

CASE 1-1 Starbucks—Going Global Fast

The Starbucks coffee shop on Sixth Avenue and Pine Street in downtown Seattle sits serene and orderly, as unremarkable as any other in the chain bought years ago by entrepreneur Howard Schultz. A few years ago however, the quiet storefront made front pages around the world. During the World Trade Organization talks in November 1999, protesters flooded Seattle's streets, and among their targets was Starbucks, a symbol, to them, of free-market capitalism run amok, another multinational out to blanket the earth. Amid the crowds of protesters and riot police were black-masked anarchists who trashed the store, leaving its windows smashed and its tasteful green-and-white decor smelling of tear gas instead of espresso. Says an angry Schultz: "It's hurtful. I think people are ill-informed. It's very difficult to protest against a can of Coke, a bottle of Pepsi, or a can of Folgers. Starbucks is both this ubiquitous brand and a place where you can go and break a window. You can't break a can of Coke."

The store was quickly repaired, and the protesters scattered to other cities. Yet cup by cup, Starbucks really is caffeinating the world, its green-and-white emblem beckoning to consumers on three continents. In 1999, Starbucks Corp. had 281 stores abroad. Today, it has about 5,500—and it's still in the early stages of a plan to colonize the globe. If the protesters were wrong in their tactics, they weren't wrong about Starbucks' ambitions. They were just early.

The story of how Schultz & Co. transformed a pedestrian commodity into an upscale consumer accessory has a fairy-tale quality. Starbucks grew from 17 coffee shops in Seattle 15 years ago to over 16,000 outlets in 50 countries. Sales have climbed an average of 20 percent annually since the company went public, peaking at \$10.4 billion in 2008 before falling to \$9.8 billion in 2009. Profits bounded ahead an average of 30 percent per year through 2007 peaking at \$673, then dropping to \$582 billion and \$494 billion in 2008 and 2009, respectively. The firm closed 475 stores in the U.S. in 2009 to reduce costs.

Still, the Starbucks name and image connect with millions of consumers around the globe. Up until recently, it was one of the fastest-growing brands in annual *BusinessWeek* surveys of the top 100 global brands. On Wall Street, Starbucks was one of the last great growth stories. Its stock, including four splits, soared more than 2,200 percent over a decade, surpassing Walmart, General Electric, PepsiCo, Coca-Cola, Microsoft, and IBM in total returns. In 2006 the stock price peaked at over \$40, but now has declined to \$4.

Schultz's team is hard-pressed to grind out new profits in a home market that is quickly becoming saturated. Amazingly, with over 10,000 stores scattered across the United States and Canada, there are still eight states in the United States with no Starbucks stores. Frappuccino-free cities include Butte, Montana, and Fargo, North Dakota. But big cities, affluent suburbs, and shopping malls are full to the brim. In coffee-crazed Seattle, there is a Starbucks outlet for every 9,400 people, and the company considers that the upper limit of coffee-shop saturation. In Manhattan's 24 square miles, Starbucks has 124 cafés, with more on the way. That's one for every 12,000 people—meaning that

there could be room for even more stores. Given such concentration, it is likely to take annual same-store sales increases of 10 percent or more if the company is going to match its historic overall sales growth. That, as they might say at Starbucks, is a tall order to fill.

Indeed, the crowding of so many stores so close together has become a national joke, eliciting quips such as this headline in *The Onion*, a satirical publication: "A New Starbucks Opens in Restroom of Existing Starbucks." And even the company admits that while its practice of blanketing an area with stores helps achieve market dominance, it can cut sales at existing outlets. "We probably self-cannibalize our stores at a rate of 30 percent a year," Schultz says. Adds Lehman Brothers Inc. analyst Mitchell Speiser: "Starbucks is at a defining point in its growth. It's reaching a level that makes it harder and harder to grow, just due to the law of large numbers."

