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### The Commoditization of Starbucks

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## The Commoditization of Starbucks

### Abstract

[Excerpt] Is the coffee empire that Starbucks built beginning to fall? In a memo sent to the senior management of the company in February 2007, Howard Schultz warned that Starbucks was in danger of losing its romance and theater, which he believes are fundamental to the Starbucks experience. He noted, "Over the past ten years in order to achieve the growth, development, and scale necessary to go from less than 1,000 stores to 13,000 stores and beyond, we have had to make a series of decisions that, in retrospect, have led to the watering down of the Starbucks experience, and, what some might call the commoditization of our brand." Calling the memo subject "The Commoditization of the Starbucks Experience," Schultz questioned corporate decisions to use automatic espresso machines and eliminate some in-store coffee grinding. He worried that store design decisions to gain scale efficiencies and higher sales-to-investment ratios had turned stores into sterile cookie-cutter properties, without the warmth of a neighborhood cafe. Streamlining store design was a financial decision, but the result was that stores no longer have the soul of the past. Schultz envisioned the cafes as a "third place" where people gather between home and work and feel some of the romance of the European cafe, but this feature may have disappeared, to be replaced by a chain store feel versus a neighborhood store.

### Keywords

hospitality firms, case studies, Starbucks, cafes

### Disciplines

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### Comments

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# The Commoditization of Starbucks

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Is the coffee empire that Starbucks built beginning to fall? In a memo sent to the senior management of the company in February 2007, Howard Schultz warned that Starbucks was in danger of losing its romance and theater, which he believes are fundamental to the Starbucks experience. He noted, "Over the past ten years in order to achieve the growth, development, and scale necessary to go from less than 1,000 stores to 13,000 stores and beyond, we have had to make a series of decisions that, in retrospect, have led to the watering down of the Starbucks experience, and, what some might call the commoditization of our brand."<sup>1</sup> Calling the memo subject "The Commoditization of the Starbucks Experience," Schultz questioned corporate decisions to use automatic espresso machines and eliminate some in-store coffee grinding.<sup>2</sup> He worried that store design decisions to gain scale efficiencies and higher sales-to-investment ratios had turned stores into sterile cookie-cutter properties, without the warmth of a neighborhood cafe. Streamlining store design was a financial decision, but the result was that stores no longer have the soul of the past.<sup>3</sup> Schultz envisioned the cafes as a "third place" where people gather between home and work and feel some of the romance of the European cafe, but this feature may have disappeared, to be replaced by a chain store feel versus a neighborhood store. The memo directed to CEO Jim Donald was a call to regain the romance and return to the Starbucks Experience. Schultz illustrated his fear that Starbucks was commoditizing its brand by noting:

*For example, when we event to automatic espresso machines, we solved a major problem in terms of speed of service and efficiency. At the same time, we overlooked the fact that we would remove much of the romance and theater that was in play with the use of the La Marzocca machines. This specific decision became even more damaging when the height of the machines, which are now in thousands of stores, blocked the visual sight line the customer previously had to watch the drink being made, and for the intimate experience with the barista.<sup>4</sup>*

Other decisions, like the addition of drive-through windows and hot breakfast sandwiches, and Starbucks starts to look like a fast-food chain. As Schultz sees it, "Many of these decisions were probably right at the time, and on their own merit would not have created the dilution of the experience; but in this case, the sum is much greater and, unfortunately, much more damaging than the individual pieces."<sup>5</sup> For example, during fiscal 2007, the Company operated approximately 2,300 drive-through locations and served sandwiches in 4,800 U.S. and 1,600 international stores.<sup>6</sup>

In the United States, almost 80 percent of orders are now consumed outside the store, and 66 percent of company-owned stores sell lunch, further eroding the sense of place. A shifting customer demographic shows that the average income and education levels of Starbucks customers have gone down as well, while the customer base of fast-food giant McDonald's has remained stable.<sup>7</sup> As part of a big push into food, Starbucks sells lunch at more than two-thirds of its company-owned locations in the United States. The loss of coffee aroma, so worrisome for Schultz, is now replaced with the smells of food.

One of the risks of rapid expansion is that the company may be losing its unique identity as it strives for operational effectiveness. "If we just become about products, and not about the people side, I think the experience changes, and changes for the worse," commented Jim Ailing, president of Starbucks' U.S. business, in an interview just before the Schultz memo. "We never want to lose sight of where we came from," he noted.<sup>8</sup> The Schultz memo supports this view and notes:

*While the current state of affairs for the most part is self induced, that has led to competitors of all kinds, small and large coffee companies, fast food operators, and mom and pops, to position themselves in a u/ay that creates awareness, trial and loyalty of people who previously have been Starbucks customers. This must be eradicated.<sup>9</sup>*

Starbucks wants to continue its growth as one of the world's most recognized brands, without losing the uniqueness that has made it so successful. The company, in the past decade, has expanded from 1,000 stores to more than 15,000. But can it continue to charge premium prices and further grow as competition intensifies from fast-food providers like McDonald's and Dunkin' Donuts. Is the Starbucks experience being watered down?

