

Rustic Coffee:
A Strategy for
Challenging Starbucks

Ben Aronin, Abe Fetterman, Xin Liu, Joyce Peng
BEM 106
May 28, 2004

Question

Howard Schultz pioneered the mainstream market for the Italian-style espresso shops in the US after buying the small Starbucks chain in 1987. Since then, the industry has exploded across the US and continues to grow at a phenomenal rate. The retail market for specialty coffee is not yet mature, so moving into it now could still be very profitable.

The strategic question we pose is: How can we successfully and most profitably enter the retail specialty coffee business that is dominated by Starbucks?

Executive Summary

Start a franchised chain of coffee shops that will initially concentrate on the rural areas (the chain will henceforth be referred to under a working title of “Rustic Coffee”). Rural development will serve as a nursery in which Rustic Coffee can grow without competition while establishing a distinctive national brand identity than can later be used to compete directly with Starbucks. We will sell franchises for large areas so that franchisees can follow a more coherent strategy for the stores, such for tactics such as allowing cannibalizing sales like Starbucks.

Raise the quality and business relevance of complementary goods, because many people will stay in the store. Do not try to compete mostly on price, as this will undercut the quality signal for specialty coffee. Extract more concessions from the bean and labor suppliers, because they have minimal bargaining power, and this will generate a comparative advantage over Starbucks.

Strategic Analysis

Entry

Overall, the entry barriers for selling specialty coffee in rural areas are quite low.

The continuing rapid expansion of Starbucks, including into rural areas, offers empirical evidence that on the level of individual stores, entry barriers are low. Since our corporate focus will be on areas underserved by Starbucks, our franchisees will mostly open stores in locations with no close competition.

While we cannot achieve national coverage immediately, we want blanket coverage and heavy marketing in areas that we do enter. Company-owned stores in the start-up area could follow the blanket placement strategy, and then franchisees would imitate it (assuming it is successful). The advantages of scale in this industry are not overwhelming, as shown by the abundance of independent coffee shops and small chains. One of the main scaling advantages is brand recognition. Ubiquitous stores serve as a substitute for expensive advertising. Even without the close spacing of urban markets, being a destination location in every large town in a county would have an analogous effect.

The main axes of differentiation are location, quality, products, atmosphere, and taste. Locating away from Starbucks is central to the rural entry strategy. On quality, we are emulating the quality of Starbucks because of Starbucks's success, though our franchised structure may result in slightly worse quality control. We will offer more food products than Starbucks, because we expect the eat-in-the-store market to be a larger proportion of business in rural areas. The "grab-and-go" market of people who stop in on the way to office jobs will be much less important than it is in urban areas. We will have minor style and taste differentiation from Starbucks, the exact nature of which can be decided by specialists in those areas. Although we will initially be mostly in markets without Starbucks, later expansion into contested markets will require differentiated style and taste to win over some of Starbucks's customers.

Since we will be the vanguard of the specialty coffee industry opening in new markets, customer education will be a necessary part of our marketing. Hopefully some knowledge of Starbucks will reduce the amount of customer education required. Customer familiarity with the market will be a much more important consideration when

challenging existing Starbucks locations, where marketing would need to focus on sending a “better than Starbucks” message.

Entry barriers related to experience in the industry are low. The learning curve in specialty coffee is mostly limited to business methods, as opposed to product design. Even much of the business method information can be copied from other retail industries. Selecting franchisees with experience in their regions would essentially outsource expertise to reduce the demands on the central company.

Rivalry

Rustic Coffee will have to compete with the multitude of current competitors in the specialty coffee business. While we hope to minimize this by starting in less saturated areas, it is possible that these companies will respond to entry by erecting stores nearby, creating direct competition. The most serious threat is from Starbucks, which is infamous for creating stores everywhere and has plans to expand in rural areas.

One way to compete with the brand names currently in existence is to create brand loyalty. This can be done by ensuring quality (e.g. with refunds or free drinks if there are problems) and by directly rewarding loyalty (e.g. with membership cards or with “buy 10 drinks get the 11th free” deals). Getting buy-in from the franchisees would be essential for these programs to succeed.

It is unlikely that competitors will change core business strategies in response to Rustic Coffee. Quality competition would be very difficult to achieve, as it would require a restructuring of Starbucks’s business structure. Price competition would do too much damage to the businesses and has not been a factor near earlier entrants. It is difficult for consumers to determine the quality of a coffee-shop before purchasing a drink, so the price of the coffee can be used to signal the quality. That is, customers wanting a gourmet drink may be turned off by a store with lower prices simply because of the lower prices. Beyond signaling of quality, there is some status symbol effect to what coffee you are drinking, so that higher prices in and of themselves make the product more desirable to some people. If the quality signaling and status symbol effects are large enough, they may negate price competition even during later stages of the product life cycle.

