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# Starbucks Corp. (SBUX)

Q2 2016 Earnings Call

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good afternoon. My name is Connor, 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 2016 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] Thank you.

Ms. Doraisamy, you may begin your conference.

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### Durga Doraisamy

*Director of Investor Relations*

Good afternoon, everyone. This is Durga Doraisamy, Director of Investor Relations for Starbucks Coffee Company. Thank you for joining us today to discuss our second quarter 2016 results which will be led by Howard Schultz, Chairman and CEO; Kevin Johnson, President and COO; and Scott Maw, CFO. Joining us for Q&A are Cliff Burrows, Group President-U.S. and Americas; John Culver, Group President-China/Asia Pacific, Channel Development and Emerging Brands; Matt Ryan, Global Chief Strategy Officer; and Adam Brotman, Global Chief Digital 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.

Please refer to our website at [investor.starbucks.com](http://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 at [investor.com](http://investor.com) – at [investor.starbucks.com](http://investor.starbucks.com).

I would now turn the call over to Howard. Howard?

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### Howard S. Schultz

*Chairman & Chief Executive Officer*

Thank you, Durga, and welcome, everyone. I taped my conversation today before heading to Johannesburg, where earlier today we opened the first of approximately 150 stores in South Africa, Starbucks's 71st international market.

In Q2, Starbucks' powerful 24,000-store global retail operation again drove record financial and operating performance, including record revenues, record profits, a 7% increase in comp store sales in the U.S., a 6% increase in comp store sales globally, our 25th consecutive quarter of comp store growth at or above 5% and a stunning increase of 5% in transaction growth and 18% in revenue growth in China. And we remain on plan to end fiscal 2016 with approximately 25,000 stores globally. Our recent classes of new and remodeled retail stores continue to defy established consumer trends away from traditional bricks-and-mortar retailing and deliver record-breaking unit sales, unit economics and return on investment; very strong performance metrics that underscore the increasing power and relevance of the Starbucks brand around the world.

In light of two very favorable recent developments, I'd like to take a few moments to frame for you the enormity of the near-in and long-term global single-serve opportunity that lies ahead for Starbucks. As many of you know, the last five years Starbucks has built a powerful, sustainable, premium single-serve business, operating on the Keurig K-Cup rails. And today, Starbucks has the leading U.S. market share of both premium single-serve and of premium roast and ground and is the leading brand on the K-Cup platform.

In 2016, we will sell approximately 1.5 billion Starbucks K-Cups, up almost 20% over last year and representing multiples of K-Cup category growth overall. Last month, we extended our relationship with Keurig on highly favorable terms that provide us with improved economics and increased operating flexibility, including the ability to sell directly into office and other complementary highly profitable channels of distribution. The Starbucks single-serve aspirations do not end with North America, nor do they end with K-Cup, and now we have capability and a clear line of sight on a second equally attractive single-serve opportunity. Because while Keurig has the dominant share of single-serve brewers in North America, it has virtually no share or relevant brewer product anywhere beyond North America.

Outside of North America is Nestlé's Nespresso unit that has the leading share of premium single-serve, with a rapidly growing installed base of what we estimate to be over 25 million largely espresso-based brewers in homes around the world. Nespresso also has a strong presence in global away-from-home and hospitality channels utilizing the same capsule design it uses for at home. So here's the opportunity, and it's big.

For years, customers have been asking us to produce Starbucks branded Nespresso-compatible capsules so they could enjoy Starbucks's quality and espresso varieties through their Nespresso machines, just as they do through their K-Cup brewers in North America. But we could not satisfy that demand because we had not yet cracked the code on roasting, grinding, and packing Starbucks Coffee in order to deliver Starbucks quality in a cup through a Starbucks-designed Nespresso compatible capsule. But now we have. And as we announced at our Annual Shareholders Meeting last month, starting this fall, we will begin leveraging our retail, CPG, e-commerce, digital and loyalty assets in order to market Starbucks's espresso varieties directly to Nespresso's installed customer base.

We're starting with Europe, Nespresso's largest market, and where in some countries single-serve represents over 40% of all coffee consumed, and 50% of our best Starbucks customers own a Nespresso machine at home. And in the future, we will begin selling Starbucks branded Nespresso compatible pods in additional Starbucks retail markets around the world.

Improved economics and increased flexibility with Keurig in North America will combine with the new global opportunity presented by Starbucks Nespresso compatibles to enable us to substantially increase the size and profitability of our single-serve business overall and to add significant shareholder value in the quarters and years ahead.

We also have big long-term plans for single-serve across CAP and in China. As the only truly global premium coffee brand, particularly in China, we are ideally positioned to leverage our deep connection to our customers and our unique retail store footprint to be on the forefront of single-serve in all CAP markets as the morning and at-home coffee ritual evolves.

Let me turn to China. Starbucks has committed to China, and we now have over 2,000 stores in 100 cities in China and are adding over 10 new stores every week. Our business in China remains very strong, and I personally have no doubt that the Chinese government's commitment to true economic reform is genuine and that its plan to double 2010 per capita income by 2021, resulting in a middle-class in China approaching 600 million people, almost twice the size of the entire current U.S. population, is achievable.

We are building our business in China through the lens and with the learnings of the success of our business in the U.S. We're building trust in the Starbucks brand and deep authentic connections between our customers and our partners. We're continuing to deliver an elevated in-store experience for our customers, we're increasingly, established Starbucks as a third place between home and work, and we're giving back to the communities we serve, all of which are enabling us to strengthen the equity of the Starbucks brand and develop and expand our retail, license and CPG businesses and partnerships.

Our partnership with Tingyi that will provide us with over 1 million points of ready-to-drink Frappuccino distribution in China beginning later this quarter is just one notable example, and there will be many that will follow. Today, not only are we building our brand and a great retail store business in China, but we are building a unique retailing capability that separates us from all other retailers and consumer brands and that we will leverage to continue growing our China business long into the future.

And on June 16, we will open in China what will, in all probability, become the Starbucks highest grossing retail store in the world virtually overnight. It is a stunning new Starbucks store at the main entrance of the new Shanghai Disneyland, a destination that may well become the number one tourist attraction in Asia. Our new Shanghai Disneyland store will showcase the Starbucks experience in all its glory and our premium coffee position and once again underscore the power and the relevance of the Starbucks brand in China and in CAP overall. We're honored that the Disney Company chose Starbucks to so prominently greet its guests at the entrance of the new park.

I am more convinced than ever that Starbucks is just getting started in China, and I am equally convinced that as we fully roll out our new partnerships with the leading digital companies and brands in China and leverage our unique digital, mobile, card, gifting and loyalty programs across our business in China later this year and ultimately across CAP overall, we will perform at even higher levels of success and profitability in the future than we do today.

Starbucks continues to redefine the customer-facing mobile and retail experience of the future. Kevin will be taking you through how we are combining proprietary technologies, digital engagement and customer loyalty to create and leverage a dynamic, integrated digital and mobile ecosystem that will continue to [audio gap] (10:35) business and propel it forward, including providing additional details around our Stars Everywhere initiative, the unique and highly opportunistic partnership we recently announced with JPMorgan Chase and Visa, and our breakthrough initiatives around personalization that are enabling us to deliver highly targeted and highly profitable one-to-one marketing programs to our customers wherever they may be.

I am particularly proud to report that we grew our MSR loyalty program 8% by adding approximately 1 million new members in Q2 alone and that we now have over 12 million active My Starbucks Rewards members in the U.S. And the MSR program changes that took effect on April 12 will, for the first time, reward both customer frequency and overall spend, resulting in increased rewards for our best customers at the same time as it enhances in-store efficiency, speed of service and our customer experience overall.

