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Starbucks Corp. (SBUX)

Q1 2019 Earnings Call

CORPORATE PARTICIPANTS

Durga Doraisamy

Vice President, Investor Relations, Starbucks Corp.

Kevin Johnson

President, Chief Executive Officer & Director, Starbucks Corp.

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

Rosalind Gates Brewer

Chief Operating Officer, Group President & Director, Starbucks Corp.

OTHER PARTICIPANTS

Sharon Zackfia

Analyst, William Blair & Co. LLC

David E. Tarantino

Analyst, Robert W. Baird & Co., Inc.

John Glass

Analyst, Morgan Stanley & Co. LLC

David Palmer

Analyst, RBC Capital Markets LLC

Sara Harkavy Senatore

Analyst, Sanford C. Bernstein & Co. LLC

John William Ivankoe

Analyst, JPMorgan Securities LLC

Matthew DiFrisco

Analyst, Guggenheim Securities LLC

Jeffrey A. Bernstein

Analyst, Barclays Capital, Inc.

Karen Holthouse

Analyst, Goldman Sachs & Co. LLC

Andrew Charles

Analyst, Cowen & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Hector and I will be your conference operator today. I would like to welcome everyone to the Starbucks Coffee Company's First Quarter Fiscal Year 2019 Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I'll now turn the call over to Durga Doraisamy, Investor Relations. Ms. Doraisamy, you may now begin your conference.

Durga Doraisamy

Vice President, Investor Relations, Starbucks Corp.

Good afternoon, everyone, and thank you for joining us today to discuss our first quarter results for fiscal year 2019. Today's discussion will be led by Kevin Johnson, President and CEO; and Pat Grismer, CFO. And for Q&A, we will be joined by Roz Brewer, Chief Operating Officer and Group President Americas, John Culver, Group President International, Channel Development and Global Coffee and Tea.

This conference call will include forward-looking statements which are subject to various risks and uncertainties that could cause our actual results to differ materially from these statements. Any such statements should be considered in conjunction with cautionary statements in our earnings release and Risk Factor discussions in our filings with the SEC including our last annual report on Form 10-K. Starbucks assumes no obligation to update any of these forward-looking statements or information. GAAP results in fiscal 2019 include several items related to strategic actions including restructuring and impairment charges, transaction and integration costs and other items. These items are excluded from our non-GAAP results. Please refer to our website at investor.starbucks.com to find the reconciliation of non-GAAP financial measures referenced in today's call with their corresponding GAAP measures.

This conference call is being webcast and an archive of the webcast will be available on our website through February 22nd, 2019.

I will now turn the call over to Kevin.

Kevin Johnson

President, Chief Executive Officer & Director, Starbucks Corp.

Well thanks, Durga, and good afternoon, everyone. I'd like to start by taking this opportunity to thank our outgoing VP of Investor Relations, Tom Shaw, for his leadership over the past couple of years and to wish him well as he pursues a new opportunity outside our industry. Durga is a five-year Starbucks partner and a 20-year veteran of Investor Relations and I'm thrilled that she's stepping up to lead our IR function in close partnership with Pat.

Now last month, we were pleased to meet with many of you in New York not only to showcase our latest Starbucks Reserve Roastery, but to also discuss the next chapter in Starbucks' growth agenda, which we call growth-at-scale. We shared with you our strategy to streamline the business, drive growth in the key markets of U.S. and China, expand our global reach through the Global Coffee Alliance, while simultaneously returning significant capital to our shareholders. This strategy is working, as evidenced by our Q1 results, and we remain confident in the longer-term outlook for the business.

Integral to our growth-at-scale strategy is a higher level of focus and discipline to drive predictable, sustainable, long-term growth and shareholder returns. The positive business momentum that we experienced in the fourth quarter of fiscal 2018 clearly sustained throughout Q1. The strength of our results in Q1 has further reinforced the confidence and conviction we have, both near-term and long-term in our strategy.

Now let me give you a few of the key financial headlines for the quarter. Record revenue of \$6.6 billion representing 9% growth versus prior year. Comp sales growth of 4%, including another quarter of sequential improvement in traffic comp. Net store growth of 7% on a global basis versus prior year with over two-thirds of our new store openings outside the U.S. Continued digital momentum with U.S. active rewards members growing 14% to 16.3 million and return of \$5.5 billion to shareholders through a combination of dividends and buybacks. These results were enabled in part by solid execution during our holiday season.

Our holiday plan was informed by insights we gathered from customers who highlighted what they appreciate from Starbucks during the holidays. We leverage those insights to reignite the customer connection in many ways. With improved brand and product awareness, sharper and cleaner holiday merchandising, relevant new offerings such as our limited-edition red cup promotion and an enhanced in-store experience. This comprehensive insight-driven approach delivered results, and importantly, created momentum that provides a solid foundation for future quarters, helped in part by strong performance in our gift card business.

Taking a step back from the solid results in the quarter, I'd like to highlight the broader approach we're taking to sustain growth well into the future, and to update you on the progress we're making to advance this strategy. As a reminder, our growth-at-scale agenda is composed of three key building blocks: Streamlining our business, focusing on three strategic priorities and amplifying the Starbucks brand.

Our streamline efforts over the past six quarters are paying off by allowing us to bring more focus and discipline to our three strategic priorities of accelerating growth in our targeted markets of U.S. and China, expanding global reach of the Starbucks brand leveraging the Global Coffee Alliance with Nestlé, and increasing shareholder returns. Importantly, we are doing all of this while staying true to our brand promise with the understanding that the foundational elements will remain pivotal as we continue to build our brand through the Starbucks Experience, the quality of our coffee and our corporate reputation for doing good. And as with any strong foundation, there're opportunities to amplify these cornerstones of the brand that we continue to demonstrate most recently, with the opening of our New York Roastery and soon in February with the opening of the Tokyo Roastery.

