Editor's Note: From time to time, CSP will examine a competing retailer. In this issue, we feature Starbucks Corp.

Starbucks Throws Its Weight

Starbucks already has defined the coffee experience. Can it define the meal experience?

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They say the allure of Starbucks' coffee is so powerful that the sheer number of customers driving out of their way for a morning fix has increased the duration of the a.m. commute nationwide, contributing to air pollution and traffic congestion.

They say that Starbucks' clout is so strong that it can dictate which businesses open up near its locations, and if you're a rival coffee chain—well, best look for another neighborhood.

They say that wherever a Starbucks opens, neighboring coffee shops often see a lift in sales after consumers realize they can get better quality and value for their $5 elsewhere.

With 14,000 locations and $8.6 billion in revenue worldwide, Seattle-based Starbucks Corp. has attained the colossus status achieved only by companies such as McDonald's. In the process, it has generated a host of rumors and the full range of human emotion—love, fear, hate, admiration—from competition and consumers alike.

DRIVING SALES: More than 2,000 Starbucks in North America are equipped with drive-thrus, which have helped generate an additional $200,000 in volume for first-year cafés.

What they all can agree on: Starbucks sells.

"What they did that was really brilliant: Management decided to make the company a lifestyle brand, not a food restaurant, and that's really the root of its success," says Andrew Hetzel, president of specialty-coffee consultant Cafemakers LLC, Kamuela, Hawaii.

That differentiation point is rooted in the concept of the "third place," with the first and second places being work and home. "Everyone sort of needs that third place, which is the place we can be ourselves and communicate with others—that informal but still social environment where we can feel we're part of the community," says Hetzel.

Whether it's the personalized drinks, hip music or café ambience, Starbucks has tapped into that human need like no other retailer. The result—besides billions of dollars in sales—is the transformation of consumer behavior and the foodservice industries on multiple levels.

"Coffee has become somewhat of an impulse buy," says Darren Tristano, executive vice president of foodservice research firm Technomic Inc., Chicago. "You're not thinking you want it, but there's Starbucks, you smell the coffee and say, 'OK, I need to stop.' Maybe it's an espresso after lunch, cappuccino in the afternoon or coffee in the morning; they really found a way to give you 10 different reasons to have a cup of coffee."

Despite agreement on Starbucks' accomplishments, its current and future direction is up for grabs. The potential of its expanded foodservice program, the wisdom of adding drive-thrus and the company's proximity to market saturation all have their supporters and detractors. The latter reportedly includes Starbucks' own chairman, Howard Schultz, who, in a leaked memo, fretted about the commoditization of "the Starbucks' experience."

At the same time, while sales indicate that consumers have plenty of room left in their pocketbooks and morning commute for Starbucks, the corporation is gambling with its brand as it attempts to expand its cachet, and, unwittingly, may be exposing footholds for the competition.

