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Starbucks Corp. (SBUX)

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Hector, and I will be your conference operator today. I would like to welcome everyone to Starbucks Coffee Company's Third Quarter Fiscal Year 2018 Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. [Operator Instructions]

I would like to turn the call over to Tom Shaw, Vice President, Investor Relations. Mr. Shaw, you may begin your conference.

Tom Shaw

Vice President-Investor Relations, Starbucks Corp.

Good afternoon, everyone, and thanks for joining us today to discuss our third quarter results for fiscal 2018. Today's discussion will be led by Kevin Johnson, President and CEO; Roz Brewer, Group President, Americas and Chief Operating Officer; Belinda Wong, CEO, Starbucks China; and Scott Maw, CFO. For Q&A, we'll be joined by John Culver, Group President, International, Channel Development and Global Coffee and Tea; and Matt Ryan, Chief Marketing Officer.

This conference call will include forward-looking statements which are subject to various risks and uncertainties that could cause our actual results to differ materially from these statements. Any such statements should be considered in conjunction with cautionary statements in our earnings release and risk factor discussions in our filings with the SEC including our last Annual Report on Form 10-K. Starbucks assumes no obligation to update any of these forward-looking statements or information.

GAAP results in fiscal 2018 include several items related to strategic actions including restructuring and impairment charges, transaction and integration costs, gains related to changes in ownership of international markets, and other items. These items are excluded from our non-GAAP results. Please refer to 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.

This conference call is being webcast and an archive of the webcast will be available on our website as well through August 25, 2018. I will now turn the call over to Kevin.

Kevin Johnson

President, Chief Executive Officer & Director, Starbucks Corp.

Well, thank you, Tom, and good afternoon and welcome, everyone. On today's call, I will provide an overview of our financial performance in Q3, expand on the business update we provided last month, and reinforce our strategic priorities going forward. Then I'll turn the call over to Roz and Belinda to report on our Q3 operating performance in each of our two key markets, the U.S. and China, and update you on our plans for each market going forward. Scott will then take you through the Q3 financials in detail and we'll turn the call over to the operator for Q&A.

Starbucks revenues in Q3 totaled a record $6.3 billion, up 11% over last year driven by consolidation of our East China business, strong performance from new stores, favorable FX, and comp sales increases of 1% both globally and in the U.S. Excluding FX and the net impact of streamlining activities, revenues were up 7%. June comps in the U.S. and Americas landed as expected, representing an acceleration from May and April. For the quarter our non-GAAP EPS totaled $0.62, inclusive of a $0.02 impact from the anti-bias training on May 29, representing a solid 13% increase over Q3 last year.

While we fell short of the expectations we had entering the quarter, we made measurable progress against two commitments we've made to our shareholders: to deliver predictable, sustainable growth at scale and to create meaningful increases in shareholder value long into the future. To deliver on these commitments, we continue to focus our energy, capital, and resources on executing against our three strategic priorities.

Our first strategic priority is to accelerate growth in our targeted long-term growth markets – China and the U.S. Our success in each market will be driven by further elevation and modernization of the third-place experience we deliver to our customers and continued expansion of our digital advantage. Roz will provide context around the progress we are making in the U.S. and a plan that is built with a clear understanding and focus on four evolving consumer trends. Consumers have increasingly ubiquitous digital lifestyles. Consumers want premium products, premium experiences, and value convenience. Consumers appreciate choice, including better for you food and beverage selections.

Our innovation agenda in each of food and beverage, digital, and store design is being informed by each of these trends. And we are committed to increasing the velocity of innovation at Starbucks in each of these areas, as they are all key determinants of customer and brand relevance today. I remain extremely optimistic about the future of our U.S. business for several reasons. First, our beverage innovation platform is working and we have a full pipeline of new beverages on the horizon to delight our customers in the quarters ahead. Beverage innovation is fueling growth in our core platforms of coffee, tea and refreshers and offsetting some of the softness we've seen in blended.

Second, our digital reach is expanding by every measure including a double-digit increase in active rewards membership year-over-year and the addition of 6 million digitally registered customers who are not yet rewards members but who have established a digital connection with Starbucks. And third, we have redoubled our efforts to drive disciplined operational excellence within our stores and to mindfully allocate capital with a sharp focus on managing our corporate expenses.

China represents an important part of our strategic growth agenda, and Belinda will share specific detail around the incredibly powerful long-term growth opportunities we are curating in China. While acknowledging a disappointing Q3, I want to be clear that we have 100% confidence in our growth strategy and the sustainability of the leadership position we have built in the market. Having been in China since 1999, the strength of our brand, the trust we have built with our customers and partners, and our working knowledge of the many nuances of the China market uniquely positions us for continued long-term success.

Now, keep in mind that this quarter alone, excluding the East China integration, we grew total transactions in China in the mid-teens. We are, by design, in a phase of growth in China that is primarily driven by new store expansion. We also acknowledge the need to move faster to enable delivery in China, and we are committed to piloting delivery this fall in two key cities, Beijing and Shanghai, with the intent to expand from there. We will introduce delivery in a way that combines the best coffees and the most innovative coffee and tea beverages in the world with the rapidly evolving consumer trend in China for at home and at work convenience.

So be assured that as we grow in China, we will not deviate from the culture and values that have built the Starbucks brand and resulted in Starbucks today being recognized as one of the most successful global brands, and sought after global employer of choice in China. I have complete confidence in Belinda and her team to navigate the next phase of our China growth strategy.

Now, our second strategic priority is to expand and leverage the Starbucks brand through the Global Coffee Alliance with Nestlé. We remain on track to close the Nestlé deal in our fiscal Q4. Nestlé is the ideal global partner to accelerate Starbucks growth profile by combining our global brand and coffee leadership with the world's leading distribution network, covering 189 countries. In addition, this alliance will bring Starbucks coffee to customers around world through the world's leading single-serve platforms, Nespresso and Nescafé Dulce Gusto. These single-serve platforms represent the largest install base of systems globally. The Global Coffee Alliance represents an important and highly opportunistic pillar of our growth agenda.

