A financial analysis of starbucks coffee

The aim of this financial analysis of Starbucks is to obtain a deep knowledge of annual financial reports and other corporate information, which can provide us measurable conclusions about the company. It is essential to understand the nature of company's business, by analyzing its economic and financial environment and strategy choices made in the past.

This report will begin with industry and company description, followed by financial performance overview and projection of company development over the next two years.

Conclusions drawn from above analysis will support managers in making a decision whether to invest in the company.

2. The industry description

The coffee industry is growing since 2002, and in recent years there was a boom caused by consumers becoming more educated about espresso-based drinks and how they are made (H. Holmes, 2004). The coffee industry includes 20, 000 outlets with combined revenue of $11 billion. Approximately 20 million people work in the coffee industry worldwide. Market is very concentrated at the top with the 50 companies taking up 70% of the sales, and fragmented at the bottom. Starbucks is the market leader (Franchise direct, 2010).

2. 1. Starbucks description

Starbucks Corporation is involved in: purchasing, roasting, and sale of whole bean coffees, cold-blended beverages, various food items, selection of teas, and beverage-related accessories and equipment, primarily through its company-operated retail stores. It was established in 1971 in Seattle, Washington. In 1986 Howard Shultz, Retail Sales and Marketing Manager, left the company to start his own retail coffee outlet, Il Giornale. In 1987 the original investors of Starbucks bought Peet's Coffee and sold Starbucks to H. Shultz, who renamed Il Giornale to Starbucks. Firm expended with shops in Chicago and Vancouver. Starbuck was the first coffee company to offer employee stock options in 1991 and went public in 1992. In 1990's Starbucks started distributing coffee through department stores, bookstores, hotels, supermarkets and online; it signed contract with PepsiCo, AOL and Dyer's and opened stores in Japan, Singapore, and UK. (Hoovers. com, 2008)

Starbucks has built one of the world's most powerful and recognizable brands and the image of a unique " Starbucks Experience". Its mission statement was to revolutionize the coffeehouse industry by building a perception of a coffee shop as the " third place" between work and home. Wi-fi internet access in all stores makes it a place where customers can work. The company's goal was to make each location a community center for higher-income crowd of the young and college-educated, a group that tends toward higher luxury-consumption levels. (Wikinvest. com, n. d.)

2. 2. Competition

Starbucks' close competitors include other specialty coffee shops, doughnut shops, and restaurants. Starbucks holds a dominant position in the coffeehouse market which is dispersed among the thousands of independent or small-chain coffee shops. Their largest direct competitors are Dunkin' Donuts and McDonalds. Both offer specialty coffee at a lower price.

Main competitors short description:

Dunkin', specializes in fresh baked goods, but began offering coffee in 2005. Their level of sales is at $4. 3b. Currently, their coffee sales start to exceed food sales, 5-10% of total sales are from espresso-based drinks. Dunkin' has a 22. 9% market share. (Starbucks in the aggregate category controls a 24. 7% market share)

McDonald's entered the coffeehouse industry in 2007, offering coffee at its flagship stores and opening its espresso-centric McCafe concept in some markets. McD's coffee sales generate $813m in additional annual income. Current revenue from coffee is around $490m, about 6-6. 5% of Starbuck's coffee sales. Their price point is at 18% discount on Starbucks's.

The two competitors's targets are slightly different from Starbucks. They focus on cheaper coffee to go, whereas Starbucks is providing a premium experience for a luxury price. Consequently, they compete with each other more directly than with Starbucks, however McCafe has a negative impact on Starbucks. Analysts believe that competitors will settle into separate niches, McDonald's being the better value proposition and Starbucks offering higher quality experience.

3. Financial Performance 2007-2009

3. 1. Overview of Starbucks' performance 2007-2009

In the fiscal year 2007, Starbucks achieved a solid performance. All goals like new stores opening, total revenue growth, comparable store sales growth and considerable cost rises from dairy products were completed. The consolidated operating income in 2008 was $503. 9 and operating margin 4. 9%. This was a significant decrease compared with the past few years, the reason for decrease was a changing of structure. In 2009, Starbucks faced many challenges caused by unexpected economic environment and more intense competition, which had impact on the revenue, comparable store sales, operating income and margins.

