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Starbucks Corp. (SBUX)

Q3 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Julie and I will be your conference operator today. At this time, I'd like to welcome everyone to Starbucks Coffee Company's Third Quarter Fiscal Year 2017 Earnings 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] Thank you.

Mr. Shaw, you may begin your conference.

Tom Shaw

Vice President-Investor Relations, Starbucks Corp.

Thanks. Good afternoon, everyone. This is Tom Shaw, Vice President, Investor Relations at Starbucks Corporation. Thank you for joining us today to discuss our third quarter 2017 results, which will be led by Kevin Johnson, President and CEO; Matt Ryan, Global Chief Strategy Officer; and Scott Maw, CFO. Joining us for Q&A are Howard Schultz, Executive Chairman; John Culver, Group President, Global Retail; Adam Brotman, EVP of Global Retail Ops; Kris Engskov, EVP, U.S. Operations; Belinda Wong, EVP and CEO, Starbucks China; and Tony Matta, President, Channel Development.

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.

Please refer to the tables at the end of our earnings release and on our website at investor.starbucks.com to find a reconciliation of non-GAAP financial measures referenced in today's call with their corresponding GAAP measures. Also on our website, please note that we will be posting our updated financial targets following the conclusion of our prepared remarks on the call. This conference call is being webcast and an archive of the webcast will be available on our website.

With that, I'll turn the call over to Kevin Johnson. Kevin?

Kevin R. Johnson

President and Chief Executive Officer, Starbucks Corp.

Thank you, Tom, and welcome to everyone on today's call. I'm pleased to comment on the record financial and operating results that Starbucks reported today. In Q3, Starbucks grew revenues by 9%, excluding one point of foreign exchange, expanded non-GAAP operating margin by 100 basis points, and grew non-GAAP earnings per share by 14% over Q3 last year, excluding two points of FX. We also delivered 5% comp growth in the U.S., including a transaction splitting adjusted 1% increase in traffic, our strongest comp growth in the U.S. in five quarters. Another quarter of 7% comp growth in China, largely attributed to increased traffic, and 4% comp growth globally. Noteworthy is that in addition to delivering record financial and operating performance in Q3, both our retail and CPG segments also gained meaningful increases in U.S. market share, despite the softness in both sectors.

You will recall that our revenue growth in the first half of fiscal 2017 was roughly 6.5%, and our U.S. comp growth was about 3%. So, our Q3 performance reflects the back-half acceleration we've anticipated. I'm particularly pleased that our Q3 results were delivered in the face of today's rapidly unfolding retail industry disruption. Yet despite record industry-leading performance through three quarters of fiscal 2017 and a robust pipeline of food and beverage and digital innovation coming in Q4 and the quarters ahead, today's challenging retail and consumer environments, compounded by headwinds related to the retail disruption underway has us taking the slightly more cautious view as we enter Q4.

On today's call, we will discuss the drivers of our Q3 performance and update you on the progress we've made against our operational priorities, including an update from Matt Ryan, our Chief Strategy Officer, on the ground-breaking new digital capabilities that we've contributed to our comp, revenue, and profit acceleration. We will explain how each of the strategic actions we announced today will further align Starbucks company-operated and licensed markets for maximum growth and shareholder value creation, and results in the exiting of certain non-core or slow-growth operations and assets. And we will demonstrate how together, these actions will support our growth strategy by strengthening our core, sharpening our focus, and increasing our efficiency. Then Scott will speak to the financial implications of these actions. He'll take you through our Q3 financial and operating results in detail and provide an update on Q4 guidance. Then we'll turn the call over to the operator for Q&A.

Now, to set the backdrop for today's call, I refer the comments I made last quarter regarding the two critical, transformative elements required for any brick-and-mortar retailer to survive, let alone succeed in the future: an emerging digital and mobile relationship with customers that is threaded into a branded and immersive experiential retail destination. Retailers who are agile and reimagine the art of the possible will be big industry winners. Those who do not will struggle mightily. The evidence is clear that the pace of retail transformation is accelerating with a common theme: extending the in-store experiences to include relevant digital scenarios. It is the driving force behind combinations including Walmart's acquisition of Jet.com, the combination of PetSmart and Chewy.com, and last month's announcement of Amazon's intent to acquire Whole Foods. Each of these combinations demonstrate that pursuit of enhancing the physical retail experience with a relevant and complementary digital experience.

Starbucks identified the coming seismic shift in retail years before it consumed the industry. And we are well positioned because we invested ahead of the curve to extend our global leadership around all things premium coffee and tea, developed world-leading digital and mobile capabilities linked to loyalty, create experiential third-place environments, and deep authentic connections among our customers, our partners, and the communities we serve, providing an increasingly elevated and engaging Starbucks Experience. Successful execution around each of these initiatives is why, despite the powerful retail headwinds and cross-currents underway, Starbucks continues to produce record financial and operating results quarter after quarter, and open a new class of over 2,000 stores around the world every year that continue to outperform competitors and deliver industry-leading AUVs and profit, starting virtually from the day they open their doors.

Now, let me just pause here a moment and interject a thought. At the same time as we continue to internally extend and expand our own digital capabilities, we will also continue to explore commercial partnerships with third-party digital companies. Now, these partnerships, we believe, will enable us to leverage our brand, our global retail footprint, and the customer base in order to extend our reach, including into payments, loyalty and social gifting among others, just as we are doing with great success in China with Tencent.

Now, with almost 27,000 stores in 75 countries serving roughly 90 million customer visits each week, no traditional brick-and-mortar retailer is better positioned to navigate and flourish in the global retail industry of today or better positioned to lead in the digital retail world of tomorrow. And we will do so with speed, agility, and a focus on creating long-term shareholder value.

The strategic actions we announced today are fully aligned with the long-term strategy we communicated at Investor Day last December, and they will enable us to focus on the fastest growing, highest return aspects of our growth agenda. We have clear principles that guide us in determining which markets are best served as company-operated versus licensed markets. Adherence to these principles prompted us to transition the German market to long-time license partner AmRest in 2016 and to sell our 50% interest in our Taiwan JV to long-term partner Uni-President Group in a transaction we announced today.

At the same time, we will not shy away from expanding our presence in markets that evidence strong growth opportunities at scale. We entered China almost 18 years ago, and today recognized as among the most respected brands in that country; along the way, establishing relationships, relationships with millions of customers, tens of thousands of partners, and a meaningful presence in 130 communities. Starbucks' opportunity for growth in China is unparalleled and our purchase of the remaining 50% of our East China JV is a significant milestone, reflecting our long-term commitment to China and our unwavering optimism about our future in that key long-term growth market. And we are just getting started.

We also made a significant announcement related to our growing tea business. Tea is a large fast-growing category and a key addressable market and core focus for us. Since acquiring Teavana, we have built the business into a well-recognized, super-premium global brand. We expect to sell over $1.6 billion of Teavana branded, handcrafted beverages through Starbucks stores around the world this year. Overall, our tea business has grown 40% since we launched Teavana in the U.S. five years ago, and it is up over 60% since launching in China and Japan roughly one year ago.

Innovation is key, and we continue to innovate around tea, just this month introducing Teavana Infusions, a flavor platform made from real fruits and botanicals that strengthens our lineup of healthy, less indulgent, premium cold beverages. Through our partnership with Anheuser-Busch, we've extended the Teavana brand into a ready-to-drink platform that will create even greater brand awareness and fuel further growth.

We have big plans for tea in Starbucks retail and CPG globally, but as we shared with you on our last call, many of our Teavana mall-based stores have been persistently underperforming. We conducted a strategic review of the Teavana mall-based store business and concluded that despite our efforts to reverse the trend through creative merchandising and new store designs, the underperformance was likely to continue. As a result, we will be closing all 379 of our Teavana mall stores over the coming year. Scott will speak to the financial implications of this decision shortly. Each of the actions I just described is a powerful driver of value creation that will strengthen our business and enable us to focus our resources on priorities that drive outsized current returns and long-term shareholder value, supporting our strategy and sustaining profitable growth into the future.

On our last call, I outlined five operational priorities: continuing to accelerate comp sales and transaction growth in the U.S., driving breakthroughs in food for the lunch day-part, enabling long-term growth in China, extending our digital flywheel assets, elevating through our Roasteries and the Starbucks Reserve brand. Today, I'm adding a sixth: gaining share of at-home coffee down the aisle, a subject Scott will address shortly.

