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Starbucks Corp. (SBUX)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Diego, and I will be your conference operator today. I would like to welcome everyone to Starbucks' Second Quarter Fiscal Year 2023 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 will now turn the call over to Tiffany Willis, Vice President of Investor Relations. Ms. Willis, you may now begin your conference.

Tiffany Willis
Vice President, Head of Investor Relations, Starbucks Corp.

Good afternoon, everyone, and thank you for joining us today to discuss Starbucks' second quarter fiscal year 2023 results.

Today's discussion will be led by Laxman Narasimhan, Chief Executive Officer; Rachel Ruggeri, Executive Vice President and Chief Financial Officer; and for Q&A we'll be joined by Brady Brewer, Executive Vice President, Chief Marketing Officer; Frank Britt, Executive Vice President, Chief Reinvention Officer; Michael Conway, Group President of International and Channel Development; AJ Jones II, Executive Vice President and Chief Communications Officer of Public Affairs; Sara Trilling, Executive Vice President and President of Starbucks North America; and Belinda Wong, Chairwoman and Chief Executive Officer of Starbucks China.

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 risks factors discussed in our filings with the SEC including our latest Annual Report on Form 10-K and Quarterly Report on Form 10-Q. Starbucks assumes no obligation to update any of these forward-looking statements or information.

GAAP results in second quarter fiscal year 2023 and the comparative period includes 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. All numbers referenced on today's call are on a non-GAAP basis unless otherwise noted or there is no non-GAAP adjustment related to the metric. For non-GAAP financial measures mentioned in today's call, please refer to the earnings release and our website at investor.starbucks.com, to find reconciliations of those non-GAAP measures to their corresponding GAAP measures.

This conference call is being webcast, and an archive of the webcast will be available on our website through Friday, June 2, 2023.

Also, for your calendar planning purposes, please note that our third quarter fiscal year 2023 earnings conference call has been tentatively scheduled for Tuesday, August 1, 2023.

Now before I turn the call over to Laxman, I want to mention that our prepared remarks for today's call will run approximately 40 minutes, which is longer than what we plan for future calls. But we thought it would be beneficial to give Laxman ample time to provide his observations as our new CEO.

And now with that, I'll turn the call over to Laxman.

Laxman Narasimhan

Chief Executive Officer & Director, Starbucks Corp.

Thank you, Tiffany, and good afternoon, everyone. It's both a great privilege and responsibility to serve as Starbucks' CEO. On behalf of the board of directors and our Starbucks partners, I'd like to thank Howard Shultz for his leadership of the company over the last year. Howard's return in April of 2022 came at a pivotal moment for the company and with great personal and family sacrifice. And I want to personally thank Howard for his over 40 years of ingenuity, creativity, service and enduring love for our company and the iconic Starbucks brand and for his willingness to always lean in, in service of our partners and customers.

Since joining in September, the company has given me a uniquely designed program to fully immerse myself in all aspects of our business. The program involves spending time in our stores, distribution centers, roasting plants, support centers and on our own coffee farm in Costa Rica. And I have traveled to meet our partners and business leaders in several international markets across Asia, Latin America and Europe. While Howard formally ran the company through the second quarter, my immersion exposed me to all aspects of day-to-day leadership responsibilities and well prepared me to transition into the CEO role on March 20, a few days ahead of our Annual Meetings of shareholders.

I have learned about the company through the eyes of our founders, customers, farmers, partners and the community and through listing meetings with our shareholders. Perhaps most importantly, I've been actively listening and learning from our partners, working side by side to earn my Barista certification and developing the deepest level of respect for coffee and Barista craft.

In my time with the company, I've also been working closely with the executive leadership team. I have been impressed with the great progress and forward momentum of the company. And I am optimistic about our long term growth headroom and the margin improvement potential. We also see great opportunity to further strengthen the business, elevate the brand and do everything we can do to make this a great place for partners to work. We will continue to build our reinvention plan with additional opportunities, and we will update you with these additional plans in due course.

Let me start today's call by sharing my overarching observations, the progress and momentum from our reinvention and the opportunities today ahead for Starbucks. Rachel will then walk you through the details of our second quarter fiscal year 2023 performance. We will then open the call for Q&A. What you can take away today is confirmation that we are well-positioned to continue to unlock value for all our stakeholders.

My first observation is that Starbucks is uniquely in the business of human connection. Since our earliest days, we have been a brand that brings people together. From the vantage points of serving customers in stores and in drive-through windows, many are coming to us for connection with others. There is no doubt Starbucks has conventionally been the mainstay meet-up spot. At the same time, nearly two-thirds of US consumers are by themselves when seeking a beverage or food occasion.

As a world in a crisis of disconnection where loneliness, division and polarization have become far too common, the everyday ritual of coffee is a powerful way to make connection happen with others and with yourself. Starbucks delivers connection no matter how you visit us, in stores, drive-throughs or digitally, we are there to provide this connection any place, any time.

That brings me to my second observation. Our performance is strong, but our health could be stronger. I've worked side by side with our partners in our stores and have experienced firsthand how our stores and our operations are still evolving to meet the demands of our customers. There is more work to do to tailor our stores for the demand that we see, advance our technology, enhance how we innovate our equipment and also more fundamentally how we get back to focusing on fundamental operations and executing better. A priority that is evident with my deep engagement over the last several months across supply chain, technology, reinvention, store development, store operations, marketing and product.

Take, for example, the Siren System that we showcased at Investor Day. This is one example of how we can continue to do more to better support our stores and in turn our partners. It is also about the operating processes that we have in our stores and how we make them even more robust.

