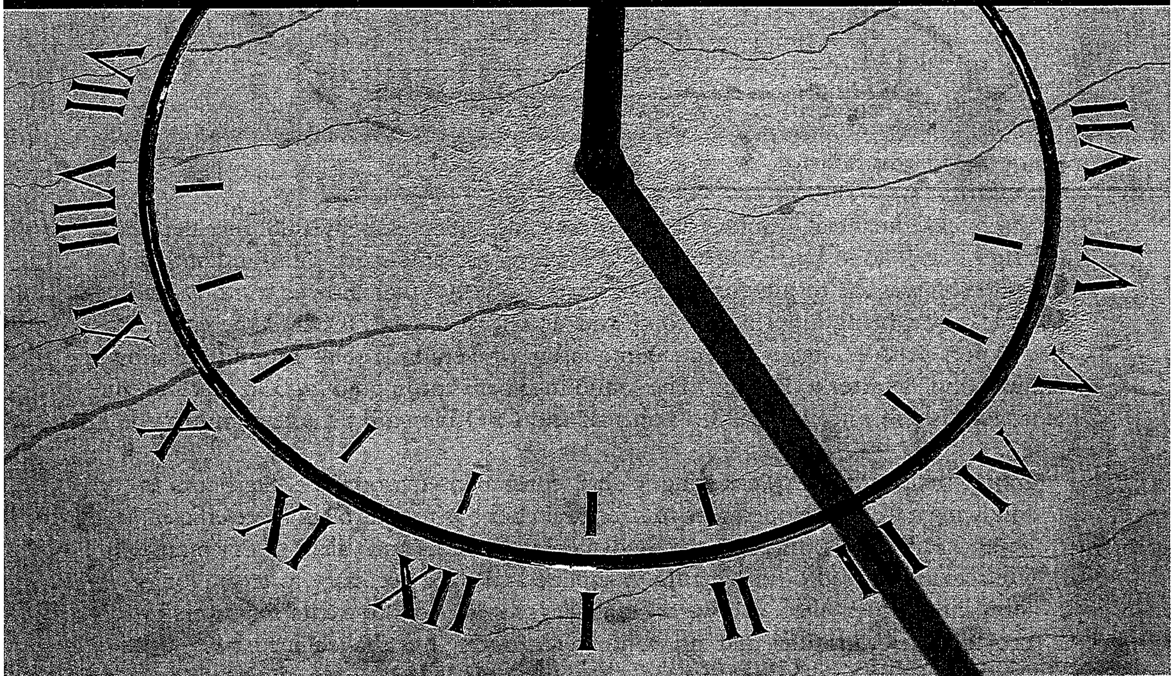
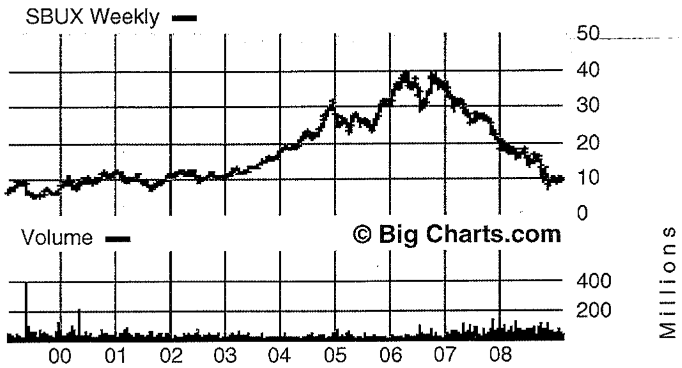
Case 2 Starbucks in 2009: The Coffee Goes Cold



After 20 years of continuous expansion accompanied by rising profits and a soaring stock price, Starbucks' downturn was unexpected and rapid. Starbucks' stock-market valuation was the leading indicator of the problems to come. After reaching a peak of $40 in October 2006, the share price declined by more than 75% over the next two years (see Figure 2.1). During 2007 growth of same-store sales and operating profits slowed. Amidst increasing concern over Starbucks' current strategy and future prospects, chairman and founder, Howard Schultz, returned as CEO at the beginning of 2008. His turnaround strategy comprised a sharp cutback in planned U.S. new store openings, revised operational and human resources practices aimed at improving customer service, "reigniting the connection with customers," and reallocating resources from the U.S. to overseas. In the summer of 2008, Schultz announced the closure of 600 U.S. stores and withdrawal from Australia.

FIGURE 2.1 Starbucks' share price and trading volume, 2000 to February 2009



Source: www.bigcharts.com

Starbucks' financial results for the year ending September 2008 revealed the damage being done by the economic downturn to same-store sales and margins. However, it was the results for the final quarter of 2008 that showed just how badly Starbucks was being hurt: net income was down by almost 70% and the company had experienced its first ever decline in quarterly revenues. Tables 2.1 and 2.2 show annual and quarterly results. The announcement prompted a 33c decline in Starbucks' share price to $9.33. Chairman and CEO Howard Schultz commented:

> In the midst of the weakening global consumer environment, Starbucks is following a well-developed plan to strengthen our business through more efficient operations and by preserving the fundamental strengths and values of our brand. We remain focused on driving the discipline and rigor necessary to create long-term shareholder value, and we are taking aggressive steps to excite customers by providing relevant value and innovation, even during this challenging time.[1]

CFO Troy Alstead, added:

> With a solid balance sheet, strong cash flow and healthy liquidity, Starbucks is well-positioned to weather the challenging global economy. We will continue to take the actions necessary to scale our cost structure to meet current business trends while positioning the company to drive margin expansion when the environment improves.[2]

Further retrenchment measures included: 300 store closures, 6700 job losses (including 700 in corporate and support positions), $500 million in operating cost savings for 2009 and a reduction in new openings of company-owned stores from 270 to 170. Schultz cut his own salary from $1.2 million to $10 000 and put two of Starbucks' three corporate jets up for sale.[3]