To duplicate the staggering returns of its first decade, Starbucks has no choice but to export its concept aggressively. Indeed, some analysts gave Starbucks only two years at most before it saturates the U.S. market. The chain now operates 5,507 international outlets, from Beijing to Bristol. That leaves plenty of room to grow. Most of its planned new stores will be built overseas, representing a 35 percent increase in its foreign base. Most recently, the chain has opened stores in Vienna, Zurich, Madrid, Berlin, and even in far-off Jakarta. Athens comes next. And within the next year, Starbucks plans to move into Mexico and Puerto Rico. But global expansion poses huge risks for Starbucks. For one thing, it makes less money on each overseas store because most of them are operated with local partners. While that makes it easier to start up on foreign turf, it reduces the company's share of the profits to only 20 percent to 50 percent.

Moreover, Starbucks must cope with some predictable challenges of becoming a mature company in the United States. After riding the wave of successful baby boomers through the 1990s, the company faces an ominously hostile reception from its future consumers, the twenty- or thirty-somethings of Generation X. Not only are the activists among them turned off by the power and image of the well-known brand, but many others say that Starbucks' latte-sipping sophisticates and piped-in Kenny G music are a real turnoff. They don't feel wanted in a place that sells designer coffee at \$3 a cup.

Even the thirst of loyalists for high-price coffee cannot be taken for granted. Starbucks' growth over the early part of the past decade coincided with a remarkable surge in the economy. Consumer spending tanked in the downturn, and those \$3 lattes were an easy place for people on a budget to cut back.

Starbucks also faces slumping morale and employee burnout among its store managers and its once-cheery army of baristas. Stock options for part-timers in the restaurant business was a Starbucks innovation that once commanded awe and respect from its employees. But now, though employees are still paid better than comparable workers elsewhere—about \$7 per hour—many regard the job as just another fast-food gig. Dissatisfaction over odd hours and low pay is affecting the quality of the

normally sterling service and even the coffee itself, say some customers and employees. Frustrated store managers among the company's roughly 470 California stores sued Starbucks in 2001 for allegedly refusing to pay legally mandated overtime. Starbucks settled the suit for \$18 million, shaving \$0.03 per share off an otherwise strong second quarter. However, the heart of the complaint—feeling overworked and underappreciated—doesn't seem to be going away.

To be sure, Starbucks has a lot going for it as it confronts the challenge of regaining its growth. Nearly free of debt, it fuels expansion with internal cash flow. And Starbucks can maintain a tight grip on its image because stores are company-owned: There are no franchisees to get sloppy about running things. By relying on mystique and word of mouth, whether here or overseas, the company saves a bundle on marketing costs. Starbucks spends just \$30 million annually on advertising, or roughly 1 percent of revenues, usually just for new flavors of coffee drinks in the summer and product launches, such as its new in-store Web service. Most consumer companies its size shell out upwards of \$300 million per year. Moreover, Starbucks for the first time faces competition from large U.S. competitors such as McDonald's and their new McCafés.

Schultz remains the heart and soul of the operation. Raised in a Brooklyn public-housing project, he found his way to Starbucks, a tiny chain of Seattle coffee shops, as a marketing executive in the early 1980s. The name came about when the original owners looked to Seattle history for inspiration and chose the moniker of an old mining camp: Starbo. Further refinement led to Starbucks, after the first mate in *Moby Dick*, which they felt evoked the seafaring romance of the early coffee traders (hence the mermaid logo). Schultz got the idea for the modern Starbucks format while visiting a Milan coffee bar. He bought out his bosses in 1987 and began expanding.

