

# STARBUCKS CORPORATION

## Background

Starbucks started operations in 1971 by opening its first retail store in Seattle and by 2003 had grown to be the world's leading retailer, roaster and brand of specialty coffee. This led to an ever increasing business risk as it expanded internationally.

The firm's objective was to establish Starbucks as the most recognized and respected brand in the world. This was achieved by its rigorous financial and marketing strategies. It also pursued opportunities to leverage the Starbucks brand through introduction of new products and the development of new distribution channels. It also devised strategies to attract new customers to its retail stores and retain the existing customers. This was done by: starting in store wireless "Wi-fi hot spots"; introducing re-loadable stored value Starbucks Card; introducing the all in one Starbucks Card with Visa credit card.

Starbucks retail stores were typically located in high traffic, high visibility locations. Each store varied its product mix depending upon the size of the store and its location. Larger stores carried a broad selection of the firm's whole bean coffees in various sizes and types of packaging as well as an assortment of coffee and espresso making equipment and accessories. Some stores also carry travel tumblers, Hear music CD, logo mugs, "grab and go" sandwiches and salads. It also established a joint venture with Pepsi -Coal Co. and began selling Frappuccino as a bottled coffee drink. Another joint venture with Dreyers' Grand ice cream made Starbucks the number one brand of coffee ice cream in US. In 1998, it entered into a licensing agreement with Kraft Foods to accelerate the growth of Starbucks products in grocery channels throughout US.

Starbucks strategy was to reach customers where they work, dine, travel and shop. This was achieved by establishing relationships which could take a number of forms – business alliances, international store licensing agreements, grocery channel licensing agreements, warehouse club accounts, interactive operations, equity investees and other initiatives related to the firm's core business.

Now since Starbucks was expanding globally as well as locally, it had to devise strategies to organize funds. It had recently announced an extension and expansion of its stock buyback. The main purpose of this act was to offset dilution from the firm's long standing employee compensation plan.

## Main Question

Howard Shultz, Chairman and Chief global strategist of Starbucks, had suggested an all equity capital structure for the next 5- 10 years to fund the firm's funds

requirement. On the other hand Mr. Casey, Chief Financial Officer, had brought up a proposal of moving from no-debt structure to 20%, 35% or 50% debt based on book values of debt and equity.

This case tries to find the best proposal for Starbucks to fund its international and local growth.

### Current Financial State (as given in case)

<i>Division Type</i>	<i>Net revenues(\$)</i> 2001	<i>Net revenues(\$)</i> 2002	<i>Change (%)</i>
Specialty Operations	2.23 bn	2.79 bn	▲ 25.3%
Food Service Accounts	130 mn	133.9 mn	▲ 3%
Retail Store licensing	62.9 mn	89.3 mn	▲ 42%
International Retail Store Licensing Group	-	-	▲ 54.7%
Grocery Channel Licensing	58.7 mn	64.5 mn	▲ 9.9%
Partnership with Dreyers Ice cream	8.4 mn	9.9 mn	▲ 17%

Please see Exhibit 1-a and Exhibit 1-b

<b>Financial Ratios</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
LT Debt / Equity	0	0	0	0
EBIT / Total Net Rev	0.09	0.07	0.1	0.1
Net Earnings / Cur. portion of LT Debt	144	134	258	307
EPS – Basic	0.28	0.25	0.48	0.56
ROE (EBIT / Tot. Share. Equity)	0.17	0.14	0.2	0.2
ROA (EBIT / Total Assets)	0.13	0.11	0.15	0.15

## Calculation of Cost of Equity

Unlevered equity beta is currently .74:

$$B^u = B^l / 1 + (D/E) \\ .74 = B^l / 1.0$$

Levered equity beta for 50% debt ratio is 1.1:

$$B^l = B^u (1 + D/E) \\ = .74 (1.5) \\ = 1.1$$

Using Hamada Version of Levered Equity:

$$B^l = B^u (1 + (1-t)(D/E)) \\ = .74 (1 + (.63)(.5)) \\ = .74 (1.32) = .98$$

Using CAPM:

$$R_e = R_f + b(R_r - R_f) \\ R_e = 4.9\% + 1.1 (12.8\% - 4.9\%) \\ = 4.9\% + 8.69\% \\ = \mathbf{13.59\%}$$

