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CASE 19
Trouble Brews at Starbucks[1]

Starbucks was the darling of Wall Street, with a strong balance sheet and double-digit growth since going public in 1992. By 2007, it had more than 15,000 stores around the world[2] and projected that the number would eventually grow to 40,000 stores, half of them outside the United States.[3] But suddenly, performance slipped so seriously that the board ousted CEO Jim Donald and brought back Howard Schultz — Starbucks' visionary leader and CEO from 1987 to 2000 and current chairman and chief global strategist — to re-take the helm.

Despite the furor, the company was hardly in dire financial straits. In 2007, it had revenues of \$9.4 billion, double-digit earnings growth and 2500 new store openings.[4] But its share price had fallen almost 50 per cent as Wall Street became increasingly worried that the chain had run out of room for further U.S. expansion. In November, the company reported its first-ever decline in customers' visits to U.S. stores.[5] Insiders and analysts alike questioned whether the brand had been irreparably damaged by a single-minded focus on

[1]This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Starbucks or any of its employees.

[2]Janet Adamy, "Schultz Takes Over To Try to Perk Up Starbucks," *Wall Street Journal*, January 8, 2008, B1.

[3]Janet Adamy, "Starbucks Sets Ambitious Goal of 40,000 Stores," *Wall Street Journal*, October 6, 2006, B3.

[4]Jonathan Birchall and Jenny Wiggins, "The Starbucks Romantic," *Financial Times*, January 12, 2008, p. 7.

[5]Ibid.

growth and short-term profitability at the expense of the brand. It was a fear that Howard Schultz himself had written about as the "commoditization of the Starbucks experience."[6]

The Beginning[7]

The Starbucks Coffee, Tea, and Spice Company was founded in Seattle in 1971 by Jerry Baldwin, Gordon Bowker and Zev Siegl, three guys with a passion for dark-roasted, European-style coffee. Coffee, they felt, was so much more than the bland beverage offered by Folgers and Maxwell House; coffee had rich, sensuous flavors if roasted and brewed correctly. Their vision was to educate consumers about fine coffees the way a sommelier educates diners about fine wines. To this end, Starbucks sold only dark-roast, whole-bean coffee from places like Sumatra, Kenya, Ethiopia and Costa Rica — no ground or prepared coffee. And it sold only manual coffee pots and equipment needed to grind and brew coffee correctly at home — no electric coffeemakers that would mask the coffee's flavor.

The Seattleites successfully developed a devoted, local customer base, but it took Howard Schultz, who joined the company in 1982, to see the potential for bigger things. Schultz had grown up in the Bayview Projects, federally subsidized housing in Canarsie, Brooklyn. His father had quit school to help support the family, served in World War II and worked a series of blue-collar jobs. As Schultz recalls, his father "never found himself, never had a plan for his life."[8] One of his most vivid childhood memories was when his father, then a delivery truck driver, broke his foot and couldn't work. Without health insurance or worker's compensation, the family had nothing to fall back on. This childhood event made an indelible imprint on Schultz, and he became determined to make something of his life. He went to Northern Michigan University on a football scholarship. He majored in communications, taking courses in public speaking, interpersonal communications and business. After a short stint in sales at Xerox, he joined Hammarplast, a Swedish manufacturer of stylish kitchen equipment and housewares. By the age of 28, he was promoted to vice-president and general manager.

While at Hammarplast, Schultz noticed that a Seattle retailer with only four stores was buying more of a particular drip coffeemaker than the department store Macy's. Curious, he went to Seattle, visited the store — Starbucks — and was instantly hooked on the "romance" of fine coffee. The owners appreciated his conversion to the real thing, but they initially rejected his offer to join their crusade, perhaps worrying that his hard-hitting New York style was unsuited to laid-back West Coast culture and that his ideas for expansion were incompatible with their mission of enlightenment. It took Schultz more than a year to convince them, but he finally won the position of Starbucks marketing director.

Schultz's Vision for Starbucks

Soon after joining Starbucks, Schultz visited Milan for a trade show. There, he saw coffee bars packed with customers on every block. Baristas and customers were laughing and talking, enjoying the moment and the espresso together. As Schultz later described it, "It was on that day that I discovered the ritual and romance of coffee bars in Italy. I saw how popular they were, and how vibrant. Each one had its own unique character, but there was one common thread: the camaraderie between the customers, who knew

[6] Howard Schultz, "The Commoditization of the Starbucks Experience," Internal E-mail, February 14, 2007, http://starbucksgossip.typepad.com/_/2007/02/starbucks_chair_2.html, accessed December 30, 2008.

[7] Howard Schultz and Dori Jones Yang, *Pour Your Heart Into It*, 1997.

[8] Ibid., p. 13.

each other well, and the barista, who was performing with flair.… 'This is so powerful!' I thought. 'This is the link.' The connection to the people who love coffee did not have to take place only in their homes, where they ground and brewed whole-bean coffee. What we had to do was unlock the romance and mystery of coffee, firsthand, in coffee bars. The Italians understood the personal relationship that people could have to coffee, its social aspect. I couldn't believe that Starbucks was in the coffee business, yet was overlooking so central an element of it."[9]

But his bosses weren't interested. Cash was tight. Besides, Starbucks was a retailer, not a restaurant or a bar; serving espresso drinks would put it in the beverage business. When Schultz pressured Baldwin to expand the Starbucks vision, Baldwin would argue, "Howard, listen to me. It's just not the right thing to do. If we focus too much on serving coffee, we'll become just another restaurant or cafeteria. It may seem reasonable, each step of the way, but in the end, we'll lose our coffee roots."[10]

