

CASE 2

Starbucks Corporation, May 2015

TEACHING NOTE

■ SYNOPSIS ■

Howard Schultz's leadership of Starbucks' transformation from a single Seattle coffee shop to a global chain of over 20,000 outlets is a tale of remarkable commercial achievement that has become part of American entrepreneurial folklore. The dramatic content of the story is enhanced by the fact that, after 20 years of leading Starbucks' continuous growth, Schultz relinquished the post of CEO in 2000. However, amidst a slump in Starbucks' profitability and sales, he returned to his former role in 2008 in order to rescue Starbucks and its core values of quality, customer focus, community involvement, and environmental responsibility. In doing so, Schultz took Starbucks' profitability, sales growth, and stock market valuation to new heights.

The case requires students to identify Starbucks' strategy and to explain why this strategy has achieved such remarkable success. In diagnosing the sources of Starbucks' outstanding performance, students are forced to address the extent to which the strategy fits both with the business environment in which Starbucks operates and its internal resources and capabilities. They must also assess the extent to which the components of Starbucks' strategy fit together into a coherent whole. Such analysis provides the basis for an assessment of the sustainability of Starbucks' success. Is Schultz taking Starbucks in the right direction or are further changes in the company's strategy called for?

■ TEACHING OBJECTIVES ■

The case is intended as an introductory case in the identification and analysis of firm strategy. The learning outcomes are:

- Expertise in the identification and articulation of a company's strategy
- Expertise in the appraisal of a firm's strategy in terms of:
 - Assessment of the success of the strategy in terms of financial performance
 - Assessment of the strategic fit of the strategy in terms of the fit both with the requirements of the external business environment and with the internal resources and capabilities of the firm
 - The internal coherence with the difference elements of a firm's strategy
- Familiarity with shareholder and stakeholder goals for the firm and recognition of the difficulty of distinguishing the two.

■ POSITION IN THE COURSE ■

Partly because of the familiarity of most students with Starbucks, and the fact that this is a relatively simple company in terms of its products and its strategy, I find that this case is a very useful introductory case for a core strategy course.

■ ASSIGNMENT QUESTIONS ■

1. What is Starbucks' strategy?
2. Assess Starbucks' strategy in relation to:
 - a) Starbucks' financial performance
 - b) The overall coherence of Starbucks' strategy in terms of its fit with the company's external and internal environments and the internal consistency of the strategy
3. Does Starbucks operate in the interests of its shareholders or its stakeholders?
4. What threats does Starbucks face; how should it counter these threats?

■ READING ■

R. M. Grant, *Contemporary Strategy Analysis* (9th edn.), Wiley, 2016, Chapter 1.

■ CASE DISCUSSION AND ANALYSIS ■

I organize class discussion around the above assignment questions:

What is Starbucks' strategy?

My experience with students at all levels (including executives) is that they often struggle to articulate the strategy being pursued by companies that they are familiar with (including their own!). Using a company's own descriptions of its strategy risks vagueness and incompleteness. For example, the case identifies:

- Starbucks' mission: "to inspire and nurture the human spirit—one person, one cup and one neighborhood at a time"
- Starbucks' stated objective: "Our objective is to maintain Starbucks' standing as one of the most recognized and respected brands in the world. To achieve this goal, we are continuing the disciplined expansion of our store base, primarily focused on growth in countries outside of the US."
- Schultz's statement: "We're not in the coffee business serving people; we are in the people business serving coffee."

In order to provide a more systematic approach to the identification and description of a firm's strategy, Chapter 1 of *Contemporary Strategy Analysis* poses some simple questions (the "Describing Strategy" slide below reformats Figure 1.6 from the book).

STRATEGY TODAY

Describing Strategy: Current Positioning, Future Direction

STRATEGY AS POSITIONING

Where are we competing?

- Product market scope
- Geographical scope
- Vertical scope

- *How are we competing?*

- What is the basis of our competitive advantage?)

