



*“With humility, our performance in Q2 is particularly gratifying in that it was achieved in the face of very challenging consumer, geopolitical and economic environments.”*

-Howard Schultz, SBUX Chairman & CEO, 2Q16 Earnings Call

THE SHIFT IS REAL

**CONFIRMING OUR SHORT CALL ON STARBUCKS (SBUX)**

October 13, 2016

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*\*ANSWERED AT THE END OF THE CALL*

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# HEDGEYE RESTAURANTS BEST IDEAS LIST

## LONG LIST

		TRADE	TREND	TAIL
1) <b>PNRA</b>	Panera Bread Company	✓	✓	✓
2) <b>DFRG</b>	Del Frisco's Rest. Group	✓	✓	-
3) <b>BWLD</b>	Buffalo Wild Wings	✓	✓	✓

## LONG BENCH

<b>SONC</b>	Sonic			
<b>YUM</b>	Yum! Brands			
<b>ARCO</b>	Arcos Dorados Holdings			
<b>EAT</b>	Brinker International			
<b>RRGB</b>	Red Robin Gourmet Burger			
<b>MCD</b>	McDonald's			

## SHORT LIST

		TRADE	TREND	TAIL
1) <b>CMG</b>	Chipotle Mexican Grill	X	X	X
2) <b>PLAY</b>	Dave & Buster's	X	X	X
3) <b>SBUX</b>	Starbucks	X	X	-
4) <b>DNKN</b>	Dunkin' Brands	X	X	X
5) <b>BLMN</b>	Bloomin' Brands	X	X	X
6) <b>JACK</b>	Jack In The Box	X	X	-
7) <b>DRI</b>	Darden Restaurants	X	X	X

## SHORT BENCH

<b>SHAK</b>	Shake Shack			
<b>TXRH</b>	Texas Roadhouse			
<b>QSR</b>	Restaurant Brands Int.			
<b>CAKE</b>	Cheesecake Factory			

Bench = timing is not right, or research is in progress.

# LET'S REVISIT THE ORIGINAL SHORT CASE (PUBLISHED APRIL 5, 2016)

1

## HIGH EXPECTATIONS FOR GROWTH IN FOOD SALES

Two years ago the management of Starbucks set out big expectations for food sales in stores. So far they have delivered. How much more room is there to go? At the end of FY15, food was 19% of sales and the company has set a goal of getting it to 25% over the next 4 years. We think that this is going to be difficult to achieve and the contribution to growth will slow meaningfully over the next 12 months.

2

## TECHNOLOGY DRIVING INCREMENTAL GROWTH

Like the potential for incremental food sales, new technology is expected to drive incremental growth at Starbucks over the next four years. At the annual meeting the company unveiled some significant changes to the Starbucks app and the loyalty program. Will these changes continue to drive significant throughput or will it see incremental adoption slow? Importantly, 2Q16 results will tell us more about the potential for the new technology.

3

## FLOW THROUGH

Since 2009, the margin expansion story at Starbucks has been extraordinary. Since the lows of 2009, on a trailing 12-months basis, operating margins have improved 1,301bps. Over the next 12 months margins are only estimated to improve 116bps. Over the last 12-months food comp growth represented ~31% of Americas total comp, average check accounted for 53.1% of the comp, if those slow incrementally, margin improvement will be difficult to achieve.

# KEY POINTS – COMPOUNDING ISSUES

1

## **FOOD SALES GROWTH WILL CONTINUE TO SLOW – THE ACHILLES HEEL**

Food as a % of the comp has declined from 38% in 4Q15 to 25% in 3Q16. While at the same time food revenue growth has slowed from 20% in 1Q16, to 16% in 2Q16 and lastly, 10% in 3Q16. Food will be to SBUX as coffee was to MCD – a distraction that did not improve the customer experience. Trying to be something you're not can be the kiss of death, especially when your four walls are not built for it. SBUX does not have the physical capacity to grow food to 25% of sales, and expectations for the potential for food need to come down.

2

## **MANAGEMENT CHANGES ARE A CAUSE FOR CONCERN**

The last time Howard Schultz stepped away from the business was in 2000 before jumping back in in January 2008. Now, eight years later, Howard once again is taking himself out of the day-to-day operations to focus on passion projects and higher level thinking for SBUX. We think the world of Howard as both an operator and a leader, and we are perplexed at the decision to have a former technology guy lead a global retail coffee business. Yes, technology may be the future, but they still need to get the coffee in the cup. There have been some technology missteps since the new leader's reign, and these could be a preview to bigger mistakes down the road.

3

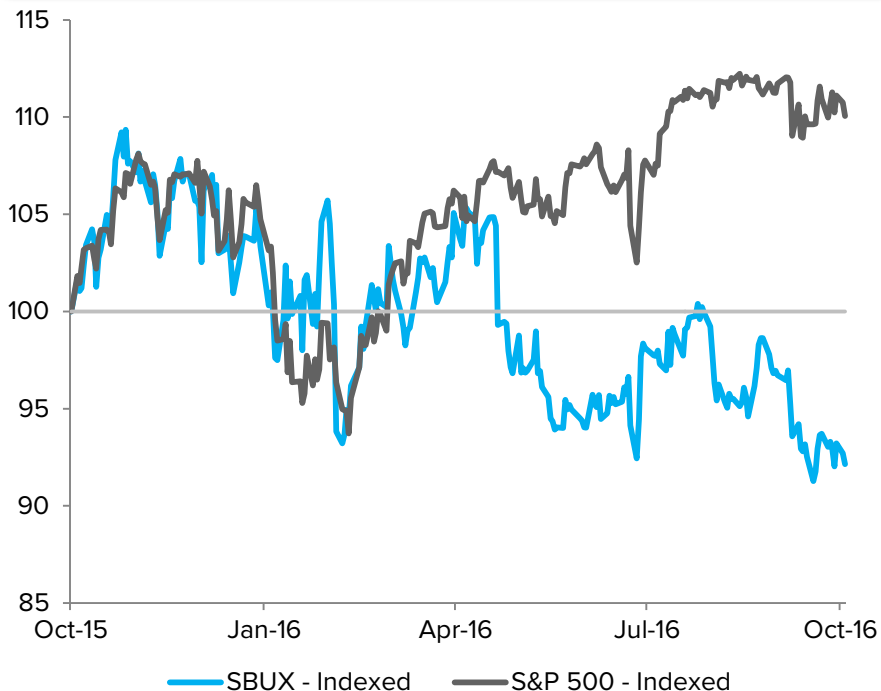
## **THIS IS A BET AGAINST 4Q16 GUIDANCE AND FY17 CONSENSUS**

Management promised that the 3Q16 comp disappointment was an anomaly and that they will revert back to achieving a 5% comp or greater in the Americas region, something they did in 25 consecutive quarters before 3Q16. During the 25 quarter streak, traffic accounted for an average of 59% of the comp, which put SBUX in a unique category. With the new loyalty program in place, it has altered the traffic numbers for SBUX and may have changed how often consumers use the brand. If we combine a general industry slow down, with slowing food growth and changes to the loyalty program, the likelihood of sales accelerating from 3Q16 are small.

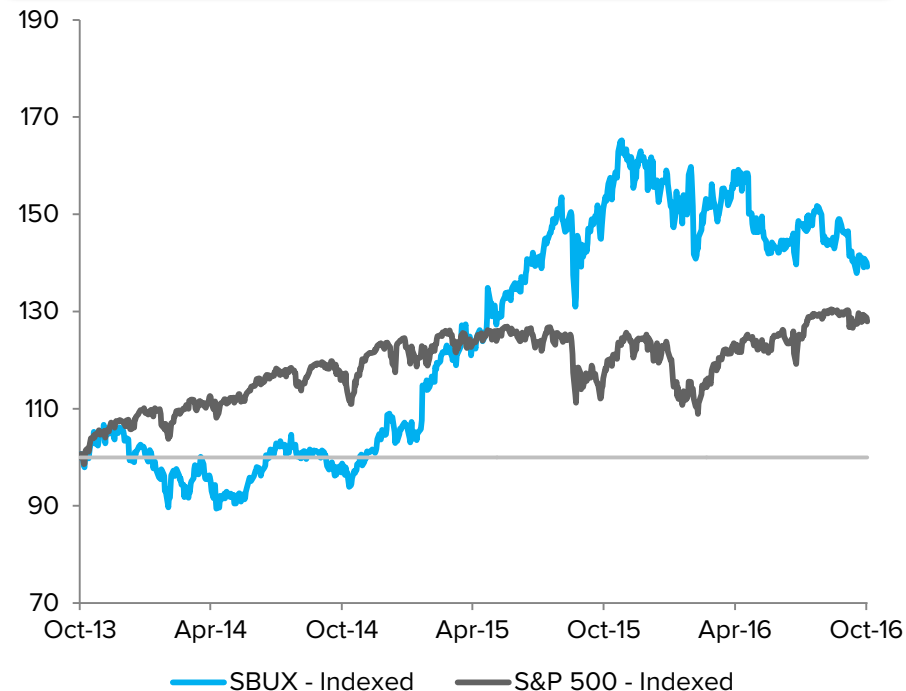
# PRICE PERFORMANCE VERSUS THE S&P 500

SBUX HAS LAGGED THE BROADER MARKET AS OF LATE

## 1 Year Performance



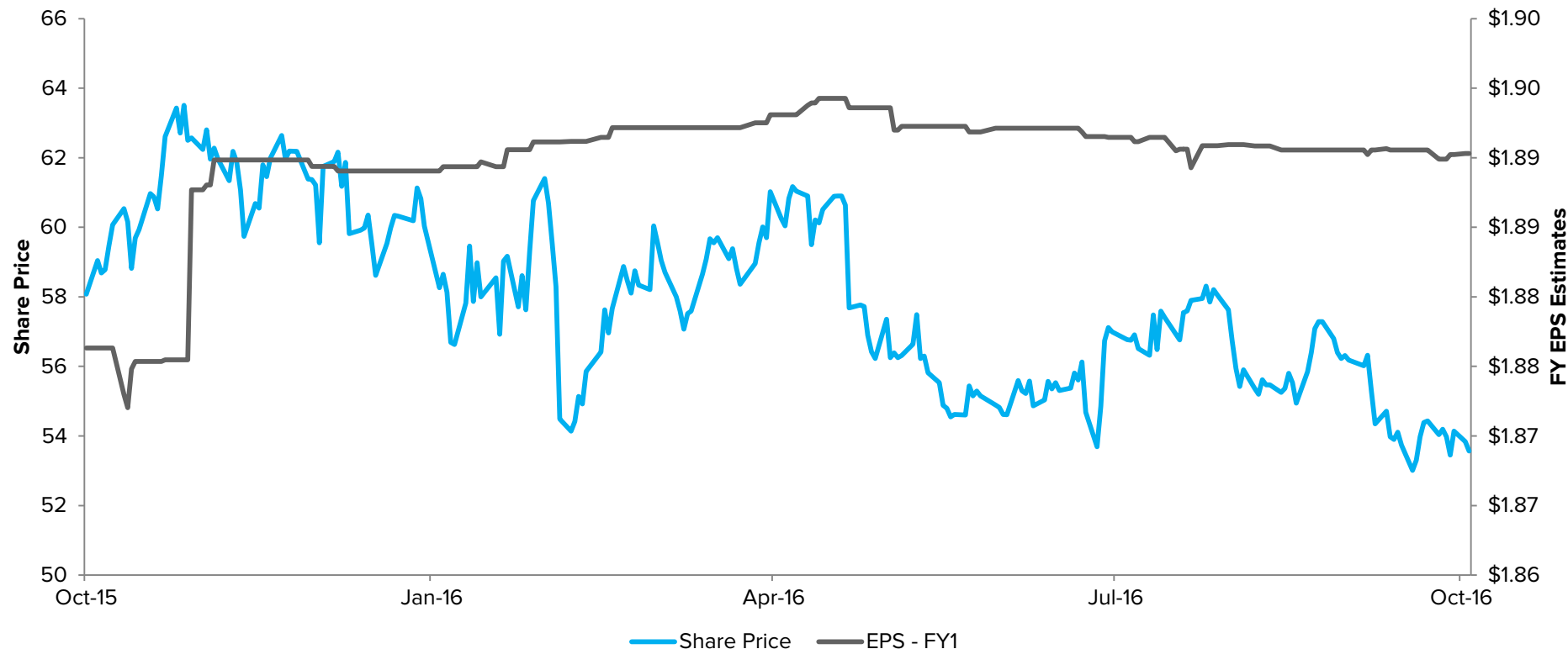
## 3 Year Performance





# FY16 EPS REVISIONS VS. STOCK PRICE

## ESTIMATES HAVE HELD RELATIVELY STEADY



# 3Q16 IN REVIEW

## A QUARTER MANAGEMENT WISHES THEY COULD FORGET ABOUT

### 3Q16 Highlights

- In the quarter the company made the strategic shift in their loyalty program from a frequency-based model to a spend-based model
- Sales were highlighted by strength in the CAP and channel development segments with weak top line results in the U.S.
- On the earnings call Howard explained that they “underestimated the interdependence of Starbucks Rewards and Frappuccino Happy Hour” which competed for consumer mindshare and affected results
- These core operational issues in 3Q16 caused a 1% decline in blender drinks due to the competing programs
- 3Q16 performance at least in the US was negatively affected by some macro headwinds dominated by weak consumer spending
- When they report 4Q16 results on November 3<sup>rd</sup> it will provide a big clue to whether the slowdown was truly self-inflicted or if they are facing major macro headwinds, our bet is on the latter
- In 3Q16 food sales growth slowed to 10%, down from 16% in 2Q16
- The slowdown in food growth could be a tell-tale sign of the slowing macro environment, or consumers just saying no thanks to the less than stellar food offering
- Kevin Johnson the newly minted COO was front and center this call, which came to a surprise to us and the broader investment community

### Key Metrics

	Actual	Consensus Estimates	Difference
Sales	5,238	5,335	(1.8%)
Con. SSS	4.0%	5.7%	(170)
Cost of Sales	39.3%	39.5%	(20)
Operating Income	1,040	1,094	(5.0%)
Con. Operating Margin	19.8%	20.5%	(70)
EPS - Non GAAP	\$0.49	\$0.49	0.0%

### Management Outlook

**This following quote from Howard Schultz during the 3Q16 call sums up managements confidence:**

“On today’s call we will demonstrate with clarity and specificity why our US comps in Q3 were an anomaly and that we have clear line of sight to returning our business to historic levels of comp growth, which has been at or above 5% for the past 25 consecutive quarters.”

#### **But we are unconvinced**

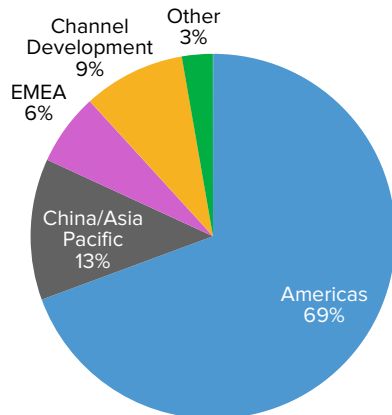
In the pages to follow we will demonstrate why we believe that this over confidence is not warranted and why SBUX is about to look a lot more pedestrian than it ever has.



**REVENUE DIVERSIFICATION PLANS WON'T AMOUNT TO ASPIRATIONS**

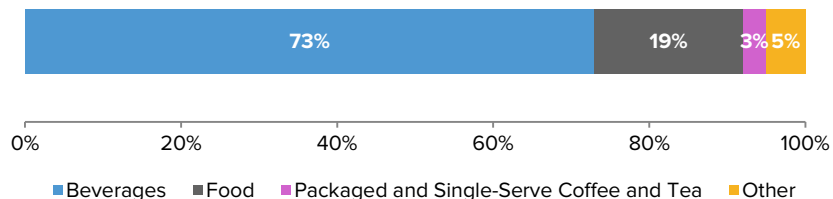
# BUSINESS MIX BREAKDOWN

## Revenue by Segment

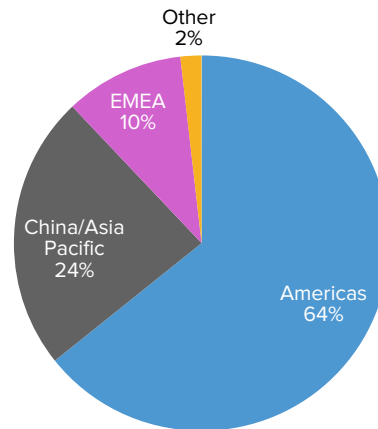


**FY2015 Revenue = \$19.2 billion**

## Retail Product Mix For Company-Owned Stores

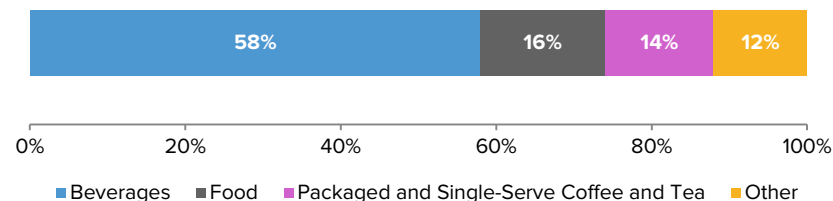


## Store Count by Region



**Total Units as of 4Q15= 23,043**

## Consolidated Revenue Mix



# STRAYING TOO FAR FROM THE CORE

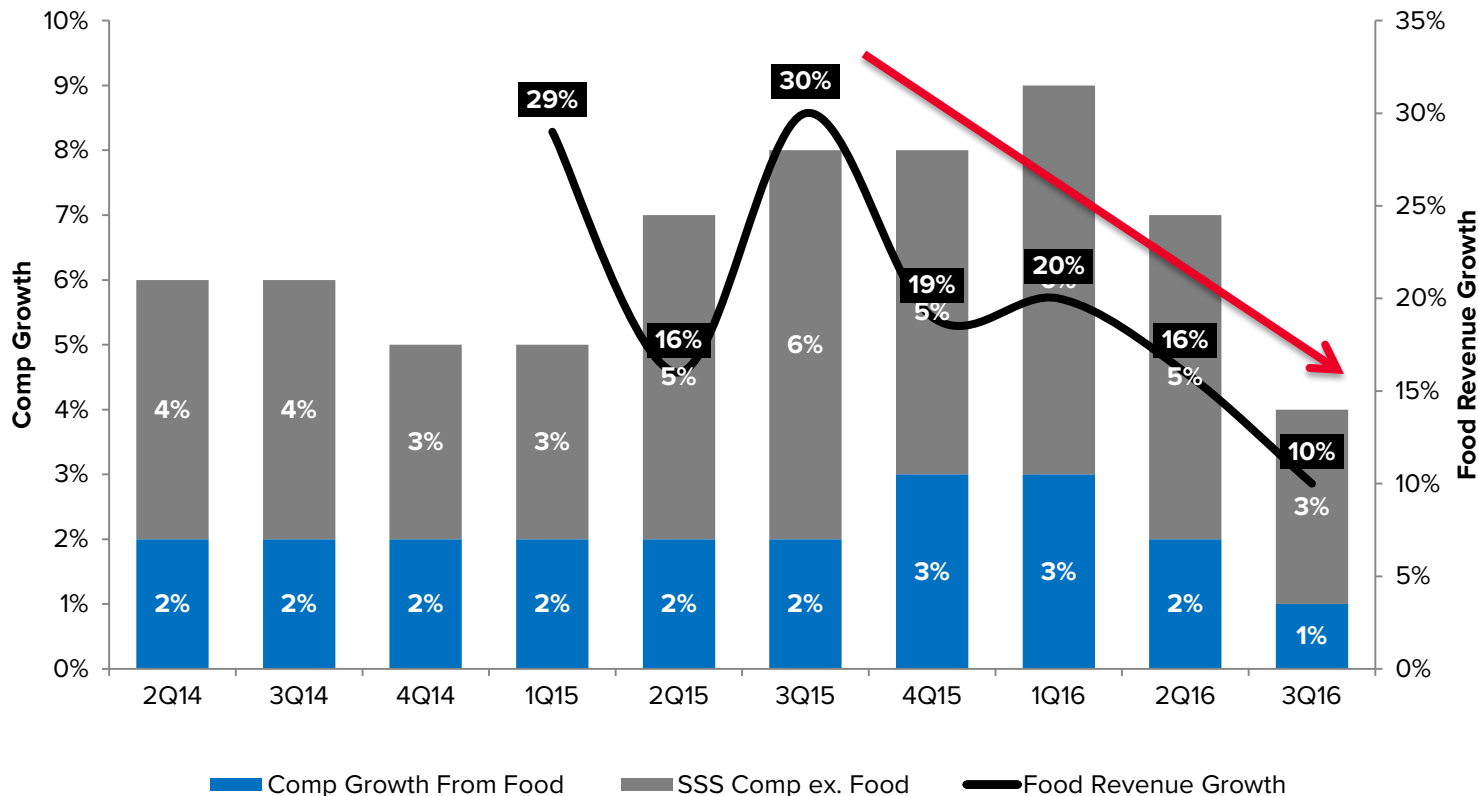
## FOCUS ON WHAT YOU DO BEST

The first time Starbucks ran into trouble was from the dilution of the “Starbucks Experience” as it attempted to sell books, CDs and other items that did nothing more than confuse customers and slow service times. Once again, the company is putting the deliverability of the “Starbucks Experience” at risk in order to pursue growth by moving away from its core business:

- 1** **New store formats:** Will not offer the “third place” experience.
- 2** **Teavana:** Management had high expectations: “Like what Starbucks did to coffee 40 years ago, we think we can do in the tea category.” Unfortunately that is not going to be the case.
- 3** **La Boulange:** Management expectations again were very lofty: “Incredible opportunity to bring the artistry of the best French bakery product to the U.S. marketplace in a similar way that Starbucks brought the romance of the Italian espresso bar to many.” Again, not much has changed!
- 4** **Alcohol:** This rollout is nothing more than a distraction that will never amount to anything.

