

## Starbucks Corporation (NYSE: SBUX)

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<b>Ticker:</b> SBUX	<b>Current Price:</b> \$58.07	<b>Stock Exchange:</b> NASDAQ
<b>Sector:</b> Consumer Discretionary A	<b>Industry:</b> Restaurants	<b>Headquarters:</b> Seattle, Washington

### Introduction:

Starbucks Corporation (SBUX), purchases and roasts high-quality whole bean specialty coffees and sells them, along with fresh, rich-brewed coffees, Italian-style espresso beverages, cold blended beverages, and a variety of coffee related food products. Currently there are over 28,000 locations worldwide with over 300,000 employees. 2017 revenues reached \$22 billion and in 2018, current revenues are up 6.5% compared to the previous and are projected to be reach \$24.6 billion. Breaking down the revenue of Starbucks, there are four main categories: Beverages (58% of total revenue), Food products (17%), Packaged and Single-serve coffees and teas (13%), and Other (12%). Starbucks strives for superior customer service and in-store experience to build a high degree of customer loyalty. Their goal is to be the world's leading premier coffee retailer by selling the highest quality of coffee and related products. Moving forward, Starbucks is putting disciplined focus on expanding globally, especially in China, where they plan to optimize the mix of company-operated and licensed stores in each new market they expand into.

<b>Price (\$):</b>	\$58.07	<b>Beta:</b>	.57		<b>2016A</b>	<b>2017A</b>	<b>2018E</b>	<b>2019E</b>
<b>Price Target (\$):</b>	\$74.54	<b>WACC:</b>	11.7%	<b>Revenue (mil)</b>	21,315.6	22,386.8	24,694.6	26,145.8
<b>52 WK H-L (\$):</b>	61.94-47.37	<b>Current Ratio</b>	1.2	<b>% Growth</b>	11.2%	5%	7.7%	10.3%
<b>Market Cap (mil):</b>	79,273.1	<b>PEG Ratio</b>	1.5	<b>EBITDA</b>	5,259.4	5,418.3	5,626.0	5,913.3
<b>Float</b>	97.1%	<b>Asset Turn</b>	1.6	<b>EBITDA Margin %</b>	24.7%	24.2%	22.2%	22.6%
<b>FCF</b>	24.3%	<b>Quick Ratio</b>	.9	<b>EPS</b>	1.93	2.09	2.48	2.64
<b>Avg. Daily Vol:</b>	10 Mil	<b>ROA (%)</b>	28.71	<b>Locations</b>	25,085	27,339	28,209	29,337
<b>Dividend (\$):</b>	1.26	<b>ROE (%)</b>	92.56	<b>P/E</b>	28.5	26.8	23.9	21.5
<b>Div Yield (%):</b>	2.4%	<b>ROIC (%)</b>	28.74	<b>Price Increase (5 Yr)</b>	18.6%	<b>S&amp;P Price Increase (5 Yr)</b>	4.8%	

### Recommendation:

We recommend a BUY on Starbucks Corporation (SBUX) based on the following attractive factors: Strong increased consumption of "Gourmet" Coffee, forecasted penetration of Asian markets, dramatic growth within younger generations which result in a strong growth potential of their financials,

specifically revenue. We also project a 28.52% upside based on our valuations. Over the past 5 years, Starbucks has seen a CAGR for revenue and net income of 11% and 16% respectively. Furthermore, store count and same store sales have grown over the past 3 years by an average of 16% and 5% respectively. We see this growth continuing in the future as Starbucks is aggressively, yet strategically, expanding in the Asian market and as consumer trends are shifting more towards specialty coffee in social/on the go settings. In China alone, Starbucks has over 60% of the market share of an industry worth around \$3.24 billion in 2017 and expected to grow to \$4.2 billion by 2020 or by nearly 24%. Starbucks is planning on capturing this new industry growth in China by opening a new outlet nearly every 15 hours with a goal of 6,000 total stores in the next five years. Looking at consumer trends, in 1999, only five percent of adults drank specialty coffee daily. Fast forward to 2017, now over 41% of adults drink specialty coffee daily. This is tremendous growth and we see it continuing as millennials are driving this trend. Even if the economic situation turns negative, coffee is relatively recession proof. Studies have been done, showing that people would be more willing to give up gas before their daily latte. They would rather give up bigger expenses first, that are more impactful and noticeable, compared to a \$2 daily latte. Coffee is a part of their daily lives and people are creatures of habit and they will continue buying coffee. Not only that, the affordability of a latte has long been its strongest suit, regardless of the economy. Coffee shops like Starbucks will always be great places to have a date, read a book, do work, meet friends, or even to grab a bite to eat. As our generation becomes more social, is there a better equipped public space? Based on all these factors, at a current price of \$74.54, we feel this is undervalued, making Starbucks a strong “buy”.

