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Starbucks: A Story of Growth

Awake as usual at 4:00 a.m., Starbucks CEO Howard Schultz sipped a cup of Tribute Blend coffee as he reviewed the galley proofs for his latest memoir—*Onward: How Starbucks Fought for Its Life without Losing Its Soul*. The quiet surroundings gave him an opportunity to reflect on the remarkable ride that had brought him and Starbucks to January 2011, the beginning of the company's fortieth year.

During those four decades, Starbucks had grown from a single location in Seattle, Washington, to a multibillion-dollar enterprise that operated more than 17,000 retail stores in fifty countries. Originally selling only coffee beans and ground coffee, it had added to its offerings prepared coffee, Italian-style espresso beverages, cold blended drinks, food items, premium teas, and beverage-related accessories and equipment. Outside of its retail stores, consumers could purchase Starbucks-branded beans, instant coffee, tea, and ready-to-drink beverages in tens of thousands of grocery and mass merchandise stores around the world.¹

As he reviewed the company's many successes, Schultz remembered the words he had spoken to Starbucks' partners just days before as they celebrated their best holiday season ever: "We have won in many ways, but I feel it's so important to remind us all of how fleeting success and winning can be."²

History

When Starbucks was founded in 1971, coffee consumption in the United States had been on the decline for nearly a decade (**Exhibit 1**). Most American coffee drinkers drank home-brewed Folgers, Maxwell House, or Nescafé—grocery store brands of light roast coffee with the smooth flavor generally preferred by Americans. Away from home, they ordered coffee with a meal at a diner or restaurant, or on the go from a fast food outlet, convenience store, or gas station.

However, in a few neighborhoods in San Francisco and New York, small local coffeehouses and specialty coffee roasters such as Peet's had recently been established. Starbucks was created in this mold with the aim to roast and sell great coffee.

¹ Starbucks Coffee Company, Investor Relations "Overview," <http://investor.starbucks.com/phoenix.zhtml?c=99518&p=irol-irhome>.

² Claire Cain Miller, "A Changed Starbucks. A Changed C.E.O.," *New York Times*, March 12, 2011.

By 1982, Starbucks had five retail outlets that sold beans and supplies for brewing coffee at home, but not prepared beverages. It also had a roasting facility and a wholesale business. This growth attracted the attention of Schultz, then the vice president of the American subsidiary of Hammarplast, a Swedish housewares company that made plastic cone coffee filters for home coffee brewing. Schultz went to Seattle to find out why a small company called Starbucks ordered more of these filters than any other customer. He liked what he found and joined Starbucks later that year as director of retail operations.

During a business trip to Milan, Italy, the following year, Schultz was struck by the city's ubiquitous espresso bars. The bars served well-prepared espresso and brewed coffee and were important places for conversation and socializing. Schultz realized that America lacked similar places offering high-quality coffee in a comfortable setting for meeting and relaxing. He left Milan with a determination to create such an establishment in America. Schultz later dubbed this "the third place" beyond home and work, a term he borrowed from *The Great, Good Place*, a book in which sociologist Ray Oldenburg laments the decline of traditional American community meeting places like country stores and soda fountains.³

Starbucks' management, however, was not receptive to the idea of selling prepared drinks, turning Schultz down with the explanation that getting into the "restaurant business" would distract the company from its core assets and activities: roasting and selling coffee beans.

In 1986 Schultz left Starbucks to open Il Giornale, a café selling espresso, espresso-based drinks such as cappuccino, and food items, in addition to whole-bean coffee. Il Giornale attracted 1,000 daily customers within six months, prompting Schultz to open two more locations. Despite his success, Schultz faced skepticism from investors—when he was trying to raise \$1.25 million to fund his expansion, Schultz was turned down by 217 of the 242 potential investors he approached, many of whom expressed concern that he had no patent on his dark roast, no special access to coffee beans, and no way to prevent someone else from imitating his concept.⁴

In 1987 Il Giornale acquired Starbucks, including its retail outlets, coffee roasting facilities, and wholesale operation. Schultz rebranded the existing stores with the Starbucks name. The first Il Giornale had been a virtual copy of a Milanese espresso bar, complete with bow-tied waiters, a stand-up coffee bar, and sleek European furniture. By contrast, the new Starbucks-branded locations were decorated in earth tones with overstuffed chairs, wood floors, and cozy fireplaces that encouraged patrons to linger and relax.⁵

Starbucks coffee was different from the coffee most Americans were used to consuming. In addition to being much more expensive, Starbucks coffee had a taste unlike typical American coffee. Starbucks roasted its beans in its own carefully controlled facility, where they were given a robust European-style flavor derisively called "Charbucks" by some,⁶ and then shipped them whole to its stores where they were ground immediately before brewing to ensure maximum

³ Ray Oldenburg, *The Great Good Place: Cafes, Coffee Shops, Bookstores, Bars, Hair Salons, and Other Hangouts at the Heart of a Community*, 3rd ed. (Cambridge, MA: Da Capo Press, 1999).

⁴ Arthur Thompson and John Gamble, "Starbucks Case Study," *McGraw Hill*, <http://www.mhhe.com/business/management/thompson/11e/case/starbucks.html>.

⁵ Bryant Simon, *Everything But the Coffee: Learning about America from Starbucks* (Berkeley, CA: University of California Press, 2009), 11.

⁶ *Ibid.*, 50.

freshness, flavor, and aroma. Starbucks espresso drinks were also prepared in a different way: a barista, a master of both the art and science of coffee production, “pulled” shots of espresso by hand using a La Marzocco machine, steamed milk to just the right temperature, and scooped elegant dollops of foam for cappuccinos, all while chatting with customers about the different varieties of Starbucks coffee.⁷

In a nod to the heart of coffee culture, Starbucks invented a quasi-Italian lingo for its drink sizes (short, tall, grande, and venti) and the drinks themselves (e.g., Caramel Macchiato and Frappuccino). No matter how a customer ordered, counter clerks were trained to repeat the order using the correct terms in the Starbucks-specified order. Their tone was described as “not one of rebuke, but nevertheless most customers learn to avoid the implied correction by stating their order in the way that helps Starbucks’s operations. . . . Indeed, for some customers, getting the order right is an aspiration, a small victory on the way to the office.”⁸

By 1996, the Starbucks mermaid logo appeared on more than 1,000 stores. Starbucks selected its locations carefully, targeting areas with large numbers of wealthy and highly educated professional workers. These were the new American elite—dubbed “bobos” (bourgeois bohemians) by commentator David Brooks—who used consumption as a way to distinguish themselves from the less enlightened masses.⁹

Soon, more and more American consumers aspired to emulate the coffee drinkers that were first attracted to Starbucks. “Customers believed that their grande lattes demonstrated that they were better than others—cooler, richer, and more sophisticated. As long as they could get all of this for the price of a cup of coffee, even an inflated one, they eagerly handed over their money, three and four dollars at a clip.”¹⁰ As Roly Morris, one of the team that helped bring Starbucks to Canada, observed, “We’re offering a lifestyle product . . . that transcends the usual barrier. Maybe you can’t swing a Beamer [BMW] . . . but most people can treat themselves to a great cup of coffee.”¹¹

Starbucks Expands (1996–2006)

Beginning in 1996 Starbucks embarked on a significant wave of growth by concurrently executing two initiatives: (1) selling Starbucks products through mass distribution channels, and (2) dramatically expanding its retail footprint. Schultz played an important role in both initiatives, first as CEO until 2000, and thereafter as chairman and chief global strategist.

⁷ Ibid., 39.

