

BA (HONS) Business Management

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INTRODUCTION

Managerial economics is a tool used to analyze the economic condition in order to make the best business decisions, ensuring the efficient utilization of resources (Keat, 2014).

ABOUT Starbucks



Figure 1: Starbucks London Location (Source: STARBUCKS, ND)

Founded in 1971 in the USA - Seattle, under the name 'Starbucks Coffee, Tea and Spice,' Starbucks grows to become the largest coffeehouse chain in the world. In the United Kingdom, there are over 1200 locations open.

Starbucks' mission is to inspire, both through the taste of coffee and the way it is served, through its extensive offerings and high quality.

Why Starbucks?

Starbucks inspires through its managerial techniques, marketing strategies, and the wise decisions it made from the very beginning, enabling it to grow and become an international leader and the epitome of modern coffee culture.

Factors that may affects demands

In this essay, I will analyze market demand and equilibrium through the factors that influence them.

Price of substitutes

If the price of a Caffè Latte increases at Starbucks, people might shift to cheaper alternatives, such as Costa or Nero, as the same offered coffee costs less.

The price of a Caffè Latte at Starbucks in the UK ranges from £2.50 to £3.50 depending on the area, and sales volume is increasing by 37%, with Starbucks recovering from the Covid-19 pandemic period, according to the official Starbucks page. Thus, if the price has remained constant but the quantity has increased, it implies an increase in demand.

As depicted in Figure 1, it can be observed that the market demand curve shifts outward, leading to an increase in the equilibrium price, indicating an increase in market supply.

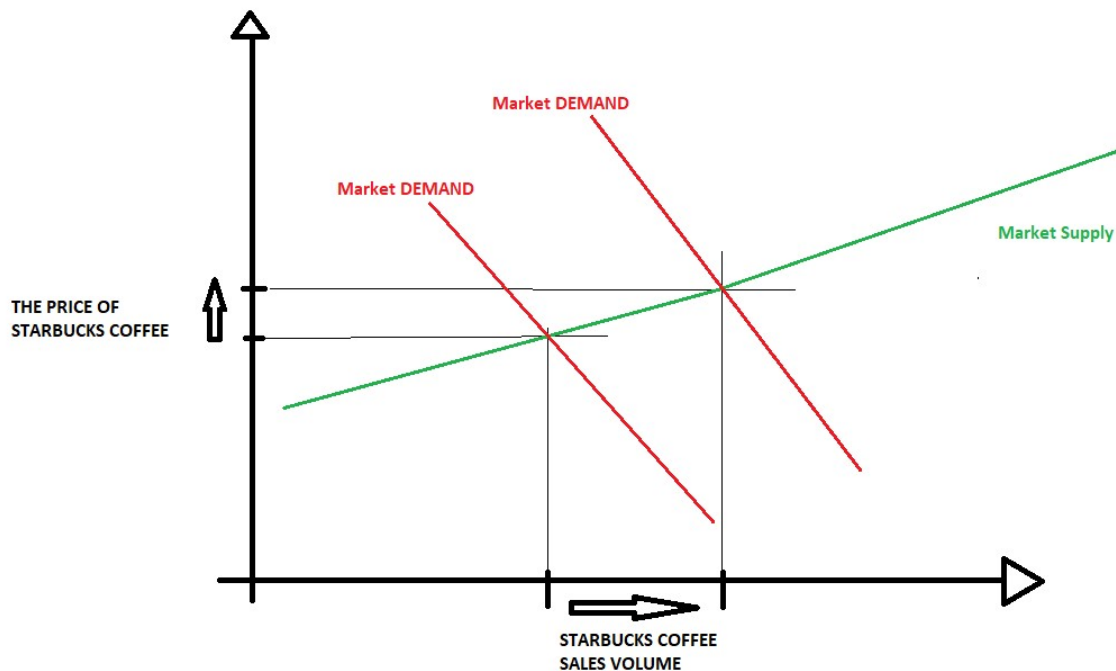


Figure 2: Increasing Demand (Source: Self Report,2023)

PRICE ELASTICITY OF DEMAND DUE TO SUBSTITUTE PRICING

Although a Caffè Latte at Starbucks might be more expensive compared to substitutes, the price elasticity of demand could potentially be low, as Starbucks might be conveniently located for the customer compared to another café offering Caffè Latte at a lower price. Thus, the travel time to purchase a cheaper Caffè Latte is more costly. The time cost for a cheaper Caffè Latte at, for example, Costa can be considered a weak substitute. Typically, we need coffee in the morning, when we are in a hurry to have a coffee, near home, on the way to work, or close to the workplace. Therefore, a cheaper coffee that requires more effort to obtain doesn't significantly alter the elasticity of demand.

