Revised June 30, 1997

Starbucks Corporation (A)

Starbucks Corporation is a Seattle, Washington-based coffee company. It roasts and sells whole bean coffees and coffee drinks through a national chain of retail outlets/restaurants. Originally only a seller of packaged, premium, roasted coffees, the bulk of the company's revenues now comes from its coffee bars' where people can purchase beverages and pastries in addition to coffee by the pound. Starbucks is credited with changing the way Americans view coffee, and its success has attracted the attention of investors nationwide.

Starbucks has consistently been one of the fastest growing companies in the United States with over 1,006 retail outlets in 1996. Over a five-year period starting in 1991, net revenues increased at a compounded annual growth rate of 61 percent. In fiscal 1996, net revenues increased 50 percent to $696 million from $465 million for the same period the previous year (see **Exhibit 1**). Net earnings rose 61 percent to $42 million from the previous year's $26 million. Sales for Starbucks have been continuing to grow steadily, and the company is still a darling of investors with a PE ratio of 58.

To continue to grow at a rapid pace, the firm's senior executives have been considering international expansion. Specifically, they are interested in Japan and other Asian countries, where Starbucks had little or no presence. Japan, the world's third largest coffee consumer after the United States and Germany, represented both a challenge and a huge opportunity to the firm. To explore what changes in Starbucks strategy were required, and the questions that might arise during expansion, this case looks at the firm's entry strategy into Japan and the nature of issues facing the firm during early 1997.

The Company Background

In 1971, three Seattle entrepreneurs—Jerry Baldwin, Zev Siegl, and Gordon Bowker—started selling whole-bean coffee in Seattle's Pike Place Market. They named their store Starbucks, after the first mate in *Moby Dick*. By 1982, the business had grown to five stores, a small roasting facility, and a wholesale business selling coffee to local restaurants. At the same time, Howard Schultz had been working as VP of U.S. operations for Hammarplast, a Swedish housewares company in New York, marketing coffee makers to a number of retailers, including Starbucks. Through selling to Starbucks, Schultz was introduced to the three founders, who then recruited him to bring marketing savvy to the company. Schultz, 29 and recently married, was eager to leave New York. He joined Starbucks as manager of retail sales and marketing.

This case was prepared by Melissa Schilling and Assistant Professor Suresh Kotha, both from the University of Washington, Business School of Administration, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

A year later, Schultz visited Verona, Italy for the first time on a buying trip. As he strolled through the piazzas of Milan one evening, he was inspired by a vision. He noticed that coffee was an integral part of the romantic culture in Italy; Italians start their day at an espresso bar, and later in the day return with their friends. (For a history of the coffeehouse, see **Exhibit 2.**) There are 200,000 coffee bars in Italy, and about 1500 in Milan alone. Schultz believed that given the chance, Americans would pay good money for a premium cup of coffee and a stylish, romantic place to enjoy it. Enthusiastic about his idea, Schultz returned to tell Starbucks' owners of his plan for a national chain of cafes stylized on the Italian coffee bar. The owners, however, were less enthusiastic and did not want to be in the restaurant business. Undaunted, Schultz wrote a business plan, videotaped dozens of Italian coffee bars and began looking for investors. By April 1985 he had opened his first coffee bar, Il Giornale (named after the Italian newspaper), where he served Starbucks coffee. Following Il Giornale's immediate success, Schultz opened a second coffee bar in Seattle, and then a third in Vancouver. In 1987, the owners of Starbucks agreed to sell to Schultz for $4 million. The Il Giornale coffee bars took on the name of Starbucks.

Convinced that Starbucks would one day be in every neighborhood in America, Schultz focused on expansion. In 1987 he entered Chicago, four years later he opened in Los Angeles and in 1993 he entered the District of Columbia. Additionally, he hired executives away from corporations such as PepsiCo. At first, the company's losses almost doubled, to $1.2 million from fiscal 1989 to 1990 as overhead and operating expenses ballooned with the expansion. Starbucks lost money for three years running, and the stress was hard on Schultz, but he stuck to his conviction not to "sacrifice long-term integrity and values for short-term profit."[1] In 1991 sales shot up 84 percent, and the company turned profitable. In 1992 Schultz took the firm public at $17 a share.

Always, believing that market share and name recognition are critical to the company's success, Schultz continued to expand the business rather aggressively. Notes Schultz, "There is no secret sauce here. Anyone can do it." To stop potential copycats, he opened 100 new stores in 1993, and another 145 in 1994. Additionally, he acquired the Coffee Connection, a 25-store Boston chain in 1994.

Everywhere Starbucks has opened, customers have flocked to pay upwards of $1.85 for a cup of coffee (latte). Currently, the firm operates stores in most of the major metropolitan areas in the U.S. and Canada, including Seattle, New York, Chicago, Boston, Los Angeles, San Francisco, San Diego, Austin, Dallas, Houston, San Antonio, Las Vegas, Philadelphia, Pittsburgh, Cincinnati, Minneapolis, Portland, Atlanta, Baltimore, Washington D.C., Denver, Toronto, and Vancouver B.C. Its mail-order business serves customers throughout the United States. Enthusiastic financial analysts predict that Starbucks could top $1 billion by the end of the decade (see **Appendix A**).

In 1996, Starbucks employed approximately 16,600 individuals, including approximately 15,000 in retail stores and regional offices, and the remainder in the firm's administrative, sales, real estate, direct response, roasting, and warehousing operations. Only five of the firm's stores (located in Vancouver, British Columbia) out of a total of 929 company-operated stores in North America were unionized. Starbucks has never experienced a strike or work stoppage. Management was confident that its relationship with its employees were excellent.

