Starbucks a Strategic Analysis

Past Decisions and Future Options

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Starbucks and the Lifecycle of Specialty Coffee:

An Industry Evolving

Introduction

Today we stand witness to a new coffee era, one made up of Caffé Lattes, Espresso Macchiatos, Cappuccinos and Frappuccinos. Specialty Coffee is here to stay and no one will be more eager to tell you that than Howard Schultz, CEO of Starbucks, the world's largest specialty coffee bar. The study of Starbucks Corporation leads one on a multifaceted journey through an organization's insinuation into a culture, its dominance of a market and its creation of a brand synonymous with loyalty, integrity and longevity. Understanding Starbucks' development into an international giant and the strategic approach they took to get there begins with the origins of coffee itself.

Ever since it first spread through the Moslem world in the sixteenth century, coffee has played a pivotal role in society by providing meeting places for intellectuals from all sides of life to converge. As coffee was slowly introduced to the European world it was recognized for both its sociability and its taste. Soon Coffee houses were prevalent throughout Europe and were the natural locations for political, literary and societal debate. It crossed the Atlantic Ocean in the mid-seventeenth century and replaced beer as New York City's favorite morning drink.

It can be said that the Boston Tea Party was the beginning of not one but two major revolutions in America. The first was the revolt of the colonists against England, and the second was coffee's dominance as the beverage of choice for patriotic colonists.

Throughout the history of America, coffee has played an important role within the context of a beverage. During the Civil War, coffee was a staple of the Union soldiers' diets with an allocation of 36 pounds of beans a year for every soldier. By the mid-1960's the average American consumed 3.1 cups of coffee a day (Sweet, 2007, p. 154). Coffee remained a commodity among average Americans until a visionary decided to bring the elegance of the Italian espresso bar to America.

Howard Schultz grew up in Brooklyn, the heavily populated borough of New York City. A no-quit attitude was fostered in the young man through a door to door sales job. Quite literally, he learned to persevere even after the door had been slammed in his face numerous times. With a thick skin and an entrepreneurial spirit, all he needed was an inspiration to give him vision. That inspiration came in the form of Starbucks Coffee. As he explains, "I felt as though I had discovered a whole new continent." (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 62)He saw a world of opportunity where coffee drinkers everywhere would convert from the traditional blends and brews or "swill" as he would say to the rich dark flavor of specialty coffee and would be willing to pay a steep premium for it.

In 1986 Schultz founded his first specialty coffee store in Seattle, Washington and soon after purchased the Seattle assets of Starbucks, including the rights to the name. Schultz's ambitious expansion plan met with tremendous success. His vision quickly materialized, as Starbucks penetrated most of the Northwest at an ever increasing rate. Starbucks then transitioned into the Midwest by opening in Chicago, soon thereafter expanding into the global empire we know today.

As Starbucks expanded, a new emphasis was placed on recruiting talented leadership capable of guiding the tremendous momentum of the company. A vast amount of resources were devoted to constructing an organizational infrastructure adequate to support the anticipated future size of Starbucks. Schultz believed that many business visionaries failed by not creating the proper processes and systems to insure an appropriate foundation for their entrepreneurial visions to be implemented. Throughout the 80's and early 90's Schultz and his colleagues created the financial, accounting, legal logistics and planning necessary for the organization to go national.

A turning point for the firm was in the 1990s, when large numbers of customers in Los Angeles, San Francisco, Chicago and other major cities began drinking Starbucks coffee regularly. It was as if Starbucks had hit a critical mass and their belief in word of mouth over the traditional marketing campaign was beginning to reap long awaited benefits.

Senior management believed fervently that the most important of their organizational assets was the relationship fostered between Starbucks and the employees. Their philosophy was embedded in the fact that every dollar earned passed through the hands of a Starbucks' employee; thus, the employees had a profound effect on customer sentiment toward Starbucks. Consequently, Starbucks puts great emphasis on employee morale and satisfaction levels. Many policies within Starbucks have been geared to make the internal Starbucks' culture comfortable for employees, such as their innovative full health-care program for all employees working more than 20 hours a week. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 128)

In 1993, Starbucks continued its aggressive expansion and moved into the East Coast market by establishing a presence in Washington, D.C. This expansion has continued and today Starbucks operates more then 15,800 stores internationally and employs roughly 140,000 employees. It grosses $9.4 billion in annual revenue and is opening 5 new stores every day. (Starbucks Corporation, 2008) When asked whether the specialty coffee market is saturated Schultz stated, "We currently sell to 4% of the world coffee drinking market, I think we can sell to more." (Shultz, Text of Letter from Schultz, 2008)

Starbucks competes with players both within the specialty market and against those outside the specialty coffee market. Some examples of competitors within the specialty coffee market are Tully's coffee, Seattle's Best Coffee, Peet's Coffee, Caribou Coffee and other smaller chains. Those outside the specialty market include, Folgers, Proctor & Gamble, Dunkin Donuts, McDonalds and numerous other coffee serving establishments. Starbucks leverages its customer loyalty, premium quality coffee and the homey atmosphere of its stores to fend off competition.

Michael Porter's 5 Forces Analysis (Past)

My analysis begins with a thorough breakdown of the competitive environment which surrounded Starbucks Corporation in 1987, when it was first acquired by Howard Schultz. Michael Porter, author of Competitive Strategy, uses a five forces model to analyze an industrial environment and to develop an optimum strategy for success within a given industry based upon specified parameters. The five variables responsible for the forces analyzed using this model are the industry suppliers, buyers, potential new

entrants, substitute products and the competition among existing firms. Applying this model to Starbucks' formative years, I will concentrate on the examination of the competitive environment in which Starbucks was created and will generally omit consideration of social and macroeconomic forces that were present at the time.

Industry Rivalry

At the center of the five forces model is industry competition arising from the rivalries among existing firms. Defining an industry can be described as drawing a line between the established competitors and the substitute products offered by competitors outside the industry. (Porter, 1998, p. 17) The assumption is that the relevant industry is confined to the competitors within the specialty coffee segment; thus, any reference to competition from outside of the specialty coffee segment, say from basic coffee companies such as Folgers, by definition, should be considered competition from a substitute product category. However, given the difficulty in defining the boundary of the specialty coffee industry, I will analyze the effects of some basic coffee competitors attempts to enter the specialty coffee industry not as sources of potential new entrants but rather as a force adding to the rivalry among existing firms. This general competition, created by rivalry between established competitors, ultimately drives down the rate of return on invested capital toward what economists refer to as, "the industry floor rate of return," which occurs when the market is perfectly competitive. (Grant, 2008, p. 69)

The environment in which the specialty coffee industry had to compete during the late 1980s was made up of both product based competition and retail-based competition.

The product based competition was primarily with the basic coffee companies, who could attempt to enter the specialty coffee segment.   Some of the larger basic coffee companies, who made most of their sales in grocery chains, could have responded to rapid growth in the specialty coffee industry by introducing their own upscale versions of already popular supermarket brands. (Koehn, 2005) These potential retaliatory threats were unlikely to materialize given the high risk an established, branded company would be taking by entering an industry with speculative growth prospects. This conclusion follows based upon the much higher hurdle rates a major established company must surpass. Such established companies would have needed to achieve a far larger volume of sales than would a small company like Starbucks at that time in order to reap a sustainable and consequential profit margin. However, specialty coffee would have to confront product based competition from other non-coffee beverages, such as tea, juice, soft drinks, and alcohol. (Harding, 2000) In this context, specialty coffee was at an advantage because the consumption of most potentially competitive substitute products was declining relative to specialty coffee during the late 1980s. (Harding, 2000)

The retail-based competition was divided between flavored specialty coffee retailers and non-flavored specialty coffee retailers. Flavored specialty coffee came in a variety of flavors including hazelnut, amaretto, raspberry, pumpkin spice, and others that were infused into the coffee beans during the roasting process. Although Starbucks offered its coffee in a variety of flavors, they never used flavored beans, instead adding concentrate syrup to the brewed coffee, because adding flavor to the beans themselves violated Starbucks' definition of specialty coffee and, in their view, would degrade the quality of the Arabica beans. (Schrage, 2004) As defined by Starbucks, specialty coffee

has no defects and has a distinctive flavor originating from the microclimates in which the beans were produced. (Schrage, 2004) Roughly 25% of all specialty coffee sold in 1987 was flavored. (Schrage, 2004)

Because the industry rivalry which existed within the specialty coffee industry consisted of differentiating a product that was once considered a commodity and involved many differences in both flavoring techniques and presentation, the consumption of specialty coffee was rather inelastic, or insensitive to price fluctuations. This presented an environment in which price wars would not be prevalent. Furthermore, the budding state of the specialty coffee industry meant competition was limited and small in scale. The last environmental factor affecting the nature of industry competition during the era of Starbucks' founding was the market growth rate, which for retail specialty coffee was 6% in North America in 1987. (Specialty Coffee Association of America, 1988)

Potential for new entrants

The second force in Porter's model, which will be applied to the analysis of the industry environment in which Starbucks was incubated, is the potential for new entrants. The primary deterrents to new entrants into any industry are the barriers to entry. The higher the barriers to entry are within any given industry the smaller the threat of new entrants to that industry. (Porter, 1998, p. 7) The specialty coffee industry does not put a high premium on economies of scale. Although, companies with national distribution in the coffee industry at large experienced some discounts through bulk purchases and superior infrastructures, their advantages were small. This alone would imply low

barriers to entry in the specialty coffee industry. However, to make a thorough analysis, the other factors determining the total scale of all the barriers to entry combined must be considered.

Products within the industry were greatly differentiated, with varying degrees of quality, convenience, customer service, and differences in the atmosphere and ambience of the retail stores. The high differentiation within the specialty coffee industry made it possible to establish brands that could act as barriers to entry. Since most capital requirements within the specialty coffee retail industry were fixed costs, including the leasing of property, construction of roasting plants, and specialized equipment, the switching costs imposed on competitors within the industry were quite high. The basic coffee industry had created a barrier to entry by limiting the access to distribution channels through the use of exclusive contracting with grocery stores but this was not the case in the specialty coffee industry, where distribution was done primarily through retail outlets owned by the specialty coffee producers. These more transparent barriers to entry suggest neither high nor low barriers to entry in the specialty coffee industry and force us to examine the less transparent barriers to entry.

Many cost advantages can be independent of scale and may be gained by establishing one's position in an industry early. These can be referred to as first mover advantage. Some of these advantages come from proprietary product technology, favorable access to raw materials, favorable locations and a learning or experience curve. (Grant, 2008, p. 9) Those firms which established themselves early within the specialty coffee industry obtained access to the highest quality Arabica coffee beans, built in the most favorable locations and learned quickly the delicate balance between quality and

customer convenience. Since, there was no established retail specialty coffee organization within the United States, the potential for a retaliatory act against a new entrant was insignificant.

Cumulatively, the barriers to entry seem high in the specialty coffee industry in the late 1980s due to high product differentiation, high specialized capital requirements, high switching costs and disadvantages to new entrants in the form of limited access to premium Arabica coffee, limited choice of locations and a moderately steep learning curve. However, all of these barriers to entry required other firms to be established within the specialty coffee industry, which was not the case in the late 1980s, leaving the industry vulnerable to new entrants despite the potentially high barriers to entry.

Substitute Products

Another force which acts upon an organization and is included in Porter's five forces model is the threat of substitute products. The primary substitute products posing a potential threat to specialty coffee were the caffeinated soft drinks produced by Pepsi and Coca-Cola. Competitors like Pepsi and Coca-Cola offered beverages, which had the caffeine inherent in specialty coffee, at significantly lower prices. (Quelch, 2006) However, there existed large differences in taste and the demographic makeup of consumers between the two products; thus, consumers were unlikely to directly substitute coffee for caffeinated soft drinks or vice versa. The only true direct substitute for specialty coffee available was basic coffee; however, basic coffee was considered to be of

significantly lower quality than specialty coffee. As a result, it actually presented the industry with little threat of substitution.

Bargaining Power of Buyers

The bargaining power of buyers also plays an important role in determining the desirability from an investor's standpoint of the environment in which the specialty coffee industry existed at inception. The force of the buyer's bargaining power is proportional to the ability of buyers to force down prices, bargain for higher-quality products or more services, and pit rival organizations against one another. (Porter, 1998, p. 24) In the specialty coffee industry, individual consumers constituted the majority fraction of all buyers; therefore, they didn't typically buy in large volumes and did not act in concert. Both of these factors reduced the relative bargaining power of buyers in this industry. In addition, the cost of buying a cup of specialty coffee did not represent a significant fraction of any individual buyer's cost of living, reducing the tendency for price shopping and increasing the emphasis on quality and customer service.

One of the primary differences between the basic coffee industry and the specialty coffee industry is the amount of differentiation involved in the specialty coffee industry and the lack of differentiation in the basic coffee industry. This further dilutes the bargaining power of buyers through the brand premium that specialty coffee retailers demanded. As stated earlier, the largest purchasers of specialty coffee are individual consumers, who face no switching costs. (Specialty Coffee Association of America, 1988) This increases their bargaining power. Lastly, the buyer or consumer in the

specialty coffee industry does not have full information. The consumer does not know

the actual demand, market prices or supplier costs which greatly reduces their bargaining

power. Overall, then, the bargaining power of the buyers or customers of the specialty

coffee industry, which consisted largely of individual consumers, was not substantial.

Bargaining Power of Suppliers

As with any commodity suppliers, the bargaining power of suppliers to the

specialty coffee industry would be exerted by either threatening to raise the price of the

Arabica beans which are used in the production of dark roasted coffee, or by a threat of

reduction in the quality or quantity of the coffee beans themselves. The suppliers of

Arabica beans were mostly small to medium-sized family owned farms and typically sold

their crops to processors through local markets. (Lee, 2007) Primarily, these farms were

located in Latin America, the Pacific Rim and East Africa. (Lee, 2007) These farms were

numerous and unrelated to one another, with no unionization, giving them very little

collective bargaining power. Although there was no direct substitute for the Arabica

beans used in the production of specialty coffee, the vast array of farms which supplied

the crop made it easy for buyers to avoid obligations to any particular farmer, which

again eroded the bargaining power of suppliers. The farmers who produced the Arabica

beans sold exclusively to specialty coffee retailers and as such were dependent upon their

sustained business.

In spite of all of the stated reasons which suggest the specialty coffee industry is

one where the bargaining power of suppliers is severely hindered, the most important

ingredient in specialty coffee is quality Arabica beans. This allows for differentiation to occur between the numerous suppliers farms based upon the quality of beans they produce. This, in turn, should substantially increase their bargaining power as suppliers.

