Starbucks Coffee Company Fiscal 2008 First Quarter Financial Results Prepared Remarks

Remarks from Howard Schultz, chairman, president and ceo

During today's call, I will give an overview of some of the progress we've made over the past several weeks to lay the foundation for the transformation of Starbucks, as well as our first quarter results. Pete will then take you through the financials in greater detail, and after that we'll be happy to answer any questions you may have.

First, I want to say how confident I am in what's ahead for Starbucks. Over the past three weeks, I have received thousands of emails from customers and partners who share my enthusiasm. Our brand and business are truly special. People want us to succeed, and we are looking forward to transforming Starbucks for the future.

The past several weeks have also been notable for the noise about competition in the coffee space. Let me emphasize: we don't see that as the issue. What we have to do is simple: Differentiate our experience, so that when a customer walks into a Starbucks store, they get something that they can ONLY get from us: the highest quality coffee in the world served by the most passionate and knowledgeable people in the industry. We created the experience, and we will re-create that differentiation and our leadership position. We control our destiny.

And when we do that, we grow our business. We are a growth company. Our past success was built on us striving to do better and be better, on connecting with customers and innovating, and on embracing change, not fearing it. So our future growth – at the levels you and we expect from Starbucks – will also be based on those same qualities. Returning to the sort of growth we want to achieve requires us to sharpen our competitive advantages: our passion, curiosity, community, commitment and authenticity. That's how we build our deep and enduring connection with our customers.

As important, today we have an excellent platform on which to build. After all, this quarter our results included:

- Operating income of $333 million;
- Net cash from operating activities of $808 million; and
- Solid International performance, with revenue growth of 33 percent and enhanced profitability of over 60 percent in the quarter.

But at the same time, our Q1 performance clearly shows we have work to do to get our business back to where it should be. We are absolutely not satisfied with our overall performance during this period, which Pete will discuss in more detail in a few minutes.

What do we have to do? Transform the way we do business. As I described earlier in the month: we need to improve the current state of the U.S. business; reignite the emotional attachment with our people and our customers; and make fundamental changes for the long-term.

And in all three areas, going forward, we are going to make decisions based on what's right for our customers. We are laser focused on delivering what they want and expect, and providing our partners with the tools that will help them exceed their expectations.

In doing that with passion, creativity and commitment, we expect to deliver increased growth and shareholder value in a way that is sustainable and in-line with what you, and we, expect.

It has only been three weeks since the change in leadership, but we have made significant progress:

We now have put in place the organizational structure and the leadership team directly aligned to focus on customers and partners engaged in delivering on our high-impact strategies.

Martin Coles is now focusing, with me, on developing and effectively executing our strategy.

And we expect to get additional leverage across the organization with Michelle Gass, who most recently led our global product and brand group, in the new role of senior vice president, Global Strategy. She will work closely with Martin and me to help implement all aspects of our transformation plan.

We promoted Terry Davenport to lead our marketing and brand strategy group. We have also hired Harry Roberts, a former Starbucks executive, to assume the newly created role of chief creative officer and be responsible for the customer in-store experience.

We have moved Chris Bruzzo, a current partner, into the newly created position of chief technology officer, a position he earned for the exceptional work he has done since joining us from Amazon a year ago.

With a keen focus on our partners, we have promoted Chet Kuchinad, an experienced partner, to lead Partner Resources – our HR function.

In addition, we are in the process of recruiting senior executives for our newly established Global Real Estate Design and Architecture group, as well as a new chief information officer, and a leader for our Public Affairs function.

With this team, we are now positioned to free up Launi Skinner, president of our U.S. business and Jim Alling, president of International, to do what they do best: operate their businesses.

Working together, we will return to what has always set us apart, the unique Starbucks Experience – connecting with our customers by delivering the highest quality coffee and hand-crafted beverages in a warm and inviting store environment.

We have now assigned accountabilities to all our leadership team and their direct reports. They will own everything about their business and have responsibility for specific projects to drive the transformation agenda forward. We have also validated a number of programs that were already in the pipeline or underway that will support and further the vision. And for all of these, we have set timeframes for deliverables…with some coming in the very near future, especially in the U.S. business.

Make no mistake, we will transform the business while strengthening our relationship with our customers and building on our premium and leadership position.

