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from the NOVA – School of Business and Economics

Growth is not over for Starbucks,
It is empowered by digital and Geographic
Expansion

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Abstract

This paper is an equity research on Starbucks Corporation. During this report, it will be analyzed the current status of the coffee retailing industry, how it is going to evolve in the future and how it will influence Starbucks' value creation. Moreover, Starbucks' main revenue drivers will be studied and projected until 2031, based on the company strategy and on the overall external conditions affecting its activity. The result is the company's cash-flows until 2031, which will be used to compute the valuation of the company in 2020, using the fundamental analysis, predicting Starbucks' share price in this year. Lastly, it will be computed the return that shareholders should expect, in order to release our final recommendation, which is to buy the stock.

Keywords (up to four)

Valuation

Research

Starbucks

Price

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STARBUCKS CORPORATION

CONSUMER DISCRETIONARY SECTOR

STUDENTS: SOFIA OLIVEIRA AND
LEONOR SANTOS

COMPANY REPORT

03RD JANUARY 2020

Growth is not over for Starbucks

It is empowered by digital and geographic expansion

- **America still is the biggest market for Starbucks**, accounting 68% of consolidated total net revenues in fiscal 2018.
- **China, Asia, and Pacific (CAP) segment**, the second biggest market for Starbucks represents a huge opportunity. Spending on coffee in China is expected to increase by **11%** annually over the next four years. Starbucks believes it will have a stronger presence in Asia than in the US itself.
- **Practical and technological coffee experience** is crucial for Starbucks success. **Mobile orders** represent **17% of total transactions** and will continue to increase. Starbucks's desire to put technology at the heart of the brand is paying off. Partnerships with Uber Eats in America and Alibaba in China allow for Starbucks delivery services, which will empower sales increase.
- The exploration of the **continuously rising millennial population**, as well the exploration of **coffee premium drinking**, through Starbucks Reserve Stores will be key success factors.
- Partnership with Nestle, to form **the Global Coffee Alliance**, will drive globalized awareness for Starbucks brand and will allow Starbucks to benefit from Nestlé's international distribution network.

Company description

Starbucks is the number one specialty coffee retailer worldwide, with over 29,300 coffee shops spread across 80 countries. Through Licensed and company-operated shops, the company offers coffee and teas, food items, roasted coffee beans, and coffee accessories.

Recommendation: **BUY**

Price Target FY20: **94.32 \$**

Price (as of 31-Dec-19) **87.92 \$**

Reuters: SBUX.OQ, Bloomberg: SBUX US Equity

52-week range (USD)	61.40-99.72
Market Cap (USDm)	104,017,000
Outstanding Shares (m)	1184

Source: Bloomberg



Source: Bloomberg

(Values in USD millions)	2021F	2022F	2023F
Revenues	28,676	30,313	32,048
EBITDA	6,021	6,371	6,742
EBIT	4,468	4,739	5,030
Net Profit	3,407	3,614	3,836
FCF	2,555	2,812	3,081

Source: Analyst Estimation

THIS REPORT WAS PREPARED EXCLUSIVELY FOR ACADEMIC PURPOSES BY SOFIA OLIVEIRA AND LEONOR SANTOS, MASTER IN FINANCE STUDENTS OF NOVA SCHOOL OF BUSINESS AND ECONOMICS. THE REPORT WAS SUPERVISED BY A NOVA SBE FACULTY MEMBER, ACTING IN A MERE ACADEMIC CAPACITY, WHO REVIEWED THE VALUATION METHODOLOGY AND THE FINANCIAL MODEL. (PLEASE REFER TO THE DISCLOSURES AND DISCLAIMERS AT END OF THE DOCUMENT)

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Executive summary

The purpose of this Equity Research is to perform a valuation of Starbucks, in order to release an investment recommendation.

Company Overview

On the company overview section, it will be made an analysis of Starbucks company, specially its business focus and model, with the aim of providing key characteristics that will be used on the forecasting section. In short, Starbucks acts in five segments: CAP, Americas, EMEA and consumer-package goods (CPG), “offering several blends of coffee, handcrafted beverages, merchandise, and food items”¹.

Industry Overview

In this section, it will be performed an extensive analysis on the coffee retailing industry, in order to build a strong base for the forecast. This industry is highly fragmented, with a variety of players that go from large corporations to small shops around the corner. **Premium products demand, health and sustainability concerns, rising coffee consumption from the millennial population and higher digitalization** are set to drive growth in the industry.

Valuation

In a first phase, it will be presented a relative valuation, which provides the first perspective of the firm value.

With the analysis on the external factors affecting Starbucks in mind, the main revenue drivers will be identified and projected for 2031.

Since Starbucks is exploring new markets, it was needed a **forecasting period from 2018 to 2031**, in order to ensure a stabilized growth rate. From 2032 onwards, a terminal value with a **perpetual growth rate of 2.63%** has been incorporated into the model, which is in line with the **forecasted inflation rate by the International Monetary Fund (IMF)**. Furthermore, a **WACC of 6.16%** was used to discount the Cash Flows, that yielded an **Enterprise Value of USD 115.437 million**.

Our valuation results suggest that the market is undervaluing Starbucks

¹ Source: Global Data. 2019. “Starbucks Corp (SBUX) Financial and Strategic SWOT Analysis Review”

Company overview

Starbucks is the number one roaster, marketer and retailer of coffee worldwide.² In FY18, the Company operated nearly **15,300 company-operated stores** and **14,000 licensees and franchisees**, totaling about **29,300 stores** across **80 countries**. Furthermore, Starbucks generated revenues through consumer-packaged goods and foodservice operations³.

Company description

Founded in 1971, Starbucks is a **global coffee retail company** specialized in coffee and other beverages.

Starbucks aims to be “one of the most recognized and respected brands in the world”⁴. This objective is to be accomplished through disciplined **expansion of its global store base**, adding stores in both existing and developed markets such as the United States (US), but most important, more recent, higher-growth markets such as China.

The company operates its business through **five segments**: Americas, China/Asia Pacific (CAP), Channel Development, Europe Middle East and Africa (EMEA) and Corporate and Other. At the end of FY18, the company operated 17,454 stores in Americas, 8,530 stores in CAP, 3,320 stores in EMEA and 20 Corporate and Other stores (Figure 1).

Moreover, Starbucks business includes **two varieties of stores**: company-operated stores and licensed stores. In FY2018, 52% of Starbucks revenues derived from company-operated stores, while the remaining 48% were generated from licensed stores (Figure 1).

The upscaling of the brand is supported by **Starbucks' digital offerings** (including My Starbucks Rewards and Mobile Order & Pay platforms), **consumer packaged goods efforts** (K-Cups, Nespresso-compatible products, and other), **geographic expansion opportunities** (mainly China, India, and Japan), and a complementary brand portfolio (the Starbucks Reserve sub-brand in particular, bringing a premium food and craft coffee experience to its clients).

The company will also have the opportunity to expand its presence on grocery and mass-channel shelves across the globe through a **partnership with Nestle** to

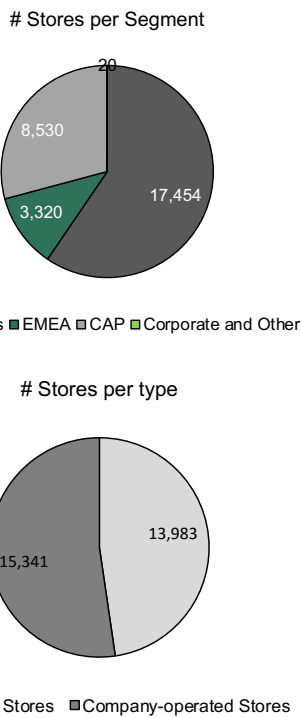


Figure 1: Number of stores in FY18, per segment and type⁴

² Source: Thomson Reuters

³ Source: Zacks Investment Research Inc. 2019. “Starbucks Corp (SBUX)”

⁴ Source: Company Report. 2018.

market, sell, and distribute the Starbucks, Teavana, VIA, and other brands across more than 190 markets across the globe.

Finally, through the partnership with Uber Eats, the company is expecting to provide for delivery services in 11 markets in 2019, which is expected to increase sales⁵.

Shareholder structure

Table 1: Top 10 Institutional Holders⁶

OWNER NAME	Value (In k\$)
Vanguard Group Inc	\$7,402,992
Blackrock Inc	\$6,644,223
State Street Corp	\$4,315,130
Magellan Asset Management Ltd	\$2,516,183
Bank of New York Mellon Corp	\$1,807,038
Northern Trust Corp	\$1,649,960
Geode Capital Management, LLC	\$1,481,327
Invesco LTD.	\$1,421,357
Bank of America Corp /DE/	\$1,392,877
Loomies Sayles & Co LP	\$1,345,858

Starbucks stock is publicly listed since 1992, under the name of SBUX, with its initial public offering (IPO) at USD 17 per share.

Starbucks' shareholder base is comprised of institutional ownership, insider ownership, general public ownership and private company ownership. Institutional ownership represents 75.89% of total shares. Insider ownership consist of managers having the stock of the company and represents nearly 2.66%, which can be considered a significant holding given the fact that Starbucks is a large-cap stock.

Lastly, general public ownership represents 21.45% and private companies represent 0.00018%, an insignificant holding, motivated mainly by strategic interests and potential capital gains.

In what concerns to dividend policy, Starbucks is particularly determined on putting shareholder returns first, which is noticed by the evolution of its dividend payout since 2015. The company pays dividends on a quarterly basis. Since 2015, Starbucks' quarterly dividend payout rose by 125%, from USD 0.16 to USD 0.36. On an annualized basis, Starbucks' quarterly dividend translates to USD 1.44 per share⁷.

Industry Overview

Starbucks Corporation acts in the **coffee retailing industry**, on the consumer discretionary sector.

Coffee retailing industry is composed by specialist outlets, that focus on the **sale of coffee**, along with other **drinks and snacks**. The coffee retailing industry product portfolio is mainly characterized by two types of goods: beverages and complementary food items. Beverages include a variety of hot drinks (brewed coffees and teas), cold blended beverages, bottled water and soft drinks. Food

⁵ Source: Business Insider. 2019. "Starbucks to launch uber eats delivery across US", Accessed October 31st 2019 <https://www.businessinsider.com/starbucks-to-launch-uber-eats-delivery-across-us-2020-2019-7>

⁶ Source: NASDAQ

⁷ Source: Motley Fool. 2018. "4 Reasons to Love Starbucks Dividend" Accessed October 31st 2019, <https://www.fool.com/investing/2018/08/23/4-reasons-to-love-starbucks-dividend.aspx>

products range from pastries to bakery items, desserts, sandwiches, and candy⁸. This industry is highly competitive and fragmented, with a **variety of players**. Since tastes for coffee are different among the world, every market has its own local competitors, smaller chains and independent coffee bars, all trying to differentiate themselves. The **major players** on this industry, and Starbucks' competitors, are: **McCafé, Costa Coffee, Dunkin Brands, Luckin Coffee and Caffè Coffee Day** as well as some little shops of premium coffee that do not belong to any large group of companies as the ones mentioned before.

Coffee-drinking has evolved considerably in the past few decades. According to the National Coffee Data Trends Report, by the National Coffee Organization, 64% of the American adults consume coffee on a daily basis. From all the trends seen in the industry, Ready-to-drink (RTD) coffee is posing new opportunities for the promotion of new products, particularly among younger costumers, which also brings more competition into the industry. "The Global RTD coffee market was valued at USD 19.05 Billion in 2017 and is projected to reach USD 36.60 billion by the end of 2025, exhibiting a CAGR of 8.5%", according to Fortune Business Insights.