I'd like to speak for a moment about the excitement we have about the Roastery in the context of Starbucks's overall brand architecture. Our Seattle Roastery continues to delight our customers and perform well ahead of original expectations. Based on experience to date, our current view is that we will ultimately open between 7 and 10 full scale Roasteries around the world in key global cities. Our second Roastery will be opening in New York's Meatpacking District on the corner of 9th Avenue and 15th Street, next to the heavily trafficked Chelsea Market, directly across the street from Google's headquarters and adjacent to Apple's downtown store in 2018. And soon we will be announcing details of our third Roastery, which will be in CAP.

In addition to providing an immersive customer experience with the Roastery and through the discipline and the opportunity of segmentation, we have been building a new premium brand, Starbucks Reserve. Starbucks Reserve are ultra-premium, micro-lot, single varietal coffees that are being sold at premium prices through select Starbucks stores around the world, creating both increased profitability and further separation from our competitors. And we will continue to open coffee-forward Starbucks stores with elevated Reserve beverage and holding products like those in Williamsburg, Brooklyn; Chelsea, London; and across Asia.

Now, following the success and the learnings from these stores, we will be opening a new class of Reserve stores beginning in fiscal 2017. We believe we have significant runway to grow and develop our Starbucks Reserve brand on a global basis.

Starbucks's performance in Q2 demonstrates the continued success of our commitments to delivering an elevated Starbucks experience to our customers and world-leading financial and operating performance and long-term sustainable, profitable growth to our shareholders. With humility, our performance in Q2 is particularly gratifying in that it was achieved in the face of very challenging consumer, geopolitical and economic environments.

And with that, from South Africa, I turn the call over to Kevin. Kevin?

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## Kevin R. Johnson

*President, Chief Operating Officer & Director*

Thank you, Howard, and good afternoon, everyone. Howard touched upon several highlights from the quarter. I will add additional color on our performance and provide further evidence that our strategies for growth are working. And I'll again demonstrate how we are being deliberate and focused in connection with the investments we are making for our future.

Let's start with the Americas segment. We now have over 15,000 stores throughout the Americas business comprised of nearly 9,000 company operated and over 6,000 licensed stores. Our Americas business continued its track record of delivering consistent, profitable growth with revenue up 10% over last year and record operating margins. Americas comp sales included a 3% increase in transactions and a 5% increase in ticket, rounding to a 7% increase in comp [audio gap] (14:48).

Our store [audio gap] (14:51) strategy is enabling the introduction of new store formats and faster and more efficient drive-throughs, express stores, and beautiful renovations that provide our customers not only with increased convenience, but a more inviting and comfortable third-place environment. This approach is enabling record-setting unit volume in our new stores.

The morning daypart, once again our fastest-growing daypart, grew 13% year-on-year, driven by Mobile Order & Pay, strong performance from our core brewed and espresso product lineup and breakfast sandwiches. Flat White and cold brew both continued to gain traction and customer acceptance and drive food attach. In addition to our hot beverage lineup, our expanded iced beverage business is resonating with customers. Our tea business in particular had its strongest quarter in over a year, up 17% year-on-year and contributing one point of comp, fueled by an accelerating sales of Teavana handcrafted tea beverages in Starbucks retail stores.

Creating new customer occasions and driving increased attach are key priorities for our food programs, and we made great progress with our food business this quarter, growing revenues 16% year-on-year and contributing over two points to our comp, with every daypart contributing to this increase. Breakfast sandwiches continue to be a strong driver of the business, delivering nearly 30% revenue growth and driving both traffic and increased attach in the morning daypart. Our innovative new lineup of lunch offerings delivered an 18% year-on-year increase in

food revenue during the lunch daypart. And we continue to test and learn as we shape our evenings program. For the first time ever, food represented more than 20% of revenue in the U.S. Our Americas segment had an outstanding Q2.

Let's now move on to the CAP segment. The China/Asia Pacific business delivered another solid quarter with revenues increasing 14% and operating income up 15% over Q2 a year ago. Noteworthy is that this is the first full quarter in which our 1,100-store Japan retail business was fully included in both our CAP comp and revenue base, resulting in CAP comp growth of 2% in traffic and 2% in ticket, rounding to 3% overall. We now operate over 5,900 stores in CAP, including over 2,000 in Mainland China in more than 100 cities.

Despite moderating GDP growth in China, Starbucks China grew revenues 18% and transactions 5% in the quarter. We saw particularly strong transaction growth in the largest cities, and our newest China stores continue to deliver record-breaking volume and profit, once again demonstrating the increasing strength and relevance of the Starbucks brand in the China market. As Howard mentioned, we will leverage our loyalty and digital flywheel in China with the rollout of certain features this year and full digital capabilities over time. Our China/Asia Pacific business continues to perform extremely well, reinforcing our confidence in the long-term growth potential of this market. While Starbucks is not immune to cyclical changes in the Chinese economy, our long-term outlook remains strong, and we're committed to increasing our store count to over 3,400 in China and to over 10,000 in CAP overall by the end of 2019 – fiscal 2019.

Let's move on to EMEA. We continue to build our 2,500-store EMEA business by increasing our store count, entering new countries, including Luxembourg in Q2, with South Africa, Slovakia and Andorra opening this quarter, and introducing new food and beverage offerings. Overall, we added 47 net new stores in EMEA, all in conjunction with licensee partners at high traffic venues such as train stations, airports, supermarkets and through geographic licensees such as Alshaya in the Middle East. We continue to see strong affinity with the brand as evidenced by the opening of our first Starbucks store in Strasbourg, France where hundreds of energized customers lined up to be among the first in the market to enjoy the Starbucks experience.

Company-operated EMEA stores delivered a 1% comp sales increase in the quarter, the 12th consecutive quarter of positive comp growth. With 72% of EMEA stores now licensed or franchised, total system comps are becoming increasingly relevant. Adjusting for continued mix shift from company-owned to licensed and foreign exchange headwinds, which together impacted revenue growth by 11 points, EMEA on an adjusted revenue basis would deliver growth of 7% and system comp growth of 4%, as well as increasing operating income in the quarter. This was in an extremely challenging consumer, economic, geopolitical environment across the region and reinforces the strength and resilience of the Starbucks brand in EMEA.

Looking ahead, we expect to see a continued mix shift to licensed stores in EMEA, where yesterday we announced entry into an agreement to license all 144 of our stores in Germany to an existing licensee partner, AmRest Holdings. This strategy supports our focus on store growth and expanded operating income.

Let's move on to Channel Development. Our Channel Development segment plays a key role in elevating the Starbucks brand outside of our retail stores. Channel Development has become our second most profitable business segment and once again delivered record revenue and record operating income, growing 8% and 17% respectively. Starbucks has the leading U.S. market share of premium single-serve on the K-Cup platform and premium roast and ground. And this quarter, we expanded our market share position in both of those categories. Our new partnership agreement with Keurig provides us with both improved economics and increased operating flexibility, including the ability to sell directly into complementary profitable channels of distribution, such as hospitality, college/university and office where we consistently grow our business at two times to three times the industry rate.



Our success in single-serve in the U.S. provides the foundation for a larger aspiration around the single-serve opportunity globally. Later this year, we will introduce the Nespresso-compatible Starbucks capsules in Europe as one step toward building a business that one day may rival the size and profitability of our single-serve business in North America. Our ready-to-drink business in North America continued to see very strong performance in the quarter driven by new beverage innovation, including iced black coffee, refreshers with coconut water and product line extensions for Frappuccino and Doubleshot Energy drinks.