Summary: The Five Market Forces in Specialty Coffee in 1987

Having applied Michael Porter's five forces model to the specialty coffee industry environment which confronted Starbucks Corporation in 1987, a conclusion can be logically derived in regard to the proportional effects of each of the forces on the competition within the specialty coffee industry. Namely, it can be concluded that the force created by industry rivalry resulted in an environment in which competition was grounded in strategies of differentiation and focus, while discouraging price wars. Furthermore, the strongest of the four forces acting on the specialty coffee industry was that of potential new entrants given the existence of established firms in North America. The bargaining power of both suppliers and buyers was negligible due primarily to the small purchasing volume each individual had to offer the specialty coffee industry. The threat of substitutes was similarly insignificant given the declining sales of carbonated soft drinks as compared to coffee and, specifically, specialty coffee. Knowing the kind of environment in which the specialty coffee industry originated, and the power each of the five forces exerted on it, an assessment of the industry attractiveness as a whole can also be made.

Specialty Coffee Industry Attractiveness

The most attractive industry for any profit maximizing firm within a capitalistic society would be one in which they can have a pure monopoly. In economics this refers to situations in which one established firm can be the sole provider of a product or service in a particular market segment. (Grant, 2008, p. 67) Industries in which monopolies are created characteristically have a lack of economic competition for the goods or services that they provide and typically have no viable substitutes. This theory of monopoly would be one end of the industry attractiveness scale, while the other endpoint would be defined by the theory of perfect competition. (Grant, 2008, p. 68)

This theory describes an economic model which uses a hypothetical market form where no one producer or consumer has any market power or ability to influence pricing. The environments in which perfect competition materializes are characterized by a multitude of established firms with identical products and very little ability to differentiate their product. (Mankiw, 2007) It is also typical in environments where all of the forces acting upon the industry are of large magnitude. As a collective society, perfect competition is desirable given its efficiency in allocating resources and ability to maximize social welfare. However, this forms the opposite point on our industry attractiveness scale because it is the most undesirable position from the standpoint of a profit maximizing firm.

This scale will help us to define the attractiveness of the specialty coffee industry in relation to these two extremes. The five forces analysis of the specialty coffee industry has allowed us to identify some of the key structural characteristics of the main players in

the industry, such as the buyers, suppliers, potential new entrants, potential substitutes and rivals within the industry. These key structural characteristics suggest that the forces exerted by these five players on the specialty coffee industry initially made it ideal for a situation to develop in which the industry structure was closer to the monopoly end point on the scale of attractiveness rather than the pure competition end point. The primary competition among rivals within the industry was not price oriented; the buyers of specialty coffee and the sellers of Arabica beans had little bargaining power at their disposal; and there existed no true substitutes for specialty coffee. The strongest force acting on the industry was that of the potential new entrants, which could be mitigated by a first mover firm if it was able to establish dominant brand recognition, successfully expand aggressively and create a defendable differentiated product. Therefore, placing the specialty coffee industry at its inception in the late 1980s on the scale defined above is now possible and it appears to reside closer to the monopoly end of the scale than perfect competition, making it a very desirable industry from the standpoint of a profit maximizing firm such as Starbucks. However, where the specialty coffee industry is placed in respect to a pure monopoly and a perfectly competitive market is not the only determinant in the absolute attractiveness of the industry.

The second important factor influencing the attractiveness of an industry is the demographic makeup of the consumer base. In 1987, the average American consumed 2.3 cups of coffee per day, which led the world in coffee consumption. (Lee, 2007) This added to the attractiveness of the industry by providing an enormous pool of potential customers. Specialty coffee consumption as a percentage of total coffee consumption in the United States had been growing at a rate of roughly 3% per year from 1985 to 1987.

(Koehn, 2005) This illustrates the beginning of what became an enormous shift in consumer preference from the basic packaged coffees to the specialty coffees.

The majority of customers who purchased their coffee from one of the five Starbucks operating in 1987 had a college degree, were male and over the age of 35. In addition, on average, the typical customer had an income over $50,000 and consumed 19 cups of coffee per week, both at and away from home combined. (Quelch, 2006) These two factors also play a significant role in determining the attractiveness of the industry because they show that the average customer of the specialty coffee industry has more financial resources, education and consumes more coffee than the typical American. This implies a consumer base that is more flexible to price fluctuations and is less likely to fuel discounting among rival competitors, or a price war. Both Michael Porter's five forces analysis of the specialty coffee industry and the demographic makeup of the consumer base, then, suggest an extremely attractive industry with large growth potential in the late 1980s.

An appropriate question at this juncture is, why a firm hadn't established a position in the specialty coffee industry given its level of attractiveness? The answer, although simple, is that specialty coffee represented a small fraction of total coffee consumption as compared to what it represents today, especially ready to drink specialty coffee. (Koehn, 2005)

Knowing why no firm had established a position in the specialty coffee industry and understanding the key structural characteristics and demographic qualities of the industry allows us to identify the ideal business strategy. The objective of any firm trying to dominate or monopolize the specialty coffee industry would be to create defendable

sources of competitive advantage through the use of barriers to entry and a horizontal or organic hierarchy that could outpace competition in innovation. Results of the five forces analysis would suggest, given the unlikely prospect of a price war and the negative repercussions of one, that price superiority alone would be an ill-advised approach.

As stated earlier in this analysis, the specialty coffee industry has the potential for high barriers to entry but lacks them due to the industries immature state and the presence of no established firms. An ideal strategy would involve a firm establishing themselves in a rapid manner through an aggressive growth strategy. In addition, another barrier to entry could be created through brand recognition for high quality standards, coupled with a variety of specialty coffees. Lastly, the ideal business strategy, which would take maximum advantage of the state of the specialty coffee industry in 1987, would cater to its high income well educated consumer base. This could be done by implementing a price premium well above the cost of the specialty coffee, thus, taking advantage of the consumer base's price elasticity and desire for world-class quality coffee. Providing exceptional customer service would reinforce this strategy. Understanding the characteristics of the appropriate competitive strategy for the specialty coffee industry as it existed in the 1980s, then, allows a comparison to be drawn to Starbucks' original generic strategy.

Starbucks' Original Generic Strategy

As defined by Michael Porter there are three potentially successful generic strategies: overall cost leadership, differentiation and focus. Overall cost leadership

implies the pursuit of cost reductions in all areas of a firm through tightly controlling

overhead, avoiding marginal, less profitable consumers and sacrificing research and

development, customer service, advertising and other areas not pertinent to the direct

manufacturing of a product. The generic strategy of differentiation involves the creation

of something that is perceived by the industry as being unique. This can take on many

different forms including but not limited to brand image, technology, features, dealer

networks and customer service. The last generic strategy mentioned is focus, which

targets a particular group, geographic market, or segment of a given product line. (Porter,

1998, p. 38)

The Starbucks seen today would seem to fit the generic strategy of differentiation;

however, the original strategy used by Starbucks was closer to the generic strategy of

focus with an emphasis on differentiation within the particular target consumer segment.

Looking at the requirements for a generic strategy of differentiation, as defined by

Michael Porter, sheds light on why this could not have been Starbucks' original generic

strategy.

A firm that focuses on the generic strategy of differentiation would demonstrate

strong marketing abilities; yet, Starbucks did not even run a television advertisement until

1998. In fact, their advertising budget only constituted 4% of their total incurred costs.

(U.S. Securities and Exchange Commission, 1998) A second characteristic common in a

company pursuing the generic strategy of differentiation is a strong and established

capability in basic research and development, with subjective as opposed to quantitative

measurement goals. The primary means by which Starbucks conducted its research and

development in 1987 was through trial and error within company stores. There was no

established research and development department within the company. A third characteristic of companies pursuing a generic strategy of differentiation is a long tradition in the industry of having unique skills or unique products. Starbucks had this reputation within the distribution segment of the specialty coffee industry. Their original store was founded in 1971 and they were known for their high-quality standards and knowledgeable staff. However, widespread retail distribution of specialty coffee within Starbucks' stores did not begin until 1987 when Howard Schultz acquired the company.

All of the characteristics of the differentiation strategy seem to suggest that Starbucks originally used a generic strategy of focus. Looking at the characteristics of a company pursuing the generic strategy of focus, as illustrated by Michael Porter, it would involve a combination of the characteristics of the differentiation strategy directed toward a specific consumer segment. In the case of Starbucks, the demographic composition of their consumer base was narrow in orientation. Their target consumer was a wealthy, educated, coffee drinker who preferred quality and customer service over a discounted price. These are very specific parameters in terms of customer base when considering the general coffee market. In regard to incorporating some characteristic differentiation strategies, Starbucks did have a corporate reputation for quality and creative flair.

It has been established, so far, that the specialty coffee industry in the late 1980s was attractive: no established firm had a defendable position within the industry. Also, both a framework for the ideal strategic approach and Starbucks' strategic approach to the industry has been identified. With this information in hand, an understanding of why Starbucks has sustained such high profit margins while at the same time increasing market share exponentially can be ascertained.

Starbucks' Success Factors

First-mover advantage

When Howard Shultz purchased the assets of Starbucks on August 18, 1987, he immediately set in motion an aggressive growth strategy targeted at the unique consumer base the specialty coffee industry attracted. The expansion plan called for 125 new stores to be opened in the first five years of operation. However, these ambitious plans would lag that of the actual expansion that Starbucks underwent. In the first year of their expansion, fiscal year 1988, Starbucks more than doubled the 11 base stores they operated by opening 15 new stores in the Pacific Northwest. From there, they proceeded to open 20 stores in 1989, 30 stores in 1990, 32 stores in 1991 and 53 stores in 1992, for a total of 150 stores in a five-year period. In order to ensure a reputation for quality and customer service Starbucks, did not adopt franchising, instead maintaining company control of all new stores. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 114)

A primary reason they were able to expand at such an aggressive rate without experiencing any significant problems was the result of an important strategic decision made in 1987 to move into both Chicago, IL and Vancouver, Canada simultaneously. With only five stores in operation at the time, all within close proximity to one another, many questioned both the abrupt move 2000 miles away to Chicago and the international expansion into Canada. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 111) These decisions, however, were made to

both prove the feasibility of Starbucks' business plan of national expansion using the generic strategy of focus and to give them an opportunity to test the waters near the East Coast before making any significant capital investments.

Expansion East

Chicago was chosen as the first major eastern expansion target because it presented numerous challenges not present in many other Midwest and East Coast cities, which would help the corporate team at Starbucks assess how best to expand throughout the country. The city was located in the heartland of the two largest basic coffee companies in the United States. The first of these two companies was Folgers, part of the food and beverages division of Procter & Gamble, and the second company was Maxwell House. Both of these companies had the financial resources and brand recognition to muffle any expansion attempts made by Starbucks. The real question which Starbucks' corporate team was trying to answer was whether these companies perceived Starbucks as a legitimate threat and whether they would act upon Starbucks' expansion into Chicago by launching a retaliatory campaign. The second goal of the move into Chicago was to establish the infrastructure necessary to operate a store far from the corporate headquarters.

Logistically, transporting a perishable product thousands of miles while maintaining its quality presented Starbucks with a significant barrier to their expansion plan, which they would have to overcome if they were to achieve success in Chicago. The solution to this was the production and utilization of flavor lock bags. These bags

allowed them to transport 5 pounds of coffee per bag without risking deterioration from moisture or the carbon dioxide released by the coffee beans. This allowed them to maintain the integrity of the Arabica beans without limiting their ability to expand. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 160)

Their first stores in Chicago were originally unsuccessful, which forced Starbucks to reassess both their matrix for selecting locations to open stores and operational components such as pricing and hiring. They found three causes for the initially unsuccessful stores. The first mistake was in not opening their stores in office building lobbies. The cold and windy winters in Chicago dissuaded people from walking outside to get a cup of coffee and since their initial stores faced the streets in the Chicago Loop, they received little foot traffic during the winters. The second mistake was in hiring inexperienced management to run the stores. Due to Chicago's great distance from Starbucks central hub in Seattle, it was more challenging to convey the ideals and methodology of Starbucks to baristas hired there. Management was required to play a much larger role in ensuring that customer service expectations were met. Third, the initial stores did not charge adequate prices given the higher cost of goods and rental prices present in Chicago and did not take adequate advantage of the inelastic demand for specialty coffee. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 120)

After gaining a thorough understanding of why success was not initially achieved in Chicago, Starbucks' corporate staff took the appropriate actions necessary to correct these problems. They closed the stores in undesirable locations, reopened in the lobbies

of high traffic buildings, hired more experienced managers, and raised prices. The

lessons learned in the Chicago stores allowed much of the following expansion to take

place with few unforeseen problems. Their expansion into Vancouver, Canada was met

with far less resistance because of the similar demographic makeup of the city compared

to Seattle and helped to convince future investors of the viability of international

prospects for the company.

California Expansion

Until 1991, when they opened their first store in California, their expansion

remained confined to the Pacific Northwest and Chicago. Unlike Chicago and

Vancouver, which were strategically important for Starbucks to success, California

simply represented a vast market with an ideal demographic makeup and open attitude

toward high quality and innovative foods. Los Angeles was chosen to be the hub city in

California given its status as a trendsetter and Hollywood's cultural ties to the rest of the

country. It was an immediate success, with the Los Angeles Times naming Starbucks the

best coffee in America before their first store in the city was opened. A second

advantage that came with opening in Hollywood was the implicit celebrity endorsements

of Starbucks propagated by the candid photos taken by paparazzi showing celebrities

holding cups of Starbucks' coffee. (Shultz, Pour Your Heart Into It: How Starbucks Built

a Company One Cup at a Time, 1997, p. 116)

The Catalog

Another means Starbucks utilized to determine the most advantageous locations to open new stores was through their mail order catalog. This catalog gave customers the opportunity to order wholesale packaged Starbucks' coffee beans from anywhere in the country. Typically areas with high concentrations of catalog orders were ones in which new store openings were well received. Thus, the catalogue gave Starbucks the opportunity to create a loyal customer following before physically entering the regional markets by opening new stores.

The 1990s

A critical mass of sorts had been reached by the early 90s and Starbucks continued their aggressive strategy of expansion into the new millennium. They planned for this enormous expansion by hiring and building ahead of the growth curve. Typically, they would hire management staff with the experience to operate the amount of stores they anticipated opening in the near future as opposed to those currently operating. In September of 1993, they built a 305,000 ft.² roasting plant in Kent, Washington capable of supplying substantially more stores than they then operated. They also purchased a sprawling nine floor office building in the SODO, SOuth of the kingDOme district of Seattle's industrial zone, with the intent of making it their permanent headquarters, which it remains today. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 143)

This aggressive expansion policy would never have taken hold if Starbucks had not maintained the quality of their product and the reputation they had for exceptional customer service. They were able to do this by creating novel approaches to motivating employees and by securing a quality supply chain.