Marginal Cost of Equity:

$$k_{equity} = (EPS/P) + g \\ = (.56/23) + .36 \\ = .03 + .36 \\ = .38\%$$

## Calculation of Cost of Debt

BBB rating was used since Starbucks' rating will fall as company assumes additional debt

### 20 Year Yield on BBB

Month	Yield
Jan-03	7.48
Feb-03	7.41
Mar-03	7.61
Apr-03	7.22
<b>Average Yield</b>	<b>7.43</b>

Why BBB Rating?

- ❖ Considered debt rating at optimal 50% debt structure  
*EBIT Interest Coverage in 2007: 6.25*
  - Implies A rating: very low default risk
- ❖ *LT Debt/Equity Goal: 50%*
  - **Implies BBB rating**
- ❖ *Total Debt/Equity in 2007: 103%*
  - Implies CCC rating
- ❖ *ROC in 2007: 13.9%*
  - Implies BBB rating

- ❖ *Free Operating Cash Flow/Total Debt: 8%*
  - Implies BB - BBB rating
- ❖ Bond Rating Definition
  - **BBB** - An obligor rated 'BBB' has ADEQUATE capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
  - **BB** - An obligor rated 'BB' is LESS VULNERABLE in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitments.

### Starbucks Capital Structure under various debt ratios

Please see **Exhibit 3**

Based on the Capital Structure calculations for various debt ratios, the optimal capital structure for Starbucks is 50% assuming a BBB debt rating.

Starbucks should leverage up to 50% debt in a phased manner over five years and reach 50% debt ratio by 2007.

**Exhibit 2** shows the 2003-2007 Starbucks Income Statement projections with the goal of reaching 50% debt ratio.

**Exhibit 4** shows the 2003-2007 Starbucks Balance Sheet projections with the goal of reaching 50% debt ratio.

### Book Value vs. Market Value

From Exhibit 4, the comparison of the Book Value and Market values is made.

2002		
387 M Shares	387 M Shares	...MV is 5x the BV
BV per Share: \$4.6	MV per share: \$23	
Total BV: <b>\$1,780M</b>	Total MV: <b>\$8,901M</b>	
2007		
354 M Shares	354 M Shares	...MV is 6x the BV
BV per Share: \$7.94	MV per share: \$47.7	
Total BV: <b>\$2,810M</b>	Total MV: <b>\$16,885M</b>	

## Analysis of Future Lease Obligations

These numbers are used in calculations in the Balance Sheet projections Exhibit 4.