Outside of North America, we continue to make meaningful progress building our global CPG footprint. Our partnership with Tingyi is on track to launch this summer where we will move to a national presence with distribution in nearly every major city in China. Through our new agreement with PepsiCo Latin America, we are enabling distribution in the Latin American market in the second half of this year. Starbucks Channel Development segment continues to perform extremely well and plays a key role in elevating our brand globally.

Let's now move on to the progress we are making on our loyalty and digital initiatives. Loyalty remains the cornerstone of our digital flywheel. And in late February, we announced changes to our Starbucks Rewards program that benefit our most loyal customers by leveling the playing field and rewarding both transaction frequency and total spend. With these changes, we also laid the foundation for customers to earn Stars Everywhere which accelerates the pace at which customers earn rewards redeemable only at Starbucks. Rewards membership has accelerated. Just last week alone, we added more than 280,000 new Rewards members. Engaging with these new Rewards members will enable us to accelerate growth of our active Starbucks Rewards customer base.

Besides bringing us new customers, the program also addresses an operational challenge where under the old program, customers would ask baristas to ring up each item individually in order to get multiple stars, a time-consuming process that created additional work for our baristas, slowed service and lengthened lines. By completely eliminating any incentive to order split, we will improve in-store operations and efficiency and increase line speed.

I want to take a moment to underscore that the changes in our rewards program will be accretive to comps over time. As we mentioned during our February Starbucks Rewards conference call, as a result of the changes to the program, we anticipate a shift of about one point of comp between transaction and ticket. Also, we may see some noise in Q3 comps as customers react to the new changes of the program; Scott will speak to this further in a moment.

At the end of the quarter, we had 12 million active Starbucks Rewards customers in the U.S. with total program spend growth of 22% year-on-year. We've seen additional growth in active Reward customers since the launch of the new program last week. Our new mobile app continues to be very well received where today over 86% of our iPhone customers and 79% of our Android customers have already upgraded to the new version of the Starbucks mobile app that released just last week. And we now have almost 19 million users of our mobile app in the U.S. alone. Mobile payment represented 24% of total U.S. tender in Q2, and Mobile Order & Pay continues to be increasingly embraced by our customers. It adds incrementality, especially at peak. Mobile Order & Pay transactions represented approximately 4% of total transactions in the quarter, which was a 40% increase sequentially.

We are just beginning to see the full benefit of Mobile Order & Pay beyond the speed and convenience it affords to both our customers and partners. Consider this: though still in its infancy, in 300 of our busiest urban stores, Mobile Order & Pay represents over 10% of transactions. And in those same stores at peak, Mobile Order & Pay



represents nearly 20% of transactions. In Portland, where we first introduced Mobile Order & Pay in December of 2014, Mobile Order & Pay transaction volume in March was up approximately 150% from March of last year.

The new Starbucks Rewards program and Starbucks mobile app have positioned us for two very exciting initiatives that you will see unfold later this year. The first initiative through a partnership with JPMorgan Chase and Visa is truly a first of its kind. A Starbucks general purpose prepaid Visa card that will enable Starbucks Reward customers to earn Stars Everywhere Visa is accepted. That's 40 million merchants worldwide. And where all stars earned can only be redeemed at Starbucks, we think this is a big win for our customers.

In the U.S., total annual spending on credit and debit cards totaled around \$9 trillion annually, roughly half on credit and half on debit cards. While the majority of credit cards in use today offer rewards or points, typically with an annual fee, there is no meaningful debit-based rewards card program out there. That means that on more than \$4 trillion of annual consumer spending, virtually no one using a debit card is getting rewards. Not anymore. This new Starbucks general purpose prepaid reloadable debit card is unique, and not only is it a win for customers, it is also a win for Starbucks by strengthening our customer engagement and providing us with a direct financial reward for every customer we sign up and leading to attractive interchange rates. Stay tuned for more details about the card and signup information later this year.

The second exciting initiative evolves around the work we are doing to enable real-time personalization. Let me frame this for you. A major contributor to the success of our rewards program has been the targeted offers that we have made to customers via e-mail. Since launching our targeted offer program in the 2013, we have been providing ways for customers to earn extra stars for purchasing certain items or making additional visits to our stores. However, existing technology had constrained our ability to laser target, respond in the moment, and vary our digital content based on what we know to be an individual customer's preferences and behaviors. All that is changing as we begin to introduce true real-time personalization across our entire digital ecosystem.

Following the successful implementation of the first wave of this new technology, we can now send significantly improved targeted communications to individual customers based on what we know about their specific tastes and interests, enabling us to become even more relevant to them. Over time, we will expand this capability to a more robust mobile app centric model that enables us at the very moment a customer orders to provide relevant suggestions and recommendations and, when appropriate, incentivized offers to delight our customers. As you can see, we are managing a significant number of accretive changes related to loyalty, digital and Stars Everywhere.

A few words on the success of the investments we continue to make in our partners and the work we're doing to improve the partner experience overall. Creating an enhanced Starbucks experience for our customers and an authentic and personal connection between our customers and our partners is core to the Starbucks experience. Last year, we began rolling out a number of significant investments in support of our in-store partners that included increased barista and shift supervisor pay rates, additional performance-based recognition, updates to our dress code, a new food benefit, as well as enhancements to our College Achievement program. These investments are paying off. We continue to see increases in partner retention, which is enabling better customer connections, and customer connection is a key driver of our record Q2 performance. As you can see, our results provide powerful evidence that our strategies and focused investments are paying off today, and setting us up for continued growth in the future.

With that, I'll turn the call over to our CFO, Scott Maw. Scott?

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## Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

Thanks, Kevin, and good afternoon, everyone. Starbucks once again delivered very strong operating and financial performance in Q2 with record Q2 performance across virtually all of our operating and profitability measures, including revenue, operating income, operating margin, and EPS. Noteworthy is that our revenues in Q2 were the highest of any non-holiday quarter in our history. EPS both GAAP and non-GAAP increased 18% to \$0.39 in Q2, the top end of our guidance range. Non-GAAP operating income increased 11% over Q2 last year to \$887 million, while non-GAAP operating margin expanded 30 basis points to 17.6%.

Margin improvement in Q2 was driven by sales leverage that more than offset the impact of ongoing investments, particularly in our partners and our digital platforms. It's important to note this quarter that our consolidated operating margin also reflects dilution from a multi-year employment tax audit accrual. More specifically, our 30 basis point increase in operating margin would have been 40 basis points higher or 70 basis points in total, and our operating income growth would have been 240 basis points higher than the reported 11% or 14% with rounding. The impact of this G&A related accrual was largely offset below the operating income line in Q2 income taxes, and is expected to be entirely offset in federal income tax expense by fiscal year-end, resulting in no impact to earnings for full year 2016.

You may recall that our Investor Day in December 2014, we discussed the importance of reversing the negative leverage we were seeing on cost of goods sold and G&A. I am pleased to report that the plans we put in place to do so are working and that on top of the significant progress we made on that front last year, so far this year we are seeing an additional 60 basis points of COGS and occupancy leverage driven mostly by COGS and 40 basis points of G&A leverage.

Return on invested capital expanded by over 100 basis points in the first half of 2016 compared to the prior year, once again reflecting excellent returns on our core businesses and demonstrating the outsized return we are generating on many of our significant newer investments. And our reported record Q2 results became even more noteworthy in light of the fact that foreign currency translation shaved a full point off revenue and two points off operating income growth in the quarter.