# FOOD WILL NOT REACH PROJECTIONS

## FOOD HAS SLOWED SEQUENTIALLY



- 1Q15 was the first quarter SBUX began explicitly stating their food revenue growth, 2Q14 through 4Q14 were stated to be DD growth quarters for food
- After hitting a peak growth period in 3Q15, food revenue growth has been in a precipitous decline to 10% in the latest period
- Food as a percent of the total comp has been in decline as well, down from a peak of 40% in 1Q15, to 25% in 3Q16
- SBUX management continues to have lofty expectations for its food business, pinned on false hopes for warmed up sandwiches and bistro boxes

# FOOD IS NOT IN THE DNA OF THE BRAND

## THERE ARE NO KITCHENS IN THE UNITS. THAT SHOULD BE ALL THAT NEEDS TO BE SAID.

- Will Princi be any different than La Boulange, will they be able to leverage the brand to accelerate food sales growth?
- Grab-and-go the only way to add capacity on the food front without major capital and labor investment, but is the quality there?
- Going more upscale to catch on with a growing consumer trend, but will likely lose on the value equation
- Tried bundle meals but that seems to have died off
- A lot of questions surround the food at Starbucks but we remain confident in our opinion that food sales will not reach their aspirations of 25% of sales



## Capacity Constraints of Food at Starbucks



- Most Starbucks locations are equipped with one or two Turbo Chef ovens in which to cook their hot food items
- SBUX faces a major capacity constraint as each oven can only cook one item at a time, with a panini taking about 1 minute 25 seconds and a breakfast sandwich taking about 1 minute 10 seconds, it makes it difficult to fulfill multiple orders in a timely manner
- If for instance 10 people in a row in line order a sandwich, the 10<sup>th</sup> person is likely to wait 5-10 minutes for their order to be filled, not exactly speed and convenience

## Bistro Boxes Driving the Food Comp

- The average SBUX customer is health oriented so would not naturally gravitate towards their warmed sandwiches and bakery items, leaving them with various cold offerings, the big one being the Bistro Box
- The last they mentioned Bistro Box growth was in 1Q16, in which they were up 65% YoY, and food revenue in total was up 20%
- Since then, as stated a few slides ago, food sales growth has decelerated significantly, and we have lost visibility on bistro box growth, leading us to believe it is also experiencing a deceleration of growth

### Bistro Box – Southwest Steak Wrap



#### Nutritional Stats (218g)

- Calories: 450
- Total Fat: 19g
- Sodium: 830mg
- Carbs: 52g
- Protein 13g

**Price: \$6.86 w/tax**



# SBUX'S FOOD IS NO HEALTHIER THAN ANYONE ELSE'S

## Starbucks

### Sausage & Cheddar Breakfast Sandwich



#### Nutritional Stats

- Calories: 500
- Total Fat: 28g
- Sodium: 920mg
- Carbs: 41g
- Protein 15g

Price: \$3.67 w/tax

### Ancho Chipotle Chicken



#### Nutritional Stats

- Calories: 440
- Total Fat: 18g
- Sodium: 1020mg
- Carbs: 46g
- Protein 20g

Price: \$6.86 w/tax

## McDonald's

### Sausage McMuffin with Egg



#### Nutritional Stats

- Calories: 470
- Total Fat: 30g
- Sodium: 830mg
- Carbs: 29g
- Protein 21g

Price: \$3.71 w/tax

### Artisan Grilled Chicken Sandwich



#### Nutritional Stats

- Calories: 360
- Total Fat: 6g
- Sodium: 960mg
- Carbs: 43g
- Protein 33g

Price: \$5.44 w/tax

## Dunkin Donuts

### Sausage Egg and Cheese on English Muffin



#### Nutritional Stats

- Calories: 450
- Total Fat: 26g
- Sodium: 970mg
- Carbs: 33g
- Protein 20g

Price: \$3.71 w/tax

### Chicken Bacon Sandwich



#### Nutritional Stats

- Calories: 730
- Total Fat: 41g
- Sodium: 1320mg
- Carbs: 58g
- Protein 31g

Price: \$4.24 w/tax

## Panera

### Sausage, Egg & Cheese on Ciabatta



#### Nutritional Stats

- Calories: 550
- Total Fat: 29g
- Sodium: 1050mg
- Carbs: 44g
- Protein 20g

Price: \$4.29 w/tax

### Sausage, Egg & Cheese on Ciabatta



#### Nutritional Stats

- Calories: 740
- Total Fat: 24g
- Sodium: 2150mg
- Carbs: 86g
- Protein 46g

Price: \$8.50 w/tax

Breakfast

Lunch

Commentary

- **Day part mix:** 50% Breakfast, 20% lunch, 15% Dinner, 15% Late Night
- **Egg ingredients:** whole eggs, whey, skim milk, soybean oil, modified food starch, contains less than 2% of the following: dicalcium phosphate, salt, sodium bicarbonate, butter flavor [sunflower oil, natural flavors, medium chain triglycerides and palm kernel oil], xanthan gum, guar gum, liquid pepper extract, citric acid

- **Day part mix:** 25% Breakfast, 37% lunch, 30% Dinner, 8% Late Night
- It is notable that although similar price, the MCD egg sandwich uses a freshly cracked and cooked egg unlike SBUX's, which has a laundry list of ingredients in its "eggs"

- **Day part mix:** 50% Breakfast, 25% lunch, 15% Dinner, 10% Late Night
- Ingredients of egg similar to SBUX's

- **Day part mix:** 20% Breakfast, 40% lunch, 40% Dinner
- Fresh cracked egg
- Panera comes with a premium price tag due to their premium ingredients and fast casual atmosphere

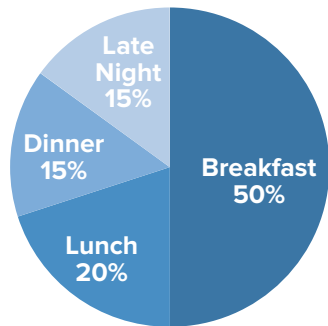


# ALCOHOL WILL NEVER BE MEANINGFUL TO THE BUSINESS

## DAYPART TO BE BRANDED 'STARBUCKS EVENINGS' (INITIALLY LAUNCHED IN 2010)

- Starbucks currently offers alcohol in a few hundred stores, and the results seem to be underwhelming and relatively neutral
- Employee answers when asked if the alcohol sells well, were neutral to negative and never completely positive, recurring answers to the question included:
  - “Yes and no”
  - “Some regulars but not busy”
  - “Not a lot of people come in for that”
  - “It’s actually a nice place to sit if you don’t want to deal with a crowded bar”
- SBUX withdrew its application to sell beer and wine at three of its San Francisco stores in April 2016, yielding to pressure from the police department and Board of supervisors, which strongly opposed the proposal. **The police department said that the city already had enough places that sell alcohol, and allowing SBUX to sell alcohol would open the floodgates for other restaurant chains to do the same**
- **Why alcohol wont work:**
  - We don’t think that people actually want to sit in SBUX and enjoy a glass of wine or beer
  - There is not always the availability of a liquor license to do this on meaningful scale across all units; as stated above there was pushback in San Francisco
  - Merely an experiment to see what incremental revenue they can get from their four walls
  - Will the tables potentially be sticky? No morning coffee drinker wants to deal with that
  - Find it hard to believe someone is going to visit SBUX in the AM for their coffee and then go back to the same place after work for wine
- **Why it could work (on a limited scale in the right markets)**
  - Millennial consumer in cities view local coffee shops as a cool hangout place, maybe they will latch onto SBUX for their wine at night as well. But that remains to be seen

### Daypart Mix

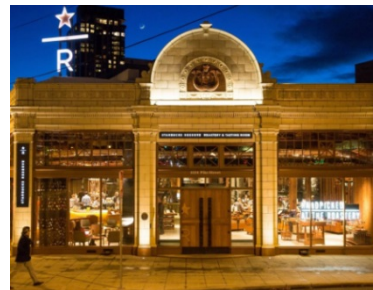
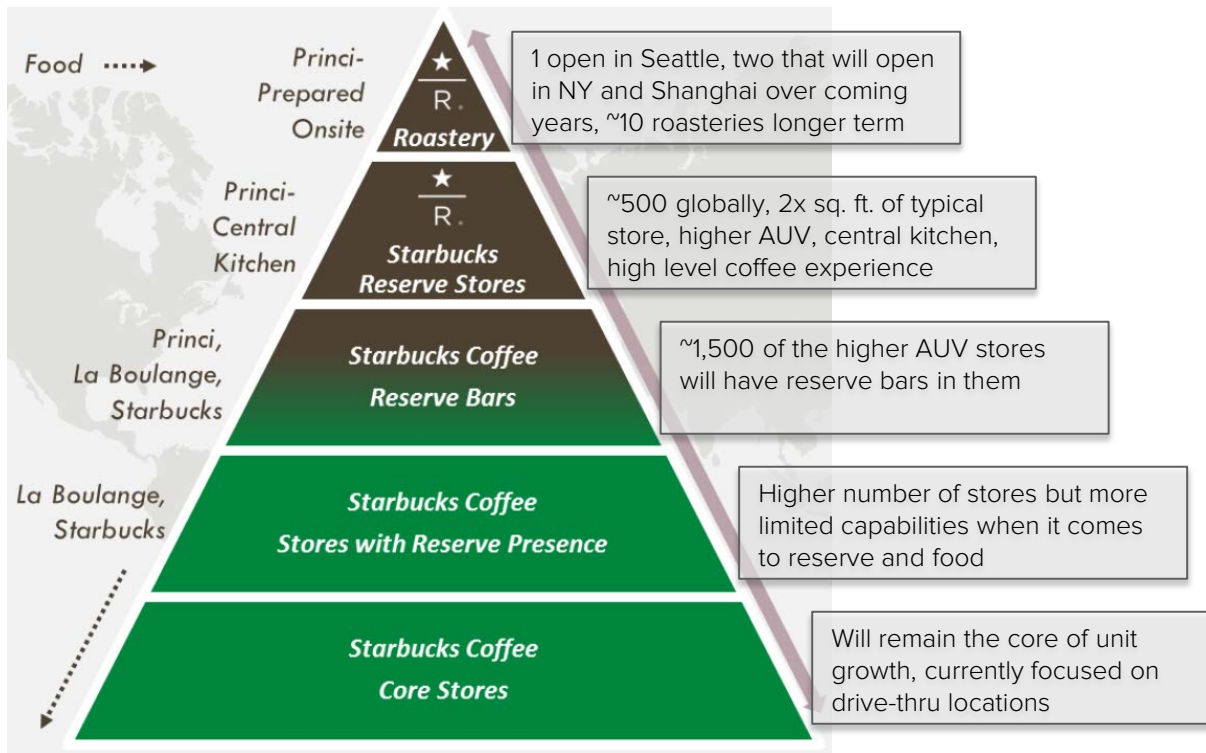


*“Starbucks Coffee Company is connecting more deeply with more customers across all day-parts and around the world than ever before” (Howard Schultz, 1Q16)*

# ROASTERY AND RESERVE ARE INCREMENTAL POSITIVES

## BUT ARE LIKELY TO REMAIN MORE OF AN ADVERTISEMENT AND INCUBATOR FOR INNOVATION RATHER THAN A PROFIT DRIVER

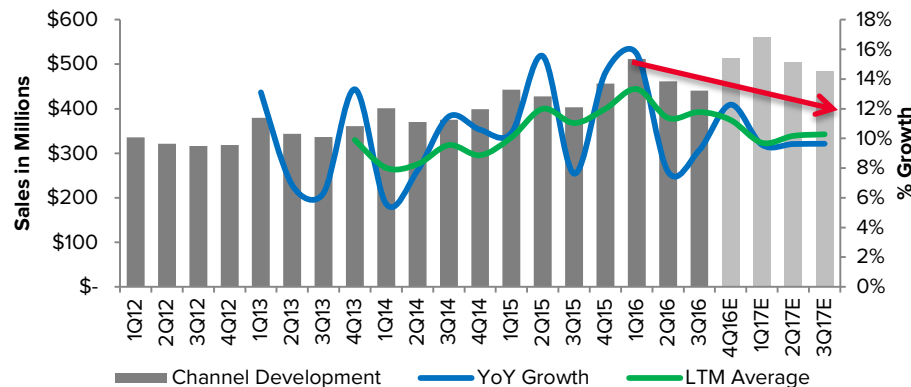
- As drinks and units become more complex, expect longer wait times at SBUX. The Affogato drink for instance, which is ice cream and espresso, or the nitro cold brew (now in 500 locations was introduced first at a roastery), and the introduction of more food (they can only cook so much so fast) will extend wait times. As you add more touch points for employees, it slows the whole process down.



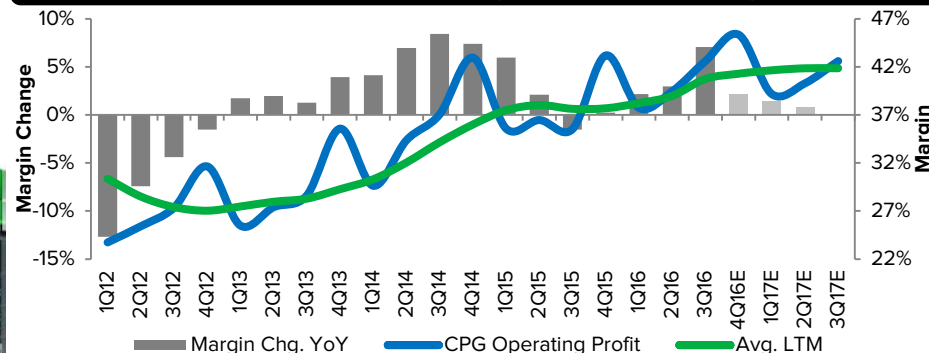
# IS THE CPG BUSINESS IMPORTANT ENOUGH TO MATTER?

- The CPG business, which represents 9% of sales is not a meaningless segment that can't be forgotten
- The fact is that CPG sales for SBUX have peaked and are beginning to slow down, SBUX has executed well to date as they have achieved a solid penetration level/and top market share positions in key sub-segments (K-Cups) and competition has begun to flood the categories in which they are competing
  - Competition entering the market ranges from small upstarts to large established coffee chains across categories
  - DNKN recently announced a partnership with KO to manufacture, distribute and sell DNKN RTD iced coffee, which will bring the competition between the two retail coffee makers to another aisle within the store
- Most recently on June 2, 2016, SBUX announced a partnership with Anheuser-Busch to produce and distribute Teavana RTD beverages with anticipated launch in the first half of 2017
- Growth in CPG in past years has been driven by taking share in packaged coffee and in K-Cups; SBUX thinks K-Cup industry has slowed, and that RTD is the new wave of growth, partnerships with PEP and ABI to provide a leg of growth across both coffee and tea

## CPG – Sales Growth



## CPG – Operating Profit Margin



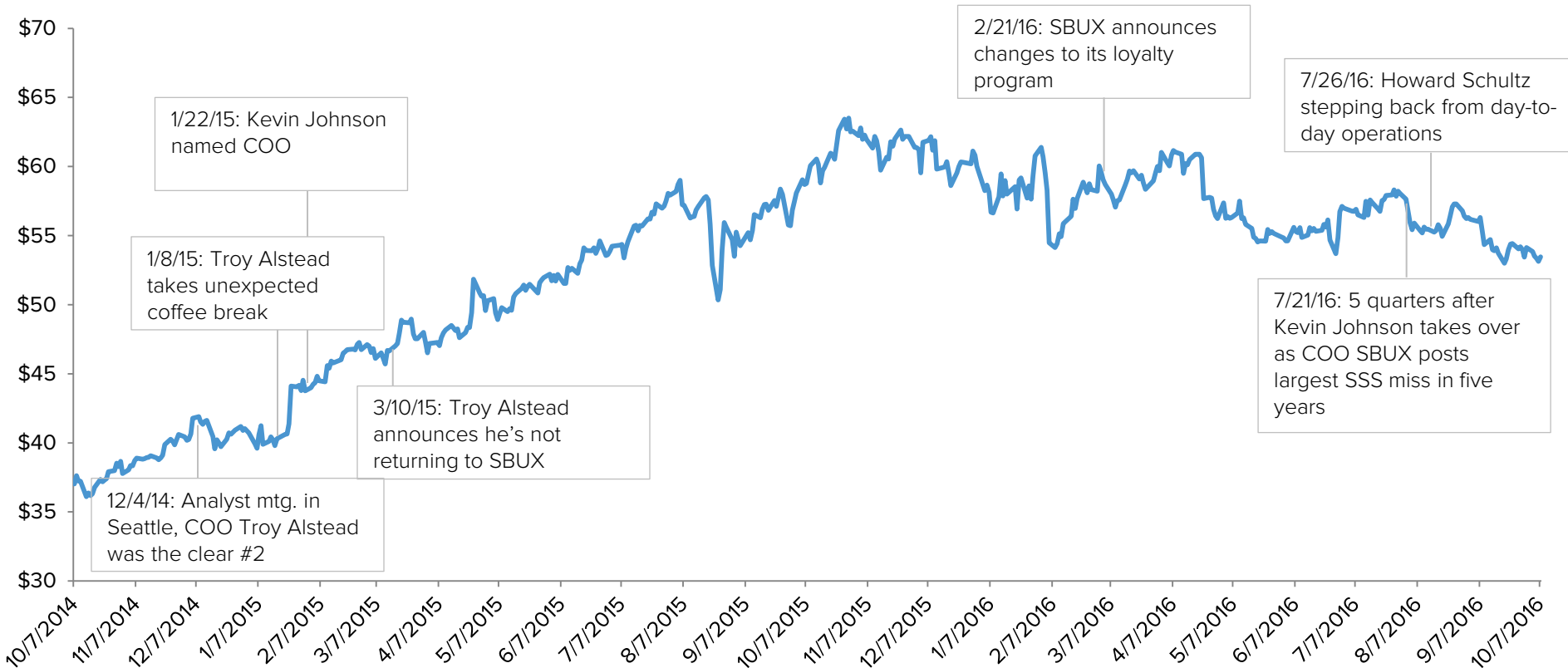
*“Starbucks occupies a front-row seat at the intersection of the physical and digital worlds like no other company anywhere in or out of retail.”*

-Howard Schultz, SBUX Chairman & CEO, 4Q15 Earnings Call

## **MANAGEMENT SHIFTS**

# CHANGES AT THE TOP OF MANAGEMENT

## THE SHIFT TO A NEW COO WITH LITTLE EXPERIENCE ADDS UNCERTAINTY



# WILL THIS TIME BE DIFFERENT?

## HOWARD SCHULTZ STEPPING AWAY FROM THE DAY-TO-DAY ONCE AGAIN

### Kevin Johnson – COO – SBUX's New Leader



- Kevin is the president and COO for SBUX, leading the company's global operating businesses across the Americas, EMEA, CAP as well as Starbucks Supply Chain, IT and mobile and digital platforms
- Reporting to Johnson will be Cliff Burrows, Group president, U.S., Americas and Teavana; John Culver, group president, China/Asia Pacific, Channel Development and emerging brands as well as other senior leaders responsible for Starbucks supply chain, mobile and digital, and information technology organizations
- March 2015 – Present: SBUX President and COO – SBUX is up 16% outperforming the S&P by 10%. Since 3Q16 SBUX stock is down roughly 7.5%, while the S&P is flat
- March 2009 – Present: SBUX Board Member
- Sept. 2008 – Feb. 2014: Juniper Networks CEO - As CEO of JNPR the stock was down 12% underperforming the S&P 500 by 74%
- 2008 - 2013: Appointed by President George W. Bush to the National Security Telecommunications Advisory Committee
- Sept. 1992 – Sept. 2008: Various roles at MSFT
  - As head of Microsoft's online and Windows platform, Kevin is widely seen as a key figure in the company coming up short in their [Yahoo takeover](#) attempt back in '08. Coincidentally, the deal fell through in May and Kevin jumped ship a couple months later in July. If Microsoft was able to get the deal done, it would have positioned their online business very well to compete with Google, as the purchase would have also allowed them to share both costs and operational efficiencies.
- Jan. 1986 – Sept. 1992: Systems Engineer at IBM



# HAS THIS COMPANY LOST ITS WAYS?

## HOW LONG HAS HOWARD BEEN OUT OF THE FOLD?

### Management Disconnect

- How long has Howard Schultz been out of the fold at SBUX?
- The recent releases by WikiLeaks would hint that his focuses have been on topics outside of SBUX for some time.
- The most recent release of documents included an email that Howard Schultz sent to Cheryl Mills (a top Clinton aide) back on July 6, 2016.
- Howard expressed his concerning thoughts about how the campaign was starting out, and how he is just one person “who cares deeply about the country and the dire need for authentic leadership.”
- We see this as evidence that Howard has had one foot out the door for more than a year now.
- Only time will tell if the technologically minded COO will be effective in leading a retail coffee business for the foreseeable future.

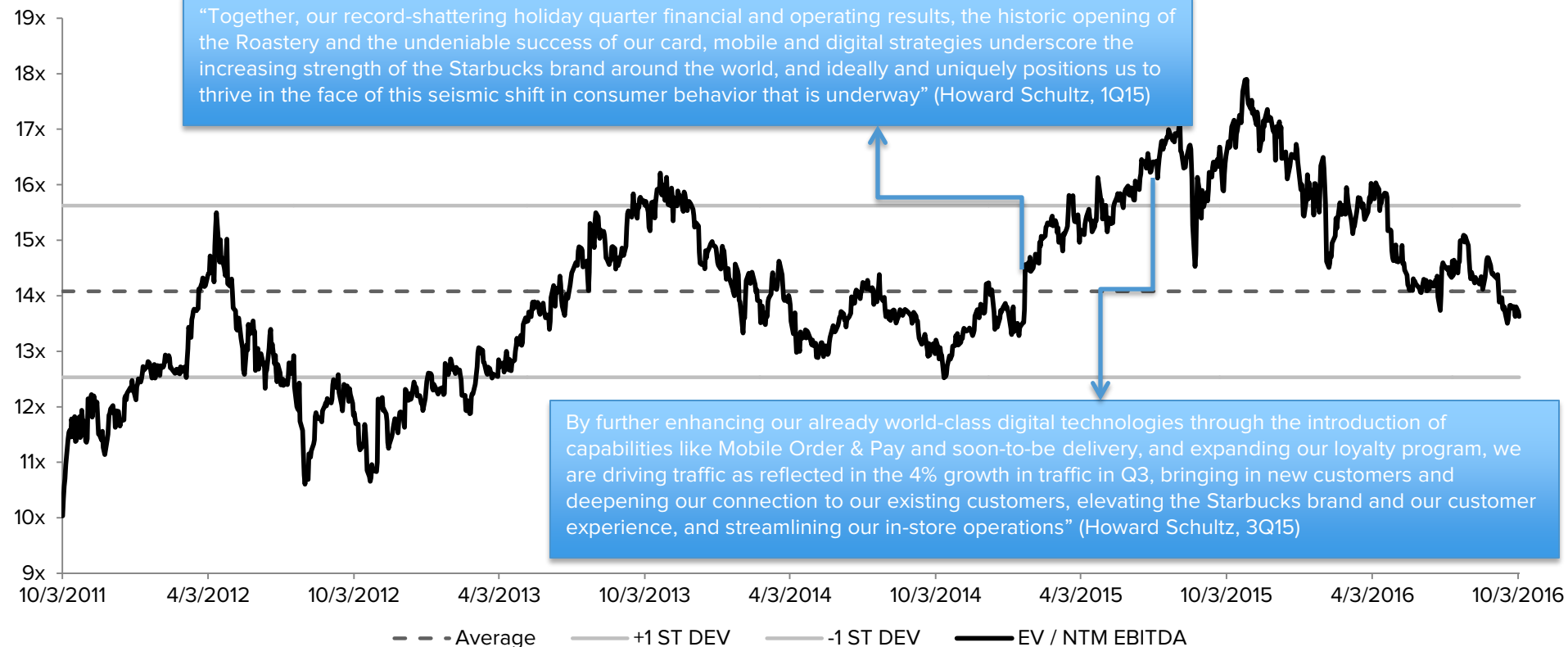
### Employee Discontent

- On the face of things it appears that SBUX management is doing plenty to keep their employees more than satisfied, whether it be industry leading wages, college tuition payments, or healthcare provided for every partner who works an average of 20 hours per week.
- All this sounds great, right? So what could the ~17,000 people who signed an online petition (started in June 2016) on [coworker.org](https://www.coworker.org) be complaining about? LACK OF LABOR.
- The problem is greatest at corporate stores, where managers, as stated in the petition, are directed to cut shifts to the bare minimum making it hard for any employees to reach 25 hours a week of work.
- As this practice of labor management drags on, cleanliness, speed of service and partner morale will continue to suffer.
- What is the tipping point to where employee discontent grows so severe that it affects customer perception? We would argue it is already getting there it just hasn't gotten bad enough for all to notice.



