

MarketLine Case Study

Costa Coffee

UK's largest branded coffee shop chain

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OVERVIEW

Catalyst

The UK coffee shop market continues to expand rapidly. Costa Coffee is by far the largest branded chain in the market, and an important revenue stream for parent company Whitbread. This Case Study uses Porter's Five Forces and Ansoff matrix analyses to examine the competitive pressures faced by Costa, and possible strategies for expansion.

Summary

- The UK branded coffee shop market has been growing strongly for many years
- Costa is the largest such chain in the UK by store count, ahead of Starbucks and Caffè Nero
- The lack of switching costs for consumers strengthens the buyer power, threat of new entrants, and level of rivalry in the market
- Costa relies on its proprietary coffee blend as the basis of its brand
- Since 1999, the company has expanded into new geographical markets, but remained focused on coffee shops as its core competency rather than reaching into radically different product categories

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COSTA IS THE LARGEST BRANDED COFFEE SHOP CHAIN IN THE UK

Costa has expanded its chain in the UK's strongly-growing coffee shop market over several years.

The UK coffee shop market is growing strongly

Coffee shops form an increasingly important sector of the UK foodservice market. Players include companies like Costa and Starbucks, which have a strong focus on coffee, and also companies like EAT and Pret a Manger for which coffee is an adjunct to a more substantial food range. Another way to segment the market is between branded chains like the foregoing, independents, and other outlets such as department store cafes.

News sources and company reports frequently quote results from Allegra indicating that the total coffee shop market in the UK had revenues of £5.8 bn in 2012, and a total of 16,000 outlets. The branded coffee-oriented chain segment in which Costa competes comprised 3,700 outlets in 2012, compared to 2,300 in 2007, an annualized rate of expansion of just under 10%. Revenue data for coffee-oriented chains is unavailable, but when both food- and coffee-oriented branded chains are considered, the 2007-2012 period saw a rise from £1.3bn to £2.3 bn, an annualized growth rate of 18%. Considering that this period included one of the country's most prolonged economic slowdowns for decades, it is clear that the market is highly buoyant.

Table 1: The UK coffee shop market, 2007 and 2012

	2007	2012	CAGR
Outlets, all coffee shops	n/a	16,000	
Outlets, branded coffee-oriented chains	2,300	3,700	9.9%
Revenue, branded coffee- and food-oriented chains	£1.3bn	£2.3bn	18%

SOURCE: WHITBREAD ANNUAL REPORTS, NEWS ITEMS

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Costa is currently the market leader

Costa is a familiar presence on the high street of many UK towns. Established in 1971 by the Costa brothers in London, it initially sold its proprietary roast coffee blend to coffee shops in the city. It continues to roast its own coffee, but in 1978 the company opened its first coffee shop. Expansion led to it becoming the UK's largest branded coffee shop chain in terms of location count. Its leading competitors, Starbucks and Caffè Nero, are considerably smaller in the UK.

Table 2: Leading UK coffee shop chain sizes, FY2012

Company	Number of UK outlets
Costa	1,392
Starbucks	717
Caffè Nero	528

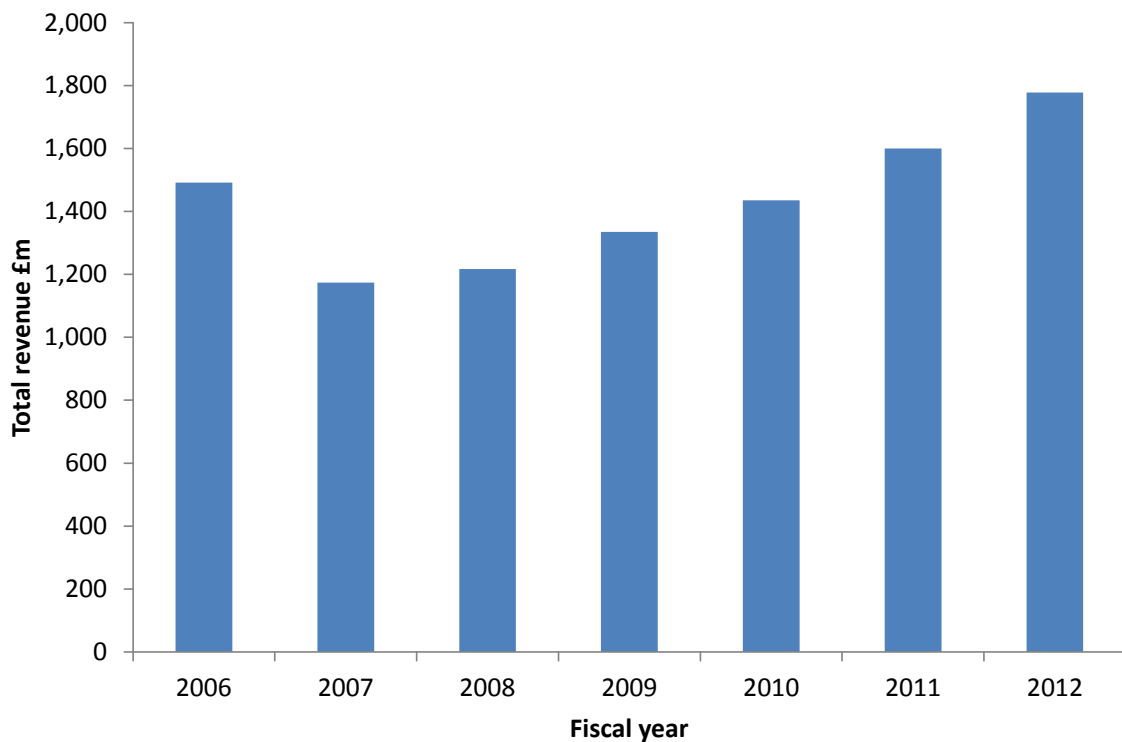
SOURCE: WHITBREAD ANNUAL REPORTS, NEWS ITEMS