Now, let me comment briefly on a few of these priorities. On our last call, I outlined a broad set of initiatives focused on accelerating U.S. comp sales. We are very pleased with the progress we've made to increase throughput in our stores in the face of rapidly increasing customer usage of Mobile Order & Pay. We are unlocking incremental growth potential across all dayparts, particularly at peak, while at the same time improving the Starbucks Experience for all customers. Food plays an important role in our growth agenda, contributing 21% of our U.S. revenue in Q3. We remain focused on driving breakthroughs in food for lunch, as we create new offerings in a relevant daypart and greater choice for our customers. These objectives were behind our decision to up-level our lunch menu lineup with Mercato, our fresh food concept. Mercato is exceeding expectations in its Chicago launch market and we're moving up the launch of Mercato in the Seattle market to August.

We are extremely excited about our strategy and the opportunity to further enable long-term growth in China. Our business has never been stronger or more robust, with revenues that consistently increase over 20% annually, driving significant margin and profit growth. We continue to open roughly 500 new stores in China every year at a rate of new store growth that will accelerate over time. Our newest class of stores continue to outperform and deliver record AUVs, now nearly 700,000 per unit, and world-leading returns. In fact, given our performance and success in China and the momentum we are seeing across the country in both retail and CPG channels, we now see the opportunity for Starbucks in China being even greater than we originally thought. We are committed to a long-term growth agenda in China, executed in a respectful fashion that instills pride in our Starbucks partners and deepens our connection to our customers and the communities we serve.

The data are clear that our beautiful stores, engaging store partners, new beverage, food, and digital innovations, and our focus on operational excellence are attracting new customers into our stores in China and bringing existing customers in more often. And with the transition of East China to a company-operated model, we will meaningfully advance our China agenda by enabling our strong, local leadership team to fully leverage our infrastructure and scale economics in order to maximize the growth opportunities ahead.

And, I'm pleased to report that already 90% of our eligible China partners are taking advantage of the fully sponsored critical illness insurance for their parents, a breakthrough partner benefit we introduced in Q3. We will continue to invest in our people and are committed to remaining one of the most admired brands and an employer of choice in China. And with the opening of our Shanghai Roastery in December, we will further elevate the Starbucks brand and introduce our customers in China, as well as visitors from all across Asia, to the immersive, ultra-premium coffee-forward Starbucks Roastery experience.

Now, our digital flywheel is a powerful proprietary asset that is driving deep customer engagement, revenue, and profit growth around the world. And we're pleased with the contributions that our digital flywheel made to our business in Q3. Given the significance of the digital initiatives underway, I've asked Matt Ryan to provide you with an overview of the Q3 contribution and share some thoughts with you on the future of digital. Matt?

Matthew Ryan

Global Chief Strategy Officer & Executive VP, Starbucks Corp.

Thank you, Kevin. Digital relationships are becoming increasingly important to Starbucks' growth, contributing both the majority of U.S. comp growth in Q3 and to our continued outperformance compared to our sector. U.S. Starbucks Rewards membership rose to 13.3 million active customers in Q3, up over 8% from last year and up 28% from two years ago. We have seen spend per member rise to record levels, up 8% over Q3 last year. Between new member acquisition and increases in spend per member, 36% of our U.S. revenues came from Starbucks Rewards members in Q3, driving the 41% of our revenues that are prepaid on our own proprietary payment platform, reflecting rapidly increasing customer adoption of our digital platforms.

At Investor Day in December, we identified our digital flywheel's four key drivers of incrementality: customer acquisition, spend-based rewards, personalized offers, and convenient ordering. The data are clear that when we acquire a new customer, the act of signing up for a digital relationship results in a sudden and sustained lift in spend, as measured by careful pre/post tracking. That's how we're able to drive so much value from a relatively small portion of customers, 13 3 million active reward customers compared to a total of approximately 75 million unique customer visits to our stores each month. We know that even modest increases in the total universe of active customers drive tremendous long-term value and we have detailed plans in place to significantly expand our universe of digitally engaged customers and drive strong, sustainable, profitable growth into the future.

Second, Starbucks Rewards are highly motivating and the conversion to a spend-based program has resulted in a clear lift in member spend. Third, personalization, in which we target specific messages and offers to individual customers based upon their history with us, has proven highly effective, as evidenced by test and control measurements in spend per member. Fourth, mobile ordering remained highly incremental, resulting in many more occasions per customer than would be the case otherwise because the convenience encourages more on-the-go visits.

Last year, we deployed new personalization technology and a new front-end experience in our app, investments that have contributed to the measurable success in digital we are experiencing. Today, we are enabling a new generation of digital innovation that will begin rolling out in waves starting this fall. This fundamental modernization of our technology stack will replace legacy rewards and ordering functionality with the new scalable cloud-based platform for rewards and ordering, improved customer data organization, and tighter integration with store-based operating systems, including inventory and production management.

The first phase of the platform rollout will enable us to flexibly change and configure rewards programs and become more nimble in creating new benefits for customers. It will enable new features and extend and expand the program by creating the ability to award exclusive benefits to subsets of our customers. For example, to customers who sign up for the new co-branded payment products we will be launching in the U.S. with Chase. The first application of the new technology will support the rollout of Starbucks Rewards in Japan this fall, with other markets following thereafter.

The second phase of the platform rollout will include new ordering functionality. We will still require stored value accounts for customers to receive stars with every purchase, but we'll no longer require customers to use a stored value account to place an order, removing a barrier to expanding usage of Mobile Order & Pay, a service that is highly incremental to our business.

This will result in digital relationships with a new pool of customers who have Starbucks accounts and payment credentials on file, expanding the universe of customers we can target with offers and communications driven by our personalization engine. As a first step, we'll be testing a guest checkout feature for first-time users of the app early in 2018.

Over time, our new technology platform will also flexibly interface with inventory and point-of-sale systems in our company-owned stores and inventory and point of sale systems owned by our licensed partners. This new foundational technology will also enable even more convenient ways for customers to order their beverages and food, providing even more reasons for customers to set up digital relationships with us.

In addition to our long-term digital technology roadmap, we continue to innovate in the short term around our newer technology platforms. We are expanding personalization by offering new offer constructs, real-time triggers and push notifications to engage customers more deeply, building on the momentum that is generating the higher spend per member. We've also committed to increase registration into the program, taking advantage of the seasonal momentum that begins after the summer season. We are removing friction in the sign-up process, improving the digital interface and registration flow, and are in the early days of testing solutions that greatly streamline sign-up.

We're also seeing results from our efforts at personalization that far exceed our own high expectations and recognize the value extending personalization to non-Rewards customers. Our marketing teams are now building the universe of customers that opt into direct communications from us. In the future, you'll hear more about our efforts to grow not just Starbucks Rewards, but the total number of people who engage with us digitally in any fashion, as our personalization engine will help us deepen engagement with customers beyond our core loyalty customers.

New ordering capabilities also means transforming our store operations, and as part of the next generation of technology in our stores, we're adding the Digital Order Manager, or DOM, now present in roughly 1,000 of our busiest Mobile Order & Pay stores. We are also making improvements to our inventory management technology, and in the future, we'll be adding capabilities to enhance customer service, including introducing tools that enable baristas to recognize customers that deserve differentiated treatment, perhaps customers celebrating birthdays or regular customers from one store who show up at a different store.

Building digital relationships takes time and focus. We see ourselves as pioneers and leaders in building digital relationships with customers and have a proven track record of success that is unrivaled in retail. At the same time, we recognize that digital companies are trying to get into traditional retail businesses, like grocery. In our business, where the scale of our physical footprint, our customers' relationships with our partners, and the third-place experience we deliver are so critical, we have an inherent advantage that digital companies will struggle to replicate.

We're not complacent and recognize that digital relationships will increasingly be the key drivers of demand generation, even in physical stores. By leading in the combination of physical and digital, we not only drive superior business results in the short term, based on rewards, ordering, and personalization, but we also make it very challenging for digital companies to outmaneuver us in the physical world. While digital companies may win in other sectors, we will be the digital company that wins in ours. The current digital trajectory we have demonstrated is proof that we are winning today and will continue to extend our lead into the future. Kevin?

Kevin R. Johnson

President and Chief Executive Officer, Starbucks Corp.

Thank you, Matt. In addition to our digital agenda, we're also investing to elevate both our brand and our customer experience around coffee through our Roasteries and the Starbucks Reserve brand. Starbucks Roasteries are at the center of our innovation strategy around branded experiential retail customer destinations. Complementing our first Roastery in Seattle are additional Roasteries now under construction in Shanghai, New York, Milan, and Tokyo, and under development in Chicago. Our Roasteries will ultimately be complemented by Reserve bars in thousands of Starbucks locations and several hundred new Starbucks Reserve stores around the world. Roasteries and Reserve stores will delight our customers with delicious food offerings through our partnership with Italian artisanal baker, Princi.