While deteriorating sales and profit performance could be blamed primarily on the global economic recession, Starbucks' languishing share price reflected broader concerns about the company's future. Had Starbucks' U.S. expansion resulted in excessive store density in some metropolitan areas? Had the growth of competition—not just from other specialist coffee chains but also from major fast-food chains such as McDonald's

TABLE 2.1 Starbucks Corporation: financial and operating performance 2004–8

Year ended September 30 (in $, millions)	2008 (52 weeks)	2007 (52 weeks)	2006 (52 weeks)	2005 (52 weeks)	2004 (53 weeks)
RESULTS OF OPERATIONS					
Net revenues:					
Company-operated retail	8771.9	7998.3	6583.1	5391.9	4457.4
Specialty:					
Licensing	1171.6	1026.3	860.6	673.0	565.8
Foodservice and other	439.5	386.9	343.2	304.4	271.0
Total specialty	1611.1	1413.2	1203.8	977.4	836.8
Total net revenues	10383.0	9411.5	7786.9	6369.3	5294.2
Cost of sales	4645.3	3999.1	3178.8	n.a.	n.a.
Store operating expenses	3745.1	3215.9	2687.8	n.a.	n.a.
Other operating expenses	330.1	294.2	253.7	n.a.	n.a.
Depreciation and amortization expenses	549.3	467.2	387.2	n.a.	n.a.
General and administrative expenses	456.0	489.2	479.4	n.a.	n.a.
Restructuring charges	266.9	—	—	n.a.	n.a.
Total operating expenses	9992.7	8465.6	6986.9	n.a.	n.a.
Operating income	503.9	1053.9	894.0	780.5	606.5
Net earnings	315.5	672.6	564.3	494.4	388.9
Net cash provided by operations activities	1258.7	1331.2	1131.6	922.9	862.9
Capital expenditures (net)	984.5	1080.3	771.2	643.3	416.9
BALANCE SHEET					
Working capital (deficit)	(441.7)	(459.1)	(405.8)	(17.7)	604.6
Total assets	5672.6	5343.9	4428.9	3513.7	3386.3
Short-term borrowings	713.0	710.3	700.0	277.0	—
Long-term debt	550.3	550.9	2.7	3.6	4.4
Shareholders' equity	2490.9	2284.1	2228.5	2090.3	2469.9
STORE INFORMATION					
Percentage change in same store sales:					
United States (%)	(5)	4	7	9	11
International (%)	2	7	8	6	6
Consolidated (%)	(3)	5	7	8	10
Stores opened during the year (net) of closures):					
United States					
Company-operated stores	445	1065	810	580	521
Licensed stores	438	723	733	596	417
International					
Company-operated stores	236	286	240	177	160
Licensed stores	550	497	416	319	246
Total	1669	2571	2199	1672	1344

TABLE 2.2 Starbucks Corporation: consolidated statement of earnings, final quarter 2008

($ millions) 13 weeks to:	Dec 28, 2008	Dec 30, 2007
Net revenues:		
Company-operated retail	2176.2	2351.5
Specialty:		
Licensing	334.3	304.8
Food service and other	104.7	111.3
Total specialty	439.0	416.1
Total net revenues	2615.2	2767.6
Cost of sales (including occupancy costs)	1196.8	1186.0
Store operating expenses	936.6	927.3
Other operating expenses	72.6	85.7
Depreciation and amortization expenses	134.3	133.2
General and administrative expenses	105.2	125.9
Restructuring charges	75.5	—
Total operating expenses	2521.0	2458.1
Operating income	117.7	333.1
Interest expense	(13.0)	(17.1)
Earnings before income taxes	98.3	326.7
Income taxes	34.0	118.6
Net earnings	64.3	208.1

and Dunkin' Donuts, which had added gourmet coffee to their menus—fundamentally changed the attractiveness of the retail market for brewed coffee? Had Starbucks failed to maintain the uniqueness of the "Starbucks Experience," which had differentiated the company from its competitors? And was this "Starbucks Experience" something that was really recognized and valued by consumers?

The Starbucks Story[4]

The rise of Starbucks from a single coffee store in Seattle's Pike Place market to a Fortune 500 company (number 261 on Fortune's 2009 listing) is now an American business legend.

Howard Schultz lived in New York where he managed the U.S. operations of a Swedish kitchenware company. Intrigued as to why a small Seattle company, Starbucks Coffee, Tea and Spice, was ordering large quantities of an unusual kind of coffee filter—a plastic cone on top of a thermos—he visited the store in 1981. The cup of coffee he was given there, made with freshly ground Sumatra beans, was a revelation. "I realized the coffee I had been drinking was swill." The owner-managers of Starbucks were Gerald Baldwin and Gordon Bowker, former University of San Francisco students who had been running the company for 10 years. Schultz was captivated by the vision of a national chain of coffee stores. Despite their reservations about the threat of Schultz's energy and ambition to the mellow ambiance of their business, Baldwin and Bowker eventually hired Schultz as their head of marketing.

Within a year of joining Starbucks, Schultz's vision of the company shifted radically. On a business trip to Milan he discovered "the romance of the Italian coffee bar" and recognized the opportunity for Starbucks to be a place where people would come to share the experience of drinking great coffee rather than to simply buy coffee beans. "It crystallized in my mind that coffee brought people together . . . and that as far as I could envision, at the time there did not exist in the U.S. a place that brought people together with coffee as the conduit."

Unable to convince his Starbucks bosses of his vision, Schultz left to open his own Italian coffee bar, Il Giornale, in 1986. A year later he bought the Starbucks company and its six stores, merged it with his three Il Giornale bars and adopted the Starbucks name for the enlarged company. By the time Starbucks went public in 1992 it had grown to 165 outlets. With the $27 million raised from the stock offering, Starbucks accelerated its expansion. From its west-coast bases in Seattle and Vancouver, Starbucks expanded nationally in both the U.S. and Canada. Expansion followed a cluster pattern—opening multiple stores in a single metro area. The idea was to increase Starbucks' local brand awareness and facilitate customers' ability to find a Starbucks anywhere within their home town. International expansion included entry into Japan in 1996 and the U.K. in 1998.

