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Analyst Article

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STARBUCKS AND STOCK PRICES

*e*Research is pleased to provide an article written by Edmond G. Eberts of RAPPORT Capital Formation Strategists Inc.

The theme of Mr. Eberts latest epistle is that CEOs must be mindful that the stock market has a long memory and that they should learn from and avoid the mistakes of the past. "It is crucial that senior executives make the right moves, or they risk being put into the penalty box until long after the game is over."

As Mr. Eberts says, "Investor confidence in the future would be greater if the shareholders had a respectable research analyst's report in hand and/or occasion to meet with the CEO and confrères."

"Although prudence and diligence are virtues, there is a high price to pay by investors and issuers alike by waiting for every last detail to fall into place before making a move. … This is especially true for companies lacking in research analyst sponsorship and news coverage, …"

We could not have said it better, Ed. So many times we have been told by companies that they do not want to initiate coverage until they have 'got the contract signed', or 'received the results of the current drill program', or 'issued their quarterly results', etc. Why would any investor buy shares of a company AFTER the news has been disseminated? They wouldn't; in fact, if the news is so good and the shares are up dramatically, they would probably be a seller. Investors want to know about a company and its prospects BEFORE the news is made public.

As Mr. Eberts says, "Although many individuals are willing to respond on short notice, institutional investors have a habit of being relatively cautious before reacting."

In his article, Mr. Eberts points out that Starbucks is an incredible marketing machine that "conjures and sells café romance to ever-growing hordes of people around the world, …" The company has a winning formula, and it exploits it effectively and continuously to achieve its boundless success. "Like Starbucks, CEOs should do whatever it takes to accelerate the process" of gaining investor confidence and satisfaction.

Mr. Eberts is interesting to read, thought-provoking, challenging, and always entertaining.

We hope you enjoy the article.

Bob Weir,
Director of Research

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Starbucks and Stock Prices

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Starbucks and Stock Prices

The stock market reflects the opinions of millions upon millions of investors, large and small. It has a very long memory and seldom lets a crook off the hook. Without the knowledge of someone who has seen it all before, the mistakes of the past are bound to be repeated in the future, at great expense to the CEO at the podium and the investors in the audience. Whereas opinion polls may direct democracies and are often used to determine economic policy, they are not able to forecast the future. They can only tell politicians what voters thought in the past and what turns them on today. Capital markets, on the other hand, can and do. It is crucial senior executives make the right moves, or they risk being put in the penalty box until long after the game is over.

UNDERSTANDING WHAT OTHERS DO

The secret to Starbucks' incredible success is how this marketing machine conjures and sells café romance to ever-growing hordes of people around the world, new disciples signing up every day of the year. Even so, its messianic leader is struggling to hold on to the company's soul, giving customers an authentic experience, an advantage none of its competitors have so far been able to duplicate. Imagine what would happen to your outfit's stock price if you could convince the shareholders to become repeat buyers as time goes on, rather than cut and run whenever there is but a minor hiccup in quarterly earnings? Better still, think about how wealthy everyone would become if you were to find a way to lure investors into paying a substantial premium, just as Starbucks does for a Decaf Triple Grande Vanilla Non-fat with Whip Latte at $4.98, compared to Tim Hortons' best at $1.51 for a large cup. But, before you can leave such a great taste in their mouths you must somehow convince them your company is substantially more than just the flavour of the month.

As a matter of interest, the American company came public in 1992 at US$17. Adjusting for five two-for-one stock splits, today's equivalent price is US$0.53 per share. Currently changing hands at US$29, its market cap stands at US$22-plus billion, reflecting a robust price-to-earnings ratio of 37 times. Canada's favourite coffee house was spun out by Wendy's International, Inc. in 2006 at $27. The current price is $35, the multiple 26-plus, and the enterprise is worth better than $6 billion. Given how hard the industry leader must run to maintain its status as a top-flight growth company, investors would be wise to ask themselves whether or not one might be better off to sell or go short the stock in anticipation of the North American economy taking a turn for the worse. Or, is it possible the premier provider has such a cult following it will continue to grow and prosper no

matter what? On the other hand, if people become more careful about how they spend their coffee money, might they switch from Starbucks to Tim Hortons? In which case the star performer is likely to lose ground. Whatever, investor confidence in the future would be greater if the shareholders had a respectable research analyst's report in hand and/or occasion to meet with the CEO and confrères, and be in a position to judge for themselves. Put yourself in their shoes and the chances are you would feel exactly the same way. So, what should be the focus of a corporate investor relations programme?

