

Using Common Size Statements to Evaluate A Company's Performance: An Application

Halil D. Kaya*

Abstract

During the period 2005-2007, Starbucks Coffee Company's shares had dropped by roughly 40%. This case encourages an examination of the possible impact of competition in the industry on Starbucks' share price performance. Students will compare the company's financials to one of its main rivals' (i.e. Panera Bread's) financials and determine whether Starbucks had been underperforming compared to its competition. Since the two companies are of different size, in order to be able to compare the two companies, students will need to use common-size financial statements. They are encouraged to explain the areas where Starbucks had underperformed when compared to its rival. As an additional task, students may examine the company's common-size statements over the 2005-2007 period to its current common-size statements, and then explain if the firm had improved in those weaker areas.

Keywords: financial statement analysis, common-size statements, common-size balance sheet, common-size income statement, Starbucks, coffee business

JEL classifications: L25, G30, F23

Introduction

It was Friday afternoon, and at Bluerock Investments, a group of junior analysts was working on a task: looking into the competition in the coffee shop industry and evaluating the recent sharp decline in Starbucks Coffee Company's share price. The company's share price had declined by roughly 40% over the past 2 years. Mr. Reynolds, the chief analyst in the company, asked them to prepare a report regarding the competition in the industry and to evaluate the possible impact of the competition on Starbucks' share price.

Adam, a recent graduate of an Ivy League MBA program in the Northeast, was chosen to lead the team. He wanted to start working on the task immediately. His objective was to present their finding next week at the weekly departmental meeting.

"We need to hurry up guys" he exclaimed. "Mr. Reynolds wouldn't wait too long for this report".

"O.K. We can start now and then work on it during the weekend. No problem for me". Katie responds.

"We can start today, and then tomorrow we can meet at the Starbucks close to here". Alex joined the conversation.

"O.K. then. That's the plan" Adam responds. "Mr. Reynolds wants us to determine the main competition for Starbucks first. But, for this initial report, he wants us to focus on the firm's competition with Panera Bread. So, we will need to compare Starbucks financials to Panera Bread's."

Katie reached for a file sitting in the middle of the table. “Here are the financial statements for both companies. I have printed their statements for 2004, 2005, 2006, and 2007” (see Exhibits 1-4).

“Starbucks’ net profit was much higher. It is more than 10 times Panera Bread’s net profit. So, Starbucks was doing much better, I guess, with respect to profitability” Katie added.

“We cannot directly compare their numbers. Starbucks is a much bigger company, so we need to use common-size statements to compare them” Adam responded.

“I remember common-size statements. We learned them in our finance class, but it was a few years back, so I have already forgotten about them” Alex said.

Competition

In the last few years, Starbucks has entered into a coffee-shop battle, fighting Dunkin' Donuts and McDonald's for the top position as coffee king. There are also smaller competitors like Caribou Coffee and Panera Bread.

Dunkin' Donuts declared war against Starbucks in 2006. While Starbucks has a more wealthy and upscale feel, Dunkin' Donuts approaches customers with traditional advertisements, representing itself as a brand for all Americans. In 2007, in order to position itself between Starbucks and Krispy Kreme, Dunkin' Donuts introduced a new line of Espresso drinks. However, its products (especially donuts) are not attractive to health conscious consumers, so it is more of a competition to McDonalds rather than Starbucks’.

McDonald's introduced flavored and iced coffees in the mid-2000s and joined the real competition. McDonalds’ existing customer base and demographic coverage were an advantage for the firm. Also, McDonalds had almost twice the number of units than that of Starbucks.

Caribou Coffee had been the second largest specialty coffee house. However, Caribou’s net revenues were only 3% of that of Starbucks. Another small competitor is Panera Bread. Panera Bread caters to the health conscious consumers. It offers bakery, salad, soup, sandwiches and coffee. It also offers a selection of tea and flavored iced coffee. Panera Bread’s modern and relaxing dining atmosphere was somewhat similar to that of Starbucks. But, it is a smaller firm with revenues represented that come to less than 10% of that of Starbucks.

Starbucks has been successful in maintaining the quality of their products and services. Therefore, their main focus has been increasing geographical coverage domestically and internationally.

Common Size Statements

“Can you believe Starbucks’ revenues had almost doubled (Exhibit 1) over the 2004-2007 period resulting in a huge increase in net income over that period?” Adam exclaimed.¹

¹ Net sales increased from \$5,294m in 2004 to \$9,411m in 2007 and net income increased from \$393m in 2004 to 672m in 2007 per Exhibit 1

“I know. It is interesting to have this increase and then this drop in the stock price,” Katie remarked. Starbucks’ stock price had dropped by 40% in 2007. The price dropped from \$37.76, the highest monthly price in its fiscal year 2006, to \$20.47, the lowest monthly price in its fiscal year 2007 (Yahoo-Finance 2009).”

Alex added: “But look at Panera Bread’s numbers (Exhibit 4). Its revenues more than doubled over that same period, and its net income also more than doubled”.

Katie asked: “So, are you saying that Panera Bread has done better than Starbucks?”