Our third strategic priority is to sharpen our focus on shareholder value return. Step one was the development of a company-wide emphasis on streamlining our business and organization. Over the past year this work has enabled us to identify the strategic steps we needed to take to better and more profitably unlock opportunities that amplify our core value drivers. Those steps include further business simplification, retail market alignment, as evidenced by our purchase of East China and the sale of smaller markets better suited for local ownership, and most recently the Global Coffee Alliance we entered into with Nestlé. Streamline has freed up billions of dollars of capital and has enabled us to focus our management attention and critical resources on the most important priorities for Starbucks, our partners, and our shareholders. Last November we committed to return $15 billion to shareholders through buybacks and dividends through fiscal 2020. As our streamline initiatives have unlocked more net capital and as we have flexed our balance sheet, we've now expanded that commitment to $25 billion through fiscal 2020. We have already returned over $5 billion to shareholders in the last three quarters alone.

Now, to deliver on our commitments, we know we must drive consistent growth at scale by driving excellence in execution and customer-focused innovation. Let me assure you that we are energized by the foundational changes we have made and the prioritization that it provides toward our core value drivers.

Before handing the call over to Roz, I want to quickly touch on our recent announcement around sustainability. Sustainability is one of three of our social impact priorities. Our aspiration to make coffee the first sustainable agricultural product is in direct support of coffee farmers around the world. Our commitment to eliminate plastic straws in all of our stores globally by 2020 is in direct support of sustainability of the planet. In the same way, our agronomists innovate on behalf of coffee farmers, our packaging teams along with partners have innovated to create strawless lids, and alternative material straw options. And we are also pursuing a broad approach to recyclable cups. We have long espoused the importance of companies doing well by doing good, and we will not waver from our focus and leadership position in sustainability.

Finally I'd like to take a moment to acknowledge Scott Maw for his partnership and tireless contributions to Starbucks. Scott will remain an integral part of the management team through November and serve for a period as a consultant to ensure a seamless and successful transition to a new CFO. Thank you, Scott. All of us at Starbucks thank you for your contributions and we wish you well. With that, I'll turn the call over to Roz.

Roz?

Rosalind G. Brewer

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

Thanks, Kevin. I'll start out with how the Americas is reinforcing its commitment to improving current transaction trends by focusing on three priorities for growth: improving customers' in-store experience, delivering beverage innovation, and driving digital relationships. I'll also provide some perspective on how we're driving enhanced profitability and increasing agility.

First I'll address Q3 results. We delivered another record performance of $4.2 billion in revenues, which represents a 6% increase over the prior year, and our new stores contributed four points of growth for the 17th consecutive quarter. The impact of Frappuccino decline and the store closures to support the anti-bias training is estimated to be three points of comp in the quarter. These were the main factors that led to a 1% comp in the Americas for Q3. Factoring into this shortfall, we continue to grow share, as supported by growth in our most loyal customers, growth in all categories except Frappuccino, including both core coffee beverages and innovative new products, such as Draft and Refreshers, continued strong growth in the morning, our most important day-part, and continued strong performance of new stores as we opened in underpenetrated geographies. With these indicators of brand strength, we continue to move with speed to reposition the business for growth.

To modernize and elevate the third place, our first priority is improving customers' in-store experience. The U.S. operations team, led by veteran Starbucks operator Rossann Williams, is keenly focused on driving efficiency, reducing the time our partners spend on administrative tasks, and redeploying that time to customer-facing tasks. We have set an ambitious target to cut up to 50% of current in-store administrative tasks by the end of fiscal year 2019 that we expect will initially unlock up to 2 to 3 hours daily to focus on customer and partner experience this fall. Through more efficient labor scheduling, automated ordering and raising store standards, we continue to leverage our earlier work around Deployment 2.0 by moving from one labor algorithm to store segmentation based on product mix, traffic patterns and store type. Partners will also have mobile access to their schedules, reducing the time it takes to communicate and manage changes. Using AI will right-size inventory levels while reducing waste, improving product availability, and reducing manual inventory tasks. And our clean, safe welcoming initiative will help to unlock the afternoon by moving disruptive tasks to after close.

Our U.S. real estate strategy will be driven by placing the majority of our new stores throughout middle America and the South with careful consideration of the format type. More than 80% of stores built in the next few years will be drive-thru, as data indicates significant opportunities for store expansion in higher growth, lower cost markets, especially when considering rising wages and occupancy costs.

At the same time, we'll continue balancing our portfolio of U.S. company-owned and licensed stores. Starting in Q1 fiscal year 2019, we'll also test a new approach to store portfolio management in Austin, along with new technology in the form of digital menu boards and drink preparation.

Next is beverage innovation. As consumer trends and consumption habits evolve, we're focused on staying ahead of the market with relevant new products that reinforce the reputation of the brand. While not yet enough to offset declines in Frappuccino sales, we see substantial accretive growth from Draft, Refreshers, Tea, and Cold Brew platforms. In general, consumer demand for cold beverages has grown from 37% of sales five years ago to more than 50% of sales today. There's also strong demand for customization, including Blonde Espresso as an alternative to our bolder signature roasts and plant-based milk and cold foam for our cold coffee and tea beverages.

I'll share a few examples. Cold foam is a cold frothed skim milk designed to be a perfect creamy finish to our cold beverages. Launched this spring, we are just beginning to explore some of the opportunities here, as evidenced by our latest offering, the Salted Cream Cold Foam Cold Brew. Drafts allows us to extend beyond Cold Brew and has proven highly incremental, especially for occasional afternoon customers. We're accelerating this platform to more than 2,800 stores by the close of fiscal year 2018, up to more than 6,000 stores by year-end fiscal year 2019. We're also exploring multi-task systems to add customization and innovation across Tea and Milk.

