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Starbucks Corp. (SBUX)

Q2 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

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

Tom Shaw

Vice President-Investor Relations, Starbucks Corp.

Good afternoon, everyone. Thanks for joining us today to discuss our second 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; and Scott Maw, CFO. Our Q&A will be joined by Cliff Burrows, Group President, Siren Retail; John Culver, Group President, International and Channels; and Matt Ryan, Global Chief Strategy 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 the 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.

I will now turn the call over to Kevin.

Kevin Johnson

President, Chief Executive Officer & Director, Starbucks Corp.

Thanks, Tom. Good afternoon and welcome, everyone. Before I share my thoughts on Q2, I want to provide an update on our efforts to address the incident that occurred in one of our Philadelphia area stores two weeks ago today. Our leadership team has been on the ground in Philadelphia over the past week to understand all aspects of this incident.

I am personally committed to act on several fronts to ensure it never happens again. The closing of our stores for racial-bias education on May 29 is a small piece of a set of ongoing actions that will systematically be woven into our processes, training, and culture moving forward. The value Starbucks provides to our partners, customers and shareholders is not only through our coffee, but also through our brand, culture, and ethos. All companies make mistakes; great companies learn from them and improve. And that is exactly what we intend to do.

Let's now shift the focus to Q2 of fiscal 2018; another quarter of record financial results for Starbucks. The quarter was highlighted by accelerating momentum across our Americas business, particularly in the U.S., with strong performance in China, including our first full quarter of consolidating results following the acquisition of East China and meaningful progress against the strategic initiative that positions Starbucks to continue delivering strong operating and financial performance in the quarters and years ahead.

Revenues in Q2 totaled a record $6 billion, up 14% over last year, driven by comp increases of 2% globally and in the U.S. and 4% in China. Importantly, we saw comps accelerate in both the U.S. and China throughout the quarter, giving us confidence in both our full year and long-term guidance. At the same time, we opened nearly 500 new Starbucks stores globally in the quarter, and now operate over 28,000 stores in 76 countries, with our newest class of stores continuing to deliver best-in-class operating and financial performance and returns. And our record Q2 non-GAAP earnings per share of $0.53 represents an increase of 18% over last year.

On today's call, I will highlight progress we are making against four of our strategic priorities: accelerating the power and momentum of our digital flywheel; enabling long-term growth in China; elevating the Starbucks experience through Roasteries, Reserve and Princi; and streamlining our operations and sharpening our focus on core value drivers. Accelerating our comp growth globally remains a top operational priority for us, and leveraging the power and momentum of our digital flywheel continues to play a key driver of comp growth.

Establishing digital relationships with many more customers represents a significant growth opportunity as we have proven that a direct communication channel combined with personalization enhances the customer experience and drives increased engagement. In Q2, we grew the number of active rewards members in the U.S. to nearly 15 million, and we implemented new ways to attract digitally registered customers beyond our rewards program.

We are widening the aperture of our digital flywheel through a range of customer interaction touch points, including opening up Mobile Order and Pay to all customers, leveraging Wi-Fi sign-up in our stores, and reinventing Happy Hour through the use of single-use digital coupon, all of which are yielding results. Together these initiatives and related efforts will generate a few million additional registered customers by year-end, and we are already running ahead of our expectations. We are now leveraging the digital flywheel to prove out that we can deepen engagement and incrementality with newly registered customers, the same way we have for active rewards customers.

In addition to significant progress in digital, we continue to strengthen the foundation supporting our long-term growth plans in China. The integration of East China is progressing as planned and positions us well for the future. We now have over 3,200 company operated stores in 141 cities across Mainland China. The opportunities for Starbucks in China, which are significant, are growing along with the size and scale of our business, and the deepening connections among our partners, our customers and the Starbucks brand.

Starbucks entered China nearly 20 years ago intent on playing the long game by building and growing the business with deep, genuine respect for the Chinese culture, our partners and customers, and with empathy for the human experience. No western company or brand is better positioned to benefit from the rapidly expanding Chinese middle class expected to exceed 600 million or twice the size of the entire U.S. population by 2021.

We continue to mindfully evolve a coffee culture in China where the reward will be healthy, long-term profitable growth for decades to come. Supporting this view is the fact that per capita coffee consumption in China is only about one half of one cup per person per year compared to roughly 300 or so cups per person per year in the

U.S. and even more than that in certain Western European markets. China is an important part of our strategy and we look forward to demonstrating the enormity of the opportunity at our first China Investor Day in Shanghai beginning May 16.

China also highlights another core strategy: elevating the Starbucks experience through Roasteries, Reserve, and Princi. Our extraordinary Shanghai Roastery is building upon our long history in China, and casting a bright halo over all Starbucks business in China and throughout Asia. Since opening in December, customer traffic in the Roastery continues to exceed all expectations with average ticket three times that of a typical Starbucks China store. Customers continue to line up for hours to enter the Shanghai Roastery and will be taken on an immersive, multisensory coffee, food, and tea journey.

And our Starbucks Roastery in Seattle, opened in 2014, continues to delight customers and drive double digit comps. In November, we opened the Princi bakery and café in the Seattle Roastery and are seeing further lift in total food sales, followed by the first Starbucks Reserve store with a Princi bakery to an overwhelming customer response.

We are now venturing into building standalone Princi bakeries complete with Starbucks Reserve coffees and coffee bars. These stores will feature Reserve coffees, Princi food and design elements from the Roastery in markets across the globe. We will build on a solid foundation with the opening of our Milan Roastery in September and our New York Roastery in November. Tokyo and Chicago will follow in 2019. The potential opportunity for Siren Retail over the next decade is significant as it represents the finest of experiential retail around all things coffee, and we're off to a solid start.

In addition to our growth priorities, we continue to streamline our business and sharpen our focus on our highest value targets. Since assuming the responsibility as CEO of Starbucks one year ago, we have taken a number of value-creating actions including selling Tazo to focus on Teavana, closing our Teavana retail stores in the U.S. and Canada, transitioning our internal e-commerce site to a commercial site, rationalizing the merchandise offered for sale in our lobbies, maximizing value by transitioning certain geographic markets from company-operated to license models, and acquiring the East China joint venture to fully integrate company operated model across Mainland China. These actions, while beginning to yield positive economics, will become increasingly accretive over time.

We are evaluating more streamline actions to come as we further position Starbucks for sustained long-term profitable growth. It has been an active first year for me as CEO of Starbucks. I've been focused on building a world-class leadership team, streamlining our business to better focus on value creation, and executing against a clear strategy to drive growth and long-term value creation for our shareholders. We have much work to do, but I'm pleased with our progress to date and feel grateful for the support of the extraordinary leadership team joining me on this journey.