### **Investment Thesis:**

**Asian Market Penetration:** Starbucks’ largest growth market is China and over the next five years, they are putting tremendous focus on this new market. Starbucks is doing this in a strategic way, as they have learned from their mistakes in the past when they tried to enter Australia without considering their culture and specific market. In Australia, the company grew very quickly in a couple of years until 2008, when they started shutting down most of their stores. Today, the company is starting to rebound in Australian market, as they are taking a more strategic approach. The point I am getting at is Starbucks learned from their mistakes and is rapidly expanding in China by using a strategic approach. Starbucks has planned and executed collaborations with Chinese partners, superior supply chains, adopting local technologies and food items of the Chinese culture to thrive in this new market. Beyond these physical changes, Starbucks took it a step further, truly incorporating the Chinese Culture. Since the first Starbucks opened in China in 1999, the company has meticulously organized its efforts in China around the three key pillars of Chinese culture: Family, Community, and Status. By using this approach, Starbucks now has over 60% of the market share in China worth around \$3.24 billion. Currently, Starbucks has roughly 3,500 stores in 141 cities in China and within the next five years, they plan on doubling the number of stores to over 230 cities. The company has also said that China has their most innovative, efficient and profitable stores. According to Starbucks, “Starbucks’ newest class of stores in China are delivering the highest average unit volumes, return on investment and profitability of any market’s prior store classes in its history.”. On top of new store growth, Starbucks struck a deal with Tingyi, a leader in China’s ready-to-drink beverage category, to distribute Starbucks’ premade lattes across 400 major cities with over 125,000 points of distribution. As the specialty coffee sector continues

to grow in China, we firmly believe, Starbucks has positioned themselves to follow this growth to continue being the industry leader.

**Partnerships:** A big part of Starbucks' success and continued future growth comes from partnerships with major companies around the world. One key partnership, especially for the Chinese market, is with Alibaba. This partnership formed in August of this year and it is a strategic "New Retail" partnership that will allow a seamless Starbucks experience to revolutionize the coffee industry in China. Utilizing the Alibaba ecosystem, including Ele.me, Hema, Tmall, Taobao, and Alipay, Starbucks is providing delivery services using "Starbucks Delivery Kitchens" for delivery order fulfillment. They will leverage this ecosystem to create an unprecedented virtual Starbucks store to even further personalize the online Starbucks experience for Chinese customers. By the end of the year, this virtual store experience, created through the Alibaba partnership, is expected to roll out to over 2000 store in 30 cities. Starbucks is also using Alibaba to incorporate mobile pay and last year alone, more than 60% of Starbucks' tender in China was paid digitally through mobile app with Alibaba's technology. The company will continue to use this technology as they believe it is one of the transformative elements of modern retail.

Another key partnership that Starbucks has formed this year is with Nestle. This will allow Starbucks to accelerate and grow their global reach of Starbucks brands in Consumer-Packaged Goods and Foodservice, which currently accounts for roughly 15% of their revenue. Specifically, this deal granted Nestle the rights to market, sell, and distribute the Starbucks brand. This global partnership will help bring the Starbucks experience to millions of new homes around the world with Nestle's reach and reputation. In China, the ready-to-drink coffee market is worth \$1.3 billion and is dominated by Nestle, who controls 71%, while Starbucks only has 3.1% of the market. By partnering with Nestles, Starbucks will now have access to more than 1.5 million distribution outlets to sell its ready-to-drink coffee, which should dramatically boost sales. This partnership is also very important to shareholders because the after-tax proceeds Starbucks received for this deal (\$7.2 Billion) is going to be used to accelerate Starbucks' aggressive share buyback program. By year 2020, Starbucks plans on returning around \$25 billion in cash to its shareholders with these share buybacks and dividends.