3. 2. Income statement analysis 2007-2009

While net revenues of Starbucks haven't been stable from 2007 to 2009 (first increasing then decreasing), its total operating income have also been moving in 2008 it decreased by 52, 2% and it was $503. 9 million, 4. 9% of total net revenues. The reason for decrease was high distribution costs and high rent expenses. In 2009 it increase again by $58. 1. Main reason for this improvement was the restructuring charges which contain: assets impairment, lease exit and severance costs. In 2008 and 2009 while net revenues were $10, 383 million and $9, 774. 6, total operating expenses were $9, 992. 7 million in 2008 and $9, 334. 5 in 2009 that means expenses were highly eating up more than 96% of the net revenues. The company suffered a major loss of 113. 185% in net earnings between 2007 and 2008. Starbucks' realized that he need to re-think its business strategy. In 2008, the company incurred restructuring charges of $266. 9 million due to store closures in the US and Australia and reduction of the work force. Starbucks Company derived 84% of total net revenue from the company-operated retail stores. They opened 681 new stores in the last 12 months and this offset -3% losses in comparable store sales. Total net revenue of 2009 was showed a decrease of 5. 9%, stayed at $9, 774. 6. The company-operated retail also went down. In detail, there was a change of nearly 6. 7% in comparable, for 4% decrease in transactions and a 2% decrease in the average value per transaction.

Figure 1: Net Revenue of Starbucks 2007-2009 (Starbucks annual financial report)

Figure 2: Operating Income of Starbucks 2007-2009 (Starbucks annual financial report)

Figure 3: Net earnings of Starbucks 2007-2009 (Starbuck annual report)

3. 4. Balance sheet

In term of assets, the total assets for the three years kept staying around $5, 600 million. The total current assets in 2009 were $2, 036 million. This was higher than in 2008 and 2007 due to the high cash and cash equivalents in 2009. The marketable securities in 2007 were $157 millions so in 2007 the company had more short term investment. On the other hand, the total liabilities in 2008 were the highest in three years because of the commercial paper and short-term borrowing in 2008. Additionally, there was no short-term debt in 2009 but it was the highest accrued expenses during the three years. The shareholders' equity in 2009 was the highest in three years owing to the additional paid-in capital.

3. 4. Ratio analysis:

By doing ratio analysis, the company performance would be evaluated more clearly.

As we can see the current ratio for the 2009 was higher than 2008 and 2007. In 2008 and 2007, the current ratio was under 1. That means Starbucks was not in good financial health in these two years. However, this situation didn’t exist for a long time but it was not a good sign. The current ratio for 2009 was 1. 29, so the company had 1. 29 times more current assets than current liabilities. That means Starbucks was able to cover its own obligations.

As the Exhibit 1 shows the quick ratio was low for 3 years that is all below 1. This indicates that the company had difficult to turning their inventory into cash like a short-term liability which the company could not pay off immediately. In 2007, the profit margin of Starbucks was 7. 15%. This means 7 cents of each dollar is company’s profit. In the next two years, the profit margin decreased by nearly 3 percent. That means the net income in 2009 was visibly lower than 2007. It may mainly caused from the increase of the restructuring charges.

The return on assets ratio in the year 2007 was 13. 77% while the ratio declined to 6. 95% in 2009. From this we know Starbucks earned more in 2007 and the net income in 2007 was higher than in 2009. The reason for this decrease results is also from increase cost of the restructuring and innovation in 2008 and 2009.

In terms of leverage ratio, to measure its ability to meet financial obligation from 2007 to 2009 the debt ratio was around 50%. That means nearly 50% of funds for assets came from debt. This does not seem good for the company and the most liabilities were long-term liabilities.

The debt to equity ratio from 2007 to 2009 was pretty high and the highest point was in 2007, so in 2007 more debt was used.

