



## Starbucks' Global Quest in 2006: Is the Best Yet to Come?

Amit J. Shah

*Frostburg State University*

Thomas F. Hawk

*Frostburg State University*

Arthur A. Thompson

*The University of Alabama*

In early 2006, Howard Schultz, Starbucks' founder, chairman of the board, and global strategist, could look with satisfaction on the company's phenomenal growth and market success. Since 1987, Starbucks had transformed itself from a modest nine-store operation in the Pacific Northwest into a powerhouse multinational enterprise with 10,241 store locations, including some 2,900 stores in 30 foreign countries (see Exhibit 1). During Starbucks' early years when coffee was a 50-cent morning habit at local diners and fast-food establishments, skeptics had ridiculed the notion of \$3 coffee as a yuppie fad. But the popularity of Starbucks' Italian-style coffees, espresso beverages, teas, pastries, and confections had made Starbucks one of the great retailing stories of recent history and the world's biggest specialty coffee chain. In 2003, Starbucks made the Fortune 500, prompting Schultz to remark, "It would be arrogant to sit here and say that 10 years ago we thought we would be on the Fortune 500. But we dreamed from day one and we dreamed big."<sup>1</sup>

Having positioned Starbucks as the dominant retailer, roaster, and brand of specialty coffees and coffee drinks in North America and spawned the creation of the specialty coffee industry, management's long-term objective was now to establish Starbucks as the most recognized and respected brand in the world. New stores were being opened at the rate of roughly 32 per week in 2005, and management

expected to have 15,000 Starbucks stores open worldwide going into 2006. Believing that the scope of Starbucks' long-term opportunity had been underestimated, Schultz had recently increased the targeted number of stores from 25,000 to 30,000 worldwide by 2013, at least half of which were to be outside the United States.<sup>2</sup> He noted that Starbucks had only an overall 7 percent share of the coffee-drinking market in the United States and perhaps a 1 percent share internationally. According to Schultz, "That still leaves lots of room for growth. Internationally, we are still in our infancy."<sup>3</sup> Although coffee consumption worldwide was stagnant, coffee was still the second-most-consumed beverage in the world, trailing only water.<sup>4</sup>

Starbucks reported revenues in fiscal 2005 of \$6.4 billion, up 205 percent from \$2.1 billion in fiscal 2000; after-tax profits in 2005 were \$494.5 million, an increase of 423 percent from the company's fiscal 2000 net earnings of \$94.6 million.

### COMPANY BACKGROUND

Starbucks got its start in 1971 when three academics, English teacher Jerry Baldwin, history teacher Zev Siegel, and writer Gordon Bowker—all coffee aficionados—opened Starbucks Coffee, Tea, and Spice in touristy Pike's Place Market in Seattle. The three partners shared a love for fine coffees and exotic teas and believed they could build a clientele in Seattle that would appreciate the best coffees and

**Exhibit 1** Number of Starbucks Store Locations Worldwide, 1987–2005

Fiscal Year	Number of Store Locations at End of Fiscal Year	Fiscal Year	Number of Store Locations at End of Fiscal Year
1987	17	1997	1,412
1988	33	1998	1,886
1989	55	1999	2,135
1990	84	2000	3,501
1991	116	2001	4,709
1992	165	2002	5,886
1993	272	2003	7,225
1994	425	2004	8,569
1995	676	2005	10,241
1996	1,015		

**Licensed Locations of Starbucks Stores, 2005**

Asia-Pacific		Europe–Middle East–Africa		Americas	
Japan	572	Spain	39	United States	2,435
China	185	Saudi Arabia	38	Canada	118
Taiwan	153	Greece	38	Mexico	60
South Korea	133	United Arab Emirates	37	Hawaii	51
Philippines	83	Kuwait	32	Puerto Rico	11
Malaysia	62	Turkey	24	Peru	6
New Zealand	41	Switzerland	21	The Bahamas	2
Indonesia	32	France	16		
	1,261	Lebanon	10		2,683
		Austria	9		
		Qatar	8		
		Bahrain	8		
		Cyprus	7		
		Oman	4		
		Jordan	4		
		United Kingdom	2		
			297		

Source: 2005 10-K report.

teas, much like what had already emerged in the San Francisco Bay area. They each invested \$1,350 and borrowed another \$5,000 from a bank to open the Pike's Place store. The inspiration and mentor for the Starbucks venture in Seattle was a Dutch immigrant named Alfred Peet, who had opened Peet's Coffee and Tea, in Berkeley, California, in 1966. Peet's store specialized in importing fine coffees and teas and

dark-roasting its own beans the European way to bring out the full flavors. Customers were encouraged to learn how to grind the beans and make their own freshly brewed coffee at home. Baldwin, Siegel, and Bowker were well acquainted with Peet's expertise, having visited his store on numerous occasions and listened to him expound on quality coffees and the importance of proper bean-roasting techniques.

The Pikes Place store featured modest, hand-built, classic nautical fixtures. One wall was devoted to whole-bean coffees, while another had shelves of coffee products. The store did not offer fresh-brewed coffee by the cup, but tasting samples were sometimes available. Initially, Siegel was the only paid employee. He wore a grocer's apron, scooped out beans for customers, extolled the virtues of fine, dark-roasted coffees, and functioned as the partnership's retail expert. The other two partners kept their day jobs but came by at lunch or after work to help out. During the start-up period, Baldwin kept the books and developed a growing knowledge of coffee; Bowker served as the "magic, mystery, and romance man."<sup>5</sup> The store was an immediate success, with sales exceeding expectations, partly because of interest stirred by a favorable article in the *Seattle Times*. For most of the first year, Starbucks ordered its coffee-bean supplies from Peet's, but then the partners purchased a used roaster from Holland, set up roasting operations in a nearby ramshackle building, and developed their own blends and flavors.

By the early 1980s, the company had four Starbucks stores in the Seattle area and had been profitable every year since opening its doors. But then Zev Siegel experienced burnout and left the company to pursue other interests. Jerry Baldwin took over day-to-day management of the company and functioned as chief executive officer; Gordon Bowker remained involved as an owner but devoted most of his time to his advertising and design firm, a weekly newspaper he had founded, and a microbrewery that he was launching known as the Redhook Ale Brewery.

## *Howard Schultz Enters the Picture*

In 1981, Howard Schultz, vice president and general manager of U.S. operations for a Swedish maker of stylish kitchen equipment and coffeemakers, decided to pay Starbucks a visit—he was curious about why Starbucks was selling so many of his company's products. The morning after his arrival in Seattle, he was escorted to the Pikes Place store by Linda Grossman, the retail merchandising manager for Starbucks. A solo violinist was playing Mozart at the door (his violin case open for donations). Schultz was immediately taken by the powerful and pleasing

aroma of the coffees, the wall displaying coffee beans, and the rows of coffeemakers on the shelves. As he talked with the clerk behind the counter, the clerk scooped out some Sumatran coffee beans, ground them, put the grounds in a cone filter, poured hot water over the cone, and shortly handed Schultz a porcelain mug filled with freshly brewed coffee. After only taking three sips of the brew, Schultz was hooked. He began asking the clerk and Grossman questions about the company, about coffees from different parts of the world, and about the different ways of roasting coffee.

A bit later, he was introduced to Jerry Baldwin and Gordon Bowker, whose offices overlooked the company's coffee-roasting operation. Schultz was struck by their knowledge about coffee, their commitment to providing customers with quality coffees, and their passion for educating customers about the merits of dark-roasted coffees. Baldwin told Schultz, "We don't manage the business to maximize anything other than the quality of the coffee."<sup>6</sup> The company purchased only the finest arabica coffees and put them through a meticulous dark-roasting process to bring out their full flavors. Baldwin explained that the cheap robusta coffees used in supermarket blends burned when subjected to dark roasting. He also noted that the makers of supermarket blends preferred lighter roasts, which allowed higher yields (the longer a coffee was roasted, the more weight it lost).

Schultz was also struck by the business philosophy of the two partners. It was clear that Starbucks stood not just for good coffee but also for the dark-roasted flavor profiles that the founders were passionate about. Top-quality, fresh-roasted, whole-bean coffee was the company's differentiating feature and a bedrock value. It was also clear to Schultz that Starbucks was strongly committed to educating its customers to appreciate the qualities of fine coffees. The company depended mainly on word of mouth to get more people into its stores, then built customer loyalty cup by cup as buyers gained a sense of discovery and excitement about the taste of fine coffee.

On his trip back to New York the next day, Howard Schultz could not stop thinking about Starbucks and what it would be like to be a part of the Starbucks enterprise. Schultz recalled, "There was something magic about it, a passion and authenticity I had never experienced in business."<sup>7</sup> The appeal of living in the Seattle area was another strong plus. By the time he landed at Kennedy Airport, he knew in his heart

he wanted to go to work for Starbucks. At the first opportunity, Schultz asked Baldwin whether there was any way he could fit into Starbucks. While Schultz and Baldwin had established an easy, comfortable personal rapport, it still took a year, numerous meetings at which Schultz presented his ideas, and a lot of convincing to get Baldwin, Bowker, and their silent partner from San Francisco to agree to hire him. Schultz pursued a job at Starbucks far more vigorously than Starbucks pursued hiring Schultz. There was some nervousness about bringing in an outsider, especially a high-powered New Yorker who had not grown up with the values of the company. Nonetheless, Schultz continued to press his ideas about the tremendous potential of expanding the Starbucks enterprise outside Seattle and exposing people all over America to Starbucks coffee. He argued that there had to be more than just the few thousand coffee lovers in Seattle who would enjoy the company's products.

At a meeting with the three owners in San Francisco in the spring of 1982, Schultz once again presented his ideas and vision for opening Starbucks stores across the United States and Canada. He thought the meeting went well and flew back to New York, believing a job offer was in the bag. However, the next day Jerry Baldwin called Schultz and indicated that the owners had decided against hiring him because geographic expansion was too risky and they did not share Schultz's vision for Starbucks. Schultz was despondent, seeing his dreams of being a part of Starbucks' future go up in smoke. Still, he believed so deeply in Starbucks' potential that he decided to make a last-ditch appeal; he called Baldwin back the next day and made an impassioned, reasoned case for why the decision was a mistake. Baldwin agreed to reconsider. The next morning Baldwin called Schultz and told him the job of heading marketing and overseeing the retail stores was his. In September 1982, Howard Schultz took over his new responsibilities at Starbucks.

### *Starbucks and Howard Schultz: The 1982–1985 Period*

In his first few months at Starbucks, Howard Schultz spent most of his waking hours in the four Seattle stores—working behind the counters, tasting different kinds of coffee, talking with customers, getting to know store personnel, and learning the

retail aspects of the coffee business. By December, Jerry Baldwin concluded that Schultz was ready for the final part of his training, that of actually roasting the coffee. Schultz spent a week getting an education about the colors of different coffee beans, listening for the telltale second pop of the beans during the roasting process, learning to taste the subtle differences among Baldwin and Bowker's various roasts, and familiarizing himself with the roasting techniques for different beans.