In Q3, we continued to solidify and extend our brand and market positions and our global leadership around all things coffee and tea. While our investment in Roasteries and Reserve stores enables a world-class, ultra-premium, coffee-forward experience in flagship locations around the globe, it also establishes a core innovation center second to none that will continue to fuel innovation across the Starbucks platform.

The ongoing disruption and transformation of the retail industry is accelerating, with very few winners. With another quarter of solid global growth and record financial performance, Starbucks is a clear winner. And we will continue to win by playing the long game, all around the world. The strategic actions we announced today were developed and pressure-tested against the requirements that they strengthen our core, enable profitable growth, reduce costs and complexity, and facilitate a more tactical deployment of our capital and resources to areas where they will generate the highest returns. Each will achieve those objectives, and by doing so, contribute to our ability to continue delivering industry-leading increases in revenue and profits, and outsized returns to our shareholders.

I'll now turn the call over to Scott for a deep dive into our operating performance and financial results in Q3. Scott?

Scott Harlan Maw

Executive Vice President and Chief Financial Officer, Starbucks Corp.

Thank you, Kevin, and good afternoon, everyone. Starbucks once again reported record operating and financial performance in Q3, reflecting the back-half acceleration we've been anticipating. Nonetheless, as Kevin shared, despite posting record performance in Q3 and further extending our lead compared to the industry overall, the combination of trends in the quarter and ongoing macro pressures impacting the retail and restaurant sectors overall, has us a bit more cautious going into Q4. On today's call, I'll cover three topics. First, I will provide an overview of our Q3 operating and financial performance. Next, I'll provide additional context around the strategies under way to sharpen our focus and enable accelerated growth and further increases in return on capital, and finally, I will provide guidance for Q4. We will be providing our initial growth targets for fiscal 2018 on next quarter's earnings call, just as we did coming into this year.

GAAP operating income was $1 billion and non-GAAP operating income was $1.2 billion, up 15% including one point of negative FX. Operating margin totaled 18.4% on a GAAP basis and 20.8% on a non-GAAP basis, up 100 basis points year-over-year, primarily driven by sales leverage partially offset by increased partner investments in the Americas. GAAP EPS was $0.47, inclusive of impairment charges primarily related to the closure of our principally mall-based Teavana stores, a development I will discuss shortly. Excluding these and other charges, non-GAAP EPS grew 12% to $0.55 in Q3 including two points of negative impact from FX.

I'll now take you through our Q3 operating performance by segment. Americas revenue grew 10% year-over-year to $4 billion in Q3, primarily driven by 1,002 net new store openings over the past 12 months, and 5% comp growth, this segment's strongest comp performance in five quarters. Excluding the impact of order consolidation following last year's transition to the new Rewards program, America's segment transaction comp was a positive 1% in Q3. We expect Q3 of fiscal 2017 to be the last quarter reflecting any meaningful impact from order consolidation.

While we are pleased that our Americas segment delivered top-line improvement in a difficult retail and consumer environment, we did experience a softening in transaction comps as we moved through the quarter. Momentum entering the quarter, beginning with April's wildly successful introduction of the Unicorn Frappuccino was strong, but comp trends softened in the back half of the quarter, and this softness has continued into July. The slowdown included a lower than expected lift in non-discounted Frappuccino beverages following Happy Hour, as well as somewhat lower than expected sales of other core beverages during the period. Lunch was our fastest growing daypart, driven by increased customer adoption of our food lineup and better-for-you beverage options.

Peak showed sequential quarter improvement, albeit somewhat less than we had forecast, and the afternoon was pressured across several core beverage categories. Reversing this trend and increasing transactions in the U.S. remains a key priority for us and we have several initiatives supporting this priority underway, including strengthening and leverage our digital and marketing capabilities, driving food and beverage innovation, and further improving our operations and in-store execution.

Matt covered digital innovation, so I'll take food and beverage innovation and our progress on improving throughput. As we move through summer, we have a full pipeline of food and beverage innovation, including hot and cold, better for you and indulgent offerings for all dayparts. On the beverage side, our recently introduced Teavana Shaken Iced Tea Infusions, an innovative approach to delivering robust flavor in a healthy way by combining our core iced teas with the unique, freshly-steeped blends of fruits and botanicals is performing very well. So, too, are our new Iced Cascara Coconutmilk Latte and returning favorite Iced Coconutmilk Mocha Macchiato.

And within food, we have expanded our lineup of protein-forward offerings with improved Bistro Boxes and the introduction of a seared steak and egg wrap and two new varieties of lunch bowls. Clearly, our commitment to food innovation is delivering, as evidenced by the two points of comp growth from food we reported again this quarter.

Let's now turn to our throughput initiatives. You will recall that our throughput improvement is slated to come in three waves. So first, targeted improvements in labor, resulted in our introducing dedicated Mobile Order & Pay rolls during certain hours in our busiest stores and has already contributed to both improved throughput at peak and improved customer service scores. Noteworthy is that our highest volume MOP stores experienced the greatest increases in customer experience scores this quarter.

Second wave initiatives include deployment of the Digital Order Manager, a high-value, low-cost technology that is both further increasing throughput and providing us with an extremely valuable source of new data to further optimize store operations and further elevate our customer experience. The DOM contributes to an improved MOP customer experience by providing mobile notifications to customers when their order is ready and facilitating a smoother experience at the handoff point. And it improves the MOP partner experience by replacing the paper-based ticket consolidation process with a modern touch screen order consolidation tool.

Additional wave two actions include further carefully targeted investments in labor and the introduction of a new approach to beverage production and deployment that we call channel production. By creating distinct production channels utilizing current equipment and labor allocations, this new order production and deployment capability is enabling a throughput unlock in the stores where we are testing the approach. Our third wave enhancements begin rolling in October 2017 and include improved spacing and production capacity in all new and remodeled stores, new production sequencing software, and an enhanced labor scheduling platform.

In Q3, Americas operating income grew 8% and operating margin was roughly flat compared to last year. Increased investments in our U.S. store partners remained a headwind, though the Q3 impact was more muted than in prior quarters as the business lapped a significant one-time bonus paid to partners last year. In addition, the mix shift resulting from lower beverage comps combined with strong food sales put some additional pressure on gross margins again this quarter. Of our 5% U.S. comp growth in Q3, three points were driven by beverage with continued strong sales of iced beverages, including iced coffee growing 33% year-over-year, and Refreshers, including the highly successful Pink Drink, growing 57%. And for the second consecutive quarter, food delivered two points of comp, driven entirely by attach.

Let's move on to China/Asia-Pacific. Starbucks China/Asia-Pacific region delivered another quarter of strong performance with year-over-year revenue and operating income growth of 9% and 22%, respectively. CAP revenue of $841 million was driven largely by net new stores and comp growth of 1%, driven by an acceleration in China comps to 7%, offset by softness in Japan. As we have previously noted, CAP comps are currently more heavily weighted towards Japan, where revenue, profitability, and new store performance remained very strong. Noteworthy is that over the nearly three years since we acquired the market in Japan, it's been delivering an average of 3% quarterly comp growth, profitable new store growth, and that has accelerated, and total revenue and profit growth in Japan are running in line with our initial deal assumptions.

CAP has now reported five consecutive years of double-digit revenue and operating income growth through Q3. CAP's operating margin expanded 280 basis points to 26.6% on a GAAP basis and 270 basis points to 28.3% on a non-GAAP basis. Contributing to CAP's Q3 margin expansion was the final impact from the now fully-lapped transition to a value-added tax structure in China and a nearly 30% increase in income from our joint venture operations, including South Korea and East China.

Turning to EMEA. Our EMEA segment delivered solid results, and at 2%, its strongest comp growth in seven quarters. In Q3, led by strong performance in the U.K. System comps in the region were even higher, increasing 5% and once again validating our decision to move certain EMEA markets to a licensed model. Revenues in EMEA totaled $250 million in Q3, a 9% decline versus prior year. However, when normalized for a 16% impact of portfolio shifts and FX, EMEA revenue actually grew 7%, driven by incremental revenues from over 311 net new stores added in the last 12 months. EMEA's GAAP operating margin totaled 4% with non-GAAP operating margin at 11% after adjusting for the impact of goodwill impairment in Switzerland, roughly flat to Q3 last year, despite 130 basis points impact from FX. We will continue to focus on improving operations and shifting the mix towards licensed stores in EMEA, efforts that have contributed to EMEA delivering solid mid-single digit system sales growth and double-digit non-GAAP operating margins for 12 consecutive quarters.