To strengthen our health, we need to think of our business as having theaters at the front with a factory in the back. Our theaters are where our store partners are focusing on their craft and delivering an elevated experience to our customers. To simplify the store-partner experience and drive greater productivity within and beyond the store level, we see significant efficiencies in our supply chain, support systems and processes. This is what I mean by our opportunity to strengthen our factory in the back.

Let me give you a few examples. Today, our store deliveries involve a high-touch one-size-fits-all model. We are out of stock in more items than we would like. Through segmentation and a format-specific approach, we will be able to lower costs by creating a better experience for our partners and ultimately for our customers.

We also have abundant opportunities to optimize what we buy across several areas as well as opportunities in how we buy it. Currently, we have over 1,500 cup and lid combinations across our network. As we streamline, we will create a portfolio of fewer, more sustainable and less costly cups while further simplifying operations in our stores. All of these opportunities will deliver top-line growth and margin expansion and create long-term value.

My third observation is that we're a company that strives to be different, and we are now operating in a different kind of world. One thing that has stood out to me here at Starbucks is our culture. Since my first day, it has been clear that Starbucks' culture is like that of no other company. There is a strong partner-first mentality that is both top down and bottom up. At the same time, the world in which we operate is evolving. There is clear opportunity to build stronger capabilities, drive even deeper engagement and adapt a global mindset.

With that in mind, as a leadership team, we fully acknowledge a need to evolve and modernize our brand, our business, our capabilities and our culture to meet the needs of an ever-changing world. We are therefore re-founding the company, and as part of that, we are getting back to its basics.

You already know about reinvention. We've also just recently introduced a new mission and set of promises as a contemporary expression of our mutual success. Our mission is this: With every cup, with every conversation, with every community, we nurture the limitless possibilities of human connection. The rollout of this work across the globe is well underway. It is driving conversations at all levels within the company and is being met with overwhelmingly positive reception.

As we evolve, what differentiates us will remain. We will modernize, yes, and we will stay true to who we are at our core, much like our promises say. We are a company that at its best works to build bridges to a better future for our partners. At our best, we uplift the everyday for our customers. At our best, we ensure the future of coffee for all. At our best, we make positive contributions to our communities. And at our best, with the environment, we give back more than we take. And as a result, we generate enduring long-term returns for our shareholders.

These have been my three overarching observations. We are in the business of human connection. Our performance is strong, but our health can be stronger, enable the theaters in the front by strengthening the factories in the back. And we continue to strive to be a different kind of company that is now operating in a different kind of world.

Through this lens, we will be disciplined in delivering against what has been limiting us in our journey towards the limitless future. We are seeing great progress in the work underway with our reinvention plan and the capacity for much more. We've only just scratched the surface of what we can accomplish with this iconic brand and company. We see significant growth headroom, having opportunity to further separate Starbucks from others. We also see opportunities to expand margins while continuing to invest in the business for the long term.

With that, let me turn to our second quarter performance. The company exceeded expectations in Q2 fiscal year 2023 by nearly all measures, delivering strong results across the broader Starbucks portfolio. Our performance including continued success in the US and international markets, as well as the recovery we are seeing in China can be attributed to the strength of the global brand, relevant innovation in our products and stores and powerful execution by our partners.

Let me first start globally and then with North America and the US. Our Q2 revenue was $8.7 billion, up 14% from the prior year and up 17% excluding more than 2% impact of foreign currency translation. North America delivered revenue growth of 17% in Q2, growing to $6.4 billion. We captured a remarkable 11% comp growth globally with 12% comp growth in both North America and the US for the second quarter, driven by mid single-digit growth, balanced between transactions and ticket. Our North America growth comes on top of 12% comp growth in the prior year. We expect this demand to continue as we push the envelope with innovation.

A recent example is the highly successful launch of Oleato, an innovation Howard identified and has personally led for us. In fact, we've already reached an audience of 5 billion people since our announcement of the February global launch of Starbucks Oleato beverages, making this one of the top-five product launches in the last five years in terms of brand awareness and excitement.

The new innovative beverage platform is currently available in 650 stores across three markets, Italy, Japan, and the US. Given the success we have seen, we look forward to bringing this exciting new offering to more stores and more markets around the world this year.

Scaled profitable innovation is one of the things that fuels our performance and is a continued area of focus. Our performance is the result of a near-perfect intersection of three things: one, our successful innovative beverages suggest our Pistachio Cream Cold Brew that inspires the expanded use of modifiers; two, our in-demand food portfolio which resulted in record sales of our Sous Vide Egg Bites and Breakfast Sandwiches; and three, our attractive convenience capabilities of mobile Order & Pay, drive-through and delivery which saw sequential improvement and now accounts for 74% of Q2 US company-owned revenue. You can expect us to lean strongly on purposeful innovation to further capture the tremendous opportunity, both in what we do and in how we do it.

Speaking of convenience channels, our 90-day active Starbucks Rewards membership added more than 400,000 members in the quarter in the US, bringing our total membership to 30.8 million members. In addition, we've increased membership by 4 million year-over-year in the US, representing 15% growth. Rewards members account for 57% of US company-operated revenue in Q2 which marks the highest contribution on record and represents growth of 3% on a year-over-year basis. We are excited about our growth in active Rewards members, as it's a contributing factor in consistent demand. We have been a vanguard in this area, and you can expect us to further invest and lead.

An example of that investment is Starbucks Connect which is now in over one-third of our US-licensed stores, giving our customers even more opportunities to engage with our brand. With such a diverse portfolio across our US-licensed locations such as hotels, airports and other retailers, coupled with increasing offerings of convenience, we are able to capture further demand evidenced by revenue in the quarter up 25% year-over-year, supporting our strategy to meet and serve our customers wherever they are.