We will consistently use this growth-at-scale framework to guide our communications with investors going forward. So let me share a few more details about the progress we've made against our three strategic priorities, and what to expect for the balance of the year, starting with accelerating growth in our two long-term growth markets: the U.S. and China.

In the U.S., we're focused on three operating initiatives: Enhancing the in-store experience, delivering beverage innovation and driving digital relationships. Enhancing the in-store experience encompasses building customer connections and creating those best moments that keep customers coming back time and time again. Our Starbucks store partners who proudly wear the green apron are at the center of connecting with customers and we are on a mission to support them by simplifying work and reducing some of the non-customer-facing tasks that historically have taken up to 40% of their time. This is freeing up more time for our partners to connect with customers.

For example, we've shifted certain cleaning tasks to afterhours and we're automating product planning and replenishment, which reduces store clutter and time away from customers. This work will span multiple quarters. The actions taken thus far are already paying off as our customer connection scores continue to improve in Q1 on both a sequential and year-over-year basis, and importantly, across both the morning and afternoon dayparts.

We're also creating a new channel for customers to engage through Starbucks Delivers. Our partnership with Uber Eats is gaining momentum and we expect to bring delivery to nearly a quarter of our U.S. company-operated stores by April, including our second market in San Francisco, which launched earlier this week. Our early experience is encouraging and has provided us a blueprint for how to operationalize this new channel, an important step to create a seamless workflow for our partners. From a customer perspective, Starbucks Delivers is being seamlessly integrated into the Uber Eats mobile app, enabling full beverage customization and fully integrating into our store operations to ensure a premium Starbucks Experience.

Moving on to our second U.S. priority, beverage innovation. Our focus here is ongoing, led by the momentum we are seeing with cold beverages across multiple dayparts. The focus of our latest beverage innovation evolves around iced espresso, draft Nitro beverages and Refreshers. We have expanded the deployment of our Nitro offering from about one-third of U.S. company-operated stores last quarter to 40% in just one quarter and we remain on track to reach our goal of 100% penetration by the end of fiscal 2019. Draft Nitro beverages represent a significant opportunity for the brand. This platform is differentiated, provides theater and drives incrementality.

We also made great progress on our third U.S. priority, driving digital relationships, our enabler of convenience, awareness and value. To build our digital ecosystem, we widened the aperture of digital reach and created a funnel of activation that is leading to increases in active membership in our Starbucks Rewards program. Since we started these efforts last spring, we have acquired 13 million digital customer registrations and we're excited about the potential this has to drive our Starbucks Rewards program.

I'm pleased to share that in Q1, we expanded our active member base by an impressive 1 million customers, a 14% increase, that takes active reward membership to 16.3 million. This result was driven by leveraging our increased digital reach as well as a more seamless customer onboarding experience, greater Mobile Order and Pay adoption and enhanced personalization features. Between digitally registered and active rewards customers, we are now approaching 30 million digital connections in the U.S.

Starbucks Rewards continues to be a powerful enabler of loyalty and we are thoughtfully evolving the program to provide greater choice and flexibility for Rewards members. We will enhance the program this spring to enable loyalty customers to earn and redeem more quickly and redeem those awards across a broader range of items in our stores. We have leveraged learnings and customer insight from prior changes to the rewards program to inform our work ahead of this launch. This includes a robust marketing activation plan to drive not only awareness of the changes, but overall awareness of the program and key customer benefits. As we've shared in the past, lack of awareness has historically been one of the limiting factors to customer adoption and we have a significant opportunity to amplify a powerful message around loyalty.

Having covered the U.S., let's talk a bit about our second largest and fastest-growing major market, China. This month marks the 20th anniversary of Starbucks in China and we continue to play the long game with our purpose-driven growth agenda. We recognize the tremendous opportunity ahead requires navigating a rapidly-evolving competitive landscape, changing consumer behaviors and a dynamic economy. With a large and growing addressable market around coffee, we expect competition to remain highly promotional and disruptive.

As we've done over the past 20 years in China, we will continue to learn and adapt as we create a broader coffee culture, expand our presence in both new and existing cities and deliver a differentiated Starbucks Experience throughout China, whether it's serving customers in our beautifully-designed stores or enabling new channels, like Starbucks Delivers.

China represents a large opportunity in a dynamic market which informs the low single-digit comp guidance that we outlined last month. The bigger story in China is total transactions driven by our store growth, which underpins approximately 80% of our growth algorithm in China. This quarter, our store base in China grew by 18%. Comps stabilized at 1% and we remain confident in the future opportunity. The launch of our China digital partnership with Alibaba, the rapid expansion of our Starbucks Delivers program now in more than 2,000 stores and the added coverage of Star Kitchens in Hema supermarkets are just the beginning.

Starbucks Delivers is already contributing mid-single-digit transaction mix in our key markets of Beijing and Shanghai, which validates customer demand and reinforces the significant runway of opportunity ahead. The benefit from our unique Starbucks virtual store integrated throughout the Alibaba ecosystem is largely still ahead of us as awareness and adoption build. Along with the recent upgrade of our Starbucks Rewards program, new food and beverage offerings and powerful new store economics, we remain bullish on our path in China and the growth that lies ahead. We are playing the long game in China.

Moving on to our second strategic priority, expanding our global reach through the Global Coffee Alliance. This is the story of two leading global companies with unique capabilities coming together to accelerate growth of coffee around the world. The transition of the North America business to Nestlé has gone extremely well and we are rapidly shifting our attention to growing the share of Starbucks capsules on Nestlé platforms accelerating our leadership position in North America and expanding the presence of Starbucks Coffee into international markets. We remain on track with our go-to-market strategies to bring Starbucks products to life across the Nespresso and Dolce Gusto platforms beginning this spring and progressing throughout the remainder of the year.

Naturally, we will focus initially on strategic markets across traditional CPG and foodservices channels and we look forward to sharing our progress with you in the months and quarters ahead. We are very pleased with the initial success of the strategic partnership and very optimistic about its potential.