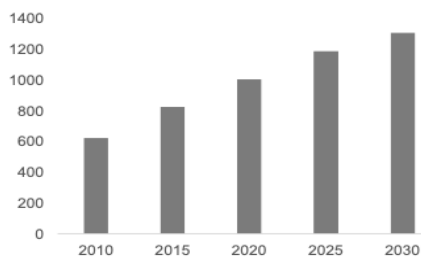


Figure 2: Households with an Annual Disposable Income over 10,000USD in million⁹

Launching of **innovative beverages, rising demand for higher quality products, and increasing disposable income of consumers** (see Figure 2) are believed to incentive growth in the industry. The exploration of the continuously **rising millennial population, the exploration of coffee premium drinking, the rising of environmental and health concerns and digital engagement** will be key success factors for coffee market participants.

- **Premium Coffee**

The growing demand of premium beverages, commercialized to target customer segments that search for unique features and higher quality, is expected to foster growth. The "National Coffee Data Trends" report, conducted by the National Coffee Organization in the US can be a clear example of this trend. This study used a sample of 2,815 people who reported drinking a beverage other than water within the past day. This study claims that "for the first time in the report's 69-year history, gourmet coffee reached a 60/40 advantage over traditional non-gourmet coffee among past-day drinkers."¹⁰

USA and Europe show higher consumption per capita and higher household consumption of premium coffee. According to a survey taken by Allegra WCP in 2017, a rising number of Americans is demanding higher quality coffee. 55% of

⁸ Source: Grin. 2018. "Coffee Shop Industry - A Strategic Analysis" Accessed October 31st 2019, <https://www.grin.com/document/111348>

⁹ Source: Market Line

¹⁰ Source: Daily Coffee News. 2019. "2019 Coffee and Beverage Trends: Inside the NCA's Annual Report" Accessed October 31st 2019, <https://dailycoffeeneeds.com/2019/03/11/2019-coffee-and-beverage-trends-inside-the-ncas-annual-report/>

over 5,000 consumers surveyed responded they would be willing to pay a higher price to consume better quality coffee, giving a price ceiling of \$3.18 per beverage on average¹¹. This survey leads us to conclude that in the future, **there is a premium market for Starbucks to continue to explore**. Actually, Starbucks has already started to explore this market, through Starbucks' Reserve Stores and also with new products on its existent stores. Launching of new beverages such as the "Flat White" espresso and "Shaken" iced teas, which can be considered to be premium, are a key factor to increase revenues, since these drinks are more expensive than regular ones and costumers are willing to pay for it. Moreover, Starbucks' baked products also saw price increases over the years, since recipes have changed to guarantee higher quality and authenticity.

- **Health and Environmental Concerns**

As part of an **evolving cultural pursuit of healthier food habits and environmental concerns**, consumer preferences are changing towards the consumption of nutritious and high-quality hot beverages, which come from sustainable sources, over more artificial drinks. There is an increasing demand for products from natural origin associated with health benefits, in opposition to more processed foods. According to L.E.K.'s 2018 consumer food and beverage survey, "nearly 1,600 consumers demand health claims to be more nuanced and carry specific attributes. Among this group, 73% to 86% say they would pay extra for food products with health and wellness attributes that resonate. This is about 15 to 20 percentage points more than in 2016"¹².

- **Rising Millennial Population**

According to Financial Times and the World Data Lab, the **global spending power of millennials will soon surpass that of any other generation**. Millennials, a 19-34-year-old demographic, are an important driving force on the coffee market expansion and are set to drive the future of economy. As reported by the National Coffee Association, millennials are responsible for nearly 44% of the United States coffee consumption. In eight years, until 2016, daily coffee intake among millennials has risen from 34% to 48%.

Global millennial spending power is set to overtake generation X by 2020 and will continue to rise

Forecast annual aggregate income, by generation (\$tn)

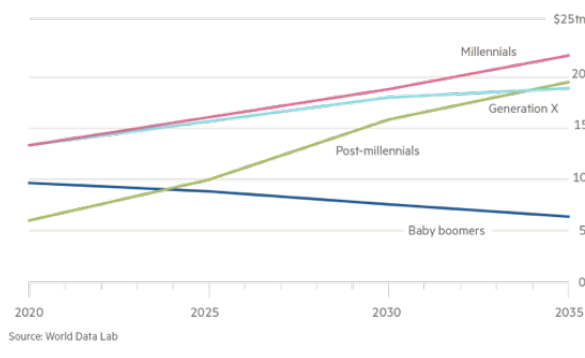


Figure 3: Global Millennial Spending Power¹³

¹¹ Source: Coffee Talk. 2016. "Boom in US coffee shop market set to continue" Accessed October 31st 2019, <https://coffeetalk.com/ctpress/10-2016/37079/>

¹² Source: L.E.K Consulting. 2018. "Consumer Health Claims 3.0: The Next Generation of Mindful Food Consumption" Accessed October 31st 2019, <https://www.lek.com/insights/ei/next-generation-mindful-food-consumption>

¹³ Source: Financial Times

• **Digital Coffee Experience**

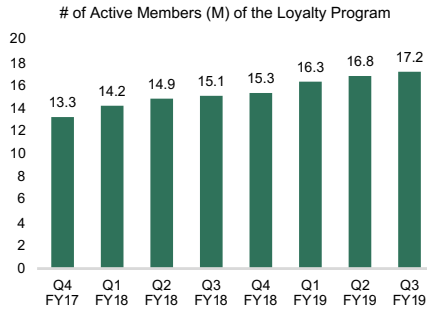


Figure 4: Active Members of the Loyalty Program (in millions) ¹⁴

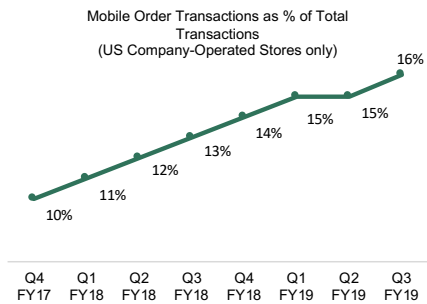


Figure 5: Mobile Order Transactions as % of Total Transactions ⁴

Besides the quality and the investment on premium coffee, there is an increasing trend towards a **more technological coffee experience**. Since the launch of its mobile app in 2015, when other competitors did not have such features, Starbucks has been the leader on mobile ordering. The company is known for being a pioneer in using its digital platform to enhance customer's coffee experience while gaining revenue and customer loyalty. Through Starbucks Rewards program, loyal customers can achieve certain benefits depending on their consumption levels.

Management expects rewards-member acquisition, mobile order-and-pay adoption and the new rewards program launched in fiscal 2Q to boost same-store sales by 1-2 percentage points a year. US results have been strong so far in 2019.

Mobile order and pay adoption boosted same-store sales by 2 percentage points, achieving **16% of total transactions** in the US in 3Q 2019 (Figure 5).

Delivery is another important trend on the restaurants sector. Starbucks has taken a great effort on this matter, recently shown by its **partnership with Uber Eats in the US**, to provide delivery services among the country. It also entered a **partnership with Ele.me, the leading Chinese food delivery platform**, to bring delivery services to 30 cities across China. This focus on customer services through digital means, can be considered a significant competitive advantage, coming essentially from being the first coffee retailer offering these facilities.

When comparing Starbucks to its most direct competitor, Costa Coffee, one can see that Starbucks is clearly at advantage as it allows customers to pay through the app on their phones, while Costa Coffee only allows for collecting points that can be used when making a purchase at the store. Recently, Costa Coffee has also launched a new mobile app that allow for digital purchasing. However, Starbucks has its app since 2015, it had the chance to build a much higher client network than companies that are starting now to invest on reward and mobile-order programs.

Following the abovementioned trends, the players of coffee industry are betting on higher quality, allied with the right use of technology, to transform coffee in an experience.

¹⁴ Source: Company Information

Competitors

Competition in the coffee retailing industry has escalated in recent years, with multiple competitors joining the market, trying to take advantage of the unexplored trends of the industry.

Table 2: The Coca-Cola Company main Financial Figures ¹⁵

The Coca-Cola Company (in million USD)	
Revenues 2018	31,856
Revenues 2019 (Current)	33,558
EBITDA 2018	9,786
EBITDA 2019	10,576
Net income 2018	6,434
Net income 2019 (Current)	7,748

Table 3: McDonalds' main Financial Figures ⁵

McDonalds (in million USD)	
Revenues 2018	21,025
Revenues 2019 (Current)	20,891
EBITDA 2018	10,219
EBITDA 2019	11,872
Net income 2018	5,857
Net income 2019 (Current)	6,088

Table 4: Dunkin Brands' main Financial Figures ⁵

Dunkin Brands (in million USD)	
Revenues 2018	1,322
Revenues 2019 (Current)	1,354
EBITDA 2018	459
EBITDA 2019	515
Net income 2018	231
Net income 2019 (Current)	248

1) **The Coca-Cola Company** is a beverage company, with presence in more than 200 countries. Recently, The Coca-Cola company acquired Costa Coffee, which was previously owned by Whitbread. Costa Coffee is the largest coffee retailer in the United Kingdom (UK) and the second largest worldwide, after Starbucks. It has over 3000 stores spread across 30 countries. In the UK alone, it operates more than 2000 restaurants. However, in the US it has no presence. Costa Coffee has a business focus more similar to Starbucks than other competitors we are going to mention because, like Starbucks, its effort is the promotion and sale of coffee, while all the other coffee retailers present a more diverse product mix. Like Starbucks, Costa Coffee is looking at international expansion to drive growth, being the second company with higher presence in China, after Starbucks.

2) **McDonalds – McCafe** was founded in 1993 in Australia and implemented in 2001 in the United States. McCafe strongly arose as one of Starbucks' competitors, gaining market share through the years. Backed by the extensive spread of McDonald's stores worldwide, McCafe offers food and other drinks, in addition to coffee. When compared to Starbucks, it presents a lower price on coffee, which can be considered a competitive advantage for McCafe. However, these two companies compete against each other simply because both sell coffee. While Starbucks is making an effort to increase its market share mostly in the premium sector, McDonald's is striving for Starbucks' original customer segment, by offering specialty coffee.

3) **Dunkin Donuts** is a donut and coffee seller based in Massachusetts, in the U.S. It runs its business through more than 11,500 outlets, present in more than 35 countries.

Dunkin aims to operate in over 18,000 U.S. locations, according to its annual report. It is also investing on drive-thru facilities and in a digital platform which is currently being tested. Unlike Starbucks, the company is not only focused on coffee retailing, though it started to explore the coffee market years ago. The

¹⁵ Source Bloomberg

chain's management has revealed its commitment to offer the lowest price in the market, allying quality to low prices. However, through a higher product customization and a clear focus on the client's experience, Starbucks created an exclusive brand, which is what makes it distinct from Dunkin. While Dunkin's space is much more alike to a fast-food chain outlet, Starbucks spaces invite people to spend time there, transforming coffee-drinking in a remarkable experience.

Table 5: Café Coffee Day's main Financial Figures¹⁶

Coffee Day Enterprises (in million USD)	
Revenues 2018	519
Revenues 2019 (Current)	600
EBITDA 2018	108
EBITDA 2019	81
Net income 2018	10
Net income 2019 (Current)	18

4) **Café Coffee Day** is a global company with headquarters in Bangalore, India, and the largest Arabica beans producer and Exporter in Asia. As at 2018, Café Coffee Day operated 1,700 cafes, spread across 245 cities in India. Additionally, Café Coffee Day has approximately 600 kiosks and 30,000 vending machines operating in India¹⁷. Besides its regular coffee shops, this company offers varied coffee experiences, targeting different customer segments. For example, its Café Coffee Day Lounges are made for families, while Café Coffee Day Square targets people who search for single-origin, premium coffees.

This company has now expanded to Czech Republic, Nepal, as well as some countries in Africa. It is considered a big competitor for Starbucks in the Asian market, especially in India, since it is a brand that is already well established and naturally fits better in the Asian culture than Starbucks.