Employee Satisfaction

From the perspective of the Starbucks' corporate team, the quality of the baristas and other employees was the most important ingredient of Starbucks' success, next to the specialty coffee itself. As Howard Schultz said in reference to his employees, "these people are not only the heart and soul but also the public face of the company. Every dollar earned passes through their hands." (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 125) Vast financial resources and time were dedicated to pursuing the best means of obtaining the highest quality employees available.

A novel approach used by Starbucks was to raise health care benefits and extend them to all employees working more than 20 hours a week. Conventional wisdom would lead one to believe that this measure would raise costs to an unacceptable degree. The corporate staff at Starbucks reasoned that increasing healthcare benefits would not only attract higher-quality employees but would decrease the turnover rate and potentially decrease the overall expenses for the company. Their strategic assessment of the effects increased health-care benefits would have on the company expenses proved correct with the passing of time.

The cost of training a new barista at Starbucks was $3000 in 1989, when they initially began to offer the higher healthcare benefits, and the cost of providing an employee with full health benefits was $1500. With the typical turnover rate at a retail or fast food chain ranging between 150% to as high as 400% a year, Starbucks turnover rate of 60% at the barista level and 25% at the managerial level was the lowest in their industry. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 128) Without many mathematical calculations it is easy to come to the conclusion that the increased health benefits did indeed save Starbucks money.

The second unique initiative that the Starbucks' corporate team implemented was an employee stock ownership plan affectionately referred to as Bean Stock. The basic plan was to grant stock options to every employee, companywide, from top managers down to the baristas, in proportion to their level of base pay. Initially, the stock options were offered at 12% of base pay but were then boosted to 14% of base pay. Because Starbucks offered these stock options to 700 employees as a private company they had to obtain a special exemption from the Securities and Exchange Commission. The SEC typically required companies with more than 500 registered shareholders to file for public status. (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 135)

By involving all employees in the equity success of the company, Starbucks effectively created a clear incentive for employees to both reduce costs and treat customers with exceptional service. In addition to the beanstalk program, Starbucks initiated an open forum every quarter to explain the company's progression and also to encourage questions and suggestions from all employee levels. After the program was

initiated, the word employee was no longer used on internal documents; instead it was replaced with the word partners. This was another ploy to create employee loyalty and dedication.

Maintaining quality of Arabica beans

In order to ensure that the quality of Arabica beans stayed at a consistently high level, Starbucks pursued strategies to secure their supply-chain. In spite of the extraordinary domination Starbucks eventually had within the specialty coffee industry, they never utilized their market power directly against their coffee suppliers to lower bean prices and, thus, improve their profits. Instead, Starbucks saw an opportunity to encourage social change by forming a strategic alliance with conservation international.

A general definition of strategic alliances is a relatively formalized agreement between two or more organizations, Starbucks and Conservation International in this instance, in the pursuit of a joint objective or coordination between the two organizations in activities. There are many different reasons why an organization such as Starbucks would undertake a strategic alliance with an organization such as Conservation International. Some of the primary reasons include the attempt to reduce risk, the attainment of economies of scale, preemption of competition, an attempt to overcome government barriers, or the facilitation of international expansion. A couple of the variables an organization looks at before establishing a strategic alliance with a partner are their prior alliance history and whether they have partners in common.

By collaborating publicly with Conservation International, Starbucks stands to increase their legitimacy with other NGOs; thus, reducing the risk of protests and the negative implications those protests would have on their brand image. This alliance also allowed Starbucks to attain economies of scale in regards to their ability to contribute positively to the community and the environment by tapping in to some of the expertise offered through Conservation International. (Reavis, 2004)

The most important aspect of the strategic alliance with conservation international was the collaborative development of C.A.F.E. practices (Coffee and Farmer Equity Practices). The primary goal of the C.A.F.E. practices was to enhance the coffee farmer's quality of life and to ensure a long-term stream of high quality coffee. The initiative was governed by three important principles. The first of these principles was to develop a sustainable supply of high-quality coffee beans from a stable source of coffee farmers who were not exploited by their trading partners. The second principle was to maintain the environmental integrity of the lambs Farm. Lastly, the initiative sought to ensure that the families of the farmers lived in societies that were healthy, secure and supportive. (Reavis, 2004) This mutually beneficial arrangement between Starbucks and the coffee farmers also helped to counteract an increasing oversupply of low-quality coffee, which acted to suppress the price of coffee, inhibiting the farmer's ability to improve production.

The C.A.F.E. practices were a guideline for farmers that encouraged high-quality coffee and economic transparency. The farmers who met the C.A.F.E. practice guidelines were given preferential treatment when Starbucks made buying decisions. They were also given economic incentives to meet the guidelines. The requirements

included contributing positively to the conservation of soil, water, energy and biological diversity. Additionally, they were expected to demonstrate economic accountability for their hiring and equitable payments to those who worked for them. (Reavis, 2004) To see the C.A.F.E. practices refer to exhibit 6.

The societal implications of the C.A.F.E. practices were the most direct and obvious ones but Starbucks indirectly benefited greatly from the program. In regard to their supply-chain, the program allowed them to lock in the highest quality suppliers which gave them a competitive advantage over many of the other specialty coffee retailer's. The suppliers who would invest to meet the qualifications for Starbucks program would have incentives to stay with Starbucks and would face switching costs for attempting to supply another specialty coffee company. Additionally, this decreased Starbucks' susceptibility to price and supply volatility given the long-term relationships developed with the suppliers through the program.

Another way in which Starbucks benefited from its strategic alliance with conservation international by promoting the C.A.F.E. practices was through the positive externalities the program had for the marketing of Starbucks. As the 90s progressed into the new millennium it became more important for companies to display corporate social responsibility. This also allowed Starbucks to charge a premium price on the grounds that the coffee was procured through a highly selective process that ensured that only the best beans were used. Lastly, these initiatives would allow for more transparency in the supply chains from which Starbucks purchased their coffee beans. (Lee, 2007) Increased visibility would enhance Starbucks' ability to understand the needs of their suppliers and to better predict future shortages in supply.

The Third Place

In today's interconnected world it is important to develop a feeling of community. This is part of the reason Starbucks is so adamant about ensuring the well being of its suppliers, for they are a part of the company's greater community. A large part of Starbucks' appeal to people is the sense of community the customers feel when they walk through the door. Starbucks tries to offer a "third place", where people can get away from the daily routines of their lives and enjoy a cup of coffee from Sumatra, Kenya or Costa Rica. It is a place where the noise and hostility ever present in the city dissipates. Most important, it is a place that offers casual social interactions.

Ray Oldenburg, a Florida sociology professor, attributes much of Starbucks' success to its ability to offer this third place or as he puts it, the great good place in modern society. He explains that, "without such places, the urban area fails to nourish the kinds of relationships and the diversity of human contact that are the essence of the city. Deprived of these settings, people remain lonely within their crowds." (Shultz, Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time, 1997, p. 120)

The ability of Starbucks to take advantage of this need for a third-place is not entirely attributable to their own strategic planning. Many other developments unassociated with Starbucks were occurring during their aggressive expansion. Two of the most prevalent themes during the 1990s and early millennium were that of increasing numbers of people working from their homes and the increasing use of the Internet and

mobile computing devices capable of accessing it. Both of these developments aided

Starbucks in the additional flexibility that they afforded the general population.

Today, Starbucks has gone to great lengths to take advantage of these

advantageous environment changes. For example, they have recently struck a deal with

AT&T, which will allow them to offer free wireless internet access to some customers at

the majority of its US stores. The deal will give approximately 12 million broadband

customers unlimited free access to the internet at more than 7000 Starbucks' locations.

(Searcey, 2008) Additionally, Starbucks will give two hours of free internet access per

day to people who have a Starbucks' card, which is a card customers can load with

money to pay for purchases. Starbucks has also enabled customers to access an iTunes

play list in stores, which shows the music playing in real time and gives them the

opportunity to purchase music digitally. (Searcey, 2008)

Five Factors in Starbucks' Success

Starbucks' success thus far can be attributed to five primary factors. The first of

these factors was their ability to design a strategic approach to growth that quickly

demonstrated the feasibility of their business model and took advantage of some key

demographic groups. Next was there ability to attract the highest-quality employees

through the implementation of a superior healthcare plan while reducing costs and giving

equity ownership to all employees. The strategic alliance they had with conservation

international allowed them to create a sustainable supply chain of high quality coffee.

The three previous factors helped enable them to foster the fourth factor in their success,

a community environment in which casual social interactions could take place. The fifth

factor to their success was there ability to adapt to the changing dynamics of their

consumer demographics. All of these factors have allowed them to stay at the forefront

of the specialty coffee industry.

Michael Porter's 5 Forces Model (Present)

My focus, so far, has been on the industry environment in which Starbucks first

competed in 1987 and the strategic components that have led to their success over the last

20 years. The analysis will now move forward to the present, where I will apply Porter's

five forces model to the environment surrounding Starbucks today in order to develop an

accurate understanding of the current specialty coffee industry.

Industry Rivalry

The dynamics of the industry rivalry within the specialty coffee industry has

changed dramatically since 1987. Unlike the early days of the specialty coffee industry

when Starbucks competed primarily against other small-scale specialty coffee retailers

they now compete against companies of varying sizes and different exposures to specialty

coffee. Starbucks competes with a variety of smaller scale specialty coffee shops, mostly

concentrated in different regions of the country. All of these specialty coffee chains are

differentiated from Starbucks in one way or another.

Caribou Coffee is a Minneapolis-based specialty coffee chain that competes with Starbucks. They are similar to Starbucks in their attempt to create a third-place but distinguish themselves by creating an entirely different atmosphere. Where Starbucks strives to create an upscale European atmosphere, Caribou coffee tries to implement a more American feel to their coffee houses. They do this by modeling their coffee houses after rustic Alaskan lodges. (Quelch, 2006) Often they will use knotty pine cabinetry, numerous fireplaces and soft seating. Also they offer a barrage of magazines and newspapers as well as the guarantee of speedy service and free refills. In addition, they offer free WiFi, drive through accessibility and meeting rooms for rent. Founded in 1992, Caribou coffee now operates roughly 500 stores, employs over 6000 people and grosses roughly $230 million in revenue a year. (Caribou Coffee, 2008)

A Canadian-based company, A.L. Van Houtte, operates roughly 100 corporate outlets and franchises, serving nearly 3 million cups of coffee per day. Through their subsidiary VKI technologies, they have become the world leader in the design, manufacture and distribution of coffee making equipment and related products. They also operate the largest coffee services network in North America serving roughly 71,000 different workplaces in major cities throughout the United States. (A.L. Van Houtte, 2005)

As the original inspiration for Starbucks, Peet's Coffee and Tea Company which originated in Berkeley, California still poses a serious competitive threat. The three founders of Starbucks purchased Peet's Coffee and Tea Company in 1984 from Alfred Peet and later sold the assets of Starbucks to the now CEO, Howard Schultz. Although much slower to expand than Starbucks, in fact, ironically Schultz originally separated

from the then owners of Starbucks, later purchasing the company from them because he could not persuade them to undertake an aggressive expansion, Peet's has recently opened a new roasting plant in Alameda, California which will enable them to double their current annual sales of $250 million. They currently operate 166 stores in the US and have recently moved into the Seattle metropolitan area, home of Starbucks' headquarters and the original Starbucks' store. (Peet's Coffee & Tea, 2008) In 2007, the three Peet's locations in the Seattle metropolitan area outperformed all Starbucks' stores in the nearby vicinity in same-store sales, store revenue and total customer receipts per store. Peet's strategy is to differentiate themselves from Starbucks by creating a super premium brand by offering the freshest coffee in the market. They ensure the freshness of their coffee by delivering "roasted to order" coffee, which involves roasting small batches of coffee and shipping them to the retail shops within 24 hours of roasting. (Review, Despite Growth, Starbucks Can't Dislodge Local Rivals, 2007)

In addition to these smaller scale specialty coffee companies, Starbucks must now compete against two of the largest companies in the fast food industry who have recently entered the specialty coffee segment. The first of these competitors is Dunkin Donuts, who claims to be "the world's largest coffee and baked goods chain." Currently, Dunkin Donuts operates about 5,500 franchises around the United States, 80 stores in Canada and 1,850 throughout the rest of the world. Dunkin Donuts had revenues of roughly $5 billion in 2007. In the past couple years the franchise has put enormous emphasis on their coffee beverages. They serve coffee beverages in an assortment of types and styles including espresso, cappuccino and latte. They also serve their coffee in an assortment of flavors including French Vanilla, hazelnut, cinnamon and numerous others. When

Starbucks recently temporarily shut down 7,100 of their stores to retrain their baristas, Dunkin Donuts responded by extending their hours of operation and offering small lattes, cappuccinos and espresso drinks for $.99. (Adamy, Starbucks Upgrades Espresso Machines, 2007)

The largest industry rival currently facing Starbucks is the McDonald's restaurant fast food chain. McDonald's originated from a single San Bernardino, California hamburger stand, which opened in 1948, and has turned into what is now the world's largest restaurant chain with over 14,000 restaurants in the United States alone and gross revenues in excess of $22 billion. The key to McDonald's success has been the consistent quality standards they achieve for their food, coupled with their quick service and low prices. (Adamy, McDonald's Takes on Starbucks, 2008)

10 years ago Starbucks and McDonald's were at complete opposite ends of the spectrum in the restaurant industry. However, McDonald's, encouraged by the success of its upgraded drip coffee, began testing numerous drinks sold under the name McCafe. Starbucks meanwhile, with its rapid expansion, was adding drive-through windows and numerous breakfast sandwiches, similar to the Egg McMuffin's served at McDonald's, to their stores. These measures have drawn the two companies closer together as competitors due to an encroachment into the demographic consumer base made by each company. (Review, Is Starbucks a Broken Brand? , 2008)

The McCafe, first conceptualized in Australia during 1993, was brought to the United States in 2001. The concept took a quarter of the typical McDonald's restaurant and added leather couches and a decorative counter on which cappuccinos and sweets were sold. The McCafes did not take hold initially, not making it past their first trial

period, primarily due to the poor conditions of the stores in which they were placed.