And finally, let me comment on our third strategic priority of increasing shareholder returns. As we first outlined last June, we are committed to return \$25 billion of cash to shareholders through fiscal 2020 and we are on track to do just that. In fiscal 2018, we returned approximately \$9 billion of cash through buybacks and dividends, and with the additional \$5 billion accelerated share repurchase plan initiated on October 1st, we have now returned over \$14 billion of our total commitment of \$25 billion.

So in summary, our growth-at-scale strategy is working and our leadership team is fully committed to the future growth and vibrancy of Starbucks. To the more than 350,000 Starbucks partners who proudly wear the green apron, I thank you. You have always been at the center of everything we do to create that warm and welcoming Starbucks Experience in our stores. Because of you, we were able to distribute bean stock to nearly 200,000 partners in 21 markets around the world this past year. We hired over 21,000 veterans and military spouses and nearly 65,000 opportunity youth over the past three years, and we welcomed more than 12,000 Starbucks partners into a pathway to a college degree through the Starbucks College Achievement Program. I am proud to be your partner.

And with that, I'd like to officially welcome Pat to his first Starbucks earnings call. Pat?

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

Thank you, Kevin, and good afternoon, everyone. I too am pleased with the overall business momentum that we demonstrated in the first quarter with solid revenue growth of 9%, driven by net new store growth of 7% over the past 12 months and global comp growth of 4%. 9% revenue growth for the quarter included an approximate 1% unfavorable impact of foreign currency translation and an approximate 1% net benefit from streamline related activities, primarily the acquisition of East China, the Global Coffee Alliance and the sale of Tazo. Non-GAAP EPS of \$0.75 was up 15% versus prior year and included a net favorable impact of \$0.07 related to discrete income tax items, primarily the release of certain tax reserves.

I'll now take you through our Q1 operating performance by segment. Our Americas segment delivered 8% revenue growth in Q1, primarily driven by net new store growth of 5% over the past 12 months and 4% comp sales growth, with flat comp transaction growth in the U.S., a sequential quarterly improvement as Kevin highlighted earlier. For the second consecutive quarter, beverage, our highest margin category, was the primary driver of U.S. comp growth contributing 3 points of the 4 points in Q1 followed by 2 points from food and a 1-point decline in lobby. Beverage growth was led by our espresso and brewed platforms, which delivered the highest contribution to comp growth in nine quarters.

Of note, iced beverages continued to lead this growth across all dayparts with strong performance from Starbucks Refreshers, iced espresso and iced coffee, in particular, Cold Brew and Nitro. And although lobby continued to weigh on comp due to our SKU rationalization efforts that are improving store level profitability and streamlining the in-store experience, our overall holiday offerings performed well. From a daypart perspective, we saw improvement across the board with continued strong growth in the morning and afternoon performance that was the best in the last five quarters. Americas non-GAAP operating margin declined 60 basis points to 22.4% in Q1, primarily due to partner investments including tax form funded investments partially offset by sales leverage.

Moving on to China/Asia Pacific, our fastest-growing business segment. CAP segment revenues grew 45% in Q1. Excluding the net 32% combined impact of streamline activities, notably the acquisition of East China and foreign currency translation, revenue grew 13% in the quarter. This was driven by 13% net new store growth over the past 12 months and 3% comp sales growth, including 1% comp transaction growth.

I'll now highlight the first quarter performance of two key markets in our CAP segment, China and Japan. China delivered comp sales growth of 1% in Q1, including a 2% decline in comp transactions, consistent with the fourth quarter of fiscal 2018. 3% comp ticket growth was driven by our Starbucks Rewards loyalty program, food and merchandise. Importantly, we sustained our high rate of store growth in China, entering 10 new cities in the quarter. And with 18% growth in net new stores over the past 12 months, we ended the quarter with nearly 3,700 stores in 158 cities. We are also pleased that our newest class of stores in China continued to deliver strong profits and returns on investment.

Our Japan business delivered an outstanding quarter driving mid-single-digit comp sales and transaction growth that lifted comp for the overall CAP segment. These results were driven by holiday marketing efforts, which led to successful LTO performance in both blended and brewed beverages. We are also pleased with the continued growth in Starbucks Rewards program in Japan representing 22% of sales in Q1 and reaching 1.6 million active members, a 33% increase over the prior year.

CAP's non-GAAP operating margin declined by 210 basis points to 23%, primarily due to the ownership change in East China. Excluding the combined 220 basis point impact of the East China acquisition and unfavorable foreign exchange, the segment's non-GAAP operating margin was essentially flat.

On to our Channel Development segment, which reported a revenue decline of 20% in Q1, including the impact of the Global Coffee Alliance which reduced segment revenues by approximately \$130 million in the quarter, as expected. Excluding the impact of the Global Coffee Alliance, segment revenues increased 1%. Non-GAAP operating margin declined by 700 basis points to 35.9% in Q1, including a 770 basis point margin dilutive impact of the Global Coffee Alliance. Absent that impact, the segment's non-GAAP operating margin improved 70 basis points.

Finally, at the consolidated level, non-GAAP operating margin of 17.4% in Q1 represented a decline of 180 basis points year-over-year, largely due to streamline related activities. Excluding the 110 basis point impact of these activities, non-GAAP operating margin declined by approximately 70 basis points reflecting impact of partner investments, including tax reform funded items as well as strategic investments in our Siren Retail business, which remains in the concept development phase. These investments were partially offset by the benefit of sales leverage.

Now moving on to our guidance for fiscal year 2019. We still expect fiscal 2019 GAAP EPS in the range of \$2.32 to \$2.37 because the \$0.07 benefit from discrete income tax items in Q1, which I mentioned earlier, is largely offset by a net increase in cumulative unfavorable tax items related to the 2018 Tax Reform Act. However, relative to our previous guidance, we do expect non-GAAP EPS in fiscal 2019 to increase by \$0.07 resulting in a range of \$2.68 to \$2.73, mostly because the tax reform-related adjustment is excluded for non-GAAP reporting.

