

Evercore ISI Consumer & Retail Summit

Company Participants

- David Palmer, Analyst
- Patrick Grismer, CFO & Executive VP

Presentation

David Palmer {BIO 6061984 <GO>}

David Palmer, Evercore ISI's food and restaurant analyst. I'm really excited and honored to have Pat Grismer, Starbucks' CFO, with us here today.

Pat joined the company in late 2018 from Hyatt, having recently been the CFO there. And prior to that, he spent 14 years at Yum! Brands in various finance roles.

So he certainly knows the role, and he knows global brands.

Welcome, Pat.

Patrick Grismer {BIO 15965217 <GO>}

Thank you. Glad to be here.

David Palmer {BIO 6061984 <GO>}

You provided a lot of good disclosure last week. So thank you for that.

We can circle back to some questions that we have about the recovery in the near-term realities.

Questions And Answers

A - David Palmer {BIO 6061984 <GO>}

But perhaps I was wondering if you could start off with a comment about how you think Starbucks will be positioned immediately after the COVID period is behind us, sort of that medium-term view.

I think more specifically, I think investors are seeing economic and commuter headwinds that might linger, but also recognize that Starbucks has done pretty much everything right as far as we can tell and through the virus for its partners, leaning in, in terms of store format and digital.

So this can mean bigger share gains and maybe even margins ahead.

So maybe tee us up with a comment about how you're thinking about exiting this crisis.

A - Patrick Grismer {BIO 15965217 <GO>}

Certainly, David. Thank you. Now let me start by saying that current challenges and future headwinds aside, we are very optimistic about the future, and we're taking steps to ensure that Starbucks will emerge from this experience even stronger. The progress we're making in our two lead growth markets, the U.S. and China, reinforce our belief that we will fully recover our business in due course.

We continue to expect that China's comparable sales will trend towards slightly flat by the end of our fiscal fourth quarter, and that the U.S. will continue to show improvement with recovery extending into next fiscal year.

At Starbucks, the third place has always been about community connection and convenience. And we know that in the current environment, likely to continue for some time, physical distancing is a vital need state for customers.

We already have a variety of ordering and service channels that provide a contactless experience, including drive-through, entry way pickup with Mobile Order & Pay and delivery. And additionally, the transformation of our store portfolio and the acceleration of innovative store formats, like Starbucks pickup, and new operating protocols, like curbside delivery, aligned with customer preferences that have evolved as a result of COVID-19, enabling us to connect with customers and serve our communities safely and even more conveniently. Combined with our focus on the customer experience beverage innovation and digital assets, we are well positioned to regain the momentum we had before COVID-19.

Now that said, as you mentioned, disruption to weekday morning routines, notably, commuting to work and school, is the strongest headwind that we're facing and will be more difficult to recover. However, there are two key tailwinds that we are -- that are helping Starbucks. First, strong brand loyalty, which is inspiring customers to replace past routines with new routines in different locations and at different times of the day. Second, consumers' desire in an increasingly stressful world for the comfort and the care that are unique to the Starbucks Experience.

So we're leaning in on these brand strengths as we continue to execute the game plan that was instrumental to pre-COVID success, an elevated partner in customer experience, breakthrough beverage innovation and increased digital customer engagement.

Now with respect to the broad economic headwinds, we expect, likewise, brand loyalty will provide some measure of support to our business, along with the fact that a Starbucks Experience is seen as an affordable treat.

We will continue to reward loyalty and drive frequency through personalized offers to Starbucks Rewards members, which have proven effective in the past.

A - David Palmer {BIO 6061984 <GO>}

That's great, Pat. I can attest to my wife and daughter being -- using this as an affordable break these days. I wanted to circle back and reflect on your last couple of years at Starbucks, which have been pretty good years, ones where you've been improving.

The firm broadly has been improving leading up to that 8% monster same-store sales immediately preceding the COVID-19 crisis. What did you see at Starbucks when you were joining? What progress do you see in the inside and the opportunities that -- versus the opportunities you saw at the beginning?

A - Patrick Grismer {BIO 15965217 <GO>}

Well under the leadership of our CEO, Kevin Johnson, the growth at scale agenda had been clearly established, focusing the company on a tight list of priorities while also enabling that focus through targeted streamline initiatives to simplify the business and drive efficiencies.

