

COUNTRY RISK ANALYSIS OF STARBUCKS IN ISRAEL



Introduction

“Starbucks purchases and roasts high-quality whole bean coffees and sells them along with fresh, rich-brewed, Italian style espresso beverages, a variety of pastries and confections, and coffee-related accessories and equipment -- primarily through its company-operated retail stores. In addition to sales through their company-operated retail stores, Starbucks sells whole bean coffees through a specialty sales group and supermarkets. The company’s objective is to establish Starbucks as the most recognized and respected brand in the world. To achieve this goal, Starbucks plans to continue to rapidly expand its retail operations, grow its specialty sales and other operations, and selectively pursue opportunities to leverage the Starbucks brand through the introduction of new products and the development of new distribution channels” (The Company). Starbucks is considering expanding into the Israeli restaurant industry to see if there are opportunities for growth. Currently, Israel is a technologically advanced market economy with substantial government participation. The proceeding subsections will further analyze certain risk and economic factors that will affect Starbucks if they choose to expand into the Israeli restaurant industry.

Product/country motivation

The company our group has chosen is Starbucks. “Starbucks has become a popular premier restaurant business in the United States and has expanded into the international market with more than 1,500 coffeehouses in 31 markets outside North America” (Starbucks Coffee International). Starbucks should expand into countries, such as Israel, to increase the recognition of their brand and grow its sales to accomplish its

objective to establish them as the most recognized and respected brand in the world. Since there are already many established American restaurants operating in the Israeli restaurant industry, consumers in Israel should be more enticed to buy Starbucks' products. Furthermore, the Israeli economy has been in a recession due to factors such as the Israeli-Palestinian conflict, increasing declines in the high-technology and tourism industries, and strict fiscal measures in the face of growing inflation. According to Don Montuori, Acquisitions Editor for Packaged Facts, "In a slow economy, people are reluctant to or unwilling to purchase big-ticket items." In addition he stated, "But what's driving – and in fact saving – the gourmet beverage market is the attitude among consumers that spending a dollar or two more on an upscale drink is a luxury they can afford, and if that drink is also positioned as a having a health benefit, all the better" (Consumer Spending on Upscale Ready-to-Drink Items Driving Growth in the \$14.7 Billion Premium Beverage and Confectionery Market). In order to have ultimate control over the management of all operations, Starbucks should set up operations in Israel rather than forming joint ventures or exporting Starbucks' products from the United States to Israel. "Most of the world's coffee is grown between the Tropic of Cancer and the Tropic of Capricorn on plantations in Africa, Southeast Asia, and the Americas" (The Company). So, many of the inputs in developing coffee comes from abroad for Starbucks. The Starbucks in Israel will receive all of the revenues in New Israel Shekel and will import products such as coffee beans, cups, etc. from the United States. This will mean that all operating expenses will be in U.S. dollars.

Trade Environment and Regulatory Barriers

Israel has few trade or regulatory barriers that would hinder the operations of Starbucks. The Israeli economy depends primarily on imports of crude oil, grains, raw materials, and military equipment. Israel is largely self-sufficient in food production except for grains. “In 2002, it is estimated that Israel imported \$30.8 billion free on board. Cut diamonds, high-technology equipment, and agricultural products (fruits and vegetables) are their leading exports. Israel’s estimated exports in 2002 were \$28 billion free on board” (Middle East: Israel: Economy).