Additionally, for fiscal 2019, we now expect our GAAP effective tax rate to be in the range of 21% to 23% and our non-GAAP effective tax rate to be in the range of 20% to 22%. Finally, in light of the ongoing earnings growth model that we shared at our 2018 Investor Day in December, we are conforming our fiscal year 2019 global comp growth guidance to be between 3% and 4%. All other full year 2019 guidance metrics, including net new stores and operating margin, are unchanged from what was communicated on our Q4 fiscal year 2018 quarterly earnings call and reaffirmed at our 2018 Investor Day.

Although it's not our practice to give quarterly guidance, I'd like to provide some qualitative commentary on the shape of our P&L for the balance of the year. As a reminder, we will lap the East China acquisition at the beginning of Q2, at which point we will no longer see the year-over-year benefit to our total revenue growth. At the same time, we will still bear the year-over-year revenue headwind from the Global Coffee Alliance. We expect these factors to yield significantly lower revenue growth in Q2 compared to Q1. And given the fact that Q2 is a seasonally low period for us and with the continued substantial carryover of last year's U.S. tax reform-related investments, we also expect our non-GAAP operating margin percentage to be lower in Q2 compared to Q1.

We are in the early phases of our G&A reduction program, having just started in Q1 and the benefits to the P&L will not begin to meaningfully materialize until the back half of the fiscal year. This is an area of continued focus for us and we remain committed to reducing G&A spending as a percentage of system sales over the next three years to drive profitable growth-at-scale, while making the necessary investments in our business. As we start to lap the tax reform-related investments in Q3 and with the benefit of our continued focus on improving G&A efficiency, we expect our non-GAAP operating margin percentage to be higher in the second half of the year compared to the first half, even with the one-time cost of our global leadership conference that will impact Q4. Please note that all of this is consistent with our full year guidance for 2019.

To summarize, we are pleased with our first quarter performance and view these results as a validation of our strategies to grow Starbucks at scale, with greater focus and discipline. We appreciate the hard work of Starbucks' partners around the world, in our stores, at our roasting plants and in our support centers who deliver these results in a manner that remains true to our company's mission and values, which is the core of our business.

And with that, Kevin and I are happy to take your questions, joined by Roz Brewer and John Culver as Durga outlined at the top of our call. Thank you. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Sharon Zackfia with William Blair. Please proceed with your question.

Sharon Zackfia

Analyst, William Blair & Co. LLC

Q

Hi. Good afternoon. You probably didn't make as big of a deal as I would have expected about gross margin going up in the Americas for the first time in a couple of years. I don't know if you can give any more color around that, if it's just because of the beverage mix leading the comp and whether or not you believe that's sustainable for the rest of the year.

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

A

Thank you, Sharon. This is Pat. Happy to take your question. We typically don't highlight gross margin, but what I will do is speak to the performance of the Americas' OI margin, just to give you some flavor for how we saw that play out in the quarter. In the quarter, we realized meaningful operating efficiencies and positive sales leverage, which includes some gift card accounting benefits, but those were more than offset by an unusually high-level of investments including seasonal marketing expense to support holiday, product mix and inflation, primarily higher wages. And to give you a flavor for how we see this playing out balance of year, we do expect stronger margin tailwinds and lighter margin headwinds compared to the first quarter, and thus, less store level margin contraction as the year unfolds.

Specifically looking at product mix and what happened there in the first quarter, we experienced an adverse margin impact as beverage mix shifted from Blended to Refreshers and also from higher food sales, but that was partially offset by the positive impact of lower merchandise sales.

Operator: Our next question comes from David Tarantino with Robert W. Baird. Please proceed with your question.

David E. Tarantino

Analyst, Robert W. Baird & Co., Inc.

Q

Hi. Good afternoon. My question's on China and I just – maybe it's a two-part question. First is holding the line on comps sequentially despite, I guess, some signs of a slower macro economy over there. So I was just wondering if you could comment on how you think you did on a relative basis if you benchmark your sales over there versus others.

And then, secondly, I think you mentioned that the delivery roll out in the first couple of big markets has led to mid-single-digit percentage of product mix. Is that all incremental or are you seeing a mid-single-digit lift in the sales or is that cannibalizing some of the in-store sales and how does that compare to what you expected as you started the roll out? Thanks.

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

A

Thanks, David. I'll comment briefly and I'll hand over to John Culver to go into some more detail. On your first question, I think the fact that the performance we delivered of 18% increase to new stores plus stabilizing our comp at a 1% comp growth, that's delivering double-digit transaction growth, which we think is the most important metric for us to focus on. In China, our new stores are highly profitable and they're working well. So, we're going to continue to play the long game and I think we'll let you benchmark us versus others as their data comes out, but I think we're very comfortable and very confident in the strategy that we have in China.

I'll let John comment further on that and take your question on delivery.

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

A

Yeah, David. I think that overall from a China perspective, we saw strong Q1 performance and continued momentum in the business. And as I shared in New York at Investor Day, really, just looking at the total transaction growth in the market, the new store build-out which represents about 80% of our total revenue growth and the fact that we continue to increase our overall share in the market as we build-out our store footprint.

Clearly, the environment in China right now, we've demonstrated our ability to navigate what is a changing consumer, economic and competitive environment. But as Kevin said in his comments, we are playing the long game and we believe in the strategy that we have in place and the strategy is focused in a couple different areas. First, it's continuing to expand our store footprint and the reason we're doing that is because we continue to see very strong returns and best-in-class performance in the new stores that we're building.

The second thing that we're focused on, again, is continuing to grow the total revenues in the market. In the quarter, we grew 19% when you normalize for FX as well as the East China integration, and our store count overall grew 18% as we opened up 10 new cities, so we now operate 3,700 stores across 158 cities.

