

>: Should You Brew a Fresh Cup of Starbucks Stock?

Monday, April 14, 2008 / Dylan Jovine

IT HAS HAPPENED TO EVERY SUCCESSFUL COMPANY IN THE HISTORY OF CAPITALISM.

Sony. Apple. AOL. Coca-Cola. General Electric. Walt Disney. Home Depot. IBM.

You name the company, and if they've been successful, it's happened to them.

First, the company introduces a brand new product or service that dazzles consumers.

Then, prospective customers turn into repeat customers who turn into die-hard customers.

Thousands of die-hard customers mean big sales, big profits, a dominant market position and a soaring stock price.

And then, just like clockwork, it happens. You can almost set your watch to it every time.

The success of Company A invites rabid competition. Before you know it, Company B, C and D begin selling the same product to try to muscle in on the action. Whoever said imitation is the sincerest form of flattery never worked in corporate America.

And right now this entire process is happening to one of my own personal favorite companies, Starbucks Corp. (SYM: SBUX).

Starbucks is currently selling for \$17.25 per share, down substantially from its 52-week high of \$32.

That's no surprise given that almost every headline you read about the company these days is negative.

McDonalds (SYM: MCD) and Dunkin Donuts are suddenly aggressive competitors... Commodity prices -- such as milk and coffee beans -- are rising putting the squeeze on profit margins. And let's not forget cannibalization: too many new Starbucks stores have popped up too close to old Starbucks stores, and now they're competing directly against each other for business.

Some analysts will have you believe that this is the end of the line for Starbucks. The glory days are over. The sky is falling. Adios Muchacho.

I have a different take on the situation...

What's happening to Starbucks is normal. Totally normal. It's what happens to every successful company. It's called "growing up."

In business terms, Starbucks appears to be moving from the hyper-growth phase of its life cycle into the more mature phase of its life cycle. And as with any business transition, there can be severe pains associated with it ... especially for companies in denial about what's really going on.

In Starbucks' case, they tried desperately to match their growth rate of the 1990's with a couple of bad ideas. The first was to put a Starbucks store seemingly on every corner. That can be remedied fairly easily by closing stores cannibalizing other ones and by being very disciplined about where you open future stores.

The second bad idea was Starbucks' initiative to introduce all types of menu items that you'd find in a McDonald's, not in a coffee house.

As a businessman I can totally understand the need to increase the amount of transactions per visit. And heck, it seems logical that anyone who would come to the store to buy coffee would also want other items.

But as Howard Schultz recognized very quickly, many of these growth initiatives had a shockingly perverse effect -- Starbucks was becoming "McDonaldized."

That's right. By forcing Starbucks to carry the equivalent of the "Egg McMuffin," McDonalds changed Starbucks just as much as Starbucks changed McDonalds (by forcing them to care about coffee).

In fighting parlance, McDonalds was like a boxer who made Starbucks fight McDonalds-style. And I'm not quite sure if a guy like Howard Schultz -- the man who brought the European coffee house to America -- wants Starbucks to become like McDowell's from the movie "Coming to America." ("They got the golden arches, we have the golden arcs. They have the Big Mac. We have the Big Mick.")

So it's back to basics for Howard and Starbucks, and I'm sure the "turnaround plan" looks something like this:

Step One: De-McDonaldize. Start by getting rid of the "Egg StarMuffin" and get back into your European fresh-brewed coffee-house roots. CHECK.

Step Two: De-Cannibalize. One Starbucks in each neighborhood is cool. One on every corner is annoying. Eliminate stores with heavy overlap and slow down

the growth of new stores. CHECK.

Step Three: Reactivate Famous Pricing Power: When they get their cache back, they'll be able to more easily pass on commodity price increases to their die-hard coffee customers. Anyone who paid \$4.50 for a steamed milk and espresso drink called a "latte" will surely pay \$4.75 as long as they don't think they're buying it from McDonalds. Heck, just title the drink a "Soy Jovine Double Latte Carousel Machiatto" and I'm sure you'll be able to charge \$6 bucks for it. CHECK.

Step Four: Internationalize Quickly: Starbucks doesn't work in Europe, the place that almost invented the coffee house. But Asia is a huge market, and Starbucks should be getting 50% of total sales from overseas. CHECK.

Step Five: Respect the Brand: Last, but certainly not least, recognize that growth cannot come at the expense of your brand. Never toss away what made you successful in the first place. And the ingredients that made Starbucks successful in the first place were one part coffee and one part environment. CHECK.

If you look at all of the recent announcements Starbucks has been making (eliminating the egg sandwich, launching new coffees, etc.) it looks like they're executing the plan the way they need to, and that's the second key sign of a turnaround (the first sign is admitting you have a problem).