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

Rosalind Brewer

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

Great. Thank you, Kevin. I will start by reflecting on my first six months as Chief Operating Officer of Starbucks. I came to Starbucks to be part of a uniquely defined company, and I can tell you with great certainty that I have found that here. Great companies are defined by how they respond during a period of adversity. As we chart our path forward in the aftermath of the Philadelphia incident, I am confident that our learnings and actions will result in a greater level of operational excellence, consistent with our mission and our values. Earlier this quarter, for the

16th year in a row, Starbucks was recognized by Fortune magazine as the fifth most admired company in the world. Following that accomplishment, we recently announced that after years of great diligence and commitment, Starbucks has achieved 100% pay equity for women and men and people of all races performing similar work in United States. Staying true to our mission and values will always define Starbucks, despite the financial tenor of the landscape in which we operate. And for that, I'm particularly proud to be on this journey leading the Americas.

I'm also very proud to report that in Q2, Americas and the U.S. business delivered results that were in line with our forecast, and more importantly, we drove momentum throughout the quarter. The Americas segment achieved record Q2 revenues of $4 billion, reflecting 8% year-over-year growth, mostly from new stores which contributed four points for the 16th consecutive quarter. Comps accelerated from under 1% in January to 3% in both February and March, driven by a mix of beverage and food growth leading to a strong 2% for the full quarter. This is the first quarter since quarter three fiscal year 2017 that our comp growth had positive contribution from our non-rewards customers, and this bodes well given the advances we are making in broadening our digital relationships. Operating margin declined 220 basis points to 20%, which we expected this quarter given our strategic decision to invest in partners, higher product cost of goods sold as food growth continues, and lower forecasted comp of 2%.

Over the past six months, in addition to getting to know the many amazing partners that we have wearing the green apron, we have also deeply focused on understanding in more detail exactly who our customer is and what he or she wants from us. We have over 75 million customers who come to Starbucks each month. This includes the nearly 15 million customers inside our Starbucks Rewards program, and these customers love our brand. But the majority of our customers visit Starbucks one to five times a month. So let me tell you a little bit more about this occasional customer. We know that many of these customers, largely those whom we don't have a digital relationship, do not visit as frequently and have a low awareness of either new product introductions or many of our great core offerings. In fact, over this past year, only one in four of these non-Starbucks Rewards occasional customers were aware of our new offerings and key promotions as compared to nearly double that of our frequent Starbucks Rewards customers. And these customers make up nearly 50% of the volume sold in the afternoon, which is greater than their share of other day-parts. Said more simply, these customers are a material part of our current afternoon challenges. These differences are driving a shift in our marketing initiatives, particularly in the afternoon to drive more relevant product promotions and focus on these customers.

As Kevin mentioned, we are also highly focused on driving more digital relationships outside of Starbucks Rewards to help develop relevant marketing and offers for more occasional customers. And while the specific focus is on serving customers through our amazing partners, we do so by leveraging the same key priorities that were outlined more than a year ago. These priorities include: Digital relevance and the expansion of our digital relationship, which Kevin covered in detail; innovation in both our products and our marketing activities; and an unwavering focus on the customer experience in our stores. So let's dig a little deeper into why I'm confident these three priorities with my focus on today's call specifically to innovation and the customer experience, both will continue to drive momentum in the U.S. business.

Let me start with product innovation and marketing. In the past, we focused on a drumbeat of promotional offerings, which have not led to sustained growth, leading us to decrease the number of time-limited offerings by nearly 30% versus a year ago. Our new approach to marketing will be centered on meaningfully strengthening customer relationships by increasingly targeting our offers to each customer. While we still have unique products such as Crystal Ball Frappuccino, our focus will shift to leveraging platforms with broader appeal. For example, for customers who prefer a lighter, sweeter espresso experience, Blonde Espresso offers a second espresso roast, which can be applied to an entire platform of existing beverages. Initially, Blonde was only slated to have approximately six weeks of marketing support, but given our new focus and the early success of the product, we now plan to continue to market the platform throughout the balance of this year.

In addition to more platform marketing, we are also shifting our paradigm from singular offerings to more personalized offers by customers at the right time. Our revised Happy Hour is a testament to this shift. Previously we offered a special only on Frappuccino over a short time period to anyone and everyone, even customers who might have come in anyway. This worked for a few years as the lift we saw in the period following Happy Hour covered the cost of the discounts. But the past two years has not worked from a profitability standpoint. So we reimagined Happy Hour. The new program will be used to sign customers up for direct digital relationships and to promote the great variety of beverages that we offer all year long. This one-to-one offer will leverage our personalization capabilities and drive significant incrementality. Other benefits include more predictable and efficient scheduling of partners and an ongoing promotional opportunity to feature new beverages and drive afternoon. In Q2, we had our first Happy Hour using this new approach and saw strong incremental profits and appealed disproportionately to customers outside of the Starbucks Rewards program.

And while we're innovating in the way in which we reach our customers, it is an extension of having the right offering for each day-part. Our customers love cold beverages, and not just in summertime. In fact, Q2 is traditionally one of the coldest quarters in our fiscal year, and even then, iced beverages contributed nearly 40% of our overall revenue growth. We will continue to drive innovation in our cold offerings in Q3, starting with the recent introduction of cold foam, a creamy froth layer typically associated with our hot hand-crafted beverages that will now add more customization, more flavor, and more theater across our cold platform. Next week we will introduce our newest Frappuccino, which will become a core offering within our blended platform for customers who want a special up-level delicious afternoon treat. Along with our ongoing Nitro Cold Brew expansion and core products extension with plant-based milk, we will convey a balanced message on an array of offerings within our portfolio. Our goal is for our cold beverages to be a must-have by leveraging innovative ways of marketing to drive both morning and afternoon occasions.

Food also continues to be a critical opportunity for our future and has consistently contributed in the 1% to 2% comp range for many years now. This momentum continued in Q2 with food's share of total U.S. sales at 22%, up 100 basis points versus prior year and over 1% contribution to comps, driven by strength in Sous Vide egg bites and breakfast sandwiches. Beyond the AM, the lunch occasion remains a critical focus, and our ability to drive growth depends on a balance of leveraging our core offerings and relevant new innovations. As such, we plan to expand our Mercato platforms starting with San Francisco this month to reach nearly 1,800 stores across six markets by fiscal year end.

We know that our comp growth is directly linked to the engagement that our customers have with our partners. Knowing that, we launched the first change in our deployment routine in over five years this past quarter with what we call Deployment 2.0. What's unique about this new labor routine is that it moves us from a one-size fits all deployment plan to a dynamic store specific deployment solution that will continue to evolve with the business.

