



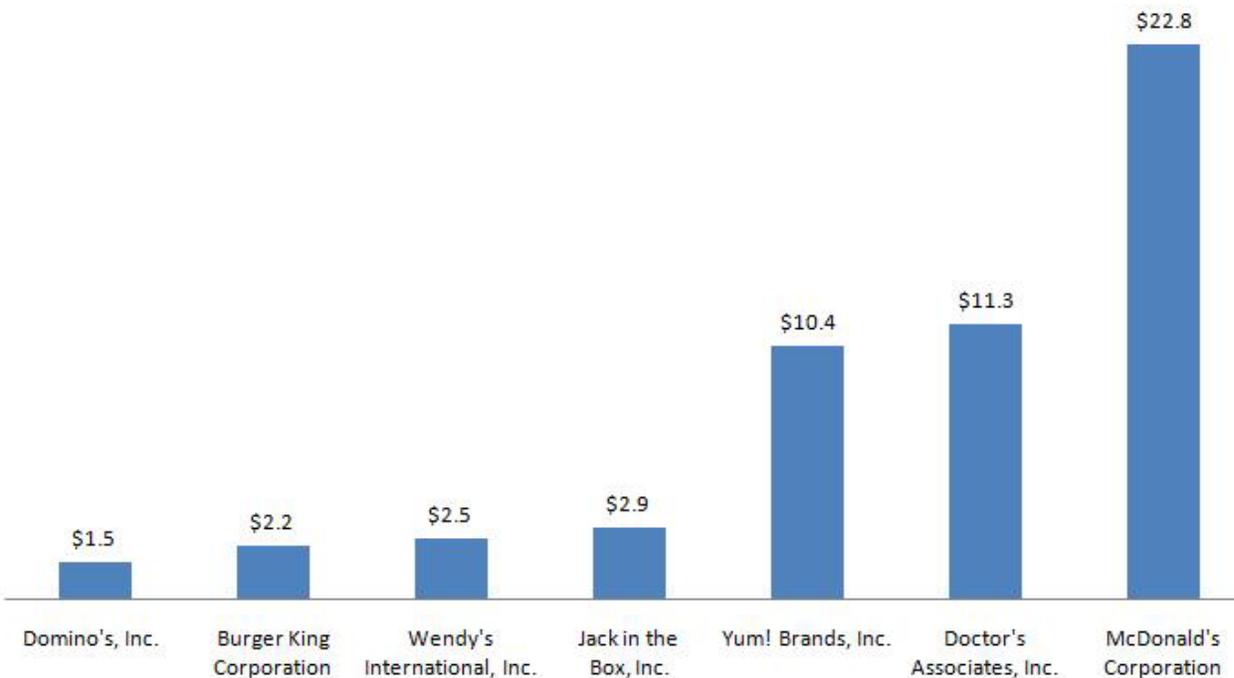
## McDonald's: Breaching the Luxury Coffee Market

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McDonald's Corporation, the world's largest fast food restaurant chain, owns and franchises more than 31,000 restaurants in 120 countries.<sup>1</sup> McDonald's owes much of its success to the standardization of its fast food products, which include the Big Mac and the Happy Meal. McDonald's has had a reputation of serving cheap, quick, and unhealthful foods. Recently, documentaries such as *Super Size Me* has tested that reputation and induced the corporation to adopt a more health-conscious stance by introducing healthier items such as salads and wraps to the menu. Nonetheless, McDonald's revenues are steadily increasing, growing 27% over the three years ending in 2007. Estimated total revenue within the fast-food world market in 2007 was \$120 billion, with McDonald's leading with a 19% market share over major competitors such as Doctor's Associates, Inc. (Subway) and Burger King.<sup>2</sup>



**Figure 1.** 2007 Total Revenue of McDonald's and Fast-Food Major Competitors

Strong and growing profits in the fast food sector show that McDonald's has been doing the right things by extending into developing world markets such as China and Latin America. Recent strategies have focused on introduction of innovative products to the menu to accommodate changing consumer preferences and cultural differences. Increasing sales at existing restaurants is the current strategy. McDonald's has remodeled many of its restaurants to make them more appealing and modern, as well as extended store hours.