Starbucks' organic growth was augmented by selected acquisitions: the U.K.-based Seattle Coffee Company in 1998, Seattle's Best Coffee and Torrefazione Italia in 2003, and Diedrich Coffee in 2006.

Starbucks' Strategy

The Appendix describes Starbucks' business and provides data on its performance.

The Starbucks Experience

Central to Starbucks' strategy is Schultz's concept of the "Starbucks Experience." Starbucks stores—like the original Il Giornata coffee bars—were founded on Schultz's idea of creating a "third place": somewhere other than home and work where people could engage socially amidst the shared experience of drinking good coffee. Despite his original idea of replicating Italian coffee bars where customers mostly stand to drink coffee, Schultz adapted his vision to "the American equivalent of the English pub, the German beer garden and the French café."[5] With the addition of wi-fi, Starbucks stores become a place to work as well as to socialize. The Starbucks Experience combined a number of elements:

- The coffee beans of high, consistent quality. As explained in the Appendix under "Product Supply," Starbucks forms long-term arrangements with coffee growers in order to ensure that Starbucks' requirements are met while ensuring the economic viability of the growers.
- Employee involvement. The counter staff at Starbucks stores—the baristas—played a central role in creating and sustaining the Starbucks Experience. Their role was not only to brew and serve excellent coffee but to engage customers in the unique ambiance of the Starbucks coffee shop. Starbucks' human-resource practices with regard to firing, training and remunerations

were very different from those of other U.S. restaurant chains. "Schultz felt he had to make employees partners in his vision. He had to infuse them with the Starbucks culture, provide them with personal security, and give them a reason to be involved in the success of the business."[6] Starbucks' employee selection was careful and rigorous—placing a heavy emphasis on adaptability, dependability, capacity for teamwork and willingness to further Starbucks' principles and mission. Its training program extended beyond basic operating and customer-service skills to educating employees abut coffee. Unique among catering chains, Starbucks provided health insurance for almost all regular employees.

- Community relations and social purpose. Schultz's approach to human resource management was not simply about the role of Starbucks' employees as key agents in transmitting the Starbucks' Experience, but also part of a broader vision of a common humanity: "I wanted to build the kind of company my father never had the chance to work for, where you would be valued and respected wherever you came from, whatever the color of your skin, whatever your level of education. Offering heathcare was a transforming event in the equity of the Starbucks brand that created unbelievable trust among our people. We wanted to build a company that linked shareholder value to the cultural values that we want to create with our people."[7] Schulz's vision was of a company that would earn good profits but would also do good in the world: "Perhaps we have the opportunity to be a different type of global company. One that makes a profit but at the same time demonstrates a social conscience."
- The layout and design of Starbucks stores were seen as critical elements of the experience. Starbucks has a store design group that is responsible for the design of the furniture, fittings and layout of Starbucks' retail outlets. Like everything else at Starbucks, store design is subject to meticulous analysis and planning—following Schultz's dictum that "retail is detail." While every Starbucks store is adapted to reflect its unique neighborhood, "there is a subliminal unifying theme to all the stores that ties into the company's history and mission—"back to nature" without the laid-back attitude; community-minded without stapled manifestos on the walls. The design of a Starbucks store is intended to provide both unhurried sociability and efficiency on-the-run, an appreciation for the natural goodness of coffee and the artistry that grabs you even before the aroma. This approach is reflected in the designers' generous employment of natural woods and richly layered, earthy colors along with judicious high-tech accessorizing . . . No matter how individual the store, overall store design seems to correspond closely to the company's first and evolving influences: the clean, unadulterated crispness of the Pacific Northwest combined with the urban suavity of an espresso bar in Milan."[8]
- Starbucks' location strategy—its clustering of 20 or more stores in each urban hub—was viewed as enhancing the experience both in creating a local "Starbucks buzz" and in facilitating loyalty by Starbucks' customers. Starbucks' analysis of sales by individual store found little evidence that closely located Starbucks stores cannibalized one another's sales. Recognizing that convenience of location was critical to driving sales, Starbucks began adding drive-though windows to some of its stores and locating stores specifically to capitalize on drive-through customers.

Diversification

Broadening Starbucks' product range was partly about responding to customer demand (for example, requests for iced coffee eventually led to Frappuccino) and partly about building the Starbucks Experience. "The overall strategy is to build Starbucks into a destination," explained Kenneth Lombard, then head of Starbucks Entertainment. This involved adding food, music, books and videos. As a music publisher and retailer of CDs, Starbucks was hugely successful—particularly its "Artists Choice" series where well-known musicians chose their favorite tracks. "I had to get talked into this one," says Schultz. "But then I began to understand that our customers looked to Starbucks as a kind of editor. It was like, 'We trust you. Help us choose.'"

However, Starbucks was also expanding beyond its company-owned stores. As the Appendix illustrates, Starbucks expansion has included:

- Licensed stores. The desire to reach customers in a variety of locations eventually caused Starbucks to abandon its policy of only selling through company-owned outlets. Its first licensing deal was with Host Marriot, which owned a number of food and beverage concessions in U.S. airports. This was followed by licensing arrangements with Safeway and Barnes & Noble for opening Starbucks coffee shops in their stores. Overseas, Starbucks increasingly relied upon licensing arrangements with local companies.
- Distribution of Starbucks retail packs of Starbucks coffee through supermarkets and other retail food stores.
- Licensing of Starbucks brands to PepsiCo and Unilever for the supply of Starbucks bottled drinks (such as Frappuccino and Tazo teas).
- Financial services, notably the Starbucks/Bank One Duetto Visa card, which combined a store card with a Visa credit card.
- *Via* instant coffee. On February 12, 2009, news broke of Starbucks' plan to introduce an innovative instant coffee. The product was the result of long-term R&D project that had been revived by Schultz as part of his drive to reinvigorate innovation at Starbucks. *Via* was based upon a proprietary patented process which allowed the company to "absolutely replicate the taste of Starbucks coffee." It would sell through Starbucks stores at $2.95 for a pack of three. Other commentators were less sanguine. Andrew Hetzel of coffee consultancy Cafemakers, stated: "I have an expectation of what it will be like, and I think it will be harmful for the brand."[9]

Managing Turnaround

Since his return as CEO in January 2008, Schultz's redirection of Starbucks' strategy has involved more than retrenchment. Central to his hyperactive leadership was his belief that the company needed to rediscover and revitalize the "Starbucks Experience" and reestablish its connection with its customers.