We expanded our Refreshers line with the new Mango Dragonfruit, whose performance helped fuel strong double-digit growth in the overall Refreshers platform. And we introduced several coconut and almond milk-based beverages, including our new Iced Vanilla Bean Coconutmilk Latte. In sum, having established ourselves as the premier retailer of specialty coffee, leaning into cold-focused beverages and platforms is where we can further differentiate, premiumize, and continue to lead the market.

Our third priority is digital. Our digital flywheel remains a compelling opportunity to connect with customers in a personalized way, driving convenience, product awareness, value, and ultimately incrementality. We now have 15.1 million active Starbucks Rewards members, up 14% year-over-year, driving 40% of tender in the U.S. Spend per member has grown in the mid-single digits range, with Mobile Order and Pay representing 13% of transactions.

We'll significantly enhance the appeal of the rewards program next spring when, for the first-time, customers will be able to redeem different amounts of stars for different products, giving them a choice to use stars sooner for lower ticket items or save for higher ticket items like lunch, packaged coffee, and merchandise.

We're also quickly building a strong base of direct digital relationships with non-SR customers, registering 6 million since March. We're marketing to them with special offers including invitation-only Happy Hour. And as we learn more about their transaction histories, we'll target increasingly relevant offers to drive more incrementality and engagement. This expanded focus on digital is expected to drive an incremental one to two points of comp by year-end fiscal year 2019.

In closing, we recognize the work we need to do to deliver transaction growth in the U.S. and have balanced plans and talented teams in place to deliver against those expectations in the coming quarters.

I'll now turn the call over to Belinda.

Belinda Wong

Chief Executive Officer-Starbucks China, Starbucks Corp.

Thank you, Roz. Good afternoon, everyone. I appreciate the opportunity to speak to you from Shanghai in order to expand on Kevin's comments around Starbucks' solid foundation in China, put our Q3 performance in context, and provide details on the steps we're taking to deliver comp and profit growth consistent with our historical performance and future expectations.

Relative to our historical success, we believe the minus 2% comp we posted in Q3 is not a reflection of the strength of our business and brand in China. On the contrary, I assure you that the enormity of the opportunity that we shared with you at our China Investor Day remains fully intact.

Let me take you through the factors that combined in somewhat of a perfect storm to drive our Q3 underperformance. And when I explain what we're doing about each, I suspect you'll leave today's call confident in our understanding of the transitory situation and in our action plans to resume the level of consistent profitable growth that both you and we expect.

First, as Kevin mentioned, we're making progress on our plans for delivery across China. We start this fall in Beijing and Shanghai with plans to expand across the country as we enter calendar 2019. We're fine-tuning details and approach over the coming weeks, fully confident that delivery will enhance the premium Starbucks experience our customers expect, fueling comp growth and financial performance in FY 2019 and beyond.

The delivery opportunity has enabled a different yet not unusual competitive retail environment in China. Starbucks' success, growth and sustainable long-term business approach has incented upstarts and other players to enter the coffee business from time to time. Yet over the long-term the focus we put on the quality of our coffee, the passion of our partners, beautiful third-place environments, and the premium Starbucks experience we deliver has always set the bar for performance and market success.

While recent coffee market entrants have chosen to capitalize on delivery combined with heavily discounted offers, there's significant compromises at play in terms of quality, experience, and business sustainability. These will prove to be short-lived. Let me assure you that our new delivery service will adhere to the high standards our customers in China have come to expect with regard to the Starbucks experience. And we're fully confident that the holistic and premium nature of our experience in store or delivery and the quality of our products will differentiate our offer to customers as we expand our business in China.

While we do expect to see some residual comp headwinds as competitive promotions unwind over time, we do have a strong plan going forward. Besides delivery, we have broad reach and depth in the digital space. Starting in June, we have now expanded our digital social gifting on the Alipay platform which today boasts 520 million monthly active users, providing a new channel which we can communicate and engage with our customers and drive transactions to our stores.

We also have a strong pipeline of innovation. This includes doubling the availability of our Coffee Meets Ice Cream product line to 1,100 locations, expanding our successful cold foam innovation to include three new offerings: Cold Foam Caramel Macchiato, Green Tea Latte, and Cold Brew, and up-leveling our bakery platform. These have all been big hits in early testing and we are excited to expand these offerings to more customers this quarter.

Finally in Q3 we did experience higher-than-expected levels of sales transfer from existing stores to new stores due primarily to the acceleration of new store openings in the first half of the year. We intentionally choose to move faster in key investment clusters to seize specific opportunities, resulting in 60% more store openings in the first half of FY 2018 versus the prior year, excluding East China. While this acceleration has temporarily impacted comp growth, we continue to achieve best in class performance from new stores opened in the last 12 months. I am absolutely sure that our intentional and strategic investment actions were the right moves to set us up for strong future growth in both market share and profitability.

Looking ahead, the pace of new store openings should result in more typical levels of sales transfer. We remain on plan to add 600 net new stores per year and to achieve our goal of 6,000 stores in 230 cities across Mainland China by the end of fiscal 2022. Starbucks continues to invest in China for the long term.

In closing, I would like to share a few thoughts. Number one, there's no substitute for our 47-year history of sourcing, roasting and blending the world's highest quality arabica coffees or our direct connections with coffee farming communities around the world including Yunnan in China. The proof and the quality are in the cup.

Two, we have learned from our 19-year experience and developed a very strong brand and a profitable and sustainable operating model in China that competitors have yet to figure out and will never be able to replicate.

Three, we will continue to build our business in China by fostering deep connections among our partners, their families, our customers, and the communities we serve.

Four, we're proud to deliver a third-place experience that inspires and fosters human connection that is relevant to the Chinese consumer aspirations. This will continue to be a majority of the specialty coffee occasions in China and our business for the years to come.

