Starbucks Concludes Packaged Coffee Dispute Webcast

Company Participants

- Howard Schultz, Chairman, President and CEO
- JoAnn DeGrande, VP, IR
- John Culver, Group President of China
- Troy Alstead, CFO and Group President

Other Participants

- Bonnie Herzog, Analyst, Wells Fargo Securities, LLC
- Jeffrey Bernstein, Analyst, Barclays Capital
- Joe Buckley, Analyst, BofA Merrill Lynch
- Michael Kelter, Analyst, Goldman Sachs
- Sara Senatore, Analyst, Sanford C. Bernstein & Co.

Presentation

Operator

Good afternoon. My name is Shawntay. And I will be your conference operator today. At this time, I would like to welcome everyone to the Starbucks Company conference call.

(Operator Instructions)

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

JoAnn DeGrande {BIO 2134543 <GO>}

Thank you. Good morning. This is JoAnn DeGrande, Vice President of Investor Relations for Starbucks Coffee Company. Joining me on the call today are Howard Schultz, Chairman, President and CEO; Troy Alstead, CFO and Group President; and John Culver, Group President of China/Asia Pacific, Channel Development and Emerging Brands.

This 30-minute conference call will include forward-looking statements which are subject to various risks and uncertainties that could cause our actual results to differ materially from these statements. Any such statements should be considered in conjunction with cautionary statements in yesterday's release announcing the Starbucks-Kraft litigation decision and the risk factor discussions in our filings with the SEC, including our last annual report on Form 10-K.

Starbucks assumes no obligation to update any of these forward-looking statements for information. This conference call is being webcast. And an archive of the webcast will be available on our website at investor. Starbucks.com.

With that, let me turn the call over to Howard.

Howard Schultz {BIO 1432255 <GO>}

Thank you, JoAnn. Good morning. And thank you all for joining us. Yesterday, we received a decision from the arbitrator in the Kraft dispute, which we strongly disagree. But given the size of the award, we thought it would be helpful to provide you with some context and transparency.

While we are all disappointed by the conclusions reached by the arbitrator, regaining full operating control of our packaged-coffee business was, without question, the right strategic decision for Starbucks, our brand. And our shareholders. Since taking direct control of the business, we have changed the trajectory of our CPG segment and our global strategy; developed an entire pipeline of innovation; deepened our relationships with the trades; and significantly grown revenue and profit, with more premium positioning down the aisle.

We have also built a leading and growing position in premium single cup -- an opportunity that was not available to us under the Kraft agreement -- the fastest growing segment in at-home coffee. As we reported on last month's earnings call, Starbucks today is firing on all cylinders, with record operational and client financial performance in both FY12 and the year that just ended in FY13.

And we are literally in the very nascent stages of building a multi-billion-dollar global consumer package business. Having gained full operating control, we now have the flexibility and the freedom to control our own destiny and, most importantly, preserve and enhance the Starbucks global business and brand around the world.

It is difficult when a decision like this goes against you. But let's just take a look at this. It is a one-time charge in a single moment in time. And now it is behind us. Our plans, capabilities. And aspirations are well beyond where Kraft could've possibly taken this business. We are moving forward and not in the least looking back.

Now I will turn the call over to Troy.

Troy Alstead {BIO 5724238 <GO>}

Thank you, Howard. Earlier this morning we filed a Form 8-K, which includes an updated P&L reflecting the impact of the litigation expense in Q4 and FY13. The $2.2-billion ruling, plus approximately $557 million interest expense and attorney's fees, which includes projected interest through the payment date, is recorded as an operating expense as part of our unallocated corporate expenses.

Full financial statement impact, including the balance sheet and statement cash flows, will be available in Starbucks annual report on Form 10-K for FY13, which will be filed later this month. Throughout FY14, as we report our quarterly results, we will include a comparison of FY14 GAAP results with FY13 non-GAAP results, excluding the impact of this litigation expense.

As we have discussed since the arbitration process got underway, Starbucks has adequate liquidity to fund the payment, both in the form of cash on hand and our anticipated issuance of approximately $750 million in additional debt during the next three months. Note that the financial impact of this litigation does not change our strong earnings target for FY14. And we remain committed to delivering earnings in the range of $2.55 to $2.65 per share, consistent with the target range we provided on our recent Fourth Quarter earnings call.