Creating His Own Story

Not willing to abandon his dream, Schultz departed Starbucks and opened *Il Giornale*, Italian for *daily*. His plan was to re-create the Italian espresso bar experience. To his surprise, Starbucks was his first investor, supplying $150,000. "It isn't a business we want to go into ourselves," Baldwin explained, "but we'll support you."[11] It was a start, but Schultz needed $1.7 million: $400,000 for the initial store, to demonstrate the practical operation and consumer appeal of an Italian espresso bar, and $1.3 million for eight additional espresso bars, to show that the idea would work on a larger scale. In the first year, Schultz spoke to 242 potential investors; 217 said "no."[12] Their arguments became all too familiar: "Coffee is a commodity." "Coffee consumption in the U.S. has been trending down since the mid-1960s." "Coffee shops are everywhere." "Americans will never pay $1.50 for a cup of coffee." Still, he persisted.

By 1987, Schultz had acquired the seed capital and opened three espresso bars. Then, in an unexpected twist of fate, Starbucks' owners decided to sell — six stores, the roasting plant and the name. Schultz had to go for it. He raised four million dollars, acquired Starbucks, adopted its name and began to expand. Fifteen new stores were opened in fiscal year 1988; 20 in 1989; 30 in 1990; 31 in 1991; and 53 in 1992; all company-owned.[13] Schultz explained, "We're so fanatical about quality control that we keep coffee in our hands every step of the way from raw green beans to the steaming cup. We buy and roast all our own coffee, and we sell it in company-owned stores.… Why? The answer can be found in the last cup of lousy coffee you drank. Unlike shoes, or books, or soft drinks, coffee can be ruined at any point from its production to consumption…. Coffee is a product so perishable that building a business on it is fraught with peril. The minute we hand our coffee over to someone else, we're extremely vulnerable to its quality being compromised."[14]

But Starbucks wasn't just about the coffee. It was also about recreating the Italian coffee bar culture. Schultz wanted Starbucks to become the "Third Place," the place between home and work where people gather, relax and interact with one another. To encourage customers to linger over a cup of coffee, Starbucks paid a great deal of attention to the details of the store — everything from the layout, to the furniture, to the music. Even more important

[9] Ibid., pp. 51-52.

[10] Ibid., p. 61.

[11] Ibid., p. 66.

[12] Ibid., p. 73.

[13] Ibid., p. 114.

[14] Ibid., pp. 171-172.

were the baristas, whose ability to engage the customer was the heart of the Starbucks experience. Understanding the difficulty of managing human capital, especially when two thirds of workers were part-time, Schultz felt he had to make employees "partners" in his vision. He had to infuse them with the Starbucks culture, reward them with a sense of personal security and give them a reason to be involved in the success of the business.

To instill the requisite coffee knowledge in recruits, Starbucks developed a 24-hour training program covering Coffee Knowledge (four hours), Brewing the Perfect Cup (four hours), Customer Service (four hours) and basic retail skills. To provide personal security, Schultz fought with his board to offer health insurance to all partners, even the part-timers. "Treat people like family, and they will be loyal and give their all. Stand by people, and they will stand by you," he argued. The math made sense; at the time, it cost $1,500 a year to provide an employee with full benefits, compared with $3,000 to train a new hire.[15]

And to increase involvement in the success of the business, he offered Bean Stocks — a pseudo stock option plan for partners with at least six months at the store.[16] As "stock holders," store partners had an incentive to participate in decision-making, to suggest cost-cutting measures to increase profitability and to help maintain the integrity of the brand. If they felt that management was straying from the Starbucks vision, they had the right and responsibility to call them on it. The result of these initiatives was a more satisfied partner base. For baristas, turnover averaged 60 to 65 per cent, compared to 150 to 400 per cent in the average retail or fast-food chain. For store managers, turnover was around 25 per cent compared to 50 per cent for other retailers.[17]

Starbucks Goes Public

With just over 100 stores in four states and Vancouver, British Columbia, Starbucks went public in 1992. Initially priced at $17 a share, the stock jumped to $21 at the opening bell. By the end of the day, the initial public offering (IPO) had raised $29 million for the company — $5 million more than expected — and Starbucks' market capitalization stood at $273 million.[18] Being a public company took Starbucks into the big leagues; it made millions for the believers who invested in the company, provided critical funds for future expansion and helped attract talented new people.

But Wall Street can be a fickle master. As Schultz described it, "Alongside the exhilaration of being a public company is the humbling realization, every quarter, every month, and every day, that you're a servant to the stock market.… Running a public company is an emotional roller coaster. In the beginning, you accept the congratulations as if you really deserve them. Then, when the stock price falls, you feel you have failed. When it bounces back, it leaves you dizzy. At some point, you have to divorce yourself from the stock price and just focus on running the business."[19]

Expanding the Business Model

To satisfy Wall Street and stave off competitive threats, Starbucks made growth its mantra. Starbucks was in a race to establish national dominance before other emerging specialty coffee bars and yet trying to fly under the radar of the "big boys" — such as Procter & Gamble, who had purchased Millstone Coffee, the largest whole-bean supplier

[15]Ibid., p. 127.

[16]Ibid., p. 134.

[17]Ibid., p. 128.

[18]Ibid., p. 185.

[19]Ibid., pp. 188-189.

to grocers. To grow and claim leadership in the category, Starbucks focused on a strategy of new products, a stronger connection with customers as the Third Place and expanding store locations in the United States and abroad.

