

Oppenheimer Consumer Conference

Company Participants

- Kevin R. Johnson, CEO, President & Director
- Scott Harlan Maw, Executive VP, CFO & Principal Accounting Officer

Other Participants

- Brian John Bittner, MD and Senior Analyst, Oppenheimer & Co. Inc., Research Division
- Unidentified Participant, Analyst, Unknown

Presentation

Brian John Bittner {BIO 17258322 <GO>}

Thank you, again for coming to the 18th Annual Oppenheimer Consumer Conference. And thanks for joining us for the last presentation of the day. We're obviously very grateful to have Starbucks Corporation with us, a company that arguably has represented the best large-cap growth story in consumer for a number of years.

At Oppenheimer, Starbucks is an outperform-rated stock with a $66 price target. What we're going to do is we're going to have Kevin and Scott both give a presentation. Then afterwards, we're only going to do about 10 minutes of Q&A. And then they actually have a conference call scheduled for 6 p.m. after this presentation that you can all listen to as well.

So with that, I will hand it over to Kevin.

Kevin R. Johnson {BIO 3773960 <GO>}

Brian, thank you. It's a pleasure to be here today. I'm here with Scott, our Chief Financial Officer. Roz Brewer is with us in the audience, our Chief Operating Officer, along with our IR team.

The IR team has asked me before we begin to just mention the forward-looking statements and the safe harbor message that's before you.

I want to begin by setting some context. I think oftentimes, it's too easy to fall into the trap of looking at the morning comp report or the weekly financial flash or preparing and looking at the quarterly earnings. I want to set context for the long term. Many have written about transitions from founder-led to founder-inspired companies. Now I personally have experienced it myself multiple times. In fact, I've worked with founders for the last 25 years. When I joined the Starbucks board nearly a decade ago, I had the opportunity to work with Howard Schultz, one of the iconic entrepreneurs and founders of our generation. And the last 3.5 years working intimately with Howard.

In fact, our 2 offices are connected by a door. And that door is symbolic. It's symbolic of the open and transparent partnership we have developed. And it's also symbolic of Howard's willingness to teach and my desire to learn everything I could about his nearly 4 decades of experience building Starbucks.

And we have worked in a very thoughtful, intentional way to ensure that this is a smooth transition into the next chapter of Starbucks. And we're now at an inflection point. Certainly, with Howard transitioning off the board and entering a new chapter of his life, it's an inflection point, a transition.

And what I want to share with you today are some -- not only some unique things that I think I can bring to the table at this important time for Starbucks. But our priorities and the focus that we have that I believe will transition this company into a great next chapter of growth at scale.

Now 3 things that I think I bring that are a little bit different. I tend to be much more data driven and analytical. And I'm bringing that to Starbucks. But I'm also very appreciative and respectful of the creative and the emotional aspects of the brand. Certainly, I tend to bring a much more disciplined approach to picking the priorities. And that's because in my experience at scale, if you pick the right priorities and you put the resources and energy behind them, you move the needle. And third, I believe in a distributed leadership model, transitioning from a hub-and-spoke leadership model to a distributed model where I unleash the creativity, the power and the energy of a world-class leadership team and that we get more parallelism and more agility in the innovation we're bringing to market.

Now why is that so important? Well if you look at the fact that Starbucks was founded in 1971 and over that 47 years has built a global reach and scale second to none. We operate in 77 countries, over 28,000 stores, over 330,000 Starbucks' partners proudly wear the green apron, serving nearly 100 million customer occasions a week, global scale.

And in that journey, we've created significant shareholder value. Now if I were to think about this next chapter and the fact that over these 47 years in a founder-led model, we've created an iconic consumer brand with global scale, this next chapter starts to think about growth at scale.

And in many ways, the size and complexity of scale can often be the enemy of speed. And so the focus that we're going to have is on the core value drivers for the brand. We're going to become more agile innovators. And we're going to do it in a way that unlocks shareholder value.

So let's just start by looking at the past three years of the financial track record. Over the past three years since I've joined the leadership team, we've delivered a top line revenue CAGR of 10%, 17% on earnings per share. And we've returned $12 billion of capital to shareholders. That said, our growth has been slowing. Now when you think about growth at scale, growth at scale means we deliver predictable sustainable growth at scale in a way that creates shareholder value.

In this last quarter, we had an unplanned initiative related to the incident in Philadelphia that culminated in us closing our stores on May 29. And with that unplanned incident, it is not an excuse for the fact that we're looking to post a 1% comp globally this quarter. In fact, I expect better, our shareholders deserve better. And this leadership team and I are committed to fix this.

Now the fact that since May 29, our business in the U.S. has been comping and tracking at a 3 comp for the month of June is not an excuse. Growth at scale means we deliver consistent growth quarter after quarter, month after month, week after week, year after year. And we've got to get into that dynamic.

Now how do we do that? Well the first set of actions we've been taking over this past year are characterized as streamlining the company. And the entire purpose of this is being very thoughtful and intentional about how we're structuring the company in a way that allows us to amplify our focus on the core value drivers.

Three pillars. Retail market alignment. Retail market alignment means looking at each marketplace that we operate in the world and understanding what's the holding capacity of stores, what's the return on invested capital and what is the best model to drive growth and shareholder value. That is why we have transitioned a number of markets from company-operated to licensed.

Specifically over this last year, Germany, Singapore, Taiwan, Brazil all transitioned from company-operated to licensed. Our licensed partners are fantastic. And our licensed partners in deploying their capital consistent with our brand will grow that market faster than we would. And it allows us to focus our shareholder capital on the higher return on invested capital market opportunities that we have and that we can grow.

