Starbucks Corporation (SBUX)
Recommendation: BUY

By: Sebastian Alvarado
Michael Dockett
Michael Romano
William Ferguson

Finance 684 – Asset Management
Graduate Student Investment Fund
Dr. Liaw
Spring 2007

Table of Contents

Executive Summary

Starbucks competes in the Service Sector, Specialty Eateries Industry and is the dominant player in the Gourmet Coffee segment. Starbucks has committed itself to a philosophy of Corporate Social Responsibility. This philosophy has led the company to develop ethical and environmental guidelines for the sourcing of its coffee beans. Starbucks has been a major player in the effort to reduce CO2 emissions that are leading to global climate change.

Starbucks is committed to enhancing and providing an excellent work environment for its employees. Starbucks employs 145,800 people worldwide.

Starbucks, founded in 1985, by Howard Shultz has achieved an impressive rate of growth in earning per share of 20% per year for the past decade. The company has witnessed steady revenue growth in this time period revenues in spite of overall economic downturns. Return on assets and return on equity are well above the industry average in 2006.

With an impressive growth rate in store openings and success in maintaining the profitability of current operations, Starbucks has demonstrated its ability to grow steadily and responsibly. Although short term margins have tightened as a result of this aggressive expansion, its long term growth projections show promising growth in retail locations, steady sales growth at existing locations, and a continuously expanding product line that differentiate it from the competition and keep its customers coming back.

Starbucks' ability to combat the risks and external threats that it faces from world economic factors, competitive forces come from its solid brand image, and its dedication to continual product innovation and the quality services that it offers its customers prove it to be a worthy investment.

The financial analysis of the company also provides us with more than ample reason to purchase Starbucks stock. Through our analysis using the Capital Asset Pricing Model, we've found the expected return on Starbucks to be 8.46%, which is higher than the required rate of return of 5.04% for the same 5 year period. The total present value that we have calculated for Starbucks is $38.07, approximately 30% higher than the current market price of $29.32, as of March 14, 2007. These factors coupled along with solid track record of EPS and revenues growth over the past decade, demonstrates Starbucks' financial health, and leads us to issue a buy recommendation for Starbucks.

History of Coffee

It is believed that coffee was first consumed as a hot beverage in East Africa during the 11th century. Today, coffee is one of the most popular beverages, with more than $80 billion in retail sales worldwide. The coffee industry provides a livelihood for an estimated 25 million coffee farmers in more that 60 coffee-producing countries.[i]

The coffee market has seen prices of a pound of coffee swings between a low of $0.42 in 2001 to $1.04 today. Prices have swung in response to the levels of supply. There are two forms of coffee beans available for purchase: Arabica and Robusta. Arabica coffee beans are grown at high elevations in the Tropic of Cancer and Capricorn. They are grown on small family owned farms to large scale estates.

Formation of Starbucks

Starbucks was formed in 1985 under the direction and leadership of Howard Schultz. Howard currently serves as the Chairman of the Board and lead visionary of the company. Starbucks purchases and roasts high-quality whole bean coffees and sells them, along with fresh, rich-brewed coffees, Italian-style espresso beverages, cold blended beverages, a variety of complimentary food items, coffee related accessories and equipment, a selection of premium teas and a line of compact discs, primarily through Company-operated retail stores.[ii]

Corporate Social Responsibility

Starbucks has differentiated itself in a numbers of ways. One of the most important has been its' unwavering commitment to Corporate Social Responsibility. The mission of Starbucks as described in its 2006 report on Corporate Social Responsibility is to "establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles as we grow." These uncompromising principles have led to specific and significant policy decisions.

Starbucks uses the following Guiding Principles to measure the appropriateness of their decisions:

- Provide a treat work environment and treat each other with respect and dignity
- Embrace diversity as an essential component in the way we do business
- Apply the highest standards of excellence to the purchasing, roasting and fresh delivery of our coffee
- Develop enthusiastically satisfied customers all of the time
- Contribute positively to our communities and our environment
- Recognize that profitability is essential to our future success

Coffee Purchasing Practices

Coffee and Farmer Equity (C.A.F.E.) is a Starbucks initiative that has created a set of industry-leading, comprehensive coffee-buying guidelines. The guidelines address coffee quality, financial transparency, and social and environmental responsibility.

All suppliers that become members of CAFÉ must undergo a third party review to assess their adherence to the quality and sustainability guidelines established by CAFÉ. Starbucks is willing to pay a premium for the highest quality coffee beans. So, it is in the best interest of the farmers to continue improving their crop, farming and business practices.

CAFÉ members must provide a living wage, protect workers rights and provide a safe humane workplace and living environment. In addition, members must ensure that sound environmental practices are employed to manage waste, and protect and conserve water quality and energy.

Growth and Expansion

Starbucks is known in the industry as having an exceptional real-estate and store development talent. Each Starbucks store is individually designed. This is necessary because Starbucks doe not build it own stores but rather leases or buys existing space and converts it into a Starbucks The design team came up with four store designs – one for each of the four stages of coffee making: growing, roasting, brewing, and aroma.[iii] Each of these designs could be modified for a particular stores needs.

In Fiscal 2006, Starbucks opened 2,199 new stores, bringing the worldwide total to 12,440 locations.[iv] Starbucks pursued a growth strategy of saturating large cities with Starbucks stores even if new stores cannibalized nearby stores customers. After establishing a hub of stores in a city they would then expand outward to surrounding communities. They pursued a Starbucks on every corner approach.

Starbucks has been welcomed into communities as a gathering place for residents. It has served as a catalyst for other premium retailers to enter a community. As Starbucks has expanded globally it has been careful to respect the differences in culture and has been responsive to in times of misunderstandings and conflict.

Starbucks realizes that as it grows into a global company it must retain its small local store feel. To this end Starbucks has continued its tradition of giving and being involved in the local community. Starbucks gave $36.1 million in community investments in fiscal 2006. Chairman Shultz, in a memo sent to key staff and leaked on the internet, recently reminded his staff not to stray away from the founding principles and core values and business of Starbucks as it expands.

In markets outside of the United States Starbucks has either opened company owned stores or has licensed a local reputable and capable company with retailing know-how in the target host country to develop and operate new Starbucks stores.[v] Starbucks does not franchise. It prefers the tighter controls offered in a licensing arrangement.

In 2002, Starbucks joined forces with T-Mobile to bring Wi-Fi internet access into 1,200+ Starbucks locations. The goal was to get enhance the reputation as Starbucks as a place between home and work, a place where people can meet, relax, and stay awhile.

Environmental Impacts

Global warming is a major concern for the management of Starbucks as it could become disruptive to the production of raw materials. In response to the threat of global warming Starbucks has implemented a three year Climate Change Mitigation strategy aimed at purchasing renewable energy, focusing on energy conservation, and advocating for collective action.

An energy source is confided renewable if it can be replaced naturally. Starbucks has bought 100% wind renewable energy certificates, offsetting 124 million pounds of CO2.[vi] By pooling its energy purchasing with other companies, Starbucks was able to achieve renewable energy pricing close to its' conventional pricing.

Starbucks continues to conserve energy at its retail stores buy upgrading its machines and tools to more energy efficient machines and tools. Store managers are now given software tools to help manage energy consumption.

Starbucks has pushed for collective action to find a solution to the global warming crisis. They have teamed up many organizations tackling this important issue and have even placed six full pages advertisements in the New York Times calling for collective action.

Health and Wellness

Keeping it customers health and wellness in mind, Starbucks provides nutrition information on all its' products. It has reduced trans-fats in its products and has expanded its offerings allowing for increased customization by its consumers. Starbucks has become an advocate for health care reform within the United States.

Workplace Practices

Starbucks' goal "is to create the best possible workplace environment for our partners (employees), one that attracts and retains the most talented individuals and is regarded by them as a great place to work."[vii] Starbucks greatest asset is its' Partners.

Starbucks has made an institutional commitment to provide a competitive wage and generous benefits package to its partners. Even part-time partners are offered health care coverage. Starbucks treats its partners so well that several attempts to unionize its' workforce have failed. Starbucks Total Pay package includes competitive base pay, bonuses', comprehensive health coverage, income protection, vacation, stock options, a savings program, adoption benefits, tuition reimbursement and partner perks.[viii]

Partners in turn, are expected to bring out the romance of the Starbucks Coffee House experience for the consumer. Partners are encouraged to learn their customers' names and to remember their favorite beverage. The Partners are key to the success of the Starbucks brand.

Starbucks has also made extensive use of Partner View Surveys. They solicit anonymous feedback from all of their employees and compile statistical reports on the findings and make changes where needed. Each Partner receives twenty-four hours of training within their first two weeks on the job. Partners can also take advantage of several training programs such as the Coffee Masters Program, Servant Leadership Workshop, Career Power and Career Power for Coaches Workshop.

Management trainees attend an 8-12 week training course. They receive a through overview of the company with a focus on the company values, principles and culture.

Staffing

As of October 1, 2006, Starbucks employed approximately 145,800 worldwide. In the United States Starbucks employed approximately 123,600 people, with 116,100 in Company-operated retail stores and the remaining in the Company's administrative and regional offices, and store development, roasting and warehousing operations.[ix]

Among the management team at Starbucks we have the following key individuals:

Howard Schultz, Founder and Chairman of the Board
James L. Donald, Starbucks Corporation, President and Chief Executive Officer
James C. Alling, President, Starbucks Coffee U.S.
Martin Coles, President, Starbucks Coffee International
Dorothy J. Kim, Executive Vice President, Supply Chain Operations
David A. Pace, Executive Vice President, Partner Resources
Michael Casey, Executive Vice President, Chief Financial Officer and Chief Administrative officer

SWOT Analysis

Strengths

Expansion of Products and Services

Starbucks Gift Cards

The surge in sales of Starbucks gift cards is developing into a very promising ordeal for the company. For the first quarter of 2007, the aggregate volume stored on Starbucks Cards was 40% higher than the first quarter of the previous year. Starbucks Cards have proven to be an excellent way of guaranteeing a certain amount of future sales. Cards that were sold in one quarter will guarantee sales in future quarters. This boost in sales will be especially beneficial in quarters that have been known to be significantly rough for the company.

Expansion of Food Items

Starbucks is further expanding their lunch items menu which includes prepackaged sandwiches and salads. These items are currently offered at 69% of their retail stores in the United States versus only 59% one year ago.

They have drastically expanded the number of their stores offering warm breakfast sandwiches to approximately 1,200 stores. With a mere 225 stores offering warm breakfast sandwiches at the end of the first quarter in 2006, they expect this "warming platform" to reach 3,400 stores by the end of 2007 and 6,500 stores by the end of 2008. This can be considered a reactive measure taken against efforts by competitors such as McDonalds and Dunkin Donuts to gain share of the coffee industry by offering customers breakfast sandwiches to go along with their cup of coffee.