Interests earned ratio in Starbucks during the 3 years was extremely high like in 2007, the ratio was nearly 28 times, but finally in 2009 the ratio was around 15 times a year. It could be a really good margin since the company was able to cover its interest expenses 15 times with operating income.

3. 5. Cash flow

Operating activities: the net cash provided by operating actives in 2009 was highest during the 3 years. The main part of activities was depreciation and amortization. Same as in 2008 the company spent $604. 5 thousands on depreciation and amortization.

Investing activities: the net cash used by investing activities in 2007 was $-1201. 9 thousands. The main costs here were addition to property, plant and equipment and the company also spent money on purchasing available-for-sale securities. But in 2009 the net cash used by investing activities was $-421. 1 thousands. This was much less than in the 2007. The reason for this was the company spent less money on additions to property, plant and equipment.

Financing activities: the net increase/ (decrease) in cash and cash equivalents in 2009 was $330. 0 thousands. That means Starbucks gained money from financing activities in 2009 while in 2008 and 2009 they had losses in financing activities. The reason for the gain of money in 2009 was the profit in short-term borrowing and nothing spent on the issuing of long-term debts.

4. Forecasting 2010-2011

In order to project the next two fiscal year performance of Starbucks, particularly to construct the pro forma income statements of 2010 and 2011, establishing the revenue (or sales) projection should be the first task of all. In the next steps, the rest items of the statement would be projected by the percent of sales method since it does provide simple, logical estimate of many important variables (Higgins, 2009). In fact, there was a visible growth of Starbucks revenue in both volume and speed during the period of time from 2000 to 2009. Especially, from 2000 to 2007, the annual company sales increased in steady pace in the range of 20% to 29%. This impressive growth of Starbucks revenue was a sophisticated proof for its great business strategies during the beginning of this decade. However, the story had some changes since 2008. At the end of this fiscal year, Starbucks finished with $10, 383 million revenue, in comparison with 2007, the growth ratio was 10. 3% only, the lowest ratio since 2000. Continuously, in the midst of the US economic crisis, Starbucks sales got negative growth at 5. 9% after finish the fiscal year 2009, stay at $9, 744 million.

Figure 4: Starbucks' Sales chart in 2000-2009 (in Millions)

Obviously, the trustable estimation should be the sophisticated one, that normally came from data base statistic analyses. Specifically, with the availability of the last ten years data of Starbucks revenue, it was possible to apply most of time series forecast methods such as moving average, weighted moving average, exponential smoothing, and so on. Since each method had its own advantages and limitations, it is necessary to compare how every method would reflect the same provided data (Exhibit 4).

The value of W3 (for the Weighted moving average method) and Î± (for the Exponential smoothing method) were decided high at 0. 6 and 0. 3 due to the emphasis of the closest time period in term of its impact to the next following year. As a result, the forecasts for 2010 sales were quite low though there was still a slightly growth than 2009. Among the three methods, the weighted moving average method seems to be the most appropriated one since it had the smallest value of the Mean Absolute Deviation. Basically, it proved that this method had less forecasting error than others and might be the best choice of all. To be clear, the plot chart was established base on the result of the three forecast methods in Figure X.

Figure 5: Plot of Actual Sales and Forecast Sales for 2010 in three different models (in $ Million)

Visibly, the line created from weighted moving average method was the closest one to the actual sales line. Its trend reflected almost similarly to the actual during the period of time from 2003 to 2009. That is why this method was chosen to determine the 2010 Starbucks sales instead of the two methods remaining. Objectively, $9, 920. 81 million may not be a number that Starbucks' shareholders and investors really expect, even it showed slightly growth at 1. 5% than 2009. However, in some levels, it seems to reflect quite appropriately the reality of the economic conditions as well as the Starbucks status. In spite of many positive signs of the economic recovery, Starbucks is still continuing its plan to close 800 retail stores over two year 2009 and 2010. Since the 566 stores had already released in 2009, another 244 are expecting to be cleared in fiscal year 2010. Thus, it could be hard to see a rapid growth in revenue of Starbucks at the end of fiscal year 2010.