<sup>1</sup> [http://www.hoovers.com/mcdonald%27s/--ID\\_\\_10974--/free-co-profile.xhtml](http://www.hoovers.com/mcdonald%27s/--ID__10974--/free-co-profile.xhtml)

<sup>2</sup> [http://www.wikinvest.com/stock/McDonald%27s\\_\(MCD\)](http://www.wikinvest.com/stock/McDonald%27s_(MCD))

## Coffee

A new market that McDonald's is trying to enter in the United States is the luxury coffee market, a market revolutionized by Starbucks Corporation. McDonald's has already begun its infiltration by introducing its own espresso drinks line: latte (hot/iced), mocha (hot/iced), and cappuccino. More than 7,000 stores nationwide currently sell the new beverages, and McDonald's plans to add espresso machines to the majority of its 14,000 stores nationwide by mid-2009. This aggressive addition is aided by the growing awareness of the economic recession and the new demand for low cost food items. "We know our customers are looking for those affordable luxuries," McDonald's spokeswoman Danya Proud said. "We know our customers are visiting us, now more than ever, for many of our well known breakfast items, and we know our coffees continue to be a growing category."<sup>3</sup> The new espresso line is integrated directly into the front counter menu, and simplifying the process by using English size names (small, medium, large) rather than Italian ones. McDonald's projects \$1 billion annual revenue from its new espresso line.

Internationally, McDonald's started competing against Starbucks a long time ago. Since 1993, McDonald's has operated under the name McCafe in many countries outside of the United States, such as Australia, Ireland, and Germany. McCafe is a completely separate entity from McDonald's. However, this upscale coffee and pastry shop often operates in tandem with the standard McDonald's restaurant. They share the same entrance, but the McCafe section offers big booth couches, upscale tables, Wi-Fi, and sophisticated curvy room and wall arrangements. Customers who dine in McCafe sections are served food on china with stainless-steel flatware. Restaurants in Australia, where the McCafe concept was created, have reported an average of 15% increase in sales boost from McCafe.<sup>4</sup> Currently, there are over 1,300 McCafe stores worldwide serving coffee and healthier sandwich and soup offerings.<sup>5</sup> In 2001, McDonald's opened its first McCafe in the United States; however, it closed within a year.<sup>6</sup> Since then, fewer than 10 new McCafes have opened their doors. It remains unseen whether more McCafe store units will make their way to the United States.

McDonald's current strategies are distinctly different: specialty coffee and McCafe. One aims to start an in-store line of espresso drinks fully integrated with the current menu, while the other calls for the creation of a completely different restaurant. *Note:* although McCafe is the name of the McDonald's coffee and espresso line, here we will only refer to McCafe as the store.

## Why Should McDonald's Enter the Specialty Coffee Market?

There are still profits to be made. Starbucks' revenue is growing, though its growth has declined in 2008. Due to the economic downturn, people are less willing to pay \$4 for a drink at

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<sup>3</sup>[http://money.cnn.com/news/newsfeeds/articles/djf500/200903051645DOWJONESDJONLINE001045\\_FORTUNE5.htm](http://money.cnn.com/news/newsfeeds/articles/djf500/200903051645DOWJONESDJONLINE001045_FORTUNE5.htm)

<sup>4</sup>[http://findarticles.com/p/articles/mi\\_m3190/is\\_20\\_35/ai\\_74700848](http://findarticles.com/p/articles/mi_m3190/is_20_35/ai_74700848)

<sup>5</sup>[http://seekingalpha.com/article/73378-mcdonald-s-q1-2008-earnings-call-transcript?source=homepage\\_transcripts\\_sidebar&page=-1](http://seekingalpha.com/article/73378-mcdonald-s-q1-2008-earnings-call-transcript?source=homepage_transcripts_sidebar&page=-1)

<sup>6</sup>[http://findarticles.com/p/articles/mi\\_m3190/is\\_23\\_39/ai\\_n13808203](http://findarticles.com/p/articles/mi_m3190/is_23_39/ai_n13808203)

