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Starbucks: From Grande Success to Venti Problems

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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Over the last few decades, Starbucks has had a long and successful journey. Initially, the brand emerged as a leader in the premium coffee market and found further success in the rapidly developing Chinese market. These dual pillars of growth endowed Starbucks with a cult like status as a leading stock in the continuously evolving restaurant sector.

However, those were the good old days. The path ahead now seems to be riddled with uncertainty, and Starbucks has been delivering below-average returns for the past five years. The future appears just as unclear.

So, what are the major hurdles that Starbucks faces?

US Challenges: The brand's primary strategy in maintaining same store sales growth (SSS) has been through pricing. Nonetheless, this approach has led to decreased transaction volumes as customers resist paying high prices. Despite Starbucks occupying a premier position in the coffee market, it continues to be a mass market product. Elevating prices adversely affects demand and traffic, which is the present scenario. Even the Starbucks Rewards program experienced a 4% decrease in active reward members since Q4. This loyalty program serves as a distinguishing factor for the brand, as it offers customers personalized promotions to sustain buying habits. Currently, the company is navigating through challenging tides while hoping for improved SSS in the coming year.

China Price War: Interestingly, Starbucks' issues in the US seem easier to tackle than those in China. China presents unique challenges, some of which could be structural in nature. The days when Starbucks could open new locations and monopolize the market are now in the past. In fact, the brand is losing market share to both new and existing competitors. Luckin Coffee, following a significant accounting scandal, has bounced back and is expanding its stores by the thousands annually, alongside another rising competitor, Shenzhen Meixixi Food & Beverage. Starbucks has found itself caught in a relentless cycle of offering promotions in order to retain customer footfall in its stores, indicating deeper structural flaws. It seems improbable that Starbucks can reverse these trends fundamentally. The coffee market's pricing largely falls below Starbucks' offerings and remains firmly centered around tea. The base case suggests more competition, loss of market share, and declining profitability.

The decline of Starbucks is far from certain. Its foundational base still ranks among the best in restaurant history. However, it is a reminder that the restaurant industry poses significant challenges for investors. Consumer habits and behaviors are unpredictable, and there is a constant surge of new restaurants in each category, each offering unique ambience and menu choices. Additionally, the rise of the “do-it-yourself” home coffee culture, which has flourished during the pandemic, poses yet another challenge. To put it bluntly, the business is getting tougher.

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Canada's Wake-Up Call

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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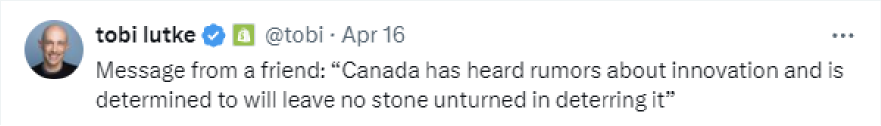
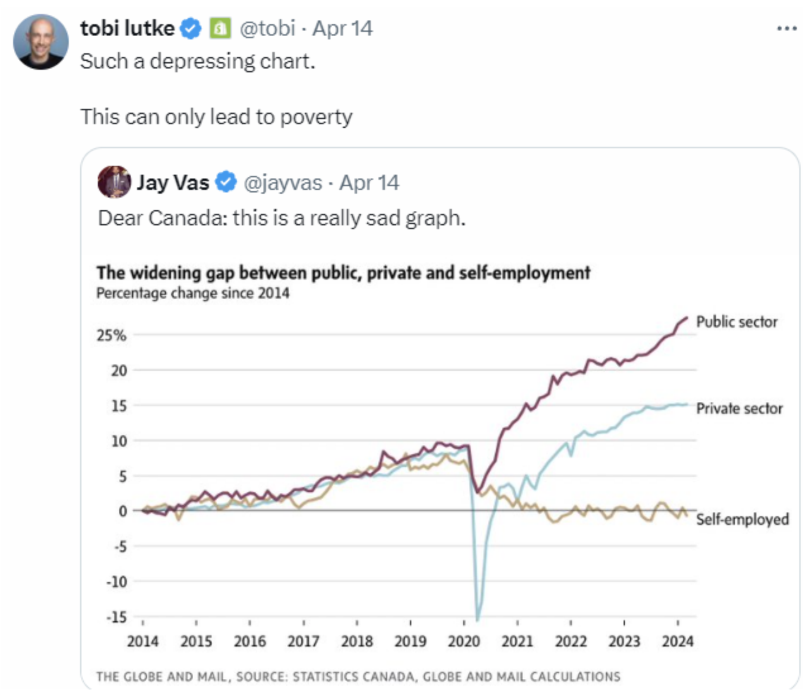
(Disclaimer: These are all my personal views)

