



CASE 25

STARBUCKS, 2015

In 2015, Starbucks was the undisputed world leader in specialty coffee retail, with over \$16 billion in annual revenues (see Table 1). Starbucks had nearly 200,000 employees and over 21,000 Starbucks-branded cafes in 60 countries (about 10,700 of those were owned and operated by Starbucks itself, while 10,600 were operated by licensees and franchisees). In addition, Starbucks owned the Seattle's Best Coffee, Torrefazione Italia, Teavana's Heaven of Tea brands, and more.¹

The company had grown remarkably fast over its short life and was still exceptionally profitable, with a 23.1% return on assets in 2014 (compared to 6.8% at Peet's Coffee and Tea, 14.0% at Keurig Green Mountain Coffee, 13.4% at McDonald's, and 5.5% at Dunkin' Donuts). However, its growth had not always been smooth; in fact, Starbucks had shuttered about 900 stores during 2008 and 2009. As its domestic market appeared to be approaching saturation, Starbucks began to focus on growing its international locations and diversifying into other product lines where its now-iconic brand could create value.

THE HISTORY OF STARBUCKS

In 1971, three Seattle entrepreneurs, Jerry Baldwin, Zev Siegl, and Gordon Bowher, 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 bustling 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 recruited him to bring marketing savvy to the loosely run company. Schultz, 29 years old, recently married, and eager to leave New York, moved to Seattle and joined Starbucks as manager of retail sales and marketing.

One year later, Schultz visited 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. Coffee is an integral part of the romantic culture in Italy; Italians start their day at an espresso bar, and return with their friends later. There were 200,000 coffee bars in Italy, and 1,500 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 rushed back to tell the Starbucks owners of his plan for a national chain of Starbucks cafes stylized on the Italian coffee bar. The owners, however, were less enthusiastic, and said that they did not want to be in the restaurant business. Undaunted, Schultz wrote a business plan, videotaped dozens of Italian coffee bars, and began to look for investors. By April 1986, he had opened his first coffee bar, *Il Giornale* (named after the Italian newspaper), where he served

Table 1 Selected Data for Starbucks, McDonald's, and Dunkin' Donuts, 2014

	Starbucks	McDonald's	Dunkin'	Industry Median
Stores	21,100	36,000	11,000	
Annual sales	\$16.40B	\$27.44B	\$748.71M	
Employees	191,000	420,000	1,134	
Market cap	\$112.68B	\$90.22B	\$4.43B	
Gross profit margin	58.84%	44.29%	86.03%	32.38%
Pre-tax profit margin	19.73%	26.90%	32.17%	0.06%
Net profit margin	14.57%	17.34%	23.55%	2.53%
Return on equity	47.08%	32.97%	45.49%	0.09%
Return on assets	23.14%	13.42%	5.50%	0.04%
Days sales outstanding	13.52	16.15	51.22	0.72
Inventory turnover	17.56	234.84	—	1.35
Asset turnover	1.59	0.77	0.23	1.24
Current ratio	1.21	1.52	1.24	1.12
Quick ratio	—	—	—	0.77
Leverage ratio	0.34	1.17	4.93	0.24
Total debt/equity	0.34	1.17	4.94	0.24
Interest coverage	—	13.71	4.78	7.35

Starbucks coffee. Following II Giornale's immediate success, Schultz opened a second coffee bar in Seattle, and then a third in Vancouver, Canada. In 1987, the owners of Starbucks finally agreed to sell to Schultz for \$4 million. The II Giornale coffee bars took on the name of Starbucks, and a star was born.