Starbucks than in previous years. Consumers are reevaluating the value of the product they are purchasing and are looking for substitutes. Due to the weakening of Starbucks' grasp on the market, it is a prime time for McDonald's to step in and offer a more affordable, mid-range quality substitute. Although most of Starbucks' customers are highly loyal to the brand and are likely to dismiss McCafe products due to McDonald's reputation as a fast-food restaurant, there will be a fraction of Starbucks' consumers that will be willing to switch to a McDonald's latte if it provides better value. Therefore McDonald's needs to reshape the image of its espresso coffee line into a better quality product and deliver more accommodating service in order to gain a share of Starbucks market. Starbucks makes a 58.5% gross profit to cost margin compared to McDonald's 30.3%—that is enough room for a competitor to jump in<sup>7</sup>. Since beverages have higher profit margins than food, McDonald's will only benefit from the adapted menu.

		FY '04	FY '05	FY '06	FY '07	FY '08
<b>Consolidated</b>	<b>Total</b>	\$5.3B	\$6.4B	\$7.8B	\$9.4B	\$10.4B
	<b>% Increase</b>	30%	20%	22%	21%	10%
<b>U.S.</b>	<b>Total</b>	\$4.3B	\$5.1B	\$6.2B	\$7.3B	\$7.9B
	<b>% Increase</b>	23%	20%	21%	19%	7%

**Table 1.** Starbucks Corporation Revenue Summary. Notably the growth from 2007 to 2008 has shrunk by 50%.

Introduction of an espresso coffee line to McDonald's will also allow it to gain a share of untapped consumer markets that Starbucks has not breached. By introducing an innovative coffee line at a fair price, its current customer base will be able to transition to the changes without feeling slighted by McDonald's choice to imitate Starbucks. McDonald's has historically targeted families with children through toys in Happy Meals and PlayPlaces. The draw of children will lead the parents there as well. With the introduction of McCafe drinks, going to McDonald's will not seem as much of a chore for these adults, since they will be able to sip on a nice latte while the children play and eat. If McDonald's is able to improve their image and introduce medium quality luxury coffee and espresso drinks, they would create an atmosphere that would greatly appeal to parents while maintaining traditional appeal to the children. Establishing itself as a worthwhile place to stay and have a conversation over a cup of cappuccino among soccer moms will save time for these parents as they will not have to travel to two different places to socialize with other parents and satisfy the cravings of their children, something that Starbucks cannot provide with their atmosphere.

A second untapped consumer base will lie in the McDonald's breakfast consumers. When a regular coffee just will not suffice, a latte or cappuccino provides the perfect pairing to the McDonald's breakfast combo. If McDonald's keeps its espresso line unpretentious and inexpensive, it will gain a large profit from consumers who upgrade from coffee to espresso. Coffee is a complement to many of the other foods that McDonald's serves and is a great way to add \$2-3 to a meal purchase, especially since costs for preparing the drinks are so low. Unlike Starbucks, which offers only a paltry line of sandwiches and fruit and cheese platters,

<sup>7</sup> <http://www.bloomberg.com/apps/news?pid=10000103&sid=a8vu6bHkhysI>

McDonald's offers a large variety of menu items and far better prices. Although most of McDonald's current blue-collar and lower income consumers probably scorn Starbucks' pricing, the introduction of a similar espresso line in McDonald's will not generate a similar response because it will be integrated into its current menu at prices that its consumers can cope with. Thus, entering the coffee market will not cause backlash with the current McDonald's consumers; it will only strengthen its hold on them by getting them addicted to lattes.

Geographically, McDonald's can also enter into consumer markets that Starbucks has not entered. Starbucks' popularity is greatest in urban areas where there is high traffic in high profile coffee drinkers. Starbucks in rural areas would probably not be as profitable since their image is associated with unnecessarily expensive drinks. Not only does Starbucks market to a limited population, but the population density in general will also not rationalize operating a store in these areas since it would not generate enough profit.