So, does all this mean I think Starbucks is a buy?

I do. As long as Starbucks can maintain a return-on-equity in the 25% - 28% range, its price-to-earnings ratio (P/E) should approximate it. And with today's P/E of 19 that means the stock, in my view, is worth closer to \$25 - \$30 per share than it is to its current price of \$17.25.

But there is a caveat here (for all you short-term traders): I'm buying Starbucks with the same attitude I would take as if I were buying the entire company. Or an entire store. In other words, I plan to hold the investment for many, many years (indeed, I've been waiting over a decade for the company to slip and for the stock price to come under pressure).

So whether the stock drops a bit after I buy it or rises a bit after I buy it is of no concern to me (if you are NOT comfortable with that, then Starbucks probably isn't the stock for you).

What is of concern to me is to invest my money in a place where I believe I can earn returns on my capital consistent with the returns Starbucks earns on its capital.

In any day and age, earning 25% returns annually isn't something to sneeze at. But in the era of 2% savings yields Starbucks looks more attractive every day.



Dylan Jovine
Chief Investment Officer

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Economic Calendar for the Week of April 14 - April 18

Monday, April 14

8:30AM - Retail Sales

Release Details

- Importance (A-F): This release merits an A-.
- Source: The Census Bureau of the Department of Commerce.
- Release Time: 8:30 ET around the 13th of the month (data for one month prior).
- Raw Data Available At: <http://www.census.gov/svsd/www/advtable.html>.

The retail sales report is a measure of the total receipts of retail stores. The changes in retail sales are widely followed as the most timely indicator of broad consumer spending patterns. Retail sales are often viewed ex-autos, as auto sales can move sharply from month-to-month. It is also important to keep an eye on the gas and food components, where changes in sales are often a result of price changes rather than shifting consumer demand.

Retail sales can be quite volatile and the advance reports are subject to rather large revisions. Retail sales do not include spending on services, which makes up over half of total consumption. Total personal consumption is not available until the personal income and consumption reports are released, typically two weeks after retail sales.

Highlights

- Briefing.com Forecast: 0.4%, 0.7% ex-autos
- Market Consensus: 0.1%, 0.2% ex-autos

Key Factors

- The gains come from higher gasoline prices. Retail sales ex-gas stations are expected to be flat, leaving only 2 gains over the last six months.
- Auto sales are expected to decline given the lowest number sold in 15 years.
- Other durable goods (building materials, furniture, electronics) are expected to show a fourth monthly decline.
- Nondurables (food, merchandise, health) are expected to show a modest gain in addition to the jump at gas stations.

Big Picture

Retail sales are slowing under the weight of high gas prices, falling home prices and weakening consumer confidence. The housing recession drags consumer durable goods (e.g. furniture, building equipment, appliances) as auto sales remain extremely weak. Despite the historically low unemployment rate and moderate income growth, high energy prices have had a deflating effect on consumer spending and big ticket durable goods purchases particularly. Retail goods sales add to service spending to leave total consumer spending.

Tuesday, April 15

8:30AM - PPI: Producer Price Index

Release Details

- Importance (A-F): This release merits a B-.

- Source: Bureau of Labor statistics, U.S. Department of Labor.
- Release Time: Around the 11th of each month at 8:30 ET for the prior month.
- Raw Data Available At: <http://stats.bls.gov/news.release/ppi.toc.htm>.

The Producer Price Index measures prices of goods at the wholesale level. There are three broad subcategories within PPI: crude, intermediate, and finished. The market tracks the finished goods index most closely, as it represents prices for goods that are ready for sale to the end user. Goods prices at the crude and intermediate stages of production often provide an indication of coming (dis)inflationary pressures, but the closer you get to crude goods, the more that these prices track commodity prices which are already available in traded indexes such as the CRB (Commodity Research Bureau).

At all stages of production, the market places more emphasis on the index excluding food and energy, referred to as the core rate. Food and energy prices tend to be quite volatile and obscure trends in the underlying inflation rate. Though the market reaction is determined by the month/month changes, year/year changes are also noted by analysts. The index is not revised on a monthly basis, but annual revisions to seasonal adjustment factors can produce small adjustments to past releases.

Highlights

- Briefing.com Forecast: 0.4%, 0.1% core
- Market Consensus: 0.4%, 0.2% core

Key Factors

- Core prices expected to dip to 0.1% after the strong 0.5% and 0.4% gains over the last two months.
- The removal of the -0.1% core decline a year ago leaves a return to a 2.6% yoy gain. Compares to the decade high 2.8% yoy gain in July 2005.
- No carry over to core consumer prices where core commodity prices are flat from a year ago.
- Total PPI to edge lower to 6.2% annual gain from the 26 year high of 7.4% yoy in January.
- February core intermediate goods prices are at 4.8% yoy, core crude goods at 21% yoy.
- However, the leaks are severe in the producer pipeline given the weak pricing power. The non core (food, energy) pressures will continue.