# 5 YEAR VALUATION TREND

## NOT GOING BACK TO THE PEAK





*“On today's call we will demonstrate with clarity and specificity why our US comps in Q3 were an anomaly and that we have clear line of sight to returning our business to historic levels of comp growth, which has been at or above 5% for the past 25 consecutive quarters.”*

-Howard Schultz, SBUX Chairman & CEO, 3Q16 Earnings Call

**THE “ANOMALY” LIKELY TO CONTINUE**

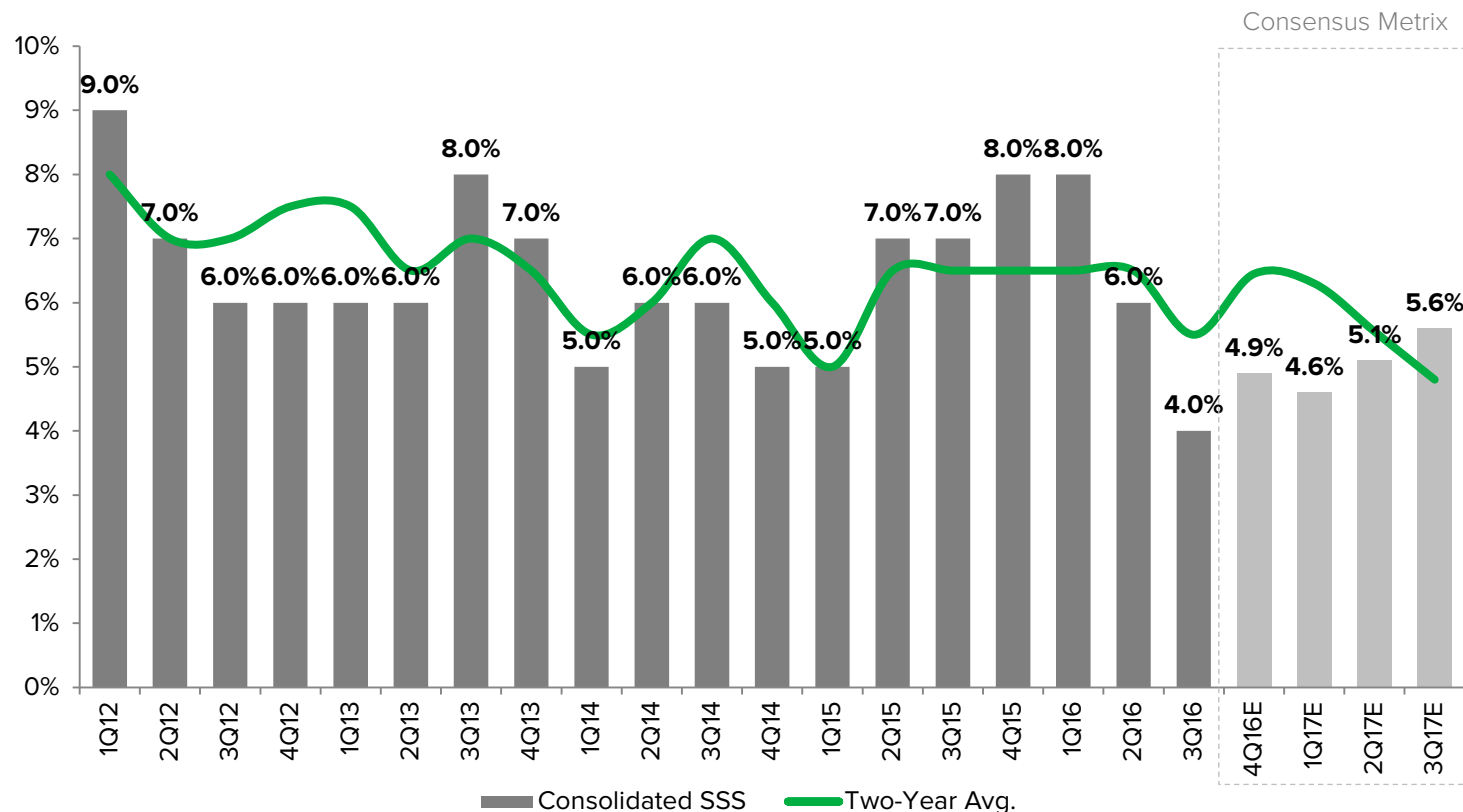
*“With humility, our performance in Q2 is particularly gratifying in that it was achieved in the face of very challenging consumer, geopolitical and economic environments.”*

-Howard Schultz, SBUX Chairman & CEO, 2Q16 Earnings Call

## **CONSOLIDATED SSS TRENDS**

# CONSOLIDATED SSS

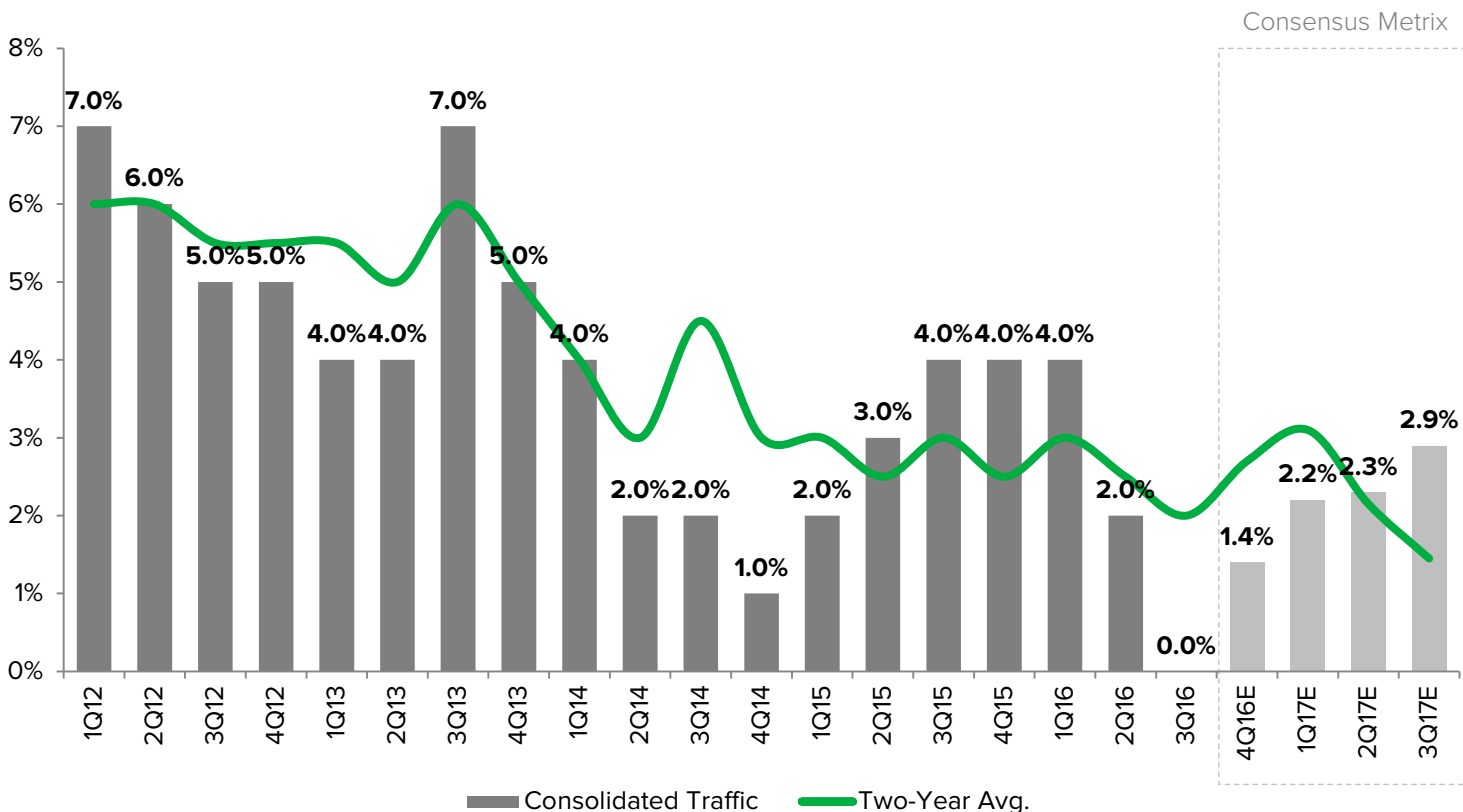
## NO REASON FOR THE UPWARD TREND IN THE 2-YEAR IN 4Q16



- Going against harder comparables and arguable a more questionable global economy it is tough for us to see SBUX having this magnitude of an improvement in 4Q16
- In 4Q16 consensus is projecting a 100bps increase in 2-year trends followed by a deceleration in the following quarters

# SBUX CONSOLIDATED TRAFFIC

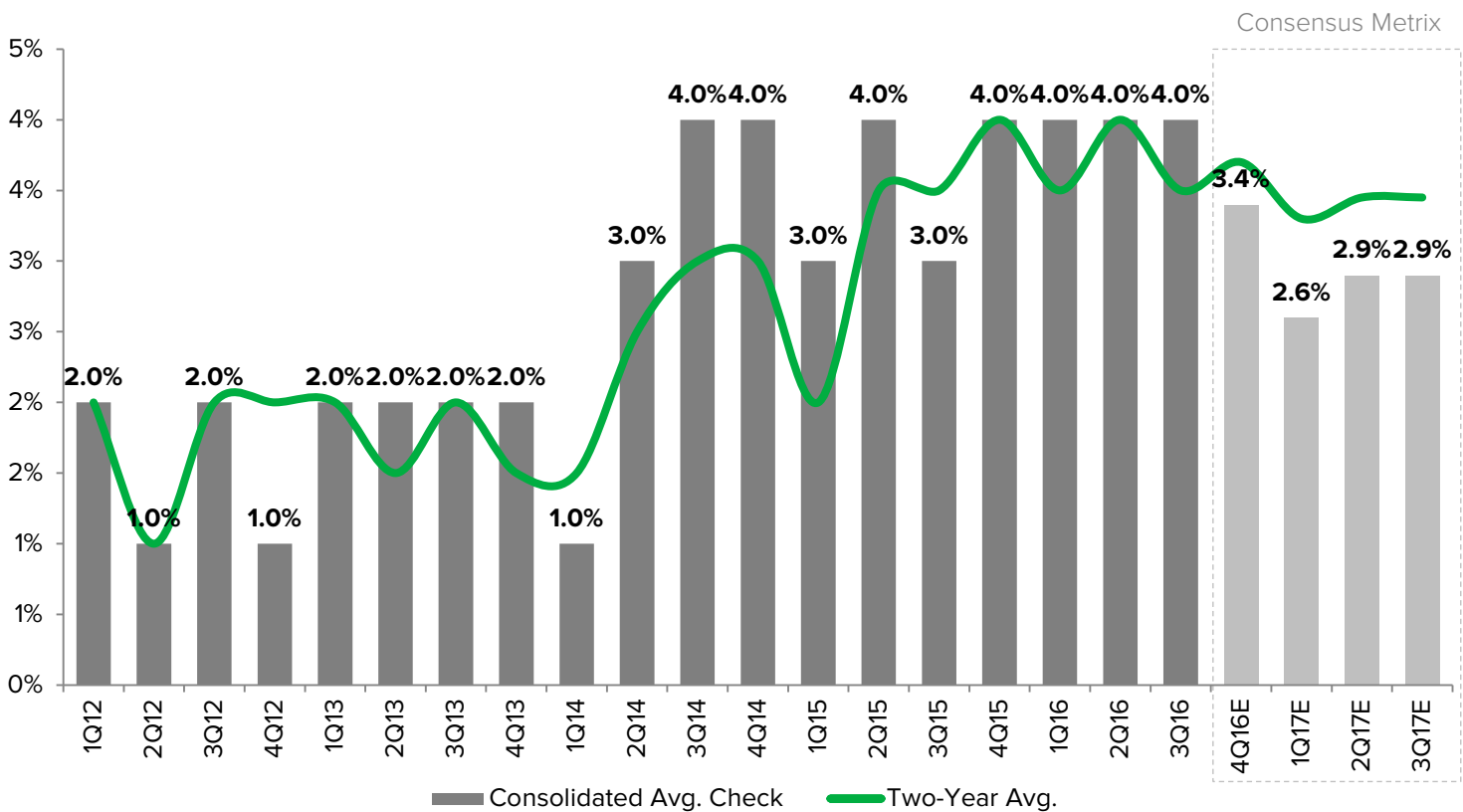
## THE COMPANY HAS BEEN OVERSTATING TRAFFIC FOR YEARS



- It's possible that given the challenges in the USA and Europe that SBUX can see consolidated traffic declines in the next two quarters.
- The acceleration to 2.9% is likely not going to happen.

# CONSOLIDATED AVERAGE CHECK

## EXCESSIVE PRICE TAKING A TOLL



- The slowing growth in food sales will slow the growth in average check.
- SBUX has become an expensive purchase for the aspirational consumer

# CONSOLIDATED UNIT GROWTH

## UNIT GROWTH REMAINS IN HIGH SINGLE DIGIT RANGE GLOBALLY



- Strong MSD growth headed into an economic slowdown
- We are not calling for a shutdown of growth á la 2009, but maintaining this level of growth and capex infusion into a slowing economy, particularly in the U.S., will not be a good use of capital



# AMERICAS SSS TRENDS

# ISSUES IMPACTING THE AMERICAS SALES TRENDS

## THE HEADWINDS ARE MOUNTING

### TAILWINDS

- Top brand
- Beverage innovation
- Good vibes
- Mobile Order & Pay

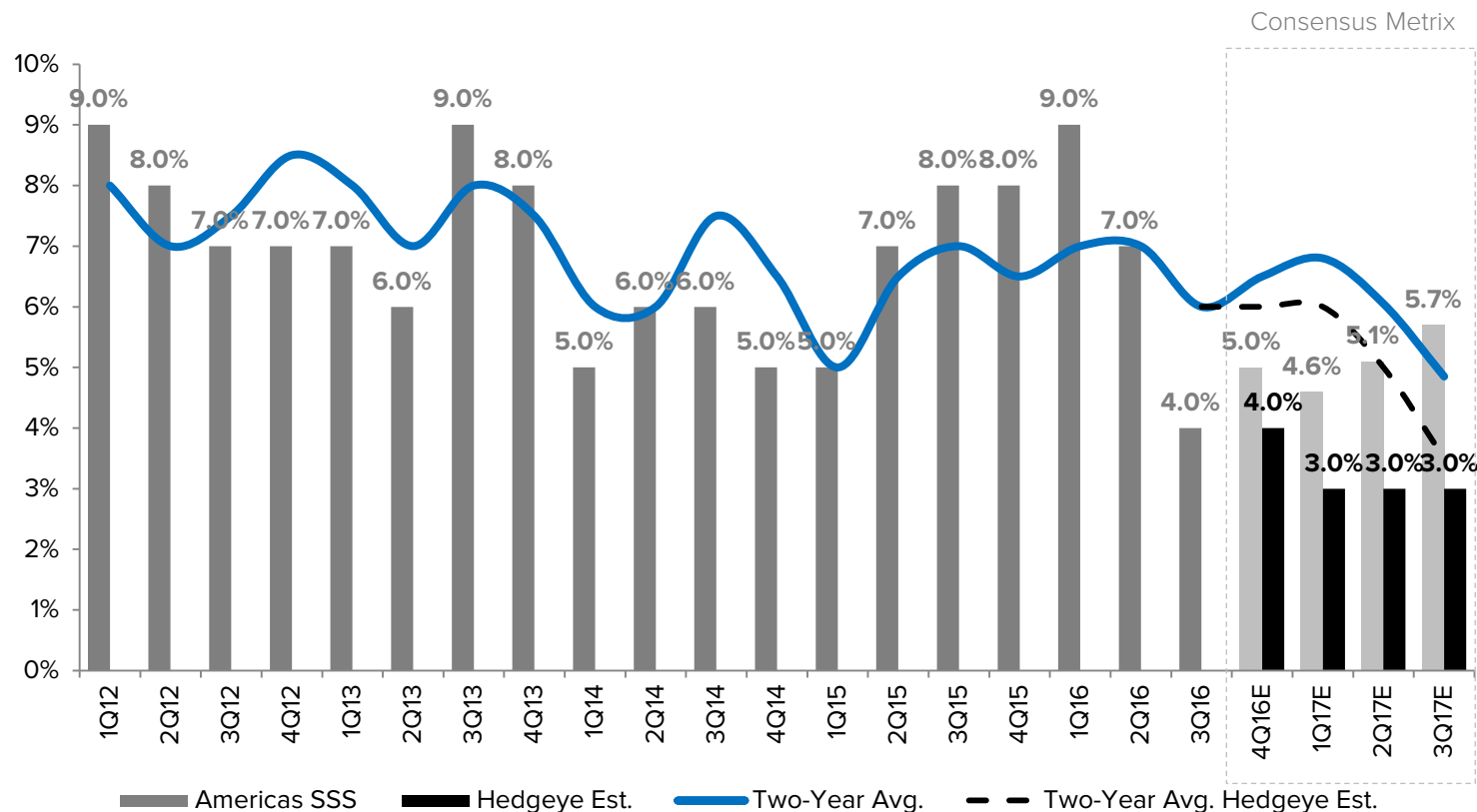
### HEADWINDS

- 5% SSS estimate for 4Q16 is aggressive
- 2017 sales and traffic acceleration?
- Consumer income is being stretched by healthcare, rent and other expenditures
- Is the political turmoil excuse real or just hot air?
- Competitive pressures intensifying
- Food growth slowing
- Aggressive pricing
- Did the changes to the loyalty program alter consumer behavior?



# AMERICAS SSS

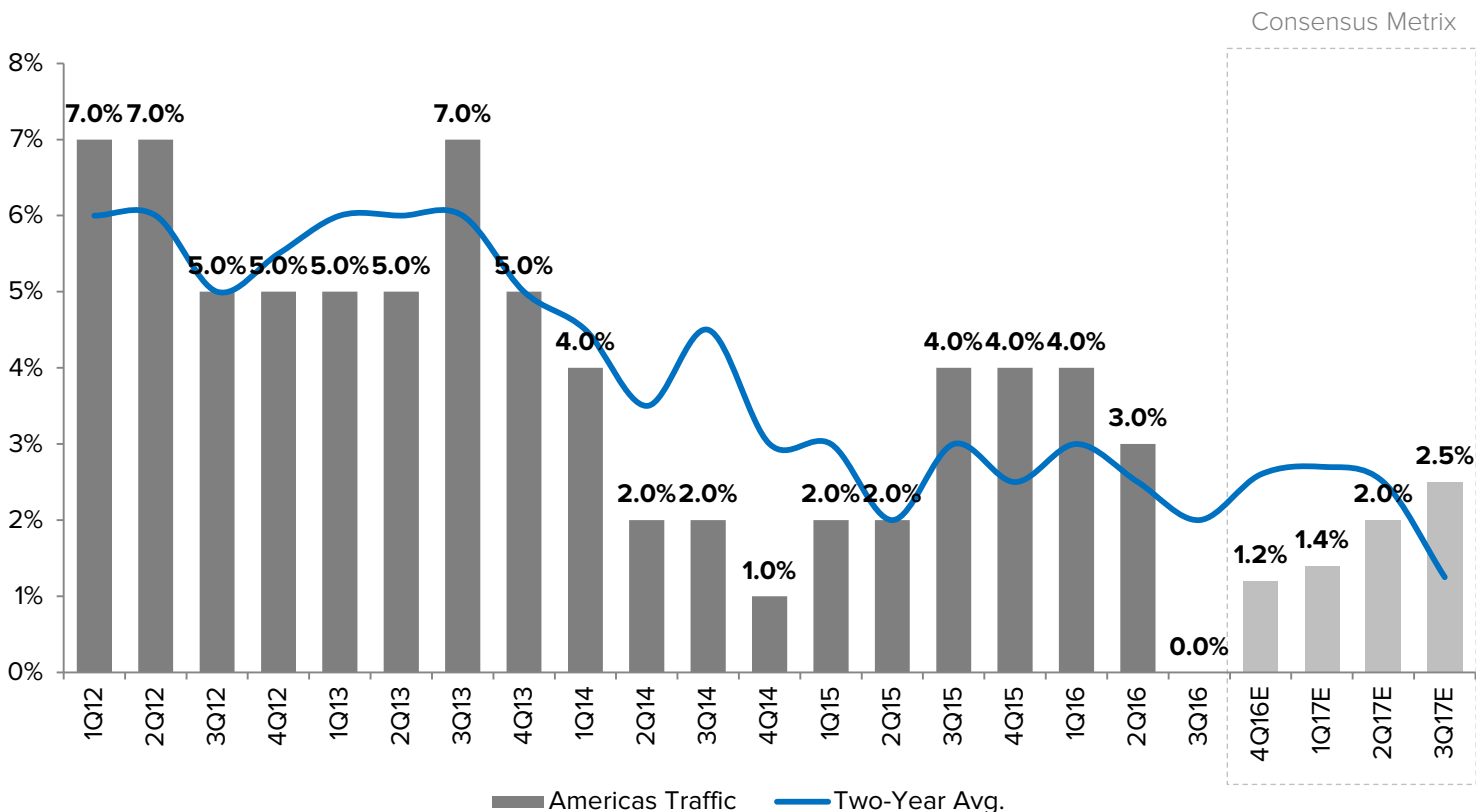
## THE STOCK RISES AND FALLS WITH AMERICAS PERFORMANCE



- On the margin, have the changes in the loyalty program altered the purchase behavior of the core customer?
- Transactions are bound to suffer despite the growth in loyalty members
- The political turmoil that has continuously been blamed across the restaurant industry, and SBUX is no different, has only gotten more intense as the weeks have gone by; leading us to believe that this effect has only been magnified since their last earnings release

# AMERICAS TRAFFIC

## ACCELERATION IN 2-YEAR TREND IS UNWARRANTED

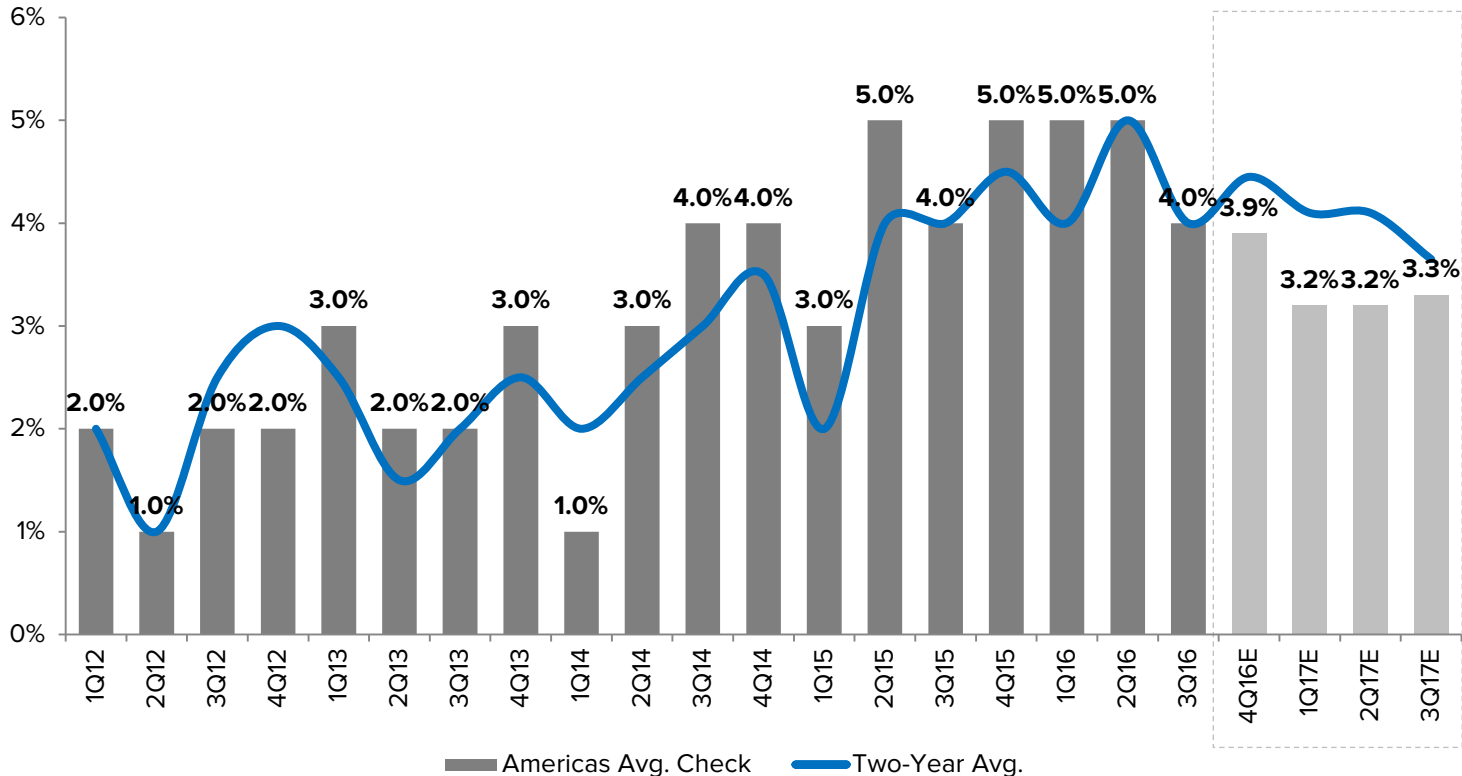


- Traffic almost went negative in 3Q16 as it was negatively affected by 1 point due to the lack of check splitting since changing the format of the loyalty program, as Scott Maw pointed out during a recent investor conference
- In the current quarter, the switch will have a negative 2% impact, so that coupled with slowing trends and tougher comps could lead to a disaster traffic quarter for SBUX