One major concern for entering the high-end coffee market is that the coffee fad has ended. This fad, which Starbucks has been able to capitalize on and expand to the giant corporation they are today, could be on the tail end of its lifespan. Young adults drank on average of 3.2 cups of coffee per day in 2008 which is a slight increase from 3.1 cups per day in 2007.<sup>8</sup> The growth seems to have slowed down when compared to previous years.<sup>9</sup> Figures seem to indicate a slowing of growth in Starbucks' major target market. Even if the overall consumption of luxury coffee decreases, McDonald's may get an edge in the market as there will be a large portion of the consumers who would prefer medium quality coffee for a lower price. Because of this and the current economic downturn, a large portion of Starbucks' market would disappear in favor of the cheaper McDonald's alternative. The luxury coffee industry would have much lower profits, thus McCafe may not be profitable as it begins to establish itself, whereas the store-front espresso line would not be as affected since it targets a very different consumer base which buys the coffee as a complement to their McDonald's meal. The espresso line can also be easily removed from the menu should it prove to be unprofitable because the espresso machines alone are much smaller capital investments than the McCafe stores.

In any case, McDonald's should not try to focus on the yuppie and young adult generation of coffee drinkers that currently go to Starbucks for their coffee needs, at least in the development stage of their luxury coffee line. After McDonald's unveiled their espresso drinks, reviews in news articles have been mixed. One particular comment within a *Chicago Tribune* article states, "it was a crap shoot, when it comes to quality" at McDonald's.<sup>10</sup> Some have stated that they are glad to have an alternative to Starbucks, but the lack of a barista noticeably affects the quality of drinks. At McDonald's, the process of making a latte has been completely automated to minimize employee training and ensure consistency. Still, customer responses vary from "decent" to "absolutely disgusting". With this sort of response, the yuppie generation, who are

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8 <http://www.ncausa.org/i4a/pages/index.cfm?pageid=38>

9 <http://www.ncausa.org/i4a/pages/index.cfm?pageid=38>

10 <http://leisureblogs.chicagotribune.com/thestew/2008/12/mcdonalds-mccaf.html>

accustomed to the quality they get at Starbucks, will be skeptical of substituting with the McDonald's espresso drinks.

## **McCafe**

The idea behind McCafe is to essentially enter the luxury coffeehouse business most well exemplified by Starbucks. By adopting a new brand, McDonald's is able to serve coffee and espresso drinks in a place the McDonald's image has not tainted. Much like previous McDonald's run restaurants such as Chipotle and Boston Market, McCafe will have different menus and décor. Unlike McDonald's other brands, however, McCafe can be paired up with existing stores, either as a separate section or as a separate sales counter. Not only can the sales of the original restaurants be increased, but the restaurant may also benefit from a better reputation and increased popularity. This will definitely be true in the early stages of implementation of these stores, because people will get naturally curious. This is also when establishing McCafe as a worthy and cost-friendly substitute to current coffeehouses and dispelling a negative reputation as a low quality coffee brand will be important.

In other countries, McCafe has already seen much success over the past few years. The desire for European style coffee at a lower price popularized McCafe in countries such as Australia and Germany. While this concept has already been proven by Starbucks to be successful in the US, it may already be too late for McDonald's to try and become a major competitor in the market. The fad that helped Starbucks become the international corporation it is today peaked during the 90's and early 2000's. Around this time McDonald's had started to roll out the McCafe brand in Australia and other countries. McCafe was successful in these countries because they entered the market nearly at the same time as Starbucks entered into the global market in 1995.<sup>11</sup> In fact, in Australia, McCafe is leader in the coffeehouse market. In the US, the brand is not well known to the majority of Americans because there is a dearth of McCafe stores. Expanding now is ill-advised because the concept has long since lost its novelty. It will be hard to compete with the stranglehold Starbucks, Coffee Bean, Karibou, Peet's Coffee, and other major competitors already have in the US market.