HOW TO MAKE A FAVOURABLE FIRST IMPRESSION

Every well-organized meeting has an agenda to allow the participants to know what topics are to be discussed and in which sequence. So does every successful sales call. If you want to show you mean business and gain a step or two on the competition, be sure to arrive ten minutes early for the appointment. If for any reason you will be late, phone and tell the receptionist or executive assistant by how much. Never blame someone else for your tardiness. No excuse is ever good enough.

Having introduced yourself and exchanged pleasantries, make certain the customer's desk is clear so as to be in the right frame of mind, ready to pay close attention to your spiel. Stress the superior quality of the products or services or both that you have come to offer at a competitive price and, above all, emphasize your company's long-established and enviable record for just-in-time delivery. As time is precious, answer any and all questions directly and succinctly. Never get up to leave without first asking for an order. Failing to do so is a serious mistake, one you will have difficulty erasing and regret long into the future. In meeting with investment research analysts, institutional portfolio managers and even an investment dealer retail investor sales force, the same principles apply. Whether existing investors or not, they must be convinced you are on the up and up, have a reputation for telling the truth and in matching or exceeding financial performance expectations. If there is any chance of the numbers coming up short, the causes must be explained well in advance of the quarterly results announcement. The reason being that the capital markets can smell a rat long before it ever comes to light, and you do not want to have the critics turn against you in disgust, never again to recommend your company's securities or products to buyers of any sort.

HOW TO CINCH THE ORDER

As Starbucks has so cleverly demonstrated, in marketing a new product or service or issue of securities, a company must be prepared to spend money to establish its credibility. Trying to hitch a ride on someone else's coattails will only send the buyers their way, never yours. Though prudence and diligence are regarded as virtues, there is a high price to pay by investors and issuers alike by waiting for every last detail to fall into place before making a move. One is oft better served by quick analysis that is 80 percent right, rather than holding back until one is 95 percent sure. This is especially true for companies lacking in research analyst sponsorship and news coverage, as there tends to be a lag between the release of financial information and it being fully reflected in the stock market. Thereby, a substantial amount of cash can be made, or saved, by acting in advance of the crowd. Similarly, bargains can be had when disappointing news arises that masks favourable longer-term potential. So CEOs are advised to always stand their ground, and not get blown away by unjustified complaints. Though many individuals are willing to respond on short notice, institutional investors have a habit of being relatively cautious before

reacting. They are criticized more for a wrong call than praised for a right one, and because of size their orders take longer to fill. They almost never deviate far from their peers, making it doubly difficult to get them to buy a new name, except when an IPO or equity financing is offered at a substantial discount. In which case, they usually bitch and complain about their less-than-satisfactory allocation, seldom to make up the shortfall in the aftermarket, preferring to sell out rather than make their rivals look good by bidding up the price of the common shares or income trust units.

SETTING THE STAGE FOR MULTIPLE EXPANSION

While only one lone CEO has ever told me his company was overvalued, hundreds upon hundreds have proclaimed the very opposite. Most have little understanding of the reasons why one stock has a propensity to outperform another over an extended period of time. A foolish few of the blowhards believe they have the wherewithal to teach research analysts and investors a lesson or two about making money. However, that is not how to get the investment community to support your cause. Nor is it the way to the new fifty-two-week high list. Simply put, the shareholders' collective knowledge will always be greater than that of any single person, their understanding of the capital markets more profound than that of a suite of senior executives anywhere in the world. If the ultimate goal is to be the subindex leader in terms of cash flow and earnings per share multiples, they must get off their high horses and mingle with those who can make such happen, or not. Otherwise they risk being tossed out on their derrières before the next annual general meeting.

BEWARE THE FINANCIAL MEDIA

Many CEOs aspire to have their company become a marquee name. Some are prepared to go to whatever lengths it takes to become the focus of a feature article in a respected business magazine. However, when such a company's stock price performance is compared with that of a major index or a competitor's in the same industry, statistical testing shows that positive stories generally mark the end of a period of superior performance, a negative one the beginning of a turnaround in financial results. The same applies to an announcement of plans to move into a fancy new head office, or the purchase of a major league sports franchise, neither of which would even be so much as contemplated at the bottom of the cycle. On the other hand, layoffs and write-offs are usually a sure sign the nadir has been reached and the tide has turned to the benefit of investors.

