

STARBUCKS

Ariff Kachra prepared this case under the supervision of Professor Mary Crossan solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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Mr. Howard Schultz, the Chairman and CEO of Starbucks Corporation, had just given a speech on the future of the coffee industry at a well-known business school. As he left the lecture hall, he stopped at the University's most popular coffee shop, the Brewery. The shop's sign indicated that it was "Now Serving Starbucks Coffee." As Mr. Schultz ordered the House Blend, he noticed that the Brewery was a far cry from any Starbucks coffeehouse. The shop was messy, the service was poor, and the coffee was average. As Mr. Schultz was leaving the Brewery, Orin Smith, Starbucks President and COO, called him on his cellular phone. McDonald's, whom Starbucks had turned down a number of times, was once again petitioning for a contract to serve Starbucks coffee. On the plane back to Seattle, Washington, Mr. Schultz's thoughts drifted back to his experience at the Brewery and the call from McDonald's. He asked himself two questions: Was Starbucks growing in the best way possible? Was Starbucks overextending in its quest for growth?

SPECIALTY COFFEE INDUSTRY

Coffee was the second most traded commodity next to oil. It was divided into two categories: specialty coffee and basic coffee. Specialty coffee was the highest echelon of quality coffee available in the world. Many people described it as gourmet coffee. There was no one accepted definition in the industry; however,

everyone agreed that specialty coffee was of higher quality than basic supermarket brand coffee.

It was estimated in 1994 that the specialty coffee industry was growing at a rate of 15 per cent per year and that the basic coffee industry was suffering. Although most consumers only saw this division at the retail level, specialty versus basic coffee was a concept that originated with the coffee grower.

SUPPLIERS

Specialty coffee companies did not typically deal with suppliers, i.e., coffee farmers, directly. They dealt with exporters instead. About a third of the coffee farms in the world were less than three acres. These farmers did not have the desire, the volume, the money, the expertise, or the connections to export coffee themselves because most countries regulated coffee sales. Coffee processors or exporters regularly visited smaller farmers and bought their coffee¹ either in cherry or parchment.² The coffee would then be moved to a mill where there would be other farmers' production from the same or different regions. After husking the parchment, the millers sold it to the exporter(s). It was common place for coffee to change hands as many as five times before it reached a specialty coffee seller. Typically, coffee was moved from the farmer, to the collector, to the miller, to the exporter, to the importer, and finally, to the specialty coffee seller.

The bean suppliers that managed this process well, typically concentrated on high quality Arabica beans for which they could command premium prices. Lower quality bean suppliers concentrated on Robusta beans. This quality division was somewhat congruent to the way the industry was divided, i.e., lower quality beans were harvested for the commercial industry and higher quality beans for the specialty coffee industry. (Industry experts estimated that specialty coffee made up 31 per cent of the total coffee consumption; see Exhibit 1.)

The price of certain coffee was a direct reflection of the quality and quantity of coffee available at a particular time. It was very difficult to get price confirmations because a successful coffee harvest was dependent on so many different factors. These included weather conditions, health of the coffee trees, harvesting practices, disease and infection caused by insects, and the social, political, regulatory and economic environments of the coffee-producing countries. For example, the 1975 Brazilian frost drove the price of coffee up, and U.S. coffee consumption never recovered from the 18.5 per cent decline.

¹This process varied by country.

²Once the coffee cherry had been washed and dried, what remained was the coffee bean in some sort of husk.

CONSUMERS

Coffee consumption patterns had changed in the United States. In 1996, the per capita consumption of coffee was 1.7 cups per day per person, a significant decrease from the two to three cups daily consumption in the 1960s and 1970s. The National Coffee Association attributed this decrease to poor product development, packaging, and position (price focused) by the industry's leading coffee producers. However, now it seemed that coffee consumption was on the rise. The following compares U.S. consumption rates to global consumption rates:

In terms of kilograms of coffee per person consumed in 1985, the United States at 4.7 ranked tenth, behind Sweden (11.6), Denmark (11.0), Finland (10.0), Holland (9.5), Germany (6.8), France (5.5), and Italy (4.9) among the coffee-consuming nations and behind Costa Rica (6.5) and Brazil (5.5) among the coffee-producing nations. Overall, in the decade between 1975 and 1985, Europe's levels of imported coffee rose significantly, those of Japan doubled, while those of the United States remained steady despite increased population.³

The recent popularity of specialty coffee was the result of four consumer trends: (1) the adoption of a healthier lifestyle had led North Americans to replace alcohol with coffee; (2) coffee bars offered a place where people could meet; (3) people liked affordable luxuries and specialty coffee fit the bill; and (4) consumers were becoming more knowledgeable about coffee.

Profile

According to Avenues for Growth — A 20-Year Review of the U.S. Specialty Coffee Industry,⁴ 22 per cent of the U.S. consumers purchased specialty coffee. This 22 per cent of the population typically lived and worked in urban areas, and had an annual income over \$35,000. Research had shown that two parent families with a stay-at-home mother, purchased 41 per cent more specialty coffee than the average. Single people, purchased 39 per cent more than the average and consumers with college degrees purchased 49 per cent more than the average. Females purchased slightly more specialty coffee than men and coffee consumption was higher among individuals aged 30 to 59 than those aged 20 to 29.⁵ Research by many coffee companies had found that once a consumer learned to appreciate a high-quality specialty coffee, he or she did not go back to his or her favorite average quality brew.

³*Encyclopaedia of American Industries, Volume 1, Manufacturing Industries, SIC 2095, Roasted Coffee.*

⁴*Montgomery Securities, April 30, 1996, Volume 27.*

⁵*1995 Winter Coffee Drinking Study, National Coffee Association of the U.S.A & Montgomery Securities Volume 27.*

Community Gathering Place

Consumers' patterns of socializing had changed since the 1980s. While the mid-1980s were characterized by the pursuit of entertainment outside the home, in the early 1990s, people wanted to stay home. There was a move away from restaurants and dance clubs. Now, in the second part of the decade, there seemed to be a resurgence of outside-the-home entertainment. Coffeehouses were able to fill this need and were more accessible than bars. Coffee's image had changed from being purely a breakfast drink to a beverage that could be enjoyed any time and as a social catalyst. Coffee purchasers wanted more than just a place where they could get a higher quality cup of coffee. They wanted a place that answered a life-style need. Increasingly, coffee shops were turning into living rooms, where people sat back and enjoyed a cup of coffee or something else and relaxed with their friends or business associates. Coffeehouses had become community gathering places.