Shortly after I joined, we introduced a new long-term growth model to clarify the building blocks of sustained double-digit EPS growth at scale. Since then and until the impact of COVID-19, we've been very much focused on disciplined execution of the growth at scale agenda, allocating resources to the highest priorities, which are, again, elevating the partnering customer experience, driving beverage innovation and increasing digital customer engagement, while also sustaining strong net store growth and capitalizing on our global coffee alliance with Nestlé, which has extended the reach of the brand.

This tight focus, combined with disciplined execution, have contributed to steadily strengthening operating results while also helping to unlock growth. And then COVID-19 arrived, and our focus has really been on, first, mitigating and containing the spread of the virus, then monitoring and adapting to the current environment, and now, fully restoring the business and building resilience for the future.

A - David Palmer {BIO 6061984 <GO>}

I want to follow up on that beverage part of the equation. Domestic trends, particularly in the domestic side of the business. It seems like beverage contribution has been a big part of the improvement. I think the beverage contribution had been in the 2% range in the old days when you were just joining. It's been more like three to six points lately. To what do you attribute this beverage contribution gap, this improvement?

A - Patrick Grismer {BIO 15965217 <GO>}

Well we're particularly pleased with the innovation in our cold beverage platform, which has become increasingly popular at all times of the day. Cold beverages have

grown in popularity over the last four years. And while there's naturally, as you would affect some seasonality between winter and summer, the fact is that the platform has continued to grow even in the colder months every year. Key drivers of that have been innovation around Cold Brew, Nitro, Cold Brew, Cold Foam, iced teas and refreshers.

So a whole range of cold beverages. And those collectively have helped to mute the impact of a decline in the more indulgent cold beverage platform, frappuccino.

Our focus on beverage innovation is moving toward differentiated platforms rooted in well-researched consumer insights with less reliance compared to past years on beverage LTOs and sparks that really don't have a lasting impact. These innovative beverage platforms create new opportunities for us to introduce seasonal variations on a more regular basis.

Now at the same time, we're also rolling out new and sometimes proprietary beverage brewing and dispensing technologies at scale.

So that includes our Nitro Cold Brew as well as our Mastrena two espresso machines, and that delivers the best coffee quality and consistency at improved speed of service, and it meets customers' evolving preferences, including for wellness.

Now following the holiday season this past year, which was our best ever, we added more plant-based milk beverages, knowing consumers are increasingly looking for those alternatives, yet providing customers the ability to customize their beverages with those alternative milks. This included a regional rollout of oat milk in the Chicago area, and we plan to expand that in the coming months.

More recently, for our spring season, we introduced Pineapple Matcha and Golden Ginger, both iced coconut milk drinks that have quickly become fan favorites. And then as we reopen stores in May, we introduced a new summer lineup of beverages and food. That included our Iced Guava Passion Fruit drink, another hand-shaken coconut milk-based beverage. Our upcoming follow-on promotion will include even more innovation in the beverage -- in the cold beverage space.

So we'll continue to innovate there while further enhancing our Cold Brew and Nitro platforms, delivering, again, seasonal innovations, such as this last year, Pumpkin Cream Cold Brew and Irish Cream Cold Brew. And then finally, introducing even more textural variations, capitalizing on our proprietary Cold Foam at scale.

So plenty of room for innovation with so many highly differentiated platforms that we've deployed across our business at scale.

A - David Palmer {BIO 6061984 <GO>}

That's great. You guys have really improved a lot on the beverage side. It's been super impressive.

Let's talk about loyalty and digital a bit. U.S. loyalty membership growth has accelerated in the last few years. It had been dipping as low as 8% or so. It's now mid-teens. Clearly, China digital usage has been ramping really hard lately, but I think it's just as interesting how at scale, when you're doing it, it's still rapid growth in the U.S. Could you speak to the digital contribution's growth and how that might be changing due to the crisis?

A - Patrick Grismer {BIO 15965217 <GO>}

Great questions, David.

So before the onset of COVID-19, we had seen the contribution from digital from our loyalty program increase from about one point of comp to two points of comp.

We're really pleased that the more recent loyalty offers and enhancements to digital that we've launched coming out of COVID have really reengaged customers and have helped to drive sales, as evidenced by a meaningful increase in average weekly downloads and activations of the Starbucks mobile app since the campaign started in early to mid-May.

Customers are increasingly reliant on the mobile app with new users adopting the app for contactless ordering. Average retention amongst new users increased relative to pre-COVID levels, and they represent a larger share of app visits.

We continue to utilize various digital tools and techniques to drive traffic into our stores, including loyalty, program promotions and personalized offers.

We're also seeing increases in digital engagement in China, as you mentioned, compared to pre-COVID-19, and that appears to be fairly sticky in terms of consumers pivoting to more Mobile Order & Pay and mobile order for delivery experiences.

