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RESEARCH HenryFund.Org

Retail Coffee Market

Consumer Discretionary

February 7, 2020

Industry Rating **Overweight**

Investment Thesis

We recommend being overweight in the retail coffee industry over the next year. The shift in consumer preference towards specialty coffee beverages, as well as the continued increase in per capita coffee consumption will continue to grow annual revenues in the industry for the coming years. As consumer increase their caffeine intake while preferring coffee as their preferred caffeinated beverage, we believe the industry will continue its strong performance with major players continuing to take market share.

Drivers of Thesis

- The retail coffee industry has seen revenue increase by around 4% over the past five years. We forecast that the retail coffee industry will continue growing around 2% which provide opportunities for industry players to grow their bottom line
- Consumer preferences have shifted towards higher-end specialty coffee beverages which retailers have higher margins on individual sales. We forecast this trend to continue especially with the younger generation favoring specialty coffee
- We believe that on-premise coffee consumption will continue to gain traction as less people are drinking coffee at home. This will drive revenue growth for coffee shops and ready to drink coffee products which have higher margins

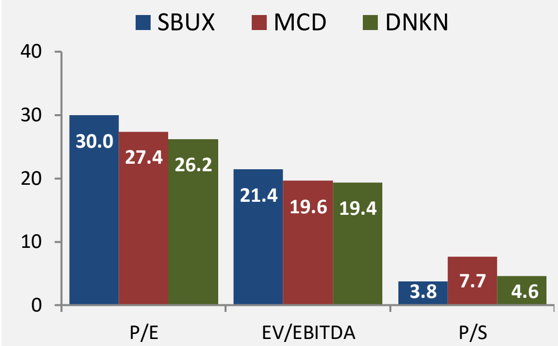
Risks to Thesis

- We expect positive industry revenue growth to continue in the coming years. However, growth has begun to slow the last three years and it could be reaching its peak and industry revenue will be lower than our projection of 2% growth the next 5 years
- Lower consumer confidence and economic stability will push customers away from specialty higher-end coffee and back to regular drip coffee and will dent revenue growth

Key Statistics

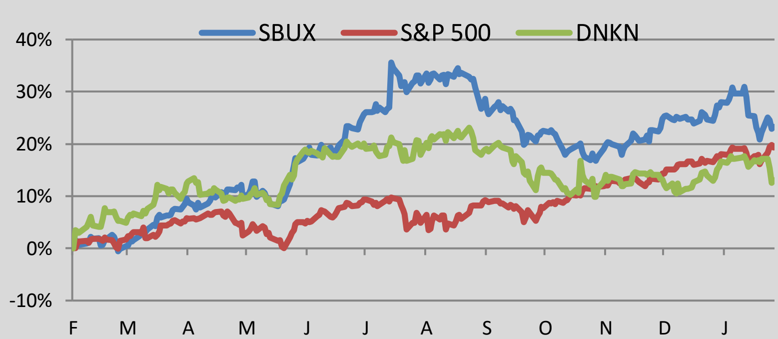
Market Cap.	**(In Billions)**
McDonalds Corp.	$161.51
Starbucks Corp.	$102.71
Keurig Dr. Pepper	$37.43
Monster Energy	$32.32
Luckin Coffee	$9.61
Dunkin Brands Inc.	$6.30

2019 Revenue	**(In Millions)**
McDonalds Corp.	$21,077.0
Starbucks Corp.	$26,509.0
Keurig Dr. Pepper	$11,120.0
Monster Beverage	$4,282.2
Luckin Coffee	$125.3
Dunkin Brands Inc.	$1,307.0



Source: FactSet & Company 10K's

12 Month Performance



Source: Yahoo Finance Historical

Industry Description

Companies that operate in the retail market for coffee are the sellers of coffee. The market includes on-premises and off-premises coffee consumption including both hot and iced coffee, instant and regular coffee beans and other formats. Players within the industry include sellers from all major retail channels of coffee products sold to final consumers. Overall, the retail coffee market is highly fragmented as it is comprised of many retailers and restaurants which include; grocery stores, coffee shops, fast-food chains and convenient stores.