The other area that we're focused on is continuing to expand our digital partnership with Alibaba, and you mentioned Starbucks Delivers. We've rapidly rolled out in less than 90 days to 2,000 stores across 30 cities and we're seeing a strong awareness being built. We're seeing strong trial and we're seeing a growing adoption level from customers. I would say that from some of the metrics, the average delivery time is approximately 19 minutes, when a customer orders the time they receive it. We're seeing strong performance in both Beijing as well as Shanghai. And the average ticket that we're seeing through the delivery orders is a bit higher than what we see in our average core stores and the mix tends to be more beverage-led and, in particular, espresso-led. So, we feel good about the progress that we're making.

In terms of incrementality, to your question, we are seeing some positive impact, but I would just say that it's too early to call exactly what that impact is, but we're encouraged by the initial results that we're seeing and we feel as though we've got a competitive edge the market. We've set new standards for delivery of coffee to our customers and to customers throughout China. We've obviously introduced innovation with splash-proof lids for hot and cold beverages, tamper-proof packaging seals and individual hot and cold delivery containers. And so,

we're very encouraged by what we're seeing on the delivery platform through Starbucks Delivers as well as through our partnership with Alibaba.

Operator: Your next question comes from John Glass with Morgan Stanley. Please proceed with your question.

John Glass

Analyst, Morgan Stanley & Co. LLC

Q

Hey, thanks very much. On the U.S. business, two questions. One is, I know you gave some detail around daypart and product mix. How did the progression of comps work from a My Starbucks Rewards member versus non-Starbucks Rewards member. Are you sort of seeing just more visits from your loyal members, are you getting some of those less frequent users to come back? And maybe is that part of – are you seeing the actualization or can you quantify the benefit from some of those more – those new digital relationships that you have?

Can you also discuss just, if delivery will ultimately be available in the U.S. through the Starbucks app or is it only the Uber Eats app and why is that? I would think you'd want to capture your customers who're already visiting your app to get delivery and not direct them to the third-party app.

Rosalind Gates Brewer

Chief Operating Officer, Group President & Director, Starbucks Corp.

A

Thank you. This is Roz. I'll answer that question for you. So first of all, let me start with the breakdown between SR and non-SR. We typically don't give great detail in that area between SR and non-SR, but I will tell you that we continue to grow our business at peak in the mornings and that's when we see our strongest Starbucks Rewards customer in our stores. So we continue to grow very well there. I'll also mention that within the quarter, we saw a very nice improvement in the number of Starbucks Rewards customers. We added 1 million new Starbucks Rewards members to the business.

When we look at those numbers, that is a number that – we've not achieved that number since 2015. So we're pleased with where we're growing the Starbucks Rewards customer. I'll also tell you that we continue to see spend-per-member lift on the Starbucks Rewards customer that we are pleased with and we're also continuing to do work to convert those customers that have joined us from a non-SR perspective, and to get them to join us as an SR member. So our work continues there.

Your second question was around how are we thinking about – I think your question

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

A

Starbucks Delivers in the Starbucks app?

Rosalind Gates Brewer

Chief Operating Officer, Group President & Director, Starbucks Corp.

A

Yeah. Starbucks Delivers, right, in the app. So that work is ongoing. So we just migrated from Miami to San Francisco this week. And in the work that we're doing, the software integration is the most important part of the work that we can do right now. We are pleased with what we've seen just in this short week with the integration of the software. We are, right now, currently only able to access through the Uber app, but there is work coming to bring us forward so that they can access Starbucks Delivers through the Starbucks Rewards app, so that is coming.

Operator: Your next question comes from David Palmer with RBC Capital Markets. Please proceed with your question.

David Palmer

Analyst, RBC Capital Markets LLC

Q

Thanks. Just follow ups on China, on delivery. How could that delivery contribution to growth progress based on what you're seeing in terms of the ramp of adoption, just in these first few months? And could you also give a sense about what's the pace of that roll out after these first 2,000? And then, also, you had previously talked about co-marketing opportunities with Alibaba. Something a few hundred million of customers that you can market to. How is that going to ramp as well? Thank you.

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

A

Great. David, just real quick on the delivery side. As we shared in the comments, as Kevin shared, right now what we're seeing is delivery is contributing in the mid-single-digit range to our transaction mix and the key markets are Beijing and Shanghai. So we are seeing nice solid growth in terms of transactions that are coming through delivery and we're going to continue again to focus on how do we build awareness around the delivery of Starbucks Delivers through Alibaba and the Alibaba apps as well as the Starbucks apps. We're going to focus on gaining trial and then obviously, getting repeat and growing adoption. So those are the three big areas that we're focused on.

When you look at the overall opportunity that we've seen with Alibaba as part of the partnership, right, I think that there's a couple things to note. First off, we have the Starbucks Delivers program through Ele.me as well as through the Star Kitchens program with Hema, and that is an area that we continue to invest in jointly together and continue to grow and roll out.

The second area, I would say, is as it relates to Tmall and the opportunity that we see to make Starbucks' products accessible through the Tmall site. And today, through this partnership, we now have the number one position in terms of sales in the food and beverage card category across China, and in particular, on the Tmall site. The virtual store that I talked about at the Investor Day is something that we have kicked off with Alibaba that gives us access to their 600 million users and gives them the opportunity to become Starbucks Rewards members at a much easier pace and with no and very little friction.

So what have we seen from a Starbucks Rewards program? From a Starbucks Rewards program, our 90-day active membership grew over 14% in the quarter. We now have 7.3 million active members and the total membership across Starbucks Rewards stands at 22 million, which showed an overall 8% increase in membership. So we're very, very pleased with the partnership and the opportunity that we're seeing with it and the opportunity to continue to innovate.

Operator: Your next question comes from the line of Sara Senatore with AllianceBernstein. Please proceed with your question.