Balance of Payments

The balance-of-payments for Israel ran a current account deficit, which accounted for “2.1% of GDP in 2002, approximating the level in previous years—2% of GDP—except for 2000” (Part 1: The Balance of Payments). Table A-1 in appendix 1 illustrates the current account of Israel from 2000-2002 in millions of U.S. dollars. Some of the factors that caused the current account to have an increasing deficit are the continued global slump, especially in the high-tech industry, and the ongoing security difficulties from the Israeli-Palestinian conflict. These factors were offset by the domestic recession which decreased imports and caused the real currency to depreciate. “In 2001, the following countries were Israel’s export partners: US 42.8%, Benelux 7.4%, Hong Kong 6.0%, Germany 4.8%, UK 4.8%, and Japan 3.2%” (The World Factbook: Israel). “In the same year their import partners were: US 23.5%, Benelux 10.2%, Germany 7.9%, UK 6.7%, Switzerland 6.0%, and Italy 5.3%” (The World Factbook: Israel). This information clearly shows that Israel depends on the United States for being their highest percentage of imports and exports. The current account deficit balance with Starbucks’ entry into

the Israeli market will not have an adverse affect on the business. Israel will be affected with the current account's steady deficit and the capital/financial account's deficit in 2002. Not only are they importing more than they are exporting, but they do not have a great deal of direct foreign investment. This is a serious threat that Starbucks is facing with setting up operations in Israel.

“In the financial account, foreign investments and resident external investments declined by about one-fourth relative to 2001” (Part 1: The Balance of Payments). Table A-2 in appendix 1 illustrates Israel's capital and financial account from 2000-2002 in millions of U.S. dollars. “Net capital inflows in Israel's financial account were sizeable during the years of the global economic boom, mainly due to the technology direction of Israel's economy, but stopped in 2001 and did not continue in 2002” (Part 1: The Balance of Payments). Foreign investment in emerging markets such as Israel declined when it became apparent that the global markets and the economy would not rebound quickly. In view of weakness in the markets and the decrease in capital flows, Israel's high-tech intensity led to a significant decline of its share in capital flows, especially in issues abroad. “The decline in foreign direct investment (FDI) arose due to investors' internalization of the awareness that the global crisis, especially in high-tech, would not pass quickly and due to nonresidents' perception of investment in Israel as a riskier endeavor in 2002 than before” (Part 1: The Balance of Payments). As a result, individual nonresident deposits in Israel decreased this year by \$0.8 billion. The major factors that drove the current account direction towards a deficit is the fact that consumption in the country rose by 4.62% from 2000-2001 and 5.68% from 2001-2002. “It rose steadily from 263,762 to 291,619 million shekels from 2000-2002” (Carson). Another factor that

caused a current account deficit is government expenditures in the country. “In 2000 Israel had a surplus of 4,019 million shekel and then had a 17,270 million shekel surplus in the following year” (Carson). From 2000-2002, Israel has run a current account deficit. This may suggest that this is normal for Israel.

Overview of the Israeli Economy

“As of August 2003, Israel was ranked 43rd in the world in per capita GDP of \$19,000” (World Facts and Figures). “After a 6.4% growth rate in 2000, Israel was faced with its first GDP growth decrease in over fifty years by registering a 0.4% real growth rate in 2001” (World Facts and Figures). It went from \$U.S. 18,400 in 2000 to \$U.S. 17,300 in 2001 and \$U.S. 15,600 in 2002. Graph A-3 in appendix 2 illustrates Israel’s per capita GDP from 2000 to 2002.

Inflation and unemployment rates have increased over the same three-year period. “Although inflation in 2000 and 2001 held steady at 1.1%, it demonstrated a spike in 2002 of 5.5%” (World Facts and Figures). “Unemployment followed suit at 8.8% and 9.3% in 2000 and 2001, respectively. This was followed by a spike in 2002 of 10.3%” (World Facts and Figures). Israel’s inflation and unemployment rates from 2000 to 2002 are shown in Graph A-4 in appendix 2. The reality of a declining GDP along with increased inflation and unemployment may leave room for a capitalizing on government incentives to encourage FDI and stimulating the economy in Israel.

The Israeli Shekel is floating against the dollar. The Bank of Israel will intervene from time to time by increasing or lowering interest rates when exchange rates fall outside of a pre-determined exchange rate band. This can be summarized as a “managed

float”. Israel has completely abolished foreign currency control and the shekel is now a freely convertible currency. Since Israel has widened their rate band and has taken a deliberate “hands-off” approach, there is little to no risk of doing business based on the exchange rate regime.