We believe this enhance to contributed to the comp improvement that we saw over the quarter. It considers an individual store's product and channel mix data by day-part, assigns responsibilities by role, and deploys baristas to production positions, thereby balancing work to optimize customer connections. It is that unlock, the time for our partners to connect directly with our customers, that will help us deliver a better experience in our stores overall.

While we are still in the early stages of this new deployment tool, and the initial benefits are weighted to peak times, we are already seeing success led by improvements in our critical morning day-part, which also drove most of our overall comp performance in Q2. We know there is additional opportunity ahead to continue growth in the morning and in the afternoon where we have struggled in recent quarters. We must perform in both day-parts.

Taking all the learnings gained in recent months, the consumer, marketing relevance, and operational efficiency, we are launching a focused campaign around afternoon starting next month and extending through August. We will be driving a consistent and sustained message to the consumer that leverages the fantastic line-up of new beverages that I spoke about earlier, great food pairings, a more welcoming environment for our customers, and reinforced engagement with our customers once they are in our doors. Much of this we already do well today, but the power will be in bringing it all together with the universal view of what we have learned and what we know about the 75 million customers that we have the privilege to serve.

As we look to the back half of fiscal 2018 and heading into fiscal 2019, our commitment to growth and elevate the business, I will highlight that the focus remains on two critical areas: Increasing transaction comps and cost efficiency. The specifics I've discussed above are all aimed at driving increasing transaction comps, particularly for beverage. Scott will discuss cost efficiency in more detail, and I'm deeply engaged in driving the middle of the P&L savings in labor, waste, and in our supply chain. While we have had some early success in these focused areas so far, we have so much opportunity ahead of us. I am confident of that. So as I sit here today, I have no doubt that our largest business has ample room for growth. I look forward to sharing more about our success next quarter.

I'll now turn the call over to Scott.

Scott Maw

Executive Vice President & Chief Financial Officer, Starbucks Corp.

Thank you, Roz, and good afternoon everyone. Starbucks delivered strong 14% year-over-year revenue growth in Q2 of 2018, including 3 points of net benefit resulting from consolidation of our recently acquired East China business and other streamline related activities. These activities include Teavana mall store closures in the quarter, the Tazo divestiture in December, and the conversion of certain international retail operations from company-owned to licensed models. Also, FX benefited revenue growth by 2% in Q2. Non-GAAP operating margin of 16.2% represented the decline of 170 basis points year-over-year, primarily driven by food mix shift and incremental partner investments, primarily in the U.S. It's important to note that the decline in operating margin in Q2 was in line with our forecast.

I'll now take you through our Q2 operating performance by segment. Roz covered many of the key operating metrics and actions in our Americas segment, so I'll focus on Americas operating margin decline of 220 basis points to 20%, largely attributable to an acceleration of our partner investments in the quarter and food-related mix shift. I will discuss specific improvements in our outlook for Americas operating margin shortly. New store profitability in the U.S. remains very strong with year one ROIs of approximately 60%, down somewhat from the expectation we shared at our most recent investor day, primarily due to rising labor costs in urban markets. Nonetheless, our store level returns in the U.S. remain among the strongest in our industry.

Moving on to China/Asia Pacific, CAP revenues grew 54% over prior year in Q2 to $1.2 billion. Adjusting for the 41-point net impact attributable to the consolidation of East China, the licensing of Singapore and Taiwan, as well as foreign currency translation, CAP revenue still grew a very solid 13% in Q2. Japan delivered our first quarter of positive comp since Q1 of fiscal 2017, driven by a strong beverage line-up. Our recently launched Japan Starbucks Rewards program continues to outpace expectations with membership reaching 2.4 million only six months after launch.

CAP operating margin declined 570 basis points to 17.2%, primarily due to the 600-basis point impact resulting from the consolidation of the East China business. New store performance in both Japan and China remained very strong with year one ROIs of approximately 80% in China and 45% in Japan, both representing best-in-class performance and both in line with store level returns we discussed during our most recent investor day.

Turning to EMEA; EMEA delivered revenue growth of 15% to $266 million or 4% after adjusting for 11 points of FX. Given that 84% of EMEA's nearly 3,200 stores are now licensed, system sales, which increased 24% year-over-year or 15% adjusted for FX, are a more accurate reflection of our brand and business strength in the region. Similarly, while EMEA's company operated comp in Q2 was a negative 1%, driven largely by continued softness in the UK, the system-wide comp was a much stronger positive 3%.

EMEA Q2 GAAP operating margin included $31 million of incremental costs primarily related to the impairment of goodwill associated with our business in Switzerland, reflecting the difficult operating environment in that market. Excluding the nearly 12 points for these costs, non-GAAP operating margin of 10.1% declined 190 basis points year-over-year, but was flat excluding FX. We remain encouraged by the stronger performance of our EMEA licensed business, where we experience strong operating income growth and meaningful margin expansion and remain convinced that our shift to licensing will drive improved profitability as we move towards and into 2019.

On to Channel Development; Channel Development had a strong Q2 with revenues reaching $500 million, up 8% year-over-year. Our Channel Development team remains laser focused on profitably gaining market share in both premium roast and ground and K-Cup categories, and was successful on both counts in Q2 despite increased competition and increased promotional activity down the aisle. In the quarter, Starbucks outgrew the overall coffee industry by a 3 to 1 margin, resulting in another point of share gain in each of the roast and ground and K-Cup categories.

Channel Development's operating margin expanded 100 basis points to 43%, benefiting from the lapping of last year's unfavorable 220-basis point impact from the revenue deduction adjustment. The adjusted margin decline was largely a result of less JV income from our North American Coffee Partnership. We are confident that our NACP business will stabilize as we execute against marketing and innovation plans for the back half of the year.

Looking at our capital deployment efforts during the quarter, we continued to take action against our commitment to return $15 billion to shareholders over the next three years, repurchasing $1.6 billion in stock this quarter. In line with the strategy, we also issued $1.6 billion in long-term debt in February.

Let's move onto 2018 targets. We continue to expect consolidated revenue growth in the high-single digits, excluding approximately 2 points of favorability from the East China acquisition and other streamline related activities. We continue to expect full-year comps to grow near the low end of our 3% to 5% long-term guidance, and we remain on plan to open approximately 2,300 net new Starbucks stores globally. We continue to anticipate a moderate decline in full-year operating margin for both company and the Americas compared to 2017, inclusive of the incremental investment we are making in our partners and digital initiatives following U.S. tax law reform, most of which will begin impacting operating profit in the current quarter.

We still anticipate tax reform investments of $180 million to $220 million on a run rate basis in 2018 with a little less than half of this amount impacting 2018 profits given the timing of investments during this fiscal year. The moderate full-year decline in operating margin in the Americas assumes less margin contraction in Q3, with Q4 margin expected to approach the prior year level.