Currently the firm is organized as a matrix between functional and product divisions. The firm's functional divisions include: Marketing; Supply Chain Operations (Manufacturing, Distribution, Purchasing); Human Resources; Accounting; International; Planning and Finance; Administration (facilities, mail); Communications and Public Affairs; and Merchandising (the group that focuses on product extensions for food and beverages). The firm's product-based divisions include: Retail North America (this division accounts for the bulk of the company's business and is split into regional offices spread throughout the United States); Specialty Sales and Wholesale Group (handles large accounts such as restaurants); Direct Response (a division that focuses on mail order/Internet-related orders); International; and Licensed Concepts Unit. Because of the overlap in these divisions (e.g., Marketing and Retail North America), many employees report to two division heads. Notes Troy Alstead, the company's Director of International Planning and Finance, "We have avoided a hierarchical organization structure, and therefore we have no formal organization chart." **Exhibit 3** provides a partial list of Starbucks' top management.

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[1] *Success*, April, 1993.

Market and Competition

Americans have a reputation for buying the cheapest coffee beans available. Most American coffee buyers have to fight growers to keep them from just showing them the culls. Much of the canned coffee on American supermarket shelves is made from the robusta bean--considered to be the lowest quality coffee bean, and the highest in caffeine content. Japanese, German, and Italian buyers, in contrast, are known for buying the best beans, primarily Arabica. There are many different types and grades of Arabica and robusta beans, though for years Americans have treated them as a generic commodity.[2]

The US Coffee Industry

US coffee consumption peaked in 1962. At that time Americans were drinking an average of 3.1 cups per day. However, from the 1960's to the 1980's coffee consumption declined, bottoming out at an average consumption of 1.8 cups per day, or $6.5 billion annually. Over the past decade, coffee demand has been stagnant, with growth only occurring in some of the specialty coffees (see **Exhibits 4a, 4b** and **4c**). Whereas three-fourths of all Americans were regular coffee drinkers in the 1960's, today only half of US population consumes coffee.[3]

There has been a marked consumer trend towards more healthful fare, causing overall coffee consumption to decline. Although the coffee industry had expected decaffeinated coffee brands to increase, decaffeinated sales in the grocery stores have been steadily dropping, making decaffeinated coffee one of the fastest-declining categories in the supermarket.[4] Industry observers note that many consumers are disappointed with the flavor of decaffeinated coffees and have opted to give up coffee entirely. Demand for better tasting coffees has also hurt the instant coffee market, with sales of instant coffee have as well declining too. While the instant coffee technology impressed consumers following its introduction in 1939, younger coffee consumers appear to be spurning instants.

The Growth of Gourmet Segment

The more faithful coffee drinkers have turned to the gourmet decaffeinated coffees, specialty flavors, and whole bean coffees. According to the Specialty Coffee Association of America (SCAA), the gourmet coffee segment grew by more than 30 percent each year for the past three years. The SCCA predicts that by 1999 specialty coffee will capture about 30% of the market (up from 17 percent in 1988) for combined retail sales of $5 billion. Also by 1999, the number of espresso bars and cafes is expected to grow to more than 10,000, up from 4,500 in 1994, and 1,000 in 1989.

Sales of specialty coffee have climbed steadily. For instance, in 1969 the retail sales volume of specialty coffee totaled just under $45 million. However, sales grew to more than $2.0 billion in 1994. During 1994, the specialty coffee segment represented about 19 percent of all coffee sold. This figure was up from 10 percent in 1983. However, by 1996 about 30 percent of all coffee drinkers consumed specialty coffees. This amounted to a customer base of approximately 35 million people in the United States. Today, specialty coffees such as espressos and lattes have become so popular that they are being offered in drive-through cafes and coffee stands throughout many parts of the United States.[5]

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[2] The *Chicago Tribune*, July 1, 1993.

[3] According to the *Berkeley Wellness Letter*, a newletter from the University of California, 53 percent of all coffee in the United States is consumed at breakfast. Further, 11 percent of the US population drink decaf coffee, and 10 percent drink instant coffee. Of the people who drink instant coffee most are over the age 55.

[4] The *Wall Street Journal*, February 25, 1993. According to the National Coffee Association brewed coffee accounted for all 85 percent of all coffee consumed in the US during 1995. This was followed by Espresso-based drinks (14 percent) and Express coffee (1 percent).

[5] Espresso, despite its potent flavor, is lower in caffeine than the canned coffees offered in supermarkets. It is made with Arabica beans that are lower in caffeine content, and the brewing method yields less caffeine per cup.

Some analysts attribute the explosive growth in specialty coffees to the poor economy. They note that as people scale back in other areas, they still need their “minor” indulgences. Although many people cannot afford a luxury car, they can still afford a luxury coffee.[6] Despite this growth, some analysts anticipate trouble on the horizon for the specialty coffee business. As evidence, they cite several indicators. For instance:

· In many markets some of the smaller coffee houses have closed due to excessive competition.

· In Los Angeles, the city council (in response to complaints about rowdy late-night patrons) was considering an ordinance that would require coffeehouses open past midnight to obtain a license. This move , suggest analysts, is a sign that the coffee business is maturing.

· The cost of coffee beans is expected to rise in the near future, tightening margins for coffee merchants. Coffee farmers are switching to more profitable fruit and vegetable crops, reducing the world's supply of coffee beans.

