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A Cold Cup of Coffee From Starbucks

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For the first time in **Starbucks'** (SBUX) history, the company is feeling the impact of slower traffic trends. Whether this is due to a slowing of the consumer or a shift of sales to cheaper competition was not disclosed by the company. In fact, management danced around the issue with a supercilious diatribe about the Starbucks "experience." I believe that the company is beginning to lose traffic because of its insistence on raising prices while the competition, which is selling lower priced premium coffees, is seeing traffic moving its way.

Starbucks stock is falling down to a level where we finally have contraction of P/E multiples and growth to be at more reasonable levels. The risk from here is that the company cannot maintain its growth, that the U.S. business deteriorates because of the consumer and competition while cost pressures have to be absorbed rather than passed on. The shares, at most, have another point or two of downside and 3 to 5 points of upside. I would remain neutral on Starbucks at this juncture.

The company reported fourth-quarter 2007 EPS of 21 cents on net revenue of \$2.44 billion. For the full year, Starbucks earned 87 cents per share on net revenue of \$9.4 billion.

Same-store sales grew at 4% in the quarter and 5% for the year. The entire quarterly comp growth and 4% of the annual comp growth was from increasing average ticket size. Starbucks instituted two price increases during the year. The company is seeing pressure on traffic as customers are feeling the impact of the economic downturn. The price increases have helped to offset cost and traffic pressures.

Starbucks opened 615 new stores in the fourth quarter and ended the year with more than 15,000 stores in 43 countries. Over 4,300 stores are outside the U.S. In the U.S., Starbucks opened 1,065 new stores in 2007. Drive-in locations now constitute more than 30% of company-owned U.S. stores. The company is reducing the "velocity" of its new store openings and has revised it down to 900 new company and 700 licensed stores in the U.S. in 2008. Management sees a long-term market opportunity for 40,000 stores, with tremendous growth opportunity in China.

In the U.S., total and company store revenue rose 19% year over year. Cost of sales including occupancy rose to 41.7% from 39.4% in the year-ago period. The rise was due to higher dairy costs, which added 100 basis points, and shift in sales mix, which added another 70 basis points. U.S. operating expenses improved 90 basis points, to 42.2%. Other operating expenses improved to 24.3% from 27.4% year over year. Operating margins declined 70 basis points year over year primarily on the back of higher occupancy costs.

In the international segment, net revenue increased 31%, and company-operated revenue rose 32%, benefitting 6% from favorable foreign currencies. Operating margins improved to 10.8% from 7.3% for the quarter. This was due to lower G&A expenses.

Starbucks issued \$550 million of debt and purchased \$342 million of stock during the quarter. For fiscal 2007, the company generated \$1.3 billion in cash vs. \$1.1 billion in 2006.

Management's guidance for 2008 is as follows:

- 2,500 new store openings, of which 900 are U.S.-company, 700 are U.S.-licensed; 300 are international-company and 600 are international-licensed;
- same-store comps in the 3% to 5% range;
- net revenue growth in the 17% to 18% range;

- stable U.S. margins and 100-basis-point international margin improvement;
- EPS of \$1.02 to \$1.05 vs. consensus of \$1.05; and
- an effective tax rate in line with the 2007 rate of 36%.

Starbucks Preview: Growth Is Slowing

Starbucks (SBUX) is scheduled to release third-quarter 2007 results and conduct its quarterly conference call after the markets close on Thursday. Analysts expect the company to earn 21 cents per share on sales of \$2.43 billion. In the year-ago quarter, Starbucks earned 17 cents on sales of \$2 billion.

Growth is clearly slowing at Starbucks and, as a result, so has its earnings multiple.

Starbucks is getting squeezed on both ends. It is facing raising dairy and coffee prices, which have forced the company to push price increases onto consumers. At the same time, the company is facing increasing competition in the U.S., primarily from **McDonald's** (MCD) and to a lesser extent from **Tim Hortons** (THI) and Dunkin Donuts. This is apparent as traffic at its U.S. locations has been slowing and is trailing growth overseas.

The overseas growth is what the Starbucks bulls are hanging their hats on. Much similar to **Yum! Brands** (YUM) being held back because of lousy U.S. operations despite strong growth in China, however, Starbucks also can expect to see the U.S. be a drag on global growth in the future.

Put this all together, and we should expect gross-margin contraction and weak same-store sales growth. Starbucks has to do something to support its stock price, and I would not be surprised if management makes some announcement out of left field, such as a domestic downsizing, a stock repurchase or management changes.

I was short Starbucks and recently covered that short. For now, I would expect the shares to trade in a range that is most likely to be driven by discrete events such as earnings calls, same-store sales data or corporate announcements.

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At the time of publication, Rothbort was long MCD, although positions can change at any time.

Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele.

Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.

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