Table 6: Luckin main Financial Figures⁶

Luckin Coffee (in million USD)	
Revenues 2018	120
Revenues 2019 (Current)	299
EBITDA 2018	-213
EBITDA 2019	-298
Net income 2018	-456
Net income 2019 (Current)	-531

5) **Luckin** coffee is a Chinese coffee retailer, founded in 2017. Luckin appeared with the goal of developing the coffee culture in China, through innovative mobile technologies and low prices.

Nowadays, Luckin is opening stores at a rate of 200 to 300 in a month, with the goal of overcoming Starbucks' presence in China, which now has about 3,700 coffee shops on that market. Besides growing through the number of stores, Luckin has developed a mobile App with coffee delivery where the first order is for free, as a way of attracting new clients in a faster way, which is considered a competitive advantage. However, Starbucks recently partnered with Alibaba as a way of preventing the fierce competition. This strategy of rapid growth has caused Luckin to have negative earnings, that the company believes it will recover in the future.

6) **Restaurant Brands** is one of the leading fast-food restaurant companies worldwide, and the owner of Burger King, Tim Hortons, and Popeyes. Currently, it has presence in over 100 countries, counting with approximately 26,000 outlets.

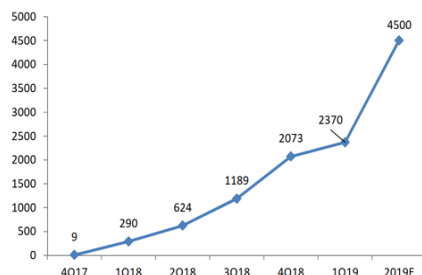


Figure 6: Luckin unit growth¹⁸

¹⁶ Source: Bloomberg

¹⁷ Source: QZ. 2015. "This Indian Coffee Chain is beating Starbucks at its own game", Accessed November 2019 <https://qz.com/india/416670/this-indian-coffee-chain-is-beating-starbucks-at-its-own-game/>

¹⁸ Source: Company Report

Table 7: Restaurant Brands main financial figures ¹⁹

Restaurant Brands (in million \$)	
Revenues 2018	5,357
Revenues 2019 (Current)	5,509
EBITDA 2018	2,182
EBITDA 2019	2,403.5
Net income 2018	743.5
Net income 2019 (Current)	848.4

Restaurant Brands became a direct competitor for Starbucks since 2014, when it acquired the Tim Hortons brand. Tim Hortons was founded in 1964 and it is the one-stop shop for coffee, breakfast, lunch and doughnuts in Canada, and one of the main coffee retailers in the US, where it operates more than 4,500 stores.

Market Segments

Americas

The Americas segment is the **most important market** for Starbucks, being the most relevant both in terms of sales and number of stores.

In FY18, the Americas segment reported revenues of US\$16,732.2 million (67.7% of the company's total revenue), which grew 7.1% YoY, and reported a CAGR of 8.7% during 2014-18¹⁰.

In the US, Starbucks is the **“leading specialty coffee retailer”**²¹ with over 14,400 company-owned and licensed locations.

Revenue in the US coffee segment amounts to US\$80,916m in 2019 and the market is expected to grow annually by 4.5% (CAGR 2019-2023)⁹. The United States continues to be one of the major coffee importers in the world, which implies a high coffee consumption. The average per capita coffee consumption is set at 3.7 kg in 2019. Moreover, in FY18, Coffee consumption in the US amounted to nearly 26.5 million 60-kilogram bags, which represented a 3% growth when comparing with the previous fiscal year, according to Statista (Figure 7).

Millennials (aged 18-39) are driving the coffee industry in the U.S. to historic records. According the National Coffee Association (NCA), 44% of US coffee consumers are millennials.

The American consumer **enthusiasm for coffee varieties** is also driving the coffee consumption increase. The demand for gourmet coffee, which includes espresso-based and ready-to-drink beverages is growing significantly.

Furthermore, the drink has benefited from **promotion as a healthy beverage**. A study of 2017 published in ‘*Annals of Internal Medicine*’ journal, showed the benefits of drinking coffee regularly to the improvement of life expectancy.

Domestic consumption of coffee in the United States from 2013/14 to 2018/19 (in million 60-kilogram bags)

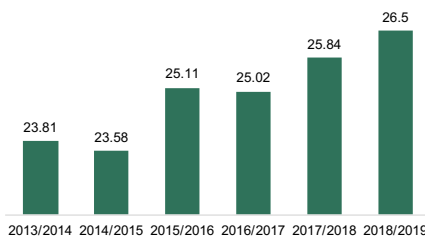


Figure 7: Domestic consumption of coffee in the United States from 2013/14 to 2018/19 (in million 60-kilogram bags) ²⁰

Evolution of the number of stores in Americas

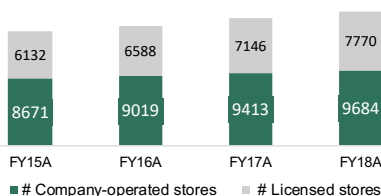


Figure 8: Evolution of the number of stores in America ²²

¹⁹ Source: Bloomberg

²⁰ Source: Statista

²¹ Source: Zacks Investment Research Inc. 2019. “Starbucks Corp (SBUX)”

²² Source: Company Report

According to the National Coffee Association (NCA), after the results of the study were disclosed, daily coffee drinkers increased from 57% to 62% in that year.

However, since Americas is a mature market, Starbucks has been innovating, namely in what concerns to **delivery offer and technological use**.

This can be noticed by the revenue mix that composes the Americas segment, mainly in the United States. Cafés accounted for only 51% of Starbucks' US revenues in 2018. 37% of revenues came from Drive thru orders and 12% from mobile orders²³. US demand for mobile ordering and pick-up is high and the company aims to expand delivery services in the US in early 2020. A clear example of this is Starbucks' partnership with Uber Eats to bring its beverages to US customers' doorsteps, as it had already done in China.

Besides the emphasis in digital engagement (particularly building the rewards program, delivery and adding mobile-ordering and payment), Starbucks is focused on improving the customer experience, by adding more 'Reserve and Roastery' stores to its portfolio and on beverage innovation ('Nitro Cold Brew', 'Cloud Macchiato', 'Refreshers' and other cold beverages) to continue its growth.

In fact, the three mentioned factors are driving same-store sales growth acceleration in this segment and will continue to do that over the next years

■ CAP

Nowadays, CAP segment, mainly China, is crucial for the success of Starbucks long-term strategy. In FY18, the CAP segment reported revenues of USD 4,473.6 million (18.1% of the company's total revenue), which grew 38.1% YoY, and reported a CAGR of 41.1% during 2014-18²⁴. Although tea drinkers dominate in China, Chinese consumers are increasingly turning to coffee. Currently, the average person consumes only three cups of coffee per year versus 363 cups for the average U.S. consumer²⁵. Therefore, coffee retail has a lot of future growth potential in China as spending on coffee is expected to increase by 11% annually over the next four years²⁶.

Consequently, Starbucks is taking advantage of this market opportunity, aiming to open **3,000 new stores in China, and thus doubling the current number over**

Evolution of the number of stores in CAP

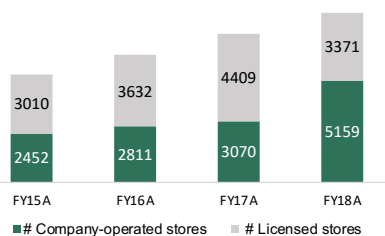


Figure 9: Evolution of the number of Stores in CAP ²⁴

²³ Source: Business Insider. 2019. "Starbucks to launch uber eats delivery across US", Accessed October 31st 2019 <https://www.businessinsider.com/starbucks-to-launch-uber-eats-delivery-across-us-2020-2019-7>

²⁴ Source: Company Report

²⁵ Source: Fool. 2019. "Reasons Starbucks stock is a Buy ahead of Earnings", Accessed October 31st 2019 <https://www.fool.com/investing/2019/10/22/3-reasons-starbucks-stock-is-a-buy-ahead-of-earnin.aspx>

²⁶ Source: Statista

the next five years. This aligns with the company’s goal of operating 10,000 stores in China within 10 years²⁷.

However, Chinese economy is **slowing down**, continuing to suffer the consequences from the trade war with the United States, which can undermine Starbucks strategy to boost coffee demand in this market.

Starbucks is also seeing **increasing competition** for those selling coffee and tea in the country. Competitors include chains such as KFC and Luckin Coffee, both of which are also rapidly expanding locations in a bid to attract coffee lovers with lower-priced products. Luckin, for example, is seeking to overtake Starbucks by opening more stores in two years than the industry giant has in 20 years.

Yet, Starbucks is keen to **capture first-mover advantage in China.** This translates into plans for mid-teens annual new-unit growth in the next several years, with over 60% of these stores to be built in China's top 13 cities. New locations will make up about 80% of the Asia-Pacific region's revenue growth, with same-store sales accounting for the other 20%.

Beyond the **geographic expansion** of Starbucks stores, Starbucks also aims to improve results in China market by **expanding its loyalty program, delivery and adding mobile-ordering and payment.** China has the largest online food delivery market in the world, mainly due to China's economy strong economic growth in the last decades, that changed lifestyles and increased digitalization. Moreover, its large young population also contributes to the huge dimension of this market.

Regarding the mobile-ordering and payment, Starbucks has been betting on delivery service, after partnering with Ele.me, the food-delivery platform owned by Alibaba (BABA). Mobile order and pay options are now available in 300 stores in Beijing and Shanghai.³⁰ In consequence, last year, ‘Rewards’ members in China grew 45% to 10MM and digital ordering has expanded from near zero to 10%, with 7% from delivery and 3% from mobile order and pick up

Finally, **luxury and premium goods consumption in China is forecasted to grow** strongly due to increasing affluence levels (Figure 12), which encompass premium coffee drinks. Given this, by opening a high-end coffee store in Shanghai, “Reserve Roastery”, Starbucks is looking to profit from increasing consumer spending.³¹

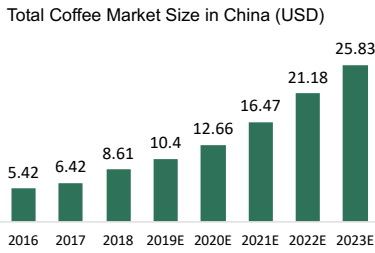


Figure 10: Total Coffee Market Size in China (USD)²⁸

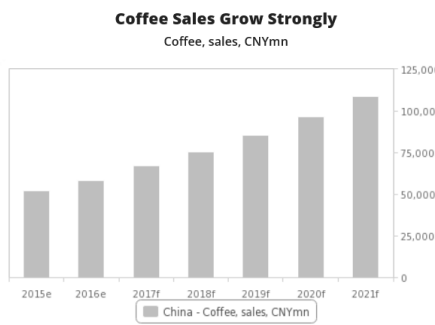


Figure 11: Coffee Sales Growth in China (in millions CNY)²⁹

By 2025, 7.5 million wealthy Chinese households are expected to spend 1 trillion renminbi in luxury goods.

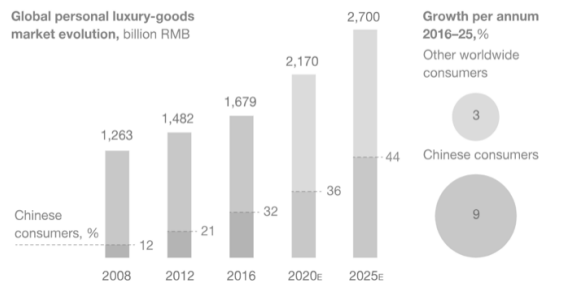


Figure 12: Spend of Chinese people in luxury goods³²

²⁷ Source: Fool. 2019. “Reasons Starbucks stock is a Buy ahead of Earnings”, Accessed October 31st 2019 <https://www.fool.com/investing/2019/10/22/3-reasons-starbucks-stock-is-a-buy-ahead-of-earnin.aspx>

²⁸ Source: Company Report and JP Morgan Estimates

²⁹ Source: BMI/National Statistics

³² Source: McKinsey and Company

▪ EMEA

Evolution of the number of stores in EMEA

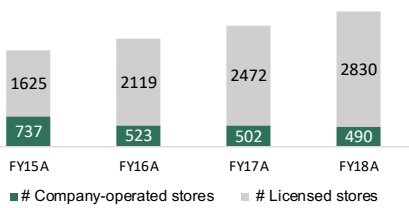


Figure 13: Evolution of the number of stores in EMEA³³

Europe Middle East and Africa (EMEA) is a segment where Starbucks intends to increase its presence, expecting **300 new stores per year**, virtually all licensed, for the next years.