EXECUTIVE SUMMARY

Overall, the retail market for coffee has experienced relatively strong growth over the past five years. We believe this trend will continue as coffee sales increase with GDP as consumers continue purchasing more coffee overall. For these reasons, we recommend an **OVERWEIGHT** position in the retail coffee market in the coming year. We believe that firms that offer specialty coffee products, like Starbucks, are best positioned for changing consumer demand in the coffee industry, as well as the beverage industry as a whole.

With a growing industry, there is plenty of opportunity for retail coffee players to continue increasing their bottom-line growth and take market share from other direct competitors as well as other beverage alternatives. However, it is critical for firms to stay on top of consumer trends and continue to innovate new products and coffee blends. With coffee being a consumer staple in America, and the younger generation of coffee drinkers continues demanding more premium quality coffee options, Starbucks is best positioned in the industry. If companies are able to continue do so, we believe that major players in the industry will be able to increase margins and outperform the broader market in coming years.

INDUSTRY OVERVIEW

The retail coffee market has changed dramatically over the past decade with individuals now choosing coffee as their caffeinated beverage of choice as well as consumers shifting towards more expensive specialty coffee beverages as there first choice.

Coffee has long been a soft commodity grown from a plant in many subtropical and tropical climates that humans consume on a regular basis. Its caffeinated effects and distinct taste have made it become one of the most popular beverages in the world, with more than 400 billion cups consumed each year. In 2019, 57 percent of American adults reported that they drank coffee on a daily basis. This number has continued to rise in the past five years largely driven by an increase in per capita coffee consumption. During this time period, per capita coffee consumption has risen at an annualized rate of 1.1 percent since 2014. With an increase in total coffee consumption as well as a market shift of consumers towards higher-end and higher-margin coffee options, the industries revenues have expanded with major higher-end companies like Starbucks, exceeding industry averages.

Retailers in the industry have started to push towards adding high-quality Arabic based coffee beans and single-origin options, which have allowed retailers to markup their prices to their customers. Although the retailers have struggled with slower demand in plain coffee options, strong demand in cold brew and nitro coffee beverages have helped offset this and increase overall coffee demand. Having higher demand for these more personal and specialized coffee options have substantially benefited retailers being able to raise their price point in contrast to regular coffee.

As the industry begins to trend towards more and more specialized coffee, we believe that the industry will continue its push towards more personalized, customer specific options and continue benefiting the high-end retail coffee players like Starbucks Corporation who offer these specialty coffees. We believe this era represents a new emerging coffee beverage segment in personalization that industry players will need to capitalize on if they want to continue taking market share.

However, consumers have also started to increase use of more instant coffee options such as K-Cups. Coffee sales from grocery and marketplace retailers have grown in recent years due to the increased demand for these packaged coffee sachets. This specific consumer shift is largely due to customers wanting coffee fast and not having to wait. Players in the industry are able to benefit from this coffee segment. It represents an alternative revenue stream and is evidenced by both the increased demand of instant coffee cups as well as Starbucks ready-brew coffee.

Revenue Growth

Overall, the industry has grown at an annualized rate of 4 percent the last five years to reach $46,5 billion in revenue which included an increase of 1.8 percent in 2019. The average industry profit margin also increased during the last five years to reach 7.7 percent of annual revenue in 2019. Over the next 5 years, we expect revenue reach over $50 billion. The chart below shows the historical revenue growth in the industry.

Year	Growth %	Revenue $ millions
2005	0.0	23,442.9
2006	8.3	25,399.9
2007	8.6	27,572.9
2008	4.6	28,848.3
2009	1.2	29,206.2
2010	6.8	31,196.6
2011	7.7	33,591.5
2012	4.2	35,006.1
2013	1.4	35,511.2
2014	7.9	38,319.8
2015	8.8	41,708.5
2016	6.3	44,347.1
2017	1.2	44,865.9
2018	1.8	45,685.6
2019	1.8	46,519.5

Source: IBIS World

In the next five-year period, we also expect coffee bean prices to rise at an annual rate of around 1 percent. This will enable coffee retailers to continue raising their prices and increasing their margins in the future.

RECENT DEVELOPMENTS

2019 NCA: Coffee Trend Report Analysis

Over the past year in 2019, total coffee consumption in the US has remained relatively flat [3]. However, this trend has continued while more Americans are regularly drinking specialty, gourmet coffee instead of regular coffee. Specifically, in 2019, for the first time in the NCDT's history, specialty coffee reached a 60/40 advantage over traditional non-specialty coffee among past day drinkers[3].