COMPETITION

Product-Based Competition

In retail coffee-house sales, Specialty coffee not only competed with basic coffee, it also competed with tea, juice, soft drinks, alcohol and other coffee and non-coffee-related drinks. However the consumption of all of these beverages relative to specialty coffee was declining.

Specialty Coffee could be divided into flavoured coffee which represented 25 per cent of all specialty coffee sold and non-flavoured coffee. Flavoured coffee referred to coffee that was flavoured with a variety of essences during the roasting process. Popular flavours included hazelnut, amaretto, raspberry, etc. Flavoured coffee was not offered by specialty coffee companies like Starbucks, Peet's, Caribou Coffee and The Coffee Station, but the opposite was true for Timothy's, and The Second Cup. Flavored coffee was popular among traditionally non-coffee drinkers, younger coffee drinkers, and those interested in a low calorie substitute for desserts or snacks. For a comparison of retail sales of different types of coffee, see Exhibit 2.

Another important product substitute was specialty coffee originating from basic coffee companies in the grocery chain. To respond to the phenomenal growth in specialty coffee in the grocery chain, many large, basic coffee manufacturers were moving into more specialty brands by introducing upscale versions of already popular supermarket brands. However, industry analysts forecasted that there would be a shift in consumer purchasing of specialty coffee. Currently, grocery stores were responsible for 81 per cent of specialty coffee sales; this figure was expected to fall to 46 per cent in 1999. This shift would result in greater amounts of coffee being purchased from specialty stores: 19 per cent currently to 54 per cent in 1999.

Retail-Based Competition

The Specialty Coffee Association of America estimated there would be room for about 10,000 coffee retail outlets in the United States and Canada by 1999. But only 5,500 of those would be coffee bars and cafes; the rest would be carts.⁶ The following table depicts the amount of room for growth in the retail coffee industry:

Location	Population (millions)	Number of Starbucks Stores	Current Population /Store	Population necessary to support a coffee house	Maximum number of coffee stores supportable by market	Total Starbucks Stores as a percentage of total possible stores
Top 50 U.S. Markets	144.9	914	158,581	54,470	2,661	34%
Vancouver, Toronto, Ottawa, Montreal, Calgary	11.3	113	99,611	56,000	201	56%
Top 100 U.S. & Major Canadian Markets	180.2	1,074	167,784	55,000	3,276	33%
Total U.S. & Canadian Markets	276.2	1,074	257,128	56,000	4,931	22%

From William Blair & Company, Starbucks Corporation, June 20, 1997

Given the low barriers to entry in the retail specialty coffee market, there were more than 3,485⁷ competitors in the market. However, most of these were one-store establishments with no real plans for growth. A description of those companies that had developed a strong regional and/or national presence follows.

⁶*Chicago Tribune, Sunday, March 10, 1996*

⁷*"Caffeine Rush: Customers are High on Gourmet Coffee and so are Operators" Restaurant Business, January 1, 1996*

DIEDRICH'S COFFEE	GREEN MOUNTAIN COFFEE INC.	COFFEE PEOPLE
<ul style="list-style-type: none"> made with its own freshly roasted beans sold light food items and whole bean coffee a few wholesale customers operated a total of 32 coffeehouses in Texas, Colorado, and California 1996 sales: \$10.2 million 	<ul style="list-style-type: none"> primarily a wholesaler of specialty coffee (3,000 customers) small number of retail operations with in-store roasting facilities roasted over 25 high quality Arabica coffees to produce over 70 varieties 1996 sales: \$38.3 million 	<ul style="list-style-type: none"> located in suburban neighbourhoods and business districts, averaging about 1,500 to 2,000 square feet in size used specialty kiosks located in high traffic locations such as airports and shopping malls hoped to have 100 locations by 1998
A.L. VAN HOUTTE	BARNIE'S COFFEE & TEA COMPANY	CARIBOU
<ul style="list-style-type: none"> offered 36 types of ground coffee, nine types of flavored coffee and 54 types of whole beans sold its coffee through restaurants, including its own network of 107 café-bistros (only four corporate stores) good reputation as a vendor of coffee to offices, hotels, etc. 1996 sales: \$164.1 million 	<ul style="list-style-type: none"> focussed on the merchandising aspect of coffee retailing; it offered 400 different branded products typically seated about 50 people and was located in malls its newest innovation was a restaurant, La Venezia Cafe; seated 200 people and offered 47 different coffees 	<ul style="list-style-type: none"> wanted to be the third place between work and home where people could socialize implemented a very American feel to its coffeehouses rather than a European feel offered very fast service, magazines, newspapers, free refills, and seating had 50 stores; analysts predicted that it would be a growth leader
COFFEE BEANERY	CHOCK FULL O'NUTS	CAFE APPASIONATO
<ul style="list-style-type: none"> franchiser who operated 175 units across the United States coffee beverages and food accounted for 80 per cent of the sales and 20 per cent came from merchandise focus had always been on malls but it was now shifting its focus to free-standing locations begun franchising coffee carts 	<ul style="list-style-type: none"> operated as a coffee supplier to the restaurant industry enough contracts with restaurants to warrant its own fleet of 150 trucks recently, company had begun diversifying into different coffeehouse formats like double drive-throughs and sit-down retail outlets, about 3,000 square feet in size 	<ul style="list-style-type: none"> small but aggressive player in the industry primarily a coffee roaster sold its coffee in its own retail outlets, franchised stores, wholesale coffee to specialty stores and restaurants, grocery division, direct mail, exports to the Pacific Rim, private label coffee production and co-label ventures with fast food chains, such as Taco Bell

SECOND CUP

Second Cup was primarily a franchiser (90 per cent of all locations), and as a result, the company was consistently cash flow positive and had the benefit of taking little operating risk at the store level. Traditionally, the Second Cup was mall-based, but in the past few years it had moved into more stand-alone locations. These locations were established rather quickly and were not always on prime real estate. In its retail concept, the Second Cup offered specialty coffee drinks, varietals, flavored coffee and snack items.

The Second Cup was very growth-oriented and believed strongly in growth via acquisitions. One of its major acquisitions included Gloria Jean's (247 locations), in the United States. Including its own 243 stores, the Second Cup was the second largest player in the specialty coffee industry. Where the Second Cup's revenues came from liquid coffee and snack food items, Gloria Jean's obtained a high percentage of sales from coffee mugs, related items and coffee beans.