Now a comment, we are actively exploring strategic options in other appropriate markets. Streamline is not finished. There are more steps to follow.

In addition to converting those markets to licensed, we also invested capital to acquire 100% of our joint venture in East China. And that was the recognition that we have a phenomenally significant growth opportunity ahead in China. And the best way to capture that is to unify Mainland China as a company-operated model. We'll talk a bit more about that in a minute. But this is all about focusing on markets with the right business model and the right growth agenda.

The second pillar under streamline, business simplification. This is looking at every aspect of the business. And if there are noncore, slow-growth assets, we've divested of them. If there are things we can do to simplify things and simplify operations, we've done that. This is all about operating margin improvement.

So we've divested of Tazo to allow us to focus on our core premium tea brand Teavana. We closed the Teavana retail stores, understanding that when we launched Teavana, we sold over $1.6 billion of Teavana in our U.S. Starbucks stores. So closing those stores allowed us to focus on that distribution channel. And now we're taking Teavana through our channels business down the aisle.

We transitioned our e-commerce site, shut down our internal e-commerce site, transitioned to our channel partners. Companies like Amazon can do it better than we can. And we've been going through a process to optimize our SKUs in the lobby and in many parts of the store, all with an eye on operating margin improvement.

Then finally, we recently announced this Global Coffee Alliance with NestlÃ©. I'm going to go into this in more detail. But this is absolutely about accelerating global growth and taking the phenomenal business we've built in our channels in the U.S. and Canada and taking it global, at the same time, bringing Starbucks coffee to the Nespresso and Dolce Gusto platforms.

Now by streamlining the company, it allows us now to amplify our management attention, our capital, our resources and our entire team with partners to execute against the most important strategic priorities for the company. And they are as follows: number one, it's about accelerating our growth in our targeted long-term growth markets, China and the U.S. Those 2 markets have a significant opportunity to continue to drive the growth agenda for the company while benefiting from all the licensed markets that are then paying royalties and product fees that will help grow those markets.

Now China and the U.S., 2 important priorities they have, the first is extend and amplify our digital advantage. I'm going to take you through some data and some new things that we've done with the Digital Flywheel. The #1 thing to unlock comp growth in the U.S. is expanding the number of digital relationships we have. In parallel with that, we're going to take you through how we are modernizing and elevating the third place experience. And those 2 pillars are consistent pillars that we've got to execute against in China and in the U.S.

Second priority is to expand and leverage the Starbucks brand with this Global Coffee Alliance through NestlÃ©. We now have combined efforts in this alliance with 2 of the most significant consumer brand players in the category of coffee. And we'll take you through what that's going to mean.

Then third is about sharpening our focus on shareholder value return. So we're going to walk through how all of these priorities come together and how this really sets the agenda for growth at scale.

Now China. We hosted 1.5 days China investor conference in Shanghai in May. So I'm not going to go through all the content materials that we went through there. Those are all posted for you to review on the website. But I just want to touch on 3 important points. The first is characterizing the opportunity. First of all, you look at the growing middle class. And everybody reports and the analysts predict that middle class is growing from a population of 300 million to 600 million by the year 2022. 600 million people in China in the middle class is roughly double the entire population of the United States.

And roughly 450 million of those 600 million are millennials. So you have a younger generation who is being introduced to premium coffee at the point in time when they are growing in numbers and at a point in time where they value the opportunity to connect with others over coffee and tea in our stores. And so the inflection point of this growth with what we're investing in, we think, is meaningful.

Coffee consumption. If you look at China, the average number of cups per capita per year is less than 1. It's about 0.5 cup per year. In the U.S., it's about 300. So the opportunity to introduce this growing population to coffee and do it in a way that elevates their experience through experiencing coffee at a Starbucks store is a significant one.

Now there's a very clear growth agenda. We have an entire team led by Belinda Wong, the CEO of Starbucks China. And a growth agenda that really is anchored around partners and their families and how we create the environment for our Starbucks partners to succeed and grow and have opportunity to be a part of the Starbucks journey, creating that third place experience, extending it to digital and then also extending it down the aisle in grocery and mass merchant, all the while doing it in a way that's consistent with the culture and the values and the consumer sentiment in China.

Now China really is our second home market. In fact, the long-term growth targets that we have since we're now in the process of integrating and unifying East China have allowed us to increase the new store growth count by 20%. We increased it from 500 stores a year to 600 stores a year.

Now as we build 600 stores a year, by 2022, that should take us to north of 6,000 stores in China. As we're building in these new stores, we are going to enter approximately 100 new cities in China. And each of those cities is the size of Los Angeles or greater in population. So we're moving into 100 new cities that do not have a Starbucks present that have a population the size of Los Angeles or greater.

Now I'll comment that China, the game is about new store growth. It is about expanding the presence and the reach and growing the number of transactions and the number of customer visits we have through new stores. So we'll continue to see ebbs and flows and same-store comp. But this is a play of establishing the brand.

And certainly, if we look at this quarter, there's going to continue to be new dynamics in China. Right now, one of the priorities the team in China has is to -- they're in deep discussions with a large delivery partner to now light up delivery -- mobile ordering and delivery in our stores. That is a key priority they have. And so if we look at how they're driving on their comps and what they need to do this quarter, it's about new store growth and are we enhancing the experience by now expanding into things like mobile order and delivery. That's China.