A - David Palmer {BIO 6061984 <GO>}

During the last call, you talked about how digital has -- you're getting better at doing digital. It's not just about penetration. It's the ways that you're doing more personalized marketing and operational adjustments to that digital. Could you speak to that angle and how you're perhaps leveraging digital better?

A - Patrick Grismer {BIO 15965217 <GO>}

Absolutely. It's something that we are especially pleased with because we think that it is a significant competitive advantage for us and something that will continue to fuel our recovery from the current COVID-19 impacts.

But really, over the last five years, the company has made very significant, very thoughtful investments in our digital flywheel, and it has become much more powerful with each passing year. And of course it's anchored by our Starbucks Rewards program, which enhances the customer experience through some very

relevant features that provide customers with a convenient way to place orders and to receive, as you mentioned, those highly personalized offers that unlock value and drive incremental spending.

So kind of with that as a background, about a year ago, we enhanced the Starbucks Rewards program in the U.S., significantly increasing the flexibility with which customers can redeem stars or loyalty rewards, and we call that multi-tier redemption.

These changes were very well received by customers pre-COVID and continue to be. Growth of our 90-day active rewards members accelerated to 15% year-over-year growth in our second fiscal quarter, reaching 19.4 million active members at the end of the second quarter. Loyalty members accounted for 44% of U.S. tender, and we see evidence of continued growth in the current environment.

So let me tell you a little bit more about this multi-tier redemption, because I think it's important to understand what changed from a design perspective and why that's resonating so strongly with our customers. The multi-tier redemption has enabled current -- or continued growth in the member base and has also helped to drive member engagement for new members. Attracting new customers to become members of the loyalty program is a strategic imperative for us because we know from our experience over a period of years that when we convert members or customers from nonmembers to members, we see their spending increase.

We see an increase in frequency, and we see an increase in average spend. And those changes in customer behavior tend to be very sticky.

So it's a strategic imperative for us. And multi-tier redemption has proven to be a very significant unlock for us in that regard.

The previous program had a -- what we call the green tier, which was a barrier for some customers in terms of joining the program. New members had to earn 300 Stars just to reach gold status, and then they had to earn another 25 Stars to reach their first reward.

So -- or that was 125 Stars.

So net-net, they add to amass or accumulate 425 Stars before they could earn their first reward. The new program eliminated the green tier altogether.

So new members can start redeeming as early as 25 Stars now. Additionally, they can now redeem their Stars at five different tier levels, ranging from 25 to 400 Stars. And as we've added new items such as merchandise and at-home coffee for which members can redeem stars, these changes collectively are resonating with our customers in a very significant way and contributed to the growth in our active member base, as I mentioned before.

We do expect to see higher levels of digital engagement going forward as customers appreciate the effortlessness of the experience and they see the value of becoming a Starbucks Rewards member.

So the last thing I'd like to highlight here is what we're doing next, what's next to build on this outstanding momentum that we've built with our digital flywheel. And that's something we call Stars for Everyone. It's been in the works for several years now, and I'm excited to say that we're reaching the end of the development phase, and we do anticipate launching this towards the end of this fiscal year.

We expect that it will meaningfully impact business results next fiscal year.

And here's the insight. One of the most significant barriers preventing our customers from signing up for our rewards program is the requirement to preload payment onto a Starbucks gift card in order to earn Stars.

So to remove this barrier, we're launching a program where any customer who registers a credit card or a debit card can earn Stars. And it's a way to attract customers who wish to benefit from our rewards program and all the value that, that unlocks and all that, that enables by way of personalized offers without having to prepay through a gift card.

So again, in the final stages of development, expect to launch toward the end of this fiscal year with meaningful impact next fiscal year.

So collectively, all of these innovations are helping to reinforce and strengthen, which is something that is a key competitive advantage to us and something that we view as a tailwind to our recovery coming out of COVID-19.

A - David Palmer {BIO 6061984 <GO>}

That's very cool. That's under the category of why didn't you do this earlier. This is -- seems like such a good idea. One of the things that you talked about last week and previously was store format. It's obviously a hot topic. You've been talking about transforming the asset base in the U.S. with more pickup locations to go with your drive-throughs, which are already the majority of your growth. This plan will include some closures. I think there's curiosity about what this all will mean in terms of renegotiated rent reduction.

But perhaps we can focus on, because it's probably too early to say, on what that rent impact is going to be.