I'll now take you through how each of our major operating segments performed in Q2. In Q2, our Americas segment operating margin expanded 80 basis points over Q2 last year to 23.5%, primarily driven by sales leverage and favorable commodity costs, partially offset by ongoing store partner and digital platform investments, that together adversely impacted operating margin by 100 basis points in the quarter. Noteworthy again, as we mentioned last quarter, is that we continue to see essentially no net cannibalization of existing stores as we expand our store footprint in the Americas and leverage our full portfolio of new and existing store formats. For the full fiscal year, we continue to expect the Americas segment to deliver moderate margin expansion over prior year.

Let's move on to our China/Asia Pacific segment. In Q2, on a GAAP basis, CAP operating income grew 15% over last year to a Q2 record \$129 million, and operating margin expanded 20 basis points to 19.1%, driven primarily by strong sales leverage and higher income from our joint venture operations partially offset by the impact of foreign currency translation and the impact of increased compensation and benefit costs and store operating expenses. Excluding the 90 basis point impact of foreign exchange, CAP margins expanded by 110 basis points in the quarter.

Profitability of our Japan and China store portfolio continues to increase with our profitability of our store class up nicely from the previous age class. And as Kevin mentioned, returns on our new stores in these two important

markets are among the highest Starbucks is generating anywhere in the world. For the full fiscal year 2016, we expect CAP revenue growth to be within our previously stated mid-teens target range and CAP margins are now expected to be roughly flat compared to 2015 levels.

We also still expect CAP comps for the year to be in the mid-single digits despite falling just below that threshold for the current quarter, somewhat impacted by the addition of our Japan business into the CAP comp calculation. Japan is the largest component of the CAP comp base with a weighting of just over 50% of the total.

Turning to EMEA, EMEA's operating margin declined 10 basis points in Q2 relative to last year to 10.3%, largely due to certain gains in the prior year related to the sale of assets as we shifted more stores from company operated to our licensed model. Excluding these gains and the impact of FX headwinds, EMEA's operating margin expanded slightly in Q2. As Kevin mentioned, our licensed stores in EMEA showed strong comp and profitability growth in Q2 and income from licensees now represents roughly 60% of the total operating income we generate from EMEA. Despite challenging macroeconomic, geopolitical and consumer environments that persist across the EMEA region, we remain confident that EMEA's operating margins will approach 15% in fiscal 2016, once again up nicely over the prior year.

Our Channel Development segment had another very strong quarter in Q2. Operating margin increased 300 basis points in the quarter to 39.5%, and operating income reached a new quarterly record of \$182 million, up 17% over last year driven primarily by cost of sales leverage, favorable coffee costs and higher income from our North American Coffee Partnership with Pepsi. For the full fiscal year, we expect Channel Development to increase revenues by approximately 10% year-over-year with the back half of the year growing in the high single digits following the 12% growth rate we saw in the first six months.

Channel Development's record breaking Q1 performance, very strong Q2 results and positive outlook for the balance of the year has us confident that the segment will post moderate margin expansion in fiscal 2016 over last year. Given the momentum we are seeing in the business, we are also expecting strong operating leverage over the next two quarters.

Given the excellent performance across the company year-to-date, we are moving the bottom end of our fiscal year 2016 EPS range up slightly from our previous guidance while retaining the top-end. GAAP EPS is expected to be in the range of \$1.85 to \$1.86 and non-GAAP EPS in the range of \$1.88 to \$1.89 including the 53rd week, which by our rough estimate adds approximately \$0.06 to Q4. For Q3, we are expecting GAAP EPS in the range of \$0.47 to \$0.48 and non-GAAP EPS in the range of \$0.48 to \$0.49. For the full year, foreign exchange is now expected to negatively impact revenue growth by one point to two points and operating income growth by two points to three points. We continue to expect to grow revenues by 10% or greater on a 52-week basis with the 53rd week adding approximately two points to the full fiscal year figure. And we remain confident in our ability to deliver comp sales growth somewhat above the mid-single digits for the full fiscal year 2016. But as Kevin indicated, there exists the potential for some bumpiness in Q3 as a result of the Starbucks Rewards program changes that took effect earlier this month. And as we mentioned on our February Starbucks Rewards conference call, going forward we expect to see a point or so of movement between traffic and ticket within comp in each of the next four quarters as our customers adapt to the changes.

Noteworthy is that given the significant value and benefits conferred on our customers in the new program, we fully expect the changes to be accretive to each of comps, revenue and profitability over time. The investment in our partner and digital initiatives globally will total between \$275 million and \$300 million in fiscal 2016 compared to approximately \$145 million in fiscal 2015. And the benefits and the returns we are realizing from these investments are becoming increasingly apparent. We continue to expect consolidated operating margin for fiscal 2016 to increase slightly relative to 2015 on both GAAP and non-GAAP basis, reflecting strong revenue

growth, sales leverage and increased operating efficiency and performance, partially offset by the impact of increased partner and digital investments.

Moving on to commodities, with 2016 costs coffee needs fully priced, we expect a slightly favorable impact for the year. We will continue to take careful advantage of lower coffee prices while ensuring that we source only the highest quality coffee and provide fair economics to coffee growers around the globe. We expect to add approximately 1,800 net new stores globally in fiscal 2016, 700 in Americas, 900 in China/Asia Pacific, and 200 in EMEA. The outlook for our effective tax rate is now expected to be approximately 34%, and we still expect capital expenditures of \$1.4 billion for fiscal 2016.

Finally, with the strong cash flows driven by our record-breaking holiday period, we took advantage of recent equity market volatility and significantly increased our share buyback activity since the end of Q1. We returned \$1.6 billion to shareholders in Q2 alone, the highest amount in any single quarter in our 24-year history as a publicly-traded company, with share repurchases in the quarter nearly equal to buyback activity in all of 2015. And as we announced today, our Board of Directors recently increased our share buyback authority by an additional 100 million shares.

As I mentioned at the outset, Q2 was another quarter of strong growth and excellent financial, operating and profit performance for Starbucks. And once again, the credit goes to our partners around the world who continue to deliver an elevated Starbucks experience to our customers every day.

The tremendous momentum we have created over the first half of fiscal 2016 ideally positions us to benefit from the investments we are making in our partners, in our stores, and in groundbreaking innovation and to continue delivering world-class returns to our shareholders. And we will do so despite today's challenging global economic and geopolitical landscape.

Now, we'll turn the call back to the operator for Q&A. Operator?

## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] Your first question comes from David Palmer with RBC Capital Markets. Your line is open.

David Palmer

*RBC Capital Markets LLC*

Q

Thanks. Good evening. With regard to the rewards switch that you just mentioned and that noise that you mentioned that tradeoff of one point to two points, is there a net drag to overall same store sales that you're seeing so far, or is this simply just an exaggerated version of the traffic versus check tradeoff that you expected earlier?

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Yeah, thanks, David. We're not trying to signal any trends that we're seeing early in the quarter or post launch. And in fact, as Kevin referenced, we have seen an increase in account activity and customer acceptance post launch. All we're trying to say is this is a big change. It's a very positive change. We're bullish on it in the long-term. But it's a big change in customers. We've got a number of plans in place to leverage the new program, and we'll keep an eye on things as the quarter moves on. But you notice we haven't changed our guidance for the year, and we're not trying to signal anything about intra-quarter trends.

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

John William Ivankoe

*JPMorgan Securities LLC*

Q

Great. Thank you. There's been a lot of focus on getting COGS leverage and G&A leverage over the past couple of years. So the question is really on the labor expense at the store where you have been making significant investments over the last four quarters or so. So as we think about over the next year, do those increases in labor costs begin to slow, and is there anything that Starbucks can do to begin to get more efficiency out of that line which has been deleveraging?