⁸ Frances X. Frei, “Breaking the Trade-Off Between Efficiency and Service,” *Harvard Business Review* 84, no. 11 (November 2006): 92–101.

⁹ David Brooks, *Bobos in Paradise: The New Upper Class and How They Got There* (New York, NY: Simon & Schuster, 2001).

¹⁰ Simon, *Everything But the Coffee*, 7.

¹¹ Ibid., 8.

Selling Through Mass Distribution Channels

The first product Starbucks sold through mass distribution channels in the United States was its bottled Frappuccino coffee drink, brought to market through a joint venture in 1996 with Pepsi-Cola North America. The arrangement drew on Pepsi's expertise in managing store supply and demand but allowed Starbucks to retain control over the development and sale of its products.¹² Around the same time, the company partnered with Dreyer's to produce a premium coffee-flavored ice cream. Soon after, Starbucks began to test market Starbucks-branded coffee beans and ground specialty coffee in grocery stores and supermarkets. In 1998, approximately a year after market testing, Starbucks coffee was on the shelf in approximately 3,500 supermarkets in ten West Coast cities.¹³

On September 28, 1998, Starbucks announced a long-term exclusive licensing agreement with Kraft Foods "to accelerate growth of the Starbucks brand into the grocery channel across the United States."¹⁴ The agreement gave Kraft responsibility for all distribution, marketing, advertising, and promotions for Starbucks whole bean and ground coffee in more than 25,000 grocery, warehouse club, and mass merchandise stores.¹⁵

Kraft was the largest coffee seller in the United States. Its grocery store brands Maxwell House, Yuban, and Sanka sold at much lower prices than Starbucks. In 1998, a 13 oz (375 g) can of Maxwell House sold for approximately \$2.50, while a 13 oz (375 g) bag of Starbucks beans was priced at \$7.45. Kraft's higher-end brand, Gevalia, was only available by mail order.¹⁶

In 1998 Starbucks sold approximately \$50 million of whole bean and ground specialty coffee in grocery stores (compared to approximately \$1 billion in sales for Maxwell House and \$1.3 billion for Folgers in the same year).¹⁷ By 2010 Starbucks coffee sales in grocery stores had grown to \$500 million (a 10 percent increase over the previous year). In the same year, the sales of Folgers, the market share leader, fell by 2.1 percent. The sales of Maxwell House, the number two ground coffee brand, grew by only 2.8 percent to approximately \$1.5 billion.¹⁸

In addition to moving into mass distribution channels, Starbucks also expanded its product distribution through licensing agreements. It concluded an agreement in 1995 to provide coffee on all United Airlines flights, and in 2001 agreed to provide Starbucks coffee for all restaurants, room service, and meeting rooms at Hyatt hotels. By 2008, 16 percent of Starbucks revenues came from sources other than its company-owned retail stores.¹⁹

¹² Sarah Theodore, "Starbucks Brews New Coffee Concepts," *Beverage Industry* 98, no. 11 (November 2007): 30–34.

¹³ "Partners in Supermarkets: Maxwell House & Starbucks," *Tea and Coffee Trade Journal*, November 1, 1998, <http://www.allbusiness.com/manufacturing/food-manufacturing-food-coffee-tea/727029-1.html>.

¹⁴ Ibid.

¹⁵ "Starbucks Corporation's Initial Memorandum in Opposition to Kraft Foods Global, Inc.'s Motion for Preliminary Injunction," January 6, 2011, 3, in *Kraft Foods Global Inc. v. Starbucks Corporation*, Civil No. 10-9085 (CS), U.S.D.C., S.D.N.Y. (Hereafter, "Starbucks Brief").

¹⁶ Vanessa O'Connell, "Starbucks, Kraft to Announce Pact for Selling Coffee," *Wall Street Journal*, September 28, 1998.

¹⁷ Matt Andrejczak, "Ripple Effects Likely as Starbucks, Kraft Part Ways," *Wall Street Journal*, November 8, 2010; Stephanie Thompson, "Brand Builders: Kraft Foods and Maxwell House," *BrandWeek*, May 4, 1998.

¹⁸ Dian L. Chu, "Why A Starbucks-Kraft Feud Will Be Costly For Both Companies," *EconMatters* (blog), *Business Insider*, December 14, 2010, <http://www.businessinsider.com/starbucks-kraft-2010-12>.

¹⁹ Starbucks Annual Report 2008, "Fiscal 2008 Financial Highlights."

Dramatically Expanding Retail Stores

By 1996 Starbucks had opened just over 1,000 stores. Within five years, that number had grown to nearly 5,000 (**Exhibit 2**). In 2007 Starbucks operated 15,000 stores and in the same year publicly announced a goal to open 40,000 locations worldwide, with 20,000 in the United States alone. (In the same year, McDonald's operated approximately 14,000 restaurants in the United States and 31,000 locations worldwide.²⁰)

The expansion of Starbucks attracted media attention, not all of which was positive. On April 1, 1996, National Public Radio aired a satirical report that "Starbucks will soon announce their plans to build a pipeline costing more than a billion dollars, a pipeline thousands of miles long from Seattle to the East Coast, with branches to Boston and New York and Washington, a pipeline that will carry freshly roasted coffee beans."²¹ *The Onion* lampooned the growth of Starbucks stores in 1998 with the mock headline, "Starbucks, the nation's largest coffee-shop chain, continued its rapid expansion Tuesday, opening its newest location in the men's room of an existing Starbucks."²²

Schultz was undeterred by critics. Reflecting on the company's growth in 1998, he commented,

Customers don't always know what they want. The decline in coffee drinking [in the years before Starbucks existed] was due to the fact that most of the coffee people bought was stale and they weren't enjoying it. Once they tasted ours and experienced what we call "the third place" . . . a gathering place between home and work where they were treated with respect . . . they found we were filling a need they didn't know they had.²³

In conjunction with this expansion, Starbucks made some operational changes. First, the La Marzocco espresso machines Starbucks had used since its inception were replaced with push-button Verismo models. This decision simplified the hiring and training of baristas since the Verismo machines produced a uniform product with less operator training. They also reduced the time to pull an espresso shot from sixty seconds to thirty-six seconds, helping stores meet the company's stated goal of serving every customer within three minutes.²⁴

On the other hand, the height of the Verismo machines' grinding apparatus blocked the customer's view of the barista, and the simplicity of the machine eliminated much of the romance and theater that accompanied a barista's customized preparation of each order. Some longtime customers insisted that the new machines produced inferior espresso.

Another change involved the coffee beans. Delivering a consistent Starbucks flavor required that the beans be roasted centrally and distributed to the global network of stores. There they were ground just before brewing in order to preserve the volatile oils that produced the best-tasting—

²⁰ McDonald's Annual Report 2007.

²¹ Mark Pendergrast, *Uncommon Grounds: The History of Coffee and How It Transformed Our World* (New York, NY: Basic Books, 1999), 378.

²² "New Starbucks Opens in Rest Room of Existing Starbucks," *The Onion*, June 27, 1998, <http://www.theonion.com/articles/new-starbucks-opens-in-rest-room-of-existing-starb>, 560.

²³ Scott S. Smith, "Grounds for Success (Interview with Howard Schultz)," *Entrepreneur*, May 1998, 120.

