

The Future of Starbucks



An Analysis by Team Macchiato:

Zack Higbee

Chen Yee Liaw

Calvin Ting

Kevin Tjho

Michelle Ton

Executive Summary

Starbucks Corporation has arguably been the most successful coffee chain in the past few decades, using their aggressive expansion strategies to push out much of its competition. Through its expansion, Starbucks has focused on creating a dense network of stores all around America, while also opening up new locations all around the world. By leading the retail coffee market, Starbucks is able to sell its coffee for a premium price and increase their profitability. Its success can be seen in the gradual rise of its stock prices from 1992 – 2007, reaching almost 6000% of their initial public offering¹.

Yet, in the recent year, the market has shown Starbucks to be in constant decline, as their stock has dropped about \$15/share, a value they have been above since 2004. Also, looking at Starbucks' SEC filings, we can see that its comparable store sales have decreased significantly in US markets since 2004. This has prompted Team Macchiato to evaluate Starbucks' current strategies in addition to the retail coffee market as a whole. To evaluate the problem, one of the biggest questions to consider is to what extent is the "designer coffee" market just a fad. In other words, will the allure of gourmet Starbucks coffee be maintained or will more appealing options threaten the success of Starbucks' primary product? If the designer coffee market is indeed a fad industry, we need to evaluate Starbucks' possible options to avoid further decline.

Problem Definition

The overarching question that we should answer is how Starbucks can stay profitable in the future. A good place to start involves evaluating the current market for coffee; from this point, we can gather information about market performance and determine the extent to which designer coffee appeals to current consumers. Through market analysis, we can investigate whether or not the demand for gourmet coffee is wavering. We will evaluate whether coffee companies in general are having trouble maintaining profitability or if it is just Starbucks that has declined in recent times. If the market is indeed in decline, we must answer the following questions:

- If designer coffee is just a fad, is the temporary popularity approaching the end or has the fad already ended?
- What are the options available to companies like Starbucks that specialize in fad coffee products?

Afterwards, it is necessary to analyze Starbucks's strengths, weaknesses, opportunities, and threats. From this analysis, we can determine Starbucks's motivations behind their current

¹ www.finance.yahoo.com, SBUX.

business strategies. Also, what strategies should Starbucks pursue in the future in order to avoid further decline and how can Starbucks counteract efforts from competitors?

The Current Situation

Compared to the rest of the market, during the past year Starbucks' stock has steadily declined in value. Meanwhile, Peet's Coffee, one of Starbucks' major competitors, has had its stocks perform about the same as the rest of the market, following the general trend of rises and drops that the market experienced.

Since May of 2007, Peet's stock has remained steady, peaking in December 2007 at 30 dollars a share, and reaching a low of 20 dollar a share in the middle of March 2008. Meanwhile, Starbucks has been on a steady decline, its stocks dropping by 50% of their value since May of 2007, from about 30 dollars a share down to 16 dollars a share. The last time Starbucks stock was traded above 20 dollars a share was at the end of January 2008. In comparison, in the past year, the lowest Peet's stock has been was 19.89 a share.

Considering other minor competitors who have been encroaching on Starbucks's coffee business, both McDonald's and Burger King have been outperforming the market in the past year. Last year, Consumer Report rated McDonald's coffee above Starbucks coffee for the first time.

Another important financial aspect to evaluate is Starbucks' comparable store sales, or the percentage of revenue growth among their existing stores. Since Starbucks' primary strategy is to expand at a much higher rate than its competitors, it is much more useful to get a sense of how Starbucks' existing coffee stores are performing, rather than including their newly expanded locations. A glance at Starbucks' SEC Filing for the fiscal year of 2007 reveals that Starbucks' annual comparable store sales growth has steadily decreased from 11% in 2004 to 4% in 2007 in US markets². In February of 2008, Starbucks reported that its comparable store sales contracted 1%, due to 2% increase in the average value per transaction offset by a 3% decrease in the number of transactions³. Though their international comparable store sales growth has consistently remained around 7-8%, their overall consolidated same-store sales growth has decreased from 10% in 2004 to 5% in 2007. This dramatic decrease in growth may be financial evidence that Starbucks' performance as a specialty coffee chain is waning.

When comparing net revenue growth instead, Peet's and Starbucks both have shown a relatively consistent percentage for the past three years (18 – 20%)⁴. Additionally, in Starbucks' most recent

² Starbucks 10-K Filed 11/29/2007 (SEC Website)

³ Starbucks 10-Q Filed 2/8/2008 (SEC Website)

⁴ Starbucks 10-K Filed 11/29/2007 (SEC Website)

quarterly performance report, they mentioned that they will no longer be announcing their same store sales growth. Their reasoning stems from "...near term changes that will significantly impact the Company's U.S. retail stores...[and comparable store sales metrics] will not be an effective indicator of the Company's performance⁵." Removal of this information from the public eye is indicative of an unhealthy downturn in Starbucks' expected performance.

Problem Analysis

As of late, Starbucks has clearly been declining compared to its main competitors and compared to the market. One cause of this may be the current economic downturn. The slowdown in the economy has changed people's spending habits. According to the Associated Press, "Research by WSL Strategic Retail found that ...premium brands or food and specialty coffees...are [among] the top areas where people are trimming their spending."⁶

Starbucks considers itself a premium coffee provider, as is evident from the statement from The Economist "Howard Schultz once said that he finds it painful when people compare his firm, Starbucks, to McDonald's. The founder of the world's biggest chain of coffee shops thinks a visit to Starbucks should involve "romance and theatre", a far cry from the pit-stop-like experience of eating a meal at the world's biggest fast-food chain."⁷

According to The Economist, "Not all of Starbucks' poor performance is of its own making. Prices for food commodities are at all-time highs, prompting the firm to increase prices twice in the past year. This has scared off customers, who have been defecting to fast-food chains such as Dunkin' Donuts or Panera Bread, which sell reasonable coffee for as little as a quarter of the price of a fancy Starbucks brew."⁷

Meanwhile, on one front, Starbucks has continued to embrace this legacy of unique excellence and high quality coffee. According to USA Today, Schultz "...says the company is having success in Boston and Seattle testing a premium coffee that sells for \$2.50 per cup, about a buck more than a similar cup of the regular drip coffee. 'We're going to go up in experience — not down,' he says."⁸

Facing competition from McDonalds and Dunking Donuts, Starbucks experimented with \$1 bottomless 8oz. cups of coffee for a short time in Seattle. However, Schultz "...axed a test of dollar cups of coffee in Seattle"⁸. In addition, he's specifically stated "We're not in the fast-food business."⁸

⁵ Starbucks 10-Q Filed 2/8/2008 (SEC Website)

⁶ http://money.cnn.com/2008/04/25/news/economy/doing_without.ap/index.htm

⁷ http://www.economist.com/business/displaystory.cfm?story_id=11021146

⁸ http://www.usatoday.com/money/industries/food/2008-03-18-starbucks-changes_N.htm

Thus, as we can see, Starbucks is committed to remaining in the premium coffee and premium service industry. Though their slowdown is partially caused by the market, it is clear that other competitors have not been affected as badly, so internal strategy may be the cause for their decline. Their strategy of not stooping down to the level of a fast food provider, for example, may be hurting them during this economic downturn.