The crisis of September 11th and the resulting political environment in the Middle East have played important roles in shaping the value of the New Israeli Shekel. Over the past twelve months the Shekel has gradually depreciated against the dollar. Graph A-5 in appendix 3 illustrates the Israeli Shekel/U.S. Dollar (ILS/\$) spot exchange rate from August 11, 2003 to October 31, 2003. Some of the economic trends attributable are the steady decline in real interest rates and a rise in inflationary expectations. In August of 2003, the Bank of Israel lowered the interest rate 5% to 7%.

With the election of the new parliament and increased peace negotiations with Palestinian leaders, it would seem likely that the inflation will remain under control after the gradual decrease it has experienced in 2003. The economic recovery program being implemented by the new government should help to moderately increase GDP. However, even with the positive outlook, the political environment can be very unpredictable at best. The impact of this data on Starbucks’ financial plans is to move in now while the shekel is in its depreciation phase. Most of Starbucks’ upfront costs will be in the initial penetration mode. Once Starbucks establishes operations and begins earning revenue, they hope to take advantage of a stronger shekel to trade for more dollars.

There are not any notable recent changes in Israel’s monetary policy that would have impacted the economy and the exchange rate. Israel’s main problem is the same problem they have had for many years, inflation. Their main objective is to stay between

their inflation target goals so that it does not significantly hurt the value of the shekel in the international market. Israel's policy makers also have been trying to make the country's monetary policies more transparent.

There are not any new political events that have affected Israel's currency over these past ten weeks, but there is one ongoing political event that is constantly affecting the country's economy. That ongoing event is the constant conflict, fighting, and violence with Arab terrorists that has plagued the State of Israel since its inception. These security issues have left a lasting negative impact on Israel's economy. "The ongoing regional security problem is gradually spreading to the whole of the economy through weaker investor and consumer sentiment, stated the International Monetary Authority (IMF) in its recently completed Article IV Consultation with Israel" (menareport.com). These security concerns are a major reason for most of Israel's economy problems and inflation issues. That is why peace in the Middle East is so important to the State of Israel because it would cause a very significant positive impact on their economy, economic growth, and the entire region itself. "IMF Directors emphasized that the restoration of peace, given Israel's strong fundamentals, would yield substantial economic gains to the region as a whole" (menareport.com). If there ever is peace in the Middle East, look for Israel to become a bigger player in the international market and also draw a lot more investors interested in their country.

Israeli Shekel/U.S. Dollar Exchange Rate Risk Related to Starbucks

The real exchange rate did change over the past year. As of November 14, 2002, the exchange rate (ILS/\$) was quoted at 4.6880, and as of November 14, 2003, the

exchange rate (ILS/\$) was quoted at 4.5278. The difference of this change was -0.1602 which meant that the percentage change in the spot rate during the past year was -3.42%. This percentage change in the spot rate over the past year when added to the inflation rate in the United States of 1.6% and then subtract by the inflation rate in Israel of 5.7% resulted in a percentage change in the real exchange rate of -7.52%. (Refer to appendix 6 for a breakdown of the numbers.) This negative change in the real exchange rate over the past year implies a couple of things about purchasing power parity and the competitiveness of Starbucks' product in Israel.

The main implication on the purchasing power parity for the local Starbucks in Israel is that it is actually cheaper for the Israeli Starbucks to buy its supplies from the United States in dollars. This means that the implication on the competitiveness of Starbucks in Israel's market is that it is higher. Since Starbucks can purchase their supplies for less money from the United States and pay in dollars, this lowers the Israeli Starbucks' costs. This in-turn enables the Israeli Starbucks to sell their coffee at a lower price since their costs are lower. If the Israeli Starbucks is able to sell their coffee at lower prices than their competitors, it makes them more competitive in their respective Israeli market.

