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Stupid Investment of the Week

Commentary: Starry hopes but few bucks from coffee giant

By Chuck Jaffe, MarketWatch
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BOSTON (MarketWatch) -- Optimists not only see the cup half-full, they see "buying opportunities" in seemingly every stock the market drives down.

Pessimists see the cup half-empty; the slightest hiccup is reason to bail before the bottom falls out.

Somewhere in the middle is a third cup where you can find a Stupid Investment of the Week. This time, it's a coffee cup filled with Starbucks blend.

Stupid Investment of the Week highlights concerns and conditions that make a security less than ideal for the average investor. It is written in the hope that pointing out foibles and fables in one issue will make problems easier to spot elsewhere. While obviously not a purchase recommendation, neither is the column intended to be an automatic sell signal, as there may be times when dumping a worrisome issue serves to compound the problem.

That's particularly true of Starbucks Corp. (SBUX) , which actually falls into the camp of stocks I typically love. It's a brand-name company with good margins, a healthy balance sheet and a solid history of growth, trading well-below historic highs and selling a product with steady demand.

To be sure, investors can make a case to buy Starbucks now. The issue is how long will it take for that investment to pay off. Most people don't buy a stock hoping it goes down or sideways, and there are enough questions about Starbucks so that even the optimists may be ground down before the market comes by with a refill.

Rich aroma

To see why, you need to first consider the positives about Starbucks.

The best-looking statistic to my eye is return on equity that reached almost 30% last year, which typically is the sign of a well-managed, efficiently run company. The shares are reasonably priced for a value investor, trading at about 20 times earnings. Having lost more than 40% in 2007 and another 15% so far this year, those positives give Starbucks the feel of a stock that might be poised for a turnaround.

Sales were up, but mostly because of new stores rather than same-store sales growth. That's a bit problematic because after 16 years of showing same-store sales growth of 5% or more, the company has decided to stop reporting comparable store activity. Management purportedly wants to stay focused on long-term growth and not have to worry about erratic same-store movements over the short term, but they don't get to have it both ways.

If "comps" were a big plus before and the company has stopped reporting them, that's not a good sign. I don't mind when a company stops giving earnings guidance -- as Starbucks also has done -- or certain other bits of information that might pull the focus off of long-term results, but making the change after so many good years just feels hinky.

Share buybacks have cheered investors, although the addition of some debt at the end of last year may balance out that positive.

Strange brew

Company founder Howard Schultz recently returned to the role of CEO and plans to focus the company back on its core business. It's hard to bet against him given his past success, but this is a different environment than the company faced in its early days. And while Starbucks unveiled a new "back-to-its roots" coffee just this week, it'll be awhile before anyone recognizes if the strategy actually adds to the bottom line.

Moreover, the economy's troubles have people questioning their spending. Dedicated coffee drinkers won't change brands until their personal situation becomes dire, but people who aren't so loyal may switch to a cheaper outlet, brew their own, or simply cut back. Spread over an entire economy -- and assuming it will be harder to lure customers to some of those newly opened stores -- there's got to be some impact that eventually trickles down to Starbucks' bottom line.

David Trainer, president of New Constructs, a Nashville, Tenn.-based independent research firm, says that current valuations on Starbucks stock "imply that the company will grow profits at 10% for the next 10 years. ... Top line revenues may grow -- if they are very lucky at 10% for 10 years -- but their profits will not come close."

Trainer cites five big concerns facing profit margins, starting with the competitive squeeze from competitors -- especially fast-food chains that have better distribution for the lines of premium coffee they've started serving. Starbucks also has to watch out for copy-cat competitors selling similar products, improved in-home coffee machines, declining consumer interest and saturation of the marketplace, all of which makes it harder to grow sales just by opening more stores.

Trainer is hardly alone in this view. Ken Shreve, markets desk anchor for Investor's Business Daily, notes that a lot of professional investors seem to be changing their tune on Starbucks. The fund has seen a decline in mutual-fund ownership for six straight quarters. At the end of 2007, 284 funds owned the stock, down from 430 at the start of the skid.

"The heavy decrease in mutual-fund ownership in recent quarters is a red flag," Shreve said. "You want to ride the coattails of big investors when they are starting to accumulate a meaningful position in a stock; you don't want to try to buy it when it's being sold. And right now, this stock is being sold."

In the end, Starbucks' stock has the taste of tepid dishwater more than hot java. Most investors, served such a thin concoction, will wish they'd put their money to work on a real buying opportunity rather than waiting around for a bounce.

Chuck Jaffe is a senior MarketWatch columnist. His work appears in dozens of U.S. newspapers.

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