Moving on to reinvention, we are making great progress. The investments we've made in our partners, stores and technology are already producing a return whether it's through productivity gains or partner satisfaction. We are pleased with the multifaceted progress to date.

For example, Barista turnover reduced by over 9% from a high in March Q2 of fiscal year 2022, leading to fewer newer hires per store. We've been able to increase the average hours per Barista per week by 4% year-over-year, a metric we know is one of the many meaningful inputs in achieving the desired compensation of our partners. Clearly, partner scheduling is a real opportunity for us, and we are laser-focused on it.

Additionally, items per labor hour, a metric which reached a record high in December 2022, continued its strong pace into and throughout Q2 despite seasonal trends. This demonstrates increased productivity in the midst of strong volumes, all while partner engagement and customer connection scores stabilized.

The rollout of handheld cold foam blenders, supporting customization demand, commenced in the quarter with completion targeted for third quarter, just in time to support our summer demand as the desire for cold foam customization continues to grow. The Clover Vertica brewers also begun to roll out in this quarter and will be in nearly 40% of our company-operated stores across the US by the end of this fiscal year. The Vertica offers our customers our freshest cup of brewed coffee while driving efficiencies in time and waste across our network. This is yet another example of how innovation amplifies what we do best, in this case coffee served even better.

The ultimate proof point of innovation and the progress against our reinvention is our Q2 margin in North America of 19.2%, a 200-basis point expansion year-over-year. We have more to do to reinvent our business. Though we have further opportunity ahead, we are proud to see that our strategies are working and momentum is building.

Moving on to international, we are pleased with the strength and growth across our broader portfolio. Q2 revenue was $1.9 billion, up 9% from the prior year and up 19% excluding a 10% impact of foreign currency translation, representing our third highest quarterly revenue due largely to China's faster than expected recovery. We also achieved our highest ever quarterly system sales internationally, and we delivered a company-operated 7% comp driven by transaction growth, spotlighting demand.

Strong comps were also captured across the regions outside of China with markets like Japan and the UK both posting double-digit comps for the eighth consecutive quarter.

We're very pleased to see our international store strategy is working. In the quarter, our net new stores grew by 363, representing 8% growth year-over-year. As we look ahead to the end of the fiscal year, we will reach 20,000 stores across the international segment, on pace with the growth strategy we outlined at Investor Day. We expect China to remain on track to achieve our 13% net new store growth target for this year.

Additionally, Asia-Pacific, EMEA and Latin American markets are also expected to contribute meaningfully, becoming an area of further emphasis and a more significant contributor to our overall global growth.

Moving on to China, Q2 marked a significant turning point when we finally began to emerge on three years of unprecedented COVID disruptions, embarking on the recovery journey that we have envisioned. We saw robust recovery in Q2, reinforcing the resilience of our partners, the strength of our brand and the close relationships that we have built with our customers.

We experienced faster than expected recovery, closing the quarter with nearly $800 million in revenue, up 3% from the prior-year and up 11% excluding the 8% impact of foreign currency translation. Comp growth of 3% marks the first positive comp since the third quarter of fiscal year 2021.

Importantly, we accelerated our store development in the quarter, opening 153 net new stores, more than doubling the net new stores from the previous quarter. We now operate over 6,200 stores across 244 cities, keeping us on track to meet our goal of 9,000 stores by 2025. Our bold decision to continue opening new stores in the past three years despite COVID disruptions and mobility restrictions is paying off as they continue to deliver returns and profitability.

Further accelerating recovery is our rapidly expanding omni-channel business. Starbucks Delivers achieved 21% year-on-year growth to make up 23% of sales mix, while overall mobile ordering reached 47% of sales, 4% over the prior year. Delivery demand remained robust even after consumer mobility has recovered, demonstrating that it is highly incremental and interwoven into our customers' lifestyles.

Our attractive portfolio supports the increasing demand, putting us in the position of strength to capture opportunity as China transitions to this next phase of recovery. While we don't expect a straight line of recovery, we are confident in our long term opportunity. We look forward to serving our customers with the elevated experience only Starbucks can deliver.

Now, let me wrap up the segment performance with Channel Development. Our Starbucks brand and successful partnerships continue to fuel the success of our Channel Development business with revenues of over $480 million in the quarter, up 4% year-over-year.

Our US at-home coffee continues to resonate with customers as are winning the seasons with well-received promotions and product launches. In terms of ready-to-drink, Starbucks has outgrown the category in sales growth for two consecutive quarters and remains the number one brand in the US. To continue this trend, we launched our much anticipated Pink Drink and Paradise Drink which have already been met with overwhelming excitement.

Before I pass the call over to Rachel, I want to again extend my gratitude to our partners, our leadership team and to Howard for the significant progress we have made as a company this past year. I also want to reinforce my confidence in our reinvention, the work underway to re-found our business, brand and culture and our position to fully realize the limitless potential of Starbucks.

For our long term sustainable growth, we will look to discover ways to, first, further elevate the brand by getting the basics right, operating our stores well and with a beverage-forward food-attached focus for renovation. Second, build on our leadership position in digital by scaling and introducing new and relevant customer experiences. Third, evolve to a more global presence for our business and for our brand. Fourth, work to become less wasteful and move with greater speed. And fifth and critically, reinvigorate our culture around what it means to be a partner at Starbucks.

With a reinvention plan driving progress against our business goals, a contemporized mission and a brand differentiated with human connection, our momentum is strengthening the business overall. Our focus on delivering elevated experiences will continue to set us apart.

As I look to close my remarks for the call, I want to reaffirm our guidance for the year, reflecting my optimism for our future even while recognizing we are operating in a challenging environment. I have great confidence in our leadership team and our partners as we carry on this journey together. We continue to build our plans for the medium to long term to recognize our limitless long term growth potential. I could not be more excited nor more grateful for the opportunity to build upon Starbucks' iconic legacy and shepherd in a new era for the company.