STRATEGY AS DIRECTION

What do we want to become?

- Vision statement

- *What do we want to achieve?*

- Mission statement
- Performance goals

- *How will we get there?*

- Guidelines for development
- Priorities for capital expenditure, R&D
- Growth modes: organic growth, M&A, alliances

**COMPETING FOR THE
PRESENT**

**PREPARING FOR THE
FUTURE**

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In terms of Starbucks' positioning

- Where is Starbucks competing? (I.e. What business is it in? What are its product offerings? In which geographical markets is it located?)
- How is it competing?

These questions should elicit a number of contributions ranging from broad aspects of strategic positioning (e.g. providing a "third place") to specific elements of Starbucks' strategy (its products, its sourcing strategy, its HR policies; CSR activities).

The left-hand box in the slide below suggests how these points can be organized in terms of the components of Starbucks' positioning.

Describing Starbucks Strategy

STRATEGY AS POSITIONING

WHAT? The products/services

- Company-operated stores (coffee, other drinks, food, coffee beans, coffee equipment)
- Licensed stores
- Consumer products, foodservice, brand licensing,
- Financial services

HOW? Differentiation

- Product quality
- Retail ambience
- Values: CSR, environmental sustainability, fairness, human connectedness,
- Employee relations
- Directly-managed outlets

THE
"STAR-
BUCKS
EXPER-
IENCE"

STRATEGY AS DIRECTION

- International expansion
- Growth in consumer products (food & beverages through the grocery trade)

The key, however, is to recognize how the various elements of Starbucks' strategy fit together into a coherent whole. This is where the concept of the "Starbucks Experience" plays a central role.

Schultz's vision for Starbucks was never purely product-focused: Starbucks was not simply about supplying quality coffee, from the start it was about creating community (the "third place" between home and work). The Starbucks Experience is a social and psychological experience in which the pleasure of drinking quality coffee is augmented by a whole range of tangible and intangible factors. Starbucks' values play a central role here: treating employees with respect and consideration, providing support to the growers of coffee, embracing environmental and social responsibility.

The performance slump of 2007 to 2009 offers some insights into the importance of this Starbucks Experience. Schultz identified several ways in which the Starbucks Experience had been undermined: the central role of the coffee (including its aroma) masked by that of different food products, the de-skilling of baristas by the use of automatic coffee machines, the compromising of core values in the quest for rapid growth.

But what about the future? Starbucks' strategy is not just about how it is positioned in 2015, but also about what it is to become in the future. Starbucks' mission statement offers little indication of where the limits to Starbucks' ambitions lie: does "one person, one cup and one neighborhood at a time" extend ultimately to the whole world?

Schultz's recent initiatives, however, and his "Blueprint for Profitable Growth" offer some clear indications of Starbucks' strategy for the future. Starbucks' growth may be "disciplined"—but it's also highly ambitious in relation to:

- International growth: a heavy focus on expansion in Asia—especially China
- New business growth through new products—including new products and businesses (Via instant coffee, the Teagan chain of tea shops, Evolution juices)—and (most important) Starbucks' major push into grocery products distributed through the grocery trade (e.g. supermarkets).

These components of Starbucks' current direction are shown in the right-hand box of the above slide.

Assess Starbucks' strategy in relation to: (a) Starbucks' financial performance

To assess Starbucks' strategy, it is useful to establish an understanding of the company's overall performance. Starting with the financial numbers also has the benefit of refocusing students' attention away from "big picture" notions of strategy down to the nitty-gritty of profit metrics.

Useful indicators of the financial health of Starbucks include the following:

<i>(from Table 1)</i>	2014	2013	2012	2011	2010	2009	2008	2007
Sales growth (%)	10.7	12.0	13.7	9.2	9.6	(5.9)	10.3	20.9
Return on average equity (%)	42.4	58.1*	29.2	30.9	28.2	14.2	13.2	29.8
Operating margin (%)	18.7	16.5*	15.0	14.8	13.3	5.3	4.8	11.2
Long term debt/Equity	38.8	29.0	10.8	12.5	14.9	22.1	22.1	24.1
Note: *Before deducting \$2.78bn. in special charges relating to the Kraft settlement.								