Big Picture

Annual growth rose to a quarter century high of 7.4% in January given the surge in energy prices but has fallen off to 6.4% yoy in February. Annual growth was just 2.3% in August before the acceleration in energy prices. Higher food prices also weigh in as the core component has turned a bit stronger to 2.4%. More important, to date core producer pipeline pressures are not providing any lift to core consumer prices. CPI core commodity prices are flat from a year ago despite the rise in core PPI prices. That is, core wholesale/commodity pricing pressures aren't yet pressuring retail prices as non-core energy and food prices are.

Wednesday, April 16

8:30AM - CPI: Consumer Price Index

Release Details

- Importance (A-F): This release merits a B .
- Source: Bureau of Labor statistics, U.S. Department of Labor.
- Release Time: 8:30 ET, about the 13th of each month for the prior month.
- Raw Data Available At: <http://stats.bls.gov/news.release/cpi.toc.htm>.

The Consumer Price Index is a measure of the price level of a fixed market basket of goods and services purchased by consumers. CPI is the most widely cited inflation indicator, and it is used to calculate cost of living adjustments for government programs and it is the basis of COLAs for many private labor agreements as well. It has been criticized for overstating inflation, because it does not adjust for substitution effects and because the fixed basket does not reflect price changes in new technology goods which are often declining in price. Despite these criticisms, it remains the benchmark inflation index.

CPI can be greatly influenced in any given month by a movement in volatile food and energy prices. Therefore, it is important to look at CPI excluding food and energy, commonly called the "core rate" of inflation. Within the core rate, some of the more volatile and closely watched components are apparel, tobacco, airfares, and new cars. In addition to tracking the month/month changes in core CPI, the year/year change in core CPI is seen by most economists as the best measure of the underlying inflation rate.

Highlights

- Briefing.com Forecast: 0.3%, 0.2% core
- Market Consensus: 0.3%, 0.2% core

Key Factors

- 0.3% gain leaves unchanged annual growth of 4.0%. Compares to 2% yoy gain in August before energy prices surged.
- Energy prices provide another lift in March as the core is expected at 0.2%.
- Annual core growth edged back to 2.4% annual growth. Reached a low of 2.1% yoy in Aug/Sept before rising to 2.5% yoy in January.
- Core commodity prices are flat from a year ago, energy (19% yoy) as services (3.2% yoy) provide the core pressure.
- Core hot spots: the services of medical care (5% yoy) and education (6% yoy). Owners equivalent rent (30% of core CPI) has softened to 2.6% yoy from 4.1% at the start of 2007.

Big Picture

The core rate of consumer inflation reached a decade high of 2.9% yoy in September 2006, eased off to 2.1% and has climbed back to 2.3% yoy in February. The stickier prices for medical care and tuition will continue to hold firm as yoy core commodity prices are flat from a year ago despite the pressure down the pipeline. Energy prices provide the monthly swing and the largest underlying pressure. In the big picture its aggregate demand which provides the price direction as sub-potential growth (below 3%) will ease the core inflation

pressures over time. The Fed more closely watches core PCE prices as an inflation guide which stands at 2.0% yoy -- at the low end of 2008 Fed expectations and the high end of the Fed's 1%-2% 'comfort zone'. Overall CPI reached a 14 year high of 4.7% yoy in Sept '05 as energy prices have provided the recent lift to the current 4.0% yoy.

8:30AM - Housing Starts and Building Permits

Release Details

- Importance (A-F): This release merits a B-.
- Source: The Census Bureau of the Department of Commerce
- Release Time: 8:30 ET around the 16th of the month (data for one month prior).
- Raw Data Available At: <http://www.census.gov/const/www/newresconstindex.html>.

Housing Starts are a measure of the number of residential units on which construction is begun each month. A start in construction is defined as the beginning of excavation of the foundation for the building and is comprised primarily of residential housing. Building permits are permits taken out in order to allow excavation. An increase in building permits and starts usually occurs a few months after a reduction in mortgage rates. Permits lead starts, but permits are not required in all regions of the country, and the level of permits therefore tends to be less than the level of starts over time.

The monthly national report is broken down by region: Northeast, Midwest, South, and West. Briefing recommends analyzing the regional data because they are subject to a high degree of volatility. The high volatility can be attributed to weather changes and/or natural disasters. For example, an unexpectedly high level of rain in South could delay housing starts for the region.