With that I'll now turn it over to Rachel to discuss our Q2 fiscal year 2023 results in greater detail. Rachel?

Rachel Ruggeri

Chief Financial Officer and Executive Vice President, Starbucks Corp.

Thank you, Laxman, and welcome to your first Starbucks earnings call. And good afternoon, everyone.

I'm so proud to discuss our outstanding Q2 performance, underscoring strength in both top line and margin globally. We delivered double-digit comp in all company-operated markets excluding China as well as positive comp in China driven by better than expected recovery and saw continued strength in our licensed markets. This momentum was made possible by the investments we are making in our stores and partners and allowed us to continue unlocking capital to reinvest in our business.

As a result, our business and brand remains strong. As we begin on this next step in our journey, I'm confident that our execution against our reinvention plan and broader strategies will progress us into our new era.

Our Q2 consolidated revenues reached $8.7 billion, slightly above our Q1 level and up 14% from the prior year and up 17% excluding more than 2 percentage impact of foreign currency translation. Revenue growth was primarily driven by 11% comparable store sales growth, 6% net new company-operated store growth year-over-year as well as continued momentum in our global licensed markets. This is remarkable performance on every level but specifically given the seasonality pressures we typically experienced in Q2.

Q2 consolidated operating margin expanded 130 basis points from the prior year to 14.3%, exceeding our expectations, primarily driven by sales leverage, including better than expected recovery in China, pricing, productivity improvement and lapping prior-year COVID-related pay. The margin expansion was partially offset by investments in store partners, higher G&A costs in support of reinvention and inflation.

Q2 EPS was $0.74, up 25% from the prior year. In addition to our strong global performance and better than expected recovery in China, this also includes an approximately $0.03 of one-time benefit from Starbucks Rewards redemption tier changes in North America which reduced the related liabilities.

I will now provide segment highlights for Q2. North America delivered revenue of $6.4 billion in Q2, another quarterly record and up 17% from the prior year. The growth was primarily driven by a 12% increase in comparable store sales consisting of 6% and 5% growth in transactions and average ticket respectively, as well as net new company-operated store growth of 4% year-over-year, further strengthened by the continued momentum of our licensed store business.

The segment's outstanding performance was led by the US, posting 12% comp in Q2 with transaction and ticket equally contributing to the growth, also bolstered by lapping the Omicron variant of COVID in the prior year. Remarkably, store traffic has surpassed pre-pandemic levels in our busiest day-parts. And even with higher levels of beverage customization and complexity, we were able to serve the surge in traffic as we unlocked incremental store capacity through reinvention.

Starbucks Rewards tender reached a record 57% of US company-operated sales in the quarter, showcasing customer loyalty and connection and indicating a successful launch of the changes to our Star redemption tiers.

We also continued to expand our store footprint across the US, reaching over 9,300 stores with stores opened in the last few years driving nearly 50% cash-on-cash returns despite the inflationary environment.

As part of our development strategy, we are committed to enhancing sustainability through greener stores with the program saving almost $60 million in annual operating costs in the US alone through water savings and energy reduction when compared to historic store practices. Our runway of growth coupled with store-level cash returns and commitment to sustainability is exceptional for a company of our scale, contributing meaningfully to our robust capital position and ability to continue reinvesting in our business.

US licensed stores revenue sustained its momentum this quarter, up 25% from the prior year with strength across the portfolio and further supported by the rollout of Starbucks Connect, as Laxman spoke about earlier, broadening our opportunity to reach our customers through our expanding network of stores.

North America's operating margin was 19.2% in Q2, expanding 200 basis points from the prior year primarily driven by pricing, sales leverage, productivity improvement and lapping prior-year COVID-related pay, partially offset by store-partner investments and inflation.

As you heard at the top of the call, we are already seeing our reinvention plan come to life. Whether it's through improved partner turnover and engagement, a better customer experience or productivity, our amplifying efforts fueled margin growth in the quarter. A margin benefit of approximately 60 basis points was also captured in the quarter due to the reevaluation of our Starbucks Rewards liability which will not reoccur in the balance of the year.

Moving on to International, the segment delivered revenue of $1.9 billion in the quarter, also a Q2 record and up 9% from the prior year. When excluding a 10% impact from foreign currency translation, the segment's revenue grew 19%, reflecting double-digit growth in all major markets, including China. The growth was driven by strength across our licensed businesses, a 10% net new company-operated store growth year-over-year and a 7% increase in comparable store sales from transactions.

Our international markets across the globe continue to demonstrate strong momentum. Excluding China, the segment's Q2 revenue grew 14% from the prior year or up 25% when excluding an 11% impact of foreign currency translation. Once again, our international markets excluding China collectively achieved double-digit comp growth, driven largely by transactions.

Let me highlight the incredible performance of Japan this quarter, our third largest market globally which surpassed 1,800 stores and delivered their eighth consecutive quarter of double-digit comp in Q2, as Laxman mentioned earlier. The market also up-leveled its Star Rewards program through introduction of a multi-tier redemption system, designed to offer more customer choices and elevate the program economics.

Subsequent to the quarter, in April, Japan also became the third global market to introduce Oleato beverages, offering the innovative lineup at more than 60 of their select stores including the Starbucks Reserve Roastery Tokyo. While still early, our performance in this market, a market that embraces innovation, appears promising.

Shifting to China, China posted comp growth of 3% in Q2, meaningfully exceeding our expectations including 30% comp growth in March, as we began lapping heightened mobility restrictions in the prior year. From the early weeks of January, when China emerged from peak infections and mobility restrictions were lifted in different cities, we saw broad-based recovery across all trade zones, day-parts and city tiers. This was fueled by a strong rebound in traffic as customers returned physically to our stores to enjoy moments of reconnection.