Competition for the Gourmet Segment

Starbucks faces two main competitive arenas -- retail beverages and coffee beans. Starbucks whole bean coffees compete directly against specialty coffees sold at retail through supermarkets, specialty retailers, and a growing number of specialty coffee stores. According to senior executives at Starbucks, supermarkets pose the greatest competitive challenge in the whole bean coffee market, in part because supermarkets offer customers the convenience of not having to make a separate trip to “a Starbucks’ store.” A number of nationwide coffee manufacturers, such as Kraft General Foods, Procter & Gamble, and Nestle, are distributing premium coffee products in supermarkets, and these products serve as substitutes for Starbucks coffees. Additionally, regional specialty coffee companies also sell whole bean coffees in supermarkets.

Starbucks’ coffee beverages compete directly against all restaurant and beverage outlets that serve coffee and a growing number of espresso stands, carts, and stores. Both the company’s whole bean coffees and its coffee beverages compete indirectly against all other coffees on the market. Starbucks management believe that their customers choose among retailers primarily on the basis of quality and convenience, and, to a lesser extent, on price.

Starbucks competes for whole bean coffee sales with franchise operators and independent specialty coffee stores in both the United States and Canada. There are a number of competing specialty coffee retailers. One specialty coffee retailer that has grown to considerable size is Second Cup, a Canadian franchiser with stores primarily in Canada. In 1996 there were 235 Second Cup stores in Canada. Second Cup also owns *Gloria Jean’s Coffee Bean* and *Brother’s Gourmet*, both franchisers of specialty coffee stores that are primarily located in malls in the United States. Gloria Jean’s, founded in 1979, operated 249 retail stores with about $125 million in annual sales in 1996. Brother’s Gourmet is a Florida-based coffee chain with almost 250 franchisee-owned locations in the Chicago area.

Seattle’s Best Coffee (SBC) competes fiercely with Starbucks on Starbucks’ own turf, Seattle. This firm is following Starbucks’ lead in national expansion. However, unlike Starbucks, SBC sells franchise rights to its stores in order to expand rapidly with limited capital. SBC takes advantage of Starbucks’ market presence by waiting for Starbucks to invest in consumer education. Then, once customers are familiar with the concept of gourmet coffees, SBC enters that market. In following this approach, the firm has had an easier time finding franchisees. SBC intends to operate 500 stores by 1999.

Starbucks also competes with established suppliers in its specialty sales and direct response (mail order) businesses, many of whom have greater financial and marketing resources than Starbucks has. Lately, competition for suitable sites to locate stores has also become intense. Starbucks competes against restaurants, specialty coffee stores, other stores offering coffee stands within them (e.g. bookstores, clothing retailers, kitchenware retailers) and even espresso carts for attractive locations. In many metropolitan areas a single square block may have four or five different coffee beverage stores. This level of competition prompted Brother’s Gourmet Coffee to abandon its 1995 expansion plans after it determined

[6] The *Wall Street Journal*, February 25, 1993.

that the market was almost saturated and that Starbucks was already in all of their markets. Finally, the firm also competes for qualified personnel to operate its retail stores.

The Starbucks Legacy

In establishing Starbucks' unique approach to competition, Schultz had four companies in mind as role models: Nordstrom, Home Depot, Microsoft, and Ben & Jerry's. Nordstrom, a national chain of upscale department stores based in Seattle, provided a role model for service and is part of the reason that each employee must receive at least 24 hours of training. Home Depot, the home improvement chain, was Schultz's guideline for managing high growth. Microsoft gave Schultz the inspiration for employee ownership, resulting in Starbucks' innovative Bean Stock Plan. And Ben & Jerry's was his role model for philanthropy; Starbucks sponsors community festivals, donates money to CARE for health and literacy programs in coffee-growing countries, and donates to charity any packages of coffee beans that have been open a week.

Schultz's goal is to: "Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining uncompromising principles as we grow." He has since articulated six guiding principles to measure the appropriateness of the firm's decisions (see **Exhibit 5**).

Securing the Finest Raw Materials

Starbucks coffee quality begins with bean procurement. Although many Americans were raised on a commodity-like coffee composed of Arabica beans mixed with less-expensive filler beans, Starbucks coffee is strictly Arabica, and the company ensures that only the highest quality beans are used. Dave Olsen, the company's senior vice president and chief coffee procurer, scours mountain trails in Indonesia, Kenya, Guatemala and elsewhere in search of Starbucks' premium bean. His standards are demanding and he conducts exacting experiments in order to get the proper balance of flavor, body and acidity. He tests the coffees by "cupping" them--a process similar to wine tasting that involves inhaling the steam ("the strike" and "breaking the crust"), tasting the coffee, and spitting it out ("aspirating" and "expectorating").[7]

From the company's inception, it has worked on developing relationships with the countries from which it buys coffee beans. Traditionally, most of the premium coffee beans were bought by Europeans and Japanese. Olsen has sometimes had to convince coffee growers that it is worth growing premium coffees--especially since American coffee buyers are notorious purchasers of the "dregs" of the coffee beans. In 1992 Starbucks set a new precedent by outbidding European buyers for the exclusive Narino Supremo Bean crop.[8] Starbucks collaborated with a mill in the tiny town of Pasto, located on the side of the Volcano Galero. There they set up a special operation to single out the particular Narino Supremo bean, and Starbucks guaranteed to purchase the entire yield. This enabled Starbucks to be the exclusive purveyor of Narino Supremo, purportedly one of the best coffees in the world.[9]

Vertical Integration

Roasting of the coffee bean is close to an art form at Starbucks. The company currently operates three roasting and distribution facilities: two in the Seattle area, and one in East Manchester Township, York County, Pennsylvania. In the Seattle area, the company leases approximately 92,000 square feet in one

[7] The *Sacramento Bee*, April 28, 1993.
[8] This Columbian coffee bean crop is very small and grows only in the high regions of the Cordillera mountain range. For years, the Narino beans were guarded zealously by Western Europeans who prized their colorful and complex flavor. It was usually used for upgrading blends. Starbucks was determined to make them available for the first time as a pure varietal. This required breaking Western Europe's monopoly over the beans by convincing the Columbian growers that it intended to use "the best beans for a higher purpose."
[9] The *Canada Newswire*, March 1, 1993.

building located in Seattle, Washington, and owns an additional roasting plant and distribution facility of approximately 305,000 square feet located in Kent, Washington.