In regard to fiscal year 2011, since all of the three forecasting method above only allowed forecaster to see the result of 2010 revenue, the Linear Regression method was applied to estimate the sales in 2011. By collecting the sales data from the last three years (2007 to 2009) in quarterly, by the calculation of the regression line (Exhibit 11), the value of a (the y intercept) and b (slope of regression line) were found. These two values were use to determine the dependent variable (y). The regression forecast of sales in equation is: y = a + bx (Exhibit 5).

The forecast results of $10, 078. 21 and $10, 189. 41 for each year of 2010 and 2011 once again confirmed about the growth trend of Starbucks sales in the next two year. Nonetheless, base on the Starbucks' plan of opening over 500 new stores in US and over sea during 2011, there should be a stronger increase in sales of Starbucks in this year. Subjectively, the authors believed that Starbucks revenue would increase no less than 15% in 2011. In other words, if the 2010 revenue was forecasted at $9, 920. 81 million, the same item in 2011 would be around $11, 408. 93 million. This result was also determined base on many positive factors that Starbucks could get benefits from such as the economic recovery in higher volume and speed, the more effective operating of Starbucks after the reorganizing process in its retail stores system as well as the objective increase in customers demand. Moreover, the volume of average transaction would be higher due to the increase in cost of goods sold and the impact of inflation.

In the Exhibit 6, all the operating performances of Starbucks from 2005 to 2009 were displayed in detail by the percent of total revenue. Base on those historical data and theirs visible trends, it was possible to anticipate logically the operating results for next two fiscal years 2010 and 2011 (Exhibit 7).

According to the Exhibit 14, the net income of Starbucks stays at $466. 27 and $479. 18 million for each of 2010 and 2011. This may be considered as the acceptable results in regard to the challenges of the current circumstance. In fact, the forecast net income of 2010 is 19. 3% higher than 2009. Since the revenue of 2010 did not rise in a strong level (only 1. 5%), this impressive net income mainly came from the reducing the stores operating expenses and the more effective tax rate. In 2011, the operating expenses are expected to increase and stay at 95. 2% of total sales, this is an objective fact that many items in operating expenses areas are in trend of steady increase year by year accompany with the business enlarge strategy of Starbucks, such as store operating expenses or general and administrative expenses. However, this ratio might be less in the next following years if the restructure process of Starbucks would get its aims of improving efficiency of cost control in various activities.

Conclusion and recommendation

Starbucks has been the largest specialty coffee retailer in its industry, but due to the problems with our economy, it has been seeing an effect on its sales and profits. The economic situation has affected consumers spending at Starbucks and other luxury goods. Starbucks also raised prices by an average of 9 cents a cup in July of 2007, causing U. S. customers who face higher food, fuel and housing expenses to go to McDonald’s and Dunkin’

Donuts for cheaper coffee. These issues have affected Starbucks stock's performance in the market and are slowly making this stock an unfavorable one for potential investors. My recommendation for potential investors would be to hold off on purchasing stocks from Starbucks at this moment because now is not a good time to invest in them. I would advise these investors to keep looking into this stock until they see a positive change in its market pattern and that would be when I would advise them to purchase the stock; before its price increases higher than the average market price. My recommendation for investors holding the share of the company would be to hold on to it until they can see for certain if Starbucks stocks will continue to go down and become a loss or maybe potential go back up and become profitable as they once were. After conducting my research, I believe the Starbucks stock will eventually start going up again after they put into effect their plans for the upcoming year. This stock is definitely a valuable one that I would not let go of if I owned shares in it. Starbucks hold value to its stock, which is why my advice to shareholders is to hold off on selling their shares until they see how the upcoming year goes for the company. In a response to the McDonald's challenge Starbucks is teaming up with Burger King, which has announced that by September 2010 it would begin selling Starbucks' Seattle's Best Coffee in about 7, 250 U. S. outlets it would launch its first national advertising campaign.