### **The McThreat**

In early 2008, McDonald's announced its intention to install coffee bars with baristas in nearly all of its U.S. locations. Serving cappuccinos, lattes, and a Frappe (similar to Starbucks' Frappuccino) is expected to add \$1 billion to McDonald's annual sales of \$21.6 billion.<sup>10</sup> Espresso machines will be in view of customers, and McDonald's promises a simple small, medium, and large sizing system rather than the sometimes confusing tall, grande, and venti sizing of a Starbucks cup. Mr. Schultz acknowledged the challenge, noting: "We understand all too well that we have built a very attractive business for others to look at and try and take away. We are up for the defense and we are going to get on the offense."<sup>11</sup>

McDonald's executives contend that they are not challenging Starbucks, but rather the move to espresso drinks is part of catering to evolving consumer tastes. The transition for McDonald's has been in play since the early 21st century. Back in 2001, McDonald's opened its first McCafe in Chicago, a concept it had opened almost a decade earlier in Australia. In 2003, the company began its efforts to rethink the brand through a turnaround strategy called Plan to Win, which included remodeling store interiors by moving to softer lighting and muted colors,

along with installing wireless Internet access. This initiative was followed in 2006 with the upgrading of drip coffee to a stronger premium blend.

McDonalds beverage expansion is not limited to coffee. It also plans to add PepsiCo products like Mountain Dew, Lipton green tea, and Red Bull, along with providing flavor shots so customers can create their own drinks like cherry Sprite and vanilla Diet Coke. Coke remains a key partner for McDonalds, and company spokespersons are not concerned about the fast-food chain offering competing beverages.<sup>12</sup>

As for taste, when *Consumer Reports* magazine compared coffee from mega-chains Starbucks, McDonald's, Burger King, and Dunkin' Donuts, a surprising winner emerged. While the tasters found Starbucks coffee to be "burnt," they also reported that McDonald's coffee "beat the rest."<sup>13</sup> It was "decent and moderately strong. Although it lacked the subtle top notes needed to make it rise and shine, it had no flaws." The nickname "char-bucks" may be well earned, according to some consumers, but others contend that people have different tastes and coffee is a matter of taste.

### **The Birth of Starbucks**

Starbucks Coffee, Tea and Spice opened its first store in April 1971 in the Pike Place Market in Seattle, Washington.<sup>14</sup> Its original owners, Jerry Baldwin and Gordon Bowker, had a passion for dark-roasted coffee, which was popular in Europe but hard to come by in America in the 1960s. "They founded Starbucks for one reason: They loved coffee and tea and wanted Seattle to have access to the best."<sup>15</sup> Starbucks stood not only for good coffee, especially dark-roasted coffee, but also for educating its customers about its product.

Jerry, a lover of literature, named the company Starbucks, after the coffee-loving first mate in *Moby Dick*, because it "evoked the romance of the high seas and the seafaring tradition of early coffee traders." The original store did not brew and sell coffee by the cup, but instead offered a selection of 30 varieties of whole-bean coffee.<sup>16</sup> Although Starbucks was bringing high-quality coffee to Seattle, coffee was generally regarded as a commodity item. In Italy, coffee bars serving espresso drinks offered more than great coffee: they provided a great coffee experience.<sup>17</sup> It took the vision of one man to turn coffee from a commodity into an experience. His name was Howard Schultz.

### **Howard Schultz, The Visionary**

Howard Schultz came from humble beginnings, growing up in a subsidized public housing project (Bay View Houses) in Brooklyn, New York. His father was a factory worker and truck driver, and his mother worked as a receptionist. He went to Canarsie High School and was able to attend college because of a football scholarship. In 1975, he graduated with a bachelor's degree in communications from Northern Michigan University, becoming the first member of his family to earn a college degree.

After college, he worked as a sales trainee at Xerox and then moved to Hammerplast, a Swedish housewares company, where he rose to vice president of U.S. sales.<sup>18</sup> While he was at Hammerplast, Howard discovered Starbucks, which was a customer of his. After visiting the company and meeting its owners, he knew that he wanted to be part of Starbucks and see it grow nationwide. Baldwin and Bowker hired Schultz as director of retail operations and marketing in 1982.<sup>19</sup>

While traveling through Italy to learn more about the coffee business, Schultz was amazed that the country supported about 200,000 espresso bars, with 1,500 in the city of Milan alone. Convinced that this was the way to get Starbucks to appeal to a greater number of people, he proposed the idea to his bosses. Starbucks sold only coffee beans at the time, but it tested the idea of serving coffee at the new downtown Seattle store in 1984. The test was a great success, but the owners decided not to expand the concept. This disagreement caused Schultz to leave the company in 1985 and start his own coffee-bar company, *Il Giornale*.<sup>20</sup>

### **Il Giornale**

Schwartz envisioned bringing the romance of Italian coffee bars to America. To realize this dream, the first *Il Giornale* was opened in April 1986, as a genuine Italian-style coffee bar. Schultz joined forces with Dave Olsen, who had run a successful coffeehouse in Seattle called Cafe Allegro. Cafe Allegro was a place where students and professors would hang out, studying philosophy or debating U.S. foreign policy while drinking cappuccinos. It was this type of coffeehouse that Starbucks later became—a gathering place in the neighborhood.<sup>21</sup>

Schultz and Olsen shared a passion for coffee and similar views on how to run a business. Schultz's strengths were communicating the vision, inspiring investors, raising money, and planning for growth. Olsen had a deeper understanding of how to operate a retail cafe, hire and train baristas, and ensure the best-quality coffee. After adapting their original concept to fit customer needs, such as varying the music from only opera and the move to selling coffee in paper cups to boost carryout business, it was time for expansion. The chain expanded to a second Seattle store and its first international store in Vancouver in April 1987.<sup>22</sup>