As the industry begins to trend towards more and more specialized coffee, we believe that the industry will continue its push towards more personalized, customer specific options and continue benefiting the high-end retail coffee players like Starbucks Corporation who offer these specialty coffees. We believe this era represents a new emerging coffee beverage segment in personalization that industry players will need to capitalize on if they want to continue taking market share.

Past-Day Coffee Consumption

With relatively slow total coffee consumption growth, the number of people who reported drinking coffee the past day was 63 percent, which is an increase of 6 percent from the 57 percent mark in 2016 [3]. The study showed that people over the age of 60 had the strongest past-day consumption at 72 percent, while the youngest population (18-24 years) reported the lowest percent at 47 [3]. Traditional coffee past-day consumption showed a small decrease of 1 percent down to only 15 percent now[3]. Since 2012, traditional regular coffee has seen a 7 percent decrease in past-day consumption, while espresso-based drinks have risen over 10 percent in that same period [3]. Interestingly, African Americans had one of the largest increases in 2019 with past-day consumption of specialty coffee increasing 7 percent up to 40 percent in 2019 [3]. We see this as a positive for future growth in the industry as the African American population have in the past typically strayed away from more specialized coffee[3].

Where Coffee is Prepared

In order to carefully analyze the coffee industry, it is important to understand where the majority of consumers are having and making their coffee. Recent trends have shown that consumers have begun to consume more coffee away from their homes and purchasing it at retail coffee shops and stores. In 2012, 84 percent of people said they drank coffee the day before prepared at their home [3]. The number decreased to 78 percent in 2019 [3].

CBD Coffee

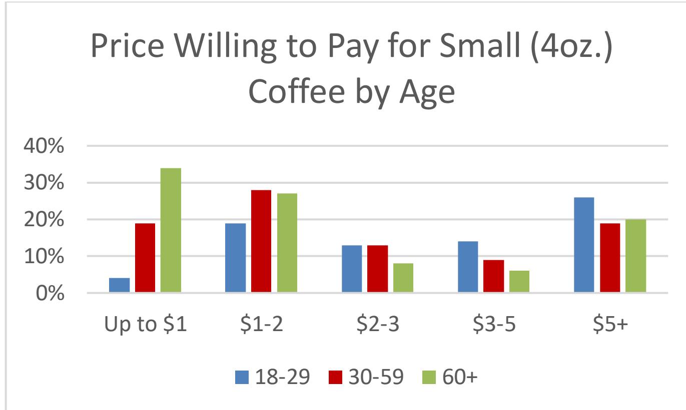
New this past year is the introduction of CBD (or cannabidiol) in coffee products. With recent regulations legalizing CBD, as well as marijuana in certain states, both CBD and cannabis have become very popular for health and wellness with the hype around the products increasing rapidly. Combine this trend with consumers' growing appetite for customizing their coffees, companies have been capitalizing on the trend and products infused with CBD and cannabis have come to the market. However, there is still large amount of skepticism in the industry due to its new nature and the lack of understanding and regulation at this point [5]. In 2019, the NCA study added questions regarding CBD to their survey. The study showed that 62 percent of Americans were aware of CBD as a new ingredient to their coffees with the youngest age group (18-24 years old) being the least aware of the substance [3]. However, this age group, along with 25-39-year old's, were most likely to try it. This demonstrates that the younger generation is more interested in CBD infused coffee and why we believe this might be an important trend for retail coffee companies to take advantage of and grow their bottom line [5].

INDUSTRY TRENDS

Target Market

Starbucks targets customers who value quality coffee. This differs from many of the top competitors who target the value coffee market as opposed to higher end coffee types. On top of products, Starbucks has stayed up to date on leading edge technology including mobile online ordering through their applications, as well as Uber Eats.

Overall, we believe that Starbucks true target market is on consumers of the millennial age and Gen Z age which positions them best due to their quality product positioning. The following chart outlines the prices that people are willing to pay for a small cup of coffee by age group.



Source: Statistica

As you can see, the younger generation, specifically the 18-29 age group was very willing to pay over $5 for a small cup of coffee. Compared to the younger generation, the 60+ age just wants to pay $1 for a cup of coffee. In general, this demonstrates that the older generations do not see value in premium coffee, but the younger generation does. We believe this signals the changing consumer preferences and demonstrates how to retail coffee industry is positioned to continue adapting to more specialty coffee. This preference of younger consumers to pay more for specialty coffee will help Starbucks to increase their operating margins going forward.