Analysis of Starbucks Using Porter's Five Forces

1. The Threat of Substitution

Substitutes (Products)

- Other beverages apart from Starbucks coffee and tea – Examples include soda, fruit juice, smoothies, water, beer and other alcoholic drinks
- Other “quick-grab” foods apart from pastries, muffins, doughnuts, etc sold at Starbucks. Examples include burgers, burritos, tacos, sushi, snack food

Substitutes (Environment/Ambience)

- Lower-end or “less luxurious” coffee places
- Places that offer people a place to hang out, chat, relax or even work. Examples include tea houses, fast food places, ice-cream parlors, side-walk cafes, and bars and pubs

2. The Threat of New Entry

- The entry barrier for the coffee industry is relatively low, even for premium coffee like Starbucks. Any large and well-funded company where capital is not a problem could be potential entrants.
- Some of the more current and ongoing threats of new entrants include fast food chains such as McDonalds, Burger King and Dunkin Donuts.

3. Competitive Rivalry

- Other coffee chains. Examples include Coffee Bean & Tea Leaf, Gloria Jeans Coffee, Peet's, and San Francisco Coffee House
- Smaller privately owned coffee houses
- Secondary coffee providers. Examples include McDonalds, Burger King, Dunkin Donuts

4. The Bargaining Power of Suppliers

- Not much bargaining power for coffee bean suppliers due to the importance of Starbucks' business to any individual supplier, and the fact that Starbucks probably accounts for a large percentage of any individual supplier's sales.. This gives Starbucks the ability to dictate the price of coffee bean sales.
- Similarly, suppliers of paper and plastic products, such as cups, napkins, lids, etc, have very little bargaining power due to the large amount of alternative sources Starbucks could draw from. In addition, Starbucks has formed contracts with such suppliers, giving them effectively no bargaining power.
- There is more bargaining power for suppliers of technological innovations such as automated coffee machines, latte and espresso machines, etc because there are not as many suppliers for such equipment as there are for coffee beans.

5. The Bargaining Power of Buyers

- In the past, buyers did not really have bargaining power when it came to premium coffee such as Starbucks. The sheer scale of Starbucks' business reduces the bargaining power of any single group of buyers.
- With newer entrants and competitors such as McDonalds who claim to offer premium roast coffee of reasonable quality for lower price, buyers now have slightly more bargaining power than they've had in the past.

SWOT Analysis

Looking into Starbucks specifically, we need to analyze how it performs as a company and whether or not it will continue to perform. In order to gauge this performance we look at both the company's characteristics and those of the surrounding market and see what needs to be done for the future. An excellent tool for gauging these qualities is Strengths, Weaknesses, Opportunities, and Threats analysis, also known as SWOT analysis. Considering the strengths of Starbucks:

Strengths:

Pretty much everyone, at least within the US, knows the name Starbucks and associates it with high-end coffees. In addition, people see Starbucks as the biggest and best in the business. This is a significant strength because Starbucks has a natural edge over its lesser-known competitors in that people already associate it with a high quality and popular experience.

The enormous number of Starbucks locations allows them to reach almost every domestic market as well as a good number of international ones. This allows them to implement new products quickly across a large demographic and ensures a large exposure of clientele to prevent new

entrants from gaining market share. Additionally, taking advantage of existing establishments such as Barnes and Noble and opening smaller cafés in other businesses allows them to expand their market while keeping costs low. This also allows them expand their marketing potential to different demographics.

While their business isn't as well established internationally as a company like McDonalds, there is an extremely large benefit to having a globalized business (see Appendix). Aside from the obvious scale advantages, being international also helps to prevent the rise of international competitors that may build up enough capital to jump into the American market.

Starbucks has a well-known practice to make efforts to preserve the environment and be ethical in its dealings. This gives the company a good public image, which serves to counter some criticism that its sheer size creates. Its size also helps its position in the market. Being ahead of all its competitors in the industry in terms of size and volume allows them to set the prices and prevent the growth of other companies.

Starbucks successfully changed the public opinion of coffee products from a commodity to a luxury good, and in so doing, enabled an increase in price for these goods to a much higher level than would have been possible before.

Starbucks' mission to make its stores a "third place" for people to go besides work and home comes by offering services like free internet and comfortable chairs. This goal gives Starbucks the ambiance to go along with its product. While Starbucks has an exceptional edge in the coffee industry, it has some weaknesses that may leave it vulnerable to changes in the market.

Weaknesses:

While most people consider Starbucks coffee a luxury good and would pay whatever price is set for it, there is an increasing opinion that Starbucks charges too much. They are also very inflexible in terms of location. For example, Starbucks charges the same price for their products whether you're in LA or Beijing.

Basically, the main problem for Starbucks is that its entire business rests on the coffee industry. If coffee does turn out to be a fad, they must diversify or go out of business whereas other competitors, such as Dunkin Donuts, have investments in a variety of industries.

In addition to fixing its prices for international customers, Starbucks also has lacked some tact in the way of international relations. In Israel, Starbucks has had a hard time taking off because it won't maintain kosher standards. In general, Starbucks keeps its business plan formulaic and centralized and does not tailor its branches to the locations they are being placed in.

Moreover, Starbucks offers only one flavor of coffee, as opposed to its competitors such as Peet's and Coffee Bean & Tea Leaf, which offer a large variety of coffee's to choose from. This lack of selection makes Starbucks an unappealing choice for many coffee drinkers.

Opportunities:

By purchasing companies such as Seattle's Best, XM Café, and Tazo Tea, Starbucks used a different brand name to get business in a different market niche. Starbucks also offers a range of products that it sells to other companies such as its bottled Frappuccinos and other specialty goods, which expand its market at a lower cost than opening full branches.

They used their vast resources to develop an international business. This generated even more revenue for Starbucks and really helped to develop their brand image. One of their biggest opportunities continues to be in expanding and diversifying their business with their vast wealth.

Threats:

Recently, serious competition has presented itself. Several companies are developing coffee products that rival those of Starbucks. Companies such as Peet's and the Coffee Bean have grown large enough to seriously compete with Starbucks. Other companies, such as McDonalds, Dunkin Donuts, Burger King, etc, already have the infrastructure in place and are instead adding quality coffee to their menus to compete with Starbucks.