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Right. What I would say, John, is we expect to continue to make those partner in digital investments as we move through time. We know that they're driving comps. We have talked before about the tie between the changes we made about a year ago in pay for our U.S. store partners and the increase in comps that started at the same time. And in fact, what we see is at the stores that have the lowest turnover, they have the highest comps. And we've seen turnover tick down since we've made those changes. So it's all tied together, it's highly accretive and highly profitable. So we'll continue to make those investments.

And as we go into each year, we'll talk a little bit about the size of those investments, the impact on leverage. But there are other places in the P&L that we can go to continue to grow EPS at 15% to 20%, which is our long-term range, G&A and COGS just being two of them. And then [audio gap] (44:50) and the team have done a nice job driving productivity on – in the stores and Mobile Order & Pay has been a key aspect of that to help us with throughput at peak. And as Kevin said, peak was once again our fastest-growing daypart in this quarter. Last quarter, it was our fastest-growing daypart in over five years. And as you know, last quarter is the first quarter we

had Mobile Order & Pay fully rolled out and what we're seeing, based upon the numbers that Kevin showed, is in those busiest stores at peak, Mobile Order & Pay is driving significant productivity and throughput. So those are all places elsewhere in the P&L we can go to fund the investments we need to drive growth.

**Operator:** Your next question comes from Joe Buckley with Bank of America Merrill Lynch. Your line is open.

Joseph Terrence Buckley  
*Bank of America Merrill Lynch*

Q

Thank you. I was wondering, in the CAP segment, if you could be a little bit more specific on the same store performance in both Japan and China?

John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Yeah, Joe. This is John. First off, obviously, from a CAP perspective, the composition of comp has changed dramatically over the past year with the weighting of Japan coming in. If you go back a year ago, sequentially Japan was not included in the comp base at all in 2015 and it was only partially included in Q1, and now we have it fully included in Q2. When you look at the total comp growth for the region, we came in at a rounding basis of 3%. 2% of that was transactions and 2% was ticket. But more importantly, when you go into China and you dig underneath China, we delivered a 5% transaction growth rate across the country. And when you dig even deeper into that, in our Tier 1 and Tier 2 cities where we have over 65% of our stores, we outpaced that 5% growth – transaction growth rate significantly. So for us, we have great optimism around the opportunity that exists for us in China as well as in Japan. We continue to see very strong new store performance, as Scott highlighted, in both China and Japan, with record revenues and record sales results and significant return on investment. So for us, we remain very bullish on the opportunity that exists not only in China, but then also across the entire segment.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

And I would add, in those larger cities, that's where we have most of our new store growth targeted. And so that's why you see revenue growth at 18% and the overall CAP segment continuing to drive the profitability and revenue growth that we expect.

**Operator:** Your next question comes from Keith Siegner with UBS. Your line is open.

Keith R. Siegner

*UBS Securities LLC*

Q

Thank you. Just two quick questions on Channel Development. The first one, it sounds like there's so much good stuff coming later this year: new economics with K-Cups, we've got Nespresso-compatible pods, we've got ready-to-drink options expanding. There's a lot of moving pieces that sound very beneficial. But yet you mentioned lower revenue growth in the second half. Maybe you could talk through why?

And then the second part of it would be, against the five-year operating profit targets that you laid out in December 2014, one of them was doubling Channel Development. Would all of these new announcements that you made, are we still within that target? Could this actually outpace that target? Where are we against that five-year plan? Thanks.



John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Yeah, Keith, this is John. Let me take the first part of the question, and then I'll turn the second piece over to Scott. And clearly, Channel Development continues to perform very, very strong for us as a company with the 8% revenue and 17% income growth in the quarter. We are gaining share across all categories that we operate in, whether it's the roast and ground category, premium coffee, or K-Cups. This was our 17th consecutive quarter of share growth in the Channel Development business across all categories. And in the quarter, we grew five times the category average and our shares increased over 100 basis points. Roast and ground, we now have a 25.3% share growth and K-Cups share now sits at 16.3%.

And when you look at the success that we're having in channels, a couple things are driving it. First, it's the execution that we're seeing in the stores and the merchandising that we're doing and the fact that we're winning down the aisle. It's the fact that we're increasing our points of distribution. We've seen significant success with the larger pack size that we've introduced and clearly that's been driving our share gains across all our major categories.

In addition, we've taken the My Starbucks Rewards program and introduced that down the aisle as well, where in the quarter we saw an 18% increase in the number of codes that were redeemed and today we have over 20 million codes entered by over 2 million MSR customers in the CPG segment. So for us, we're very encouraged by the results that we're seeing in the category and in the segment, and we're very bullish on continuing to deliver that double-digit growth for the entire year as we look to finish out the year strong.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Yeah, Keith, on your second question, what I would say is in the near term, the new Green Mountain agreement doesn't go into place until later this quarter. So not – a little bit more than a quarter impact in this year's earnings. Over the long-term, there could be upside to the range that we gave back at Investor Day, and I think one of the key pieces to that is all of the international opportunities that Kevin and John laid out. And so I think as you look at international CPG growth, particularly over the medium-term, out a couple, three years, once the partnerships get up and running and we get product rolling off the lines, if those things go as well as we expected, there could be some upside there.

John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Yeah, Keith, and just one other thing I would just add on the K-Cup opportunity, when you look at K-Cups, we grew more than three times the rate of the category this past quarter. And the new Keurig agreement gives us an opportunity to extend the agreement, number one, on very favorable terms. We have improved economics coming in, as Scott highlighted. But more importantly, we have greater operating flexibility in terms of being able to drive more innovation into the K-Cup category, additional SKUs, and new packaging. And we also have the opportunity to now sell the K-Cups directly into office, into food service, college and universities, hotels, and C stores. So, we're on track this year to do about 1.5 billion K-Cups, and we expect this category to push near the 20% growth rate for the entire year for us. So very optimistic on the opportunity that K-Cups has.

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

John Glass

*Morgan Stanley & Co. LLC*

Q



Thanks very much. I just want to go back to the Americas traffic of 3%. You seem very pleased with the throughput given mobile ordering. Is there other constraints in other parts of the business? I mean, the 5% and the 3% don't add up to – they add up to 8% to 7%, so one of those or both of those are probably a little less than a whole number.

And just as a related question, in my observation, does the new chip credit cards – has that slowed transactions down, for example? Are there obvious bottlenecks or maybe just a little color around that in general, please?

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**Clifford Burrows**

*Group President-Americas, US & Teavana Region*

**A**

Yeah, thanks, John. I have to say I'm really pleased with the traffic we're seeing. The 3% on traffic and the 5% on ticket, as you say, rounding to a 7%. It's our 25th consecutive quarter of 5% or better comp growth for the Americas. At the same time, we're seeing very, very strong growth in our new stores, and they are adding, in total, 4% to our revenue growth. So things are very, very healthy and we're seeing great progress there. Mobile Order & Pay just gets better and better as it becomes a normal part of doing our business. And as you heard earlier, the strength in the higher volume stores at peak gives us confidence we can keep growing our capacity and our comp through the stores.

I think the other thing just to add is daypart. We are seeing growth across all dayparts being led by the morning. So we're very, very pleased with this. And the EMV or the Chip and PIN is negligible at the moment. We're in the early phases of rolling out, and we're just working through the ways that that will be implemented across the system and we're planning for it not to have any impact on transaction speed overall.

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**Scott Harlan Maw**

*Executive Vice President and Chief Financial Officer*

**A**

And, Adam, why don't you talk a little bit more about Mobile Order & Pay and what we're seeing?