Now, seven years later, McDonald's has invested $700 million in its "plan to win" strategy, initiated in 2003, which has led to the remodel of thousands of US locations. The project has led to the gutting of many dilapidated franchises by tearing out the molded plastic booths and replacing them with extra large leather chairs. The company has also improved the ambience and atmosphere in many stores by replacing the bright color schemes with more contemporary muted tones and softer lighting. (Adamy, McDonald's Takes on Starbucks, 2008)

With a rejuvenated brand image, McDonald's is preparing for the biggest addition to its menu in 30 years. The company will be installing coffee bars along with "baristas" who will serve cappuccinos, lattes, mochas and the Frappe, a knockoff of the Starbucks' ice blended Frappuccino, throughout 2008 and into the beginning of 2009. The initiative is expected to add $1 billion to McDonald's annual sales. McDonald's, which has never displayed food assembly devices, will place the Espresso machines at the front counters in an attempt to engage their customers with the theatrics involved in creating mochas and frappes. Unlike Starbucks, the baristas at McDonald's will not steam pitchers of milk and combine them with shots of espresso but rather will wait for a single machine to make all components of each drink. The competitive threat posed by McDonald's can be summarized by referring to the February 2008 edition of the Consumer Reports magazine, which rated the McDonald's drip coffee as better tasting than Starbucks. (Adamy, McDonald's Takes on Starbucks, 2008)

The specialty coffee industry has experienced explosive growth over the past 20 years. As a consequence, many companies have recognized the potential for profit and

have tried to capitalize by entering the industry. This has resulted in a drastic increase in competition within the specialty coffee industry. The diversity among these competitors still remains very high but the grounds on which companies are differentiating themselves are changing. As larger and larger companies enter the industry the strategic stakes become higher, pushing some companies such as Dunkin' Donuts and McDonald's to differentiate themselves through price superiority. (Adamy, At Starbucks, Too Many, Too Quick? , 2007)

In summary, the current impact of the industry rivalry force created by the competition between specialty coffee retailers is very high, especially as contrasted to what it was at the time of Starbucks' rapid expansion twenty years ago. The growth of the industry has slowed while the number of competitors within the industry has increased. Both of these factors, in addition to Dunkin' Donuts and McDonald's high strategic stakes in the specialty coffee industry, have caused this change from weak to strong industry rivalry.

Potential for New Entrants

Another of the five forces in Porter's model, which has changed significantly since the late 80s when we analyze the current environment in which Starbucks competes, is the potential for new entrants. As stated earlier, the primary deterrents to entry in the specialty coffee industry are the various barriers to entry. The economies of scale within the specialty coffee industry have increased as the size of the top players has increased. Companies such as Dunkin' Donuts and McDonald's have national

distribution channels through which they can transport their specialty coffee at a relatively low cost compared to potential new entrants who have no such developed distribution systems. These larger companies are also able to economize on their accounting operations and marketing budgets by facilitating their specialty coffee operations from the same department as for all segments of their businesses. Finally, these larger corporations are also able to reap economies of scale through their purchasing by negotiating long term contracts with coffee farmers and purchasing coffee beans in bulk quantities at discount prices.

There is numerous cost disadvantages imposed on new entrants that are independent of the economies of scale considerations. As the industry matures, the ability to access distribution channels and select from the highest quality coffee beans has becoming increasingly difficult. Most of the favorable store locations within the larger metropolitan areas have already been occupied by current competitors within the specialty coffee industry. Additionally, many companies now have proprietary product technology involved in the production of their specialty coffee as well as lower per unit costs due to an experience curve. (Adamy, Venti Changes at Starbucks, 2008)

Product differentiation within the specialty coffee industry has moved away from the purely objective and defined traits such as the taste of the coffee, convenience of the stores and prices charged. The industry has progressed toward more subjective traits such as the ambience of the store, the social responsibility of the company and brand identification. Many companies have gained very loyal customer bases stemming from their past advertisements, customer service, objective product differentiations and early

entry into the industry. All of this makes it more difficult for new entrants to gain a solid

customer base. (Gulati, 2007)

From the analysis above, it can be ascertained that the barriers to entry in the

specialty coffee industry have increased substantially. As a consequence, the potential

threat of new entrants has gone down. Since, the industry does not have large capital

requirements, smaller specialty coffee shops are still prevalent throughout the United

States and the potential for more of them to enter the industry is still present. However,

these new entrants can be disregarded given the unlikely nature of their concerted

expansion and the inconsequential effects they have singly on the overall demand in the

consumer market.

Substitute Products

The force created by substitute products in the specialty coffee industry has

decreased. Many companies that presented the specialty coffee industry with a threat in

the form of substitute products have actually entered the industry and now compete

directly by offering their own premium coffee selections. The primary substitute

products still posing a threat to the specialty coffee industry are the caffeinated soft

drinks offered by Pepsi and Coca-Cola. However, even these substitute products pose

little threat to the premium coffee industry. In the past five years, studies done on the

percentage of meals or snacks that included a carbonated soft drink as opposed to coffee

have shown a reversal in consumer preference. Coffee has gradually gained preference

over carbonated soft drinks. This is mostly attributed to the health concerns associated

with carbonated soft drinks and the new evidence showing coffee as a relatively healthy alternative. (Harding, 2000)

Supplier Bargaining Power

With the extensive growth in the specialty coffee industry, supplier bargaining power has changed in numerous ways. In 1987, when the first Starbucks was conceived, the farmers from whom Starbucks purchased its premium coffee beans were numerous, small and unconnected to one another. Currently, many of the farmers who sell to Starbucks and other premium coffee chains are united by an initiative known as fair trade certified coffee, which was organized by TransFair USA. Under this initiative, companies such as Starbucks are given the opportunity to advertise their coffee as being fair trade certified if they purchase from coffee suppliers that are democratically owned cooperatives. (Argenti, 2004)

This initiative was designed to ensure that the coffee farmers would be compensated fairly for their crops. Their increased unity under this initiative worked as a positive externality by increasing their ability to exert bargaining power over their buyers. The fair trade coffee certification is looked at by consumers in their decision of where to purchase their premium coffee. Thus, although the farmers are still numerous and small they are now connected through the initiative launched by TransFair USA and act in some respects like one large entity. Although the farmers of premium Arabica beans are still in constant competition with the substitute Robusta coffee bean growers,

their bargaining power is not significantly diminished by this threat due to the unlikelihood of a big premium coffee retailer adopting the substitution. (Argenti, 2004)

Originally, specialty coffee retailers such as Starbucks comprised the vast majority of sales made by the premium coffee farmers. As the industry has grown, more companies and restaurants, specializing in a broader array of products than just specialty coffee, have begun to purchase from the premium coffee farmers. This has made the relative size and importance of the companies, such as Starbucks, within the specialty coffee industry less significant to the farmers. With other customers to supply, the coffee farmers are less constrained by the specialty coffee industry and its specific demand. This acts to increase the bargaining power of the coffee farmers.

As competition increases within the specialty coffee industry, there is a greater emphasis on differentiating products through superior quality. The coffee beans which are supplied by the farmers are the most important input to the brewing process for a company such as Starbucks, making them increasingly important. For many specialty coffee company's their success is riding on their ability to produce higher quality coffee than competitors, which acts to further increase supplier bargaining power.

When Starbucks first began purchasing premium Arabica coffee beans in the late 1980s, they executed purchases incrementally throughout the year. Currently, they lock their coffee suppliers into long-term contracts to dilute potential price volatility. These contracts have stipulations within them which place a financial burden on the coffee suppliers if they choose to supply a different company. By creating these switching costs for the premium coffee suppliers, Starbucks has diminished their ability to play one buyer against another, which decreases their bargaining power. (Lee, 2007)

A last component to the analysis of supplier bargaining power within the current specialty coffee industry environment is the threat of forward integration. Technically, the farmers can forward integrate by setting up smaller coffee shops and brewing their own batches. This is, however, extremely unlikely and has yet to occur.

When comparing the bargaining power of suppliers today in the specialty coffee industry to the bargaining power of suppliers during the late 1980s, it is apparent that suppliers are more powerful today. The increased unity among the coffee farmers, decreased significance of specialty coffee retailer's purchases as a proportion of premium coffee bean sales and increased importance placed on high quality coffee beans by the purchasers have all acted to increase the bargaining power of the supplier group. Although Starbucks has locked some of the coffee suppliers into long-term contracts not all suppliers are affected; thus, the supplier bargaining power is only marginally diminished by that tactic.

Bargaining Power of Buyers

The last component of Michael Porter's five forces analysis to be applied to the modern specialty coffee industry is the force created by the bargaining power of buyers. The primary buyers in the specialty coffee industry remain individual consumers, who neither engage in concerted behavior nor individually purchase in large volumes relative to the total sales of a corporation such as Starbucks. Unlike the late 1980s, however, there are a few buyers who purchase in large volumes. These large buyers are typically other multinational corporations who choose to serve Starbucks brewed coffee in their

offices. However, the effects of losing one of these buyers to a competitor would not be detrimental to a company with a large sales volume such as Starbucks. (Adamy, With Starbucks, Investors Need Patients, 2008)

Neither the individual consumers nor the multinational corporations who purchase specialty coffee commit a significant fraction of their resources to these purchases. This makes the buyers less sensitive to price fluctuations and gives the players within the specialty coffee industry more control over pricing. This acts to decrease the bargaining power of both the buyer groups.

The expansion of the specialty coffee industry created a wider array of competitors who offered high quality specialty coffee. This made it much harder for the players in the specialty coffee industry to differentiate themselves through quality and turned quality into the industry standard. In addition to the increasing quality standardization which specialty coffee has undergone, the buyers face no switching costs and have an enormous selection of retailers from whom they can buy.

The buyers of specialty coffee do pose a credible threat of backward integration. This threat can be carried out if a buyer chooses to start a mom and pop specialty coffee store in close proximity to an established specialty coffee store. Same-store sales are roughly 20% lower in Starbucks stores located within a two block vicinity of mom-and-pop specialty coffee stores. (Review, Is Starbucks a Broken Brand? , 2008)

The ability of buyers to backward integrate is enhanced by the availability of all information regarding the demand, market pricing, and supplier costs in the specialty coffee industry through sources such as the World Wide Web. With full information, the buyer is in a better position to ensure that they pay a favorable price and receive an

appropriate level of quality from the product. The amount of bargaining power that can be exerted by the buyers within the specialty coffee industry has increased as a result of the availability of information regarding market variables. This along with the other previously discussed changes to the dynamics of buyer bargaining power has increased its overall magnitude from the level it was at in the late 1980s.

Summary: Five Forces Analysis as of 2007

Having applied Michael Porter's five forces model to the specialty coffee environment which confronted Starbucks in 2007, a conclusion can be logically derived regarding how the proportional effects of each force on the competition within the specialty coffee industry has changed since 1987. Specifically, the force created by industry rivalry has gone from one grounded in strategies of differentiation and focus while discouraging price wars to an extremely competitive environment where differentiation is increasingly difficult and price wars are looming. The strength of the force imposed by the potential for new entrants has decreased as a result of more formidable barriers to entry. The bargaining power of both suppliers and buyers has increased as a result of increased unity among the suppliers and the accessibility of information to the buyers. The threat of substitutes is still insignificant given the continued declining sales of carbonated soft drinks compared to coffee and specifically specialty coffee.

The Specialty Coffee Industry Life Cycle:

An Evolutionary Process

Through the application of Michael Porter's five forces model to the specialty coffee industry in which Starbucks currently competes, an understanding of the relative magnitude of each of the five competitive forces has been developed. Understanding how these forces affect the industrial environment in which Starbucks competes allows us to assess the structural components of the environment and how they have changed in response to numerous variables. However, this industry-specific approach is only sufficient in explaining the industry environment based on past occurrences, it is insufficient for the formulation of future strategic positioning, because it is not always clear what industry changes will occur in the future. Therefore, another analytical model will be applied to the specialty coffee industry in order to gain an understanding of the probable course of future evolution in the specialty coffee industry.

The first concept which will be applied to the specialty coffee industry is the product lifecycle. This lifecycle is based on the assumption that all industries pass through a number of generic stages. The four generic stages are introduction, growth, maturity, and decline. They are defined using the rate of growth in sales in an industry. As an industry's sales grow and decline through the numerous stages, inflection points can be marked in order to determine where the stages start and end. This concept also makes the assumption that all industries go through an S-shaped pattern in their sales growth.

Specialty Coffee Growth Rate

When analyzing the specialty coffee industry's sales growth from 1990 to 2007, as illustrated in exhibit 1, we can see that the industry experienced enormous growth in total sales between 1998 and 2002. Using exhibit 2, which depicts the generic stages of the industry lifecycle in a graphical format, we can compare the two and pose a hypothesis as to where the specialty coffee industry is in this life cycle. Namely, this comparison suggests that the specialty coffee industry is near the inflection point between the growth stage and the maturity stage in the industry lifecycle. Having pinpointed where we believe the specialty coffee industry is in the lifecycle allows us to assess the likely future evolution of the industry.

The most important evolutionary changes affecting any industry are the long run changes to its growth rate. This is often what leads to the largest structural changes in an industry and influences future strategy the most heavily. There are a few important external forces which have played a part in the specialty coffee industries sales growth rate. The first of these factors is the change that has occurred to the demographic composition of the consumer base to which the specialty coffee industry caters. (Porter, 1998, pp. 164-165)

One of the primary changes to the demographic composition of the industry, which has affected the demand for specialty coffee, is the decreased income elasticity caused by a lower average income among specialty coffee buyers. This can be seen in exhibits 8. Specialty coffee is seen as an expendable luxury by the majority of the consumer base. When the average income of the consumer base goes down, so too does the consumption of specialty coffee by the average consumer. Since, the majority of high

income consumers already purchase specialty coffee; the demographic composition of the industry will continue to see a decrease in the income level of the average consumer.

The next factor affecting the long run anticipated changes in the specialty coffee industry's growth rate is the changing consumer lifestyles associated with the development of the Internet and personal computing devices capable of accessing it. Throughout the 1990s the proportion of the workforce who chose to work from home increased as the Internet allowed them access to the materials they needed to complete their work while away from the office. This created a positive externality for the specialty coffee industry by giving people the need to find a place that was more casual than their office and yet still allowed them the opportunity to get away from their homes. The specialty coffee shop became that location or as Starbucks refers to it "The Third-Place" between the home and the office, which catered to the necessities and preferences of the home workers. This change in consumer needs helped spark the dramatic growth rate in specialty coffee sales that we saw toward the end of the 1990s. This trend, which helped to spur the growth rate of specialty coffee, has already had its largest impact given the saturation of mobile computing devices capable of accessing the Internet. (Adamy, Starbucks Turns to TV as Growth Sags, 2007)

Along with the increased quality of specialty coffee, there has been an increase in the quality of regular coffee, which is specialty coffee's largest competitor and is offered by many of Starbucks' current competitors, such as Dunkin' Donuts and McDonald's. Although both of these brands also offer specialty coffees, they also offer steeply discounted regular coffee which has been maintaining sales volume, as compared to specialty coffee sales over the last five years. This indicates that regular coffee is

beginning to meet the needs and to satisfy the tastes of the coffee consumer base. As seen in exhibit 9 the quality of coffee is the 6th most important determinant in a consumers purchasing decision.