Developing New Products

One of the first additions to the management team after the company went public was Howard Behar, who had 25 years of retail experience in the furniture business and in resort development. While many people inside Starbucks have had a lasting impact on its success, it was Behar who actually changed the way the company thought. Time and again, he argued that it wasn't just about the coffee or about the brand, it was about the customer. Behar's crusade was not always met with open minds, as Schultz recalled in his book, *Pour Your Heart into It*:

> *Howard had been at Starbucks less than a month when he came to me one day and asked, "Have you been reading the customer comment cards?"*
>
> *"Sure," I said, "I read them. I read them all."*
>
> *"Well," he replied, "how come you're not responding?"*
>
> *"Responding to what?"*
>
> *"Look at all the people who want nonfat milk."*
>
> *"Well," I explained, "I did a formal tasting a number of times this year of lattes and cappuccinos made with nonfat milk and they just didn't taste good."*
>
> *"To whom?" Howard was clearly growing impatient with my answers.*
>
> *"To me…"*
>
> *"Well, read the customer comment cards. Our customers want nonfat milk! We should give it to them."*
>
> *I answered — and Howard never lets me forget it — "We will* never *offer nonfat milk. It's not who we are."*[20]

The nonfat milk question led to one of the biggest debates in Starbucks' history. Coffee purists were scandalized. Store managers were frustrated — how could they handle more than one type of milk without slowing store operations? Still Behar persisted, eventually getting Schultz to authorize an in-store test. The stores didn't fall apart, customers got what they wanted and Starbucks stopped losing sales to more accommodating competitors. Nonfat milk was in.

The Frappuccino story is similar. Starbucks management refused to consider a cold blended beverage on principle — it wasn't a true coffee drink. This time, it was a couple of store managers in southern California who took the initiative after seeing their afternoon and evening customers defect to competitors who offered cooler, more refreshing coffee beverages. They began experimenting with different recipes and ingredients; they varied the blending time; they changed the ratio of ice to liquid. They tested their concoction with customers, and again, customers approved. Corporate came around. Within a year of rolling out Frappuccinos nationally, store sales of Frappuccinos were $52 million, seven per cent of total annual revenues.[21]

The success of the Frappuccino inspired more new products, many developed at local stores, then refined and disseminated nationally by corporate. Seasonal offerings, such as a strawberry and cream Frappuccino in the summer and gingerbread latte at Christmas,

[20]Ibid., pp.166-167.

[21]Ibid., pp. 208-209.

were introduced. Food items such as cookies and pastries began to make their way into the store. “Food is a big part of where we are going…” said Orin Smith, a member of Starbucks’ senior management team. “It is not going to be a lot of any one thing. It will be food that makes sense and complements the customers and their choice of beverages.”[22] Starbucks would later introduce cold sandwiches and salads for lunch as well as hot breakfast sandwiches.

As the company became more comfortable in expanding beyond its traditional roots, it developed products with other companies — a bottled Frappuccino with Pepsi, a coffee-flavored ice cream with Dreyer’s and a coffee liqueur with Jim Beam. The extensive distribution networks of these companies afforded Starbucks access to supermarkets and restaurants with their broader customer base. But even in negotiations with much larger and more experienced partners, Starbucks took care to protect its brand. The partnership with Pepsi — a company 100 times the size of Starbucks at the time — was a fifty-fifty arrangement, in which Pepsi ceded Starbucks a high degree of control over its brand equity and product formulas.[23]

Location, Location, Location

At the same time, Starbucks was adding new stores at a rapid clip. Its sophisticated model for store expansion was based on a matrix of regional demographic profiles and an analysis of how best to leverage operational infrastructure. For each region, a large city was targeted to serve as a “hub,” where teams of professionals could be located to serve as support for new stores. Markets were entered with the goal of expanding out to 20 or more stores in the first two years. From the core, it branched out to nearby “spoke” markets, including smaller cities and suburban locations with demographics similar to the typical customer mix.

Starbucks didn’t advertise when entering a new market; it didn’t have the funds. Instead the store devised a grassroots campaign, beginning with the selection of a highly visible location — such as DuPont Circle in Washington, D.C., or Astor Place in New York — for the flagship store. Artwork was designed to celebrate each city’s personality, and it was used on commuter mugs and T-shirts. In each market, Starbucks planned at least one big community event to celebrate its arrival, with the proceeds going to a local charity. Local “ambassadors” were recruited from new partners and from customers whose names were part of Starbucks’ database of catalog customers. They were given tickets to the grand-opening event and two free-drink coupons with a note asking them to “Share Starbucks with a Friend.”[24]

As Starbucks expanded its business, the company sometimes perplexed onlookers with its store placement strategy, for stores were oftentimes opened across the street from one another. But Starbucks had learned that nearby stores didn’t necessarily hurt one another’s sales and in fact could actually help. Early on, it had opened a large store 30 yards from a tiny but top-performing store tucked in a building that was to be closed for remodeling. To the company’s amazement, the two stores not only coexisted; they thrived. Dense store placement became the model for store location throughout the country — with similar, profitable results.[25] (Coca-Cola and PepsiCo Inc. have experienced similar results in placing a new vending machine next to an existing one; initially, sales of the first one drop but rebound quickly as more customers drink more soft drinks.)

[22]Sarah E. Lockyer, “Full Steam Ahead,” *Nation’s Restaurant News*, May 3, 2004, p. 4.

[23]Howard Schultz and Dori Jones Yang, *Pour Your Heart Into It*, 1997, p. 222.

[24]Ibid., p. 255.

[25]Dina ElBoghdady, “Pouring It On,” *The Washington Post*, August 25, 2002, H1.