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In 1995, Costa was acquired by Whitbread. At the time Whitbread had a large portfolio of restaurant and casual dining chains, hotels, pubs and bars. By 2012, it had divested several of these. Costa remained one of its key businesses. Its expansion was continuous, with a move into the international market inaugurated in 1999. More recently it has begun to offer its coffee via vending machines, and as instant and ground coffee sold in supermarkets.

Costa is increasingly important to Whitbread's revenue, accounting for 30% of the total in FY2012, and also contributing 18% of the parent company's total operating profit.

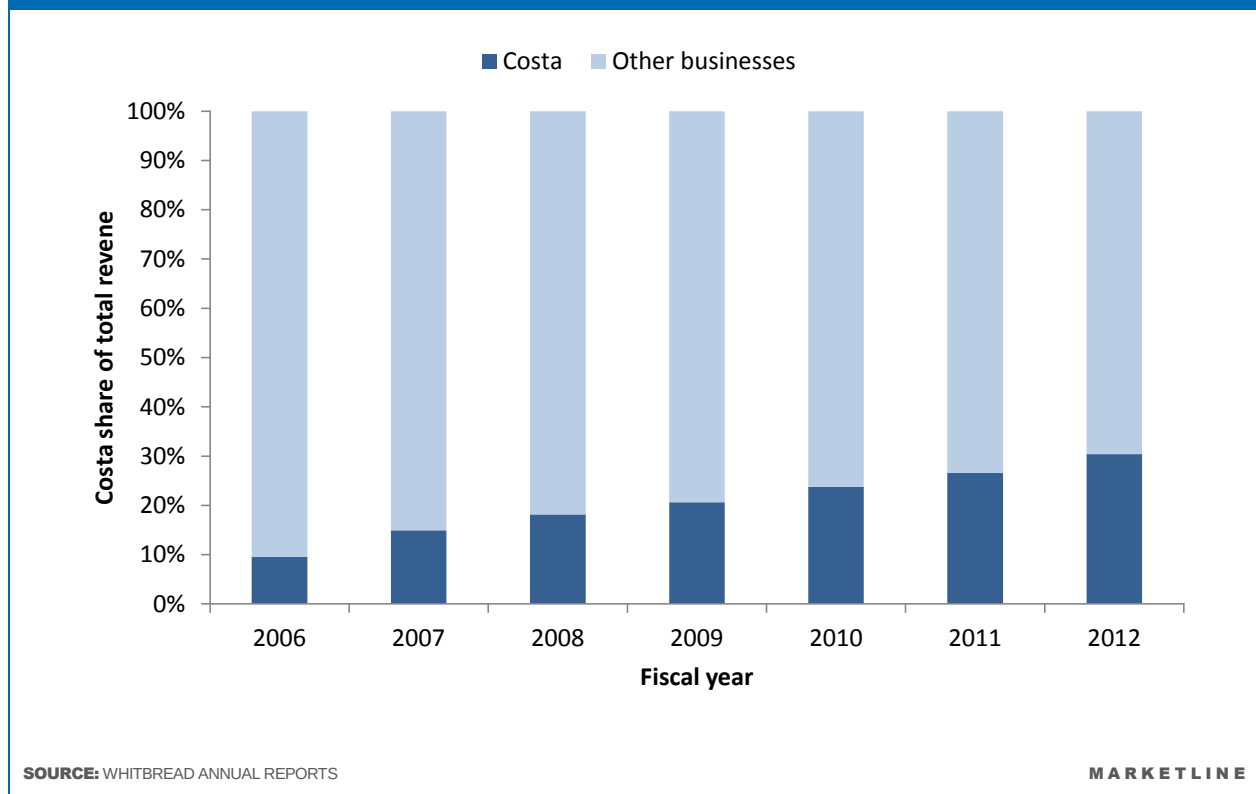
Figure 1: Whitbread plc revenue, £m, FY2006-2012



SOURCE: WHITBREAD ANNUAL REPORTS

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Figure 2: Costa's contribution to Whitbread total revenues, %, FY2006-2012



Please note that Whitbread/Costa financial year ends in March. In this Case Study, references to 'FY2012' refer to the 12 months ending March 31 2012.

FIVE FORCES ANALYSIS OF THE MARKET

Harvard Business School economist Michael Porter developed his Five Forces framework as a way of analyzing the level of competition in a market. A simple way to understand their significance is to realize that the stronger the forces, the more difficult it is for a market player to remain profitable.

How competitive is the UK coffee shop market?

The following analysis shows that the competitiveness of the UK coffee shop market is moderate to strong.

Customers can get what they want from several different companies, who might have shops only a few meters apart on the high street, and operate with minimal regulation by government. New companies can enter easily, new shops can be opened and underperforming ones closed without much difficulty.

These factors mean that the market is relatively free of distortions. In this situation, strategic options available include price competition, brand identity, and product/service quality. Costa and its leading competitors have tended to focus on the last two.

The market is expanding rapidly at the moment, which makes revenue growth easier. But the branded coffee shop is a relatively new concept in the UK. Successful players, such as Costa, will need to plan for a future when the market has reached maturity.