The first of these actions, as we told you earlier this month, is to slow the pace of U.S. store openings. We now plan to open a total of approximately 1,175 net new stores in the U.S. this year, down 34 percent from our fiscal 2007 openings. That includes closing approximately 100 underperforming stores. In addition, for 2009 we plan to open fewer than 1,000 new U.S. stores.

By reducing the number of openings, we expect to optimize our resources and potentially reduce cannibalization of existing stores.

We have also taken decisive action in other areas to enhance the Starbucks Experience. Let me give you an example....

We have decided that by the end of fiscal year 2008, we will discontinue warmed breakfast sandwiches in our North American stores. The highest priority for our food team is to develop the right offerings so that we are the source of healthy breakfast on the go, and also provide the best baked goods in the business, to complement our superior coffee and espresso beverages. Our customers have told us they want a healthy breakfast alternative. No one in the market has responded to that need, and we believe that by being innovative we have a unique opportunity to do so.

Some of you may be asking why we made this decision … In short, the scent of the warmed sandwiches interferes with the coffee aroma in our stores, which is key to the coffee experience that forges our connection with customers. Moreover, while our customers liked our sandwiches, they told us that they missed the aroma of coffee. We will continue warming pastries and selling lunch, with some modifications to the lineup.

We recognize there could be a short-term revenue impact to this decision, but it is right for the business. And if we execute flawlessly on our core – coffee – then we will drive customer engagement and longer-term top and bottom line growth.

That is just one example of some of the changes you will see in the coming months that will substantially change the retail experience in the U.S. At our Annual Meeting of shareholders on March 19th, we will lay out 5 specific, bold "consumer facing" initiatives that will be a major catalyst for change and transformation. They will be innovations through which we will: extend our coffee leadership; reinvest in making our stores the third place for the next decade; encourage a deeper dialogue with our customers; and further strengthen our partners' and customers' relationships with one another. And that will just be the beginning.

These actions will reaffirm for customers and the marketplace that, unlike others, we are not a reseller of commodity-based coffee roasted by a third party. We never have been – and never will be. We will utilize our 35-plus years of ethically sourcing, buying and roasting the finest coffee in the world to reaffirm our coffee authority.

We are confident through our actions we will get back on track in redefining the customer experience and expanding the differentiation in the market between us and the others in the coffee business.

At the same time as we have devoted considerable attention to the U.S. strategy, we are capitalizing on our substantial International opportunities.

This fiscal year, we will open approximately an additional 75 net new stores in international markets, increasing the international store opening target for the year to about 975 net new stores. In fiscal 2009, that number will rise to over 1,000 new stores internationally, and mark the first time that our International store openings will outpace those in the U.S. As we continue to build our business around the world, we are encouraged by the strong customer response in existing markets, and the tremendous reception our brand receives in new markets, such as the Czech Republic. We opened our first store in Prague this month to near-record crowds and sales, and given the centuries-long café tradition there, it’s a market that we view as a great opportunity to compete and succeed. Further, the strong initial response is a great sign for our expansion in Central and Eastern Europe. We plan for Poland and Hungary to be the next markets there.

I want to emphasize that the capital we are putting toward our international business is focused on profitable growth. We will also leverage what we learn in different markets around the world to share best practices in all of our stores.

We are very excited about the opportunities that lie ahead of us not only in the U.S. and International businesses, but also in our Consumer Products Group. As you will hear from Pete, our CPG business had a solid quarter and we view it as an important growth driver both for our brand and our performance.

We are also mindful that as we take these actions to deliver improved top-line performance in the future, we also intend to realize opportunities to leverage back-end costs.

Given all of the work underway, we view fiscal 2008 as a year of refocus and renewal. But there are no quick-fix solutions – it will take time. We are confident our transformational changes will position us well for the long-term.

Consequently, there will be moving pieces in the coming months that include funding for our innovations, and we also expect there will be continued weakness in the macro-economic environment that affects our customers.

For these reasons, during this critical period of transition and transformation, we believe that you should expect low double-digit EPS expansion for this fiscal year.

By the end of the fiscal year, however, we anticipate that Starbucks will have gone through the transition, be reinvigorated, and our customers will have a new experience in our stores. And in fiscal 2009, we will be well on the path of providing sustainable growth and long-term value for our shareholders.

Accordingly, we believe that you – and we – need ways to measure our progress as we build and then leverage our strong foundation to capture those long-term growth opportunities.

Therefore, we are committed to coming back to you quickly, in April when we announce our second quarter results, with quantifiable, longer-term metrics. Pete will discuss what we are planning in some more detail in just a few minutes. And with those longer-term metrics in place, we are discontinuing annual guidance for fiscal 2009 and beyond.