²⁴ Simon, *Everything But the Coffee*, 46.

and smelling—coffee. However, measuring and grinding beans for every pot of coffee was time consuming and hampered a store's ability to meet the three-minute service goal. As a result, Starbucks stopped shipping coffee to its stores as whole beans to be ground throughout the day and instead shipped air-tight packs of pre-ground beans that it claimed would maintain their flavor for one year.²⁵

In addition to these easily observable changes, one observer suggested that as it expanded, Starbucks “skimped on quality [of the coffee beans it purchased] knowing that its trademark dark, smoky roast covered up imperfections,”²⁶ and added: “In its mission statement, Starbucks pledged to serve the ‘finest coffee in the world,’ but its need for mountains of beans have made this impossible.”²⁷

The look and feel of the stores was also affected by the dramatic growth in their numbers. In order to lower store-opening costs, in 1996 Starbucks limited new stores to four standardized design templates, each of which allowed for limited variation in materials and details.²⁸

Growth also exposed weaknesses in operations and supply chain management. Stores regularly ran out of ingredients—such as flavored syrups and bananas—that were necessary to meet customer demand. Merchandise displays in the stores were inconsistent—even as Starbucks expanded the variety of non-coffee merchandise it sold, some of its stores did not carry basic coffee-making items such as filters and French presses. According to Schultz, “in 2008 the chance of a store getting everything it asked for on time and intact was about 35 percent, and it was highly likely that every day, thousands of stores were out of something.”²⁹

Information technology was much the same. Each store had a computer in its office, but it generally could not run spreadsheet software, access the Internet, easily send e-mails outside of the company, or send or receive e-mail attachments.³⁰ The lack of Internet connectivity as late as 2008 was particularly ironic given Starbucks' popularity among its customers as a Wi-Fi hotspot. Cash registers ran MS-DOS software that required drinks to be entered in a predetermined order: size, drink name, and then additions such as syrup or an extra shot of espresso. Any deviations to this sequence required the entire sale to be voided and re-entered.³¹

During this period, Starbucks broadened its business, starting with a foray into music. This began with the marketing of compilation CDs of music played in its stores, but the company quickly expanded into selling entire kiosks full of music, and even produced an album—the award-winning *Genius Loves Company* featuring Ray Charles—that sold more than 32 million copies, 25 percent of which were purchased at its stores. Buoyed by this success, Starbucks moved into book publishing and movie production.³²

²⁵ Ibid., 45.

²⁶ Ibid.

²⁷ Ibid., 15.

²⁸ Thompson and Gamble, “Starbucks Case Study.”

²⁹ Howard Schultz and Joanne Gordon, *Onward: How Starbucks Fought for Its Life without Losing Its Soul* (New York, NY: Rodale Books, 2011), 186.

³⁰ Ibid., 150.

³¹ Ibid.

³² Ibid., 21.

The Rise of Competitors (2006–2008)

The expansion of Starbucks was good for the coffeehouse industry in the United States, a phenomenon dubbed the “Starbucks Effect.”³³ By 2006 there were approximately 24,000 specialty coffee establishments in the United States, nearly 60 percent of which were independently owned and operated (having three or fewer outlets).

Independent coffee shops often differentiated themselves from Starbucks by serving coffee that was handcrafted by expert baristas. Michael Philips, a barista for Chicago-based Intelligentsia coffee and the winner of the 11th Annual World Barista Challenge, compared himself to a cross between a bartender and a sommelier. Baristas at Intelligentsia trained between two and five months before they were allowed to serve coffee; by contrast, baristas at Starbucks typically had two weeks of training. Philips derisively referred to Starbucks employees as “button pushers” who were “no different from fry chefs at McDonald’s.”³⁴

At these coffeehouses, customers waited for their drinks for much longer than Starbucks’ stated three-minute goal; for example, brewing individual cups of coffee to order required at least six minutes per cup. Some of these competitors also roasted their coffee beans inside the store.³⁵ Prices were often significantly higher than those at Starbucks (**Exhibit 3**).

Starbucks also found itself competing against smaller chains that resembled pre-expansion Starbucks stores, complete with manual espresso machines and hand-scooped coffee. These chains—including Peet’s Coffee and Tea (which featured La Marzocco manual espresso machines in many stores), the Coffee Bean & Tea Leaf, and Caribou Coffee—operated between 150 and 500 stores, but customers seemed to perceive them more like independent coffeehouses. When Caribou Coffee was forced to close in Ann Arbor, Michigan, as a result of escalating rent, one patron claimed it was “like the end of Ann Arbor.”³⁶ By contrast, Starbucks was often perceived as a heartless corporate predator. As one observer noted, “For a growing slice of the population, ‘Wal-Mart,’ ‘Starbucks’ and ‘chain’ have become dirty words, while local, independent and unique have become core values.”³⁷ Similar to independent coffee retailers, these small chains charged prices about 10 percent higher than Starbucks locations in the same geographic area (**Exhibit 3**).

At the other end of the market, fast food restaurants such as Dunkin’ Donuts and McDonald’s had started offering specialty coffee. Dunkin’ Donuts, which had enjoyed a loyal coffee following since its inception in 1948, was described by one expert as a “coffee company disguised as a donut company.”³⁸ By 2009, 80 percent of McDonald’s outlets in the United States were serving cappuccinos and espresso drinks, supported by aggressive advertising, including billboards that read “Four Bucks is Dumb” and “Large is the New Grande.” Surveys by one restaurant analyst conducted shortly after McDonald’s began selling coffee suggested that 60 percent of Starbucks customers would “trade down” to McDonald’s coffee if it were faster and cheaper.³⁹ The

³³ Vijay Vishwanath and David Harding, “The Starbucks Effect,” *Harvard Business Review* 78, no. 2 (March 2000): 17–18.

³⁴ Alexia Elejalde-Ruiz, “Not Your Average Joes,” *Chicago Tribune*, April 28, 2008.

³⁵ Melissa Allison, “Should Coffeehouses Roast Their Own Beans?” *Seattle Times*, June 26, 2009.

³⁶ Kara Wenzel, “Soaring Rent Forces Popular Coffee Shop to Say Goodbye,” *Michigan Daily*, March 21, 2001.

³⁷ Jason Daley, “That’s a Starbucks?” *Entrepreneur*, November 2009, 93.

³⁸ Pendergrast, *Uncommon Grounds*, 387.

³⁹ Sean Gregory, “Latte with Fries? McDonald’s Takes Aim at Starbucks,” *Time*, May 7, 2009.

McDonald's product was competitive from the standpoint of taste—in February 2007 it won a taste test against Starbucks and Dunkin' Donuts conducted by *Consumer Reports*.⁴⁰ McDonald's and Dunkin' Donuts offered prices 9 to 17 percent lower than those of Starbucks (Exhibit 3).

The competitive position facing Starbucks did not go unnoticed by its management. In a *Harvard Business Review* article, Schultz wrote,

*Big-time people began to notice this coffee business is a good business and highly profitable. McDonald's and Dunkin' Donuts were on the very low end. . . . [A]t the higher end were the independents that went to school on Starbucks. And there was this feeling of 'let's support the local companies.' So Starbucks was being squeezed to the middle, and that is an undesirable place for us to be.*⁴¹

Schultz Returns as CEO (2008)

As 2008 dawned, Starbucks was in crisis: financial results from the previous quarter were the worst in its history as a public company. On January 7, Schultz returned to Starbucks as CEO at the request of the board of directors. He immediately announced a “transformational agenda” of strategic initiatives to revitalize the company with which he was so closely identified.

Perhaps the most widely discussed decision was the closing of nearly 1,000 stores that Starbucks believed would not generate an acceptable return even after other planned changes were made to operations. Greeted in the popular press with headlines such as “Starbucks Goes from Venti to Grande,”⁴² the closings marked the first contraction in the number of stores in the company's history. The decision was driven, at least in part, by dramatic declines in same-store sales (Exhibit 4). Among the stores that were closed, 70 percent had been opened during the previous three years and some had been open only a few months.⁴³

An op-ed in the *Wall Street Journal* commented on the reaction of Starbucks customers to the closing of their local stores.