Price of complements

Demand for Caffè Latte at Starbucks will depend on the price of coffee beans and the transportation of coffee beans. The higher the price of coffee beans, the more the coffee price will increase, meaning that more people will opt to forgo purchasing coffee from Starbucks and choose to make their coffee at home, thereby paying only the cost of the beans.

PRICE ELASTICITY OF DEMAND DUE TO PRICE OF COMPLEMENTS

As Sloman and John explain, 'Cross-price elasticity of demand measures the responsiveness of demand for one good to a change in the price of another. For substitute goods, the value will be positive; for complements, it will be negative. The cross-price elasticity will be greater the closer the two goods are as substitutes or complements.' (Economics for Business, 2019, p.83).

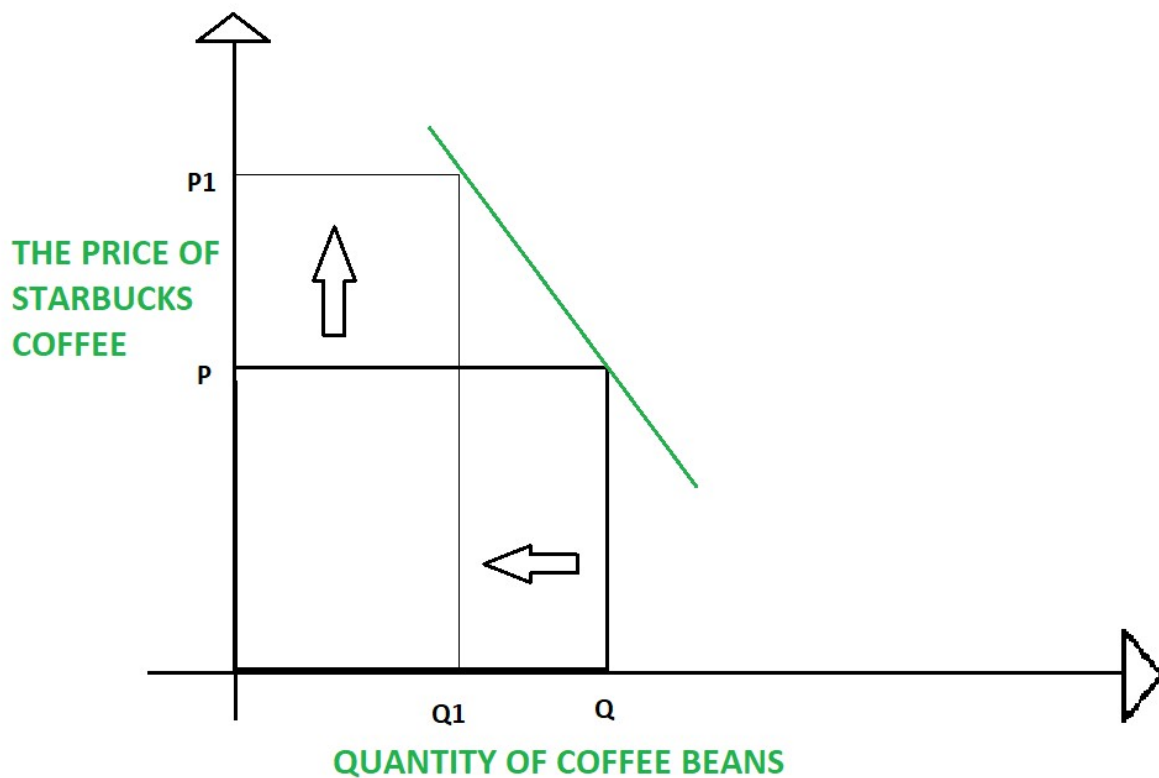


Figure 3: Complementary Goods (Source: Self Report,2023)

Starbucks sources from 2022 indicate that due to the increase in energy costs and droughts in certain parts of South America, the price of coffee beans has risen. As a result, coffee prices have increased by approximately 3.5%, with no signs of decline (Alex, 2022).