Turning to Channel Development, Channel Development had a very solid Q3, delivering strong revenue growth of 9%. Starbucks K-Cup sales increased 10% in the quarter compared to 0.5% growth for the K-Cup category overall, driving our share of the K-Cup category up 1.4% to 16.6% overall and our roast and ground sales grew 8% in the quarter compared to 0.4% growth in roast and ground overall, resulting in a 1% category share gain to 13%. We will continue to focus on profitably growing share of both K-Cup and roast and ground, but expect somewhat lower top and bottom line growth in Q4 as deceleration in the categories overall has invited increased competition and discounting.

Tea is a core focus of ours and, as Kevin mentioned, we're having great success with Teavana in both Starbucks retail stores and grocery. We have already shipped over 2.5 million bottles of Teavana ready-to-drink teas in just five months with all four flavors already ranking in the top ten in the premium single-serve RTD tea category in our active markets. And we plan to launch Teavana branded packaged tea in grocery channels by the end of the fiscal 2018. Channel Development's operating income grew 12% in Q3 and the segment delivered 130-basis-point improvement in operating margin to 43.9%, driven principally by lower coffee costs and higher income from our North American Coffee Partnership with Pepsi.

Let's now shift to the strategic actions we announced today. Despite our size and scale, Starbucks remains very much a growth company. The opportunities that exist for us globally are significant and we are doubling down on our investments in key profitable growth areas, including Mainland China and digital, to further accelerate growth in the years ahead. This shift in capital deployment towards more profitable, higher returning assets will result in increased focus and be accretive to returns going forward. You could hear of additional actions as we move towards and into fiscal 2018, but let's start with details around the actions we announced today, beginning with tea.

As Kevin mentioned, today, we announced the decision to close all of our Teavana stores. As a result of this decision, we took an asset impairment and goodwill charges of approximately $100 million in Q3. The charges are specifically called out in a separate line item on our income statement where we will also include various charges related to streamlining our operations over the coming quarters. Closure of the Teavana stores will occur over the next several quarters and additional related charges are likely to be incurred over the same periods. While resulting in near-term costs, removing the ongoing operating loss and associated overhead will result in a fairly rapid payback of our exit costs.

We're also extremely excited about expanding our ownership of the Mainland China market. Funding for the estimated $1.3 billion purchase of our JV partner's remaining stake in Mainland China will come from existing offshore cash and result in no additional debt. Excluding the substantial gain we will recognize on the acquisition, amortization of acquired intangible assets, and other acquisition related expenses, we expect the transaction to be break-even to slightly accretive in the first year. We expect accretion to build over time, as we integrate the acquired operations into our existing Mainland China business.

The acquisition will add approximately $1 billion in revenue in the first year following closing. The final sales price will not be determined until our fiscal Q2 of 2018. We will provide further detail around the financial impact of this transaction when we report our Q1 FY 2018 results in January and will likely schedule a separate modeling call related to the acquisition as we did in connection with the Japan transaction in 2014.

Clearly with this acquisition, we are entering a new phase of our growth strategy in CAP and we look forward to sharing additional details about the opportunity and our progress in CAP in the quarters ahead. At the same time as we are consolidating our position in Mainland China, we are shifting our 50% JV ownership in Taiwan to a fully licensed structure in exchange for approximately $175 million. This represents the largest licensing transaction in our history and is in complete alignment with our strategy to license in markets that we have growth potential, but where returns are better served by a partner with deep local expertise.

So, let's move on to 2017 targets. We said consistently that the back half of the year would show improvement compared to the front half. That continues to be our expectation, but we now expect results a bit lower than our previous guidance, given the choppiness we saw in Q3 and are seeing in early Q4. Specifically, we now expect revenue growth to come in at the low end of our previous guidance range of 8% to 10%, excluding one point of FX and two points of impact from the 53rd week in fiscal 2016. We are also projecting global comp growth for Q4 at 3% to 4%. As a result, our EPS guidance is revised as follows: full-year GAAP EPS in the range of $1.96 to $1.97 and full year non-GAAP EPS in the range of $2.05 to $2.06, representing an EPS growth range of 12% to 13%, excluding one to two points of FX. Fourth quarter GAAP EPS will be in the range of $0.53 to $0.54 and non-GAAP EPS will be in the range of $0.54 to $0.55.

We continue to expect non-GAAP consolidating operating margins to show slight improvement compared to FY 2016 on a 52-week basis. For segment operating margins in FY 2017, we expect Americas operating margin to be moderately lower than last year, CAP operating margins to show strong expansion, EMEA operating margins to be roughly flat to 2016, excluding FX, and Channel Development to post strong operating margin improvement for the year with Q4 margins roughly flat year-over-year. Looking at commodities and FX, our coffee needs are locked for fiscal 2017 and we expect commodities to be slightly favorable for the year. We are also 70% price-locked for fiscal 2018, at coffee prices roughly comparable to 2017.

As we've discussed our goal is to grow G&A at the core at half the rate of revenue growth and we are on track to achieve this goal for the year. Specifically, G&A as recorded year-to-date fiscal 2017 was up 5%, up 10% from last year after adjusting for current and prior year anomalies of approximately five points. Core G&A, which comprises over 80% of the total, was roughly half of the 10% increase with innovation G&A comprising the other half. We remain committed to managing our core G&A growth rate while investing for the near- and long-term and, as Kevin mentioned, renewed focus on our core business will positively impact our ability to keep G&A at or below the current target.

We have significantly increased our capital returns to shareholders over the past five years with buybacks up from roughly zero in 2009 to $1.2 billion this year to date in 2017. Going forward, we will continue to accelerate cash return to shareholders, and as we announced in Investor Day, to increase our dividend payout range to 40% to 50%. We now expect to open 2,200 net new stores globally in 2017. This reflects an increase of 100 net new stores for the Americas to 900 net new stores for the year. All other targets for FY 2017 remain the same.

At the time of our last earnings call, we were seeing significant positive momentum in our principal global retail markets, particularly the U.S. However, that momentum ebbed and flowed over the quarter. The actions we have put in place are beginning to gain traction, but stiff consumer and industry headwinds remain. So, while lowering current year guidance as we enter Q4 is difficult, given the uncertainty we are seeing in the marketplace, we feel that doing so is the better part of valor and the appropriate action to take. At the same time, we know that each of the strategic actions we announced today will strengthen our core and be accretive to future returns.

Consistent with past practice, we will provide 2018 targets on our Q4 call. This allows us to complete our annual planning process and have further clarity around critical investments in 2018 and more granularity around the timing and impacts of the strategic actions we announced today. Given all of this, we will also discuss any revisions to our long-range targets on the Q4 call. Despite our size and scale, Starbucks' financial aspirations remain unchanged, to be a best-in-class growth retailer at scale. As always, credit for our success today and tomorrow belongs to our 330,000 passionate Starbucks partners around the world who deliver an authentic Starbucks Experience roughly 90 million times around the world each week. Our partners have our great respect and appreciation.

With that, I'd like to turn the call over to the operator for Q&A. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator instructions] Your first question comes from John Ivankoe from JPMorgan. Your line is now open.

John William Ivankoe
Analyst, JPMorgan Securities LLC

Q

Hi, thank you. The question is just broadly on the Americas business. Your comps aren't quite what you hoped they were going to be, very well documented consumer and industry issues, yet 900 net new stores in the Americas, which is a big addition. You could potentially put pressure on comps, which is what I'd like you to talk about and also difficulty in attracting or retaining labor this far into an economic cycle. So, the question is really two different things. Does it make sense to begin to think about whether that 900 net new stores in the Americas should hit a plateau or even come down over time, given challenges that may even worsen in the out years? And then secondly, if you can update us in terms of your practices of attracting and retaining partners, at this point, both for existing and new stores.

Scott Harlan Maw
Executive Vice President and Chief Financial Officer, Starbucks Corp.

A

Thanks, John, it's Scott. I'll take the first part and then I might have John Culver help me a bit with the second. The first thing I would say is our portfolio growth rate in the U.S. has stayed pretty constant over the last few years, so while the number of stores have come up, the percentage of portfolio growth has stayed pretty stable.

And we're able to track quite accurately the cannibalization results that happened from those new stores, and what we've seen over many years is very, very little impact of net new cannibalization of those new stores. And I attribute that to a significant improvement in the analytics under Matt Ryan's team of where we place stores, the trade areas we place stores in, the type of stores that we're putting in those trade areas, and so we continue to see that kind of very, very small cannibalization and extensive store growth opportunities. And the only other thing I'll say before I hand it to John is remember that that 900 is split roughly evenly between company-owned stores and licensed stores, and those licensed stores are unique opportunities for us to get access to real estate.

John, do you want to talk about labor?

John Winchester Culver
Group President-Starbucks Global Retail, Starbucks Corp.