*A friend said that the Starbucks stores' bitter-enders reminded her of the protests against the closing of the neighborhood Catholic churches. True. The stores are like secular chapels. . . . Back in the glory days, when cities had a church every 10 blocks, no one would go to a church blocks away with the same service. They wanted their church . . . I don't go to Starbucks that much. I don't go to the Baptist church either. But I'm glad that we've got one just about everywhere.*⁴⁴

Closing underperforming stores was part of a broader strategy aimed at reducing operating costs. Through a combination of procurement savings, improved logistics, reduced operations waste, and labor cost savings, Starbucks cut \$580 million in operating costs in 2009. The

⁴⁰ “McDonald's Coffee Beats Starbucks, Says Consumer Reports,” *Seattle Times*, February 2, 2007.

⁴¹ Adi Ignatius, “We Had to Own the Mistakes, Interview with Howard Schultz,” *Harvard Business Review*, July 2010.

⁴² Barbara Kiviat, “Starbucks Goes From Venti to Grande,” *Time*, July 2, 2008.

⁴³ Schultz and Gordon, *Onward*, 156.

⁴⁴ Daniel Henninger, “Starbucks Nation,” *Wall Street Journal*, July 24, 2008.

revamped supply chain operations delivered 90 percent of store orders on time and without errors.⁴⁵

While he was closing underperforming stores and improving the supply chain, Schultz undertook several smaller initiatives, including introducing new low-profile but still semi-automatic espresso machines; offering free refills on same-day purchases; and returning to in-store coffee grinding. Schultz also took the very public step of closing all Starbucks company-owned stores for an afternoon to retrain all baristas in the production of espresso-based drinks.

During this time, Starbucks also introduced a new roast of coffee, Pike Place Roast. Previously, Starbucks had offered a rotating selection of coffee bean/roast combinations, such as French Roast, Sumatra, or Kenyan. This meant that a Starbucks tall drip coffee could taste dramatically different on different days or in different stores. Customers that did not know Starbucks rotated its coffees attributed the difference to operational inconsistencies. The new roast, whose flavor was described as “round, smooth, and balanced” with a “mild, sweet finish,”⁴⁶ was offered every day as the Starbucks “default” coffee alongside a bolder-flavored option.

Despite these and other actions, over the next fifteen months Schultz watched the stock price of Starbucks decline to half of its peak value.

Starbucks Pursues New Growth Initiatives (2009–2011)

Starting in 2009 Starbucks undertook three new growth initiatives outside of its retail coffeehouse presence. First, it made several moves to expand its presence in the “away from the store” coffee market. Second, it pursued coffee initiatives outside of the Starbucks brand. Finally, Starbucks acquired a supplier that moved it into the business of manufacturing high-end coffee brewing equipment.

Expanding Presence in “Away from the Store” Coffee

STARBUCKS ENDS ITS KRAFT RELATIONSHIP

On October 5, 2010, Starbucks publicly announced its intent to terminate its twelve-year exclusive relationship with Kraft for distribution of its whole-bean coffee in grocery channels. In January 2010 Schultz had sent an e-mail to Irene Rosenfeld, CEO of Kraft, stating that Starbucks “cannot accept the continued share erosion and lack of progress we are experiencing down the grocery aisle.”⁴⁷ According to Starbucks, Kraft’s performance did not improve after the January e-mail, and it saw no signs of a reversal of the steady decline in Starbucks whole-bean coffee sales. Unable to reach a negotiated settlement with Kraft, Starbucks unilaterally terminated the agreement effective March 1, 2011, and turned to an arbitrator to determine the settlement amount it would pay Kraft.

⁴⁵ Schultz and Gordon, *Onward*, 325.

⁴⁶ *Ibid.*, 86.

⁴⁷ Starbucks Brief, 11.

Ending the Kraft relationship aligned with Schultz's vision for Starbucks' retail stores and its presence in consumer packaged goods (CPG) mass distribution channels.

I think we've identified a very big opportunity to do something that really has not been done before. And that is the following: there are many, many companies, domestically and around the world, that have built a domestic national footprint around retail stores, just like Starbucks—the Gap, Costco, Wal-Mart, Coach, Zara. And there are many consumer-packaged-goods companies—Pepsi, Coke, Kellogg's, Campbell's. There hasn't been one company I can identify that has been able to build complementary channels of distribution by integrating the retail footprint and the ubiquitous channels of distribution—in our case, grocery stores and drug stores.⁴⁸

STARBUCKS PRODUCES AN INSTANT COFFEE

Terminating the Kraft agreement gave Starbucks complete control over promoting its newest consumer product—instant coffee.

Starbucks had been experimenting with instant coffee since 1989, when it was approached by Don Valencia, a cell biologist who had developed an innovative method for freeze-drying cells for examination under a microscope. Valencia had developed a way to apply the technique to coffee beans, which enabled him to carry high-quality coffee on long hiking trips. After being hired by Starbucks to create a commercially viable version of his technique, Valencia first created a powdered coffee extract that was critical to the creation of a shelf-stable Frappuccino, a Starbucks ice cream created with Dreyer's, and Double Black Stout, a coffee-and-beer combination product from Redhook Ale Brewery.⁴⁹

In late 2009 Starbucks launched the culmination of Valencia's research: Starbucks VIA, a water-soluble coffee offered in single-serve packages or “sticks.”⁵⁰ Even though instant coffee represented a \$20 billion market worldwide, analysts were skeptical about the company's chances in the category, which accounted for \$700 million in sales in the United States,⁵¹ or about 8 percent of the overall market.⁵² This external skepticism was matched by internal resistance and hesitancy among partners (the Starbucks term for employees) because instant coffee was perceived to be a “down-market” category.⁵³

Schultz predicted VIA would create “additional usage occasions” for coffee, which would increase sales of the entire instant coffee category.⁵⁴ This vision was reflected in the slogan, “Never be without great coffee”⁵⁵ and in the single-serve package design, which was ideal for coffee on the go. In 2011 Schultz commented,

⁴⁸ Allen Webb, “Starbucks' Quest for Healthy Growth: An Interview with Howard Schultz,” *McKinsey Quarterly*, March 2011.

⁴⁹ Dan Richman, “Donald Valencia, 1952–2007: Starbucks Executive Left Corporate Career for Social Activism,” *Seattle Post-Intelligencer*, December 14, 2007.

⁵⁰ Unfortunately, Valencia passed away from cancer in 2007, more than a year before his instant coffee product was launched.

⁵¹ E.J. Schultz, “How VIA Steamed Up the Instant-Coffee Category,” *Advertising Age*, January 24, 2011.

⁵² *Ibid.*

⁵³ Schultz and Gordon, *Onward*, 247–48.

⁵⁴ E.J. Schultz, “How VIA Steamed Up the Instant-Coffee Category.”

⁵⁵ Schultz and Gordon, *Onward*, 257.