Immediate Consumption Trends

Over the past five years, coffee retail like coffee shops and others distribution channels that sell coffee for immediate consumption have fared well as coffee has become the caffeinated drink of choice for many Americans [7]. The number of restaurants and shops distributing coffee in their product offerings has also increased [2]. Growth in the number of retail distribution channels has also helped the industry grow, however, more traditional distribution channels, such as coffee shops have been the primary area of growth within the immediate consumption revenue channel [2].

The two main drivers of growth for coffee shops come from the shift towards specialty coffee beans and blends and also the growing demand of espresso drinks, cold brews and nitro coffees [2]. Coffee shops have been able to develop strong customer loyalty by providing a plethora of different specialty coffee products to their customers. Such specialty beans sourced specifically from global based coffee bean plantations are purchased at a higher price and thus retailers are able to purchase a premium for specialty coffees [2]. This consumer shift has grown the industries revenue and increased margins.

As mentioned in the NCA, specialty coffee drinks have risen significantly in the last few years with greater than 35 percent of people drinking more specialty coffee when compared to 2016 [3]. On the opposite side of the spectrum, regular coffee has made up a shrinking portion of overall industry revenue. Specifically, specialized coffee like single-origin, premium cold brews, nitro coffees and Arabica blends have all increased significantly while regular coffee has begun to fall off the tracks [2].

Retail Distribution Trends

As for off-premise consumption, like grocery stores and supermarkets, the increase in demand for single-cup coffee formats has helped stimulate revenue in the industry [2]. The NCA stated that 41 percent of coffee drinkers have a single-cup brewer, like a Keurig machine. This number has dramatically increased since 2015 when on 10 percent of coffee drinkers owned a single-cup brewer [3]. Due to the consumers shift away from regular, drip-brew coffee, the industry has been able to benefit from the more expensive nature of coffee in K-Cup packaging in which retailers have a higher margin [3]. However, we believe that this industry trend has overall hurt major coffee retail shops like Starbucks overall. This is due to the fact that K-Cups are an alternative to going and getting your coffee in a shop. Although brands like Starbucks have still benefited from developing their own K-Cup flavors, the alternative revenue channel has taken industry share away from other coffee consumption methods.

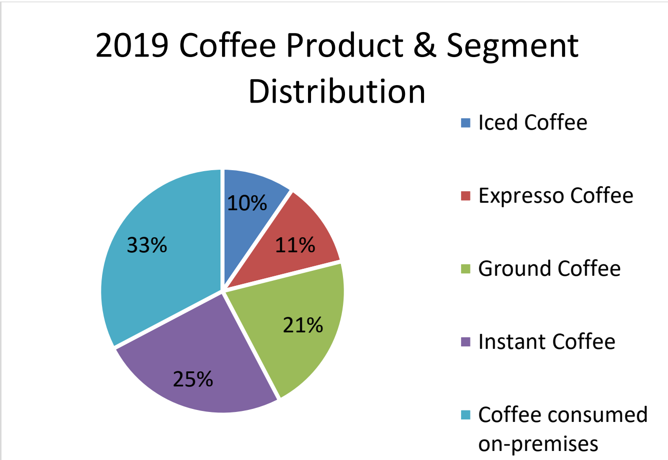
The retail distribution segment of the industry has also benefited from the increase in popularity in instant coffee, which have become increasingly more specialized and gourmet [2]. Starbucks has demonstrated this new trend popularity through their instant-brew coffee, which, in past years, has been a low-cost option for consumers, is becoming increasingly more high quality and offered in numerous different flavors and blends to attract customers [1]. Overall, this exemplifies the trend of time-strapped individuals' preference to consume more specialty coffee in numerous flavors, over regular drip coffee. This trend has allowed coffee retailers, like Starbucks, to develop a market niche by selling coffee in various flavors, blends and varieties. By doing so Starbucks is able to increase their market share within not only the coffee industry but also the beverage industry and charge the high premiums for their products while not losing out on customer demand.