Also note that Starbucks remains in a very healthy financial position with strong cash flow generation. We will continue to grow our cash return to shareholders in 2014 and beyond by increasing, over time, both dividends and share repurchases.

Over the course of our relationship with Kraft, which began in 1998 for the distribution, marketing, advertising and promotion of Starbucks packaged coffee, we became increasingly dissatisfied with both the trajectory of the business and the way in which the Starbucks brand was being positioned down the aisle. Kraft failed to deliver on their responsibilities to our brand under the agreement. And the performance of the business suffered and deteriorated as a result.

We attempted to work with Kraft management to resolve the issues. But to no avail, at which point we determined that it would be within our right. And in the best interest of our business and our shareholders, to terminate the agreement. Our objective in doing so was clear.

By bringing the packaged coffee business in house, we could shore up our market share, improve the growth trajectory of the business, bolster our brand positioning. And build a robust leading position in the fast-growing premium single-serve segment. Details of the agreement termination and arbitration process can be found in our prior public disclosures. We're looking forward to putting this matter behind us and further developing our global channel development business.

I will now ask John Culver to make a few remarks before we open the call up for good[ph] questions.

John Culver {BIO 15817924 <GO>}

Thank you, Troy. As Troy said, we are pleased to have this behind us. Taking direct control of this business has energized the accelerated growth of Channel Development and enabled us to build a very strong, direct-selling relationship with retailers.

More importantly, beyond accelerating growth, this move has also allowed us to further elevate and differentiate our brand while enhancing our positioning and increasing our presence down the aisle. Over the past couple of years, we have built very strong capabilities and invested in the talent needed to win and position us for future success. And since 2011, our business results clearly demonstrate the benefits of the sharpened focus and strong execution of our partners throughout the business.

Our innovation pipeline is now the strongest it has ever been. And we have the leading market share of premium packaged coffee down the aisle. In FY13, Channel Development reached $1.4 billion in revenue. Adding to a strong revenue base is earnings momentum, with profitability growing 47% over the last two years.

At the same time, industry-wide coffee category sales have grown 24% since 2011, while Starbucks at-home coffee sales have grown 62%. As to premium single cup, in two short years we have grown our dollar share to 18.4%, including the sale of more than 1 billion K cups and 200 million sticks of VIA.

Our accomplishments to date, combined with our continued market-leading innovation, including the early and quantitative success of our stars-down-the-aisle loyalty program and Starbucks' signature aisle merchandising initiative, have made our Channel Development segment a meaningful contributor to Starbucks' record results and a key enabler of the strategic flywheel we discussed in our Q4 earnings call. Channel Development is now the Company's second-largest operating segment. And we are well on our way to capturing the very large, global-growth opportunity in front of us and building a multi-billion-dollar business.

In closing, the unique combination of value, rewards. And our premium positioning will allow us to continue to build and grow our leadership in premium packaged and single-serve coffee. Regaining full operating control of our packaged-coffee business has positioned us to take full advantage of the large and growing opportunity we have within our Channel Development business. And we are fully committed to delivering double-digit top-line and bottom-line growth in Channel Development in 2014 and the years ahead.

Let me now turn the call over to the operator for Q&A. Shawntay?

Questions And Answers

Operator

(Operator Instructions) Jeffrey Bernstein, Barclays.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Great, thank you very much. Two questions. First, from a financial standpoint. Troy, if you could just offer any additional color. You mentioned the $750 million in debt you took on or are taking on. I was just wondering whether there was any potential for incremental debt beyond that, especially seeing that maybe this payout is more than you were anticipating.

You mentioned, in FY14 guidance, still comfortable with that earnings range. I'm just wondering whether this payout alters at all your investment or CapEx plans or the share repurchase that you were expecting to be making in FY14. And I have one follow-up.

A - Troy Alstead {BIO 5724238 <GO>}

Thanks, Jeff. Let me be clear about the debt. Very recently, just in the last couple of months, as you know, we took out $750 million in debt.

The -- what I've referred to today in my comments is an additional $750 million that we anticipate issuing in the coming few months. So those are two distinct debt offerings. And I just want to be clear. And that does reflect -- having received the arbitration yesterday, that reflects our standard of that amount and the financing that we'll need to add to the strong cash that we have on hand.