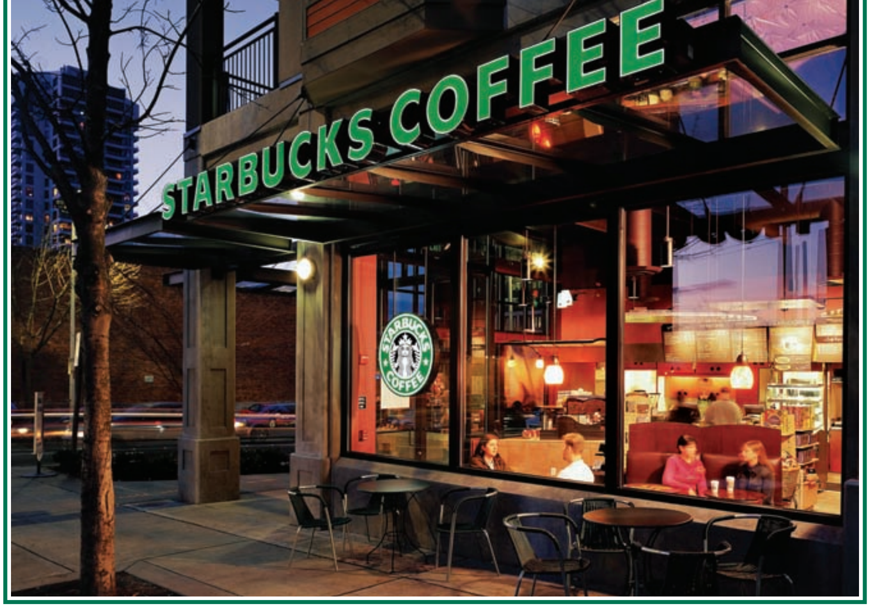
24

The number of countries Starbucks bought coffee from in 2006.

Current State of Affairs

Perhaps the first measure of a company is the size of its following. To this point, Starbucks has led nearly every operator in the foodservice space, improving the quality of product, revamping interior stylings and reshaping consumer tastes.

Of course, it all starts with the coffee.



14,000 AND COUNTING: Starbucks currently operates 14,000 stores in 40 countries, 10 times the number of locations vs. a decade ago. The coffee retailer's ultimate goal is to hit 40,000 stores worldwide.

Although it's become somewhat popular to disparage the quality of Starbucks' coffee—a March 2007 article by *Consumer Reports* rated the chain's brew as "strong, but burnt and bitter"—consumers have undeniably awoken to bolder blends. It has forced other retailers to re-examine their coffee lineup.

"There're still people who like a weaker coffee in comparison to Starbucks, and again, that's still a very large portion of our business," says Brian Matlock, vice president of food management for Rutter's Farm Stores, York, Pa. "But at the same time, there's a very distinct segment of folks that like a stronger cup of coffee."

Rutter's introduced two new brews—a premium house blend and espresso roast—to woo that segment. The bolder blends have been so robust they've actually pushed down sales of the milder regular blends from 80% to 40% of Rutter's total coffee sales.

QSRs also have followed Starbucks' lead, both in brew and café ambiance [CSP—2007 Foodservice Resource Guide, p. 79].

"If you take look at what McDonald's is doing to its interiors, Yum Brands through Taco Bell is doing with enhancement of the interior—it's not just because fast-casual is putting pressure on them with a more upscale environment," says Tristano of Technomic. "It's because Starbucks has become the norm: the comfy couches, the Internet access, the location that's really much nicer than a typical QSR."

Starbucks' closest specialty-coffee competition comes from Caribou Coffee Co., which clocks in at 475 locations worldwide. In comparison, in California alone there are more than 2,000 Starbucks stores.

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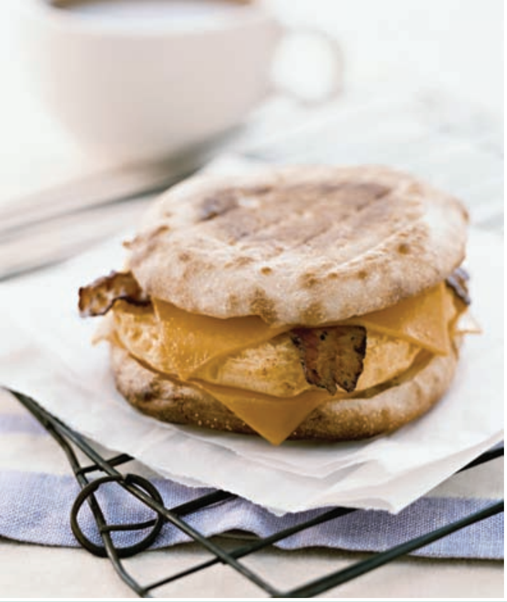
>
> **ANDREW HETZEL** *Cafemakers LLC*



TIME TO EAT: Starbucks' latest foodservice push includes hot breakfast sandwiches and cold, prepackaged lunch sandwiches and salads. The offerings are not the first time the coffee giant has experimented with food; it provides both a bundling opportunity and a way to meet customer needs.