In FY18, the EMEA segment reported revenues of USD 1,048 million (4.2% of the company's total revenue), which grew 9.3% YoY, and reported negative growth of 5.1% during 2014-18¹⁵.

According to the company's report, "EMEA total net revenues for fiscal 2018 increased USD 89 million (9%) over fiscal 2017, primarily due to higher revenue from licensed stores (USD 64 million) and company-operated stores (USD 25 million). Company-operated stores increased USD 25 million (4%), mainly due to favorable currency translation (USD 31 million). Licensed store revenues increased USD 64 million (16%) due to higher product sales and royalty revenues from licensees (USD 56 million), resulting from the opening of 356 net new licensed stores, and favorable foreign currency translation (USD 4 million)".

Starbucks has been changing its model in EMEA from **company operated stores to a licensed model** instead, which is noticeable in the Middle European markets, especially in Germany, France and Switzerland. This shift from company operated stores comes from the need of adapting more easily to each countries' culture. When compared to America, EMEA segment has a much wider variety of preferences in what concerns to types of coffee and food habits.

This different consumer preferences had hindered Starbucks success in the past and led Starbucks to rely on its licensees' knowledge to satisfy each country's specific demand.

Moreover, the licensing model also allows for a greater geographical expansion than company operated stores. Relying on these licensing partnerships leads Starbucks' to focus on its main strategic goals, which currently are more related with the CAP and Americas segments. On top of that, the licensing model has a higher operating margin than the company operating one. Since all the costs of maintenance are borne by the licensee, Starbucks collects its licensing fee, without incurring on so many costs as under the company operating model. Besides that fact, the company can significantly reduce its maintenance and expansion capital on this segment, freeing capital for investing in more promising markets.

Furthermore, Starbucks is planning on moving its licensing support center to London and close the existing one in Amsterdam. With this decision, Starbucks

³¹ Source: Fitch Solution Store – Market Research Analysis & Industry Reports

³² Source: McKinsey and Company

³³ Source: Company Report

believes it will be able to better monitor its licensing model in Europe, ensuring long-term growth.

This strategy, together with the high coffee consumption in EMEA is helping Starbucks to improve its results in Europe. **European market represented 33% of the global coffee consumption** in 2018, totalizing 3,222 thousand tonnes of coffee, having the **highest consumption of coffee per capita in the world**, according to the Coffee Market Report, by the International Coffee Organization³⁴.

However, **there are some risks in the European market, mainly due to Brexit**. A study performed by Allegra Consultancy in 2018, showed that uncertainty regarding UK's future relationship with the European Union affected the coffee sector in 2018. "Nearly half (49%) of industry leaders surveyed by Allegra stated that Brexit was **harming their business**, while 46% of the participants remained neutral and the remaining 5% stated they faced a positive impact. 69% agreed that UK's exit negatively impacted consumption levels, while 87% of industry leaders surveyed believed **Brexit negatively affected UK economy**"³⁶.

Besides impacting coffee consumption levels, Brexit can lead to slower processes and increasing administrative expenses, as well as logistics barriers between countries, which harms the transactions between global companies. Consequently, this can affect Starbucks licensing model in Europe, which is now centered in London.

On the positive side, though the European coffee market can be considered to be stagnated, the increasing population and the development of new beverages will be key factors to the growth of this market. The rising demand for **specialty coffee**, with attributes such as signature blends and specially crafted will be a key driver for the EMEA market.

As of 2018, United Kingdom has the highest number of new coffee shops in Europe³⁷. Following the present consumer trends, mainly the quest of digital features and the demand for exclusive and healthy products, industry players are all trying to differentiate themselves.

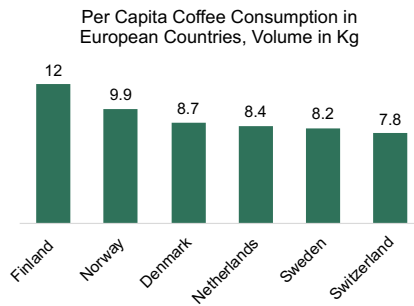


Figure 14: Per Capita Coffee Consumption by country ³⁵

³⁴ Source: CBI, Market Information. 2019. "Coffee Trade Statistics", Accessed November 21st 2019, <https://www.cbi.eu/market-information/coffee/trade-statistics/>

³⁵ Source: International Coffee Organization

³⁶ Source: The Caterer. 2019. "Growth of Coffee Shops could be slowed by hard Brexit", Accessed 21st November 2019, <https://www.thecaterer.com/news/foodservice/growth-of-coffee-shops-could-be-slowed-by-hard-brexit>

³⁷ Source: Mordor Intelligence. 2019. "Europe Coffee Market – Growth, Trends, and Forecast (2020-2025)", Accessed November 21st 2019, <https://www.mordorintelligence.com/industry-reports/europe-coffee-market>

▪ Channel Development

Besides EMEA, CAP and America, Starbucks has a fifth segment – Channel Development Segment, which has been a key driver of profit growth for the company.

In FY18, the Channel Development segment presented revenues of USD 2,297.3 million, which accounted for 9.3% of the company's total revenue, growing 1.8% year on year, and reporting a CAGR (2014-2018) of 10.4%³⁸.

This segment includes product sales that are external to the company's traditional coffee shops, namely roasted whole bean and ground coffees, Seattle's Best Coffee, Starbucks and Teavana-branded single-serve products and ready-to-drink beverages³⁸.

In 2018, Starbucks announced an alliance with Nestlé S.A. Within this alliance, the main goal for Starbucks is to increase and accelerate its presence in international markets where the company has no CPG (Consumer Packaged Goods) presence. Under this alliance, Nestlé will sell Starbucks packaged coffee globally, by selling Nespresso and Nescafé Dolce Gusto capsules with Starbucks signature.

As a consequence of this alliance, a large portion of the Channel Development segment, and all the consumer package goods business were included in the licensing model of Starbucks, in the fiscal year of 2018.

Relative Valuation

Table 8: Multiples of Comparable Companies ³⁹

	EV/ EBITDA	P/ SALES	P/E
DUNKIN' BRANDS	18.04	4.55	26.01
MCDONALD'S	16.08	29.17	25.06
DOMINOS PIZZA	22.28	3.37	28.96
YUM! BRANDS	20.62	5.64	27.64
RESTAURANT BRANDS	17.56	3.49	22.55
STARBUCKS	23.99	3.93	31.29

To value Starbucks using the relative valuation method, five comparable firms were selected: Restaurant Brands, McDonalds, Dunkin Brands, Yum! Brands and Dominos Pizza. These companies, like Starbucks, belong to the restaurants industry, have a strong presence in the US as well as in the rest of the world and have the higher market capitalization among the industry.

Table 9: Comparables Information

	Profit Margin	~ # Countries	~ # Stores	Market Cap
DUNKIN' BRANDS GROUP INC	17.5%	35	18,800,000	6,339,000,000
MCDONALD'S CORP	27.4%	115	37,000,000	147,800,000,000
DOMINOS PIZZA	10.8%	85	11,600,000	11,940,000,000
YUM! Brands	20.9%	125	45,000,000	30,000,000,000
RESTAURANT BRANDS	11.6%	100	26,000,000	30,267,000,000
STARBUCKS	14.3%	80	29,300,000	104,683,100,000

Afterwards, EBITDA was considered the most suitable metric to compute Starbucks' enterprise value, whereas P/Earnings and P/Sales were used to compute the firm's fair value of equity. The previously mentioned figures were

³⁸ Source: Company Report. 2018

³⁹ Source: Bloomberg

regarded as the best proxies to the firm's free cash flows, thereby used as vehicles to perform an accurate relative valuation of the firm. Moreover, it was used the median of the comparables' multiples, as a way of excluding outliers.

Even though the comparable companies were chosen to be the most similar to Starbucks possible, it is not easy to find fair comparables for Starbucks, due to its business being exclusively focused on the retail of coffee and due to its atypical capital structure, with an extremely low debt-to-equity ratio (0.11). This capital structure led us to take into account price ratios, since they do not consider the debt of companies.

The multiples valuation results can be seen in the following table:

Table 10: Multiples Valuation Results

EBITDA		SALES		EARNINGS	
EBITDA 2018	6,588	Revenues 2018	24,720	Earnings 2018	4,518
EV/EBITDA (Median)	18x	P/S (Median)	5x	P/E (Median)	26x
EV/EBITDA (Lower)	17x	P/S (Lower)	3x	P/E (Lower)	25x
EV/EBITDA (Upper)	21x	P/S (Upper)	6x	P/E (Upper)	28x
+ Enterprise Value	115,687				
- Net Debt	3,329.28				
= Equity Value	112,358	= Equity Value	112,474	= Equity Value	117,513
Shares Outstanding	1,184.20	Shares Outstanding	1,184.20	Shares Outstanding	1,184.20
Share Price	94.53	Share Price	94.98	Share Price	99.23

These multiple results led us to conclude that the market is undervaluing Starbucks. However, they should be used to calibrate and complement the intrinsic valuation results and should not be taken in consideration alone.

Intrinsic Valuation

Revenues

Under an intrinsic valuation model, such as DCF and APV models, revenues projection is crucial and a main driver for the valuation results.

Since Starbucks structures itself within four segments, and each segment has its own growth targets, revenues forecast was performed taking this structure into account, resulting on a sales forecast for every segment.

Starbucks has realigned its priorities to focus its business on the Asia/Pacific and America segments. To sustain that growth, Starbucks reorganized its support team and freed up resources by closing its Teavana retail stores and partnering with Nestle to create the "global coffee alliance". Hence, these two segments will have the biggest impact in future total net sales.

- **Americas Segment**

For the American market, where the USA is undoubtedly the main driver, it was estimated a growth in **the number of stores by 4% in the first five years of the**

forecasting period. Historically, Starbucks has been growing at an average of about 4% in this market. The growing specialist coffee market in the US (with an expected CAGR of 4.5% for the next five years), the rising of the millennial population, said to be a main driver for the coffee market, and the increasing coffee consumption due to health benefits, support this growth rate.

Furthermore, we expect this **growth rate to be decreasing until it achieves 2%, the inflation rate for the US.** We believe Starbucks will continue to grow in this market, but not as dependent on the number of stores as before. Though the number of stores will continue to increase to cover more locations and support the strategic realignment mentioned above, it is expected that the partnership with Uber Eats in the US will drive more revenues per store without the need for a 4% rate of growth in the number of stores over all of the forecasting years, as occurred in the past. We believe that the trend is to **reduce the growth of the stores number and start selling more per store.** Moreover, the **partnership with Uber Eats will contribute to increase the revenues per square feet of US stores.** Though this metric has been relatively stable over the years, at USD 0.0007mln/square feet on average, we expect this value to increase over the forecasting period, to converge to USD 0.0008mln **revenue per square feet, implying a 1% increase each year.** Over this increase, it was applied the expected inflation rate for the US over the forecasting period.

Moreover, the potential increase in Reserve Stores and the “**premiumisation**” of Starbucks brand will also contribute to the increase in revenues per square feet, due to possible price increases. Reserve stores are a key long-term growth driver, which is just on an infancy stage, that helps the company to play on the premium coffee sector, that was discussed on the industry overview section, said to be a main driver for coffee retailing industry success.