The emergence of single serve instant coffee cups has also begun to shape the industry in the past five years [2]. Coffee made for single-cup brewing accounted for more than a quarter of every dollar that consumers spend for single cup at-home consumption [2]. The major player in the industry, Starbucks, has been able to account for a large portion of the single-serve market with their different Starbucks K-Cup coffee flavors. Starbucks has been able to market its brand and also increase their revenue channels through distributing their K-Cup flavors in single-cup formats. These versions of coffee are more expensive than regular drip coffee due and thus coffee retails have benefited from higher margins through these sales. Overall, the industry has shown relatively strong and stable revenue growth as consumers start valuing coffee quality and have shifted from purchasing regular coffee in larger bulk.

Changing Retail Coffee Distribution Structure

With consumers starting to choose coffee as their caffeinated beverage of choice, retail stores like convenience stores, supermarkets and general retail stores have all started incorporating more coffee into their product strategies, which has boosted the number of retail coffee industry operators [2]. These retail distributors have also begun increasing the number of specialty coffee beverages into their product portfolios to appeal to the increasing demand from consumers.

Retail Coffee Products and Segments



Source: IBIS World

Within the retail coffee market products are divided into five main segments by product and consumption location. As mentioned, consumer preferences have changed. The pie chart above demonstrates the revenue breakdown by product and segment for 2019. As we can see, coffee consumed on-premise had the highest percentage of industry revenue, while iced coffee represented the lowest percentage but one of the fastest growing products in the retail coffee industry.

MARKETS AND COMPETITION

Threat of New Entrants

The barriers to enter the retail coffee industry are relatively low and thus the threat of new entrants is moderate. Although coffee retailers need to have the necessary facilities, equipment, furniture and employees, retailers are able to lease this equipment and lower their initial costs and outflows in order to be operational [2]. With moderate concentration and saturation within, the top three players having less than 45% of industry revenue, potential entrants have a relatively easy opportunity to enter a local market and cater to a specific niche in the industry [2]. However, it is very difficult for new entrants to grow their brand large enough to be truly global brands like Starbucks. On top of this, the possibility of being successful even at a local level remains low to moderate as retailers have a tough time competing against major players. Only a selected number of firms have been able to successfully grow their retail coffee brands large scale like Starbucks and Dunkin. Another threat of new entrants in the retail coffee industry comes from franchisees which allow operators to open new stores and secure resources like equipment, training and computer systems through the franchise [2]. Expanding franchise brands will continue to put pressure on other players in the industry as firms compete for market share.

Threat of Substitutes

The number of substitute products is high. The coffee industry does have a threat from external operators and products with the main ones including energy drinks, tea, and other beverage substitutes like soda. Additionally, the coffee industry is susceptible to changes in health and wellness surrounding the effects of caffeine and caffeinated beverages. Thus, the industry is subject to changes in consumer attitudes surrounding caffeine and could pose a threat to the coffee and caffeine market [2]. On the other hand, the coffee industry's major external threat comes from the growth in the energy drink industry. Major companies like Red Bull and Monster pose great risks as both beverages are highly marketed through their caffeine levels and effects which attract consumers. Specifically, energy drinks offer higher contents of caffeine which has drawn in customers away from their regular coffee drinks.

Bargaining Power of Buyers

The bargaining power of customers in the retail coffee industry is moderately low. Due to the small size of individual purchases, single buyers do not hold influence on prices. However, in an industry so highly competitive, industry players must be price sensitive in relation to their competition as there are multiple other retailers' consumers can switch and purchase from. However, customers in the coffee industry have shifted to be more quality sensitive and thus willing to pay higher prices for premium coffee products [2].

Overall, price levels are set by consumer demand and competition within the industry.

Bargaining Power of Suppliers

The power of suppliers in the retail coffee industry are relatively low. However, with the extensive growth in the specialty coffee industry, supplier bargaining power has changed in numerous ways. Currently, many of the farmers who sell to Starbucks and other premium coffee chains are united by an initiative known as fair trade certified coffee. This initiative was designed to ensure that the coffee farmers would be compensated fairly for their crops. Their increase in unity of coffee suppliers under the initiative has worked as a positive externality for suppliers by increasing their ability to exert bargaining power over their buyers [2]. However, overall suppliers have relatively low bargaining power due to the abundance of coffee suppliers to choose from. However, as the industry trends to more specialized quality coffee, suppliers have a little more power in their prices.