During 2008, Starbucks employees from all parts and all levels of the company met to reconsider the company's purpose and principles. The result was a revised mission statement (see the Appendix). Also important to the reaffirmation of Starbucks' core identity was a renewed emphasis on corporate social responsibility.

In October 2008, Starbucks held its annual leadership meeting in New Orleans—the first time the meeting had been held outside Seattle. Starbucks used the convention as an opportunity to field 10 000 volunteers on a variety of community projects ranging from repainting damaged houses to cleaning up neighborhoods. Other initiatives included:

- *Starbucks Shared Planet*— a set of environmental sustainability, community service and ethical targets to be achieved by 2011.
- Increased commitment to small-scale coffee farmers by doubling Starbucks purchases of Fair Trade Certified Coffee in 2009.
- Partnership with Bono and the Global Fund to donate 5 cents from the sale of each serving of certain Starbucks' beverages to support AIDS programs in Africa.

Schultz also reviewed operating practices to examine their consistency with the Starbucks Experience and Starbucks image. One key change was a return to "hand-made" coffee. To speed coffee making Starbucks had replaced its La Marzocco espresso machines, which required baristas to grind coffee for each cup, with automatic Verismo machines, which merely required baristas to press a button. During 2008, Starbucks spent millions installing new coffee machines where cups of coffee were made individually from freshly ground beans. Schultz also insisted on revising Starbucks' food menu—notably withdrawing toasted breakfast sandwiches whose aromas masked those of the coffee: "The breakfast sandwiches drive revenue and profit but they are in conflict with everything we stand for in terms of the coffee and the romance of the coffee."

Most of all, Schultz traveled Starbuck's far-flung empire meeting with employees ("partners") with a view to reinforcing Starbucks' values and reigniting their drive and enthusiasm. Jenny Wiggins of the *Financial Times* describes an October 2008 meeting at London's Barbican Center for 1000 Starbucks store managers from Britain and Ireland. In addition to inspiring tales that exemplified the "humanity of Starbucks" and the role that managers played in creating an experience that "values and respects" customers, Schultz challenged his store managers with the severity of the current situation and the need to return to the values and practices that had made Starbucks a special place.[10]

By re-emphasizing Starbucks' core values, reversing store expansion, eliminating non-core products and returning to the quality of the coffee and customer service, Schultz was doing much to correct the errors of the past. The question is whether the Starbucks concept has the same distinctiveness and appeal in the second decade of the twenty-first century as in the last decade of the twentieth century. According to Don Williams, CEO of brand consultants Pi Global: "Starbucks must seriously and rapidly re-evaluate what the brand stands for, what it sells, and what the consumer experience should be. Far from exuding an air of everyday indulgence, the often slightly dog-eared assembly line that is your average Starbucks store is suffering the double whammy of being both too familiar and overpriced."

Even if Schultz succeeds in reinvigorating Starbucks, it is clear that the market for gourmet coffee, especially in North America, has changed greatly over the past two decades. Despite a widely held view that Starbucks has saturated its market, it is clear that competition is strong, with Starbucks being attacked from below (McDonald's, Dunkin' Donuts) and above (Illy, Lavazza) (see Exhibit 2.1).

EXHIBIT 2.1

Competition in the U.S. Coffee Shop Market

Sales of premium, brewed coffee were estimated to have grown by 157% between 2000 ($3 258 million) and 2005 to reach some $8 372 million. The total number of coffee shops in the U.S. increased by 70% between 2000 and 2005, bringing the total to a staggering 21 400 or one coffee house for every 14 000 Americans.

Although Starbucks was the primary driver of this growth and far-and-away the market leader, it was also subject to competition from numerous directions.

- Starbucks' traditional competitors were independent coffee shops and cafes, some of which had grown into local chains.
- Starbucks had also spawned a number of imitators who aspired to grow into national chains. Of these Caribou Coffee, with 495 coffee shops in 15 states, was its nearest competitor.
- Starbucks competed with a range of catering establishments that supplied coffee as part of a broader menu of food and beverages. Increasingly these outlets were seeking to compete more directly with Starbucks by adding premium coffee drinks to their menus. McDonald's had introduced a premium coffee (which *Consumer Reports* rated more highly than Starbucks' coffee) and was adding *McCafes* to many of its burger restaurants. Burger King and Dunkin' Donuts had also moved upmarket in their coffee offerings. McDonald's and Dunkin' Donuts both targeted Starbucks in their advertising. The McDonald's web site, Unsnobbycoffee.com implicitly identified Starbucks as overpriced and "snobbish." Dunkin' Donuts' web site, DunkinbeatStarbucks.com, encourages emailed messages such as: "Friends don't let friends drink at Starbucks."

Outside of the U.S., Starbucks faced different competitive situations country-by-country. In most of them competition was even more intense than in the U.S. Starbucks' withdrawal from Australia was a consequence of a highly sophisticated coffee market developed and educated by immigrants from southern Europe (Italy in particular) and the Middle East.

High standards of coffee preparation and strong local preferences were also a feature of most European markets. Moreover, Starbucks also had to contend with international expansion by the Italian coffee roasters—most notably Illy, which had successfully established itself at the pinnacle of quality. A key challenge that Starbucks faced is that, once it had educated North Americans about the joy of good coffee, these new coffee connoisseurs would go on to seek superior alternatives to Starbucks.