In recent times, the Second Cup had become quite active in developing alliances with other food service companies. Through its alliance with Cara Operations Ltd., the Second Cup hoped to gain access to a number of its partner's institutional and retail sites such as Harvey's and Swiss Chalet. The Second Cup also held a 30 per cent interest in the Great Canadian Bagel that operated 120 stores in 1996 and was planning to own 175 by the end of 1997. Finally, the company had also struck a deal to serve its coffee on Air Canada flights. Revenues for 1996 amounted to \$63.3 million.

See Exhibit 3 for a comparison of the industry competitors using different financial and growth measures.

STARBUCKS' STRATEGY

Starbucks' strategy for the future was presented in the following extracts of a letter to Starbucks' shareholders. This letter, from Howard Schultz, Chairman and CEO, and Orin Smith, President and Chief Operating Officer, appeared in the company's 1996 Annual Report:

We have firmly established our leadership position, ending fiscal 1996 with more than 1,000 retail locations in 32 markets throughout North America and two new stores in Tokyo, Japan. With more than 20,000 dedicated partners (employees), we are creating opportunities every day for millions of customers around the world to enjoy the Starbucks Experience. From selecting the finest Arabica beans to hiring the most talented people, we are committed to applying the highest standards of quality in

everything we do When you walk into a Starbucks store, when you open a mail order package, when you drink our coffee on United Airlines, it is our goal to offer more than just a great cup of coffee — we want to offer a memorable experience We are excited about the global possibilities as more new customers embrace our business, and we know that we have many brand-building opportunities ahead of us. In 1994, when we entered into a joint venture agreement with Pepsi-Cola to develop ready-to-drink coffee products, we knew that we wanted to redefine the category we look forward to the positive reception of bottled Frappuccino but most importantly, we know that we have developed a platform for bigger product innovations. During fiscal 1996, we installed proprietary, state-of-the-art roasting and manufacturing equipment to create a world-class logistics and manufacturing organization Our specialty sales and marketing team has continued to develop new channels of distribution our direct response group launched a new America Online Café Starbucks store we continue to work towards our long-term goal of becoming the most recognized and respected brand of coffee in the world We believe more strongly than ever that at the heart of our continuing success lie the company's two cornerstones, coffee and our people Twenty-five years from now, when we look back again, if we can say that we grew our company with the same values and guiding principles that we embrace today, then we will know we have succeeded.

STARBUCKS' BUSINESS SYSTEM

Sourcing

Starbucks sourced approximately 50 per cent of its beans from Latin America, 35 per cent from the Pacific Rim, and 15 per cent from East Africa. Having a diversified portfolio allowed Starbucks to offer a greater palette of coffees to its customers while being able to maintain a hedged position.

Starbucks maintained close relationships with its exporters by working directly with them and providing them with training. Mary Williams, Senior Vice-President of Coffee at Starbucks, described what it took to be considered an official Starbucks' exporter:

If I am working with a dealer who has sold me 5,000 bags of Guatemalan for January's shipment and he knows that he is not going to be able to deliver, I don't want to hear about it in January. I want him to call me in September and say, 'Mary, we are going to

have trouble with this January. What can we do? How can we work this problem out? What can I do to help you? Shall we switch it to another coffee?' If I have a quality problem, I expect to be able to call up the person I bought the coffee from and say: 'Sorry, I have to reject this; it doesn't meet our standards.' I expect them to say: 'OK, we will take it back, no problem and we will replace it.' Both the customer service and consistency are the things we look for over time.

Exporters of high quality coffee were very anxious to become Starbucks suppliers because Starbucks purchased more high quality coffee than anyone else in the world. Starbucks' relationship with its suppliers was so good that if Supplier 'A' sold to a number of different buyers and it had only one container of a certain coffee, Starbucks would be the first to get it.

To ensure quality, Starbucks extracted three different samples of coffee from every shipment of 250 bags. Sample one was an offer sample sent by an exporter trying to make a sale to Starbucks. Sample two was taken just before the shipment was due to be sent. Sample three was extracted from the shipment, which arrived at the coffee roasting plant. At every stage of sampling, Starbucks reserved the right to reject the coffee if it was not in line with its quality standards.

Starbucks hoped to double volumes over the next three years. This could make the ability to find coffees that would meet its quantity/quality requirements difficult. Starbucks needed to offer an increasing number of blends to deal with its increasing volumes, since blends provided more flexibility around components. Mary Williams explained:

When you blend coffee, it's like baking a cake; you need to put lots of different kinds of spices in a spice cake; you don't necessarily have to have cinnamon, nutmeg and allspice. You can have other kinds of spices, and the consumers of that cake will not know the difference, because it tastes like a spice cake. So a House Blend with a particular flavor profile can have different types of the same quality components to reach the same flavor profile. Moving towards offering more blends and revolving varieties is one of the most important things Starbucks can do to ensure the quality/quantity mix of the coffee we buy.

Despite Starbucks' large supply needs, growing its own, high-quality coffee was an option that was never seriously considered.

ROASTING AND BLENDING

Roasting was a combination of time and temperature. Recipes were put together by the coffee department once all the components had been tested and were up to standard. Despite computerized roasters which guaranteed consistency, roasting was not a complete science; it was more of a technological art. This was because the people roasting the coffee had to understand the properties of the roasting process, i.e., managing temperature and being able to roast coffees along different roast curves. Roasting was essential to Starbucks, because how a coffee was roasted could change its entire taste.

Starbucks undertook a great deal of research by roasting its coffees in many different ways, under many different temperature and time conditions to ensure that it was getting as much as possible from the bean. These trial and error sessions allowed Starbucks to build signature roasting curves. These roasting curves were then built into proprietary computer software. The method by which they were developed was as much a result of the technology as the art. This ensured that even if a roaster were to defect to another competitor, he/she would not be able to duplicate Starbucks' signature roasts.

After roasting and air cooling, the coffee was immediately vacuum-sealed in one-way valve bags. This packaging was unique in its ability to ensure freshness, since it allowed gases naturally produced by fresh roasted beans out without letting oxygen in. This one-way valve technology extended the shelf life of Starbucks coffee to 26 weeks. However, Starbucks did not keep any coffee on its shelves for more than three months and for the coffee it used to prepare beverages in the store, the shelf life was limited to seven days, after the bag was opened.

SUPPLY CHAIN OPERATIONS

Starbucks Supply Chain Operations (SCO) claimed it had the best transportation rates in the industry, a complex bakery distribution model, a forecasting process for "who will need coffee when" that was generally very accurate, strong inventory turns for the specialty coffee industry, and a fully integrated manufacturing and distribution process that protected the coffee beans from oxygen from the time beans were roasted to the time they were packaged (closed loop system). Starbucks had developed these skills and benefits because it benchmarked against its competitors, hired experts, and believed strongly in the concept of integrated supply.