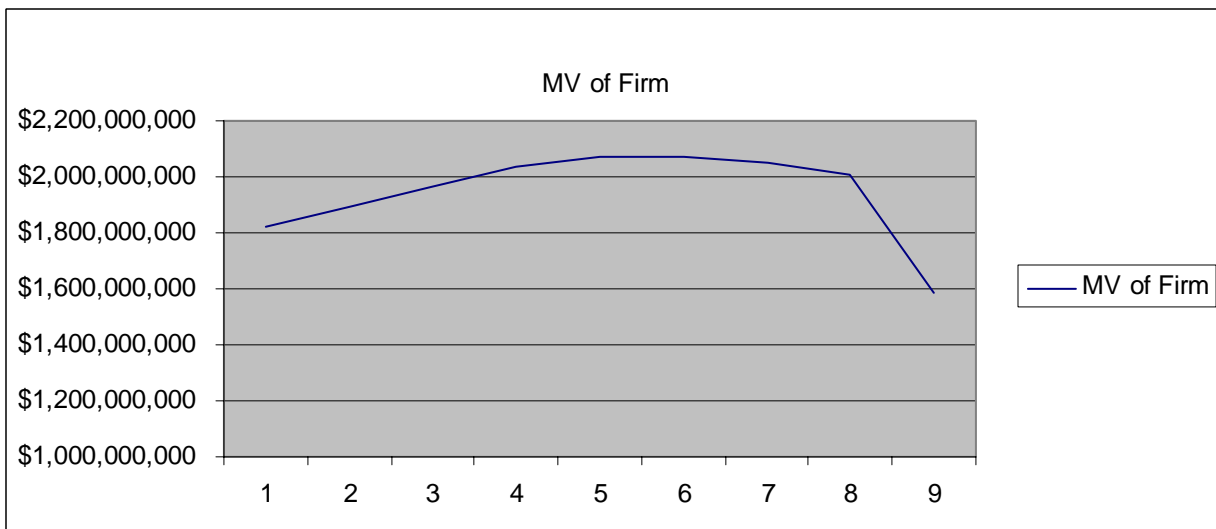
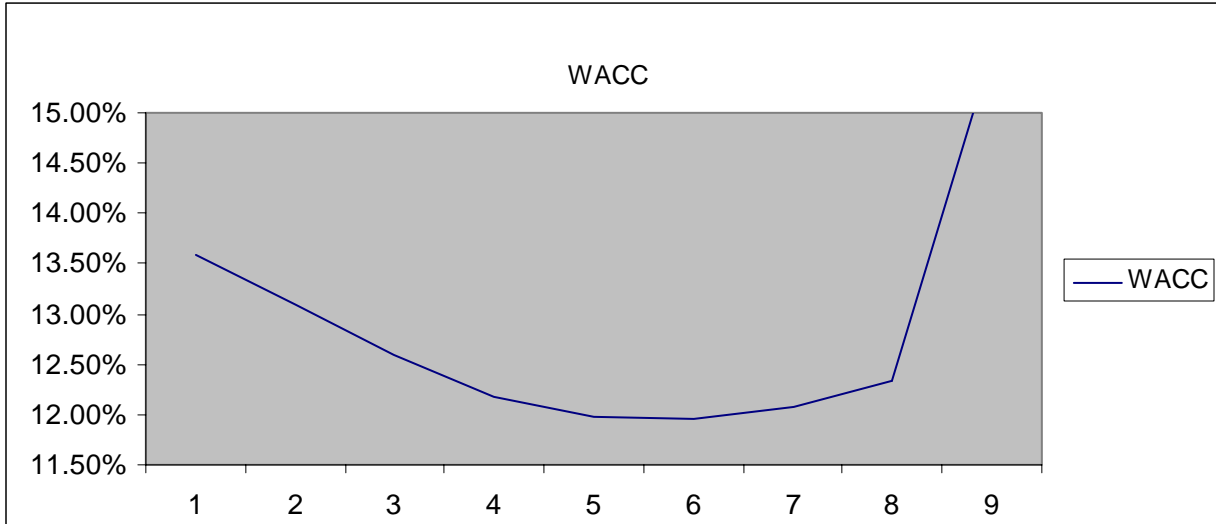
<i>Year</i>	<i>Commitment</i>
<b>2003</b>	248,026
<b>2004</b>	243,519
<b>2005</b>	232,641
<b>2006</b>	219,384
<b>2007</b>	203,394
<b>Thereafter*</b>	863,874

\* Took NPV of the average lease payment for an estimated 3 years

<b>Year</b>	<b>Total Lease Value</b>	<b>NPV</b>
2003	\$2,101,829	\$1,230,227
2004	\$1,762,812	\$1,129,336
2005	\$1,519,293	\$1,020,885
2006	\$1,286,652	\$910,342
2007	\$1,067,268	\$799,835