Now, with respect to our future investments, absolutely nothing changes in how we will invest into the future, both in terms of our capital spending for the year, in terms of our renovation program, in terms of our new store development. We have a strong expectations and plans for growing the business and making the appropriate investments in it. And because of the healthy balance sheet we have, the phenomenally strong cash flow that our business generates, the healthy growth plans that we have in place, we certainly won't deter any of the investments we are making into the business for this year.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Got it. And just to clarify, John, I think you mentioned in terms of the Channel Development, you said on a number of occasions a multi-billion-dollar opportunity.

Just because there are so many pieces in it and because we now do have the headwind of the Kraft so on behind us, the largest components of that -- is it safe to say that the two biggest pieces would be the single serve and the package? And if so, a ballpark of what those represent in terms of percentage of sales or prioritize in terms of profitability just so we can get a look at that business going forward.

A - Howard Schultz {BIO 1432255 <GO>}

Jeff, let me speak to part of it. And then I will have John add some qualitative aspects. Packaged coffee is a, as you know, a nicely profitable business for us, very high margin.

We have grown profitability of packaged coffee significantly in the last two years since taking direct operational control and really expanding our presence down the aisle, deepening the relationship with the trade. All of that has been very significant to us and it's allowed us to grow both top line and profitability of packaged coffee to Starbucks.

Also during that span of time, as you know, we've rapidly grown to the leading position in premium single cup. And we now have dollar profitability in single cup that is rapidly approaching the dollar profitability we have in packaged coffee -- so, very healthy components. All of that is incremental over the last two years.

And without putting specific numbers on that, you can see that all of that is attributable, really, to us bringing that fully in-house and building the capabilities to take that model directly to the trade. John?

A - John Culver {BIO 15817924 <GO>}

Yes. Jeff, thanks for the question. Obviously, we are in the early days of building this multi-billion-dollar business. And we have been able to establish a very strong foothold and leadership position in the US and Canadian markets.

In addition, what we have also been able to do this year is built -- over the last couple of years, is build a very strong innovation pipeline. And whether that is in the K-cup area, whether that is with our stars-down-the-aisle loyalty program, or whether that is with our signature aisle rollout that we have been doing just recently, these programs have enabled us to accelerate the growth of the packaged-coffee business and increase our position in the marketplace.

In addition, we also see tremendous opportunity outside of the US. Today, we sit in 29 markets. And obviously, we have a great opportunity to expand that beyond the 29 markets across the globe and increase the over 100,000 points of distribution we currently have globally. So we're very optimistic and very confident about the future. And we're looking forward to continuing to grow this business at the double-digit rate that I have commented on already.

Q - Jeffrey Bernstein {BIO 7208345 <GO>}

Great, thank you.

Operator

Sara Senatore.

Q - Sara Senatore {BIO 16508078 <GO>}

Two questions, kind of related, one about the US business and then another sort of follow-up on the global commentary. Can you talk about the outlook for packaged coffee in the US?

If we look at some of the channel data more recently, it looks like maybe there has been a little bit of a retrenchment since the nice uptick you had following the price cuts. So I am just trying to figure out, should we think about that business as somewhat volatile and relatively slow growth, or are we at a point where maybe we are going to start to see some real impact from a lot of the innovation you have talked about in the core packaged coffee?

Then, the adjacent question was about, could you update us on where you are with respect to China? Because I know that, that's something Howard has talked about, the opportunity there. Have there been any developments in terms of points of distribution or how you think about that market? Thank you.

A - John Culver {BIO 15817924 <GO>}

Hi, Sara, this is John. As I said in our Q4 earnings call, I believe and am fully confident that we are well positioned to navigate any volatility that exists in the US market as it relates to packaged coffee or as it relates to the premium single-cup business. We have got a very strong innovation pipeline starting with this holiday season and then leading into Q2 and for the remainder of this year.

What you will see is that our performance for the business is going to build by quarter, with the back half being stronger due to the impact of the list-price reduction we took last year in May. And again, we are well positioned to deliver that double-digit growth for the full year. Probably what you will see over the first couple of quarters is high single-digit growth. But that will accelerate in the back half of the year. And we will deliver double-digit growth for the year.