Starbucks tried to build its supply chain operations in order to eliminate redundancy and maximize efficiency. Supply chain operations served four business units: the retail store units, the specialty sales and wholesale channels, the mail order business and the grocery channel. According to Ted Garcia, Starbucks'

Executive Vice President, Supply Chain Operations, the phenomenal growth in these business units was posing challenges to supply chain operations:

Supporting four business units in an integrated, effective, efficient, cost-effective method, is a challenge. We are trying new and innovative things. We are not afraid to enter into agreements or challenge our suppliers such as United Parcel Service (UPS) to do things in new and innovative ways.

RETAIL SALES

The retail outlet had been Starbucks' fundamental growth vehicle. For many customers Starbucks was not only a place to drink coffee but also an experience. Howard Schultz's vision for Starbucks was a place that offered interesting coffee-related drinks in a theatrical kind of atmosphere, which pivoted around an espresso machine:

You get more than the finest coffee when you visit Starbucks. You get great people, first-rate music, a comfortable and upbeat meeting place, and sound advice on brewing excellent coffee at home. At home you're part of a family. At work you're part of a company. And somewhere in between there's a place where you can sit back and be yourself. That's what a Starbucks store is to many of its customers — a kind of 'third place' where they can escape, reflect, read, chat or listen.⁸

Starbucks' formula was firmly based in its coffee, its employees, its merchandising, its ownership philosophy, its real-estate approach, its image, and its innovativeness.

Employees

Starbucks' store employees (baristas) tended to be either in college or university. They received a great deal of training and were able to talk about a variety of different coffees and processes. Having baristas that had a strong coffee education was essential because Starbucks' consumers were becoming more and more knowledgeable about coffee. Mary Williams, SVP Coffee for Starbucks, outlined the nature of the questions asked of the baristas at Starbucks:

We have very educated consumers. They ask very interesting questions of the people who work in our stores; such as, 'I am having chocolate mousse for dessert, what kind of coffee should I

⁸1995 Annual Report, Starbucks Corporation

serve?'; or 'I am having shrimp scampi for dinner and a fruit salad for dessert, what kind of coffee should I serve?' So we have to give the baristas some kind of a basis and background so that they can answer these difficult questions.⁹

Developing coffee knowledge and service expertise demanded a great deal of effort from employees and as Starbucks grew, finding enough good people that could replicate the values, culture and service experiences was an ongoing challenge.

Merchandising

Starbucks only carried the highest quality merchandise. In terms of coffee-making equipment, it purchased its machines from manufacturers like Krups, Gaggia and Bodum. It also offered accessory items bearing the Starbucks Logo such as coffee mugs, grinders, coffee filters, storage containers and other items. In terms of merchandising, Starbucks faced challenges related to the design of a nationally consistent merchandising program, since many of its stores dealt with individual suppliers.

Real-estate Approach

Starbucks considered itself to be real estate opportunistic. It did not always wait for the perfectly designed location, i.e., a box. It had a design team that could fit a location in many retail spaces, be it a corner, a trapezoid, or triangle. This flexibility, in addition to Starbucks' concept of store clustering, which often placed retail outlets across from one another or on the same block, allowed Starbucks to maximize its market share in given areas of a city and to begin building a regional reputation.

To meet its growth needs Starbucks had approximately 20 real estate managers across the country. These managers worked with "street sniffers," i.e., professionals who specialized in identifying the best retail locations. Their commissions were paid either by the landlord or by Starbucks. These real estate brokers were guaranteed a minimum commission per location. If the landlord's brokerage commission did not cover the minimum, Starbucks paid the difference. This engendered a very loyal relationship between Starbucks and the real estate network.

⁹Mary Williams, SVP Coffee, Starbucks Corporation

Starbucks was very disciplined about its entire approach to real estate:

Discipline is the difference between locating a store in a targeted demographic area this year, in order to get in there and gain market share versus being disciplined enough to wait for the corner or the mid-block with a parking lot. Discipline is rooted in the ability to understand the differences and business issues involved with taking a store today that may do \$750,000 versus waiting for a store that may do \$1 million. Understanding and acting upon location issues such as corners, parking lots and co-tenants; that's the discipline of it.¹⁰

As Starbucks grew and the number of 'A' sites in 'A' markets decreased, one of the key challenges faced by Starbucks was to constantly motivate its real estate staff to continue to generate 20 to 40 solid stores per month. Starbucks had to meet this challenge if it was going to meet its goal of 2,000 stores by the year 2000. Traditionally, Starbucks had been focused on the retail store on Main and Main of every major North American city. Now it was expanding to the Main and Main of different regions within a city. See Exhibit 4 for the actual and forecasted income statement of a typical store.

Another way in which Starbucks hoped to reach a new customer base was through the introduction of its new espresso carts or kiosks. By introducing Starbucks Espresso Carts, the company had succeeded in branding the coffee cart, which had always been a brandless, grassroots type of specialty coffee retailer. Starbucks called its version of the espresso cart Doppio. The Doppio was an eight by eight-foot cube that unfolded into a larger stand with sides, counters, and Starbucks' trademark finishes. It would allow the company to take advantage of sales areas such as train stations, street corners, malls, etc. Starbucks was in the initial stages of its Doppio strategy.

Domestic versus International Retail Image

The retail system is the base or anchor of the brand-building strategy, the essence of the company's passion for quality coffee, and the showcase for the lifestyle that Starbucks is defining. It is this lifestyle attribute of the brand that could catapult the company beyond its roots as a specialty retailer/restaurant with a few closely associated brand extensions.¹¹

Starbucks decided to enter the international market place to prevent competitors from getting a head start, to build upon the growing desire for Western brands, and

¹⁰Arthur Rubinfeld, *Senior Vice-President Real Estate, Starbucks Corporation*

¹¹Merrill Lynch Capital Markets, *Starbucks Company Report, September 16, 1996*

to take advantage of higher coffee consumption rates in different countries. It focused on Asia Pacific simply because it did not have the resources to go into different areas of the globe at once and because one half of the world's population lived a five and a half hour flight from the area. It was expected that in the next five to 10 years, international retail's contribution would be sizeable. See Exhibit 6 for a forecast of International Retail's potential contribution to Starbucks' earnings. Also see Exhibit 5 for a forecast of Starbucks' growth in the Pacific Rim.