*While I might not have specifically articulated this back then, I sensed that Starbucks had the potential to once again create a new product category so that, one day, coffee lovers who once would not have dreamed of drinking instant coffee would drink ours.*⁵⁶

To the surprise of many, tasters (including those at *Consumer Reports*) found VIA coffee similar in quality to traditionally brewed Starbucks Colombian coffee.⁵⁷ At the press introduction of VIA in New York, attendees were surprised to find out that the coffee they were served was actually instant. Joe Nocera of the *New York Times* commented, “It fooled us.”⁵⁸ Similar “surprise” taste tests were conducted at several internal Starbucks meetings where partners were gathered to taste two new coffees; only later were they told one was instant. According to Schultz, no one ever questioned the “authenticity” of the samples.⁵⁹

When it was first launched, VIA was sold only in the company’s stores, where Starbucks offered taste tests comparing it with traditionally brewed Starbucks coffee. Participating customers received a free coffee on their next visit and a \$1 discount coupon for a three-pack of Starbucks VIA. Then in May 2010 Starbucks partnered with Acosta Sales & Marketing to expand the distribution of VIA to 37,000 grocery, mass merchandise, and drug store outlets throughout the United States.⁶⁰

VIA was priced at about \$1 per 3 oz (85 g) stick. This price was two-thirds the price of a cup of Starbucks in-store coffee (Exhibit 3), but three to ten times the price per serving of other instant brands, most of which cost less than twenty cents per serving (see **Exhibit 5**). In March 2011, *Coffee Review*⁶¹ conducted a blind taste test of VIA and competing instant coffee brands that showed price and appeal were not closely correlated.⁶² Despite its high price, the taste of Starbucks Colombia VIA was ranked below the lower priced Nescafé Taster’s Choice 100 percent Colombian. The results were even more striking for Italian Roast VIA, which was ranked seventh in taste, scoring below Trader Joe’s Colombia Instant Coffee despite a per-serving price ten times higher.

After one year, global sales of VIA topped \$135 million. This made it the number five instant coffee brand by volume in the United States, taking share from other brands, including market leader Folgers instant.⁶³ That same year, the instant coffee category grew 15 percent after declines in three of the previous four years.⁶⁴ Schultz commented at an investor conference, “The grocery channel, the trade, would probably have no interest in a traditional new instant coffee priced at six

⁵⁶ Ibid., 244.

⁵⁷ “We Compare Coffee: New Brews McCafé and Starbucks Instant,” *Consumer Reports*, August 2009, <http://www.consumerreports.org/cro/magazine-archive/august-2009/food/new-brews/overview/new-coffee-taste-test-ov.htm>.

⁵⁸ Joe Nocera, “Is Instant Coffee the Answer for Starbucks?” *Executive Suite* (blog), *New York Times*, February 17, 2009, <http://executivesuite.blogs.nytimes.com/2009/02/17/is-instant-coffee-the-answer-for-starbucks>.

⁵⁹ Schultz and Gordon, *Onward*, 257–58.

⁶⁰ “Starbucks Expands VIA, Debuts New Seattle’s Best Logo,” *Beverage Industry*, June 2010.

⁶¹ *Coffee Review* is an online guide offering blind taste testing of coffee and rankings on a 100 point scale similar to Robert Parker’s famed Bordeaux wine guides.

⁶² The taste testers also scored VIA substantially lower than coffee made from Starbucks CPG beans. See Kenneth Davids, “Instant Coffees and Starbucks VIA: Beyond Bad,” *Coffee Review*, March 2011.

⁶³ E.J. Schultz, “How VIA Steamed Up the Instant-Coffee Category.”

⁶⁴ Ibid.

times traditional instant coffee unless it had the brand name of Starbucks and was validated in our stores. . . . And that's exactly what's happened."⁶⁵

SINGLE-SERVE POD COFFEE

Single-serve brewed coffee was another fast-growing segment of the "away from the store" coffee market. Single-serve brewing machines, which became widely available in 2005, produced one cup of freshly brewed coffee in less than a minute by forcing hot water through a coffee "pod." A brewing machine itself cost \$75 to \$275 and each pod/cup of coffee cost between \$0.50 and \$1. This was more than the \$0.10 per cup cost of drip coffee, but consumers liked that the single-serve coffee was "faster, easier, and doesn't force the entire household to drink the same thing in the morning."⁶⁶ Coffee companies, including Procter & Gamble, Kraft, and Nestlé, were attracted by the potential follow-on sales, as each machine owner might purchase up to 1,000 pods each year.⁶⁷

The market for single-serve machines and coffee in the United States was \$509 million⁶⁸ in 2010, a doubling of the previous year's sales.⁶⁹ Those sales represented only 7 percent of the fresh coffee market, but that was a significant increase from the 2 percent share in 2008. Furthermore, the share of single-serve coffee was expected to reach 10 percent in 2012.⁷⁰ Despite these impressive gains, Starbucks indicated that by late 2010, only 20 percent of its customers owned a single-serve brewer at home.⁷¹

The leader in the U.S. home single-serve market was Keurig (owned by Green Mountain Coffee Roasters), with 6 million machines sold and a 71 percent share of the total single-serve market. Keurig's machine used proprietary technology and its K-cup pods were covered by patents.⁷² In 2009 Keurig shipped 1.6 billion K-cup pods, a 63 percent increase from the previous year.⁷³ Keurig's market lead was based on its strong position in offices, where workers had opportunities to sample Keurig products before purchasing a machine for their personal use.

Kraft's Tassimo system was a distant second to Keurig, with only 2 to 3 percent of the single-serve market.⁷⁴ As part of its relationship with Kraft, Starbucks had granted Tassimo exclusive distribution rights for single-serve versions of its flagship Starbucks brand, as well as Seattle's Best Coffee and Tazo.⁷⁵ These agreements were canceled on March 1, 2011, when Starbucks severed its distribution relationship with Kraft for whole-bean coffee.⁷⁶ Immediately following

⁶⁵ Ibid.

⁶⁶ Emily Bryson York, "Starbucks Eyes Single-Serve Coffee Market," *Chicago Tribune*, February 12, 2011.

⁶⁷ "Single Serve Coffee Pod Case Study: The Rise of the One Cup Coffee Trend (Procter & Gamble, Kraft & Nestle)," *Data Monitor*, 2005, 1–14.

⁶⁸ York, "Starbucks Eyes Single-Serve Coffee Market."

⁶⁹ Suzanne Vranica, "The Single-Serve Push: Coffee-Machine Makers Launch Big Holiday Campaigns as Field Grows Crowded," *Wall Street Journal*, October 14, 2010.

⁷⁰ York, "Starbucks Eyes Single-Serve Coffee Market."

⁷¹ "Starbucks, Green Mountain Brew Single-Cup Deal," *USATODAY.com*, March 10, 2011, http://www.usatoday.com/money/industries/food/2011-03-10-starbucks-green-mountain-single-cup_N.htm.

⁷² York, "Starbucks Eyes Single-Serve Coffee Market."

⁷³ Paul Ziobro, "The 'K-Cup' Runneth Over—Bidding War Erupts for Single-Serve Coffee Packager," *Wall Street Journal*, November 24, 2009.

⁷⁴ York, "Starbucks Eyes Single-Serve Coffee Market."

⁷⁵ Starbucks Brief, 10.

⁷⁶ Andrejczak, "Ripple Effects Likely as Starbucks, Kraft Part Ways."

termination of its Kraft agreement, Starbucks concluded a deal with Courtesy Products, the largest provider of in-room coffee service in the United States, that gave Starbucks Coffee presence in the on-demand brewing systems in 500,000 hotel rooms.

On March 10, 2011, Starbucks signed an agreement with Green Mountain Coffee Roasters to sell K-cup versions of Starbucks coffee and tea for Keurig users through food, drug, club, specialty, and department store retailers.⁷⁷ The deal made Starbucks the “sole super-premium coffee brand made for the Keurig brewing system.”⁷⁸ Following the announcement of this agreement, Starbucks’ share price increased 9.9 percent, and Green Mountain closed up 41.4 percent. Shares of Starbucks’ rival Peet’s fell by 11.4 percent.⁷⁹

Developing Non-Starbucks Branded Businesses

In addition to growing its presence in the “away from the store” coffee market, Schultz also focused on developing non-Starbucks branded businesses.