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**Adam B. Brotman**

*Chief Digital Officer*

**A**

Yeah, thanks. This is Adam. So, first of all, as we mentioned in the remarks earlier, our overall average number of percentage of transactions for Mobile Order & Pay is 4% across all stores, all dayparts, all store types in the U.S. But that's just the beginning of the story with Mobile Order & Pay.

First of all, Kevin mentioned in his remarks, over 10% of all orders at our busiest 300 stores are mobile orders, and it's been noted that we're seeing mobile orders comprise 7% of all orders at our busiest 1,200 stores. So when you really look at our busiest stores, Mobile Order & Pay is very important.

And drilling into that further, when you look at the busiest [audio gap] (54:48) peak for those 300 busiest stores, for example, mobile orders are already approaching 20% of transactions at those peak hours. So you're really seeing how Mobile Order & Pay is benefiting all customers. It's benefiting the overall store performance in all these stores because of the incrementality and throughput unlock. Of course, Mobile Order & Pay is allowing customers convenience so they can have that incremental visit, incremental occasion they wouldn't normally have time for, but it's also driving a huge capacity unlock because of the program. You take 20% of transactions at peak, out of the line, out of POS, and you see it benefit all stores and allow customers to benefit from less people in line and allow partners and customers to benefit from the fact that now our partners can concentrate more of their energy on making food and beverage, on connecting with customers, and that's a big capacity and throughput unlock. And as a result, we're seeing Mobile Order & Pay meet or beat all of our expectations and grow as we mentioned in a way that's very pleasing to us.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

And, John, I'd just also remind you that Cliff's business had nearly 9,000 stores. It's going to approach \$15 billion in revenue this year, and it's rounding down this quarter to 7% comps with 3% transaction. Those are really significant numbers, and I just sort of remind everyone of that.

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

Andrew Charles

*Cowen & Co. LLC*

Q

Great. Thanks. One thing we didn't touch on is with the full quarter of delivery now underway, just was curious about your early learnings from that. Your customers using it primarily in the mornings or is it more balanced over the course of the day relative to in-store transactions? And also, what would lead you to expand the Green Apron Delivery to more stores? What do you need to see before you do that? Thanks.

Adam B. Brotman

*Chief Digital Officer*

A

Thanks, Andrew. This is Adam. It's still very early on delivery. So, the headline is that we're continuing to learn. Yes, the orders are in the morning like we're seeing in other examples. But frankly, we're continuing to learn how does this integrate with our technology, what's the customer behavior, what's working well? And so we're not prepared to talk too much about delivery yet while we're still in the learning phase but stay tuned for more in the future.

**Operator:** Your next question comes from Nicole Miller with Piper Jaffray. Your line is open.

Nicole M. Miller Regan

*Piper Jaffray & Co (Broker)*

Q

Thanks. Just one question, two quick clarifications, if I may. Back on the Channel Development question earlier, because I think it's an important one, if I recall right, lower coffee prices would be shared with the consumer in Channel Development more so, well, than a retail store, and maybe that's what's driving high single-digit growth because there is discounting. You give back when coffee prices go down, whereas underlying business is still – when you normalize that growing double digit. I just want to see if that gut check is right.

And then, did Easter have any shift – any impact, the early Easter, that you would call out? Thanks and congrats on another great quarter.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Yeah, Nicole, I think what I would say is we continued to grow volumes significantly independent of price. I will say that both in K-Cups and roast and ground, it's competitive. We continue to gain share in that competitive environment. We continue to outgrow in food service by many times the industry. So we're able to work through that pricing. But we are seeing volume growth somewhat above revenue growth. So I think that lines up with your overall pricing comment.

John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Yeah, Nicole, this is John. I would agree with what Scott said. The volumes when you take pricing out and you just look at total pounds sold, our pounds are outpacing as well. So we feel very confident that the business again is very healthy down the aisle, that we continue to take share, and that we are priced appropriately for the consumer. And we're not only taking it from other premium retailers, but you're seeing the mainstream customers also trading up into the premium segment and trading into Starbucks, frankly.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Any impact from Easter, John?

John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

No sequential impact to Easter. We did have a very good Easter holiday, as we did last year.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Great.

Clifford Burrows

*Group President-Americas, US & Teavana Region*

A

I'm not sure, Nicole, whether you were commenting on Easter as it refers to the retail business, but here in the U.S., early Easter did not have a material impact. It obviously does change spring breaks, but all in all, it is not significant to the quarter.

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

Jeffrey Bernstein

*Barclays Capital, Inc.*

Q

Great. Thank you very much. Maybe just two related questions on the U.S. comp. Just first, it would seem like the compares now – well, they have been growing increasingly difficult as we move through this whole year, so I am just wondering whether it would be fair to expect the comp deceleration at least on a one-year basis from the current 7%, just based purely on a comparison.

And as a follow-up, I am just wondering whether the offset on that – or what the offset on that could be? And it would seem like Mobile Order & Pay would be the biggest near-term opportunity to buck that trend. It seems like you're talking quite favorably about the order and pay signup and whatnot. Just wondering whether you can perhaps frame for us where it could go, and I think you said it's now 8 million transactions a month. I think the number was 6 million just last quarter and I know we're in very early ramp-up mode, so I'm just wondering if you had any insight into where that number could go over the next 12 months. Thanks.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

I think I'm going to have Adam start with the mobile order question. I'll talk about U.S. comp guidance, and Cliff can jump in on the operational things we have going.

Adam B. Brotman  
*Chief Digital Officer*

A

Yeah, Jeffrey. This is Adam. So just in terms of the growth in Mobile Order & Pay, let me touch on a couple of things. One is that you're right, so we had 8 million Mobile Order & Pay transactions per month run rate on this quarter, up from the 6 million the previous quarter. And so you get the 40% sequential growth that Kevin mentioned. You also have the fact that we are seeing a huge number of new capabilities that we're going to be adding to this, which will continue to grow that momentum and accelerate us. So one of them is that we added the ability for customers to redeem their rewards in the Mobile Order & Pay flow just 10 days ago. We're seeing great customer excitement about that. And as I've said before, we're going to continue to add a large number of new features for Mobile Order & Pay, including favorite stores, favorite orders and recommendations in the flow, all of which will contribute to the growing acceleration of Mobile Order & Pay as we move over time.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

And then on guidance, what I would say, Jeffrey, is we're still saying somewhat above mid-single digits for the year. That obviously relies on good performance in the U.S. business, and I'll let Cliff talk to some of the things we have lined up for the back half of the year. It expects good performance in CAP as we look at the back six months and some recovery in EMEA. But as we look forward, we have a number of things in each of those geographies as the summer comes up to drive additional transaction, additional [ph] comps (1:02:19) and additional profitability. And I'll let Cliff speak to the [indiscernible] (1:02:20).

Clifford Burrows

*Group President-Americas, US & Teavana Region*

A

Yeah. Thanks, Scott. It really does start, Mobile Order & Pay. We've got our new Starbucks Rewards, and we're really excited by the early sign-up and contribution that is going to come from that. We have a fantastic season ahead of us, building on the strength of last year, whether it's Frappuccino or later on in the summer with our cold brewed coffees, our iced coffees and a recent introduction of Nitro into select stores. And we're in the early phase of that. And I think our Teavana iced teas are set for a fantastic season. And all of that is going to be complemented by the continued growth we are seeing in our food in the U.S. now, where we're up to 20% contribution coming from food, and it's the first time we've seen it there, and we continue to see growth in our cold beverages. So we've got a great season ahead.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Matt, maybe talk a little bit about the new rewards program.