Competition was not only in the form of other coffee-shop chains. Increasingly coffee drinkers were being introduced to the secrets of good coffee at home. A widening range of home espresso makers included sophisticated, easy-to-use coffee systems introduced by Nescafé (Nespresso) and Lavazza (A Modo Mio).

TABLE 2.3 Starbucks, Caribou Coffee and McDonald's: Financial Comparisons, 2005–8

	Starbucks, year ended				Caribou Coffee, year ended				McDonald's, year ended			
	August 2008	*August 2007*	*August 2006*	*August 2005*	*December 2008*	*December 2007*	*December 2006*	*December 2005*	*December 2008*	*December 2007*	*December 2006*	*December 2005*
Sales ($m)	10383	9411	7787	6369	253.9	256.8	236.2	198.0	23522	22787	20895	19117
Depreciation and amortization ($m)	549	467	389	n.a.	24.9	32.2	21.5	16.4	1208	1193	1191	1172
General and admin. expense ($m)	456	489	479	n.a.	29.1	32.3	25.9	22.7	2355	2367	2296	2118
Operating income ($m)	504	1,054	894	781	(15.5)	(30.4)	(9.5)	(4.1)	6443	3879	4433	3984
Net income ($m)	316	673	564	494	(16.3)	(30.7)	(9.1)	(4.9)	4313	2395	3544	2602
Company operated outlets	9217	8536	7185	6135	414	432	440	386	6502	6906	8166	8173
Total outlets	16680	15011	12440	10241	511	484	464	395	31967	31377	31 046	30766
Sales per co. outlet	0.988	1.018	0.988	0.953	0.553	0.551	0.546	0.554	2547	2.204	1.885	1.715
Total assets ($m)	5673	5344	4429	3514	89.6	111.8	136.3	148.0	28462	29392	28 974	29989
Shareholders' equity ($m)	2491	2284	2229	2090	43.9	59.3	88.4	96.9	13382	15280	15 458	15146

Appendix: Extracts from Starbucks Corporation 10-K report for Fiscal Year 2008

Part I

Item 1: Business

General Starbucks Corporation was formed in 1985 and today is the world's leading roaster and retailer of specialty coffee. Starbucks (together with its subsidiaries, "Starbucks" or the "Company") purchases and roasts high-quality whole bean coffees and sells them, along with fresh, rich-brewed coffees, Italian-style espresso beverages, cold blended beverages, a variety of complementary food items, a selection of premium teas, and coffee-related accessories and equipment, primarily through Company-operated retail stores. Starbucks also sells coffee and tea products and licenses its trademark through other channels such as licensed retail stores and, through certain of its equity investees and licensees, Starbucks produces and sells a variety of ready-to-drink beverages. All channels outside the Company-operated retail stores are collectively known as specialty operations.

The Company's objective is to establish Starbucks as one of the most recognized and respected brands in the world. To achieve this goal, the Company plans to continue disciplined expansion of its retail operations, to grow its specialty operations and to selectively pursue other opportunities by introducing new products and developing new channels of distribution.

Revenue Components The following table shows the Company's revenue components as a percentage of total net revenues and related specialty revenues for the fiscal year ended September 28, 2008:

Revenues	Percentage of total net revenues	Percentage of specialty revenues
Company-operated retail	84	
Specialty:		
Licensing:		
Retail stores	8	48 %
Packaged coffee and tea	3	21 %
Branded products	1	4 %
Total licensing	12	73 %
Foodservice and other:		
Foodservice	4	25 %
Other initiatives	<1	2 %
Total foodservice and other	4	27 %
Total specialty	16	100 %
Total net revenues	100	

Company-operated Retail Stores The Company's retail goal is to become the leading retailer and brand of coffee in each of its target markets by selling the finest quality coffee and related products and by providing each customer a unique

Starbucks Experience. The *Starbucks Experience*, or third place beyond home and work, is built upon superior customer service as well as clean and well maintained Company-operated retail stores that reflect the personalities of the communities in which they operate, thereby building a high degree of customer loyalty.

Starbucks' strategy for expanding its retail business is to increase its market share by selectively opening additional stores in existing markets and opening stores in new markets to support its long-term strategic objectives. As described in more detail in Management's Discussion and Analysis in this 10-K, the Company committed in June 2008 to close approximately 600 underperforming Company-operated stores in the U.S. The decision was an integral part of its transformation strategy, first announced in January 2008, and was a result of a rigorous evaluation of the U.S. Company-operated store portfolio. The store closures were initiated in the fourth quarter of fiscal 2008 and are expected to be completed by the end of fiscal 2009.

Starbucks Company-operated retail stores accounted for 84% of total net revenues during fiscal 2008. The following table summarizes total Company-operated retail store data for the periods indicated:

	Net stores opened year ended		Stores open as of	
	Sept. 28, 2008	Sept. 30, 2007	Sept. 28, 2008	Sept. 30, 2007
United States	445	1065	7238	6793
Canada	104	97	731	627
United Kingdom	84	66	664	580
China	37	42	178	141
Germany	27	36	131	104
Thailand	24	18	127	103
Singapore	12	8	57	45
Australia	(64)	4	23	87
Other	12	15	68	56
Total international	236	286	1979	1743
Total Company-operated	681	1351	9217	8536

At the end of fiscal 2008, the Company operated approximately 2800 drive-through locations, compared to approximately 2300 at the end of fiscal 2007, representing approximately 35% and 31%, respectively, of Company-operated stores in the U.S. and Canada combined.