In July 2009 Starbucks opened 15th Avenue Coffee and Tea in Seattle, followed closely by Roy Street Coffee and Tea. Both stores served espresso drinks made with the La Marzocco machines used in the original Starbucks stores and offered multiple options for brewing coffee by the cup, including manual pour-over, French press, Synesso, and Clover drip coffee machines. The décor featured recovered furniture, and the menu offered select small-batch micro-roasted coffee along with beer, wine, and made-to-order food items. The stores offered Starbucks coffee and Tazo tea and delivered “the same high quality with the same heart in a new way.”⁸⁰ Some customers protested that the stores were a deliberate attempt by the company to deceive them.⁸¹

When the company reopened its renovated Starbucks store on Olive Way in Seattle in October 2010, it incorporated features from 15th Avenue and Roy Street, including expanded food offerings and wine and beer. These changes were designed, at least in part, to improve sales after two o’clock, a time period that accounted for only 30 percent of the company’s sales.⁸² In January 2011 Starbucks rebranded 15th Avenue Coffee and Tea as Starbucks and announced that the planned future stores of this type would carry the Starbucks name.

Starbucks also announced it would grow its Seattle’s Best Coffee brand into a multibillion-dollar “approachable” premium coffee using the tagline “Great Coffee Everywhere.” The brand had been acquired by Starbucks in 2003 along with its fifty stores and its large supermarket business, which included a strong presence in the profitable flavored beans category—a category Starbucks had never entered.⁸³ Seattle’s Best president Michelle Gass described Starbucks as a

⁷⁷ “Starbucks, Green Mountain Brew Single-Cup Deal.”

⁷⁸ Julie Jargon, “Starbucks in Pod Pact,” *Wall Street Journal*, March 11, 2011.

⁷⁹ Prior to the announcement of this partnership, it was speculated by many analysts that Peet’s would establish its own partnership with Green Mountain.

⁸⁰ Jennifer Zegler, “Ingredient Spotlight: New Initiatives Expand Starbucks’ Reach,” *Beverage Industry*, June 2010.

⁸¹ Cindy Tickle, “Faux Starbucks Baristas Protest Outside New 15th Ave Coffee & Tea,” *The Examiner*, July 25, 2009.

⁸² Bruce Horowitz, “Starbucks Remakes Its Future with an Eye on Beer and Wine,” *USATODAY.com*, October 22, 2010, http://www.usatoday.com/money/industries/food/2010-10-18-starbucks18_CV_N.htm.

⁸³ Kevin Helliker, “Starbucks Targets Regular Joes; Firm to Offer Second Coffee Brand—Its Seattle’s Best—in Fast-Food Outlets, Supermarkets, Machines,” *Wall Street Journal Online*, May 12, 2010, <http://peaknewsroom.blogspot.com/2010/05/starbucks-targets-regular-joes-with.html>.

“destination coffee experience” and Seattle’s Best as coffee “brought to the consumer when they make other retail choices.”⁸⁴

Seattle’s Best signed agreements to sell coffee at more than 9,000 Subway restaurants and 7,000 Burger King locations, where the coffee was to be offered hot and iced, with the option of adding vanilla or mocha flavorings and whipped topping. Seattle’s Best sought opportunities in other locations not compatible with the Starbucks brand, such as movie theatres, convenience stores, and even vending machines. In May 2011 Starbucks announced that Seattle’s Best was now available in 50,000 locations in the United States.

In order to appeal to coffee drinkers who avoided Starbucks because it was “too expensive or high-end,”⁸⁵ Seattle’s Best was promoted as “unpretentious.”⁸⁶ It was priced above mass-market coffees but below the Starbucks price, and its smoother flavor profile appealed to the palates of consumers who found Starbucks coffee too strong.

Acquiring the Coffee Equipment Company

Schultz encountered another potential growth opportunity for Starbucks shortly after returning as CEO. While touring independent coffeehouses in New York City, he noticed a queue of people waiting for a cup of drip coffee that cost \$6—nearly four times the price of drip coffee at Starbucks. Schultz was amazed by the quality of the product, which he compared to coffee produced in a French press without the labor-intensive process.

The coffee was made by an \$11,000 machine called the Clover, which customized the coffee-brewing process and the resulting flavor by controlling dose, brewing temperature, and brew time. Schultz saw three benefits of the Clover for Starbucks: (1) it produced a superior cup of coffee on par with the commercially impractical French press method, (2) it offered drip coffee customers the theater that was part of the production of espresso-based drinks, and (3) because it made coffee one cup at a time, it could allow Starbucks to offer coffee brewed from smaller batch specialty beans, which was otherwise impractical. These factors, plus the apparent consumer willingness to pay a premium price for coffee from the Clover, convinced Schultz to first test it in his stores, and then acquire the company that created it—Coffee Equipment Company (CEC) located in Ballard, Washington.

In Schultz’s judgment, immediate revenue was not the justification for acquiring CEC. The “important” aspect of the acquisition “was the message of confidence that Clover’s acquisition would send to partners, customers, and shareholders, reassuring everyone that Starbucks was once again committed to decisiveness and coffee innovation.”⁸⁷ Michelle Gass offered an additional rationale: “Frankly, we just don’t want anyone else to have it.”⁸⁸

⁸⁴ Ibid.

⁸⁵ Beth Kowitt, “Starbucks’ Seattle’s Best Brand: The Next Old Navy?” *Fortune*, May 25, 2010, http://money.cnn.com/2010/05/25/news/companies/starbucks_seattles_best.fortune/index.htm.

⁸⁶ Helliker, “Starbucks Targets Regular Joes.”

⁸⁷ Schultz and Gordon, *Onward*, 95.

⁸⁸ Matthew Honan, “The Coffee Fix: Can the \$11,000 Clover Machine Save Starbucks?” *Wired*, July 21, 2008.