Schultz made a point of acclimating himself to the informal dress code at Starbucks, gaining credibility and building trust with colleagues, and making the transition from the high-energy, coat-and-tie style of New York to the more casual, low-key ambience of the Pacific Northwest (see Exhibit 2 for a rundown on Howard Schultz's background). Schultz made real headway in gaining the acceptance and respect of company personnel while working at the Pikes Place store one day during the busy Christmas season that first year. The store was packed and Schultz was behind the counter ringing up sales of coffee when someone shouted that a shopper had just headed out the door with some stuff—two expensive coffeemakers it turned out, one in each hand. Without thinking, Schultz leaped over the counter and chased the thief up the cobblestone street outside the store, yelling, "Drop that stuff! Drop it!" The thief was startled enough to drop both pieces and run away. Howard picked up the merchandise and returned to the store, holding the coffeemakers up like trophies. Everyone applauded. When Schultz returned to his office later that afternoon, his staff had strung up a banner that read: "Make my day."<sup>8</sup>

Schultz was overflowing with ideas for the company. Early on, he noticed that first-time customers sometimes felt uneasy in the stores because of their lack of knowledge about fine coffees and because store employees sometimes came across as a little arrogant or superior to coffee novices. Schultz worked with store employees on customer-friendly sales skills and developed brochures that made it easy for customers to learn about fine coffees. However, Schultz's biggest inspiration and vision for Starbucks' future came during the spring of 1983 when the company sent him to Milan, Italy, to attend an international housewares show. While walking from his hotel to the convention center, he spotted an espresso bar and went inside to look around. The cashier beside the door nodded and smiled. The

## Exhibit 2 Biographical Sketch of Howard Schultz

- His parents both came from working-class families residing in Brooklyn, New York, for two generations. Neither completed high school.
- He grew up in a government-subsidized housing project in Brooklyn, was the oldest of three children, played sports with the neighborhood kids and developed a passion for baseball, and became a die-hard Yankees fan.
- His father was a blue-collar factory worker and taxicab driver who held many low-wage, no-benefits jobs; his mother remained home to take care of the children during their preschool years, then worked as an office receptionist. The family was hard pressed to make ends meet.
- He had a number of jobs as a teenager—paper route, counter job at luncheonette, an after-school job in the garment district in Manhattan, a summer job steaming yarn at a knit factory. He always gave part of his earnings to his mother to help with family expenses.
- He saw success in sports as his way to escape life in the projects; he played quarterback on the high school football team.
- He was offered a scholarship to play football at Northern Michigan University (the only offer he got) and he took it. When his parents drove him to the campus to begin the fall term, it was his first trip outside New York. It turned out that he didn't have enough talent to play football, but he got loans and worked at several jobs to keep himself in school. He majored in communications, took a few business courses on the side, and graduated in 1975 with a B average—the first person in his family to graduate from college.
- He went to work for a ski lodge in Michigan after graduation, then left to go back to New York, landing a sales job at Xerox Corporation. He left Xerox to work for Swedish coffee-equipment maker Hammarplast, U.S.A., becoming vice president and general manager in charge of U.S. operations and managing 20 independent sales representatives.
- He married Sheri Kersch in July 1982 and later became the father of two children.
- His father contracted lung cancer in 1982 at age 60 and died in 1988, leaving his mother with no pension, no life insurance, and no savings.
- He became a principal owner of Seattle SuperSonics NBA team in 2001 and also a principal owner of Seattle Storm of WNBA.
- He owned about 32 million shares of Starbucks worth about \$950 million in December 2005.

Source: Howard Schultz and Dori Jones Yang, *Pour Your Heart Into It* (New York: Hyperion, 1997).

barista behind the counter greeted Howard cheerfully and moved gracefully to pull a shot of espresso for one customer and handcraft a foamy cappuccino for another, all the while conversing merrily with those standing at the counter. Schultz thought the barista's performance was "great theater." Just down the way on a side street, he entered in an even more crowded espresso bar where the barista, whom he surmised to be the owner, was greeting customers by name; people were laughing and talking in an atmosphere that plainly was comfortable and familiar. In the next few blocks, he saw two more espresso bars. That afternoon, when the trade show concluded for the day, Schultz walked the streets of Milan to explore more espresso bars. Some were stylish and upscale; others attracted a blue-collar clientele. Most had few chairs, and it was common for Italian opera to be playing in the background. What struck Schultz was how popular and vibrant the Italian coffee bars were.

Energy levels were typically high, and they seemed to function as an integral community gathering place. Each one had its own unique character, but they all had a barista who performed with flair and maintained a camaraderie with the customers.

Schultz remained in Milan for a week, exploring coffee bars and learning as much as he could about the Italian passion for coffee drinks. Schultz was particularly struck by the fact that there were 1,500 coffee bars in Milan, a city about the size of Philadelphia, and a total of 200,000 in all of Italy. In one bar, he heard a customer order a *caffè latte* and decided to try one himself—the barista made a shot of espresso, steamed a frothy pitcher of milk, poured the two together in a cup, and put a dollop of foam on the top. Schultz liked it immediately, concluding that lattes should be a feature item on any coffee bar menu even though none of the coffee experts he had talked to had ever mentioned them.



Schultz's 1983 trip to Milan produced a revelation: The Starbucks stores in Seattle completely missed the point. There was much more to the coffee business than just selling beans and getting people to appreciate grinding their own beans and brewing fine coffee in their homes. What Starbucks needed to do was serve fresh-brewed coffee, espressos, and cappuccinos in its stores (in addition to beans and coffee equipment) and try to create an American version of the Italian coffee bar culture. Going to Starbucks should be an experience, a special treat, a place to meet friends and visit. Re-creating the authentic Italian coffee bar culture in the United States could be Starbucks' differentiating factor.

### *Schultz Becomes Frustrated*

On Howard Schultz's return from Italy, he shared his revelation and ideas for modifying the format of Starbucks' stores with Jerry Baldwin and Gordon Bowker. But instead of winning their approval for trying out some of his ideas, Schultz encountered strong resistance. They argued that Starbucks was a retailer, not a restaurant or coffee bar. They feared that serving drinks would put them in the beverage business and diminish the integrity of Starbucks' mission as a purveyor of fine coffees. They pointed out that Starbucks had been profitable every year and there was no reason to rock the boat in a small, private company like Starbucks. But a more pressing reason not to pursue Schultz's coffee bar concept emerged shortly—Baldwin and Bowker were excited by an opportunity to purchase Peet's Coffee and Tea. The acquisition was finalized in early 1984, and to fund it Starbucks had to take on considerable debt, leaving little in the way of financial flexibility to support Schultz's ideas for entering the beverage part of the coffee business or expanding the number of Starbucks stores. For most of 1984, Starbucks managers were dividing their time between operations in Seattle and the Peet's enterprise in San Francisco. Schultz found himself in San Francisco every other week supervising the marketing and operations of the five Peet stores. Starbucks employees began to feel neglected and, in one quarter, did not receive their usual bonus due to tight financial conditions. Employee discontent escalated to the point where a union election was called. The union won by three votes. Baldwin was

shocked at the results, concluding that employees no longer trusted him. In the months that followed, he began to spend more of his energy on Peet's operation in San Francisco.

It took Howard Schultz nearly a year to convince Jerry Baldwin to let him test an espresso bar. Baldwin relented when Starbucks opened its sixth store in April 1984. It was the first store designed to sell beverages, and it was the first store located in downtown Seattle. Schultz asked for a 1,500-square-foot space to set up a full-scale Italian-style espresso bar, but Jerry agreed to allocating only 300 square feet in a corner of the new store. As a deliberate experiment to see what would happen, the store opened with no fanfare. By closing time on the first day, some 400 customers had been served, well above the 250-customer average of Starbucks' best-performing stores. Within two months the store was serving 800 customers per day. The two baristas could not keep up with orders during the early-morning hours, resulting in lines outside the door onto the sidewalk. Most of the business was at the espresso counter, while sales at the regular retail counter were only adequate.

Schultz was elated at the test results, expecting that Jerry's doubts about entering the beverage side of the business would be dispelled and that he would gain approval to pursue the opportunity to take Starbucks to a new level. Every day he went into Baldwin's office to show him the sales figures and customer counts at the new downtown store. But Baldwin was not comfortable with the success of the new store, believing that it felt wrong and that espresso drinks were a distraction from the core business of marketing fine arabica coffees at retail. Baldwin rebelled at the thought that people would see Starbucks as a place to get a quick cup of coffee to go. He adamantly told Schultz, "We're coffee roasters. I don't want to be in the restaurant business . . . Besides, we're too deeply in debt to consider pursuing this idea." While he didn't deny that the experiment was succeeding, he didn't want to go forward with introducing beverages in other Starbucks stores. Schultz's efforts to persuade Baldwin to change his mind continued to meet strong resistance, although to avoid a total impasse Baldwin finally did agree to let Schultz put espresso machines in the back of possibly one or two other Starbucks stores.

Over the next several months, Schultz made up his mind to leave Starbucks and start his own company. His plan was to open espresso bars in high-traffic downtown locations, serve espresso drinks and coffee by the cup, and try to emulate the friendly, energetic atmosphere he had encountered in Italian espresso bars. Baldwin and Bowker, knowing how frustrated Schultz had become, supported his efforts to go out on his own and agreed to let him stay in his current job and office until definitive plans were in place. Schultz left Starbucks in late 1985.

### *Schultz's Il Giornale Venture*

With the aid of a lawyer friend who helped companies raise venture capital and go public, Howard Schultz began seeking out investors for the kind of company he had in mind. Ironically, Jerry Baldwin committed to investing \$150,000 of Starbucks' money in Schultz's coffee bar enterprise, thus becoming Schultz's first investor. Baldwin accepted Schultz's invitation to be a director of the new company, and Gordon Bowker agreed to be a part-time consultant for six months. Bowker, pumped up about the new venture, urged Schultz to take pains to make sure that everything about the new stores—the name, the presentation, the care taken in preparing the coffee—be calculated to elevate customer expectations and lead them to expect something better than competitors offered. Bowker proposed that the new company be named *Il Giornale Coffee Company* (pronounced *il jor NAHL ee*), a suggestion that Schultz accepted. In December 1985, Bowker and Schultz made a trip to Italy, where they visited some 500 espresso bars in Milan and Verona, observing local habits, taking notes about decor and menus, snapping photographs, and videotaping baristas in action.