Rivalry Among Existing Competition

Concentration of companies within the retail coffee market is medium. The market is highly fragmented with numerous different coffee shops, restaurants, grocery stores, supermarkets and gas stations that offer different types of retail coffee products. In 2019, 45 percent of the annual industry revenue is concentrated within the top three coffee retailers [2]. However, outside of the top three industry players, there are nearly 500,000 different industry establishments throughout the United States that offer coffee products [2]. This has enabled many smaller, independent coffee retailers to operate in a niche market by attracting customers through the basis of convenience and being local. Also, the retail coffee industry has an abundance of different kinds of coffee products including freshly brewed, ready to drink, instant coffee and single-cup coffee and coffee beans and grounds which all pose competition among each other on which specific products experience the highest demand and margins.

PEER COMPARISIONS

Due to the highly competitive nature of the retail coffee industry, there are only a couple major players that make up a significant amount of market share in the industry. The following section will analyze the three major players within the industry which include Starbucks, Dunkin Brands and McDonalds.

Starbucks (SBUX)

Starbucks is the industry leader. They currently have the largest portion of market share at 30.5 percent. Starbucks was founded in 1985 and roasts, markets and retails coffee and specialty coffee. The company has a global presence, operating in over 78 countries and over 31,000 locations. The company sells coffee, tea, other beverages and food items through its company-operated stores as well as alternative channels like licensed stores, convenient stores and grocery stores. In order to control quality, Starbucks is involved in several stages of their coffee production including purchasing, roasting, packaging and distributing to its locations. Starbucks has also begun offering free WIFI access and wireless charging locations for its customers in its stores. This has helped Starbucks increase store traffic as well as the number of potential purchases by offering these upscale amenities for a coffee shop.

	Domestic Stores	International Stores	Total Stores
2019	15,041	16,215	31,256

Source: FactSet

Compared to competitors, Starbucks has a very equal distribution of store locations both domestically and internationally. As the retail coffee market in the U.S. is very mature compared to emerging markets, we believe that Starbucks may begin to cannibalize their sales with new domestic store openings, and thus why we believe the international store count will continue to increase as Starbucks makes a large push into Asia.

Dunkin Brand (DNKN)

Dunkin is Starbucks largest competitor in the market. Dunkin currently has 11.5 percent of market share within the industry, which is second behind Starbucks. Dunkin Donuts was founded in 1950 and operates as a subsidiary of Dunkin Brands. The company retails coffee and baked goods and has a presence in over 60 countries and distributes to around 21,000 points worldwide. Industry-relevant revenue was derived from both franchisee-owned and company-owned coffee sales. However, in 2017, the company transitioned to be a 100 percent franchised business model.

	Domestic Stores	International Stores	Total Stores
2019	11,969	8,943	20,912

Source: FactSet

As we can see above, Dunkin has less prevalence in the number of total stores compared to Starbucks. Specifically, Dunkin has a much smaller count of stores in international locations compared to Starbucks. This could represent a possible growth strategy for the company to better compete with Starbucks on a global scale.

Dunkin competes within the retail coffee industry much differently from Starbucks. Starbucks markets itself as a higher end coffee brand that appeals to customers who are willing to pay a premium for quality coffee. Dunkin on the other hand, competes on the other side of the spectrum. Specifically, Dunkin markets itself as a low price for quality coffee shop.

McDonalds (MCD)

McDonalds is a very different type of player in the retail coffee market than Starbucks. McDonalds recently transitioned to their McCafe business model as the company begins to target more of the coffee market. However, Starbucks is not necessary known for their coffee products. Thus, McDonalds is targeting consumer much like Dunkin is by catering to the modest quality at a lower price point. When comparing Starbucks to other major players in the retail coffee market, it is important to realize that coffee is not the main focus of McDonalds. Rather so, the company has made a push to enter into the market and due to its global brand name, poses threat to current market players. As shown below, McDonalds currently has over 38,000 store locations worldwide.

	Domestic Stores	International Stores	Total Stores
2019	13,846	24,849	38,695

Source: FactSet

Compared to Starbucks and Dunkin, McDonalds has a much greater international presence in store location with nearly 25,000. As we can see from the tables, the three main players in the industry all have a relatively similar number of domestic store locations within the 11,000 to 15,000 store range. However, the biggest difference among retail coffee industry players comes from the international exposure that each company has.