In addition, a number of our near-term changes will directly impact the retail stores. Therefore, we will not report same store sales comps, as they will not be an effective indicator of our performance. Once our U.S. performance normalizes following our actions, we will evaluate the value of reporting quarterly same store sales comps.

We believe these actions are the right thing for our company and our investors. They will assist our people and management team in making the right business decisions to focus on the customer, and in running the business to create long-term growth and value for shareholders.

Before I hand the call over to Pete, let me just make a comment on one particular subject that's gotten a lot of attention in the last few weeks – the $1 brewed coffee, eight ounce short cup test.

With a brand like ours and stores all over the world, we conduct dozens of tests a year…and it's inevitable that people will get interested in a test like this. We are running it in a limited number of stores in the Seattle area to respond to the economic pressures that our customers are under.

Right now, as a test, it makes sense to us: Starbucks is built on premium coffee and a premium experience. And similar to other leading global consumer brands, we believe there are opportunities to create segmentation, provide an entry point for new customers, and generate trial in a way that will also maintain the value of the core brand proposition.

We intend to reaffirm our position as the coffee authority and maintain our leadership position at the high end while broadening our appeal. I would like to emphasize this offering is just a test. We will be listening intently to our customer feedback, as well as evaluating whether such a product advances our business objectives and creates value while maintaining our leadership position.

Now let me invite Pete to take you through the quarter. Pete…

Remarks from Pete Bocian, executive vice president and cfo

Thanks, Howard, and good afternoon, everyone.

- Revenues for the quarter were up 17 percent to $2.8 billion, from $2.4 billion a year ago.
- Operating income for the quarter increased to $333 million from $320 million in the prior year. Operating margins contracted 160 basis points to 12 percent, from last year's first-quarter margin of 13.6 percent, driven by the U.S. business. In the quarter, both International and CPG operating margins improved, and favorable Corporate G&A contributed positively as well. The decline in the consolidated margins was the result of higher cost of sales and occupancy, and an increase in store operating expenses, again, driven by the U.S. business. I will provide more detail behind these drivers when I talk about the U.S. results.
- Earnings per share increased to $0.28 cents in the first quarter of this fiscal year, in line with our expectations, and compared to $0.26 cents per share in Q1 of '07. As expected, higher dairy costs resulted in a negative $0.02 impact to EPS in the quarter. That said, while the $0.28 cents was what we expected overall entering the quarter, results from International, our Consumer Products Group and back-end G&A exceeded our expectations, offsetting a much softer U.S. business.

- Non-operating factors impacting net earnings for the quarter included higher interest expense driven by an increased level of debt when compared to the first quarter of 2007. The debt was used to repurchase shares, resulting in a net neutral impact on earnings per share in the quarter. We also had a slightly better effective tax rate year over year.

- Comparable store sales growth was 1 percent for the quarter – all driven by the International business. I will talk more specifically about the business results later in my segment discussions, but it's clear that our U.S. business continues to feel the negative impact of the macroeconomic environment, not dissimilar to what other retail brands are seeing. A bright spot in the quarter was International same store sales growth, where we continued to show strength, with a 5 percent increase year over year.

Let me now move to first-quarter results for our operating segments.

U.S. total net revenues increased by 14 percent to $2.1 billion in the first quarter of fiscal 2008. Company-operated retail revenues rose 14 percent to $1.9 billion for the quarter, driven by the opening of 1,077 new company-operated retail stores in the last 12 months. Comparable store sales declined 1 percent in the quarter, driven by a 3 percent decrease in transactions. We did have a 2 percent increase in the average value per transaction, mostly due to the price increase taken at the end of July 2007. And while it had a positive impact on the average value per transaction, we believe pricing had the opposite affect on transactions. While this performance was below our plan and expectation entering the quarter, we believe it is consistent with and reflects the pressure the consumer is experiencing in this difficult economic climate. For us, this has resulted in decreased frequency of visits by our customers to our U.S. stores. While we cannot directly impact the economic environment, we do believe that slowing the opening of new stores in the U.S., along with the closure of underperforming locations, will take some of the pressure off of existing stores, allowing us to make better decisions around how we deploy our capital.