Five, our world class retail locations, store footprint and design, unit economics, growing CPG presence and new delivery capability ideally position us to continue to lead in the marketplace and deliver venti sized returns. I assure you that Starbucks' runway in China is wide and long, and I remain absolutely convinced that China will become Starbucks' largest and most strategic market in the world.

Thank you, and I'll now turn the call over to Scott. Scott?

Scott Maw

Executive Vice President & Chief Financial Officer, Starbucks Corp.

Thank you, Belinda and good afternoon, everyone. Starbucks consolidated revenue growth was in excess of 7% after adjusting for 4% of favorable impact from streamline activities and FX in Q3, and despite falling short of forecast, reflects the underlying strength of the Starbucks business and brand around the world.

Our Americas business reported 6% revenue growth despite challenging macro and Starbucks-specific operating environments. CAP reported 11% revenue growth after adjusting for 35 points of streamline activities and FX, with China revenue growth once again in the high teens on the same basis. Channel Development delivered 10% revenue growth after adjusting for 4 points of streamline activities and EMEA delivered 6% revenue growth excluding 4% of FX favorability. The bottom line is that we continue to gain share in virtually every market where we do business domestically and around the world, at the same time as we make meaningful progress against our commitments to deliver sustainable growth at scale.

Non-GAAP operating margin of 18.5% represented a decline of 230 basis points year-over-year primarily driven by 130 basis points from incremental investments related to the U.S. tax law change and estimated anti-bias training impacts. Product mix shift largely related to food as well as planned partner and digital investments also contributed to the decline.

I'll now take you through our Q3 operating performance by segment. The U.S. reported a 1% increase in comp growth driven by 2 points of growth in core beverages including espresso, tea and refreshers, and 1 point from food. This was offset by over 2 negative points related to softer than expected blended sales well below what we forecast for the quarter. Consistent with recent quarters, peak transactions volume was strong with softness continuing in the afternoon, primarily in Frappuccino sales.

Separately, I'd like to highlight that the estimated impact of anti-bias training to comps was slightly less than one-half point. Americas' non-GAAP operating margin declined 250 basis points to 21.9%, largely attributable to 150 basis point impact from U.S. tax law related investments and the estimated impact of the anti-bias training. Net of these items, our Q3 margin landed roughly where we originally forecast and showed improvement from Q2 levels.

Moving on to China-Asia-Pacific. CAP revenues exceeded $1 billion for the second straight quarter, reaching a record $1.2 billion in Q3. Japan revenues grew by 6% excluding two points of FX favorability. And Korea, our fifth largest global market, delivered system revenue growth in the mid-teens, driven by a 6% increase in system comps and contribution from net new stores. Noteworthy is that CAP grew non-GAAP operating income by 30% despite a 310 basis point decline in non-GAAP operating margins to 25.2%. The decline in operating margin was primarily due to a 280 basis point impact from consolidation of the East China business. Excluding the consolidation, CAP margin was down slightly to prior-year. CAP remains a huge growth opportunity for Starbucks both inside and outside of China, made even more so by the exciting longer term CPG and food service opportunities presented by the Nestlé alliance.

Let's turn to EMEA. EMEA delivered roughly flat comp growth in Q3 in the face of continuing economic and competitive headwinds. System-wide comps, however, came in at a solid plus 3% in the period. EMEA's non-GAAP operating margin expanded by 310 basis points in Q3, driven primarily by strong performance from licensed stores. We remain encouraged by the improved performance in EMEA with both operating income growth and meaningful margin expansion, and convinced that the portfolio shift to licensing will result in further increases in profitability as we move into 2019.

On to Channel Development. Channel Development had a very strong Q3. Starbucks continued to outpace industry growth, adding another point of share in roast and ground to reach 13% dollar share and continuing to lead premium brands in the K-Cup coffee category with a 16% dollar share. Channel Development's non-GAAP operating margin was 42.7%, solid performance given the maturity of the coffee category and increased competition down the aisle.

As we close out fiscal 2018, most of our targets remain consistent with previous guidance, but I'd like to highlight a few specifics. We continue to expect consolidated revenue growth in the high single digits, excluding approximately two points of favorability from the East China acquisition and other streamline-driven activities. Full year comps will likely come in just below our 3% to 5% range and we expect Q4 to be at the lower end of this range. We remain on plan to open approximately 2,300 net new Starbucks stores globally with best in class operating margins in both company owned and licensed markets. We continue to anticipate a moderate decline in full year operating margin for both total company and the Americas compared to 2017 inclusive of the incremental investments we're making in our partners and digital initiatives following U.S. tax law reform and the impact of the anti-bias training. However, we now expect a slight year-over-year decline in operating margin in the Americas for Q4, reflecting somewhat lower than initially expected comp growth.

Within the CAP segment, we continue to expect operating margin to be down moderately in fiscal 2018 relative to last year, due to the consolidation of East China. Excluding this impact, we continue to expect CAP operating margin to be moderately higher year-over-year. We still expect EMEA's operating margin to be flat adjusted for FX compared to 2017. We still forecast revenue growth in the mid-single digits for Channel Development in fiscal 2018, excluding the impact of Tazo and the 2017 revenue deduction adjustments. And we continue to expect Channel Development operating margin to decline moderately in FY 2018 relative to the prior year, a result of increasingly competitive market conditions discussed on prior earnings calls.

As a refinement to our EPS guidance in June, we expect fiscal 2018 GAAP EPS in the range of $3.26 to $3.28 and non-GAAP EPS will be in the range of $2.40 to $2.42, up approximately 17% from last year. Importantly, this guidance factors in the full $0.03 impact of anti-bias training for U.S. partners, including the portion that carried over into Q4. These EPS estimates also assume that the pending Nestlé transaction closes on or after the final day of fiscal 2018. We anticipate that the Nestlé transaction could close as early as the end of August, which would result in a diluted EPS impact of $0.02 to $0.03 in FY 2018. I would remind you that we expect revenue and EPS to be negatively impacted in 2019 by two points to three points each as a result of this transaction, with a range around the final number driven primarily by the potential accounting treatment for the $7.2 billion upfront payment.