Buyer power

Buyer power refers to the ability of a company's customers to constrain its prices. Several factors influence buyer power, and some of the most important in the coffee shop market are considered below.

Costa's buyers include millions of individuals, plus thousands of businesses

Individual consumers are the principal buyers in the coffee shop market. In 2010, Costa reported sales of 211.4 million cups of coffee in its 1,600 global outlet network. This means that each coffee shop has on average 360 customers a day. If any individual customer chooses not to go to a Costa outlet, the impact on revenue is not great.

However, Costa also has B2B operations. Its Costa Express vending machines allow clients such as leading food retailer Tesco to offer Costa coffee to their own customers. There are currently 900 UK-based Costa Express clients. Approximately 4,000 UK wholesalers are currently purchasing 'Proud to Serve Costa' branded coffee, alongside espresso machines and marketing resources, which they can offer to their foodservice customers. Although the loss of a business customer would be more significant to Costa than the loss of a B2C customer, it is clearly not operating in an oligopsony ('few buyers') market. This tends to weaken buyer power.

Figure 3: Costa's logo for foodservice companies offering its coffee



Inherent switching costs for coffee shop customers are low, but raised by loyalty schemes

When a customer doing business with a company decides to switch to doing business with a competitor, switching costs may be incurred. These are separate from the cost of the goods and services themselves. For example, if an airline decides to stop buying Boeing 747s and use Airbus A380s instead, it may incur costs in training its pilots on the new planes. In the coffee shop market, switching costs for consumers are effectively zero. This strengthens their buyer power: a customer who has visited Costa on Monday does not incur any switching cost if he or she goes to Starbucks on Tuesday. Business customers may face somewhat higher switching costs, for example, the cost of rebranding to Costa.

Figure 4: Costa's Coffee Club loyalty scheme



SOURCE: COSTA

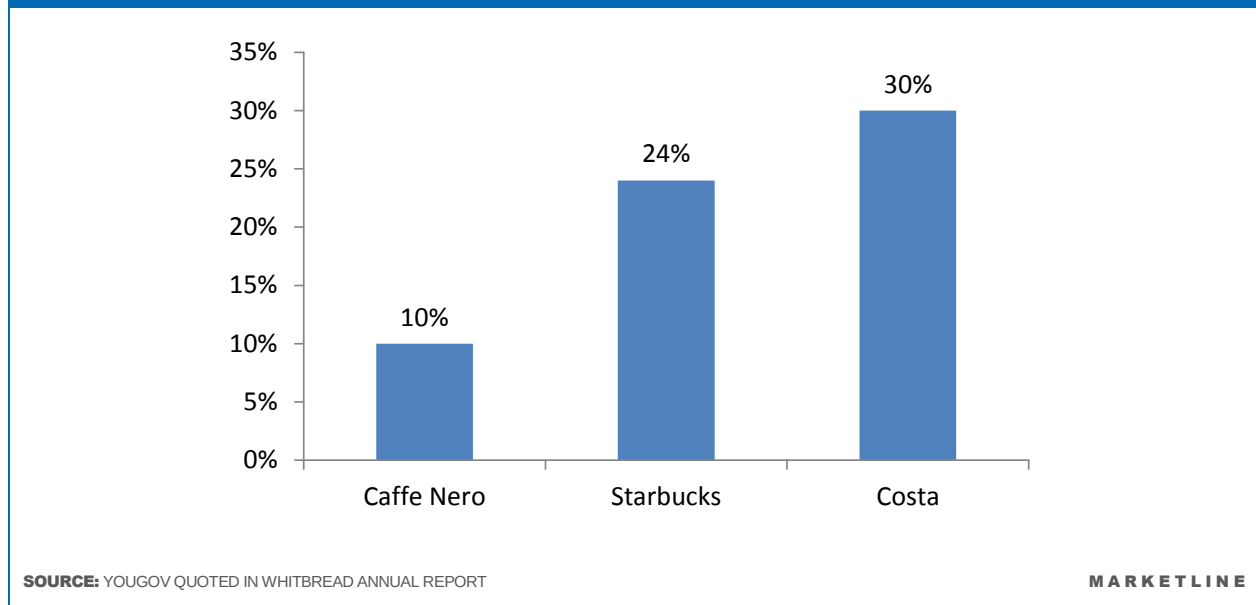
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Costa has a loyalty scheme. Costa Coffee Club offers customers a swipe card which records one point for every £1 (\$0.62) spent. These points can be redeemed in-store in the form of free coffee and food. Starbucks Rewards, which include a phone app, and the more traditional ink-stamped loyalty card offered by Caffè Nero, work in a similar fashion. Such schemes have the effect of introducing an artificial switching cost. Once customers have collected some Coffee Club points, a switch to a competitor will "cost" them the additional points they could have generated at Costa. This weakens buyer power.

Costa enjoys brand loyalty

Switching costs in this market may be low, but this does not necessarily mean that buyers will switch. A YouGov poll quoted in Whitbread's FY2012 annual report indicates that Costa has the greatest appeal to UK consumers of the three leading coffee shop brands. When asked which they would choose if the three brands were in front of them, 30% opted for Costa. Whitbread also quotes a 2011 survey by Allegra Strategies. This found that out of a panel of UK consumers who were not loyal to any particular brand, 40% preferred Costa. If a company can differentiate itself by its service offering, and create a strong and popular brand, customers are likely to remain loyal. This weakens buyer power.