Matthew Ryan

*Executive Vice President, Global Chief Strategy Officer*

A

Sure. And let me comment first of all that we were a little over a week out from launch here, so these are very early days, but they're very encouraging nonetheless. In addition to the signups we're seeing, the new people raising their hands to join, we're seeing a couple other very encouraging things. Spend per member is up across the board, and I know somebody is going to ask this question, so let me try to get ahead of it here. We do obviously track all cohorts of people in our rewards program, and they are the people who are going to be better off by the new rules, they are going to be the majority of people who are more or less the same and a small minority of people who will earn rewards a little bit slower. All three of those cohorts are up in terms of spend so far. And we see absolutely no difference in the percentage among those three cohorts. So we are not seeing any of the noise that has been speculated on coming to bear. So very encouraging news there. And we'll be keeping a very close eye on it, and

obviously, there's a lot of unlocked that comes with the new rewards program as well, too. It's enabling the stars as currency initiatives because of the lowering of the denomination of the star. We have a lot of runway ahead with this, and we're very excited about what it will do in the long-term.

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

David E. Tarantino

*Robert W. Baird & Co., Inc. (Broker)*

Q

Hi. Good afternoon. My question actually you just answered on the loyalty program, but I guess as a follow-up to that, the new partnership that you have with the prepaid debit card, I am curious to know how you are planning to support that and how that will work in terms of stars being earned and just what the pace of that rollout and development of that strategy might be? And then, was that the primary motivation for reducing the value of the stars or are there other initiatives that have yet to be announced that are on the way?

Matthew Ryan

*Executive Vice President, Global Chief Strategy Officer*

A

Sure. It's a multiple-part question. Let me see if I can remember all of them and get through it. With the program, the timetable for the actual product facing forward to customers will be late this year. The product obviously will work just like the current product works except it will bear the Visa mark on it, and it will be a general purpose stored value card that works everywhere. We'll be announcing all the details about how to sign up and the exact value proposition as we get closer and have a way for customers to sign up. But we're on track to do it this year.

With regard to whether or not that was the primary motivation, the answer is no. There are a number of different things that we're going to be able to do as a result of lowering the denomination of a star. So you can expect this to be the first of a number of partnerships that you'll see down the road in the future.

**Operator:** Your next question comes from Jason West with Credit Suisse. Your line is open.

Jason West

*Credit Suisse Securities (USA) LLC (Broker)*

Q

Yeah. Thanks. Sorry to circle back on this again but, Scott, I am just still confused about the message you guys are sending around the rewards change. It sounds like signups are up, you are very happy with the overall program, but you're using the word noise and bumpiness. So I am just trying to understand, are you saying that there has been some customer pushback on the changes and it's going to take time for people to get used to the new system? Or are you saying there has actually been a strengthening in the program? That would be helpful. Thanks.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

Yeah. I just want to remind, we launched it a week ago. And so the first week metrics that Matt talked about are encouraging. But there's obviously a lot of customer spending and behavior that will happen over the coming weeks. And given the importance of the MSR program and the significance of the changes, we think broadly beneficial. But to some customers, they may not feel so benefited. We want to just make sure we communicate to you guys that there could be some noise. We're not seeing it yet. We'll see how the quarter plays out. So nothing in the early results but this is a big deal for us and we want to make sure we get it right.

Howard S. Schultz  
*Chairman & Chief Executive Officer*

A

Scott, can I add something from South Africa about that?

Scott Harlan Maw  
*Executive Vice President and Chief Financial Officer*

A

Yes.

Howard S. Schultz  
*Chairman & Chief Executive Officer*

A

First of all, I have been very quiet on the phone because you guys are doing such a great job. But it's very odd sitting here in South Africa listening to this. But I think the answer to the question is with great transparency, we just want to make sure that everyone understands this is a complicated change for our customers, lots of training for our people, and I think the better part of valor is just to say to you upfront that there could be some noise in the quarter. We're not signaling anything, but as Matt said, we're building something so significant over the long-term that I wouldn't be so concerned about noise in the quarter if there is some because what's happening here is we're building something so enduring and so unique that I think it's going to be one of the most significant changes to the equity of the brand, customer experience. And as Kevin said earlier, the opportunity for Stars Everywhere in terms of ubiquity of people using that debit card and the only way they can bring back stars and get rewards is to Starbucks is going to be a significant flywheel effect on our overall business. So I think we just wanted to just be open with you about the complication and the degree of the significant change. But the long-term is so beneficial for our customers and obviously to our shareholders.

Scott Harlan Maw  
*Executive Vice President and Chief Financial Officer*

A

Thanks, Howard.

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

Andrew Marc Barish  
*Jefferies LLC*

Q

Hey, guys. I want to circle back on Channel Development, more on the profitability side. Margin-wise, you're up 250 basis points in the first half, yet just guiding to moderate improvement for the year. So what are the cost implications or are there things going on with the new Nespresso rollout in the back half of the year with whomever you are using? And actually, who are you using to manufacture those, if you care to share?

Scott Harlan Maw  
*Executive Vice President and Chief Financial Officer*

A

I'll take the first part of the question. I think you can expect to see margin expansion in that same range that you saw in the first half, which is obviously very strong at 250 basis points. I guess it's just the definition of moderate. We continue to see revenue growth opportunities. We continue to take share, and we continue to do that at highly profitable overall margins. And so we see that continuing throughout the rest of this year. And although the Green Mountain change doesn't impact us too much this year just because of the timing of it, that has a chance to help us as we look forward into next year. And I'll let John answer that manufacturing question perhaps.



John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Yeah, Andy, I'm not going to disclose who we're working with from a manufacturing standpoint, only to say that we are in a position now to launch the Nespresso-compatible pods in both our retail stores, as well as through the CPG channels across the U.K. and France later this year. We are focusing first and foremost on Europe because there's 25 million machines of Nespresso machines that are installed there. It's a very similar size right now in comparison to the number of install base on Keurig here in the U.S., and we feel there is a significant opportunity to build this capsule business similar to the way we built the K-Cup business here in the U.S. And as Howard highlighted on his comments, single-serve represents 40% of the coffee consumed in-home in Europe and nearly 50% of our Starbucks customers have Nespresso machines in their homes and so we see this as being a big opportunity.

Beyond Europe, the big size of the prize is going to be in CAP, and more importantly in China, and we are going to continue to look at how we expand the single-serve opportunity as the only truly leading global premium coffee brand in Asia across our store footprint, and really go after this opportunity as well. So looking forward to the growth opportunity that exists both in Europe as well as in Asia around the single-serve opportunity.

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

Karen Holthouse

*Goldman Sachs & Co.*

Q

Hi. Thanks for taking the question. So I have a question a bit more on the rolling out of a better targeting solution. I'm curious what the end game of this is. Is it something that you think you will be able to better control exactly, what percentage of rewards are redeemed? Does it ultimately lead to more redemptions per person or more traffic per person on the back end of it? And I might have missed it in the prepared remarks, but was there – is it something that's rolling out now or something that's coming later this year? Thanks.

Matthew Ryan

*Executive Vice President, Global Chief Strategy Officer*

A

Sure. Matt Ryan here. We're in the process of rolling that out and you'll see that across the remainder of this year. What we're talking about doing is basically stepping up our game with regard to how we communicate with customers and there are a couple key components to it right now. To date, we've really communicated in a targeted way via e-mail. And as we progress through the year, you're going to begin to see the targeted communication emerge within our digital platform, specifically our app with recommendations. So we don't catch people in the moment right now. We will be catching people in the moment as time goes on, so that's a very important piece.