U.S. cost of sales including occupancy costs as a percentage of total revenues increased to 41.1 percent, compared to 39.3 percent in Q1 of last year, up 180 basis points. While this is a slight improvement from how we finished 2007, continued pressure from dairy, and to a lesser extent, the shift in sales mix to higher cost products combined with overall lower store transactions, continues to drive year over year increases.

U.S. store operating expenses increased to 40.5 percent of related U.S. retail revenues compared with 39.1 percent a year ago. This increase was primarily due to wage increases driving higher payroll-related expenditures as a percentage of revenues, and softer sales from our U.S. company-operated stores.

U.S. other operating expenses improved 120 basis points to 25.0 percent of related specialty revenues from 26.2 percent in the prior year, primarily due to leverage gained from a growing revenue base in our U.S. Licensed stores and Foodservice channels.

U.S. operating income declined to $311 million during the quarter from $325 million in Q1 of fiscal 07. Operating margins came in at 14.6 percent of total revenues for the first quarter of fiscal 2008, from 17.5 percent a year ago, primarily driven by higher cost of sales including occupancy and higher store operating expenses, partially offset by lower G&A as a percentage of total net revenues.

Currently, the U.S. business represents a significant amount of the Company's revenues and profit so softness in the U.S. business has a material impact on overall results.

That said, we are encouraged by the improvement in performance of our International business in the quarter, and we continue to believe this represents a significant opportunity for growth and profitability for the company going forward.

International total net revenues increased 33 percent to $541 million in the first quarter from $405 million in the first quarter of fiscal 2007. Company-operated retail revenues increased 33 percent to $461 million, mainly due to the opening of 285 new company-operated retail stores in the last 12 months, favorable foreign exchange movement in the Canadian dollar and the British pound sterling, and comparable store sales growth of five percent for the quarter. The comparable store sales increase resulted from a three percent increase in the number of customer transactions and a two percent increase in the average value per transaction. We believe the growth in International revenues continues to demonstrate the strong acceptance of our brand and the Starbucks Experience globally.

International operating income increased 63 percent to $54 million in the first quarter compared to $33 million a year ago. In the quarter, we delivered the first installment on our commitment to grow and improve operating margins, with a 180 basis point expansion, from 8.2 percent of revenues in the first quarter of last year, to 10.0 percent of revenues in this fiscal year's first quarter. This improvement was due to lower occupancy costs year over year in the UK and lower store operating expenses overall. We are pleased with our Q1 operating margin expansion, and will continue to drive for margin improvements going forward.
Now let me turn to results from our Global Consumer Products Group.

Total net revenues for CPG increased 11 percent to $101 million in the first quarter of fiscal 2008. Increased product sales and royalties from the International ready-to-drink business along with increased sales of packaged coffee and tea in our International and U.S. markets contributed to the increase.

Operating income for CPG was $51 million in Q1 of '08, compared to $42 million in the first quarter of fiscal 2007. The Operating margin expanded to 50.3 percent of related revenues, from the 45.9 percent reported in Q1 of fiscal 2007, primarily driven by a decrease in the cost of sales expense as a percentage of revenues.

Before I move on to a few comments related to our balance sheet, I want to note the 50 basis point improvement in G&A expenses as a percentage of total net revenues. This demonstrates progress we are making in leveraging our scale and infrastructure, while at the same time, we are also implementing systematic changes, which we expect will better position the company's back-end infrastructure to deliver more efficient service and support to our retail network.

As previously reported, the company issued $550 million of 6.25% Ten-year Notes in Q4 of '07, a component of our strategy to reduce the overall weighted average cost of capital for the company.

Proceeds from this offering were primarily used to repay short term borrowings and fund additional share repurchases. Our longer term outlook on the company's capital structure is unchanged: any additional funding would be consistent with management's strategy of targeting leverage and coverage ratios to be roughly in line with a high Triple B rating over the medium-term, which is where we are today.

During the first quarter, the company repurchased 12.2 million shares of common stock for a total cost of $295 million. After the first-quarter share repurchase, there were only 1.3 million shares of remaining authorization. As you saw today in our press release, we announced a new share repurchase authorization by our Board of Directors for up to an additional 5 million shares of our common stock. Going forward, we will make use of this authorization, in line with the parameters mentioned earlier.

To summarize the quarter, there were a number of positives:

- We achieved revenue and EPS expansion in line with our expectations, in spite of a more negative U.S. economic environment;
- We delivered notable improvement in the International margin and will continue to drive for improvements going forward;
- CPG and G&A leverage also provided positive contributions to overall results. We will continue to focus on opportunities to leverage our scale and infrastructure, and we are encouraged by the energy and attention we are already seeing around a global platform approach.