When Starbucks entered new markets, these store clusters acted as billboards, creating awareness. And as demand grew, clustered stores helped to manage store traffic, particularly in the crucial hours before 10 a.m. when as much as 60 per cent of a store's sales occur.[26] During this period, it's not uncommon for customers who perceive the wait time to be too long — due to long lines, parking difficulties or any other problem — to leave without their coffee. More stores meant a better chance for customers to find a short line or empty parking space and for Starbucks to capture the sale.

The ubiquity of the stores also helped drive sales throughout the day. "Where a lot of our growth is, is driving that incremental cup that someone may not have planned to buy," said Doug Satzman, a director of new store development in California. Standing on the corner of Mission and Fourth Streets in San Francisco — where there is a Starbucks on three of the four street corners — Satzman explained: "If you're over here [referring to the Metreon, an entertainment mall on his right] you are not likely to cross the street. If you're in the hotel, you might be going to the right to Market Street" to the shopping area.[27] The people in the complex on the third corner might not bother to go outside at all. But with a store on each corner, it was easy to grab a cup of Starbucks from any direction.

Once the company realized that convenience drove sales, it was only a matter of time until the company added drive-through service. Initially targeted to parents with young children, the drive-through windows quickly became a hit with a broader market, resulting in average annual sales of around $1.3 million — compared to $1 million at stores without a window.[28] The downside of the drive-through locations was the cost of real estate and additional partners needed to operate the window. In addition, the bottlenecks in the drive-through could be far worse than those in the store, even though the average time to serve customers was about the same. "In the store, it's an issue of queuing — someone can have a complex order and step aside while it's being made," said John Glass, an industry analyst with CIBC World Markets.[29] But a drive-through customer could not step aside, and all the cars behind that customer could do was wait. To address these problems, baristas' headphones were set to "ding" when a car pulled into the drive-through chute and a digital timer measured service times. The stores also added order confirmation screens to improve order accuracy and additional pastry racks to reduce time to serve.

To add new locations in areas otherwise inaccessible to the chain, Starbucks ventured into licensing. Airports were a natural venue for Starbucks, but all U.S. airport retail locations were run by concessionaires — in the case of food and beverages, Host Marriott. Licensing went against the chain's belief that it needed to control the customer's experience, but the additional exposure seemed worth the risk. Initially, the Host Marriott venues did not fully meet Schultz's expectations, but the partners cooperated to make the relationship work. Licensing, Schultz found, was like a marriage: "Whether it works is a matter of whom you choose as a partner, the amount of due diligence you do beforehand, and how things go during the courtship. If you jump in with little preparation, you risk setting yourself up for failure."[30]

Following the success of its relationship with Host Marriott, Starbucks initiated partnerships with retailers such as Safeway and Barnes & Noble. These licensing agreements created greater customer convenience in established markets, but they also gave

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[26]Barbara Kiviat, "The Big Gulp at Starbucks," *Time*, December 18, 2006, p. 124.

[27]"Why Did Starbucks Cross the Road?" *Wall Street Journal*, April 3, 2007, B1.

[28]Steven Gray, "Fill 'er Up — with Latte," *Wall Street Journal*, January 6, 2006, A9.

[29]Ibid.

[30]Howard Schultz and Dori Jones Yang, *Pour Your Heart Into It*, 1997, p. 174.

Starbucks a way of entering new markets when it could not afford to build company-owned stores. Licensees agreed to build in-store coffee bars at their own expense and to provide the employees who operated the counter. Starbucks trained the baristas and the drinks were prepared with Starbucks ingredients and recipes. In selecting licensees, Starbucks carefully considered whether the image and goals of the licensee would be consistent with those of Starbucks. Target made the cut; Wal-Mart didn't.

Connecting with Customers

To create the sense of community that is central to the Third Place, Starbucks added music, books and movies to its product mix. "The overall strategy is to build Starbucks into a destination," explained Kenneth Lombard, then president of Starbucks Entertainment.[31] "We know there are going to be endless opportunities as this strategy continues to grow, and we're going to look at each and every opportunity."[32] Added Schultz, "Starbucks isn't an entertainment company. But we want to have an entertainment strategy that supports the foundation of the coffee experience that our customers have come to expect and enjoy."[33]

Hear the Music Music had always been a part of the Starbucks environment, with stores playing primarily jazz and classical instrumentals and eventually adding jazz vocals to the mix. Time and again, customers asked Starbucks where they could buy what they heard there. So when Schultz stumbled upon a music store called *Hear Music* in the Stanford Shopping Center in California, he was intrigued. At Hear Music, customers could come in, listen to any one of more than 150,000 titles and create a custom mixed CD complete with personalized title, liner notes and artwork on the disc and jacket in just five minutes. Even more impressive were the people, who were as knowledgeable and passionate about music as Schultz was about coffee. It was clear that their vision for Hear Music was similar to his vision for Starbucks. "When I think about the average music-shopping experience, what I would call the sense of romance about music is gone," Schultz recalled. "But when I saw Hear Music that first time, it was clear that they had cracked the code on the sense of discovery that music should have."[34] He was so impressed he bought the company.

Soon after, Starbucks began offering compilations from Hear Music in its stores, launching a popular series of CDs called "Artist's Choice." The series included musicians as diverse as Yo-Yo Ma, Tony Bennett, Lucinda Williams and the Rolling Stones, all sharing their favorite songs. But the breakout success for Starbucks came when Hear Music co-produced and distributed Ray Charles' posthumously released album *Genius Loves Company*, a collection of duets between Charles and performers such as Norah Jones, James Taylor and B.B. King. The CD — boosted by the biographical film *Ray* and the artist's death — sold nearly three million copies, a quarter of those through Starbucks; no new Ray Charles release had come close to that level in years.[35] To make the success of the store's investment even sweeter, the CD won eight Grammy awards.