Table 11: Forecasted Number of Stores in Americas

	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E
# Company-operated stores	10 780	11 172	11 578	11 999	12 435	12 863	13 279	13 683	14 071	14 442	14 794
<i>Growth Rate</i>	4%	4%	4%	4%	4%	3%	3%	3%	3%	3%	2%
# Licensed stores	9 682	10 419	11 211	12 065	12 983	13 944	14 950	15 997	17 087	18 216	19 383
<i>Growth Rate</i>	8%	8%	8%	8%	8%	7%	7%	7%	7%	7%	6%
Licensed (% Total)	47%	48%	49%	50%	51%	52%	53%	54%	55%	56%	57%

- **EMEA Segment**

In EMEA market, the trend is **an increase in licensed stores over company operated stores.** As mentioned before, this shift in the portfolio towards more licensed stores will impact the company’s value mainly due to increasing operating margin, quicker expansion and a higher engagement to the local culture, which Starbucks consider key when opening stores in different markets. A clear example

of this strategic measure is the fact that Starbucks fully licensed Starbucks operations in France, the Netherlands, Belgium and Luxemburg to its longstanding strategic partner Alsea, the largest independent chain restaurant operator in Latin America, which will operate and develop Starbucks stores in EMEA markets, building on Starbucks growth agenda. It is expected that Starbucks will continue to license more stores in EMEA as a way of focusing on its key markets – Americas and CAP. Hence, EMEA stores growth will be mainly through licensing partnerships, with an **increase of 300 licensing stores per year**, according to company's guidance, disclosed on company's results presentation. In what concerns to **company operated stores**, this type of store was **set to decrease over the forecasting period**, according to the company's current trend and **stabilize at year 2023**, with about **460 stores**.

Table 12: Forecasted Number of Stores in EMEA

	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E
# Company-operated stores	463	459	457	457	457	457	457	457	457	457	457
<i>Growth Rate</i>	-1%	-1%	0%	0%	0%	0%	0%	0%	0%	0%	0%
# Licensed stores	3 730	4 030	4 330	4 630	4 930	5 215	5 480	5 720	5 930	6 107	6 246
<i>Growth Rate</i>	9%	8%	7%	7%	6%	6%	5%	4%	4%	3%	2%
Licensed (% Total)	89%	90%	90%	91%	92%	92%	92%	93%	93%	93%	93%

Concerning revenues per square feet, it was assumed that they will continue to be equal to the historical average, increasing only by the expected inflation. Though it would be possible to increase this metric through price increases and more reserve stores, the risks mentioned on the industry overview section lead us to believe that it would be the same on average, only increasing at the expected inflation rate for the UK (given by IMF), as a proxy for the whole market, since it is the European country where Starbucks has higher presence.

- **CAP Segment**

For the CAP market, where China and Japan are the biggest markets, it was forecasted an ambitious increase on the number of stores, due to the relevant potential growth that China represents and Starbucks strategic focus. **For 2021**, the target is to have **11.700 stores** in the CAP segment, which implies opening 1100 stores per year, including company operated and licensed. It was assumed that Starbucks will continue to **open about 1100 per year until 2024**, which implies a **7% growth rate in company operated stores** and **9% in licensed stores**, which goes in accordance with the expected growth rate for this market (8% in 2024 according with a report from Global Industry Analysts Inc).

The ratio of licensed stores over the total number of stores has been relatively stable over the years, at an average of 52%, so this ratio was maintained over the forecasting period, to divide the 1100 stores per year in company operated and licensed.

The growth on the number of stores in this segment is sustained by the increasing demand of coffee in Asia, due to changes in consumption habits, increasing population and increased purchase power among Asian countries (Japan and China essentially), together with breakthrough mobile technology and delivery services.

Table 13: Forecasted Number of Stores in CAP

	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E
# Company-operated stores	6 727	7 250	7 772	8 295	8 819	9 342	9 858	10 363	10 853	11 322	11 766
<i>Growth Rate</i>	8%	8%	7%	7%	6%	6%	6%	5%	5%	4%	4%
# Licensed stores	4 939	5 462	5 984	6 507	7 049	7 608	8 182	8 765	9 355	9 948	10 538
<i>Growth Rate</i>	12%	11%	10%	9%	8%	8%	8%	7%	7%	6%	6%
Licensed (% Total)	42%	43%	44%	44%	44%	45%	45%	46%	46%	47%	47%

Revenues per square feet were set to **increase 1% per year** until they reach \$0.00053mln per square feet. This increase is sustained by the **partnership between Starbucks and Alibaba**, to provide for delivery services, assuming that Starbucks will earn clients through this mean that would not be consuming Starbucks products otherwise. Over this increase, it was applied the **expected inflation rate for China** in the forecasting period, as a proxy for the whole segment.

Finally, in what concerns to the channel development sector, it was forecasted to be a function of nestle sales, due to the recent Global Alliance Strategy of Starbucks with Nestle.

Having the number of licensed and company stores and the revenue per square feet forecasted, it is needed to estimate the square feet per store. For licensed stores, the license royalty has also to be estimated.

License sales-based fee was estimated according to the historical values for each segment, since each segment has its own licensed fee and this value has remained stable over the past 5 years. For Americas segment, it was maintained as 15.33%, for the CAP segment it was maintained at 10.05% and for the EMEA segment it was maintained at 13.36%.

Square feet per store was maintained on average, according to historical values. According to analyst estimations, the average Starbucks store size varies depending on urban versus suburban location, but it ranges from 1,900 - 2,100 square feet, so the average value was considered (2000 square feet per store).

Working Capital

Working Capital Items in FY18
(in million USD)

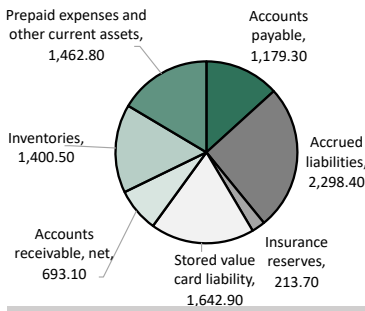


Figure 15: Main working capital captions in FY18 (in Million USD)

Working Capital Items in FY31E
(in million USD)

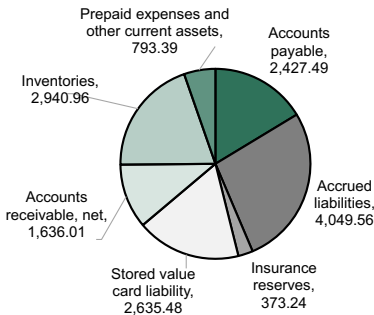


Figure 16: Main working capital captions in FY31 Estimated (in Million USD)

Starbucks vs Customer Discretionary Sector in DSI, DPO and DSO

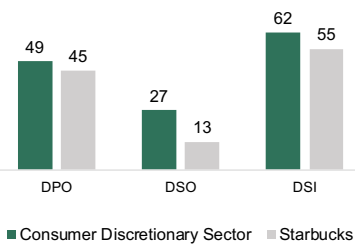


Figure 17: DSI, DPO and DSO metrics

Starbucks' current assets comprise trade **accounts receivable, inventory, and prepaid expenses and other current assets**. Starbucks' core current liabilities include those liabilities that are related to the ongoing operations of the firm, such as **accounts payable, accrued liabilities, insurance reserves and store value card liability**. The latter, together with accounts receivable, accounts payable and inventories has a huge impact on Starbucks working capital needs. Stored value card liability accounts for nearly 6% of the company's liabilities and comes from the value that costumers hold in the Starbucks' mobile app, as well as the value that costumers carry on their gift cards. Every time a costumer tops up a gift card or its account in the mobile app, the company recognizes the top up value as a liability on the balance sheet.

This liability was predicted as a percentage of revenues, considering the historical average of the stored value card liability over revenues.

Accounts Payable, accounts receivable and inventories were estimated with the following days outstanding:

Table 14: DSO, DSI and DPO actual and forecasted

	FY16A	FY17A	FY18A	FY19E	FY20E – FY23E	FY24E – FY28E	FY29E – FY 31E
DSO	13	13	12	13	13	13	13
DSI	58	55	50	50	55	55	55
DPO	31	32	42	43	43	44	45

Days Sale Outstanding (DSO) and Days of Sale Inventory (DSI) were assumed to be constant over the forecasting period, since historically they were stable and way better when compared to the industry values.

Looking at the **Days Payable Outstanding (DPO)**, one can notice an upward trend. However, it still is below the industry level (49 days). This led us to predict that DPO will tend to increase slightly each year, till **45 days**, following the Starbucks effort to increase this metric.

Capital Expenditure

The property, plant and equipment (PP&E) of Starbucks depends on the number of company-operated stores opened every year (which imply all the required equipment and the furniture).

That being said, it was calculated the PP&E per company-operated store, that showed an increase from **USD 0.32 million in FY14 to USD 0.41 million FY18**. This ratio takes into account the tendency to increase the number of licensed stores over company operated stores, and the consequent impact on the investment in

PP&E. The ratio increase already reflects the premium strategy implementation, as it is part of Starbucks' culture to invest many resources on the its spaces as a way of differentiating itself against competitors. Moreover, the opening of 'Reserve and Roastery' stores also requires high investment. Thus, it was assumed the ratio will remain at USD 0.41 in the forecasting years.

Regarding the forecast of intangible assets, **it was assumed a percentage of revenues equal to the one observed in the last year (FY2018)**. Actually, this percentage has been increasing over the historical years, assuming a value of **4.2%** of revenues in FY2018 (comparing with 1.7% in FY14). The increase observed was mainly due to high investments made by the company to improve the technological coffee experience (e.g. the Mobile Order & Pay system). Since Starbucks will continue to invest on its digital features in the coming years, **it is assumed the ratio will remain as high as in 2018**.

Finally, since we do not have any expectation of future acquisitions by Starbucks in the next years and the goodwill impairment is unexpected and unusual (not something we would project in future periods), it was assumed the **goodwill will remain flat** over the projection period and the same as in FY18 (USD 3,542 million).

Gross Margin & Costs Projection

Starbucks' operating costs include cost of sales, occupancy costs (such as rent and insurance), store operating expenses, depreciation and amortization expenses and general and administrative expenses, according to company report.

Firstly, **cost of sales** was projected as a **percentage of revenues**. The cost of sales/revenues ratio has been increasing over the last three years, reaching a level of **41% in FY18**. According to the company's reports, these costs have been increasing mainly in the US, due to a product mix more focused on premium food and to company's commitment in innovation. Starbucks is expected to continue implementing this strategy, so **it was assumed a ratio for the forecasting period of 42%**, implying a higher investment on premium products and food quality.

In its turn, **store operating expenses** were estimated as a percentage of PP&E, **representing 29.10% of PP&E in FY18**. Process and capacity growing efficiency, trough the continuous improvement of processes and workflows is a key success factor for Starbucks. One example of these initiatives is the adjustment of personnel to sudden changes in demand, allowing for a greater cost efficiency. Thus, assuming Starbucks will continue to improve its operational efficiency, it was assumed a decrease of about 2 basis points per year, in order to reach a 28% percentage of stores operating expenses/PP&E.