Starbucks retail sales mix in 2005 was 77% beverages, 15% food items, 4% whole-bean coffees, and 4% coffee making equipment and accessories.[x]

Strong Financials

Starbucks' net revenues increased 22% in the 2006 fiscal year for a total of $7.8 billion. Their earnings increased 18% from the previous year from $494 million in 2005 to $581 million. The increase was primarily attributable to the opening of 1,040 new locations in 2006 and comparable store sales growth of five percent for the quarter. According to Starbucks president and CEO Jim Donald, "[Starbucks] demonstrated the strength of [their] business model as [they] opened a record number of new stores around the world, which contributed to strong top line growth, and [they] enhanced and expanded [their] product offerings through innovation and entry into new channels."

Starbucks' first quarter 2007 earnings increased 19.2% to $0.26 per share, directly in line with its earnings estimates. Analysts at PiperJaffray believe that although historically Starbucks worst quarter has been the second quarter, it will do rather well due to gift card redemptions that take place in that time period. The revenues collected from the recent spike in gift card purchases is expected to offset any issues regarding margin compression, which has been an issue for Starbucks in the recent past.

Additionally, in the past few years Starbucks repurchased shares twice. They bought back $1.1 billion in 2005 and $475 million in 2006. This adds stability to their stock price and enhances shareholder value.

Brand Image

Over the years, Starbucks has developed a brand image that has transitioned customers into the "coffeehouse culture." It offers its customers a "third place" to go after work and home. They can purchase a premium Starbucks product, relax and enjoy access to the Internet, read a book, or listen to music with friends. This experience has set the company apart from some of its competitors who offer only a cup of coffee and perhaps a bite to eat. It is this cultural evolution that has allowed the company to successfully grow and profit while charging premium prices for its products.

Starbucks has also extended its brand in retail stores by distributing products such as packaged coffee, ready-to-drink beverages, and ice cream. In addition to its company-owned locations, it also offers these products outside of its coffee shops through fast-food establishments and groceries. Starbucks has developed and trademarked several of its product offerings, which include Tazo teas, Starbucks Hear Music compact discs, Seattle's Best Coffee Torrefazione Italia coffee, bottled Frappuccino coffee drinks, Starbucks DoubleShot espresso drinks, and Superpremium ice creams.

A line of entertainment products has also been added to Starbucks arsenal with the inclusion of music, movies and books among its product line. On March 12, 2007, Starbucks announced that it would partner with Concord Music to create a Starbucks record label under the Hear Music brand. The label will encourage artistic freedom and will focus on emerging artist as well as established talent.

Weaknesses

Higher Costs of Sales

A mixture of increasing costs of distribution, and increased rent related to a growth in store openings has recently lowered Starbucks' EBIT margins. In fact Starbucks' cost of sales increased 26.6% in the first quarter of 2007 versus the first quarter of 2006.

Additionally store operating costs, particularly wage increases for its hourly employees, have also contributed to this effect. Analysts propose that these are short term issues resulting mostly from their rapid expansion of their number of locations. Product costs, particularly higher dairy costs and increases in commodity coffee costs (up 8% since beginning of fourth quarter of 2006), are adding to the higher cost of goods sold. According to a report from Robert W. Baird & Co., it is anticipated that these cost pressures will ease in 2007 as Starbucks has locked in 90% of its coffee needs for 2007 at August-September 2006 prices, before the spike in prices occurred.

Uncontrolled Expansion

As much as the expansion and increase of its retail stores is good for profits, they must make sure that the have initiated a rapid growth plan in place in order to manage existing operations and maintain consistent performance. It is crucial that they find suitable locations for their new operations as well as hire competent managers and maintain sufficient supply and distribution of its raw materials such as Arabica coffee beans.

Being the provider of premium coffee products, they must also maintain the product and service characteristics that have enabled them to be so profitable over the years. In other words they must not promote expansion at the expense of their differentiation, in terms of its customer services and superior product line. Along with this risk are the general risks that come along with expansion into international market and with overseas licensing agreements.

Opportunities

Overseas Expansion

As of the first quarter of 2007 Starbucks has 13,168 locations world wide. Their management team sees long term potential for over 40,000 locations world wide. This estimate is considered attainable in light of its current penetration levels in U.S. markets, a large international opportunity, particularly in Brazil and India, and a high demand for their product.

According to Robert W. Baird & Co, it is expected that the near-term growth of their locations will be 17-20% per year. Customer demand for the Starbucks brand remains strong on an international basis. Currently, Starbucks is expanding into both Egypt and Brazil, two new markets that the company has yet to explore. Expansion overseas will undoubtedly give Starbucks an advantage over some of its competition who remains unable or uninterested in overseas expansion. At this point, the growth potential overseas seems unlimited.

Product Line Extension

Starbucks' commitment innovation and invention has not gone unnoticed and unrewarded. Product line expansion is crucial to the company's growth and success. Its expansion of its food line, its continuous addition of new blends and flavors of beverages, and its penetration into the entertainment market in the form of books, compact discs, and DVD’s, have proven to be financially sound.

An internal email recently sent out by Chairman Howard Schultz solidifies their commitment to just that. In the message he sternly announces that “[Starbucks] does not embrace the status quo and constantly push[es] for reinvention. This is a consistent, longstanding business philosophy to ensure we provide our customers the uplifting experience that they have come to expect.

Threats

<u>The World Economy</u>

The state of the economy, particularly consumer spending, may pose a threat to Starbucks’ overall sales growth. Some factors include the increased debt service levels resulting from adjustable-rate mortgages and interest rates, the slowdown in the housing market, and the potential spike in gas and oil prices. Factors such as these will affect discretionary spending. Starbucks may fair less susceptible to shifts in discretionary spending than other premium eateries in the industry due to its higher-income target demographic, and the habitual nature of coffee consumers.

<u>Consumer Preference and Health Concerns</u>

Consumer preferences play an omnipotent role in the success of any company in the food services industry. Health-related concerns regarding caffeinated beverages could easily dampen the demand for coffee. Additionally, the demand for coffee may be different in other cultures outside the U.S. It is crucial that Starbucks do its share of cultural research to find out what markets will adhere to its coffee “experience” most easily.

<u>Competition from Fast-Food Services</u>

In a recent statement, McDonalds announced that it will be piloting the addition of espresso and cappuccino machines in locations throughout New York, New Jersey, and Michigan. Dunkin Donuts was recently labeled as “the hottest coffee chain” in a customer loyalty survey performed by major marketing firm Brand Key. Fast food chains are aiming to gain market share in the market for coffee and coffee-products such as espresso and cappuccino, and with substantial financial, marketing and management resources, they could be very successful. With the addition of fast-food companies into the coffee market, differentiation will be crucial to Starbucks’ survival. They must concentrate on offering customers the “experience” that they have over the years, and provide reason for customers to pay premium prices for their innovative products.

Starbucks vs. Competition

Starbucks (SBUX)

Starbucks Corporation is considered the top provider of premier coffee products in the world. They purchase and roast whole bean coffees. Their product line includes brewed coffees, Italian-style espresso beverages, cold blended beverages, various food items, and a selection of premium teas. In recent years the company has expanded its reach into products such as coffee-related accessories and equipment, an entire line of compact discs. They also produce and sell ready-to-drink beverages such as bottled Frappuccino drinks and Starbucks Doubleshot espresso drinks, along with a line of ice cream flavors.

Sodexho Alliance (ADR) (SDX)

Sodexho Alliance operates in the food management industry. They provide outsourced food and facilities management services to various businesses, institutions, healthcare facilities and universities. They also operate in the service vouchers and cards business. Primarily they issue and manage the provision of paper and debit card vouchers to their clients' employees for foods, products and services. Sodexho Alliance's estimates for operating profits are approximately 10% in the first quarter of 2007, surpassing analysts according to Reuters estimates. They recently celebrated their one year anniversary since converting to zero trans-fat oil products in its food service operations.

Caribou Coffee Company, Inc (CBOU)

Caribou Coffee operates the second largest non-franchised coffee chain in the United States, behind Starbucks. The company is headquartered in Minnesota and currently employees almost 6,000 people. It currently operates more than 420 Stores in 18 states in the U.S. Arcapita, a Bahrain-based investment group, owns approximately 60% of the company. Its retail stores resemble ski lodges and Alaskan cabins. It offers various coffee blends; specialty coffee drinks, teas, and baked goods. Caribou coffee also sells whole bean coffee as well as brewing supplies and equipment.

For 2006, the company's total net sales increased by a record of 19%, mostly attributed to the opening of 60 new company-owned locations in the past 12 months. The company posted a net loss per share of $9.1 million or $ (0.47) per share in 2006, versus a loss of $4.5 million or $(0.29) per share for 2005. This has largely been attributed to the depreciation expense resulting from opening their new locations. Caribou plans to expand in 2007 by initiating a franchising program to help reach new locations and new customers.

Tim Hortons Inc. (THI)

Tim Hortons is Canada's leading quick service restaurant brand, which operates a chain of more than 2,800 coffee and donut shops, including 336 locations in the U.S. The company offers a variety of coffee and cappuccino, along with various baked goods including donuts, bagels and croissants. They also have added a lunch menu to their offerings including soup, sandwiches and chili. The majority of Tim Hortons locations are franchises, and include free-standing as well as kiosk and mall-based units.

The 2006 fourth quarter profits quadrupled to $67.9 billion from a year-ago period in which they were hurt badly by assets write downs and charges related to their spin-off from Wendy's International and initial public offering. CEO Paul House attributes their financial success in 2006 to their introduction of a new breakfast sandwich line and feels that the company feels it "is well positioned to deliver solid, steady long-term growth."

Competition from the Fast-Food Sector

For many years, Starbucks' most formidable competition came from other coffee house companies such as Caribou Coffee, Tim Hortons, Panera Bread and smaller single proprietary establishments. However, recently fast food chains have latched on to the consumer trend in premium coffee products, and seem to be aiming to take market share away from Starbucks by challenging the worthiness of its coffee "experience" and by perhaps turning customers on to the fast-food gourmet coffee market which they have created.

The two main rivals to Starbucks right now are undoubtedly McDonalds (MCD) and Dunkin Donuts, which is owned by Dunkin Brands, Inc., a privately owned company. McDonalds currently announced that it will be taking steps towards implementing cappuccino and espresso machines in its stores. It is currently testing this strategy in McDonalds stores throughout New York, New Jersey, and Michigan. McDonald's also offers a new Premium Roast coffee, which it claims is made from 100% Arabica coffee beans, a high-premium blend that is also used in many of Starbucks' products. It claims that the Premium Roast coffee is "richer, bolder, and more robust than (their) previous blend…" McDonalds has also increased its customer service by having its employees add the cream and sugar to the coffee for the customer. This type of additional service is an attempt to equalize itself to the personal service provided by Starbucks baristas.

With its advertising campaign labeled "America Runs on Dunkin," Dunkin Donuts is selling the idea that coffee is fuel, rather than a "lifestyle," as it is marketed to be by Starbucks. Dunkin is trying to recreate the meaning of coffee to the consumer as being a part of their day. Grabbing a cup of coffee every morning is seen as being a task to fulfill, rather than an experience in itself. It now offers a variety of coffee blends, chai tea, and espresso products, but is not looking to reinvent itself to become more like Starbucks. Rather, Dunkin Donuts is trying to reinvent coffee in its own way.