Overall, among the major players Starbucks is the clear leader in the industry with Dunking being the closest competitor. Both companies operate in similar way and have relatively similar product offerings, however, Dunkin markets itself from its lower price in which they attract customers through a value approach rather than that of specialty. However, Dunking has struggled with the bottom-line growth, especially compared with Starbucks in the recent five years. Dunkin's domestic store locations have not experienced more than 2% same store sales growth since 2015 while Starbucks has increase substantially more.

Margin Comparisons

Starbucks has significantly lower margin than its peers across the board. As seen below, Starbucks has a gross margin of 21.9% compared to Dunkin and McDonald's who both have gross margins around 50%.

	Gross Margin	EBIT Margin	Net Margin
Starbucks	21.9%	15.1%	13.8%
Dunkin' Brands Group	49.0%	31.6%	17.7%
McDonald's	52.7%	42.2%	28.6%

Source: FactSet

However, after analysis we were not surprised to see this in Starbucks operating margins. Starbucks has a significantly lower percent of licensed stores compared to its peers. This explains the margin differences because a company with more licensed stores has higher margins, but lower total revenue.

	Licensed	Company Operated
Starbucks	48%	52%
Dunkin' Brands Group	100%	0%
McDonald's	94%	6%

Source: FactSet

As seen in the chart above, Starbucks has only 48% of licensed stores. Dunkin on the other hand operates on a 100% licensed store business model. McDonalds also has a very high percentage of Licensed stores at 94%.

INDUSTRY ECONOMIC DRIVERS

The key economic drivers that fuel coffee spending stem from per capita coffee consumption, demand from supermarkets and grocery stores, the price of coffee and per capita disposable income.

Per Capita Coffee Consumption

The industry has seen steady growth in per capita coffee consumption over the past decade [2]. However, growth in per capita coffee consumption has been slightly constrained over the past five years due to consumers favoring more gourmet specialty coffee. As consumers have moved towards this specialty coffee which sells at higher prices, consumers purchase smaller amounts due to the higher price points [9]. This has slowed the overall coffee consumption the past five years as seen in per capita coffee consumption [8]. However, this shift in consumer preference has benefited the industry from more consumers purchasing the higher margin coffee. We predict this trend of increasing per capita coffee consumption to continue in the future which represents an opportunity for the industry as consumers continue to shift towards coffee as their caffeinated beverage of choice.

Demand from Supermarkets and Grocery Stores

Overall demand for coffee from supermarkets and grocery stores are a key factor affecting the retail coffee market due to the largest overall quantity of retail coffee demand coming from these distribution channels [2]. Specifically, supermarkets and grocery stores are the key channel for customers to purchase their at-home coffee products. These retail distributors offer coffee beans and grounds, single-cup brewer coffee as well as instant coffee. As demand in single-cup and instant coffee have grown, we expect demand from supermarkets and grocery stores to continue to increase, possibly taking relatively small market share away from retail coffee shops.

World Price of Coffee Beans

As a key commodity in the retail coffee industry, coffee bean prices are very important in determining industry operators' operational costs and profitability. As the price of coffee beans rises, retailers are typically forced to increase their prices as well [2]. However, due to an abundance of competition in the industry, this can severely hurt retailers' overall sales. Typically, coffee bean prices have shown price volatility die to fluctuations in harvesting from global coffee plantations [9]. Market expectations believe that coffee prices will rise slightly in the future which will hurt retailers' margins if they are not able to raise their own prices to consumers [2].

Per Capita Disposable Income

Due to coffee being a consumption good for humans, per capita disposable income is a key component in determining coffee demand. As per capita disposable income rises, consumers switch to higher quality coffee options [2]. Per capita disposable income has risen slightly over the past five years in the same time period we have seen consumers switch to these higher quality options. We see this positive trend continuing in the future with expectations of increases in per capita disposable income in the next few years.

CATALYSTS FOR GROWTH

Going forward we see a large importance for retail coffee players to continue innovating new products. With consumer trends changing often, companies must be able to clearly identify what types of coffee products consumers will be demanding in the future. With the increased push towards more personalized coffee beverages, we believe it is imperative that coffee distributors begin offering the personalization that customers want if they want to continue growing sales. The days of plain old regular coffee seem to be behind us.