About \$400,000 in seed capital was raised by the end of January 1986, enough to rent an office, hire a couple of key employees, develop a store design, and open the first store. But it took until the end of 1986 to raise the remaining \$1.25 million needed to launch at least eight espresso bars and prove that Schultz's strategy and business model were viable. Schultz made presentations to 242 potential investors, 217 of whom said no. Many who heard Schultz's hour-long presentation saw coffee as a commodity business and thought that Schultz's espresso bar concept lacked any basis for sustainable competitive advantage (no patent on dark roast, no

advantage in purchasing coffee beans, no ways to bar the entry of imitative competitors). Some noted that coffee couldn't be turned into a growth business—consumption of coffee had been declining since the mid-1960s. Others were skeptical that people would pay \$1.50 or more for a cup of coffee, and the company's unpronounceable name turned some off. Being rejected by so many of the potential investors he approached was disheartening (some who listened to Schultz's presentation didn't even bother to call him back; others refused to take his calls). Nonetheless, Schultz maintained an upbeat attitude and displayed passion and enthusiasm in making his pitch. He ended up raising \$1.65 million from about 30 investors; most of the money came from nine people, five of whom became directors.

The first *Il Giornale* store opened in April 1986. It had 700 square feet and was located near the entrance of Seattle's tallest building. The decor was Italian, and there were Italian words on the menu. Italian opera music played in the background. The baristas wore white shirts and bow ties. All service was stand-up—there were no chairs. National and international papers were hung on rods on the wall. By closing time on the first day, 300 customers had been served—mostly in the morning hours. But while the core idea worked well, it soon became apparent that several aspects of the format were not appropriate for Seattle. Some customers objected to the incessant opera music, others wanted a place to sit down, and many did not understand the Italian words on the menu. These "mistakes" were quickly fixed, but an effort was made not to compromise the style and elegance of the store. Within six months, the store was serving more than 1,000 customers a day. Regular customers had learned how to pronounce the company's name. Because most customers were in a hurry, it became apparent that speedy service was essential.

Six months after opening the first store, Schultz opened a second store in another downtown building. A third store was opened in Vancouver, British Columbia, in April 1987. Vancouver was chosen to test the transferability of the company's business concept outside Seattle. Schultz's goal was to open 50 stores in five years, and he needed to dispel his investors' doubts about geographic expansion early on to achieve his growth objective. By mid-1987, sales at the three stores were running at a rate equal to \$1.5 million annually.

## *Il Giornale Acquires Starbucks*

In March 1987 Jerry Baldwin and Gordon Bowker decided to sell the whole Starbucks operation in Seattle—the stores, the roasting plant, and the Starbucks name. Bowker wanted to cash out his coffee business investment to concentrate on his other enterprises; Baldwin, who was tired of commuting between Seattle and San Francisco and wrestling with the troubles created by the two parts of the company, elected to concentrate on the Peet's operation. As he recalls, "My wife and I had a 30-second conversation and decided to keep Peet's. It was the original and it was better."<sup>10</sup>

Schultz knew immediately that he had to buy Starbucks; his board of directors agreed. Schultz and his newly hired finance and accounting manager drew up a set of financial projections for the combined operations and a financing package that included a stock offering to Il Giornale's original investors and a line of credit with local banks. While a rival plan to acquire Starbucks was put together by another Il Giornale investor, Schultz's proposal prevailed—and within weeks Schultz had raised the \$3.8 million needed to buy Starbucks. The acquisition was completed in August 1987. The new name of the combined companies was Starbucks Corporation. Howard Schultz, at the age of 34, became Starbucks' president and CEO.

## **STARBUCKS AS A PRIVATE COMPANY: 1987–1992**

The following Monday morning, Howard Schultz returned to the Starbucks offices at the roasting plant, greeted all the familiar faces, and accepted their congratulations. Then he called the staff together for a meeting on the roasting plant floor:

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>11</sup>

Schultz told the group that his vision was for Starbucks to become a national company with values and guiding principles that employees could be proud of. He indicated that he wanted to include people in the decision-making process and that he would be open and honest with them.

Schultz believed that building a company that valued and respected its people, inspired them, and shared the fruits of success with those who contributed to the company's long-term value was essential, not just an intriguing option. His aspiration was for Starbucks to become the world's most respected brand name in coffee and for the company to be admired for its corporate responsibility. In the next few days and weeks, Schultz came to see that the unity and morale at Starbucks had deteriorated badly in the 20 months he had been at Il Giornale. Some employees were cynical and felt unappreciated. There was a feeling that prior management had abandoned them and a wariness about what the new regime would bring. Schultz decided to make building a new relationship of mutual respect between employees and management a priority.

The new Starbucks had a total of nine stores. The business plan Schultz had presented investors called for the new company to open 125 stores in the next five years—15 the first year, 20 the second, 25 the third, 30 the fourth, and 35 the fifth. Revenues were projected to reach \$60 million in 1992. But the company lacked experienced management. Schultz had never led a growth effort of such magnitude and was just learning what the job of CEO was all about, having been the president of a small company for barely two years. Dave Olsen, a Seattle coffee bar owner Schultz had recruited to direct store operations at Il Giornale, was still learning the ropes in managing a multistore operation. Ron Lawrence, the company's controller, had worked as a controller for several organizations. Other Starbucks employees had only the experience of managing or being a part of a six-store organization. When Starbucks' key roaster and coffee buyer resigned, Schultz put Dave Olsen in charge of buying and roasting coffee. Lawrence Maltz, who had 20 years' experience in business and eight years' experience as president of a profitable public beverage company, was hired as executive vice president and charged with heading operations, finance, and human resources.

In the next several months, a number of changes were instituted. To symbolize the merging of the two



companies and the two cultures, a new logo was created that melded the designs of the Starbucks logo and the Il Giornale logo. The Starbucks stores were equipped with espresso machines and remodeled to look more Italian than Old World nautical. Il Giornale green replaced the traditional Starbucks brown. The result was a new type of store—a cross between a retail coffee-bean store and an espresso bar/café that has now become Starbucks' signature.

By December 1987, the mood of the employees at Starbucks had turned upbeat. They were buying into the changes that Schultz was making and began to trust management. New stores were on the verge of opening in Vancouver and Chicago. One Starbucks store employee, Daryl Moore, who had started working at Starbucks in 1981 and who had voted against unionization in 1985, began to question the need for a union with his fellow employees. Over the next few weeks, Moore began a move to decertify the union. He carried a decertification letter around to Starbucks' stores securing the signatures of employees who no longer wished to be represented by the union. He got a majority of store employees to sign the letter and presented it to the National Labor Relations Board, which then decertified the union representing store employees. Later, in 1992, the union representing Starbucks' roasting plant and warehouse employees was also decertified.

### *Market Expansion Outside the Pacific Northwest*

Starbucks' entry into Chicago proved far more troublesome than management anticipated. The first Chicago store opened in October 1987 and three more stores were opened over the next six months. Customer counts at the stores were substantially below expectations. Chicagoans did not take to dark-roasted coffee as fast as Schultz had anticipated. The first downtown store opened onto the street rather than into the lobby of the building where it was located; in the winter months, customers were hesitant to go out in the wind and cold to acquire a cup of coffee. It was more expensive to supply fresh coffee to the Chicago stores out of the Seattle warehouse (the company solved the problem of freshness and quality assurance by putting freshly roasted beans in special FlavorLock bags that used vacuum packaging techniques with a one-way valve to allow carbon dioxide to escape without allowing air and moisture in). Rents were higher in Chicago than in Seattle,

and so were wage rates. The result was a squeeze on store profit margins. Gradually, customer counts improved, but Starbucks lost money on its Chicago stores until, in 1990, prices were raised to reflect higher rents and labor costs, more experienced store managers were hired, and a critical mass of customers caught on to the taste of Starbucks products.

Portland, Oregon, was the next market Starbucks entered, and Portland coffee drinkers took to its products quickly. By 1991, the Chicago stores had become profitable and the company was ready for its next big market entry. Management decided on California because of its host of neighborhood centers and the receptiveness of Californians to high-quality, innovative food. Los Angeles was chosen as the first California market to enter. L.A. was selected principally because of its status as a trendsetter and its cultural ties to the rest of the country. L.A. consumers embraced Starbucks quickly, and the *Los Angeles Times* named Starbucks as the best coffee in America even before the first area store opened. The entry into San Francisco proved more troublesome because San Francisco had an ordinance against converting stores to restaurant-related uses in certain prime urban neighborhoods; Starbucks could sell beverages and pastries to customers at stand-up counters but could not offer seating in stores that had formerly been used for general retailing. However, the city council was soon convinced by café owners and real estate brokers to change the code. Still, Starbucks faced strong competition from Peet's and local espresso bars in the San Francisco market.

Starbucks' store expansion targets proved easier to meet than Schultz had originally anticipated, and he upped the numbers to keep challenging the organization. Starbucks opened 15 new stores in fiscal 1988, 20 in 1989, 30 in 1990, 32 in 1991, and 53 in 1992—producing a total of 161 stores, significantly above the 1987 objective of 125 stores.

From the outset, the strategy was to open only company-owned stores; franchising was avoided so as to keep the company in full control of the quality of its products and the character and location of its stores. But company ownership of all stores required Starbucks to raise new venture capital to cover the cost of new store expansion. In 1988, the company raised \$3.9 million; in 1990, venture capitalists provided an additional \$13.5 million; and in 1991, another round of venture capital financing generated \$15 million. Starbucks was able to raise the needed funds despite posting losses of \$330,000 in 1987,

\$764,000 in 1988, and \$1.2 million in 1989. While the losses were troubling to Starbucks' board of directors and investors, Schultz's business plan had forecast losses during the early years of expansion. At a particularly tense board meeting where directors sharply questioned Schultz about the lack of profitability, Schultz said:

Look, we're going to keep losing money until we can do three things. We have to attract a management team well beyond our expansion needs. We have to build a world-class roasting facility. And we need a computer information system sophisticated enough to keep track of sales in hundreds and hundreds of stores.<sup>12</sup>

Schultz argued for patience as the company invested in the infrastructure to support continued growth well into the 1990s. He contended that hiring experienced executives ahead of the growth curve, building facilities far beyond current needs, and installing support systems laid a strong foundation for rapid, profitable growth on down the road. His arguments carried the day with the board and with investors, especially since revenues were growing by approximately 80 percent annually and customer traffic at the stores was meeting or exceeding expectations.

Starbucks became profitable in 1990; profits had increased every year since 1990 except for fiscal year 2000 (because of \$58.8 million in investment write-offs in four dot-com enterprises). Exhibit 3 provides a financial and operating summary for 2000–2005. Exhibit 4 shows the performance of the company's stock price. The stock had split 2-for-1 five times. In September 2005, Starbucks' board of directors approved the repurchase of up to 5 million shares of common stock; a total of 35.7 million shares had been repurchased since the company went public.

## HOWARD SCHULTZ'S STRATEGY TO MAKE STARBUCKS A GREAT PLACE TO WORK

Howard Schultz deeply believed that Starbucks' success was heavily dependent on customers having a very positive experience in its stores. This meant having store employees who were knowledgeable about the company's products, who paid attention to

detail in preparing the company's espresso drinks, who eagerly communicated the company's passion for coffee, and who possessed the skills and personality to deliver consistent, pleasing customer service. Many of the baristas were in their 20s and worked part-time, going to college on the side or pursuing other career activities. The challenge to Starbucks, in Schultz's view, was how to attract, motivate, and reward store employees in a manner that would make Starbucks a company that people would want to work for and that would generate enthusiastic commitment and higher levels of customer service. Moreover, Schultz wanted to send all Starbucks employees a message that would cement the trust that had been building between management and the company's workforce.