In addition to offering a higher grade, more premium coffee product than in the past, both fast food companies have also used the entire breakfast meal as a way of creating a complementary way of adding value to the cup of coffee. Their statement: a cup of coffee would go great with a McGriddle breakfast sandwich, or with the new Maple Cheddar breakfast sandwich available at Dunkin Donuts.

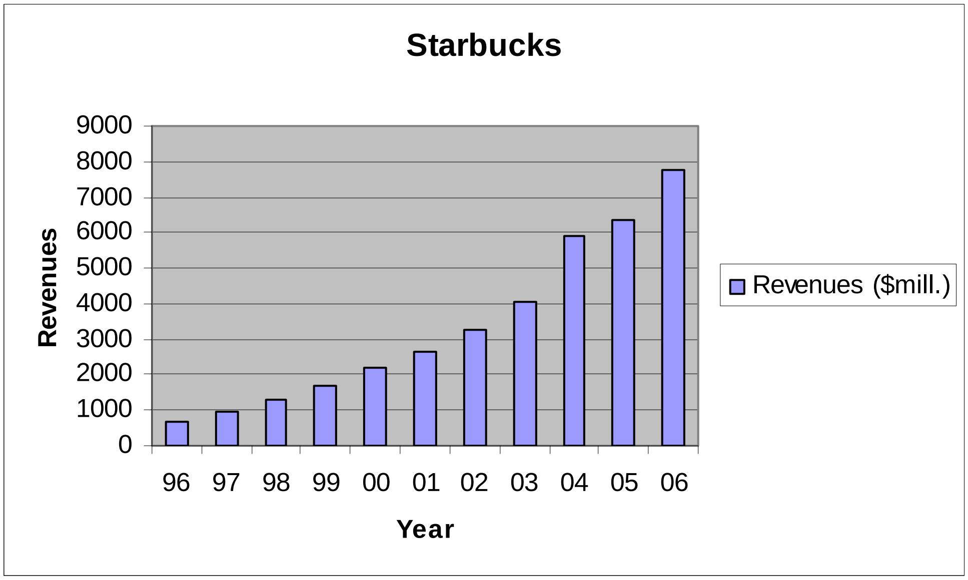
Financial Conditions

Table 1

Income Statement	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Revenues	2649.0	3288.9	4075.5	5294.2	6369.3	7786.9
COGS	2081.6	2598.3	3206.8	4153.3	4968.1	6126.7
SG&A	151.4	202.2	244.6	304.3	357.1	473.0
Depreciation	163.5	205.6	237.8	289.2	340.2	387.2
Income from Equity Investments	28.6	35.9	38.4	59.1	76.6	94.0
Operating Income	281.1	318.7	424.7	606.5	780.5	894.0
Interest Expense	0.0	0.0	0.0	0.4	1.3	8.4
Other Income	7.8	9.3	11.6	14.5	17.1	20.6
EBIT	288.9	328.0	436.3	620.6	796.3	906.2
Income Taxes	107.7	121.4	168.0	231.7	301.9	324.7
Income from Continuing	**181.2**	**206.6**	**268.3**	**388.9**	**494.4**	**581.5**
Nonrecurring Gain (Excluded)	0.0	8.5	0.0	0.0	0.0	-17.2
Reported Net Income	181.2	215.1	268.3	388.9	494.4	564.3
EPS - Income from Continuing (diluted)	**0.23**	**0.25**	**0.34**	**0.48**	**0.61**	**0.73**
Nonrecurring Gain per share (diluted)		0.02	0.00	0.00	0.00	-0.02
Reported EPS (diluted)	0.23	0.27	0.34	0.48	0.61	0.71

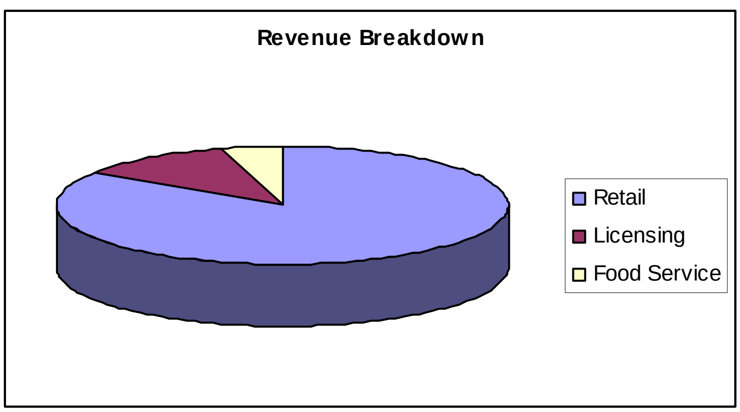
When looking at Starbucks' profit and loss statement, the one thing that stands out is the company's consistent operating performance since its inception and more recently since the dawning of the new millennium. The company has produced consistent revenue growth led by its signature coffee business. The company has moved to the forefront of the coffee industry, with annual revenue growth of more than 20% this decade. Given the company's aggressive expansion plans both domestically and abroad, we expect this trend to continue well into the next decade.

Chart 1



The following chart is a breakdown of Starbucks revenues. The company derives its revenue from three different sources. They include the retail business, licensing revenues and the company's foodservice operations.

Chart 2



The steady top-line advances have been matched by consistent earnings growth. This is evident in the company's fully diluted per-share data listed in the income statement. The company's share earnings have increased 26%, 41%, 27%, and 16%, year over year, respectively, in 2003, 2004, 2005, and 2006.

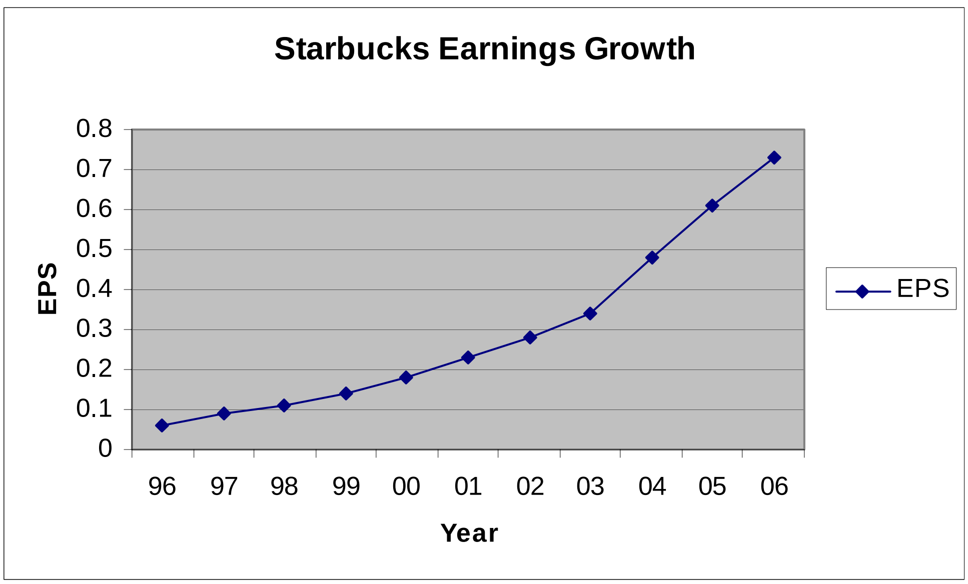
An efficient operating model has helped Starbucks for the most part keep operating expenses in line. The strong revenue growth, combined with an efficient cost structure, should allow for further bottom-line advances over the next three to five years. We believe that earnings growth will once again surpass 20% in 2007.

In 2006, the bottom line was hurt by higher green coffee prices, a mix shift toward non-beverage items (e.g., food, books, music, and DVDs), and a sharp rise in labor costs. Staffing increases at the managerial level, which have been needed to support the company's aggressive development plans both at home and abroad, took a bite out of earnings in the final quarter of 2006. However, we expect the profit squeeze to subside in 2007.

A broad-based price increase (1.7%) last October and gains in several international markets, should more than offset commodity price pressures and unfavorable product mix issues. And although the hiring spree will likely continue in 2007, labor costs should be less of an issue, thanks to staffing adjustments and operational improvements this year.

We look for Starbucks to once again post earnings growth north of 20% in 2007.

Chart 3



Ratio Analysis

In order to evaluate Starbucks financial health and performance we will conduct a ratio analysis of Starbucks over the last five years. We have also provided ratios of a few of Starbucks' publicly-trade competitors. Dunkin Doughnuts, one of Starbucks' main rivals in the United States, is a privately held company, thus its financial performance is not accessible to the public. For comparison purposes we have provided ratios for Tim Hortons, Caribou Coffee, and Sodexho Alliance, SA. A good portion of our comparisons will focus on Sodexho Alliance, simply because it is similar to Starbucks in size and worldwide stature. Starbucks will be evaluated against its competitors based on the following criteria: profitability, liquidity, solvency, efficiency, valuation, and growth. Starbucks performance will also be examined with the use of DuPont Analysis over the period of five years.

Profitability Ratios

These ratios measure how efficiently the company uses its resources. Higher profitability could be attributed to greater efficiency. By looking at the last five years of Starbucks income statement and including ratios of its main competitors we can determine whether the company is operating efficiently or not.