A

Yeah, just real quick. One thing I would just add on the new stores and the performance, clearly, we believe that there's still a long runway for growth for new stores in the U.S. And there's a lot of opportunity to continue to infill. We are seeing strong performance, not only in our core stores in the new stores, but then also through drive-through. And we're going to continue to focus in this area. We have not seen cannibalization, as Scott highlighted, and we believe in the growth strategy we have in place. It's been 13 consecutive quarters that our new and non-comp stores have contributed at least 4% to our growth on a quarter-to-quarter basis, so I feel good about the trajectory that we're on.

In terms of partner retention, obviously we continue to make investments in our people, both in terms of wage and in terms of benefits. We continue to see retention increase. In the most recent quarter, our retention sequentially increased versus the previous quarter as well as versus last year's same quarter.

We feel good about the partner engagement that we have in our stores. When you look at how we measure partner engagement, those scores on a year-over-year basis exceeded last year. So, we feel good about the engagement that we're having from our partners, and then more importantly, how that translates into the customer experience. And we all know that our partners bring the experience to life for our customers, and, as part of that high level of engagement that they have, our customer experience scores are sitting at record highs right now, so we feel good about what we're seeing there.

Operator: Your next question comes from the line of David Tarantino from Baird. Your line is now open.

David E. Tarantino
Analyst, Robert W. Baird & Co., Inc.

Q

Hi, good afternoon. I have another question on the Americas business. I guess, as we think about the trends you saw through the quarter softening after April, there's been a lot of talk on the call about sort of macro issues. I was just wondering how you determine that this is more of a macro issue and not a company-specific issue. And perhaps could you comment on whether you think April was just inflated by the Frappuccino launch, and maybe when you take that out, maybe the trend has been a little bit more stable or do you actually see a deceleration in the overall business? Thanks.

Matthew Ryan
Global Chief Strategy Officer & Executive VP, Starbucks Corp.

A

Thanks, David. Matt Ryan here. And I want to get to the short-term question. Well, let me frame first with a little bit of a long-term view here, which is that in the U.S. and just about any other market we've studied, there's been a decades-long trend for growth away from home, food and beverage consumption, driven by demographics and people just want more convenience. And we're strongly bullish on the long-term continuation of that trend.

However, in the past year, we've seen some pullback from that trendline, as we have from time to time, with consumers in the U.S. shifting some discretionary spend to other categories. We look at all sorts of sources of data here, including corroborating credit and debit card spend data. But we think the best source of industry comp intelligence comes from the APT index, which is a metric developed by Applied Predictive Technologies, that's the name of the company, that aggregates and tracks actual comp data from a broad set of more than 100,000 retail restaurant and QSR competitor locations on a weekly basis, allowing us to understand just how well we're doing versus important benchmarks.

And for Q3 overall, the APT index showed decelerating and negative comp for QSR and restaurant industries, while Starbucks' own metrics accelerated comp to 5%. In fact, the differential between Starbucks and the industry increased significantly in Q3 compared to the past several quarters, and that's just on the comp stores. It excludes the effect of any further market share gains we have as a result of our strong pace of new store openings.

Within the quarter, we did see some deceleration in month-to-month comp performance for both industry benchmarks and Starbucks, but Starbucks steadily outpaced the competition. And I'll let [ph] someone else (51:56) comment on that as well.

What we really think this is about is the strong performance in share capture having to do with the pipeline of product innovation, the continued improvements to store operations that you heard about, and growth in digital engagement. And it's the trifecta of these three things: product innovations, ops excellence and digital, will continue to support market share capture in the short term. And should the current pullback in industry performance go back to the long-term trend, as we think it will, it will help align us and set us up for success there.

Operator: Your next question comes from the line of Sara Senatore from Bernstein. Your line is open.

Sara Harkavy Senatore
Analyst, Sanford C. Bernstein & Co. LLC

Q

Yes, thank you very much. I'd like to also just ask a few questions about the comp drivers going forward. On the core coffee, it sounds like it's been a bit softer for the last couple quarters. So, I'm just trying to understand what might be driving that. We know some of the QSRs have gone aggressively against coffee beverages and I was wondering if it might be competitive in nature. And then food, by contrast, is doing quite well. So, as we think about that going forward, is this largely going to be a kind of a ticket-driven comp with attach driving that food? And how do we think about food offsetting the core coffee? Thanks.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Yeah. Sarah, this is Kevin. I'll comment and then hand to John Culver. In our U.S. business, 2 points of our comps came from our core beverages, and that's across all dayparts. So, certainly, our core coffee and espresso and core beverages contributed 2 points of comp. Food contributed 2 points of comp and then innovation beverages contributed the other 1 point. So, there's 3 points of comp from beverage, 2 points from food. And that just highlights why it's important for us to continue to drive innovation, both in food and in beverage.

So, when you think about the innovation on beverage side, we've got a number of new things we've been doing around both hot and cold. You take some of the iced espresso beverages that we've been launching and bringing to market, Iced Macchiato is an example, continued innovation and deployment of Nitro into more stores for Nitro Cold Brew, very popular. Certainly, this quarter, the Teavana Infusions is an example of that. And then in the last quarter the Refreshers; kind of evolved around the Pink Drink as an example, but the Refreshers also helped. So, we've seen good comp growth from not only our core beverages, but also the innovation that we've been doing around other beverages as well as food. John, I'll let you add other comments if you have any.

John Winchester Culver
Group President-Starbucks Global Retail, Starbucks Corp.

A

Yeah, just to add a few things to what Kevin expressed. First off, we're very pleased with the success food is having in our stores and the continued attach rate. And we talked about the success across all dayparts and the growth that we saw in the quarter across all dayparts. Lunch was the fastest growing daypart and it was driven by food attach, as well as our refreshment and iced beverages. And when you break down that beverage growth for the total quarter, we saw good growth in espresso, core espresso. We saw growth in brewed and we did see growth in blended as well as refreshment, all right?

And to put a finer point on that, a couple of highlights there. First was Iced Coffee and Cold Brew. We actually grew Iced Coffee and Cold Brew 33% in the quarter. In addition, we also grew iced espresso, a core beverage, plus 27% in the quarter. And then refreshment, driven by Pink Drink, grew 57% in the quarter. So, we're seeing strong growth as it relates to core, as well as refreshment and in iced drinks.

From a food standpoint, we saw innovation come into the quarter with the new protein boxes and the enhancements that they brought and the additional attach that they drove at lunch. We also saw growth in our core bakery and breakfast egg sandwiches in the morning daypart, which was great. And then we continue to see great success with the Sous Vide Egg Bites and we have plans to have that available nationally in the early part of August, which we're excited about.

So, we feel good about the mix. Clearly, we want to continue to focus on transactions, and transactions is all about making sure that we're building those customer connections and that we are operating our stores at the level we expect and that our customers have come to expect.

Operator: Your next question comes from the line of Jeffrey Bernstein from Barclays. Your line is now open.

Jeffrey Bernstein
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much. Just following up on the U.S. trends that you talked about kind of post-April, I'm just wondering whether you – as you read the data, whether you see a noticeable change in the actual consumer behavior, or perhaps the way they're using Starbucks products. Just wondering, kind of as you tie that in with maybe promotional activity, it seems like the industry is aggressive. I was just wondering whether you'd characterize Starbucks as being aggressive or what type of offers are more successful. Fearful that maybe people are getting too aggressive with the promotions where you can actually turn off customers, especially with the one-on-one offers. So, anything related to change in usage patterns and the aggressive nature in terms of your promotional activity.

Scott Harlan Maw
Executive Vice President and Chief Financial Officer, Starbucks Corp.

A

Yeah, thanks, Jeffrey, it's Scott. What I would say is there was no real impact other than the normal positive lift we saw all quarter around Starbucks Rewards. So we're not seeing any fatigue at all on the offers or in personalization. If anything, as Matt discussed, that's accelerating.

What I would say, and I think this is what John was talking about, we did see some softness in the afternoon. It grew, it just grew a little bit less than we had expected and that was partly Frappuccino, but not only Frappuccino. We saw some softness in some of our iced products, as well, again versus what we expected, they still grew, but just a bit lower as we moved through the quarter. And then Morning Peak, as I said in my prepared remarks, that accelerated linked quarter, which was great because we're starting to see real traction around some of the throughput things we're working. But again, the acceleration we saw as we moved through the quarter wasn't quite as much as we'd hoped. And so, that's how I would describe the slowdown. It wasn't really in that promotional afternoon period, and we didn't see any impact from what we do with Starbucks Rewards other than continued lift and acceleration.

Operator: Your next question comes from the line of John Glass from Morgan Stanley. Your line is open.