## Graphical Representation of the WACC Rate under different Debt structures

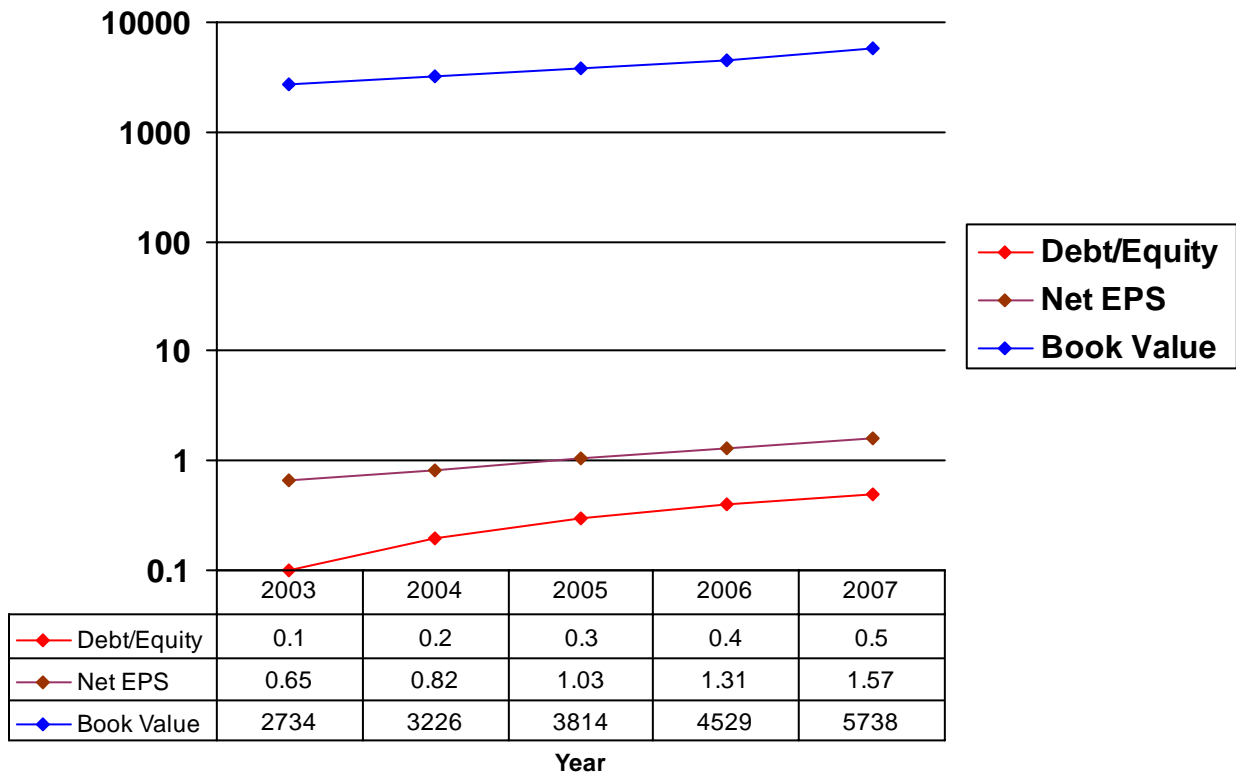
WACC at 50% debt is lowest, assuming a bond rating of BBB.



## Financial Analysis of Starbucks from 2003 – 2007 with 50% debt ratio target

(Based on calculations in Exhibit 2 and Exhibit 4)

	2003	2004	2005	2006	2007
Funds from Operations/Debt	2.0	1.1	0.8	0.7	0.6
Net EPS Basic	\$0.65	\$0.82	\$1.03	\$1.31	\$1.57
Shares Buyback	14.8 M @\$27.6	7.1 M @\$33.1	7.3 M @\$39.7 5	6.6M @\$47.7	0.4 M @\$57.2
Cumulative Shares Bought-back	14.81 M	21.91 M	29.21 M	35.86 M	<b>36.18 M</b>
Book value	\$2734 M	\$3226 M	\$3814 M	\$4529 M	<b>\$5738 M</b>



### **Recommendation - Starbucks should use 50% debt ratio.**

Increases share-holder value

- With 50% debt ratio, Book Value can be doubled over five years from \$2,292 M in 2002 to \$5,738 M in 2007.

Offsets dilution of shares

- 36.2 million Shares can be bought back.

Reduces cost of capital

- WACC is 11.96% with a Bond Rating of BBB.

### **Effect of increased leverage on Starbucks**

Increased leverage will help Starbucks get the tax advantage of paying interest and lower its cost of capital. The company currently does use some debt, by way of lease agreements. Since, Starbucks has been a profitable company and generates enough internal capital and retained earnings, it does not necessarily need more debt, for its operations. Since it is planning to expand further into international markets, Mr. Schultz can use the extra cash raised from the debt offering for opening new stores and buying back shares to offset the dilution caused by employee stock options.