Roasters are promoted from within the company and trained for over a year, and it is considered quite an honor to be chosen. The coffee is roasted in a powerful gas-fired drum roaster for 12 to 15 minutes while roasters use their sight, smell, hearing and computers to judge when beans are perfectly done. The color of the beans is even tested in an Agtron blood-cell analyzer, with the whole batch being discarded if the sample is not deemed perfect.

The Starbucks Experience

According to Schultz, "We're not just selling a cup of coffee, we are providing an experience." As Americans reduce their alcohol consumption, Schultz hopes to make coffee bars their new destination. In order to create American coffee enthusiasts with the dedication of their Italian counterparts, Starbucks provides a seductive atmosphere in which to imbibe. Its stores are distinctive and sleek, yet comfortable. Though the sizes of the stores and their formats vary from small to full size restaurants, most are modeled after the Italian coffee bars where regulars sit and drink espresso with their friends.

Starbucks stores tend to be located in high-traffic locations such as malls, busy street corners, and even grocery stores. They are well lighted and feature plenty of light cherry wood. Further, sophisticated artwork hangs on the walls. The people who prepare the coffee are referred to as "baristas," Italian for bartender. And jazz or opera music plays softly in the background. The stores range from 200 to 4,000 square feet, with new units tending to range from 1,500 to 1,700 square feet. In 1995, the average cost of opening a new unit (including equipment, inventory and leasehold improvements) was about $377,000. The firm employs a staff of over 100 people whose job is to plan, design and build the unique interiors and displays. The Starbucks interiors have inspired a slew of imitators.

Location choices so far have been easy; Starbucks opens its cafes in those cities where their direct mail business is strong. By tracking addresses of mail-order customers to find the highest concentration in a city, Starbucks can ensure that its new stores have a ready audience. Although this would normally imply cannibalizing their mail order sales, mail order revenues have continued to increase.

The packaging of the firm’s products is also distinctive. In addition to prepared Italian beverages such as lattes, mochas and cappuccinos, the retail outlets/restaurants offer coffee by-the-pound, specialty mugs, and home espresso-making machines. *Biscotti* is available in glass jars on the counter. Many of the firm’s stores offer light lunch fare including sandwiches and salads, and an assortment of pastries, bottled waters and juices. Notes George Reynolds, a former senior vice-president for marketing:

> [Starbucks’] goal is to make a powerful aesthetic statement about the quality and integrity of their products, reaffirming through their visual identity the commitment they feel to providing the very best product and service for customers.

The company has also developed unique strategies for its products in new markets; for instance, for its passport promotion, customers receive a frequent buyer bonus stamp in their "passport" every time they purchase a half-pound of coffee. Each time a customer buys a different coffee, Starbucks also validates their “World Coffee Tour.” Once a customer has collected ten stamps, they receive a free half-pound of coffee. The passport also contains explanations of each type of coffee bean and their country of origin.

Despite the attention to store environment and coffee quality, Starbucks’ effort at bringing a premium coffee and Italian-style beverage experience to the American market could have been lost on consumers had the company not invested in consumer education. Starbucks employees spend a good portion of their time instructing customers on Starbucks' global selection of coffee and the different processes by which the beverages are produced. Employees are also encouraged to help customers make decisions about beans, grind, and coffee/espresso machines and to instruct customers on home brewing. Starbucks’ consumer education is credited with defining the American espresso market, paving the way for other coffee competitors.[10]

Building a Unique Culture

While Starbucks enforces almost fanatical standards about coffee quality and service, the policy at Starbucks towards employees is laid-back and supportive. They are encouraged to think of themselves as partners in the business. Schultz believes that happy employees are the key to competitiveness and growth:

> We can't achieve our strategic objectives without a work force of people who are immersed in the same commitment as management. Our only sustainable advantage is the quality of our work force. We're building a national retail company by creating pride in--and stake in--the outcome of our labor.[11]

Schultz is also known for his sensitivity to the well-being of employees. Recently when an employee had come to tell Schultz that he had AIDS, he reassured him that he could work as long as he wanted to, and when he left, the firm would continue his health insurance. After the employee left the room, Schultz reportedly sat down and wept. He attributes such concern for employees to memories of his father:

> My father struggled a great deal and never made more than $20,000 a year, and his work was never valued, emotionally or physically, by his employer. . . This was an injustice. . . I want our employees to know we value them.

A recent article on the firm in *Fortune* points out:

> Starbucks has instituted all sorts of mechanisms for its Gen X-ers to communicate with headquarters: E-mail, suggestion cards, regular forums. And it acts quickly on issues that are supposedly important to young kids today, like using recycling bins and improving living conditions in coffee-growing countries. To determine the extent to which Starbucks has truly identified and addressed the inner needs of twentysomethings would require several years and a doctorate. But anecdotally, the company appears to be right on the money.[12]

On a practical level, Starbucks promotes an empowered employee culture through employee training, employee benefits programs, and an employee stock ownership plan.