Over the past six years, Starbucks has combined strong sales growth with high profitability: its ROE during 2007-14 places the company among the top quartile of the Fortune 500 companies. Interestingly, even when Starbucks was experiencing its "crisis" during 2008-9, its ROE and operating margins were still at levels which many companies would regard as highly satisfactory! (For instance: the 13.2% ROE in 2008 was probably close

to double Starbucks' cost of equity capital.) Following Schultz's return, profitability exceeded the levels achieved before the financial crisis—remarkable in a world with excessive debt and subdued consumer spending.

Additional observations:

- International expansion (especially into Asia) has been a major source of revenue growth to, even though profitability is lower than in the US
- Diversification successful. In particular, expansion into the grocery trade ("Channel Development") has generated rapid sales growth and high operating margins (averaging 48% during 2013-14)
- Efficiency gains: store operating costs as a percentage of sales revenue have been reduced in recent years.

To explore the basis of Starbucks' stellar performance, let us look more closely at its strategy.

Appraising Starbucks' Strategy

[A] Financial Performance

- **Remarkable! 2011-2014:**
 - Average annual revenue growth 11.5%
 - Operating margin 16.7%
 - ROE 40.1% (excluding 2013 special charges)
- Even during "crisis" of 2008-9 ROE a healthy 13.7%
- International expansion major contributor to growth (esp. Asia-Pacific), but profitability lower than US
- Expansion into grocery trade ("Channel Development") v successful: rapid sales growth, high operating margins (averaging 48% during 2013-14)
- Efficiency gains: reduction in store operating costs as % of sales

Assess Starbucks' strategy in relation to: (b) The overall coherence of Starbucks' strategy in terms of its fit with the company's external and internal environments and the internal consistency of the strategy

Fit with the external business environment

- Identifying an underserved market. Despite the US being a large and mature market for coffee, Schultz's insight was to see a potential market opportunity characterized, first, by quality brewed coffee beverages; second, by venues where consuming coffee could provide the basis for a social and emotional experience.
- An appealing differentiation strategy. Starbucks' differentiation extends throughout the value chain: from carefully selected coffee beans where the growers are provided with support services and a fair deal, through to the ambiance of the Starbucks coffee shops where interior

design, music and the interaction with Starbucks' employees are all designed to complement the "Starbucks Experience."

Fit with Starbucks' resources and capabilities

In the three decades since Schultz bought out the original Starbucks company, Starbucks has established a closely integrated set of capabilities that encompass the sourcing of coffee beans, the design and formulation of beverage products, the location and development of new stores, operations management, marketing and public relations, and human resource management.

However, central to the development and deployment of these capabilities has been the insight and leadership provided by Howard Schultz, who has been the source and custodian of Starbucks' strategy and its values and the key communicator for the company in establishing and maintaining the company's relationship with employees, customers, the media, and the financial markets. The central role of Schultz is confirmed by Starbucks' declining performance that followed his relinquishing of the CEO role and its revival that followed his 2008 return.

Internal coherence of the Starbucks strategy

The key to the effectiveness of the Starbucks strategy is the way in which the multiple components of the strategy fit together into a consistent differentiation strategy. The "Starbucks Experience" is a multifaceted differentiation strategy that combines the physical products—coffee and other drinks and food items; the physical environment in which they are prepared, served and consumed; the relationship between the Starbucks employees and the customers; the signals of quality in terms of the "art of the barista"; the values of community, social engagement, and environmental responsibility that the company communicates. The strength of the Starbucks strategy is the way in which all these elements complement one another.