John Glass
Analyst, Morgan Stanley & Co. LLC

Q

Thanks very much. When you look at the last four or so quarters in the U.S., transactions have been roughly flat. So, it seems like you're not attracting new customers, you're getting a lot out of your existing customers, and that's been one of the benefits of My Starbucks Rewards. So, when you talk to the customers that either aren't going or lapsed, what do they want to see from Starbucks that would get them to come? In other words, is it a value issue that keeps them away? I mean, retail may be tough, but many QSRs are thriving in this environment. Maybe it's because you're emphasizing value and that's not the game that they play. But what is it that people who don't go to Starbucks want that you can try to provide them that would get them to come? It seems like the brand is well known, but it's narrowly used.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Yeah, John, this is Kevin. I'll comment and then hand it over to Matt to add to this. I think, as Scott said, there's no evidence that the discounting that's going on amongst the value players is affecting us. I think they serve a different market and we're very focused on the product innovation and the more premium experience that we think attracts a different customer type. And so, the things that we've got to continue to do are number one, we've got to ensure that operational excellence in our stores is maintained and constantly enhanced. Now, we saw growth in every daypart. A lot of the operational enhancements in our stores has been focused on peak to make sure that we're creating a great improved experience in those stores with high volumes with Mobile Order & Pay, great progress there. And then it's also product innovation. I think, as John mentioned, the product innovation we've had both around food and beverage has helped us in the lunch daypart, in the afternoon day part. And then the third aspect, in addition to a great in-store experience in food and beverage innovation is as we bring new customers into Starbucks, one of the most important things we want to do is find ways to establish a digital mobile relationship with those customers, even if they're not at the point of joining the Rewards program.

And so, that's a lot of what Matt talked about in his section on the digital agenda. We're going to now start opening the aperture of the reach that we can get with the digital mobile relationship and we're going to start by experimenting with things on this guest checkout and some other initiatives that we have on the digital side. But I think the key has got to be a great in-store experience and innovative new food and beverage offers that bring those customers in or perhaps, who are less frequent into the stores and then figure out how to translate that into a longer relationship. And I'll let Matt extend his thoughts.

Matthew Ryan
Global Chief Strategy Officer & Executive VP, Starbucks Corp.

A

Yeah. Not a lot more to add to that except for that when you're in a difficult periodic from time-to-time operating environment, what becomes very critical is your ability to talk to customers. And we saw that clearly in the results. It wasn't anything more than our ability to communicate that helped bring in our Starbucks Rewards customers at the level they were doing. So, for us it's important to extend the number of relationships we have so that we can continue to bring people into the franchise and we have plans to do that.

Howard S. Schultz
Executive Chairman, Starbucks Corp.

A

This is Howard. I was just going to remind people, we seem to be focusing a great deal on the slowdown in the second half of the quarter, and potentially the early part of April, but let's re-establish the fact that we had a 5% comp in the quarter and a 1% increase in traffic. We have not seen any other retailer or QSR company this quarter report a 5% comp. So, while you are beating us up a bit for lowering comps for Q4, which is the better part of valor because we are only three weeks into July, which is linked to the last quarter, let's reestablish common language. We had a 5% comp, 1% increase in traffic, and a 6% increase in China, mostly on traffic, while we're doubling down on the growth and development in China, which we have said publicly will be as large or bigger than our U.S. business. But once again, 5% comp, your number, in the quarter.

Operator: Your next question comes from the line of Matt DiFrisco from Guggenheim Securities. Your line is now open.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC

Q

Thank you very much. My question is with respect to sort of looking at the earnings side related in the fourth quarter to that 2% to – 3% to 4% comp that 12% to 13% growth. How much of that earnings growth is reflective of that 3% to 4% environment versus some new investments that you started to begin to talk about that are going to take effect in yield in 2018? I wonder is the model supportive in a 3% to 4% comp environment, 12% to 13% EPS or is that diluted also from some ramped-up investment to return to mid-single digit comps for 2018?

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Great. Thanks for the question, Matt. Just to remind you, what we guided last quarter for the fourth quarter, I think it's important for the question. So, last quarter, we adjusted our rest of year earnings guidance because of an impact we saw from the Teavana mall store performance. That will continue as we get ready to close those stores. We also significantly increased our investment, primarily in the fourth quarter around what we call Cyber Retail, so Reserved, Roastery and Princi, as well as digital.

So, the short answer is indeed the fourth quarter reflects an acceleration in those investments, so that's important. And then the second thing is there is a little bit of slowdown in the earnings growth in the fourth quarter compared to what we guided last time from the lower comps, both in the U.S. and in Japan, but the last quarter, you'll remember, we adjusted fourth quarter because of those investments, so that is an increase as we move through the year.

Operator: Your next question comes from the line of Karen Holthouse from Goldman Sachs. Your line is now open.

Karen Holthouse
Analyst, Goldman Sachs & Co. LLC

Q

Hi. So, taking a step back, if, hypothetically speaking, some of these headwinds, whether it's retail traffic or food app, food away from homes don't go away, are there particular things that we should be looking at or initiatives layering on the horizon that you think would be able to be pretty proactive changes in the comp trajectory? Specifically, the digital management tool, is that so that you can go back to driving growth at peak in those stores? Maybe the Mercato lineup, just anything you can kind of think of layering in going out through fiscal 2018? Thanks.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Yeah, Karen. This is Kevin. I'll comment and then hand it over to Matt. Clearly, the initiatives that we're driving around food and innovation around food and beverage is driving lift today, and that's going to continue to help us in comp going forward, independent of what's happening in the industry and the initiatives that we have in digital. And sort of the outline that Matt took you through.

I think the fundamental improvements we're making in throughput and the customer experience, especially at peak, those are three things that are giving us good results today and those results will continue. So, Matt maybe I'll let you comment a bit more on the digital.

Matthew Ryan
Global Chief Strategy Officer & Executive VP, Starbucks Corp.

A

Yeah. Just to re-summarize digital, you have to think about it as short-term and long-term things we can do to unlock value in digital. In the short term, we're going to continue to lean in hard to personalization and that spend per member [ph] metric (01:06:36), so we see that coming. But we also have a major opportunity to lean hard on customer acquisition, as well too, and we have strong plans throughout the remainder of this quarter and into next to do exactly that.

In addition to that, moving forward, we laid out some broad ideas for where the digital flywheel goes down the road, and by broadening the digital flywheel beyond the narrow aperture of people with stored value cards and Rewards right now, we see large long-term opportunities for growth by creating more digital relationships. And we see, even in a tough environment like today, digital relationships enable us to communicate with customers and bring them into our stores with frequency.

Operator: Your next question comes from the line of David Palmer from RBC Capital Markets. Your line is now open.

David Palmer
Analyst, RBC Capital Markets LLC

Q

Thank you. Matt, Kevin, you both mentioned detailed plans to get after the digital customer and acquiring those customers has a powerful impact. That growth in that customer has slowed over the last few quarters and you're talking about the Chase collaboration. Is that the major way that you're going to get after getting new customers? And if so, do you have any sense of how meaningful that can be and what the runway would be? Thank you.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.
A

There are a few things here. First of all, just as a reminder that the lower 8% number that we reported in membership growth for Starbucks Rewards this quarter was a result of having had last year an unusual growth in Q3. So, if you look at our two-year growth, it's still at 26% year-on-year and it's fairly consistent.

That said, we know that there's more for us to do and we're going to continue to lean in. Chase will become a reason why we'll engage more people down the road, but in the short term, we see some significant promotional and just old-fashioned block and tackle customer acquisition opportunities in the quarter ahead, as well as continued improvements to the user experience and the sign-up experience to reduce frictions that cause people to drop off in the activation funnel. So, we're leaning in hard in that in the short term and then we have a lot more plans in the longer term including Chase.

Matthew Ryan
Global Chief Strategy Officer & Executive VP, Starbucks Corp.
A

David, I'd just remind you that the increase from last year that was higher than normal was when we launched the new program. We had a lot of marketing and promotion against that.

John Winchester Culver
Group President-Starbucks Global Retail, Starbucks Corp.
A

And David, one of the things I would just add, this is John, we are also looking at ways that we can activate our customers in the stores. How can our stores become much more active to activate and bring new Rewards members into the program and that's something else we're looking at, as well.

Operator: Your next question comes from the line of Jason West from Credit Suisse. Jason, your line is now open.