**Consumer trends:** With a coffee shop being a staple in nearly every American town, it is clear that we as a nation can't live without our coffee. Over the last few years there has been a noticeable shift in the coffee landscape as gourmet coffee now makes up 60% of daily coffee consumption. Over the past year, the number of specialty coffee drinkers has increased nearly 10% and is now at 41%. This is mostly driven by a strong increase in younger generations entering the coffee market. According to the National Coffee Association, for the first time in nearly 68 years, consumers are purchasing more coffee on the go than making it at home. This proves to be very attractive and directly benefits Starbucks. Since Starbucks currently dominates the gourmet coffee market they have and will directly profit from this shift. The increase in popularity of social media can be directly correlated with the dependence of gourmet coffee, especially among younger generations. Starbucks certainly knows how to dominate this generation especially in an era where social media is king. One secret to Starbucks' success is their view towards social media, "Getting customers is good. Keeping customers is great." No matter which Starbucks platform you visit, it is noticeable that they all have the same touch and feel, giving off a warm and friendly vibe. This strategy has proven to be successful especially among younger generations. We feel this strategy will continue to drive growth leading to increased sales.

### Valuation:

Two separate models were used in the valuation of Starbucks. The first was a discounted cash flow model. The cash flows for the first five years were calculated separately, the second stage used a conservative growth rate of 6% for five years, and a terminal growth rate of 2.5%. This led to a one-year price estimate of \$72.43 which gives Starbucks an upside of 13.43%. Our next valuation model was an EV/EBITDA multiples model. We used a peer group of five different companies that can closely be related. Using the multiples approach we came to a price estimate of \$79.46. We then split these two valuations 70/30 favoring the DCF approach. This is because we believe the DCF approach is more accurate due to the fact that many of Starbucks peers don't have similar market caps. Our final one-year price estimate is \$74.54, with an upside of 28.52% from the closing price on October 25th of \$58. This leads us to believe Starbucks has a target price range between \$70-\$80 per share.

### Risks:

**Regulations in China:** Currently, Starbucks is seeing its biggest growth from further penetrating into the Chinese region, however, there are many aspects that could hinder continued expansion in this market. China has a very tough regulatory market and if they decide to change certain conditions, Starbucks' expansion strategy could come to an end. Other factors such as food safety issues or tensions with the U.S. and China could take a turn for the worst and the brand could be damaged, certainly halting ambitious expansion plans in China. Overall, this is an external risk and it would affect every company in this emerging market, not just Starbucks. All of this uncertainty is a concern for investors and Starbucks is doing everything they can within their control to properly continue expansion in China.

**Boutique coffee sellers and cheaper rivals (Competition):** Competition within this industry is very aggressive, especially as new boutique and cheaper rivals enter. Starbucks' main competitors include Dunkin Brands, McDonalds, and convenience store brands. For years, no other company could touch Starbucks in terms of their "third place" model which include the factors of beverage quality, store setting, service, and culture. Competition has now caught up and they are able to provide better products and overall experience than Starbucks can. This is no secret to Starbucks and they are constantly innovating and partnering with global companies to keep and expand their market share. They are also often the front runner in emerging markets, where they are strategically growing their operations.