Appraising Starbucks' Strategy [B] Strategic Fit

- **Fit with the external environment:**
 - **Identifying an underserved market**
 - a) Mass-market potential for quality coffee beverages in the US
 - b) Potential for coffee shops as a social venue in the US ("Third Place")
 - **Creating an appealing, integrated, comprehensive differentiation strategy**
 - **Recognizing the potential for Starbucks concept to work in overseas countries—especially those without a strong domestic coffee culture**
- **Fit with internal resources & capabilities:**
 - **Developing the physical, human, reputational, and managerial resources**
 - **Developing the marketing, sourcing, product development, operational, and CSR capabilities needed to support the strategy**
- **Internal coherence of the strategy: overall fit within the Starbucks' "activity system"**

The importance of this coherence is seen in the evidence of declining financial performance between 2007 and 2009. Schultz's diagnosis of this period of "crisis" is that Starbucks' eagerness to expand resulted in compromising some key elements of the "Experience." For example: the masking of coffee aroma by breakfast

foods, the de-skilling of baristas with the introduction of automated coffee machines, and the weakening of relationships with customers.

However, does international expansion and diversification compromise the coherence of the Starbucks strategy? In relation to overseas markets (e.g. China) it is not obvious that the “Starbucks Experience” – which includes the “third place” concept, fairness to employees, and environmental awareness – has the same appeal. In relation to diversification, it is not obvious that the “Starbucks experience” relates well to Via instant coffee, drive-thru Starbucks stores, or Starbucks “channel development” business. Not does it seem consistent with the trend for an increasing proportion of Starbucks outlets to be licensed rather than company operated (see Tables A1 and A2).

Does Starbucks operate in the interests of its shareholders or its stakeholders?

The typical response I receive from students is that Starbucks is a stakeholder-focused company. When I ask “How do you know?”, the answers are typically:

- The company says it is—Schultz claims to have created “a different kind of global company” that “makes profit but also...demonstrates a social conscience”
- The company takes account of the interests of its stakeholders in ways that other companies in its industry do not. For example:
 - Health care and educational benefits for employees
 - Schemes to support and train coffee growers
 - Community involvement (e.g. charity work by employees)
 - Environmental responsibility.

Does Starbucks Pursue Shareholder Interests or Stakeholder Interests?

- **The company claims to operate in the interests of shareholders, employees and society:** “a different kind of global company” that “makes profit but demonstrates a social conscience”
- **Evidence of stakeholder orientation:** Provides benefits to stakeholders that other food & drink chains do not:
 - Health care and educational benefits to employees.
 - Schemes to support and train coffee growers.
 - Community involvement (e.g. charity work by employees)
 - Environmental responsibility.
- **But:** given Starbucks’ differentiation strategy and its premium pricing are Starbucks’ HR policies and CSR activities incompatible with long-term profit maximization? Would long run profitability increase by eliminating these stakeholder benefits?
- **Starbucks behavior during 2008-9 profit slump:** Starbucks closed many outlets, prioritized profits over sustaining jobs

True, McDonalds and Domino’s Pizza are more parsimonious in their offer of benefits to stakeholders. However, is this the result of different objectives but because the competitive positioning is different? Starbucks charges a price premium of about 60% over the price of McDonalds’ coffee. The customer is paying for the “Starbucks Experience”—having the satisfaction of drinking coffee produced by a happy, prosperous grower, being served by employees who are not worrying about the costs of their next doctor’s visit, and with the pleasure of knowing that Starbucks is active in protecting the environment. A key question is whether Starbucks would increase its

long run profitability if it cut healthcare benefits, withdrew from its grower cooperative activities, and abandoned its sustainability stance?

It is revealing to look at Starbucks' behavior in situations where shareholder and stakeholder interests were in conflict. Thus during 2009-10, when profits were down, Starbucks chose to close a large number of unprofitable outlets. In this instance, it seems that Starbucks put profits (i.e. shareholder interests) before jobs (i.e. employee interests).

What threats does Starbucks face; how should it counter these threats?

Looking ahead, Starbucks faces a number of challenges.