Jason West
Analyst, Credit Suisse Securities (USA) LLC
Q

Yeah, thanks. I guess it's along the lines of these investments, and you guys talked about some investments last quarter as well. Were these contemplated in the longer-term guidance that you had provided or are you sort of stepping up the level of investment here in the near term and we should expect that to put a bit more pressure on margins than usual, I guess, particularly in the Americas segment? Thanks.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.
A

Let's talk about this year and then the longer term. Jason, what I would say is last quarter we definitely stepped up the level of investments this year and that's part of the reason we adjusted guidance last quarter. And as I responded to Matt, that was a piece of the reason the fourth quarter earnings growth decelerates a little bit. Broadly, what I said about the three different investments in the profile, is for Siren Retail investments, so, Reserve Roastery and Princi. Those, as far as their impact on margin this year, I think it's at its peak this year. We will continue to grow those investments from a dollar basis, but because we have a significant number of Roasteries that are in pre-opening right now, the impact on March is pretty high. And as we get into next year, it will be lower. It will still increase in investment. When I look at partner investments, I think we're in the middle of that cycle, so, we'll continue to lean in on partner investments as we get into next year although again, we'll talk to you a little bit on what happens from a margin standpoint as it relates to those.

On digital investments, we continue to grow that and it will continue to grow from a dollar spend year-on-year. Some of that is capitalized, so the impact on margin and P&L is a little bit less. But the reality is, all of those investments, particularly around digital and around partner investments, we need to continue to make those because they're driving the kind of returns that allowed us to do a 5% comp this year and take additional share.

Operator: Your next question comes from the line of Andrew Charles from Cowen and Company. Your line is now open.

Andrew Charles
Analyst, Cowen & Co. LLC

Q

Thank you. Kevin, switching gears a little bit, your discussion about the opportunity to partner with third-party digital firms reminds me of around five years ago when Starbucks discussed opportunities to partner with third-party technology or financial services companies and monetize the My Starbucks Rewards loyalty data. Just given your background and connections in the tech space, are these partnerships you're looking to enter involve revisiting these conversations?

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Well, I think, Andrew, clearly, the entire retail sector is going through this massive disruption and it's clear that the winners coming out of this are going to be those companies who find elegant ways to bring an in-store experience together with a digital experience. And I highlighted the number of examples of companies and the work they're doing, you know, including the most recent discussion around Amazon's announcement to combine with Whole Foods. And so, we certainly have a lot of experience in different partnerships with digital tech companies that we've engaged in over the years. And I think we're continuing to have dialogue with a number of pure-play tech companies around are there things that we could do that create significant breakthroughs? And we're going to continue those discussions and see where it leads us. But it is about accelerating the pace of transformation that we're going through. Howard, you want to add to that, please?

Howard S. Schultz
Executive Chairman, Starbucks Corp.

A

I would just add, as Kevin had in his prepared remarks, what we've seen over the last few months with Walmart and Jet.com and PetSmart and Chewy and most recently Amazon and Whole Foods, I think this is just, we're in the nascent stage of these kinds of commercial relationships that are going to elevate the experience of a brick-and-mortar retail company. And having said that, Starbucks is probably best positioned, given our national footprint, the demography of our customers, and where we're located to have those kinds of conversations. I think it would be premature to kind of get into who they are, but clearly, we are a very viable partner, given the change in the industry.

Operator: Your next question comes from the line of Andy Barish from Jefferies. Your line is now open.

Andrew Marc Barish
Analyst, Jefferies LLC

Q

Hey, guys. One more, I guess, on the margin side of things. It seems like the focus on the mix in the Americas U.S. stores is shifting more to food and kind of hand-crafted beverages, which, I think, have lower gross margins, as you pointed out, more labor complexity to them. What is the offset to that over time, if in fact, that's going to continue to be the sort of main products that help drive comp right now?

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Yeah, Andy, what I would say is hand-crafted beverages actually have some of the higher margins on a gross margin basis that we have in our stores. So, that includes iced teas and espresso beverages, very high gross margins and actually quite high operating margins, as well, even with the labor. But I take the spirit of your question. The way I would describe it is the challenge we have a bit with our mix is mostly versus what we had forecast in the quarter, where food is actually coming in a little bit stronger, which is a good thing because it's accretive to operating margin after leveraging all of the fixed cost and labor and rent, so that's the first thing. Where we've come up a bit short, and it's pressuring gross margins is, we just don't have quite as much beverage comp as we would like to see. So, adding more hand-crafted beverages, more iced teas, more core beverages, that will help with the mix challenge that we have. And I think as you see comps hopefully accelerate as we move through and into next year, that will help with the gross margin. So, it's really strong food growth and a little bit underweighted mix from beverage.

Operator: Your next question comes from the line of Gregory Francfort from Bank of America. Your line is now open.

Gregory R. Francfort
Analyst, Bank of America Merrill Lynch

Q

Hey, guys, just one quick one. Can you just help us on the China business provide any insight into just the recent margin profile and sort of rough margin breakdown? As we think about sort of over the longer-term China's contribution to the growth algorithm, is this something that's going to be additive to the longer-term algorithm or do you view it as replacing some of the U.S. contribution, just given the size and scale of that business? I guess, is it an additive piece or maybe more of a replacing, in terms of the longer-term thinking?

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Yeah, Greg, let me start. This is Kevin and then I'll hand it over to Scott for some specifics. First of all, we have been in China now for 18 years. And as a company, we have worked very diligently to build our brand, build relationships with our partners, create beautiful stores, a connection to customers, and when you think about a consumer brand that has more reach and relevance across China, it's hard to think of anyone that is better positioned.

Number two, the unification of Mainland China as a company operated model will enable us to accelerate the pace of growth, and do it in a way consistent with the values and the culture that we've created in China. We have a world-class leadership team with Belinda right here on the phone with us today. And so if you think about the next two decades, I think the growth opportunities before us are unparalleled by anyone. So, I think of this as we have two major growth engines for Starbucks: the U.S. that's operating at scale and China that has this huge runway of growth in the form of new stores and reaching millions, tens of millions, of more customers. And so, both of them are core to what we are doing and they're core to our strategy, which is why the strategic actions we announced today, we believe are the right things to do because it allows us to put more energy and more focus behind the things that matter the most. Scott, you want to...

Scott Harlan Maw
Executive Vice President and Chief Financial Officer, Starbucks Corp.

A

Yeah, I think the only thing I would add to that is when you look at the performance of China, we've got 20% revenue growth and operating income is growing quite a bit faster than that. So, operating margins in China have been expanding at a pretty rapid rate over the last handful of years. So, as we look at this acquisition, we see significant opportunity once we get through probably the first year or so, where we get a little investment done, some integration done to significantly accelerate the East China market and broaden the types of returns we've seen across the rest of Mainland China.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Belinda, do you want to add anything before we close the conversation on China?

Belinda Wong
Chief Executive Officer, Starbucks Greater China

A

Sure. Thank you. What I would add is that the momentum for our business here has never been stronger, and it's really the early days of China. Yes, we have been investing heavily ahead of the curve, but we're really just in chapter one and I think this acquisition will really well position us to leverage our scale and the infrastructure we already built. But again, this is only at its very early stage and we have to continue to invest in our infrastructure, our system, and especially our people. And with the middle class rising, the coffee consumption rising, people picking up more and more drinking coffee, I see enormous opportunities ahead, and we're really just getting started.

And one last thing I would add is that our job every day here is to make new friends and get new connections going and really being very good at getting new customers to understand Starbucks and to go through the Starbucks journey. That is what we have been doing the last 18 years, basically, and I see that as our focus and we'll stay laser-focused on bringing new customers into our business and continue on with our new store growth in China.

Howard S. Schultz
Executive Chairman, Starbucks Corp.

A

The question that was asked earlier of Kevin regarding potential commercial partnerships with tech companies or pure-play digital companies, we've learned a great deal from the relationship we have with Tencent in China. In only six months we've had over 2 million social gift transactions, which is just an unbelievable level of acceleration and velocity in a very short period of time. We do not have social gifting at that level here in the U.S., but clearly, we've got sightline on what that could be in the U.S. and the relationship that we have built with Tencent.

So, the other thing I'd say is when you asked the question, a lot of the answer is based on the fact that bricks-and-mortar retailers are in need of a pure-play digital partner. But what we're also seeing in these discussions is that the digital companies and tech companies realize more than ever that there's going to be one customer interface, and that interface is as important to a tech company to have a brick-and-mortar relationship as it is for a brick-and-mortar relationship company to have a digital relationship.

And so, once again, I think you're going to see lots of these kinds of things take place, as well as what I've been saying for the last few years, and that is, a level of consolidation and store closures, which we've all seen. But Starbucks, despite the cyclical issue of the macro environment, we are in the mix not only in these conversations, but clearly, the level of store growth, the level of customer profile, and the continuation of the velocity of building the equity of the brand domestically and around the world, and as Kevin said, the power we have to grow two businesses at once, a more mature business that clearly is not saturated here in the U.S. with the number of stores we continue to open with great success, and as Belinda said, the very early, nascent stages of what we're going to have, which is thousands of retail stores in China, multiple points of distribution in terms of product, and a digital relationship with multiple companies, based on the fact that the consumer in China is well more advanced than the U.S. consumer in terms of being a digital native.