Finally, I want to talk a bit about G&A savings and the 1% of system sales reduction target we introduced last month. Roz will be leading this effort with my support, and this is a three-year goal for us, and we anticipate it to be somewhat front-end loaded with 35% to 45% of the savings occurring next fiscal year on a run rate basis. By way of background, we remain focused on improving both our operating efficiency and how we work, and plan to use a portion of the resulting savings to fuel investments for future growth. These will be thoughtful, high impact savings that speed up decision-making and enable us to focus our efforts on the largest growth opportunities. It is not just a cost-cutting exercise. Working with our outside consultants, we have already identified significant savings opportunities in areas such as improving spans and layers within our organization.

Before handing the call back to the operator for Q&A, I want to thank everyone for their support of my recent decision to retire. I will always be deeply appreciative to Kevin, Howard and the Starbucks board and the leadership team for their partnership during my seven-year tenure at Starbucks, and for their support in my decision. I am also deeply appreciative to the over 330,000 Starbucks partners around the world who wear the green apron. Over the past years I've also come to know most of you on today's call. I thank you for your engagement and your support of Starbucks and of me. I can say without equivocation that the best days for Starbucks lie ahead. With that, I'll turn the call back to the operator. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Sharon Zackfia with William Blair. Please proceed with your question.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Hi, good afternoon. I guess a question on the development outlook for the Americas as you focus on the center and Southern portions of the country. Can you give us kind of some perspective on how those AUVs look versus the rest of the country?

And I know you mentioned they're lower cost, but I'm thinking maybe they're also lower revenues. Any perspective on what the new units might look like going forward versus maybe the class of 2017 or class of 2016?

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

A

Sharon, this is Kevin. We'll have Roz talk a little bit about where we're focused on store builds, and then Scott will follow up on the part of your question around the economics.

Rosalind G. Brewer
Group President, Chief Operating Officer & Director, Starbucks Corp.

A

So, first of all, if you just look at our quarterly revenues, four points of our revenue growth came from new stores and in that configuration is quite a bit of mid-America and Southern states, so we're already seeing that performance play through for us. So we're encouraged by what we're seeing with our current portfolio.

Going forward, we are focusing in that area. I will tell you that in areas like Seattle and Manhattan, while we're encouraged by the business that we have in those areas, we are putting less units in those two geographies, but at the same time they're highly dense areas with increased occupancy cost and increased labor spends in those areas. So we're already seeing the performance from our current portfolio that is already targeted towards middle America and the Southern parts of the states, so we're encouraged by what we're seeing and so we're going to continue that process.

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

A

And I would add is we've moved towards more drive-thru. Roz referenced 80% or more drive-thrus. We've actually seen the AUVs accelerate over the past four or five years, so even as we've gone into some of those suburban areas the drive-thru format has about 25% to 30% more revenue than our typical in metro non-drive-thru format. So the weighting out of those drive-thrus are actually both quite high AUVs and really good profitability.

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

John William Ivankoe
Analyst, JPMorgan Securities LLC

Q

Hi, thank you. I was hoping just with the amount of kind of puts and takes in G&A if there's a dollar amount that we could talk to, maybe in fiscal 2019 and fiscal 2020, maybe even beyond as you think about, really, the potential of the business from an efficiency and effectiveness point of view. Because obviously there's a lot of different ways to look at this – percentage of system sales, percentage of revenue, per store basis, what have you? I was hoping if you could help, steer us just in terms of the actual dollar type of number that might be the right level of spend for Starbucks going forward.

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

A

Yeah, thanks, John, it's Scott. Let me just try to narrow the range in a bit for you. We're literally in the middle of our annual planning process. So we'll come back in the fall and give you more specifics. But let me try to tighten in the range, because I know it's hard to model.

First of all, what we've talked about is one point of system sales. And just to roll forward system sales. The last time we talked about it was in our December 2016 Investor Day, and we said it's about $30 billion. So, if you grow that at the rate of revenue, you're somewhere in the mid-$30 billion, call it the $35 billion range. We'll be around a point of that building over three years. And what I said in my prepared remarks is we think 35% to 45% of that comes on a run rate basis in 2019. So the way that we'll – when we get into the fall, we'll take a look at fourth quarter exit rate of G&A as a percent of system sales. That will be our peg point. And then we'll roll forward three years to take 100 basis points or approximately 100 basis points out of that, with 35% to 45% of that coming in 2019.

So that should allow you to narrow it in a little bit. Obviously there is some range around that as we get into the specifics of exactly how quickly we can execute on some of these things, where the big opportunities lie. But that allows you to tighten up your modeling a bit, I think.

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

Jeffrey Bernstein
Analyst, Barclays Capital, Inc.

Q

Great, thank you very much. I've just a question on China broadly. I know a few weeks back when you guided for the quarter, you were talking about maybe flat to modest negative comp. It seems like it came in down 2%. So, I'm wondering, maybe, if you could just talk about the trend through the quarter. And more importantly, I guess, just looking back over the past few quarters, it seems like it's been a fairly steady decline from the high-single digits to the mid-single digits to where we are today. So it would seem like there are some factors above and beyond maybe just the perfect storm that is the fiscal third quarter. Just wondering if maybe you could talk a little bit about the broader macro headwinds that perhaps China is seeing there, or just how you distinguish between what unit cannibalization might be versus maybe if there's some consumer pushback? Just wondering how you assess those two things to make sure the business is still as healthy as you think it is. Thank you.

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

A

Yeah, Jeff, this is Kevin. I think we'll have Belinda talk a little bit about what she saw in the quarter. I think, we're – we don't think it's always helpful to go into trends within the quarter, but I think – let's give Belinda an opportunity to share with you a perspective of the health of the brand, the health of the business in China. Belinda?

