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Starbucks to start turning corner

By Lisa Baertlein - Analysis

LOS ANGELES (Reuters) - Starbucks Corp should begin reaping benefits from slashing costs, closing stores and removing trinkets from shelves, but analysts say growth could remain elusive until the U.S. economy heals.

"It's good that they've addressed (costs). But let's be honest, the hard part for any retailer right now is improving sales," said Edward Jones analyst Jack Russo.

Economists and analysts expect the U.S. economy to stabilize in the second half, or in early 2010, and several analysts say it could be a year or longer before Starbucks' all-important U.S. same-store sales turn positive.

Beyond that, McDonald's Corp's aggressive push into coffee remains a risk to Starbucks' future growth and some analysts wonder whether consumers will resume old spending habits after the recession ends.

On Tuesday, the world's largest coffee chain will report results from its fiscal third quarter ended June.

Several analysts expect that the decline in sales at stores open a least 13 months moderated in the most recent June quarter, but expect them to remain in negative territory for the immediate future.

But in this market, less bad is the new good.

Robert W. Baird analyst David Tarantino recently upgraded Starbucks' shares to "outperform".

"We have become more confident in the near-term outlook following our recent field research, which pointed to an improvement in category traffic trends in Starbucks's third quarter," Tarantino wrote in a client note.

U.S. same-store sales fell 10 percent in the December quarter and were down 8 percent in second quarter ended in March.

"The December double-digit negative same-store sales for U.S. operations could prove to be the bottom," said Tom Forte, an analyst at Telsey Advisory Group.

Like many of his peers, Research Edge analyst Howard Penney doesn't expect Starbucks to make an immediate return to growth.

"For the next one to two years, this is all about running the assets they have better," Penney said.

"A lot of their improvement will come from economic conditions getting better," he said. "Ultimately, they'll find a new product that will be a blockbuster. They don't have that yet."

Starbucks shares are largely unchanged from their year-ago close of $14.39. In the company's heyday from 2006 and early 2007 shares traded above $30 per share.

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According to Reuters Estimates, analysts on average expect the company to post earnings excluding items of 19 cents per share, up from 16 cents a year ago. In the year-ago quarter, Starbucks posted its first-ever net loss as a public company on charges related to restructuring and store closures.

Starbucks has laid off thousands of workers around the globe; is slated to close nearly 1,000 stores worldwide; and has slashed plans for new store openings.

After downshifting from expansion mode, it has said it is on schedule to serve up $500 million in cost savings this year.

It has tightened up store operations by reducing waste and reworking employee schedules.

It tossed out low-margin music CDs and other unrelated merchandise, a move that hurt overall sales but focused the company on more profitable items like coffee drinks.

"They didn't really focus on running their stores right. When you're forced to do that, you make some decisions that will ultimately will benefit the store," Research Edge's Penney said.

Starbucks is also upgrading its food to make it healthier and tastier, debuting new products like Via instant coffee and boosting marketing programs ranging from loyalty cards to Facebook giveaways.

While the jury is still out as to whether McDonald's will steal customers from Starbucks with its aggressive coffee push, Starbucks' efforts should help the cafe chain squeeze more profits out of every store.

Long-term, analysts say that Starbucks should be able to compete, if not beat, McDonald's store operating margins.

In addition, Penney said Starbucks should generate $600 million in cash flow in 2009 and another $700 million in 2010.

"It gives them leverage to potentially do things to create value for shareholders. That's down the road, that's not this quarter," Penney said.

(Reporting by Lisa Baertlein; editing by Leslie Gevirtz)