IS STARBUCKS RUNNING OUT OF STEAM?

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The coffee wars scorch on. Retail wunderkind Starbucks Corp. has come up with a few new tricks in recent months in its attempts to widen the lead it has built over other java sellers at a time when Dunkin' Donuts has its sights set on becoming a national player and upscale upstarts try to erode the chain's marketshare.

In the past decade, consumers and real estate developers alike congregated to the Seattle-based chain, making it the leader in the U.S. specialty coffee market and a preferred anchor tenant for shopping centers less than 15,000 square feet. As a result, the company today operates 9,814 U.S. stores (6,281 are company-owned, 3,533 are run through licensing agreements) and has become a global phenomenon.

But Starbucks may be vulnerable in a tougher consumer climate. Are people going to spend $4 for coffee now that the housing bubble has popped and gas and food prices are rising? Does that open the door for Dunkin' Donuts--as a lower cost alternative--to gain ground?

Lower-than-expected sales growth during the company's fiscal third quarter may be one indication that Starbucks' momentum is slowing. (Starbucks did not return calls seeking comment.) During that period, the company reported same-store sales growth of 4 percent and a 20 percent increase in net revenue to $2.4 billion. That was good--but the growth missed analysts' expectations of 6 percent growth, reflecting flat traffic for the second consecutive quarter, according to Marc Greenberg, retail analyst with Deutsche Bank. Greenberg worries the waning traffic and increased pressure from competitors will hurt Starbucks' aggressive expansion plans.

"Starbucks is growing up, and coping with maturity is rarely an easy process," Greenberg wrote in a research note on August 1.

For now, it's still opening stores at a rapid pace. During the third quarter, the firm opened 668 stores, as part of its expansion target of 2,400 new stores by the end of fiscal year 2007 (1,700 of those are planned for the domestic market). For next year, it is forecast to open another 1,700 locations in the U.S.

Owners and operators of smaller strip centers that rely on Starbucks as an anchor are watching closely. The retailers' brand recognition and traffic-driving potential make centers with Starbucks very popular investment targets. Such centers trade at cap rates in the 5 percent to 6 percent range, below the national average of 6.65 percent for all strip centers, according to Anthony Villasenor, principal of retail investment with La Jolla, Calif.-based real estate services firm Lee & Associates

"Starbucks-anchored properties might trade at a lower cap rate than the credit Starbucks deserves, but investors know it, they use it and they think it will be around forever," says Adam Lutz, principal with Farmington, Mich.-based Lutz Real Estate Investments.

Meanwhile, a center of equivalent size and profile anchored by a Dunkin' Donuts or another coffee chain would trade at 25 basis points to 35 basis points higher than one with Starbucks, says Chad Firsel, executive vice president of the investment services practice with Chicago-based brokerage NAI Hiffman.

The power of the Starbucks brand name is so strong that RetailWorks, a Southfield, Mich.-based strip center developer and manager that operates as a joint venture of REDICO, Lutz Real Estate Investments and iCap Realty Advisors, often determines the location of entire projects based on where Starbucks wants to build new stores. Where a Starbucks goes, other national tenants, including banks and wireless service providers, soon follow, Villasenor says.

"Starbucks brings in a higher-end clientele, which is more desirable for co-tenancy," says Villasenor. "Nobody is even close to them in terms of market dominance."

Still, Canton, Mass.-based Dunkin' Donuts has risen as an unlikely challenger. The firm is an institution in the Northeast going on 60 years. In the past decade it accelerated its growth largely due to the popularity of the chain's coffee. Beverages now account for between 60 percent and 70 percent of the company's annual revenues, according to a *Fast Company* report.

In its fiscal year 2006 ending August 2006--the last year for which information is available--Dunkin Donuts posted sales revenues of $4.6 billion overall. In contrast, Starbuck's global retail revenue was $6.6 billion. (Dunkin's parent company, Dunkin' Brands, Inc., is privately-owned by a consortium of Bain Capital Partners, the Carlyle Group and Thomas H. Lee Partners and thus does not release quarterly or monthly sales figures.)

Still, investors don't see Dunkin' Donuts the same way they do Starbucks, Villasenor notes, in large part because the chain operates through franchises, with lease terms and store performance that vary depending on the market.

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