And we are at the intersection of that in ways that no other brick-and-mortar company is in China, based on the fact that we're in 130 cities with 2,800 stores, but it's also the profile of the consumer in China, and with almost $1 million AUV in the morning ritual starting in China building almost every day, this business in China, I think, is significantly underestimated both by the people who analyze our business and, I think, candidly, in the market value of Starbucks.

Operator: Your next question comes from the line of Nicole Miller from Piper Jaffray. Your line is now open.

Nicole Miller Regan
Analyst, Piper Jaffray

Q

Thank you. Good afternoon. I very much respect and understand the prudent nature of revising your guidance as you exit the year. The number one question I get asked from investors, so I'm hoping you'd be willing to address it, is why not just do so for the long-term guided range? I think the algorithm currently states 10% to 15%, and again, it's the number one question I get asked. So, do you want us to think about that differently going forward, either to the lower end or an actual restatement or removal of that as you go forward? Again, just to the nature of being as transparent and prudent as you can be. Thank you so much.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Nicole, this is Kevin. Thank you for the question. As we think about long-range guidance going forward, we certainly understand and acknowledge the question. People look and say, FY 2017 year-to-date performance has been slightly below that long-range guidance, and so it's a valid question.

First of all, I think it's important to know that when we guide for fiscal year 2018 next quarter, we will also in that guide provide you with any updates to our long-range guidance. Now, you might say well, why do you wait until then? Well, look, we've got line of sight to what – these strategic announcements we made today. Scott commented on the fact that East China acquisition is neutral to accretive in year one. We've got some variability in the Teavana mall store in terms of the pace of closures that we've got to work through over this next quarter. And so, I think it's important for us to take the time to ensure that if there are any other strategic actions we take between now and Q4, that we factor those into long-range guidance, that we have the final results for FY 2017 as the basis for long-range guidance. And then, frankly, we're right in the middle of creating our annual operating plan for fiscal year 2018. And we think it's important that that annual operating plan is completed as part of any update we give in long-range guidance. And then you should expect that on our October call.

And I appreciate that's a question and I know it's an important one and I just ask for your patience, but we are completing the process and the things to do it thoughtfully and responsibly and be transparent with you and our investors.

Operator: Our next question comes from the line of Will Slabaugh from Stephens. Your line is now open.

Will Slabaugh
Analyst, Stephens, Inc.

Q

Yeah, thank you. Wanted to shift back to China for a minute if we could. If we're able to look out one, two, three years down the road, will we be talking more about tea, coffee, or food growth in China? And how do you think that that might change versus what you're seeing today?

John Winchester Culver
Group President-Starbucks Global Retail, Starbucks Corp.

A

This is John. I know that you'll be talking about growth across all those categories. Clearly, the growth of espresso-based beverages and the way in which our customers in China have embraced that, we see a long runway for growth, and we have a strong innovation pipeline around that. In the comments we talk about tea and the growth of tea that we've seen since we've introduced Teavana being at nearly 60% in China and Japan, and so tea will continue to be a focused area as well.

In food, we've just done a lot of work around transforming our food program in China and rolling that out to our stores and we're seeing traction. So, we're going to continue to grow across all categories. And when we open up the Shanghai Roastery, that will give us a whole other level of innovation that we are going to be able to bring into our stores, whether it's coffee-based beverages or tea-based beverages or our food items. So, Belinda, I don't know if you want to make any…

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

Yeah, Belinda, maybe you could give us some more color and share a little bit more of how you're driving both food and beverage innovation and what you see unfolding here over the next few years in China.

Belinda Wong
Chief Executive Officer, Starbucks Greater China

A

Yes, well, thank you. When you look at our 7% comp, what's nice about it is it's mostly from transactions. So, we're getting new customers to come in and trial the experience. And also, what's nice about that is we see growth in all dayparts. That means we're serving different segments of customers. Some come in for our breakfast and we're seeing morning daypart increase as well as the afternoon and evening. So, we continue to open stores to serve different customers and their needs.

Like what John said, we're heavy up on our investment on food. We're also seeing great results from our launch of Teavana from last year, especially summertime right now and the iced tea is doing very well. And this is only the beginning and we're going to double-down again on our investment for afternoon refreshment in the tea category, especially in the afternoon segment.

So, I guess what I'll summarize it to be is that, we're going to laser-focus on making sure all dayparts will be relevant for different customers, depending on the location, the cities that we're in. We're also opening a lot of new stores and entering new cities as we meet our customer for the first time. So, we're doing all that at the same time, and I'm very certain that we'll see growth in all dayparts coming in the next few years.

Operator: And our last question comes from the line of R.J. Hottovy from Morningstar Research. Your line is open.

R.J. Hottovy
Analyst, Morningstar, Inc. (Research)

Q

Thanks. Just one last question on U.S. and really around product innovation here. One of the things we're hearing from a lot of the QSR and other restaurant firms is more on the menu simplification part of the equation, and obviously, it seems like you're going against the grain on that with more products and more innovation. What's the right balance? What is your analysis showing in terms of the right balance with the right amount of products on the menu? Is it something that could streamline and speed up the throughput process? Just kind of curious to get your thoughts on that as you look at a number of the things within the restaurants?

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

R.J., this is Kevin, I'll start and then hand over to Scott to add to it. First of all, one of the things that we're always very thoughtful about, as we're doing innovation around food and beverage, is to be thoughtful about how that lands in the store and the experience it creates for our partners who prepare the food and beverage for customers and for customers. And so, if you think about much of the work we do is innovation around what we think of as platforms. And we are, in many ways in beverage, we have the capability to customize beverages for individual customers at scale. And the way we've been able to do that is be very thoughtful about the platforms that we launch and then the things that differentiate or allow a customer to differentiate and customize that platform. Example would be when you think about our espresso platform. Certainly, customers can substitute different types of milks, whether it's coconut milk or almond milk and the set of things we've done there. Flavor profiles.

So, by being thoughtful about how we do that innovation, we actually do it in a way that simplifies that customization in our stores for our partners. That said, we always have to be cautious that we're not expanding the platforms or the complexity or the SKU counts too much.

The final comment I'll make, and I'll hand over to Scott, is that I also think we're going through an exercise right now, really looking at the SKUs and doing some SKU rationalization. We're not at end of job on that, but I think that's one that we're constantly looking at the long tail of SKUs that are low volume in stores and figuring out how to constantly prune those and put more energy than in keeping things fresh and vibrant for customers. Scott?

Scott Harlan Maw
Executive Vice President and Chief Financial Officer, Starbucks Corp.

A

I would only add I think Kevin nailed it on the beverage customization side. There is opportunity around food and around packaged coffee in our stores and we're in the process of looking at that, so we'll come back to you in future quarters as we work our way through that.

Kevin R. Johnson
President and Chief Executive Officer, Starbucks Corp.

A

You said last thing...

Howard S. Schultz
Executive Chairman, Starbucks Corp.

A

Yeah, just the last thing. I think one of the hallmarks of Starbucks, which continues to be highly relevant, is customization, and our ability to customize beverages is not about the number of SKUs we have. It's about the customer's demand and preference to customize their own beverage. And so, when it goes back to the question about our people and retention and the training, this is where we are at our best and this is where we do not have any other company in our space that is even second to us.

So, I think you're going to see us play up customization at a higher level as we enter fiscal 2018, because we've always known how important that is, but it's becoming more and more important with this millennial consumer.

So, just in closing, what I would say is we remain as optimistic as ever about the future of our company. We thought it was very prudent to really share with you what we experienced at the tail end of the quarter, and what we're experiencing the first few weeks, only three weeks into the 13-week quarter in Q4, but enough information to just be sensitive and be straight with you. We understand the question about long-term guidance, but as Kevin said, we have a lot to absorb and digest while we are in the AOP period, and like always, we'll be straight up and be very honest with you about where we stand. But our optimism for what we're doing inside the U.S. and what we announced today in China has never been stronger, so you should hang up this call, I hope, with realizing how bullish we are and how strong we feel about the future of our company. Thank you very much.

Operator: And at this time, I'd like to turn it over to Tom for any closing remarks.

Tom Shaw

Vice President-Investor Relations, Starbucks Corp.

Thanks again, everybody, for joining us and we look forward to speaking with you again on our fourth quarter earnings call, which we have tentatively scheduled for Thursday, November 2. Thanks.

Operator: This concludes Starbucks Coffee Company's third quarter fiscal year 2017 earnings conference call. You may now disconnect.