The contracts that are available for the Israeli Starbucks are forwards, futures, options, and money market types of hedging. Hedging their payables position would be best since the shekel is currently appreciating against the U.S. dollar. This way we would be locked into a price in case of fluctuations in the exchange rates between the U.S. and Israel.

Israeli Stock Market

The stock price for Starbucks has done fairly well over the past ten weeks. It has steadily risen during this time period almost three dollars from \$29.16 to \$32.07.

Starbucks' stock price's rise can be attributed to the fact that the company's stock had been given and "upgrade" by Banc of America Securities. "Starbucks (nasdaq: SBUX - news - people) shares rose on news that Banc of America Securities upgraded the coffee retailer to 'neutral' from 'sell' and raised the target price to \$28 from \$20. Banc of America said it expects 'recent same-store sales strength to continue' and said sales could benefit from Starbucks' recently launched Visa credit card, new products, service initiatives and increased marketing spending" (Forbes Staff). These are the main factors for Starbucks recent rise in the stock market.

Starbucks' stock also shows some correlation with the S&P 500 Index (^SPX) and the Tel Aviv Stock Exchange (^TA100). If you refer to graph A-6 in appendix 4, you will notice that Starbucks' stock is not highly correlated with the S&P 500 Index. There is some correlation, however. During the past four weeks, Starbucks' stock has been highly correlated with the S&P 500 Index. From October 24, 2003 to November 14, 2003, both Starbucks and the S&P 500 Index have followed the same trend. They both rose steadily until November 7, 2003 where both prices reached a peak, and then slightly dropped the following week ending on November 14, 2003. If you refer to graph A-7 in appendix 4, you will notice that Starbucks' stock is, for the most part, highly correlated with the Tel Aviv Stock Exchange. Over the entire ten week period that was examined, both Starbucks and the Tel Aviv Stock Exchange rose and fell simultaneously. The only noticeable difference where the two were not correlated in the past ten weeks was in

week six ending on October 17, 2003. During this week, Starbucks' stock price fell while the value of the Tel Aviv Stock Exchange rose.

When Starbucks' stock was compared against the exchange rate there was some correlation found; however, it was not highly correlated with the exchange rate over the entire ten week period. If you refer to graph A-9 in appendix 5, you will notice that only during a two week period from the end of week six to the end of week eight was Starbucks' stock correlated with the exchange rate. During the rest of the ten week period, both Starbucks' stock and the exchange rate were inversely related. When Starbucks' stock price rose, the exchange rate fell, vice versa.

Conclusion

After reviewing the economic environment of Israel it has been determined that the expansion of Starbucks into the Israeli market would involve too much excess country risk. The economic factors that have greatly impacted the Israeli market the most are the Israeli-Palestinian conflict and its unsteady inflation rates. Due to political unrest and the Israeli-Palestinian conflict creating a downturn in the economy, it would not be a savvy business investment for the Starbucks Corporation. Over the course of the past few years, Israel has tried to stay within their inflation target goals because of volatile inflation rate fluctuations. Starbucks should re-evaluate the possibility of expanding into the Israeli market when Israel's inflation rates have been stabilized and the Israeli-Palestinian conflict has minimized.

APPENDIX

Table A-1

Israel Current Account Balance 2000-2002 (in millions of U.S. dollars)

	2000	2001	2002
Current Account	-671	-1776	-1226
MTB	-2883	-3004	-3560
Bal on Services	2656	-553	-617
Income Balance	-6927	-4628	-3599
Current Transfers	6483	6409	6549

Source: Carson, S. Carol, Director. International Financial Statistics. Vol LVI No. II. Washington D.C.: International Monetary Fund, Nov. 2003.