Given the magnitude of these sequential improvements, I'd like to spend a few minutes walking you through how we build our America margin performance from the second quarter through the fourth quarter of 2018. We will deliver several improvements to make it happen. First, comps improved to a strong 3% in the second half of the year. While we believe we will hit the 3% mark in the third quarter, we recognize year-over-year comparison requires progress across our initiatives to reach this level. These initiatives give us even greater optimism for the fourth quarter. Second, we expect beverage comps to improve and we will deliver at least 1 point of traffic growth. And third, we will accelerate our savings across COGS, waste and labor from approximately $120 million in the first half of the year to over $160 million in the second half.

Roz covered the first two components in detail, and as you saw over the last two quarters when we posted lower comps and higher food weighted product mix, both have a meaningful impact on margin. On the third component, our COGS savings target is over $170 million for the full fiscal year, consistent with prior years. And we are executing well against this goal by more effectively leveraging sourcing, manufacturing and distribution opportunities just as we have for the past several years.

We have a well-established set of processes in place, and they continue to deliver. During 2018, we have also significantly increased our focus on improving labor productivity and increasing labor leverage, and this focus is beginning to pay off at an accelerating rate. In Q2, labor run rate savings were driven by improvements in our store-specific coverage models, including the specifics Roz discussed with Deployment 2.0. Also, we have seen our major productivity metric, items per labor hour increase relative to the prior year, demonstrating that our focus on deployment and lean principles is also starting to pay dividends.

Regarding waste, the opportunity is significant, both in connection with waste itself and in connection with lost sales due to product availability. In our U.S. company-owned business alone, waste cost is about $500 million per year. That figure will always be significant because product availability combined with our strict product quality requirements inherently result in a certain amount of waste in our business model. But we believe we can cut this roughly $500 million by at least 15% over the next 18 months by leveraging lean principles and better managing outlier stores in our portfolio that generate greater waste than expected.

In Q2 alone, we realized savings by focusing on those stores that had very high waste as a percentage of sales and improving training around our bakery pull to thaw processes. This strong momentum in these three savings areas plus planned reductions in G&A and other store related costs will contribute meaningfully to Americas' margin over the next two quarters, and I would add that Roz is the perfect partner for finance to help capture these savings opportunities.

In the CAP segment, we continue to expect operating margin to be down moderately in fiscal 2018, relative to last year given the consolidation of East China. Excluding this impact, we continue to expect CAP operating margin to be moderately higher year-over-year. The East China acquisition is now expected to add approximately 2 points of growth to total company EPS for 2018, the high end of our previously discussed range. We now expect EMEA's operating margin to be roughly flat adjusted for FX compared to 2017.

For 2018 Channel Development, we now see low single digit revenue growth and a moderate decline in operating margin versus the prior year. However, when excluding the impact of Tazo and the 2017 revenue deduction adjustments, Channel Development revenue growth is forecast to be in the mid-single digits, and operating margin will decline moderately. We consider this slight downward revision prudent given increasing competition and our results through the first six months of the year.

Finally, we still expect a GAAP tax rate of 23%, but our non-GAAP tax rate is now expected to be 25% versus 26% discussed last quarter. While the absolute difference appears to be a full point, the actual impact is less than half a point, driven primarily by changes in several routine discrete tax items and not due to any changes in our estimates of tax reform. Given all of these inputs, we expect 2018 GAAP EPS in the range of $3.32 to $3.36. Non-GAAP EPS will be in the range of $2.48 to $2.53, up 20% to 23% from last year. Importantly, all of this guidance excludes the impact of store closures and U.S. partner training that Kevin mentioned earlier. We are still quantifying these impacts and will report back to you on the full impact on next quarter's call.

Before handing the call back to the operator for Q&A, I want to underscore that we have a clear set of actions underway to improve comp growth and profitability as we move through the year, and that we will continue to invest in our business strategically and with a long game mentality while at the same time taking decisive action to maximize our brand portfolio and ensure that we will continue to drive shareholder value long into the future. Our performance in Q2 once again demonstrates the correctness and success of the strategies that have guided the Starbucks business over the last 40 plus years. Once again, credit for our success goes to our 350,000 store partners around the world who continue to go above and beyond by delivering an elevated Starbucks experience to their customers every day.

With that, I'll turn the call back to the operator. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Sara Senatore with Bernstein. Your line is open.

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

Q

Oh, thank you very much. Two questions, if I may. They're related, and they're about the Americas and the U.S. top line, comp in particular. So the first is can you just talk about the growth in the rewards program? Because in the context of looking to expand your digital reach, I guess I've been surprised a little because you have seen some nice growth in that membership, but the comps have been softer. So does it – is there just a lag? Is it take time to learn what your customers are doing? Or is there something to be said about maybe the incremental digital relationship isn't quite as impactful as it used to be? And then the second point is could you just talk a little about the ticket that you saw in the quarter mix, and where it was coming from? Thank you.

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

A

Sure. This is Matt Ryan on the first question. I'll hand it over to Roz for the second part of your question. With regard to the rewards program, we continue to see strong growth in the rewards program. That remains a driver of the positive momentum we saw across the quarter. Reminder, membership up 12% year on year, to almost 15 million, and the growth per member in spend was mid-single digits again too. So both of those are very strong numbers, and both reflect the contribution that the rewards program is making to our business right now. With regard to the newer digital relationships, that's going to be something that happens over time to our business, the contribution from those efforts which really began at the very end of the quarter, so that it was not a material impact yet to our business. We expect to see that really kick in sometime next year.

Roz, I'll have you answer the ticket question.

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

A

We had the question between transactions and ticket, and so transactions were flat across the quarter, and we saw improvement in ticket across the quarter as we move from the January timeframe through March. Remember, coming into January, we were just slightly under 1% comp, and then February, March, full comp of 3% in February and 3% in March, and getting us to the 2% overall for the quarter.

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

A

Can I just add, the ticket was split pretty evenly between pricing and attach. So we still see really strong attach, and food continues to do very well. Our opportunity, as Roz said, is really in driving beverage.

Operator: Your next question comes from David Tarantino with Baird. Your line is open.

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

Q

Hi. Good afternoon. Just first a clarification, Scott. I wanted to make sure I understood your commentary around the third quarter comps. I think, you mentioned that you expect it to be plus 3%, despite the tougher comparison, but I wasn't sure how to interpret that in light of your comment about the initiatives needing to work. So, if you could clarify that, that would be great. And then my real question is about the afternoon day-part, and what you're seeing in that day-part related to your operating metrics. And specifically, my question relates to sort of consumer feedback scores and how you're executing in the afternoon, and whether you think this new labor tool will help you to improve those execution scores and generate better momentum that way? Thanks.