Because of the nature of McCafe, its target market will ultimately overlap significantly with Starbucks' market. With the inclusion of McCafe, McDonald's may draw from the luxury coffee crowd as a dwindling economy forces people to become more cost-conscious. While this may widen McDonald's customer base, McDonald's may be investing in a shrinking market. As previously mentioned, this coffee drinking boom may have just been a fad that is currently fading. This slowing growth paired with a tough economic situation has forced Starbucks to close over 600 stores since July 2008.<sup>12</sup> If McDonald's is to open McCafe stores in the U.S. separate from its McDonald's restaurants, success is not guaranteed because the coffee market is fairly saturated. Most profitable regions already have a plethora of Starbucks stores and other

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<sup>11</sup> <http://www.starbucks.com/aboutus/timeline.asp>

<sup>12</sup> <http://www.starbucks.com/aboutus/pressdesc.asp?id=880>

coffeehouses. Furthermore, its reputation as a low quality brand may discourage many coffee drinkers from trying McCafe. Although McCafe is its own brand, it is hard to separate it from its parent company because of the obvious similarities in name.

Not only is McDonald's trying to enter a slow-growth market, the customers it caters to differ from that of McCafe. McDonald's has always catered to the fast food crowd; customers expect fast service, cheap products, and consistency across stores. Quick turn-around is essential to McDonald's, whereas McCafe stores are designed to encourage lounging. Coffeehouse regulars are also used to adding customizations to their drinks. Customization requires McDonald's to hire a much more intelligent and consequently more expensive labor than the average McDonald's employee to man the barista station. In essence, McCafe is an unnatural concept to McDonald's and may struggle to be a major player in the already congested luxury coffee market.

Creating the McCafe will undoubtedly require a sizeable capital investment. The goals of such an establishment would require a large makeover of the current restaurants. McDonald's current hard seats would need to be replaced by more comfortable benches and chairs, and table styles would need to be changed. In addition to the furniture, investments must be made in the new menu. If McDonald's plans on adding tarts, pastries, and muffins to their product line, they must adapt their current equipment to handle these types of foods. This would include large items such as new ovens, but also new china and stainless steel flatware to produce the atmosphere of the café. In addition, creating a line of specialty drinks would require new drink machines. Espresso machines of commercial scale will be necessary (which retail from \$5,000 to over \$20,000), but will be even more expensive if they need to be automated to McDonald's standards. Anthony, an employee of a local Pasadena McDonald's, stated that "the machine does everything for you." However, our attempts at acquiring a latte from said restaurant was thwarted because the machine had broken down a few days ago. Maintenance of the machines is very significant to a coffeehouse because espresso must always be available. At a Starbucks, this problem would never have occurred.

## **Competitor Response**

McDonald's is a fast food restaurant, thus it is always in competition with other traditional fast food chains, such as Burger King and Wendy's. Stiff competition forces any novel concept introduced by one of these restaurants to be copied by the others. In 2005, quickly following McDonald's introduction of Premium Salads, Burger King released the TenderCrisp Chicken Garden Salad. McDonald's is uniquely suited in this industry, however, because of their domination in the kids market. Play Places and Happy Meals have led children to prefer anything with the McDonald's logo on it.<sup>13</sup> As a result, McDonald's attracts many parents who come only to satisfy their children. These products would be mainly aimed at the customers who are already in the restaurant. Thus the introduction of more coffee products at McDonald's

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13 [http://www.nutritionalwellness.com/archives/2007/nov/11\\_fast\\_food.php](http://www.nutritionalwellness.com/archives/2007/nov/11_fast_food.php)

would not be an obvious attempt to win customers from other fast food chains. If another fast food restaurant attempted to copy McDonalds' move, they would have a difficult time, as they would be competing with the industry leader who also has the first mover advantage. McDonald's cannot be imitated because competitors are not as uniquely positioned to serve espresso drinks to parental markets.

Entering the luxury coffee and specialty drink market will also move McDonald's into competition with Starbucks and other coffee shops. The extent of the customer overlap is probably not very high, however. Starbucks provides high quality products at expensive prices. They also provide a soothing and trendy atmosphere. McCafes would need to duplicate this atmosphere, placing them in direct competition with these other establishments. It is better for McDonald's to only introduce the espresso line in existing stores to avoid direct competition. By serving espresso drinks in current locations, McDonald's will be providing medium quality, cost friendly beverages within the fast-paced McDonald's atmosphere. McDonald's will be selling to a very differentiated and untapped market, which will give Starbucks less incentive to respond to the competition.