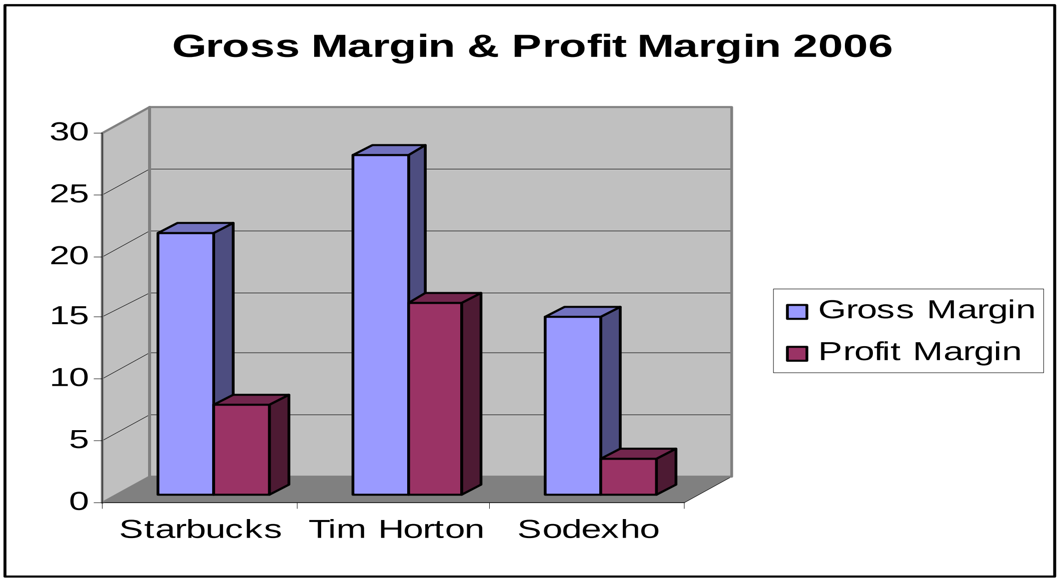
Table 2

Performance Ratios	2001	2002	2003	2004	2005	2006	Hortons	CC	Sodexho
Gross Profit Margin	21.4%	21.0%	21.3%	21.5%	22.0%	21.3%	27.6%	59.5%	14.4%
Operating Margin	10.6%	9.7%	10.4%	11.5%	12.3%	11.5%	22.9%	Nil	4.7%
Pretax Profit Margin	10.9%	10.0%	10.7%	11.7%	12.5%	11.6%	21.7%	Nil	3.9%
Net Profit Margin	6.8%	6.3%	6.6%	7.3%	7.8%	7.3%	15.6%	Nil	2.9%

Gross Profit Margin - Indicates how efficiently a company manages its largest assets and biggest costs. From a gross profit standpoint, we like what is going on at Starbucks. The company's gross profit margin has held steady, in the 21% to 22% range, over the last five years. This indicates that no matter how the economy is performing, Starbucks has been able to efficiently manage its costs structure. It has done an excellent job of managing it cost structure even during a difficult stretch in 2006, which included elevated commodity and fuel costs. Starbucks underperformed its two smaller competitors (Tim Hortons and Caribou Coffee) in 2006, but we were encouraged by its healthy lead over Sodexho Alliance last year.

Net Profit Margin – Shows us how much profit a company makes for every $1 it generates in revenues. Starbucks' net profit margin was 7.5% in 2006. Although down a bit from 7.8% in 2005, the product of the aforementioned costs, it still surpassed the rate achieved in 2002, 2003, and 2004. This is an encouraging sign for the company. We anticipate that the NPM will increase moving forward, as commodity costs moderate to more normal levels. Starbucks' NPM was also much stronger than two of its competitors, Sodexho Alliance and Caribou Coffee. The latter is still operating in the red.

Chart 4



Liquidity Ratios

Liquidity ratios indicate how well positioned a firm is to meet any future short-term obligations. Liquid assets include cash, marketable securities, and accounts receivables, among others.

Table 3

Liquidity Ratios	2001	2002	2003	2004	2005	2006	Hortons	CC	Sodexho
Current Ratio	1.3	1.6	1.5	1.7	1.0	0.8	1.4	1.4	1.0
Quick Ratio	0.7	0.9	0.8	1.0	0.4	0.4	0.6	0.9	0.3
Collection Period		10.3	9.4	8.7	9.4	9.6	21.2	5.4	51.6
Days to Sell Inventory		33.6	34.0	33.2	35.1	34.7	14.0	13.4	5.6

Current Ratio – Measures the company's ability to pay short-term creditors with assets that can be quickly converted into cash. Although a ratio of 2 is an ideal situation (firm has twice as many current assets as current liabilities), we are not alarmed by Starbuck's 2006 current ratio of 0.8. Overall the Starbucks is not very leveraged, so the company's ability to meet its obligations should not be a problem.

Quick Ratio – Measures the company's ability to pay off short-term creditors without relying on the sale of inventories. Much like the current ratio, we don't believe that the low quick ratio is a problem. The company has other means to pay its short-term obligations. The company's aggressive strategy of using short-term debt to finance its day-to-day operations is actually rather astute, given the attractive short-term lending rates.

Collection Period – The company's ability to collect its accounts receivables quickly is yet another reason why we feel the lower-than-normal current and quick ratios are not a problem. Starbucks does a much better job of converting their receivables into cash then competitors Tim Hortons and Sodexho Alliance. The firm's 2006 figure of 9.6 compares very favorably to Tim Hortons' ratio of 21.2 and Sodexho's plus-50 ratio.

Leverage Ratios

Leverage ratios focus on a firm's debt structure. They tell us how much the company finances with debt as opposed to equity. The balance between debt and equity determines the company's capital structure. The leverage ratios provided here show us to what extent both Starbucks and its competitors used borrowed funds to finance their purchases of assets. The times interest earned ratio shows the company's ability to cover the interest on its financing charges.

Table 4

Solvency Ratios	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**Hortons**	**CC**	**Sodexho**
Total Debt to Assets	NMF	NMF	NMF	NMF	8.0%	15.9%	22.9%	Nil	24.6%
Total Debt to Equity	NMF	NMF	NMF	NMF	13.4%	31.5%	39.2%	Nil	119.0%
Times Interest Earned	NMF	NMF	NMF	NMF	NMF	108.9	18.0	Nil	7.4%

Total Debt to Assets – This ratio for the better part of Starbucks' operating history was not meaningful. The company in past years has used equity and internal cash flows to finance all acquisitions and expansion initiatives. However, with the company's strategy evolving to include rapid international expansion, Starbucks has dipped into the attractively priced bond market to finance recent initiatives. At roughly 16% in 2006, the company could still use debt to finance additional assets without putting a strain on its business. Starbucks' balance sheet is also not as leveraged as its competitors. Both Tim Hortons and Sodexho both have higher ratios than that of Starbucks.

Total Debt to Equity – This ratio indicates the degree of financial leverage that the firm is using to enhance its return. A rising debt-to-equity ratio may signal that further increases in debt caused by purchases of inventory or fixed assets should be restrained. Starbucks' debt-to-equity ratio is well below that of its rival Tim Hortons and Sodexho. In fact, Starbucks is not a highly leveraged company (total debt-to-equity ratio of 31.5%), which provides an opportunity in the future for the company to enhance its earnings through increase leverage.

Times Interest Earned – This measure for Starbucks adds to strength to our argument that Starbucks' relatively low current and quick ratios are not a cause for concern. At nearly 109 times, the company is well equipped to cover any interest payments on its outstanding debt obligations.

Return on Investment Ratios

The following two ratios show what kind of return the company is getting on its investments. They are two crucial measures of how the company is performing. We like what we see here for Starbucks. The company has witnessed steady growth in these two ratios since early this decade.

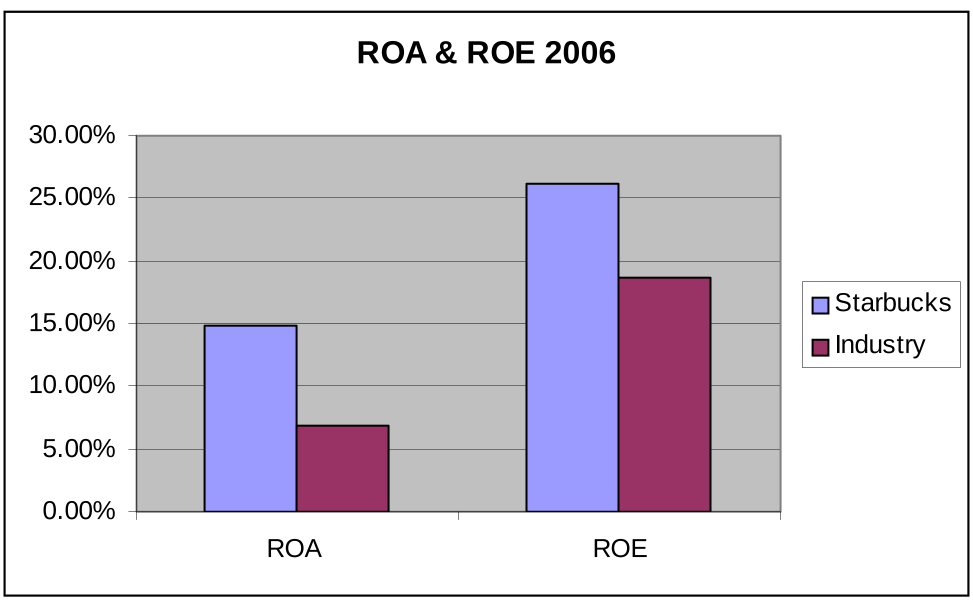
Table 5

Return of Investment Ratios	2002	2003	2004	2005	2006	Hortons	Sodexho	Industry
Return on Assets	9.9%	10.7%	12.8%	14.5%	14.8%	16.5%	1.8%	6.8%
Return on Equity	13.9%	14.1%	17.1%	21.7%	26.1%	49.1%	23.5%	18.7%

Return on Assets – This measure has steadily improved over the last five years. It has grown from 9.9% in 2002 to nearly 15% at the end of fiscal 2006. The company's assets are returning nearly $0.15 on $1.00 invested by the company. This gives Starbucks, as well as the investment community confidence that future investments will provide a nice return for the company.

Return on Equity – This shows the return stockholders are earning on their investment in the enterprise. Starbucks' shareholders return has skyrocketed in recent years, fueled by steady bottom-line growth. An aggressive share repurchase program has also enhanced shareholders value. Starbucks bought back roughly $1.1 billion and $475 million of common stock in 2005 and 2006, respectively. The repurchases more than offset any dilution resulting from the exercise of stock options by officers and employees.

Chart 5



Efficiency Ratios are designed to measure the firm's ability to generate revenues and control costs.

Table 6

Asset Utilization Ratios	2002	2003	2004	2005	2006	Hortons	CC	Sodexho
Cash Turnover	10.6	10.8	10.6	13.3	20.5	9.2	9.6	10.7
A/R Turnover	35.0	38.4	41.6	38.5	37.5	16.9	67.1	7.0
Sales to Inventory	13.6	13.4	13.8	13.1	13.2	35.6	23.4	75.6
W.C. Turnover	10.6	12.9	9.0	-360	-19.2	-3.4	15.1	-123.1
Fixed Asset Turnover	2.7	3.1	3.7	3.8	3.8	1.5	2.4	32.9
Total Asset Turnover	1.6	1.6	1.8	1.9	2.0	1.0	1.7	1.7

Asset Turnover – This ratio calculates the total revenues for every dollar of assets a company owns. Starbucks ratio stands at a healthy 2.0. More importantly, this ratio has improved every year since the beginning of this decade. It shows that SBUX has done a good job of integrating new assets into the company's mix. Starbucks has done a better job of utilizing its assets than all three of its competitors.

Inventory Turnover – Measures the number of inventory turns per year. At slightly more than 13 times, Starbucks has done an excellent job of turning over its inventory. Starbucks has been more efficient than both of its main competitors.

Average Collection Period – This ratio has improved in each of the last two years, falling from nearly 42 days at the end of 2004 to 37.5 at September 2006. A shorter collection time is better for the firm.

Fixed Asset Turnover - This ratio remained relatively flat in 2006 after improving in the previous three seasons. This is a good sign that Starbucks is effectively utilizing its plant and equipment.