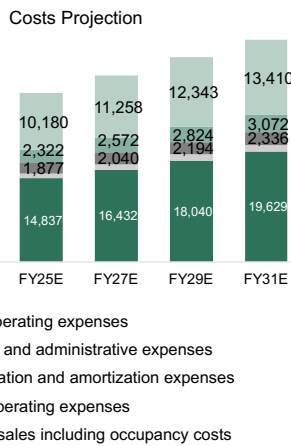


Figure 18: Costs Projection from 2021 to 2031 (in million USD)

Gross Margin Evolution (Million USD)

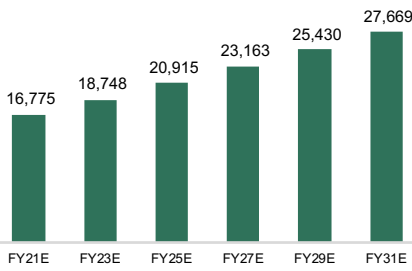


Figure 19: Projected Gross Margin Evolution (in million USD)

Table 15: Starbucks' cost of debt estimation

Rating	Baa1
Yield	3.49%
Probability default	0.15%
Recovery rate	31.3%
Rd	3.39%

Depreciation and Amortization expenses were forecasted as a **percentage of PP&E (21.05% 5-year historic average)**, since these costs are a function of the number of company-operated stores.

Finally, over the last five years, the **SG&A represented 6-7% of revenues**. Consequently, it was assumed that this ratio will remain at **6.50%** in the forecasting period.

WACC

In order to estimate Starbucks Corporation's weighted average cost of capital, it was needed to compute the cost of equity and cost of debt, as well as estimate the capital structure the company will maintain in the future.

Concerning the cost of debt, it was taken in consideration the yield of maturity of the company's latest issued senior unsecured bond with 30 years to maturity (3.49%), Starbucks debt recovery rate and annualized probability of default. The recovery rate and annualized probability of default were based on Moody's annual default study and the credit rating for Starbucks (Baa1). Considering the **yield of 3.49%**, an **annualized probability of default of 0.15%** and a **recovery rate of 31.3%**, the **cost of debt for Starbucks is 3.39%**, which implies a **debt beta of 0.27**.

Moreover, to compute the cost of Equity, the Capital Asset Pricing Model was used. This model shows that the expected return on a security depends on the beta of the security, the risk-free return and a risk premium.

For the risk-free rate, it was used the yield of a 10-year US Government Bond, which at the current date trades at 1.74%.

To determine the beta of the stock, we performed a regression on Starbucks' three-year weekly stock returns and S&P 500 Index three-year weekly returns. These calculations yielded to a beta of 0.77, inserted in a 95% confidence interval of 0.6 to 1.

The resulting beta was then compared with Starbucks' comparables beta, by computing and unlevering the betas from the following companies: Dunkin Brands, Dominos Pizza, Restaurant Brands, Yum! Brands and McDonalds, using the respective capital structures. The median of these results has been applied to Starbucks' market debt-to-equity ratio of 11%, which yields a levered beta of 0.50. To be more conservative, this beta was not used, since, as said before, there is no business similar enough to Starbucks.

The last input needed to compute Starbucks' cost of equity was the market risk premium. A weighted average was performed, using US risk premium as a proxy for Americas segment, China risk premium as a proxy for Asia/Pacific segment and

Table 16: Country risk premium estimation⁴⁰

Country	Risk Premium	Revenues per Segment	Weight
China	7%	4,473.60	20%
UK	7%	1,048.00	5%
US	6%	16,732.20	75%
Total	6.2%	22,253.80	

⁴⁰ Source: New York University

UK risk premium as a proxy for EMEA segment, resulting on a 6.19% market risk premium.

Under a market risk premium of 6.19%, a risk-free rate of 1.74% and a Beta of 0.77, Starbucks cost of equity is 6.54%.

Table 17: Cost of Equity Estimation

Rf	1.74%
Be	0.77
MRP	6.19%
Re	6.54%

Looking at Starbucks' capital structure, one can see that it is a company with a significant low level of leverage, with a debt to equity ratio of 11% and the correspondent debt-to-enterprise value ratio of 10%. **The company has stated before that it plans to maintain this capital structure in the future.** This fact is supported by past capital structures which have been stable over the past years and it is not foreseen any change.

With a **statutory tax rate of 21%** and considering the capital structure mentioned above, the **weighted average cost of capital of Starbucks is 6.16%**.

Growth Rate

The definition of the growth rate is crucial for the results of a discounted cashflow methodology, since it is the rate at which the terminal value will be calculated. This terminal value has a higher weight on the valuation results than the cashflows of the forecasting period. Consequently, DCF models are very sensitive to growth rate assumptions. For this reason, a sensitivity analysis on this rate will be performed on a further section.

In order to compute the terminal growth rate, a **weighted average of the inflation rate forecast for each segment was performed**, taking the percentage that each segment has on the overall company revenues as weights. Hence, terminal growth rate was estimated at **2.63%**.

Target Price

After all the forecasted values mentioned in the section above, a Discounted Cash Flow method has been applied. The cash flows were discounted using the mid-year method and a **WACC of 6.16%**, which has been elaborated on the section above. Summing the discounted future cashflows and the terminal value which has a growth rate of 2.63% as an assumption, we get a core enterprise value of USD 114,583 million. Furthermore, by adding the non-core assets at book value (valued at USD 854 million) and subtracting the net debt, the resulting equity value is USD 111,695 million. Taking into account an amount of 1184 million of shares outstanding, it was obtained a USD 94.32 share price.

Therefore, our model releases a **BUY recommendation** for Starbucks Corporation at a YE 2020 target share price of USD **94.32**. This price implies a capital gain of USD 5.92 per share, taking into account Starbucks' current share price of USD 87.92. This capital gain, together with a "cash" gain, of USD 3 per share, that

corresponds to a dividend of USD 0.67 per share, per quarter, **yields a total shareholder return of 13%**.

Sensitivity Analysis on DCF Assumptions

The results of the DCF model are subject to significant uncertainty because they are highly dependent on key inputs – discount rate and growth rate.

Therefore, it is needed to perform a sensitivity analysis on the share price in order to analyze the variety of results that arises with different assumptions.

Table 18 presents the company’s stock price sensitivity to changes in the weighted average cost of capital and terminal growth.

From this analysis, it is concluded that the target price is very sensitive to changes on both assumptions, varying between USD 67.18 and USD 160.91 per share.

Table 18: Sensitivity analysis on DCF assumptions

		Wacc								
		4.16%	4.66%	5.16%	5.66%	6.16%	6.66%	7.16%	7.66%	8.16%
g	1.62%	147.16	121.52	103.17	89.39	78.67	70.10	63.10	58.61	53.57
	2.12%	176.83	140.45	116.08	98.63	85.53	75.33	67.18	61.93	56.25
	2.62%	225.80	168.66	134.08	110.91	94.32	81.86	72.16	65.91	59.42
	3.12%	321.98	215.22	160.91	128.04	106.01	90.23	78.38	70.77	63.21
	3.62%	597.23	306.69	205.21	153.57	122.31	101.36	86.35	76.83	67.83

Final Conclusions

The main factors that justify our BUY recommendation are:

Strong brand position: Starbucks is the leader in all coffee segments, from specialty coffee to premium single-served market, being one of the most recognized coffee brands worldwide.

Loyalty program and digital offerings: We expect the company to amplify its digital advantage to accelerate sales growth in the US and China through initiatives such as home delivery and Mobile Order & Pay.

Focus on innovation: Starbucks has been innovating around beverages, health and wellness, tea and core food offerings. Cold Brew, Draft Nitro beverages, and plant-based modifiers, including almond, coconut, and soy-milk alternatives are some of the categories in which the company has been betting on⁴¹. Moreover, Starbucks is making an effort to offer more nutritional and healthy products to its customers, which is expected to drive growth.

Premiumisation: Starbucks is increasingly focused on launching premium versions of its products. In addition to their core stores, the company has opened

⁴¹ Source: Zacks Investment Research Inc. 2019. “Starbucks Corp (SBUX)”

Reserve and Roastery stores which are more sophisticated and oriented to the customer experience. At these stores, the premium coffee is produced using innovative coffee-brewing techniques, providing a high-end experience to its customers. We believe this strategy will help drive sales growth and improve brand awareness.

Expansion of Starbucks' Channel Development footprint: Through the alliance with Nestle, which gives it the rights to market Starbucks' products beyond its company operated and licensed stores, Starbucks brands will be expanded to about 190 countries worldwide, increasing Starbucks brand awareness and geographical presence.

Emphasis on China: CAP is Starbucks' segment with the fastest growth, mainly due to the increasing coffee consumption, rise of disposable incomes in Asian countries and increasing success of digital platforms. The investment in innovative store designs, up-leveling products offerings, together with growing operational efficiencies will strongly contribute to the company's value creation. Indeed, Management expects that CAP will drive Starbucks growth during the next five years.

Appendix

Income Statement

	FY18	FY19B	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E
Americas														
Company-operated sales	14905.10	14985.75	15763.15	16515.98	17270.97	18078.13	18923.02	19807.39	20693.08	21576.58	22454.21	23322.18	24176.60	25013.47
# Company-operated stores	9684.00	10036.22	10401.25	10779.56	11171.63	11577.96	11999.07	12435.49	12862.92	13279.31	13682.62	14070.82	14441.89	14793.86
Sft/store	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00
Revenues/sft	0.0008	0.0007	0.0007	0.0007	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008
Licensed														
Licensed sales	1814.00	1870.60	2105.05	2278.70	2463.51	2678.91	2916.70	3173.20	3438.23	3721.28	4023.25	4341.41	4674.58	5022.86
# Licensed stores	7770.00	8361.21	8997.41	9682.01	10418.71	11211.46	12064.52	12982.50	13944.36	14949.60	15997.40	17086.65	18215.89	19383.33
Sft/store	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00
Sales/sft	0.0008	0.0007	0.0007	0.0007	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008	0.0008
Licensed sales-based Fee	15.17%	15.25%	15.44%	15.36%	15.29%	15.30%	15.33%	15.35%	15.33%	15.32%	15.32%	15.33%	15.33%	15.33%
CPG, foodservice and other														
CPG, foodservice and other sales	13.10	13.34	13.64	13.97	14.29	14.62	14.96	15.30	15.65	16.01	16.38	16.76	17.14	17.54
%Total Americas Revenues	0.08%	0.08%	0.08%	0.07%	0.07%	0.07%	0.07%	0.07%	0.06%	0.06%	0.06%	0.06%	0.06%	0.06%
US Inflation (FMI October 2019)		1.80%	2.30%	2.40%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%
CAP														
Company-operated sales	4096.90	5437.16	6014.14	6585.97	7168.63	7762.29	8375.21	8993.94	9622.05	10265.07	10899.01	11528.07	12146.86	12749.79
# Company-operated stores	5159.00	5681.64	6204.27	6726.91	7249.55	7772.18	8294.82	8819.42	9341.92	9858.01	10363.18	10852.79	11322.11	11766.44
Sft/store	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00
Revenues/sft	0.0004	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005
Licensed														
Licensed sales	365.70	374.46	430.22	485.94	542.74	600.62	660.24	722.42	787.53	856.16	926.40	998.67	1072.54	1147.55
# Licensed stores	3371.00	3893.64	4416.27	4938.91	5461.55	5984.18	6506.82	7049.07	7608.32	8181.50	8765.14	9355.36	9947.89	10538.16
Sft/store	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00	2000.00
Sales/sft	0.0004	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005	0.0005
Licensed sales-based Fee	13.66%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%	10.05%
CPG, foodservice and other														
CPG, foodservice and other sales	11.00	11.33	11.70	12.09	12.49	12.90	13.34	13.79	14.26	14.76	15.28	15.81	16.37	16.94
%Total CAP Revenues	0.25%	0.19%	0.18%	0.17%	0.16%	0.15%	0.15%	0.14%	0.14%	0.13%	0.13%	0.13%	0.12%	0.12%

Financing Result Before	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Taxes and OCI	170.30	104.61	241.01	332.28	405.77	474.72	539.39	600.27	657.78	711.41	761.19	807.27	849.67	888.41
Tax Shield	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	41.72	25.11	57.84	79.75	97.39	113.93	129.45	144.07	157.87	170.74	182.69	193.75	203.92	213.22
Financial Result	128.58	79.50	183.16	252.54	308.39	360.79	409.94	456.21	499.91	540.67	578.51	613.53	645.75	675.19
Comprehensive Result	4343.30	3144.38	3259.22	3392.87	3543.83	3713.32	3898.96	4097.57	4303.25	4518.65	4739.44	4965.53	5195.47	5427.99