Convinced that Starbucks would one day be in every neighborhood in America, Schultz was intent on growing the company slowly, with a very solid foundation. He hired top executives away from corporations such as PepsiCo, and he was determined that future profits would be well worth early losses. 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.² Starbucks

lost money for 3 years running. The stress was hard on Schultz, but he stuck to his conviction not to "sacrifice long-term integrity and values for short-term profit."³ In 1991, sales shot up 84%, and the company broke into the black. Everywhere Starbucks opened, people flocked to pay upward of \$2.00 and more for a cup of coffee. Enthusiastic analysts began to predict that Starbucks would top \$1 billion by the year 2000, but Schultz preferred to play the company's early successes down, asserting that it is better to "underpromise and overdeliver." The analysts, it turned out, had *underestimated* Starbucks' success—by 2000, it was taking in over \$2 billion in revenues. In the 22 years between 1993 and 2015, Starbucks averaged an annual revenue growth rate of 26% a year.

COMPETITION IN THE SPECIALTY COFFEE SEGMENT

In the United States in 2012, specialty coffee accounted for 37% of all cups of coffee consumed, and for nearly 50% of all coffee revenue. Though the United States was the single largest buyer of unroasted coffee in the world in 2012, emerging markets were exhibiting strong growth, and many experts anticipated that Brazil would surpass the United States in coffee consumption sometime between 2014 and 2016.

Worldwide, independent coffee shops still make up the majority of coffeehouse locations, though prominent chains have emerged in many regions. Starbucks has long held a leading position in its home market, selling over 50% of the specialty coffee purchased in cafes in the United States over the last several decades, and easily dominating local specialty coffee competitors such as Caribou Coffee and Peet's Coffee & Tea. However, in recent years, Both Dunkin' Donuts and McDonald's began targeting Starbucks' growing customer base with coffee offerings based on high-quality, Arabica brews at a lower cost than Starbucks' beverages. With a very large number of existing stores (see Table 1), both competitors posed big threats if they were effective in wooing customers away from Starbucks. Furthermore, Starbucks faced other, more entrenched competition in many of its international markets (see Figure 1 for a breakdown of market share by regional areas).

Caribou Coffee

Founded in 1992, Caribou Coffee operates 470 coffeehouses in about 20 states and in many international markets (particularly in the Middle East and South Korea). Its 2012 sales were \$326.5 million, and then the company was taken private in 2013. Its stores are designed to look like mountain lodges and sell only specialty coffee, baked goods, and coffee brewing supplies. However, like Starbucks, the company also sells roasted coffee to grocery stores and has a licensing agreement to make single-serve K-cups for home brewing using Keurig machines.

McDonald's

Founded in 1948 in San Bernardino, California, McDonald's grew to become the world's largest quick-service restaurant. Boasting about 36,000 restaurants in 119 countries and \$27.4 billion in sales (see Table 1), McDonald's is probably the best-known restaurant in the world. Though its menu is most famous for hamburgers and fries, in the last 2 decades McDonald's has developed healthier food items in response to social pressure mounted against burger chains. In 1993, a McDonald's licensee, Ann Brown, created the McCafé—a coffeehouse style outlet that would offer high-end coffee beverages similar to Starbucks'. In response to its early success, McDonald's also introduced a line of special coffee drinks called McCafé into its other restaurants.

