

## Starbucks Coffee: What Commercial Real Estate Investors Should Know

By David V. Tran

### Company Summary

Starbucks Coffee, sometimes referred to as Fourbucks Coffee is the largest coffeehouse chain in the world. It opened its first store in 1971 in Seattle's waterfront Pike Place Market by three partners: Jerry Baldwin, Zev Siegel, and Gordon Bowker to sell high-quality coffee beans and equipment. In 1982, Howard Schultz, the current Chairman and CEO joined the company as the Director of Marketing. He was impressed by the popularity of the espresso bars in Italy after he traveled to Milan in 1983. Back to the US, he convinced the founders of Starbucks to sell both coffee beans and espresso beverages. However, the idea was rejected so he left the company and founded *Il Giornale* coffee bar chain in 1985. In 1987 Howard Schultz and *Il Giornale* bought Starbucks with \$3.8M and renamed *Il Giornale* coffee bars to Starbucks and turned it into the Starbucks you know today. The company went public with the symbol SBUX in June 26, 1992 at \$17/share with 140 stores. Since then the stock has split 5 times. As of May 2008, SBUX is traded at about \$16, down from the high of \$39.43 in November 2006.

Starbucks opened the first overseas store in Tokyo, Japan in 1996. The company currently has about 16,000 stores, employs 172,000 partners, AKA employees as of September 2007 in 44 countries. It has annual sales of over \$10B with most recent quarterly revenue being \$2.526B. About 85% of Starbucks revenue comes from company-operated stores.

Starbucks does not franchise its operations and has no plans to franchise in foreseeable future. In North America, most stores are company-operated. You may see some Starbucks stores inside Target, major supermarkets, University campuses, Hospitals, and Airports. These stores are operated under licensing agreements to provide access to real estate which would otherwise be unavailable. Starbucks receives licensee fees and royalties from these licensed locations. At these licensed retail locations, the workers are considered employees of that specific retailer, not Starbucks. As of 2008 it has 7087 company-operated stores and 4081 licensed stores in the US. Internationally it has 1796 company operated stores and 2792 joint-venture or licensed stores in 43 foreign countries. The pace of expansion

is slowing down as the company plans to open 1020 US stores in 2008, less than 400 stores in 2009 down from 1800 stores in 2007. In addition, it also plans to close 100 stores in 2008.

### Risks to Real Estate Investors

Starbucks coffee buildings remain a popular investment for many investors. When you consider investing in a property occupied by Starbucks, you need to understand the following risks of your investment:

- 1. Recession-sensitivity:** a hungry man can survive with a Big Mac & fries but can live without a four-buck Frappuccino. This means Starbucks is very sensitive to economy downturn as seen in 2007 and 2008 compared to Burger Kings and McDonalds. This may be the main reason sales at stores in the US open at least a year are expected a mid single-digit percentage decline, the first drop ever. It triggers Howard Schultz to return to the CEO post. The company plans to double its marketing spending to \$100M in 2008 to drum up sales. It began an aggressive coupons campaign offering free drinks every Wednesday through May 28, 2008. This may be a sign of desperation. On April 22, 2008 Starbucks cut its outlook for the year citing weak economy.
- 2. Calorie & Sugar:** Starbucks drinks have more sugar & calorie in which consumers are more and more concerned due to explosion of obesity and diabetes epidemic in the US. For example, its Strawberries & Crème Frappuccino® Blended Crème - whip has 120 grams (over 1/4 lb) of sugar, and 750 calorie on its Venti 24 oz size. If it becomes a trend that consumers decide to cut down on the sugar drinks, or stick to low-carb diets then it will have impact on Starbucks revenue.
- 3. Competition:** McDonalds, Wendy's and Dunkin Donuts now also offer espresso at lower prices to compete with Starbucks. They will capture some revenue from Starbucks, especially from cost-conscious customers. The current Starbucks prices are already pretty high; it's very hard for Starbucks to increase



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the prices in the near future without affecting the traffic to its stores.

4. **High-expenses business model:** while Starbucks profit margin is high as it pays an average \$1.42 per pound for the unroasted coffee, its business is very labor intensive just like any other foods businesses. It takes between 10-20 employees to run one store. All eligible part-time and full-time partners in the US and Canada receive benefit package consisting of stock option plan, 401k with company matching, medical, dental & vision coverage. Starbucks is voted as the 7-th best company to work for in the US in 2008 by the Fortune magazine employee's survey. What is good for employees may not be good for the employers. These benefits are normally only available to key employees or managers in the restaurant industry. Historically, the costs of these health benefits rise faster than the rate of inflation. In the long run, they may have negative impact on Starbucks bottom line. Should Starbucks not perform well, it may be under pressure as a public company to close more stores.
5. **Special-purpose building:** Starbucks freestanding building is a special-purpose building designed specifically for Starbucks. Should Starbucks decide not to close or not to renew the lease, it's hard to re-lease the property. There are few tenants out there

real estate investor, you don't want to invest in a property that will be closed in the future. Since Starbucks does not release sales revenue for a particular location, you just need to make an educated guess. Based on annual revenue and numbers of stores operated by Starbucks, the average annual revenue per store is about \$1M. In addition, if the annual rent to revenue ratio is less than 10% there is a good chance the location is profitable. For example the annual revenue for the Starbucks in Ohio should be more than \$585,590. Besides picking a store at a good location (refer to the article titled "What 'Location' Means in Commercial Real Estate" by this author), and the cap rate you should consider the following:

1. **Densely-populated area:** more people mean more customers size and thus more revenue. The Starbucks in FL, GA and TX on Table 1 are more promising. Note: the author tries to be sensitive by not disclosing the exact locations.
2. **Low-rent:** the Starbucks in MS pays \$112,184 for base rent. To be profitable it needs to have annual revenue of \$1.12M. However, since there are only 188 people within 1 mile and 4923 residents within 3 miles radius from the store, it's less likely the store ever achieves that revenue. Besides Starbucks pays \$5.15/SF which is very high compared to just \$3.52/SF in a fast growing, high income, densely-populated in GA where there are

Starbucks Location	1-mile (people)	3-miles (people)	AHI (\$/year)	SF	Base-rent (\$/yr)	Rent/SF (\$/mo.)	Price (\$)	Cap (%)
Ohio	296	2609	88375	1613	58,590	3.03	868,090	6.75
Florida	9186	55270	68595	1816	75,000	3.44	1,262,000	6.10
Georgia	5715	57201	143936	1750	74,000	3.52	1,091,000	6.75
Mississippi	188	4923	77372	1816	112,184	5.15	1,558,000	7.20
Texas	5944	40970	75043	1752	92,914	4.42	1,327,340	7.00

**Table 1: Rent comparables for free-standing Starbucks Buildings**

Location	SBUX rent (\$/year)	SBUX SF	rent (\$/SF/mo.)	Other tenant SF	Rent (\$/SF/mo.)	Rent Difference
California	30096	1248	2.01	1245	2.50	-19%
Kansas	43200	1600	2.25	1600	1.33	68%
Utah	38568	1950	1.65	1200	1.86	-11%
New Mexico	92004	2000	3.83	2500	1.92	100%
New York	125004	1785	5.84	2810	2.75	112%

**Table 2: Rent difference in multi-tenant Starbucks retail centers**

willing to pay the high rent like Starbucks. It's hard to use it as a fast food restaurant due to a relative small square footage. Besides, it does not have a commercial kitchen. Once vacated by Starbucks, the property value will most likely go down.

**Starbucks Real Estate Operation**

Starbucks divides the US & Canada into 17 real estate territories, each has its own store development office to develop the market in its territory. The developers constructed freestanding buildings about 1800 SF with drive thru in a location with high visibility, heavy traffic. Once the location is approved by the territory office, Starbucks typically signs a 10 year NNN lease with 2 five year options in which landlords are responsible for roof and structure. All the leases normally have corporate guarantee which means Starbucks will continue paying rent in the event it has to close the store. The lease often has 10% rent increase every 5 years. The rent is between \$1.65/SF in a store in Utah to \$5.84/SF in New York. This rent survey is based on the rents at just 30 Starbucks properties, 18 of them are free standing, on the market for sale through out the US as of April 2008.

**Starbucks Location with Minimal Store Closure Possibilities**

During tough times, e.g. in 2008 when sales are declining Starbucks will attempt to cut costs and close underperforming stores. As a

57,201 residents within 3 miles radius and average household income (AHI) of over \$143K/year. It's hard to understand how the Starbucks in MS could be an irreplaceable location in an area with just 188 people within 1 mile radius from the property! While offering the highest 7.2% cap, this property appears to be a good investment but it actually has the highest risk of underperforming and could be closed down in the future. Alternatively, Starbucks could attempt to renegotiate the lease with lower rent during tough times. While Starbucks has not asked for rent reductions yet, it is not surprised if Starbucks will do so to improve its bottom line in the future. In either case, the property value will go down.

3. **Rent Premium:** while most Starbucks properties are freestanding in which it occupies 100%, you may see a Starbucks in a small multi-unit strip center with a few other tenants. It normally occupies the end unit with drive thru and thus must pay a premium rent compared to the adjacent unit. However, most of the time Starbucks pays substantially higher rent. For example, in Table 2 it pays \$5.84/SF compared to just \$2.75/SF by a tenant in the unit next door in a center in New York or 112% higher. In this strip center should the rent for the unit occupied by Starbucks be reduced (due to closure or rent renegotiation) the value of the center will be reduced substantially. You certainly don't want to invest in this property.