SPECIALTY SALES

Specialty sales were agreements with retailers, wholesalers, restaurants, service providers, etc. to carry Starbucks coffee. Specialty sales not only provided Starbucks with revenue growth potential but also with increased name recognition. Starbucks partnered with companies that were leaders in their field, companies that had stellar reputations for success and quality. Partnerships existed with many different companies, some of which included:

- **United Airlines** — Starbucks was served on all domestic and international flights.
- **Nordstrom** — Starbucks had developed a special blend for Nordstrom.
- **Barnes & Noble Bookstores** — Starbucks operated individual but attached locations. Many of these locations had separate entrances that allowed them to stay open even after Barnes & Noble closed.
- **PepsiCo** — Starbucks and PepsiCo had jointly developed the Frappuccino product, a milk-based cold coffee beverage in a bottle.
- **PriceCostco** — Starbucks had developed a special brand name, Meridian, for PriceCostco.
- **Red Hook Breweries** — Starbucks provided coffee concentrate as an ingredient for one of the brewery's beers, Double Black Stout.
- **Dreyers' Ice Cream** — In this joint venture, Starbucks had its own brand of ice cream that Dreyers' promoted via its grocery channels.
- **ARAMARK** — This was the world's leading provider of a broad range of services to businesses, reaching 10 million people a day at more than 400,000 locations. Through ARAMARK, Starbucks coffee was now being served at over one hundred of those locations, including such college campuses as the University of Florida and Boston University, corporations such as Boeing and Citicorp, and hospitals such as St. Vincent's in New York. ARAMARK also had a few licenced locations.

Some of these partnerships involved serving Starbucks coffee, some were for product development and others were for store development. Starbucks was actively increasing its participation in specialty sales contracts.

NEW VENTURES

Three of Starbucks' newest business ventures included its contract with Dreyers' Ice Cream, its bottled Frappuccino product with Pepsi and its penetration into the grocery channel.

It was estimated that Starbucks' ice cream would perhaps reach \$40 million at retail and contribute at least \$500,000 to earnings during fiscal 1997. Although the return was somewhat limited (see Exhibit 6), it opened Starbucks to an entirely new customer base, reinforced its premium quality image, and built its reputation with supermarket chains.

Bottled Frappuccino was Starbucks' attempt to introduce a quality ready-to-drink coffee beverage into the North American market place. Starbucks viewed this bottled beverage as a \$1 billion opportunity. These estimates were from Pepsi, who said that it had never seen a product test quite as well as bottled Frappuccino, where 70 per cent of testers became repeat purchasers. Other products that had hit the billion dollar mark with less favorable test results were Ocean Spray Juices and Lipton Iced Teas. The product might even do better in countries where there was already a market for cold coffee beverages, like the Pacific Rim. Bottled Frappuccino was currently being offered in all Starbucks retail stores and had begun to be distributed via PepsiCo's national distribution channels. See Exhibit 6 for a forecast of bottled Frappuccino's contribution to Starbucks' future earnings.

In penetrating the grocery market, Starbucks met with a great deal of success when it began test marketing in the Portland area. Now it was test marketing the Chicago market. If it was successful in Chicago, then it would consider initiating a national roll out with the expectation that in five years it would be nationally available. See Exhibit 6 for an estimate of the impact of a national roll out on Starbucks' earnings. Mr. Orin Smith, Starbucks President and COO, explained how he viewed the importance of Starbucks' penetration into the grocery chain:

Presence in supermarkets is not essential to Starbucks' survival or prosperity. However, in the interest of being a major player in coffee for the home, we have to be available in supermarkets. This is because convenience plays a key role in the decision to purchase coffee for the home. Therefore, no matter how many stores we open, we will never overcome the 'convenience' advantage of supermarkets. For us, the choice is clear: Are we going to allow supermarkets to continue to capture 70 to 80 per cent of the home coffee business or are we going to join up and take our piece of that? Supermarkets are very interested in carrying Starbucks Coffee because we can offer them greater margins; we can grow their

business and we will help pull consumers out of the lower priced categories into our category.¹²

Other areas of opportunity included the introduction of Starbucks coffee to the higher echelon restaurants and day-part chains. Day-part chains are retail outlets catering to the day-time trade. Examples are bagel shops, juice bars, lunch counters etc.

MAIL ORDER

For a long time, mail order had allowed Starbucks to meet the needs of its customers not located near a Starbucks retail store and its regular home users. The company had a direct mail program entitled Encore. Encore customers received a monthly shipment of a different type of either ground or whole bean coffee. This program helped boost sales by increasing transaction size, and introducing customers to a wider range of company products.

HOWARD SCHULTZ

Howard Schultz began his coffee career with Starbucks Coffee Company in 1982, when it used to be a retailer solely of whole bean coffees. On a buying trip to Italy, in 1983, the vast number of coffee bars in Milan inspired Mr. Schultz. He returned to Starbucks and presented his idea to expand the whole bean retailer into a coffee bar. The Board of Directors rejected his idea and two years later, Mr. Schultz left Starbucks to start his own coffee bar company which he named Il Giornale. After two years of great success, Il Giornale purchased the Starbucks name and assets and changed the names of all of its retail outlets to Starbucks.

Howard Schultz came from rather humble beginnings. He remembered how his father used to work hard for little money and no respect. He said his upbringing instilled in him “not a fear of failure but a fear of mediocrity.” He was the first in his family to get a college degree and had always been an over-achiever. He was young and energetic at 45 and very hands-on in the company.

Howard is very creative, he is very inspiring, he is exceptionally demanding, he is tremendously competitive, exceptionally ambitious, and has very high standards in everything we can do and he is always ratcheting the bar up. He really cares about people; anything anyone would do to damage the culture — he would be right on it.¹³

¹²Orin Smith, Chief Operating Officer, Starbucks Corporation

¹³Orin Smith, Chief Operating Officer, Starbucks Corporation

Howard Schultz played a very important and unique role at Starbucks.

The barista's interpretation of the vision is the engine of the company, Howard is the on-board computer, and to some extent he is also the fuel that drives through it. People around here feel very much that they are following Howard up some mountain with a flag clenched under their teeth and they give 110 per cent.¹⁴

HUMAN RESOURCES

Starbucks had a very flat organizational structure. Everyone from the CEO to a barista was a partner and not an employee. Starbucks placed a great deal of effort into seeking the thoughts and opinions of its baristas, because they were in direct contact with Starbucks' customers. Starbucks' retail management, at headquarters, kept in regular contact with field people. Many people in the stores knew Deidra Wager, the Executive Vice-President of Retail, and would not hesitate to call her directly to talk about the retail group's decisions. The head office managers had sessions with people in the field, standard mission reviews where they collected questions from anyone about any topic and then responded, and open forums where they heard from and listened to the partner base.