Another potential threat is that coffee is just a fad and eventually people will grow out of it. If this is the case, Starbucks' only hope is to diversify its business into other industries to potentially give it some security from fluctuations in the coffee market. Because of the specialization of their industry, Starbucks is very dependent on supply factors such as the price of coffee beans, which could hurt their business.

Analysis of Starbucks' Competitors

While Starbucks is still considered the dominating coffee chain corporation, in recent years, its hold on the coffee has loosened considerably. The recent competition facing Starbucks has not been from newcomers, but rather from older coffee chains that have increasing consumer loyalty and from established fast food corporations that have altered their focus to incorporate the rising trend of coffee. Starbucks has also been unsuccessful in unseating many independent mom and pop coffee houses, which have both hometown familiarity and loyalty.

One of Starbucks' biggest competitors is considered to be Dunkin Donuts. While Dunkin Donuts has always been moderately successful in selling coffee, especially because of the complimentary pairing of donuts and coffee, in the past few years the corporation has begun to aggressively promote its coffee. Dunkin Donuts recently hired celebrity Rachael Ray to be the face of their new

advertising campaign, which has the slogan, “America Runs on Dunkin”⁹. Moreover, Dunkin Donuts has started to emulate several Starbucks strategies, including holding a free coffee day a week after Starbucks held its free coffee giveaway. While Starbucks is still the largest retail chain, a 2007 survey conducted by research firm Brand Keys has found that Dunkin Donuts is No.1 in terms of customer loyalty (Starbucks came in at No. 2)⁹.

While Dunkin Donuts has found its greatest success in the Northeast, Starbucks’ main West Coast rival has always been Peet’s Coffee & Tea. Starbucks’ stocks have fallen significantly below the market in the past year, while other coffee chain competitors such as Peet’s Coffee & Tea have had their stocks remain at market level or above. Peet’s Coffee & Tea, which was founded only 5 years before Starbucks, has stayed in the coffee industry due to its focus on quality coffee. It has not tried to beat Starbucks’ moneymaking strategies of selling music and appearing edgy, but instead it has remained true to its core as a coffee shop that sells quality coffee. Peet’s concentration on quality coffee comes across with stances such as never restreaming milk, roasting beans in small batches, and maintaining a large variety of coffees for customers to choose from¹⁰.

Peet’s strategy of opening across the street or nearby to Starbucks locations has allowed it to take advantage of Starbucks’ popularity for its own gain, giving consumers an alternative coffee shop to go to. Additionally, Peet’s has never concentrated on store expansion, choosing to maintain its current stronghold in California. Because of this, on the West Coast, Starbucks does not command the same customer loyalty that Peet’s does.

The Coffee Bean & Tea Leaf has similarly done well by making sure to appear different than Starbucks with its large tea selection and its successfully innovative nature. Coffee Bean & Tea Leaf was the first corporation to popularize Chai Lattes and Ice Blended Coffee Drinks, both of which have been massively successful and emulated by Starbucks. The Coffee Bean & Tea Leaf was also able to find success in Israel, a place where Starbucks was unable to conquer, because Coffee Bean & Tea Leaf boasts kosher drinks and allows smoking.

Starbucks has strong competition from other coffee shops, but surprisingly, the other main competitors rising in the coffee market are prominent fast food chains. Corporations such as McDonald’s and Burger King have been around much longer and have a much bigger establishment than Starbucks does. They already have the infrastructure in place to sell coffee, and these fast food chains have recently been promoting what they assert is coffee that’s of similar quality to Starbucks for a cheaper price. For the same sized cup of coffee, McDonalds

⁹ <http://articles.moneycentral.msn.com/Investing/Extra/DunkinAndMcDonaldsTakeOnStarbucks.aspx>

¹⁰ <http://super-reviews.com/articles/new/peet's-coffee:-40-years-and-still-going-strong.html>

charged \$1.35, Burger King charged \$1.40, and Starbucks charged \$1.55¹¹. McDonald's has recently confirmed an increase in its breakfast business, which is cited as due to their Newman's Organic Coffee line. Burger King's coffee is also praised as high-quality fast-food coffee, especially with its choices of decaf, regular, and turbo.

While Starbucks has strategically opened its stores nearby small, privately-owned coffee shops in attempts to drive them out of business, in many cases the effort to drive away the smaller mom and pop shops has backfired. Starbucks' marketing for their newly opened stores only drew more customers for the independent coffee places in the vicinity. Independent coffee shops have even gone so far as to open up more coffee shops next to Starbucks, similar to Peet's strategy of chasing Starbucks locations. And the smaller independent shops have the upper hand in terms of customizing their coffee shop to appeal to small towns, such as endorsing hometown football teams.

Starbucks faces stiff competition from all sides. Its mass marketing leaves it unable to gain the consumer loyalty that smaller coffee shops have, and fast food conglomerates are far more established than Starbucks is.

Fragmentation:

Probably one of the biggest problems for Starbucks is the constantly increasing fragmentation of the retail coffee industry. There is no question that Starbucks dominates the coffee industry and that they are far larger than any of their competitors. For this reason, they have not had much trouble with market share in the past. However, there are now so many players in the industry and in competing industries that they are slowly taking their toll on Starbucks' sales. As an example of this, McDonalds' sales rose 8.2% by the end of 2007 after they began scaling up their coffee service.¹²

The rapid up rise of these types of competitors has hurt Starbucks just because of the sheer volume of the competition. Both competing companies and substitute companies have been on the rise, and because of this, the market for Starbucks has been shrinking. In 2005, the sales of organic coffees rose 40% according to Food and Beverage International.¹³ This shows that smaller but still powerful coffee companies, such as Vermont's Green Mountain Coffee Roasters, have significant traction in the coffee market. This apparent shift in the market has caused it to become

¹¹ http://www.consumerreports.org/cro/food/beverages/coffee-tea/coffee-taste-test-3-07/overview/0307_coffee_ov_1.htm

¹² <http://www.bloomberg.com/apps/news?pid=20601087&sid=a38bWZePUXLk&refer=home>

¹³ <http://www.fbworld.com/News%20Releases/2006/06.12.06/organic%20coffee.html>

more fragmented as people begin trying other brands of coffee instead of immediately choosing Starbucks. Similar trends can be seen in the change of consumer preference towards healthier drinks. These overall trends have fragmented the market because Starbucks and similar coffee companies do not have the edge on the retail industry that they once did. This problem ties into the much larger problem of the coffee “fad.” While it is not entirely determined that coffee is a transient fad and not just suffering from a brief decline, it is certainly obvious that Starbucks must take action to continue its dominance on the luxury drinks industry.