Starbucks' success with CDs — at a time when veteran music retailers like Tower Records were filing for bankruptcy — did not escape the attention of the recording industry. With guaranteed in-store play and a built-in distribution network of thousands of

[31]Eunjung Ariana Cha, "DVDs and Fries," *The Washington Post*, August 28, 2005, A1.

[32]Steven Gray and Kate Kelly, "Starbucks Plans to Make Debut in Movie Business," *Wall Street Journal*, January 12, 2006, A1.

[33]Ibid.

[34]Alison Overholt, "Listening to Starbucks," *Fast Company*, July 2004, p. 50.

[35]Steven Gray and Ethan Smith, "New Grind: At Starbucks, a Blend of Coffee and Music Creates a Potent Mix," *Wall Street Journal*, July 19, 2005, A1.

outlets, recording companies began to compete fiercely to supply one of the handful of CDs sold at any given time in Starbucks stores. Heritage artists such as Carole King, James Taylor, Paul McCartney and Joni Mitchell signed exclusive deals for the initial distribution of new recordings. And Starbucks helped introduce little known groups such as the rock band Antigone Rising and international artists such as Italian pop singer Zucchero. Concord Records President Glen Barros said he turned to Starbucks for the final say on whether to sign a new singer: "If they'll be our partner, we'll do it." Added another record-label executive, Starbucks is the "new cute girl that everyone wants to take to the dance."[36]

From offering CDs, Starbucks began to experiment with in-store personalized CDs. It introduced kiosks called Media Bars that let customers listen to music and create their own digital compilations while sitting in comfortable lounge chairs waiting for their latte. The bill — 99 cents a song — was paid with a Starbucks card or credit card.[37] "Our customers respond to music," said Anne Saunders, then senior vice-president of marketing. "Part of why they come is as an entertainment destination, for a respite, a break with friends, as a place for community gathering. The idea for the music service is very grounded in why people come to Starbucks."[38]

The Readers' Corner In an early misstep, Starbucks offered a literary magazine called *Joe* — it lasted only six months before Schultz decided, based on slow sales, that the product "didn't add any value."[39] But with its success in the music arena, Starbucks began to think about how it might extend its entertainment platform. The store chose Mitch Albom's *For One More Day* as its first book. To kick off sales and spark a communitywide dialogue, 25 Starbucks stores around the country offered discussion groups of the book, complete with free coffee. Publishers looked on with interest. "One of the big problems in the book industry is that outside of Oprah, there's no really widely accepted authority to recommend books," said Laurence Kirshbaum, founder of LJK Literary Management agency. Starbucks was beginning to see itself as that authority. "Customers say one of the reasons they come [to Starbucks] is because they can discover new things — a new coffee from Rwanda, a new food item. So extending that sense of discovery into entertainment is very natural for us. That's all part of the Starbucks experience," said Saunders.[40]

And On to the Red Carpet In 2006, Starbucks took the leap from music into movies through a promotional deal with Lions Gate Entertainment for *Akeelah and the Bee*. The movie was about an 11-year-old African-American girl from south Los Angeles who discovered a passion for words and, with the help of her teacher, reached the National Spelling Bee. Because of its largely African-American cast and urban setting, Lions Gate feared that the movie would only appeal to a narrow audience. A connection with Starbucks would guarantee broader exposure as well as provide an endorsement for the movie. As Jon Feltheimer, CEO of Lions Gate, saw it, "[Starbucks] is a company with a pristine brand putting their brand on the line and saying, 'You should go to this movie.'"[41]

Starbucks promoted the film aggressively, putting movie-related trivia games on its chalk boards and coffee-cup sleeves, as well as distributing the soundtrack. It held advance

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[36]Ibid.

[37]Stanley Homes, "First the Music, Then the Coffee," November 22, 2004, p. 66.

[38]Alison Overholt, "Listening to Starbucks," *Fast Company*, July 2004, p. 50.

[39]Susan Dominus, "The Starbucks Aesthetic," *New York Times*, October 22, 2006, p. 1.

[40]Ibid.

[41]Steven Gray and Kate Kelly, "Starbucks Plans to Make Debut in Movie Business," *Wall Street Journal*, January 12, 2006, A1.

screenings for its baristas and holders of Starbucks cards. "The baristas want to tell their customers about the things they get excited about, and we're convinced this movie is going to be one of those things," said Anne Saunders, who had been promoted to Starbucks' senior vice-president for global brand strategy and communications. For its part, the deal included an undisclosed share of the movie's box-office proceeds. It also gave Starbucks an opportunity to broaden the use of its in-store Wi-Fi network by running trailers for the movie. "We've known for quite some time that the Wi-Fi opportunity in our stores [is] the perfect place for shorts, documentaries and other things that wouldn't be seen on the big screen," Schultz said.[42] The box office receipts, however, were disappointing.