Figure 5: Consumer response to the question, Which would you choose?



Price sensitivity is moderate

If one compares the retail price of coffee shop beverages to the retail price of coffee beans, it is clear that the gross margin per cup is quite high. However, strong market growth suggests that the prices are not high enough to deter customers. The convenience and pleasant ambience of the coffee shop add sufficient value to justify spending what is only a small percentage of most consumers' disposable income. This suggests that price sensitivity in this market is moderate, and buyer power correspondingly weakened.

Supplier power

Suppliers for Costa and its competitors include coffee and food products, retail space, and labor.

The quality of the coffee is central to the brand

Different consumers have different tastes, so it is not possible to rank coffee shop products in an objective way, and say that one chain offers "better" coffee than its competitors. However, what is important to players in this market is that having arrived at a specific blend of coffee, it can maintain the supply consistently. Customers will expect a particular experience from Costa, and deviation from the normal flavor of the coffee will affect this.

Furthermore, the brand identity of coffee shops can exploit a certain mystique about the exotic sourcing and careful preparation of the beans. Costa began its existence in 1971 as a coffee roasting company supplying coffee shops in London with their Mocha Italia blend of Arabica and Robusta beans, and Costa's marketing continues to make much of the uniqueness and high quality of this product, still used in Costa's beverages today.

The global coffee commodity market is dominated by the 'big four': Sara Lee, Nestle, Procter & Gamble, and Kraft. These companies buy beans from generally small-scale growers and intermediaries. Although some coffee shop chains may source their own coffee, its price is likely to be strongly affected by the presence of the big four.

Beyond the quality of coffee as an ingredient, ensuring that it is ethically sourced is important to some consumers. Fair Trade and Rainforest Alliance-certified coffee may command a higher price from suppliers.

All these factors tend to strengthen supplier power.

Foodservice is a labor-intensive industry

The foodservice and hospitality industry in general is labor-intensive. For Whitbread, total employee costs (wages, salaries, pensions, etc.) over the FY2007-2012 period were a fairly constant proportion of total costs (33-35%). The average annual salary per employee rose from £10,182 in FY2007 to £14,493 in FY2012. These figures include Costa and also Whitbread's hotel and restaurant business. In comparison, the UK median salary in FY2012 was £26,500.

Many of the positions available in the foodservice industry require relatively little experience, and Costa provides training for its baristas. This means that any available positions are open to a potentially large number of candidates, especially since unemployment rates are currently high in the UK. It is common for these to be remunerated at the national minimum wage.

In 2012, the national minimum hourly wage was raised to £6.19 for employees aged 21 and older, remaining at £4.98 for 18-20 year olds. However, a sample of job advertisements (January 2013) for Costa baristas suggests that wages, while well below the UK median on a full-time-equivalent basis, are also above the statutory minimum. This implies that the company is experiencing at least some competition for suitable employees.

Overall, the power of employees viewed as suppliers of labor is assessed as fairly weak.

Retail rents are significant costs

Many retailers with "bricks and mortar" high street outlets are experiencing tough competition from online sellers. Foodservice companies are spared from this, as customers must be physically present in their establishments. However, the downside to this requirement is that foodservice companies are often in a weak position compared to their landlords. Costa has to be located in areas of high population density to ensure a high volume of customers, and will typically need to be in the more salubrious parts of a town. Real estate in such places tends to have high rent.

In 2012, there was a stagnation or slight decrease in rents for commercial properties throughout much of the UK. (London took no part in this trend, with rents there rising significantly). Over the 1999-2011 period, British Property Federation data shows that the number of commercial leases with break clauses has tended to rise. This means that from the tenants' perspective, the power of the landlord as a supplier of vital real estate is weakened.

New entrants

When it is easy to enter a growing market, incumbents are likely to find their position challenged by new companies.

The coffee shop market has low capital barriers to entry

Foodservice generally has fairly low barriers to entry in comparison with other industries. The existence of a multitude of independent cafes, restaurants, and coffee shops is testimony to this. Many individuals and families can raise sufficient capital to get a lease on a suitable property, buy equipment, and start in business. Costa was founded by two brothers with a small coffee roasting business; Starbucks by three partners who originally worked as teachers and a writer.

Expansion can be relatively straightforward

If the first coffee shop is successful, opening a second requires similarly low levels of capital. Furthermore, company can follow two routes to expansion. It may opt to own and manage additional outlets directly, or offer franchises to other companies or individuals. The latter is often used fast food companies such as McDonalds, which know that this model will be attractive to franchisees who want to run their own businesses, but who will benefit from the brand strength and support of the franchisor.

Regulation is not burdensome

The main industry-specific government regulation for coffee shops will generally be related to food safety and hygiene.

However, this is not very onerous, and will mainly involve ensuring that staff members are properly trained.

Intellectual property is only moderately important

The intellectual property of incumbents, meaning patents, copyrights, and employee knowhow, can be a significant entry barrier in some industries. For example, it is extremely difficult to challenge Microsoft in the operating system market. The company has spent decades developing Windows, and has built up a vast amount of formal and informal intellectual property in doing so. Moreover, writing an operating system is a huge technical challenge in itself.

In the coffee shop market, intellectual property is much less important. While market leaders can charge a premium on the basis of their superior coffee whose exact composition is a trade secret, a challenger might offer something acceptable to most consumers for a slightly lower price.