Belinda Wong
Chief Executive Officer-Starbucks China, Starbucks Corp.

A

Okay, hi, thank you, Jeff, for your question. First of all, delivery as a whole, it's becoming a lifestyle ritual in China. And consumer behaviors are changing. This is a trend we'll be addressing through Starbucks Delivery to complement our third-place in-store strategy.

Second is competitive landscape in China, which we'll also address through our Delivery services, as well as our growth agenda we shared during our Investor Day with our elevated Starbucks experience and the innovations that we do.

Third will be the higher than expected level of sales transfer that I shared before from existing stores to new stores. That may have an impact in the short-term. But for sure the right thing to do to expand our market share now and in the long run.

Don't forget operating in a developing coffee market, we need to continue to grow our presence through new stores. This means more than 75% of our growth comes from new store and we needed to do that because we're in a developing coffee market. We need to cultivate coffee culture, we need to share coffee with people who have never tried coffee. And our comp accounts for 25% of our growth. And we will continue to innovate and deliver meaningful and relevant experience to our customers to drive comp. But, again, growing greater market share in this market. So, I have no doubts that China will be back on track very soon in terms of our comp. So, thank you.

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

A

Yeah, and Jeff let me just reinforce a couple of key points that I think are important – this is Kevin. First of all, as Belinda said and as I said in my comments, the market in China that we are in a market growth phase that is all about new store expansion. The fact that we're in roughly 130 to 140 cities and expanding into the next 100 cities over the next three years is critical. And the reason we grew transactions in the mid-teens in China is because of new store growth. And it is where – it is through that expansion that we're enabling the brand to not only deepen its engagement with customers in the cities that we're in but also to expand into new cities.

And so I think, as Belinda highlighted those – our stores are performing. Some of them are the most profitable stores in the world. The new ones we're building are the most – some of the most profitable stores in the world, and it is about store expansion. And so I just want to reinforce that point because that is the core strategy for China right now and it will be for the next several years.

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

John Glass
Analyst, Morgan Stanley & Co. LLC

Q

Thanks very much. Your comp guidance if I'm reading this correctly for the fourth quarter is 3% or so, the low end of 3% to 5%, which, I guess, surprises me in the context of where you landed this quarter, and particularly in the U.S. So can you just talk about why you think that's a conservative or reasonable number?

Can you also just talk – I know you mentioned June was where you thought it was, is July a similar number?

And how much of that is the pricing overlap? In other words, is traffic improving in your business? Is that what's getting you more confident, or is that still an area of tension, and it's really just the price mix that's maybe benefiting comps right now?

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

A

Yeah, well, let me just – I'll start, John, on the question and then I'll hand over to Roz to add a bit more on the mix of things that are driving it. But first of all, I commented that following the Oppenheimer comments the quarter unfolded as we anticipated, just reconfirming sort of the statements we made at Oppenheimer. I don't think it's helpful to get into intra-quarter trends because that I think confuses the issue.

So what gives us confidence? Well, you look back at this last quarter, Q3, when we had some very unusual things we had to navigate in the quarter. Certainly the situation in Philadelphia and the fact that we've closed all our stores for an afternoon – that had an impact. But also the fact that we delayed the launch of the spring/summer marketing campaign by two weeks or so in that quarter. We lost some momentum, and since we then deployed that we clearly saw we were gaining momentum, and so that gives us some optimism in terms of what we're doing.

Second, our digital customer base has grown dramatically. Look, we've grown our active rewards members by 14% to 15.1 million, we've added 6 million of these digitally registered customers that we are now learning how to engage with and figuring out how to drive some more engagement with them. That combined with the pipeline of beverage innovation gives us confidence as we look forward and into this quarter.

Let me hand over to Roz to talk a little bit about – there was a question on pricing and attach and things that are driving some of the ticket there. And Roz, I'll let you comment on that and maybe Matt on pricing. But, Roz?

Rosalind G. Brewer
Group President, Chief Operating Officer & Director, Starbucks Corp.

A

Yeah, sure, let me give a little bit more flavor to our comp performance. So first of all, I'll start off with, if you break down our comp, we've got two points of that coming from beverage and another point coming from food. So we're encouraged in terms of what we're seeing. All of our core categories except for Frappuccino grew in the quarter, both our core coffee beverages, our innovative new products such as Drafts and Refreshers, so we're seeing growth in every category. We're seeing food attachment from our breakfast sandwiches happening, where up to 22% of our portfolio is food, so we're seeing that have a nice impression on our ticket. We're still growing in morning peak, and that's our most important day-part, and we're still growing in the morning. And then lastly I'll tell you we're seeing strong performance of our new stores that we just talked about that we're placing in these markets of middle America and in the South.

So that gives us encouragement that we're on the right track. Just the isolation of moving transactions is our focus and we need to get those transactions through our beverage growth. And when Kevin talked about the afternoon day-part, it is a soft part of our business. The marketing campaign that we ran through the beginning of the spring is still ongoing. It's actually the largest media spend we've done in a while – consistent, focused on afternoons and absolutely focused on a new occasion in the afternoon with teas and refreshers. So we're going to maintain our plans to continue this work that we're doing because we're encouraged from what we're seeing right now.

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

David Palmer
Analyst, RBC Capital Markets LLC
Q

Thanks, good evening. I...

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

David, you're breaking up. David, you're breaking up. Can you start over?

David Palmer
Analyst, RBC Capital Markets LLC
Q

Yes. I wanted to ask a question about the U.S. business. It looks like the afternoon and beverage contribution to growth has been a particular problem. Could you talk about that? And given the fact that you're now seeing digital user growth resume, that takes off the table that as an issue. So I guess the question is, how much do you think the U.S. comp slowdown has been a beverage innovation problem versus other, not having a Cold Brew or a Teavana shake and tea? And how do you feel about the beverage innovation pipeline at this point? Thanks.