The U.S. In the U.S., much of what we've got to do is really adapt to the rapidly changing consumer trends. And we identified 4 trends that we're focused on. The first is digital. And on digital, it's not just enabling Mobile Order and Pay and delivery.

It's about establishing a digital relationship with more customers so that we can communicate with them. And that digital relationship allows us to then use our personalization engine and all the software platform that we've built to deepen that engagement and do it in a way that's contextually relevant and situationally relevant to every customer that we touch. So digital becomes a very critical priority or market trend that we're focused on.

Second is convenience. Now we've been focusing on convenience. As we launched Mobile Order and Pay, as we've started to build out drive-throughs attached to our stores, as we think about new store formats, for example, we're piloting a new store format right now in Manhattan at the Empire State Building that is a Mobile Order pickup store only. It's right next to another store. So we're now starting to pilot more things around convenience.

Now in pursuing convenience, we're going to be very careful not to disturb or disrupt the fact that we create community in our stores. But we think we have an opportunity to continue to extend both in a very unique way that no others can do.

Third is premiumization. And this is about providing custom beverages, custom handcrafted beverages at scale. It's about premium ingredients, premium beverages and a premium experience. And that's something that consumers are looking for. Consumers are looking for those experiences and those premium beverages that are customized for them.

Then the fourth trend is health and wellness. And there's a number of consumer reports that sort of point to the fact that more consumers are going to choose healthier-for-you food and beverage. Now how does this manifest itself at Starbucks? Well let me just show you one data point.

On the left here, I show you -- from our company-operated stores in the U.S., I show us the blended Frappuccino category and how revenue was -- grew 17% in FY '15 and then steadily declined until year-to-date through May, it was at minus 3%. Now Frappuccinos, that entire category in the industry, is in decline.

The category of what's called slushie coffee, which is what this falls under, is in decline. And so we're seeing a similar thing. Now these are oftentimes more indulgent beverages, higher in sugar, higher in calories. What we're seeing is then consumer shifting to healthier beverage choices, better-for-you beverages. We see that in our Teavana Shaken Iced Teas. And we see that in our refreshment portfolio.

If you look at our recent Afternoon Made campaign, this is why we are amplifying many of these core beverages and amplifying the range of offerings that we have that allow us in that afternoon daypart to shift much of that customer base who's choosing not to -- from more indulgent beverage to focus on a healthy -- healthier, better-for-you beverage.

So what are the actions? Well we're going to accelerate relevant product innovation around our core beverages. And this is really exemplified by 3 things. First of all, we launched Blonde Espresso earlier this year. And in launching Blonde Espresso, you see we sustained an ad campaign for a long period of time to give customers the opportunity to experience and taste and understand what flavor profile they prefer. They can have Blonde Espresso or Signature Espresso. It's another way to premiumize through customization.

And since that campaign ended, the Blonde Espresso trend is continuing. So we set some -- we established a new product. We educated the customer base. And a portion of those customers choose Blonde Espresso in their beverage choices.

Second, with Teavana and Refreshers, with Teavana Shaken Iced Tea Infusions. With the Infusions, what we've done is we've separated flavor with natural ingredients from botanicals and fruits from sugar. So now with Teavana Shaken Iced Teas, a customer can then choose to have the flavoring they want. And they can either get it unsweetened, lightly sweetened or sweetened. So we're putting the customer in control of some of their choices.

This concept of separating flavor from sugar is something we're working on now to deploy across the entire platform where customers can have their coffee and tea beverages in a certain flavor and separate that decision of the sugars and the sweetener.

So beverage innovation is key. Certainly, our coffee beverage, our Espresso beverages, Teavana, Refreshers, one of the key things we've seen is the shift or the growth in cold. And so our iced espresso beverages, our Cold Brew, Nitro Cold Brew are all doing very well in this environment.

Now the final piece of this is really acknowledging that plant-based beverages, plant-based proteins are a choice that many consumers are gravitating towards. And we've introduced almond milk, soy milk, coconut milk as choices in our beverages. And coming later this summer, we have a blended protein Cold Brew where we start using then plant-based proteins in a blended beverage with Cold Brew. So plenty of innovation coming on the product road map really focused around those trends.

Now how do we make customers aware of all these new beverages and the choices that they have? The answer is expanding the breadth of digital relationships is the #1 thing we can do in the U.S. to drive comp.

Now let me just share with you what we've done just in the last 90 days. If you look back June a year ago, a year ago, we had approximately 13 million active Rewards members. And I'll remind you, those active Rewards members use the mobile app to order and pay. And in fact, that mobile app has become the #1 mobile payment in the U.S. -- mobile payment scenario in the U.S., Starbucks mobile app at Starbucks. Now to widen the aperture and attract more customers to our Digital Flywheel, we took 3 very significant actions that launched in the last 90 days.

Number one, we opened up Mobile Order and Pay for all customers. No longer do customers have to sign up for the Rewards program. They could go and download the app and do a mobile order and just put in their Visa card. And so customers have the opportunity to use that. Second, for use -- for Wi-Fi in our stores, we had customers sign up for Wi-Fi by giving us their email address. And we then simplify their ability to connect to Wi-Fi going forward. And those customers then opted in for us to communicate with them digitally, what we call a digital registration.

Then third, we reimagined Happy Hour. Happy Hour used to be sort of a mass discounting time period that anyone that came in the store could participate in that discount. What we've done with the reimagined Happy Hour is you now have to sign up -- you have to register digitally and we use a digital single-use coupon for customers to participate in Happy Hour.