Brands are strong

The existing market leaders have strong brands, and this is likely to be the major obstacle to entry. If consumers are happy with their existing coffee shop, how would a new entrant persuade them to transfer their allegiance? Creating an equally strong brand image, backed up by a truly different product and customer experience, will be vital.

Overall, the threat of new entrants is high. While the three leaders may have little to fear from independents starting up, a more concerted and large-scale challenge could impact them. Tesco's minority stake in the 'artisan' coffee shop Harris & Hoole, for example, could propel this newcomer into a strong position.

Substitutes

Indirect competition from alternative products or services can affect market players' freedom to raise their prices.

Bars, cafes, and fast food outlets are key substitutes for coffee shops

Coffee shops fulfill several needs, providing not only food and drink, but also a space where people can meet friends and family, relax, or work on their computers. Some of these functions can be provided by bars serving alcoholic drinks, cafes and sandwich bars such as Pret a Manger, and fast food restaurants such as Burger King. There are no switching costs (other than those created by loyalty schemes) for consumers who wish to go to a bar rather than a coffee shop, for example.

In practice, the threat from substitutes may be less than expected, as coffee bars can differentiate themselves in more subtle ways. For example, in the UK it might be acceptable to have a business meeting in a coffee shop, while a fast food restaurant or bar would be seen as inappropriately casual, or simply too noisy. Also, different foodservice establishments can target different socioeconomic classes. In the UK, coffee shops are viewed as of higher status than fast food restaurants. Many consumers who go to the former would not wish to go to the latter.

Rivalry

Interaction between players in a market can vary from cut-throat competition to collusion.

The coffee shop market in the UK is growing rapidly

As described in the foregoing section, recent years have seen healthy growth in the UK's branded coffee shop market. In itself, this tends to reduce rivalry between the market players. The reason is that if the available revenues are expanding, one company can increase its own sales without necessarily encroaching on its competitors.

Exit costs are low, making it easy to close down underperforming locations

The coffee shop market has fairly low exit costs. While a complete exit would be difficult for any of the three majors in the UK, because it constitutes an important source of revenue, it is relatively easy to close individual stores. For example, with most employees relatively low-paid, statutory redundancy payments will be correspondingly low in cases where they

must be paid. The rising number of leases with break clauses means that it may be less costly to exit an agreement with a landlord. Compared to, say, heavy industry there is little in the way of sunk costs – capital expenditure on equipment and so on that is difficult to recover.

Low exit costs translate to reduced rivalry between market players. Suppose a high street has two competing coffee shops, with similar fixed costs, but the number of potential customers is too small for both to be profitable. One option would be to battle it out: spend more on advertising, stay open longer (thus increasing wage costs), and compete ruthlessly on price. This might be necessary if exit costs are high, but unless one company goes out of business, the likely result of all these tactics would be a further reduction in profits for both. For a large chain, it might be preferable to exit that particular market, since the costs of doing so are low. This would hand that local market to its rival, but its resources can then be deployed elsewhere.

Costa is geographically fairly diverse

The three leading coffee shop chains in the UK market have different levels of geographic diversity. Starbucks has a total of 17,651 stores (Q2 2012), of which around 4% are located in the UK. Caffè Nero is much more exposed to the UK, with 88% of its 600+ global store count based in the country. Costa falls between the two, with 63% of its 2,203 coffee shops based in the UK.

The stronger their dependence on a single geographical market, the higher the degree of rivalry between market players is likely to be.

Table 3: Leading UK coffee shop chains international operations, 2012

Company	Countries present	Global outlets	UK outlets	Percentage of global outlets located in the UK
Starbucks (2011)	57	17,651	717	4.1%
Costa	26	2,203	1,392	63.2%
Caffè Nero	4	600	528	88.0%

SOURCE: WHITBREAD ANNUAL REPORTS, NEWS ITEMS **MARKETLINE**

Customer switching costs are low

As discussed earlier, the inherent switching costs for consumers are low in the coffee shop market. This tends to intensify rivalry between players. With no switching cost barrier to encourage consumers to patronize any one chain, they are free to respond to competitive tactics such as price cuts or innovative marketing campaigns.

To defend against this, players should focus on brand identity and the quality of the products and service they offer. Customers who have found what they want from one company are less likely to switch to competitors.

The large chains are formidable competitors

According to Allegra Strategies, the UK had almost 16,000 coffee shops in 2012, including independents and branded chains. Approximately one in three coffee shops are part of a branded chain, Starbucks, Costa, and Caffè Nero account for 2,637 of them, or 16% of the total coffee shop market. While this may appear to be a rather small percentage, foodservice markets generally tend to be fragmented. It is in the nature of a successful brand that it is easily recognized, while independents may be less visible on the high street.

The large chains are formidable competitors, especially for independents. The financial reserves mean that it is easy to

expand, opening premises in prime locations, and offering customers their now-familiar brands. These factors boost rivalry in the market.

WHAT STRATEGIES DOES THE ANSOFF MATRIX SUGGEST?

A management team may have many ideas about how to grow the company. To bring clarity to their decision-making, the Ansoff matrix may be useful.

The Ansoff matrix considers four market-product situations

Mathematician Igor Ansoff published the concept of the Ansoff matrix in 1957. It neatly summarizes four possible situations for a company's products and the markets in which it operates.

From the company's perspective, a market can be categorized as 'new' or 'existing'. An existing market is one in which the company already operates; a new market is one in which the company could potentially operate in as a route to expansion. The company's products can be categorized similarly. An existing product (or service) is one the company already offers, a new product is one that it could offer.