### **Schultz Buys Starbucks**

The original owners of Starbucks decided to focus on Peet's Coffee & Tea and put Starbucks, which consisted of six retail stores and a roasting plant, up for sale. Schultz and Olsen raised the \$3.8 million and purchased Starbucks in August. They changed the name of all the 11 Giornale stores to Starbucks because of its stronger brand name in Seattle and among mail-order customers. In a meeting with employees shortly after acquiring the company, Schultz told the staff:

*All my life I have wanted to be part of a company and a group of people who share a common vision.... I'm here today because I love this company. I love what it represents.... I know you're concerned... I promise you I will not let you down. I promise you I will not*

*leave anyone behind.....In five years, I want you to look back at this day and say, "I was there when it started. I helped build this company into something great."*<sup>23</sup>

Schultz had great plans for expansion even then, promising investors that Starbucks would open 125 stores in five years.<sup>24</sup> During the next five years, Starbucks remained a privately held company and expanded its number of stores at a faster pace than planned. With a base of 11 stores in 1987, Starbucks opened 15 stores in 1988 and 20 in 1989. Seeing that their targets were being easily met, Starbucks stepped up their expansion efforts and had 165 stores by 1992. While limited to the Pacific Northwest, Chicago, and parts of California, the strategy was to build customer loyalty through market saturation. The mail-order business helped facilitate this approach by broadening their reach to customers outside their retail locations.<sup>25</sup>

### **Going Public**

Schultz took the company public in 1992 to raise capital to fuel growth. Starbucks' managers refused to franchise the stores, because they did not want to jeopardize the quality of their product, and the IPO would provide the additional capital needed to keep pace with their desired growth plans. On June 26, 1992, Starbucks stock was listed on NASDAQ. The offering was priced at \$17 per share, but it immediately jumped to \$21. The IPO raised \$29 million for Starbucks, and by the closing bell the company's market capitalization stood at \$273 million. This was only five years after Schultz and Olsen bought the company for \$4 million.<sup>26</sup>

With more capital on hand, the company was now positioned to expand—and expand it did. In April 1993, Starbucks opened its first East Coast store in Washington, D.C. The company then moved its efforts to New York and Boston in 1994. Starbucks International was formed the same year, and Starbucks' began to expand its senior management team by hiring confident managers with experience in growing businesses.

Serving as CEO from 1987 to 2000, in July 2000, Howard Schultz showed his commitment to Starbucks' plan to expand globally by stepping down as CEO and assuming the role of chief global strategist. While the company has grown incredibly since he took over, Schultz said, "We're only in the infant stages of what Starbucks is going to be."<sup>27</sup> Turning over the office of CEO to Orin Smith, who later retired in 2005, Schultz was not worried about global expansion, but something did keep him awake at night:<sup>28</sup>

*What worries me is the question, "How do we maintain our culture, our intimacy with the customer?" What doesn't worry me anymore is how large the market is and how big the prize ultimately can be around the world. I can clearly see the path to how big the opportunity is. The question is whether we can do that and preserve intact, and possibly enhance, the experience the customer has.*

### **The Vision and Guiding Principles**

The primary purpose of Starbucks is to roast and sell high-quality whole-bean coffees, a variety of pastries and sandwiches, and coffee-related accessories and equipment. It also sells

coffee beans through a specialty sales group and supermarkets. With a vision to establish Starbucks as the most recognized and respected brand in the world, the company has branded its coffee not only through its retail stores and through grocery stores, but it has also licensed its brand for other food and beverage products.

In 1994, Starbucks created a new drink called a Frappuccino®, a cold drink made from ice, coffee, sugar, and low-fat milk. It was a hit, drawing many non-coffee drinkers into the store and increasing sales on hot days. A bottled version is sold in grocery stores through the North American Coffee Partnership, a joint venture between Starbucks and PepsiCo.<sup>29</sup>

To further its brand building, Starbucks formed strategic partnerships to get access to more of its target customers. Such partnerships have made it possible to drink Starbucks' coffee at Nordstrom, at Barnes & Noble, on Holland America cruise lines, and at various hotel chains.<sup>30</sup> In order to offer its products in airports and schools, Starbucks also made strategic alliances with Host Marriott and Aramark.<sup>31</sup>

In 1998, Starbucks launched a partnership with Kraft, a unit of food and tobacco giant Philip Morris, to distribute whole beans and ground coffee to more than 20,000 grocery stores in the United States. Starbucks has a partnership with Nesde's Dreyer's Grand Ice Cream subsidiary to market gourmet ice cream, and partners with Beam Global Spirits to sell coffee-flavored liqueur. Starbucks even expanded into the music industry, partnering with Capitol Records to sell specialized musical compilations in Starbucks stores. The company owns the Seattle's Best Coffee company. Teas produced by its wholly owned subsidiary, Tazo Tea Company, round out the product offerings that are intended to enhance the brand.<sup>32</sup>