# AMERICAS AVERAGE CHECK

## NO ONE CAN PRICE TO THIS DEGREE AND GET AWAY WITH IT FOREVER

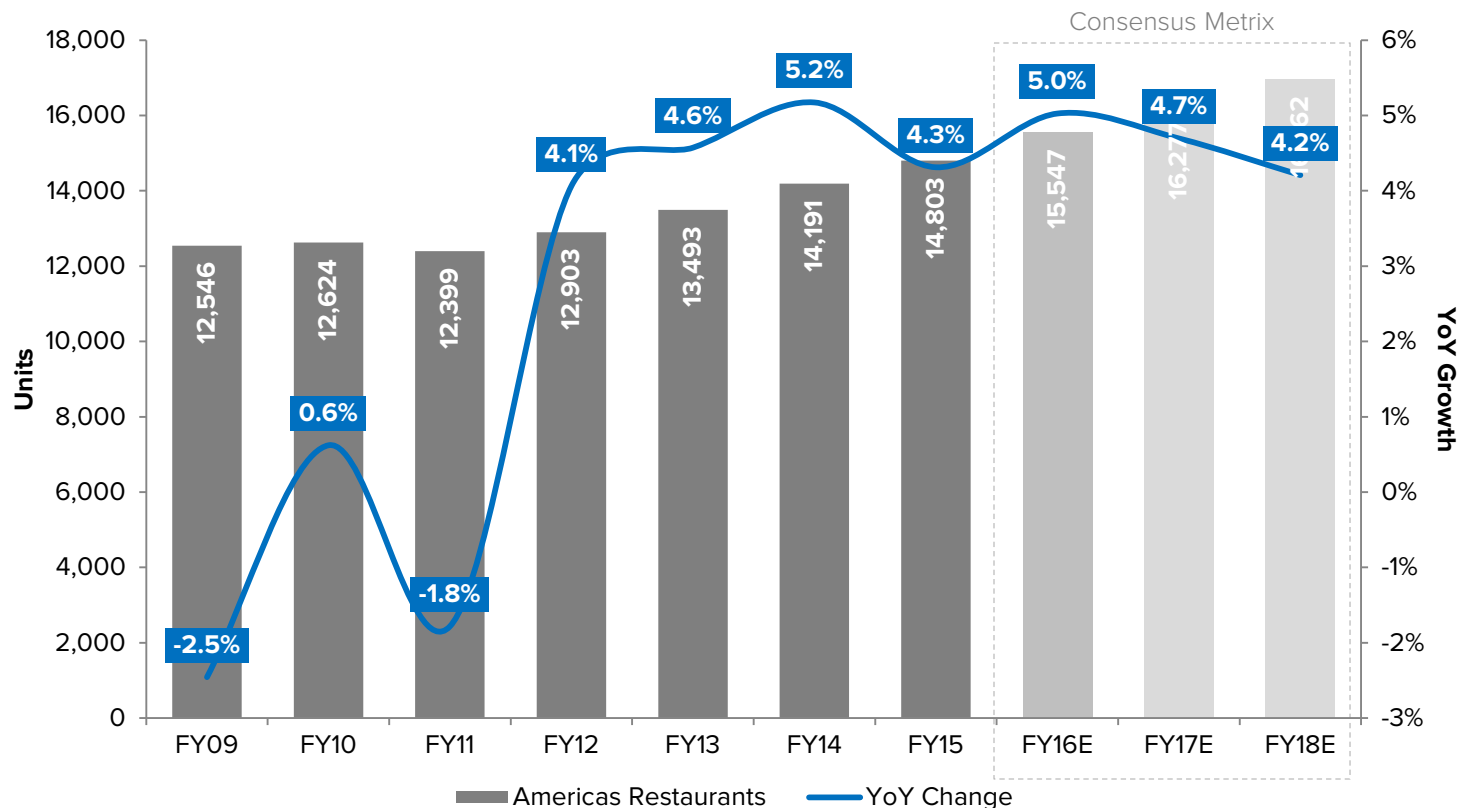
Consensus Metrix



- Excessive price increases overtime, for a commodity type product can be the kiss of death, take for instance BWLD
- Average check is a broader barometer of spending beyond just price increases, but it is evident that SBUX has been far too aggressive on price
- Most recently on July 12, 2016 SBUX made price adjustments at company operated stores (60% of the U.S. units), SBUX said customers would experience 10 to 20 cent increases on select sizes of brewed coffee and 10 to 30 cents on espresso beverages and tea lattes
- SBUX announced they expected the average customer ticket to increase by about 1%, noting that 65% of beverages did not have a price change

# AMERICAS UNIT GROWTH

## IS MSD UNIT GROWTH THE RIGHT NUMBER?



- Opening different stores than they were five years ago
- Opening drive-thru's now at a more accelerated pace versus typical stores
- The future units of SBUX, Roastery, Reserve, SBUX with reserve bars and core stores will be a small part of the equation
- Unit growth rate projected to decline in the coming years by consensus estimates, but is the decline enough given the saturation of the market place and the worsening economic conditions?



# CAP SSS TRENDS

# ISSUES IMPACTING CAP SALES TRENDS

## THE HEADWINDS ARE GROWING

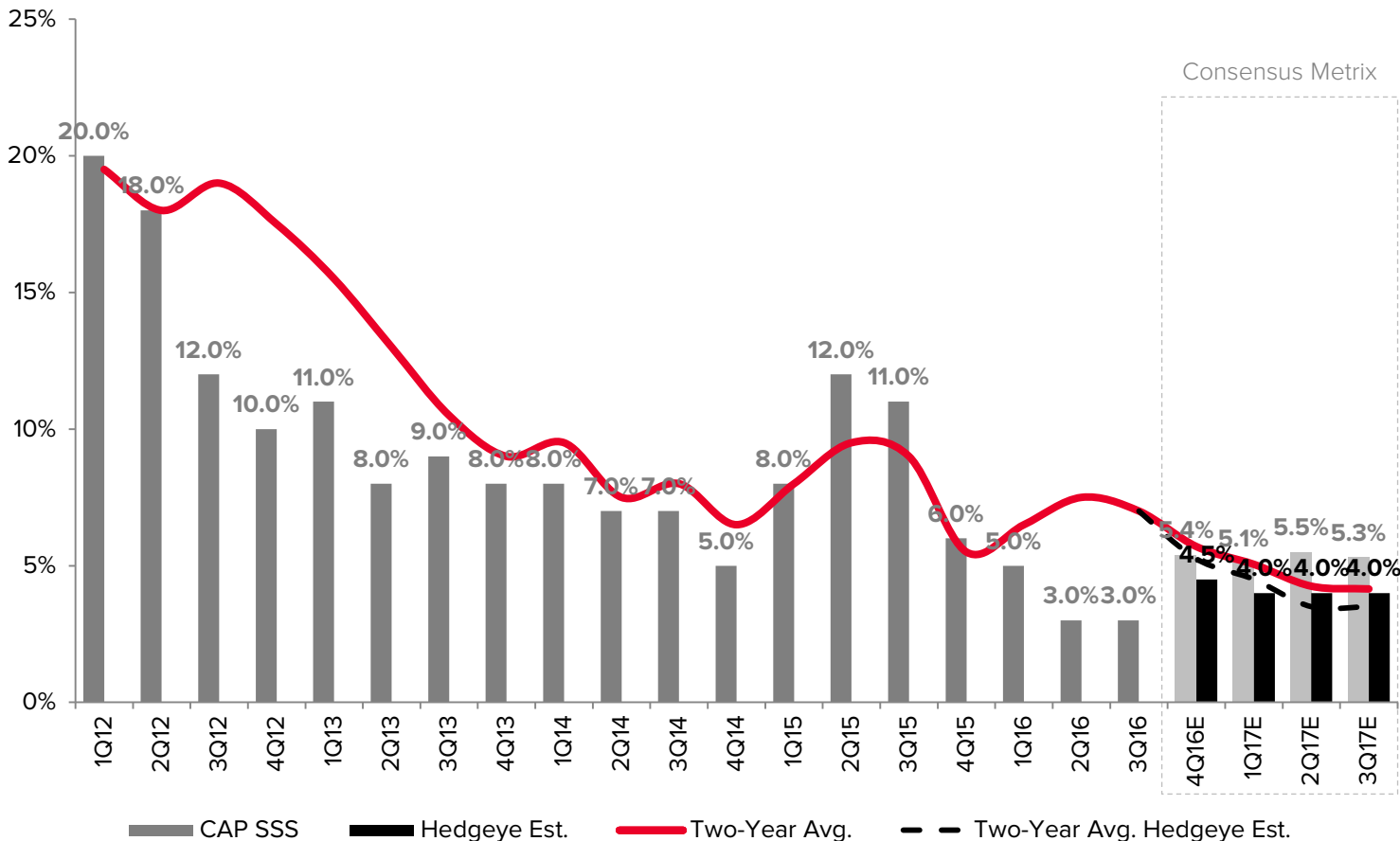
### TAILWINDS

- Japan (4.9% of units) positive SSS but economic challenges persist
- China (7.9% of units) posting positive SSS of 7% (6% traffic) in 3Q16
- Mobile payment in China
- First ever Starbucks mobile-app in Japan
- Teavana rollout in 4Q16

### HEADWINDS

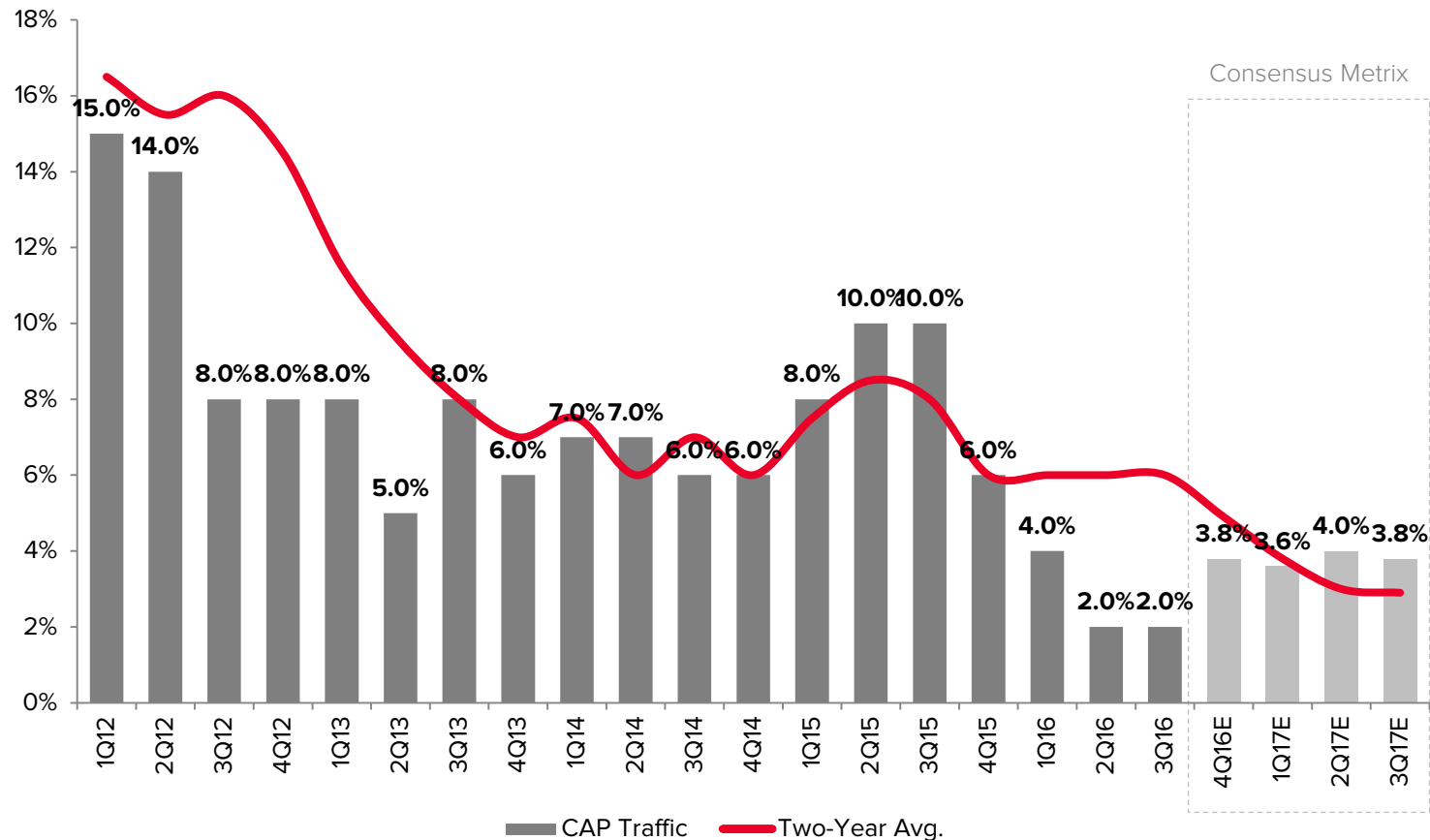
- Regional Economic challenges persist
- “Starbucks is not immune to cyclical changes in the Chinese economy”
- FX
- The 5.4% SSS estimate would be the first sequential improvement in 5 quarters.
- Economic data out of China

# CAP SSS



- CAP region is slowing down accordingly, and consensus may actually have these estimates right, or at least in the right direction
- With news that KFC is going to start taking coffee more seriously at all locations in China and other competitors encroaching on this space it will undoubtedly impact SBUX
- Additionally, although it is the fastest growing economy it is not growing as fast as it once was, leading us to agree with this downward trajectory

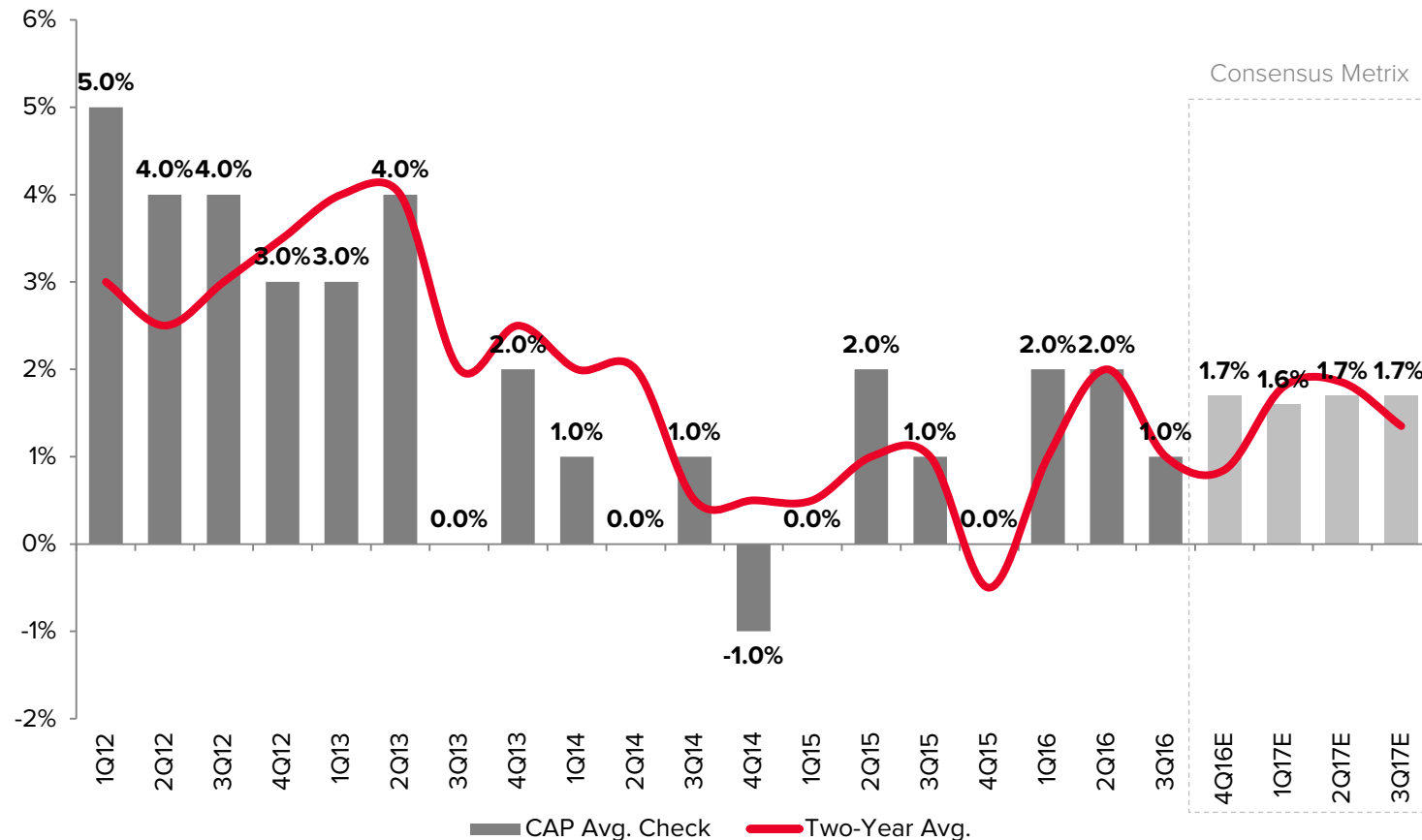
# CAP TRAFFIC



- CAP traffic two-year average is expected to decline 110bps to 4.9% in 4Q16



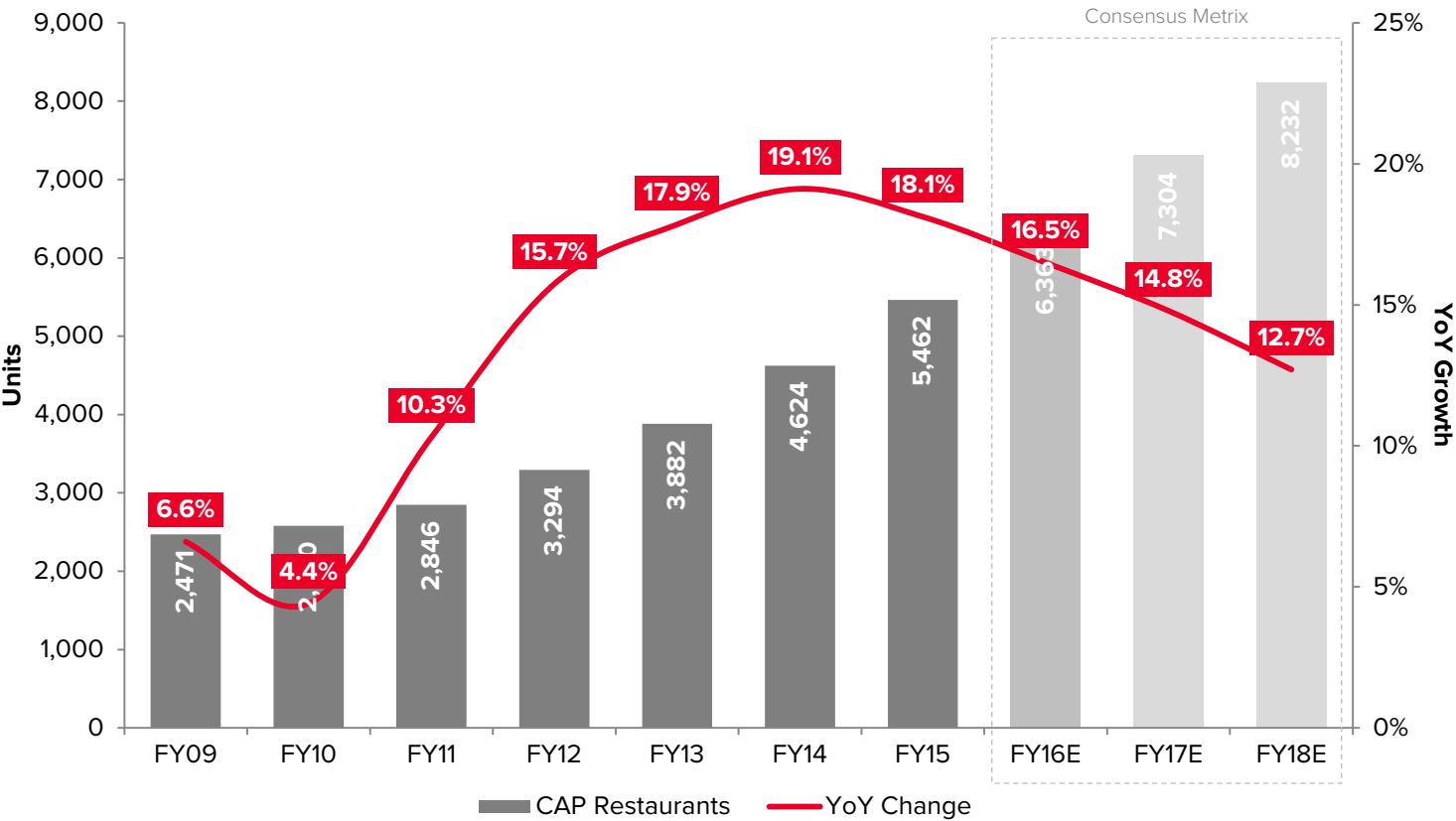
# CAP AVERAGE CHECK



- After going through a heightened period for average check in 2012/2013, the metric has moderated to the LSD range

# CAP UNIT GROWTH

XXX



- CAP unit growth declining to a more modest pace which we like



# EMEA SSS TRENDS

# ISSUES IMPACTING EMEA SALES TRENDS

## THE HEADWINDS ARE GROWING

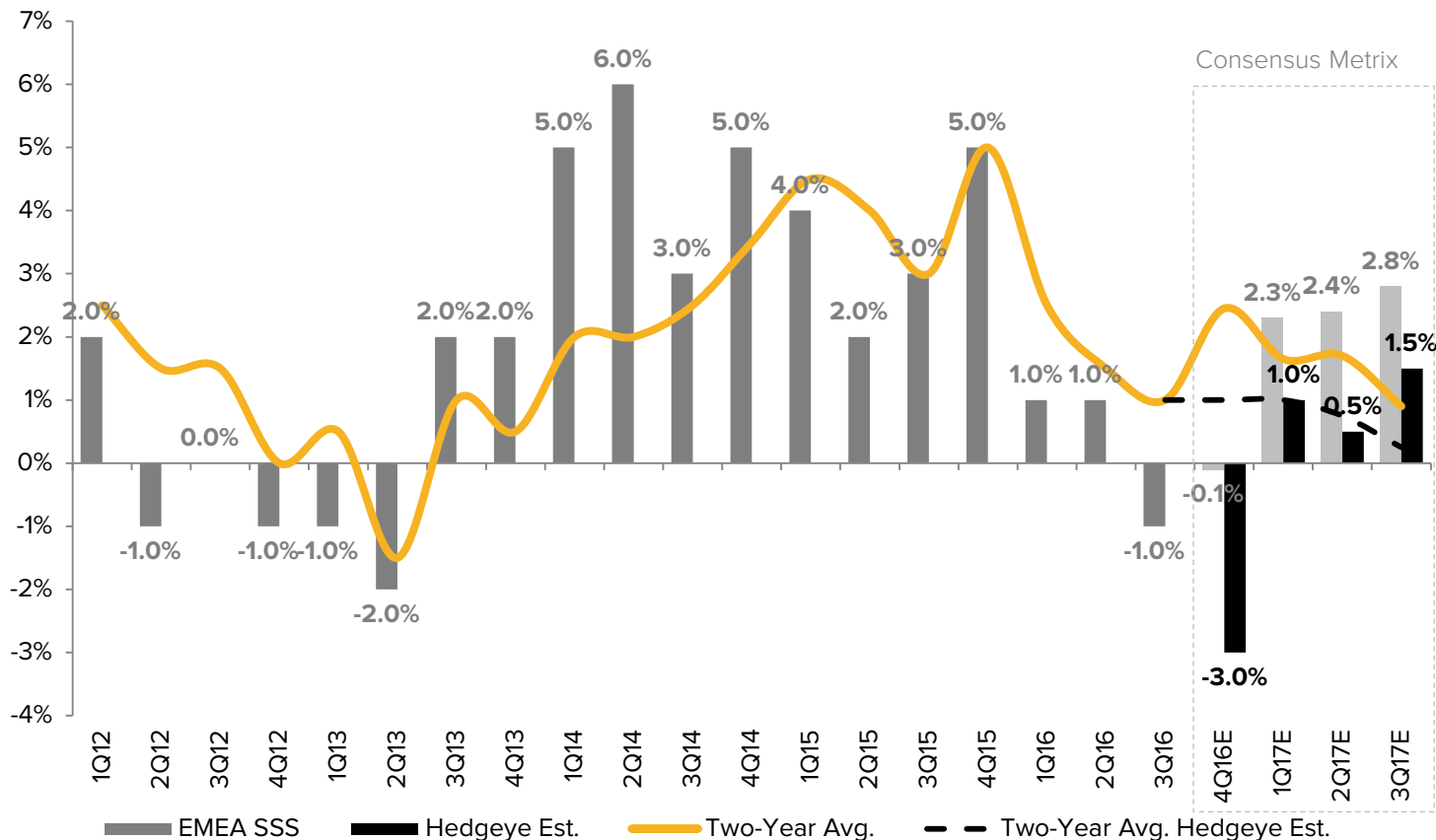
### TAILWINDS

- 79% of the stores are licensed
- recent launch of the Teavana Shaken Iced Tea platform
- Flat margins at best in 2016