Figure 6: The Ansoff matrix

	Existing products	New products
Existing markets	Market penetration	Product development
New markets	Market development	Diversification

SOURCE: MARKETLINE

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Costa has higher penetration of the UK market than its competitors

While starting out as a coffee roaster and wholesaler in 1971, the company opened its first coffee shop in London in 1978. So Costa's main "existing product" is its proprietary coffee blend, its main "existing market" is the UK branded coffee shop market.

To reach consumers, a coffee shop chain needs to have outlets that are physically close to them. Increased market penetration therefore needs as large a network of coffee shops as possible.

As of 2012, company had 1,366 coffee shops (company-owned and franchised) in the UK. Detailed statistics on its early

expansion are unavailable. However, in 1999 it had 133 UK outlets. This corresponds to a 1978-1999 CAGR of 26%. In comparison, the CAGR for the ten-fold increase seen during the 1999-2012 period corresponds to a CAGR of 20%. It is clear that the early years of the company were marked by increasing market penetration, as the Ansoff matrix suggests.

More recently, annual growth in its UK chain has become similar to the rates seen in its early days, perhaps in part because Whitbread is focusing more on Costa and the opportunities offered by the burgeoning UK market, having divested many of its foodservice businesses in the mid-2000s.

Other strategies to increase penetration include marketing campaigns and loyalty schemes. Costa introduced a pre-pay loyalty card in 2007, and transferred to its Coffee Club scheme in 2010. In the same year, Costa launched its first television advertising campaign. The advert focused on the skills of its baristas, asking 'Can a monkey make a perfect cup of coffee?' The answer, it turned out, is no.

Further penetration of the market is possible

As of FY2012, the company had 8.5% of the total UK coffee shop market by number of outlets. In comparison, Starbucks has around 5% and Caffè Nero around 3%. As the UK market is continuing to grow in terms of revenue, increasing its penetration remains a viable strategy for Costa. In the first half of FY2013, the company increased its UK store count by 14%, indicating that its management team is in fact doing this.

Perhaps surprisingly, Costa's first national marketing campaign (with the theme '7 out of 10 coffee lovers prefer Costa') was launched as late as 2009. Consistent with the Ansoff matrix, Costa is likely to continue investing in such campaigns going forward to increase its penetration in the UK coffee shop market.

In 2012, the company began to offer Wi-Fi in its UK shops. The service is provided by telecommunication company O2, and allows customers 30 minutes free access. This is likely to increase the attractiveness of Costa establishments to customers. Caffè Nero began offering free Wi-Fi in the UK in August 2011, Starbucks followed suit a couple of months later.

Costa offers a range of food and drink products

Moving on to the 'existing market-new product' quadrant of the matrix, it is easy to see how Costa has developed its product range. Initially, it sold essentially one product: roast coffee. Once it had entered the coffee shop market, extending its product range would have been necessary. At present, Costa offers various forms of Italian-style coffee (espresso, latte, and so on), but also other beverages, sandwiches, pastries, and so on.

Coffee is likely to remain central despite future product development

When Apple introduced the iPod, it was best known as a personal computer company. To start selling portable music players was unexpected but turned out to be extremely successful. One reason for this is that for many years, Apple had had a relentless focus on the visual design and user-friendliness of its products. The iPod was not simply an MP3 player but also a beautiful and desirable object.

Would Costa ever make a similar jump into a different category of product? It seems unlikely. Coffee is central to its brand identity and operational competencies, just as visual design is central to Apple's. Instead, Costa is more likely to continue its current strategy of developing new food and drink products that are a good match to its existing identity. For example, in H1 FY2013 the company introduced a new food range, and added Café Caramello, Cortado, and Chai Latte to its coffee beverage range. Its Ice Cold Costa drinks, launched in June 2011, showed a double-digit y-o-y increase in sales for the period, indicating the importance of innovation in its product offering.

Figure 7: Ice Cold Costa launched in June 2011



SOURCE: COSTA

MARKETLINE

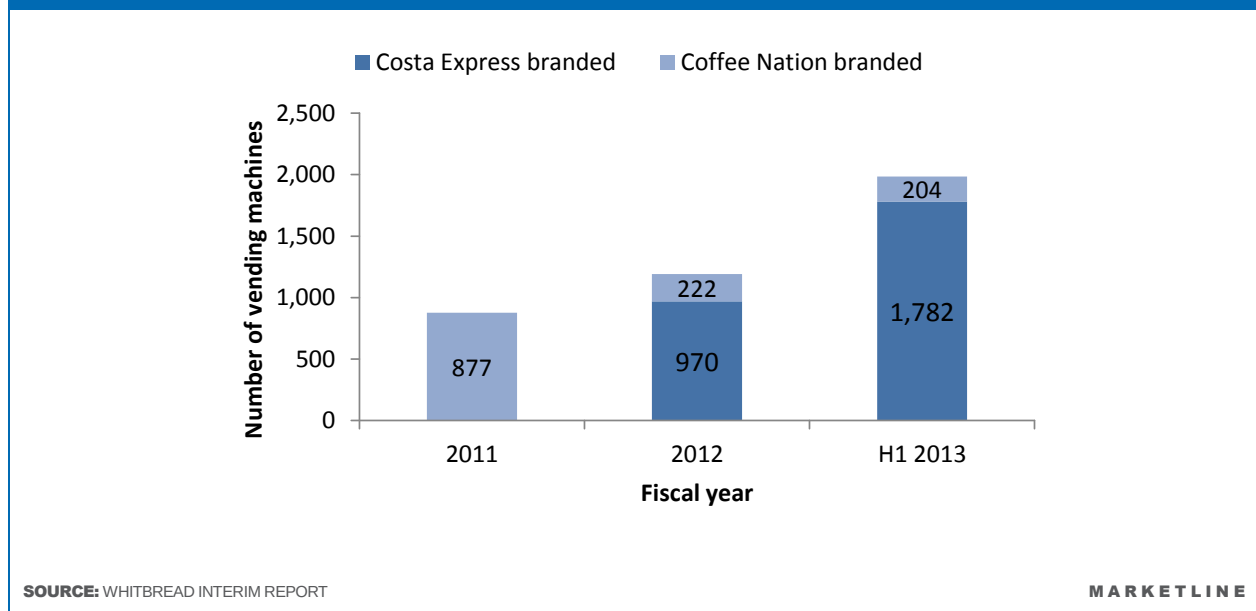
The Coffee Nation acquisition lets Costa take its core product to new markets