Part of Starbucks’ problem deals with the commoditization of coffee in general. Right now coffee “...is the 5th most widely traded commodity in the world”¹⁴. Frankly it’s a surprise that they have made it this far without significant problems. Some of the reason for this success is in their specialty drinks. Starbucks does not make much money on its regular coffee sales, but instead, it can make large amounts of money on its specialty coffee drinks that other companies have a harder time duplicating.

This new growth in the specialty drink industry has made it necessary for Starbucks to keep ahead of the competition by getting serious about its coffee. The bottom line is that one of the only things that continues to appeal to regular coffee drinkers is the Starbucks brand. With rapidly growing competition and so many new options for consumers, they need to seriously reconsider their coffee practices.

What Should Starbucks Do?

For many years, Starbucks faced almost no competition in the coffee business. It was Starbucks, the “luxury coffee”, or coffee taken as a commodity. However, with the entry of the competition mentioned previously, Starbucks is no longer the sole dominant player. These firms are a threat to Starbucks as they strive to provide “premium coffee” comparable to Starbucks’ but at a lower price. Despite that, we should consider whether the Premium Roast Coffee in McDonalds or in Dunkin Donuts is actually comparable to that of Starbucks in terms of flavor, aroma and quality. There have been mixed reviews from recent surveys in the public media, suggesting that there might be some behavioral economics going on. Whether or not Starbucks coffee is better than other coffee seems to be the matter of perception rather than actual quality. Below are some potential strategies that Starbucks should consider in overcoming their recent decline.

¹⁴ <http://tutor2u.net/economics/revision-notes/as-markets-coffee.html>

1. Strategies to Renew the “Starbucks Brand Name”

Advertising and Promotion

In an effort to renew their brand name, Starbucks first needs to address an important issue, namely the need to convince people that Starbucks coffee is superior to other coffees and beverages. This is vital because if the general perception is that McDonald’s coffee is comparable to Starbucks coffee, then there would be no incentive for consumers to pay a premium for Starbucks coffee. To approach this problem, Starbucks needs to be more aggressive in their advertising campaigns - to educate and notify the public the specialty and uniqueness of Starbucks coffee. In 2006, Starbucks allocated only \$38 million on marketing, compared to \$782 million allocated by their closest rival, McDonalds. Even Dunkin Donuts, which is considerably smaller than Starbucks, allocated a total of \$116 million on advertising in that year.¹⁵ It is clear that as incumbents, Starbucks needs to heighten its advertising efforts in order to maintain leadership in the coffee industry.

Previously, Starbucks’ advertising strategy has been focused on “in-the-store” relationships. They retain customer loyalty by providing personalized interactions to their customers. Therefore, the Starbucks counters usually house large numbers of baristas and general employees who would proactively communicate and attend to customer needs. Although it has proven to be a relatively successful strategy, Starbucks needs to counter against McDonald’s marketing approach that is more aggressive. For instance, McDonalds launched a website that “mocks” the apparently over-rated Starbucks coffee, at <http://www.unsnobbycoffee.com>. Although Starbucks prides itself in providing a luxury good (hence “snobby”), they should educate the public more effectively than it currently does, about the unique characteristics of the Starbucks coffee to assure its customers that they are paying a premium that is worth the money.

In addition to that, Starbucks should focus mainly on advertising its core business, its coffee. Of late, they’ve concentrated too much in marketing their music, films, books and other businesses that supplement the coffee business. As a result, they’ve deviated and neglected the product that really defines Starbucks. By doing so, customers might think that the music/film marketing strategy was implemented to compensate Starbucks’ mediocre coffee. In terms of marketing specifically for their coffee, Starbucks should diversify their advertising channels. Instead of relying mainly on employee-customer relationship, they should also venture more assertively into advertisements via the internet, printed and visual media.

¹⁵ [http://www.wikininvest.com/stock/Starbucks_\(SBUX\)](http://www.wikininvest.com/stock/Starbucks_(SBUX))

Product Differentiation

In renewing the Starbucks brand, apart from convincing consumers why Starbucks coffee is superior through large-scale marketing efforts, Starbucks should also work on product differentiation. Although McDonalds claims to offer premium coffee at a lower price, it would be inefficient for Starbucks to start a price war. Such a move is not favorable because Starbucks coffee is supposed to epitomize a luxury good, where people are willing to pay a premium for it. Besides, a price war would lead to further decrease in pricing, and it reaches a point where it would not be profitable for both parties. Instead, Starbucks should work on differentiating its coffee. They should invest in extensive research and development efforts to develop new flavors, blends, or even roast fusions. Novelty by itself is a good advertising tool. In introducing the novel and supposedly “revolutionary” product developed, they should start by providing free samples for a limited period of time. If the response is good, they can then proceed to introduce the new product to all stores. Starbucks has implemented the \$1 sampling strategy, however, there needs to be a follow-up to that strategy. Because the \$1 coffee is cheap, people would tend to get that coffee more frequently during the sampling period. After a certain duration, Starbucks ought to increase the price from \$1 to the usual price for profits, because by then, presumably, a large fraction of its consumers have gotten hooked to the coffee. From a behavioral economics perspective, these people would be more willing to pay the usual price because they feel that they have reaped the benefits throughout the sampling period.

Product differentiation may also be used as a strategy to overcome the downside of the current economy. With the ongoing recession in the United States, consumers would be conservative in their spending, and are less likely to spend \$4 on a cup of coffee. Starbucks could create a new product that is more cost efficient, hence, sold at a lower price. Instead of deviating from its “luxury, premium” status, Starbucks can counter this problem by promoting it as part of their marketing strategy to help consumers save during this transient recession. Not only would they be able to compete with lower priced coffee offered by its competitors, they also would retain their customers during the economic downturn. Starbucks’ flexibility in adapting to the economy to serve their customers’ needs might even heighten their brand name.

Coffee Variety and Quality Control

In catering to different consumer preferences, Starbucks needs to increase its variety of coffee offered. Currently, Starbucks only offers one type of coffee to its consumers, while its competitors, such as Peet’s Coffee, offer multiple types of coffee to suit a wider range of customers. Examples would include different kinds of coffee brews specific to coffee drinkers who either do or do not add milk to their coffee. Above all, Starbucks needs to ensure that the coffee offered is of the highest quality. Otherwise, customers would not have an incentive to pay such a premium price for Starbucks coffee.