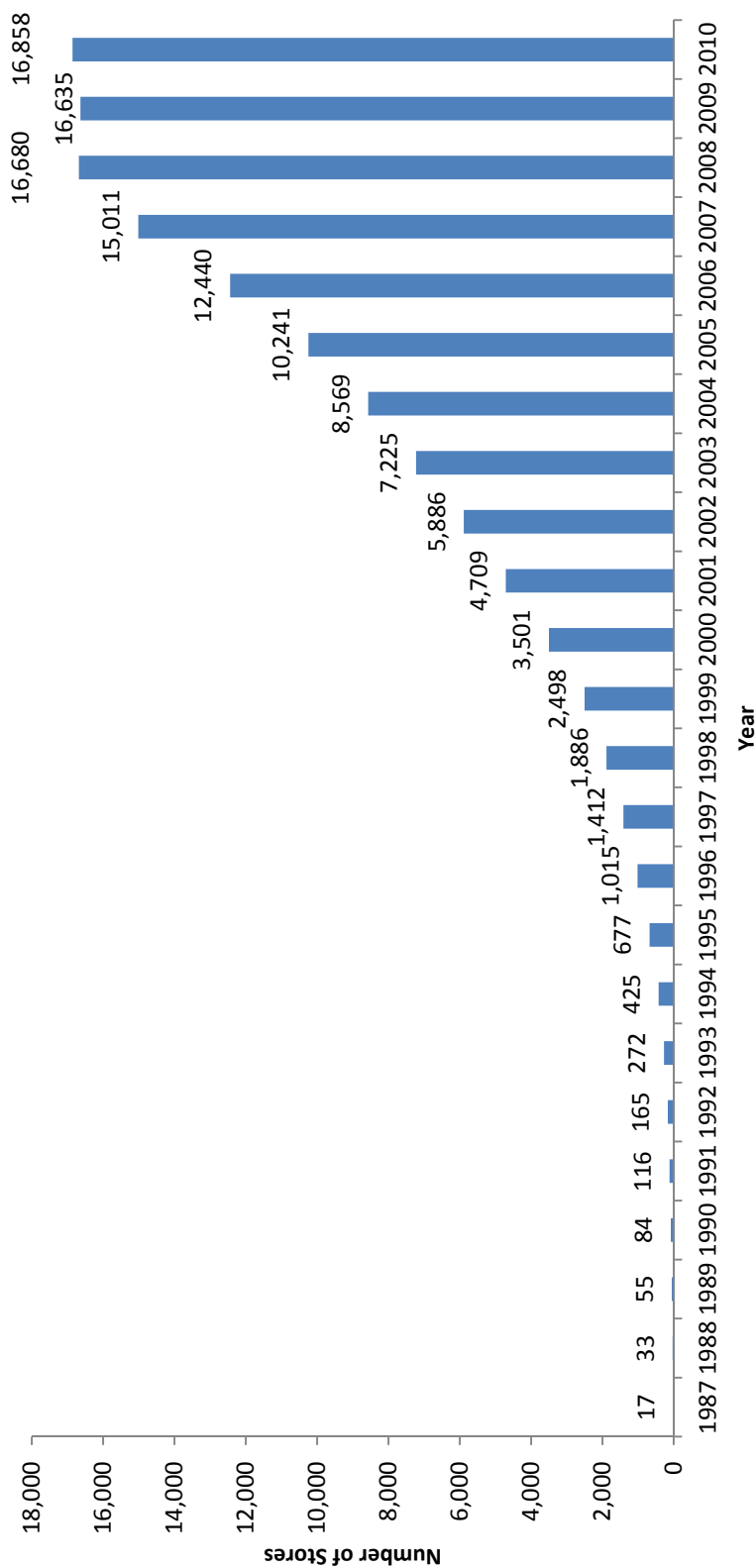
Conclusion

The clock read 6:15 a.m., and with his coffee and review finished, Schultz was ready to head to the office. As he climbed into his car he contemplated the challenges that lay ahead as he continued to lead Starbucks toward his vision of a great, enduring company.



Exhibit 1: U.S. Coffee Consumption, 1960–2008

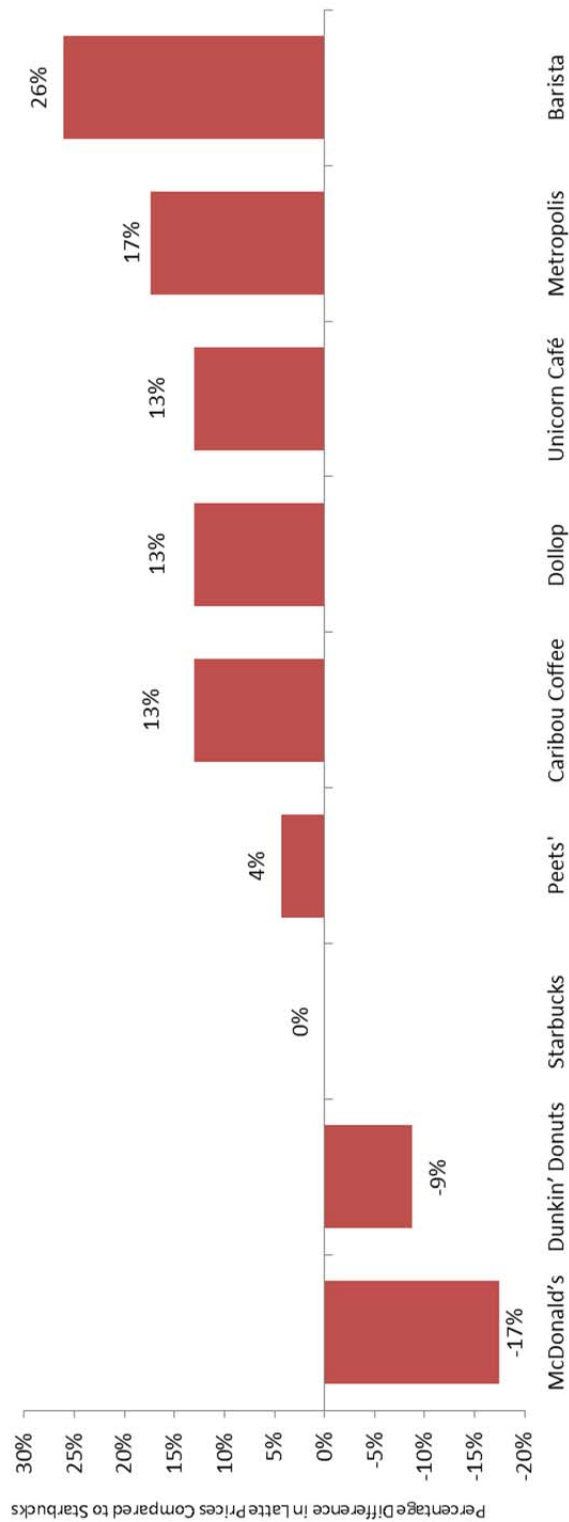
Source: Economic Research Service (ERS), U.S. Department of Agriculture (USDA). Food Availability (Per Capita) Data System.