1st Quarter Fiscal 2007 Snapshot

Starbucks' performance during the first period of fiscal 2007 (ended December 31st) was very similar to the prior few quarters. The company's gross, operating, and profit margins eroded slightly, the result of large infrastructure investments (especially in China), wage increases, and a higher mix of non-beverage items. The large investments are part of the company's ongoing strategy to aggressively expand its overseas operations. Starbucks believes that China and India, with their booming populations of young consumers with ample discretionary income, represent an attractive growth opportunity. Although these costly investments may crimp near-term margins, they should boost SBUX's growth potential over the next five to 10 years.

The company reported first-quarter sales of $2.355 billion, which represents a healthy year-over-year advance of 22%. More importantly, the company's same-store sales advances over the first three months of the new fiscal year were well above the industry averages. Comparable sales continue to track well within management's long-term target range of 3%-7%. The continued top-line growth, coupled with our expectation that margins will improve later this year when cost-cutting efforts take full hold, augurs well for Starbucks' performance over the final nine months of the year. According to Thomson Financial, Wall Street's consensus estimate for fiscal 2007 remains at $0.89 a share, this represents more than a 20% year-over-year advance.

The company continues to maintain a healthy balance sheet as evidence in its first-quarter figures. Starbucks has more than $400 million of cash and cash equivalents on hand. The company also paid down a significant amount of debt in the first quarter. This, along with the company's strong cash flow generation, gives it the financial flexibility to continue its very aggressive expansion plans both home and abroad.

CAPM – Capital Asset Pricing Model

We have obtained our expected return [E (ri)] on the stock Starbucks (SBUX) by using the Capital Asset Pricing Model (CAPM). The general idea behind CAPM is that investors need to be compensated in two ways:

• The Risk free rate [(Rf)] and
• The risk [(β)].

The Risk Free rate (Rf) is used to compensate investors for placing money in any investment over a period of time. We have obtained the risk free rate by using the three-months Treasury bill, and the Risk free rate is 5.04%. The other half of the formula represents risk and calculates the amount of compensation the investor needs for taking on additional risk. This is calculated by taking a risk measure (beta- β) that compares the return of the asset to the market over a period time and the market premium (Rm-Rf).

The CAPM says that the expected return [E (ri)] of a security or a portfolio equals the rate on a risk-free security plus a risk premium. If this expected return does not meet or beat the required return, then the investment should not be undertaken. According to the CAPM, to calculate the Expected return on a given asset, we use the formula below.

$$E(r_i) = r_f + \beta_{im}(E(r_m) - r_f).$$

• E(ri) is the expected return on the capital asset
• Rf is the risk free rate of interest
• Bim (the Beta) the sensitivity of the asset returns to market returns
• E (rm) is the expected return of the market

• E (rm) – Rf is sometimes known as the market premium or risk premium (The difference between the expected market rate of return and the risk free rate of return.

For the security Starbucks (SBUX), we have calculated the Beta (β) by using the 5 year weekly historical prices from March 1st 2002 to March 1st 2007, and the Beta calculated is 0.69. The risk free rate we have obtained from the three months T-bill is 5.04%. The expected market return is 10.0% by using the return of the S&P 500 Index (average of the above indicted period), and by using those actual numbers and the expectations, we have calculated that the expected return for Starbucks (SBUX) is 8.46%.

CAPM

Rf =	**5.04%**
β =	**0.69**
E(Rm) =	**10.0%**
E(Rs)=	**Rf + β (Rm-Rf)**
E(Rs)=	**8.46%**

The expected rate of return on Starbucks is **8.46%**.

Du Pont Analysis

ROE = Net Profit Margin * Asset Turnover * Financial Leverage Ratio

$$\frac{\textbf{Net Income}}{\textbf{Avg Equity}} = \frac{\textbf{Net Income}}{\textbf{Sales}} * \frac{\textbf{Sales}}{\textbf{Avg Total Assets}} * \frac{\textbf{Avg. Assets}}{\textbf{Avg Equity}}$$

Fiscal Year 2002

$$\frac{215{,}073}{1{,}551{,}282} = \frac{215{,}073}{20{,}152} * \frac{20{,}152}{1{,}998{,}931} * \frac{1{,}998{,}931}{1{,}551{,}282}$$

1.3 * 0.065 * 1.59 = 0.138 = **13.9%**

Fiscal Year 2003

$$\frac{268{,}346}{1{,}902{,}808} = \frac{268{,}346}{4{,}075{,}500} * \frac{4{,}075{,}500}{2{,}511{,}200} * \frac{2{,}511{,}200}{1{,}902{,}808}$$

1.32 * 0.066 * 1.62 = 0.141 = **14.1%**

.

Fiscal Year 2004

$$\frac{388{,}888}{2{,}284{,}600} = \frac{388{,}880}{5{,}294{,}247} * \frac{5{,}294{,}247}{3{,}028{,}950} * \frac{3{,}028{,}950}{2{,}284{,}600}$$

1.33 * 0.074 * 1.75 = 0.171 = **17.1%**

Fiscal Year   2005

$$\frac{494,370}{2,288,550} = \frac{494370}{6,369,300} * \frac{6,369,300}{3,420,950} * \frac{3,420,950}{2,288,550}$$

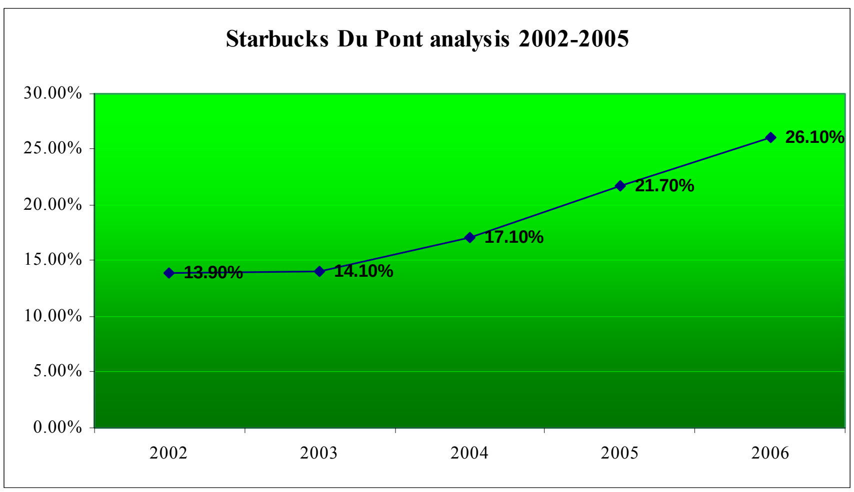
1.49 * 0.078 * 1.86 = 0.217 = **21.7%**

Fiscal Year 2006

$$\frac{564,259}{2,159,400} * \frac{564,259}{7,786,942} * \frac{7,786,942}{3,971,300} * \frac{3,971,300}{2,159,400}$$

1.84 * 0.073 * 1.96 = 0.261 = **26.1%**

Chart 6



The Du Pont analysis shows that the ROE has increased over the period of five years mainly due to an increase in the financial leverage, followed by the asset turnover and the net profit margin.

Discounted Cash Flow Analysis

We have determined that a discounted cash flow model is the best method to evaluate Starbucks' stock. Provided below are our financial projections for the company through 2012. These projections, along with our CAPM estimates, are used in the following discounted cash flow model.

Table 7

Income Statement Projections*						
	2007E	**2008E**	**2009E**	**2010E**	**2011E**	Term.
Revenues	9550.0	11625.0	13810.0	16560.0	19700.0	Val.
COGS	7625.0	9300.0	10693.0	12822.4	15244.7	Pages
SG&A	490.0	580.0	759.6	910.8	1083.5	26&27
Depreciation	450.0	545.0	769.2	922.4	1097.3	2012
Income from Equity Investments	98.0	116.0	165.7	198.7	236.4	Base
Operating Income	1083.0	1316.0	1753.9	2103.1	2501.9	Year
Interest Expense	10.0	12.5	15.2	18.2	21.7	
Other Income	30.0	35.0	37.3	44.8	53.3	
EBIT	1103.0	1338.5	1776.0	2129.7	2533.5	
Income Taxes	408.0	495.0	657.1	788.0	937.4	
Income from Continuing	695.0	843.5	1118.9	1341.7	1596.1	
Nonrecurring Gain (Excluded)	0.0	0.0	0.0	0.0	0.0	
Reported Net Income	695.0	843.5	1118.9	1341.7	1596.1	
EPS - Income from Continuing (diluted)	0.89	1.07	1.45	1.77	2.13	
Nonrecurring Gain per share (diluted)	0.00	0.00	0.00	0.00	0.00	
Reported EPS (diluted)	0.89	1.07	1.45	1.77	2.13	

**Starbucks' revenue estimates were obtained from Thomson One Analytics. They are an average of Wall Street analysts' projections. The expense and income line items were projected using the using ratios obtained from common-sizing the historical income statements.*

<u>Explanation of how Income Statement figures were calculated</u>

The line items expenses that are found in our projections for Starbucks out to 2012 were estimated using the five-year average of the company's common-sized income statement. The common-sized income statement for the years 2001 through 2006 showed that each line-item expense was very stable, giving us confidence that we could use those ratios to project expenses for the next five years. The expenses were calculated from the sales estimates that we obtained from Thomson Financial. Each expense item was calculated as a percentage of forecasted total sales. Our estimates for the above line-item expenses were compared to several sell-side analysts' projections for fiscal 2007 and 2008 to eliminate any possible errors. The annually sales forecasts for Starbucks were the average consensus estimate of Wall Street analysts.