All Starbucks stores offer a choice of regular and decaffeinated coffee beverages, a broad selection of Italian-style espresso beverages, cold blended beverages, iced shaken refreshment beverages, a selection of premium teas and distinctively packaged roasted whole bean coffees. Starbucks stores also offer a variety of fresh food items, including several healthy choice selections. Food items include pastries, prepared breakfast and lunch sandwiches, and salads as well as sodas, juices, and bottled water. Starbucks continues to expand its food warming program in the United States and Canada, with approximately half of these stores as of September 28, 2008 providing warm food items, primarily breakfast sandwiches. A range of coffee-making equipment and accessories are also sold in the stores. Each Starbucks store varies its product mix depending upon the size of the store and its location. Larger stores carry a broad selection of the Company's whole-bean coffees in various sizes and types of packaging, as well as coffee and espresso-making equipment and accessories. Smaller Starbucks stores and kiosks typically sell a full line of coffee beverages, a limited selection of whole-bean coffees and a few accessories such as travel tumblers and logo mugs.

Retail sales mix by product type for Company-operated stores was as follows:

Fiscal year ended	Sept. 28, 2008	Sept. 30, 2007	Oct. 1, 2006
Beverages (%)	76	75	77
Food (%)	17	17	15
Coffee-making equipment and other merchandise (%)	4	5	5
Whole bean coffees (%)	3	3	3
Total (%)	100	100	100

Specialty Operations Specialty operations strive to develop the Company's brands outside the Company-operated retail store environment through a number of channels. Starbucks strategy is to reach customers where they work, travel, shop and dine by establishing relationships with prominent third parties that share the Company's values and commitment to quality. These relationships take various forms, including licensing arrangements, foodservice accounts and other initiatives related to the Company's core businesses. In certain situations, Starbucks has an equity ownership interest in licensee operations. During fiscal 2008, specialty revenues (which include royalties and fees from licensees, as well as product sales derived from specialty operations) accounted for 16% of total net revenues.

Licensing—Retail Stores In its licensed retail store operations, the Company leverages the expertise of its local partners and shares Starbucks operating and store development experience. Licensee partners provide improved and, at times, the only access to desirable retail space. Most licensees are prominent retailers with in-depth market knowledge and access. As part of these arrangements, Starbucks receives license fees and royalties and sells coffee, tea and related products for resale in licensed locations. Employees working in licensed retail locations are required to follow Starbucks detailed store operating procedures and attend training classes similar to those given to employees in Company-operated stores.

During fiscal 2008, 438 Starbucks licensed retail stores were opened in the U.S. and, as of September 28, 2008, the Company's U.S. licensees operated 4329 stores. During fiscal 2008, 550 International licensed stores were opened. At September 28, 2008, the Company's international operating segment had a total of 3134 licensed retail stores. Product sales to and royalty and license fee revenues from U.S. and international licensed retail stores accounted for 48% of specialty revenues in fiscal 2008.

At fiscal year end 2008, Starbucks total licensed retail stores by region and specific location were as follows:

Asia Pacific		Europe/Middle East/Africa		Americas	
Japan	814	Turkey	107	United States	4329
China	269	Spain	76	Mexico	241
South Korea	254	Greece	76	Canada	231
Taiwan	221	United Arab Emirates	69	Other	44
Philippines	150	Saudi Arabia	65		
Malaysia	113	Kuwait	57		
Indonesia	69	France	46		
New Zealand	43	Switzerland	42		
		Other	147		
Total	1933	Total	685	Total	4845

Licensing—Packaged Coffee and Tea Through a licensing relationship with Kraft Foods, Inc. ("Kraft"), the Company sells a selection of Starbucks and Seattle's Best Coffee branded packaged coffees and Tazo® teas in grocery and warehouse club stores throughout the United States. Kraft manages all distribution, marketing, advertising and promotion of these products.

The Company sells packaged coffee and tea internationally both directly to warehouse club customers, such as Costco, and through a licensing relationship with Kraft in Canada and the U.K.

By the end of fiscal 2008, the Company's coffees and teas were available in approximately 37 000 grocery and warehouse club stores, with 33 000 in the U.S. and 4000 in international markets. Revenues from this category comprised 21% of specialty revenues in fiscal 2008.

Licensing—Branded Products The Company licenses the rights to produce and market Starbucks branded products through several partnerships both domestically and internationally. Significant licensing agreements include:

- the North American Coffee Partnership, a joint venture with the Pepsi-Cola Company in which Starbucks is a 50% equity investor, manufactures and markets ready-to-drink beverages, including bottled Frappuccino® beverages and Starbucks DoubleShot® espresso drinks;
- licensing agreements for the manufacturing, marketing and distribution of Starbucks Discoveries®, a ready-to-drink chilled cup coffee beverage, in Japan and South Korea;
- a licensing agreement established in August 2008 with Unilever and Pepsi-Cola Company for the manufacturing, marketing and distribution of Starbucks super-premium Tazo® Tea ready-to-drink beverages in the U.S. and Canada;
- the International Coffee Partnership, another joint venture with the Pepsi-Cola Company, to manufacture, market and distribute ready-to-drink beverages internationally, which currently includes bottled Frappuccino® beverages in China and Mexico.

Collectively, the revenues from these branded products accounted for 4% of specialty revenues in fiscal 2008.

Foodservice The Company sells whole bean and ground coffees, including the Starbucks and Seattle's Best Coffee brands, as well as a selection of premium Tazo® teas and other related products, to institutional foodservice companies that service business and industry, education, healthcare, office coffee distributors, hotels, restaurants, airlines and other retailers. The majority of the Company's direct accounts are through national broadline distribution networks with SYSCO Corporation and U.S. Foodservice. Starbucks foodservice sales, customer service and support resources are aligned with those of SYSCO Corporation and U.S. Foodservice.

The Company's total foodservice operations had over 19 000 accounts, primarily in the U.S., at fiscal year end 2008. Revenues from foodservice accounts comprised 25% of total specialty revenues in fiscal 2008.

Product Supply 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. The Company purchases green coffee beans from coffee-producing regions around the world and custom roasts them to its exacting standards for its many blends and single origin coffees.