Those 3 actions in the last 90 days have generated 5 million new digital relationships. So we now have 5 million digitally registered customers who have opted in for us to communicate with them. We're seeing good response and good outcomes in our new reimagined Happy Hour. And this number will do nothing but grow.

Over the next 3 to four years, we're going to consistently find ways to acquire new customers and now engage deeper with new customers. But with our 15 million active Rewards members plus this incremental new 5 million digital registered customers that we've acquired in the last 90 days, we're now at 20 million digital relationships.

So what's next? Three major initiatives will enable acceleration of digital in fiscal '19 and beyond. I want to start with the one in the middle here, Stars For Everyone. In the spring, we are now going to launch a program where anyone that registers a credit card or a debit card can earn stars, simple as that. And every time you do a transaction in the store with that same debit card and credit card, they will earn stars. They'll earn stars at a lower rate than rewards customers. But they will earn stars. It's a way to now attract customers who want to benefit from the rewards program simply by using their credit card and debit card.

In addition, when we launch Stars For Everyone in the spring, we're also going to go to a multi-tier redemption where, let's say, a less expensive product in the store could be redeemed for fewer stars, where a more expensive product in the store might require more stars. That does 2 things. Number one, it allows a customer to have a lower number of stars they need to earn before they can start getting benefits and rewards. And it also allows us to widen the range of products that we make available for customers to redeem stars for and do it in a way that is a responsible way on the discounting and margin. So those 2 events will create another wave of customer acquisition.

Then perhaps one of the most important things we're doing is we are applying our personalization engine to these new digitally registered customers.

Now you think about this, our ability from a technology standpoint to look at tokenized credit card transactions, map up to a digitally registered customer allows us to point this personalization engine that has driven significant comp growth with our active Rewards members and start to focus it on these digital registered customers.

We think the combination of things we are doing as we go into FY '19, we expect that to drive an incremental 1% to 2% points of comp in the U.S. Digital, very important.

Store portfolio. There are 3 principles that we're using to really determine how we're managing our store portfolio in the U.S. The first is we're going to grow our store portfolio, targeting underpenetrated geographies. Now many have speculated, have we hit a saturation point in the U.S.? I want to show you the data that shows we have not. And our job is to make sure we are targeting the right markets, the right geographies with those new stores.

We're going to leverage our store formats to blend those store formats in a way that we can better serve customers in that area. Some stores may have a drive-through, some may be a Reserve bar format. Some may just be a core Starbucks store.

And in addition, we relocate, reposition and close certain stores, as we have always done. The principles we've used here as we deploy capital is, are we deploying capital in a way that is that store is hitting the right AUV and margin to give us the hurdle on return on invested capital.

So when we think about optimizing the store portfolio, what I show you here is the data. This is a data-driven approach where we map the number of the population per store that is supported by a store. And we start by looking at metropolitan statistical areas and then counties and broaden it out. But you can see, all of the space in Middle America, in the Midwest and down through the South is wide open. And so a large proportion of our new store growth are going in the areas where we are underpenetrated.

On new U.S. store growth, we intend to maintain the pace of new store growth going into fiscal year '19 of company-operated stores.

Now I mentioned every year, we prune some number of company-operated stores, either because we need to reposition them, the lease is expiring or they're underperforming. Typically, that number is up to 50 stores. Going into fiscal year '19, we are going to prune approximately 150 stores. Now we're going to increase the number of stores that we're going to prune in this fiscal year '19 based on the data that shows us by pruning those stores, we get not only comp lift. But we get operating margin and operating income lift as well.

And these stores are typically in more dense areas. Oftentimes, they're in urban areas where wage pressures and occupancy and sometimes other regulatory actions that have been taken are making those stores unprofitable. So we're going to increase the pruning to 150 stores.

On the licensed number of stores, we are also going to reduce the number of new licensed stores in fiscal year '19 by approximately 100 stores. And this is working closely with our licensed -- our channel licensed partners in the U.S. And part of this is they're not building out new store footprints as fast. But it's also the realization that managing this portfolio means we look at not only where company-operated stores are located. But where licensed stores are located. And we know that we drive more shareholder value in a company-operated store simply by the economics than in a licensed store. So we're being thoughtful about how we optimize the store portfolio. And Scott will share a bit more on the financials and the details.

The third place experience is very important as we optimize the store portfolio. I'll comment briefly on Siren Retail. We currently have 2 Roasteries: Seattle and Shanghai. And we're pleased those Roasteries continue to grow. We continue to evolve. And we have 4 additional Roasteries under construction: Milan, New York, Chicago and Tokyo. It takes us about a year to build 2 of these. So for the next 18 months, two years, we're going to be busy fulfilling the pipeline of what we've created here.

Now I think of these as brand amplifiers. I think of these as innovation hubs for the brand. And so we're going to stay with where we're at on 6 of these Roasteries for right now until we continue to see how they evolve and the economics of them going forward. But we do believe there may be opportunities for others. It's just premature to make that decision. Right now we've got the work ahead of us to continue to open these wonderful beautiful stores and continue to drive on the economics behind them.

The Reserve stores with Princi, I want to introduce a new term. When we launch a new store format, we launch that store format in what I call concept phase. Concept phase means we deploy capital, we deploy resources, we build a number of these stores and then we iterate on how to create the right ingredients, the right mix of whether it's staffing, the store design, products to hit the AUV and the operating margin we need for these stores to hurdle a return on invested capital target that we use. So the Reserve stores with Princi, we now have 1 in Seattle. And we will build here in the coming six months or so 6 to 10. And we're going to use those 6 to 10 as our sandbox for concept phase.