1. Is the US market oversaturated and over- competitive?

- *Market saturation.* Starbucks had about 12,000 US stores (both owned and licensed) at the beginning of 2015: is this excessive—especially given the growing number of outlets serving quality coffee, both independents and chains?
- *Competition.* Starbucks pioneered the mass marketing of gourmet coffee. Yet making good-tasting coffee is not a scarce capability. Not only have there been many Starbucks imitators, but also other catering chains have added gourmet coffee to their menus. Of these, the case mentions Dunkin' Donuts and McDonalds as the most prominent. In addition to competition from below by the fast-food chains, there is also competition from above in the form of the traditional suppliers of high quality coffee. Among these the Italian companies – such as Illycaffè - have been particularly prominent. One scenario is that Starbucks becomes squeezed in the middle—McDonalds, Dunkin Donuts and the like claim the mass market for gourmet coffee, while the connoisseurs move to the quality coffees offered by European and specialist suppliers.
A further threat is the home-brewed market. With the market for home espresso coffee makers growing (led by Keurig Green Mountain in the US and Nescafé's Nespresso system in Europe), so coffee drinkers can make high quality coffee at home or in the office.
One scenario is that Starbucks' role is transitional: ie, it taught North American coffee drinkers what quality coffee tasted like—but these consumers then graduated to better things.

2. *Starbucks' product diversification.* Starbucks' core business is supplying coffee through its US retail stores. However, as it has extended its brand to a broad diversity of products, its Consumer Products Group which sells Starbucks-branded products through the grocery trade is now a major growth area—and is profitable. But does this fit with Starbucks' resources and capabilities—sure it is exploiting the Starbucks brand, but the capabilities required for distributing and marketing through supermarket chains are very different from those required in Starbucks' core business. Should Starbucks stick to brand licensing rather than direct involvement in the grocery trade?
3. *Overseas expansion.* Schultz has established ambitious goals for overseas expansion (especially for China, and Starbucks has also entered India). Despite Starbucks being a very American phenomenon, its overseas growth has been rapid, pointing to a widespread acceptance of the Starbucks concept. However, overseas performance has been mixed: same store sales have been almost stagnant in Europe, Middle East and Africa (Table 2). Also, profitability is *lower* internationally than in the US.
4. *Compromising the “Starbucks Experience”.* For all Schultz's emphasis on returning to Starbucks' core values and principles, some aspects of Starbucks' strategy sit uneasily with the “Starbucks Experience” as it has conventionally been articulated. Students may question whether Starbucks' introduction of its Via instant

coffee, increased licensing (Starbucks has less direct control), and the increasing number of drive-through Starbucks contribute to a lack of *strategic coherence*.

5. *How relevant is the “Starbucks Experience”?* Lack of fidelity to the Starbucks’ concept raises the issue of whether the appeal of the “Starbucks Experience” exists more in the mind of Howard Schultz than in the experience of customers. Starbucks provides a highly standardized, systematized retail experience where a large proportion of sales are take-away. Are the Starbucks ambiance, its values and principles, its corporate social responsibility activities really key differentiators in the minds of consumers? If Schultz is wrong about the centrality of the “Starbucks Experience”, the first implication is that Starbucks needs to reanalyze the reasons for its past success: if the ambiance and social atmosphere provided by the “third place” are not critical to Starbucks customers, then the likelihood is that it is more mundane factors -- the quality of the coffee, the convenience of the Starbucks’ locations, consumers’ desire for consistency and familiarity -- that are more critical. The implication is that Starbucks needs to worry less about values and ambiance, and focus more on the coffee, the location of outlets, and keeping costs and prices low.