The company is still capable of designing and opening a store in 16 weeks or less and recouping the initial investment in three years. The stores may be oases of tranquility, but management's expansion tactics are something else. Take what critics call its "predatory real estate" strategy—paying more than market-rate rents to keep competitors out of a location. David C. Schomer, owner of Espresso Vivace in Seattle's hip Capitol Hill neighborhood, says Starbucks approached his landlord and offered to pay nearly double the rate to put a coffee shop in the same building. The landlord stuck with Schomer, who says: "It's a little disconcerting to know that someone is willing to pay twice the going rate." Another time, Starbucks and Tully's Coffee Corp., a Seattle-based coffee chain, were competing for a space in the city. Starbucks got the lease but vacated the premises before the term was up. Still, rather than let Tully's get the space, Starbucks decided to pay the rent on the empty store so its competitor could not move in. Schultz makes no apologies for the hardball tactics. "The real estate business in America is a very, very tough game," he says. "It's not for the faint of heart."

Still, the company's strategy could backfire. Not only will neighborhood activists and local businesses increasingly resent the tactics, but customers could also grow annoyed over having fewer choices. Moreover, analysts contend that Starbucks can maintain about 15 percent square-footage growth in the United States—equivalent to 550 new stores—for only about two more years. After that, it will have to depend on overseas growth to maintain an annual 20 percent revenue growth.

Starbucks was hoping to make up much of that growth with more sales of food and other noncoffee items but has stumbled somewhat. In the late 1990s, Schultz thought that offering \$8 sandwiches, desserts, and CDs in his stores and selling packaged coffee in supermarkets would significantly boost sales. The specialty business now accounts for about 16 percent of sales, but growth has been less than expected.

What's more important for the bottom line, though, is that Starbucks has proven to be highly innovative in the way it sells its main course: coffee. In 800 locations it has installed automatic espresso machines to speed up service. And several years ago, it began offering prepaid Starbucks cards, priced from \$5 to \$500, which clerks swipe through a reader to deduct a sale. That, says the company, cuts transaction times in half. Starbucks has sold \$70 million of the cards.

When Starbucks launched Starbucks Express, its boldest experiment yet, it blended java, Web technology, and faster service. At about 60 stores in the Denver area, customers can pre-order and prepay for beverages and pastries via phone or on the Starbucks Express Web site. They just make the call or click the mouse before arriving at the store, and their beverage will be waiting—with their name printed on the cup. The company decided in 2003 that the innovation had not succeeded and eliminated the service.

And Starbucks continues to try other fundamental store changes. It announced expansion of a high-speed wireless Internet service to about 1,200 Starbucks locations in North America and Europe. Partners in the project—which Starbucks calls the world's largest Wi-Fi network—include Mobile International, a wireless subsidiary of Deutsche Telekom, and Hewlett-Packard. Customers sit in a store and check e-mail, surf the Web, or download multimedia presentations without looking for connections or tripping over cords. They start with 24 hours of free wireless broadband before choosing from a variety of monthly subscription plans.

Starbucks executives hope such innovations will help surmount their toughest challenge in the home market: attracting the next generation of customers. Younger coffee drinkers already feel uncomfortable in the stores. The company knows that because it once had a group of twentysomethings hypnotized for a market study. When their defenses were down, out came the bad news. "They either can't afford to buy coffee at Starbucks, or the only peers they see are those working behind the counter," says Mark Barden, who conducted the research for the Hal Riney & Partners ad agency (now part of Publicis Worldwide) in San Francisco. One of the recurring themes the hypnosis brought out was a sense that "people like me aren't welcome here except to serve the yuppies," he says. Then there are those who just find the whole Starbucks scene a bit pretentious. Katie Kelleher, 22, a Chicago paralegal, is put off by Starbucks' Italian terminology of grande and venti for coffee sizes. She goes to Dunkin' Donuts, saying: "Small, medium, and large is fine for me."

As it expands, Starbucks faces another big risk: that of becoming a far less special place for its employees. For a company modeled around enthusiastic service, that could have dire consequences for both image and sales. During its growth spurt of the mid- to late-1990s, Starbucks had the lowest employee turnover rate of any restaurant or fast-food company, largely thanks to its then unheard-of policy of giving health insurance and modest stock options to part-timers making barely more than minimum wage.