One of the requests that employees had made to the prior owners of Starbucks was to extend health care benefits to part-time workers. Their request had been turned down, but Schultz believed that expanding health care coverage to include part-timers was the right thing to do. His father had recently passed away with cancer and he knew from his own experience of having grown up in a family that struggled to make ends meet how difficult it was to cope with rising medical costs. In 1988, Schultz went to the board of directors with his plan to expand the company's health care coverage to include part-timers who worked at least 20 hours per week. He saw the proposal not as a generous gesture but as a core strategy to win employee loyalty and commitment to the company's mission. Board members resisted because the company was unprofitable and the added costs of the extended coverage would only worsen the company's bottom line. But Schultz argued passionately that it was the right thing to do and wouldn't be as expensive as it seemed. He observed that if the new benefit reduced turnover, which he believed was likely, then it would reduce the costs of hiring and training—which equaled about \$3,000 per new hire; he further pointed out that it cost \$1,500 a year to provide an employee with full benefits. Part-timers, he argued, were vital to Starbucks, constituting two-thirds of the company's workforce. Many were baristas who knew the favorite drinks of regular customers; if the barista left, that connection with the customer was broken. Moreover, many part-time employees were called upon to open the stores early, sometimes at 5:30 or 6:00 a.m.; others had to work until closing, usually 9:00 p.m. or later. Providing these employees with health care benefits,

he argued, would signal that the company honored their value and contribution.

The board approved Schultz's plan, and part-timers working 20 or more hours were offered the same health coverage as full-time employees starting in late 1988. Starbucks paid 75 percent of an employee's health care premium; the employee paid 25 percent. Over the years, Starbucks extended its health coverage to include preventive care, crisis counseling, dental care, eye care, mental health, and chemical dependency. Coverage was also offered for unmarried

partners in a committed relationship. Since most Starbucks' employees were young and comparatively healthy, the company had been able to provide broader coverage while keeping monthly payments relatively low. The value of Starbucks' health care program struck home when one of the company's store managers and a former barista walked into Schultz's office and told him he had AIDS:

I had known he was gay but had no idea he was sick. His disease had entered a new phase, he explained, and he wouldn't be able to work any longer. We sat

**Exhibit 3 Financial and Operating Summary for Starbucks Corporation, Fiscal Years 2000–2005 (dollars in 000s)**

	Fiscal Years Ending <sup>1</sup>					
	October 2, 2005	October 3, 2004	September 30, 2003	September 29, 2002	September 30, 2001	October 1, 2000
<b>Results of operations data</b>						
Net revenues:						
Retail	\$5,391,927	\$4,457,378	\$3,449,624	\$2,792,904	\$2,229,594	\$1,823,607
Specialty	977,373	836,869	625,898	496,004	419,386	354,007
Total net revenues	\$6,369,300	\$5,294,247	\$4,075,522	\$3,288,908	\$2,648,980	\$2,177,614
Cost of sales and related company costs	2,605,212	2,191,440	1,681,434	1,350,011	1,112,785	961,885
Store operating expenses	2,165,911	1,790,168	1,379,574	1,109,782	867,957	704,898
Other operating expenses	197,024	171,648	141,346	106,084	72,406	78,445
Depreciation and amortization expenses	340,169	289,182	244,671	205,557	163,501	130,232
General and administrative expenses	357,114	304,293	244,550	234,581	179,852	110,202
Income from equity ventures	76,745	59,071	36,903	33,445	27,740	20,300
Operating income	\$ 780,615	\$ 606,587	\$ 420,850	\$ 316,338	\$ 280,219	\$ 212,252
Internet-related investment losses <sup>2</sup>					2,940	58,792
Gain on sale of investment <sup>3</sup>				13,361		
Net earnings	\$ 494,467	\$ 388,973	\$ 265,355	\$ 210,463	\$ 178,794	\$ 94,564
Net earnings per common share—diluted <sup>4</sup>	\$0.61	\$0.49	\$0.34	\$0.54	\$0.46	\$0.24
Cash dividends per share	0	0	0	0	0	0
<b>Balance sheet data</b>						
Current assets	\$1,209,334	\$1,350,895	\$ 924,029	\$ 772,643	\$ 593,925	\$ 459,819
Current liabilities	1,226,996	746,259	608,703	462,595	445,264	313,251
Working capital <sup>5</sup>	(17,662)	604,636	335,767	328,777	165,045	146,568
Total assets	3,514,065	3,386,541	2,776,112	2,249,435	1,807,574	1,491,546
Long-term debt (including current portion)	3,618	4,353	5,076	5,786	6,483	7,168
Shareholders' equity	\$2,090,634	\$2,470,211	\$2,068,689	\$1,712,456	\$1,366,355	\$1,148,399

(Continued)

**Exhibit 3 Continued**

	Fiscal Years Ending <sup>1</sup>					
	October 2, 2005	October 3, 2004	September 30, 2003	September 29, 2002	September 30, 2001	October 1, 2000
<b>Store operations data</b>						
Percentage change in comparable store sales <sup>6</sup>						
United States	9%	11%	9%	7%	5%	9%
International	6	6	7	1	3	12
Consolidated	8	10	8	6	5	9
Systemwide stores opened during the year <sup>7,8</sup>						
United States						
Company-operated stores	574	514	506	503	498	388
Licensed stores	596	417	315	264	268	342
International						
Company-operated stores	161	141	124	117	151	96
Licensed stores	341	272	256	293	291	177
Total	1,672	1,344	1,201	1,177	1,208	1,003
Systemwide stores open at year-end <sup>8</sup>						
United States <sup>9</sup>						
Company-operated stores	4,867	293	3,779	3,209	2,706	2,208
Licensed stores	2,435	1,839	1,422	1,033	769	501
International						
Company-operated stores	1,133	972	831	707	590	411
Licensed stores	1,806	1,465	1,193	937	644	381
Total	10,241	8,569	7,225	5,886	4,709	3,501

<sup>1</sup>The company's fiscal year ends on the Sunday closest to September 30. All fiscal years presented include 52 weeks, except fiscal 2004, which includes 53 weeks.

<sup>2</sup>In fiscal 2000, the company wrote off most of its investment in four ill-fated dot-com businesses. In fiscal 2001, the company wrote off an additional \$2.9 million in Internet-related investments.

<sup>3</sup>On October 10, 2001, the company sold 30,000 of its shares of Starbucks Coffee Japan Ltd. at approximately \$495 per share, net of related costs, which resulted in a gain of \$13.4 million.

<sup>4</sup>Earnings per share data for fiscal years presented above have been restated to reflect the 2-for-1 stock splits in fiscal 2006 and 2001.

<sup>5</sup>Working capital deficit as of October 2, 2005, was primarily due to lower investments from the sale of securities to fund common stock repurchases and increased current liabilities from short-term borrowings under the revolving credit facility.

<sup>6</sup>Includes only Starbucks company-operated retail stores open 13 months or longer. Comparable store sales percentage for fiscal 2004 excludes the extra sales week.

<sup>7</sup>Store openings are reported net of closures.

<sup>8</sup>International store information has been adjusted for the fiscal 2005 acquisitions of licensed operations in Germany, southern China, and Chile by reclassifying historical information from licensed store to company-operated stores.

<sup>9</sup>United States stores open at fiscal 2003 year end included 43 SBC and 21 Torrefazione Italia Company-operated stores and 74 SBC franchised stores.

Source: 10-K reports for 2005, 2004, 2003, 2002, and 2000. Notes reflect 2005 10-K report.

together and cried, for I could not find meaningful words to console him. I couldn't compose myself. I hugged him.

At that point, Starbucks had no provision for employees with AIDS. We had a policy decision.

Because of Jim, we decided to offer health-care coverage to all employees who have terminal illnesses, paying medical costs in full from the time they are not able to work until they are covered by government programs, usually twenty-nine months.

### Exhibit 4 The Performance of Starbucks' Stock, 1992–2005



Source: <http://finance.yahoo.com> (accessed December 28, 2005).

After his visit to me, I spoke with Jim often and visited him at the hospice. Within a year he was gone. I received a letter from his family afterward, telling me how much they appreciated our benefit plan.<sup>13</sup>

In 1994 Howard Schultz was invited to the White House. He met one-on-one with President Bill Clinton to brief him on the Starbucks' health care program.

### The Creation of an Employee Stock Option Plan

By 1991 the company's profitability had improved to the point where Schultz could pursue a stock option plan for all employees, a program he believed would have a positive, long-term effect on the success of Starbucks.<sup>14</sup> Schultz wanted to turn all Starbucks employees into partners, give them a chance to share in the success of the company, and make clear the connection between their contributions and the company's market value. Even though Starbucks was still a private company, the plan that emerged called for granting stock options to all full-time and part-time employees in proportion to their base pay. The plan, dubbed Bean Stock, was presented to the board in May 1991. Though board members were concerned that increasing the number of shares might unduly dilute the value of the shares of investors who had put up hard cash, the plan received unanimous approval. The first grant was

made in October 1991, just after the end of the company's fiscal year in September; each partner was granted stock options worth 12 percent of base pay. Each October since then, Starbucks has granted employees options equal to 14 percent of base pay, awarded at the stock price at the start of the fiscal year (October 1). When the Bean Stock program was presented to employees, Starbucks dropped the term *employee* and began referring to all of its people as *partners* because everyone, including part-timers working at least 20 hours per week, was eligible for stock options after six months. At the end of fiscal year 2004, Starbucks' employee stock option plan included 38.4 million shares in outstanding options; new options for about 9 million shares were being granted annually.<sup>15</sup>

### Starbucks Stock Purchase Plan for Employees

In 1995, Starbucks implemented an employee stock purchase plan. Eligible employees could contribute up to 10 percent of their base earnings to quarterly purchases of the company's common stock at 85 percent of the going stock price. As of fiscal 2005, about 14.8 million shares had been issued since inception of the plan, and new shares were being purchased at a rate close to 1 million shares annually by some 18,800 active employee participants (out of almost 55,100 employees who were eligible to



participate).<sup>16</sup> During fiscal 2004, the U.K. Share Incentive Plan, a new employee stock purchase plan was introduced, discontinuing the original plan established in 2002. As of fiscal 2005, 10,732 shares had been issued.<sup>17</sup>

## *The Workplace Environment*

Starbucks' management believed the company's pay scales (around \$9–\$12 per hour) and fringe benefit package allowed it to attract motivated people with above-average skills and good work habits. Store employees were paid several dollars above the hourly minimum wage. Whereas most national retailers and fast-food chains had turnover rates for store employees ranging from 150 to 400 percent a year, the turnover rates for Starbucks baristas ran about 65 percent. Starbucks' turnover for store managers was about 25 percent, compared to about 50 percent for other chain retailers. Starbucks executives believed that efforts to make the company an attractive, caring place to work were responsible for its relatively low turnover rates. One Starbucks store manager commented, "Morale is very high in my store among the staff. I've worked for a lot of companies, but I've never seen this level of respect. It's a company that's very true to its workers, and it shows. Our customers always comment that we're happy and having fun. In fact, a lot of people ask if they can work here."<sup>18</sup>

Starbucks' management used annual "Partner View" surveys to solicit feedback from the company's

workforce of over 115,000 people worldwide, learn their concerns, and measure job satisfaction. In the latest sample survey of 1,400 employees, 79 percent rated Starbucks' workplace environment favorably relative to other companies they were familiar with, 72 percent reported being satisfied with their present job, 16 percent were neutral, and 12 percent were dissatisfied. But the 2002 survey revealed that many employees viewed the benefits package as only "average," prompting the company to increase its match of 401(k) contributions for those who had been with the company more than three years and to have these contributions vest immediately.