The coffee service system was built on three principles: hospitality, production and education. Starbucks expected baristas to be customer-service oriented by being hospitable, effective in making exactly the type of drink the customer requested and able to answer the customers' coffee-related questions. This demanded a great deal of effort on behalf of the baristas. To prepare them for the challenge, they all underwent 24 hours of training before they were allowed to serve a cup of coffee to a Starbucks customer. Every employee, even those that were hired for executive positions, went through the same training program, which included a two-week term in a store.

In addition to training, Starbucks paid its partners a slightly higher wage than most food service companies. Also, all employees received health insurance (vision, dental, medical), disability and life insurance, and a free pound of coffee each week. All company employees also received "Bean Stock," an employee stock option plan. This was quite profitable for some employees.

From its baristas to its senior managers, Starbucks took great care in recruitment. For baristas, turnover rates were about 60 per cent; this was less than half of the industry average (150 to 300 per cent). Many of the senior managers came from companies like Taco Bell, Nike, McDonalds, Hallmark, Wendy's, and Blockbuster. These managers knew how to manage a high growth retailer.

¹⁴Scott Bedbury, *Senior Vice-President, Marketing, Starbucks Corporation*

ORGANIZATIONAL CULTURE

The following six guiding principles, from the company's 1995 Annual Report, helped Starbucks measure the appropriateness of its decisions:

1. Provide a great work environment and treat each other with respect and dignity.
2. Embrace diversity as an essential component of the way we do business.
3. Apply the highest standards of excellence to the purchasing, roasting, and fresh delivery of our coffee.
4. Develop enthusiastically satisfied customers all of the time.
5. Contribute positively to our community and our environment.
6. Recognise that profitability is essential to our future success.

The following statements captured employee sentiments about Starbucks' culture.

When people ask me what I do for a living, I say: I drink coffee and talk about it. That's my job — not too shabby. I have a lot to learn, and a lot of places I can go if I wanted to leave Starbucks, but its so interesting and I've met the neatest people that work here. I have a lot of passion for it. You know you go through bumps and grinds because we've changed a lot but it's like being in any kind of relationship. You fall in love, it's all great, everything is beautiful and then you find out that there are some things like wrinkles or bad habits. You work on those and then you're in puppy love again. I love working at Starbucks; my husband thinks it's pretty twisted. I mean I was a store manager and I lived at my store . . . people would say that you do such a great job and I would say that I couldn't do it without these people — I can't do it alone — none of us can. I totally rely on the wealth and depth of knowledge that other people have, the background they bring to Starbucks, their support and work ethic. And I just embrace that hugely; I can bring my weird ideas and be as goofy as I want one day or as serious as I need to be another day and its OK. When I started at Starbucks someone told me: you tell me what you want to do and I will help you.¹⁵

In a day offsite, with Jim Collins (author of Built to Last), the senior management team of 40 people or so was divided into 10 groups of four. First, we identified our own set of values and then when we broke into groups of four people and combined our lists of values. It was absolutely mind-boggling that we all came back and had exactly the same list of values. Collins had never seen anything like that. Everyone is passionate about what they do, about life,

¹⁵ Aileen Carrell, *Coffee Taster, Starbucks Corporation*

about everything. Everybody has a sense of integrity, that we want to succeed but we want to do it in a fair, equitable, ethical way. We care about winning; you know we aren't ashamed to admit that we want to be successful, that we do care about people and do respect our partners. The fifth value was our entrepreneurial spirit. We don't want this to become a big company; we want to continually strive to be innovative and continually rejuvenate the company.¹⁶

FINANCIAL

Starbucks' stock price and EPS had been rapidly increasing over the last five years (see Exhibit 7). In the span of six months, from January to June 1997, four prominent investment companies had rated the company as a "BUY" in their report to investors. See Exhibit 8 for a forecast from each of these companies regarding EPS, P/E ratios and share price. One investment company that rated Starbucks as a long-term buy stated:

Since its 1992 IPO, Starbucks has executed its strategy to near perfection, achieving its initial goal of building the country's leading branded retailer of specialty coffees. As growth in its North American retail business decelerates from unsustainably rapid rates, the company is now in the early stages of pursuing a more ambitious goal — to build the most recognized and respected coffee brand in the world. Current initiatives include the development of Starbucks stores with local partners in the Pacific Rim, domestic brand extensions into packaged ice cream and bottled beverages, and test-marketing Starbucks whole bean coffees in the supermarket channel. While greatly enhancing the company's long-term growth potential, we believe these new pursuits also raise the risk profile of the stock. With SBUX shares trading at 33 times our estimate of calendar 1998 EPS, we believe extraordinary intermediate-term appreciation relies upon the successful execution of these ventures. Given the strength of the brand, our confidence in management, and impressive joint-venture partners, we are optimistic that these activities, in the aggregate, will contribute significantly to Starbucks' profitability over the next three to five years. We conclude that Starbucks remains a core holding for long-term growth stock investors, albeit with higher risk, as it transitions from a category-dominant domestic branded retailer into a global consumer brand.¹⁷

¹⁶Liz Sickler, Director, Special Projects, Starbucks Corporation

¹⁷William Blair and Company on June 20, 1997

In North America, Starbucks owned all of its retail outlets other than host licensing arrangements. However, owning all of its stores, Starbucks was faced with the prospect of depending heavily on equity and debt financing to grow. Its competitors like Seattle's Best Coffee and the Second Cup were all franchised, and consequently, needed less internal financing to roll out stores. For Starbucks' balance sheet, see Exhibit 9. For the income statement, see Exhibit 7.

MARKETING

Of key concern in Starbucks' marketing department was its brand equity. The retail business had historically been Starbucks' source of brand equity. This had meant that Starbucks was never just about the coffee; it was about a place, an experience.

Starbucks now wanted to develop its brand beyond being the preferred outlet from which to purchase coffee to becoming the preferred consumer brand. Scott Bedbury, Starbucks' Senior Vice-President of Marketing, explained its brand:

We are transitioning from a very retail centric view about the brand to a view that will allow us to say that Starbucks' role is to provide uplifting moments to people every day. I didn't say coffee! If you go beyond coffee, you can get to music, you can get to literature, you can get to a number of different areas. It can also become a license to dilute the brand. Therefore our goal is to remain true to our core, coffee. After all we are the protectors of something that is 900 million years old. Just like when you drop a rock in a pond there will be ripples that come outside that core, Starbucks is not just a pound of coffee, but a total coffee experience.