As investors, we spend a lot of time appreciating the vision of management and how they hope to shape their company and impact society indirectly through their entrepreneurship. In Canada, our great success story is Shopify, founded by Tobi Lutke. He also happens to be an avid social media poster and to put it mildly, Tobi is concerned about the direction of our economy and especially the prospects of technological innovation as we enter the AI era. In all honesty, I'm surprised these posts from last month were largely forgotten when they first were released. It should be a bigger deal that a successful Canadian tech entrepreneur running a $100 billion company is sounding this pessimistic. Let's explore this further and have a deeper conversation about the challenges Canada is facing today and how we can build a more constructive vision for the future.



tobi lutke @tobi · Apr 16

Message from a friend: "Canada has heard rumors about innovation and is determined to will leave no stone unturned in deterring it"



tobi lutke @tobi · Apr 14

Such a depressing chart.

This can only lead to poverty

Jay Vas @jayvas · Apr 14

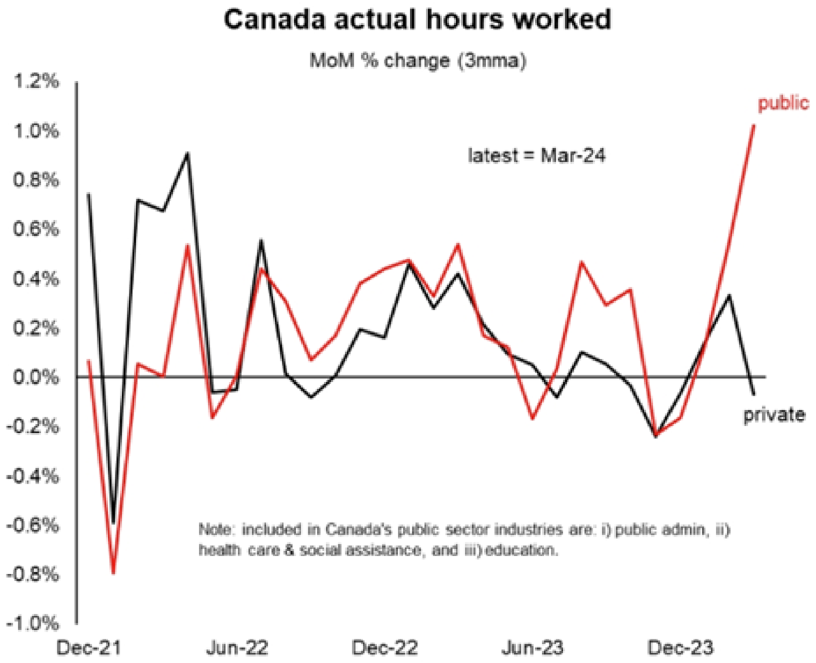
Dear Canada: this is a really sad graph.