Employee Training. Each employee must have at least 24 hours of training. Notes *Fortune*:

> Not unlike the cultural blitz of personal computing, Starbucks has created one of the great marketing stories of recent history, and it’s just getting started. The company manages to imprint its obsession with customer service on 20,000 milk-steaming, shot-pulling employees. It turns tattooed kids into managers of $800,000-a-year cafes. It successfully replicates a perfectly creamy caffe latte in stores from Seattle to St. Paul. There is some science involved, and one of its primary labs happens to be Starbucks’ employee training program.[13]

Classes cover everything from coffee history to a seven-hour workshop called “Brewing the Perfect Cup at Home.” This workshop is one of five classes that all employees (called partners) must complete during

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[10] Though *Consumer Reports* rated Starbucks coffee as burnt and bitter, Starbucks customers felt otherwise, and most of Starbucks’ early growth can be attributed to enthusiastic word-of-mouth advertising. The typical Starbucks customer is highly proficient in the science of coffee beans and brewing techniques. The coffee bars even have their own dialect; executives from downtown Seattle businesses line up in force to order "tall-skinny-double mochas" and "2% short no-foam lattes."
[11] *Inc.*, January, 1993.
[12] *Fortune*, December 9, 1996.
[13] *Fortune*, December 9, 1996.

their first six weeks with the company. This workshop focuses on the need to educate the customer in proper coffeemaking techniques.

Store managers (who have gone through facilitation workshops and are certified by the company as trainers) teach the classes. The classes teach the employees to make decisions that will enhance customer satisfaction without requiring manager authorization. For example, if a customer comes into the store complaining about how their beans were ground, the employee is authorized to replace them on the spot. While most restaurants use on-the-job training, Starbucks holds bar classes where employees practice taking orders and preparing beverages in a company training room. This allows employees to hone their skills in a low-stress environment, and also protects Starbucks' quality image by allowing only experienced baristas to serve customers.[14] Reports *Fortune*:

> It's silly, soft-headed stuff, though basically, of course, it's true. Maybe some of it sinks in. Starbucks is a smashing success, thanks in large part to the people who come out these therapy-like training programs. Annual barista turnover at the company is 60% compared with 140% for hourly workers in the fast-food business. 'I don't have a negative thing to say,' says Kim Sigelman, who manages the store in Emeryville, California, of her four years with the company. She seems to mean it.[15]

Employee Benefits. Starbucks offers its benefits package to both part-time and full-time employees with dependent coverage available. Dependent coverage is also extended to same-sex partners. The package includes medical, dental, vision and short-term disability insurance, as well as paid vacation, paid holidays, mental health/chemical dependency benefits, an employee assistance program, a 401k savings plan and a stock option plan. They also offer career counseling and product discounts.[16]

Schultz believes that without these benefits, people do not feel financially or spiritually tied to their jobs. He argues that stock options and the complete benefits package increase employee loyalty and encourage attentive service to the customer.[17] Notes Bradley Honeycutt, the company's vice president, HR services and international: "[Our] part-timers are on the front line with our customers. If we treat them right, we feel they will treat (the customers) well."[18] Sharon Elliot, HR senior vice president offers another explanation, "Most importantly, this is the right thing to do. It's a basic operating philosophy of our organization."

Despite the increased coverage, Starbucks' health care costs are well within the national average, running around $150 per employee per month. This may be due, in part, to the fact that its employees are relatively young, resulting in lower claims. Half of the management at Starbucks is under 50, and retail employees tend to be much younger. Starbucks is betting on the increases in premiums being largely offset by lower training costs due to the lower attrition rate. Comments *Fortune*:

> It has become boilerplate public relations for corporations to boast about how much they value their people. But Starbucks really does treat its partners astonishingly well. The pay --between $6 and $8 an hour--is better than that of most entry-level food service jobs. The company offers health insurance to all employees, even part-timers. . . Walk into just about any Starbucks, and you'll see that these are fairly soft hands: Some 80% of the partners are white, 85% have some college education beyond high school, and the average age is 26.

The Bean Stock Plan. Employee turnover is also discouraged by Starbucks' stock option plan known as the Bean Stock Plan. Implemented in August of 1991, the plan made Starbucks the only private company

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[14] *Training*, June 1995.
[15] *Fortune*, December 9, 1996.
[16] The decision to offer benefits even to part-time employees (who represent roughly two-thirds of Starbucks' 10,000 employees) has gained a great deal of attention in the press. According to a Hewitt Associates L.L.C. survey of more than 500 employers, only 25% of employers offer medical coverage to employees working less than 20 hours a week. It was difficult to get insurers to sign Starbucks up since they did not understand why Starbucks would want to cover part-timers.
[17] Inc., January, 1993.
[18] *Business Insurance*, March 27, 1995, p.6.

to offer stock options unilaterally to all employees. After one year, employees may join a 401(k) plan. There is a vesting period of five years; it starts one year after the option is granted, then vest the employee at 20 percent every year. In addition, every employee receives a new stock-option award each year, and a new vesting period begins. This plan required getting an exemption from the Security Exchange Commission, since any company with more than 500 shareholders has to report its financial performance publicly--a costly process that reveals valuable information to competitors.