Starbucks tried again the next year with a nature documentary, *Arctic Tale,* from Paramount Classics and National Geographic Films. The film was about a walrus pup and a polar bear who grew up and found their frozen environment melting beneath them. This time, in-store promotions were supplemented with Starbucks-hosted discussions on climate change.[43] "We introduced *Arctic Tale* to our customers because we want to spark a dialogue about environmental issues," Lombard said. "The coffeehouse is a great place to inspire such discussion. There is no more important issue facing our planet today than climate change." Starbucks' promotion was an "avenue to get people of all ages to talk … and hopefully be inspired to be a part of the solution."[44] Box office sales for "Arctic Tale" were again disappointing and failed to leverage Starbucks' "voice as a cultural arbiter."[45] But both Paramount and National Geographic Films executives said they were pleased with the Starbucks effort. "They were great partners and awesome to work with," said a National Geographic executive. "They did everything they said they would do. I'd work with them again in a heartbeat."[46]

Global Expansion

Starbucks began its expansion outside North America in 1995 with a partnership with SAZABY Inc. to open Starbucks coffeehouses in Japan. Skeptics initially doubted whether the Starbucks formula would play in countries that did not have a coffee culture. But since that time, Starbucks has invaded nearly every corner of the world — either through its "living-room-in-a-coffee-house" format or through its "corners" concept or through mini-outlets placed in airline offices, sports stadiums, airports, hotels and bookshops. By 2008, Starbucks had 4500 locations in 43 countries outside the United States.[47] Its overseas menus were anchored by the same lattes, cappuccinos and drip coffees as in the United States, with some modification for local tastes. In Athens, for example, local patrons find a thick layer of fine residue at the bottom of their coffee, and in the United Kingdom, customers can have a cheese and marmite sandwich. (Marmite is a black yeast spread favored only by the British and a few of its former colonies.) For the most part, the formula has worked. Even in the United Kingdom, where high tea is sacrosanct and a "nice cuppa tea" is the remedy for almost anything, Starbucks was thriving. In London, there were more Starbucks locations than in New York City.[48]

[42]Ibid.

[43]Janet Adamy, "Starbucks Sticks with Film-Promotion Plan," *Wall Street Journal*, June 28, 2007, B2.

[44]Marc Graser, "Rough Start for Starbucks," Variety.com, August 23, 2007, www.variety.com/article/VR1117970763.html?categoryid=13.

[45]Janet Adamy, "Starbucks Sticks with Film-Promotion Plan," *Wall Street Journal*, June 28, 2007, B2.

[46]Marc Graser, "Rough Start for Starbucks," Variety.com, August 23, 2007, www.variety.com/article/VR1117970763.html?categoryid=13.

[47]Janet Adamy, "Starbucks Brews Growth Abroad," *Wall Street Journal*, June 12, 2008, B2.

[48]Ibid.

Overall, the expense of building stores and other infrastructure in overseas locations meant that Starbucks global operations were not yet a major contributor to the company's bottom line. In addition, there have been challenges; the most public of these was Starbucks' withdrawal from the historical grounds of the Forbidden City in China after a ground swell of negative public opinion developed. Starbucks also delayed its entry into India and Russia, a move that some have said put Starbucks at a disadvantage. Such delays gave local competitors time to prepare for the onslaught and move into prime locations. And real estate prices continued to rise while the company waited.[49]

But Starbucks executives stressed that the chain was welcomed in the overwhelming majority of places it opened. "What we've found everywhere we've opened is we become a landmark overnight," said Martin Coles, president of Starbucks Coffee International. And, he continued, "We do not spend a great deal of time focusing on our competition."[50] In fact, Starbucks insisted that competition brought out the best in the company and helped grow the overall coffee market.

A Perfect Storm

By 2007, Starbucks had become one of the most widely recognized and admired global brands. Consistent with Schultz's memory of espresso bars on every corner in Milan and with his belief that a public company must grow robustly to please Wall Street, Starbucks seemed to be everywhere. But growth had had unintended consequences. And Starbucks was about to be challenged by a shifting competitive environment and a difficult economy.

Incremental Decisions and Unintended Consequences

From the very beginning, Starbucks had added stores at a rapid pace, so it surprised many analysts when the company announced in 2004 that it intended to double its pace of expansion. To meet this promise to Wall Street, "there was a little bit of a frenzy to get locations open," recalled Matt Dougherty, a real estate broker with Nevada Commercial. A Florida broker who worked with Starbucks agreed, "We pumped it up, we accelerated, but when you do that you sacrifice real estate. There was a disconnect somewhere in Seattle between those decisions and what the reality was on the ground. The opportunity was not always there."[51] Other analysts suggested that the company — swayed by the perks offered by landlords eager to bring Starbucks' cachet to their neighborhoods — simply ignored its own winning store location formula.[52]

The net results of expansion were a larger customer base and a changed profile for the "average" Starbucks customer. In 2000, about three per cent of Starbucks customers were between the ages of 18 and 24; 16 per cent were people of color; 78 per cent had college degrees, and the average annual income was $81,000. By 2005, 13 per cent of customers were between 18 and 24; 37 per cent were people of color; 56 per cent were college graduates, and the average income was $55,000.[53]

In addition, the increased accessibility of Starbucks — through store openings as well as licensees — had also changed consumers' perceptions of Starbucks. The store wasn't

[49]Janet Adamy, "From Seattle, with Lattes," *Wall Street Journal*, August 31, 2007, B1.

[50]Ibid.

[51]Brad Stone, "The Empire of Excess," *New York Times*, July 4, 2008.

[52]Andrew Bordeaux, "Is It Possible to Grow Too Fast?" July 9, 2008, *Growthink Blog*, www.growthink.com/content/it-possible-grow-too-fast.