Consumer Income

Starbucks customers are described as having high incomes, which is why large cities and affluent neighborhoods undoubtedly have Starbucks locations. However, there are also Starbucks locations in areas with average incomes. Starbucks maintains a moderate price, not overly expensive but not overly cheap, appealing to high-income customers while ensuring that customers with average incomes also feel comfortable.

The increase in consumers' incomes results in the fact that a higher price will not negatively impact them. With an elevated income, the quantity demanded will increase, consequently elevating the demand and reaching a higher equilibrium point. The income effect signifies a change in purchasing power and quantity demanded.

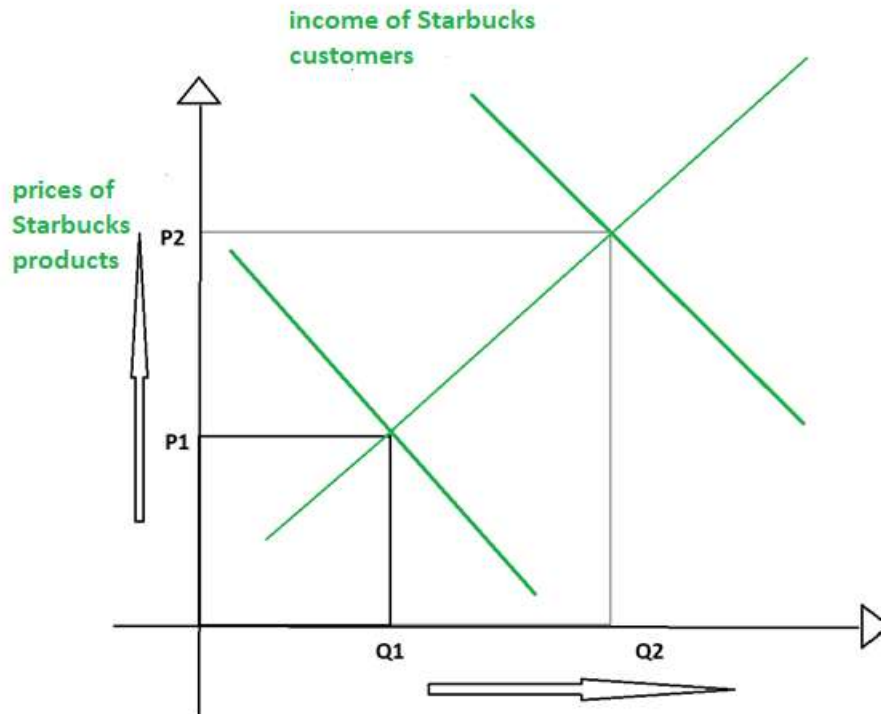


Figure 4: Consumer Income (Source: Self Report,2023)

Consumer tastes & preferences

Starbucks is renowned for the variety of products offered and the flavors it introduces. Starbucks customers are served with various coffee combinations, depending on the season.

Successful businesses, like Starbucks, understand how to predict the strength of demand and are adaptable to changing customer preferences. Starbucks knows how to modify product prices without alienating its customers, emphasizing the quality of the coffee offered. It is also attentive to changes in competitors' prices as well as changes in consumer incomes. As Sloman (2014) states, 'it will want to know the price, cross-price, and income elasticities of demand for its product.' (Essential Economics for Business, 2019, p. 55). Starbucks knows its market, conducts frequent customer surveys, enabling them to satisfy demand and choose what is most suitable for their customers.

Consumer expectations of price

Starbucks customers have an expectation that Starbucks prices will increase, yet this is a factor that could impact demand. There might be a possibility that Starbucks customers delay

purchasing Starbucks coffee or replace it with a cheaper alternative. However, this is NOT the case. Starbucks customers will not be affected by price increases because an increase in coffee price is a standard of the quality of Starbucks products and services. Consumer expectations have an impact on demand; in the case of Starbucks, demand remains unchanged even if the price increases. Both current and future expectations influence demand. Baye (2016) say “This type of consumer behavior often is referred to as stockpiling and generally occurs when products are durable in nature. We often see this behavior for less expensive durables, too; consumers may stockpile laundry detergent in response to temporary sales at grocery stores. The current demand for a perishable product such as bananas generally is not affected by expectations of higher future prices.”(Managerial Economics and Business Strategy,2016,p.36).

