital. And loyalty, as we have yet to fully unleash the capabilities and breadth of our social, digital. And loyalty access in this market. With the deep customer loyalty this unique market has developed its own approach to this space, catering to local preferences. And we are very excited to build on that. We will be also able to leverage best practices from our global supply chain operations, research and development. And store development.

I'll now walk through key aspects of the transaction. Currently, Starbucks and Sazaby each own approximately 39.5% of Starbucks Japan shares. And the remaining 21% is held by public shareholders. This acquisition is structured as a two-step tender offer under Japanese law.

In the first step, Sazaby will sell its entire 39.5% ownership to Starbucks, for approximately \$505 million. After the first tender offer step closes, we will own

approximately 79% of the outstanding shares of Starbucks Japan.

We will then launch the second step in the tender offer to acquire all the remaining outstanding shares. The price for the second step of the tender offer is approximately \$409 million. Following the completion of the second step, any remaining public shareholders will be cashed out at the second step price. Starbucks will have full ownership of the business after remaining shareholders are cashed out.

In terms of the timing, we're expecting the first step to be completed by the middle of the First Quarter in FY15. And the final step should be completed in the first half of calendar 2015. The majority of the funding for this transaction comes from our substantial existing offshore cash. And will result in minimal additional leverage. We expect the transaction to be slightly accretive in the first year, excluding a gain on the acquisition, amortization of significant acquired intangible assets. And acquisition-related expenses. We expect this accretion to build over time.

We will discuss further details about the financial impact of the transaction when we report our Fourth Quarter and FY14 results in late October. As I mentioned earlier, we are very excited about this acquisition, because of its immediate profitability. And the multiple opportunities for accelerated growth. This is the start of a new chapter in our international growth strategy. And we look forward to sharing with you the opportunities and progress as they unfold.

Echoing Howard, we are sincerely honored and grateful to Sazaby for their nearly twenty-year partnership. I personally was part of the Starbucks International business 20 years ago, when we first formed our partnership with Sazaby and established Starbucks Japan. And I had the opportunity and honor to work directly with Yuji Tsunoda and his team, as we laid the foundation to bring our first store to Japan in 1996. Their contribution is enduring. And it will always be an integral part of the Starbucks experience.

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

Questions And Answers

Operator

(Operator Instructions)

Your first question comes from the line of Sara Senatore from Sanford C. Bernstein.

Q - Jonathan Wing {BIO 17600921 <GO>}

This is Jonathan Wing in for Sara. Just a question about the dynamics of the coffee market in Japan. Not typically conceived as a high-growth market. But maybe just describe the opportunities. And see with them, how you think about prioritizing

those. And again, in the context of does it change Starbucks' longer-term growth algorithm? Thanks.

A - Troy Alstead {BIO 5724238 <GO>}

I think this is a good opportunity to ask John Culver, who is dialing in from Tokyo, to take that question. John?

A - John Culver {BIO 15817924 <GO>}

Thanks, Jonathan. First off, the dynamics of the market are such that this is a very large coffee market. And in particular, as it relates to brewed coffee. When you look at the amount of brewed coffee we saw in our stores, it's some of the highest amount of brewed coffee that we sell anywhere in the world, in line with what we see in the US.

But beyond that is the fact that we have been able to build a footprint of over 1,000 stores, which is a national footprint, which next year we open our final prefecture in Japan. With that, we see opportunity to continue to grow the retail store footprint, particularly around drive-through, which we feel is a big opportunity. We also feel that there is a big opportunity to continue to accelerate the growth beyond the retail stores and channels. So with the ready-to-drink business, where we only have a 2% share of the RTD coffee business here.

Then also, beyond that, is to leverage our digital and mobile assets in Japan, to drive customers both into our stores as well as into channels outside of our stores. For us, we have been able to build a very respected and admired brand, the leading brand in Japan. And we feel very positive about the opportunity to continue to leverage that and grow well into the future here.

Q - Jonathan Wing {BIO 17600921 <GO>}

Thanks.