On the other hand, the continued weakness in the U.S. business was disappointing, although not entirely unexpected given continued deterioration in this challenging economic and operating environment. And, as anticipated, higher dairy costs had a significant negative impact on our U.S. margins.

So what are we doing to turn the U.S. business around?

To begin with, earlier this month, we committed to further slowing U.S. store growth, including more aggressively closing underperforming locations. We have made substantial progress over the past few weeks. As Howard mentioned earlier, we have identified approximately 100 underperforming U.S. company-operated retail stores. These anticipated closures for our U.S. company-operated stores followed an in-depth analysis of our portfolio, and is nearly 6 times our prior 3-year average for store closures. These actions – coupled with a reduction in new store openings - brings us to our fiscal 2008 U.S. company-operated store openings target of approximately 650 net new company-operated stores and 525 licensed stores.

In our International business, we will open about 75 additional net new stores this fiscal year – moving faster on the growth opportunity in International, where we are still in the early stages.

Looking out to fiscal 2009, we plan to open more than 1,000 net new stores in International markets and less than 1,000 new locations in the U.S., with approximately half of those to be company-operated stores. This marks a significant crossover point in our growth strategy as we plan to build out more new stores in International markets than in the U.S. beginning in fiscal 2009. It also signals progress toward increasing the future contribution from our International business to the overall enterprise.

In a year of significant transformation for us and a very difficult macroeconomic environment, we are looking to deliver low double-digit earnings growth….lower than expected, but a year that we believe balances the need for transformation and investment, with delivering near-term results.

When we come back in late April with our Q2 results, we will be prepared then to deliver to you our 3-year view through 2011. At that time, we will provide you with our 2011 targets for:

- Revenue – from a total company view, as well as for our three business segments: U.S., International and CPG;
- Operating income for the company and for each segment;
- Earnings per share;
- Capital deployed and Free cash flow.

We will also provide you with some color as to how the performance during that three-year period will sequence. And we do expect to make progress and start delivering in 2009.
With that, I will turn the call back over to Howard for his closing remarks.

Remarks from Howard Schultz, chairman, president and ceo

Thank you, Pete. Before I open the call up to your Q&A, I want to share one other encouraging result with you…one that cannot be quantified and that many of you may discount…but one that I believe is emblematic of the success that lies ahead for Starbucks.

Our connection with our customers begins with our partners who are so closely reflective of those we serve. We do not need to rely heavily on focus groups to develop new ideas; our relevance with our customers comes from the fact that we are among them, part of the same communities and part of their lives.

That is why I am so excited by the overwhelmingly positive internal response and engagement by our partners. Their focus and commitment will help us realize our objectives with our customers, and our goals for creating long-term growth and shareholder value.

This is a sentiment that is echoed in Fortune Magazine's recently released "100 Best Companies to Work" where we ranked number 7. This is our debut in the top 10, and the highest ranking we have received in the 10 times that we have been included in the list.

Having a strong group of dedicated partners at all levels of the company provides a critical boost to our efforts. We believe passionately that when we invest in our people, build an emotional connection with them and get them fully engaged with our strategy and agenda, we see the positive results in our performance. To help us achieve that, we are bringing back our annual Leadership Conference in the Fall of 2008. This is the most important and strategic event that we hold for store managers and above. And it is a major internal signal that the transformation is not only occurring for customers, but for our people as well. Not only does it help us generate understanding and enthusiasm about our vision and strategy throughout our organization, but it ensures that we maintain the links between our field and corporate leadership. This year, we will also augment it with a series of open forums for all of our partners around the world.

Everyone here at Starbucks knows that we have a lot of work ahead of us. Rest assured though, planning and in fact execution are well underway. We have shared with you a summary of what we have accomplished already in these past three weeks. In about six weeks from now, we look forward to showing you our innovative platforms which will begin to re-invent the customer experience. And then, six weeks from that time on April 30th, we will frame out in detail our strategic and financial plans. At that time we will also give you a date, for later in the year, when we intend to host an Analyst Conference to tell you more about where we are and what we have on tap…as well as introduce you to some of the leadership team who are so critical in making it happen.

We are all very excited about the future for Starbucks, and confident the actions we are taking will deliver long-term shareholder value and maintain our position as one of the world's most recognized and respected brands. Now let me open the call to your questions.

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