The option plan did not go uncontested by the venture capitalists and shareholders on the board. Craig Foley, a director and managing partner of Chancellor Capital Management Inc. (the largest shareholder before the public offering) noted that, "Increasing the shareholders substantially dilutes our interest. We take that very seriously." In the end he and others were won over by a study conducted by the company that revealed the positive relationship between employee ownership and productivity rates, and a scenario analysis of how many employees would be vested. Foley conceded that: "The grants are tied to overachieving. If you just come to work and do your job, that isn't as attractive as if you beat the numbers."[19]

Since the Bean Stock plan was put into place, enthusiastic employees have been suggesting ways to save money and increase productivity. The strong company culture has also served as a levy against pilferage; Starbucks' inventory shrinkage is less than half of 1 percent.

In 1995 Starbucks demonstrated that its concern for employee welfare extended beyond the U.S. borders. After a human-rights group leafleted the stores complaining that Guatemalan coffee pickers received less than $3 a day, Starbucks became the first agricultural commodity importer to implement a code for minimal working conditions and pay for foreign subcontractors.[20] The company's guidelines call for overseas suppliers to pay wages and benefits that "address the basic needs of workers and their families" and to only allow child labor when it does not interrupt required education.[21] This move has set a precedent for other importers of agricultural commodities.

Leveraging the Brand

Multiple Channels of Distribution. While Starbucks has resisted offering its coffee in grocery stores, it has found a variety of other distribution channels for its products. Besides its stand-alone stores, Starbucks has set up cafes and carts in hospitals, banks, office buildings, supermarkets and shopping centers. In 1992 Starbucks signed a deal with Nordstrom to serve Starbucks coffee exclusively in all of its stores. Nordstrom also named Starbucks as the exclusive coffee supplier for its restaurants, employee lunchrooms and catering operations. As of 1992, Nordstrom was operating 62 restaurants and 48 espresso bars. A year later, Barnes & Noble initiated an agreement with Starbucks to implement a "cafe-in-a-bookshop" plan.

Other distribution agreements have included office coffee suppliers, hotels, and airlines. Office coffee is a large segment of the coffee market. Associated Services (an office coffee supplier) provides Starbucks coffee exclusively to the 5,000 northern California businesses it services. Sheraton Hotel has also signed an agreement to serve Starbucks Coffee. In 1995 Starbucks signed a deal with United Airlines to provide Starbucks coffee to United's nearly 75 million passengers a year.[22]

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[19] *Inc. Magazine*, January, 1993.
[20] The *Wall Street Journal*, April 4, 1995.
[21] The *Wall Street Journal*, October 23, 1995.
[22] In the past, one interesting outlet for Starbucks coffee was Starbucks' deal with Smith Brothers, one of the Northwest's oldest dairies. Smith Brothers used to sell Starbucks coffee on its home delivery routes. The idea for the alliance actually came from the dairy, a supplier for Starbucks. Management at Smith Brothers began to wonder if Starbucks' rapid growth might prompt them to look for other dairies to supply its milk. A report in the Seattle *Times* (November 6, 1992) noted that Earl Keller, Sales Manager for Smith Brothers, got the idea that "Maybe if we were a good customer of theirs, it would be more difficult for them to leave us." In 1992, Smith delivered 1,000 pounds of coffee beans a week. The coffee was sold at the same price as in Starbucks' retail stores, and the only complaint has been that Smith does not carry all 30 varieties. The company no longer sells coffee through Smith Brothers.

While Starbucks is the largest and best-known of the coffeehouse chains and its presence is very apparent in metropolitan areas, the firm's estimates indicate that only 1% of the US population has tried its products. Through these distribution agreements and the new product partnerships it is establishing, Starbucks hopes to capture more of the US market.

Brand Extensions. In 1995, Starbucks launched a line of packaged and prepared teas in response to growing demand for tea houses and packaged tea. Tea is a highly profitable beverage for restaurants to sell, costing only 2 cents to 4 cents a cup to produce.[23]

Starbucks coffee is not sold in grocery stores, but its name is making its way onto grocery shelves via a carefully-planned series of joint ventures.[24] An agreement with PepsiCo Inc. brought a bottled version of Starbucks' Frappuccino (a cold, sweetened coffee drink) to store shelves in August of 1996. A similar product released a year before, called Mazagran, was a failure and was pulled from the shelves; however, both Starbucks and PepsiCo had higher hopes for Frappuccino.[25] Starbucks also has an agreement with Washington-based Redhook Ale Brewery to make a product called Double Black Stout, a coffee-flavored stout. In another 50-50 partnership, Dreyers' Grand Ice Cream Inc. distributes seven quart-products and two bar-products of Starbucks coffee ice cream.

Other partnerships by the company are designed to form new product associations with coffee. For instance, Starbucks has collaborated with Capitol Records Inc. to produce two Starbucks jazz CDs, available only in Starbucks stores. Starbucks is also opening tandem units with Bruegger's Bagel Bakeries and had bought a minority stake in Noah's New York Bagels in 1995. This minority stake has since been sold.

International Expansion

From the beginning, Schultz has professed a strict growth policy. Although many other coffeehouses or espresso bars are franchised, Starbucks owns all of its stores outright with the exception of license agreements in airports.[26] Despite over 300 calls a day from willing investors, Schultz feels it is important to the company's integrity to own its stores. Further, rather than trying to capture all the potential markets as soon as possible, Starbucks goes into a market and tries to completely dominate it before setting it sights on further expansion. As Alstead points out, "Starbucks hopes to achieve the same density in all of its markets that they have achieved in Seattle, Vancouver and Chicago."

In 1996, the firm opened 307 stores (including four replacement stores), converted 19 Coffee Connection stores to Starbucks, and closed one store. In 1997, Starbucks intends to open at least 325 new stores and enter at least 3 major new markets in North America including Phoenix, Arizona, and Miami, Florida. Moreover, Schultz plans to have 2,000 stores by the year 2000.