Table A-2

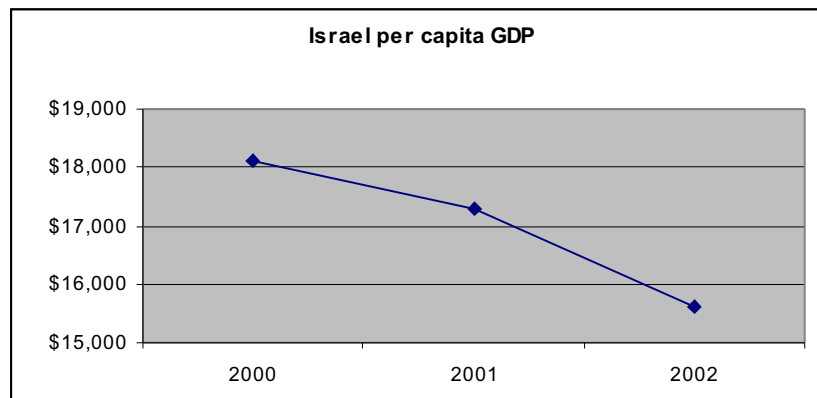
Israel Capital/Financial Account Balance 2000-2002 (in millions of U.S. dollars)

	2000	2001	2002
Capital Account	455	681	151
Financial Account	3428	631	-2060
Total	3883	1312	-1909

Source: Carson, S. Carol, Director. International Financial Statistics. Vol LVI No. II. Washington D.C.: International Monetary Fund, Nov. 2003.

Graph A-3

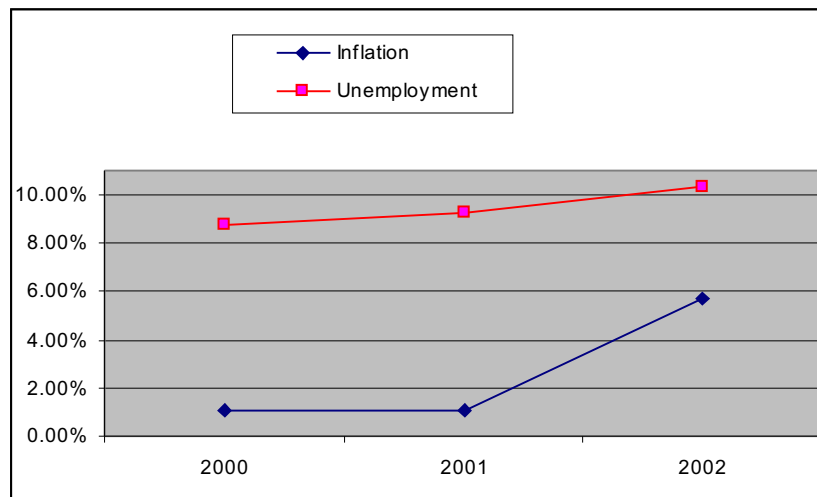
Israel Per Capita GDP 2000-2002



Source: Israel. World Facts and Figures. 15 Nov. 2003.
<<http://www.worldfactsandfigures.com/countries/israel.php>>.