2. Strategies to Build and Retain Customer Loyalty

Privilege Card and Rewards Program

To date, Starbucks has implemented its Starbucks Card program, whereby consumers can reload credit online, and essentially use it as a “cash card” at any Starbucks store. In addition, cardholders can also register online to qualify for rewards each time they use their Starbucks card. Some of the benefits include complimentary beverages after a certain number of purchases, free refills, and free syrup and milk options¹⁶. Despite this sound strategy, it does not differ from other reward programs offered by its competitors. For instance, Coffee Bean & Tea Leaf also implements a relatively similar rewards program, whereby consumers get complimentary drinks and various other benefits.

Having a non-distinct rewards program provides no incentive for coffee drinkers to choose Starbucks over other its competitors. For instance, if there were a person driving along a street looking for a coffee place, he would probably not take the trouble to look for a Starbucks, and instead would settle for something convenient such as McDonalds or Gloria Jeans Coffee. However, this would not be the case if Starbucks had a superior rewards program. One possibility would be to cooperate with airline companies and other large retail companies and combine their rewards program with that of Starbucks. Essentially, a United Airline privilege cardholder can accumulate “miles” while a GAP cardholder can obtain GAP rewards even when they spend at Starbucks. If such synergies exist, then consumers would have more incentive to choose Starbucks over other brands simply because it would be wealth maximizing.

Starbucks Drive-Through

Although Starbucks’ strategy has been to open as many stores as possible, most of its stores are mid-sized. There have been reports from recent surveys on people’s opinions about the lack of tables and seats in Starbucks during peak periods, namely in the mid-mornings. It is possible that if one finds no available table in Starbucks, she will choose to go to some other place that offers reasonable coffee and a table to work or read. As a result, Starbucks loses potential customers. Furthermore, although Starbucks is located at every street corner, it is usually located in such a way that it is difficult to find a parking space. People prefer convenience, and this usually means pulling over and making a quick run to get coffee or a snack. As a result, Starbucks loses a portion of its customers during peak periods because most people would rather go elsewhere, such as a place with drive-through counters like McDonalds.

One possibility would be for Starbucks to increase its store space to accommodate crowds during peak periods. However, this might not be cost-efficient because enlarging current Starbucks stores

¹⁶ https://www.starbucks.com/customer/faq_qanda.asp?name=card

requires a big investment. Starbucks has already started implementing drive-thrus around the country, and there is potential for them to expand. It should be noted that drive-thru Starbucks locations should be implemented only as a supplement to retail stores, targeting customers who are in a hurry, and whose main purpose is merely to satisfy their daily caffeine intake. Because Starbucks' relatively recent drive-thru initiative has not been aggressively marketed, mostly to prevent this new concept from interfering with the Starbucks image, a "new brand" could be created to overcome this problem. For instance, this new subsidiary could be called "Starbucks Express" to differentiate its retail stores. In that sense, Starbucks still retains its original brand name as a luxury good, and the new distribution channel provides an extra means for consumers to buy Starbucks coffee.

3. Strategies towards Cost-Efficiency

Focus on the Coffee

Considering the weak economy, Starbucks should also consider strategies that would reduce cost, as well as strategies that would promote growth and profit. In recent years, Starbucks has started venturing into other businesses apart from coffee. Examples include the music, film, and book marketing business. In doing so, not only are they diluting the value of their coffee, but they are also incurring a large cost. One way to reduce cost would be to specialize and focus on marketing their coffee. By being involved in fewer businesses, cost is reduced, and all the resources can then be channeled towards improving their core product.

Effective Store Expansion Decisions

Considering the recession in the US economy, it would be favorable for Starbucks to put a halt on its strategy to open more stores in the United States. In 2007 alone, Starbucks opened 1700 new stores, amounting to a total of over 15000 stores, and aimed to reach 40000 stores in the future¹⁷. Considering Starbucks' financial performance as well as the economic climate in the United States, it would be efficient for Starbucks to stop adding stores in the US and instead work on renewing its brand and customer base.

Furthermore, the budget allocated for store expansion in the US would be put to better use for expansion in other countries that have greater growth potential, specifically China. Expanding into China would be a good opportunity for Starbucks, considering China's fast-growing economy where more people are likely to splurge on luxury goods. Recent reports have shown that Starbucks locations in Beijing have reported at least 30% growth in annual sales¹⁸. With such

¹⁷

http://www.nytimes.com/2008/01/12/business/12nocera.html?_r=2&adxnnl=1&oref=slogin&adxnnlx=1210134311-AyKV9QhXOvjwTQxUBwLlw&oref=slogin

¹⁸ http://www.atimes.com/atimes/China_Business/HF15Cb06.html

promising growth rates, it would be favorable for Starbucks to take a break in the saturated US market, and venture into younger growing markets. Other countries with promising growth potential include Russia and Brazil, where the coffee market is still in its infancy stage¹⁹.

4. Strategies towards further growth

Expansion into the corporate market

In February of 2008, after years of unbridled growth, Starbucks reported for the first time that it would slow the pace of store growth in the United States. This was a marked deviation from its previously consistent philosophy that “the primary driver of the Company’s revenue growth continues to be the opening of new retail stores, both Company-operated and licensed, in pursuit of the Company’s objective to establish Starbucks as one of the most recognized and respected brands in the world”^{20,21}. The running joke for several years has been to ridicule the fact that frequently, one can encounter Starbucks stores across the street from each other, illustrating how ineffective Starbucks’s expansion strategy is. Starbucks has saturated nearly every profitable market with its company-owned and licensed retail stores, and sustaining growth by the sheer number of new store openings is becoming more and more difficult, especially given the amount of cannibalization of existing store sales by new stores.

As stated in their annual report, “Starbucks is committed to selling only the finest whole bean coffees and coffee beverages. To ensure compliance with its rigorous coffee standards, Starbucks controls its coffee purchasing, roasting and packaging, and the distribution of coffee used in its operations.” Currently, Starbucks only sells its brewed coffee in its retail stores, where baristas trained by Starbucks prepare coffee for customers. It also provides “Foodservice” by selling whole bean and ground coffees to “companies that service business, industry, education and healthcare accounts, office coffee distributors, hotels, restaurants, airlines and other retailers.”²² However, the products are delivered, per contractual agreements, through SYSCO Corporation’s and US Foodservice’s distribution networks. As a result, these products are part of the Starbucks brand only in name. This represents a distancing of the product from the Starbucks brand name, and poses a risk to the Starbucks brand if the quality of coffee brewed by these customers is not up to par with the standards set by Starbucks for its retail stores.