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

A

Thanks, David. I'll take the first part, and then I'll hand it to Roz. So we do see a 3% comp in the third quarter. I was trying to add a little color, recognizing that given the Happy Hour from last year and the Unicorn Frappuccino promotion from last year. We understand that comp momentum is likely to build over the quarter. But at the end of the day, the simple answer to your question is we expect to deliver 3% for the third quarter as well. Roz?

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

A

Yeah, so looking at the details around the afternoons, what we know about the occasional customer in the afternoon is that they don't shop with us as frequently, and they're not aware of our offerings as our Starbucks Rewards customers. What we also know about our business in the afternoons, is that we have used our afternoons to train our new partners that were just joining as baristas, and we have heavy routines in the afternoon. And so what we learned from managing our peak in the morning and managing routines, we're applying that to the afternoon so that we apply the right kind of labor when the customers are in the store. We are also looking at our afternoons in a different way. We know that the afternoon customer is looking for refreshment, and they are really interested in cold brew. So the new offering that we'll have in the product line is around cold brew, refreshers, and teas. We'll also be reducing the number of limited time offer, LTOs, that we have by 30% year-over-year. That gives us a chance to simplify the work in the afternoon so that the partners can engage with the customers so you'll get both the experience when you're in the Starbucks cafe. You'll also -- we'll also receive better efficiencies by use of the labor at that timeframe, and also too in the afternoons, we are introducing a new marketing platform around this new beverage line-up that we have in the afternoon. So we've learned a lot about that occasional customer. We've learned what happens in our stores with our partners, and we're adjusting that and getting their routines in line. And then we're investing in consistent marketing over a longer period of time for the afternoon growth.

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

A

Yeah, David, this is Kevin Johnson. Let me just build on Roz's comments. Clearly the morning day-part, very important to us. And we've been increasing throughput at peak, recognizing that the dominant customer need state in the morning is the need state of convenience. And then what we've figured out too is that as we transition into the afternoon day-part, the need state starts to balance between both convenience and community. And so the deployment program that Roz mentioned earlier has acknowledged that and has figured out how we transition the way that we even deploy our labor, but how we also transition the activities that they do to create the right experience. So number one is experience. Number two is product as Roz said, and a lot of this has to do with cold beverages. And number three is then the changes we made in marketing to raise awareness. And we think the combination of the three: Improving the experience, delivering products that our customers want in the afternoon and raising awareness of those will tap into that occasional customer in that particular day-part. And I think, we've put all the right ingredients in place and we're executing on those with intent.

Operator: Your next question comes from Sharon Zackfia with William Blair. Your line is open.

Sharon Zackfia
Analyst, William Blair & Co. LLC

Q

Hi. Good afternoon. I recognize it's tempting to spend all of our time on the U.S., but China and Asia-Pacific is growing so rapidly at this point. And I don't want to steal the thunder from your Chinese analyst day, but I guess, given the rapid growth there as a percent of the operating profit mix, I mean, how do you frame kind of the size of the prize at Asia-Pacific, and what should we view as the main risk to you achieving your goals there?

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

A

Thanks for the question, Sharon. I'll intro this a little bit, but I want John to talk a little bit about what we're seeing in China, and then we'll get back to the question on guidance.

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

A

Yeah, so, Sharon, China, obviously we're approaching 20 years in the market, and the business there continues to perform above expectations. And really, for us, it's about taking the long term view on how we build the business there. If you look at overall growth around the entire CAP segment, revenue at 13% after all the noise around FX and equity changes, China far exceeded that growth rate. China drove 4% comp in the quarter. Transactions continue to grow which signals we're bringing in more new customers as well as increasing frequency of our existing customers. New store growth continues to remain strong. We opened 112 stores in the quarter. We now operate over 3,200 stores in 140 cities, and more importantly was the number as well that Scott I think highlighted on the new stores in the 80% ROI that we see. So the model within China is very strong and has a very strong foundation on which to grow.

Equally important have been the investments that we've made over the last 20 years, and particularly the investments we've made in our people, whether that has to do with the insurance benefits around critical care for parents that we announced last year, whether that has to do with initial paid benefits that we continue to add to.

All those things elevate the partner experience for our partners in the market. The elevation of the brand is also important. In December, we opened the Shanghai Roastery, and end of the quarter, this was the first full quarter of operations. And I know we highlighted on the last call that the Shanghai Roastery does twice the dollar volume in one day that an average Starbucks store does in a week. And we've seen that still maintain and grow. Now in Q2, we did see a shift in terms of the business, and the shift that we saw was due to the shift in the Chinese Lunar New Year. And basically this year the Chinese Lunar New Year was three weeks later than it was the year before. And what we saw was that January started out soft, February came back from a comp perspective, and then once we got through Chinese New Year, we actually normalized to a regular comp performance that we had traditionally seen. So all in all, the China business remains very strong. We remain very bullish, and we can't wait to have you in Shanghai in May.

And then just around Asia-Pacific in total, we now operate 8,000 stores in the region. Japan also is a significant growth driver of our business. We saw for the first time in several quarters Japan return to positive comps. We also saw strong momentum with the recently introduced My Starbucks Rewards program in Japan. And then the other highlight I would just call out is Korea. Korea is also continuing to perform. We now operate nearly 1,200 stores in that market, and that business continues to do very well. So, overall Asia, China, is a big part in the most growth – biggest growth-driver for the company going forward.

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

Yeah, Sharon, this is Kevin. I know, Scott will weigh in with sort of the near-term view on what this means for guidance as we look near-term, but let me just share a long-term view, long-term. We've been in China for 20 years, but you think long-term if China could achieve the same kind of results that we have in the U.S., you would say the number of middle class in China is 600 million, that's double the size of the U.S. Then if you look at what, in my comments, the current coffee consumption in China is 0.5 a cup per year per person versus 300 cups per year per person in the U.S. So you look at that math, that means it's over 1,200 times the opportunity size as the U.S. in terms of consumption. Now that's long term, and we have to do all the things that John mentioned, and we are taking a long-term view, but the opportunity is significant. Scott?

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

And the only thing I would add is in the last quarter's call, we said that China Asia-Pacific will be 40% of our business unit operating income growth, obviously given both the performance this quarter in China Asia-Pacific, the outlook that we have and a little bit lower performance in some of the other segments, that now is going to approach 60% of business unit operating income this year. So that is clearly a big growth driver for Starbucks.

Operator: Your next question comes from John Ivankoe with JPMorgan. Your line is open.