Today Starbucks offers coffee, handcrafted beverages, merchandise, fresh food, entertainment, consumer products, and the Starbucks Card.<sup>33</sup> The Starbucks Card is a reloadable stored-value card introduced in 2001. The entertainment products include a selection of music, books, and film from emerging talents. Key strategic relationships in its entertainment business include a relationship with Concord Music Group, which manages the Hear Music record label, and William Morris Agency, which identifies book projects that it can offer in Starbucks' stores as well as provide strategic counsel on opportunities in the entertainment space. Strategic relationships with Apple and AT&T are expected to help enhance the customer experience through the use of Wi-Fi and other in-store technology.<sup>34</sup>

### **The Starbucks Mission**

With more than 15,000 stores worldwide, Starbucks has fulfilled its vision of being one of the most recognized and respected brands in the world. But has the expansion of its brand into more than 35 countries, with partners in retail segments selling ice cream, teas, CDs, books, and other lifestyle products, taken the company away from its mission? The Starbucks mission is to "Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles as we grow." The guiding principles used to help make decisions include:<sup>35</sup>



1. Provide a great work environment and treat each other with respect and dignity.
2. Embrace diversity as an essential component in the way we do business.
3. Apply the highest standards of excellence to the purchasing, roasting, and fresh delivery of our coffee.
4. Develop enthusiastically satisfied customers all of the time.
5. Contribute positively to our communities and our environment.
6. Recognize that profitability is essential to our future success.

### **Social Responsibility**

The principle of contributing positively to communities and the environment is so important to Starbucks that it works with partners and suppliers to devise sustainable methods for coffee production. In order to minimize its environmental footprint, Starbucks entered a partnership with The Center for Environmental Leadership in Business. Together, they developed guidelines that they believe not only protect their high standards, but also promote the high-quality coffee market. The guidelines are based on the following criteria:<sup>36</sup>

- Quality baselines that are based on maintaining Starbucks quality standards
- Social conditions that are based on conforming to local laws and applicable international conventions related to employee wages and benefits
- Environmental issues based on growing and processing standards that contribute to conservation of soil and water and to biological diversity
- Economics issues that will benefit rural communities by boosting producer income, expanding employment and educational opportunities, and enhancing local infrastructure and public services

Even with the high standards that Starbucks holds itself to, the company faced demands from many social and environmental groups. Environmental activists such as the Organic Consumers Association (OCA) complained about Starbucks' use of milk from cows that have been treated with growth hormones. Starbucks responded to the complaint by offering organic milk for an extra charge.<sup>37</sup>

Social activists in Central America accused Starbucks of abusing poor coffee farmers by paying them low prices for their coffee beans. In an attempt to protect its brand image, Starbucks developed guidelines to pay farmers a premium price if they met certain standards. In 2004, Starbucks paid on average \$1.20 per pound (\$2.64 kg) for high-quality coffee beans, or 74 percent higher than the commodity market's price during that year.<sup>38</sup> However, some human-rights organizations say this doesn't address the underlying poverty that is "killing coffee farmers and their families." In general, activists suggest, "It's time for Starbucks to share the wealth."<sup>39</sup> In response to these demands, Starbucks encouraged farm groups who sell coffee beans to Starbucks to pay acceptable wages, avoid child labor, and provide acceptable living conditions.<sup>40</sup> They also began initiatives to help provide farmers with access to credit at

favorable rates. For example, the company committed \$2.5 million through Conservation International's Verde Ventures Fund to assist small-scale farmers in Latin America and Asia.<sup>41</sup>

Starbucks formed a partnership with Conservation International in 1998 to promote environmentally sound methods of growing coffee.<sup>42</sup> Furthermore, Starbucks invested \$200,000 to support eco-friendly crops in Mexico in 2003, only to find out that these crops had better taste and greater economic potential.<sup>43</sup> Since then, the company has given an additional \$1.5 million to support expansion of the Conservation Coffee™ program in Central America, Peru, and Colombia.

### **The Starbucks Experience**

*We are not in the coffee business serving people, but in the people business serving coffee. The equity of the Starbucks brand is the humanity and intimacy of what goes on in the communities. . . . We continually are reminded of the powerful need and desire for human contact and for community, which is a new, powerful force in determining consumer choices. . . . The Starbucks environment has become as important as the coffee itself.*<sup>44</sup> —Howard Schultz, Chairman of Starbucks

The Starbucks experience is a combination of an empowering corporate culture that shares the wealth with employees (partners) and in turn creates a unique and personal experience for customers. Schultz believed that in order to build respect and confidence with customers, the company first had to build respect and confidence with the employees.<sup>45</sup> Howard saw this benefit as a part of his core strategy: "Treat people like family, and they will be loyal and give their all. Stand by people, and they will stand by you."<sup>46</sup>

### **A Great Work Environment**

Starbucks has focused on creating a culture in which employees are truly partners—meaning shareholders with a stake in the outcome of the company. Howard Schultz wanted Starbucks to not leave the employees behind as the company became more successful. He saw his father struggle through life working at low-paying jobs where he was treated poorly, and he sought to treat his employees the best he could. He planned to do this by offering a higher wage than other restaurant and retail stores and by offering benefits that weren't available elsewhere. He felt that offering these benefits was a key competitive advantage that attracted more knowledgeable and eager people.