Exhibit 5 contains a summary of Starbucks' fringe benefit program. Starbucks was named by *Fortune* magazine as one of the "100 Best Companies to Work For" in 1998, 1999, 2000, 2002, 2003, 2004, and 2005. In 2005, Starbucks was ranked 11th, up from 34th in 2004. In October 2005, Starbucks had approximately 115,000 employees worldwide, of which 97,500 were in the United States. It had 91,200 employees in its U.S. company-owned stores. Employees at 10 stores in Canada were represented by a union.

## *Starbucks' Corporate Values and Business Principles*

During the early building years, Howard Schultz and other Starbucks' senior executives worked to instill some key values and guiding principles into

### *Exhibit 5* Elements of Starbucks' Fringe Benefit Program

- |   |   |
|---|---|
| • Medical insurance   | • Sick time   |
| • Dental and vision care  | • Paid vacations (first-year workers got one vacation week and two personal days)   |
| • Mental health and chemical dependency coverage                          | • 401(k) retirement savings plan—the company matched from 25% to 150%, based on length of service, of each employee's contributions up to the first 4% of compensation. |
| • Short- and long-term disability   | • Stock purchase plan—eligible employees could buy shares at a discounted price through regular payroll deductions  |
| • Life insurance  | • Free pound of coffee each week  |
| • Benefits extended to committed domestic partners of Starbucks employees | • 30% product discounts   |
| • Stock option plan (Bean Stock)  | • Tuition reimbursement program   |

Source: Compiled by the case researchers from company documents and other sources.

the Starbucks culture. The cornerstone value in the effort “to build a company with soul” was that the company would never stop pursuing the perfect cup of coffee—it would continue buying the best beans and roasting them to perfection. Schultz remained steadfastly opposed to franchising; he wanted the company to be able to control the quality of its products and build a culture common to all stores. He was adamant about not selling artificially flavored coffee beans: “We will not pollute our high-quality beans with chemicals.” If a customer wanted hazelnut-flavored coffee, Starbucks would add hazelnut syrup to the drink, rather than adding hazelnut flavoring to the beans during roasting. Running flavored beans through the grinders would result in chemical residues being left behind to alter the flavor of beans ground afterward; plus, the chemical smell given off by artificially flavored beans was absorbed by other beans in the store. Furthermore, Schultz didn’t want the company to pursue supermarket sales because it would mean pouring Starbucks’ beans into clear plastic bins where they could get stale, thus compromising the company’s legacy of fresh, dark-roasted, full-flavored coffee.

Starbucks’ management was also emphatic about the importance of employees paying attention to what pleased customers. Employees were trained to go out of their way—even to take heroic measures if necessary—to make sure customers were fully satisfied. The theme was “Just say yes” to customer requests. Further, employees were encouraged to speak their minds without fear of retribution from upper management—senior executives wanted employees to be straight with them, verbalizing what Starbucks was doing right, what it was doing wrong, and what changes were needed. Management wanted employees to be involved in and contribute to the process of making Starbucks a better company.

A values-and-principles crisis arose at Starbucks in 1989 when customers started requesting nonfat (skim) milk in making cappuccinos and lattes. Howard Schultz, who read all customer comments cards, and Dave Olsen, head of coffee quality, conducted taste tests of lattes and cappuccinos made with nonfat milk and concluded they were not as good as those made with whole milk. Howard Behar, recently hired as head of retail store operations, indicated that management’s opinions didn’t matter; what mattered was giving customers what they wanted.

Schultz said, “We will never offer nonfat milk. It’s not who we are.” Behar, however, stuck to his guns, maintaining that use of nonfat milk should at least be tested—otherwise, it appeared as if all the statements management had made about the importance of really and truly pleasing customers were a sham. A fierce internal debate ensued. One dogmatic defender of the quality and taste of Starbucks’ coffee products buttonholed Behar outside his office and told him that using nonfat milk amounted to “bastardizing” the company’s products. Numerous store managers maintained that offering two kinds of milk was operationally impractical. Schultz found himself in a quandary, torn between the company’s commitment to quality and its goal of pleasing customers. Then, one day after visiting one of the stores in a residential neighborhood and watching a customer leave to go to a competitor’s store because Starbucks did not make lattes with nonfat milk, Schultz authorized Behar to begin testing.<sup>19</sup> Within six months, all 30 stores were offering drinks made with nonfat milk. Currently, about half the lattes and cappuccinos Starbucks sells are made with nonfat milk.

Schultz’s approach to offering employees good compensation and a comprehensive benefits package was driven by his belief that sharing the company’s success with the people who made it happen helped everyone think and act like an owner, build positive long-term relationships with customers, and do things efficiently. He had vivid recollection of his father’s employment experience—bouncing from one low-paying job to another, working for employers who offered few or no benefits and who conducted their business with no respect for the contributions of the workforce—and he had no intention of Starbucks being that type of company. He vowed that he would never let Starbucks employees suffer a similar fate, saying:

My father worked hard all his life and he had little to show for it. He was a beaten man. This is not the American dream. The worker on our plant floor is contributing great value to the company; if he or she has low self-worth, that will have an effect on the company.<sup>20</sup>

The company’s employee benefits program was predicated on the belief that better benefits attract good people and keep them longer. Schultz’s rationale, based on his father’s experience of going from one low-wage, no-benefits job to another, was that if

you treat your employees well, they in turn will treat customers well.

## STARBUCKS' MISSION STATEMENT

In early 1990, the senior executive team at Starbucks went to an off-site retreat to debate the company's values and beliefs and draft a mission statement. Schultz wanted the mission statement to convey a strong sense of organizational purpose and to articulate the company's fundamental beliefs and guiding principles. The draft was submitted to all employees for review and several changes were made based on employee comments. The resulting mission statement, which remained unchanged in 2005, is shown in Exhibit 6.

Following adoption of the mission statement, Starbucks' management implemented a "Mission Review" to solicit and gather employee opinions as to whether the company was living up to its stated mission. Employees were urged to report their concerns to the company's Mission Review team if they thought particular management decisions were not supportive of the company's mission statement. Comment cards were given to each newly hired employee and were kept available in common areas with other employee forms. Employees had the option of signing the comment cards or not. Hundreds of cards were submitted to the Mission Review team each year. The company promised that a relevant manager would respond to all signed cards within two weeks. Howard Schultz reviewed all the comments, signed and unsigned.

## STARBUCKS' STORE EXPANSION STRATEGY

In 1992 and 1993 Starbucks developed a three-year geographic expansion strategy that targeted areas that not only had favorable demographic profiles but also could be serviced and supported by the company's operations infrastructure. For each targeted region, Starbucks selected a large city to serve as a hub; teams of professionals were located in hub cities to support the goal of opening 20 or more stores in the hub in the first two years. Once stores blanketed the hub, then additional stores were opened in smaller, surrounding spoke areas in the region. To oversee the expansion process, Starbucks created zone vice presidents to direct the development of each region and to implant the Starbucks culture in the newly opened stores. All of the new zone vice presidents Starbucks recruited came with extensive operating and marketing experience in chain store retailing.

Starbucks' strategy in major metropolitan cities was to blanket the area with stores, even if some stores cannibalized another store's business.<sup>21</sup> While a new store might draw 30 percent of the business of an existing store two or so blocks away, management believed its "Starbucks everywhere" approach cut down on delivery and management costs, shortened customer lines at individual stores, and increased foot traffic for all the stores in an area.

In 2002, new stores generated an average of \$1.2 million in first-year revenues, compared to \$700,000 in 1995 and only \$427,000 in 1990. The steady increases in new-store revenues were due partly to growing popularity of premium coffee drinks and

### Exhibit 6 Starbucks' Mission Statement

Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles while we grow.

The following six guiding principles will help us measure the appropriateness of our decisions:

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

partly to Starbucks' growing reputation. In more and more instances, Starbucks' reputation reached new markets even before stores opened. Moreover, existing stores continued to post sales gains in the range of 2–10 percent annually. In 2005, Starbucks posted same-store sales increases averaging 8 percent (refer back to Exhibit 3), the 14th consecutive year the company had achieved sales growth of 5 percent or greater at existing stores. Starbucks' revenues had climbed an average of 20 percent annually since 1992.

One of Starbucks' core competencies was identifying good retailing sites for its new stores. The company was regarded as having the best real estate team in the coffee bar industry and a sophisticated system for identifying not only the most attractive individual city blocks but also the exact store location that was best; it also worked hard at building good relationships with local real estate representatives in areas where it was opening multiple store locations. The company's site location track record was so good that, as of 1997, it had closed only 2 of the 1,500 sites it had opened; its track record in finding successful store locations was still intact as of 2005 (although specific figures were not available).

## *International Expansion*

In markets outside the continental United States (including Hawaii), Starbucks had a two-pronged store expansion plan: Either open company-owned and company-operated stores, or else license a reputable and capable local company with retailing know-how in the target host country to develop and operate new Starbucks stores. In most countries, Starbucks used a local partner/licensee to help it recruit talented individuals, set up supplier relationships, locate suitable store sites, and cater to local market conditions. Starbucks looked for partners/licensees that had strong retail/restaurant experience, had values and a corporate culture compatible with Starbucks', were committed to good customer service, possessed talented management and strong financial resources, and had demonstrated brand-building skills.

Starbucks had created a new subsidiary, Starbucks Coffee International, to orchestrate overseas expansion and begin to build the Starbucks brand name globally via licensees. (Refer back to Exhibit 1 for the number of licensed international stores in

each country.) Starbucks' management expected to have a total of 10,000 stores in 60 countries by the end of 2005. As of August 2005, Starbucks was located in 34 countries, with 1,049 company-operated stores and 1,734 licensed locations outside the United States. The company's first store in France opened in early 2004 in Paris. China was expected to be Starbucks' biggest market outside the United States in the years to come. Thus far, Starbucks' products were proving to be a much bigger hit with consumers in Asia than in Europe. In 2003, the Starbucks Coffee International division was only marginally profitable, with pretax earnings of only \$3.8 million on sales of \$603 million. However, the profitability picture improved in 2004, with pretax profits rising to \$51.7 million on sales of \$803 million. And it did even better in fiscal 2005, with pretax earnings of \$86.4 million on sales of \$1.03 billion.