Sara Harkavy Senatore

Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you. I've two follow-ups, if I may. One on delivery. I was just wondering if you could talk about the economics at all either in China or the U.S. I know you said you don't know. Yet, you don't have firm numbers on

incrementality, but are there any sort of hurdles that you would need to clear in terms of percentage incrementality for this to be profitable or accretive? Just trying to understand what it might look like and whether the bar is lower in China because it's lower labor costs.

And then my second follow-up is on just the MSR customers. To Roz's point, it's the greatest growth since 2015, but obviously the comps are a bit slower now. So, is there anything to say about the nature of those new customers that you're acquiring, just perhaps lower spending in general or less of a lift when they join? Thank you.

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

A

Hey Sara, this is John. So to your first question on delivery and margin impact. As part of the guidance that we've provided, we've modeled in a slight dilution of margin for our business in China, but that is offset broadly across the CAP segment and roughly in line with us delivering a roughly flat margin across the entire segment. We're going to continue to look at ways to optimize the margin, but more importantly, how do we rapidly expand this program and grow it in a way that brings more customers into the Starbucks brand and extends our reach because ultimately what we want to do, is grow our overall share of consumption and our overall total revenues. And we feel very good about the position that we're in, the way we have this modeled into our P&L in FY 2019.

Rosalind Gates Brewer

Chief Operating Officer, Group President & Director, Starbucks Corp.

A

Sara, just a few tidbits on the U.S. delivery progress. So, we were encouraged exiting the work that we were doing in Miami and it's given us some insights in terms of how important it is for us to have the software integration to be successful, so that the process actually works and the partners can execute very cleanly in the stores, so that's going well. But in Miami, we did learn that we have a little bit larger ticket with the delivery order.

Secondly, we also learned that we are able to deliver certain beverages very well, and others not. And so we are refining the menu so that we can make sure we understand when this program is fully rolled out that we understand what the menu needs to be. And then lastly, I will tell you one of the things that we learned in Miami is the operational pieces around what needs to happen so that we have effective delivery. So that's what we know at this point, but it was encouraging enough for us to advance. You'll see us go into six more areas – six additional areas over the next four weeks to six weeks and hopefully we'll be able to share more at the end of second quarter with you.

You asked a question about SR members versus non-SR and what are we learning about the new non-SR members? One of the things we have been learning with the non-SR members, we're watching their spend levels. We're noticing that some of our non-SR members shop more with us in the afternoon. They're more of an occasional customer for us. And then lastly, I wanted to remind you that we are introducing our multi-tier redemption program that starts in second quarter of this year. That will allow us to provide access to our customers. And when you think about that program, we're excited about it because it continues to allow us to provide access to our brand, but in addition to it, it gives you access to benefit broadly to this non-SR group. So, we are adjusting the program that'll happen in second quarter and we look forward to sharing more information with you as we get through the introduction of it.

Operator: Your next question comes from the line of John Ivankoe with JPMorgan. Please proceed with your question.

John William Ivankoe
Analyst, JPMorgan Securities LLC

Q

Hi. Great. Thank you. I wanted to revisit China, if I may. I have three separate questions and hopefully I don't miss anything in asking these. Firstly, the East China impact on comps, it's obviously a very big market that I think will enter the comp base for the first time in the second quarter of 2019. Do you expect that to be a positive or negative as that slug of stores come in?

Secondly, it's been mentioned, I think, a couple times delivery in China is in 2,000 of 3,700 stores approximately, or 30 out of 158 cities. So, obviously I can understand the major market concentration there, but in terms of thinking about percentage of the stores or percentages of markets to where delivery could make sense based on what you're seeing today, should we expect China to have 100% delivery coverage at the end of 2019 or 2020, or does it make sense for you to just have a bigger delivery business in fewer stores?

And then the third question on China, and Kevin this is in reference to some comments that you made in your prepared remarks, that China was highly promotional and disruptive. If I didn't see the results, I probably would have thought they would have been worse than they actually were based on what those comments were related presumably to your competition. So talk a little bit more highly promotional and disruptive and whether there is anything that you would consider doing tactically or near-term in order to hold on to your rightful share of same-store traffic if you do think that that could become more of an issue than it's previously been?

Kevin Johnson
President, Chief Executive Officer & Director, Starbucks Corp.

A

Thanks, John. We'll have maybe Pat take the first question on East China impact on comps.

Patrick J. Grismer
Chief Financial Officer & Executive Vice President, Starbucks Corp.

A

Hello, John. Just to provide a little bit more perspective on how we see that working into our results. East China moves into the comp base for the first time in Q2, which means that the weighting of China in the comp base will comprise approximately 55% of CAP's comp results. As was discussed on the East China modeling call last year, these stores modestly underperformed company-operated stores from a comp perspective given a higher-level of sales transferred due to an accelerated pace of new store openings. But as we've had a year now to align these stores with our pre-existing company-owned business, the results of East China are fully embedded in the guidance that we provided previously for 1% to 3%. So we do not now expect that they will have a materially dilutive impact to our reported comps for China or for CAP.

Kevin Johnson
President, Chief Executive Officer & Director, Starbucks Corp.

A

John, do you want to take the second question on the percent of stores for delivery?

John Culver
Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

A

Yeah. Sure. John, I think you bring up a good question and obviously we continue to assess how do we want to continue to cover our markets, how do we want to continue to reach customers and build out the footprint of the delivery service. Your question around could you expect 100% of our stores having delivery? I would say initially, we're not going down that path from the standpoint of when you get into some of these trade areas, we have a condensed footprint in those trade areas. So we will leverage certain stores in those trade areas. We're going

through that evaluation right now and looking at it. We feel good, very good about the first 2,080 stores that we have, the 30 cities that we're in and the coverage that we're providing and we'll continue to roll out new stores as we continue through the year.

Kevin Johnson

President, Chief Executive Officer & Director, Starbucks Corp.