Now once a format exits concept phase, it goes into commercial phase. The Reserve bars, the Reserve bar, which is the experience bar for Starbucks Reserve, that does not include Princi. China, the team in China was the ones -- were the ones that created that concept. They're now at more than 150 of those Reserve bars. And they're in commercial phase. They're growing more as they continue their store growth in these new cities.

In the U.S., we have about 20 of these stores in concept phase. And it is a goal that I've given our team to really work over this next year to get that store format to the point where it hurdles the economics to allow us to get into commercial phase. We will not exit until we hit that target. But we've set that as a clear goal.

Then finally, our core Starbucks stores are in commercial phase. Now one of the things I've done recently is I just promoted Liz Muller to be the Chief Design Officer of the company reporting to me. Liz is a longtime partner in our store design. She has single-handedly led the team who's designed all the Roasteries, all the Reserve stores and intimately involved in the Reserve bars. She did a lot of work on the core Starbucks brand prior to that. And so Liz is going to play that creative role to ensure that as we're designing these stores and as we're taking concepts from the Reserve brand, that we're bringing them into our core brand and weaving them together in a way that have impact.

The next thing we look at in the U.S. is really -- and globally is really the investment we make in our partners and how that investment translates to an enhanced customer experience. Now we've been on a multiyear journey to continue to invest in wage and best-in-class benefits for our partners.

Now I'll tell you, at the end of the day, it is those 330,000 partners who proudly wear the green apron in our stores who create that Starbucks Experience. And we will continue to do everything we need to do and can do to ensure we create a great partner experience for them, that we attract the kind of partners that create that Starbucks Experience, create that connection with customers and continue to help grow this brand. We're going to do everything we can to continue to create great opportunities for our partners.

In parallel with that, we've worked to enhance the customer experience, not only through partners but by helping make partners' jobs easier. Just 2 examples of that was the work we did around Deployment 2.0. Deployment 2.0 was the set of routines and the tools that we gave partners in the stores to handle not only the high volumes that they were seeing at the peak morning daypart. But also then how to transition into the afternoon daypart and simplify the work that they have to do.

Then SKU optimization is another one. We've reduced the number of SKUs in our lobbies. We've reduced the number of SKUs in the stores, which makes it easier for inventory management and easier -- or less administrative tasks for partners. So they can focus more on the customer.

Then finally, I'll just close with the Global Coffee Alliance. Now in this Global Coffee Alliance, NestlÃ© brings over 5 million points of presence in 189 countries. And you think about their expertise in CPG and their alignment around all things coffee. I think -- I view this purely as a growth agenda for shareholders. Now we could say, here are the alternatives. We have a CPG or channels business in the U.S., Canada. We could go build one organically in all the other countries we're in. That would take many, many years and a significant investment; or we can do this Global Coffee Alliance with Nestle, which allows us to rapidly accelerate that growth. That growth in channels in CPG is a brand amplifier for our stores. And we do it with a partner that we think we have a great alignment and a great opportunity with.

In addition, they are opening up what have yet to have been closed platforms, Nespresso and Dolce Gusto. If you saw what happened when we introduced K-Cups on top of the Keurig machine and Starbucks-branded coffee on the Keurig platform quickly became the #1 premium brand and ultimately the #1 brand in share on the Keurig. The fact that there's estimates that the Nespresso and Dolce Gusto installed base in households and offices around the world is more than double that of Keurig. So that, too, is growth.

Then we're going to partner with NestlÃ© around sustainability, making coffee the first sustainable agricultural product. And that's the work we do in our Farmer Support Centers, the agronomy research and the things that we do on the ground with farmers.

So the NestlÃ© partnership around the Global Coffee Alliance is an important one. We're making good progress on the regulatory front. We expect that to -- that partnership with that alliance to close this summer. And so that's an important aspect as well.

Now in these efforts to streamline that I started with, retail market alignment, business simplification and the Global Coffee Alliance, I'll remind you, we have freed up $8 billion of shareholder capital in the last year. We redeployed approximately $1.3 billion of that capital into East China to then unify Mainland China and set us up for our growth agenda. And the sum and net of all those actions, accretive in revenue and earnings per share in fiscal '18 and '19.

Now in addition, those streamlined actions are allowing us to now focus our attention on key value drivers: U.S. and China, Global Coffee Alliance and returning cash and creating value for our shareholders.

And to take you through a bit more on that, I want to introduce and let Scott Maw take you through some of the numbers. Scott?

Scott Harlan Maw {BIO 18637895 <GO>}

Thanks, Kevin. Just a few things I want to touch on here. And then we'll wrap up and go into Q&A. I'm going to touch on a couple of items that Kevin talked about and give a little bit more financial detail behind some of the points he made. Then I'll talk a little bit about a couple of updates to our guidance.

So the first thing I want to build on is the points that Kevin made about our store portfolio and just give a little more texture around the changes that we're proposing, both a little bit in 2018. But importantly, as we move into 2019. So what this chart shows is it shows our portfolio growth rates split between company-owned. So percentage of new stores for company-owned and percentage of new stores for licensed stores.

And what's important to understand here, in our company-owned store base, which obviously drives the majority of our profit and comp and revenue growth in the U.S., that's been pretty steady at about 4% growth of net stores, a little bit of increase. But it's rounded to 4% for years. All of the growth that we've driven on increasing that percentage from 4% to 6% overall has come in licensed stores. And those have been opportunities that have been good for us to execute on, in conjunction with our partners, getting that real estate that we wouldn't normally have access to and have been accretive. But that's where the portfolio growth is coming from, licensed stores.