The widening gap between public, private and self-employment
Percentage change since 2014

THE GLOBE AND MAIL, SOURCE: STATISTICS CANADA, GLOBE AND MAIL CALCULATIONS

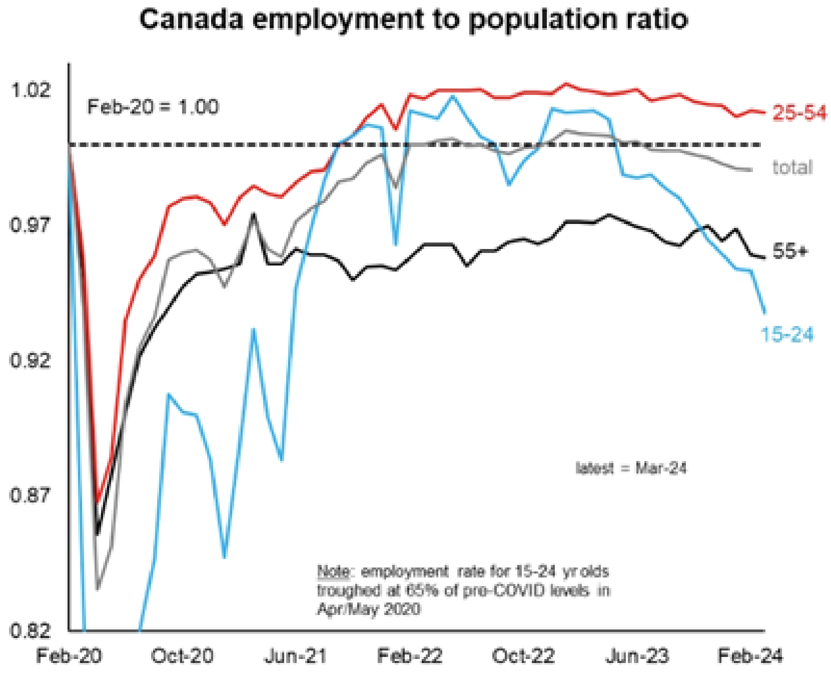
Our Challenges Today:

Our Expanding Public & Private Employment Divide: We are seeing the expansion of a gap between hours worked in the private sector and the public sector. To put it mildly, there is a boom in public sector employment and hours worked even as private payrolls are dipping into negative territory. Given we are talking about a monthly change, a small gap in the data compounds quickly over a year or two. The widening gap is a cause for long term concern because by design, the public sector is shifting economic resources from one area to another, placing a greater burden on private companies to generate the economic wealth to distribute in the first place. This is an indirect tax on productivity with the downstream effects being felt years into the future. We just had a strong payrolls report but this isn't about spot metrics, but a general trend over multiple years.



Source: Macquarie Research

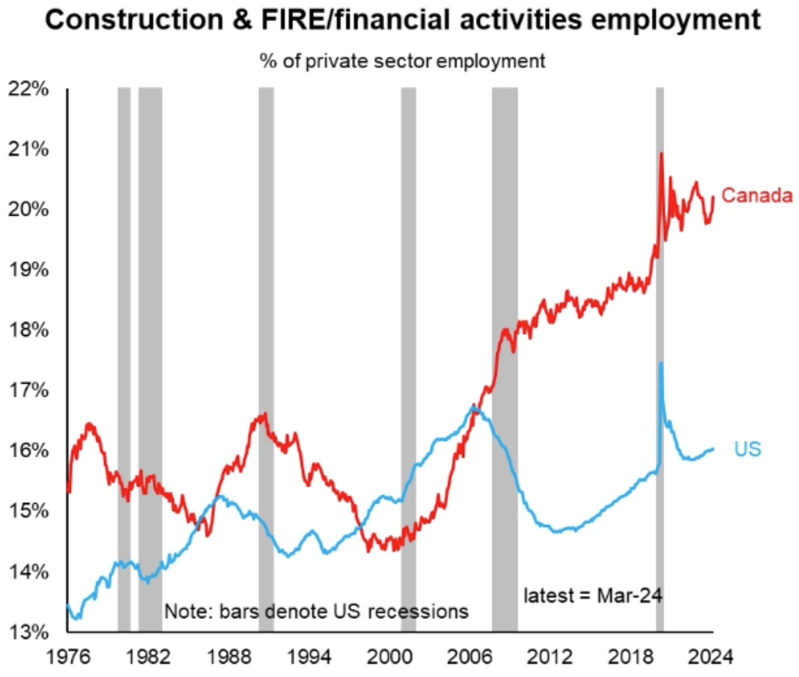
Our Youngest Generation Falling Behind: Looking through the research, the trend that surprised me most is the accelerating weakness especially amongst the youngest Canadians who are just entering the job market. The employment rate for Canadians between the ages of 15-24 is trending lower at an accelerated rate and is now below the 55+ group that has seen a structural drop due to early retirements post Covid. The soft underlying economic trends are being felt most acutely by the youngest and most aspirational demographic of the employment pool. The importance of this headwind cannot be understated. Breaking into the job market is one of the most meaningful milestones for anyone in their life, we cannot let this part of the social contract in society be broken.