So far, Starbucks had avoided franchising, preferring licensing because it permitted tighter controls over the operations of licensees. Often, Starbucks opened foreign stores as a minority partner with local companies. In 2005, Starbucks assumed 100 percent equity ownership of previously licensed operations in Germany and Chile (where it had been a 20 percent equity partner), and it boosted its ownership of stores in southern China from 20 percent to 51 percent.

In May 2005, Starbucks announced the first step into expanding its consumer products channel in the South Pacific region by launching the sales of its Frappuccino line in Japan and Taiwan. The combined ready-to-drink markets in these countries represented more than \$10 billion in annual sales.<sup>22</sup> Marketing of Frappuccino products also began in South Korea through agreements with leading local distributors; the ready-to-drink coffee segment in South Korea represented \$320 million in annual consumer sales.<sup>23</sup>

## *Employee Training and Recognition*

To accommodate its strategy of rapid store expansion, Starbucks put in systems to recruit, hire, and train baristas and store managers. Starbucks' vice president for human resources used some simple guidelines in screening candidates for new positions, "We want passionate people who love coffee . . . We're looking for a diverse workforce, which



reflects our community. We want people who enjoy what they're doing and for whom work is an extension of themselves."<sup>24</sup>

Every partner/barista hired for a retail job in a Starbucks store received at least 24 hours training in his or her first two to four weeks. The topics included classes on coffee history, drink preparation, coffee knowledge (four hours), customer service (four hours), and retail skills, plus a four-hour workshop titled "Brewing the Perfect Cup." Baristas spent considerable time learning about beverage preparation—grinding beans, steaming milk, learning to pull perfect (18- to 23-second) shots of espresso, memorizing the recipes of all the different drinks, practicing making the different drinks, and learning how to customize drinks to customer specifications. There were sessions on operating the cash register, cleaning the milk wand on the espresso machine, explaining the Italian drink names to unknowing customers, selling home espresso machines, making eye contact with customers, and taking personal responsibility for the cleanliness of the store. Everyone was drilled in the Star Skills, three guidelines for on-the-job interpersonal relations: (1) maintain and enhance self-esteem, (2) listen and acknowledge, and (3) ask for help. And there were rules to be memorized: Milk must be steamed to at least 150 degrees Fahrenheit but never more than 170 degrees; every espresso shot not pulled within 23 seconds must be tossed; never let coffee sit in the pot more than 20 minutes; always compensate dissatisfied customers with a Starbucks coupon that entitles them to a free drink.

In response to feedback through 2003 Partner View Survey, Starbucks expanded its training and career development offerings by adding the following:<sup>25</sup>

*Coffee Masters Program:* A set of courses in which partners deepen their coffee knowledge and expertise. More than 7,000 partners have taken advantage of this training either partially or fully.

*Servant Leadership Workshop:* A workshop that emphasizes trust, collaboration, people development, and ethics. Approximately 6,200 partners attended this workshop.

*Career Power and Career Power for Coaches Workshop:* A workshop designed to provide partners and their managers with an opportunity to reflect on their personal values,

career dreams, and development through coaching and feedback. More than 200 partners in Seattle attended the workshop.

Management trainees attended classes for 8 to 12 weeks. Their training covered not only the coffee knowledge and information imparted to baristas but also the details of store operations, practices and procedures as set forth in the company's operating manual, information systems, and the basics of managing people. Starbucks' trainers were all store managers and district managers with on-site experience. Among their major objectives were to ingrain the company's values, principles, and culture and to pass on their knowledge about coffee and their passion about Starbucks.

When Starbucks opened stores in a new market, it launched a major recruiting effort. Eight to 10 weeks before opening a store, the company placed ads to hire baristas and begin their training. It sent a Star team of experienced managers and baristas from existing stores to the area to lead the store-opening effort and to conduct one-on-one training following the company's formal classes and basic orientation sessions at the Starbucks Coffee School in San Francisco.

To recognize the partner contributions, Starbucks had created 19 different awards programs ranging from frequent awards to high-level cash awards. Some of the high-level awards included Manager of the Quarter for store manager leadership, Green Apron Awards for outstanding customer service, and Green Bean Awards for exceptional support for company's environmental mission.

## *Real Estate, Store Design, Store Planning, and Construction*

Starting in 1991, Starbucks created its own in-house team of architects and designers to ensure that each store would convey the right image and character. Stores had to be custom-designed because the company didn't buy real estate and build its own free-standing structures like McDonald's or Wal-Mart; rather, each space was leased in an existing structure, making each store differ in size and shape. Most stores ranged in size from 1,000 to 1,500 square feet and were located in office buildings, downtown and suburban retail centers, airport terminals, university campus areas, and busy neighborhood shopping



areas convenient for pedestrian foot traffic and/or drivers. Only a select few were in suburban malls.

Over the years, Starbucks had experimented with a broad range of store formats. Special seating areas were added to help make Starbucks a desirable gathering place where customers could meet and chat or simply enjoy a peaceful interlude in their day. Flagship stores in high-traffic, high-visibility locations had fireplaces, leather chairs, newspapers, couches, and lots of ambience. The company also experimented with drive-through windows in locations where speed and convenience were important to customers and with kiosks in supermarkets, building lobbies, and other public places.

A “stores of the future” project team was formed in 1995 to raise Starbucks’ store design to a still higher level and come up with the next generation of Starbucks stores. The vision of what a Starbucks store should be like included such concepts as an authentic coffee experience that conveyed the artistry of espresso making, a place to think and imagine, a spot where people could gather and talk over a great cup of coffee, a comforting refuge that provided a sense of community, a third place for people to congregate beyond work or the home, a place that welcomes people and rewards them for coming, and a layout that could accommodate both fast service and quiet moments. The team researched the art and literature of coffee throughout the ages, studied coffee-growing and coffeemaking techniques, and looked at how Starbucks’ stores had already evolved in terms of design, logos, colors, and mood. The team came up with four store designs—one for each of the four stages of coffeemaking: growing, roasting, brewing, and aroma—each with its own color combinations, lighting scheme, and component materials. Within each of the four basic store templates, Starbucks could vary the materials and details to adapt to different store sizes and settings (downtown buildings, college campuses, neighborhood shopping areas). In late 1996, Starbucks began opening new stores based on one of four formats and color schemes. But as the number of stores increased rapidly in 2000–2003, greater store diversity and layout quickly became necessary. Exhibit 7 shows the diverse nature of Starbucks stores.

To better control average store opening costs, the company centralized buying, developed standard contracts and fixed fees for certain items, and consolidated work under those contractors who displayed good cost control practices. The retail

operations group outlined exactly the minimum amount of equipment each core store needed so that standard items could be ordered in volume from vendors at 20 to 30 percent discounts, then delivered just-in-time to the store site either from company warehouses or the vendor. Modular designs for display cases were developed. And the whole store layout was developed on a computer, with software that allowed the costs to be estimated as the design evolved. All this cut store opening costs significantly and reduced store development time from 24 to 18 weeks.

In August 2002, Starbucks teamed up with T-Mobile USA, the largest U.S. carrier-owned Wi-Fi service, to experiment with providing Internet access capability and enhanced digital entertainment to patrons at over 1,200 Starbucks locations. The objective was to heighten the “third-place” Starbucks experience, entice customers into perhaps buying a second latte or espresso while they caught up on e-mail, listened to digital music, put the finishing touches on a presentation, or accessed their corporate intranet. Since the August 2002 introduction of Wi-Fi at Starbucks, wireless Internet service had been added at over 1,700 more stores. Internal research showed that the average connection lasted approximately 45 minutes and that more than 90 percent of accesses were during the off-peak store hours.

During the early start-up years, Starbucks avoided debt and financed new stores entirely with equity capital. But as the company’s profitability improved and its balance sheet strengthened, Schultz’s opposition to debt as a legitimate financing vehicle softened. In 1996 the company completed its second debt offering, netting \$161 million from the sale of convertible debentures for use in its capital construction program. This debt was successfully converted into common stock in 1997. Over the next eight years, strong internal cash flows allowed Starbucks to finance virtually all of its store expansion with internal funds; in 2005, the company had less than \$3 million in long-term debt on its balance sheet despite having \$1.8 billion in net investment in facilities and equipment, but it did have long-term liabilities of \$193.6 million associated with lease obligations at its stores.

## *Store Ambience*

Starbucks management viewed each store as a billboard for the company and as a contributor to

*Exhibit 7* Scenes from Starbucks Stores





building the company's brand and image. Each detail was scrutinized to enhance the mood and ambience of the store, to make sure everything signaled "best-of-class" and reflected the personality of the community and the neighborhood. The thesis was "Everything matters." The company went to great lengths to make sure the store fixtures, the merchandise displays, the colors, the artwork, the banners, the music, and the aromas all blended to create a consistent, inviting, stimulating environment that evoked the romance of coffee, that signaled the company's passion for coffee, and that rewarded customers with ceremony, stories, and surprise. Starbucks was recognized for its sensitivity to neighborhood conservation with the Scenic America's award for excellent design and "sensitive reuse of spaces within cities."

To try to keep the coffee aromas in the stores pure, Starbucks banned smoking and asked employees to refrain from wearing perfumes or colognes. Prepared foods were kept covered so that customers would smell coffee only. Colorful banners and posters in tune with seasons and holidays kept the look of Starbucks stores fresh. Company designers came up with artwork for commuter mugs and T-shirts in different cities that were in keeping with each city's personality (peach-shaped coffee mugs for Atlanta, pictures of Paul Revere for Boston and the Statue of Liberty for New York). To make sure that Starbucks' stores measured up to standards, the company used "mystery shoppers" who posed as customers and rated each location on a number of criteria.

## THE PRODUCT LINE AT STARBUCKS

Starbucks stores offered a choice of regular or decaffeinated coffee beverages, a special "coffee of the day," and an assortment of made-to-order Italian-style hot and cold espresso drinks. In addition, customers could choose from a wide selection of fresh-roasted whole-bean coffees (which could be ground or not on the premises for take-home in distinctive packages), fresh pastries, juices, hot and iced teas, coffeemaking equipment, coffee mugs and other accessories, and music CDs. From time to time, stores ran special promotions touting the company's special Christmas Blend coffee, shade-grown coffee from Mexico, organically grown coffees, and various

rare and exotic coffees from across the world. In 2003, Starbucks began offering customers a choice of using its exclusive Silk soymilk specifically designed to accentuate its handcrafted beverages using espresso roast coffee and Tazo chai teas; the organic, kosher soymilk appealed to some customers as a substitute for milk or skim milk in various coffee and tea beverages.