We also are going to be able to use triggers and to target much more individually than we currently do. We have limitations because of the technology right now on how many different messages we can put out. Those limitations go away with the investments in technology that we've already made. So you'll see, from a customer perspective, more relevant, more targeted messages, some of which will be offers, and that will allow us to basically manage those more economically in the future.

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



Matthew DiFrisco  
*Guggenheim Securities LLC*

Q

Thank you. I think you may have answered this question in a different way, but I just wanted to make sure that there was specific mention of how you're going to – you looked at the Mobile Order & Pay transition and also the combination of switching over to the new loyalty program as being accretive to both margins and to the top line over time. I wonder, was that purposely said to say over time? Is there any investment when you switch over in the loyalty program that you might do that might be upfront loaded to hold on to that lower ticket customer that might look at this as his reward program is being devalued a little bit, the guy who spends less than \$5 per transaction? I was just curious if that was purposely said over time, meaning there might be some upfront investment to discount that guy or give him extra rewards and target him so you don't – so you keep him thinking he is getting big rewards.

Scott Harlan Maw  
*Executive Vice President and Chief Financial Officer*

A

Thanks, Matt. No, there's no big upfront investment from a technology standpoint or from any customer standpoint. What I will say is we're obviously investing in marketing and in-store training for partners and messaging for customers just to make sure everyone is crystal clear on the program. And then as we talked about in our February call, we have a number of contingency plans and things that we can do with some of the personalization capabilities that Matt just talked about to target any cohorts of customers that may be displaying lower frequency or different types of behavior. But those won't be expensive. They won't be a big impact in the quarter. I think the only reason we said over time is obviously we expect the momentum to build with this program. Customer will become familiar with it. They'll get used to earning more stars. We'll layer in the Chase opportunity in some of the other Stars Everywhere opportunities, and those will really build. But it will be profitable immediately and build over time.

Matthew Ryan  
*Executive Vice President, Global Chief Strategy Officer*

A

If I just could add to that. One of the things when you sign up new members, you don't necessarily see all the value in the first few weeks or even first few months of somebody signing up, it is something that laps over time. So as you build the membership of Starbucks Rewards, that is a benefit that keeps on showing up in the results for not just months but years to come.

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

David Palmer  
*RBC Capital Markets LLC*

Q

Thanks for the follow-up. Just a quick one on breakfast sandwiches. Your check growth has been up 5% and I think you said breakfast sandwiches are up 30%. That might be the majority of the check growth, if I'm doing the right math. I guess the question is, how are you doing it? Do you think you can keep it going with regard to that sales layer? Thanks.

Clifford Burrows  
*Group President-Americas, US & Teavana Region*

A

Matt (sic) [Dave] (1:16:55), we said that breakfast sandwiches were up nearly 30% in the quarter year-on-year, food overall was up 16%, lunch contributed an 18% growth. So you're absolutely right. We're getting some uplift on ticket plus better attach from food. But by no means is that accounting for all of our growth. We continue to

focus on price giving us between 1% and 2%, and the rest is from either the swift movement to a higher ticket product or increased attach, and we're seeing a mix of all three of those.

Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

A

And, David, I would just add in the morning day part, the breakfast sandwich is a meaningful contributor, but really it's all three of those items that Cliff outlined: a bit of price, premiumization or up-leveling, and attach at morning and at lunch both very strong.

**Operator:** The last question comes from R.J. Hottovy with Morningstar. You may ask your question.

R.J. Hottovy

*Morningstar, Inc. (Research)*

Q

Thanks. I had a quick follow-up question on the single-serve business and I was particularly struck by Howard's comments about the future opportunity in CAP with the single-serve product. I was just hoping you could give us a preliminary roadmap as to how you see this business evolving over the next couple of years, and in particular if there is any particular hurdles that you have to overcome to really accelerate that business. Thanks.

John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Yeah, thanks, R.J. This is John.

Howard S. Schultz

*Chairman & Chief Executive Officer*

A

John, can I just...

John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Sure. Go ahead, Howard.

Howard S. Schultz

*Chairman & Chief Executive Officer*

A

John, can I lead with that and just give it right back to you?

John Winchester Culver

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Sure.

Howard S. Schultz

*Chairman & Chief Executive Officer*

A

I think John should answer the question specifically, but the thing that I would mention is throughout Asia and specifically Japan and China, we have a very, very large strategic advantage in that distribution in terms of educating the consumer, demonstrating the product and really I think leveraging our ability to educate the customer the way we have just with regard to our basic coffee business. We are in a unique position to leverage the national footprint we have in Japan, in Korea, and obviously in China. And it will be very difficult for the single-serve companies who are in the machine business to really create national distribution. So our ability to leverage

the equity of the brand, the in-store experience puts us in a lead position. And I think that, as John said in his comments, there's no global super-premium brand of coffee, and specifically, that doesn't exist at all in Asia other than Starbucks. So we're in a very unique position as we have to train the customer, educate them on all-things-coffee. And as the category evolves, and it certainly will, the biggest prize for single-serve ultimately is going to be China. And our store base is going to give us a tremendous advantage, not if, but when that market emerges.

John, go ahead.

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**John Winchester Culver**

*Group President-China/Asia Pacific, Channel Development and Emerging Brands*

A

Yeah. And the only thing I would add, Howard, to that is the fact that the single-serve business is really – does not exist in China nor in Asia to any significant degree. So this is all white space. And as Howard said, we are truly the only global premium coffee brand both in Japan, Korea, China, or the rest of Asia that is going to be able to leverage a retail footprint and an awareness and a trust level with our consumers on educating them about in-home consumption of single-serve coffee. So we are building plans as it relates to going after this opportunity, and we will follow up with you on what those plans are going to look like in future calls.

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**Scott Harlan Maw**

*Executive Vice President and Chief Financial Officer*

A

Before we end the call...

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**Howard S. Schultz**

*Chairman & Chief Executive Officer*

A

It wasn't too long ago – go ahead, I'm sorry. I'm sorry. I was just going to say it wasn't that many years ago where people would not walk in the street holding a Starbucks cup because they might lose faith in Asia. Now, obviously, throughout Asia, specifically Japan and China, that's exactly what's going on. It wasn't that many years ago where the morning ritual did not exist in many of those countries and other than China that it now exists and we're beginning to see it in China. So single-serve is going to be a major business throughout the region, and we're going to be in a winning position to take advantage of it.

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**Scott Harlan Maw**

*Executive Vice President and Chief Financial Officer*

Howard, I thought before we ended the call, we would just turn it back to you to see if you had any final comments.

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**Howard S. Schultz**

*Chairman & Chief Executive Officer*

Well, I was just saying now that we have opened here in South Africa, this is our 71st country and market, I just wish that the people listening to the call could witness firsthand what we have seen now throughout the world, and that is the universal acceptance of Starbucks Coffee Company and what we're doing in-store, the relationship we have with our partners, the relationship we have with our customers. And I have said for many, many years, these are the still the early days of the growth and development of the company. And despite with 24,000 stores globally, I've never been more enthused especially sitting here so far away from our home in Seattle and seeing exactly what we started in the early years, and that is Starbucks being the third place between home and work and delivering extraordinary cup of coffee. And it's just a wonderful opportunity for us once again to open up a new market, especially here in South Africa.

## Scott Harlan Maw

*Executive Vice President and Chief Financial Officer*

Thank you.

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**Operator:** This concludes Starbucks Coffee Company's second quarter fiscal year 2016 earnings conference call. You may now disconnect.

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