One of the key challenges faced by Starbucks was trying concretely to define its brand image. Company executives felt that this was essential before Starbucks started mounting grand-scale national-advertising campaigns and other brand leveraging activities. Liz Sickler, Starbucks Director of Special Projects, commented:

I don't think that we leverage our size well enough. Very often we have strong competition in local markets from Caribou, to Seattle's Best Coffee to the Second Cup in Canada. And it's always mind-boggling how they can be so competitive in their local markets despite the fact that our national brand image is so much stronger. We need to take advantage of our national presence. We need to compete on our brand recognition. I think that's why we started to do some national advertising this year to see if that's how we can

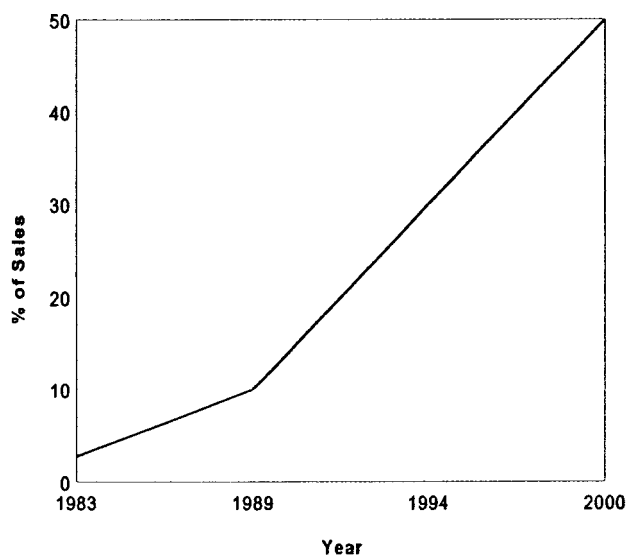
leverage our size. I think going into different distribution channels and leveraging the brand is the answer.

OPTIONS

Howard Schultz and the senior management at Starbucks were committed to the company's strategy. It was felt that Starbucks' current strategic direction would allow it to sustain growth by continuing the development of the Starbucks brand image and by increasing its presence in different markets. Starbucks was growing very rapidly and was consistently evaluating new opportunities in its domestic and international retail markets, new specialty sales partners, penetration in the grocery channel and the future potential of its mail order business. How the company should react to all of these opportunities was one of Mr. Schultz's key concerns.

Exhibit 1

**SPECIALTY COFFEE SALES
AS A PERCENTAGE OF TOTAL COFFEE SALES**



Source: Specialty Coffee Association of America, Montgomery Securities Volume 27

Exhibit 2

COMPARING THE RETAIL SALES OF COFFEE (US\$ MILLIONS)

	1990	1994	1998E	1990–1994 growth	1994–1998E growth
Ground Regular	2,050	1,240	800	–11.8%	–10.4%
Ground Decaffeinated	650	575	450	–3.0%	–5.9%
Ground Specialty	810	1,315	1,635	12.9%	5.6%
Instant Regular	1,175	1,010	780	–3.7%	–6.3%
Instant Decaffeinated	385	295	170	–6.4%	–12.9%
Whole Bean	255	380	500	10.5%	7.1%
Ready-To-Drink	5	250	1,255	165.9%	49.7%
Total	5,330	5,065	5,590	–1.3%	2.5%

Source: Yorkton Securities Inc., March 25, 1997

Exhibit 3

COFFEE CHAINS' STOCK PRICES AND MARKET CAPITALIZATIONS

Company	Year		Market Cap. (\$ millions)
	High (\$)	Low (\$)	
U.S. Companies			
Brothers	4.63	2.13	30.8
Coffee People	9.38	6.00	21.4
Diedrich	12.00	3.00	23.6
Green Mountain	7.50	6.88	24.8
Starbucks	40.25	21.50	2,438.5
Canadian Companies			
Cara	4.80	3.30	440.2
Van Houtte	28.35	18.50	225.6
Second Cup	13.35	9.15	137.2

COMPARING THE COFFEE CHAINS

Company	TEV (1)/EBITDA (2)	Net Margin
U.S. Companies		
Brothers	6.0	-14.0%
Coffee People	8.4	1.7%
Diedrich	15.6	1.2%
Green Mountain	7.3	3.3%
Starbucks	25.1	6.0%
Average	14.5	
Canadian Companies		
Cara	7.7	5.8%
Van Houtte	7.8	4.7%
Second Cup	13.2	-3.7%
Average	17.9	

(1) TEV is total enterprise value defined as current market cap plus debt less cash. Debt and cash are as latest available balance sheet date.

(2) EBITDA for Brothers and Diedrich is trailing 12 months.

Source: Yorkton Securities Inc., March 25, 1997

Exhibit 4

ANALYSIS OF UNIT ECONOMIC TRENDS
(US\$ thousands)

	1994	1995	1996	1997E	1998E	1999E
Cash Investment:						
Store Build Out (1)	330	357	315	310	305	300
Pre-opening	16	23	21	20	20	20
Beginning Inventory	17	20	24	20	20	20
Total Cash Investment	363	400	360	350	345	340
Average Sales/Store (2)	820	820	850	825	790	765
Average Sales/Investment	2.3x	2.1x	2.4x	2.4x	2.3x	2.3x
EBIT Margin (3)	18.9%	17.5%	16.5%	18.0%	17.8%	17.6%
EBIT	155	144	140	150	141	135
ROI (EBIT/Cash Invested)	43.0%	36.0%	39.0%	43.0%	41.0%	40.0%

(1) Estimated investment per store opened during the fiscal year.

(2) Estimated average sales and EBIT for units open at least one year.

(3) EBIT includes marketing and field level overhead expenses.