### HEADWINDS

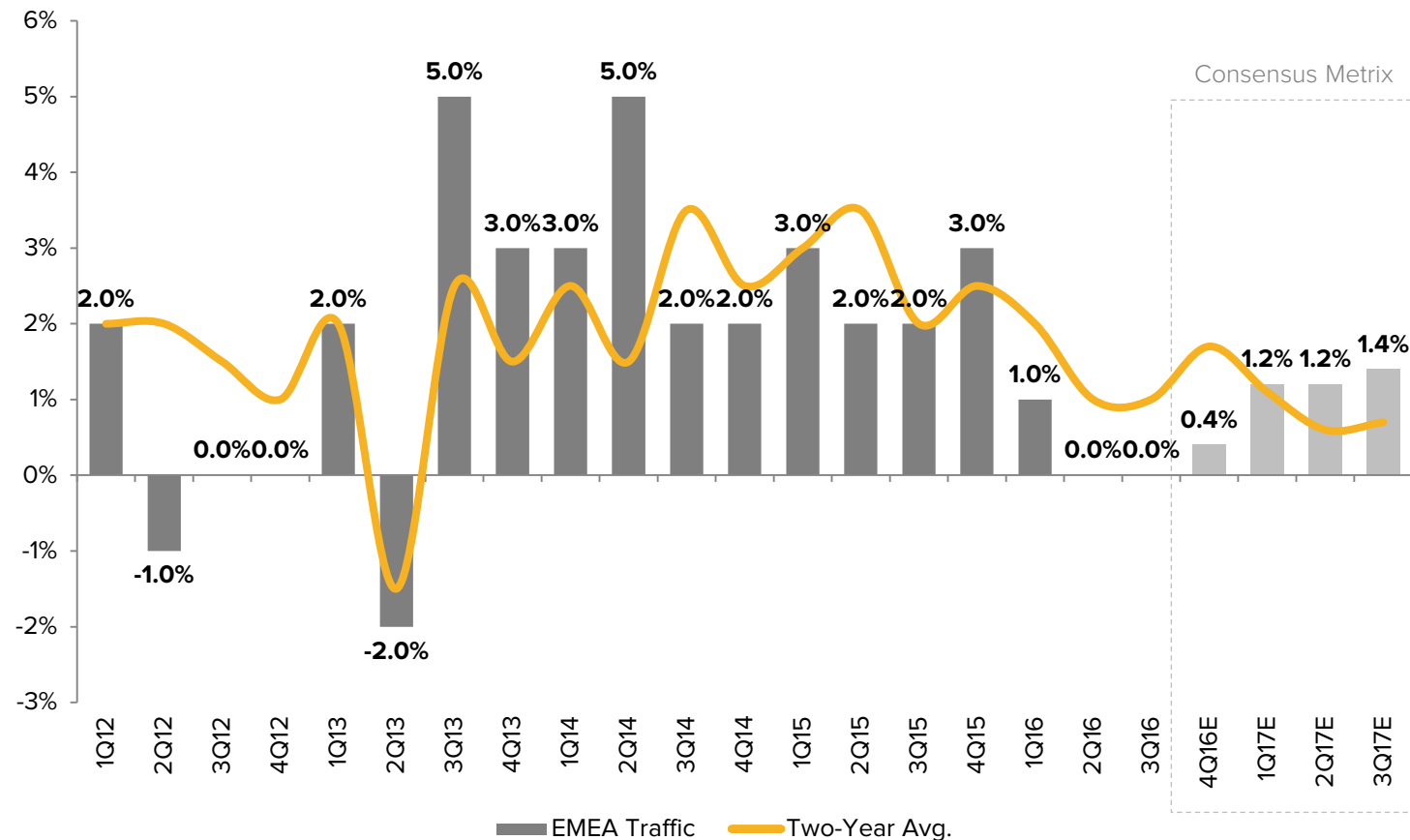
- Mounting competition in key countries (UK)
- Social turmoil
- Brexit
- Currency weakness
- Slow growth European economy
- SSS estimates for 1H17 are very aggressive
- Can SBUX grow the average check?
- Two consecutive quarters of flat traffic

# EMEA SSS



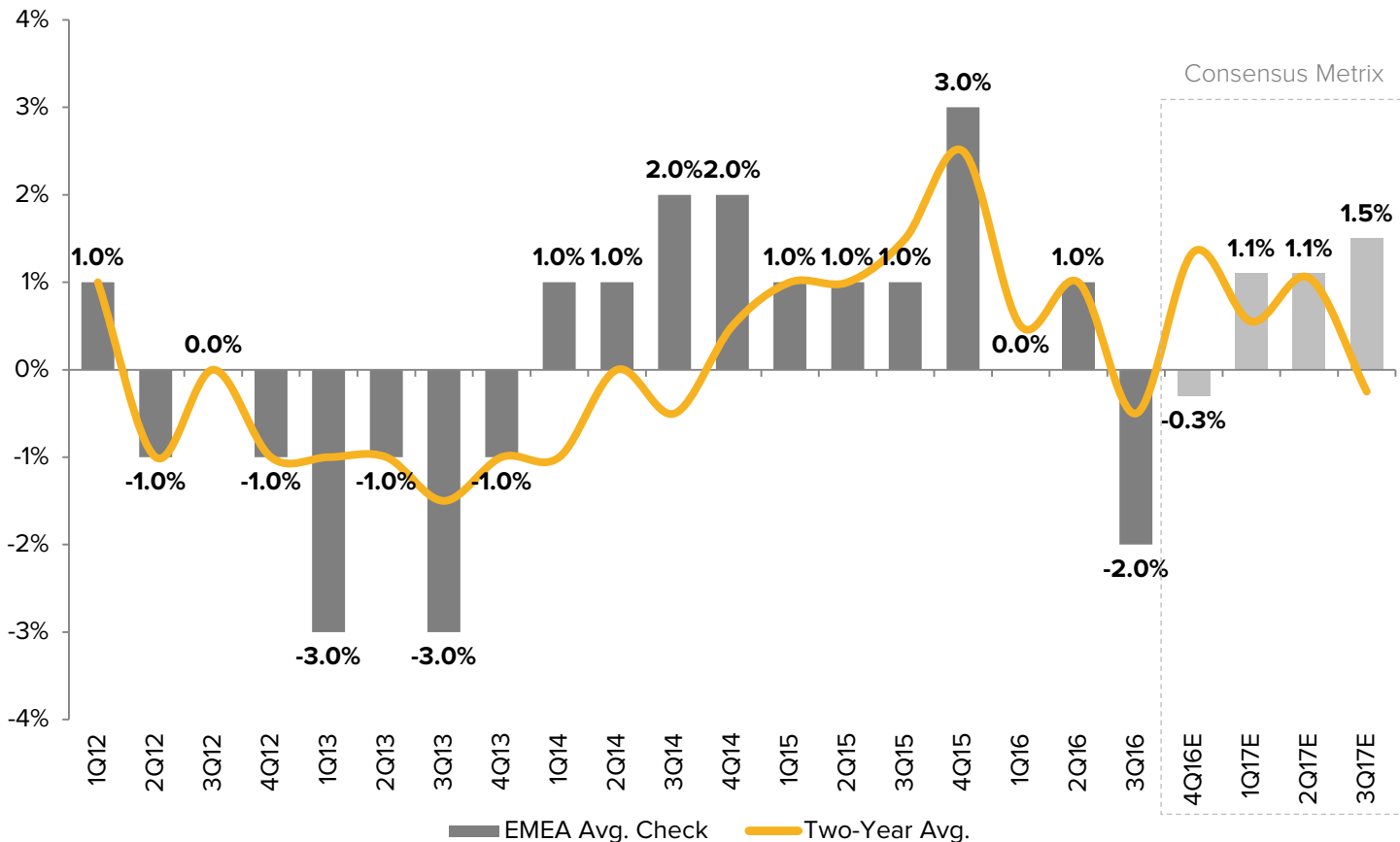
- We don't see why a -3% SSS in the EMEA region is out of the question.
- After posting a -1% comp in 3Q16 going against a 3.0% comparison, now going against a 5.0% in an equally as challenging if not worse macro environment, this region could be in for a big surprise to the downside.

# EMEA TRAFFIC



- Likelihood of traffic being negative in 4Q rising, and yet there continues to be an inherent positive bias towards this Q4 release

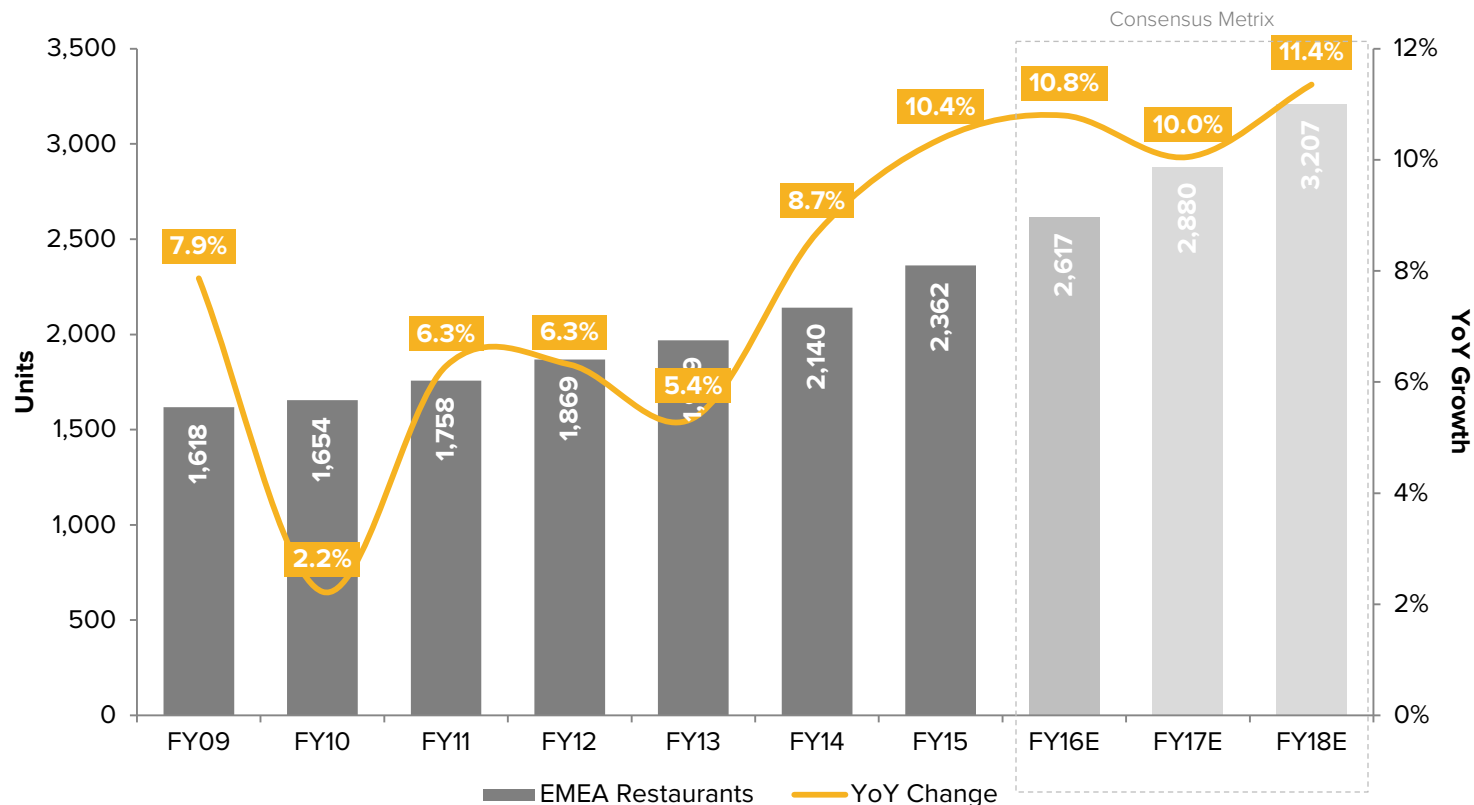
# EMEA AVERAGE CHECK



- Average check has a high likelihood of going negative in 4Q16

# EMEA UNIT GROWTH

## GROWTH IS ACCELERATING INTO AN INCREASINGLY COMPETITIVE ENVIRONMENT

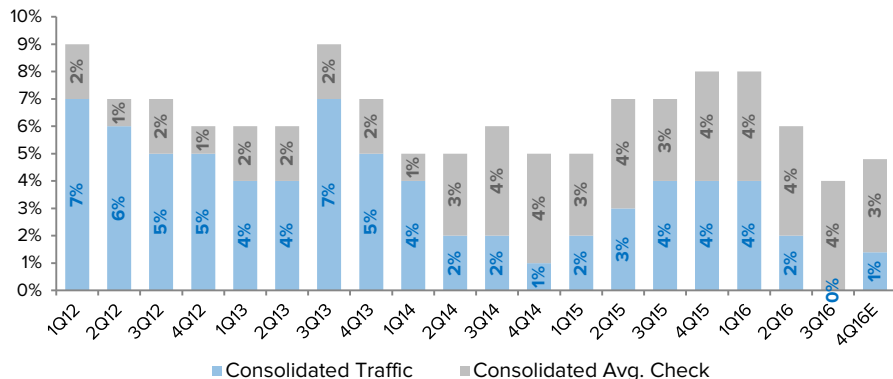


- SBUX has been working diligently to shift towards more licensed stores in the EMEA region
- Licensed stores now represent 79% of EMEA locations as of 3Q16, versus 66% in 3Q15

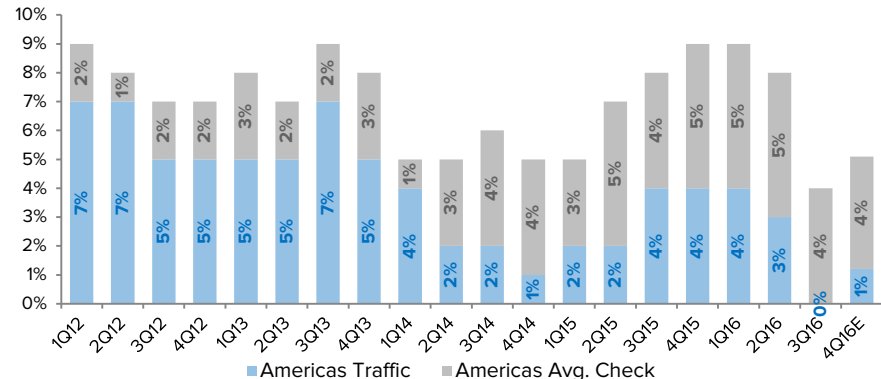


# REGIONAL SSS COMPOSITION

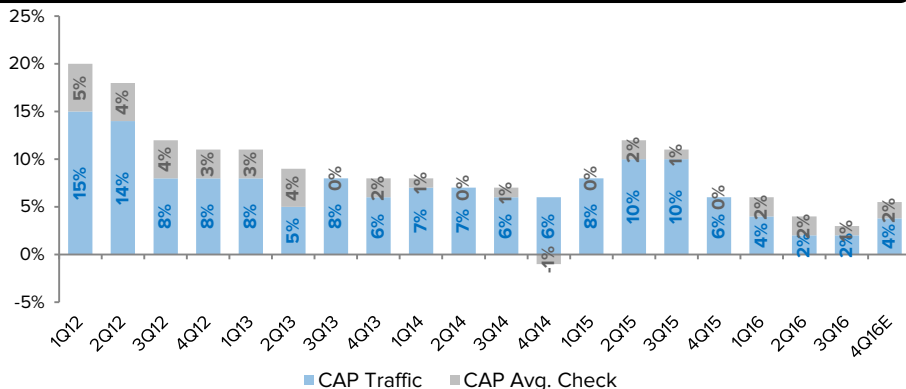
## Consolidated



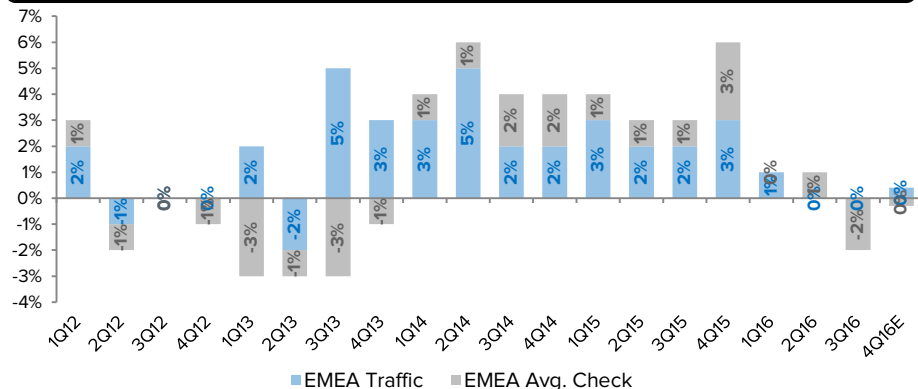
## Americas



## CAP



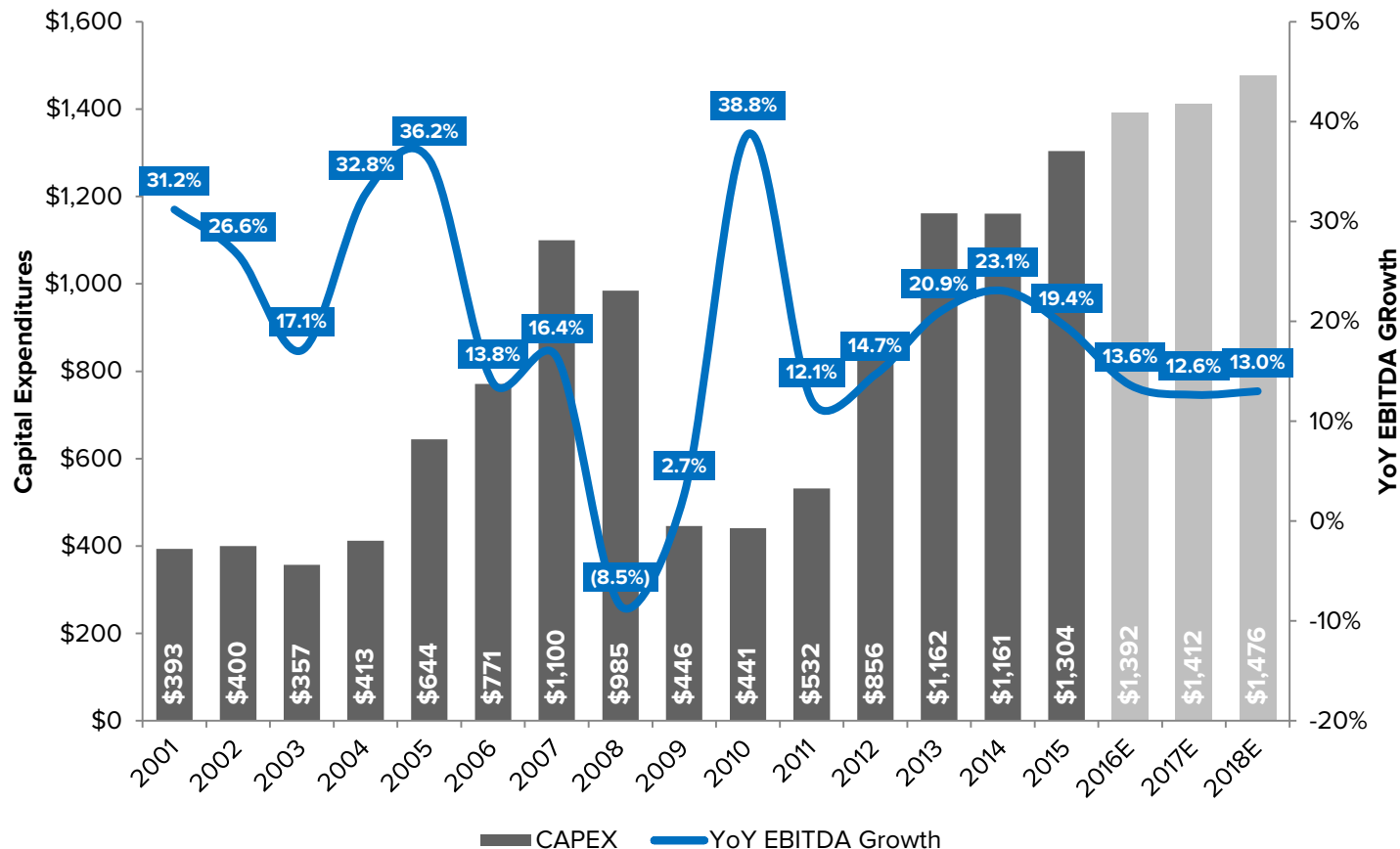
## EMEA





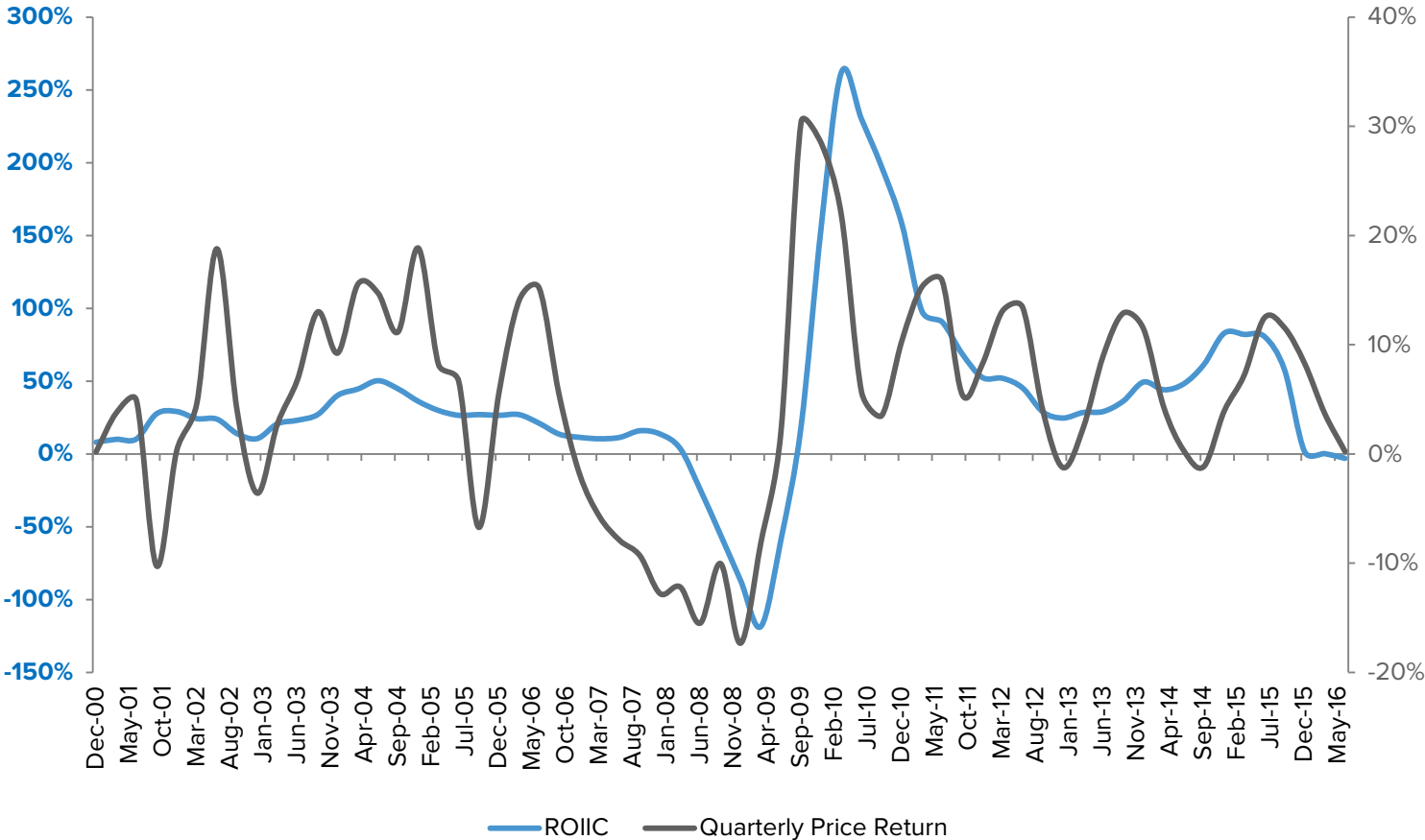
# CAPITAL DEPLOYMENT

# CAPITAL EXPENDITURES



- Aggressive spending on new units is a significant component to the long-term growth story
- Like other mature brands aggressive spending on new units can lead to declining ROIIC