In terms of China, we are well positioned -- with Jeff Hansberry now in his role in Hong Kong -- to drive the opportunity for growth in China. We have recently introduced bottled Frappuccino in that market. Sales are going very well there. And we are just in the very early days of building out that capability, that organization. And we are well positioned to capture that opportunity going forward. So we are very optimistic about accelerating the growth there as well.

Q - Sara Senatore {BIO 16508078 <GO>}

Thank you.

Operator

Bonnie Herzog, Wells Fargo.

Q - Bonnie Herzog {BIO 1840179 <GO>}

I was hoping you could talk about new relationships you are forming and distribution agreements you are assigning to build the multi-billion-dollar global packaged-coffee business you mentioned. And what have been some of the lessons learned. And what are you looking for in partners, especially as you try to increase your global points of distribution, which could prove to be challenging?

Then also, could you provide an update on your relationship with Pepsi and how that business is performing. And then possibly highlight some of the differences in that relationship that have allowed that business to flourish? Thank you.

A - John Culver {BIO 15817924 <GO>}

I think under the direct model, what we have able to do is to accelerate the relationships and build much deeper relationships with the key retailers here in the US and abroad. We have now customer teams up against the top retailers across the country where we have been able to go in and build out that -- the relationship and, more importantly, increase our presence down the aisle.

As it relates to the international opportunity, we continue to accelerate the relationships and business partnerships in that space as well. I will use Japan as an example. We have a very strong relationship with Suntory, where we have a very well established ready-to-drink business. We continue to accelerate that growth in that market.

And when you look at the opportunities that we have to continue to build out partnerships across our international markets, we are very confident that we have got very strong relationships in place that we can continue to accelerate the growth. In terms of the China opportunity, again, we feel very confident that China presents a big opportunity for growth. And we will continue to accelerate in China as well.

Then lastly, around Pepsi, our Pepsi partnership is a very strong partnership here in North America. We have been able to increase distribution this past year. And we delivered a record year with our ready-to-drink business, as I commented in Q4 earnings call.

And we have been able to drive meaningful innovation in the area of delivering an iced coffee product through the NACP partnership, as well as building out and delivering a Discoveries product down the aisle as well. So we are very confident that, that business will continue to accelerate and grow. And we're very happy and pleased with our partnership with Pepsi.

Q - Bonnie Herzog {BIO 1840179 <GO>}

Thank you.

Operator

Joe Buckley, Bank of America Merrill Lynch.

Q - Joe Buckley {BIO 1491816 <GO>}

Troy, can you say when the payment is due?

A - Troy Alstead {BIO 5724238 <GO>}

Joe, the exact payment date is not yet determined. That will be subject of some further follow up with the arbitrator.

Q - Joe Buckley {BIO 1491816 <GO>}

Okay. Then, I think you know that I have always viewed this as an acquisition with the purchase price yet to be determined. And I am wondering if we think of it in that light, if you could talk about the valuation maybe at the time you took the business in, what the $2.27 billion -- $2.23 billion, rather, implies. And what that might imply at today's run rate for the business on an EBITDA basis.

A - Troy Alstead {BIO 5724238 <GO>}

I'll speak on it a bit, Joe. We don't, in our filings, disclose separately product line profitability. So I won't give you every bit of what you are looking for. But let me speak to it in general terms.

Because there are, of course, two elements to the trajectory of the business, the profitability of the business. And if you are going to look at it as -- in terms of M&A, you would look at both the cash flows. But the opportunity and the expected growth in those cash flows going forward. Both of which -- by the way, as we have regained operating control and really begun to build this business out in the last two years, as John has described, both of those have grown significantly.

So we have grown profitability, cash flow coming out of our packaged-coffee business and anticipate to continue to be able to do that as time goes forward. That's been a business we have been in for many, many years now, originally in the Starbucks stores and then ultimately down the aisle. We have a leading share and continue to hold the leading share down the aisle and generate incremental profitability over time. And have absolutely driven meaningful incremental profitability as a result of bringing that business under our direct control.