As competition continues to be fierce within the industry, we see a large catalyst for growth through brand loyalty rewards programs. With a large emphasis on same store sales growth in the industry, repeat customers are key to being successful in the industry. Companies that offer rewards programs are able to capture more customer loyalty and increase the incentive for customers to visit their stores and make purchases. We believe that rewards programs will continue to be a major aspect to capturing more sales in the future and something firms we need to continue adapting in order to stay successful.

As the retail coffee market in the United States is in a very mature stage and highly concentrated, we believe the largest opportunity for growth is in Asian and emerging markets. We suspect this will continue to be a key growth area in the future for global brands to continue expanding.

INVESTMENT POSITIVES

- Growth in per capita coffee consumption continues to increase
- Annual coffee revenue has been increasing steadily for over the past decade
- Consumer have started to shift towards higher-end specialty coffee beverages which have increased margins
- Coffee is consumer durable and is the caffeinated beverage of choice among Americans

INVESTMENT NEGATIVES

- In the event of an economic downturn, consumers may switch to lower quality, cheaper coffee options which will reduce margins
- A rise in instant coffee cups, such as Keurig, have dented demand for coffee shops and harmed profitability through lower margins
- Worries of Coronavirus could cause stores to close and reduce consumers spending at on-premise consumption coffee shops

ECONOMIC ANALYSIS

Real Gross Domestic Product (GDP)

Positive economic growth will continue to drive consumer spending in the global economy as well as the consumer sector. Real GDP is the most important indicator of the U.S. economy by providing a holistic view of the health of the economy, taking into account inflation and deflation. Personal consumption expenditures account for 68% of the share of GDP[10]. As a retail company, Starbucks revenue is largely driven by consumer spending and positive economic growth. The US economy grew by 2.3% in 2019 which was driven by consumer consumption and business investment. With current scares due to Corona virus, we expect slower global growth in the coming years, we expect growth rates to hover around the 2% in the coming years. We estimate growth to stay steady around this level for the next four years, before increasing slightly to the most recent five-year GDP average of 2.3% in the long run.

Consumer Confidence

The Consumer Confidence Index (CCI) is a predictive indicator of consumer spending and also measures the optimism of citizens in the United States. As mentioned, having a strong consumer is imperative for a company like Starbucks making consumer confidence a key economic indicator to examine. Recently, consumer confidence numbers have reached historically high levels despite the recent volatility in the market. Consumer Confidence was reported at 130.7 in February up from 130.4 in January of 2020[9]. We expect consumer confidence to decrease in the next 6 months as well as the next two years. In the next two years, we expect to see CCI steadily decline to down around 110.0 as consumers become more pessimistic regarding slowing global growth and an inverted yield curve.

Unemployment Rate

The Unemployment Rate is another overall indicator of the health of the economy. Though, it is more of a lagging indicator than a leading one. Low unemployment tends to lead to increased disposable income and a positive effect on consumer spending and confidence. Low levels of unemployment and increased disposable income are reflected in the high consumer confidence levels currently seen in the US economy. 2019 was a strong year for job growth which saw the unemployment rate drop to 3.6%[14]. The unemployment rate has showed steady declines over the last six years. These low levels of unemployment can be directly correlated with the strong consumer confidence we have seen. Specifically, low unemployment levels lead to increased consumer spending. We see this as a positive growth outlook for Starbucks and something that has been driving their growth in recent years. We believe that the rate is beginning to level out as it continues to approach extremely low levels. In the coming six months, we expect unemployment levels to increase slightly. In the next two to three years, we expect unemployment rates to increase slightly and hover around 4%, which is the estimated natural rate of unemployment for the United States[15].

KEYS TO MONITOR

We believe the key factors to monitor in the retail coffee industry are continual changes in consumer preferences as well as overall consumer confidence. Due to the fact that the retail coffee industry has largely benefited the last five years due to the increased demand of higher priced specialty coffee, we believe it is imperative that consumer confidence remains strong in order to the industry to continue to outperform. If there was a sudden shift in economic sentiment, we believe that the retail coffee industry, and specifically higher end coffee retailers like Starbucks, may be in danger as consumer will shift away from higher priced coffee and shift towards cheaper coffee options such as brewing their own coffee, or purchasing their coffee for cheaper coffee shops.

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