Starbucks Rewards active members rebounded to 17.8 million by the end of Q2 and hit a new record-high by the first week of Q3. The sharp immediate rebound in traffic demonstrated the strength of our brand and the relationships that we have built with customers, as well as our strong operating muscle to capture the pent-up demand, all of which drove rapid improvement in average weekly sales in Q2.

Looking ahead to the balance of the year, the speed of recovery in terms of average weekly sales will moderate after the faster than expected rebound achieved in Q2. For the remainder of the fiscal year, we will continue to face uncertainties, such as changes in customer behaviors and the pace of international travel recovery as COVID in China enters a new endemic phase. Nevertheless, we feel confident Starbucks is well-positioned for this next phase of recovery.

Operating margin for the International segment was 17% in Q2, expanding 390 basis points from the prior year, mainly driven by sales leverage across markets but specifically driven by the better than expected recovery in China, partially offset by higher store partner wages and benefits.

Shifting to Channel Development, the segment's revenue grew 4% from the prior year to $481 million in Q2, in line with our expectations driven primarily by growth in the Global Coffee Alliance. Global Channel Development extends customer occasions beyond our stores to amplify and diversify the Starbucks presence around the world. Our newer at-home platforms including Starbucks by Nespresso and Starbucks Creamers continued to drive growth for the Global Coffee Alliance.

We remain the market leader in global ready-to-drink categories with North America Coffee Partnership outgrowing the category and continuing to gain share for the past two quarters in a row. The North America Coffee Partnership saw share gains across platforms, and we're excited about our robust pipeline of innovation.

To name a few, we launched Frappuccino Mini Cans in late March to bring a perfect-sized treat to our consumers. We're also elevating our portfolio with bottled Starbucks Pink Drink and Starbucks Paradise Drink which were inspired by popular hand-crafted beverages in our stores and just hit store shelves in April.

The segment's operating margin was 35.6% in Q2, down 710 basis points from the prior year primarily due to impairment charges against certain manufacturing assets and mix shift. Excluding the impairment, the segment's margin was nearly 40% for the quarter, and we continue to expect Channel Development's margin to normalize in the mid-40s range towards the end of the year.

Now moving on to our guidance for fiscal 2023. As Laxman discussed, we are reaffirming our guidance for the fiscal year, balancing our incredible momentum and optimism with the economic uncertainties we continue to face around the world. Let me provide some additional insights on our outlook.

First, in the US, a meaningful part of the 12% comp in the quarter reflected a lap of Omicron in the earlier part of the quarter which was incorporated into our original guidance for Q2. US comp has normalized as anticipated in March and into Q3, with expected annual comp continuing to be in the guidance range of 7% to 9%.

Second, similar to comp, our Q2 North America margin also benefited from lapping a sizeable amount of COVID pay in relation to Omicron, accounting for 120 basis points of year-over-year expansion, as well as Starbucks Rewards tier change impact of 60 basis points which are not expected to recur in the balance of the year.

Third, as I discussed earlier, we expect China's average weekly sales to sequentially grow in Q3 and Q4 but at a more moderate pace. Acknowledging the uncertain environment, we expect China comp to improve in the back half of the year driven in large part by the lap of mobility restrictions in Q3 of the prior year coupled with the continued recovery, leading to low to mid single-digit comp on a full year basis.

Lastly, although China's Q2 margin was also stronger than expected, it benefited from the timing of certain investments. As we continue to ramp our operations in the balance of the year, we plan to resume investments required to drive sustainable growth over the long term.

Further, here are some points of clarification on guidance. Regarding the shape of margin, we continue to expect sequential margin improvement in both Q3 and Q4. We expect Q3 margin near the prior-year level with Q4 expanding meaningfully over prior-year as we lap the significant investments in wages and benefits. Note the quarterly margin shape in Q3 and Q4 is not expected to mirror the prior year.

We also expect EPS to step up in the second half of the fiscal year, improving sequentially in Q3 and Q4. We expect year-over-year EPS growth in Q3 to be meaningfully lower than our fiscal guidance range of 15% to 20% with Q4 year-over-year EPS growth slightly above the high end of our guidance range.

Our guidance continues to include the impacts of significant investments related to our reinvention plan, as well as inflationary pressures which are moderating. We continue to expect our G&A growth to be outsized in fiscal year 2023. A large portion of the G&A growth will reflect critical technology investments which we believe will fuel our reinvention and business growth.

Importantly, as we conclude the first half of the fiscal year, our global performance is closely tracking to our original expectations as the significant unexpected headwinds in China were offset by strong performance in the US and the rest of the world. While we continue to navigate our path to recovery in China, coupled with the heightened level of macro uncertainty around the world, we are confident that the reinvention investments we are making in our partners, stores and customers will continue to guide our growth, delivering on our original fiscal 2023 outlook.

Lastly, despite the current interest rate environment, our balance sheet remains very healthy supported by our strong cash flows and a measured financial policy targeting leverage below three times lease-adjusted debt to EBITDA. We are in an enviable position to continue to invest in our business, deliver on our shareholder return commitments and retain financial flexibility in the face of current economic uncertainty.

In summary, here are key takeaways from my discussion today. One, our global business and brand remains strong, demonstrated by both top line and margin performance in Q2. We are brewing on all cylinders across our building blocks of growth, namely strong comp propelled by digital engagement, unrivaled innovation and engaged partners, store growth anchored by best-in-class cash returns and margin uplifted by reinvention as it continues to gain traction.