Canada employment to population ratio

Source: Macquarie Research

Our Real Estate Obsession: It's not an exaggeration to say that Canadians are obsessed with real estate. You're probably thinking "Hot take Dan, what's next, the sky is blue?", but hang in there. The key point to emphasize is not just the impact on consumer balance sheets or the crowding out of entrepreneurship by real estate speculation, the under-reported story is the employment side. The Canadian financial services sector, which heavily services real estate, has ballooned to record highs especially after Covid-19. Private sector employees who work in Construction & Financial Services, Insurance, Real Estate (aka F.I.R.E) comprise over 20% of private payrolls, a widening gap with the US. Even as the private sector is struggling to grow in the face of a ballooning public sector, we are seeing private payrolls expanding in the most economically sensitive areas. This leaves Canadian employment vulnerable to the swoons of our housing market as any real estate market shock is not just a wealth effect headwind, but also an employment income one.



Source: Macquarie Research

The most unnerving part of sharing this analysis is we are looking at the data during a strong global economic backdrop. In a recessionary scenario, the current structural issues Canada is wrestling with are going to get significantly worse. I remain hopeful that we talk about these sources of economic vulnerability early and honestly before a recession raises the temperature and fosters an environment for stop-gap short-term solutions that fail to tackle the core issues.

Our Future Opportunities:

Tapping Our Resource Abundance: Canada is uniquely positioned as a resource superpower in the western hemisphere. Our reserves across a wide cross-section of mission critical commodities spans oil, natural gas, nickel, copper, uranium, potash, farmland, timber, fisheries, hydro power generation and so much more. We can and should be the "Saudi Arabia" of not just oil, but a broad base of commodities that modern nations need to build next generation technologies and manufacturing. There are no EV's without nickel and no low-cost power sources for data centers without abundant uranium supply. We have it all with strong governance and environmental regulations to ensure their sustainability.

Leveraging Our Trade Agreements: Canada is positioned geographically right next to the largest economy and the wealthiest consumer base in the world. Even better than proximity, there is a long-standing trading relationship that has been re-enforced and enshrined through the NAFTA I & II agreements that enable a free trade zone that is the largest in the world. This is a principal advantage Canada enjoys along with Mexico, there is no friendlier partner with the US than Canada. Accessing the US market across different industries is critical in achieving global scale as successful Canadian companies that have expanded to the US are scaling a pool of demand that is over 10x greater and without the economic protectionism that usually limits geographic expansion. Shopify is a perfect example of this scaling advantage: Canada is only 6% of their revenue while the US is 66%. Despite this disparity, Shopify has 6,000 employees in Canada and 8,900 employees in the US. That's a pretty good deal for Canada, in my view.