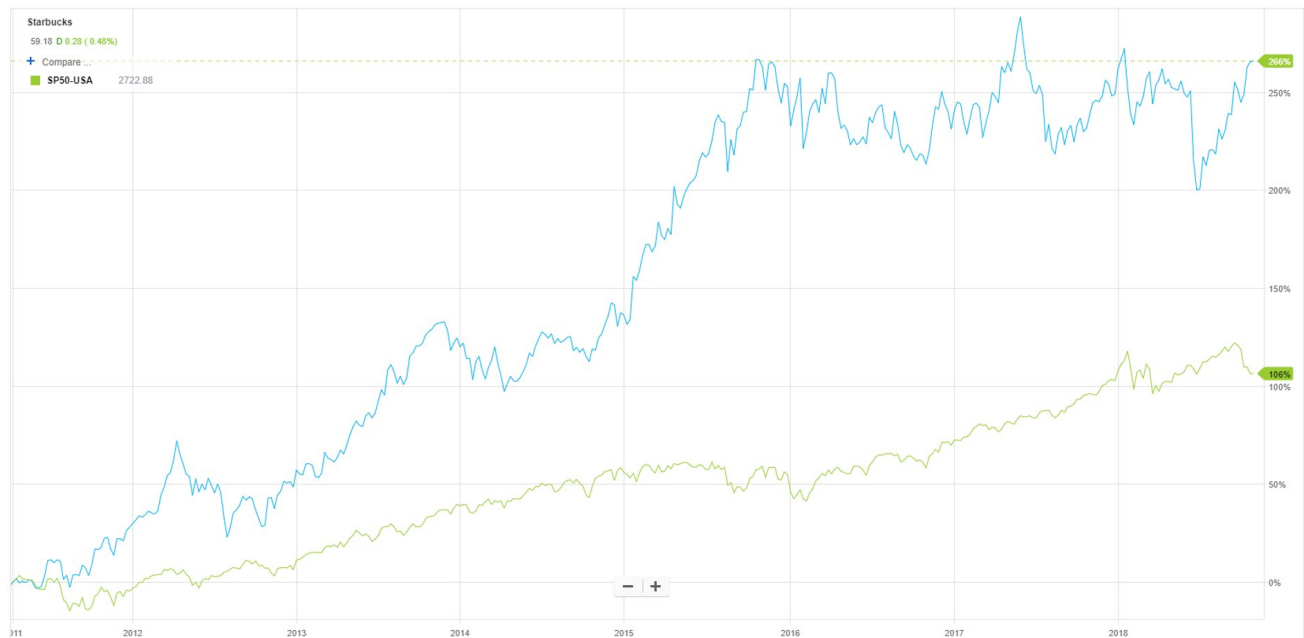
**Commodity Prices:** Starbucks uses a great deal of commodities that range from coffee beans, sugar, and milk to make its products. This risk is outside of Starbucks' control; however, they can use derivative contracts to mitigate some of this risk. With these contracts, they can hedge their risk in case prices skyrocket. Past data shows that a derivatives strategy is effective for Starbucks' bottom line and they will continue to use this strategy in the future.

### Management:

As of April 3rd, 2017 Kevin, Johnson assumed the helm of CEO with Starbucks Corporation. For the first year of being CEO, Johnson was overshadowed by the former CEO and recently departed executive chairman, Howard Shultz. However, since Shultz's departure at the end of June, Johnson has been able to assume full responsibility and is successfully carry out his responsibilities. Johnson is very qualified for

this position as he has had various executive roles at Microsoft for 16 years and was the previous CEO of Juniper Networks from 2008 to 2014. Johnsons current compensation is based heavily on performance bonuses which leads us to believe he will make decisions that will directly benefit Starbucks as he ultimately will be rewarded based on how the company performs. Johnson's goal is to continue growth in emerging market, form strategic global partnerships, and strengthen current market locations. Overall, the individuals that make up Starbucks C-Suite level average a tenure of 8 years with the company and average 54 years of age. Therefore, we feel Starbucks possesses well qualified individuals that will continue to lead and successfully grow the company.

### Stock Chart of Past Performance:



Starbucks- Blue, S&P 500-Green

### Peer Analysis:

Name	Ticker	Market Cap	Sales	EBITDA	P/E	ROE	Enterprise Value
<b>Starbucks Corp.</b>	<b>SBUX</b>	<b>79,273</b>	<b>24,116.2</b>	<b>5.2 B</b>	<b>23.80</b>	<b>92.6%</b>	<b>84,168.9</b>
<b>Dunkin' Brands</b>	DNKN	6,027	1,103.3	476.5 M	26.36	NA	8689
<b>McDonalds Corp</b>	MCD	136,618.5	21,587.6	9.9 B	23.34	NA	166789
<b>Nestle</b>	NESN	253,555.1	93,34.52	19,084.9 B	31.08	13.9%	284519
<b>Whitbread</b>	WTB	8,072.7	3,635.8	1024.4	15.5	18.2%	11698.3
<b>Farmer Bros. Co</b>	FARM	413.2	605.5	43.9 M	NA	16.6%	512.1

<b>Peer Average</b>		42,626	24,055.1	6,109.3	24.02	20.6	94,441.5
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**Ownership:**

<b>% of Shares Held by All Insider Owners:</b>	2.79%
<b>% of Shares Held by Institutional &amp; Fund Owners:</b>	97.2%

**Top Five Shareholders:**

Holder	Shares	% Outstanding
Vanguard Group	95,848,826	7.10
BlackRock Inc.	84,654,465	6.27
State Street Corp.	54,043,461	4.01
Capital Group Cos Inc.	50,907,581	3.77
Morgan Stanley	47,116,946	3.49