A

Then John, I'll comment on your third question and I'll let John Culver add to that. But my comments about competition being highly promotional is just a reflection of the fact that there're a number of instances where our competitors will use price, free coffee, buy one get four free, a lot of promotional kinds of techniques for them to get a customer, and for us clearly the top-line metric for competitiveness is total transaction growth in China. And the fact that we grew new stores by 18%.

Those new stores are performing very well. They're delivering a significant portion of new transaction growth, plus our same-store comp growth and we're getting that by continuing to do what we do well, which is differentiate on the quality of the experience in our stores, the quality of our handcrafted beverages that our Starbucks partners customize for each and every customer, and we're now complementing that with the China digital partnership with Alibaba which is giving us reach now to 600 million people who are regular users of the Alibaba apps, and we're complementing that with the Microsoft or the Starbucks Rewards program that we launched and that John pointed out, the traction that we're getting behind that. So all those things together, I think, we're performing very well and we recognize that the Starbucks value proposition and the things that we do well, we keep doing those and we're going to keep growing that total transaction number and that will serve us well.

John, do you want to add to it?

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

A

I would just add that, clearly as I've shared John, we remain focused on the long-term opportunity that we see in China. And as we make our investment in this market, we feel that the short-term, the mid-term and the long-term prospects are significant for our company. So, we're committed to continuing to grow in this competitive environment. I would say that you see the returns that we've been able to generate in the market through our new stores and the growth rates that we've been able to deliver in terms of the top-line, in terms of total transaction growth.

We have a very healthy economic model, but more importantly we have a premium brand that is positioned very strongly in the market. And as competitors come in, they will help build awareness, they will help build consumption, but we feel we're positioned to win over the long-term in the market and economically, clearly, we've got a healthy economic model and others are out raising carbon a consistent basis trying to fund their model.

Operator: Your next question comes from Matthew DiFrisco with Guggenheim Securities. Please proceed with your question.

Matthew DiFrisco

Analyst, Guggenheim Securities LLC

Q

Thank you so much. My question is with respect to the My Starbucks Rewards within the Americas. I think Kevin you mentioned in your prepared remarks that spring time I didn't know exactly which quarter that was going to fall into if that's going to be fiscal 2Q or 3Q with regards to some marketing behind some of the new plans to continue

this strong activation of those digital connections you made on to bringing them into the My Starbucks Rewards ecosystem. So I was curious, could you give us some more color or details on how we could expect the rewards program to change and how maybe to just protect against any hiccups from that being altered as it has in the past sometimes occurred?

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

A

Yeah Matthew, let me just clarify and I'll hand it over to Roz. The fact that we've established 13 million digitally registered customers is part of the feeder pool in the way that we can now bring those customers into Starbucks in a deeper relationship and ultimately we'd like to bring them into our Starbucks Rewards program and that's going to be an ongoing effort, and there's a lot of the tools and things that we've implemented to help simplify the onboarding and help communicate and amplify the value proposition of the rewards program to them. There's also the changes we're making to the program that I'm going to hand it over to Roz to talk about how we're enhancing the value proposition of Starbucks Rewards through the changes that Roz will take you through.

Rosalind Gates Brewer

Chief Operating Officer, Group President & Director, Starbucks Corp.

A

So Matthew, just a few things. First of all, it is second quarter where we will begin marketing to the non-SR 13 million digitally-registered consumers. I wanted to remind the group that this is still a transaction-to-spend-based program. So this is a spend-based program and we're just opening the range of opportunities. Some of the customer benefits of the new program is all members will now be able to redeem from the start. No more levels to hurdle like instant gold. There's options to redeem faster. So the earlier program engagement by offering lower thresholds for items and add-ons. And so choice and flexibility are really at the heart of this program and we really believe that it'll really increase the overall appeal of the program to these individuals that we've not been able to attract straight into the Starbucks Rewards program.

So we're going to continue to learn about these individuals and access and market to them. They were part of the group that we marketed the new Happy Hour program to and we were able to monitor their response against the new Happy Hour program just by their e-mail accessibility. So this program rolls out in second quarter, so we're looking forward to see the response to it at that time but we're encouraged at this point.

Operator: Your next question comes from Jeff Bernstein with Barclays. Please proceed with your question.

Jeffrey A. Bernstein

Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much. Two related questions on China. The first one, Kevin or John, I mean you mentioned playing the long game and clearly the competition is not offering the quality of product or the type of in-store experience that you are, but they are offering I guess the much desired delivery at seemingly a much lower price. So I'm just wondering is there any way to maybe attack that specifically for those customers that just want delivery and don't necessarily want the full experience to be more competitive on price? Because it does seem like at least the largest competitor, they're growing units north of 100% in 2019. I know yours is high-teens, which is normally quite high for the overall industry, but it does seem like there's a ramp in growth coming from potentially those others.

My other question was just quickly for Pat. In your former restaurant life, you've really spent a lot of time focused on China and ultimately decided that in that case, franchising was the best option. I'm just wondering as you look

at the Starbucks business in China, what's different that gives you confidence that the right approach is to focus entirely on company ownership especially with all this promotional and disruption activity? Thank you.

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

Thanks, Jeff. John, you want to take the first one on China?

A

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

Yeah. Jeff, for us on China and in particular on delivery, we feel that we are well-positioned from a price value perspective with our customers and we always assess this, but when you look at the experience that we provide, the investments that we've made into the delivery experience, to make sure that the quality of the product is there and the true differentiators that customers have come to expect around Starbucks, we feel that we are well-positioned to win in the delivery space in China. We'll continue to monitor, but I would just say that we are positioned well in the short-term as well as the long-term to capture the delivery opportunity.

A

Kevin Johnson

President, Chief Executive Officer & Director, Starbucks Corp.