The last factor which promises to have an enormous impact on the long run changes in the growth rate of the specialty coffee industry is the penetration of the target consumer group. As seen in exhibit 4, for the last three years the daily consumption of specialty coffee in the United States among adults has remained around 15.5%, while occasional consumption has remained around 60%. This alone does not mean that the market is completely saturated but does suggest that the specialty coffee industry is selling the vast majority of its coffee to repeat buyers and should expect this pattern to persist in the future. Because specialty coffee is not a durable good, a leveling off of industry penetration does not forecast a decrease in demand but does suggest a leveling off of demand.

All of these factors seem to suggest a future decrease in the growth rate of the specialty coffee industry. Future demographic changes will further decrease income elasticity and negatively affect the growth rate while the movement toward people working out of their homes has leveled off and will no longer add to the growth of the specialty coffee industry. The quality of substitute products will continue to increase causing the penetration of the customer group to most likely fall, though the recent trend is one of leveling off.

Target Consumer Segment

When specialty coffee was first being produced, its target consumer segment was the upper income class. This can be seen in Exhibit 8, which shows a survey Starbucks conducted during the 1990s and highlights the high education and income of its average consumer. This specific customer segment has been nearly fully penetrated. Any additional growth will most likely come from those consumers with middle or lower incomes. These two classes are historically more motivated by discount products over branded products.

Another change in consumer habits has been brought on by the accumulation of knowledge by the buyers regarding specialty coffee. As buyers have become more sophisticated and purchasing is based on better information, a natural tendency for specialty coffee to be treated more like a commodity has developed. This increased knowledge and natural tendency for commoditization will continue, unless nullified by changing the buyers experience either through new advertising appeals or increased product variations.

The specialty coffee industry is not technologically sophisticated and therefore lacks proprietary knowledge. The scarce amount of proprietary knowledge that exists within the industry has been diffused, with suppliers, distributors and customers acting as conduits between the many competitors within the industry. Due to a lack of proprietary barriers to entry in the specialty coffee industry, the maturity phase will be synonymous with eroded profitability levels if no other defendable barriers to entry are created. In addition to the wide dispersion of proprietary knowledge and industry know-how, there has been an accumulation of experience among the established firms. However, the

advantages gained by a superior experience curve are not substantial in the specialty coffee industry and will not be a maintainable barrier to entry.

In the last year there have been two extremely important entrants into the specialty coffee industry. The first is the entry of the largest restaurant chain in the world, McDonald's. The second is the entry of Dunkin' Donuts, whose announcement regarding their strategic emphasis characterized specialty coffee as being their new flagship product. The entry of these two large established firms has ushered in a new era of price discounting given the efficiency of their distribution channels. Their ability to offer more affordable specialty coffee, coupled with a remaining target consumer segment that is composed primarily of the middle to lower income individuals, will diminish future profit margins. (Adamy, Starbucks Upgrades Espresso Machines, 2007)

From these conclusions regarding the future evolution of the specialty coffee industry, we can postulate that there will not be a push toward consolidation. Consolidation and mobility barriers tend to move together. When mobility barriers are high, concentration will inevitably increase, whereas, low mobility barriers will allow new firms to replace those that are unsuccessful. The primary contributors to mobility barriers are those discussed previously regarding diffusion of proprietary knowledge and accumulation of experience, both of which constitute low mobility barriers in the specialty coffee industry. (Porter, 1998, p. 172)

Strategic Adaptation Strategies

The analysis of the evolution of the specialty coffee industry as a whole allows us to assess the possible adaptation strategies for the one that would most appropriately fit with Starbucks long term goals, while taking into consideration their current capabilities. Organizational theorists believe in both organizational inertia and view evolution as occurring within individual organizations through the process of variation, selection, and retention. (Grant, 2008, p. 275) Within Starbucks, one source of organizational inertia is the capabilities and routines developed through their established infrastructure and the set pattern of interactions among the numerous organizational members, which has developed over time.

Another form of organizational inertia present at Starbucks is the complex configuration between their strategy, structure, and systems. The fit that they have created between their numerous components would be disturbed if the idiosyncratic combinations, which have allowed them to succeed, were changed independently. Rather, any change to their overall strategy will have to encompass additional changes to their structure and their management systems, culture, employee skills and all other characteristics of the Starbucks' organization.

These forms of organizational inertia make it more difficult for an organization such as Starbucks to reformulate their strategies without considerable capital investment and the possibility of immeasurable costs in broken tradition and lost synergies. Therefore, organizational inertia can be looked at as a barrier to change, but it is not absolute and organizations have shown the ability to adapt to both changes over the generic lifecycle and to technological change.

The first thing an organization must do to adapt to a changing lifecycle is to determine where the industry is in that lifecycle. We have previously done this. From the assumptions made in this analysis, we have postulated that Starbucks and the specialty coffee industry in the United States is at the end of its growth stage and in the beginning of its mature stage. The changes that will occur during this transition are largely predictable. The buyer market will slowly become fully saturated and repeat buyers will become the primary constituents of the consumer base, with a stronger emphasis on discounting and less differentiation between brands. Product quality will continue to improve throughout the marketplace, leading to industry standardization and much slower product development. Marketing will focus more on advertising a broad product line, good service and packaging deals. Manufacturing and distribution will see some overcapacity along with lower labor skills due to an increased demand for high labor skills relative to an inelastic supply of labor. (Porter, 1998, p. 240)

Understanding these changes is the first step to establishing the capabilities necessary to formulate a proper strategy to combat the negative attributes associated with a maturing industry. These capabilities should allow a company such as Starbucks to pursue a strategy that does not seek to increase market share. The appropriate strategy should attempt to maintain an image of quality and enhance both effectiveness of existing marketing and use of new forms of marketing.

The next step is formulating a proper strategy to overcome the barriers to change present in an organization such as Starbucks, in the form of organizational inertia. This would involve developing a fundamental understanding of what the primary contributors to that inertia are. This in turn involves identifying the existing routines and capabilities,

the hierarchy structure, along with the power structure and identifying the ingrained perceptions of the business from an outsider's perspective.

Starbucks' Corporate Capabilities

Starbucks has numerous capabilities but the ones that allow them to stand apart from the other specialty coffee companies are their market leadership, superior real estate locations, and their supply chain operations. Serving the largest market share in the specialty coffee industry gives Starbucks the capability to set industry trends, which they have done in the past with drinks such as the Frappuccino. Their superior retail locations give them powerful capabilities over their competitors. They have stores that are exposed to areas with much higher foot traffic and better local demographic compositions. Also, given the high visibility associated with their premium retail locations the cost of their marketing budget is significantly reduced due to the incidental advertisements there storefronts naturally offer. However, Starbucks' strongest capabilities are in their supply chain operations.

These operations are superior to competitors in the specialty coffee industry for a few primary reasons. First, Starbucks transportation rates are the best in the industry. Both their bakery distribution model, coupled with their sophisticated forecasting process, enable them to accurately identify where coffee is needed and when. (Lee, 2007) This allows them to make appropriate and on-time deliveries. In addition, their complex manufacturing and distribution process allows them to maintain strong inventory turns as compared to competitors in the specialty coffee industry. Most important to their supply

chain operations superior capabilities is their ability to protect the integrity of their coffee beans from the detrimental effects of oxygen and time through a closed loop system of packaging. (Lee, 2007)

The synergies created through their complimentary capabilities were only enhanced by the company culture, which enabled them to eliminate redundancy and maximize their efficiency. The company culture was guided by six principles which Starbucks believed were keys to their success. These principles demanded creation of an environment that: (1) nurtured respect and dignity; (2) embraced diversity; (3) applied the highest standards to all areas of operation; (4) developed satisfied customers; (5) contributed to the community and the environment; and (6) recognized profitability as essential to success.

The hierarchy and power structure at Starbucks was administrative, with a superior to subordinate downward flow moving from top to bottom. However, at the store level there was a modular system, where every store employee was cross trained in operational aspects and allotted freedom to make many decisions at their own discretion. (Koehn, 2005) This allowed the company to economize with coordination among the largest subunits, allowing adaptability at the storefront level. This two-pronged approach was necessary to maintain the homey atmosphere within their stores, while not hindering their ability to manage their large-scale organization.

When Starbucks was first popularizing specialty coffee in the late 1980s, the perception of the industry by outsiders was of an affordable luxury, which companies could differentiate from one another using varied quality standards and a variety of store atmospheres. Today the perception of specialty coffee has changed with the entrance of

McDonald's and Dunkin' Donuts. This can be seen in exhibits 7 documenting a survey which has been done regarding what traits customers look for in their specialty coffee. There is a new emphasis on price and corporate social responsibility as well as convenience of store location.

Competitive Advantage in a Mature Industry

Now that we have established the position of the specialty coffee industry in reference to the industry lifecycle and have a fuller understanding of Starbucks' corporate capabilities, we can establish the most likely means by which Starbucks can secure a competitive advantage over their competitors. It is first important to determine how Starbucks should reorient their strategic focus, given the characteristics of a mature industry. Our discussion will then progress to an analysis of how Starbucks' strategy can be effectively incorporated into their structure and throughout their systems.

When an industry enters into the mature state there is a reduction in the number of opportunities available to established firms to develop a competitive advantage. Many times the focus is shifted away from differentiation based superiority to cost-based superiority. Thus, low cost often becomes the overall driving force of corporate profit. Low cost advantage can be achieved through increased economies of scale. In the case of Starbucks, they should improve their capabilities in their distribution network and maintain their industry lead in low transportation costs.

Starbucks, however, should not attempt to pursue cost advantage in low-cost inputs. In the specialty coffee industry, quality is determined in large part by the quality of the raw inputs, Arabica coffee beans, which are used during the brewing process. Starbucks also should not attempt to seek a cost advantage through their labor force. Undercutting these two inputs would place their brand reputation at risk, which would have a very detrimental effect on their profits.

Another cost reduction strategy that Starbucks should implement, however, was identified by Hambrick and Schecter as being successful among other mature US businesses. This strategy is called asset and cost surgery. In the case of Starbucks, this would involve a reduction in excess capacity. Primarily, this refers to the halting of national expansion and the closing of under performing stores. Additionally, the strategy could involve cutting back on their marketing and inventory budgets. (Grant, 2008, p. 323)

In mature industries, segment and customer selection becomes crucially important to maintaining a high profit margin. While the trend in the specialty coffee industry is to target the general population, Starbucks should focus on a customer segment that offers the greatest amount of price elasticity. This segment is composed of those customers most loyal to the Starbucks' brand who are also in the highest income bracket.

In order to cater to these customers, Starbucks should establish a more sophisticated database of their most loyal customer's preferences and cater to them. For example, in exhibit 10 it can be seen that in a survey taken in 2002, 34% of survey responders believed that Starbucks could make them feel more like a valued customer by implementing improvements to their service. In the same survey, 83% of Starbucks

customers rated a clean store as one of the most important traits to creating customer satisfaction.

As discussed previously, there are fewer opportunities in a mature industry to create a competitive advantage using differentiation as your strategy. However, an organization should still strive to find ways in which they can differentiate themselves from their competition. In a mature industry, the strategy of differentiation is particularly attractive because it offers insulation from the price competition inherent in a cost leadership strategy. The goal should shift away from differentiating physical attributes and towards differentiating the organizations systems and bureaucratic set up as well as their image within the industry.

To create this differentiation an organization such as Starbucks needs to focus on creating new innovative approaches to doing business or create "new game strategies." This strategic innovation can come in the form of adding new products or services that perform novel yet related functions. Specifically, the orientation in product and service development should be toward rejuvenation of the brand's image. Starbucks should also reconsider their assumptions as to what factors contribute to success in the specialty coffee industry and whether they can effectively change these factors.

Starbucks original success was fostered out of their ability to break away from the conventional wisdom that coffee could not be sold at a steep premium. By redefining the success factors in the specialty coffee retail industry Starbucks was able to prosper. If they wish to experience the same success in the future the industry's success factors must once again be addressed and questioned. For example, will customers continue to pay a steep premium for specialty coffee in order to enjoy the ambience of a store or the

exceptional customer service it offers? Have McDonald's and Dunkin' Donuts' entrance into the specialty coffee industry redefined the success factors by offering high quality coffee at substantially reduced prices?

These questions lead an organization such as Starbucks into the more important analysis of their structural setup, systems, and organization. During an industry transition out of the growth stage and into the mature stage, it becomes extremely important for Starbucks to understand what changes they must make to their structural setup, systems and organization in order to adapt successfully. This holds so much importance because attaining success in a mature industry is dependent on achieving operational efficiency while maintaining the ability to innovate and be responsive to customers.

A mature industry implies stability within the industry environment, slow technological progress, a greater emphasis on cost efficiency and a need to stay innovative. The question, then, is how an organization such as Starbucks can establish a more efficient hierarchy without limiting their ability to innovate. In the past, an organization would focus on creating a machine bureaucracy; however, this would severely limit Starbuck's ability to adapt to any abrupt industry environmental changes and their ability to innovate.

Thus, their structure, systems, and bureaucratic set up must emphasize more flexibility with higher levels of autonomy and nonhierarchical coordination. This increased flexibility can be achieved by eliminating as many positions within the hierarchy as possible; encouraging greater communication among the varied business units; and decentralizing the decision-making process. To encourage efficiency, Starbucks should implement incentives based on achievement of specified targets in the

form of financial rewards for promotion. Penalties should also be applied to those business units who fail to meet acceptable standards.

Market Signaling

As a last step, before suggesting specific actions Starbucks should take in order to adapt to their new industry environment, I will analyze the market signals that can be interpreted from some of their announcements and actions as well as those of their competitors. In general, a market signal as it pertains to this analysis is an action by a competitor which directly or indirectly signals their intentions, motives, goals or current internal environment.