"Any of the bigger chains that have 50-plus locations right now that I'm aware of are carbon copies—and in some cases, lesser carbon copies—of what Starbucks is doing," says Hetzel. "That's why we haven't really seen any dominant successor rise to the occasion with rapid expansion of thousands of units based on quality or really something unique."

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>
> **DARREN TRISTANO** *Technomic Inc.*

Starbucks' edge lies in customer loyalty. According to research conducted in the fourth quarter of 2006 by Sandelman & Associates, 23% of Dunkin' Donuts customers reported purchasing coffee from Starbucks, while only 13% of Starbucks customers reported buying coffee from Dunkin' Donuts. Meanwhile, Starbucks customers visited the chain an average of 5.2 times in the past month, vs. Dunkin' Donuts' average of 4.4 times.

The company is even reputed to influence the location of its competition. "They've got a tremendous amount of market power when it comes to securing retail locations," says Hetzel. "They can enter into nationwide and in some cases, international agreements with property holders to exclude competitors from those locations, to get first right of refusal on sites."

This being said, Hetzel sees the most effective competition against Starbucks coming not from national chains but from smaller regional players and even independents who focus on product quality and service, both traditional trademarks of the Starbucks brand that some argue have suffered under the company's growth.

In fact, the competitive difference between today's Starbucks and an innovative independent with a focus on superpremium can manifest itself in sales. "A 20% bump in business as the result of a Starbucks opening up next door is not unusual for a well-run coffee shop," says Hetzel.

Food for Thought

The work Starbucks has done thus far in shaping consumer behavior extends beyond bolder coffee and reaches into meal occasions.

"They really have done a great job of expanding their use, creating new dayparts—like snacking opportunities—and creating a very social occasion for business workers, friends and family to go out and have that time and indulge themselves in coffee," Tristano says.

14,000
The current number of stores Starbucks operates worldwide—10 times the number of locations vs. a decade ago.

This past year, Starbucks expanded its foodservice program into hot breakfast sandwiches and refrigerated, prepackaged lunch sandwiches and salads. Breakfast is available at more than 1,700 Starbucks stores in 10 markets, while the lunch offerings are sold at more than 4,400 locations. The company's retail sales mix in 2006 consisted of 77% beverages, 15% food, 3% whole-bean coffee and 5% coffee-making equipment and other merchandise, according to Starbucks' annual report.

It's actually a return to focus that occupied the company some years back.

Maurice Minno, a partner with Minneapolis-based foodservice consultancy ISUS Inc., served as Starbucks' vice president of fresh food from 1999 to 2000. His brief time at Starbucks came as then-president John Richards focused the company on expanding into food.

Richards spearheaded the now-defunct Starbucks Café concept—complete with waiter service and freshly prepared breakfast, lunch and afternoon dinner items—to be a learning lab for the company around fresh food. The push, however, was on shaky ground from the start.

"John and Howard [Schultz] had difficulty in both embracing the direction for Starbucks around food," Minno explains. "John had a great push for it and Howard's feeling was—and I believe, still is—he did not want anything in the store that would disrupt or conflict with the fresh-dispensed beverages, the core part of the business, as he viewed it."

How, then, to view the most recent

40,000

The ultimate number of stores Starbucks plans to open worldwide—three times the number of locations today.

foray into food? Perhaps it's spurred by increased breakfast competition from QSRs such as McDonald's and the lure of increased sales, which is especially strong for a public company.

According to Starbucks, the morning program averages $35,000 in incremental revenue per store, while lunch has produced approximately $30,000 per location. In addition, per-store food sales rose 11.8% from 2002 to 2006, above the 6.5% growth in overall per-store volumes.

"We strive to provide our customers with the uplifting experience they have come to expect from Starbucks," company spokesperson Bridget Baker says in an e-mail interview. "Food has always been a part of the coffeehouse experience, and our food offerings are designed to pair with our Starbucks coffee."