Costa has a couple of strategies for the 'new market-existing product' quadrant of the Ansoff matrix. One is the development of a new distribution channel: the coffee vending machine market.

In March 2011, Costa's parent company Whitbread acquired Coffee Nation in a £60m deal. At the time, Coffee Nation operated 877 self-service coffee vending machines in the UK, mainly in locations such as Tesco supermarkets and service stations on motorways (similar to freeways). They differed from other hot drink vending machines by using fresh milk and ground coffee instead of powdered milk and instant coffee. At the time, Whitbread's CEO commented: "Customers increasingly want great tasting coffee on the go, which makes the self-serve coffee market very attractive".

Integration of the company into the Costa Enterprise division involved a rebrand of the machines as Costa Express, and the use of Costa's Mocha Italia coffee. Two years after the acquisition, the total machine count had more than doubled to 1,986 of which only 10% retained the old branding. A contract with Shell accounted for 500 of the new locations. Coffee Express sales for H1 FY2013 were up 87% year-on-year. Not only is the installed base of machines expanding, but according to the FY2012 annual report, the average number of drinks dispensed by a machine increased by 20% once it had been rebranded as Costa.

Figure 8: Coffee Nation integration as Costa Express



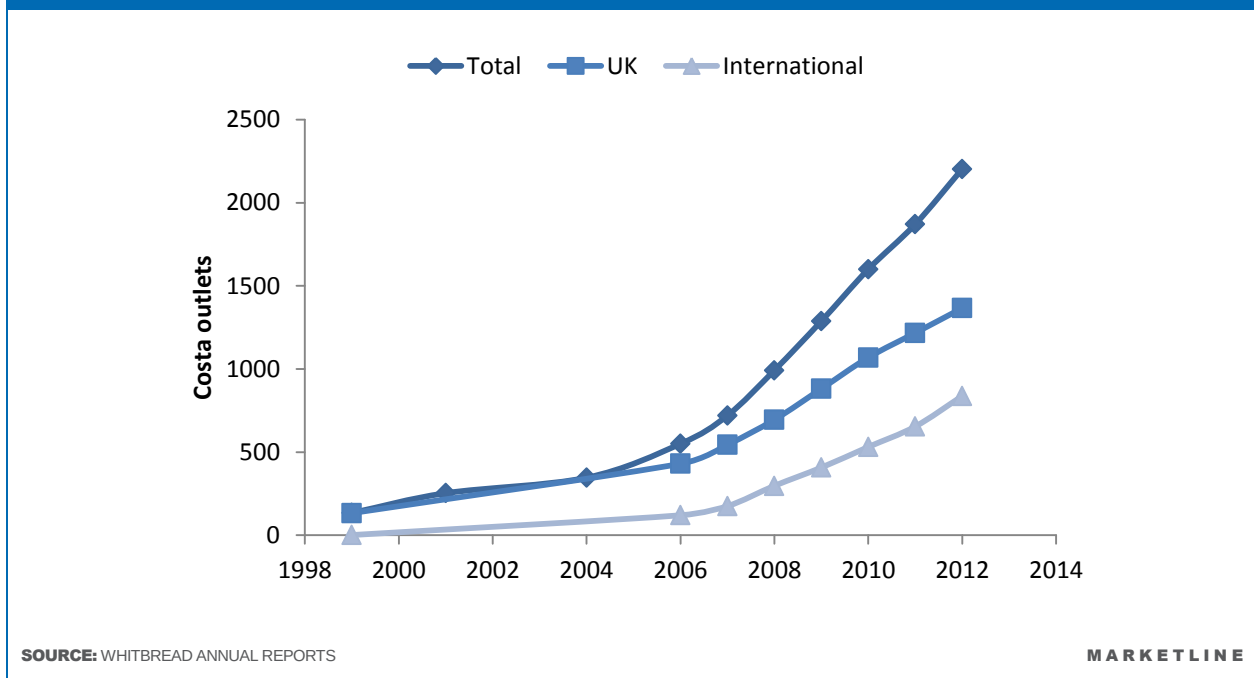
Supermarket retail will challenge Starbucks

Starbucks has been selling its Via instant coffee to consumers through supermarkets since 2011. In mid- 2012, Costa began offering At Home range of instant and ground coffee using the same channel. It is too early to judge the success of this move. However, given that customers drink coffee at home for different reasons than they patronize coffee shops, it looks to be a good way of exploiting the Costa brand strength and core competency without cannibalizing coffee shop sales.