Operator

Your next question comes from the line of Jeffrey Bernstein from Barclays. Your line is open.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Just actually two quick questions, one, I am wondering if you could just clarify, I think you said no impact to FY14 results, modestly accretive to FY15. And I'm just wondering whether that was incorporated in your initial guidance you provided in July, to meet with the lower end of 15% to 20%? My main question was, if you could just give some insight. And it has been very impressive, Japan's resilience despite the challenging macro that you mentioned, I'm wondering if you give any current update on those trends?

I think you said 4% of the last three years in Japan on average. But has there been any change in trajectory? It seems like a lot of your multi-national peers have talked about significant softness in those regions. And I'm just wondering if your Japan business is holding up better than those. And to what you attribute that to? Thank you.

A - Troy Alstead {BIO 5724238 <GO>}

Thanks, Jeff. I'll let Scott speak to the financial question. And then John can address the recent comp trends and how we might speak about that.

A - Scott Maw {BIO 18637895 <GO>}

Any accretion from the Japan deal was not included in the guidance we gave last quarter. So we'll update the FY15 guidance as we get into our call next month. John?

A - John Culver {BIO 15817924 <GO>}

Jeffrey, I think for us, what we have seen over the last 18 years that we've been operating stores here, is that we have been able to navigate the macroeconomic environment very well here in Japan, through both the ups and downs, on an external basis. What we have delivered is a business model that, as I said, now encompasses over 1,000 locations.

It has got some of the highest transactions anywhere in the world. It averages high ticket for us, compared to other markets we operate in and when you look at the store margins, the store margins are in that low 20% to 25% range.

For us, we feel that we are in a very good position to navigate any of the macroeconomic uncertainties. And more importantly, we have used Japan to drive innovation, both here in the market. But then also bring innovation from Japan on our store designs and on product innovation into other markets that we operate in. So Japan for us is a very strategic market. And as I said, our brand here is very strong and healthy. And has become a much beloved brand from a customer and partner perspective.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Thank you.

Operator

The next question comes from the light of land of Brian Bittner from Oppenheimer. Your line is open.

Q - Brian Bittner {BIO 17258322 <GO>}

Congratulations. When you talk about the growth opportunity, can you just give us a little bit more on the numbers side of that? How many stores you plan to open per year over the next couple of years. And when you think about where you could get to there in Japan, from the 1,000 you're at today, how do you think about that? Then

just a second question is you talk about the restaurant level margins, which are obviously very impressive, what does it look like on an EBIT margin basis? If you could provide us any commentary on that, that would be helpful as well.

A - Troy Alstead {BIO 5724238 <GO>}

Brian, in terms of specific growth targets for the next year or two, we're not going to speak to those today. We will certainly talk more about that as we approach our October earnings call. So we will give you a bit more details on both of your questions, both how we think about growth going forward, as well as EBITDA margins and otherwise, as appropriate. What I will say for today is just underscoring what we said earlier.

This is a tremendous opportunity for us. We believe it will accelerate growth. With more than 1,000 stores in Japan now, we are nowhere near done with the retail store development.

But very importantly, this accelerates and opens up increased opportunity for us for our portfolio of brands for other channel development in ways that we haven't even begun to explore yet. So there's no question for us, this gives us an opportunity, both on the store growth side of things. But also developing our brand more meaningfully in Japan. And the impact again, to specific margins, we'll talk about we get to the earnings call.

Q - Brian Bittner {BIO 17258322 <GO>}

Okay. And if I could just follow-up with one last quick one, is there any reason for the big difference in the valuations attributable to both of the tranches that you're taking out?

A - Troy Alstead {BIO 5724238 <GO>}

Scott?

A - Scott Maw {BIO 18637895 <GO>}

Yes. If you look at the structure, we have obviously different values for the Sazaby piece. And for the public piece. When we look at those in total, we are very confident that the value that Sazaby's getting, given their significant stake and what they have added to the business, plus what we're paying on the public shareholders, we think all of the parties involved are getting a great value and a great deal. And we're really happy with what that means for us for a total return basis, as we look forward. But it is common and appropriate, given the ownership structure, for those values to be done differently.

Q - Brian Bittner {BIO 17258322 <GO>}

Okay. Thank you. Congratulations again.