Source: William Blair & Company, 1997

Exhibit 5

STARBUCKS CORPORATION PROJECTED PACIFIC RIM DEVELOPMENT (A)
(US\$ millions)

	1997E	1998E	1999E	2000E
New units	13	30	55	100
Ending units	15	45	100	200
Average unit volume	\$1.0	\$1.0	\$1.0	\$1.0
Total sales (a)	\$9	\$30	\$73	\$150

(a) Note that total sales reflect sales of joint ventures, partnerships, and licensees. We expect additional partnership agreements in the Pacific Rim to be disclosed before year-end. In fact, an executive of President Foods (the largest food company in Taiwan and a 7-Eleven franchisee) was recently quoted saying that the company expected to develop Starbucks stores in Taiwan, and perhaps China. Given the magnitude of the opportunity in the Pacific Rim, we do not anticipate development in Europe until at least 1999. Whereas the long-term potential of international development is tremendous, we expect expenses of building infrastructure and growing rapidly will be a drag on Starbucks profits at least through 1999. Depending on the structure of future international ventures, this business could become a significant consumer of Starbucks investment capital.

Source: William Blair & Company, 1997

Exhibit 6

**PROJECTED AVENUES OF GROWTH — ESTIMATED CONTRIBUTION FROM JOINT VENTURES
(US\$ millions)**

	1995	1996	1997E	1998E	1999E
Annual Investment					
Ice Cream	0.0	0.9	2.0	1.0	0.5
Bottled Beverages	1.2	2.7	18.0	15.0	10.0
Whole Bean	0.0	0.0	3.0	5.0	9.5
Total	1.2	6.0	30.0	33.0	35.0
Retail Revenues					
Ice Cream	0.0	15.0	40.0	45.0	50.0
Bottled Beverages	0.0	0.0	65.0	250.0	300.0
Whole Bean	0.0	0.0	1.3	43.8	78.8
Total	0.0	15.0	114.8	368.8	501.3
Contribution to Starbucks Earnings:					
Ice Cream	0.0	-0.7	0.5	2.4	3.0
Bottled Beverages	-1.2	-0.4	-0.5	4.4	7.9
Whole Bean	0.0	0.0	-0.5	1.6	4.5
Total	-1.2	-1.1	-1.5	8.4	15.4
Joint Venture Contributions	-1.2	-1.1	-1.5	8.4	15.4

Source: William Blair & Company, 1997

Exhibit 7

INCOME STATEMENT
(US\$ thousands)

	1994	1995	1996	1997E	1998E	1999E
Net Revenues						
Retail	248,453	402,874	600,367	827,003	1,053,796	1,276,840
Specialty Sales	26,498	47,917	78,702	110,331	148,612	193,552
Direct Response	9,972	14,422	17,412	22,066	25,792	30,008
Total Net Revenues	284,923	465,213	696,481	959,400	1,228,200	1,500,400
Store Operating Expenses	90,087	148,757	210,693	296,200	368,700	441,800
Other Operating Expenses	8,698	13,932	19,787	24,200	31,800	40,200
Cost of Sales and Related Occupancy Costs	162,840	262,408	409,008	548,800	687,000	827,700
Operating Income	23,298	40,116	56,993	90,200	140,700	190,700
Other Expenses	-5,544	3,027	11,508	3,600	-2,600	-7,000
Earnings before income taxes	17,754	43,143	68,501	93,800	138,100	183,700
Income Taxes	7,548	17,041	26,373	36,100	53,200	70,700
Net Earnings	10,206	26,102	42,128	57,700	84,900	113,000
Preferred Stock Dividends Accrued	-270	0	0			
Net Earnings Available to Common Shareholders	9,936	26,102	42,128	57,700	84,900	113,000
Net Earnings Per Share	0.17	0.36	0.47	0.70	1.00	1.30
Weighted Average Shares Outstanding	57,575	71,909	80,831	88,600	89,500	90,400
Average Share Price	25	15	24			
Price Earnings Ratios	148	42	51	51	36	28

Note 1: The \$0.47 EPS in 1996 excludes the gains from the sale of Noah's Bagels.

Note 2: The \$0.17 EPS in 1994 would be \$0.22 without the one-time charges associated with the acquisition of Coffee Connection.

Note 3: On December 1, 1995, the company recorded a 2 for 1 stock split to holders of record on November 1, 1995. Net earnings per share for all years have been restated to reflect the stock split.

Sources: Starbucks Annual Reports & William Blair & Company

Exhibit 8

FORECAST OF STARBUCKS' EPS, PE RATIO AND SHARE PRICE

Robinson-Humphrey Company Inc.	1996	1997E	1998E
Earnings Per Share	\$0.54*	\$0.70	\$1.00
Price / Earnings Ratio	55.6 times	42.9 times	30.0 times
Forecasted Share Price			\$49.00

**Includes a one-time gain on the Sale of Noah's Bagels.*

Alex. Brown & Sons	1996	1997E	1998E
Earnings Per Share	\$0.48	\$0.70	\$0.98
Price / Earnings Ratio		39.0 times	27.8 times
Forecasted Share Price			\$45.00

Painewebber Inc.	1996	1997E	1998E
Earnings Per Share	\$0.47	\$0.70	\$0.95
Price / Earnings Ratio		40.5 times	30.0 times
Forecasted Share Price			\$42.00

William Blair and Company	1996	1997E	1998E	1999E
Earnings Per Share	\$0.47	\$0.70	\$1.00	\$1.30
Price / Earnings Ratio	76.1 times	51.1 times	35.8 times	27.5 times

Exhibit 9

BALANCE SHEET
(US\$ thousands)

	1994	1995	1996	1997E	1998E	1999E
Assets						
Current Assets:						
Cash and Cash Equivalents	8,394	20,944	126,215	128,900	53,200	21,000
Accounts Receivable	5,394	9,852	17,621	24,300	31,100	38,000
Inventories	56,064	123,657	83,370	122,500	149,600	178,100
Other Current Assets	14,728	50,897	112,335	12,500	16,100	19,600
Total Current Assets	84,580	205,350	339,541	288,200	250,000	256,700
Property and Equipment, Net	140,754	244,728	369,477	496,700	617,600	733,600
Other Assets	6,087	18,100	17,595	43,100	78,100	121,100
Total Assets	231,421	468,178	726,613	828,000	945,700	1,111,400
Liabilities and Shareholders' Equity						
Current Liabilities						
Accounts Payable	9,128	28,668	38,034			
Other Current Liabilities	31,290	42,378	63,057			
Total Current Liabilities	40,418	71,046	101,091	134,100	165,800	198,100
Other Liabilities	81,105	84,901	173,862			
Shareholders' Equity:						
Common Stock	89,861	265,679	361,309	519,400	604,300	717,200
Retained Earnings	20,037	46,552	90,351			
Total Shareholders' Equity	109,898	312,231	451,660			
Total Liabilities	231,421	468,178	726,613	828,000	945,700	1,111,400

Sources: Starbucks Corporation Annual Reports & William Blair & Company