Highlights

- Briefing.com Forecast: 1015K starts, 975K permits
- Market Consensus: 1025K starts, 970K permits

Key Factors

- A -4% to -5% decline still leaves the level above the 17 year low reached in December.
- Starts are less than half the pace of the January 2006 peak.
- The downward trend in new home sales isn't expected to end soon and argues for a long wait for stability in new construction.
- Tighter mortgage lending and huge unsold inventories are also lengthening the wait for stability in starts.
- Permits to build are expected to fall about -1% from the 16 year low of February.

Big Picture

Housing starts reached a 17 year low in December with no sign of the fundamentals (housing demand) needed to turn the direction over the intermediate term. The plunge has been a large drag on economic growth as further risk surrounds the defaults/foreclosures coming from sub-prime and other mortgage borrowers. The

upturn could be a long way off in early 2009. The correction for the inflated housing market was expected (and needed) but with a more moderate decline as the poor quality mortgage lending has added strongly to the downturn. Stability will have to wait for new home sales to tick higher and unsold inventory to significantly thin. Continued lending to low risk mortgage borrowers is needed just to get the declines to decelerate. Housing starts have fallen 53% since the January 2006 peak.

9:15 - Industrial Production

Release Details

- Importance (A-F): This release merits a B-.
- Source: Federal Reserve.
- Release Time: 9:15 ET around the 15th of the month (data for month prior).
- Raw Data Available At: <http://www.federalreserve.gov/releases/G17/Current/g17.txt>.

The index of Industrial Production is a fixed-weight measure of the physical output of the nation's factories, mines, and utilities. Manufacturing production, the largest component of the total, can be accurately predicted using total manufacturing hours worked from the employment report. One of the bigger wildcards in this report is utility production, which can be quite volatile due to swings in the weather. Severe hot or cold spells can boost production as increased heating/cooling needs drive utility production up.

In addition to production, this monthly report also provides a measure of capacity utilization. Though the rate of capacity utilization is seen as a critical gauge of the slack available in the economy, the market does not completely trust this measure. Capacity is very difficult to measure, and the Fed essentially assumes that growth in capacity in any given year follows a straight line. One can therefore predict the capacity utilization rate quite accurately based on the assumption for production growth. The 85% mark is seen as a key barrier over which inflationary pressures are generated, but given revisions to these data and the difficulties with capacity measurement, the 85% mark should be viewed cautiously. It would be appropriate to look for corroborating inflation indications from commodity prices and vendor deliveries.

Highlights

- Briefing.com Forecast: 0.1%, capacity utilization 80.4%
- Market Consensus: -0.1%, capacity use 80.4%

Key Factors

Manufacturing aggregate hours were flat in March -- strongest in four months.

Suggests a small rise in manufacturing output after February's -0.3% decline.

Electricity use argues for a small gain in utilities, higher oil prices are in line with a gain in mining output.

Moderate gain in annual production contrast with a decline over the last six months.

Revisions leave capacity utilization expected to be unchanged at 80.4%, manufacturing near February's 78.7% -- both well below the inflation danger zones.

Big Picture

Industrial production is slowing after the early 2007 lift that followed the deceleration in late 2006. 6 month growth is negative despite the moderate 1.3% gain from a year ago. Strong export demand provides welcome support. The risk ahead is that business capital investment stalls given the weaker economic growth outlook which feeds in to factory orders, production and the economy overall. Capacity use stands at 80.4% -- below the level historically consistent with inflationary pressures -- as manufacturing reflects more excess capacity at 78.7%.

Thursday, April 17

10:00AM - Philadelphia Fed Index

Release Details

- Importance (A-F): The Philadelphia Fed Index merits a B.
- Source: The Philadelphia Federal Reserve bank.
- Release Time: Third Thursday of the month at 12 ET for the current month.
- Raw Data Available At: <http://www.phil.frb.org/>

In Brief

There are many regional manufacturing surveys, and they tend to be ranked in order of timeliness and the importance of the region. The Philadelphia Fed's survey is first each month, actually coming out during the third week of the month for which it is reporting. Several smaller surveys are then released before the Chicago purchasing managers' report on the last day of each month. A few, such as the Atlanta and Richmond Fed surveys, are released after the NAPM and are of little value. The purchasing managers' reports are measured like the national NAPM - 50% marks the breakeven line between an expanding and contracting manufacturing sector. For the Philadelphia and Atlanta Fed indexes, 0 is the breakeven mark.

These surveys can be of some help in forecasting the national NAPM - particularly the Philadelphia and Chicago surveys which are more closely watched due to their timeliness and the fact that these regions represent a reasonable cross section of national manufacturing activities.

Highlights

- Raw Data Available At: <http://www.phil.frb.org/>