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

Let me take sort of the first response to that, David, and then I'll hand it over to Roz to talk a little bit about the beverage innovation pipeline. First of all, the most important day-part for Starbucks is the morning day-part. And we are growing comp in the morning day-part. We're growing transactions in the morning day-part. The area that we've highlighted that we've had softness has been that afternoon from 2:00 on and then evenings from 4:00 PM on. So, when we look at this, the fact that the morning day-part that's growing is a very, very, very positive metric.

Number two, when I look at the beverage portfolio and I look at the core platforms, Coffee, Espresso, Tea and Refreshers, all of those are growing. And they're offsetting the softness we've had in blended. So all of a sudden, you start to intersect the issue around blended and afternoons has sort of been amplified in this quarter because this is the quarter of Frappuccinos. And so you put that together and I think much of that is sort of explained.

Now, as Roz mentioned, the campaign that we have for the afternoon and the cold beverages that we're driving around afternoon made, I think we're feeling good about that. Let me hand it over to Roz to talk a little bit about the pipeline of innovation.

Rosalind G. Brewer
Group President, Chief Operating Officer & Director, Starbucks Corp.
A

Sure. So we actually feel pretty good about the velocity of innovation at Starbucks in terms of the beverage business. First of all, we're seeing a strong shift to Cold and we're playing directly in that space. Our mix is up to 50% with our cold mix of our beverages. And if you look at everything we focused on in terms of our newness, it has been in cold beverage.

In addition to the addition of our Blonde espresso at the beginning of the year, we're seeing our customers customize even their cold beverages with Blonde espresso. So focusing on innovation in core coffee and then innovation in blended with the Premium Frappuccino, we introduced three of those this quarter, and we're pleased with how those three are moving for us. And we've also customized with cold foam and we're getting momentum on refreshers and teas.

And then not only the innovation on beverages but in food. And so we introduced a new egg bite, Sous Vide Egg Bite this quarter. We're encouraged what we see there. And then when you combine that kind of innovation in food and beverage with what we're doing with the acceleration in digital, we're matching all the customer information that we're gathering with what their needs are.

One thing I will isolate is that our Cold Brew is really resonating with our male millennials. So, when we wrap our arms around our consumer-driven needs for the growth in our business and innovation, it sends us directly towards a cold platform and continuing to innovate in our core coffee business. So we actually feel pretty good about our beverage lineup and the innovation pipeline.

Operator: Your next question comes from Sara Senatore with Bernstein. Please proceed with your question.

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

Hi, thank you. A question about the U.S. unit growth and then just a quick follow-up on China. In the U.S. you said, you're talking – you're testing a new approach to portfolio management. Is that with reference to the mix of company-operated versus licensed, or is it about how you evaluate stores more – perhaps more quickly and decide whether they're meeting their hurdle rates? Just trying to understand what that might – what implication that might have for store growth going forward.

And then on the China piece, I know you're seeing some cannibalization, but I'm also curious – I would assume there's a pretty steep maturity curve in China. So aren't you seeing any kind of offsetting comp lift from that?

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

We'll have – Sara, let's have Roz take your first question on U.S. unit growth and optimizing the store portfolio and then Belinda will talk a little bit about China. So, Roz?

Rosalind G. Brewer
Group President, Chief Operating Officer & Director, Starbucks Corp.
A

Yeah, so let me just clarify the point on store growth. So, we're still adding a significant number of stores on both our company-owned and our licensed units. And I will tell you what we're doing is looking very closely at managing the trade areas in terms of where we place stores. And then there's a second piece to that, Sara, that talks about the formats that we place. So I think you're aware that 80% of our portfolio going forward – actually approaching 90% now, is drive-thru. But we're also looking at exactly where those drive-thrus can complement an express unit or complement a cafe. So we're looking very surgically at where we place our units and being really smart about that, with the focus of the geography in middle America and the Southeast. And so you'll see that play out in our stores coming forward. And we are not slowing our growth in those concentrated areas.

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

Belinda, do you want to talk a little bit about China?

Belinda Wong
Chief Executive Officer-Starbucks China, Starbucks Corp.
A

Yes. Sara, hi, Belinda here. I assume you mean the specialty coffee market in China being mature or maturing. This is not the case at all. I think we shared the stats before on 300 cups in the U.S. and then 0.4 cup in China. And we're working hard to cultivate a coffee culture here. Even in tier 1 cities like Beijing and Shanghai. So there's plenty of room to grow. And with the middle class up-and-coming more and more people – our job is to make sure more and more people get to try what we love, which is coffee and sharing our passion. So there's plenty of room to grow.

John Culver
Group President - International and Channel Development, Starbucks Corp.
A

Hey, Sara, also, this is John, just to add to the discussion around China on the maturity curve, if you're talking about the new store growth. And when you look at our new stores, we track very closely how the new stores perform once we open them and through that first year and then as they enter the comp base we've got a very disciplined approach where we review that every single month.

As we shared previously, the store payback of the new stores is within a year of the opening. And as they enter the comp base, they enter the comp base at a very consistent historical level of the stores that are currently sitting in the comp base. So we feel very good about this maturity curve and the fact that it hasn't really shifted that much at all from an historical standpoint. And we feel very good about continuing to build out the store footprint based on the fact that our new store performance continues to exceed all the expectations. And the returns are very, very healthy in overall store level profitability of those stores, as well as the whole portfolio is very healthy. And that gives us optimism for the future. We talk about the importance of comp. That's clearly important. But at the end of the day, as Kevin shared, it is about new store growth right now, as we seed the market and develop this coffee culture.

Last quarter we grew revenue 17%. We grew transactions in the mid-teens. We continue to grow overall transactions in the marketplace, attracting new customers into our stores as well as continuing to elevate the frequency of our existing customers. And so we feel very good about that.