"My view is that foodservice is really totally in line with the business they're in," says Minno. "They're truly in the convenience, on-the-go, fresh-dispensed beverages, and also fresh-food retail business."

Tristano is less certain, seeing both benefits and potential pitfalls.

"The consumer will be a little more confused as to what they do," he says. "It was very clear a year ago that they were a place to get coffee and for a social occasion. Now they're a place to go have a meal." As long as Starbucks can apply its efficiency with preparing coffee against providing meal options to keep transaction times down, Tristano sees room for both offerings.

"It doesn't cost them any more in terms of rent to be able to offer sandwiches," he says. "Likely the cost of labor and product won't be significant. The profit margin on those products, when amortized against fixed costs, will be much higher. Anything that's

SHOPPING STARBUCKS

Starbucks has been taking knocks lately for lengthy transaction times both at the counter and the drive-thru. CSP decided to put the current state of service to the test. In nearly 20 visits to local Starbucks locations, editors tested transaction times, customer service and merchandising.

The results: Although there's room for improvement, no one experienced the rumored 15-minute wait times, although 6- to 7-minute waits are not uncommon. Meanwhile, customer service remains a high point.

CUSTOMER SERVICE

"Polite," "pleasant," "extremely friendly and happy" typified staff inside the café and at the drive-thru. When glitches occurred, employees apologized and tried to rectify the problem. A "tip mug" at one drive-thru appeared to be overflowing with $1 bills.

At least two editors encountered poor service. In one instance, an employee was unable to print out a receipt and seemed to lack knowledge about the beverage she was making.

POINT OF SALE PURCHASE

At the drive-thrus, POP material included boards advertising the new breakfast sandwiches and the latest Frappuccino. An ice bucket at the pick-up window of one location held Starbucks' proprietary Ethos bottled water.

Inside the cafés, one editor was persuaded to change his order and purchase a raspberry mocha thanks to POP signage. Another noticed an appetizing food display "that made me want something to eat. It was visually appealing, healthy and upscale."

TRANSACTION TIME

Both the shortest—and longest—waits could be found at the drive-thru. These ranged from 46 seconds spent ordering a brewed cup of coffee to 6 minutes and 17 seconds waiting for a blended espresso drink and breakfast sandwich. The average wait: 3 minutes, 3 seconds at the drive-thru, and 4 minutes, 7 seconds in the cafe.

Editors cited the efficiency of the baristas. One observed that while a dedicated person was making sandwiches, the cashier did not hesitate to take the editor's order and then interrupt the sandwich maker to make sure it got on the list.

UPSELL $

Incidence of suggestive selling was about 50/50, with six visits including a pitch for a particular product—breakfast sandwich, raspberry mocha, an accompanying drink—and three, a general "anything else?"

incremental will deliver a higher rate of return. And investors want a higher rate of return."

Minno sees room for improvement, however, before food becomes another Starbucks draw. "Fresh food clearly is not positioned in Starbucks as a destination-driving category from my view," he says. "It's not a driving part of why a customer is going to Starbucks." To make that leap, Starbucks must continue to focus on improving product quality, variety and merchandising, he says.

BIRTH OF A STAR: The very first Starbucks opened in Seattle across from Pike Place Market in 1971. In the first years of its existence, the chain sold only beans and ground coffee. It did not start selling prepared beverages until 1984.

Drive on Through

A mainstay of the QSR business, Starbucks has fully embraced the drive-thru, including it in 42% of new locations built last year. As of April 2007, more than 2,000 Starbucks in North America were equipped with drive-thrus.

Tristano sees drive-thrus as a complementary piece of Starbucks' business. "Monday through Friday, it's really important to give options to people who don't have time to get out of the car," he says. "It creates more convenience for the consumer, and it may get heavy users to use you even more."

It's hard to argue with solid sales: New stores with drive-thrus posted first-year volumes of $1.0 million in 2006, compared to $780,000 for locations without the amenity.