Most organizations intentionally send market signals to competitors within their industry. However, some announcements can be inadvertently misinterpreted if attention is not paid to the subtle details, which is required during this second order competitor analysis. There are many different types of market signals, which reveal a competitor's true intentions. While most announcements are truthful regarding organizational intentions, others are bluffs meant to mislead an opponent into an incorrect strategic assessment of the future industry environment. (Porter, 1998, p. 76)

The first market signals that we will discuss fall into the category of prior announcements of future actions. In the context of this analysis, a prior announcement can be defined as any communication by an industry competitor conveying its intentions with regard to taking a particular action. One reason for an organization to make a prior announcement would be to stake out a commitment or effectively preempt and dissuade

any competitor from trying to initiate the same action. An organization would also make

a prior announcement of a move to make a threat, test a competitor's sentiments,

communicate pleasure or displeasure, convey a conciliatory step, and avoid costly

simultaneous moves and/or to communicate with the financial community. (Porter, 1998,

p. 77)

On January 31, 2008, Starbucks revealed the first portion of the turnaround plan

devised after Howard Schultz returned to corporate leadership. They described how they

would reduce the number of new locations planned for opening this year by 350 and

would halt sales of hot breakfast sandwiches, due to their smell interfering with the

aroma of coffee which should be infusing the stores. Schultz also revealed that Starbucks

would look more closely at how they could appeal to price conscious customers through a

strategy which he termed "segmentation." At the same time, he stated, "We're not going

to get into any price value discounting that would dilute the premium place we occupy."

(Adamy, Starbucks Slows Expansion, Seeks New Customer Segment, 2008)

This prior announcement made by Starbucks could be interpreted as a conciliatory

step made in hopes of disarming any hostility from competitors to Starbucks

"segmentation" strategy. By publicly stating that the firm would not compete on price

value discounting, Starbucks could be seen as attempting to discourage McDonald's and

Dunkin Donuts from trying to compete with them solely based on price, with hopes of

avoiding a future price war.

Another example of a prior announcement of moves made by Starbucks was

embodied in a letter from Howard Schultz intended for the partners of Starbucks. This

letter, dated January 7, 2008, explained in a broad scope the long term strategic

modifications Starbucks intended to make. Many of the things listed on the agenda

referred to the emotional attachment Starbucks had with its customers and what they

were going to do to reignite that emotional attachment. (Shultz, Text of Letter from

Schultz, 2008) This announcement was probably made with the purpose of rallying

internal support and communicating the firm's long-term commitment to modifying their

strategy in an attempt to adapt to the new industry environment.

Organizations such as Starbucks also make announcements of results or actions

after the fact. For example, Starbucks issued a statement on January 7, 2008 confirming

the return of Howard Schultz as acting CEO. This statement was issued primarily to

confirm rumors that had already been circulating and to ensure all other firms of the

CEOs return, which has potential influence on their behavior. (Wall Street Journal, 2008)

Announcements regarding results or actions after the fact can almost always be

interpreted as truthful given the SEC screening procedures and potential liability issues

involved in knowingly communicating falsified information.

Sometimes a competitor will discuss and give an explanation of their moves

hoping to convey the logic behind them or to fill the press with how costly and difficult

they were. Such announcements can serve to deter other firms from either trying the

move themselves or from trying to retaliate against them. Recently, Starbucks has been

making many announcements regarding the large amount of resources they will expend

restoring the quality of their brand, through a long-run commitment to improving all

dynamic aspects of the customer experience. When discussing strategic changes, Schultz

described the solution as having "no silver bullet fix" and requiring a "diligent long-term

approach", which again confirmed their long-term commitment. (Adamy, Schultz Takes Over to Try to Perk Up Starbucks, 2008)

Another important market signal to pay attention to is the manner in which changes are implemented. A competitor can begin by introducing their products in an insignificant peripheral market, or quite the opposite, can introduce a product immediately into the "bread and butter" market of its rival. Advertising campaigns can also be issued to directly combat a competitor's products. (Porter, 1998, p. 83) For example, when McDonald's began testing its new McCafé concept in the Kansas City area, it ran an advertisement campaign aimed at directly combating Starbucks. The ad stated that you would not get a "condescending look for mispronouncing the size of the drink at McDonald's." This can be interpreted as a direct stab at Starbucks' Italian size nomenclature, such as "Grande" and "Venti." (Adamy, McDonald's Takes on Starbucks, 2008)

Starbucks, on the other hand, has initiated its own strategic changes to their corporate structure in a progressive manner. Upon the return of Howard Schultz to the position of CEO, an announcement was made regarding a realignment of the executive ranks. Starbucks and Howard Schultz made good on the promise by reshuffling several top management positions in early January. In mid-January a couple of vice presidents were eliminated while in late February 600 administrative positions were cut. (Adamy, Starbucks Cuts 600 Positions, 2008; Adamy, Starbucks Shifts More Executives, 2008; Adamy, Two more Starbucks Executives Leave in Management Shake-up, 2008) This steady progression illustrates their commitment to their previous announcement and increases the credibility of many of their prior announcements.

When a competitor moves away from past goals, it usually signals a significant realignment in organizational strategy. Diversions from past goals usually lead to a period of intense attention to signaling in competitor analysis and many announcements made by industry rivals. Starbucks recent announcement of a trial $1 dollar refill policy for tall coffee's in their Seattle locations and the recent announcement of dropping some of their options, such as organic milk, suggests realignment towards cost efficiency, which was not present in the past. (Adamy, Starbucks Tests $1 Cup, Free Refills in Seattle, 2008)

Some market signals are in response to another competitor's move. The cross-parry is when one firm initiates a move in response to a competitor's move but does so in a different area. The move in a different area, however, still affects the initiating firm and can be interpreted as a warning. For example, when Starbucks closed 7,100 of their US locations from 5:30 p.m. to 9 p.m. one night to retrain baristas, Dunkin Donuts responded by offering their coffee for a dollar between 5:30 p.m. and 9 p.m. on the same day. This can be interpreted as a cross-parry market signal directed at Starbucks, warning them about the direct competition which Dunkin' Donuts intends to pose. (Adamy, Starbucks Closes Stores To Retrain Baristas, 2008)

Finally, an organization can use a "fighting brand" as a market signal. This signal is related to the cross-parry but threatens the competitor firm by introducing a brand that effectively punishes them for a prior move. An example of this was Starbucks introduction of the $1 test Cup, with free refills in the Seattle locations, which was previously mentioned and could be seen as a retaliatory action made in response to a similar offer made by McDonalds. This action by Starbucks can be interpreted by their

competitors as a warning to not fight Starbucks on price alone. (Adamy, Starbucks Tests $1 Cup, Free Refills in Seattle, 2008)

Summary of Analysis

This paper began by analyzing the specialty coffee industry environment, using Michael Porter's five forces model. From this initial analysis we were able to then move on to ascertain what made the specialty coffee industry particularly attractive in its formative years and why it had not been taken advantage of before the arrival of Starbucks. We found the specialty coffee industry in 1987 to be particularly attractive given the demographic composition of its consumer base, the lack of established competition and the growing trend worldwide toward specialty coffee consumption.

The specialty coffee market had not been taken advantage of prior to 1987 due to its relatively small percentage share of the total coffee market. What Starbucks saw and others did not was the high rate of growth which specialty coffee was experiencing within the realm of general coffee consumption. In other words, the specialty coffee market was growing at a significantly higher rate than the overall coffee market. Starbucks initially used an aggressive generic strategy of focus to take advantage of this small portion of the overall coffee market and eventually transitioned into a strategy of differentiation.

Their success was fostered as a result of four actions taken by Starbucks. The first factor which aided their success was their first mover advantage. Starbucks' aggressive expansion plan was more ambitious than any other specialty coffee retailer. As a result, they captured strategic locations, loyal customers and created a strong brand image before their rivals. The second action taken by Starbucks, which resulted in their

success, was their aggressive expansion plan. They used the first year to demonstrate the feasibility of their aggressive expansion plan by opening in Chicago, Illinois and Vancouver, Canada. By opening stores so far from their headquarters they had to both quickly learn how to run stores that were located thousands of miles away and in different countries and develop the infrastructure necessary to coordinate an international operation. This included having to create an efficient distribution system and hiring employees who would be able to communicate Starbucks' message and manage operations far away from headquarters.

At Starbucks, employee satisfaction also played a pivotal role in their success and was of the utmost importance to the executives at Starbucks, especially the company's leader, Howard Schultz. By creating a health care program that gave full benefits to all employees working more than 20 hours a week and creating an employee stock ownership plan, they inspired employees to new levels of performance and loyalty, which greatly aided their brand image. Finally, the last factor which added to their success was their ability to consistently produce the highest quality specialty coffee.

Having developed a solid understanding of why Starbucks has succeeded over the past 20 years, Michael Porter's five forces model was once again applied, only this time to the present specialty coffee industry environment. This analysis yielded a different conclusion regarding the five forces and their proportional impacts on industry competition and rivalry. Over time, the specialty coffee industry has become much more competitive, with increased supplier bargaining power, increased buyer bargaining power, the continued threat of new entrants, better substitute products and more industry competitors.

Understanding the specialty coffee industry environment in its formative period, why it was attractive, the strategy Starbucks used to succeed and how that industry environment has changed, we next described the specialty coffee market in terms of Michael Porter's industry lifecycle model. We concluded that the specialty coffee industry is in a transitional period from the growth stage to the maturity stage. With this information, an adaptation strategy appropriate to this transitional period was conceptualized, with reference to the corporate capabilities of Starbucks.

The adaptation strategy that seems to hold the highest potential for success is one that takes account of the decreased growth rate of the specialty coffee industry, the changing future demographic composition of the consumer base, and yet, the vast potential for international expansion. Knowing the appropriate adaptation strategy for this transitional period, an assessment of Starbucks' capabilities was made. Starbucks has numerous capabilities which separate them from the other specialty coffee retailers, including: their ideal retail locations, their superior supply chain operations and their company culture.

The last part of this analysis focused on how to develop a competitive advantage within a mature industry and, given the market signaling going on between the industry rivals, what the future seems to hold in store for the specialty coffee industry. Having thoroughly analyzed the past, present and future of the specialty coffee industry and the general strategies necessary to attain success, a list of recommendations specific to Starbucks can be ventured.

Recommendations for Future Action

Increase International Expansion

The first and most pressing action which Starbucks should take is to reduce their US expansion efforts. Continued aggressive attempts at expanding in the United States by adding as many new store locations as in the past will inevitably act to cannibalize existing locations same store sales. The fundamental reason why this is true and why Starbucks should reduce their U.S. expansion plan is the conclusion reached earlier in this analysis: that the specialty coffee industry in the United States has entered the mature stage. One of the qualities inherent to the mature stage of the industry lifecycle is overcapacity. Any significant expansion efforts in an environment where overcapacity is present will be met with failure.

By reducing their expansion efforts in the United States, Starbucks can redirect the capital saved into their international expansion efforts. The international market provides an ideal target for expansion for three important reasons. First is the lack of penetration of specialty coffee in many nations and the potential market share which these nations represent. For example, Starbucks currently operates roughly 16,000 stores with 10,000 in the United States and 6000 internationally. Yet, the United States has not ranked in the top 10 for total coffee consumption per person in the last 25 years. This suggests that internationally, there is an enormous coffee drinking population to be tapped into. (Starbucks Corporation, 2008)

Another reason that international expansion presents a particularly good opportunity is due to the likelihood that such expansion would act as a catalyst for innovation. For instance, originally, Starbucks introduced their Tazo tea brand into the Japanese market. After a successful trial run in Japan, Tazo was brought into the US market. More such innovative products should be tested first in international markets

because there, Starbucks does not put its brand reputation at as great a risk. This is true since those markets have not been exposed to Starbucks for as extended a period of time and, thus, the brand is more malleable in those markets.

Rewards Program

Recently, Howard Shultz has referred to a strategy he calls "segmentation," as being one of the initiatives he will use to reach new consumer segments. A recommendation not to pursue this strategy is supported by the analysis done in this paper. As previously stated, a couple of Starbucks' primary recent competitors are McDonalds and Dunkin' Donuts. Both of these companies have given many market signals which can be interpreted as their strong commitments to selling value specialty coffee. The strategy of "segmentation" would seem to be Starbucks' counter to both McDonalds' and Dunkin' Donuts' intentions. However, if Starbucks pursues their "segmentation" strategy they risk degrading the most significant competitive advantage they possess: their brand image. By selling a discounted specialty coffee at Starbucks' locations, the overall brand's image could be degraded and an un-winnable price war with McDonalds and Dunkin' Donuts becomes more likely.

Instead of selling discounted coffee under their "segmentation" strategy, which seems aimed at appealing to the price sensitive lower end of the market which is likely destined for McDonalds and Dunkin' Donuts, Starbucks should concentrate on creating more elaborate discounting techniques to employ with their most frequent customers. This both eliminates the potential degradation of the Starbucks' brand and increases the bond customers will experience with Starbucks. Additionally, a rewards program will

encourage customers to visit Starbucks more often and will dissuade them from visiting competitor stores, such as McDonald's and Dunkin' Donuts, which seem unlikely to offer reward programs.

Rent Out Meeting Space and Install Free Wireless Internet

Next, Starbucks should create a more business and technology friendly atmosphere in its stores. With the advent of the Internet and the ever increasing array of electronic products capable of accessing it, there has been an increasing shift in consumer's work locations from office buildings to home offices. With this shift and natural human psychological needs, Starbucks is allotted an opportunity to cater to these consumers working out of the home by providing meeting space for rent. These meeting spaces should be accompanied with the addition of free wireless Internet access throughout every Starbucks store and printers accessible to the customers, which are color capable and reasonably priced.

The meeting space should be offered at a per hour rate while the printers should charge per copy. The availability of meeting space and printers, coupled with free wireless Internet access would encourage those consumers working from their homes to engage in business activities at local Starbucks. Some of Starbucks' competitors, such as Caribou coffee, have already taken advantage of this trend in consumer preference but do not currently have the market share to use it as a defendable competitive advantage.

CD Burning

In addition to free wireless Internet access, Starbucks could equip stores with a CD burning device to allow customers to burn copies of the online albums they purchase within Starbucks at a small fee. Not only would this increase the customer's options when purchasing an online album but would also encourage customers to purchase online albums within Starbucks' locations. Thus, customers could not only get the electronic version of their selected music for their Ipods but could also have a hard copy CD for use in other devices such as the vehicles which transported them to the Starbucks store. Having this extra incentive could well increase foot traffic in Starbucks' locations. Additionally Starbucks could advertise their brand and music label on the blank CDs. The labels of the CDs could use or incorporate Starbucks logo and the interactive experience the customer will have watching their CD being burned and the label being placed onto it will give them a greater sense of ownership.