[53]Steven Gray and Ethan Smith, "New Grind: At Starbucks, a Blend of Coffee and Music Creates a Potent Mix," *Wall Street Journal*, July 19, 2005, A1.

so much a destination or the Third Place as it was an "affordable luxury" — a little treat to get the morning started or a pick-me-up in the afternoon. Customer behavior reflected this as well, with 80 per cent of orders being consumed outside the store.[54]

At the same time, the increasing number of drive-through windows and in-store food items took Starbucks a step closer to fast food, which led to an internal rift between headquarters and store personnel. Store managers without drive-through windows felt their sales were being cannibalized by locations offering greater access, while managers of drive-through locations had more difficulty in generating impulse purchases for whole-bean coffee, CDs and other merchandise. Baristas resented having to cross-sell food items, a fast-food tactic. And even customers complained that cooking odors from hot breakfast sandwiches changed the "Starbucks experience." As noted by Jim Romenesko on Starbucks Gossip, an online Internet site not affiliated with the company, "If I go in there first thing in the morning, it smells like McDonald's, not a coffee shop."[55]

Efforts to increase operational efficiencies also affected the customer experience. To reduce wait time, Starbucks brought in the Verismo 801 automated espresso machines, which dispensed hot espresso at the touch of a button and allowed baristas to make drinks 40 per cent faster, but the machines were so tall that customers could no longer see the coffee being made or interact with the barista. The adoption of Flavorlock sealed bags of pre-ground coffee eliminated the step of grinding the coffee, but the stores lost the aroma of freshly ground coffee. And in an effort to reduce maintenance costs, stores were re-configured with fewer comfy chairs and less carpeting — making Starbucks a less inviting place in which to linger over a cup of coffee.[56]

By February 2007, Schultz was questioning whether the company was on the right path. The product mix — which included non-coffee drinks, food items, music, books, movies and even teddy bears — had expanded tremendously; locations — both company-owned and licensees — seemed to be everywhere. In a memo to the company's top execs, Schultz wrote, "…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."[57] The company, he lamented, had lost the "romance and theatre" of coffee-making with its meteoric expansion.

Competitors Collide

For years, the line between retailers of brewed coffee had been clearly defined. Starbucks, with its $3-plus espresso-based drinks, was in a different league from Dunkin' Donuts and McDonald's. One Starbucks marketing executive went so far as to characterize the competition as "selling hot, brown liquid masquerading as coffee."[58] But by mid-decade, their parallel worlds began to collide. Starbucks, with its drive-through window, was beginning to look a lot more like a fast-food restaurant. Dunkin' Donuts and McDonald's, seeing the profits in specialty coffee, began their own efforts to join the high-end coffee market. As Jon Luther, chief executive of Dunkin' Donuts' parent company, the U.K. group Allied Domecq PLC, said, "Espresso has become mainstream in America. And who does mainstream better than Dunkin' Donuts?"[59]

[54]Janet Adamy, "McDonald's Takes on a Weakened Starbucks," *Wall Street Journal*, January 7, 2008, A1.

[55]Barbara Kiviat, "Wake Up and Sell the Coffee," *Time*, April 7, 2008, p. 46.

[56]Ibid.

[57]Howard Schultz, "The Commoditization of the Starbucks Experience," Internal E-mail, February 14, 2007, http://starbucksgossip.typepad.com/_/2007/02/starbucks_chair_2.html.

[58]Janet Adamy, "McDonald's Takes on a Weakened Starbucks," *Wall Street Journal*, January 7, 2008, A1.

[59]Deborah Ball and Shirley Leung, "Latte Versus Latte," *Wall Street Journal*, February 10, 2004, B1.

Dunkin' Donuts was the largest seller in America of regular, non-flavored, brewed coffee through fast food outlets. Its stores were found throughout the United States, with the largest concentration in the Northeast, many in blue-collar neighborhoods. The chain rolled out its line of espresso drinks in 2003, claiming it could deliver its Italian brews "faster, cheaper, and simpler": faster, by working with a Swiss equipment manufacturer to provide real espresso and fresh steamed milk in less than a minute; cheaper, by offering drinks at prices 20 per cent lower than Starbucks; and simpler, by communicating in plain English, labeling its coffee sizes as "small," "medium" and "large," rather than the "tall," "grande" and "venti" preferred by Starbucks. In doing so, the chain hoped to "democratize" the espresso drink or as one billboard read: "Latte for Every Tom, Dick and Lucciano."

Not all Dunkin' Donuts regulars were impressed. Pat Kelly, a 26-year-old Boston police recruit who drank Dunkin' Donuts coffee daily, refused to try the new Dunkin' products. The only guy among his buddies to try a latte "got a razzing" he said. "I'm not really a latte sort of guy. Those are yuppie drinks." But some of Starbucks' yuppies took notice. Kathleen Brown, a 30-year-old Boston lawyer, used to treat herself to a $4 Starbucks Caramel Macchiato but switched to Dunkin' Donuts. "I can order a plain medium caramel latte and not deal with all that fancy stuff," she said.[60] The fact that it also costs less just made it that much sweeter.

McDonald's was slower to get into high-end specialty coffee. But this changed in 2004 when its share of breakfast traffic slipped 1.6 per cent — in large part due to declining coffee sales; coffee, it seems, drives consumers' choice of breakfast sandwiches, not the other way around. And McDonald's coffee sales had dropped 36 per cent over the past decade, while Dunkin' Donuts' and Starbucks' sales were growing.[61]

To remedy the situation, McDonald's management moved to overhaul the stores. It developed a "Plan to Win," which emphasized a shift "from growing by being bigger to growing by being better."[62] The stores would be refurbished — replacing molded plastic booths with oversized chairs, changing to softer lighting and repainting the restaurants with muted tones instead of the bright colors previously used. Wireless Internet was added. "We began to realize that we could definitely sell coffee in this environment," said Don Thompson, president of the chain's U.S. business.[63]

In 2006, McDonald's changed its drip coffee to a stronger blend and began marketing it as "premium" roast — which Consumer Reports rated "better" than Starbucks. Emboldened, the company developed an espresso line of drinks under the name McCafe. Like Dunkin' Donuts, it used a more automated process than Starbucks; instead of steaming milk in pitchers and then combining it with the espresso, McDonald's used a single machine to make all the components of each drink. And the McDonald's added flavors were limited to vanilla, caramel and mocha, significantly fewer than the thousands of combinations offered by Starbucks. Prices were also lower — $1.99 to $3.29 — $0.60 to $0.80 less than Starbucks.[64]

[60]Ibid.