In late 1988, the company began offering health benefits to all full-time and part-time employees, the only company to do so at the time. Then in August 1991, Starbucks started its Bean Stock program, which made all employees in the company eligible for stock options.<sup>47</sup> The purpose of the program was to educate employees on the importance of creating value and profits by linking them to shareholder value.<sup>48</sup>

Management wanted to make sure that the foundation on which it was building the company was linked to everyone in the organization, which would give the company the ability

to retain the staff and their values. Schultz believes that a skilled and motivated workforce is an essential element to service quality; in other words, “Satisfied partners create satisfied customers.”<sup>49</sup> Starbucks is still one of the few publicly held companies in the country to offer stock options and full health and dental coverage to all its full-time and part-time employees. These policies have contributed to a turnover rate that is well below the industry average.<sup>50</sup>

Since the early days of Starbucks, employees have had a major impact on the direction of the company. Even today, Starbucks’ management stands in front of the employees in open forums everywhere the company does business to discuss the previous quarter’s result. They discuss openly the plans, decisions, strategies, and concerns of the company. It is part of the Starbucks culture that people are given an opportunity to say what they feel, and what they feel is considered important to management. Howard Schultz recognized the tremendous trust that could be developed when people feel a sense of belonging through their participation in decisions.<sup>51</sup>

### **Customer Care – It’s Personal**

*The success of Starbucks demonstrates . . . that we have built an emotional connection with our customers. . . . We have a competitive advantage over classic brands in that every day we touch and interact with our customers directly. Our product is not sitting on a supermarket shelf like a can of soda. Our people have done a wonderful job of knowing your drink, your name, and your kids’ names.*<sup>52</sup>—Howard Schultz, Chairman of Starbucks

The key to customer care is the creation of special customer interactions. David Olson, senior vice president of Culture and Leadership Development, puts it this way, “It doesn’t matter how many millions or billions of cups of coffee Starbucks serves, if the one you get doesn’t suit you. Starbucks has to be able to perform at that level of consistency for the individual automatically, and that’s really the promise. We will deliver a drink that suits you every time—and create an experience in the process! The experience must fit the customer.”<sup>53</sup>

In an 18-month exploration of the inner workings of Starbucks, a trainer, author, and consultant watched and interviewed Starbucks partners, customers, and senior managers. The analysis led to the writing of a book titled *The Starbucks Experience*, in which five key principles are identified. The author believes that any business can adopt the following five tenets that are reflected in the Starbucks experience:<sup>54</sup>

1. *Make it your own.* A training pamphlet entitled *The Green Apron Book* tells partners to be welcoming, genuine, considerate, knowledgeable, and involved.
2. *Everything matters.* “Retail is Detail.”
3. *Surprise and delight.* One example was an advertising campaign in which Starbucks placed regular-sized (magnetic) coffee cups on the tops of taxi cabs and had the drivers give gift cards to individuals who advised them that the cup was there.

4. *Embrace resistance.* Thank customers and recognize their grievances. When employees see that management cares about feedback, they are more likely to care too.
5. *Leave your mark.* Starbucks' social and environmental commitment has led to a separate mission statement to capture the company's belief about doing the right thing for the community.

### **Difficult Economic Times**

Despite a difficult economic and operating environment, Starbucks reported solid financial performance in 2007.<sup>55</sup> Net revenues reached \$9.4 billion in 2007, and operating revenues rose by 18 percent to \$1.1 billion.<sup>56</sup> Due primarily to increasing costs of products and higher dairy costs, the cost of sales increased to 43.7 as a percentage of total net revenues for the 13 weeks ended September 30, 2007, compared to 41.7 percent in the corresponding 13-week period of fiscal 2006.<sup>57</sup> At the close of the year, Jim Donald, then president and CEO, stated, "Looking ahead, we believe in the global opportunity for Starbucks, and we remain focused on delivering the highest quality beverages and legendary service, while driving innovation and extending the Starbucks Experience to more customers throughout the world."<sup>58</sup>

However, James Walsh, an analyst at Coldstream Capital Management, voiced the following opinion: "Their outlook is pessimistic for 2008. It's going to be a tough year."<sup>59</sup> Of great concern was the slipping stock price. In the prior year, shares in the company fell more than 40 percent in a 12-month period, wiping out roughly \$13 billion in market value.<sup>60</sup> After a decade of steady growth, shares of Starbucks' stock traded at \$18.38 in contrast to \$36.29 in January 2007.

Exhibit 1 summarizes financial ratios for the company in 2007 compared to the industry, sector, and the Standard and Poor's (S&P) 500. Additional financial information is provided in Exhibits 2 to 4 that include the income statement, balance sheet, and cash-flow information for the five-year period from 2003 to 2007.

As 2007 was coming to a close, Starbucks evaluated its plan for fiscal 2008. A total of 2,571 new stores were opened in 2007, bringing the store count to 15,011, but senior leadership was beginning to rethink its U.S. expansion plans. By year-end, Jim Donald proposed adjusting new-store opening targets to approximately 2,500 net new stores on a global basis in fiscal 2008; approximately 900 company-operated locations and 700 licensed locations in the United States, and approximately 300 company-operated stores and 600 licensed stores in international markets.<sup>61</sup> Operating margins were expected to remain stable in the United States and improve internationally.