Since 1999, Costa has entered new geographical markets

Another growth strategy in this quadrant is entry into international markets. Costa remained focused on the UK in its early years, but in 1999 opened its first non-UK coffee shop, in Dubai. By FY2006 its international locations had risen to 120, and in its FY2012 annual report, Costa had 837 coffee shops outside the UK. Although UK store count is increasingly, its international presence has expanded more rapidly. While the international segment accounted for 22% of its shops in FY2006, the proportion rose to 38% in FY2012. China is an important location for the company, which grew its presence there from 32 coffee shops in FY2009 to 164 in FY2012.

Figure 9: UK and international expansion



Costa Express and international expansion will remain key strategies in this quadrant

Whitbread's recent announcements indicate that the vending machine market and further international expansion will remain key to its growth plans. They are clearly delivering revenue growth in markets that are in many cases far from mature.

Risk is somewhat higher in this quadrant than in either of the 'existing market' quadrants. For example, China has a very different food and drink culture to the West – will this make it more difficult than expected to expand successfully there beyond the largest cities? To ameliorate such risks, joint ventures with local companies, and franchises granted to individuals and/or companies with local knowledge and experience, can be used to expand the coffee house chain. The disadvantage of such an approach is that not all system sales will translate into Costa revenues, only a proportion.

Costa is unlikely to venture far into the riskier fourth quadrant

The 'new market-new product' quadrant of the Ansoff matrix is the most risky. The strategy here is described as Diversification.

Costa has so far pursued a fairly simple model: operate coffee shops with a product and experience that customers enjoy. It has been successful, and it therefore seems unlikely that the company will make a radical departure from it. As discussed above, its new product development remains focused on coffee-based beverages and similar lines, essentially fine-tuning its existing value proposition rather than jumping into an entirely different category.

The most likely way that the company will operate in the fourth quadrant might be no more than offering new food and drink lines in countries where their popularity is an unknown quantity. While there is risk here, a failure would not be catastrophic for Costa. It could be ameliorated by careful consumer surveys in advance and cautious roll-out to a small number of coffee shops.

CONCLUSIONS

Costa performs strongly in a buoyant yet competitive market

The UK coffee shop market is central to Costa's success. The market is growing strongly in revenue, and in the number of independent and branded locations.

Analysis using Porter's Five Forces framework reveals that a lack of switching costs for consumers is an important feature of the market, influencing more than one of the forces. It strengthens buyer power, even though there are millions of potential customers and the marginal revenue provided by any individual is very small. It also means that new players, attracted by the relative immaturity of the market, and exploiting its low capital and regulatory barriers to entry, can appear and threaten the incumbents. It boosts rivalry between the major chains, because there is nothing to lock a customer in to a relationship with Costa, Starbucks, or any other player.

In a competitive market, profitability is hard to achieve. How, then, has Costa been able to do it, and grow to become the UK's largest branded coffee shop chain? The main reasons are that it has created a coffee product and coffee shop experience that is demonstrably popular with customers, used this as the basis of a clear brand identity, and continued to expand its outlet chain into more and more locations. The latter is vital because in this market customers have to be able to go to a bricks-and-mortar shop, and they will not be willing to travel far to do so.

Costa is moving from lower to higher risk quadrants of the Ansoff matrix, but radical change is unlikely

Costa for many years offered existing products in an existing market: coffee and refreshments in the UK coffee shop market. Much of its early growth was achieved in this quadrant of the Ansoff matrix, which is generally regarded as the least risky. It was helped, too, by overall market growth during these years.

Since 1999, when it first accessed a new market by opening a coffee shop in Dubai, expansion in the UK has been accompanied by slightly riskier ventures. Expansion of its overseas chain since 2006 has been faster than in the UK, although the latter still represents 62% of its global chain volume. By operating in several countries, risks associated with any particular location are reduced, and the healthy UK operation acts as a backstop.

The vending machine market entered through the acquisition of Coffee Nation, and supermarket distribution of instant and ground coffee, also fall into the riskier quadrants. However, UK consumers are increasingly appreciative of higher-quality coffee and the Costa brand is well-established. Offered the opportunity to obtain Costa products outside the familiar coffee shop, many are likely to take it.

Recent reports by parent company Whitbread suggest that the current strategy for Costa is likely to continue without radical change. It has certainly served the company well so far.

APPENDIX

Definitions

Franchise – a company (franchisor) may delegate some of its operations to another company or individual (franchisee). Typically, the franchisee pays an up-front fee to the franchisor, finds a suitable location, and undertakes the day-to-day running of the business there. The franchisor permits the use of its brand and offers support with marketing etc. Franchisees are entitled to the revenues of their business net of proportional royalties paid to the franchisor.

Sources

Financials, store counts, vending machine counts, strategy – Whitbread annual and interim reports

www.whitbread.co.uk/content/dam/whitbread/siteimages/investors/results-reports

Company history, product launches, marketing – www.costa.co.uk

Coffee shop market sizing – Whitbread annual reports, news sources

Porter's Five Forces framework - <http://hbr.org/2008/01/the-five-competitive-forces-that-shape-strategy/ar/1>

Ansoff matrix framework - www.ansoffmatrix.com

Further Reading

Whitbread PLC Company Profile, MarketLine (2011)

Starbucks Corporation Company Profile, MarketLine (2012)

Ask the analyst

We hope that the data and analysis in this brief will help you make informed and imaginative business decisions. If you have any questions or further requirements, MarketLine's research team may be able to help you. The MarketLine Research team can be contacted at ReachUs@MarketLine.com.

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