McDonald's has started a vicious advertising campaign against the Seattle-based coffee company, but Starbucks cannot effectively counter. Billboards in Washington are reading, "grande is the new large," and "four bucks is dumb." Even though the truth is that a Starbucks small 12 oz. coffee is \$1.40, a cent higher than McDonald's price, and that 95% of its drinks are actually less than \$4, the ad propagates the image of Starbucks as being expensive- a view that most people already have. Given the tense economic climate, ads like these are sure to lure away some of Starbucks less elite coffee drinkers and alert other consumers to the fact that McDonald's has a new line of drinks. However, similar ads from Starbucks will likely not win over many of McDonald's customers because they are already choosing value over quality. So far, Starbucks has maintained that it will take the high road in the mudslinging. Chief marketer of Starbucks Davenport stated, "The answer to how we're going to respond to the competition is we're not going to respond. We're going to keep doing what we do and we're going to keep doing it our way."<sup>14</sup>

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14 [http://seattlepi.nwsourc.com/business/391566\\_sbuxrivals11.html](http://seattlepi.nwsourc.com/business/391566_sbuxrivals11.html)



		<b>McDonald's</b>	<b>Starbucks</b>
<b>Latte</b>	Small/Tall	\$2.39	\$2.70
	Medium/Grande	\$2.89	\$3.25
	Large/Venti	\$3.29	\$3.55
<b>Mocha</b>	Small/Tall	\$2.39	\$3.00
	Medium/Grande	\$2.89	\$3.55
	Large/Venti	\$3.29	\$3.85
<b>Cappuccino</b>	Small/Tall	\$2.39	\$2.70
	Medium/Grande	\$2.89	\$3.25
	Large/Venti	\$3.29	\$3.55

**Table 2.** McDonald's vs. Starbucks Espresso Prices (prices taken in Anaheim, CA)<sup>15</sup>

Starbucks is definitely overestimating the loyalty of its customers. Sure, there are current Starbucks customers that will continue to buy from Starbucks, but in order to maintain its lead it will have to do better and seek to grab new consumers and fight back against McDonald's. The effects of competition and lowered revenue can already be witnessed in Starbucks cafes, where many new discounts have been implemented such as the frequent customer card that gives free shots of syrup when you buy enough drinks. However, most of these discounts are targeting Starbucks' current customers only. Starbucks must find a way to improve its snobby coffee image in order to attract new business without having to lower its prices to McDonald's level. Given that Starbucks is not responding to McDonald's attacks, continued advertising campaigns by McDonald's are the best strategy to deliver its message across. Starbucks might do well maintaining its current customers loyal, but McDonald's will gain a large lead in all other areas.

## Conclusions

McDonald's should enter the high end coffee market because it is the fast food market leader and will gain much ground from being the first mover. Even though McDonald's appears to be competing directly with Starbucks, its target market is actually very different and entry will

<sup>15</sup> <http://fastfood.freedomblogging.com/mcdonalds-vs-starbucks-espresso-prices/>

be less risky due to the differentiation. For example, the new espresso line will provide the perfect complement to current McDonald's menu items and be able to satisfy the parents that bring their kids to McDonald's. The main customers of this new drink line will mostly be current McDonald's customers. The added drink line will also draw in the portion of Starbucks customers who are "on the fence" in terms of loyalty. Using automated espresso machines will not increase average serving time or require baristas, and therefore ensures efficiency and consistency, which fits in with McDonald's principles.

The current economic state and slowing growth in coffee drinkers seems to indicate that opening up McCafes in America may be a poor decision. The timing for this expansion of McCafe to the already saturated US luxury coffee market is completely off. In foreign countries where McCafe is a major coffeehouse brand, McCafe was implemented either before or during Starbucks' entry into the international market. Furthermore, the potential target market of McCafe differs from the current McDonald's market. McDonald's emphasizes inexpensive foods, consistency, and fast service and turn-around. McCafe and all other coffeehouses are meant for lounging and customizing drinks to the customers' specifications. In addition, the coffee drinking boom that created the rise of coffeehouses seems to be a fad that is declining. By the time McDonald's gets a foothold in this market, the fad may be significantly reduced and will not warrant an investment from McDonald's into McCafe.