Operator

(Operator Instructions)

Your next question comes from the line of Will Slabaugh from Stephens.

A - Howard Schultz {BIO 1432255 <GO>}

Are you there, Will? While we're waiting I will add some thoughts with the issues of growth. Obviously, of all the international markets I can think of, given our almost 20-year history and the fact that we have been an owner of this market, although not a majority owner, have been deeply, deeply, involved in a sense in co-managing and being a steward of the brand with Sazaby for almost 20 years.

All during that time I think we have marveled at the high transaction count, as well as the fact in every region we have opened in Japan, without exception, we have been accepted, we have been relevant. And we have been successful. The analysis we have done is that we are understored in that market given the high transactions and the size and scale of the population. And the trust and affinity with the brand. Coupled with the fact that, as Troy mentioned in his remarks, of all the markets in the world, the RTD, ready-to-drink, market and the vending market, specifically in Japan, which really has kind of created an industry unto itself, we have not had the kind of distribution. And certainly the 2% share, we think that is a de minimis number, given the equity of the Starbucks brand.

The last thing I say is the number one retailer in Japan. And perhaps the most respected person in all of retail in Japan is Mr. Yanai from Uniqlo. And when Uniqlo was getting ready to open up their flagship store in Manhattan on 54th and Fifth Avenue, he came to this office and sat down with us. And said he wanted the honor as a Japanese citizen coming to the US of having Starbucks in his store on Fifth Avenue.

Given the fact that Uniqlo represents a global footprint around the world. And is a fast-growing company in Japan, obviously. And we have no stores with Uniqlo in Japan, that is just one single opportunity that I would highlight. I'm not overstating the fact that we're going to be in every store. But it is a tremendous vote of confidence that someone like Mr. Yanai came to us and said, he wanted Starbucks in his flagship store in New York. And he is the number one Japanese retailer in that country.

A - JoAnn DeGrande {BIO 2134543 <GO>}

Operator, next question please?

Operator

The next question is from Keith Siegner from UBS.

Q - Keith Siegner {BIO 6299571 <GO>}

Can you hear me?

A - Howard Schultz {BIO 1432255 <GO>}

Yes.

Q - Keith Siegner {BIO 6299571 <GO>}

Just a quick question for John. The multi-faceted, or the multi-channel approach in the US has proven a really interesting competitive advantage. And you had mentioned the CPG channel opportunity and licensing opportunities. Can you give us an update on maybe where those businesses stand right now?

Do you have partners for those businesses right now? And maybe how you think about that growth opportunity? Is a something when you can fully-own those channels, or would it be a partner-style setup? Thanks.

A - John Culver {BIO 15817924 <GO>}

Keith, this is John, thanks for the question. When you look outside of our retail stores, we have a developing ready-to-drink business that we introduced back in 2005 and 2006 with our partnership with Suntory. We also have a partnership here on the packaged coffee business down the aisle with Ajinomoto Foods.

We are very happy with both of those partnerships. We see a greater opportunity now with this acquisition to bring one voice into the market and really look at our customers and look at our consumers in a way that we speak to them cross channel through our retail stores, as well as into channels outside of our stores.

We then feel that we can take our digital assets. And take the learnings that we have had in the US around digital, around stars down the aisle. And bring those learnings into Japan. And leverage those more directly with our customers in the market. And through our business partnerships. We see tremendous upside in channels outside of our stores, not only with ready-to-drink but also the packaged coffee. But then when you look at licensed stores where we are underpenetrated, as well as the food service business which is nonexistent today, we have what we feel is growth opportunities for many years to come on the business here, beyond the retail footprint.

Q - Keith Siegner {BIO 6299571 <GO>}

Thanks, John.

Operator

At this time there are no further questions. Ms. DeGrande?

A - JoAnn DeGrande {BIO 2134543 <GO>}

Thank you. That does conclude our call for today. Thank you for joining us. We look forward to talking to you again at the end of October, when we report our Fourth Quarter FY14 year-end results. Have a good evening.

Operator

This concludes Starbucks Coffee Company's conference call. You may now disconnect.

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