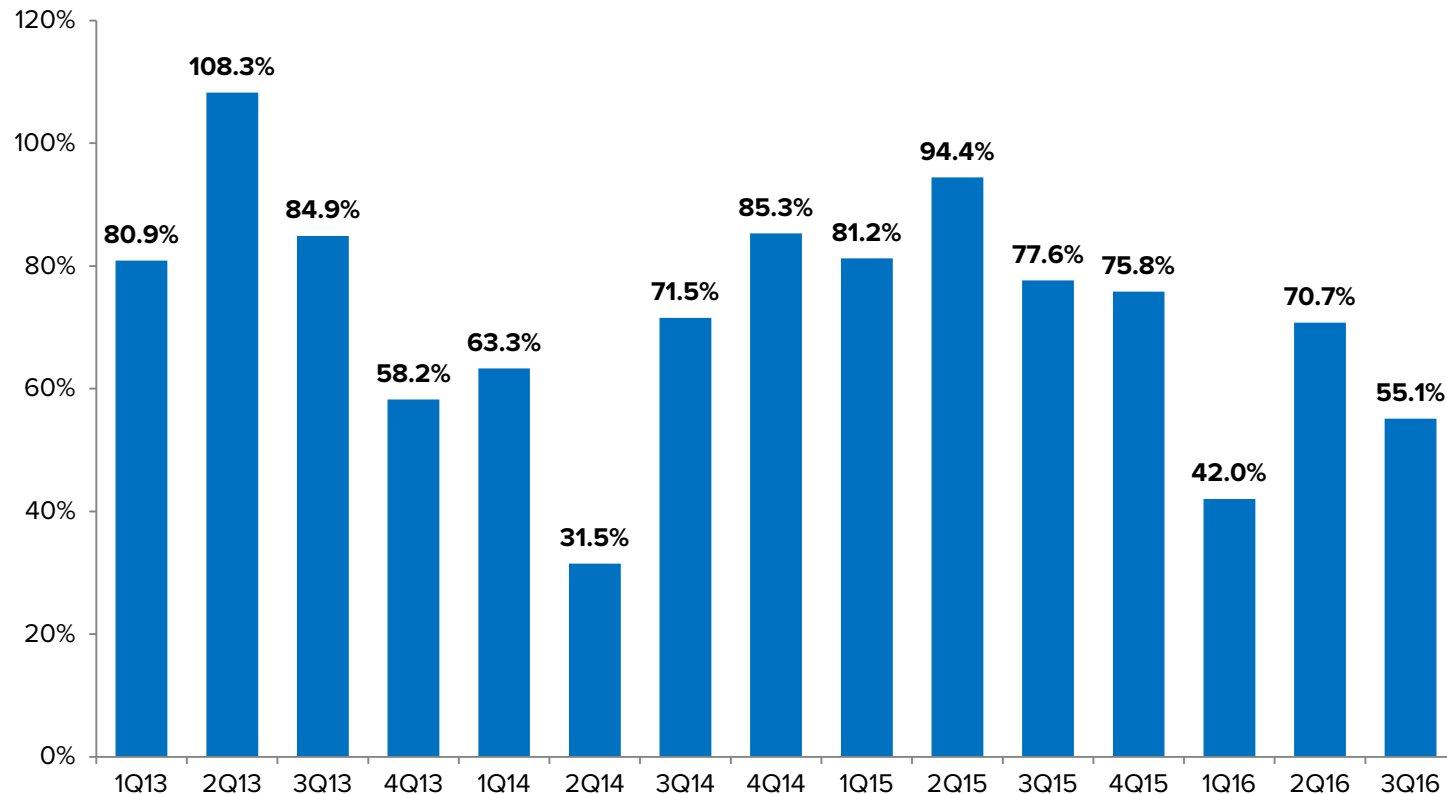
# SBUX ROIIC



- After six years of increases in capital spending ROIIC is starting to decelerate

# AMERICAS NEW STORE PRODUCTIVITY

## INCREMENTAL STORES CAUSING CANNIBALIZATION?



- Americas new store productivity continues to trend lower, as each new store is incrementally less impactful

*“There’s no doubt in our minds that delivery, like Mobile Order & Pay, will drive further incrementality and profitability for the company.”*

-Howard Schultz, SBUX Chairman & CEO, 2Q15 Earnings Call

**TECHNOLOGY NOT DRIVING INCREMENTALITY**

# MOBILE ORDER & PAY... IS IT A DIFFERENCE MAKER?

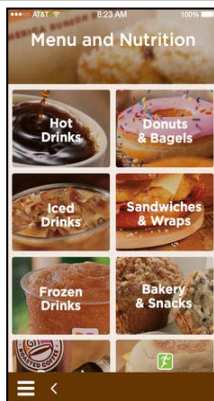
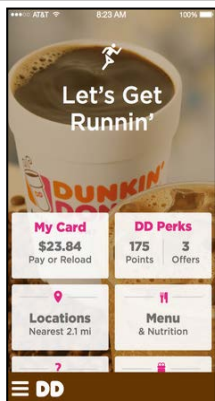
## YES, NO...MAYBE SO. BUT TRAFFIC IS SLOWING.

- In 2Q16, mobile payments represented 4% of total U.S. transactions, and by 3Q16, 5% (over 8mm transactions per week) of total U.S. transactions were executed through Mobile Order & Pay...
- For the avid Starbucks consumer, the Mobile Order & Pay app is a game changer because you greatly reduce your wait time, often to zero because you are able to order ahead, and if timed correctly, your drink is there waiting for you when you arrive
  - “When you look at our busiest stores at peak, when Mobile Order & Pay is most valuable to our customers and most effective at unlocking capacity in our stores, we see an even more impressive trend” (Kevin Johnson, President & COO)
  - “In more than 2,700 stores across the U.S., Mobile Order & Pay represents more than 10% of total transactions at peak” (Kevin Johnson, President & COO)

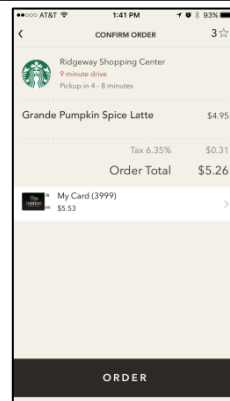
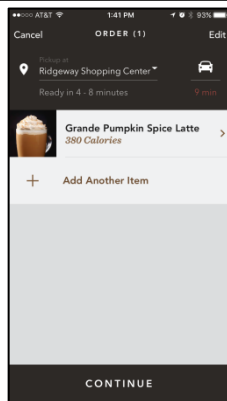
**Competitors have also entered the Mobile Order & Pay space after noticing that mobile payment can offer an entirely new level of speed and convenience to patrons...**

- “In mid-June, we launched ‘On-The-Go’ mobile ordering nationally...We now have 4.9mm members and they can now order, pay in advance with a swipe of a finger on their phone, then skip the line in order to pick up their favorite items” (Nigel Travis, Chairman & CEO Dunkin Brands Group, Inc.)
- “On-The-Go ordering is one of the most game-changing initiatives in our history” (Nigel Travis, Chairman & CEO Dunkin Brands Group, Inc.)

### DNKN



### SBUX



- Mobile Order & Pay capabilities have allowed companies, such as SBUX and DNKN, among others, to offer an added level of convenience to patrons, displaying a commitment to improving the customer experience
- Can assist in driving membership to their loyalty programs, as both companies require loyalty membership in order to use their Mobile Order & Pay platforms
- This is evident in the fact membership in the Starbucks Reward loyalty program has increased by 18% YoY



**COMPETITION NOT ABATING**



# COMPETITION

## THE COFFEE SEA IS VAST

There is no shortage of competition that SBUX is facing around the globe...

- Tim Hortons, commonly referred to as “Canada’s version of SBUX”, will be opening locations in the UK in 2017
  - Though the number of units is undisclosed, management has expressed that opening in Great Britain is a natural fit for the chain
- KFC China adding new premium coffee machines to every restaurant in China in an effort to compete more effectively with SBUX
  - The goal of this undertaking is to become a lower-cost “premium” alternative to SBUX
  - With 5,087 KFC locations in China, to SBUX’s 2,171, the footprint alone will give KFC an advantage, not to mention that KFC’s coffee will be sold for half the price of a comparable cup at SBUX

Sip on this...

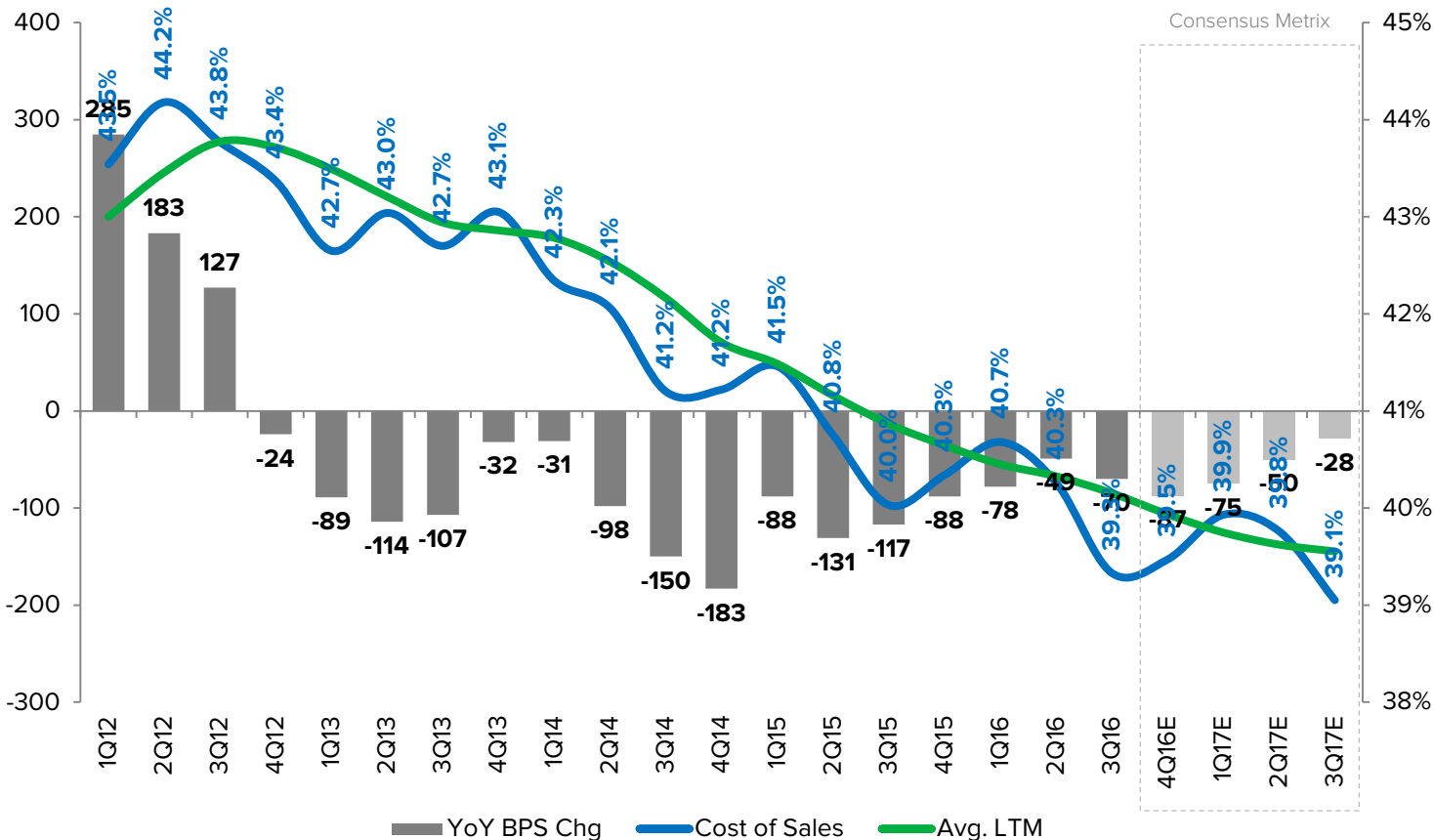
- Could slowing consumer consumption lead to more at home drinking or home preparation?
- **Macro environment:** Does the overall decrease in disposable income (due to increased healthcare and rent expenditures) affect consumer palates, forcing them to settle for a less expensive, albeit lower quality, brand?





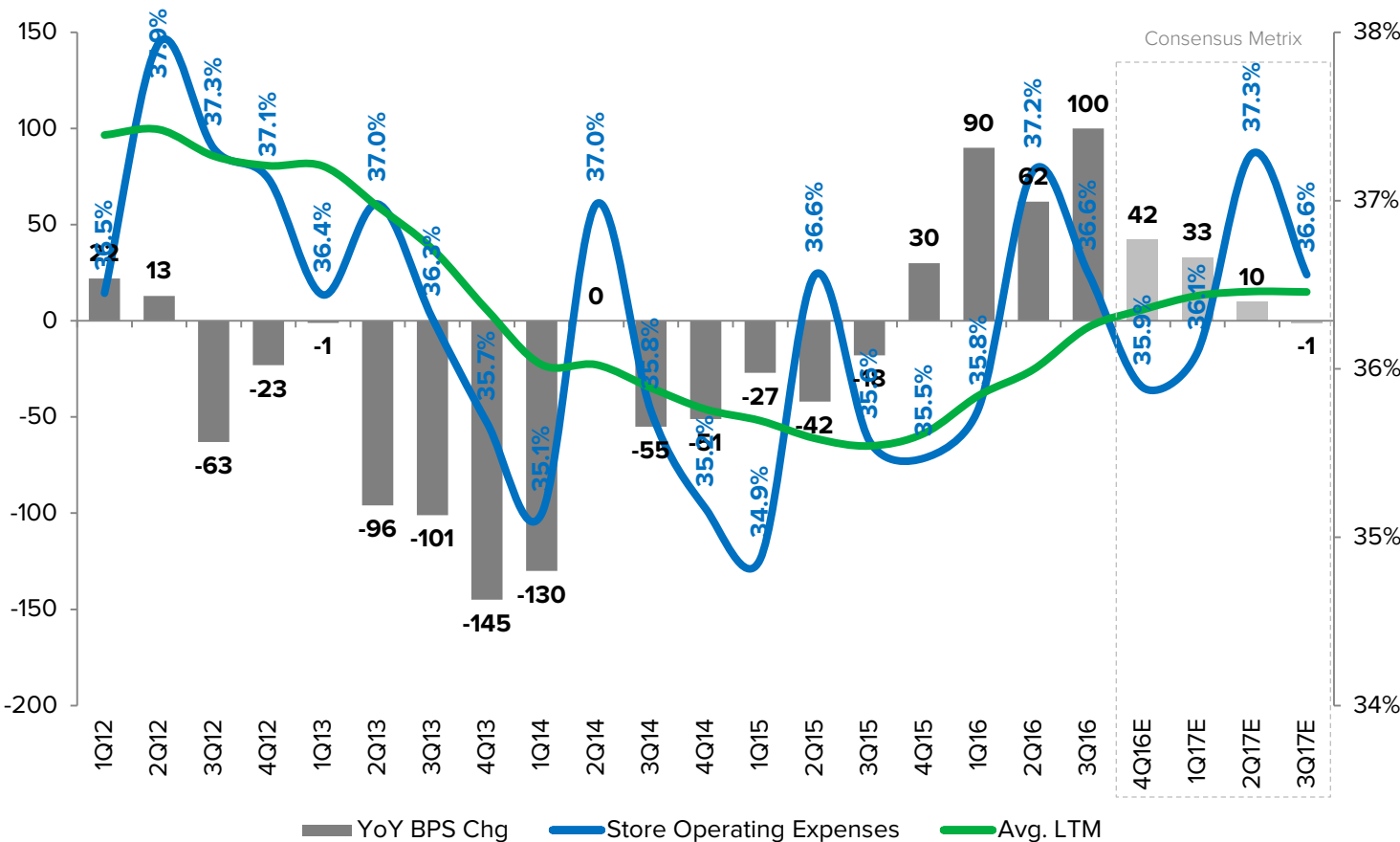
# MARGIN ANALYSIS

# CONSOLIDATED COGS AS A % OF SALES



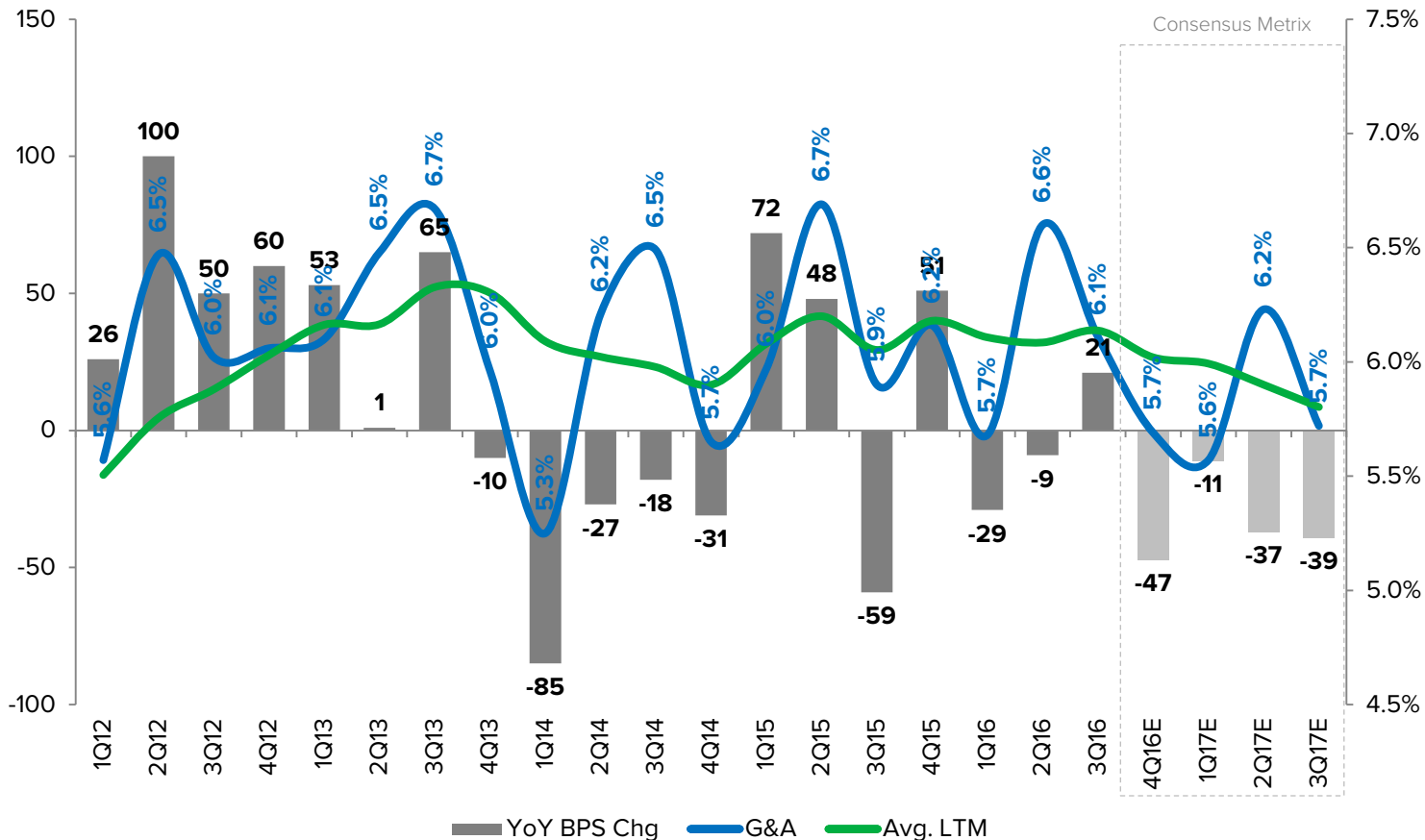
- COGS as a % of sales has been in a precipitous decline over the last four year, but with Milk and Coffee starting to turn inflationary and will no longer be a tailwind

# CONSOLIDATED STORE OPERATING EXPENSES AS A % OF SALES



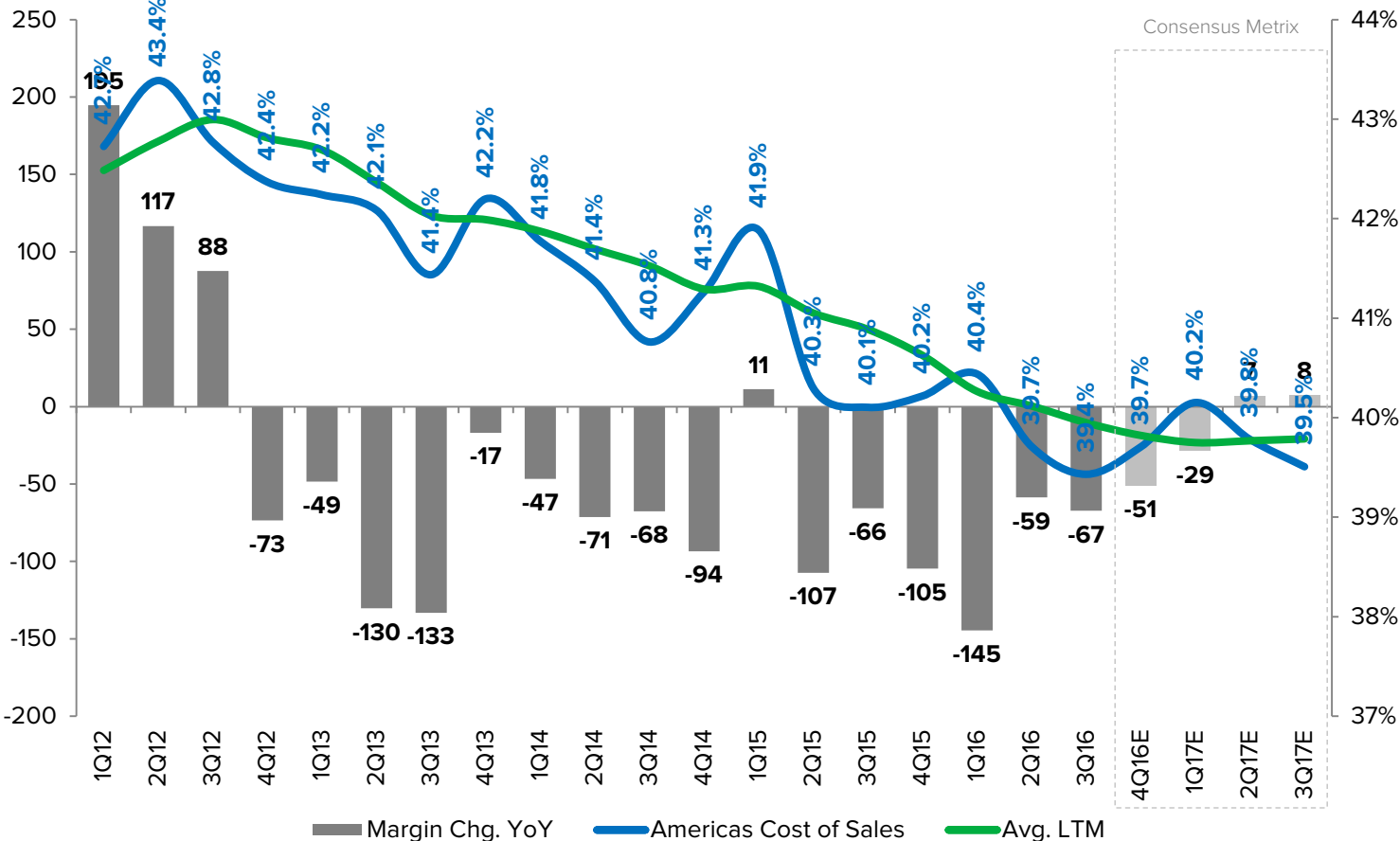
- Labor increasingly a pressure to margins