Retaining Our People: Every year, Canada is losing a sliver of its population to the US and acutely so in the highest paying and most technologically advanced industries as students earning degrees in Canadas and looking for a better opportunity down south. To put a finer point on the issue, we are losing a staggering two thirds of our computer engineering and computer science graduates to the US. To put it bluntly, if you are in the IT industry or healthcare industry, the choice is obvious. This data can also be seen through the prism of NATFA TN visas which are roughly similar despite the US having a population nearly 10x our own. The skilled worker balances at roughly 30,000 - 40,000 Canadians in the US and roughly 43,000 Americans in Canada, a roughly equal number largely due to the relative lack of high skill employment opportunities here in Canada. We cannot deepen or raise the quality of our employment pool if we don't encourage entrepreneurs to create cutting edge businesses right here at home. Tobi at Shopify chose to keep the company based in Canada when Silicon Valley was a natural destination for their venture. We need so many more stories like this to foster an ecosystem that works to create cutting edge jobs and grows the economic pie for everyone to share.

Canada walks onto the global stage endowed with advantages that are the envy of the world. We are a slumbering superpower. It's a long journey to get there, but we need to get serious about taking the first steps. Tobi is right to point out our structural fragility today, but we don't need to make that tomorrows reality.

Sincerely,

A Passionate Canadian Citizen

When Goliath Wins

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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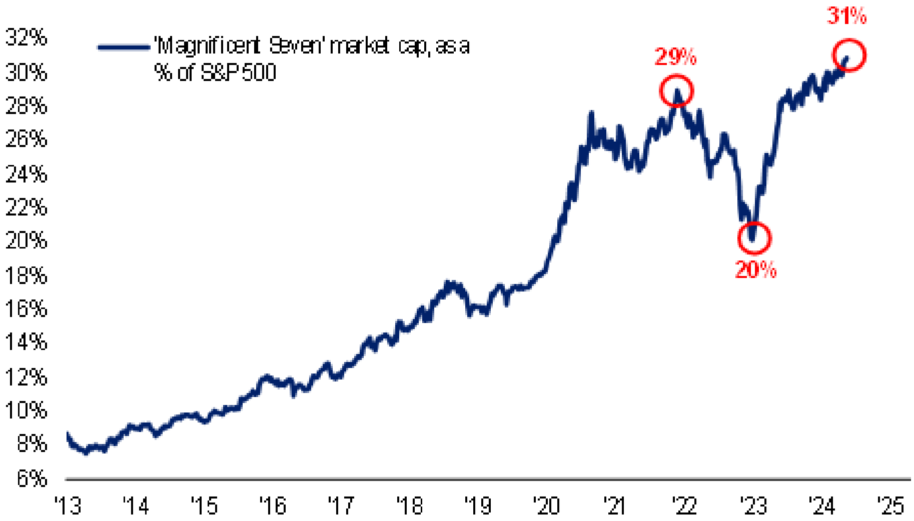
The most recent strong results by Nvidia, along with the overall impressive performance of the Magnificent 7 throughout earnings season, have marked a new high point for market concentration. The Mag 7 now represent 31% of the entire US stock market's value, a notable growth over the past decade when they made up only 8%. This is not a new phenomenon for most markets. In fact, it's quite common in most parts of the world, and until recently, the US was an exception. Take Canada, for example, where the "Big Five" banks have consistently accounted for a similar percentage of the TSX Index for many years.

Chart 3: Magnificent 7 account for 31% of S&P 500 market cap
"Magnificent 7" market cap, as a % of S&P 500



Source: BofA Global Investment Strategy, Bloomberg. Magnificent 7 = Apple, Amazon, Google, Meta, Microsoft, Nvidia, and Tesla

BofA GLOBAL RESEARCH

Source: BofA Research

However, one might wonder, what is driving this trend?

Natural Market Concentration: Many industries, particularly technology-focused ones, have been experiencing a continuous consolidation of market share by larger players. This can largely be attributed to the economic forces that push dominant, network-centric technology leaders (like Meta, Google, Apple, Microsoft) to monopolize their respective markets. Meanwhile, platforms that rely on massive global scale to offer cost-competitive products (Netflix, Amazon, Tesla) are under pressure to keep up with customers' high expectations for speed, quality, and service at competitive prices. For instance, it's far more efficient for Netflix to produce a single show for hundreds of millions of subscribers rather than spreading viewership across multiple shows for the same audience, illustrating the concept of economies of scale. However, this situation creates a paradox, especially for consumers and politicians, given the numerous anti-trust lawsuits and public criticisms leveled at these corporations. The alternatives – lower-quality products at higher short-term costs, eventually leading back to a quasi-monopoly or oligopoly structure – are far from ideal, as history has shown with AT&T.