“I am not sure” Alex responded. “I think we need to use common size statements in order to be able to compare them. Starbucks is much larger, so we cannot directly compare their numbers. We need to do some conversions”.

“What kind of conversions? I don’t know anything about converting financial statements. How do you do that?” Adam asked.

“To make sure, we need to search the web for common-size statements, or if we can still find our textbooks from our old days, we can look at them too” Alex replied.

Katie added: “I think I can find my book. It is somewhere at home”.

“Then let’s start working on this. Our charge is to prepare the common-size balance sheets and the common-size income statements for Starbucks and Panera Bread, and then to compare their revenues, expenses, assets, liabilities, and equity numbers” Alex concluded.

Exhibit 1 -Starbucks' Income Statements for Years Ending December 31 (in millions of dollars)				
	2007	2006	2005	2004
INCOME STATEMENT				
Net sales	\$9,411	\$7,787	\$6,369	\$5,294
Operating costs	\$7,509	\$6,120	\$4,963	\$4,160
Selling, general and administrative expense	\$489	\$479	\$362	\$304
Earnings before interest, taxes, depreciation, and amortization (EBITDA)*	\$1,413	\$1,188	\$1,044	\$830
Depreciation and amortization	\$467	\$387	\$340	\$280
Earnings before interest and taxes (EBIT)	\$946	\$801	\$704	\$550
Non-operating income /expense (Income from Equity Investees and Net interest)	\$152	\$117	\$93	\$75
Less interest	\$42	\$11	\$1	\$0
Earnings before taxes (EBT)	\$1,056	\$907	\$796	\$625
Taxes	\$384	\$325	\$302	\$232
Net Income before preferred dividends	\$672	\$582	\$494	\$393
Preferred dividends	-	-	-	\$0
Income from continuing operations before extra ordinary items	\$672	\$582	\$494	\$393
Adjustment for extraordinary items		\$17		
Net Income before preferred dividends	\$672	\$565	\$494	\$393
Common dividends	\$0	\$0	\$0	\$0
Addition to retained earnings	\$672	\$565	\$494	\$393

Per-share Data				
Earnings per share, Basic (EPS) - not include diluted stocks	\$0.90	\$0.74	\$0.63	\$0.49
Dividends per share (DPS)	\$0.00	\$0.00	\$0.00	\$0.00
Book value of Equity per share (BVPS)	\$3.04	\$2.91	\$2.65	\$3.12

$$g = \text{the compounded growth rate of EPS} = (2007 \text{ EPS}/2004 \text{ EPS})^{1/3} - 1 = 21.87\%$$

Source: Starbucks 2007 Annual Report. Data is provided by Research Insight

Exhibit 2 - Starbucks' Balance Sheet				
(in millions of dollars)				
	2007	2006	2005	2004
<i>Assets</i>				
Cash and equivalents	\$281	\$313	\$174	\$145
Short-term investments	\$157	\$141	\$133	\$508
Accounts receivable	\$288	\$224	\$191	\$140
Inventories	\$692	\$636	\$546	\$423
Prepaid Insurance and Lease	\$149	\$127	\$94	\$71
Deferred Income taxes (net) -Income taxes not paid	\$129	\$89	\$71	\$64
Total current assets	\$1,696	\$1,530	\$1,209	\$1,351
Long term investment (available for sale)	\$21	\$6	\$60	\$136
Equity and other investment	\$259	\$219	\$202	\$168
Net plant and equipment (net of depreciation)	\$2,890	\$2,288	\$1,842	\$1,551
Other assets	\$219	\$187	\$73	\$87
Other intangible assets (cash deposit from unearned sale)	\$42	\$38	\$35	\$28
Goodwill	\$216	\$161	\$93	\$69
Total assets	\$5,343	\$4,429	\$3,514	\$3,390
<i>Liabilities and equity</i>				
Accounts payable	\$391	\$341	\$221	\$199
Commercial paper and short term borrowings (Notes Payable)	\$710	\$700	\$277	\$0
Accruals (Compensation, Occupancy)	\$664	\$568	\$475	\$362
Accrued taxes	\$93	\$94	\$78	\$63
Other Liabilities	\$296	\$231	\$175	\$121
Current portion of long term debt	\$1	\$2	\$1	\$1
Total current liabilities	\$2,155	\$1,936	\$1,227	\$746
Deferred income taxes	\$0	\$0	\$0	\$21
Long-term bonds	\$550	\$2	\$3	\$4
Other long term liabilities (Deferred Rent, asset retirement obligations, etc.)	\$354	\$263	\$194	\$145
Total debt	\$3,059	\$2,201	\$1,424	\$916
Common stock (50,000,000 shares)	\$1	\$1	\$0	\$0
Paid in capital	\$39	\$39	\$130	\$996
Retained earnings (include repurchase of common stocks)	\$2,244	\$2,188	\$1,960	\$1,478
Total common equity	\$2,284	\$2,228	\$2,090	\$2,474
Total liabilities and equity	\$5,343	\$4,429	\$3,514	\$3,390