Demographics

Despite expectations, when you think of Starbucks, you may believe it is associated with urban areas; however, Starbucks is not always situated in cities but also in outskirts and suburbs. The reason Starbucks has been positioned in the suburbs is to cater to busy individuals who spend a significant amount of time in their cars, moving from one place to another. Furthermore, Starbucks is now also present in malls.

Starbucks, an American creation, entered the United Kingdom in 1998 and currently boasts 1214 locations. The number of customers is significant and influences demand, yet Starbucks does not cater to everyone, although it may seem so; it carefully selects its customers. Hence, the intriguing names of the coffee blends and unique style. In other words, for Starbucks, demographics matter, but location matters more. For Starbucks, emerging markets and markets with high purchasing power are crucial. This is why Starbucks does not target the continental African market for entry; it dominates in the USA, Europe, parts of Asia, and Australia. (starbucks.uk,2023)

Price Elasticity of Demand

Marks (2014) say: “Four important factors determine whether the demand for a good is price elastic or price inelastic: (1) the degree to which the good is a necessity; (2) the availability of substitutes; (3) the proportion of income a consumer spends on the good; and (4) the time available for adjustment.” (Managerial Economics,2014,p.68)

Substitution Effects. Luxury vs. Necessity

An increase in price can affect quantity and elasticity. A price increase that positively affects quantity implies that customers can afford a luxury, whereas customers who are deterred from purchasing due to the higher price suggest that the product can be easily replaced and is deemed inferior.

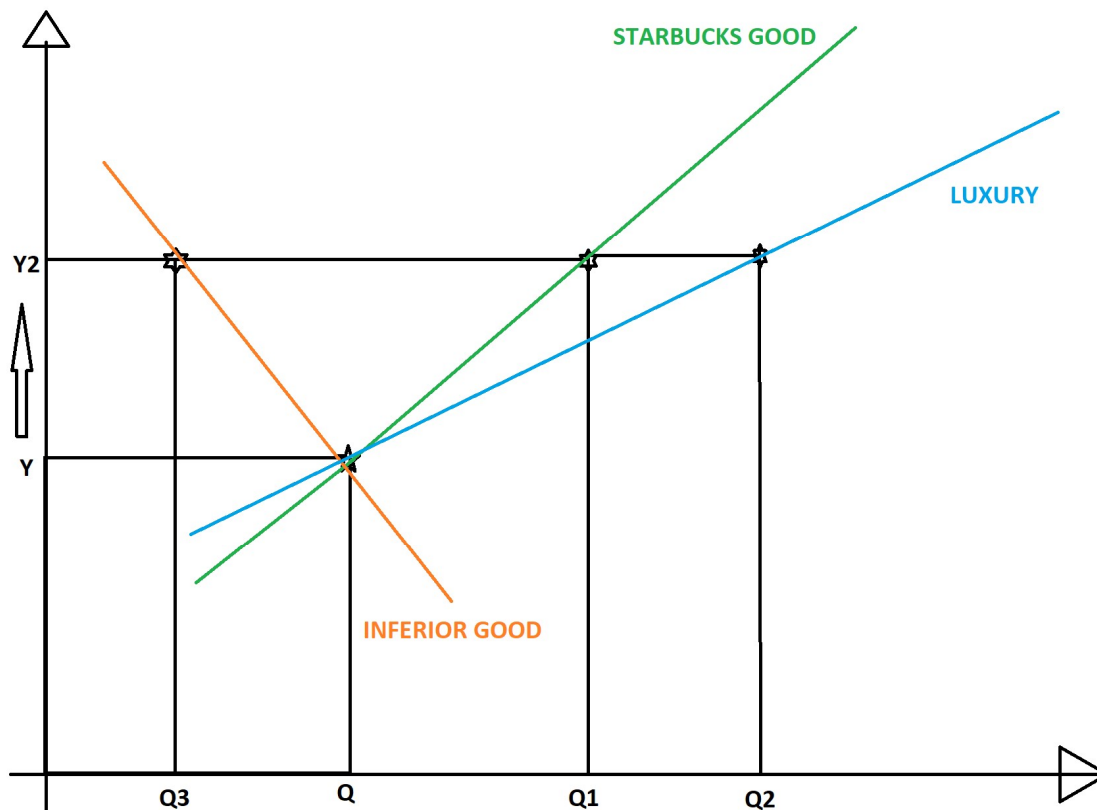


Figure 5: Substitution Effects (Source: Self Report,2023)

As evident from Figure 3, Starbucks falls under the category of a 'normal good,' as despite the price increase, the quantity demanded also increases proportionally.