Finally, comparable-store sales growth in 2008 was expected to fall in the range of 3 percent to 5 percent. As data from the first quarter of 2008 came in, revenues were up 17 percent primarily due to the U.S. business, which constitutes more than three-fourths of total net revenue.<sup>62</sup> In contrast, comparable-store sales growth remained flat with a 1 percent

### Exhibit 1: 2007 Year-End Financial Ratios

	STARBUCKS	RESTAURANT INDUSTRY	STANDARD & POOR 500
P/E Ratio (TTM)	20.02	29.22	18.23
Quick Ratio (MRQ)	0.51	0.74	1.17
Current Ratio (MRQ)	0.77	0.97	1.69
LT Debt to Equity (MRQ)	0.24	0.86	0.57
Total Debt to Equity (MRQ)	0.48	0.94	0.74
Gross Margin (TTM)	22.92	31.11	44.24
Gross Margin - 5 Yr. Avg.	24.42	30.19	44.28
Operating Margin (TTM)	10.87	13.41	19.53
Operating Margin - 5 Yr. Avg.	11.40	13.58	19.34
EBITD Margin (TTM)	14.96	18.55	23.59
EBITD - 5 Yr. Avg.	15.89	19.27	22.23
Net Profit Margin (TTM)	6.88	7.25	13.23
Net Profit Margin - 5 Yr. Avg.	7.29	8.00	12.81
Return on Assets (TTM)	13.47	8.14	8.86
Return on Assets - 5 Yr. Avg.	13.43	8.50	7.81
Return on Investment (TTM)	22.74	10.74	12.77
Return on Investment - 5 Yr. Avg.	19.90	10.76	11.34
Return on Equity (TTM)	28.81	21.94	21.69
Return on Equity - 5 Yr. Avg.	22.12	21.58	19.44
Revenue/Employee (TTM)	57,113.00	107,759.00	937,101.00
Receivable Turnover (TTM)	36.11	32.39	10.93
Asset Turnover (TTM)	1.96	1.19	0.97

Source: Adapted from Starbucks web site, 2008 and Reuters 2008.

### Exhibit 2: Income Statements, 2003–2007

	2007	2006	2005	2004	2003
Total Revenue	9,411.50	7,786.94	6,369.30	5,294.25	4,075.52
Total Cost of Revenue	7,215.01	5,866.61	4,771.12	3,981.61	3,061.01
Gross Profit	2,196.48	1,920.34	1,598.18	1,312.64	1,014.51
Total Selling/General/Administrative Expenses	489.25	479.39	361.61	304.29	244.55
Net Operating Interest Expense (Income)	-108.01	-93.94	-76.65	-58.98	-36.9
Total Other Operating Expenses	294.14	253.72	192.53	171.65	141.35
Operating Income	1,053.95	893.95	780.52	606.49	420.85
Net Non-Operating Interest Income (Expense)	2.42	12.29	15.83	14.14	11.62
Income Before Tax	1,056.36	906.24	796.35	620.63	432.47
Total Income Tax	383.73	324.77	301.98	231.75	167.12
Net Income	672.64	564.26	494.37	388.88	265.36

Source: Adapted from 2008 Reuters.

increase in the first quarter, driven by the U.S. business, while the international segment (growth of 5 percent) fared better.

As Starbucks prepares for what they believe will be a recession in the United States, they have come to the conclusion that their growth is overseas, and that they can do a better job of delivering on performance. A change of leadership at the top was Starbucks' first step toward stalling Howard Schultz's fear of commoditization of the brand.

### Starbucks Replaces its CEO

Worries about the state of the U.S. business, rising competition, and the falling stock price motivated the Board of Directors to replace their CEO Jim Donald in early 2008. Jim arrived in 2002 after a career as a grocery executive, but the overexpansion in the United States and the loss of innovation were enough to elicit his departure. Howard Schultz was asked to

**Exhibit 3: Balance Sheets, 2003–2007**

	2007	2006	2005	2004	2003
<b>ASSETS</b>					
Cash and Short-Term Investments	438.69	453.64	307.04	653.01	350.01
Net Receivables	287.93	224.27	190.76	140.23	114.45
Inventories	691.66	636.22	546.30	422.66	342.94
Prepaid Expenses	148.76	126.87	94.43	71.35	55.17
Other Current Assets, Total	129.45	88.78	70.81	63.65	47.40
<b>Total Current Assets</b>	<b>1,696.49</b>	<b>1,529.79</b>	<b>1,209.33</b>	<b>1,350.90</b>	<b>909.98</b>
Total Net Property/Plant/Equipment	2,890.43	2,287.90	1,842.02	1,551.42	1,447.74
Net Goodwill	215.63	161.48	92.47	68.95	63.34
Net Intangibles	42.04	37.96	35.41	26.80	24.94
Long-Term Investments	279.87	224.90	261.56	302.92	280.42
Other Long-Term Assets	219.42	186.92	72.89	85.56	52.11
<b>Total Assets</b>	<b>5,343.88</b>	<b>4,428.94</b>	<b>3,513.69</b>	<b>3,386.54</b>	<b>2,778.53</b>
<b>Liabilities and Shareholders' Equity</b>					
Accounts Payable	390.84	340.94	220.98	199.35	168.98
Accrued Expenses	664.29	567.99	474.93	361.84	276.15
Short-Term Debt/Notes Payable	710.25	700.00	277.00	0.00	0.00
Current Portion of LT Debt/Capital Leases	0.78	0.76	0.75	0.74	0.72
Other Current Liabilities	389.42	325.94	253.34	184.34	128.36
<b>Total Current Liabilities</b>	<b>2,155.57</b>	<b>1,935.62</b>	<b>1,227.00</b>	<b>746.26</b>	<b>574.21</b>
Total Long-Term Debt	550.12	1.96	2.87	3.62	4.35
Deferred Income Tax	0.00	0.00	0.00	21.77	12.54
Minority Interest	17.25	10.74	0.00	0.00	0.00
Other Liabilities	336.82	252.12	193.57	144.68	116.31
<b>Total Liabilities</b>	<b>3,059.76</b>	<b>2,200.44</b>	<b>1,423.43</b>	<b>916.33</b>	<b>707.42</b>
Common Stock	0.74	0.76	0.77	956.69	959.10
Additional Paid-In Capital	39.39	39.39	129.59	39.39	39.39
Retained Earnings (Accumulated Deficit)	2,189.37	2,151.08	1,938.99	1,444.89	1,058.34
Other Equity	54.62	37.27	20.91	29.24	14.27
<b>Total Equity</b>	<b>2,284.12</b>	<b>2,228.51</b>	<b>2,090.26</b>	<b>2,470.21</b>	<b>2,071.11</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>5,343.88</b>	<b>4,428.94</b>	<b>3,513.69</b>	<b>3,386.54</b>	<b>2,778.50</b>