And then just one other point I would put on China is the work that we're doing on digital and the fact that we now have 6.7 million active MSR members, and when you break that down on a per-store basis, that's nearly double what we have on a per-store basis to what we have in the U.S. And you couple that with the work we've done with Alipay social gifting, with WeChat social gifting, we are building a very robust digital ecosystem. And then you add delivery on top of that, we see very long runway for growth for us in China for many years to come. And that's why we're still very optimistic and very strong belief in the growth plans and the strategy that we've built for the market going forward.

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

Matthew DiFrisco
Analyst, Guggenheim Securities LLC

Q

Thank you. My question is more with the U.S. I guess, just two-pronged here, looking at the expansion and targeting sort of middle America. I think for those of us who have covered the stock when you guys last closed down a large portion of stores, some of that was Howard identifying that the middle of the country might have seen some of the faster growth and that they weren't really espresso drinking, and the brand didn't resonate as well when you tried to more densely populate those areas with your stores. What's changed?

And then, I guess also looking at the comp, I guess you're one of the few restaurant companies that hasn't mentioned the word at all about value, and it does seem like value is what is driving the customer, whatever that means for each individual brand respectively. How are you addressing the value equation to the customer who is not the My Starbucks Rewards customer?

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

A

Yeah, Matthew, this is Kevin I'll start and share a perspective and get some others to add. But first of all, what's changed in terms of the store performance in middle America? Well, apparently Americans in middle America like espresso beverages and our coffee because those stores are performing at higher AUVs and higher profitability than any other part of the country. And so I don't know what the experiment was back then, but it's working now.

And this is not a new thing. We've been doing this for the last couple of years and we're seeing great performance from those stores. We're using – as I outlined at Oppenheimer, we're using analytics to really look at the store, the number of stores per capita that we have in areas. We look at the demographics in those areas and we're using technology to help inform us where to go build these stores. And in since doing that, it's worked. So it's – I think the fact that just proven by the store performance we're getting on those new stores that we've been building throughout middle America and the South, they're performing well.

I think the other part, then, in terms of value, the core beverage platforms of coffee, espresso, tea, refreshers are all growing. The morning day-part is growing. When we think about the differentiators for Starbucks, we differentiate around a premium coffee, a premium experience, and we differentiate by doing custom handcrafted beverages at scale. And that is why our morning day-part just keeps growing. That is the core value proposition for our customers. And in that day-part we are growing, we're growing strong and we feel good about that. As Roz mentioned, we had – in the afternoon day-part we've had some softness in afternoon, and we've seen softness in the blended platform that we've been working to address.

I think, as I highlighted some of the consumer trends, this need state of convenience, we really have unlocked that I think in a way not only with Mobile Order and Pay, but with our drive-thrus and that's balancing then the experience we create in our stores around the third place around community. And so I think if we just look at both what we've learned over the last decade and the performance of the investments that we've made in those store formats, in those geographies, in our beverage platform, in the morning day-part, those things give us confidence that we're absolutely on the right path.

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

A

And Matt, I would just add when Roz talked about our store growth, she said middle America and across the South. And the South is actually the bigger piece of that growth when I look at the numbers. So you're talking about Southern California, Texas, Arizona, the Southeast, Florida. These are markets with a lot of growth. And in addition to the middle part of the country, which is doing great as well, we're just seeing really strong performance in those markets with drive-thru. It's completely core to the move towards cold beverages and iced coffees. It's completely core to drive-thru and the suburban strategy that we have. And so I would just broaden the middle America part to definitely talk about the broad swath of the Southern U.S.

Operator: The last question comes from Matt McGinley with Evercore ISI. Please proceed with your question.

Matthew Robert McGinley
Analyst, Evercore Group LLC

Q

Thank you. Kind of a quick point of – question about clarification on what you said, and then I have a question about China. In the guidance commentary, you noted a slight decline in the margin in the fourth quarter year-over-year. Was that driven by trends that you're experiencing already in July, or was that more of a general comment about fourth quarter relative to what you saw earlier in the year?

And then on China, Belinda, earlier in the year you noted that the China JV stores were not – that were not in the comp base were slightly below the stores that are in the comp base. Did that gap narrow as the year went on? Or when you experienced a slowdown in the stores in the comp base, did that – did they all kind of move in the same – in tandem, if you will?

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

A

Yeah, my comment on the margin wasn't indicating anything in July. I think it's really just consistent with the guidance we gave last month around lower overall profitability both in the third and fourth quarter. And obviously we had hoped when we started the year that the fourth quarter margin would be roughly flat year-over-year, and we made good progress this quarter if you take out the anti-bias training and the tax investments. And we'll make good progress next quarter, but I'm just simply saying we're probably not going to quite get to flat, which was our initial guidance. So I was just sort of chewing that up.

And Belinda, do you want to handle the second part?

Belinda Wong
Chief Executive Officer-Starbucks China, Starbucks Corp.

A

Sure. Hi, Matt. East China comp over the past few years has been somewhat below the rest of Mainland China, just as you said, due to the significant pace of store openings in that market and some other opportunities we're executing on. After East China, it's fully-owned company operated. That continues in FY 2018, and over time we expect the comps in these two pieces of the business to converge. But I'm happy to report that East China integration is progressing on track and the region is posting P&L performances in line with our expectations.

Operator: That was our last question today. I will now turn the call over to Mr. Shaw for closing remarks.

Tom Shaw

Vice President-Investor Relations, Starbucks Corp.

Yeah, thanks. And, for your planning purposes, please note our fourth quarter 2018 conference call has been tentatively scheduled for Thursday, November 1. In addition, we look forward to seeing many of you at our 2018 biennial Investor Day on Wednesday, December 12 in New York. Thanks again and have a great evening.

Operator: This concludes Starbucks Coffee Company third quarter fiscal year 2018 conference call. You may now disconnect.