Table 8

Starbucks	**Estimated Rate of Growth of 20%**						
DCF Analysis							
		2007E	2008E	2009E	2010E	2011E	
Input Data	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Sales (mill$)*	7786.9	9550.0	11625.0	13810.0	16560.0	19700.0	23650.0
Operating Profit	894	1083.0	1316.0	1753.9	2103.1	2501.9	3003.6
Operating Margin	11.5%	11.3%	11.3%	12.7%	12.7%	12.7%	12.7%
Total Income Taxes	324.7	408.0	495.0	657.1	788.0	937.4	1125.3
+ Net Tax Shield	5.3	6.3	7.9	9.6	11.5	13.7	16.5
= Taxes on EBIT	330.0	414.3	502.9	666.7	799.5	951.1	1141.8
Cash Flow Generation							
+ Operating Profit	894.0	1083.0	1316.0	1753.9	2103.1	2501.9	3003.6
- Taxes on EBIT	-330.0	-414.3	-502.9	-666.7	-799.5	-951.1	-1141.8
+ Depreciation	387.2	450.0	545.0	769.2	922.4	1097.3	1317.3
- CAPEX	-770.0	-862.4	-965.9	-1081.8	-1211.6	-1357.0	-1519.8
- Acquisitions	-91.7	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	89.5	256.3	392.2	774.6	1014.4	1291.1	1659.3
Discounted Cash Flow (DCF)		239.8	343.4	634.6	777.5	926.0	28737.2

Valuation	
Sum of DCF	31658.5
Net Debt '07 (LTD+STD-Cash)*	385.0
Net Equity Value	31273.5
Shares Outstanding	783.900
Value per Share	***39.89***

*First Call - Wall Street Analyst Projections

**Company Guidance

Cost of Capital	
Cost of Debt	5.04%
Tax Rate (Corporate)**	37.0%
Beta	0.69
E(M) - RF	3.0%
RF	5.04%
Cost of Equity	8.5%
Target Debt Ratio	30.00%
Target Equity Ratio	70.00%
Cost of Capital	6.87%

Starbucks	**Estimated Rate of Growth of 10%**						
DCF Analysis							
		2007E	2008E	2009E	2010E	2011E	
Input Data	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Sales (mill$)*	7786.9	9550.0	11625.0	13810.0	16560.0	19700.0	21670.0
Operating Profit	894	1083.0	1316.0	1753.9	2103.1	2501.9	2752.1
Operating Margin	11.5%	11.3%	11.3%	12.7%	12.7%	12.7%	12.7%
Total Income Taxes	324.7	408.0	495.0	657.1	788.0	937.4	1031.1
+ Net Tax Shield	5.3	6.3	7.9	9.6	11.5	13.7	16.5
= Taxes on EBIT	330.0	414.3	502.9	666.7	799.5	951.1	1047.6
Cash Flow Generation							
+ Operating Profit	894.0	1083.0	1316.0	1753.9	2103.1	2501.9	2752.1
- Taxes on EBIT	-330.0	-414.3	-502.9	-666.7	-799.5	-951.1	-1047.6
+ Depreciation	387.2	450.0	545.0	769.2	922.4	1097.3	1207.0
- CAPEX	-770.0	-862.4	-965.9	-1081.8	-1211.6	-1357.0	-1438.4
- Acquisitions	-91.7	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	89.5	256.3	392.2	774.6	1014.4	1291.1	1473.1
Discounted Cash Flow (DCF)		239.8	343.4	634.6	777.5	926.0	25512.6

Valuation	
Sum of DCF	28433.9

Net Debt '07 (LTD+STD-Cash)*	385.0
Net Equity Value	28048.9
Shares Outstanding	783.900
Value per Share	***35.78***

*First Call - Wall Street Analyst Projections

**Company Guidance

After conducting a discounted cash flow analysis for Starbucks at both 20% and 10% estimated growth rates, we have reached the conclusion that the market currently undervalues Starbucks' stock. We obtained a price of $39.89 at a growth rate of 20% and $35.78 at a growth rate of 10%. Both of these estimates are significantly above the current price. This analysis further strengthens our belief that at its current valuation, Starbucks stock remains a strong candidate for purchase by the Graduate portfolio.

Price-to-Earnings Ratio

To gain a better perspective as to where Starbucks stock is right now in relationship to the overall market, we have decided to look at the trend in the stock's average annual P/E ratio and its relative P/E to the 1700 stocks tracked by *The Value Line Investment Survey*. Provided below is both measures for the trailing 10-year period.

Starbucks	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Avg. Ann'l P/E Ratio	49.3	46.4	50.1	46.5	45.0	38.6	35.9	40.3	43.2	45.6
Relative P/E Ratio	2.84	2.41	2.86	3.02	2.31	2.11	2.05	2.13	2.28	2.44

***Relative P/E to the Value Line 1700 stock index**

Starbucks' stock currently trades at roughly 35 times Wall Street's 2007 consensus estimate of $0.89 a share. Its relative P/E to the Value Line 1700 stock index is currently 1.90. Both figures are well below the multiples for Starbucks in each of the last 10 years. The stock's relatively low valuation to its historical norm and the *Value Line* index, along with our positive DCF findings, make this an excellent entry point for investors looking to gain exposure to one of world's premier beverage/food services companies. Although this company's growth has slowed some since the late 1990s and early 2000s, we still believe it deserves a higher valuation multiple than it currently fetches.

Comparable Store Sales Growth

Comparable Store Sales (CSSG) is a statistic used to gauge the percentage of sales growth generated by stores in existence over one year versus sales growth from new store openings. While sales growth form new store openings is a positive metric there may come a point where new store openings begin to cannibalize sales to the existing customer base.

Starbucks has achieved sixty consecutive quarters of positive Comparable Store Sales Growth of 3-11%. Management predicts a quarterly CSSG of 3-7%.

NEW INFORMATION IN BLUE

Starbucks Corporation
Starbucks Comparable Store Sales
(Updated January 31, 2007)

	FY '95	FY '96	FY '97	FY '98	FY '99	FY '00	FY '01	FY '02	FY '03	FY '04	FY '05	FY '06	FY '07
Q-1	9%	3%	3%	5% (3% ticket, 2% trans.)	3% (-2% ticket, 5% trans.)	7% (3% ticket, 4% trans.)	10% (6% ticket, 4% trans.)	2% (-2% ticket, 4% trans.)	9% (0% ticket, 9% trans.)	10% (1% ticket, 9% trans.)	10% (4% ticket, 6% trans.)	7% (1% ticket, 6% trans.)	6% (2% ticket, 4% trans.)
Q-2	7%	8%	5%	7% (4% ticket, 3% trans.)	6% (1% ticket, 5% trans.)	10% (5% ticket, 5% trans.)	6% (5% ticket, 1% trans.)	7% (0% ticket, 7% trans.)	7% (1% ticket, 6% trans.)	12% (1% ticket, 11% trans.)	7% (3%, ticket, 4% trans.)	10% (2% ticket, 8% trans.)	
Q-3	10%	7%	6%	7% (3% ticket, 4% trans.)	6% (2% ticket, 4% trans.)	10% (5% ticket, 5% trans.)	3% (2% ticket, 1% trans.)	8% (0% ticket, 8% trans.)	8% (1% ticket, 7% trans.)	11% (1% ticket, 10% trans.)	7% (4% ticket, 3% trans.)	6% (2% ticket, 4% trans.)	
Q-4	11%	9%	5%	3% (0% ticket, 3% trans.)	8% (4% ticket, 4% trans.)	10% (5% ticket, 5% trans.)	2% (1% ticket, 1% trans.)	8% (0% ticket, 8% trans.)	9% (1% ticket, 8% trans.)	9% (1% ticket, 8% trans.)	8% (4% ticket, 4% trans.)	5% (1% ticket, 4% trans.)	
Fiscal Year	9%	7%	5%	5%	6% (1% ticket, 5% trans.)	9% (4% ticket, 5% trans.)	5% (3% ticket, 2%trans.)	6% (-1% ticket, 7% trans.)	8% (1% ticket, 7% trans.)	10% (1% ticket, 9% trans.)	8% (4% ticket, 4% trans.)	7% (2% ticket, 5% trans.)	

Q1 07 marks 60 consecutive quarters of positive CSSG.

NOTES: Comparable Store Sales reflect sales from stores that have been open for more than 13 months.
Comparable Store Sales for FY '97 and FY '98 are restated to include the FY '98 acquisition of Seattle Coffee Company.

Insider Trading

An insider is considered to be any executive, director, or officer of a certain company. It may also include owners of public companies whose ownerships consists of at least 10% of the company. Insider trading is an important component to study when you are looking to invest in a particular company. According to the SEC: "Many investors believe that reports of director' and executive officers' transactions in company equity securities provide useful information as to management's views of the performance or prospects of the company."

After studying Starbucks Corporation's recent insider trading activity, there are a few key points to note. The most recent inside purchase was made by a director on

September 8, 2006. This was a small purchase of $15,530.00 at a price of $31.06 per share. This falls in line with the price that we would recommend purchasing Starbucks.

Although, eight major insider sales have taken place since September 2006, there are a few factors to consider. First, there can be many reasons, including the need to adjust one's personal investments, for selling company stock. Secondly, none of Starbucks top executives have sold company stock since June 27, 2006. These top executives would include Chairman Howard Schultz, CEO James Donald, and CFO Michael Casey. All of their sales occurred when the market price of SBUX was between $36.00 and $39.00 per share. These sale prices are much higher than where we recommend buying the stock, and also falling in line with the fair market value of the price that we have calculated.

Correlation with Current Portfolio

In order to calculate the Correlation of Starbucks stock to other securities in the portfolio it is necessary to calculate the Expected Return, Beta, Variance, Standard Deviation and Covariance of each security in the portfolio.

The Expected Return is the return an investor expects to earn over the next period. Beta is a measure of systematic risk. The Variance and Standard Deviation assess the volatility of a securities' return. Variance is a measure of the squared deviations of a securities returns from its' expected return. Covariance and Correlation measure the interrelationship between the returns of two securities.

The Expected Return for each security was calculated using the Capital Asset Pricing Model. The Beta, with the exception of Starbucks, was obtained from published data on Yahoo Finance. The Standard Deviation of Starbucks stock was calculated at 7.58%. This measure means that there is a 68.26% probability that Starbucks returns will fall between .9 - 16%. This range is one standard deviation away, plus or minus, form the expected return.

The Covariance of Starbucks Stock Returns to other stock returns in our portfolio are all positive with the exception of XOM. XOM has a slight negative covariance. This means that when XOM has above average returns SBUX should have below average returns.

The Correlation of Starbucks stocks to other in the portfolio reveals that SBUX is slightly positively correlated to six stocks in the portfolio (COH, DELL, HOG, KSS, MCD, WMT), and slightly negatively correlated to one stock in the portfolio (XOM) and uncorrelated to eight stocks in the portfolio (COH, C, FRX, ERTS, GE, PEP, RTP,TM).

Security	Expected Return	Risk Free	Beta	Rm-Rf	Variance	Std Dev	COV w/SBUX	COOR w/ SBUX

C	7.87%	5.04%	0.57	4.96%	0.0005	2.29	0.000047	0.0273
COH	14.22%	5.04%	1.85	4.96%	0.01	9.98	0.000763	0.1008
CMCSA	10.10%	5.04%	1.02	4.96%	0.0005	2.29	0.000047	0.0273
DELL	11.93%	5.04%	1.39	4.96%	0.001	3.22	0.000381	0.1561
ERTS	14.22%	5.04%	1.85	4.96%	0.0094	9.68	0.000291	0.0396
XOM	10.64%	5.04%	1.13	4.96%	0.0007	2.71	-0.000003	-0.0015
FRX	13.12%	5.04%	1.63	4.96%	0.0013	4.4	0.000185	0.0555
GE	7.47%	5.04%	0.49	4.96%	0.0007	2.63	0.000155	0.0766
HOG	12.63%	5.04%	1.53	4.96%	0.0013	3.62	0.000399	0.1453
KSS	7.22%	5.04%	0.44	4.96%	0.0013	3.63	0.000494	0.1798
MCD	11.74%	5.04%	1.35	4.96%	0.0008	2.88	0.000372	0.1705
PEP	4.99%	5.04%	-0.01	4.96%	0.0003	1.74	0.000012	0.0088
RTP	12.03%	5.04%	1.41	4.96%	0.0017	4.16	0.000099	0.0314
TM	9.40%	5.04%	0.88	4.96%	0.001	3.16	0.000167	0.0697
WMT	5.49%	5.04%	0.09	4.96%	0.0006	2.39	0.000266	0.1465
SBUX	**8.46%**	**5.04%**	**0.69**	**4.96%**	**0.0057**	**7.58**	**0.005740**	**1.0000**

Note:The risk free rate (Rf) used was 5.04% from the 3 month U.S. Treasury Bill. The expected market return (Rm) was calculated using the S&P 500 Index of 10.00%. The beta values for each security were taken from Yahoo Finance with the exception of SBUX. The variance was calculated using 5 years of weekly return data.