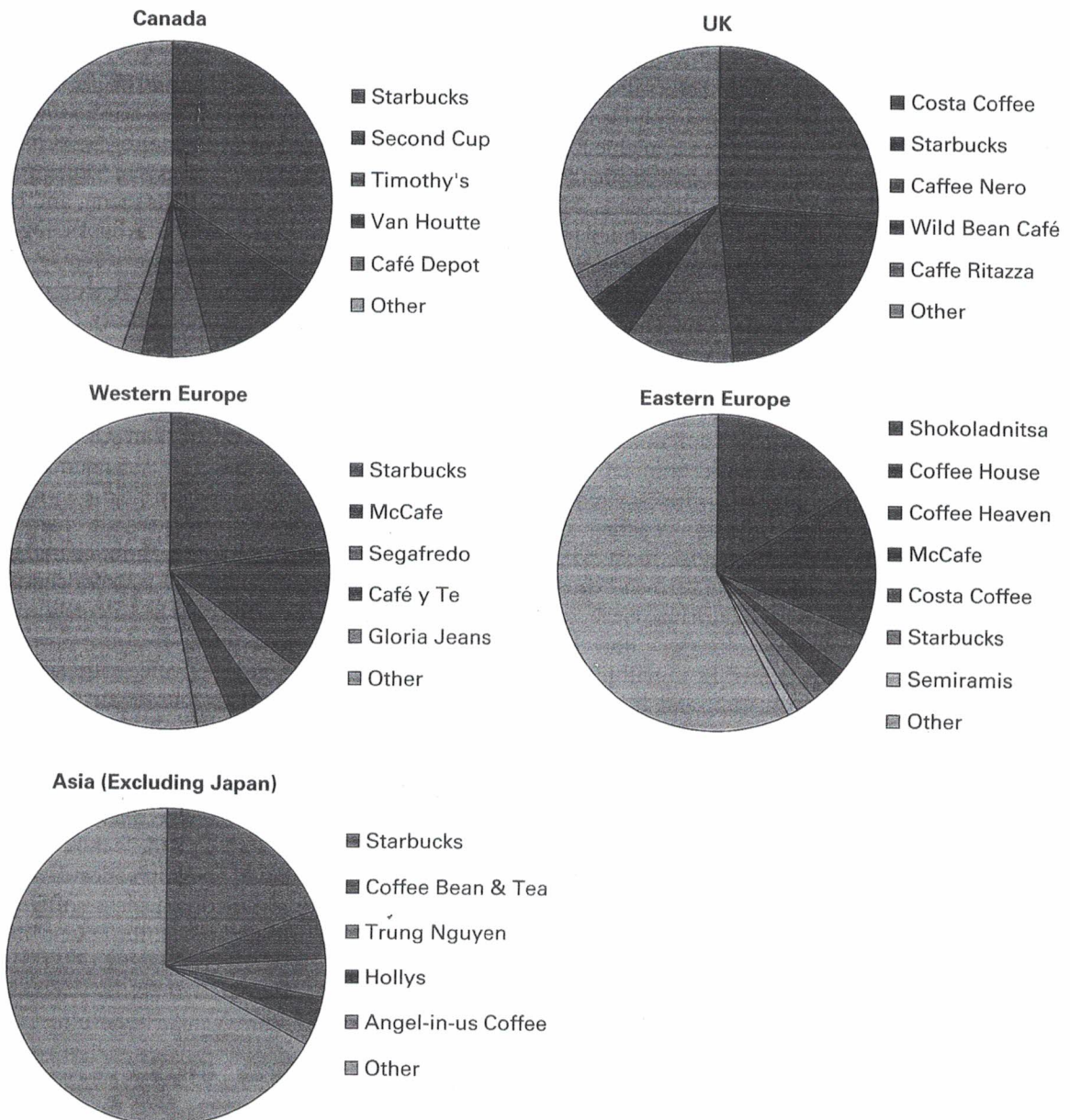
Dunkin' Donuts

Originally founded as the Open Kettle Doughnut shop in Quincy, Massachusetts, in 1948, founder William Rosenberg changed its name to Dunkin' Donuts in 1950 and began franchising the shops 5 years later. The popular franchise became famous for its wide variety of doughnuts, and expanded to become the world's leading doughnut chain, with 11,000 outlets in about 30 countries. Dunkin' Brands Group also owns Baskin Robbins and Togo Sandwiches, and collectively the chains earned \$748.7 million in sales in 2014 (see Table 1). Though it had long offered coffee, the company did not begin offering espresso drinks until 2003.

REDEFINING "A CUP OF JOE"

Starbucks' coffee quality begins with bean procurement. Whereas historically Americans had drunk a commoditylike coffee composed of Arabica beans mixed with less-expensive Robusta filler beans, Starbucks coffee is strictly specialty varieties of Arabica beans, and the company goes to great lengths to ensure that only the highest-quality beans are used. Starbucks' bean procurement standards are demanding, and the company conducts exacting experiments in order to get the

Figure 1 Specialty Coffee Market Shares by Region



Data from 2008 Bernstein Research Report, "Starbucks: Getting Its Buzz Back."

proper balance of flavor, body, and acidity. Brews are subjected to "cupping"—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")—to evaluate aroma and taste.