The company's retail sales mix in 2005 was 77 percent beverages, 15 percent food items, 4 percent whole-bean coffees, and 4 percent coffeemaking equipment and accessories.<sup>26</sup> The product mix in each store varied, depending on the size and location of each outlet. Larger stores carried a greater variety of whole coffee beans, gourmet food items, teas, coffee mugs, coffee grinders, coffeemaking equipment, filters, storage containers, and other accessories. Smaller stores and kiosks typically sold a full line of coffee beverages, a limited selection of whole-bean coffees, and a few hardware items.

The idea for selling music CDs (which, in some cases, were special compilations that had been put together for Starbucks to use as store background music) originated with a Starbucks store manager who had worked in the music industry and selected the new "tape of the month" Starbucks played as background in its stores. He had gotten compliments from customers wanting to buy the music they heard and suggested to senior executives that there was a market for the company's music tapes. Research through two years of comment cards turned up hundreds asking Starbucks to sell the music it played in its stores. The Starbucks CDs proved a significant seller and addition to the product line; some of the CDs were specifically collections designed to tie in with new blends of coffee that company was promoting. Starbucks had also co-produced a Ray Charles CD, *Genius Loves Company*, which became a multiplatinum album with significant sales from Starbucks stores.

In 2000, Starbucks acquired Hear Music, a San Francisco-based company, to give it added capability in enhancing its music CD offerings. In 2004, Starbucks introduced Hear Music media bars, a service that offered custom CD burning at select Starbucks stores, and it opened several Starbucks Hear Music Coffeehouses—a first-of-its-kind coffee and music establishment where customers could enjoy a freshly brewed cup of coffee while downloading music from the company's 200,000-plus song library

and, if they wished, have the downloaded songs burned onto a CD for purchase.

In 2005, in an average week, an estimated 30 million-plus customers patronized Starbucks, up from about 5 million in 1998. U.S. stores did about half of their business by 11:00 a.m. Loyal customers patronized a Starbucks store 15 to 20 times a month, spending perhaps \$50–\$75 monthly. Some customers were Starbucks fanatics, coming in daily. Baristas became familiar with regular customers, learning their names and their favorite drinks. Christine Nagy, a field director for Oracle Corporation in Palo Alto, California, told a *Wall Street Journal* reporter, “For me, it’s a daily necessity or I start getting withdrawals.”<sup>27</sup> Her standard order was a custom drink: a decaf grande nonfat no- whip no-foam extra-cocoa mocha; when the barista saw her come through the door, she told the reporter, “They just say ‘We need a Christine here.’” Since the inception of Starbucks Cards in 2001, 52 million Starbucks customers had purchased the reloadable cards that allowed them to pay for their purchases with a quick swipe at the cash register and also to earn and redeem rewards. The use of Starbucks Cards was a growing means of payment in Starbucks stores. In fiscal 2004, the company reached approximately \$1 billion in total life-to-date activations and reloads on Starbucks cards. Due to its success in the United States the Starbucks Card was being launched internationally, with the initial rollouts starting in Japan and Greece.

In the fall of 2003, Starbucks, in partnership with Bank One, introduced the Duetto Visa card, which added Visa card functionality to the reloadable Starbucks Cards. By charging purchases to the Visa account of their Duetto card anywhere Visa credit cards were accepted, cardholders earned 1 percent back in Duetto Dollars, automatically loaded on their Starbucks card account after each billing cycle. Duetto Dollars could be used to purchase beverages, food, and store merchandise at any Starbucks location. The Duetto card was an example of the ongoing effort by Starbucks’ management to introduce new products and experiences for customers that belonged exclusively to Starbucks; senior executives drummed the importance of always being open to re-inventing the Starbucks experience.

So far, Starbucks had spent very little money on advertising, preferring instead to build the brand cup-by-cup with customers via word of mouth and the appeal of its storefronts. The company spent a

total of \$87.7 million on advertising in fiscal 2005, up from \$49.6 million in fiscal 2003.

## *Joint Ventures and Acquisitions*

In 1994, after months of meetings and experimentation, PepsiCo and Starbucks entered into a joint venture to create new coffee-related products for mass distribution through Pepsi channels, including cold coffee drinks in a bottle or can. Howard Schultz saw this as a major paradigm shift with the potential to cause Starbucks’ business to evolve in heretofore unimaginable directions; he thought it was time to look for ways to move Starbucks out into more mainstream markets. Cold coffee products had historically met with poor market reception, except in Japan, where there was an \$8 billion market for ready-to-drink coffee-based beverages. Nonetheless, Schultz was hoping the partners would hit upon a new product to exploit a good-tasting coffee extract that had been developed by Starbucks’ recently appointed director of research and development. The joint venture’s first new product, Mazagran, a lightly flavored carbonated coffee drink, was a failure; a market test in southern California showed that some people liked it and some hated it. While people were willing to try it the first time, partly because the Starbucks name was on the label, repeat sales proved disappointing. Despite the clash of cultures and the different motivations of PepsiCo and Starbucks, the partnership held together because of the good working relationship that evolved between Howard Schultz and Pepsi’s senior executives. Then Schultz, at a meeting to discuss the future of Mazagran, suggested, “Why not develop a bottled version of Frappuccino?”<sup>28</sup> Starbucks had come up with Frappuccino in the summer of 1995, and the cold coffee drink had proved to be a big hot-weather seller; Pepsi executives were enthusiastic. After months of experimentation, the joint venture product research team came up with a shelf-stable version of Frappuccino that tasted quite good. It was tested in West Coast supermarkets in the summer of 1996; sales ran 10 times projections, with 70 percent being repeat business. Sales of Frappuccino reached \$125 million in 1997 and achieved national supermarket penetration of 80 percent. Starbucks’ management believed that the market for Frappuccino would ultimately exceed \$1 billion.

In October 1995 Starbucks partnered with Dreyer’s Grand Ice Cream to supply coffee extract for

a new line of coffee ice cream made and distributed by Dreyer's under the Starbucks brand. The new line, featuring such flavors as Dark Roast Espresso Swirl, JavaChip, Vanilla MochaChip, Biscotti Bliss, and Caffè Almond Fudge, hit supermarket shelves in April 1996, and by July 1996 Starbucks' coffee-flavored ice cream was the top-selling superpremium brand in the coffee segment. In 1997, two new low-fat flavors were added to complement the original six flavors, along with two flavors of ice cream bars; all were well received in the marketplace.

The partnerships with Pepsi and Dreyer's produced about \$20 million in revenues for Starbucks in fiscal 2005 (equal to about 2 percent of total specialty sales).

In 2004, Starbucks teamed with Jim Beam Brands to invent a Starbucks Coffee Liqueur that would be sold in bars, liquor stores, and restaurants; projections were for systemwide gross sales of over \$8 million annually. Launched in February 2005, Starbucks Coffee Liqueur was the top-selling new spirit product through August 2005, according to Nielsen. In October 2005, again collaborating with Jim Beam Brands, Starbucks introduced Starbucks Cream Liqueur, a blend of cream, spirits, and a hint of Starbucks coffee. With 22 million cordial consumers in the U.S. market, the cream liqueur category was nearly three times the size of coffee liqueur category. Both Starbucks Coffee Liqueur and Starbucks Cream Liqueur were packaged in a 750-milliliter bottle priced at \$22.99.

In April 2005, Starbucks purchased Ethos Water for \$8 million in cash. The acquisition was made to expand the line of beverages in Starbucks' stores in the United States.

## *Licensed Stores and Specialty Sales*

Starbucks had a licensing agreement with Kraft Foods to market and distribute Starbucks whole-bean and ground coffees in grocery and mass-merchandise channels across the United States. Kraft managed all distribution, marketing, advertising, and promotions and paid a royalty to Starbucks based on a percentage of net sales. The coffee that Starbucks sold in supermarkets featured distinctive, elegant packaging, prominent positions in grocery aisles, and the same premium quality as that it sold in its stores. Product freshness was guaranteed by Starbucks' FlavorLock packaging, and the price per pound paralleled the

prices in Starbucks' retail stores. Flavor selections in supermarkets were more limited than those at Starbucks stores. Going into 2006, Starbucks coffees were available in some 31,300 grocery and warehouse clubs (such as Sam's and Costco) with 30,000 in the United States and 1,300 in the international markets. Revenues from this category comprised 24 percent of specialty revenues in fiscal 2005.

Starbucks executives recognized that supermarket distribution entailed several risks, especially in exposing Starbucks to first-time customers. Starbucks had built its reputation around the unique retail experience in its stores where all beverages were properly prepared—it had no control over how customers would perceive Starbucks when they encountered it in grocery aisles. A second risk concerned coffee preparation at home. Rigorous quality control and skilled baristas ensured that store-purchased beverages would measure up, but consumers using poor equipment or inappropriate brewing methods could easily conclude that Starbucks packaged coffees did not live up to their reputation.

Starbucks had also entered into a limited number of licensing agreements for store locations in areas where it did not have ability to locate its own outlets. The company had an agreement with Marriott Host International that allowed Host to operate Starbucks retail stores in airport locations, and it had an agreement with Aramark Food and Services to put Starbucks stores on university campuses and other locations operated by Aramark. Starbucks received a license fee and a royalty on sales at these locations and supplied the coffee for resale in the licensed locations. All licensed stores had to follow Starbucks' detailed operating procedures, and all managers and employees who worked in these stores received the same training given to Starbucks managers and store employees. As of 2005, there were 2,435 licensed or franchised stores in the United States and 1,806 licensed stores in other countries. Licensing revenues increased from \$241 million in fiscal 2001 to \$673 million in fiscal 2005; domestic stores accounted for \$515 million of the revenues from licensing in 2005.

Starbucks had a specialty sales group that provided its coffee products to restaurants, airlines, hotels, universities, hospitals, business offices, country clubs, and select retailers. One of the early users of Starbucks coffee was Horizon Airlines, a regional carrier based in Seattle. In 1995, Starbucks entered into negotiations with United Airlines to serve Starbucks coffee on all United flights. There was much internal debate at Starbucks about whether such



a move made sense for Starbucks and the possible damage to the integrity of the Starbucks brand if the quality of the coffee served did not measure up (since there was different coffeemaking equipment on different planes). It took seven months of negotiations for Starbucks and United to arrive at a mutually agreeable way to handle quality control on United's various types of planes.

In recent years, the specialty sales group had won the coffee accounts at Hyatt, Hilton, Sheraton, Radisson, and Westin hotels, resulting in packets of Starbucks coffee being in each room with coffee-making equipment. Starbucks had entered into an agreement with Wells Fargo to provide coffee service at some of the bank's locations in California. A 1997 agreement with U.S. Office Products gave Starbucks an entrée to provide its coffee to workers in 1.5 million business offices. In addition, Starbucks supplied an exclusive coffee blend to Nordstrom's for sale only in Nordstrom stores, operated coffee bars in Barnes & Noble bookstores, and, most recently, had begun coffee bar operations in Chapters bookstores (Chapters was a Toronto book retailer that had sites throughout Canada) and Borders bookstores that had cafés. Starbucks also had an alliance with SYSCO Corporation to service the majority of its food-service and restaurant accounts. In fiscal 2005, Starbucks was supplying its coffees to 15,500 food-service accounts worldwide, producing fiscal 2005 revenues of \$304 million, up from \$179 million in 2001.