John William Ivankoe
Analyst, JPMorgan Securities LLC
Q

Hi. Great. Thank you. The question is on U.S. COGS and occupancy. Hitting 38% this quarter is obviously really high. And I understand that food is a specific part of that. But it does seem we've been in this cycle now for a while. It's the more food that you put on, the more your gross margins contract, and we're just not seeing it on the bottom line of operating income for the entire division. So maybe the question is for Roz, maybe it's for Kevin or all of you, I mean, how sure are we that we can add additional foods specifically from the fresh Mercato platform and have margins not be a problem from the incremental food? Obviously understanding that Mercato is a more complicated platform than what you currently have as part of the legacy system today.

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

A

Yeah, John, I'll start and then I'll turn it over to Roz. I think it's important to understand within that pressure that we're seeing of cost of goods sold is not only mix within the different types of foods, so a shift, as we said, a little bit away from bakery which has slightly higher margin towards prepared foods such as breakfast sandwiches which has a slightly lower margin.

One of the things that we're doing to try to manage that, and Roz will talk about this more, is just making sure as we bring new products in that we have the right COGS and the right pricing up front. We're pretty good at that, but I think given the pressure from food in overall cost of goods sold, we're sharpening that capability a little bit. Back when we had 5% or 6% comp growth, we could have a broader array of margin within our food mix, and it still deliver operating income margin expansion and operating income. And now that comps have slowed a little bit, we're just sharpening that analytical capability even more. And then it's important to understand, there's still significant opportunities around savings and waste and beyond. And I'll let Roz talk about that a little bit.

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

A

Yeah, so a couple things here. First, just looking at foods, we're building a food supply chain while we're evaluating the Mercato roll out and we're learning a lot. And we're developing waste initiatives as we go and looking at ingredients very carefully to make sure we understand the cost as we design the product. And as we first entered the Mercato line-up, we were actually looking at this from a real broad scale. Now, we're down to the bare tactics and really managing waste.

And then waste outside of Mercato, we're even down to the point where we're looking at even our stores that are lower performing stores from a sales perspective typically have higher waste. We have those on our list. We're going after each one of those stores to improve their waste performance by store, so very detailed work. And we're applying for the first time lean principles against that work. So we're down into the brass tactics of reducing our cost from a waste standpoint and leveraging the lean principles.

I'll also tell you that food makes a lot of sense for us, but we are very keenly aware that we have to grow our beverage business. And we want beverage to lead and that's the plan as we go forward. And you see that in the second half of the year, a lot of focus on our beverage business, adding the new cold items to complement the rest of the product line. So its beverages, new beverages, marketing against those new beverages, and then applying a food-attached plan with that.

I'd also mention that there is also savings in other parts of the business having to do with what we're seeing with labor efficiencies, and we're seeing that come forward through the work that we're doing with Deployment 2.0. So it's really a comprehensive plan around, yes, we will continue to invest in our partners. We'll continue to invest in our digital platforms. Those are paying forward now and even more in the future, and then managing this higher food mix by looking at our cost and our waste initiatives. So we're down into the brass tactics on cost through waste and labor.

Operator: Your next question comes from Jeffrey Bernstein with Barclays. Your line is open.

Jeffrey Bernstein
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much. Maybe just two related questions on your unit structure and ownership growth. First one just on the flip to the license structure. I know this has come up in years past, but maybe you could just update us on the pros and cons of whether you would consider increasing your U.S. license mix. You've clearly done it outside of the U.S., and it does seem like, over the past few years, you've actually seen that mix of license stores increase in the U.S. So I'm just wondering would this discussion on moving that further ease the cost volatility and reduce the capital requirements.

And the related question was just on the just broader unit growth, which I know comes up pretty regularly. But considering how difficult a period it is for all the brick and mortar retailers and with the comps not necessarily where you want them to be, I'm just wondering whether you have greater discussion around maybe taking a little bit of a pause. Obviously, you have the opportunity to reaccelerate the unit growth if the comps were to reaccelerate significantly, but the thoughts around maybe slowing down that growth in the short term as the U.S. business struggles to rejuvenate the comp. Thank you.

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

Yeah. Thanks, Jeffrey. I'll start and Kevin can add in. What I would say is, as it relates to ownership structure, I think what we have done has been very analytical and open-minded about what we own and what we choose to license. And if you go back just over the last two years, we've moved to license Germany, Singapore, Taiwan and, the most recent quarter, Brazil. And we continue to analyze those markets that we own and look for opportunities to license or make a conscious decision to continue to own.

So we are looking at returns. We're looking at growth profile. We're looking at overall market size when we're making those decisions, and we're actually pretty, I think, analytical and disciplined when we do that. In the U.S., we've always had, as you said, a really good mix of licensed stores and company owned stores. And there's reasons to license, particularly when we can get access to real estate that we wouldn't otherwise. But owning in the U.S. and China and some other markets really makes sense for us because of the returns that we get in those handful of markets on the stores that we own.

And just to remind you, we see three to four times the cash flow and overall profit in a company-owned store in the U.S. than we do the average licensed store. And that's just because of the royalty structure and what you have to share with the licensee. Those are wonderful stores and we like those licensed relationships, but we also want to own where we can own 100% of the cash flows and drive the financial returns that we want.

In addition, in those larger markets, obviously owning has qualitative benefits. We're faster to market. We're able to do product roll-outs and training and responses and marketing that are more difficult to do when you have a licensed mix. And so it's really about understanding and driving those returns in those markets. I don't know, Kevin, if you would add anything to that, or...

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

No, I think we've been very consistent in our approach to transition company-operated markets to licensed markets where it's makes sense, and you should expect us to continue to do so.

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

And then on opening stores, the trigger for us to slow down new store openings in any country is, if we start to see returns on those stores and revenue in those stores start to come in below our expectations. And as we talked recently at a conference and walked through what happens when we open up a company-owned store in the U.S. is the net revenue and the net transactions that that new store is able the get.

And because of the analytics that we have when we open the store, the capabilities we have particularly around drive-thrus, we give up a little bit of sales from stores around that store that the vast majority of the revenue in year one in that new store is incremental. And then those new stores grow for four or five years much faster than the average for the rest of the market. And so when you add all that up, there's really no net comp impact, and you have all of the profitability that you've got in that first year growing over time. And so we look at those store by store, P&L by P&L, we watch what happens as sales transfer, and if we start to see decay there, we will take action and we'll lower openings.

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

John Glass
Analyst, Morgan Stanley & Co. LLC

Q

Thanks very much. I wonder if you could share any more plans on how you plan to lap the Frappuccino Happy Hour from last year. Understanding that you're doing a bespoke version in the app and so I get the offers, but if it's an occasional user that you're getting in the afternoon, they may not get that. What do you have planned to defend against their coming in and being disappointed or not frequenting during that daypart?