From the company's inception, it has worked on developing relationships with the countries from which it buys coffee beans. Prior to Starbucks' rise, Americans were notorious for buying poor-quality coffee beans—most of the premium coffee beans were bought by Europeans and Japanese. In 1992, however,

Starbucks set a new precedent by outbidding European buyers for the exclusive Narino Supremo Bean crop. This Columbian crop is very small and grows only in the high regions of the Cordillera mountain range. For years, Narino beans were guarded zealously by Western Europeans who prized their colorful, 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." 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, reputedly one of the best coffees in the world.

Procurement is not the only area where extreme care differentiates Starbucks' product: roasting is close to an art form at Starbucks. Unlike most specialty coffee retailers, Starbucks roasts its own beans in its private roasting facilities in California, Nevada, Pennsylvania, South Carolina, Washington, and the Netherlands. 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 oven for 12 to 15 minutes while roasters use their sight, smell, and hearing 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.

Despite the attention to quality, Starbucks' effort at bringing a premium coffee and Italian-style beverage experience to the American market could have been lost on consumers had it not invested in consumer education. Starbucks spends far less on advertising than most chain restaurants (in 2014, for example, Starbucks spend \$315 million on advertising—just 2% of sales, compared to McDonald's' \$808 million, or 3% of its sales).⁴ Instead, it invests in securing highly visible locations, innovating in its menu, and building an iconic, ubiquitous brand. Starbucks' logo has evolved from an original, 16th-century Norse woodcut of a visibly topless mermaid to a version in which her flowing hair afforded more modesty (which was crucial for entry into countries with strong cultural taboos around nudity), to the current version which omits the nameplate, permitting Starbucks to symbolize a broader product range than just coffee (see Figure 2).

Starbucks also seeks to develop a close connection with customers. Starbucks employees are encouraged to help customers make decisions about beans, grind, and coffee/espresso machines and instruct customers on home brewing. The objective is to create a long-term relationship with customers.

In order to create American coffee enthusiasts with the dedication of their Italian counterparts, Starbucks needed to provide a seductive atmosphere in which to imbibe. The stores are sleek yet comfortable. Coffee preparers are referred to as "baristas," Italian for bartender, and *biscotti* is available in glass jars on the counter. The stores are well lighted, feature plenty of burnished wood and brass, and sophisticated artwork hangs on the walls. Jazz or opera plays softly in the

Figure 2 Evolution of the Starbucks Logo



1971-1987



1992-2011



2011-Present

background. According to Schultz, “We’re not just selling a cup of coffee, we are providing an experience.”

Many of the stores offer light lunch fare including sandwiches and salads, and an assortment of pastries, bottled waters, and juices. Starbucks also launched a line of packaged and prepared teas in 1995 in response to growing demand for teahouses and packaged tea. Tea is a highly profitable beverage for restaurants, costing only 2 to 4 cents per cup to produce.

PAMPERING EMPLOYEES

Schultz believes that happy employees are the key to competitiveness and growth. He states, “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.”⁵ Starbucks has accomplished this through an empowering corporate culture, exceptional employee benefits, and employee stock ownership programs. While Starbucks enforces almost fanatical standards about coffee quality and service, the culture at Starbucks toward employees is laid back and supportive. Employees are empowered to make decisions without constant referral to management, and are encouraged to think of themselves as partners in the business. Starbucks wants employees to use their best judgment in making decisions and will stand behind them. This is reinforced through generous compensation and benefits packages.