Graph A-4

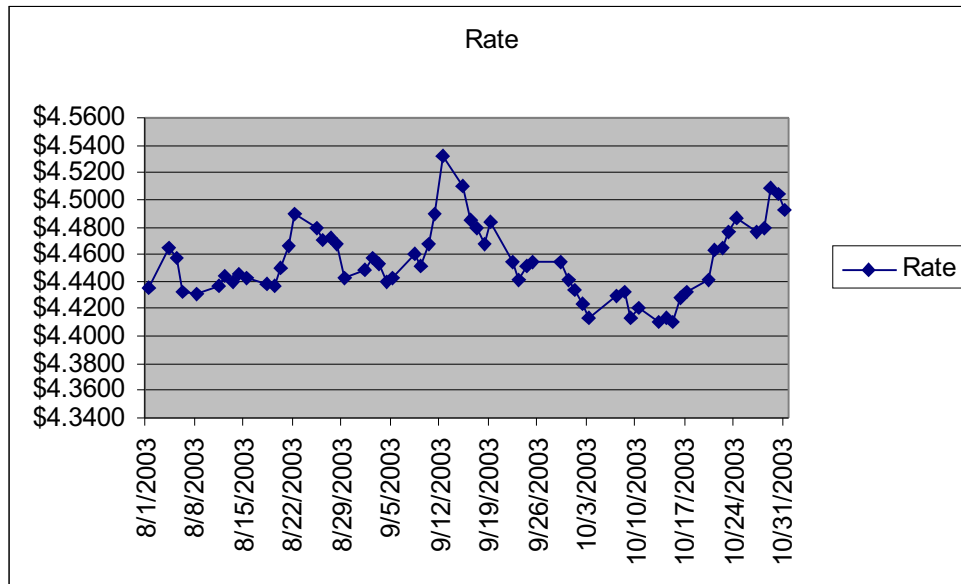
Israel Inflation and Unemployment Rates 2000-2002



Source: Israel. World Facts and Figures. 15 Nov. 2003.
<<http://www.worldfactsandfigures.com/countries/israel.php>>.

Graph A-5

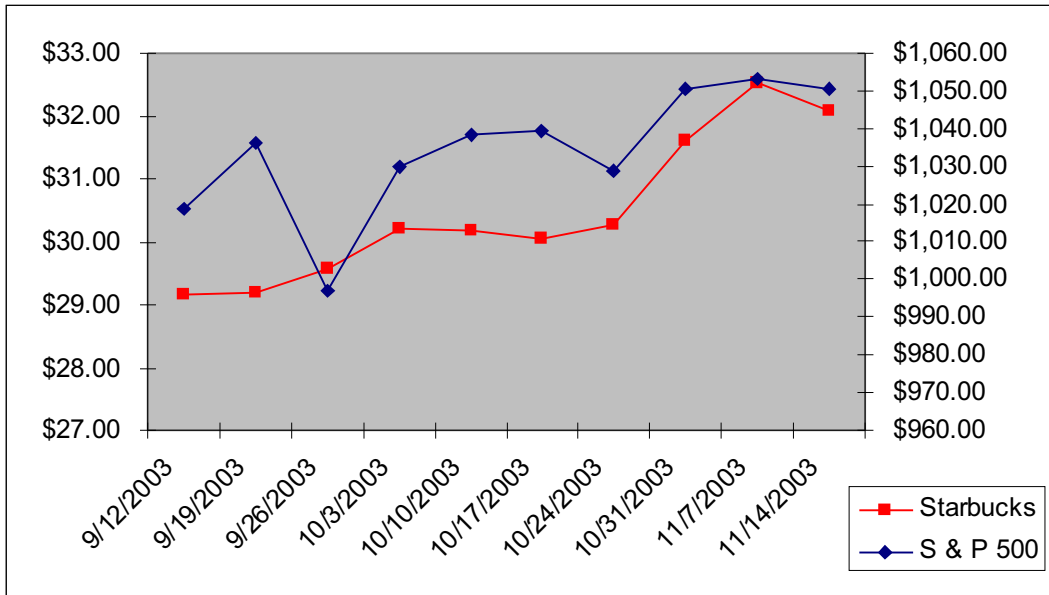
Israeli Shekel/U.S. Dollar (ILS/\$) Spot Exchange Rate



Source: Foreign exchange rates. Bank of Israel. 12 Nov. 2003.
<<http://www.bankisrael.gov.il/eng.shearim/index.php>>.