And so as comp growth has slowed a bit, particularly transaction comp growth, we've continued to fine-tune the work we do on sales transfer. I stood in this building a few months ago and gave you some more specifics on that. And in company-owned, we're still really comfortable that the net of that sales transfer and new customers acquired via store growth is very positive. And you can go back to the February presentation and take a look at that. Those numbers and that approach still holds.

But what we're thinking and what we're seeing in the licensed stores are 2 things. Number one, it's harder for us to measure that sales transfer in licensed stores. We can approximate it and we have models that estimate what that will be. But because we don't own all the data, it's not always as easy to nail it.

Also, given the growth that we have in-licensed stores and the relative impact, as Kevin mentioned, the cost, if you will, of sales transfers for company-owned, the licensed is many times the cost of company-owned to company-owned. We think it's wise to step back, take a look at that growth rate and just prune back the level of gross new stores that we're going to open. So that's where it comes, down about 100 in licensed stores.

We'll probably pull back a little bit on company-owned. But not very much and then take a look at closing about 100 incremental company-owned stores above the run rate we've been on. So 150 in total, those are the numbers that Kevin has talked about. And all of that is on the company-owned side, accretive to overall profitability.

So that means a lower net new store growth rate next year of about 3%. That probably normalizes a bit when we go into 2020 and beyond, maybe 4% or 5%. We'll revisit that as we go through. But I think the key thing is as we continue to fine-tune our analytics, a little bit slower store growth. And it's really concentrated in-licensed.

The other thing I want to talk a little bit about is owned versus licensing in a few of these company-owned markets. So Kevin has already talked about how in markets where we can get our hurdle return, we prefer to own. And this chart shows why. In markets where we can't get our hurdle return, we prefer to license and work with a licensed partner. And there are both qualitative and quantitative reasons. Again, this is a select, call it handful of large markets where owning our stores make sense.

What this does is a very simple example that says if we have a company-owned store with an AUV of $1 million and we have a licensed store in that same market at $1 million. You can see the revenue given the licensing model and the overall cash profit in dollars given licensing. Still great returns in both examples. However, you can see the cash profit in those company-owned stores is 4x the licensed store model.

And so what we've always said, when you do the economics, it's really tough to give up all that cash flow in the company-owned model and share it with licensees when you can get your return.

And the reason we see that is our business model. Our business model has a lower build cost because unlike a lot of people that we get compared to, we don't have kitchens. It has higher margins because unlike a lot of people we don't -- we get compared to, we have a high beverage mix versus a high food mix, again, overall higher gross margins. And all of that drives significantly higher profits. So that's why we're disciplined where we own. But when we can own, we think the quantitative proof is to own those stores.

The other side is the qualitative side. And Kevin talked about this. You have to remember that the most important aspect of our model is our partners in the stores. And we have to invest in those partners. We have to make sure we can attract and retain those partners.

We have the best turnover rates, the highest retention rates in the entire industry. And that's because we take it very seriously because they deliver a premium experience, a premium product, yes. But a premium experience. And the #1 driver of our success is that premium experience to our customers.

And so that is something we need to invest in. That is much easier done in these larger markets in a handful if we own those stores and can make the investments that we need to in wages, benefits, et cetera.

The other thing is we're much more nimble. So Kevin uses the word agility. We're much more agile with new product introductions, store design changes. Can you imagine how hard it would have been to do the antibias training in about 4 to 6 weeks if we were trying to work through a franchise set of stores? It wouldn't have been possible. So the ability to move and pivot pricing methodology is much more consistent and much more, in my opinion, rational and sort of easier to analyze when you own all the stores.

So those are the qualitative reasons to go with the quantitative reasons. But I just wanted to make sure you understand that overall cash profit view.

The other thing we're committing to today is to go deeper on G&A. So G&A has been growing as a percentage of system sales. We've been managing the core G&A, I think, pretty rigorously over the last couple of years. But to be honest, at 4.5% of system sales, our G&A is higher than where we want it to be from a benchmark standpoint.

So if you benchmark us versus the industry and you adjust a little bit for ownership structure, we think we're about 1 point higher than where we'd like to be. And it might be a little bit less than that, it might be a little bit more than that. But we're committed to going after that as we move towards the end of 2018 and into next year.

We're going to engage one of the large consulting firms to come in, help drive speed, bring outside-in views, best practices, tools, techniques, benchmarks, all the things that they can bring. But also to help us move quickly. This is something we really want to analyze and start executing on perhaps as early as Q4, Q1. So Q4 of this fiscal or Q1 of next fiscal to start driving some savings.

So we'll come back in Q3 earnings call here in a few weeks. And we'll go much deeper on the how much, the whats and the whens around that. But that's a commitment we're making today. The opportunity is there.

Then Kevin alluded to additional shareholder returns. So what this chart shows is you go back to 2014, we had about $1.6 billion of total cash returned to shareholders between dividends and buybacks. We'll be many multiples of that this year and next year. We started the year with a commitment to add $15 billion to -- or to do $15 billion of total buybacks and dividends between now and the end of 2020. We took that up off the back of the NestlÃ© deal and the cash that we're receiving off that to $20 billion. And today, we're taking it up another $5 billion to $25 billion. So $15 billion to $25 billion over the course of the year. And I want to -- I'll talk a little bit about how we're getting there. But that's a commitment between now and the end of 2020. Just for modeling purposes, most of that incremental $5 billion, as you can imagine, will happen in 2020 because 2019 is pretty full up with the NestlÃ© work that we need to do with the cash there.