The supply and price of coffee are subject to significant volatility. Although most coffee trades in the commodity market, high-altitude *arabica* coffee of the quality sought by the Company tends to trade on a negotiated basis at a substantial premium above commodity coffee prices, depending upon the supply and demand at the time of purchase. Supply and price can be affected by multiple factors in the producing countries, including weather, political and economic conditions. In addition, green coffee prices have been affected in the past and may be affected in the future, by the actions of certain organizations and associations that have historically attempted to influence prices of green coffee through agreements establishing export quotas or by restricting coffee supplies.

To help ensure sustainability and future supply of high-quality green coffees in Central America and to reinforce the Company's leadership role in the coffee industry, Starbucks operates the Starbucks Coffee Agronomy Company.

SRL is a wholly owned subsidiary located in Costa Rica. Staffed with agronomists and sustainability experts, this first-of-its-kind Farmer Support Center is designed to respond proactively to changes in coffee-producing countries that impact farmers and the supply of green coffee. During fiscal 2008, the Company expanded this sustainability program to Africa by establishing a Farmer Support Center in Rwanda.

The Company buys coffee using fixed-price and price-to-be-fixed purchase commitments, depending on market conditions, to secure an adequate supply of quality green coffee. Due to volatility in green coffee commodity prices, the Company has historically used fixed-price purchase contracts in order to bring greater certainty to its cost of sales in future periods and promote sustainability by paying an equitable price to coffee producers. When green coffee commodity prices are high for sustained periods of time, the Company is less likely to enter into fixed-price contracts on favorable terms and more likely to increase the use of price-to-be-fixed contracts to meet its demand for coffee. These types of contracts state the quality, quantity and delivery periods and fix the price relative to a green coffee commodity benchmark, but allow the benchmark price to be established after contract signing. An increased use of price-to-be-fixed contracts instead of fixed-price contracts decreases the predictability of coffee costs in future periods until the price of green coffee becomes "fixed" by either Starbucks or the seller.

The Company depends upon its relationships with coffee producers, outside trading companies and exporters for its supply of green coffee. The Company believes, based on relationships established with its suppliers, the risk of non-delivery on such purchase commitments is remote.

Operating Segments Segment information is prepared on the same basis that the Company's management reviews financial information for operational decision-making purposes. Starbucks has three reportable operating segments: U.S., international and CPG . . .

United States The U.S. operating segment sells coffee and other beverages, complementary food, whole bean coffees, and coffee-brewing equipment and merchandise primarily through Company-operated retail stores. Specialty operations within the U.S include licensed retail stores, foodservice accounts and other initiatives related to the Company's core business.

Fiscal year ended	Sept. 2008 ($ millions)	Sept. 2007 ($ millions)	Change (%)	Sept. 2008	Sept. 2007
				(As percentage of U.S. total net revenues)	
Net revenues:					
Company-operated retail	6997.7	6560.9	6.7	88.7	89.3
Specialty:					
Licensing	504.2	439.1	14.8	6.4	6.0
Foodservice and other	385.1	349.0	10.3	4.9	4.7
Total specialty	889.3	788.1	12.8	11.3	10.7
Total net revenues	7887.0	7349.0	7.3	100.0	100.0

Company-operated retail revenues increased primarily due to the opening of 445 new Company-operated retail stores in the last 12 months, partially offset by a 5% decrease in comparable store sales for fiscal 2008. The U.S. Company-operated retail business continued to experience deteriorating trends in transactions during the year, driven by the U.S. economic slowdown.

Licensing revenues increased primarily due to higher product sales and royalty revenues as a result of opening 438 new licensed retail stores in the last 12 months. Foodservice and other revenues increased primarily due to growth in new and existing foodservice accounts.

Fiscal year ended	Sept. 2008 ($ millions)	Sept. 2007 ($ millions)	Change (%)	Sept. 2008	Sept. 2007
				(As percentage of U.S. total net revenues)	
Cost of sales including occupancy costs	3371.7	2956.2	14.1	42.8	40.2
Store operating expenses[a]	3081.0	2684.2	14.8	39.1	36.5
Other operating expenses[b]	219.6	204.8	7.2	2.8	2.8
Depreciation and amortization expenses	401.7	348.2	15.4	5.1	4.7
General and administrative expenses	72.7	85.9	(15.4)	0.9	1.2
Restructuring charges	210.9	—	nm	2.7	—
Total operating expenses	7357.6	6279.3	17.2	93.3	85.4
Income from equity investees	(1.3)	0.8	nm	—	
Operating income	528.1	1070.5	(50.7)%	6.7%	14.6%

[a] As a percentage of related Company-operated retail revenues, store operating expenses were 44.0% and 40.9% for the fiscal years ended September 28, 2008 and September 30, 2007, respectively.

[b] As a percentage of related total specialty revenues, other operating expenses were 24.7% and 26.0% for the fiscal years ended September 28, 2008 and September 30, 2007, respectively.

Operating margin contracted significantly primarily due to restructuring charges incurred and to softer revenues due to weak traffic, as well as higher cost of sales including occupancy costs and higher store-operating expenses as a percentage of revenues. Restructuring charges of $210.9 million had a 270 basis point impact on the operating margin. The increase in cost of sales including occupancy costs was primarily due to higher distribution costs and higher rent expenses as a percentage of revenues. Higher store operating expenses was due to the softer sales, higher payroll-related expenditures and charges from canceling future store sites and asset impairments.

International The international operating segment sells coffee and other beverages, complementary food, whole-bean coffees, and coffee brewing equipment and merchandise through Company-operated retail stores in Canada, the U.K. and nine other markets. Specialty operations primarily include retail store licensing operations in nearly 40 other countries and foodservice accounts, primarily in Canada and Japan. The Company's international store base continues to increase and Starbucks expects to achieve a growing contribution from established areas of the business while investing in emerging markets and channels. Many of the Company's international operations are in early stages of development that require a more extensive support organization, relative to the current levels of revenue and operating income, than in the U.S. This continuing investment is part of the Company's long-term, balanced plan for profitable growth.