Some analysts believe that the US coffee-bar market may be reaching saturation. They point to the fact that there have been some consolidations, as bigger players snap up some of the smaller coffee bar competitors.[27] Further, they note that Starbucks' store base is also maturing, leading to a slowdown in the growth of unit volume and firm profitability. Higher coffee costs have also cut into margins, intensifying the competition in what has now become a crowded market. Recognizing this, Starbucks has turned its

[23] The *Nations Restaurant News*, July 10, 1995.
[24] According to Troy Alstead, "We are evaluating whether to offer our coffee in grocery stores, and we have done some private labelling of Starbucks coffee for Costco." The Speciality Coffee Association of America predicts that by 1999 supermarkets will account for 63 percent of all coffee sold in the America. This will be followed by gourmet stores (14%), mass market (11%), mail order (8.0%) and other (8 %).
[25] Coke and Nestle have signed a similar agreement to produce single-serving cold coffee drinks in specialty flavors such as French Vanilla, Mocha and Café Au Lait to compete with the Starbucks product.
[26] Airports often grant exclusive concessions contracts to a single provider, e.g. Host Marriott. Since Starbucks wanted to tap these markets, they negotiated licensing arrangements with Marriott to run Starbucks stands in the airports that Marriott has under contract.
[27] The *Washington Post*, August 1, 1995.

attention to foreign markets for continued growth. Notes Schultz, "We are looking at the Asia-Pacific region as the focus of our international business."

Expansion into Asian Markets

In 1996 the firm invested $1.5 million and established a subsidiary called Starbucks Coffee International Inc. The focus of this subsidiary will be on penetrating the Asia-Pacific region. According to Kathie Lindemann, the director of international operations at Starbucks:

> We are not overlooking Europe and South America as areas for future expansion. But, we feel that expanding into these regions is more risky than Asia. The Asia-Pacific region we feel has much more potential for us. It is full of emerging markets. Also consumers' disposable income is increasing as their countries' economies grow. Most important of all, people in these countries are open to Western lifestyles.

This international subsidiary consists of 12 managers located primarily in Seattle, Washington. Together these managers are responsible for: the developing of new businesses internationally, financing and planning of international stores, managing international operations and logistics, merchandising in international markets and, finally, for the training and developing of Starbucks' international managers. Since its establishment, this subsidiary has been responsible for opening Starbucks coffeehouses in Hawaii, Japan, and Singapore.[28]

Lindemann, commenting on Starbucks' approach to Asian markets, notes:

> At Starbucks we don't like the concept of franchising. Therefore, we decided to work with partners in Japan and other Asian Countries. Our approach to international expansion is to focus on the *partnership first, country second*. Partnership is everything in Asia. We rely on the local connection to get everything up and working. The key is finding the right local partners to negotiate local regulations and other issues.

When asked to list the criteria by which Starbucks chose partners in Asia, Lindemann highlights six points:

> We look for partners who share our values, culture, and goals about community development. We are trying to align ourselves with people, or companies, with plenty of experience. We are primarily interested in partners who can guide us through the process of starting up in a foreign location. We look for firms with: (1) similar philosophy to ours in terms of shared values, corporate citizenship, and commitment to be in the business for the long haul, (2) multi-unit restaurant experience, (3) financial resources to expand the Starbucks' concept rapidly to prevent imitators, (4) strong real-estate experience with knowledge about how to pick prime real estate locations, (5) knowledge of the retail market, and (6) the availability of the people to commit to our project.

Entry into Japan. In October 1995, Starbucks entered into a joint venture with a Tokyo-based Sazaby Inc. This firm was expected to help Starbucks open 12 new stores in Japan by the end of 1997. This joint-venture, amounting to 250 million yen ($2.33 million) in capitalization, is equally owned by Starbucks Coffee International and Sazaby. The Tokyo-based Sazaby, often recognized as a leader in bringing unique

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[28] The Hawaii entry is based on a joint venture with The MacNaugton Group, a real estate development firm that has been responsible for the successful introduction of several well-known mainland firms such as Sports Authority, Office Max and Eagle Hardware stores into the Hawaiian Islands. Using this joint venture, the firm plans to develop approximately 30 stores throughout the Hawaiian Islands over the next three to four years. Starbucks entry into Singapore is based on a licensing agreement with Bonvests Holdings Limited, a firm that is involved in property and hotel development, investment, related management services, waste management and building maintenance services, food and beverage retailing and marketing of branded luxury products in Singapore. Under this agreement (completed in December 1996), ten Starbucks coffee stores are expected to be opened within the first 12 to 15 months.

goods to the people of Japan, operates upscale retail and restaurant chains throughout Japan. Commenting on this joint venture, the president of Starbucks International, Howard Behar, notes:

> This powerful strategic alliance, which combines two major lifestyle companies, will provide the Japanese consumer a new and unique specialty coffee experience. . . We look at this venture as though we're starting all over again, and in many ways, we are.

With Sazaby's assistance the firm opened two stores in Tokyo in September of 1996. The first outlet was in Tokyo's posh Ginza shopping district. The Ginza store was planned so that Japanese customers can have the same "Starbucks experience" offered in U.S. stores. The firm's second store was located in Ochanomizu, a student area cluttered with colleges, bookstores and fast-food restaurants. Starbucks hopes that students and office workers in the neighborhood will come in to grab a cup of coffee and a light snack. At both stores customers can eat in the store or take out their purchases.