And then also, is there a margin benefit as you talk about margin improvement in the third quarter in particular? Is there a margin benefit to not repeating Frappuccino Happy Hour, as your comments suggested it was not been profitable as it had been in the past?

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

A

Yeah, so there – this is Roz. I'll take the first part of that question and then I'm going to ask Matt to talk a little bit more about our digital relationships that happen to be growing. So first of all, when we think about the afternoon, we are actually going after a customer base that we really haven't touched. So it feels almost like a new customer that we're introducing to the brand. We have the opportunity to talk to them about the product offering and then introduce them to the experience in the stores, which has improved if they were a lapsed customer.

So there's things that are changing that we hope will attract them to the store and then get them to eventually engage as a Starbucks Rewards member and begin to react and respond to us like our Starbucks Rewards members. So we have opportunity there. I'll also mention that the marketing efforts that we're putting around this, they are not short-term focused as we have done in the past. And this gives us a chance to tell a fuller, longer story about the offerings, and keep them engaged with us. And this is something, again, that we've not done in our business, as far as many of us can remember. And we hope this is going change how the customer enters the store. So Matt, share a little about the digital growth.

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

A

Sure. I think Happy Hour is a great example of how we're bringing this new strategy alive. So, last year, Happy Hour was a ten-day one-and-done stunt. What ended up happening is you gave the discount away to everybody. People came in, and whether or not they intended to come in, they got the discount if they're ordering a

Frappuccino. Available on one product. What we are now doing is inviting people to sign up for Starbucks. And rather than it be a one-time-a-year promotion, this is an ongoing digital relationship that we will reprise over and over again, across the year and the years. What that means is that we won't just be doing Frappuccino for ten days in May. We will be able to use this very well-known device we have called Happy Hour to promote a variety of afternoon products across the year, using it not just in May, but across the year to bring customers back into our stores on an ongoing basis. Over time, we get to know customers, what they respond to, repeat, and we're able to personalize, and do things that we could do with the Starbucks Rewards customer right now, with a much broader segment of customers. The long-term strategy is something that is going to build over time, and its part of an ongoing shift in our marketing, from a short term one and done focus to a sustained platform ongoing relationship focus with our customers.

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

And just one last thing, on that note, is that this does allow us to plan labor much more effectively, because it's a planned Happy Hour extended over a longer period of time, and more predictable, and so we're able to get labor efficiencies out of the programs that we're running now.

Operator: Your next question comes from Andy Barish with Jefferies. Your line is open.

Andrew Marc Barish
Analyst, Jefferies LLC Q

Yes, can you give us a little bit more on Deployment 2.0, and just kind of the way it rolls out over the course of the next year or so? And do you actually expect to get labor leverage? And maybe you can reference some of the markets where you've already done 2.0, you know, X-ing out some of the partner investment, obviously, that's been incremental?

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

Yes. So couple of things there. So, first of all, we have fully rolled out Deployment 2.0. We did that in February, fully rolled out by the end of the month. And actually what the program does is, first of all, it establishes the store-specific sales routines, and then we apply the labor against it. It looks at the actual product mix. It actually looks at the channel mix, and it does that by day-part. And this is the visibility that we had not had the data in our stores. And in the past, the deployment routine was actually a one-size-fits-all program. So if you were a store in Chicago, and a store in Omaha, Nebraska, we applied the same deployment plan. Now we can look at this routine by store-specific data. They have a visual digital data that shows them, and displays within the store how to apply their labor, so it's not a cookie cut or spreadsheet approach like it was before. The work is much more balanced. We are getting engagement by the partners. They're enjoying knowing their schedules, and knowing what to expect from their sales flow. So from that, we're getting two particular moves, is the partner engagement piece, and also the cost efficiency from it. We're also looking at ways that we look at the product plans, too. So again, this reducing the LTOs by 30% helps us also add predictability into the scheduling. So both of those are creating efficiencies that we need.

Andrew Marc Barish
Analyst, Jefferies LLC Q

And Roz, that rolled out in the middle of Q2, and it's fully rolled out to all stores?

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

Fully rolled out, yes.

Andrew Marc Barish
Analyst, Jefferies LLC
Q

Thank you.

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

David Palmer
Analyst, RBC Capital Markets LLC
Q

Thanks. Good evening. Question on just the priorities of the initiatives you've been talking about. I can tell that after this call, there's going to be an argument about the momentum that you laid out some sales targets over the next couple quarters that suggest and even mentioned in recent months that the momentum is building. And I know you feel like it is building, but which initiatives give you the confidence that that is going to be the case heading into fiscal 2019? You mentioned beverage innovation, digital user growth and drivers, and some of those more effective promotions. But if you had to prioritize the things that are really giving you confidence where you're getting traction or you see in the pipeline, that would be helpful. Thanks.

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

Yeah, I'll – David, this is Kevin. I'll start by answering, I think, number one the Deployment 2.0 that was rolled out really addressed areas related to the customer experience in our stores. And we're seeing the results of that in terms of not only our partner engagement but in terms of our customer satisfaction by day-part. So I think clearly that is a very important attribute. Number two, digital. And as I've commented and Matt outlined, I think, the fact that we're widening the aperture of our digital reach far beyond rewards customers to include as many non-rewards customers as we can reach, giving us a direct channel to communicate with them. And frankly, what that does is it allows us to personalize the communications to improve their experience, but it also gives us that direct access to communicate with them which raises awareness. So that combination of personalized awareness of those customers, I think, is a very important attribute. And then third, I think the product innovation that we've been driving. And so those three things have to come together. The experience, the product innovation, and then the digital connection so there's awareness and reach.

Operator: Your next question comes from Matthew DiFrisco with Guggenheim Securities. Your line is open.

Matthew DiFrisco
Analyst, Guggenheim Securities LLC
Q

Thank you. I just had two follow-up questions. Specifically to the questions about the LTOs and the Happy Hour, can you just sort of quantify? You had a couple of these initiatives, the 2.0, begin in fiscal 2Q. They're going to be drivers in 3Q, and you're going to pull back a little bit less LTOs and things like that. How much of that was already reflected in the numbers you just reported versus sort of now that we're in fiscal 3Q they're going to start? And then my second question or clarification is with respect to the same store sales commentary, it appears – is this correct to walk away with thinking that the incident in Philadelphia and the subsequent protests and some of the negative headlines around that, that did not have a meaningful impact such as I guess in years past sometimes you've had political activism and things like that that have disrupted not specific to your store, but have disrupted some of your urban stores, and you saw a little bit of volume slow down? So I guess we've weathered the storm?