Two, our fiscal year guidance remains unchanged, balancing our optimism with the economic uncertainties around the world. And finally, our new era is coming to life as we continue unlocking capacity and driving capital returns through reinvention. The investments being fused into our business is centering us on our core while increasing differentiation and building resiliency to help us realize our limitless future.

Before I close, I want to express my deep appreciation for our partners around the world, especially our Green Apron partners, for the critical role they played in achieving our success this quarter. Our future rests on the shoulders of many, and it's our collective unwavering commitment to serve our partners, customers and all of those from farm to cup in the best way possible to allow Starbucks to deliver on our limitless possibility.

With that, we will open the call to Q&A. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from John Ivankoe, JPMorgan.

John Ivankoe
Analyst, JPMorgan Securities LLC

Q

Hi. Thank you very much. The question is on the US staffing environment, specifically the store-level partners. It seems like that's where some of the biggest opportunity might really remain for this company going forward. I don't think I need to review second half of 2021, great resignation, your own specific challenges with labor, obviously a lot of news that was probably bigger than some of the labor issues even at the stores themselves.

I was really wondering where that left us in terms of staffing levels, hiring practices, training and retention, how you view the overall quality of the labor force? And I guess really importantly, how the current staffing and partner environment is being reflected in terms of overall customer service, in terms of the customer satisfaction and speed. So, if we can just spend a couple of minutes as you see the current staffing environment and the opportunity maybe over the next year? Thank you.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp.

A

Hey, John. Thank you for your question. Firstly, I will give a bit of an overview, and then I'll call on Frank and Sara to provide their perspectives.

Firstly, Starbucks continues to be a brand with a very strong employee value proposition. And we are able to attract a lot of applicants for the jobs that we have open. As I mentioned in my prepared remarks, we're seeing growing stabilization in what we see in our frontline. As I mentioned, we are seeing lower levels of attrition and greater stabilization in our retail talent.

Additionally, as you look at the improvements that we are making in our scheduling processes, we're able to deliver an average hours per week to our partners of 4% higher at this point in time. That of course does matter because it does have an implication on the compensation that they have. There are clearly more things in the pipeline as well. And, Frank, I'd love for you to give your comments on how you see the environment there.

Frank F. Britt
Chief Reinvention Officer and Executive Vice President, Starbucks Corp.

A

Yeah. It has clearly been an acute labor market environment, and we are mindful of that. We have continued our effort to build on Lax's points to distinguish ourself as a preferred employer of choice for frontline workforces. And we view that through the lens of, how do we create value for the partner as we continue to partner and building the company together.

Specifically in scheduling, we see scheduling as a significant opportunity as we continue to contour hours by store and by daypart and ultimately in service of getting our partners what their needs are relative to the shifts they would like to see week-to-week as well as the hours they need week-to-week in service of their goals professionally and otherwise.

And then finally I would say that, we have a very robust agenda to continue to programmatically improving the partner experience. We can unpack some of the specifics on that, but this is part of the ongoing agenda for reinvention. We feel pleased with our progress, but we feel like there's significant opportunity to continue to create even more opportunities for them in their careers.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp.
A

Sara, any comments from your time in stores?

Sara Trilling
Executive Vice President and President of Starbucks North America, Starbucks Corp.
A

I would just give one overlay. In addition to what's already been discussed, we've put a tremendous amount of effort over the last quarter in bringing our teams together in formats that allow them to celebrate our mission, to build capability. And it's paying off in terms of their engagement with the company. So that's one.

In fact, just last week and this week we've got partners gathering to focus at the store level all around connection and driving a different level of customer connection and customer service.

I would also say that the investments that we've made in really the core of our business, notably coffee and the way that we're celebrating our Black Apron partners, we're investing in partners going to Origin and just more training to build competency around craft is also another area that's driving engagement with our partnership at the store level.

And lastly, community, which is something that our partners care deeply about. We wrapped up our April month of service, and again that was a great way to help our partners feel connected to something bigger and with mission and values at the heart of it.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp.
A

If I can add one more thing, I think we're seeing strong pickup in the program of tipping that we have scaled across our store network.

Operator: Thank you. Your next question comes from Sara Senatore with Bank of America.

Sara H. Senatore
Analyst, BofA Securities, Inc.
Q

Great. Thank you very much. I just wanted to ask about the strength of the quarter maybe in the context of comments – other comments about the – both the near term and long term outlook. So it sounds like there was significant upside to your own expectations for the quarter, and objectively very strong. But you're not raising full year guidance which makes me wonder if maybe your reinvestment path is going to be higher than you had previously anticipated, just because some of the things Rachel mentioned. The COVID lapse I think would have been embedded in the outlook initially.

And maybe in that same vein, Laxman's view that you're reinventing or re-founding the brand, not something that I would typically associate with a brand that's putting up the kind of performance that we saw in the second quarter.

So if you could just contextualize the strength of the quarter in your full year outlook and also the view about sort of the brand going forward? Thanks.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp.

A

Rachel?

Rachel Ruggeri
Chief Financial Officer and Executive Vice President, Starbucks Corp.

A

Sure. Thanks, Sara. The way I'd like look at it is we were incredibly pleased with the performance in Q2. But when you think about, as I shared in my prepared remarks, we benefited from the lap of Omicron as well as the one-time adjustment from the Star liability. That was expected. So we expected that, and that was driven in the comp that we saw in the quarter in North America as well as broadly.

But in addition to that, while we recovered better than what we expected in China, when we look out towards the balance of the year, we expect our average weekly sales in China to continue and increase to improve sequentially quarter-over-quarter but at a more moderate pace than what we saw in Q2. We've already seen it start to moderate, and that's really driven by the fact that there's still some uncertainty in the overall environment from a recovery standpoint when you look at things like consumer behavior as well as recovery in key segments like our international travel.