Starbucks offers an industry-leading benefits package to both part-time and full-time employees. 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 401 (k) savings plan, and a stock option plan. They also offer career counseling and product discounts. The decision to offer benefits even to part-time employees garnered the firm a great deal of attention in the press. It was difficult to get companies to insure Starbucks, because they did not understand why Starbucks would want to cover part-timers. However, while many companies scrimp on these essentials, Schultz believes that without these benefits, people do not feel financially

or spiritually tied to their jobs. The stock options and the complete benefits package increase employee loyalty and encourage attentive service to the customer. Bradley Honeycutt (director of compensation and benefits) also points out that “part-timers are on the front line with our customers. If we treat them right, we feel they will treat [the customers] well.”⁶

Employee turnover is also discouraged by Starbucks’ stock option plan (known as the Bean Stock Plan). Implemented in August 1991, the plan made Starbucks the first company to offer stock options unilaterally to all employees, including part-time workers. After one year, employees may join a 401 (k) plan. There is a vesting period of 5 years; it starts 1 year after the option is granted, then vests the employee at 20% every year. In addition, every employee receives a new stock option award each year, and a new vesting period begins. This plan required the then privately-held Starbucks to get an exemption from the Security Exchange Commission, because any company with more than 500 shareholders must 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. (and the largest shareholder before the public offering) says, “Increasing the shareholders substantially dilutes our interest. We take that very seriously.” In the end they were won over by a study conducted by Orin Smith 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 company’s culture was a major component of its profitability. “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.” In 2013, Starbucks paid over \$230 million in equity awards.

Training programs are extensive at Starbucks. Each employee takes at least 24 hours’ worth of classes, covering everything from coffee history to a 7-hour workshop called *Brewing the Perfect Cup at Home*. Starbucks employees even undergo rigorous training about how to respond to cranky customers through the “Latte Method” of responding to unpleasant situations: “We Listen to the customer, Acknowledge their complaint, Take action by solving the problem, Thank them, and then Explain why the problem

occurred.”⁷ Store managers (who have gone through facilitation workshops and are certified by the company as trainers) teach the classes. The classes emphasize the empowering culture at Starbucks and 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 a 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.

Schultz is also known for his sensitivity to the well-being of employees. Once, when an employee had come to tell Schultz that he had AIDS, Schultz reassured him that he could work as long as he wanted to, and when he left Starbucks would continue to cover his insurance. After the employee left the room, Schultz sat down and wept. Schultz attributes his concern for his employees to his memories of his father. According to Schultz, his 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.”

In 1995, Starbucks demonstrated that its concern for employee welfare extended beyond 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. The company’s guidelines called for overseas suppliers to pay wages and benefits that “address the basic needs of workers and their families” and to allow child labor only when it does not interrupt required education. This move set a precedent for other importers of agricultural commodities and received high praise from global human-rights activists.

In 2000, Schulz transitioned to being the chairman and chief global strategist, but continued to stay very actively involved in the company’s operations and taking a strong stance on ethical business. Working in combination with Conservation International,

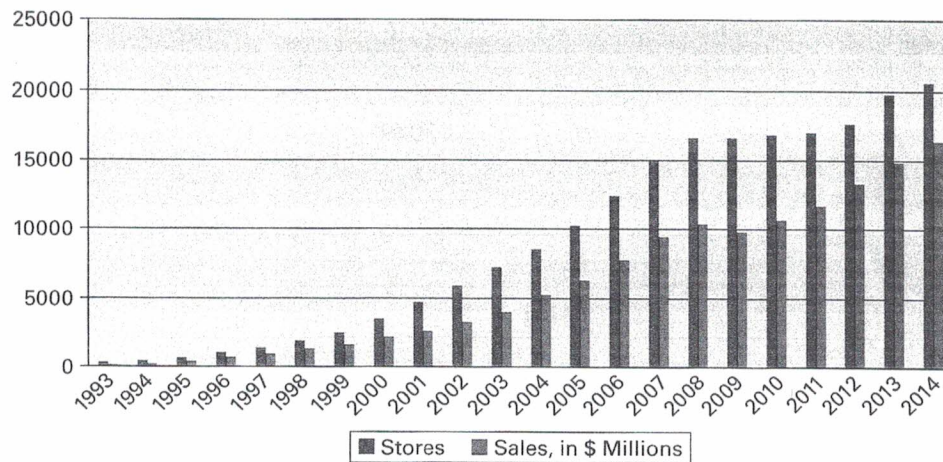
Starbucks introduced new, ethical coffee-sourcing guidelines in 2001, and began actively promoting its Coffee and Farmer Equity (CAFE) Practices that provide measurable standards for such factors as economic transparency, fair and humane working conditions, and water and energy conservation.