We'll increase our quarterly dividend actually starting this quarter, which is a quarter in advance, by 20% to $0.36 a quarter. And that dividend will run for 5 quarters and then will be right back on our normal annual cycle. But just given the overall payout ratio, given tax reform, we thought it was wise to go ahead and address and take up the payout ratio a bit this quarter and give you clarity on where we think the dividend is going to be for the next 5 quarters.

And the other thing that I think is getting lost a little bit in the translation between mainly me and you is what's happening to our leverage ratio. And so it's really important for us as a company-owned and licensed model that the leverage ratio includes capitalized leases and includes the impact of rent. So this is the leverage ratio, which is adjusted debt. So debt plus capitalized leases. And then the multiple is based upon EBITDAR.

So what we see from several years ago, right around that 1.6 level. We're adding about 1 turn by the end of this year, call it 2.6 to 2.9 between this year and next year. We'll be issuing additional debt. That's the source of the additional buybacks. What's important to call out in this is to make sure you guys see what's coming from the leverage ratio. It is going up. It will go up. Then importantly, we've made a commitment, the board, to the rating agencies that the leverage ratio will remain below 3x in all of this. So less than 3x adjusted debt to EBITDAR. And we're committed to a floor on ratings of BBB+ for S&P and Baa1 for Moody's.

So that's the debt profile. We feel really comfortable with that 3x. We want to stay below it. We think that gives us plenty of leverage, plenty of ways to increase cash return to shareholders. But importantly, the financial flexibility we need in the commercial paper market, in the international debt markets, we like that rating.

Okay. So what's this mean for guidance for this year? And we'll come back to in 2019 as we get towards full year guidance for '19. The headwinds that Kevin talked about that we were calling a 1% comp globally are primarily around the blended category and afternoons. This is a consistent message. This is our biggest quarter for Frappuccino. And it was softer than we expected. We expected a softer Frappuccino quarter given Happy Hour approach, given what happened last year with Unicorn. We had all that forecast. It was softer than we expected. And the primary category was Frappuccino and the primary daypart was afternoon. Morning peak is still comping positive.

In the May 29 antibias training, that's in that comp estimate. That's impacting it. We closed our stores. And it had an impact. I would also call out from an earnings standpoint, we had about $0.03 of investment in the antibias training. That's offset by about $0.01 of favorability from stock-based compensation adjustments. So you add those 2 together and all of this forecast has $0.02 of headwinds for those items.

Then China. So Kevin mentioned China. I just want to call out China comps. We're calling it flat to slightly negative this quarter. And it's due to some of the things that Kevin talked about and the opportunity we see in digital and the opportunity we see in delivery. I would just really emphasize that unlike the U.S., almost all of China's revenue growth comes from new stores. So it's not that comp growth isn't important, we're not saying when -- about flat comps in China. I don't want to send that message. But a huge portion of the economics in China, the profitability and revenue is coming from new stores.

And just to give you an indication of that, we'll grow transaction comps, total transaction comps, new -- sorry, transactions, both comp stores and new stores, we'll grow that in China mid-teens this year. So that tells you almost all of that is coming from new stores. And even this quarter, where transactions will be flat to negative, we'll see well over 10% transaction growth across the entire store base if you include new stores. So it's about share, it's about taking advantage of the growth in China and it's about making sure that we have stores in the right places and we're serving customers in the right way.

So when you add all that up for guidance, what we see is our previous guidance on a GAAP basis, $3.32 to $3.36. We now see that $3.23 to $3.26. And non-GAAP, $2.48 to $2.53 the last time; and this time, it will be $2.39 to $2.43 for the year. Again, remember, all those numbers have about $0.02 of those headwinds that are really somewhat unique to this quarter.

So with that, I'll wrap. And we can move to Q&A.

Questions And Answers

Q - Brian John Bittner {BIO 17258322 <GO>}

All right. So what we're going to do is we're going to do about 10 minutes of Q&A. And again, Starbucks is hosting a conference call at 6 p.m. tonight as well. And so we're just going to do a short Q&A. And I'm going to kick things off. And then raise your hand. We have 3 microphones. And so just raise your hand and wait until we give you a microphone. As it relates to the guidance for 2018, about $0.10 reduction. Is there any way you can tell us how much of that is in the Third Quarter versus kind of the Fourth Quarter? Or help us understand...

A - Scott Harlan Maw {BIO 18637895 <GO>}

Without giving specific quarterly guidance, let me give you some shape, right, because I really want to stick to annual guidance. What I would tell you is we expect some improvement in EPS, higher EPS in Q4. And that's because of some of what Kevin talked about. We expect some improvement in comps, lower than what we had originally forecast. But improvement in comps. Then we still have good momentum. And I'm sort of putting it -- Roz here in the middle of the P&L across waste, labor and COGS. And that, as we've said, accelerates through the year and that continues in the Fourth Quarter. So I expect the Fourth Quarter to have higher EPS than the Third Quarter but not quantify that specifically.

Q - Brian John Bittner {BIO 17258322 <GO>}

Okay. And just as it relates to sales growth in the United States, I think accelerating the power and momentum of your Digital Flywheel is the biggest growth opportunity. And in the Second Quarter, you implemented new ways to attract digital customers beyond your Rewards program. And I think what you showed us in the presentation today is that's working. And so I guess, the question is despite that working, the sales trends have been falling a little short. So where are you seeing the pockets of weakness? I think you called out a couple of things. But that's question one. Then two is, as far as getting these digital customers, does it take a little bit to convert them into higher-comping customers once you acquire them?