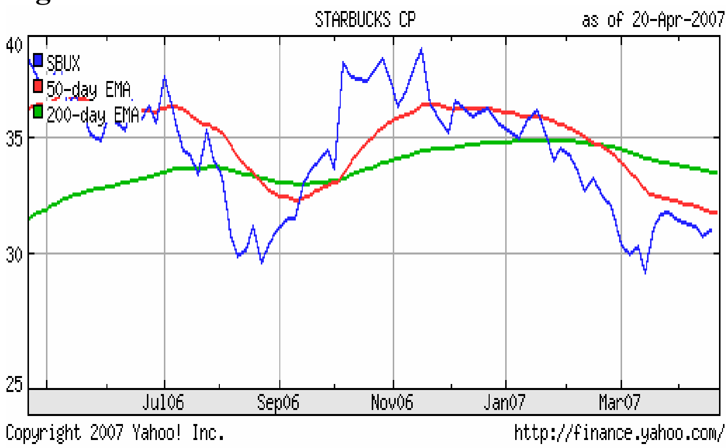
Technical Analysis

In order to support our buy-recommendation, and complete the evaluation of Starbucks' stock, we did the valuation based on the Earnings Multiplier. The tables below will further indicate whether the stock is overvalued or undervalued.

Figure 1

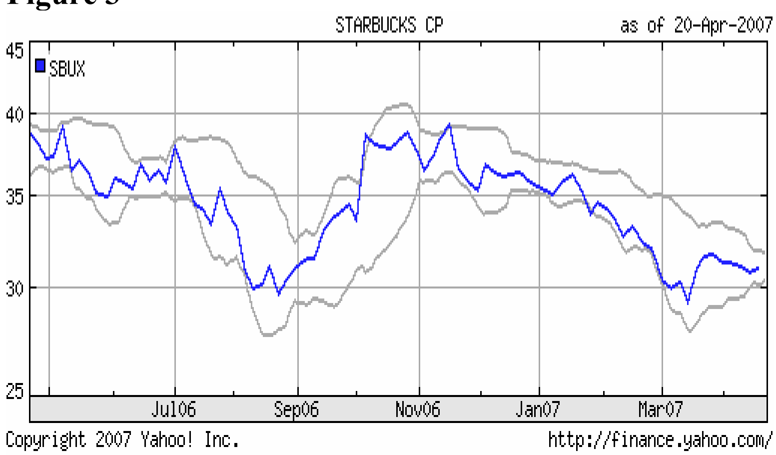
The chart shows Starbucks' stock trend for the past 1-year period.

Figure 2



Exponential Moving Average, (EMA). The red line represents the 50-day Moving Average, and the green line represents the 200-day moving average. There was an intersection between the two in February, which was a short signal. Like the market, SBUX took a sharp hit in February. Moving forward there is some uncertainty. However, there is an indication that the stock, which is below the moving average, has hit bottom and that the line is shifting to a more positive trend; thus, a good time to enter the market. This can further be supported by looking at the increased trading volume in Figure 1.

Figure 3



Bollinger Bands, (BOL) measures the degree of price changing. The spacing between the bands varies based on the volatility of the prices. During periods of extreme price changes (i.e., high volatility), the bands widen to become more forgiving. During periods of stagnant pricing (i.e., low volatility), the bands narrow to contain prices.

Figure 4

The Parabolic SAR is used to set trailing price stops. When the upper curve reaches the price line, it can be considered a good buy-opportunity; and when the lower curve hits the price line it could be seen as a sell. As seen the price line has been close to the upper curve lately.

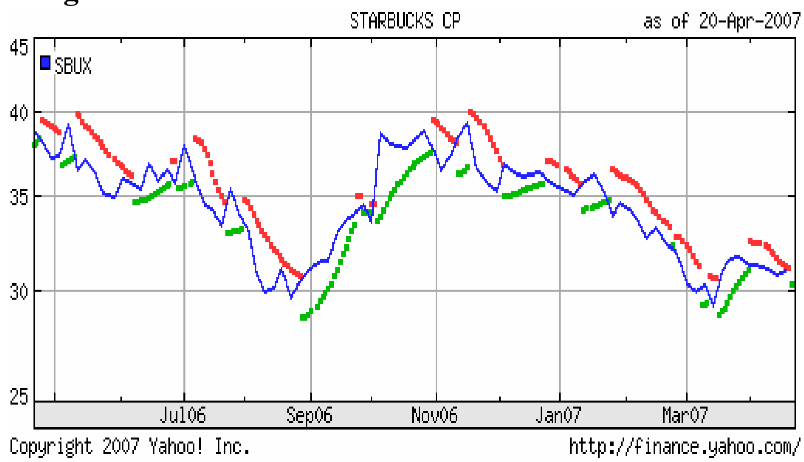
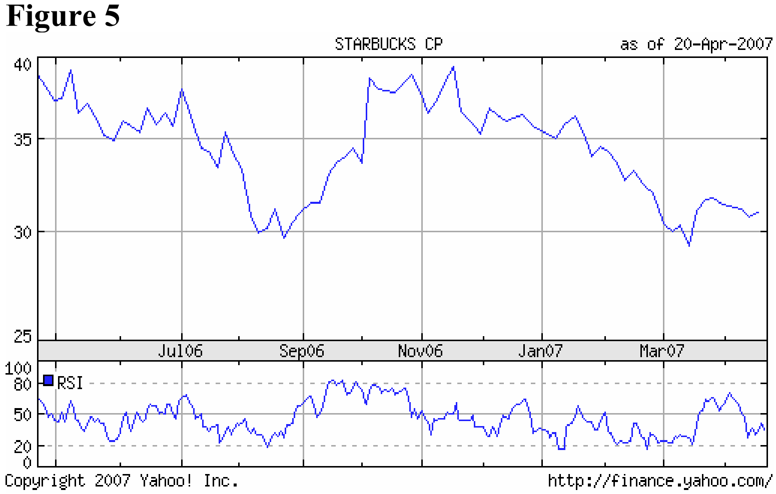


Figure 5



Relative Strength Index, RSI, compares the internal strength of a single security. By changing the price we are able to see the market strength. In this case 80 and 20 represents the overbought and the oversold, respectively. Currently the RSI is below 50 but we see a slight upward movement coming.

Conclusion

Through both financial and market analysis we've concluded that Starbucks would be a good investment, worthy of adding to our portfolio. Results from our industry and company analysis conclude that Starbucks has a stronghold on its market position, and remains a formidable market leader amongst competition ranging from coffeehouse franchises to major fast-food companies. Our financial analysis has concluded that Starbucks has an undervalued market price. This along with a promising expected return, and positive projections for future growth provide us reason to believe that it will undoubtedly add value to our current portfolio.

McDonalds (MCD) is the only security in the current Graduate portfolio that operates in the same sector as Starbucks (SBUX). McDonalds, which operates in the services sector, currently accounts for approximately 2.17% of entire $1 million portfolio. This factor along with the low correlation existing between Starbucks (SBUX) and the current components of the existing portfolio, convince us that added exposure to this particular industry, through the purchase of Starbucks (SBUX) common shares would be beneficial to the current Graduate Portfolio.

Our confidence in the future promise of this stock leads us to recommend purchasing the maximum allowable allocation of 3% of the total portfolio balance. With a current balance estimated at approximately $1 million, we suggest investing $30,000.00 into Starbucks (SBUX). With a current market price of roughly $31.00 per share of SBUX, this would amount to a purchase of 965 shares of the common stock.

Works Cited

Hoy, Peter. “Dunkin’ Donuts – Reinventing America’s Cup of Coffee.” www.fastcompany.com. October 2006.

Miller-Regan, Nicole. “Solid 1Q07 EPS Despite Margin Comp; Raising FY 08 Based On Inc. Revs & G&A Leverage.” Starbucks: Company Note. PiperJaffray & Co. February 1, 2007.

Sherman, Lauren. “Breakfast Perks up Starbucks.” www.forbes.com. January 30, 2007.

Starbucks Form10K Annual Reports for 2002, 2004, 2006. www.sec.gov

Tarantino, David. Starbucks Corporation (SBUX): Comments on Q1. Robert Baird & Co. February 1, 2007.

Thomson One Analytics. www.thomsononeanalytics.com . March 2, 2007.

Thompson, Arthur A., Strickland III, A.J. “ Starbucks’ Global Quest in 2006: Is the Best Yet to Come?” Crafting & Executing Strategy. Fifteenth Edition. 2007. Pages 468-495

Van Riper, Thomas. “Dunkin’ Donuts Edges Starbucks.” www.forbes.com. February 27, 2007

Zackfia, Sharon. Starbucks Corporation. Equity Research. William Blair & Company, LLC. February 26, 2007.

www.mcdonalds.com

www.dunkindonuts.com

---

[i] Starbucks, Report on Corporate Social Responsibility, 2006
[ii] Starbucks, Form 10-K, 12/14/2006.
[iii] Cases in Crafting and executing Strategy, p.486.
[iv] Starbucks, Report on Corporate Social Responsibility, 2006, p.12.
[v] Cases in Crafting and executing Strategy, p.484.
[vi] Starbucks, Report on Corporate Social Responsibility, 2006, p.17.
[vii] Starbucks, Report on Corporate Social Responsibility, 2006, p.22
[viii] Starbucks, Report on Corporate Social Responsibility, 2006, p.3
[ix] Starbucks, Form 10-K, 12/14/2006, p.9.
Cases in Crafting and executing Strategy, p.488.