Increase Connection with Customer

One way in which Starbucks has always differentiated itself from its competition has been through the emotional connection formed with its customers. This connection is formed in significant part by creating a store atmosphere that fits the local settings and by training baristas to increase the personal connection between themselves and their customers. Specifically, Starbucks encourages feedback from their customers to induce a

family like feeling and instructs all baristas to greet every customer with the question "how are you doing today?"

To further increase this emotional connection with their customers, Starbucks could implement digital picture frames in all store locations and upload local customer photos and perhaps even customer supplied family photos, which are appropriate in nature, upon request. Digital picture frames are capable of holding thousands of pictures which would turnover regularly all day long. Such digital picture displays are not expensive. They would not require major modifications to any stores and would have an immediate impact on enhancing the family atmosphere. By allowing customers the option of uploading some of their family photos into the digital picture frames, Starbucks gives them the chance to personalize their local coffee shop and join a community. This would be a modern, classier version of that time worn icon, the local pub with countless photos of the regulars festooning the walls.

Currently, the majority of Starbucks stores have latte machines that are positioned in such a way as to block the baristas from viewing the customers and vice versa when the barista is in the act of making the latte. These latte machines pose a serious physical obstacle to the barista's ability to establish a lasting impression on the customer. To increase the barista's opportunity to form the desired connection with the customer and also to give the customer a more worthy performance of the craft, skill, romance and theater which are present while making an espresso, these latte machines should be lowered so as to give the baristas a demonstration kitchen of sorts.

Continually Improve the Coffee

Given the specialty coffee market's transition into the mature stage of the industry lifecycle, it is important to maintain a reputation for the highest quality coffee in the industry. In February of 2008 the magazine Consumer Reports rated McDonald's drip coffee as tasting better than that of Starbucks. To ensure the quality of their coffee, Starbucks should continually analyze their brewing systems and practices and consider renovations. The brewing process should at all times be judged based upon its ability to bring out the complexities and distinctive flavors of the world's different exotic specialty coffees. Starbucks should also be intent upon protecting whatever brewing process they deem to be the best through patents or acquisition of patents, which would, in turn, provide a defendable competitive advantage.

Becoming More Environmentally Friendly

Although many efforts are being made at Starbucks to enhance their image as being environmentally friendly, as is true for all modern corporations, they still have much room to improve, thus, further differentiating themselves. There is a growing positive public sentiment toward companies that make every effort at being environmentally friendly. This is particularly true among the demographic consumer base Starbucks targets. For the first 10 years of Starbucks' existence, they would ask their customers whether they wanted their coffee to go or not. If the customer chose to drink the coffee in the store, they were given a porcelain cup as opposed to a disposable paper cup. The resurrection of this practice would be a simple way to appear more environmentally friendly. Moreover, if marketed and operated correctly, such a program

could well save Starbucks money. To encourage customers to use porcelain cups,

Starbucks could offer in-house drinkers who choose to use the porcelain cups a discount.

Other examples of ways in which Starbucks could enhance both its actual green

bona fides and its image as an environmentally friendly company would include: selling

to go mugs and re-usable sleeves at affordable prices; implementing recycling bins;

seeking to compost or otherwise recycle food waste; and encouraging customers, using

financial incentives, to recharge plastic Starbucks cards as opposed to purchasing a new

one. All of these steps would enhance Starbucks' image of corporate responsibility and

would help to further differentiate Starbucks from its competition. Ultimately, just as

with the need for the company to continually analyze and improve the coffee, going

green should be a continual process. All employees should be encouraged to suggest

environmentally beneficial initiatives. Management should make constant improvement

in this area a very public company priority, which only seems appropriate for a company

with a famously green logo.

Exhibit 1

Michael Porter's Industry Life Cycle

Exhibit 2

Specialty Coffee Industry Life Cycle

Chart: "Total Revenue in Specialty Coffee Market" plotting revenue by Year (1985–2010). Data points: $810, $945, $1,070, $1,205, $1,315, $1,440, $1,535, $1,590, $1,635, $3,000, $5,670, $8,300, $8,400, $8,960, $9,620, $11,050, $12,270, $13,500.

Exhibit 3

Specialty Coffee Industry Life Cycle

Introductory Stage | Growth Stage | Maturity Stage | Decline Stage

Total Market Sales

TIME

Total Revenue in Specialty Coffee Market

Year: 1985, 1990, 1995, 2000, 2005, 2010

$810, $945, $1,070, $1,205, $1,315, $1,440, $1,636, $1,590, $1,635, $3,000, $5,670, $8,300, $8,400, $8,960, $9,620, $11,050, $12,270, $13,500

$16,000.00, $14,000.00, $12,000.00, $10,000.00, $8,000.00, $6,000.00, $4,000.00, $2,000.00, $-

Exhibit 4

Specialty Coffee Retail in the USA 2006

CONSUMPTION

Daily Consumption of Specialty Coffee Among Adults

2002	13%	of Adult Population
2003	12%	of Adult Population
2004	16%	of Adult Population
2005	15%	of Adult Population
2006	16%	of Adult Population

"Occasional" Consumption

2002	59%	of Adult Population
2003	54%	of Adult Population
2004	56%	of Adult Population
2005	60%	of Adult Population
2006	63%	of Adult Population

Source: National Coffee Association Annual Drinking Trends Study. Visit http://www.ncausa.org

DOLLAR SIZE OF MARKET

Retail Sales Estimates Year End 2006 (in billions of $)

Coffee Cafes: 15500 locations averaging	(beverage retailers with seating) $550,000 in annual sales	$ 8.53
Coffee Kiosks: 3600 locations averaging	(beverage retailers without seating) $300,000 in annual sales	$ 1.08
Coffee Carts: 2900 locations averaging	(mobile beverage retailers) $140,000 in annual sales	$ .41
Coffee Bean Roaster/Retailers: 1900 locations averaging	(roasting on premise) $925,000 in annual sales	$ 1.76
	Total Café Segment Sales	**$ 11.78**
Food, Drug & Mass Merchandiser (FDM) Specialty Bean Sales[1]		$ .49 *
	TOTAL MARKET SIZE	**$ 12.27**

2001	2002	2003	2004	2005	2006
$ 8.30 bil	$ 8.40 bil	$ 8.96 bil	$ 9.62 bill	$11.05 bill	$12.27 bil

Source: SCAA, Mintel Group   [1] excludes Wal-mart *2004 estimate

ESTIMATED NUMBER OF OPERATING UNITS

1991	1,650	1999	12,000
1992	2,250	2000	12,600
1993	2,850	2001	13,800
1994	3,600	2002	15,400
1995	5,000	2003	17,400
1996	6,700	2004	19,200
1997	8,400	2005	21,400
1998	10,000		
	Year End	2006	23,900

Sources: SCAA, Mintel Group

Important Coffeehouse Characteristics (% of adults):
Coffee quality and convenient location: 70%
Friendly and knowledgeable staff: 40%
Variety: 35%
Price: 26%

Market Segmentation by Chains & Independents:
Coffeehouses that are independent (1-3 units): 57%
Coffeehouses that are microchains (4-9 units): 3%
Coffeehouses that are chains (10+ units): 40%

Adults buying coffeehouse brands at a grocery store: 17%
Sources: SCAA, Mintel Group

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Exhibit 5

SPECIALTY COFFEE SALES
AS A PERCENTAGE OF TOTAL COFFEE SALES
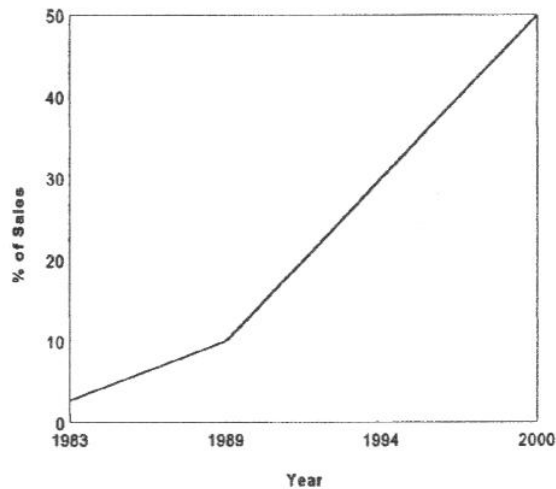
Source: Specialty Coffee Association of America, Montgomery Securities Volume 27

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 6

C.A.F.E. Practices Self-Evaluation Checklist

Product Quality – Required
- Green Preparation – Prerequisite
- Cup Quality – Prerequisite

Economic Accountability – Required
- Demonstration of Economic Transparency
- Equity of Financial Reward
- Financial Viability

Social Responsibility
Hiring Practices and Employment Policies:
- Minimum/Living Wage/Overtime Regulation*
- Freedom of Association/Collective Bargaining
- Vacation/Sick Leave Regulation
- Child Labor/Discrimination/Forced Labor*

Worker Conditions:
- Access to Housing, Water and Sanitary Facilities
- Access to Education
- Access to Medical Care
- Access to Training, Health & Safety

Coffee Growing – Environmental Leadership
Protecting Water Resources:
- Watercourse Protection
- Water Quality Protection

Protecting Soil Resources:
- Controlling Surface Erosion
- Improving Soil Quality

Conserving Biodiversity:
- Maintaining Coffee Shade Canopy and Natural Vegetation
- Protecting Wildlife
- Conservation Areas and Ecological Reserves

Environmental Management and Monitoring:
- Ecological Pests and Disease Management and Reducing Agrochemical Use
- Farm Management and Monitoring Practices

Coffee Processing – Environmental Leadership
Wet Milling
Water Conservation:
- Minimizing Water Consumption
- Reducing Wastewater Impacts

Water Management:
- Waste Management Operations/Beneficial Reuse

Energy Use:
- Energy Conservation/Impacts

Dry Milling
Waste Management:
- Waste Management Operations/Beneficial Reuse
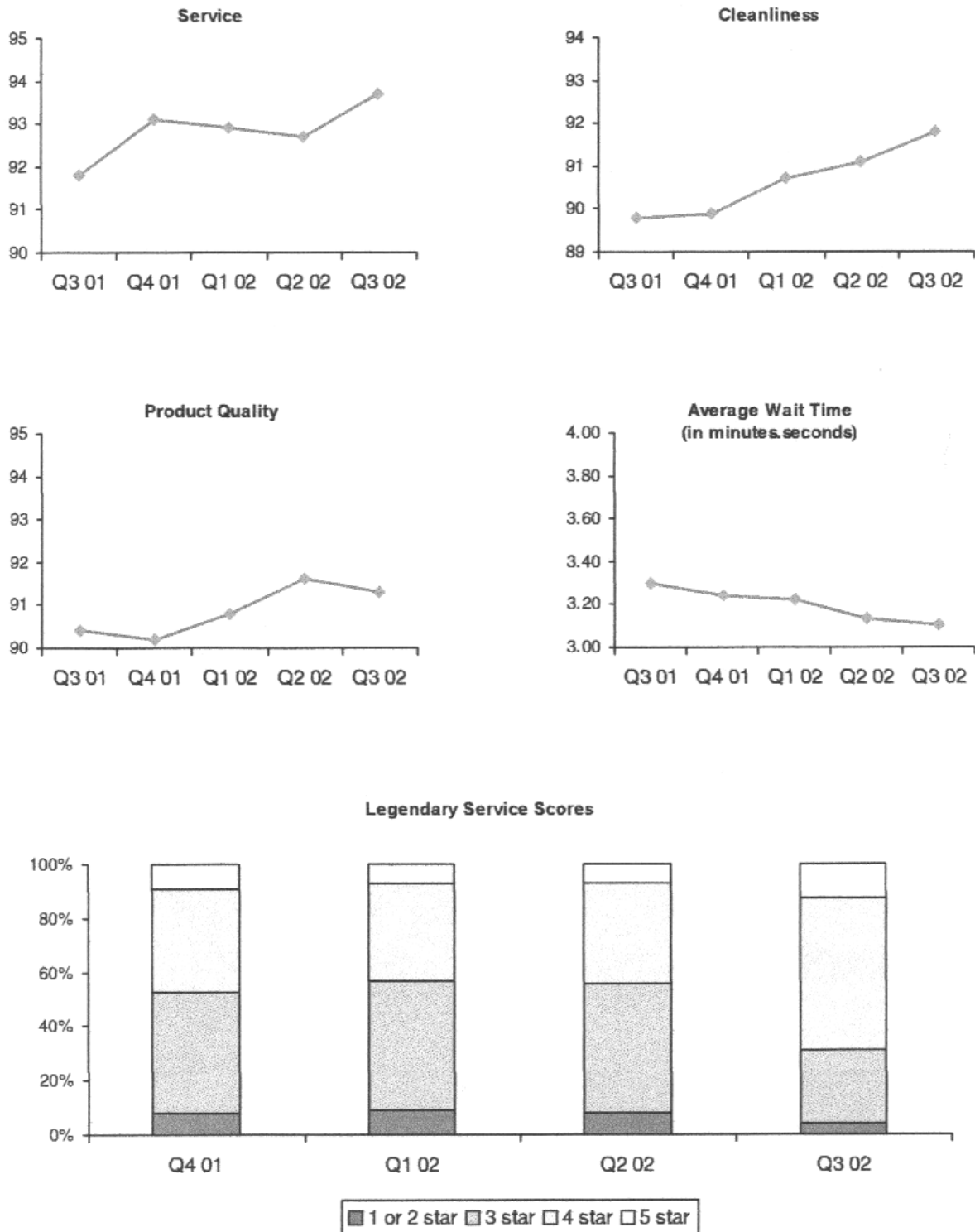
Energy Use:
- Energy Conservation/Impacts

Exhibit 7

Service

Cleanliness

Product Quality

Average Wait Time
(in minutes.seconds)

Legendary Service Scores

■ 1 or 2 star ▨ 3 star ☐ 4 star ☐ 5 star

Source: Company information.

Exhibit 8

% of Starbucks' customers who first started visiting Starbucks . . .	
In the past year	27%
1–2 years ago	20%
2–5 years ago	30%
5 or more years ago	23%

Source: Starbucks, 2002. Based on a sample of Starbucks' 2002 customer base.

	New Customers (first visited in past year)	Established Customers (first visited 5+ years ago)
Percent female	45%	49%
Average Age	36	40
Percent with College Degree +	37%	63%
Average income	$65,000	$81,000
Average # cups of coffee/week (includes at home and away from home)	15	19
Attitudes toward Starbucks:		
High-quality brand	34%	51%
Brand I trust	30%	50%
For someone like me	15%	40%
Worth paying more for	8%	32%
Known for specialty coffee	44%	60%
Known as the coffee expert	31%	45%
Best-tasting coffee	20%	31%
Highest-quality coffee	26%	41%
Overall opinion of Starbucks	**25%**	**44%**

Source: Starbucks, 2002. "Attitudes toward Starbucks" measured according to the percent of customers who agreed with the above statements.