The Price of Admission: A crucial factor often overlooked in today's discussion is the ever-rising cost of innovation. As leading tech firms invest in next-gen capabilities, the price of entry into these markets is soaring. It's becoming increasingly challenging, not to mention expensive, to build new semiconductors that require atomic-level engineering. These upstream value chain complexities drive prices up and make the subsequent investments in data centers or manufacturing facilities much more expensive than in the past. This leaves few players with the capacity, let alone the willingness, to enter or innovate within these markets when costs can climb into the billions or even tens of billions. Surprisingly, Google spends more on capital expenditures as a percentage of sales (16.1% this year) than General Electric did at its peak (12.3%). I would expect these costs will continue to rise, albeit it's unclear whether this will be a linear or exponential function.

Undoubtedly the current "Magnificent 7" label will change with time, evolving as the market narrative includes new companies and excludes others (much like FANG, FANG+BAT, MAGMA, BRICS). The critical point to note, however, is that we are transitioning into a market and economy that will increasingly concentrate as technology permeates more aspects of our already digital lives. In our search for investment opportunities, we consider both big and small, near and far, always letting the bottom-up fundamentals guide us.

Today, we witness numerous David vs. Goliath scenarios where the question isn't if Goliath will win, but rather when.

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BMO & RBC: A Financial Splitsville Story

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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Overall, this wasn't an exciting earnings season for Canadian banks, but delving deeper, there were important lessons to be learned. Once again, it's clear that in personal and commercial banking, investing and growing market share locally outshines international expansion. This was particularly evident in RBC and BMO's results this week.

So, what did we learn?

BMO’s Setbacks: BMO, after many years as a mid-sized regional bank in the US, decided to shake things up with a massive $21 billion acquisition of Bank Of The West. Unfortunately, the timing was off, coming right after the collapse of Silicon Valley Bank. This put the deal down in history as one of the worst-timed in modern Canadian history. While timing is partially excusable, I believe it's crucial to scrutinize the rationale behind the transaction itself. BMO Harris, primarily Midwestern, was attempting to become a bicoastal super-regional bank through this major transaction. BMO ended up paying an excessive premium of 1.57x Book Value and 11x all-in synergized P/E. Despite its promised cost synergies and nearly doubling the size of the US portfolio, the Return on Equity (ROE) of BMO US plummeted from an average of 17.4% to a meager 6.5%. Unsurprisingly, net income to shareholders remained basically flat, which is notably lower than any period in 2022 prior to the acquisition. BMO could have used their excess capital to buy back about 13-18% of their outstanding shares, avoiding this convoluted situation.

RBC’s Success: In contrast, RBC flourished with its acquisition of HSBC Canada a year later, one of the last strategic assets in the domestic banking landscape. Despite stiffer competition, RBC's all-in synergy P/E for the deal was a more modest 9.4x. With one month of consolidated HSBC Canada results, we can see promising early momentum. Management informed of a progressing synergy program and announced a buyback program to offset equity dilution that resulted from pre-funding the HSBC deal. To me, RBC's strategic plan seems more plausible; after all, Canada is their home turf and HSBC's customers certainly don't need to be introduced to RBC. This reduces the risk associated with complex integration and allows RBC to reach its 27% return on marginal equity goal. While it's still early days I’ll jump the gun and say, bravo RBC!

Appreciating capital allocation decisions by management is a crucial yet often overlooked element of our research. It's rare to see two similarly-sized decisions contrast so starkly concerning the future direction of a stock. Even as Canada may be entering a credit cycle, the message is clear for Canadian banks: If you’re Made In Canada, keep it simple and stay in Canada.

Have a great weekend!

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