Source: Starbucks 2007 Annual Report. Data is provided by Research Insight

EXHIBIT 3. Panera Bread's Balance Sheet				
(in thousands of dollars)				
ASSETS	2007	2006	2005	2004
Current assets:				
Cash and cash equivalents	68,242	52,097	24,451	29,639
Short-term investments	23,198	20,025	36,200	2,022
Trade accounts receivable, net	25,152	19,041	18,229	11,714
Other accounts receivable	11,640	11,878	6,929	5,542
Inventories	11,394	8,714	7,358	5,398
Prepaid expenses	5,299	12,036	5,736	1,658
Deferred income taxes	7,199	3,827	3,871	2,247
Total current assets	152,124	127,618	102,774	58,220
Property and equipment, net	429,992	345,977	268,809	201,725
Other assets:				
Investments in government securities	0	0	10,108	26,393
Goodwill	87,092	57,192	48,540	35,327
Other intangible assets, net	21,827	6,604	3,219	159
Deposits and other	7,717	5,218	4,217	2,848
Total other assets	116,636	69,014	66,084	64,727
Total assets	698,752	542,609	437,667	324,672
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current liabilities:				
Accounts payable	6,326	5,800	4,422	5,840
Accrued expenses	120,047	102,718	81,559	48,905
Deferred revenue	1,393	1,092	884	960
Total current liabilities	127,766	109,610	86,865	55,705
Deferred income taxes	0	0	5,022	5,647
Long-term debt	75,000	0	0	0
Deferred rent	33,569	27,684	23,935	20,181
Other long-term liabilities	14,238	7,649	4,867	1,776
Total liabilities	250,573	144,943	120,689	83,309
Minority interest	2,015	0	0	0
Common stock, \$.0001 par value:				
Class A	3	3	3	3
Class B	0	0	0	0
Treasury stock, carried at cost	-1,188	-900	-900	-900
Additional paid-in capital	168,386	176,241	158,984	130,970
Retained earnings	278,963	222,322	163,473	111,290
Unearned deferred compensation	0	0	-4,582	0
Total stockholders' equity	446,164	397,666	316,978	241,363
Total liabilities and stockholders' equity	698,752	542,609	437,667	324,672

EXHIBIT 4. PANERA BREAD'S INCOME STATEMENT				
(in thousands of dollars)				
	2007	2006	2005	2004
Revenues:				
Bakery-cafe sales	894,902	666,141	499,422	362,121
Franchise royalties and fees	67,188	61,531	54,309	44,449
Fresh dough sales to franchisees	104,601	101,299	86,544	72,569
Total revenue	1,066,691	828,971	640,275	479,139
Costs and expenses:				
Bakery-cafe expenses:				
Cost of food and paper products	277,715	197,182	142,675	101,832
Labor	286,238	204,956	151,524	110,790
Occupancy	70,398	48,602	35,558	26,730
Other operating expenses	121,325	92,176	70,003	51,044
Total bakery-cafe expenses	755,676	542,916	399,760	290,396
Fresh dough cost of sales to franchisees	86,579	85,618	75,036	65,627
Depreciation and amortization	57,903	44,166	33,011	25,298
General and administrative expenses	68,966	59,306	46,301	33,338
Pre-opening expenses	8,289	6,173	5,072	2,642
Total costs and expenses	977,413	738,179	559,180	417,301
Operating profit	89,278	90,792	81,095	61,838
Interest expense	483	92	50	18
Other (income) expense, net	333	-1,976	-1,133	1,065
Income before minority interest and income taxes	88,462	92,676	82,178	60,755
Loss allocable to minority interest	-428	0	0	0
Income before income taxes	88,890	92,676	82,178	60,755
Income taxes	31,434	33,827	29,995	22,175
Net income	57,456	58,849	52,183	38,580
Per share data:				
Net income per share:				
Basic	1.81	1.88	1.69	1.28
Diluted	1.79	1.84	1.65	1.25
Weighted average shares of common and common equivalent shares outstanding:				
Basic	31,708	31,313	30,871	30,154
Diluted	32,178	32,044	31,651	30,768

Author

Halil D. Kaya*

Associate Professor of Finance, Department of Accounting and Finance, College of Business and Technology, Northeastern State University, Broken Arrow, OK 74014 kaya@nsuok.edu

References

BUCX- Historical Prices for Starbucks Co –Yahoo! Finance (2009). Yahoo.com. Retrieved February 4, 2010 from

<http://finance.yahoo.com/q/hp?s=SBUX&a=08&b=30&c=2005&d=08&e=30&f=2009&g=m>

Caribou Coffee 2007 Annual Report (2007). Retrieved September 18, 2009 from

http://library.corporate-ir.net/library/19/192/192910/items/303798/CBOU-2007-Annual_Report.pdf

Panera Bread 2007 Annual Report (2007). *Panera Bread Form 10-K*. Retrieved September 12 2008 from

<http://www.sec.gov/Archives/edgar/data/724606/000136231008001100/c72517e10vk.htm#012>

Starbucks Company 2007 Annual Report (2007). *Starbucks Form 10-K*. Retrieved December 15 2008 from

<http://www.sec.gov/Archives/edgar/data/829224/000095013408021134/v50316e10vk.htm#113>

Starbucks Corporation. (n.d.). Company Information. Retrieved from www.Starbucks.com