Also as a result of bringing the business under our direct control, we have grown a highly incremental, significant rapid pace of growth in the premium single-cup space, which again is approaching -- in dollar profitability to Starbucks, in dollar cash flow to Starbucks -- the profitability of our packaged-coffee business. And we anticipate as we -- the consumer continues to shift into single serve in the years ahead, we can hold and build upon the strong leadership position that we have already developed in single cup and continue to build that and grow profitability as time goes on.

So both of those, the cash flows from those businesses and the trajectory we have going forward, support a very healthy return to our business and what we believe to be -- despite our disappointment with the final answer from the arbitrator -- supports what was a very, very good decision for Starbucks.

A - Howard Schultz {BIO 1432255 <GO>}

Troy, let me add one more thing about that. In the last earnings call, I think we shared with you that the run rate for the 12-month period for FY13 that we actually had almost $4 billion loaded on Starbucks cards. And then, going into Q1, almost $700 million. The reason I am bringing that up is that the level of innovation and the catalyst for Starbucks growth at retail is directly integrated into a rewards program, the card. And the innovation that we've brought and are bringing to mobile transactions.

Over the last year, we have already seen over 1.5 million people redeem their stars on purchases of ground or whole bean coffee down the grocery aisle. Now, we have been sharing with you, I think for over a year now, the long-term strategy of being in a position, of being the only consumer brand down the aisle that would have the ability to integrate a significant rewards and incentive program that would bounce back into our stores. In addition to that, we are beginning to thread that into Teavana stores and the Teavana brand as well.

The long-term plans that Starbucks has today is to build a multi-channel, multi-brand, multi-category CPG business that is well beyond the size and scale of it is today. And certainly, the aspirations and capabilities we have for that business, we never could've had under the roof of Kraft.

So as difficult as it might be to get beyond the sticker shock of this number, let me tell you all that, once again, the future opportunity that we have well, beyond the business today, to build a one-of-a-kind CPG business integrated into our retail business and fully integrated into the rewards program is just in a nascent stage in demonstrating to us the relevancy to the Starbucks consumer. And this is something that we will not stop domestically.

Q - Joe Buckley {BIO 1491816 <GO>}

Thank you.

Operator

Michael Kelter, Goldman Sachs.

Q - Michael Kelter {BIO 16370642 <GO>}

Actually, I have two questions. The first is, you kept to your 2014 EPS guidance despite this additional layer of interest expense from the $750 million of debt.

Where specifically do you anticipate upside from your underlying business that is going to provide the positive offset to hit that initial guidance range? The second question is, how much of your current cash balance is overseas. And will there be any tax implication from repatriating to make the payment?

A - Troy Alstead {BIO 5724238 <GO>}

Thanks, Michael. First of all, on your second question, yes, we do have a fairly healthy chunk of cash that sits overseas, somewhere approaching $1 billion at this stage. We do not intend to repatriate that cash in order to make this payment.

So we will, even after taking an additional $750 million in debt, be making the payment as the arbitrator has indicated. We will still have cash on our balance sheet, certainly some domestically but a fair amount offshore. So there will be no incremental tax expense as a result of repatriating cash. We do not anticipate doing that at this stage.

Then, with respect to guidance, what I would say is we are extremely early in our fiscal year. Our initial guidance every year is a range. And every year as we progress throughout the year, we have new plans. We have -- we tend to be nimble in terms of opportunities that come along. We will pursue new innovations.

We will adjust our growth plans as we go throughout the year. That is just our normal way of operating as we proceed throughout any given year. And that is why we will start the year as we did this year with a range that's a bit wide. And as we progress through the year, tighten up based on what we learned.

The arbitration answer yesterday was a new bit of learning for us and does add a little bit of pressure in terms of additional interest expense throughout the year from what we had been previously anticipating. But at this early stage in the year, all that fits within that guidance range and a little bit of the fluid plans that we would always approach a new fiscal year with. So I am quite comfortable we are going to deliver another strong year of earnings growth, another strong year of top-line growth. And we are going to meet our commitments.

Q - Michael Kelter {BIO 16370642 <GO>}

Thank you very much.

Operator

This concludes today's conference. At this time we have no further questions. I will now turn the call back to Ms. DeGrande.

A - JoAnn DeGrande {BIO 2134543 <GO>}

Thank you. Thank you for joining us today. This does conclude our call. We will talk to you again soon.