Exhibit 1: Income Statement

	2001	2002	2003	2004	2005	2006
Revenues	2649.0	3288.9	4075.5	5294.2	6369.3	7786.9
COGS	2081.6	2598.3	3206.8	4153.3	4968.1	6126.7
SG&A	151.4	202.2	244.6	304.3	357.1	473.0
Depreciation	163.5	205.6	237.8	289.2	340.2	387.2
Income from Equity Investments	28.6	35.9	38.4	59.1	76.6	94.0
Operating Income	281.1	318.7	424.7	606.5	780.5	894.0
Interest Expense	0.0	0.0	0.0	0.4	1.3	8.4
Other Income	7.8	9.3	11.6	14.5	17.1	20.6
EBIT	288.9	328.0	436.3	620.6	796.3	906.2
Income Taxes	107.7	121.4	168.0	231.7	301.9	324.7
Income from Continuing	**181.2**	**206.6**	**268.3**	**388.9**	**494.4**	**581.5**
Nonrecurring Gain (Excluded)	0.0	8.5	0.0	0.0	0.0	-17.2
Reported Net Income	181.2	215.1	268.3	388.9	494.4	564.3

EPS - Income from Continuing (diluted)	**0.23**	**0.25**	**0.34**	**0.48**	**0.61**	**0.73**
Nonrecurring Gain per share (diluted)		0.02	0.00	0.00	0.00	-0.02
Reported EPS (diluted)	0.23	0.27	0.34	0.48	0.61	0.71

Projected Income Statement	2007	2008	2009	2010	2011	
Revenues	9550.0	11625.0	13810.0	16560.0	19700.0	
COGS	7625.0	9300.0	10693.0	12822.4	15244.7	
SG&A	490.0	580.0	759.6	910.8	1083.5	
Depreciation	450.0	545.0	769.2	922.4	1097.3	
Income from Equity Investments	98.0	116.0	165.7	198.7	236.4	
Operating Income	1083.0	1316.0	1753.9	2103.1	2501.9	
Interest Expense	10.0	12.5	15.2	18.2	21.7	
Other Income	30.0	35.0	37.3	44.8	53.3	
EBIT	1103.0	1338.5	1776.0	2129.7	2533.5	
Income Taxes	408.0	495.0	657.1	788.0	937.4	
Income from Continuing	695.0	843.5	1118.9	1341.7	1596.1	
Nonrecurring Gain (Excluded)	0.0	0.0	0.0	0.0	0.0	
Reported Net Income	695.0	843.5	1118.9	1341.7	1596.1	

EPS - Income from Continuing (diluted)	0.89	1.07	1.45	1.77	2.13	
Nonrecurring Gain per share (diluted)	0.00	0.00	0.00	0.00	0.00	
Reported EPS (diluted)	0.89	1.07	1.45	1.77	2.13	

Exhibit 2: Balance Sheet

Assets	2001	2002	2003	2004	2005	2006
Cash & Cash Equivalents	220.5	402.2	350.0	653.0	307.0	453.6
Accounts Receivables	90.4	97.6	114.4	140.2	190.8	224.3

	2001	2002	2003	2004	2005	2006
Inventories	221.3	263.2	342.9	422.7	546.3	636.2
Prepaid Expenses	29.8	42.4	55.2	71.3	94.4	126.9
Deferred income taxes	31.9	42.1	61.5	81.3	70.8	88.8
Total Current Assets	593.9	847.5	924.0	1368.5	1209.3	1529.8

Equity and other investments	63.1	106.0	144.3	171.7	201.1	219.1
Long Term Investments	0.0	0.0	136.2	135.2	60.5	5.8
Propert Plant & Equipment	1135.8	1265.8	1384.9	1471.4	1842.0	2287.9
Other assets	36.4	53.5	52.0	85.6	72.9	186.9
Goodwill, net	21.8	19.9	88.3	95.8	127.9	199.4

Total Assets	1851.0	2292.7	2729.7	3328.2	3513.7	4428.9

Liabilities	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Accounts Payable	127.9	136.0	169.0	199.3	221.0	340.9
Accrued expenses	187.6	211.3	263.7	337.8	355.1	437.8
Current Portion of LT Debt	0.7	0.7	0.7	0.7	0.7	0.8
Deferred Revenues	10.0	42.3	73.5	121.4	175.0	231.9
Short Term Debt	0.0	0.0	0.0	0.0	277.0	700.0
Other	119.1	147.2	101.8	123.8	198.2	224.2
Total Current Liabilities	445.3	537.5	608.7	783.0	1227.0	1935.6

Deferred Income Taxes	19.1	22.5	33.2	46.7	0.0	0.0
Long Term Debt	5.8	5.1	4.4	3.6	2.9	2.0
Other Liabilities	4.9	1.0	1.0	8.1	193.5	262.8

Shareholders' Equity	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Common Stocks	791.0	891.0	959.1	956.7	0.8	0.8
Paid in Capital	0.0	39.4	39.4	39.4	129.6	39.4
Retained earnings	589.7	804.8	1069.7	1461.5	1939.0	2151.1
Accumulated other comprehensive	-5.4	-8.6	14.2	29.2	20.9	37.3
Total Shareholders' Equity	1375.9	1726.6	2082.4	2486.8	2090.3	2228.5

Total Liab. & Equity	1851.0	2292.7	2729.7	3328.2	3513.7	4428.9

Exhibit 3: Common-Sized Financial Statements

Income Statement	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Revenues	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
COGS	78.58%	79.00%	78.68%	78.45%	78.00%	78.68%
SG&A	5.72%	6.15%	6.00%	5.75%	5.61%	6.07%
Depreciation	6.17%	6.25%	5.83%	5.46%	5.34%	4.97%
Income from Equity Investments	1.08%	1.09%	0.94%	1.12%	1.20%	1.21%
Operating Income	10.61%	9.69%	10.42%	11.46%	12.25%	11.48%

Interest Expense	0.00%	0.00%	0.00%	0.01%	0.02%	0.11%
Other Income	0.29%	0.28%	0.28%	0.27%	0.27%	0.26%
EBIT	10.91%	9.97%	10.71%	11.72%	12.50%	11.64%
Income Taxes	4.07%	3.69%	4.12%	4.38%	4.74%	4.17%
Income from Continuing	6.84%	6.28%	6.58%	7.35%	7.76%	7.47%
Nonrecurring Gain (Excluded)	0.00%	0.26%	0.00%	0.00%	0.00%	-0.22%
Reported Net Income	6.84%	6.54%	6.58%	7.35%	7.76%	7.25%

Exhibit 3: Common-Sized Financial Statements

Balance Sheet						
Assets	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Cash & Cash Equivalents	11.9%	17.5%	12.8%	19.6%	8.7%	10.2%
Accounts Receivables	4.9%	4.3%	4.2%	4.2%	5.4%	5.1%
Inventories	12.0%	11.5%	12.6%	12.7%	15.5%	14.4%
Prepaid Expenses	1.6%	1.8%	2.0%	2.1%	2.7%	2.9%
Deferred income taxes	1.7%	1.8%	2.3%	2.4%	2.0%	2.0%
Total Current Assets	32.1%	37.0%	33.8%	41.1%	34.4%	34.5%

Equity and other investments	3.4%	4.6%	5.3%	5.2%	5.7%	4.9%
Long Term Investments	0.0%	0.0%	5.0%	4.1%	1.7%	0.1%
Propert Plant & Equipment	61.4%	55.2%	50.7%	44.2%	52.4%	51.7%
Other assets	2.0%	2.3%	1.9%	2.6%	2.1%	4.2%
Goodwill, net	1.2%	0.9%	3.2%	2.9%	3.6%	4.5%
Total Assets	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Liabilities	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Accounts Payable	6.9%	5.9%	6.2%	6.0%	6.3%	7.7%
Accrued expenses	10.1%	9.2%	9.7%	10.1%	10.1%	9.9%
Current Portion of LT Debt	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Deferred Revenues	0.5%	1.8%	2.7%	3.6%	5.0%	5.2%
Short Term Debt	0.0%	0.0%	0.0%	0.0%	7.9%	15.8%
Other	6.4%	6.4%	3.7%	3.7%	5.6%	5.1%
Total Current Liabilities	24.1%	23.4%	22.3%	23.5%	34.9%	43.7%
Deferred Income Taxes	1.0%	1.0%	1.2%	1.4%	0.0%	0.0%
Long Term Debt	0.3%	0.2%	0.2%	0.1%	0.1%	0.0%
Other Liabilities	0.3%	0.0%	0.0%	0.2%	5.5%	5.9%

Shareholders' Equity	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Common Stocks	42.7%	38.9%	35.1%	28.7%	0.0%	0.0%
Paid in Capital	0.0%	1.7%	1.4%	1.2%	3.7%	0.9%
Retained earnings	31.9%	35.1%	39.2%	43.9%	55.2%	48.6%
Accumulated other comprehensive	-0.3%	-0.4%	0.5%	0.9%	0.6%	0.8%
Total Shareholders' Equity	74.3%	75.3%	76.3%	74.7%	59.5%	50.3%
Total Liab. & Equity	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Exhibit 4: Financial Ratios

Operating Performance Ratios	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**Tim Hortons**	**Caribou Coffee**	**Sodexho**
Gross Profit Margin	21.4%	21.0%	21.3%	21.5%	22.0%	21.3%	27.6%	59.5%	14.4%
Operating Profit Margin	10.6%	9.7%	10.4%	11.5%	12.3%	11.5%	22.9%	Nil	4.7%
Pretax Profit Margin	10.9%	10.0%	10.7%	11.7%	12.5%	11.6%	21.7%	Nil	3.9%
Net Profit Margin	6.8%	6.3%	6.6%	7.3%	7.8%	7.5%	18.6%	Nil	2.9%
Liquidity Ratios	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**Tim Hortons**	**Caribou Coffee**	**Sodexho**
Current Ratio	1.3	1.6	1.5	1.7	1.0	0.8	1.4	1.4	1.0

Acid-Test (Quick) Ratio	0.7	0.9	0.8	1.0	0.4	0.4	0.6	0.9	0.3
Collection Period		10.3	9.4	8.7	9.4	9.6	21.2	5.4	51.6
Days to Sell Inventory		33.6	34.0	33.2	35.1	34.7	14.0	13.4	5.6

Capital Structure & Solvency Ratios	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**Tim Hortons**	**Caribou Coffee**	**Sodexho**
Total Debt to Assets	NMF	NMF	NMF	NMF	8.0%	15.9%	22,0%	Nil	24.6%
Total Debt to Equity	NMF	NMF	NMF	NMF	13.4%	31.5%	39.2%	Nil	119.0%
Times Interest Earned	NMF	NMF	NMF	NMF	NMF	108.9	18.0	Nil	7.4

Return of Investment Ratios		**2002**	**2003**	**2004**	**2005**	**2006**	**Tim Hortons**	**Caribou Coffee**	**Sodexho**
Return on Assets	ROA	9.9%	10.7%	12.8%	14.5%	14.8%	16.5%	NMF	1.8%
Return on Equity	ROE	11.7%	10.8%	11.7%	17.0%	22.9%	49.1%	NMF	23.5%

Asset Utilization Ratios		**2002**	**2003**	**2004**	**2005**	**2006**	**Hortons**	**Caribou Coffee**	**Sodexho**
Cash Turnover		10.6	10.8	10.6	13.3	20.5	9.2	9.6	10.7
A/R Turnover		35.0	38.4	41.6	38.5	37.5	16.9	67.1	7.0
Sales to Inventory		13.6	13.4	13.8	13.1	13.2	35.6	23.4	75.6
Working Capital Turnover		10.6	12.9	9.0	-359.8	-19.2	-3.4	15.1	-123.1
Fixed Asset Turnover		2.7	3.1	3.7	3.8	3.8	1.5	2.4	32.9
Total Asset Turnover		1.6	1.6	1.7	1.9	2.0	1.0	1.7	1.7