But for others interviewed for this story, the drive-thru signifies, at worst, a wrong turn in the brand's development and, at best, a work in progress.

Consultant Hetzel says, "It changes the Starbucks experience pretty dramatically—it's no longer a third place, it's just a coffee outlet, and not one where there's any feeling of community, or a chance to socialize with other people in the community.

"The reason they're going for it is, quite frankly, it's the low-hanging fruit," he continues. "It's a very profitable model, it's relatively inexpensive to get a drive-thru store popped up in a short period of time, and they can pump a good volume of people through those locations." He says the danger for Starbucks in the long-term lies with losing its reputation as a destination.

2%

The percentage of world coffee supplies used by Starbucks and the company's share of worldwide coffee consumption in 2006.

Rob Nerr, a former instructional designer with Starbucks who runs the blog GreenApronStories.com, developed an online training program for district managers on drive-thru operation—or what partners refer to as "working in the hole." In his opinion, the concept was rolled out too quickly, with the result that the brand and service have suffered.

"I've never personally bought into the idea of Starbucks being a drive-thru company," Nerr says via e-mail. "I think it is not the same experience as I remember giving in the café. Some may argue they can be the same. I'd reply, 'Show me a company who has done what the Starbucks café does as far as creating the 'experience.' "

Nerr, who says he still has a "soft spot" for Starbucks, argues that the company does not yet have the skill sets in place for designing, staffing and managing the drive-thru, which usually is staffed by two to three employees.

Like its foodservice push, Starbucks still needs to connect some dots with its drive-thru concept. The biggest area of vulnerability is re-creating the Starbucks experience. "It's a great opportunity to have [drive-thrus] because it's a great convenience," says Minno, "but during peak periods, they need to figure out how to maximize the brand experience and mitigate the long service lines with creative approaches."

Sacrificing the Experience?

It's irrefutable that Starbucks has been successful at selling its brand. But with the rapid growth and forays into food and drive-thrus, critics have argued that Starbucks is in real danger of derailing itself.

Nerr points to the fact that "the culture of coffee" has disappeared with the introduction of semiautomated espresso machines and flavor-locked coffees. "The coffee and people message is pretty much gone," he says. "It's now about customer transactions per hour."

Hetzel concurs. "It's extremely difficult—some would argue impossible—to be specialty on a large scale," he says. "First of all, coffee is an agricultural product; there's only so much of the best stuff to go around."

Second, the consultant says that staffing the thousands of locations—six Starbucks stores open each day around the world—has meant "sacrifices" to have access to a larger pool of employees. "They've had to, for lack of a better description, 'dumb down' the process so that they can get more of a worker base in their locations," says Hetzel.

But beyond the hypothetical effect on brand, there are no signs that consumers are balking. A report from research analyst David Tarantino of Robert W. Baird & Co., Milwaukee, cited that average unit volumes for company-operated stores have steadily climbed, up from $812,000 in 2002 to approximately $1.0 million in 2006, demonstrating that the saturation point isn't yet in sight.

6

The number of Starbucks cafes that open each day of the week worldwide.

"I don't think [Starbucks is] even close to its saturation point," says Minno. "The reason is because they micro-study a marketplace for opportunities for how they can maximize customer reach based on not only vehicular traffic but, just as important, pedestrian traffic flows and walking patterns."

This capacity was proven several years ago in Vancouver, where Starbucks placed two units across the street from one another. Customers liked that they did not have to cross the street to get to the café. At the same time, "If one store was overcast, in terms of the line being too long, the customers would go across street to the other Starbucks," says Minno. "It's all based around the compelling nature of the offer and the brand."

Hetzel positions the state of saturation this way: There are about 22,000 coffee bars in the United States, which has a population of about 300 million people. In Italy, 200,000 coffee bars serve a population of 60 million.

"I think we've got a lot of room for growth," he says. "The model of supply and demand doesn't really apply here because we've got an elastic market that will accommodate a better-quality product by making it more a part of their life." ■