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Starbucks (SBUX) Earnings Model

Investment Forecast Thesis & Assumptions

Overall, I am *bearish* on SBUX in the medium-term future. Economically, there may be some negative impacts of inflation and follow-on Fed decisions. The impact of COVID still looms over the economy as we do not see the world back to any "normal" conditions anytime soon. Also, there is a growing concern of unemployment as well as workers quitting due to higher demand of wages ripping through the restaurant industry overall leading to staffing challenges. Therefore, Starbucks reinvesting store level margin upside into labor (which it has a history of doing) to continue to drive market share gains which could impact medium-term profits. Lastly, SBUX narrowed both global and China sales growth for fiscal 2021. Starbucks anticipates China comparable store sales growth to be 18-20%, down from the prior estimate of 27% to 32%. In fourth-quarter fiscal 2021 China comparable store sales are anticipated to be flat. There are also significant concerns surrounding global supply chain channels throughout 2021 and consensus estimates this may continue through the next few years until COVID normalizes and supply chain issues are mitigated.

Forecast Opinion 1: There is a growing concern of unemployment as well as workers quitting due to higher demand of wages ripping through the restaurant industry overall leading to staffing challenges. Therefore, Starbucks reinvesting store level margin upside into labor (which it has a history of doing) to continue to drive market share gains which could impact medium-term profits.

- Adjusted Line 77: Americas G&A expenses (as % of total segment revenue): Added 0.5% G&A expenses as & of total revenue between 2022 – 2024

Forecast Opinion 2: Dismal channel development and supply chain issues continue to hurt Starbucks. In third-quarter fiscal 2021, net revenues in the segment declined 7% following a fall of 29% and 25% YOY in second- and first-quarter fiscal 2021, respectively. The downside was primarily due to nearly 20% unfavorable impact of Global Coffee Alliance transition-related activities and global supply chain management complications, further compounded with the global concern for COVID variants.

- Adjusted Line 54: Americas Comp store sales – Total: Reduced to 4.0% lower than management expectations between 2022 – 2026

Source: Guggenheim Equity Research

Forecast Opinion 3: SBUX narrowed both global and China sales growth for fiscal 2021. Starbucks anticipates China comparable store sales growth to be 18-20%, down from the prior estimate of 27% to 32%. In fourth-quarter fiscal 2021 China comparable store sales are anticipated to be flat.

- Adjusted Line 89: Intl Comp store sales – Total: Reduced to 3.5% between 2022 – 2025 and tapering back up through 2026

Independent outside research conducted to support my investment forecast thesis & assumptions:

"In terms of China expectations, it appears highly likely that the guidance of "roughly flat" for 4Q21e will be missed, which the buy-side investment community is very well aware of, despite the sell-side community more broadly not having caught up just yet (i.e. we only lower our estimates today). Related to this, it also appears likely that there could be downside to additional near-term quarters as well, although we imagine most will be raising one's related "out-year" estimates in lockstep." (Source: Deutsche Bank Equity Research)

"This week, the Bureau of Labor Statistics reported that quits rates in the food service industry hit 6.8%, compared to an overall quits rate of 2.9%. Guggenheim analyst Gregory Francfort notes the quits rate for food service is well above the 5% peaks seen in quits in 2006 and 2019, and 4.1% average over the past 20 years." (Sources: Yahoo Finance, Bureau of Labor Statistics)

Source: https://finance.yahoo.com/news/the-great-resignation-is-ripping-through-the-restaurant-industry-162052446.html
Source: https://www.bls.gov/news.release/pdf/jolts.pdf

ERP Model Forecast Thesis

I do believe that the recent rise in inflation, particularly wage inflation, concerns surrounding variants of COVID & lockdowns, and the increasing timeline of the US population returning to work, will prove to be persistent through 2023/2024 according to the latest data from the FOMC meeting and not just transitory. The message from the Fed's latest projections is that "transitory" is lasting an awfully long time. Next year's projected 2.3% is the highest next-year core inflation forecast since projections were first published in 2007. As a result, the Fed will be forced to begin an aggressive taper of security purchases and increase the Federal Funds rate. The policy moves, along with my expectation of continuous high unemployment through the next few years, and higher corporate taxes, will result in lower aggregate demand, and lower corporate profits over the next few years. Furthermore, I also believe that the lack of workers will force businesses to increase wages to attract people back to work, further lowering corporate profits.

Based upon my above thesis I've adjusted the variables and placed in my own inputs into the ERP Model in the following manner:

Variable 1 - The Federal Funds Rate: I have increased the Federal Funds rate according to the Sept 2021 FOMC meeting data, where: the median rate of 2022 is 0.3% and median of 2023 is 1.0%. I did this by increasing 2022 and 2023 by 15-basis points.

Variable 2 - Treasury Spread (10-yr to Fed Funds): My thesis remains in line with my research that short term yield have climbed, while the curve has flattened after inflation data released on Wednesday October 13, 2021. Yields on shorter-term U.S. Treasuries rose on Wednesday, while longer-dated yields dipped following data on consumer prices that further fanned concerns inflation will continue to climb and force the Federal Reserve to act. Therefore, I have decreased the spread input in the ERP Model.

"'The curve flattening is the market suggesting that the Fed will respond to higher inflation prints by becoming slightly more hawkish and normalizing front end rates,' Lisa Hornby, Head of U.S. Multi-Sector Fixed Income at Schroders told the Reuters Global Markets Forum."

Source: https://www.reuters.com/article/usa-bonds-idUSL1N2R92GL

Variable 3 - Equity Market Volatility (VIX): My thesis will likely lead to increasing equity market volatility; therefore, I have increased the VIX input of the model. I believe at the time of the announcement in Q12022 this VIX will increase by 30-basis points, and by 2023 level off back to the historic average.

Variable 4 - Equity Market Return Projections: With an adverse outlook of my thesis, equity market returns will likely be negative during the quarter when the Fed announces an unexpected move to hawkish policy. Therefore, I adjusted the values to -10.00% at the point of the Fed's announcement of Q12022, and then tapered back up to 2.75% by 2023.

Market Multiple Based Valuation

My DCF based (5 years) price target is $107 with an implied P/E multiple of 31.0x, while WACC is calculated to be 7.3%. My $107 price target implies a P/E multiple of 27.0x and an EV/EBITDA multiple of 17.0x on my FY2023E estimates. Using the NTM EPS estimates and NTM P/E Ratio of the last three months from July 2021 to Sept 2021, my implied multiples fall in the lower end of P/E Ratio High to Low and FY23 P/E High to Low.

Starbucks typically trades 20x to 30x forward earnings, however, due to micro and macroeconomic factors as stated earlier, such as inflation and Fed rates decisions as well as undesirability of the debt ceiling breach and a downturn of the economy, SBUX should be valued in the low end of the historic range. The P/E multiple used for valuation was 31.0x which is on the lower end of the last 3-month average, giving an implied P/E 12-month target value of $110. Combined with my implied DCF 12-month target value of $107, this results in an implied 50/50 average target value of $108, and target price band between $101 to $121.

"Also, we should mention that SBUX has a PEG ratio of 1.47. This metric is used similarly to the P/E ratio, but the PEG ratio also considers the stock's expected earnings growth rate. The Retail - Restaurants was holding an average PEG ratio of 2.32 at yesterday's closing price." (Yahoo Finance)

In the above quote - using the PEG ratio - the street consensus shows a general overvaluation of SBUX stock, further confirming my bearish attitude towards SBUX.

Source: https://finance.yahoo.com/news/starbucks-sbux-gains-lags-market-214509327.html