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

A

Matt, this is Kevin. Let me take the question on Philadelphia first, and then we'll take your first question. But on Philadelphia, I spent several days on the ground in Philadelphia along with a number of members of our leadership team to ensure that we were fully reviewing and understanding the situation, and how that could have ever happened in a Starbucks. But also to begin to craft the appropriate actions to address it so that it doesn't happen again. And I believe we are focused on the long term and doing the right things, and we will be a better company because of this. Now, I acknowledge it's still early, but we are not seeing an impact on comp sales as a result of Philadelphia. We are still assessing the overall financial impact of the actions we are taking. We've announced we're closing stores in the afternoon of May 29, and we're embarking on not only a day of discovery, but work that we're going to do to ensure that all aspects of our review are captured in the actions that we're taking. And so one thing I do know for sure is that our approach to this will pay long term dividends for Starbucks.

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

A

And Matt, on the first part of your question, what I would say is most of the things that you listed really will kick in in the back half of this year. We did see, we believe, some benefit from the Deployment 2.0 changes that Roz talked about, but the vast majority of what we talked about will build over the course of 2018.

Operator: Your next question comes from Andrew Charles with Cowen. Your line is open.

Andrew Charles
Analyst, Cowen & Co. LLC

Q

Great, thanks. I know in the China call in January, you spoke about the lower comping nature of the East China stores just given the denser penetration of these markets and since this is the first time we've seen the consolidated results, can you help to segment how the gap between legacy China and the new East China stores have historically trended just to help us model this new structure going forward and what we can expect as normalized growth rate there?

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

A

I'll have John talk a little bit about the East China business and the opportunity, but what we said, I think, on the call is that they're a little bit lower on the last call. They have been a little bit lower over time. Not dramatically lower, but a little bit lower, and it's really because of the significantly higher store opening rate in that market. John, do you want to talk a little bit about what...

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

A

Yeah, and just as a clarification, Andrew, it's not currently in the reported comp.

Andrew Charles
Analyst, Cowen & Co. LLC

Q

Right.

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

A

So we won't be reporting that until next January, but overall, the integration gives us – I mean, it's on track, first off. It gives us a great opportunity to bring East China and company-owned China together and approach the market with a single voice to both our partners and to our customers and then leverage the back end across both businesses to drive more efficiencies and then also scale for growth going forward. So Belinda and her leadership team are focused entirely on the integration of East China and making sure it's a huge success for us. We've, in the first full quarter of the integration, obviously have welcomed all the partners from East China into the business.

We are in the process of normalizing pay and benefits across both company owned as well as East China. And then also, looking at financial and accounting systems and making sure that those are synced as well. We also continue to work on supply chain and supply chain efficiencies. That work is ongoing as well as the back office systems and other key areas. And that work will continue through FY 2019. So we'll be able to provide a great update to you during the Investor Day, and just – this presents just one more opportunity for us to really take advantage of the opportunity for growth and accelerating growth in China across the Mainland.

Operator: Your next question comes from Karen Holthouse with Goldman Sachs. Your line is open.

Karen Holthouse
Analyst, Goldman Sachs & Co. LLC

Q

Hi. One quick clarification and a question. The 80% cash return number that you gave, does that include or not include stores in East China? And then actually moving sort of away from the U.S. business and actually China, looking at the other operating segment, at this point, are we down to this really is just U.S. food service and then the Roastery business? And within that, when-- I know that there's – it can be pretty substantial upfront pre-opening costs with the sort of leases you're signing, but when should we think about the Roastery business breaking even or sort of funding its own growth? Is that something that could happen in 2019 or do we need to look out farther than that? Thanks.

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

A

Yeah, on the first question, Karen, it's just the company-owned stores in China as of the end of the year last year, so it does not include East China. We'll get our arms around those stores at a detailed level and we'll give you an update as we move through time. I will say that the profitability of those stores is also quite strong, but the 80% does not include those stores. On the other segment, substantially what's in there is definitely I would say broadly Siren Retail which includes the Roasteries. But will include for example the Reserve store that's downstairs in the building here in Seattle. It will include Princi stores as we open those. It includes I believe still some revenue related to SBC. And so there's a few things in there. And it will be beyond 2019 before that segment breaks even.

Operator: The last question comes from Dennis Geiger with UBS. Your line is open.

Dennis Geiger
Analyst, UBS Securities LLC

Q

Great, and thanks for all the detail on the U.S. consumer – or your U.S. customer. That's very helpful. But I wanted to come back to the non-MSR digital relationship platform. Is there anything else you can share on your learnings at this – of the initiatives at this very early stage? Perhaps how easy it's been to get sign-ups, how easy it's been to capture those emails? And I think you mentioned that there will be several million members on that platform by year end presumably that will build into 2019. So as we get into 2019, can that customer cohort actually grow spend similar to the MSR platform year-over-year?

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

A

Sure, Matt, Ryan here. Thank you for the question. I think, the exciting thing about this strategy is that it is a long-term strategy. It's not something that is one and done this year, done in immediate response to the challenging environment we've been in. We see a huge opportunity because there are 75 million customers in our store, 15 million rewards. And the several million we're talking about this year is just the beginning.

There is a long, long road ahead of us, and we're encouraged by early signs. Now it's way, and it'd be very easy to get over our skis and get excited about the results we've seen to date, but what I can tell you is that after just a couple of Happy Hours, we know we're on the right track here. We also know that it's very easy to sign customers up because people want to have a relationship with a brand that they are very involved with. So what we have going for us that most companies don't have going for us is that people want a direct digital relationship, and we're now giving them reasons outside of Starbucks Rewards to do that. So with the kind of frequents that we have, the kind of brand love we have, we see a lot of opportunity there.

With regard to what we're going to see in terms of growth per customer and spend, too early to speculate on that. We're optimistic about what we saw in terms of the response to Happy Hours. I think Roz mentioned that we're seeing greater response to the Happy Hours from our non-SR versus our SR customer. So everything is very early, but everything is very promising. And the one thing I would stress is really it takes signing up customers, then getting to know them before we can really take advantage of the personalization and the benefits that come to the business, but we know we're on the right track.

Operator: I will now turn the call over to Mr. Shaw for his closing remarks.

Tom Shaw
Vice President-Investor Relations, Starbucks Corp.

Great, thanks Chris. As a quick reminder, we look forward to seeing many of you at our Starbucks 2018 China Investor Day starting on May 16 in Shanghai. In addition, our third quarter 2018 conference call has been tentatively scheduled for Thursday, July 26. Thanks again, and have a great evening.

Operator: This concludes Starbucks Coffee Company's second quarter fiscal year 2018 earnings conference call. You may now disconnect.