# CONSOLIDATED G&A AS A % OF SALES



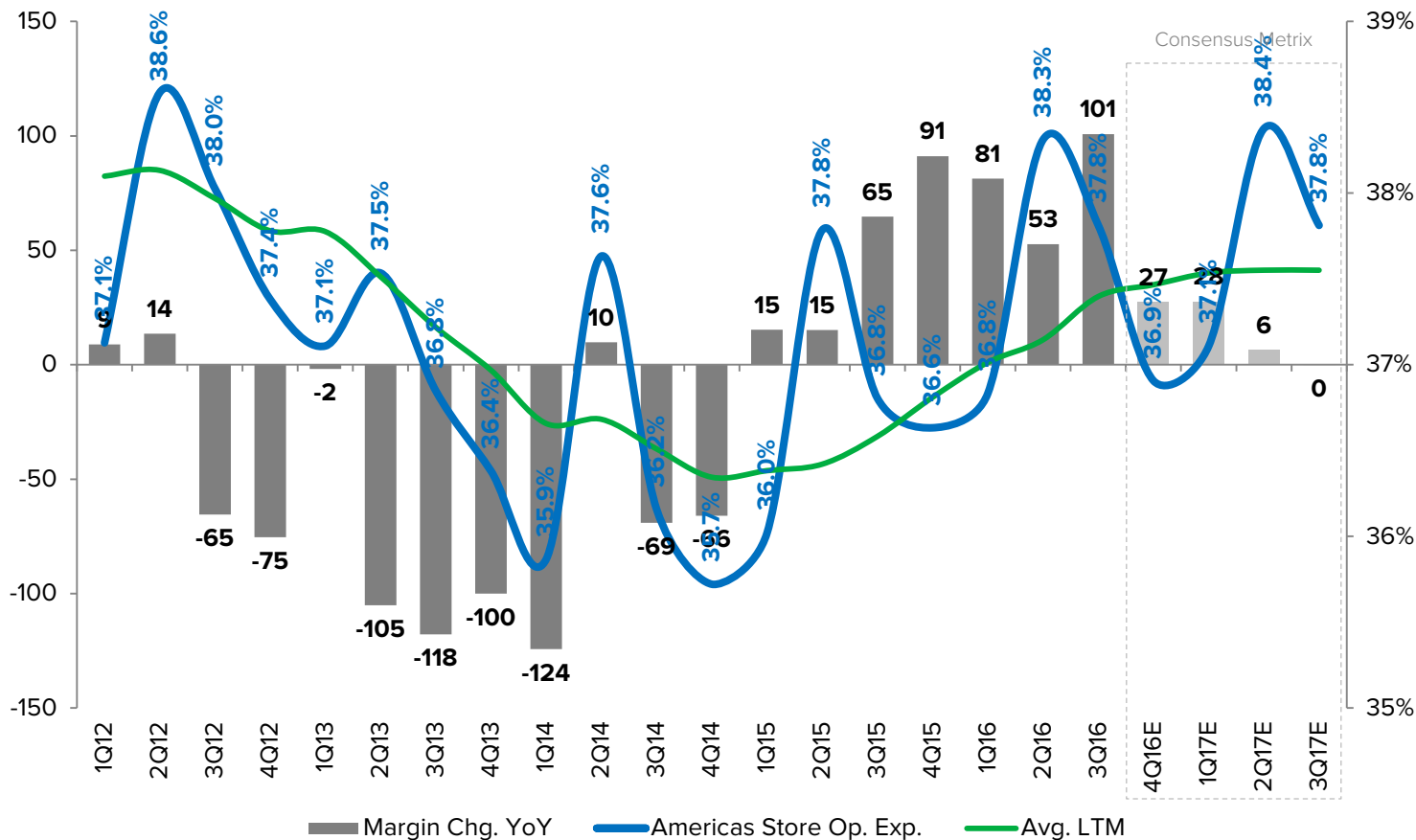
- G&A as a percent of sales projected to be down system wide for the segment

# AMERICAS COMPANY-OWNED COGS AS A % OF SALES



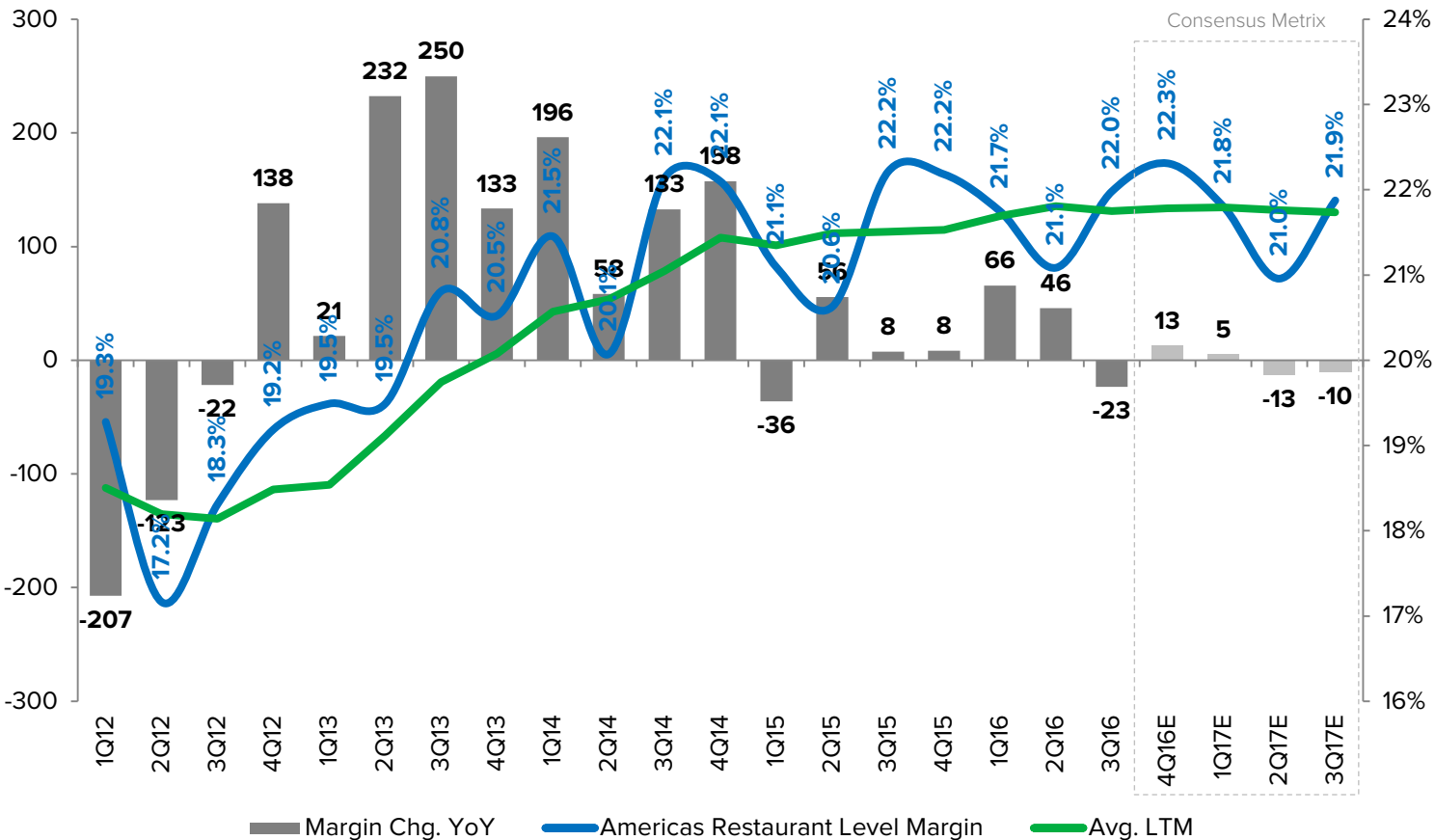
- COGS tailwinds could be in the past

# AMERICAS COMPANY-OWNED STORE OPERATING EXPENSES AS A % OF SALES



- Labor headwind will continue to put pressure on margins for SBUX along with the overall industry

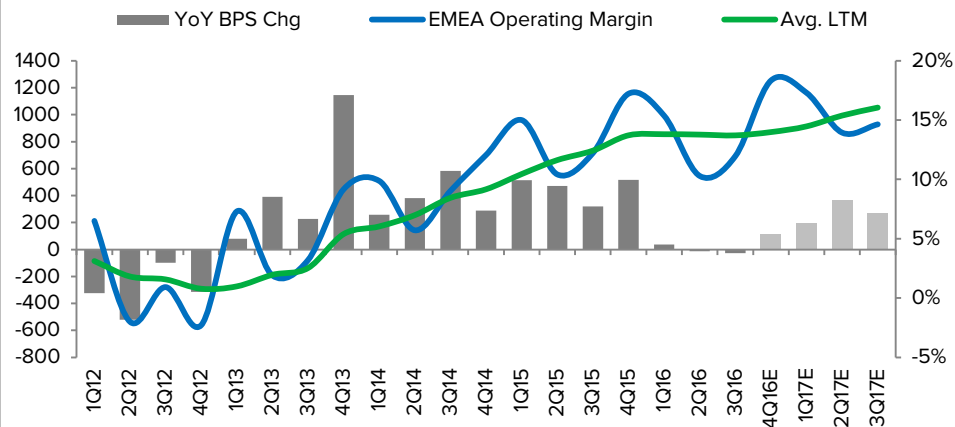
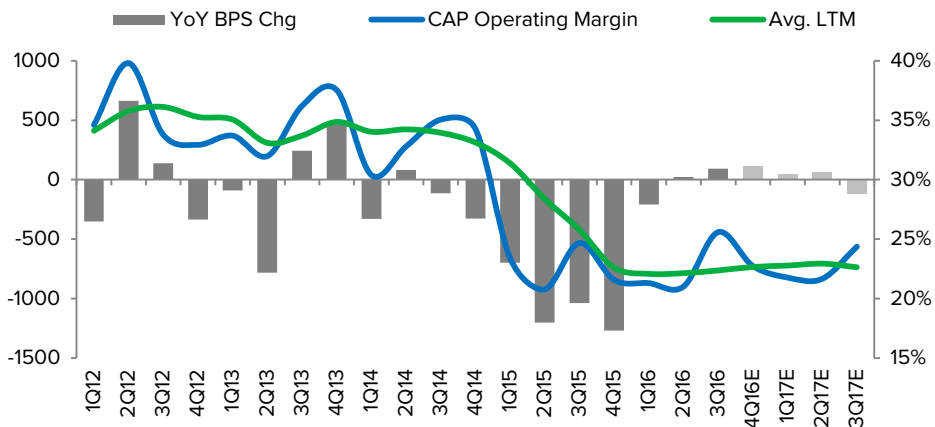
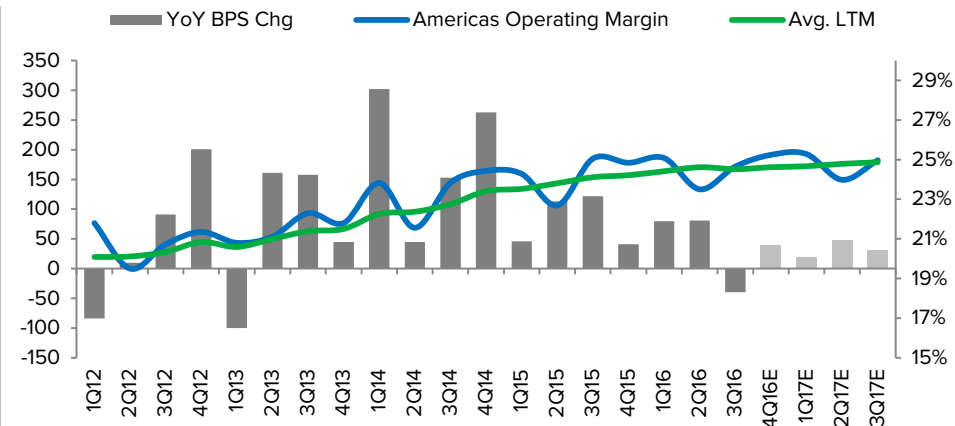
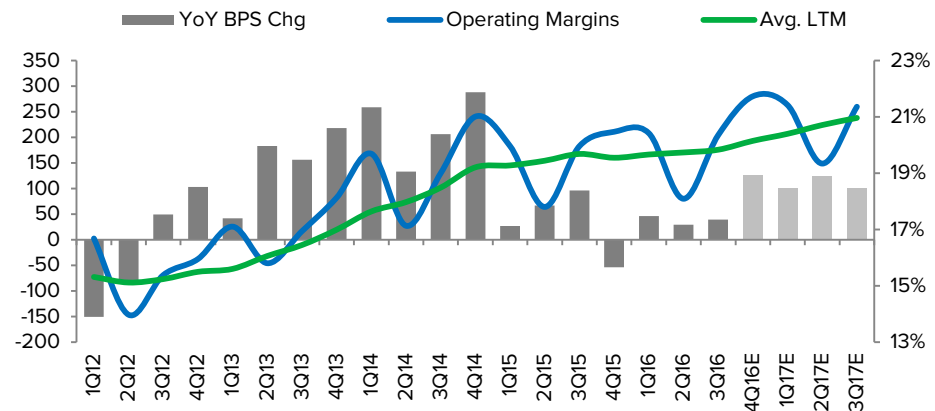
# AMERICAS COMPANY-OWNED RESTAURANT LEVEL MARGIN



- Restaurant level margins flatlinning, likely have downside from here



# OPERATING MARGINS

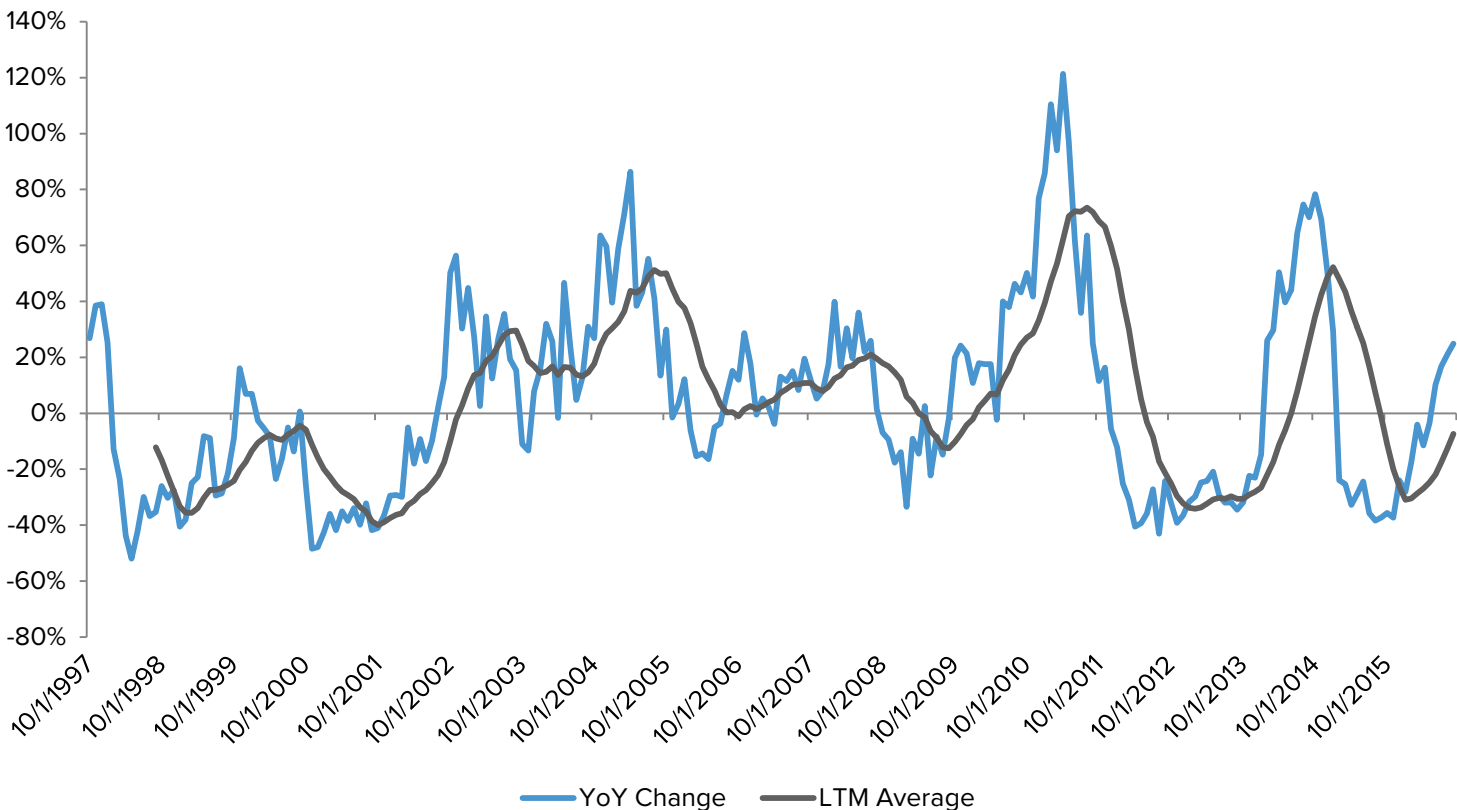




# INPUT COST INFLATION

# COFFEE

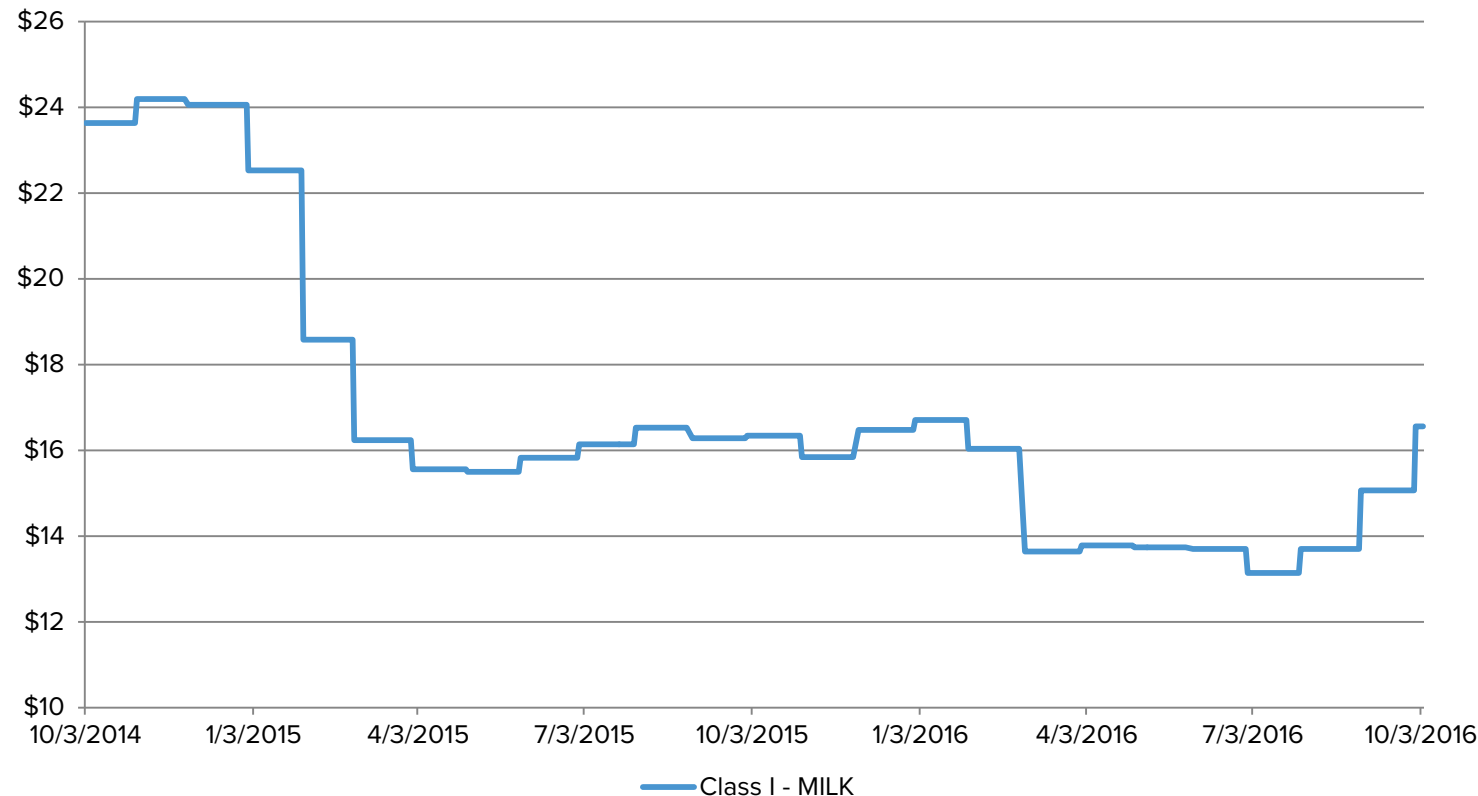
## ON THE RISE



- Our last Black Book in April 2016 represented the bottoming in coffee prices and they appear to be heading higher from here
- Peak margins will begin to deteriorate as this headwind manifests itself
- SBUX noted during the 3Q16 call that they are 50% price locked for FY17 and will update us on the projected 2017 impact of coffee costs in the 4Q16 release
- As part of their FY2011 guidance management stated they expect to absorb \$0.08 to \$0.10 in additional commodity costs mostly related to higher coffee prices

# MILK – CLASS I

## THE BOTTOM APPEARS TO BE IN



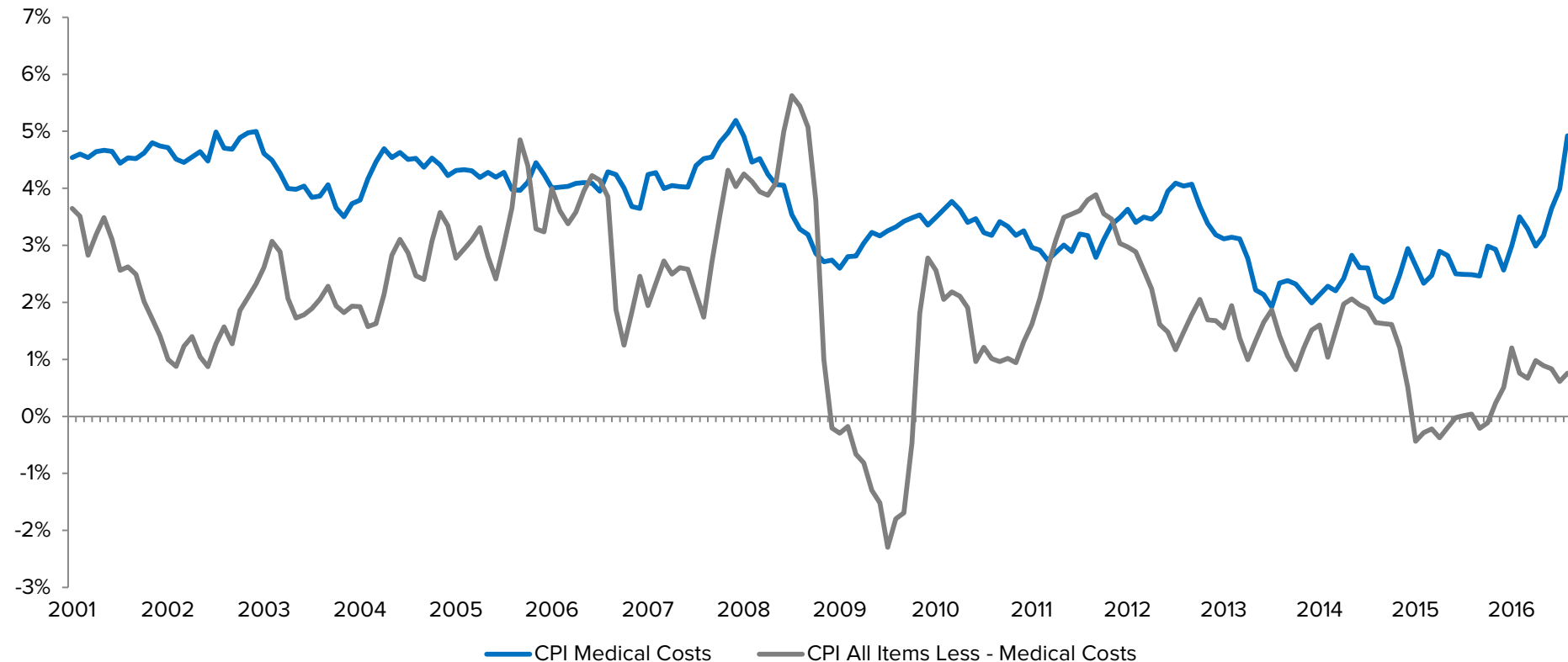
- Milk remains deflationary, but has recovered slightly, no way to tell when this will officially turn but it appears to be sooner rather than later