So when we take all of that into account, when we look at our guidance for the full year, we believe reaffirming our guidance allows us to continue to convey the momentum but also the confidence we have while still navigating a rather uncertain environment globally.

Operator: Thank you. Your next question comes from Jeffrey Bernstein with Barclays.

Jeffrey A. Bernstein
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much. Just looking out beyond this year, Rachel or Laxman, I'm just wondering how you think about the operating margins in the coming years, maybe framing it relative to pre-COVID levels. Back in the day, high teens were the norm. I'm just wondering whether that's still a realistic target. And if so, maybe by when? Or perhaps, Laxman, that's just no longer the focus, or it's just not necessarily attainable based on the outsize inflation and ongoing investments you're making in the business. I'm just wondering how you think about the top versus the bottom line balance there. Thanks very much.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp.

A

I think in terms of guidance on this call, our focus is entirely on this year, right. So we are confirming our guidance for this year. I think as I mentioned earlier, as I've gone through the immersion, and I've worked in various spots of the company, there's no question what we see is we see headroom in terms of our top line. We also see opportunities for us to improve margins over time.

I gave a couple of examples in the prepared remarks about things that were apparent. We can buy different and we can buy better. Our end-to-end supply chain has significant opportunities to reduce cost and improve availability. We can enhance our tech stack, both to lower cost and then to actually reinvest it back in the tech stack to support the large digital push that we are making. Our stores need to better reflect what is needed to meet the evolved demand from where they were initially designed. Our beverage innovation is strong. Food could use more work. And our innovation could be more purposeful and targeted.

And these are the kinds of opportunities that I mentioned, the opportunities in the factory in the back. We also have opportunities in the theater in the front. So I think as you look at it, clearly there's top line headroom, and there's opportunities to sequentially improve margins. But in this call we are focused entirely on confirming our guidance for this year.

Operator: Thank you. Your next question comes from David Palmer, Evercore ISI.

David Palmer
Analyst, Evercore ISI Q

Thanks. Wanted to get your texture on the China market and your message there. Your four-year trend versus pre-COVID levels, you're 24% below where China same-store sales would have been in this last quarter. And just doing the math on your commentary for the year, it would appear that your same-store sales would still be roughly that amount below pre-COVID level.

So the recovery would be kind of stalling out if we just assumed that low to mid single-digit comp for the year. So I know you said a lot about China, but I'm wondering what is the thought-process behind that sort of sales? And what color can you give behind it? Thanks.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp. A

Rachel? And then I'll call on Belinda for some commentary. Rachel?

Rachel Ruggeri
Chief Financial Officer and Executive Vice President, Starbucks Corp. A

Sure. Thanks, David. I think, as we look at the remainder of the year for China, as I had shared previously, we expect that our average weekly sales will continue to improve sequentially quarter-over-quarter. We also expect that our comp will improve, especially as we lap the mobility restrictions from prior-year. But when you think about the overall environment, while we're encouraged by the fact that we're seeing strong traffic in the afternoon daypart, as well as on our weekends, which just speaks to a customer need to connect, there's still a lot happening in terms of the overall environment as it relates to recovery.

And so when we put all of that together and we think about that, when we look to the balance of the year, we expect it to continue to improve but at a more moderate pace relative to what we saw in Q2. And that's what brings us to the full year guidance range of a low to mid single-digit comp, which I think when you look at that does reflect momentum, but it also reflects confidence, especially when you look at, last year we ended the year with a negative 24% comp on a full year basis and a negative 29% even more recently in our last quarter.

So that's how we're thinking about the recovery. We're very encouraged by many of the signs that we see, but there's a lot that we're navigating. And so we feel very good about the guidance we've given as we think about the back half of the year.

And with that, I'll turn it over to Belinda.

Belinda Wong
Chairwoman and Chief Executive Officer, Starbucks China, Starbucks Corp.
A

Thank you. I'll just provide some colors on our recovery. China has finally turned a new chapter from pandemic to endemic, and Q2 marked the start of our solid and broad recovery. And it's only the beginning. We see strong rebound in traffic, as Rachel has said, back to our stores for reconnection and the Third Place experience our customers have long craved. And we're best positioned for this moment because we're in a human connection business. And our unique Third Place and the Starbucks Experience cannot be replicated anywhere else.

And we achieved 30% comp in March, and the strong momentum continues in Q3. We're firing on all cylinders to accelerate our top line and bottom line growth for balance of the year and beyond. And we will leverage our market-leading store portfolio to capture the pent-up demand for reconnection, and we're ready to accelerate even faster our new store growth in the second half of the year.

Our evolving omni-channel capability, the strength of our delivery business, our Mobile Order & Pay and e-commerce all built in the past few years and ready to serve our customers for any occasion anywhere and anytime. Highly incremental. And in fact, our Mobile Order & Pay business achieved the highest record sales and mix of 24% in Q2.

We've built strong operating muscle and agility to innovate and execute. We have the ability to adapt further with speed to meet new customer needs with disciplined execution in stores.

The enduring power and strength of the Starbucks brand and the deep connection we have with our customers and partners are all second to none. With that, our 60,000 partners in China are ready to capture the exciting growth ahead. Thank you.

Operator: Your next question comes from Peter Saleh with BTIG.

Peter Saleh
Analyst, BTIG LLC
Q

Great. Thanks. I wanted to ask about the Siren System. Laxman, I think you mentioned it briefly but really didn't provide a lot more color on it. I know this is something you guys talked about in great detail at the Investor Day in the fall. Just curious if you could give us an update on the testing and rollout of this system and the impact you're expecting going forward.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp.
A

Thank you for your question. I feel very good about the progress that we're making on the equipment rollout, as well as the testing that is underway on the Siren System. As you see, some of the nearer-term equipment launches have happened and have landed on time. We have a very systematic approach to how we think about our equipment and the testing that we're doing, and I feel very good about the progress we are making on that system. So all systems go as far as we're concerned.