[61]Steven Gray and Deborah Ball, "McDonald's Sees Rivals Bite Into Breakfast," *Wall Street Journal*, April 8, 2005, B1.

[62]Neil Buckley, "McDonald's Returns to Profit after Revamp Restaurants," *Financial Times*, January 2004, p. 21.

[63]Janet Adamy, "McDonald's Takes on a Weakened Starbucks," *Wall Street Journal*, January 7, 2008, A1.

[64]Ibid.

It's the Economy!

In 2007, the U.S. economy was hit with increasing prices. A barrel of oil almost doubled in price,[65] and gasoline prices climbed from around $2.00 to $3.00 a gallon.[66] Starbucks, like many retailers, felt consumers' pain. "They finally got to the point where their customer base was so broad it wasn't recession-proof," according to Joseph Buckley of a major investment bank and brokerage firm.[67] And as gas prices continued to rise all across the United States, the $3.50 average price of a cup of Starbucks coffee now stood in direct competition with the less discretionary gallon of gas, a crucial comparison when consumers' budgets were already pinched.

As if that were not enough, the economy was further hit by the fallout of the subprime mortgage lending crisis. Because Starbucks had expanded in the South and in Southern California, regions hit hard by the housing crisis, many new stores performed below expectation. In some cases, store locations had been chosen because the population was projected to grow rapidly with new development; that development did not occur and so the expected sales did not materialize.[68] In other cases, the population was there, but sales were not.

The Fall from Grace

Confirmation of trouble within Starbucks came in 2007 when the company experienced two quarters of flat growth in same-store sales, then reported its first ever decline in the fourth quarter. Same-store sales — a measure of sales in locations open at least a year — had hovered in the mid-single-digit range all year, after years of growing at a high single-digit or double-digit rate each quarter.[69]

To beat the economic woes being touted daily in the national press, CEO Jim Donald reacted by tinkering with lower-priced product offerings. Starbucks began testing a $1 coffee and free refills on traditional-brewed coffee to attract the price-conscious consumers amid a weak economy. At $1, Starbucks would undercut the price of competitors such as McDonald's and Dunkin' Donuts. Although most sit-down restaurants top off customers' coffee free of charge, fast-food convenience restaurants have traditionally stayed away from the practice.

And during the 2007 holiday season, Starbucks ran its first national television campaign — something that Wall Street had long advocated it was time to do. The ads used "animatics" — a crisper, less-cartoonish form of animation. In one TV spot, a bearded skier and a reindeer are stuck in a ski lift and the skier offers the reindeer a cup of Starbucks coffee. Ideas for future advertising efforts were decidedly more edgy. One proposed campaign showed Americans discussing issues of importance to them — such as the war in Iraq and health care or even pop culture — and depicted Starbucks as the "living room" of the national conversation. The images would shift from inside a Starbucks store to pictures of an American soldier or, on the lighter side, Britney Spears on the day she shaved her head.[70]

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[65]*Weekly United States Spot Price FOB Weighted by Estimated Import Volume (Dollars per Barrel)* http://tonto.eia.doe.gov/dnav/pet/hist/wtotusaw.htm.

[66]Gasbuddy.com, www.gasbuddy.com/gb_retail_price_chart.aspx?time=24.

[67]Barbara Kiviat, "Wake Up and Sell the Coffee," *Time*, April 7, 2008, p. 46.

[68]Brad Stone, "Lax Real Estate Decisions Hurt Starbucks," *New York Times*, July 4, 2008.

[69]Janet Adamy, "Schultz Takes Over to Try to Perk Up Starbucks," *Wall Street Journal*, January 8, 2008, B1.

[70]Stephanie Kang, Janet Adamy and Suzanne Vrancia, "TV Campaign Is Culture Shift for Starbucks," *Wall Street Journal*, November 17, 2007, A1.

But by the end of 2007, Starbucks' stock had lost much of its luster. In early January, the company's share price was $18, down from $35 the previous year. Deciding that it was time to act, on January 7, 2008, the board brought back Howard Schultz as CEO. And Schultz came back determined to restore Starbucks' cachet as a premier brand: "I came back because it's personal; I came back because I love this company and our people and feel a deep sense of responsibility to 200,000 people and their families."[71]

Investors hailed his resumption of the CEO position, hoping that, like Steve Jobs's homecoming to Apple in 1997, it would portend a return to healthier days. But many analysts warned that investors should not expect an immediate reversal of company fortunes. "Many [investors] don't realize how long it can take to right the ship and how rocky the sailing can be during that time. Companies like Gap Inc. and Home Depot Inc. have spent several years trying to get back on track after losing their way."[72]

Schultz himself recognized that it would not be a quick fix and that choices would not be easy. In comments to the press, he warned, "We want to have the courage to do the things that support the core purpose and the reason for being and not veer off and get caught up in chasing revenue, because long-term value for the shareholder can only be created if you create long-term value for the customer and your people. We have to get back to what we do."[73]

[71]Barbara Kiviat, "Wake Up and Sell the Coffee," *Time*, April 7, 2008, p. 46.

[72]Janet Adamy, "With Starbucks, Investors Need Patience," *Wall Street Journal*, February 2, 2008, B1.

[73]Barbara Kiviat, "Wake Up and Sell the Coffee," *Time*, April 7, 2008, p. 46.