¹⁹ <http://news.bbc.co.uk/2/hi/business/4712012.stm>

²⁰ Starbucks 10-Q filed 8/10/2007 (SEC Website)

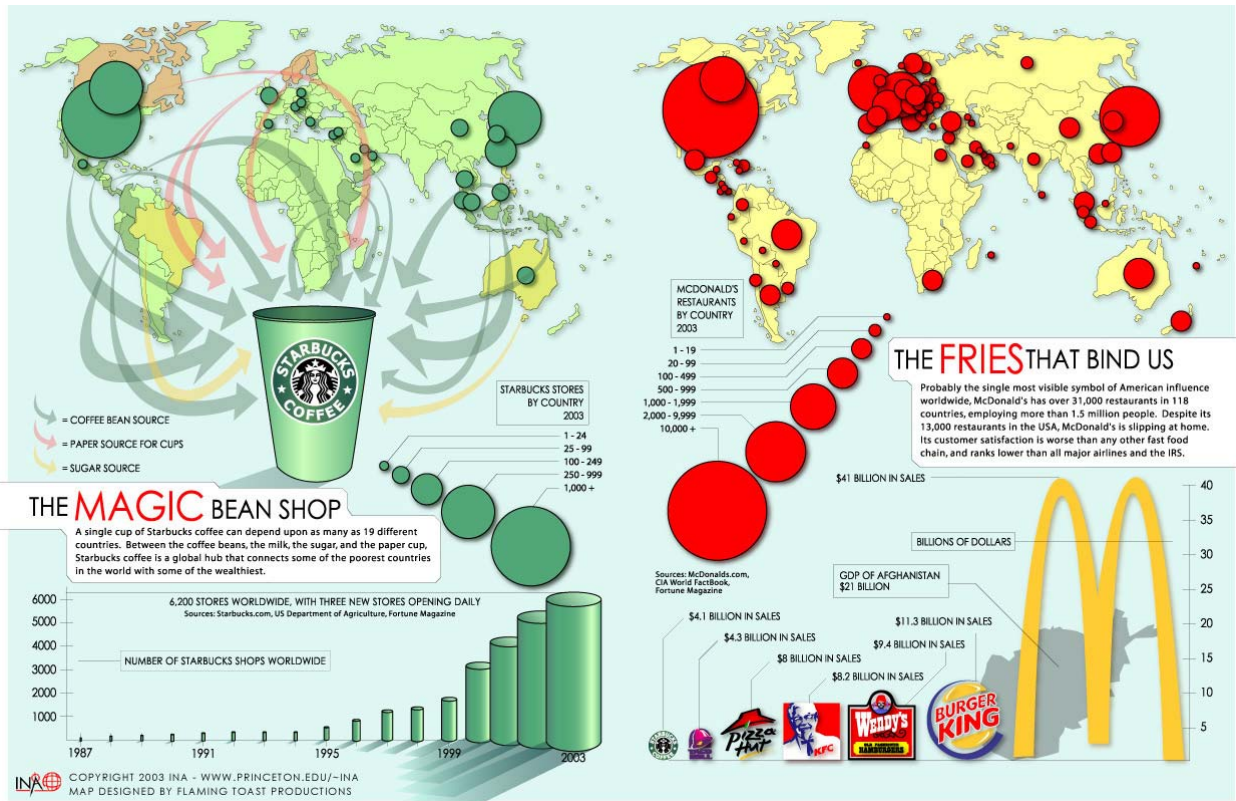
²¹ Starbucks 10-Q Filed 2/8/2008 (SEC Website)

²² Starbucks 10-K Filed 11/29/2007 (SEC Website)

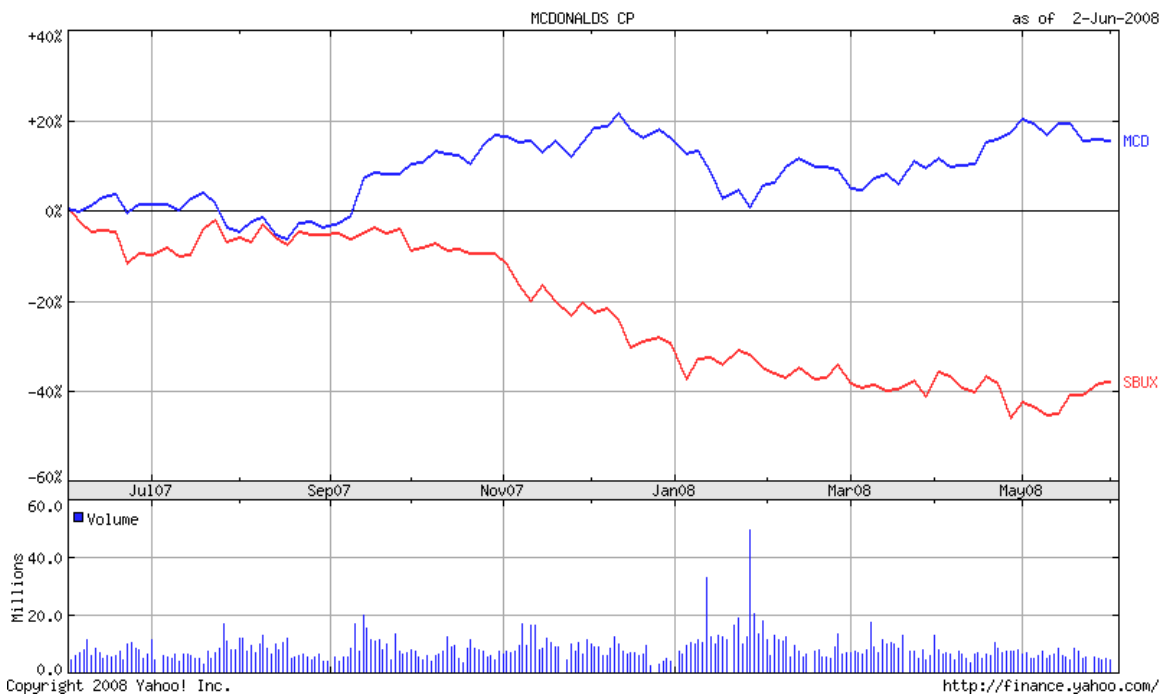
One strategy Starbucks can adopt that would allow them to continue their growth would be to enter the corporate market and begin directly selling brewed coffee to corporate offices, hotels, and other similar professional businesses. This is a beneficial business arrangement for both Starbucks and the customer. The businesses receive ready-to-serve deliveries of freshly brewed coffee of the same high quality that Starbucks provides at their retail locations, also at a discount. This allow for more convenient distribution of coffee to its employees and its customers, a beverage that is typically in extremely high demand at business offices. Starbucks can expand its brand recognition to all of the employees and customers of the companies it serves, and also can better maintain the value of the Starbucks brand by preserving the quality of its products.

One benefit of this approach is that Starbucks already has a dense network of retail stores which can be utilized as an auxiliary production and distribution network for this strategy. The coffee can be brewed on location at various retail stores, possibly during “non-peak” hours when foot traffic is low. This allows Starbucks to oversee the quality control of the coffee and ensures a high quality product that will not damage the Starbucks brand. Also, there is a high demand for coffee in many businesses, both from their employees (e.g. law firms, IT businesses) and from their customers (e.g. hotels, airline executive lounges), something that Starbucks should take advantage of in order to become a prominent player in this market.