Sara, I wonder whether you wanted to touch a little bit on some of the equipment launches that we've had so far.

Sara Trilling
Executive Vice President and President of Starbucks North America, Starbucks Corp.
A

Yes. Thank you. Happy to. Specific to Siren System, Laxman, as you said, cold beverage as well as the food station incubation tests are complete, and feasibility begins in Q3, right, for the rollout. And I think both of which, these stations have already shown measurable impact on both productivity as well as throughput and testing. So we're quite bullish on them.

And then overall, absolutely. We're already seeing the benefits of the investments that we've made in equipment. We're serving more customers during our busiest dayparts than we did pre-pandemic. And when I'm out in stores, I certainly hear firsthand from our partners how the equipment is making the work easier, and it's evident in speed with service. You can see it in our drive-through times. And you can also see it importantly in our productivity numbers.

As we're thinking about summer and the weather is warming up around the country, some of the things that we've launched more recently, cold foam blenders as well as labor at that station specifically make it easier to serve customers and enable the innovation that's going to be coming.

The last piece I'd call out that we're really excited about as it relates to our core, again, coffee, is Clover Vertica. We all know waste and throughput are going to be – they're going to benefit favorably, but I think more importantly we're putting coffee at the center. And our partners are incredibly enthusiastic about the offering that we'll give to our customers and the pride that they'll feel in terms of the quality that's in the cup. So very, very excited about that one as well.

Laxman Narasimhan A
Chief Executive Officer & Director, Starbucks Corp.

Great, Sara. Frank, you have a comment?

Frank F. Britt A
Chief Reinvention Officer and Executive Vice President, Starbucks Corp.

Yeah. Sara, you mentioned productivity. I think it's probably worth highlighting that while we typically see a decline in productivity during winter months due to seasonality in volume within our stores, compared to last year we've seen a sustainment of strong IPLH, our proxy for productivity. And I think this affirms to your point, Sara, the alchemy of partner changes in store workflow and equipment all yielding tangible value and enduring value for our partners and for our customers.

Operator: Thank you. The last question comes from Lauren Silberman, Credit Suisse.

Lauren Silberman Q
Analyst, Credit Suisse Securities (USA) LLC

Thank you for the question, and congrats. Really strong US comps in traffic. Can you unpack where the growth's coming from? Is traffic primarily coming from new customers or existing customers, Rewards members or more occasional customers? And then can you just give us an update on where you're running with transactions per store per day? Thank you very much.

Laxman Narasimhan A
Chief Executive Officer & Director, Starbucks Corp.

Great. Let me start with Brady. I think I'd love for you to give your perspectives on the questions.

Brady Brewer
Chief Marketing Officer and Executive Vice President, Starbucks Corp.

A

Sure. Yeah. On the quarter you saw in the US business an equal part in the comp between transaction comp and ticket comp. Of course, we were overlapping some bad weather last year, some Omicron surge. But really when we look under the surface of that too, as Rachel shared in her opening remarks, record customer counts for the quarter. When we look year-over-year that we saw growth there. Transaction comps growing in our busiest dayparts.

And when we get underneath the hood of that, it's really brand strength. We have growing affinity for the Starbucks brand. We saw some very good highs within the quarter for brand affinity. We look at the relevance of the innovations, our Iced Shaken Espresso platform continuing to grow, our Refreshers platform continuing to grow, which just reinforces our cold customized plant-based beverage strategy is just yielding continued growth. You heard Laxman talk about Pistachio Cream Cold Brew. We launched Oleato in the quarter. So there's so much for customers to be excited about and giving them a reason to come to Starbucks.

And then lastly, I would just say the execution. You see our Starbucks Reward membership rewarding Starbucks for that with more of their visits. Now 57% of US transactions are from our Rewards members, and what they're telling us is, as you heard me say before they are finding a beverage they can't get anywhere else.

And so all of those things compile into a great force of momentum for Starbucks, and we continue to be a strong brand that's poised for growth in the future. So...

Rachel Ruggeri
Chief Financial Officer and Executive Vice President, Starbucks Corp.

A

And I would just add, Lauren, to that that you had asked about TSDs. And we have seen our TSDs grow relative to pre-COVID levels. In fact, in our busiest daypart – our morning daypart, we have surpassed our pre-COVID levels, and that's in large part due to the momentum we're seeing in our reinvention. We're able to unlock capacity and better serve our customers, and we're seeing that come to fruition in terms of our overall strength in TSDs, which is also increasing in the early part of our afternoon. So we're encouraged by that.

And that's leading to – when Brady talked about the customer count, the growth we had in customer count, that's really across both our SR members as well as our non-SR members. So our overall customer count is increasing. Those customers are more engaged with our brand, and we see that in terms of unit growth as well as increasing transactions and then overall ticket, leading to the second highest average weekly sales that we've seen, second only to last quarter which was an all-time high. So we're incredibly encouraged by what we're seeing from an overall volume standpoint.

Laxman Narasimhan
Chief Executive Officer & Director, Starbucks Corp.

Thank you, Rachel. I'm very pleased with the results of this quarter, and we are clearly moving with momentum as a business. There's clearly further opportunities for us and for this wonderful brand. It's a privilege to lead it.

I want to thank you, all, for joining us today for our second quarter fiscal year 2023 earnings call. We appreciate your investment and your time.

Operator: Thank you. And with that, we conclude today's conference call. All parties may now disconnect. Have a great evening.