▲ GROWTH, DIVERSIFICATION, AND INTERNATIONAL EXPANSION

In Starbucks’ early years, Schultz had professed a strict, slow-growth policy. While other coffeehouses or espresso bars were being franchised, Starbucks owned all of its stores outright with the exception of key locations where the only way in was through a license agreement (e.g., airports, stadiums). Hundreds of willing investors would call every day, but Schultz turned them all down, arguing that it was important to the company’s integrity to keep all stores company owned. Furthermore, in each market that Starbucks entered, imitators would rapidly emerge. Thus, rather than creating outposts in all the potential markets as soon as possible, Starbucks went into a market and completely dominated it before setting its sights further abroad. Despite this, the company was consistently one of the fastest-growing companies in the United States (see Figure 3). Over time, Starbucks loosened its licensing policy and began accelerating the rate at which it permitted licensed stores. Licensing was particularly important for many international markets in which having a foreign partner reduced both the difficulty and risk of entry (see Figure 1).

The combination of the high-quality products and services, well-managed branding, and a reputation for social responsibility made the company attractive to both consumers and investors. By 2007, the company had over 15,000 stores. However, a combination of competition, the recession, and Starbucks’ own saturation of many markets began to spell trouble for the company. Sales declined for the first time ever in 2009. From 2007 to 2010, many Wall Street analysts were whispering that the company’s best days were behind it.⁸ Feeling that the company was in

Figure 3 Starbucks Growth in Stores and Revenues, 1993–2014



crisis, Schultz decided to return to the role of chief executive officer in 2008, noting “This has been my life’s work, as opposed to a job. I didn’t come back to save the company—I hate that description—I came back to rekindle the emotion that built it.” Though Schultz was advised to lower prices and cut benefits to employees, he opted instead to invest in a 2-year transformation of Starbucks that he called “the company’s holistic restoration.”⁹ Although Starbucks closed about 900 company-operated stores in 2009–2010, Schultz focused most of his effort on reinvigorating what he saw as the heart of the company—its commitment to exceptional service and quality. He invested in developing new product lines and line extensions, and he even closed all U.S. stores for 3 hours on the evening of February 26, 2010, to retrain about 135,000 in-store employees. His gambles paid off, and the company began to again climb to new sales and profitability highs. In 2014, Starbucks announced that all employees would get significant pay raises, and Schultz unveiled an even more ambitious “College Achievement Plan” wherein employees who work more than 20 hours a week can also work toward a bachelor’s degree through an online program from Arizona State University.¹⁰

In addition to expanding its menu selection to include more food products and drink options, Starbucks has begun diversifying in other ways. It now offers a range of cafe formats (including expanding the number of drive-through service locations),

and, in 2009, Starbucks introduced single-serve coffee packets targeted at the home brewing, office, and hotel coffee markets. The single-serve packs are designed to be brewed in Green Mountain Coffee’s Keurig brewers, and are distributed by Green Mountain. In 2012, Starbucks acquired Bay Bread and its La Boulange bakery brand, marking its entry into the French-style bakery market. It also acquired Evolution Fresh, a fruit and vegetable juice beverage company.

By 2015, Starbucks had also expanded well beyond its U.S. origins. The company’s international presence had expanded from a single store opened in Japan in 1996 to a well-diversified presence around the world by 2015 (see Table 2). Recognizing that the U.S. market was maturing, Schultz acknowledged that most of the future growth would come from emerging markets. In 2015, Schultz was focusing most of his attention on Brazil, China, India, and Vietnam.