Such perks are no longer enough to keep all the workers happy. Starbucks' pay doesn't come close to matching the workload it requires, complain some staff. Says Carrie Shay, a former store manager in West Hollywood, California: "If I were making a decent living, I'd still be there." Shay, one of the plaintiffs in the suit against the company, says she earned \$32,000 a year to run a store with 10 to 15 part-time employees. She hired employees, managed their schedules, and monitored the store's weekly profit-and-loss statement. But she was also expected to put in significant time behind the counter and had to sign an affidavit pledging to work up to 20 hours of overtime a week without extra pay—a requirement the company has dropped since the settlement.

For sure, employee discontent is far from the image Starbucks wants to project of relaxed workers cheerfully making cappuccinos. But perhaps it is inevitable. The business model calls for lots of low-wage workers. And the more people who are hired as Starbucks expands, the less they are apt to feel connected to the original mission of high service—bantering with customers and treating them like family. Robert J. Thompson, a professor of popular culture at Syracuse University, says of Starbucks: "It's turning out to be one of the great 21st century American success stories—complete with all the ambiguities."

Overseas, though, the whole Starbucks package seems new and, to many young people, still very cool. In Vienna, where Starbucks had a gala opening for its first Austrian store, Helmut Spudich, a business editor for the paper *Der Standard*, predicted that Starbucks would attract a younger crowd than the established cafés. "The coffeehouses in Vienna are nice, but they are old. Starbucks is considered hip," he says.

But if Starbucks can count on its youth appeal to win a welcome in new markets, such enthusiasm cannot be counted on indefinitely. In Japan, the company beat even its own bullish expectations, growing to 875 stores after opening its first in Tokyo in 1996. Affluent young Japanese women like Anna Kato, a 22-year-old Toyota Motor Corp. worker, loved the place. "I don't care if it costs more, as long as it tastes sweet," she says, sitting in the world's busiest Starbucks, in Tokyo's Shibuya district. Yet same-store sales growth has fallen in Japan, Starbucks' top foreign market, as rivals offer similar fare. Meanwhile in England, Starbucks' second-biggest overseas market, with over 400 stores, imitators are popping up left and right to steal market share.

Entering other big markets may be tougher yet. The French seem to be ready for Starbucks' sweeter taste, says Philippe Bloch, cofounder of Columbus Cafe, a Starbucks-like chain. But he wonders if the company can profitably cope with France's arcane regulations and generous labor benefits. And in Italy, the epicenter of European coffee culture, the notion that the locals will abandon their own 200,000 coffee bars en masse for Starbucks strikes many as ludicrous. For one, Italian coffee bars prosper by serving food as well as coffee, an area where Starbucks still struggles. Also, Italian coffee is cheaper than U.S. java and, say Italian purists, much better. Americans pay about \$1.50 for an espresso. In northern Italy, the price is 67 cents; in the south, just 55 cents. Schultz insists that Starbucks will eventually come to Italy. It'll have a lot to prove when it does. Carlo Petrini, founder of the antiglobalization movement Slow Food, sniffs that Starbucks' "substances served in styrofoam" won't cut it. The cups are paper, of course. But the skepticism is real.

As Starbucks spreads out, Schultz will have to be increasingly sensitive to those cultural challenges. For instance, he flew

to Israel several years ago to meet with then Foreign Secretary Shimon Peres and other Israeli officials to discuss the Middle East crisis. He won't divulge the nature of his discussions. But subsequently, at a Seattle synagogue, Schultz let the Palestinians have it. With Starbucks outlets already in Kuwait, Lebanon, Oman, Qatar, and Saudi Arabia, he created a mild uproar among Palestinian supporters. Schultz quickly backpedaled, saying that his words were taken out of context and asserting that he is "pro-peace" for both sides.

There are plenty more minefields ahead. So far, the Seattle coffee company has compiled an envious record of growth. But the giddy buzz of that initial expansion is wearing off. Now, Starbucks is waking up to the grande challenges faced by any corporation bent on becoming a global powerhouse.