Exhibit 2: Number of Starbucks Stores Worldwide

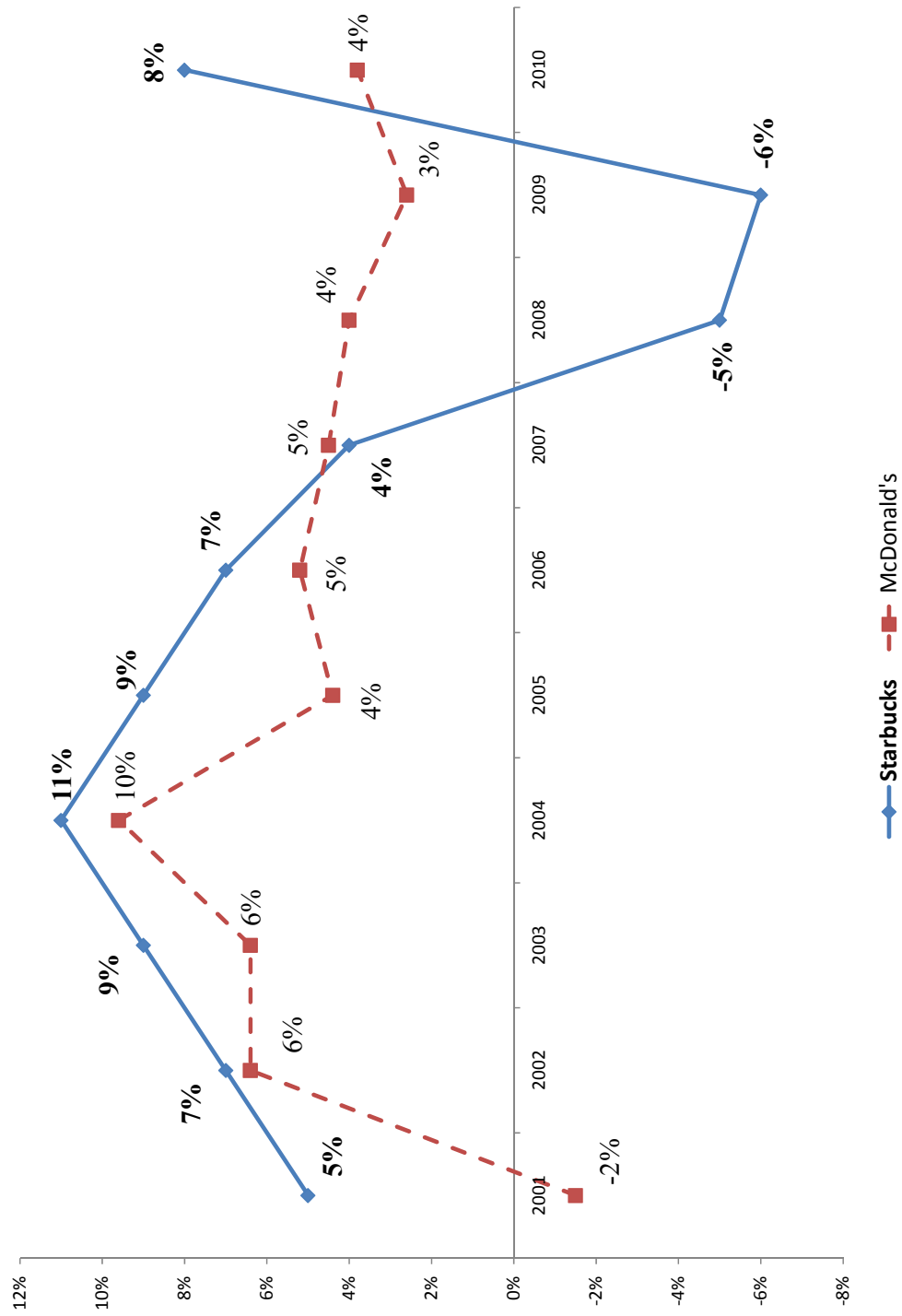
Source: Starbucks Company Timeline, http://news.starbucks.com/images/10041/AboutUs-Timeline-FINAL3_8_11.pdf.

Exhibit 3: Coffee Prices (US\$)

	Fast Food Restaurants			Small Chains			Independent Coffeehouses			
	McDonald's	Dunkin' Donuts	Starbucks	Peet's	Caribou Coffee	Dollop	Unicorn Café	Metropolis	Barista	
Drip coffee	0.96	1.44	1.56	1.68	1.80	1.80	1.80	1.68	1.80	
Latte	2.28	2.52	2.76	2.88	3.12	3.12	3.12	3.24	3.48	
Cappuccino	2.28	2.52	2.76	2.88	3.12	3.12	3.12	3.24	3.48	
Mocha	2.28	2.52	3.12	3.24	3.60	3.60	3.48	3.48	3.48	

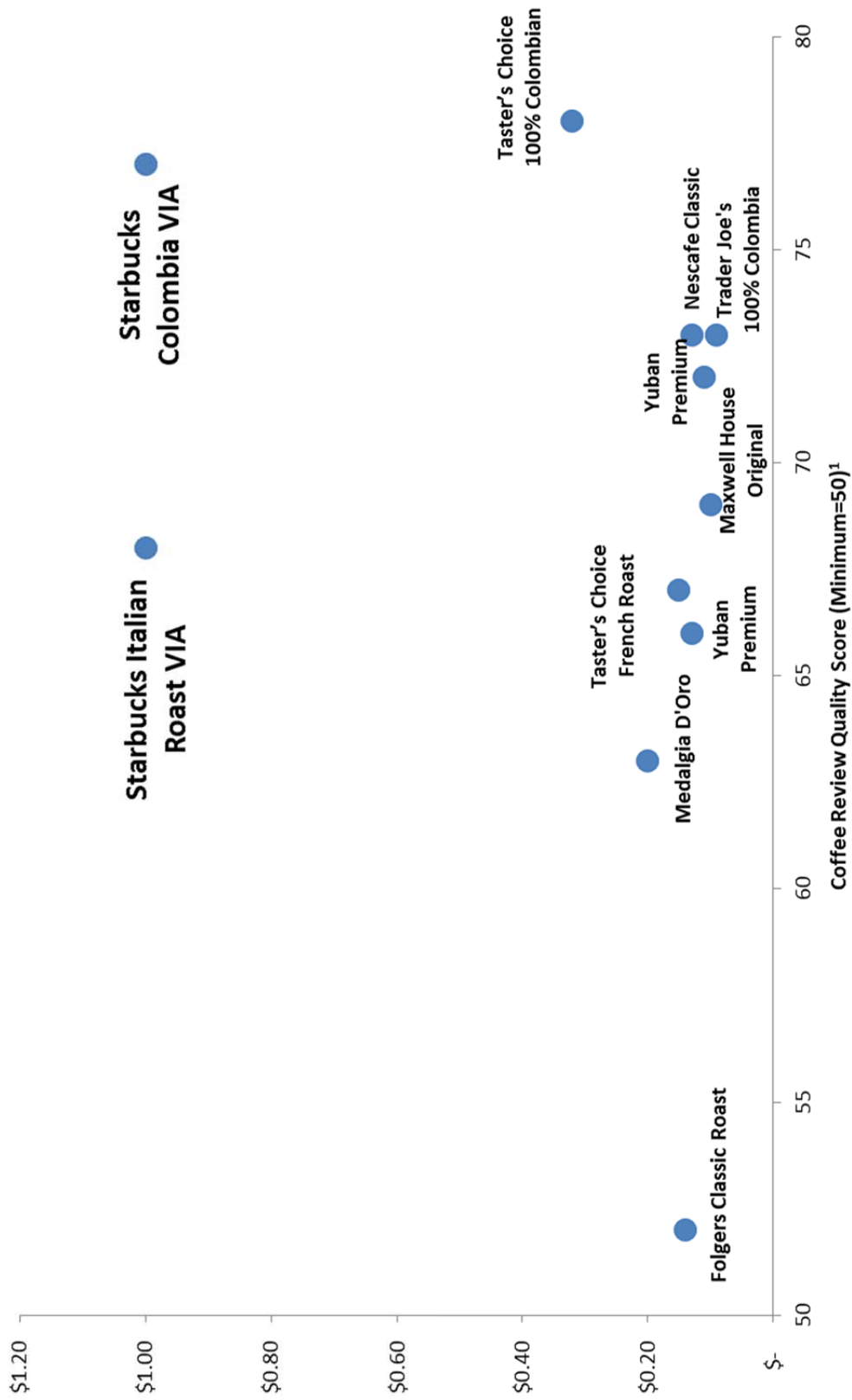
Competitor Latte Prices vs. Starbucks

Note: Prices are normalized to a 12 oz (355 ml) serving size. This normalization was obtained using the posted price for the smallest beverage size on August 6, 2010, at outlets in the Chicago metropolitan area.

Exhibit 4: Starbucks and McDonald's Same-Store Sales, 2001–2010

Source: Starbucks and McDonald's Corporation Annual Reports.

Note: Same-store sales are the percentage change in annual sales for U.S.-based stores that have been open for at least thirteen months.

Exhibit 5: Instant Coffee Price Per Serving and Quality

Source: Coffee Review, March 2011.

Note: Coffee quality scores determined by Coffee Review. Ratings are based on a scale of 50–100 and are meant to reflect the reviewer's measure of overall quality across dimensions such as aroma, acidity, body, flavor, and aftertaste.