Let me just add to John's comments, Jeff, that a lot of the promotional activity is focused on the beverage, not the delivery fee. So I think the fact that we've launched delivery gives that channel customers that want that channel and so it's less about promotional or delivery fees, more about promotional activity on the beverages we sell.

A

Pat, do you want to take the second question?

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

Yes, and thank you, Jeff, for the question. I have to tell you the economics of the Starbucks' business in China are dramatically better than the economics of the restaurant business at another company I worked with. And their returns were very good, but when you consider the fact that Starbucks is a beverage-forward concept, Starbucks has dramatically higher cash margins, and when you consider the fact that our store investment does not include a traditional kitchen, the sales to investment ratio again is dramatically superior. You combine those two things and what you have is an extraordinary return on investment. That means that it's in the best interest of Starbucks' shareholders for us to continue to deploy capital to the development opportunity in China.

A

I think you also have to take into account that given where we're at in the lifecycle of our business in China, we're in the early innings. In many respects, we're just getting started because of the vast potential we see for the Starbucks' concept in China. So absolutely it makes all the sense in the world for Starbucks to continue to deploy capital against the new store development opportunity and to maintain company ownership and operations for the foreseeable future.

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

Then just one other thing I would just add to the comments here on China is the opportunity that we see in the at-home coffee segment in China through the Global Coffee Alliance also is a big opportunity. As we expand Starbucks brand on the Nespresso and Dolce Gusto platforms and continue to accelerate the expansion of Starbucks packaged coffee in home, this is white space for us in that market and that will further extend our reach and grow the Starbucks brand in the country.

A

Operator: Your next question comes from the line of Karen Holthouse with Goldman Sachs. Please proceed with your question.

Karen Holthouse

Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks for taking the question. Kevin, you talked a little bit to the CPG business. The organic growth rate of 1% is certainly lower than what we expected. Would you attribute that to macro or competitive factors or should we think of some disruptions in distribution and whatnot around the transition to Nestlé? And if it's the latter, how long would you expect that to last for?

Patrick J. Grismer

Chief Financial Officer & Executive Vice President, Starbucks Corp.

A

Karen, this is Pat. Thank you for the question. I'll start and then turn it over to John. First, what I'd like to do is to clarify the mechanics of that adjusted 1% growth. For purposes of our [ph] excess (1:00:13) streamline growth calculations, we essentially exclude all aspects of the business that is now licensed to Nestlé leaving only the smaller portions that remain with Starbucks. And although that's the cleanest and the simplest way to remove the impact of the major transaction like this, the calculation itself belies the underlying growth in our global coffee licensing business. And we think that a more appropriate gauge of the health and growth of our channel business is market share. And so John will share with you a perspective on how our channel business has continued to grow and remain very vibrant even under this new model – in fact, enhanced by this new model.

John Culver

Group President-International, Channel Development and Global Coffee & Tea, Starbucks Corp.

A

Yeah. Yeah. And I would just say, Karen, we saw continued share growth momentum in Q1, which was very much in line with our expectations. For the Starbucks brand in total, we grew share 60 basis points. The roast and ground category grew share 90 basis points and K-Cups grew share 30 basis points. So we continue to capture share from the competition. We're very pleased with the transition that's taken place with Nestlé. We've transitioned over 500 partners to the Global Coffee Alliance. The partnership itself leverages both unique capabilities from both companies, us as the leading premium global coffee brand, them in terms of their global reach and expertise to market, sell and distribute across over 190 markets. We feel that we are well-positioned with this partnership to continue to drive strong value for the company and for our shareholders.

Operator: Your last question comes from Andrew Charles with Cowen & Company. Please proceed with your question.

Andrew Charles

Analyst, Cowen & Co. LLC

Q

Great. Thank you. You called it a strong holiday season in the U.S. Definitely a nice rebound from last year. And during the holidays you ran a TV advertising campaign, which is something you guys have done in the past, but was curious if you were pleased enough with the results to take advantage of the brand's scale and lean more to TV advertising in calendar 2019 to take advantage of that scale? And then separately, I remember you once previously called out Nitro contributes about 1% to a stores comps once that's introduced. Is that still the case? Thanks.

Rosalind Gates Brewer

Chief Operating Officer, Group President & Director, Starbucks Corp.

A

Andrew, thanks for the question. First of all, concerning the media that we ran during the holiday season, it was a benefit for us. We had typically been deeply engaged in a lot of our digital media and our one-to-one relationships through our digital relationships and the out-of-store media that we ran was effective for us. We do see every time the Starbucks brand is wildly advertised as it was. We enjoy the performance that we see. I will tell you too that those commercials did very well. We used some of our own partners in those commercials, so they were well-received. You will see us in the future do better balance of out-of-store media with digital media and we'll do a combined effort unlike what you've seen in the past.

And then the second question that you asked is around Nitro and if we see 1 point of improvement in our comp performance? I will tell you that our cold beverage platform overall actually does very well for us. When I look at our beverage performance in the holiday, cold espresso did extremely well for us and we are encouraged by Nitro, which is why we're expanding it but the 1% comp I'm not quite sure that I correlate with that number, but I will tell you that the cold platform does extremely well for us.

Operator: At this time, I'd like to turn the call over to Kevin Johnson for closing remarks.

Kevin Johnson

President, Chief Executive Officer & Director, Starbucks Corp.

Well, I want to thank all of you for joining us today. We continue to execute against our growth-at-scale strategy that we outlined in last month's investor conference and I think the results that we just posted demonstrate that that strategy is working. I also know many of you were able to join us in New York at the opening of the Starbucks Reserve Roastery in December and we're excited to announce that the Tokyo Roastery will open to the public on February 28th. So, I would invite all of you on your next trip to Tokyo to please stop by and visit this beautiful Roastery and we'd love to host you. Thanks for joining us and we look forward to talking to you again and we'll see you soon. Thanks.

Operator: This concludes Starbucks Coffee Company's first quarter fiscal year 2019 conference call. You may now disconnect.

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