But could you just speak to the returns difference, just the economics of those pickup formats and your drive-throughs relative to the traditional walk-in stores?

A - Patrick Grismer {BIO 15965217 <GO>}

Thank you, David, and I appreciate the opportunity to kind of step back from this and share how we're thinking about this strategically. Now the fact is that drive-throughs will remain the leading driver of net store growth for Starbucks in the U.S. They have accounted for 80% of our new store development in recent years, and that will continue. Those units deliver, as you would expect, higher average unit volumes and superior operating margins, because of the higher volume, the leverage that we get with that, with cash paybacks less than two years, substantially better than we see in our traditional cafes, which are for more of a sit-and-stay experience. This development will continue to be focused in geographies where Starbucks penetration is relatively low.

So the Southeast and Central regions of the country.

So that will continue irrespective of what we're doing in dense urban markets.

In the dense urban markets where we're looking to accelerate the pace of Starbucks pickup store development, that's less about growth near term. It's more about transforming those trade areas near term and to set them up for future growth.

How they compare to cafes, a more efficient asset, likely to be lower sales but a much more attractive margin profile with lower labor expense and lower occupancy costs.

So we would expect returns on those investments, even with lower sales volumes, to be at least as good as our traditional cafes, which have been good, not the same as drive-throughs, and we expect that those will improve over time.

The drive-throughs are positioned as a unit growth engine for Starbucks. Again, the pickup stores serving more as a vehicle to transform our dense urban markets, effectively to optimize our sales capture and improve profitability of those businesses, which are fairly well-established trade areas as opposed to drive-throughs, which are more new trade areas for us.

I would say, particularly in the current environment where we're seeing customer behavior shift, including more people working from home, perhaps for an extended period of time, drive-through development in suburban markets remains a priority for us.

Blending the pickup stores with traditional Starbucks stores in the dense urban markets will elevate the customer experience and, as I mentioned before, position Starbucks for long-term growth and as part of our strategy to transform those trade areas.

So different growth vehicles that we're going to be deploying differently depending on what the needs are and what the opportunities are in the various markets, but we

believe collectively will enhance overall returns and improve profitability while laying a stronger foundation for future growth.

A - David Palmer {BIO 6061984 <GO>}

That's great, and certainly seems logical, too, with the way America's moving these days. I want to circle over to how you might be helping along the recovery in some of your traditional stores. The U.S. being down 32% the last week of May. It seems that most of this was due to people not ordering in your stores that -- whether it's in the drive-throughs or the traditional cafes, ordering at the counter.

I guess that's a blend of social distancing and closed walk-in stores. You mentioned 9% were still closed at the time, and that lost urban commuter. How do you think about getting each of those types of lost occasions back or replacing that with something else? And how do you specifically see states reopening as a boost to your stores that are already open?

A - Patrick Grismer {BIO 15965217 <GO>}

Well there's no doubt that as states reopen, we are able to introduce more channels at each store, which effectively increases our sales potential.

So think about it in progressive terms.

We move from drive-through and delivery only to entry way pickup with mobile ordering, to curbside delivery where it's available, where we can provide it, to in-store ordering and pickup, all the way to in-store seating.

So it's a progression. Each expansion or extension of service, each extra channel that we have increases our capacity to accommodate customer demand and contributes to sales recovery.

We've developed data-driven tools that each store manager can use to determine based on prevailing conditions in their market, in their trade area how they can work their way along that curve. And we're seeing that continue to unfold in the U.S. As we mentioned in our 8-K, we saw nice progression from week-to-week as we undertook a massive reopening in the U.S.

We've seen that continue into the month of June as, again, we progressively opened these channels of distribution, effectively increasing our capacity to accommodate considerable customer demand, because you, yourself may have experienced this or you read about it or saw it on the news, but when we were largely limited to drive-through and some amount of delivery, we had very long lines.

We had more demand than we could accommodate.

So it also remains a priority for us to increase our operating efficiency, to increase throughput at the drive-through, but critically important is opening up these other

channels so we can better accommodate all of the demand, and that includes what I mentioned earlier, and you kind of alluded to in your question, which is replacement occasions.

We are seeing customers make shifts moving occasions to a different location closer to home as opposed to closer to the office, maybe later in the day.

So as their routines are evolving given the strong loyalty that we enjoy as a brand and some of those established habits that have built over a period of years, we're -- our goal is to make the changes necessary to our operations, backed by marketing to ensure that we are capturing that demand as we rebuild our business.