Substitutes

The market for substitutes is split between in-store and out-of-store points-of-sale. It is likely that by selling beans in-store for at-home coffee-making, the entrant may better pervade the consumers' coffee experience and so build a better name overall. Teas also enhance the reputation, and are relatively simple to incorporate into the store atmosphere and design.

Other upscale coffee shops like Starbucks are obviously close substitutes to Rustic Coffee, but physically locating away from close substitutes lessens the possibility of consumers making the substitution. Low-end coffee sellers like Dunkin Donuts are weaker substitutes, and proper differentiation in quality and atmosphere is necessary to avoid too much overlap with them.

Other non-coffee substitutes, such as colas, energy drinks, or other specialty beverages are not easily compatible with the specialty-coffee model. These markets are huge, and are unlikely to be impacted by the entry of another company into the coffee industry. For this reason their effects are not accounted for in the entry strategy.

Suppliers

The main suppliers in coffee shop chain business are: coffee beans suppliers, equipment suppliers, real estate sellers and renters, and employees.

The price of coffee beans has plummeted because of a rise in the global coffee production, due largely to the emergence of Vietnam as a coffee supplier. This has reduced the cost of beans as a proportion of the total cost of coffee drinks. The current market players have not locked up a large portion of bean suppliers, and any apparent supplier loyalty is likely just the result of economic considerations. Although there is price advantage for buying large quantity as Starbucks does, the massive surplus in supply makes this effect negligible. Moreover, Starbucks's mere 1% of the world's total coffee purchases limits its ability to influence the coffee purchase price. It is hard for Starbucks to strike a purchase price war with a potential entrant in the coffee drink business. Although the high-quality Arabica coffee counts for only 10% of the world's coffee purchases, the oversupply and the lack of concentration in coffee purchase parties eases the challenge in procuring high-quality coffee beans.

Capital equipment in coffee shops includes coffee makers, grinding equipment, and furniture. Buying smaller amounts of equipment than Starbucks might increase the relative price for Rustic Coffee, but the disadvantage will not be too big since these are all commodity goods. The suppliers are not tied to any existing coffee shops. The supply of equipment will neither prevent entry nor create a substantial competitive disadvantage to a small firm.

Starbucks has been picking spots populated with well-educated, well-paid people who are sophisticated enough to appreciate its expensive upscale coffee beverages. They are experienced in playing the real estate market to acquire suitable locations. Since Rustic Coffee will initially be operating in rural areas, the real estate market will be somewhat different, probably to the effect that the retail company will be in an even more advantageous position.

Coffee making expertise and store management experience are not proprietary and can be hired away. Employees and potential employees are benefit sensitive and thus can be competed over. Differentiation in compensation and working conditions will keep us from hiring from exact the same pool as Starbucks. As mentioned earlier, the areas we are going to open shops first are not the high salary regions. The lower rural labor cost favors our side in negotiations with employees. The relatively low skill required for employees will always give the bargaining power to the company. With franchises, workers' compensation (especially health insurance) will probably be lower than for Starbucks, which could compensate for Rustic Coffee's higher costs in other areas.

Buyers

Since we are opening in areas not densely populated with white-collar worker, we will have a lower percentage of "grab-and-go" customers. Our challenge then is to serve enough in-store customers to support our business and especially to assure customers' continued willingness to pay for the upscale coffee. To do this, we have to leverage our interior design for a cozy theme environment and to align the theme with high-quality food items.

Starbucks has a population of buyers for product lines outside its retail coffee business. It sells ground coffee for home brewing, bottled coffee drinks, ice cream, and

even coffee liqueur. We will not start with such secondary aspects of the coffee drink business but instead will concentrate on selling beverages and food within our stores.

Complements

In our rural coffee shops, complements are very important. We want to create a homey and cozy atmosphere at our stores to attract local people. The high proportion of the customer base that will stay in the store to eat increases the importance of complements. If they are staying in the store longer, they will pay more attention to the décor and will eat more food. The result is increased complementarity between the coffee and these other factors.

For the places where real estate is cheap, we could provide a garden setting for people to sit down and enjoy coffee. Perhaps an outdoor garden and an indoor garden, to accommodate different weather conditions. Although maintaining gardens would be extremely expensive if the feature were “transplanted” into urban stores later, a scaled-down version could create substantial differentiation from Starbucks that would attract a more lucrative demographic.