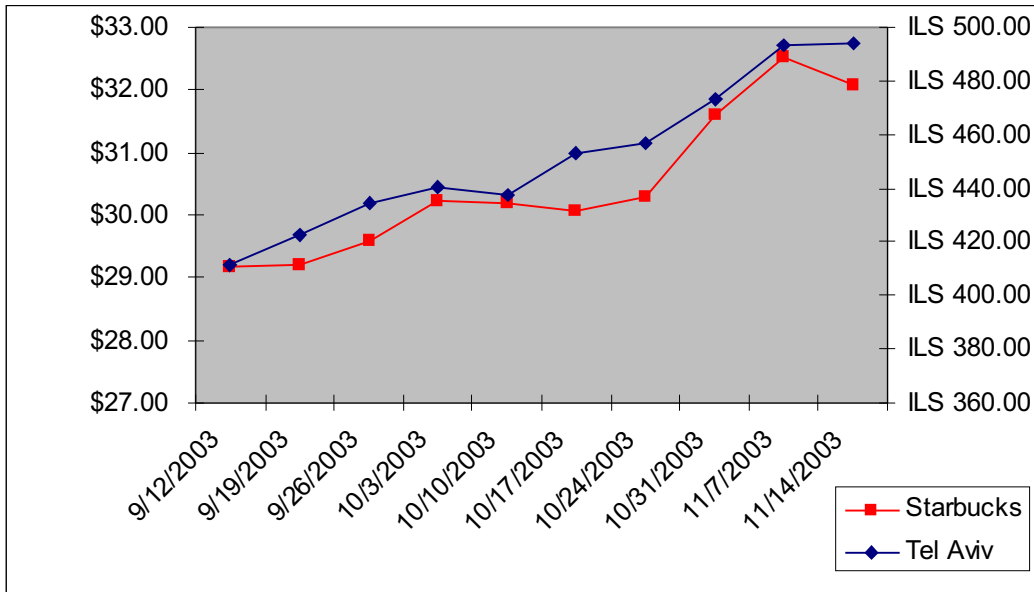
Graph A-6

Starbucks' Stock vs. S&P 500



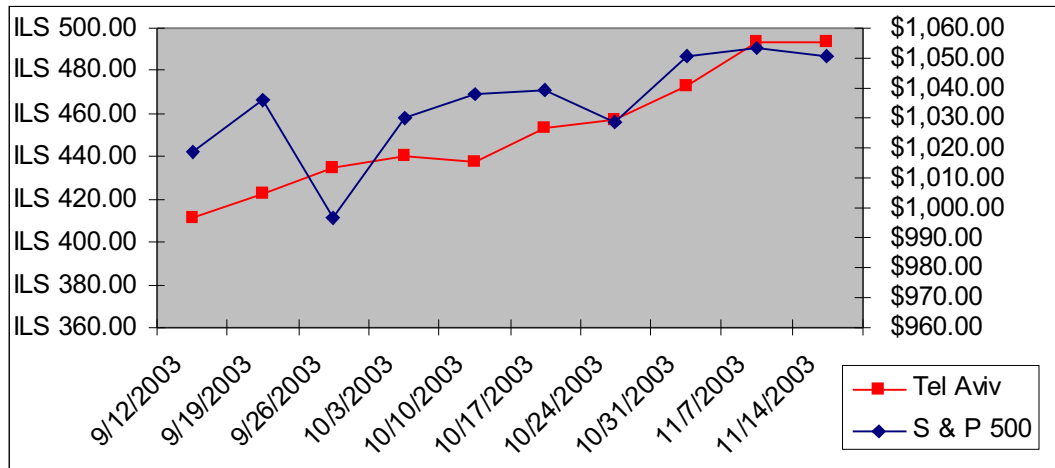
Graph A-7

Starbucks' vs. Tel Aviv Stock Exchange



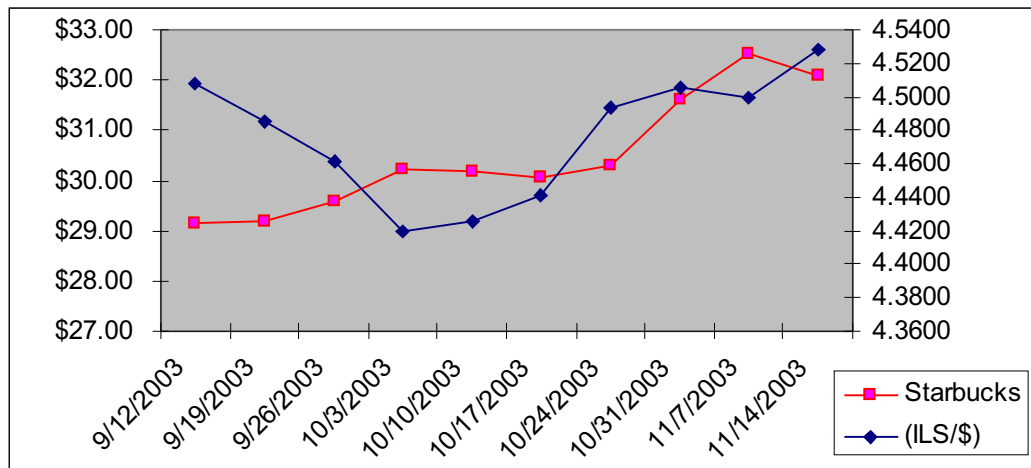
Graph A-8

Tel Aviv Stock Exchange vs. S&P 500



Graph A-9

Starbucks Stock vs. Israeli Shekel/U.S. Dollar Exchange Rate



Data Sources for Graphs A-6 through A-8: finance.yahoo.com

Data Source for Graph A-9: oanda.com

Real Exchange Rate

%chg.q(FX/\$) = -7.52%

	11/14/02	11/14/03	Inflation - Israel	Inflation - U.S.
(FX/\$)	4.6880	4.5278	5.7%	1.6%
Chg. In (FX/\$)	-0.1602			
% Chg.	-3.42%			

Works Cited

Carson, S. Carol, Director. International Financial Statistics. Vol LVI No. II.

Washington D.C.: International Monetary Fund, Nov. 2003.

“Consumer Spending on Upscale Ready-to-Drink Items Driving Growth in the \$14.7 Billion Premium Beverage and Confectionery Market.” Lifestyle: Food / Beverage. 28 July 2003 <<http://food-beverage.press-world.com/v/24117.html>>.

Int'l Finance: Middle East & North Africa: Israel. 2003 Yahoo! Inc. 30 Oct. 2003.

<<http://biz.yahoo.com/ifc/il.html>>.

Middle East: Israel: Economy. Nationmaster.com. 1 Nov.