Perhaps more importantly, Schultz no longer thinks of Starbucks as just a coffee company. As he explains, the next great challenge is to deepen the company’s involvement in health and wellness. In late 2014 and early 2015, Schultz decided to leverage the company’s influence in the world by beginning to speak out on such issues as gay marriage (Schultz supports it), gun carrying laws (Starbucks requests that people not carry guns into Starbucks even in those states that would otherwise permit it), and treatment of veterans (in March 2014, Schultz committed \$30 million of his own money to posttraumatic stress programs and

Table 2 Starbucks Stores Open as of 2014 by Geographical Area

	Company-Operated Stores	Licensed Stores
Americas:		
United States	7049	4408
Canada	940	397
Brazil	70	
Puerto Rico	19	
Mexico		403
Other		207
Total Americas	8078	5415
Europe/Middle East/Africa		
United Kingdom	522	242
Germany	157	
France	72	
Switzerland	52	
Austria	16	
Netherlands	7	
Turkey		193
United Arab Emirates		107
Spain		82
Kuwait		69
Saudi Arabia		62
Russia		65
Other		323
Total EMEA	826	1143
China/Asia Pacific		
China	614	403
Thailand	174	
Singapore	94	

	Company-Operated Stores	Licensed Stores
Japan		1000
South Korea		559
Taiwan		297
Philippines		216
Other		525
Total China/Asia Pacific	882	3000
Totals Across Regions	10143	9624

other initiatives to help veterans, and vowed to hire 10,000 veterans and military spouses by 2018).

The company drew some ire in taking on issues that bear little relationship to its core activities. Critics admonished that such initiatives risked alienating some consumers and investors, and creating elevated expectations that the company might not always be able to meet. As Schultz noted, "I can tell you the organization is not thrilled when I walk into a room and say we're now going to take on veterans [issues]." But he adds, "The size and the scale of the company and the platform that we have allows us, I think, to project a voice into the debate, and hopefully that's for good . . . We are leading [Starbucks] to try to redefine the role and responsibility of a public company."¹¹

NOTES

1. Data compiled from Starbucks SEC filings, 1996–2015, and Hoovers, May, 2015. Interviews conducted with Susan Mecklenberg, Director of Environmental Affairs at Starbucks, and Troy Alstead, Director of International Planning and Finance at Starbucks.
2. M. Rothman, "Into the Black," *Inc.*, January 1993. www.inc.com.

3. I. Abramovitch, "Miracles of Marketing: How to Reinvent Your Product," *Success Magazine*, April 1993. www.success.com.
4. M. Morrison, "Starbucks: Forging a Moment of Connection," *Advertising Age* 82 (40) (2011): 30; M. Morrison, "Bang for Its Starbucks: Hits No. 3 Despite Limited Spend," *Advertising Age* 82 (18) (2011): 1–100.
5. M. Rothman, "Into the Black."
6. S. Roberts, "Working Part Time Pays Off at Starbucks Coffee," *Business Insurance*, March 27, 1995. www.businessinsurance.com.
7. C. Duhigg, *The Power of Habit: Why We Do What We Do in Life and in Business*. New York: Random House, 2012.
8. J. Gertner, "The World's 50 Most Innovative Companies: Starbucks—For Infusing a Steady Stream of New Ideas to Revive Its Business," *Fast Company*, 163 (2012): 112–149.
9. J. H. Ostdick, "Rekindling the Heart & Soul of Starbucks," *Success Magazine*, 2012, March, www.success.com.
10. M. Rothman, "Into the Black"; D. Ritter, "3 Reasons It's Hard to Hate Starbucks," *USA Today*, July 6, 1993. www.usatoday.com.
11. D. Ritter, "3 Reasons It's Hard to Hate Starbucks"; A. Gonzalez, "Starbucks as Citizen: Schultz Acts Boldly on Social, Political Issues," *Seattle Times*, March 15, 2015. www.seattletimes.com.