For other food and drink, we will provide sandwiches, baked goods, and English teas as complementary products because food and coffee usually go together. We will put some magazines and books on the shelves to attract a more literate customer base. We will encourage franchisees to promote friendliness towards customers. The goal is to make our store an extension of home, so local people like to come.

References

- Anderson, Rick. "Starbucks: Just Getting Started." *Seattle Weekly*. April 30 - May 6, 2003. <<http://www.seattleweekly.com/features/0318/news-anderson.php>> (accessed 28 May 2004).
- Cook, Dan. "Starbucks is Still Hot." *CNN/Money*. 9 January 2004. <<http://money.cnn.com/2004/01/08/news/companies/starbucks/>> (accessed 28 May 2004).
- ElBoghdady, Dina. "Pouring it On." *washingtonpost.com (The Washington Post)*. 25 August 2002. <<http://www.washingtonpost.com/ac2/wp-dyn?pagename=article&node=&contentId=A56030-2002Aug24¬Found=true>> (accessed 1 May 2004).
- Linn, Allison. "As Starbucks expands, concerns grows about finding enough coffee growers." *The Detroit News* (from the AP). 17 April 2004. <<http://www.detnews.com/2004/business/0404/18/business-125571.htm>> (accessed 28 May 2004).
- McCarthy, Michael J. "Caffeine Emporium." *Lexington Herald-Leader* (from *The Wall Street Journal*). 20 April 2004. <<http://www.kentucky.com/mld/heraldleader/living/health/8453244.htm>> (accessed 1 May 2004).
- Starbucks 2003 Annual Report*. Part 2. <http://www.starbucks.com/aboutus/Annual_Report_2003_part2.pdf> (accessed 28 May 2004).
- "Starbucks Sales Up 11 Percent in April." *Reuters*. 28 April 2004. <<http://www.reuters.com/newsArticle.jhtml?type=businessNews&storyID=4976389>> (accessed 28 May 2004).
- Thompson, Arthur A. and John E. Gamble. "Starbucks Corporation." Online case study supplement to: Thompson, Arthur A. and Strickland, A.J. *Strategic Management*, 11th Edition. McGraw Hill, 1999. <<http://www.mhhe.com/business/management/thompson/11e/case/starbucks.html>> (accessed 28 May 2004).
- tktrimbath. "Starbucks ASM Meeting Notes." Post of the Day on *The Motley Fool*. 31 March 2004. <<http://www.fool.com/community/pod/2004/040331.htm>> (accessed 28 May 2004).

Appendix

Alternative Entry Plans

1. I Can't Believe It's Not Starbucks - copy Starbucks's products, atmosphere, organization, etc. This could be a new company or could start with an existing company following this strategy (e.g. Caribou Coffee).

Pro: Starbucks is extremely successful and has opened a new market of upscale coffee. This is our motivation for entering the market. In the absence of large economies of scale, doing the same thing could bring us similar success.

Con: At some level, this is functionally equivalent to “expand Starbucks.” Starbucks is better at expanding Starbucks than anyone else could be.
2. Emulate Starbucks’s products, atmosphere, etc., but operate most stores as franchises.

Pro: Enters the core market while reducing the amount for central management required.

Con: Does this offer enough (if any) comparative advantage to compete effectively with Starbucks, or even with second-tier competitors like Caribou?
3. Merge existing regional companies (e.g. Caribou Coffee, Coffee Bean and Tea Leaf) and unify them under a national brand.

Pro: Our goal is to be recognized as #2 to Starbucks, and this would be the fastest way to create a national competitor to Starbucks. It has the additional benefit of removing some of the most likely competitors for the #2 position behind Starbucks.

Con: There would be some loss of value in merging existing chains, because the individual appeal of acquired chains would be reduced if the brand and products were changed. Merging regional chains is also subject to substantial hold-up if one of the larger regional companies refuses to join.
4. Modify and expand Tim Hortons in America with a more upscale ambiance and more types of coffee.

Pro: Leverages a large existing (Canadian) brand with a good reputation in coffee and the strong corporate infrastructure of Wendy’s International. Sells donuts.