While there are consumers who perceive Starbucks as a luxury, in reality, Starbucks knows the extent to which it can raise prices without adversely affecting buyer demand, and even enhancing it. The Starbucks image does not cast doubt on quality, and price does not influence buyers.

Income effects

Elasticity is applicable to any variable that affects sales. Income elasticity combines the percentage change in income while keeping other factors constant (Marks, 2014). Sales are influenced by economic growth and buyers' income increase, which in turn leads to an upsurge in spending on goods and services. "Income elasticity thus provides an important measure of the sensitivity of sales for a given product to swings in the economy." (Managerial Economics, 2014, p. 69)

Starbucks customers daily allocate a portion of their salary towards coffee and breakfast. Potential buyers with lower incomes residing in rural areas might find the cost of a Starbucks coffee to be quite expensive. Demand becomes flexible when consumers are open to spending on their preferred brand's products and services. In essence, Starbucks customers are somewhat sensitive to price fluctuations. Buyers with moderate to high incomes are price-sensitive and seek more affordable alternatives, such as local cafes or home coffee machines. This factor could indicate that demand can be elastic if the offer is not properly communicated to the public. Individuals with higher incomes are not as affected as those with lower incomes; only specific consumers can withstand price and income fluctuations, upon which demand elasticity depends—an important factor. Buyers might adapt to price changes without entirely altering their habits, thus income can impact elasticity.

Demand for Starbucks products can be less elastic when perceived as a luxury rather than a necessity. Those who view Starbucks coffees as a luxury are willing to spend more due to the brand's reputation.

Demand elasticity for Starbucks products increases when considering buyers' incomes and their willingness to pay for Starbucks coffees.

Various factors can affect the elasticity of price demand. Income can make demand more elastic or inelastic, while the perception of luxury may indicate inelastic demand..

Pricing policy and Future recommendations.

Starbucks targets customers with high and medium incomes, which is why a price increase cannot negatively impact demand. However, if Starbucks were to adopt a substantial price hike, it could offend consumers and loyal customers. Starbucks needs to have differential pricing based on continents, countries, and cities.

To avoid affecting demand and losing customers, Starbucks must implement mild price increases that reflect the price of quality and the range of products in its portfolio.

Starbucks was affected during the pandemic, adapting its operations according to the period's conditions, and subsequently managed to recover and regain its strength. Nonetheless, many Starbucks locations were closed during the pandemic; however, the company successfully

implemented suitable measures to evolve, promoting online sales and making appropriate menu adjustments. Moreover, prices also underwent slight changes due to new costs, such as delivery expenses. Even under stressful conditions, customers continued to consume their morning beverage – coffee, and demand became elastic.

My recommendations for Starbucks, based on the analysis conducted, depend on market dynamics.

I believe market resegmentation would be beneficial, along with price adjustments that won't negatively impact demand but rather attract new customers. Starbucks could introduce days when Caffè Latte is offered at half-price, specifically on Mondays when customers return to work tired and slow after the weekend.

Implementing dynamic pricing could be an intelligent pricing strategy to attract more Starbucks customers. Prices should vary according to periods, seasons, holidays, or based on market demand at that time.

Competition is a significant factor, and Starbucks should consider competitors' prices to avoid losing customers due to lower prices elsewhere.

Starbucks should focus on offering the correct price in exchange for the quality of Starbucks coffee and impeccable services, both online and in Starbucks locations.

The menu could be more stratified and organized for better visibility. Customers should know what they are purchasing.

These are some of the recommendations I have in order for demand and demand elasticity for Starbucks to be managed effectively.

CONCLUSION

Starbucks is a successful business, a leader in ground coffee, and offers a variety of coffee options. The company stays attuned to consumer demands and trends. Demand can be easily influenced by substitutes, complements, income, preferences, and customer expectations. Demand is also shaped by its elasticity.

Customer satisfaction is maintained through Starbucks' adaptability to all factors influencing demand.

Starbucks employs policies and strategies to retain its existing customers while continually attracting new ones. The popularity of Starbucks flourishes due to its adept marketing strategies and its ability to play with prices in ways that align with the comfort of its target audience (individuals with moderate to high incomes).

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