In a 2005 bid to boost sales in its largest international market, Starbucks Corp. expanded its business in Japan, beyond cafés and into convenience stores, with a line of chilled coffee in plastic cups. The move gives the Seattle-based company a chance to grab a chunk of Japan's \$10 billion market for coffee sold in cans, bottles, or vending machines rather than made-to-order at cafés. It is a lucrative but fiercely competitive sector, but Starbucks, which has become a household name since opening its first Japanese store, is betting on the power of its brand to propel sales of the new drinks.

Starbucks is working with Japanese beverage maker and distributor Suntory Ltd. The "Discoveries" and "Doubleshot" lines are the company's first forays into the ready-to-drink market outside North America, where it sells a line of bottled and canned coffee. It also underscores Starbucks' determination to expand its presence in Asia by catering to local tastes. For instance, the new product comes in two variations—espresso and latte—that are less sweet than their U.S. counterparts, as the coffee maker developed them to suit Asian palates. Starbucks officials said they hope to establish their product as the premium chilled cup brand, which, at 210 yen (\$1.87), will be priced at the upper end of the category.

Starbucks faces steep competition. Japan's "chilled cup" market is teeming with rival products, including Starbucks lookalikes. One of the most popular brands, called Mt. Rainier, is emblazoned with a green circle logo that closely resembles that of Starbucks. Convenience stores also are packed with canned coffee drinks, including Coca-Cola Co.'s Georgia brand and brews with extra caffeine or made with gourmet coffee beans.

Schultz declined to speculate on exactly how much coffee Starbucks might sell through Japan's convenience stores. "We wouldn't be doing this if it wasn't important both strategically and economically," he said.

The company has no immediate plans to introduce the beverage in the United States, though it has in the past brought home products launched in Asia. A green tea frappuccino, first launched in Asia, was later introduced in the United States and Canada, where company officials say it was well received.

Starbucks has done well in Japan, although the road hasn't always been smooth. After cutting the ribbon on its first Japan store in 1996, the company began opening stores at a furious pace. New shops attracted large crowds, but the effect wore off as the market became saturated. The company returned to profitability, and net profits jumped more than sixfold to 3.6 billion yen in 2007, but declined again to 2.7 billion yen in 2009.

Most recently in Japan, the firm has successfully developed a broader menu for its stores, including customized products—smaller sandwiches and less-sweet desserts. The strategy increased

same store sales and overall profits. The firm also added 175 new stores since 2006, including some drive-through service. But McDonald's also is attacking the Japanese market with the introduction of its McCafé coffee shops.

QUESTIONS

As a guide, use Exhibit 1.3 and its description in Chapter 1, and do the following:

1. Identify the controllable and uncontrollable elements that Starbucks has encountered in entering global markets.
2. What are the major sources of risk facing the company? Discuss potential solutions.

3. Critique Starbucks' overall corporate strategy.
4. How might Starbucks improve profitability in Japan?

Visit www.starbucks.com for more information.

Sources: Stanley Holmes, Drake Bennett, Kate Carlisle, and Chester Dawson, "Planet Starbucks: To Keep Up the Growth It Must Go Global Quickly," *BusinessWeek*, December 9, 2002, pp. 100–110; Ken Belson, "Japan: Starbucks Profit Falls," *The New York Times*, February 20, 2003, p. 1; Ginny Parker Woods, "Starbucks Bets Drinks Will Jolt Japan Sales," *Asian Wall Street Journal*, September 27, 2005, p. A7; Amy Chozick, "Starbucks in Japan Needs A Jolt," *The Wall Street Journal*, October 24, 2006, p. 23; "McCafé Debuts in Japan, Challenging Starbucks, Other Coffee Shops," *Kyoto News*, August 28, 2007; "Starbucks Japan Sees 55% Pretax Profit Jump for April-December," *Nikkei Report*, February 6, 2008; see the most recent annual report at www.starbucks.com.