Con: Tim Hortons is starting in the wrong market, much closer to Dunkin Donuts than to Starbucks, and a major shift in positioning would be difficult.
5. You are Panera Bread (an upscale retail chain that sells freshly made sandwiches, bagels, pastries, salads, etc.). You are already rapidly expanding this chain of company-owned stores. Open a new chain of Starbucks-like coffee shops in the same areas as the Panera Bread stores. Sell a limited selection of pre-made Panera Bread sandwiches, etc. through the coffee shops (prepare the sandwiches at existing Panera Bread stores and ship them to the coffee shops). Sandwiches will mostly be sold in the morning to people picking up coffee on the way to work, to be eaten during lunch at work. Allow pre-orders to registered customers so that a sandwich of the proper type is guaranteed to be available when customers walk in in the morning.

Pro: The biggest advantage of this scheme is in better complementarity between coffee and food products. High quality coffee and high quality food will attract many customers who are currently stuck with low quality on one of them. One stop

shopping allows for higher prices. Independent of complementarity, there is still a substantial profitability advantage in selling more products to each customer.

Panera Bread already sells substantial amounts of specialty coffee in the morning, but its stores are not ideally positioned and laid out to capture the “Starbucks market.” Nevertheless, Panera Bread’s corporate expertise in coffee, expansion, and general retailing would be extremely valuable in starting a new coffee shop brand. This strategy makes use of unutilized late night/morning capacity at Panera Bread stores, so disruption of the existing chain would be limited.

Con: Panera Bread is a successful and rapidly growing company that already shed all its other corporate units in 1999 (including Au Bon Pain, its former parent) to focus on expanding the Panera Bread brand. Opening a new chain in a somewhat different market saddles a successful concept with enough risk to cripple the success of that concept. Dilution of expertise and focus would be a part of the risk. Selling pre-made Panera Bread sandwiches might reduce the perceived quality of the Panera Bread brand.

More Factors Considered (a list of many of the other options that did not make the final analysis)

- Addictiveness of caffeine
 - Reduces demand drop-off characteristic of other fad foods
 - Potential lawsuit vulnerability
- Unique products to establish brand recognition beyond the core coffee shops
 - Coffee-flavored “adult cereal”
 - “the best thing to get you going in the morning”
 - Smirnoff Ice-esque beverage to hook ‘em young on the soft stuff and then get them to move up to real coffee.
- Contradiction in strategic prerogatives – if you don’t differentiate from Starbucks (i.e. people will describe you as “like Starbucks”), then you should enter near Starbucks so that people are familiar with the product. But Starbucks saturates its markets, so it is better to enter somewhere that they are not entrenched yet.
- The specialty coffee industry in the growth phase of the product cycle. How does a company prepare for the mature stage?
- What existing resources can be leveraged to overcome Starbucks’s scale advantage of name recognition?
 - Existing coffee brand
 - Existing non-coffee brand
- Franchising reduces quality control, which reduces the known-quality advantage of chains
- Differentiate on complementary products
 - WiFi
 - Sandwich vs. donuts vs. etc.
 - Many others
- Have high caffeine to match Starbucks? Lower caffeine would induce withdrawal symptoms in people switching from Starbucks, making them more likely to return to Starbucks.
- What are sources of business expertise?
- Sit-in-the-store market vs. stop-in-on-the-way-to-work market
 - The former group attracts the latter to the store
- Roasting some beans locally produces a pleasant and distinctive aroma that would attract customers
- Have a “good” owner that some group of people wants to be profitable, i.e. if they are overpaying, the premium is thought of a donation. This is related to concepts like the Democratic Party credit card. Perhaps a university endowment as the owner would be a good choice.
- Tim Hortons is all over Canada. It sells good coffee. It is beginning to enter the U.S. market. Where does it fit into the specialty coffee market?
- Starbucks has an advantage in name recognition/branding and a large array of complementary products, but it also has an anti-Starbucks “following” that could possibly be tapped. However, a substantial portion of the anti-Starbucks crowd would be against any chain, so this is probably not a large potential market.

- Fair Trade strategies to differentiate from Starbucks (Fair trade coffee is sold at prices to benefit small-farmers and is produced under environmentally friendly conditions)
 - go 100% Fair Trade
 - go “evil” – lower coffee bean prices – Starbucks supposedly on average pays double the market price because it partially supports Fair Trade and quasi-Fair Trade practices
- Starbucks and other coffee shops teach people coffee appreciation, but when they gain enough appreciation they buy (or receive as gifts) fancy machines of their own (coffee grinders, espresso machines, etc.) to use at home instead of going out to buy coffee.
- What is the sensitivity of the specialty coffee business to macroeconomic changes? (e.g. do people getting pay freezes stop buying expensive coffee?)
- Could the government regulate caffeine as a drug to create an entry barrier benefiting existing companies?