Homegrown disasters seldom register in our collective consciousness, and the media is a significant reason why, resulting in an investing public that is naive, easily persuaded, and all too ripe for the next scam. While it may be heresy at this late date to mention the plight of the royalty and income trusts, I do so to illustrate a classic case of greed. Greed by issuers, greed by underwriters, lawyers and accountants. It also seems the greedy unitholders had forgotten that the media are in business to make money. They survive on advertising dollars, and rely on content to fill their pages and airtime. In this case, these factors often went hand in hand. Both national newspapers ran several dedicated sections and many puff pieces, misleading investors about the risks involved. Without the members of the fourth estate acting as the great lubricators of insouciance, the situation could never have gotten as far out of hand as it did. The change in the tax status might well have been foreseen had they not wrapped a blanket of invulnerability around the sector. Exacerbating the situation was the failure of research analysts to challenge the unbridled enthusiasm of

the CEOs who knew precious little about the fickle ways of capital markets, and of the Bay Street firms raking in tens upon tens of millions of dollars in fees and commissions. The trustophiles' rhetoric and name-calling are only hurting the industry's credibility, and are not in the best interest of the unitholders. Let us all hope such a set of circumstances will not reoccur in the future, but chances are it will!

As for the gutting-of-Canada anxiety, spare me. Takeovers happen, and with increasing frequency when corporate profits are high and interest rates low. It is called open capitalism. You either believe in it or you do not. Listless entities with healthy cash flow, a clean balance sheet and cheap shares or units are a perfect catch for a foreign buyer or a private equity firm. Expect more Canadian corporations and trusts to disappear as time goes on, only to reappear within the next ten years as vibrant IPOs, positioned to grow rapidly in the future. Better that than stagnation or government subsidies or both.

SECTOR ROTATION IS AN IMPORTANT FACTOR

Thanks to China's red-hot business climate and less concern about the prospects for the world economy, the pedal has been put to base metal prices. Though copper is considered the bellwether of economic health because of its wide use in plumbing, wiring and electronics, the demand for aluminum, nickel, lead and zinc, and uranium has also been rising at an impressive rate. Some of the buoyancy has stemmed from technically driven funds betting against the probability of commodity prices ever being so robust, and are now paying dearly for their tunnel vision. That is the good news. The bad is that investor sentiment is decidedly bullish, droves of freshly minted mining companies are being posted on the TSX Venture Exchange, dedicated mutual funds are sprouting like daffodils in spring, and the covering of short positions also suggests the big money has likely been made by now. Though credit is abundant and the appetite for risk is still high, wise investors are rethinking portfolio weightings and trimming positions. With inflation showing signs of increasing, some are steeling themselves for the possibility that interest rates may not fall as soon as many have hoped for, and we could be in for a period of backing and filling the gaps in stock prices which occurred along the way. Although expectations for earnings growth are still hale and hearty, and a number of companies could well deliver positive surprises in reporting second-quarter results, the topping out of the S&P/TSX Capped Metals/Mining Sector Index is likely to occur later this year or early next.

The outlook for the S&P/TSX Capped Energy Index is another matter. Since crude oil hit a record high of US$78.40 in mid-July last year, only to tumble to an inter-day low of US$49.90 per barrel in mid-January, US$15.38 in December 2005, and US$4.20 per MMBtu for natural gas in September 2006, the rig count from 726 in February 2006 to a low of 92 this April, the gap between energy industry securities and underlying commodity prices has narrowed. Given as the trigger-happy hedge funds have moved on and with private-equity types lurking, the outlook is once again promising. Judging by the trading patterns rather than fundamental values, an increasing number of stocks and royalty trust units have recently indicated a trend reversal from bearish to bullish. The missing links are volume expansion and price momentum. They are dependent on research-analyst confirmation, which should soon fall into place. Bargain buyers are advised to stay put until the more conventional investors join the fray. Like Starbucks, CEOs should do whatever it takes to accelerate the process. No one in their right mind wants to go unnoticed when more aggressive adversaries are laughing all the way to the bank.