Balance Sheet

	FY18E	FY19B	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E
CORE BUSINESS														
Operating cash	494.39	507.36	541.31	573.51	606.26	640.96	677.35	715.05	753.16	791.89	830.65	869.40	907.91	945.95
<i>Operating cash (% Revenues)</i>	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Accounts receivable, net	693.10	877.47	936.19	991.89	1048.52	1108.54	1171.46	1236.68	1302.58	1369.56	1436.61	1503.63	1570.22	1636.01
<i>Mid-Point valuation</i>	11.54	12.63	12.63	12.63	12.63	12.63	12.63	12.63	12.63	12.63	12.63	12.63	12.63	12.63
Inventories	1400.50	1430.24	1682.94	1783.06	1884.87	1992.76	2105.87	2223.10	2341.56	2461.98	2582.50	2702.98	2822.68	2940.96
<i>Mid-Point valuation</i>	49.59	49.59	54.69	54.69	54.69	54.69	54.69	54.69	54.69	54.69	54.69	54.69	54.69	54.69
Prepaid expenses and other current assets	1462.80	425.53	454.01	481.02	508.49	537.59	568.11	599.73	631.69	664.17	696.69	729.19	761.48	793.39
<i>Prepaid Expenses and other current assets (% Revenues)</i>	0.06	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Deferred income taxes, net	134.70	138.23	147.48	156.26	165.18	174.64	184.55	194.82	205.20	215.76	226.32	236.88	247.37	257.73
<i>Deferred Income Taxes (% Revenues)</i>	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
<i>Deferred Income Taxes (% Taxes)</i>	0.11													
PP&E	5882.30	6652.54	7013.26	7380.46	7754.30	8134.95	8522.60	8917.15	9307.14	9689.96	10062.94	10423.31	10768.33	11095.25
<i># company-operated stores</i>	14328.00	16204.15	17082.77	17977.19	18887.78	19814.95	20759.20	21720.22	22670.15	23602.64	24511.12	25388.92	26229.31	27025.61
<i>PP&E per company-operated store</i>	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41
Other long-term assets	412.20	434.29	463.35	490.92	518.95	548.65	579.79	612.07	644.68	677.84	711.02	744.19	777.15	809.71
<i>Other long-term assets (% Revenues)</i>	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Other intangible assets	1042.20	1069.54	1141.11	1209.00	1278.03	1351.19	1427.88	1507.37	1587.69	1669.34	1751.06	1832.75	1913.92	1994.12
<i>Other Intangible Assets (% Revenues)</i>	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04
Goodwill	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60	3541.60
Accounts payable	-1179.30	-1226.34	-1314.95	-1400.14	-1487.49	-1580.50	-1678.56	-1780.86	-1885.14	-1991.99	-2099.95	-2208.91	-2318.27	-2427.49
<i>Mid-Point valuation</i>	42.31	42.52	42.73	42.94	43.16	43.37	43.59	43.81	44.03	44.25	44.47	44.69	44.92	45.14
Accrued liabilities	-2298.40	-2171.97	-2317.32	-2455.18	-2595.37	-2743.92	-2899.68	-3061.09	-3224.21	-3390.01	-3555.97	-3721.86	-3886.69	-4049.56
<i>Accrued Liabilities (% Revenues)</i>	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25	-31.25
Insurance reserves	-213.70	-200.19	-213.58	-226.29	-239.21	-252.90	-267.26	-282.14	-297.17	-312.45	-327.75	-343.04	-358.23	-373.24
<i>Insurance Reserves (% G&A)</i>	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12
Stored value card liability	-1642.90	-1413.54	-1508.13	-1597.85	-1689.09	-1785.77	-1887.13	-1992.18	-2098.34	-2206.25	-2314.26	-2422.22	-2529.49	-2635.48
<i>Stored value card liability (% Revenues)</i>	-0.07	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06	-0.06
Deferred revenue	-6775.70	-6098.13	-5488.32	-4939.49	-4445.54	-4000.98	-3600.88	-3240.80	-2916.72	-2625.05	-2362.54	-2126.29	-1913.66	-1722.29
<i>Deferred Revenue (% Revenues)</i>	-0.27	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Other long-term liabilities	-1430.50	-908.02	-968.79	-1026.42	-1085.03	-1147.14	-1212.25	-1279.73	-1347.93	-1417.24	-1486.62	-1555.98	-1624.89	-1692.97
<i>Other long term liabilities (%Revenues)</i>	-0.06	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04
Total Core Invested Capital	1523.29	3058.62	4110.18	4962.35	5764.48	6519.66	7233.45	7910.76	8545.79	9139.10	9692.29	10205.64	10679.43	11113.69

	FY18E	FY19B	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E
NON CORE BUSINESS														
Short-term investments	181.50	205.05	205.05	205.05	205.05	205.05	205.05	205.05	205.05	205.05	205.05	205.05	205.05	205.05
Long-term investments	267.70	267.70	267.70	267.70	267.70	267.70	267.70	267.70	267.70	267.70	267.70	267.70	267.70	267.70
Equity and cost investments	334.70	334.70	334.70	334.70	334.70	334.70	334.70	334.70	334.70	334.70	334.70	334.70	334.70	334.70
PP&E - Real Estate	46.80	46.80	46.80	46.80	46.80	46.80	46.80	46.80	46.80	46.80	46.80	46.80	46.80	46.80
Total Non Core	830.70	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25
FINANCING														
Excess of cash	8261.91	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83	1560.83
Current portion of long-term debt	-349.90	-	-	-	-	-	-	-	-	-	-	-	-	-

Long-term debt	-9090.20	-4275.20	-5303.24	-6130.92	-6907.47	-7635.85	-8321.50	-8969.23	-9573.20	-10133.89	-10652.88	-11130.38	-11566.67	-11961.76
Net Financial Assets Equity	-1178.19	-2714.37	-3742.40	-4570.08	-5346.64	-6075.02	-6760.66	-7408.40	-8012.37	-8573.06	-9092.04	-9569.55	-10005.84	-10400.93
	1175.80	1198.50	1222.02	1246.51	1272.09	1298.89	1327.04	1356.61	1387.67	1420.29	1454.50	1490.34	1527.84	1567.02

Cash-flow Statement

	FY18	FY19B	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E
CORE BUSINESS														
NOPLAT	2858.59	2985.55	3204.05	3407.08	3613.88	3835.78	4070.57	4315.44	4564.83	4820.99	5079.62	5340.72	5602.89	5864.85
Depreciation	1247.00	1400.41	1476.34	1553.64	1632.34	1712.46	1794.07	1877.12	1959.22	2039.81	2118.32	2194.18	2266.81	2335.63
Core Operational Cash Flow	4105.59	4385.96	4680.39	4960.72	5246.22	5548.24	5864.64	6192.57	6524.05	6860.80	7197.94	7534.90	7869.70	8200.48
Core Invested Capital - Fixed Assets	2672.10	4830.05	11338.02	11751.81	12173.03	12603.88	13044.17	13493.27	13938.39	14377.25	14806.31	15222.75	15623.48	16005.44
Core Gross Capex	3788.60	-2157.95	-6507.97	-413.79	-421.21	-430.85	-440.29	-449.10	-445.12	-438.86	-429.06	-416.44	-400.72	-381.96
Core Net Capex	2541.60	-3558.36	-7984.31	-1967.43	-2053.55	-2143.32	-2234.36	-2326.22	-2404.34	-2478.67	-2547.38	-2610.62	-2667.54	-2717.59
Core Invested Capital - NWC and Others	-1148.81	-1771.44	-7227.84	-6789.47	-6408.55	-6084.22	-5810.72	-5582.51	-5392.60	-5238.15	-5114.02	-5017.11	-4944.04	-4891.74
Core Investment in NWC and Others	763.75	622.63	5456.41	-438.38	-380.92	-324.33	-273.50	-228.21	-189.91	-154.44	-124.13	-96.91	-73.07	-52.30
Core Investing Cash Flow	3305.35	-2935.73	-2527.90	-2405.81	-2434.47	-2467.65	-2507.86	-2554.43	-2594.25	-2633.11	-2671.51	-2707.53	-2740.61	-2769.89
Core Free Cash Flow	7410.93	1450.22	2152.49	2554.91	2811.75	3080.60	3356.78	3638.13	3929.80	4227.69	4526.42	4827.38	5129.09	5430.58
NON CORE BUSINESS														
Non Core Result	1613.29	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33
Non Core Invested Capital	830.70	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25	854.25
Investment Cash-Flow	468.70	-23.55	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Non-Core Free Cash Flow	2081.99	214.78	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33	238.33
Core + Non Core Free Cash Flow	9492.92	1665.00	2390.82	2793.24	3050.08	3318.93	3595.11	3876.46	4168.13	4466.02	4764.75	5065.71	5367.42	5668.91
Financial Result	-128.58	-79.50	-183.16	-252.54	-308.39	-360.79	-409.94	-456.21	-499.91	-540.67	-578.51	-613.53	-645.75	-675.19
Net Financial Assets	-1178.19	-2714.37	-3742.40	-4570.08	-5346.64	-6075.02	-6760.66	-7408.40	-8012.37	-8573.06	-9092.04	-9569.55	-10005.84	-10400.93
Change in Net Financial Assets	-739.85	1536.18	1028.03	827.68	776.55	728.38	685.65	647.73	603.97	560.69	518.98	477.51	436.29	395.08
Net Cash Transactions with shareholders	-8624.50	-3121.68	-3235.69	-3368.38	-3518.25	-3686.52	-3870.82	-4067.99	-4272.19	-4486.03	-4705.23	-4929.69	-5157.97	-5388.81
Financing Cash-flow	-9492.92	-1665.00	-2390.82	-2793.24	-3050.08	-3318.93	-3595.11	-3876.46	-4168.13	-4466.02	-4764.75	-5065.71	-5367.42	-5668.91

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Sell	Expected negative total return (including expected capital gains and expected dividend yield) over a 12-month period.

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Growth is not over for Starbucks:
Sensitivity Analysis on Starbucks'
Expansion to China

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Abstract

This paper explores the main benefits and pitfalls of Starbucks' expansion to China, which is crucial for Starbucks strategy. Moreover, it will be performed a sensitivity analysis on the company's stock price in order to evaluate potential consequences of those risks and opportunities.

Keywords

Expansion

Analysis

Price

Starbucks

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The CAP segment has become one of two significant profit centers driving Starbucks global returns, together with the Americas segment. In particular, China contributes meaningfully to both consolidated and CAP net revenues and earnings, making it the fastest growing market for Starbucks.

Starbucks strategy in China intends to explore some growth potential through expanding company owned and licensed stores and delivery coverage, but mostly, it intends to boost consumption generally, by implementing a coffee culture.

According to research firm Euromonitor International, while in the U.S. the average person drinks 300 cups of coffee per year, in China the average person drinks 4 cups of coffee per year. This is called by Starbucks management "a huge opportunity". Though China's coffee consumption may not reach 300 cups annually, Starbucks tries to get closer to the Chinese culture by selling premium tea. Management states that China will "undoubtedly" be bigger than the U.S. market one day.

The significant weight of the Chinese Market for Starbucks profit and growth brings risks and opportunities that should be taken into account when performing Starbucks' valuation. Therefore, it is important to make an analysis on the impact of several factors that can hinder or empower Starbucks success in this market.