Fiscal year ended	Sept. 2008 ($ millions)	Sept. 2007 ($ millions)	Change (%)	Sept. 2008	Sept. 2007
				(As a percentage of international total net revenues)	
Net revenues:					
Company-operated retail	1774.2	1437.4	23.4	84.3	84.7
Specialty:					
Licensing	274.8	220.9	24.4	13.1	13.0
Foodservice and other	54.4	37.9	43.5	2.6	2.2
Total specialty	329.2	258.8	27.2	15.7	15.3
Total net revenues	2103.4	1696.2	24.0	100.0	100.0

Company-operated retail revenues increased due to the opening of 236 new Company-operated retail stores in the last 12 months, favorable foreign currency exchange rates, primarily on the Canadian dollar, and comparable store sales growth of 2% for fiscal 2008. In the fourth quarter of fiscal 2008, Company-operated retail revenues grew at a slower rate year-over-year of 12% and comparable store sales were flat compared to the same quarter in fiscal 2007, both driven by slowdowns in the U.K. and Canada, due to the weakening global economy.

Specialty revenues increased primarily due to higher product sales and royalty revenues from opening 550 new licensed retail stores in the last 12 months.

Fiscal year ended	Sept. 2008 ($ millions)	Sept. 2007 ($ millions)	Change (%)	Sept. 2008	Sept. 2007
				(As a percentage of international total net revenues)	
Cost of sales including occupancy costs	1054.0	824.6	27.8	50.1	48.6
Store operating expenses[a]	664.1	531.7	24.9	31.6	31.3
Other operating expenses[b]	88.5	69.9	26.6	4.2	4.1
Depreciation and amortization expenses	108.8	84.2	29.2	5.2	5.0
General and administrative expenses	113.0	93.8	20.5	5.4	5.5
Restructuring charges	19.2	—	nm	0.9	—
Total operating expenses	2047.6	1604.2	27.6	97.3	94.6
Income from equity investees	54.2	45.7	18.6	2.6	2.7
Operating income	110.0	137.7	(20.1)	5.2	8.1

[a] As a percentage of related Company-operated retail revenues, store operating expenses were 37.4% and 37.0% for the fiscal years ended September 28, 2008 and September 30, 2007, respectively.

[b] As a percentage of related total specialty revenues, other operating expenses were 26.9% and 27.0% for the fiscal years ended September 28, 2008 and September 30, 2007, respectively.

Operating margin decreased primarily due to higher cost of sales including occupancy costs driven by continued expansion of lunch and warming programs in Canada, higher distribution costs and higher building maintenance expense due to store renovation activities. In addition, restructuring charges of $19.2 million recognized in fiscal 2008 had a 90 basis point impact on the operating margin, nearly all due to the closure of 61 Company-operated stores in Australia.

Global Consumer Products Group The Global Consumer Products Group (CPG) operating segment sells a selection of whole bean and ground coffees and premium Tazo® teas through licensing arrangements in the U.S. and international markets. The CPG also produces and sells a variety of ready-to-drink beverages through its joint ventures and marketing and distribution agreements.

Fiscal year ended	Sept. 28, 2008	Sept. 30, 2007	Change (%)	Sept. 28, 2008	Sept. 30, 2007
				As percentage of CPG total net revenues	
Net revenues:					
Licensing	392.6	366.3	7.2	100.0	100.0
Total specialty	**392.6**	**366.3**	**7.2**	**100.0**	**100.0**

Total net revenues increased primarily due to higher royalties and product sales in the international ready-to-drink business and increased sales of U.S. packaged tea and international club packaged coffee.

Fiscal year ended	Sept. 28, 2008 ($ million)	Sept. 30, 2007 ($ million)	Change (%)	Sept. 28, 2008	Sept. 30, 2007
				As a % of CPG total net revenues	
Cost of sales	219.6	218.3	0.6	55.9	59.6
Other operating expenses	22.0	19.5	12.8	5.6	5.3
Depreciation and amortization expenses	—	0.1	—	—	—
General and administrative expenses	6.4	6.3	1.6	1.6	1.7
Total operating expenses	248.0	244.2	1.6	63.2	66.7
Income from equity investees	60.7	61.5	(1.3)	15.5	16.8
Operating income	205.3	183.6	11.8	52.3	50.1

Growth of operating margin was primarily due to lower cost of sales as a percentage of related revenues, partially offset by lower income from equity investees. Lower cost of sales was primarily due to a sales mix shift to more profitable products.

Notes

1 Starbucks Corporation, press release, Starbucks Reports First Quarter Fiscal 2009 Results, January 28, 2009.
2 Starbucks Corporation, press release, Starbucks Reports First Quarter Fiscal 2009 Results, January 28, 2009.
3 Starbucks Corporation, press release, Starbucks Reports First Quarter Fiscal 2009 Results, January 28, 2009.
4 This draws upon information from "Starbuck's Timeline and History," www.starbucks.com/aboutus/timeline.asp, accessed October 6, 2009 and J. Wiggins "When the Coffee Goes Cold," *Financial Times*, December 13, 2008.
5 J. Wiggins "When the Coffee goes Cold," *Financial Times*, December 13, 2008.
6 *Trouble Brews at Starbucks* (Ivey School of Management, University of Western Ontario, Case No. 9B09A, 2009).
7 Quoted in: *Howard Schultz: Building the Starbucks Community* (Harvard Business School Case No. 9-406-127, 2006).
8 "Starbucks: A Visual Cup o' Joe," Contemporary Design Foundation, www.cdf.org/issue_journal/starbucks_a_visual_cup_o_joe.html, accessed May 15, 2009.
9 "Starbucks Instant: Will It Pass The Taste Test?" Fortune, February 13, 2007, http://money.cnn.com/2009/02/13/news/companies/starbucks_instant.fortune/, accessed May 19, 2009.
10 J. Wiggins "When the Coffee goes Cold," *Financial Times*, December 13, 2008.