2003. <<http://www.nationmaster.com/country/is/Economy>>.

Part 1: The Balance of Payments. Bank of Israel. 30 Oct. 2003.

<http://www.bankisrael.gov.il/deptdata/mehkar/doch02/eng/pe4_1.pdf>.

Starbucks Coffee International. Starbucks Corporation. 15 Oct 2003.

<<http://www.starbucks.com/aboutus/overview.asp>>.

The Company. Starbucks Corporation. 15 Oct 2003.

<<http://www.starbucks.com/aboutus/overview.asp>>.

The World Factbook: Israel. The Central Intelligence Agency. 1 Nov 2003.

<<http://www.cia.gov/cia/publications/factbook/geos/is.html>>.

The World Factbook: United States. The Central Intelligence Agency. 1 Nov. 2003.

<<http://www.cia.gov/cia/publications/factbook/geos/us.html>>.

Sources for data #11:

(ILS/\$) Source: <http://oanda.com/convert/fxhistory>

Israel's Inflation Rate Source:

<http://www.cia.gov/cia/publications/factbook/geos/is.html>

United States' Inflation Rate Source:

<http://www.cia.gov/cia/publications/factbook/geos/us.html>

Source for quotes #12:

<http://www.menareport.com/story/TheNews.php3?action=story&sid=244311&lang=e&dir=mena>

Source for quotes #14:

<http://www.forbes.com/2003/11/17/1117automarketscan07.html?partner=yahoo&referrer>