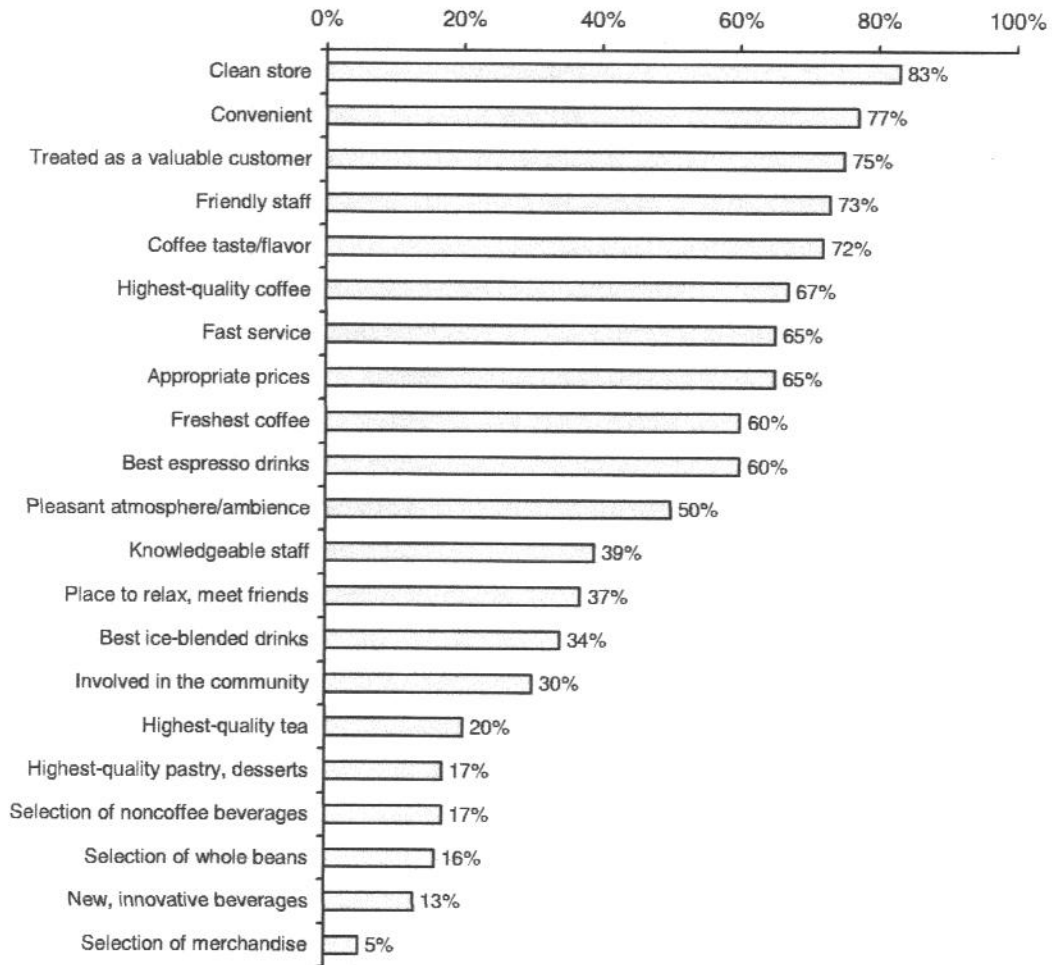**Exhibit 9** Starbucks' Customer Behavior, by Satisfaction Level

	Unsatisfied Customer	Satisfied Customer	Highly Satisfied Customer
Number of Starbucks Visits/Month	3.9	4.3	7.2
Average Ticket Size/Visit	$3.88	$4.06	$4.42
Average Customer Life (Years)	1.1	4.4	8.3

Source: Self-reported customer activity from Starbucks survey, 2002.

Exhibit 9

To be read: *83% of Starbucks' customers rate a clean store as being highly important (90+ on a 100-point scale) in creating customer satisfaction.*

Attribute	Percentage
Clean store	83%
Convenient	77%
Treated as a valuable customer	75%
Friendly staff	73%
Coffee taste/flavor	72%
Highest-quality coffee	67%
Fast service	65%
Appropriate prices	65%
Freshest coffee	60%
Best espresso drinks	60%
Pleasant atmosphere/ambience	50%
Knowledgeable staff	39%
Place to relax, meet friends	37%
Best ice-blended drinks	34%
Involved in the community	30%
Highest-quality tea	20%
Highest-quality pastry, desserts	17%
Selection of noncoffee beverages	17%
Selection of whole beans	16%
New, innovative beverages	13%
Selection of merchandise	5%

Source: Self-reported customer activity from Starbucks survey, 2002.

Exhibit 10

How could Starbucks make you feel more like a valued customer?	% Responses
Improvements to Service (total)	**34%**
Friendlier, more attentive staff	19%
Faster, more efficient service	10%
Personal treatment (remember my name, remember my order)	4%
More knowledgeable staff	4%
Better service	2%
Offer Better Prices/Incentive Programs (total)	**31%**
Free cup after x number of visits	19%
Reduce prices	11%
Offer promotions, specials	3%
Other (total)	**21%**
Better quality/Variety of products	9%
Improve atmosphere	8%
Community outreach/Charity	2%
More stores/More convenient locations	2%
Don't Know/Already Satisfied	**28%**

Source: Starbucks, 2002. Based on a survey of Starbucks' 2002 customer base, including highly satisfied, satisfied, and unsatisfied customers.

Exhibit 11

1971: The first *Starbucks*, called *Starbucks Coffee, Tea, and Spice* is opened across from Pike Place Market in Seattle, Washington. The three founders - English teacher Jerry Baldwin, history teacher Zev Siegel, and writer Gordon Bowker, derived the store's name from a *Moby Dick* character, Starbuck. The first stores do not sell beverages. They sell retail coffee beans.

1972: A second Starbucks store is opened in Seattle.

Early 1980s: Zev Siegel leaves the company. Jerry Baldwin takes over management of the company and functions as CEO. Gordon Bowker remains involved as a co-owner but other projects take up most of his time, including the launch of his new microbrewery, *The Redhook Ale Brewery.*

Sept. 1982: Howard Schultz joins the company, taking charge of marketing and overseeing the retail stores.

1984: Starbucks acquires the five stores in San Francisco's *Peet's Coffee and Tea* chain. During this period, Schultz makes several attempts to convince the original owners to start selling coffee beverages but they prefer to keep the focus on retail coffee products.

April 1984: Starbucks opens its fifth store, the first one in downtown Seattle. Schultz finally convinces the owners to test an espresso bar, making this Starbucks the first to sell coffee beverages. It becomes a huge success.

Late 1984: The Starbucks founders are still resistant to installing espresso bars into other Starbucks locations and Schultz becomes increasingly frustrated. He has visited the espresso bars of Milan, Italy and has a vision of bringing Italian-style espresso bars to America.

Late 1985: Schultz leaves Starbucks and starts the *Il Giornale Coffee Company.*

Jan. 1986: Schultz raises enough seed money to open several Il Giornale coffee houses. Starbucks founders Baldwin and Bowker support his new endeavor and invest money in the new company.

April 1986: The first *Il Giornale* store opens.

March 1987: Baldwin and Bowker decide to sell the Starbucks Coffee Company, with Baldwin keeping the Peet's segment of the company.

Aug. 1987: Schultz acquires Starbucks and rebrands all of his Il Giornale coffee houses with the Starbucks name.

1987: Starbucks opens locations in Vancouver, British Columbia and Chicago, Illinois.

1992: Starbucks goes public with its initial public stock offering. At this time it has 165 outlets.

1996: The first Starbucks opens outside of North America in Tokyo, Japan.

Sept. 1997: Starbucks Chairman Howard Schultz publishes a book called *Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time*.

2000: Starbucks sues San Francisco cartoonist Kieron Dwyer for copyright and trademark infringement after she creates a parody of the company's trademark mermaid logo. The case is eventually settled.

April 2003: Starbucks purchases Seattle's Best Coffee and Torrefazione Italia from AFC Enterprises and turns them all into Starbucks outlets.

May 2003: By this time, Starbucks has more than 6,400 outlets worldwide.

May 17, 2004: Starbucks baristas at the 36th and Madison store in Manhattan organize the first Starbucks barista union. They claim that the starting wage of $7.75 per hour is not a living wage in New York City and that the company does not guarantee a minimum number of hours.

July 22, 2004: The Retail Workers' Union IU/660 files an unfair labor practice suit against Starbucks, alleging the company threatened wage cuts and bribed employees in order to influence the results of the barista's union vote.

Oct. 4, 2004: XM Satellite Radio and Starbucks Coffee Company announce the debut of the Starbucks "Hear Music" channel on XM Radio. The station will feature 24 hour music programming featuring an "ever-changing mix of the best new music and essential recordings from all kinds of genres."

Aug. 2005: After Starbucks prints a quote from Armistead Maupin on its cups as part of their "The Way I See It" promotion, the conservative Christian group Concerned Women for America protests. The quote reads: "My only regret about being gay is that I repressed it for so long. I surrendered my youth to the people I feared when I could have been out there loving someone. Don't make that mistake yourself. Life's too damn short."

Sept. 8, 2005: Starbucks announces plans to donate funds and supplies to the Hurricane Katrina relief effort. Plans include monetary donations over $5 million as well as donations of coffee, water, and tea products.

Oct. 21, 2005: ABC's 20/20 airs the results of an investigation into coffee outlets serving regular coffee when decaf is ordered. One Starbucks outlet is found to be serving decaf loaded with caffeine. A Starbucks spokeswoman says: "in two samples taken by 20/20, the caffeine content was consistent with regular, not decaffeinated, coffee...We believe this error to be an isolated incident and an unfortunate occurrence that we take seriously. We have sent information to our stores to re-emphasize our operating procedures."

Source:
http://www.twoop.com/food_drink/archives/2005/10/starbucks_coffee_company.html

Exhibit 13

Starbucks Sourcing Guidelines

Quality Criteria: Prerequisite
Every coffee offered must meet Starbucks quality standards in order to be considered for purchase. High quality is an integral component of sustainability at all levels of the coffee supply chain.
Qualifying varieties Only arabica varieties of coffee will be purchased.
Flavor characteristics Starbucks cup quality standards are based on specific descriptions for each coffee purchased. Every coffee is expected to represent the flavor character unique to the country or region of origin. All coffees are expected to provide a perfectly clean cup with medium to heavy body, and excellent aroma. All washed coffees must be of Good Hardbean or better density and have good acidity.
Defect-free beans Starbucks requires zero defects in grade, good even color, and consistent bean size.

Environmental Impacts: 50 points
Coffee growing and processing systems should contribute to conservation of soil, water and biological diversity; employ efficient and renewable energy technologies; minimize or eliminate agrochemical inputs; and manage waste materials consistent with the principles of reduction, reuse and recycling.
Soil management Farm management practices should effectively control erosion and enhance soil structure and fertility, relying as much as possible on means such as organic fertilizers, cover crops, mulch and compost.
5 points
Water reduction Coffee should be processed using methods that reduce water consumption.
5 points
Clean water Coffee should be processed using methods that prevent pollution of surface water and ground water.
5 points
Water buffer zone Vegetative buffer zones should be in place adjacent to all water sources. No alteration should be made to the courses or hydrology of streams or other surface water bodies.
5 points
Forest and
biodiversity
conservation
Coffee production systems should maintain and enhance biological diversity on farms and surrounding areas without disturbance of natural forests.
5 points
Use of shade Existing coffee farms in forest regions should maintain or enhance shade canopy cover with diverse tree species that conserve local and endemic biodiversity.
5 points
Starbucks and Conservation International 303-055
25
Energy use Coffee growing, processing and drying should use energy

efficiently, employ renewable sources wherever possible, and
not rely on firewood obtained from forest clearing. For
example, patio drying should be used as much as practical and
solar coffee drying technology employed where feasible.
5 points
Pest management Integrated pest management systems are employed, limiting
pesticide application to extreme cases when necessary to avert
severe crop loss and substantial economic failure.
5 points
Accepted
agrochemical
Coffee production systems should minimize and wherever
possible eliminate inputs of agrochemicals such as chemical
pesticides and synthetic fertilizers.
5 points
Farms are certified organic, use organic management
techniques or are otherwise demonstrating significant
reductions in the quantity of synthetic agrochemicals being
applied.
No agrochemicals that are banned for agricultural use in their
country of use, country of origin or by international agreement
are stored or used on the farm.
Waste management Waste and coffee by-products are managed to minimize
environmental impacts by applying the principles of reduction,
reuse and recycling, for example, composing or recycling of
coffee pulp and parchment.
5 points

Social Conditions: 30 points
*Coffee production systems should ensure protection from workplace hazards and conform to local laws, as
well as to applicable international conventions related to employee wages and benefits, occupational
health
and safety, and labor and human rights.*
Wages and benefits Coffee farms that employ workers should conform to local laws
and applicable international conventions related to workers'
rights and benefits and are in a process of continual
improvement over time. Wages and benefits should meet or
exceed the minimum required under local and national laws.
Workers' rights to organize and negotiate freely with their
employers are guaranteed in accordance with local laws and
international obligations.
10 points
Health and safety Working conditions should meet or exceed applicable laws and
regulations related to health and safety of workers. Effective
measures should be taken to ensure the health and safety of
farm workers who may handle or be exposed to agrochemicals.
10 points

303-055 Starbucks and Conservation International
26
Living conditions Workers and their families, including seasonal workers, are
provided with access to potable water, sanitary facilities,
adequate housing, education and training, transportation,
and health services.
10 points

Economic Issues: 30 points
*Coffee production systems and commercialization should benefit rural communities by boosting producer
incomes, expanding employment and educational opportunities, and enhancing local infrastructure and*

public services. In order for coffee production to be sustainable, it must be economically viable at all levels of
the supply chain, from seed to cup.
Long-term
relationships
Starbucks seeks to develop long-term trading relationships
with preferred suppliers.
Incentives Through its purchasing and pricing policies, Starbucks seeks to
provide incentives and support for sustainable coffee
production, processing and shipping methods.
Economic
transparency
In order to ensure that the entire supply chain—farmer, miller,
exporter, and importer—benefits from the Starbucks preferred
supplier program, and importers benefit from the Starbucks
preferred supplier program, vendors are expected to provide
reliable documentation regarding prices paid to their suppliers.
20 points
Source: Starbucks.

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