Source: Adapted from 2008 Reuters.

**Exhibit 4: Cash Flows, 2003–2007**

	2007	2006	2005	2004	2003
<b>Net Change in Cash</b>	<b>-31.35</b>	<b>138.80</b>	<b>28.76</b>	<b>45.59</b>	<b>33.74</b>
Net Cash-Beginning Balance	312.61	173.81	145.05	99.46	65.73
Net Cash-Ending Balance	281.26	312.61	173.81	145.05	99.46
Net Income	672.64	564.26	494.37	388.88	265.36
Depreciation/Depletion	491.24	412.63	367.21	314.05	266.26
Deferred Taxes	-37.33	-84.32	-31.25	-3.77	-6.77
Noncash Items	45.38	17.13	120.92	99.58	58.02
Changes in Working Capital	159.29	221.94	-28.33	64.18	33.26
<b>Cash from Operating Activities</b>	<b>1,331.22</b>	<b>1,131.63</b>	<b>922.92</b>	<b>862.92</b>	<b>616.12</b>
Capital Expenditures	-1,080.35	-771.23	-643.30	-416.92	-377.98
Total Other Investing Cash Flow Items	-121.60	-69.81	422.68	-336.98	-238.44
<b>Cash from Financing Activities</b>	<b>-171.89</b>	<b>-155.33</b>	<b>-673.83</b>	<b>-66.55</b>	<b>30.76</b>
Foreign Exchange Effects	11.27	3.53	0.28	3.11	3.28
<b>Cash from Investing Activities</b>	<b>-1,201.95</b>	<b>-841.04</b>	<b>-220.62</b>	<b>-753.89</b>	<b>-616.42</b>
Financing Cash Flow Items	89.55	117.37	0.00	0.00	0.00
Net Issuance (Retirement) of Stock	-819.86	-694.80	-950.09	-65.82	31.47
Net Issuance (Retirement) of Debt	558.42	422.10	276.27	-0.72	-0.71

Source: Adapted from 2008 Reuters.

return to the position he held until 2000. In the role of chairman, he had focused on the company's global strategies and expansion, which now includes a significant and growing presence in 43 countries. As both chairman and CEO, he would now be responsible for the overall strategic direction of the company, with a predominant focus on everything that touches the customer. Schultz expressed his feeling on assuming the position as follows:

*I am enthusiastic about returning to the role of chief executive officer for the long term and excited to lead Starbucks and its dedicated partners (employees) to even greater heights of achievement on a global basis. We must address the challenges we face and we know what has to be done. Put simply, we are recommitting ourselves to what has made Starbucks and the Starbucks Experience so unique: ethically sourcing and roasting the highest quality coffee in the world; the relentless focus on the customer; the trust we have built with our people, and the entrepreneurial risk-taking, innovation and creativity that are the hallmarks of our success.*

In a letter sent in February 2008 to customers by the recently appointed new CEO, Howard Schultz reaffirmed his personal commitment to ensuring that guests will be provided with the distinctive Starbucks Experience. Schultz stated that there are no one-shot solutions or overnight fixes; rather, success lies in rigorous execution of the objectives he intends to outline for the company.

*The position we hold today in our customers' and partners' hearts and souls all around the world is not an entitlement. We must earn the trust of our customers every day—by how we conduct our business, how we treat each other as people and how we act as a responsible corporate citizen. We remain committed to providing health care for all full and part-time partners, executing our best-in-class Corporate Social Responsibility efforts, and encouraging our coffee suppliers to participate in our C.A.F.E. (Coffee and Farmers Equity) practices program in our origin countries.*<sup>63</sup>

### **Transformation Ahead**

First on Schultz's change agenda was realigning the leadership structure to allow the firm to move quickly in the development of new products and initiatives to enhance the Starbucks Experience. In February 2008, a new Starbucks leadership team (see Exhibit 5) was put in place that is directly responsible for executing the Company's transformation agenda. Schultz stated:

*As the leader of this talented senior executive team, I accept full responsibility for and am totally committed to the in-store customer experience. I will be directly engaged in ensuring a superior experience for our customers. Everything that touches the customer will be a priority. Change will not happen overnight. It will evolve over time, but I ensure you a positive change will occur. I, along with our dedicated partners (employees), will strive to exceed the expectations of our customers every day.*<sup>64</sup>

To introduce the Transformation Agenda, Schultz e-mailed all employees sharing the structural changes.<sup>65</sup> The transformation agenda will include:

- Improving the current state of the U.S. business by refocusing on the customer experience in the stores, new products and store design elements, and new training and tools for the Company's store partners to help them give customers a superior experience
- Slowing the Company's pace of U.S. store openings and closing a number of underperforming U.S. store locations, enabling Starbucks to renew its focus on its store-level unit economics
- Reigniting the emotional attachment with customers and restoring the connections customers have with Starbucks® coffee, brand, people, and stores
- Realigning Starbucks organization and streamlining the management to better support customer-focused initiatives and reallocating resources to key value drivers
- Accelerating expansion and increasing the profitability of Starbucks outside the United States, including by redeploying a portion of the capital originally earmarked for U.S. store growth to the international business

The 2008 global net new-store opening target was reduced to approximately 2,150 stores, down from the 2,500 stores announced at the end of fiscal 2007 by Jim Donald. This change



## **Exhibit 5: The New Senior Leadership**

**Howard Schultz**

founder, chairman, president, and chief executive officer

**Martin Coles**

chief operating officer

**James C. Alling**

president, Starbucks Coffee International

**Launi Skinner**

president, Starbucks Coffee U.S.

**Peter J. Bocian**

executive vice president, chief financial officer, and chief administrative officer

**Paula E. Boggs**

executive vice president, general counsel and secretary, Law and Corporate Affairs

**Dorothy J. Kim**

executive vice president, Supply Chain Operations

**Chet Kuchinad**

executive vice president, Partner Resources

**Harry Roberts**

senior vice president, chief creative officer

**Troy Alstead**

senior vice president, Finance and Global Business Operations

**Cliff Burrows**

senior vice president and president, Europe/Middle East/Africa

**Wendy Collie**

senior vice president, Licensed Stores and Seattle's Best Coffee

**Terry Davenport**

senior vice president, Marketing

**John Culver**

senior vice president and president, Asia-Pacific

**Michelle Gass**

senior vice president, Global Strategy, Office of the CEO

**Peter D. Gibbons**

senior vice president, Global Manufacturing Operations

**Juan Guerrero**

senior vice president, Global Logistics and International Supply Chain Operations

**Willard (Dub) Hay**

senior vice president, Coffee and Global Procurement

**Buck Hendrix**

senior vice president and president, Latin America

**Lucy Helm**

senior vice president, Global Business

**Exhibit 5: (Continued)**

**Charles Jemley**

senior vice president, Finance, Starbucks Coffee International

**Gregg S. Johnson**

senior vice president, Global Business Systems Solutions

**David Landau**

senior vice president, deputy general counsel and chief compliance officer

**Cosimo LaPorta**

senior vice president, Western Division

**Barbara LeMarrec**

senior vice president, Operations, Starbucks Coffee International

**Katharine Lindemann**

senior vice president and general manager, Foodservice

**Mark Lindstrom**

senior vice president, Western Division

**Kenneth T. Lombard**

senior vice president and president, Starbucks Entertainment

**Gerardo I. Lopez**

senior vice president and president, Global Consumer Products

**Michael Malanga**

senior vice president, Store Development

**Jim McDermet**

senior vice president, Store Services

**Colin Moore**

senior vice president and president, Starbucks Coffee Canada

**Dave Olsen**

senior vice president, Culture and Leadership Development

**Denny Marie Post**

senior vice president, Global Food and Beverage

**Robert Ravener**

senior vice president, Partner Resources, U.S. Business

**Sheri Southern**

senior vice president, Partner Resources, Starbucks Coffee International

**Michael Stafford**

senior vice president, Organization and Partner Development

**Paul Twohig**

senior vice president, Eastern Division

**Jinlong Wang**

senior vice president and president, Greater China

**Mark Wesley**

senior vice president, Real Estate/Store Development, Starbucks Coffee International

includes the closure of around 100 underperforming stores domestically and the opening of approximately 75 additional net new stores in international markets. Net new-store openings are expected to be approximately 650 company-operated locations and 525 licensed in the United States and approximately 975 stores in international markets.<sup>66</sup> Already, plans for 2009 include opening 1,000 stores internationally and less than 1,000 locations in the United States. If achieved, that goal would mark the first time the company opened more overseas outlets than U.S. operations.

What remains to be seen is if Mr. Schultz can recapture the Starbucks experience and return the company to its former status as a Wall Street darling. The transformation began with the reorganization of the management team in January 2008, followed weeks later by lay-offs and staff cuts of 600 workers.<sup>67</sup> The staffing cuts were almost all in support positions. The closing of underperforming stores and the slowing of growth in the United States are also strategies Schultz is hoping will improve the future of the company. Schultz contends:

*Taken together, these initiatives will help transform Starbucks and drive the Company's enduring success. We know that we can improve our performance by getting back to the essence of what drove Starbucks past success—our passion for the business and a complete focus on the customer and our relationship with our people. In doing so, we will rely on the continued efforts and dedication of our partners all around the world, who have and will continue to contribute so much to the Starbucks success story.*

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