The main risks that can be found on this strategy are the increasing competition in the Chinese coffee retailing market, the effects of U.S.-China relations and the slowdown of Chinese economy, which will be described in more detail on the following points:

- Competitors on the coffee market: There is a risk of competitors with lower prices entering the market, affecting Starbucks success. Luckin's expansion is the pure example of this threat. Luckin's focus is to grow at a fast pace and surpass Starbucks' presence in China. This company is fiercely increasing its number of stores, and it promotes the new stores by offering big discounts. Last quarter, its number of stores grew 210% annually to 3,680, while Starbucks' store count grew 17% to 4,125. Moreover, besides the low prices, what makes Luckin so appealing for its costumers is its mobile app and delivery service. The increasing presence of Luckin in China can lead people to prefer its lower prices and digital features to Starbucks. Luckin is also using a recruiting strategy that can hurt Starbucks. It is offering monthly salaries of USD 3,000 to USD 4,400 for staff with more than ten years of experience in cafes. This can lead to a loss of Starbucks most experienced employees, what can have a direct impact on client satisfaction and sales volume.

- **The effects of current U.S.-China relations**, including rounds of tariff increases and retaliations and increasing restrictive regulations. The U.S.-China trade war started in 2018, following Trump's administration, whose political focus was to reduce the trade deficit and rely more on U.S.-made products. By then, the largest U.S. trade deficit by country was with China, being USD 419 billion in 2018, coming specially from computers, cell phones and apparel. U.S. companies exported USD 120 billion to China, mostly being commercial aircraft, soybeans, and autos. Moreover, Trump accused China of unfair trading practices and intellectual property theft. On the other side, in China, it was understood that the U.S. was trying to limit its rise as a global economic power.

This trade war had many phases, with increases in tariffs, that can be noticed on *figure 1* and caused a strong reaction on stock markets (*figure 2*).

By December 2019, China and US had set up a deal, that will be signed in January 2020.

As part of this deal, US negotiators agreed to lower tariffs on Chinese products from 15% to 7.5%. A 25% tariff will remain on roughly USD 250 billion worth of imports. Though the majority of the goods involved in the trade war are related with metal and agriculture, these Washington-Beijing trade tensions can pose risks that can trigger anti-Americanism sentiment and a possible backlash against Starbucks. Starbucks can be targeted by Chinese consumers angered by President Donald Trump and encouraged by the Chinese government.

- **Changes in economic conditions in China:** Last quarter, the economic growth fell to its slowest pace in nearly 30 years, motivated by US trading war and domestic factors, such as the strike of the country's domestic demand. Subsequently, this slowdown brings potential

How the US-China trade war has escalated

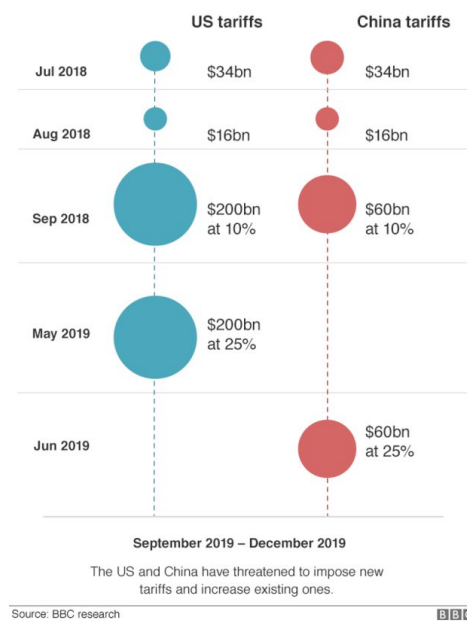


Figure 1: Trade War Timeline ¹

Stock markets since US-China trade war began
Percentage change performance since January 2018

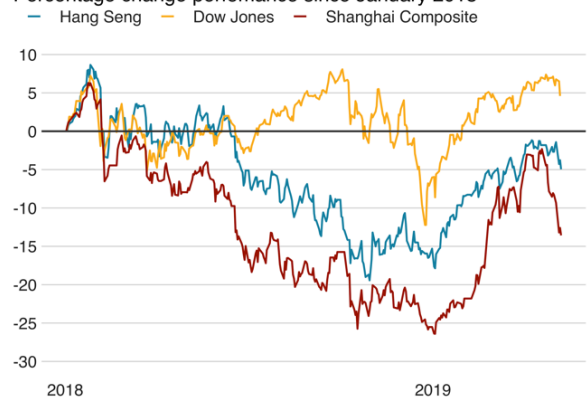


Figure 2: Stock markets performance ²

¹ Source: BBC

² Source: Bloomberg

negative effects to the growth of Chinese middle class, wages, labor, inflation discretionary spending and real estate and supply chain costs. Even though Chinese economic growth is cooling down, it continues to be one of the fastest rates of economic growth in the world. Given its enormous scale, this translates into substantial additions in absolute terms: This year, China will add the equivalent of the entire Australian economy to its GDP.³

Having the risks for this strategy well defined, on the positive side Starbucks can take advantage of a growing delivery market, increasing customer engagement and an increasing coffee culture. The main opportunities found in the Chinese market can be summarized on the following topics:

- Exploration of the delivery market: Last year, the company aligned a partnership with Alibaba, China's biggest e-commerce platform, to increase its digital and physical presence in the country. This Strategy helps Starbucks to build a higher customer base, in a competitive market, where Luckin is expanding through the use of digital features.

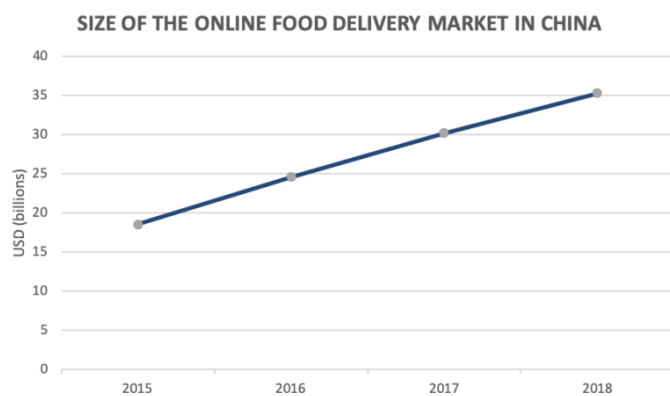


Figure 3: Food delivery market in China⁴

This service has first been introduced in key stores in prime locations in Beijing and Shanghai and will gradually become available nationwide. With this partnership, Starbucks will take advantage of the rapid growth of China's food delivery market, which is growing at a two-digit rate. According to Daxue Consulting, online food sales rose by 36.8% year-on-year in the first two months of 2018. This delivery strategy can help Starbucks to boost its revenues per square feet without the need to invest so many new stores.

- Increasing customer engagement through My Starbucks Rewards: Currently, My Starbucks Rewards has nearly 6.2 million members in China, and the member base grew 17% in the most recent quarter. This proves how much Chinese consumers are committed to Starbucks, since they have to pay an initial fee to sign up in Starbucks rewards. This program will allow the company to establish even deeper relationships through customized offers and

³ Source: McKinsey & Company

⁴ Source: Daxue Consulting

benefits going forward, encouraging costumers to consume more. Actually, in an investors meeting, Starbucks' CFO Patrick Grismer stated "when customers Starbucks rewards program, their total spend with Starbucks increases meaningfully".

- Growing of Chinese Middle Class and Growing of Coffee Consumption: China's growing middle-class market currently comprises of around 240 million Chinese consumers, according to a report by China Economic Weekly. Along with this growing population, there is a trend for an increase in disposable income. China's per capita disposable income stood at 28,228 yuan (USD 4,165) in 2018, which represents a 6.5 percent increase year-on-year in real terms⁵. This will be favorable for Starbucks, since it targets premium costumers that are ready to pay a high price for high quality coffee.

Moreover, there is an increasing trend for coffee consumption among Chinese people. Though China has historically a tea-drinking culture, Starbucks has started to offer premium-teas as a way of attracting people to its space, encouraging a coffee-drinking culture.

- Strategy of Engagement in Chinese Culture: One of the factors that make Starbucks so successful in China, and in foreign markets in general, is its effort to penetrate on each country's culture. In China it started to build its business around three key pillars of Chinese society: Family, Community and Status⁶. While other coffee retailers optimized getting customers in-and-out the door, Starbucks encourages people to stay at their outlets, making it a nice place for people to meet and bond, which meets the community and family pillars. Moreover, Starbucks is considered a "luxury" brand in China. As disposable income has risen in China, making Starbucks more accessible to the average middle-class consumer, it started to offer regular seasonal products and gift sets to emphasize its premium image. Moreover, by opening Reserve Stores, more recently a 30,000 square foot location in Shanghai, and consistently selling its coffee at higher prices than other chains, it reinforces the "status" pillar. People who consume Starbucks' products are considered to be from a higher class.

Sensitivity Analysis on Number of New Stores and Sales per Square Feet

After carefully analyzing which factors can influence Starbucks' success on this market, a sensitivity analysis was performed. The risks and benefits of CAP expansion, mainly in China, will influence the number of new stores that will be opened in that segment each year, as well as the revenues per square feet.

⁵ Source: China Daily

⁶ Source: Zakkour, Michael. 2017. "Why Starbucks Succeeded In China: A Lesson For All Retailers.", Forbes

If Chinese economy really starts to decelerate it will have impact on two levels: Firstly, revenues per square feet will decrease, since a lower number of customers will visit Starbucks' stores due to lower disposable income, for example. Secondly, Starbucks will perceive that the market does not respond to its supply and will decide to open less stores on that region. Moreover, if China-US trade war goes worse, it can lead to an anti-Americanism sentiment among Chinese people, which will also decrease revenues per square feet.

In opposition, if all the positive factors mentioned on the section above are verified, there will be an increase in Starbucks number of stores and possibly an increase in revenues per square feet. This is a relevant case especially on the demand for delivery, which is one of the main drivers for the Chinese market.

Table 1: Sensitivity Analysis Results

		Number of New Stores in CAP							
		300	500	700	900	1100	1200	1300	1400
Increase in revenues/square feet	-2.00%	76.58	77.62	78.63	79.63	80.6	81.08	81.55	82.02
	-1.50%	77.65	78.89	80.13	81.35	82.56	83.15	83.75	84.33
	-1.00%	78.79	80.25	81.72	83.18	84.64	85.36	86.08	86.8
	-0.50%	79.99	81.69	83.4	85.12	86.84	87.7	88.56	89.42
	0.00%	81.27	83.22	85.19	87.19	89.19	90.19	91.19	92.2
	0.50%	82.62	84.84	87.09	89.37	91.68	92.83	93.99	95.16
	1.00%	84.06	86.55	89.11	91.7	94.32	95.64	96.97	98.3
	1.50%	85.58	88.37	91.24	94.16	97.13	98.62	100.13	101.63
	2.00%	87.19	90.31	93.51	96.78	100.11	101.79	103.48	105.18
	2.50%	88.89	92.35	95.91	99.56	103.27	105.15	107.04	108.94
	3.00%	90.7	94.52	98.46	102.5	106.63	108.72	110.82	112.94
3.50%	92.62	96.82	101.17	105.63	110.19	112.5	114.83	117.18	
4.00%	94.85	99.26	104.03	108.94	113.97	116.52	119.09	121.68	

Caption:

< Current Price
 > Current Price < Model Price
 > Model Price

Ultimately, on the most negative case, Starbucks share price will be USD 76.58, which represents a capital loss (12%) comparatively to the current price (USD 87.92/share), assuming that Starbucks opens 300 stores in CAP segment, and revenues per square feet decrease in 2% each year. Inside the CAP segment Starbucks also has presence in other countries such as Japan and India, which are expected to drive growth, so 300 new stores were assumed as a minimum number. It is not expected for this price to be even lower, since it is supported by Starbucks' success on other segments (it was assumed the same forecasted values as in the main report for all the segments except for CAP). Furthermore, on the most positive case, Starbucks share price will be USD 121.68, which would represent a capital gain of 38%, assuming that Starbucks opens more stores than what is stated on its strategic plan.