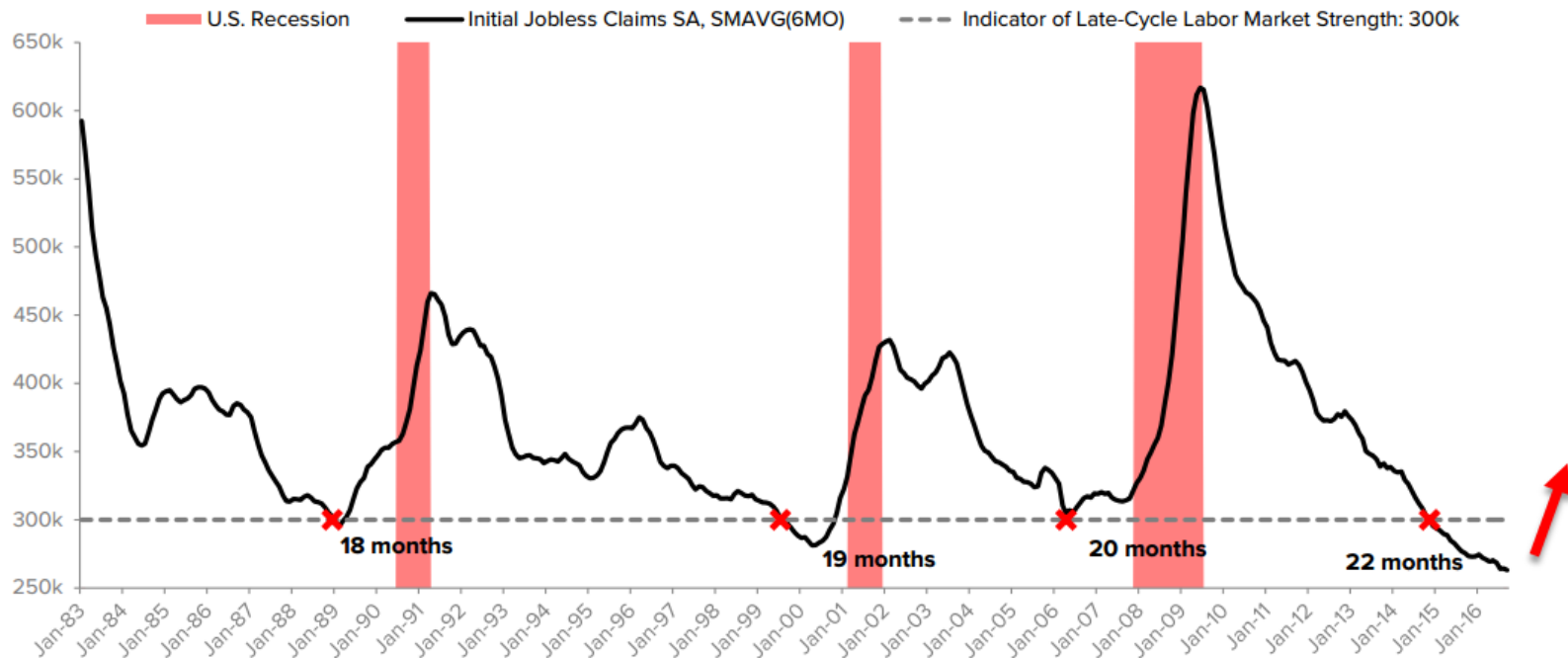
**CONSUMER DOLLAR IS STRETCHED**

# HEALTHCARE STEALING DOLLAR SHARE

## CONSUMERS NEED TO CHOOSE NEEDS OVER WANTS

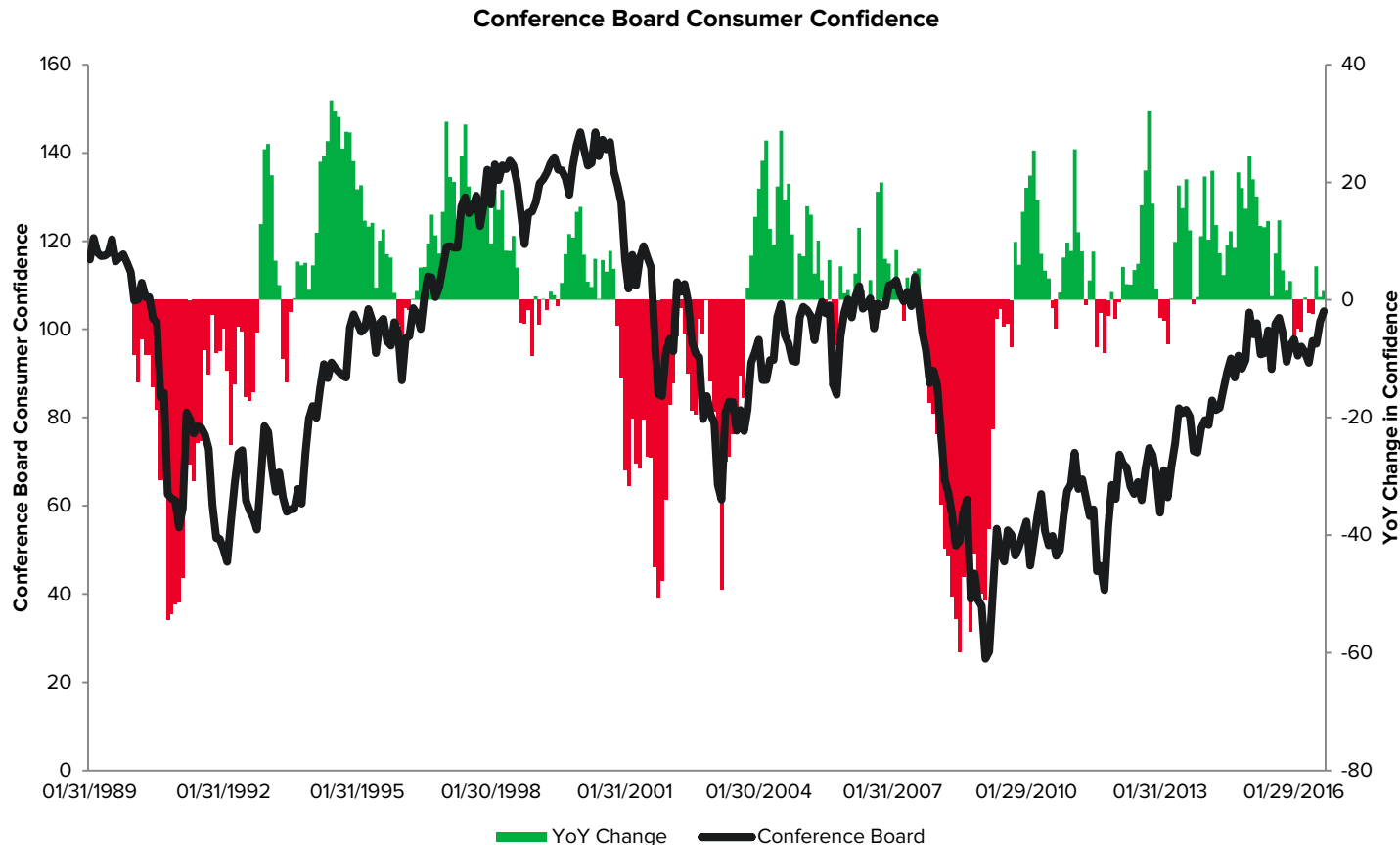


# UNEMPLOYMENT SET TO RISE?



**ANALYZING THE TREND IN INITIAL JOBLESS CLAIMS RELATIVE TO PREVIOUS LABOR CYCLES IMPLIES FIRINGS ARE MORE THAN LIKELY SET TO RISE MEANINGFULLY OVER THE NTM**

# CONSUMER CONFIDENCE



- Although consumer confidence continues to rise in the immediate term, we are confident that this is closer to the peak than the trough, and consumer confidence will churn lower over time going forward
- The previous charts will continue to impact confidence which will drive consumer expenditures on luxury habits lower, the top of that being a \$3-\$5 coffee every morning.





# SENTIMENT & VALUATION

# COMPANY DASHBOARD

Starbucks Corporation \$ 53.16

EARNINGS AND VALUATION SUMMARY				
(FY ends Sept.)	NTM	2016E	2017E	2018E
Hedgeye EPS	\$1.95	\$1.88	\$2.11	\$2.40
% Chg YoY		19.0%	12.2%	13.7%
Consensus	\$1.99	\$1.89	\$2.16	\$2.49
% Chg YoY		19.6%	14.2%	15.2%
Variance %	-2.0%	-0.5%	-2.3%	-3.5%
P/E	26.3X	27.3X	24.2X	21.2X

SUMMARY FINANCIALS			
(Consensus in mm)	NTM	FY2016E	FY2017E
Sales	\$23,177	\$21,291	\$23,098
% Chg YoY		11.1%	8.5%
EBITDA	\$5,812	\$5,156	\$5,785
% Chg YoY		13.9%	12.2%
EBITDA Margin*	25.1%	24.2%	25.0%
EV/EBITDA	13.6X	15.4X	13.7X

VALUATION	
Stock Price	\$ 53.16
Shares Outstanding	1466.6
Market Cap	\$ 77,964.5
+ Net Debt	\$ 1,285.9
+ Preferred Equity	\$ -
+ Minority Interest	\$ 2.2
<b>Enterprise Value</b>	<b>\$ 79,252.6</b>

## INVESTMENT POSITIVES

- 1) Category leading brand
- 2) Tech Innovation remains strong

## INVESTMENT NEGATIVES

- 1) Losing focus on core product line
- 2) Competition
- 3) Valuation

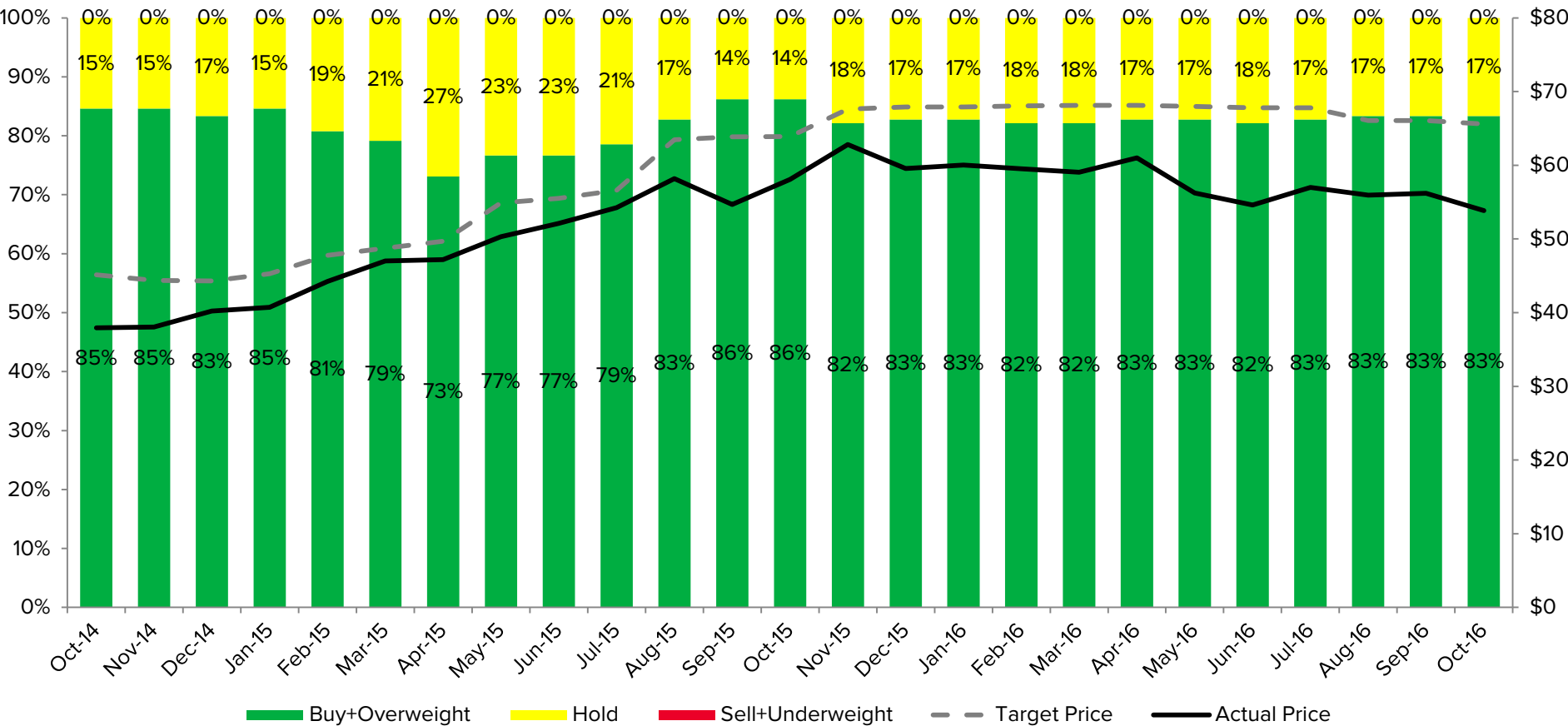
NTM EBITDA	\$ 5,811.7
NTM EV/EBITDA	13.6x
NTM EPS	\$ 2.17
NTM P/E	24.5x
1X Turn	\$ 3.96
Upside/Downside	7.5%

Source: Factset, Company Filings

\*Consensus EBITDA Margin

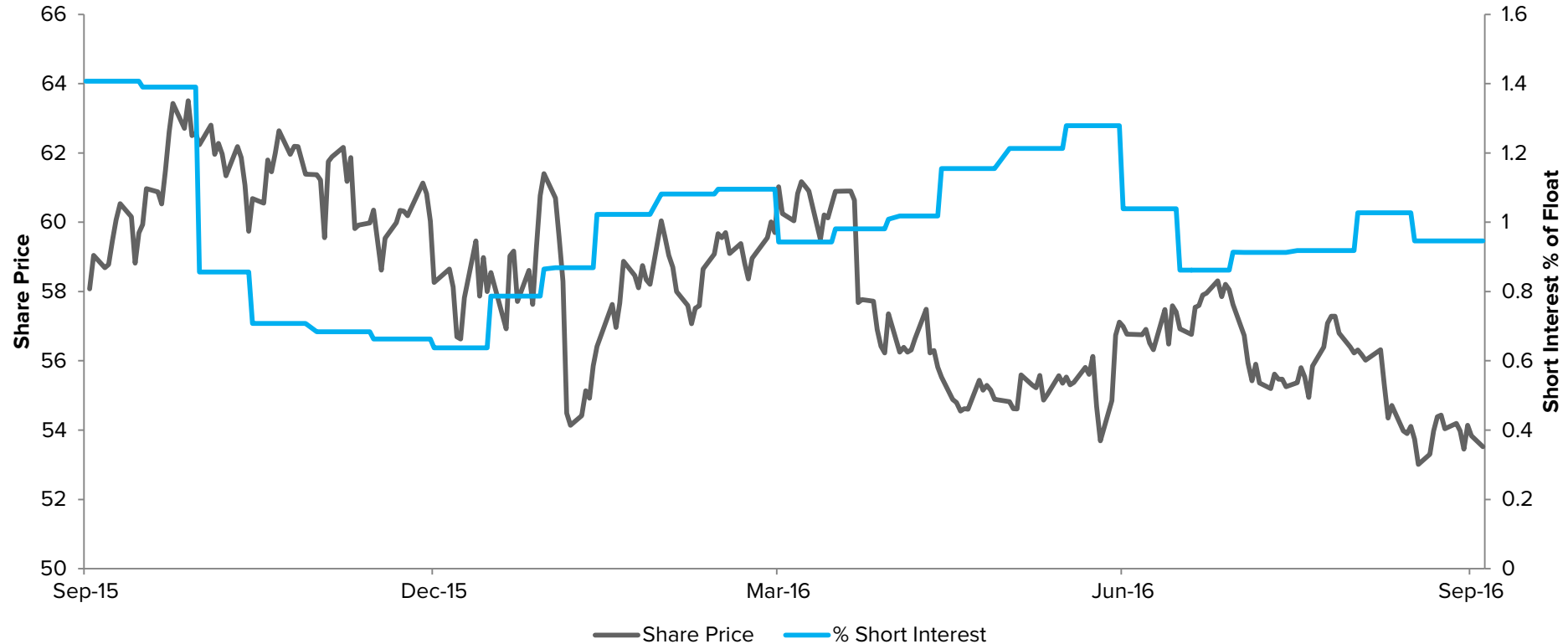
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# ANALYST RATINGS



# SHORT INTEREST

## MANY ARE UNWILLING TO BET AGAINST THE GIANT



# SELECT COMPARABLES

						Sentiment			Earnings				EBITDA							
			Equity	Net	Enterprise	Short	Dividend	Analyst			% Change	NTM			% Change	EV/ NTM	Net Debt/			
Name	Ticker	Price	Value	Debt	Value	Interest	Yield	Rating	FY1	FY2	YoY	P/E	FY1	FY2	YoY	EBITDA	EBITDA			
Quick Service Restaurants																				
Restaurant Brands International Inc	QSR	\$ 44.04	\$ 10,297	\$ 7,734	\$ 23,063	2.2%	1.5	1.8	\$ 1.53	\$ 1.77	15.2%	25.4x	\$ 1,848	\$ 2,015	9.0%	11.6x	4.2x			
Wendy's Company	WEN	\$ 10.77	\$ 2,814	\$ 2,116	\$ 4,930	10.2%	2.2	1.6	\$ 0.40	\$ 0.44	10.9%	24.7x	\$ 397	\$ 392	-1.3%	12.5x	5.3x			
Arcos Dorados Holdings, Inc. Class A	ARCO	\$ 6.04	\$ 789	\$ 509	\$ 1,299	0.2%	0.0	2.0	\$ 0.31	\$ 0.26	-16.9%	21.8x	\$ 194	\$ 234	20.8%	7.8x	2.6x			
Popeyes Louisiana Kitchen, Inc.	PLKI	\$ 51.98	\$ 1,106	\$ 106	\$ 1,211	6.8%	0.0	1.6	\$ 2.09	\$ 2.48	18.6%	21.6x	\$ 87	\$ 96	10.7%	12.8x	1.2x			
Yum! Brands, Inc.	YUM	\$ 88.94	\$ 32,642	\$ 4,415	\$ 37,118	1.5%	2.3	1.7	\$ 3.70	\$ 4.20	13.4%	21.6x	\$ 3,037	\$ 3,234	6.5%	11.6x	1.5x			
Carrols Restaurant Group, Inc.	TAST	\$ 12.99	\$ 466	\$ 195	\$ 660	4.7%	0.0	1.0	\$ 0.61	\$ 0.60	-2.6%	21.4x	\$ 93	\$ 100	6.7%	6.7x	2.1x			
Jack in the Box Inc.	JACK	\$ 95.81	\$ 3,131	\$ 890	\$ 4,021	6.0%	1.3	1.4	\$ 3.73	\$ 4.71	26.3%	20.0x	\$ 325	\$ 365	12.2%	10.9x	2.7x			
McDonald's Corporation	MCD	\$ 114.71	\$ 97,889	\$ 22,882	\$ 120,771	1.3%	3.3	1.5	\$ 5.55	\$ 6.14	10.6%	19.0x	\$ 9,329	\$ 9,717	4.2%	12.5x	2.5x			
Sonic Corp.	SONC	\$ 26.18	\$ 1,245	\$ 492	\$ 1,737	11.7%	1.7	1.5	\$ 1.29	\$ 1.44	11.4%	17.8x	\$ 170	\$ 171	0.1%	10.1x	2.9x			
Fiesta Restaurant Group, Inc.	FRGI	\$ 25.64	\$ 690	\$ 66	\$ 757	8.6%	0.0	1.5	\$ 1.32	\$ 1.44	9.8%	18.1x	\$ 96	\$ 107	11.3%	7.2x	0.7x			
Bojangles, Inc.	BOJA	\$ 15.82	\$ 575	\$ 193	\$ 768	1.4%	0.0	1.4	\$ 0.90	\$ 0.99	9.2%	16.1x	\$ 79	\$ 86	8.8%	9.0x	2.4x			
Average						5.0%	1.1	1.5					20.7x						10.2x	2.6x
Coffee																				
Panera Bread Company Class A	PNRA	\$ 190.43	\$ 4,287	\$ 238	\$ 4,528	13.7%	0.0	1.4	\$ 6.69	\$ 7.77	16.2%	25.2x	\$ 406	\$ 450	10.8%	10.8x	0.6x			
Starbucks Corporation	SBUX	\$ 53.16	\$ 77,964	\$ 1,286	\$ 79,252	1.1%	1.5	1.2	\$ 1.89	\$ 2.16	14.2%	24.3x	\$ 5,156	\$ 5,785	12.2%	13.5x	0.2x			
Dunkin' Brands Group, Inc.	DNKN	\$ 51.33	\$ 4,709	\$ 2,124	\$ 6,834	12.3%	2.3	1.9	\$ 2.21	\$ 2.43	10.0%	21.3x	\$ 455	\$ 479	5.1%	14.4x	4.7x			
Average						9.0%	1.3	1.5					23.6x						12.9x	1.8x

Analyst Rating: 1=Buy, 3= Sell

# VALUATION MATRIX

NTM EV/EBITDA Multiple												
EBITDA	11.5x	12.0x	12.5x	13.0x	13.5x	14.0x	14.3x	14.5x	14.8x	15.0x	15.3x	
	\$5,478	\$41.53	\$43.38	\$45.22	\$47.07	\$48.91	\$50.75	\$51.67	\$52.60	\$53.52	\$54.44	\$55.36
	\$5,532	\$41.96	\$43.82	\$45.68	\$47.54	\$49.41	\$51.27	\$52.20	\$53.13	\$54.06	\$54.99	\$55.92
	\$5,588	\$42.39	\$44.27	\$46.15	\$48.03	\$49.91	\$51.79	\$52.73	\$53.67	\$54.61	\$55.55	\$56.49
	\$5,644	\$42.82	\$44.72	\$46.62	\$48.52	\$50.42	\$52.32	\$53.27	\$54.22	\$55.17	\$56.12	\$57.07
	\$5,700	\$43.26	\$45.17	\$47.09	\$49.01	\$50.93	\$52.85	\$53.81	\$54.77	\$55.73	\$56.69	\$57.64
	\$5,757	\$43.70	\$45.64	\$47.57	\$49.51	\$51.45	\$53.39	\$54.35	\$55.32	\$56.29	\$57.26	\$58.23
	\$5,815	\$44.14	\$46.10	\$48.06	\$50.01	\$51.97	\$53.93	\$54.91	\$55.89	\$56.86	\$57.84	\$58.82
	\$5,873	\$44.59	\$46.57	\$48.55	\$50.52	\$52.50	\$54.48	\$55.46	\$56.45	\$57.44	\$58.43	\$59.42
	\$5,931	\$45.05	\$47.04	\$49.04	\$51.04	\$53.03	\$55.03	\$56.03	\$57.03	\$58.02	\$59.02	\$60.02
BEAR			BASE						BULL			
-22%			0%						13%			

**DOWNSIDE WILL BE DRIVEN BY A REDUCTION IN PROJECTED EBITDA AS WELL AS MARGIN COMPRESSION**

# SUMMARY OF OUR THOUGHTS

## Key Points

- 1 Global macro headwinds will persist and SBUX is not immune
- 2 Food will not become 25% of the business
- 3 Management changes are cause for concern
- 4 SBUX is highly likely to miss 4Q16 expectations and guide down for 2017

## Risks To The Short

- 1 Global economy takes abrupt turn in an upward direction
- 2 Competition goes quietly and SBUX takes market share

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