Appendix:

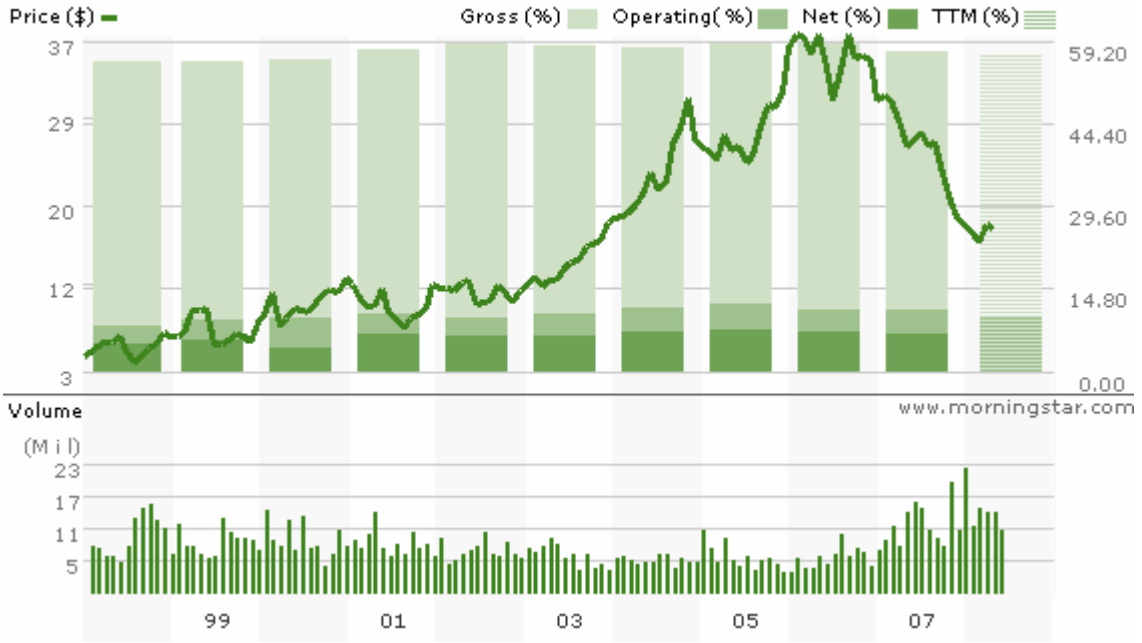


Starbucks / McDonalds Global Dominion Graph



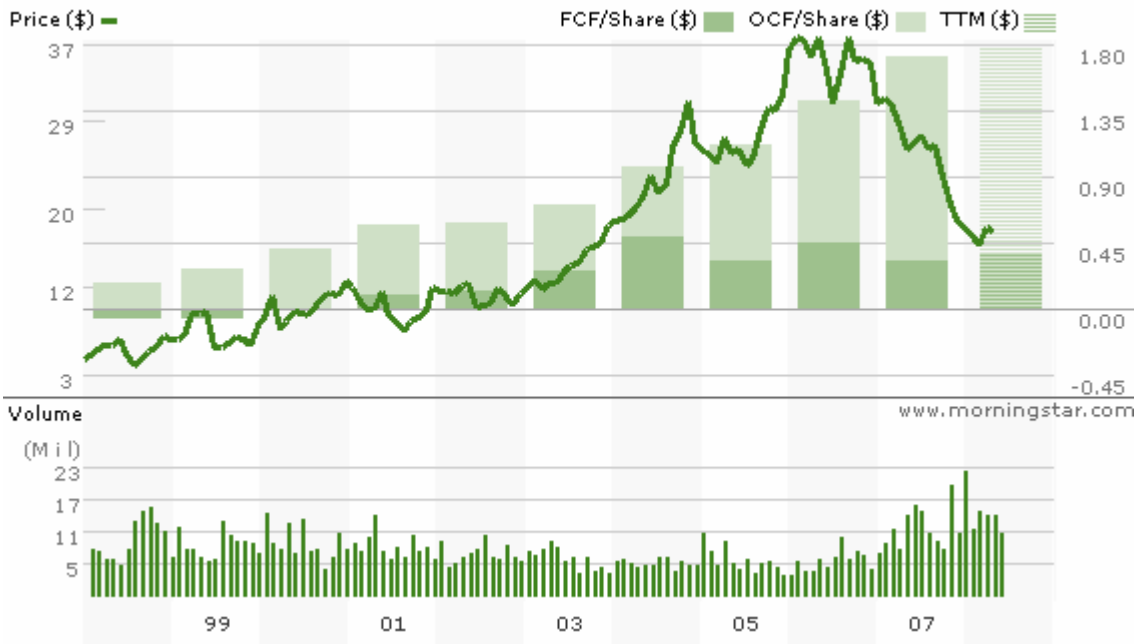
Starbucks vs McDonalds Stock Prices (May '07 – May '08)