A - Kevin R. Johnson {BIO 3773960 <GO>}

Yes. First of all, the 5 million incremental digital registrations that we acquired, we just acquired those in the last 90 days. And we have not applied the personalization engine to those customers. We are now in the process of now connecting tokenized transactions to those customers. So the personalization engine could be used. So we have not enabled personalization. The thing that we -- that is driving is this reimagined Happy Hour. And we're seeing better-than-forecasted results from that Happy Hour. So we've acquired those customers. The one place that we have been marketing to them and communicating to them is around reimagined Happy Hour. That is overperforming expectations. But we have not lit up the communications to now start marketing with the personalization engine to them. So I view this as just untapped opportunity. And the fact that we're seeing good response to the reimagined Happy Hour and the fact that we can continue to grow that base of digitally registered customers, I find, is a very good positive thing.

Q - Brian John Bittner {BIO 17258322 <GO>}

Audience? Right over there. Someone hand (Neil) a microphone.

Q - Unidentified Participant

Quick question. So I mean, clearly, it's a very strong economic environment right now. I mean, it seems like most restaurants are doing pretty well, whether it's NATTrack data or CREST data. So if you're growing the Rewards program high single digits, double digits, whatever it may be, clearly, there's an offset there. So help me understand if someone's leaving the system, why are they leaving? And where are they going for coffee? Because coffee as a category seems to be growing mid-single digit still.

A - Kevin R. Johnson {BIO 3773960 <GO>}

Yes. I'd say that our core beverage platforms continue to grow, coffee and espresso. The place that we've got negative is the occasional customer in the afternoon on blended Frappuccino. That said, with the May 29 training, we delayed the launch of our spring and summer marketing campaign that was supposed to launch in mid-April when this whole event unfolded. We delayed that by 2 weeks. And we lost momentum. Not an excuse. But that's -- if you look at the data-driven drivers of that, that's the impact. And as I mentioned, too, post-May 29, we're now comping 3 in the U.S., trending towards the 3 for the month. But that is not, in my view, not an acceptable performance. And we need to do better.

Q - Brian John Bittner {BIO 17258322 <GO>}

Anybody else in the audience?

Q - Unidentified Participant

Just taking that one step further, just as it relates to comps, if you hold the 3, if, is there anything about the Fourth Quarter -- I mean, it sounds like when we started the year and if you thought the Fourth Quarter would have been a 3 comp, I think, initially, there was a certain earnings expectation attached to that. If you end up doing a 3, would the Fourth Quarter from an earnings perspective be the same as what you imagined 3 or six months ago or whenever the last time we kind of thought about the year?

A - Scott Harlan Maw {BIO 18637895 <GO>}

I think the only thing I would say, yes. But we've got to make sure we get transaction comp growth. So one of the things we talked about in the most recent quarter is the 3 needs to have 1 point of transaction comp growth because that matters for leverage and operating income. And so if that 3 comes with transaction comp growth and we can deliver on the savings, I would say we'd be within the range of our initial guidance.

Q - Unidentified Participant

And sorry, anything about the 3 -- I'm all shouting -- anything that you see now, is it consistent with 1% for positive transactions?

A - Scott Harlan Maw {BIO 18637895 <GO>}

Transactions have been harder to come by. So it's mostly ticket, which, by the way, is consistent with what's happened year-to-date. So to Kevin's point, we hold onto that 3. We get a little transaction with that. And we'll be right back in line with what we were talking about with our guidance -- with our long-term guidance and all the things that are inherent in your question.

Q - Brian John Bittner {BIO 17258322 <GO>}

Anybody else from the audience? (Vince)?

Q - Unidentified Participant

You guys just took a price increase with declining traffic. What gives you that confidence that you can take price as traffic is tougher to come by? And how do we know that doesn't become a bigger negative as a result?

A - Scott Harlan Maw {BIO 18637895 <GO>}

Do you want me to go?

A - Kevin R. Johnson {BIO 3773960 <GO>}

Go ahead.

A - Scott Harlan Maw {BIO 18637895 <GO>}

What I would say is the analytics that we have around elasticity modeling have been and continue to be very accurate. So we can check store by store, product by product within products and also people exiting the system because of price increases. And there's been no change in that elasticity for the 4, five years that I've been CFO. They continue to have -- that's why that low level of consistent, careful pricing market by market, product by product has driven 1 to 2 points of price because we're really careful at how we do it. And Roz has actually brought additional discipline there. If we see places we can lean in, we will. But if we see that cannibalization or elasticity spike a bit, we'll pull back. And that has stayed pretty consistent over the last few years.

A - Kevin R. Johnson {BIO 3773960 <GO>}

Yes. I think we don't do across-the-board price increases. So it's very targeted and even down to micro-trading area pricing and then we have the analytics that the team -- the pricing team uses both predictive analytics. But then after they make a change, they track. And our core beverage platforms have been doing well. I think the one decliner is in our blended Frappuccino. And I think that has to do with the health and wellness trend.

Q - Brian John Bittner {BIO 17258322 <GO>}

And with that, we've hit the hour mark. So Kevin Johnson and Scott Maw, thank you for being here. We really appreciate it.

A - Kevin R. Johnson {BIO 3773960 <GO>}

Thanks, Brian.

A - Scott Harlan Maw {BIO 18637895 <GO>}

Thanks, Brian.