The food-and-drink menus in the firm's Japanese coffeehouses are similar to those in the United States. The firm offers 15 types of beverages, snacks such as cookies and sandwiches, coffee beans, and novelty goods such as coffee mugs and T-shirts. The firm's single-shot-short latte costs 280 yen in Tokyo (about $2.50, a price that is roughly 50 cents more than in the United States). According to an August 1996 industry report, a cup of coffee in Tokyo cost about 399 yen, on average, in August 1996.

Although the Japanese are not used to Italian-style coffee beverages, Starbucks executives believe that Japanese consumers are ready to embrace the Starbucks concept.[29] A report in the *Wall Street Journal*, suggests that breaking into the Japanese market may not be easy (see **Exhibit 6** and **Exhibit 7**):

> The Japanese haven't developed a taste for espresso drinks like caffe latte and caffe mocha; they drink a lot of instant coffee or ready-to-drink coffee in cans, as well as American-style hot coffee. Moreover, the Japanese coffee market may be saturated with many coffee shops and vending machines serving hot coffees. Coca-Cola alone has more than 800,000 vending machines that sell canned coffee.[30]

Similarly, a report in the *Nikkei Weekly* points out: .

> Though Japan is the world's third largest coffee consumer, its coffee shops constitute a declining industry, with high operating costs knocking many small operators out of business. In 1992, there were 115,143 coffee shops in Japan, according to the latest government survey available. That figure is nearly 30% less than the peak in 1982.[31]

Japan's coffee culture revolves around the *kissaten*, a relatively formal sit-down coffeehouse. According to the *All Japan Coffee Association*, while US and German consumers consumed 18.1 and 10 million bags of coffee in 1994, respectively, the Japanese consumed 6.1 millions of coffee bags (one bag of coffee contains 60 kilograms of coffee beans).

Despite the absolute size of the Japanese coffee market, knowledgeable analysts note that Starbucks is likely to face stiff competition and retaliation from well-established players in Japan. Two of Japan's well established coffee chains are the Doutor Coffee Company and the Pronto Corp.

Started in 1980, Doutor Coffee Company is Japan's leading coffee-bar chain. In 1996, it had over 466 shops in and around Tokyo. At times, the consumers refer to this firm as the McDonald's of coffeehouses since it provides a limited menu, and emphasizes self-service. In Doutor's shops seating is limited and counters are provided where customers can stand while they consume their beverages. The focus is on speed of service and quick turnover of customers. The average customer stay in a Doutor Coffee Shop is about 10 minutes, about one-third the stay in a typical *kissaten*. Close to 90 percent of the Doutor's coffeehouses are operated by franchisees, while the remaining 10 percent of the shops are operated directly by Doutor. A standard cup of coffee at Doutor costs 180 yen. The firm serves other refreshments, such as

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[29] The *Puget Sound Business Journal*, June 21-27, 1996.
[30] The Wall Street Journal, September 4,1996.
[31] The *Nikkei Weekly*, September 23, 1996.

juice, sandwiches and pastries. It is reported that nearly 10 million customers per month visit Doutor' coffeehouses. The firm has five shops in Ginza, the location where Starbucks opened its first store.[32]

Pronto Corp., is Japan's second largest coffee-bar chain. The firm opened its first shop in Tokyo in 1987. In 1996, it operated over 95 outlets, most of them in Tokyo. The firm's coffeehouses serve coffee and light snacks during the day, and at night they switch to neighborhood bar-type operations, serving alcoholic drinks and light meals. At Pronto, a standard cup of coffee costs 160 yen. Reacting to Starbucks' entry into Japan, Seiji Honna, president of Pronto Corp., notes: For the past few years, we've had this nightmare scenario that espresso drinks are going to swallow up Japan's coffee market. . . And we won't know how to make a good cup of espresso. . . [And now Starbucks' entry], if they really mean business, I think they'll probably put some of us out of business.[33]

But he goes on to comment:

> I don't think that the opening of the first Starbucks store in Japan would immediately be a threat to our business. . . But Starbucks could become a strong competitor if it is able to gain consumer recognition in the next three years or so. In order to do so, Starbucks will need to have about 30 to 50 stores in the Tokyo area.[34]

Yuji Tsunoda, president of Starbucks Coffee Japan Ltd., indicates the company intends to have 100 directly-owned coffee bars in major Japanese cities in the next five years.

According to Kazuo Sunago, an analyst from Japan's leading advertising firm Dentsu Inc., Japanese coffee bars lack the creativity to stop a firm like Starbucks from making inroads in the Japanese coffee market.

> As traditional mom-and pop coffee shops die off, big chains are looking for more attractive formats. . . . But they are like a dry lake bed -- void of new ideas. That's why the whole industry is stirred up about Starbucks.[35]

Comments Alstead: "The issue facing Starbucks is how, as we expand geographically and through expanding channels, will we be able maintain the Starbucks' culture."

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[32] According to a reports in the *Nihon Keizai Shimbum* (June 18, 1988), Doutor is good at segmenting the coffee market. For instance, the firm has a coffee shop for just about every taste and service level. The low-end shops are located near train stations and busy areas where people are in a hurry. In residential locations. the firm operates Cafe Colorado where people can sit and chat for a while. The price of coffee in Cafe Colorado is double that of the firm's inexpensive coffee houses. The firm also caters to more upscale customers via Cafe Doutor, where the ambiance is more elegant and the coffee price is much higher.

[33] According to a report in the *Wall Street Journal*, Honna spent time last year gathering intelligence on Starbucks' method in the United States. He reported visited, incognito, more than 20 Starbucks coffee shops along the West Coast.

[34] Reuters World Service, August 1, 1996.

[35] The Wall Street Journal, September 4, 1996.