Fundamental Financial: Margin Analysis



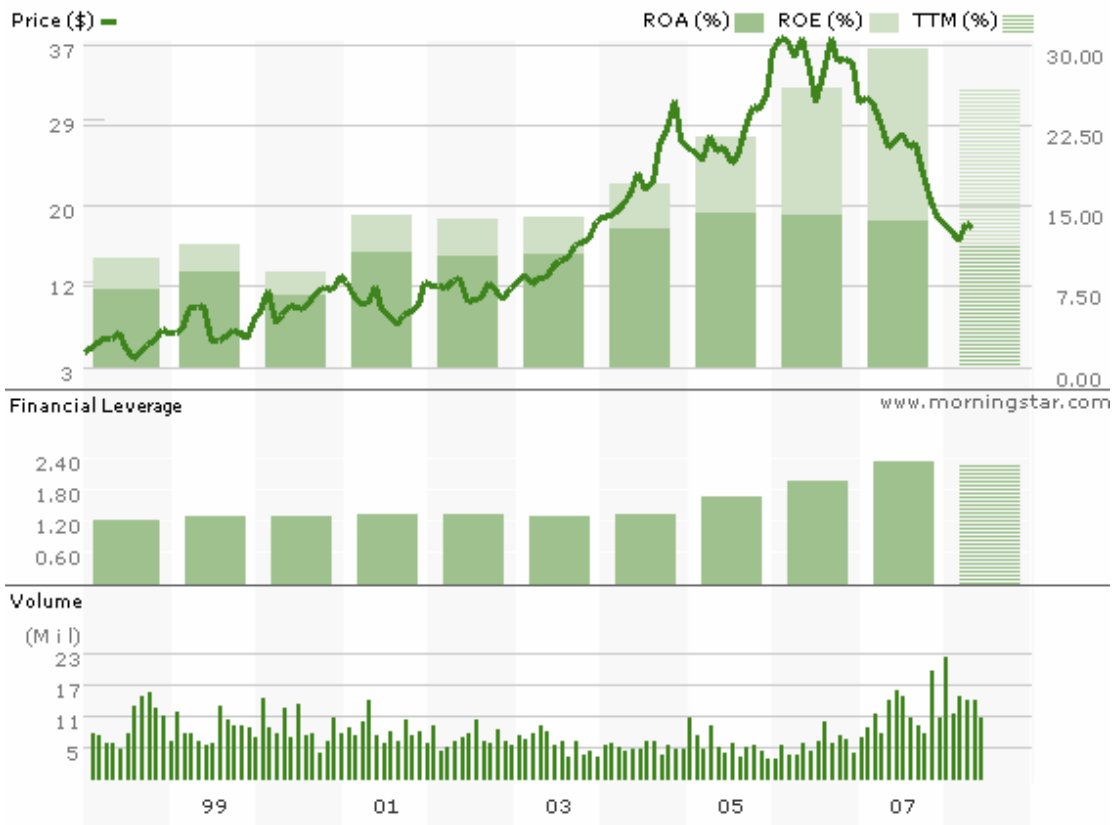
Starbucks Margin Analysis

Fundamental Financial: Cash Flow

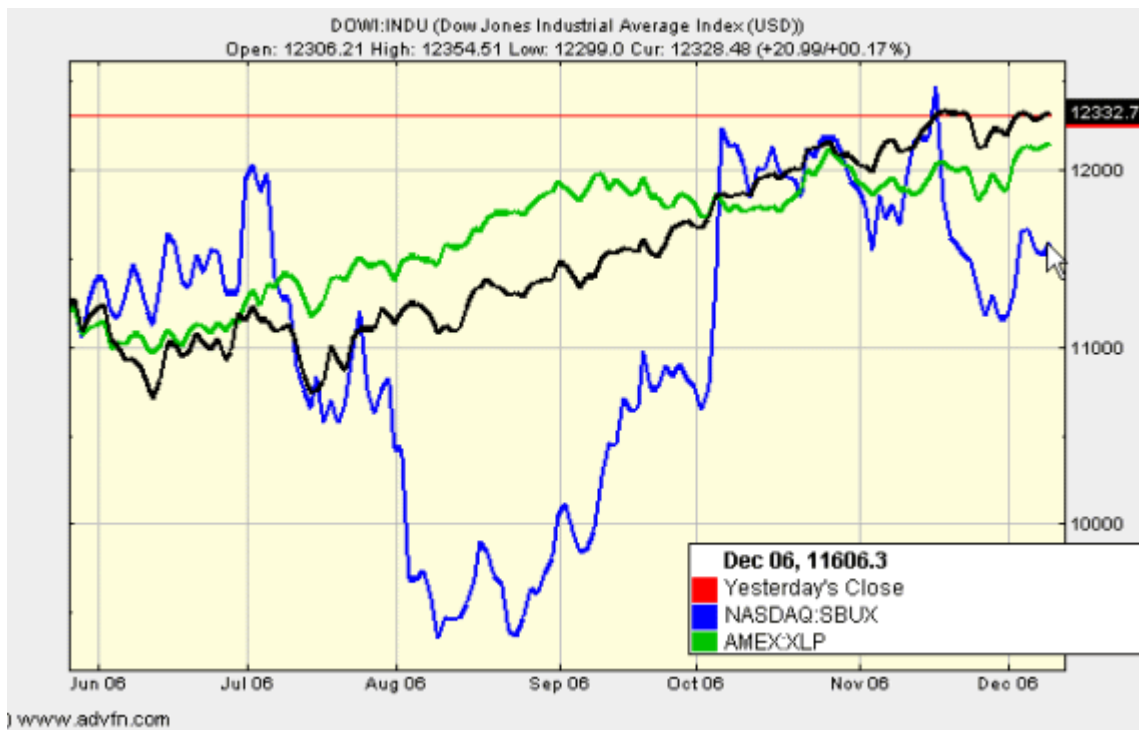


Starbucks' Cash Flow Analysis

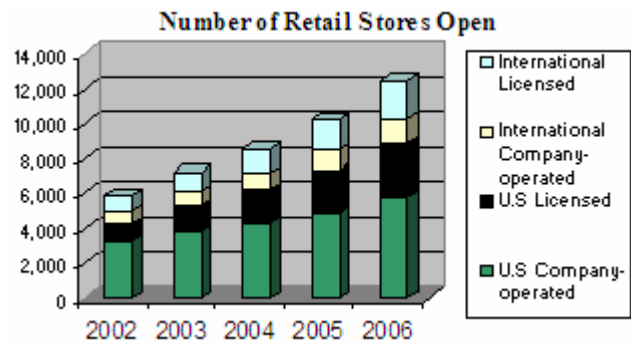
Fundamental Financial: ROE Analysis



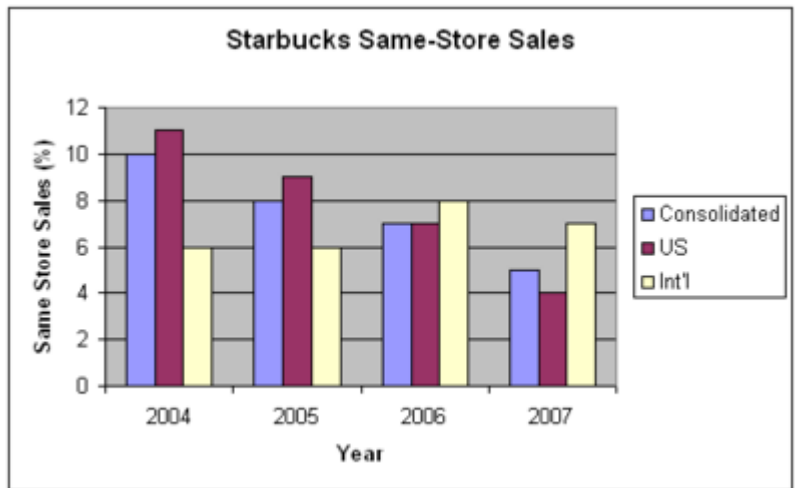
Starbucks ROE Analysis



Comparison of Starbucks to the Dow 30 and the XLP prices over a 6-month period



Number of retail stores open by Starbucks between years 2002-2006



Time Course Graph Showing Starbucks' Same-Store-Sales