A - David Palmer {BIO 6061984 <GO>}

One of the things you mentioned on the last earnings call was how marketing had been turned off, and actually customer awareness at that point, it was a while ago, but customer awareness that you were -- where you were open was low -- that you were open. Could you talk about the marketing side and the building of awareness and where you stand right now?

A - Patrick Grismer {BIO 15965217 <GO>}

The marketing has been absolutely instrumental to the progress that we've seen in sales week-on-week. As you mentioned, we closed a lot of stores for an extended period of time.

We only had 45% to 50% of our stores open in the U.S. for a period of about six weeks, and we did that for reasons of partner safety and customer safety.

So as we started to reopen large numbers of stores in the second week of May, first of all, communicating that we were open was a priority.

We do expect by the end of our fiscal year to have substantially all of our stores open. As of our 8-K last week, we had about 95% open.

So the remaining 5% we expect will open balance of year.

But after having been dark with our marketing activity for that period of six weeks, we launched a holistic marketing campaign to first drive awareness, but then right behind that, drive traffic as we reopen some of these stores. And that included traditional advertising. It included social media outreach, exterior signage, which you've probably seen, and then targeted promotions to our Starbucks Rewards members.

We also timed the first phase of our summer program launch with this marketing campaign, driving product news around, as I mentioned before, the coconut milk-based beverages that have resonated so well with customers, particularly this time of

the year, and then also rewarding customers for new app downloads and for frequency.

So strategically using our Starbucks Rewards program to drive higher levels of membership and more customer engagement through a personalized marketing. Consumers have responded really well to these offers.

And then for customers who habitually visited a specific store, they're starting to return. And importantly, the Starbucks Rewards member base is continuing to reengage at higher rates than the nonmembers. Their spend is holding to pre-COVID-19 levels, and Starbucks Rewards contribution to U.S. company-operated tender in the last week of May was at 48%, which is up from 44% in the second quarter of our fiscal year.

So we're seeing an increase there. And as I mentioned before, driving membership to Starbucks Rewards is a priority for us because of what that does to increase spend through the combination of both increased visitation and increased average ticket.

A - David Palmer {BIO 6061984 <GO>}

Thank you. Those are great data points. I'm just going to wrap things up. It's -- we've been speeding along here, and so we only have time for one more.

But let's wrap things up with a question on China. It's -- that market's obviously been earlier on the recovery and relatively aggressive in handling the issues there. You noted that same-store sales in that market could reach near flat levels by the end of fiscal 4Q. Is China just simply earlier than the U.S.? Or is the recovery in other ways fundamentally different than the U.S., including potentially lingering effects, positive and negative?

A - Patrick Grismer {BIO 15965217 <GO>}

Well it's both earlier and different.

I would also say we could not be more pleased with the steady progress we've seen in China as the business has been recovering. The first step for us was to rapidly reopen stores.

We were closed for a shorter period than in the U.S.

We had widespread closures for about three weeks as opposed to six weeks, and then we rapidly reopened stores. And then the playbook in China, very similar to the playbook in the U.S. In fact, arguably, the U.S. has followed China, which is about not only reopening stores rapidly, but then also coming behind that with marketing support to drive high levels of awareness and to drive visitation into the stores, leaning in on our digital assets with our Mobile Order & Pay and mobile order for delivery platform in China as well as product news, which focused on what we call the good, good platform, plant-based proteins and plant-based milk beverages.

We've seen changes in customer behavior as we've continued to recover the business to remain fairly sticky with sustained high levels of Mobile Order & Pay and mobile order for delivery compared to pre-COVID-19 levels.

We have seen some variability across the portfolio, as you would expect, related more to differences in the profile of the customer base in various markets.

But overall, the market has progressed well.

So I guess the last thing I would say is that the manner in which the country dealt with the crisis was also very different from the U.S. and I think contributed to the speed with which the China business recovered in terms of a more coordinated effort by the country to mitigate and contain the virus and then to mobilize resources to support the reopening of the economy.

I think that has also helped the China recovery and contributes to our belief that the business will be substantially recovered by the end of this year with comps trending to about flat.

A - David Palmer {BIO 6061984 <GO>}

Thank you, Pat. It doesn't sound like the U.S. is too far behind that either from some of the comments you made in your guidance.

But thank you so much for your time today. Good luck with the rest of your fiscal year. Thanks for joining us, everybody.

A - Patrick Grismer {BIO 15965217 <GO>}

Thank you very much, David.

We appreciate your hosting Starbucks, and best wishes for a great day. Thank you.

A - David Palmer {BIO 6061984 <GO>}

Thanks.

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