Is Starbucks’ Success Sustainable? –Emerging Issues

- Threats to its US Retail business:
 - Market saturation
 - Increased competition:
 - From above, the Italians (Illy, Lavazza, Segafreddo)
 - From below McDonalds, Dunkin Donuts & other fast-food chains
 - From home-brewed gourmet coffee (e.g. Nespresso)
- Diversification into consumer products: Fit with capabilities? Brand dilution?
- International expansion: Does the Starbucks’ strategy fit as well with foreign markets as with the US? Does the strategy need to be adapted to the needs/preferences of foreign markets?
- Compromising the “Starbucks Experience.” Do Via instant coffee, drive-thru stores, and increased licensing undermine the “Starbucks Experience”
- How important is the “Starbucks Experience” experience anyway: Are Schultz’s concepts of the “third place,” the “mystique of good coffee,” and the “Starbucks’ values” critical sources of value for customers?

■ KEY TAKE-AWAYS FROM THE CASE DISCUSSION ■

1. *Identifying strategy*

The approach outlined in Chapter 1 of *Contemporary Strategy Analysis* offers a systematic and comprehensive approach to identifying a firm’s strategy. It, first, distinguishes between strategy as current positioning and strategy as future direction and, secondly identifies the two principal dimensions of a firm’s strategic positioning: the products and markets which define the firm’s business domain, and the basis on which the firm seeks a competitive advantage.

However, the risk is that this approach to describing strategy produces only a list of components. The challenge is to synthesize these various elements in a way that reveals the logic (what Prahalad and Bettis describe as

“dominant logic” and Peter Drucker called “the theory of the business”) that underlies the strategy. In the case of Starbucks this logic is the “Starbucks Experience”: an overall conception of Starbucks’ differentiation.

2. *Assessing strategy*

[A] Financial performance. A starting point for evaluating a firm’s strategy is an assessment of its overall performance. Growth and profitability are the primary indicators of financial performance. For evaluating profitability, key benchmarks are the company’s previous profitability (i.e. is the trend upward or downward), competitors’ profitability, and cost of capital.

[B] Strategic fit. An effective strategy is characterized by:

- Fit with the external environment: especially fit with customer needs and the forces of competition)
- Fit with internal resources and capabilities
- Internal consistency: complementarity among the elements of strategy

3. *Distinguishing between the pursuit of shareholder and stakeholder goals*

Current convention is for companies to proclaim that they operate in the interests of all stakeholders. But discerning in whose interests a company operates is difficult—in many cases the interests of shareholders are aligned with those of other stakeholders (“Shared Value”). To distinguish the goals of a firm, it is useful to identify situations where profit goals conflict with the interests of employees / customers / society. Who does the firm favor in these cases?

4. *Identifying challenges for the future:*

Firm’s strategy may fit with its external and internal environments currently—but what about the future? To identify challenges and formulate responses to them, the key questions are:

- What’s changing in the external and internal environments of the firm?
- What do these changes imply for the strategic fit?
- How can the strategy change in order to adapt to emerging circumstances?

Key Take-Aways [1]

1. Identifying strategy
 - o Identifying where and how a company competes and distinguishing between positioning for today and competing for tomorrow offers a succinct framework for articulating strategy
 - o The importance of synthesis: describing all the elements of Starbucks’ strategy is not enough—we need to see how these fit together (the “Starbucks Experience”)
2. Appraising strategy.
 - o How well is the strategy performing?—A strong financial performance suggests that the strategy is OK for the present; a weak performance offers opportunities to diagnose the sources of under-performance
 - o Strategic fit:
 - Fit with the external environment (esp. customer needs and competition)
 - Fit with internal resources and capabilities
 - Internal consistency: complementarity among the elements of strategy

Key Take-Aways [2]

3. Distinguishing between the pursuit of shareholder and stakeholder goals
 - o Difficult to distinguish: in many cases the interests of shareholders are aligned with those of other stakeholders (“Shared Value”)
 - o Identify situations where profit goals conflict with the interests of employees / customers / society. Who does the firm favor in these cases?
4. Identifying challenges for the future:
 - o What’s changing in the external and internal environments of the firm?
 - o What do these changes imply for the strategic fit?
 - o How can the strategy change in order to adapt to emerging circumstances?