Other Starbucks initiatives included a 24-hour Starbucks Hear Music digital music channel available to all XM satellite radio subscribers and the availability of wireless broadband Internet service in company-owned stores in the United States and Canada. Collectively, these other initiatives accounted for 3 percent of specialty revenue in fiscal 2005.

Starbucks experimented with a mail order catalog and with online sales at its Web site, but it discontinued those operations in 2003 when sales fell off (chiefly because of the growing availability of Starbucks coffees in supermarkets and the company's expanding number of store locations).

## STARBUCKS COFFEE PURCHASING STRATEGY

Starbucks personnel traveled regularly to coffee-producing countries—Colombia, Sumatra, Yemen,

Antigua, Indonesia, Guatemala, New Guinea, Costa Rica, Sulawesi, Papua, Kenya, Ethiopia, Java, and Mexico—building relationships with growers and exporters, checking on agricultural conditions and crop yields, and searching out varieties and sources that would meet Starbucks' exacting standards of quality and flavor. The coffee-purchasing group, working with personnel in roasting operations, tested new varieties and blends of beans from different sources.

Coffee was grown in 70 tropical countries and was the second-most-traded commodity in the world after petroleum. The global value of the 2000–2001 coffee bean crop was about \$5.6 billion. By World Bank estimates, some 25 million small farmers made their living growing coffee. Commodity-grade coffee, which consisted of robusta and commercial quality arabica beans, was traded in a highly competitive market as an undifferentiated product. Coffee prices were subject to considerable volatility due to weather, economic and political conditions in the growing countries, new agreements establishing export quotas, and periodic efforts to bolster prices by restricting coffee supplies. Starbucks used fixed-price purchase commitments to limit its exposure to fluctuating coffee prices in upcoming periods and, on occasion, purchased coffee futures contracts to provide price protection. In years past, there had been times when unexpected jumps in coffee prices had put a squeeze on Starbucks' margins, forcing an increase in the prices of the beverages and beans sold at retail.

Starbucks sourced approximately 50 percent of its beans from Latin America, 35 percent from the Pacific Rim, and 15 percent from East Africa. Sourcing from multiple geographic areas not only allowed Starbucks to offer a greater range of coffee varieties to customers but also spread the company's risks regarding weather, price volatility, and changing economic and political conditions in coffee-growing countries.

During 2002, a global oversupply of more than 2 billion pounds drove the prices of commodity coffees to historic lows of \$0.40–\$0.50 per pound. The specialty coffee market, which represented about 10 percent of worldwide production, consisted primarily of high-quality arabica beans. Prices for specialty coffees were determined by the quality and flavor of the beans and were almost always higher than prevailing prices for commodity-grade coffee beans. Starbucks purchased only high-quality arabica coffee beans, paying an average of \$1.20 per pound in 2004. Its purchases represented about 1 percent of the world's coffee bean crop. The company's green coffee costs

reached a historic low in 2002 and had gradually increased since then. Given the price volatility risk, the company entered into fixed-price purchase commitments in order to secure an adequate supply of quality green coffee. As of October 2005, the company had over \$375 million in fixed-price purchase commitments, which along with existing inventory was expected to provide an adequate supply of green coffee through fiscal 2006.<sup>29</sup>

Believing that the continued growth and success of its business depended on gaining access to adequate supplies of high-quality coffees year-in and year-out, Starbucks had been a leader in promoting environmental and social stewardship in coffee-origin countries. Starbucks' coffee sourcing strategy was to contribute to the sustainability of coffee growers and help conserve the environment. In sourcing green coffee beans, Starbucks was increasingly dealing directly with farmers and cooperatives, and its policy was to pay prices high enough to ensure that small coffee growers, most of whom lived on the edge of poverty, were able to cover their production costs and provide for their families. About 40 percent of Starbucks purchases were made under three-to five-year contracts, which management believed enabled the company to purchase its future coffee bean requirements at predictable prices over multiple crop years. Coffee purchases negotiated through long-term contracts increased from 3 percent in 2001 to 36 percent in 2002. Farmers who met important quality, environmental, social, and economic criteria, which Starbucks had developed with the support of Conservation International's Center for Environmental Leadership in Business, were rewarded with financial incentives and preferred supplier status. In fiscal 2004, the company opened its Farmer Support Center in Costa Rica to support existing and potential Starbucks coffee suppliers and their communities.

Starbucks had \$375 million in fixed-price purchase commitments in October 2005 but was not planning to increase this commitment in the near future due to a significant jump in the prices of green coffee beans (in some cases the going prices for green beans were above the fixed purchase prices). The high commodity prices for coffee beans made farmers less willing to enter into fixed-price arrangements.

### *Fair Trade Certified Coffee*

A growing number of small coffee growers were members of democratically run cooperatives that were registered with the Fair Trade Labeling Organi-

zations International; these growers could sell their beans directly to importers, roasters, and retailers at favorable guaranteed "Fair Trade" prices. The idea behind guaranteed prices for Fair Trade coffees was to boost earnings for small coffee growers enough to allow them to afford basic health care, education, and home improvements. Starbucks marketed Fair Trade Certified coffee at most of its retail stores and through other locations that sold Starbucks coffees. In October 2005, Starbucks introduced Café Estima Blend Fair Trade Certified Coffee as the coffee of the week to support Fair Trade Month 2005. Starbucks expected to purchase 10 million pounds of Fair Trade Certified coffee in 2005, and it planned to purchase 12 million pounds in 2006.

### *Environmental Best Practices*

Since 1998, Starbucks had partnered with Conservation International to promote coffee cultivation methods that protected biodiversity and maintained a healthy environment. A growing percentage of the coffees that Starbucks purchased were grown "organically" without the use of pesticides, herbicides, or chemical fertilizers; organic cultivation methods resulted in clean groundwater and helped protect against degrading of local ecosystems, many of which were fragile or in areas where biodiversity was under severe threat. Another environmental conservation practice involved growing organic coffee under a natural canopy of shade trees interspersed with fruit trees and other crops; this not only allowed farmers to get higher crop yields from small acreages but also helped protect against soil erosion on mountainsides.

## **COFFEE ROASTING OPERATIONS**

Starbucks considered the roasting of its coffee beans to be something of an art form, entailing trial-and-error testing of different combinations of time and temperature to get the most out of each type of bean and blend. Recipes were put together by the coffee department, once all the components had been tested. Computerized roasters guaranteed consistency. Each batch was roasted in a powerful gas oven for 12 to 15 minutes. Highly trained and experienced roasting personnel monitored the process, using both smell and hearing, to help check when the beans were

perfectly done—coffee beans make a popping sound when ready. Starbucks' standards were so exacting that roasters tested the color of the beans in a blood-cell analyzer and discarded the entire batch if the reading wasn't on target. After roasting and cooling, the coffee was immediately vacuum-sealed in bags with one-way valves that let out gases naturally produced by fresh-roasted beans without letting oxygen in—one-way valve technology extended the shelf life of packaged Starbucks coffee to 26 weeks. As a matter of policy, however, Starbucks removed coffees on its shelves after three months, and, in the case of coffee used to prepare beverages in stores, the shelf life was limited to seven days after the bag was opened.

At the end of fiscal 2005, Starbucks had roasting plants in Kent, Washington; York, Pennsylvania; Minden, Nevada; and the Netherlands. In addition to roasting capability, the Kent, York, Minden, and Netherlands plants also had additional space for warehousing and shipping coffees. The roasting plants and distribution facilities in Kent supplied stores west of the Mississippi and in the Asia-Pacific region. The newly constructed Minden plant and distribution center was used to supply stores in the Mountain West and Midwest. The roasting and distribution facility in York, which could be expanded to 1 million square feet, supplied stores mainly east of the Mississippi. The 94,000-square-foot facility in the Netherlands supplied stores in Europe and the Middle East.

## STARBUCKS' CORPORATE SOCIAL RESPONSIBILITY STRATEGY

Howard Schultz's effort to "build a company with soul" included broad-based initiatives to contribute positively to the communities in which Starbucks had stores and to the environment. The guiding theme of Starbucks' social responsibility strategy was "Giving back to our communities is the way we do business." The Starbucks Foundation was set up in 1997 to orchestrate the company's philanthropic activities. Since 1991 Starbucks had been a major contributor to CARE, a worldwide relief and development organization that sponsored health, education, and humanitarian aid programs in almost all of the third world countries where Starbucks purchased its coffee supplies. Stores featured CARE in promotions and had organized concerts to benefit

CARE. A second major philanthropic effort involved providing financial support to community literacy organizations. In 1995 Starbucks began a program to improve the conditions of workers in coffee-growing countries, establishing a code of conduct for its growers and providing financial assistance for agricultural improvement projects. In 1997, Starbucks formed an alliance with Appropriate Technology International to help poor, small-scale coffee growers in Guatemala increase their income by improving the quality of their crops and their market access; the company's first-year grant of \$75,000 went to fund a new processing facility and set up a loan program for a producer cooperative.

Starbucks had an Environmental Committee that looked for ways to reduce, reuse, and recycle waste, as well as contribute to local community environmental efforts. There was also a Green Store Task Force that looked at how Starbucks stores could conserve on water and energy usage and generate less solid waste. Customers who brought their own mugs to stores were given a 10-cent discount of beverage purchases (in 2002, customers used commuter mugs in making purchases about 12.7 million times). Coffee grounds, which were a big portion of the waste stream in stores, were packaged and given to customers, parks, schools and plant nurseries as a soil amendment. Company personnel purchased paper products with high levels of recycled content and unbleached fiber to help Starbucks minimize its environmental footprint. Stores participated in Earth Day activities each year with in-store promotions and volunteer efforts to educate employees and customers about the impacts their actions had on the environment. Suppliers were encouraged to provide the most energy-efficient products within their category and eliminate excessive packaging; Starbucks had recently instituted a Code of Conduct for suppliers of noncoffee products that addressed standards for social responsibility, including labor and human rights. No genetically modified ingredients were used in any food or beverage products that Starbucks served, with the exception of milk. (U.S. labeling requirements do not require milk producers to disclose the use of hormones aimed at increasing the milk production of dairy herds.)

Starbucks stores participated regularly in local charitable projects of one kind or another, donating drinks, books, and proceeds from store-opening benefits. Employees were encouraged to recommend and apply for grants from the Starbucks Foundation to benefit local community literacy organizations.

### Exhibit 8 Starbucks' Environmental Mission Statement

Starbucks is committed to a role of environmental leadership in all facets of our business.

We fulfill this mission by a commitment to:

- Understanding of environmental issues and sharing information with our partners.
- Developing innovative and flexible solutions to bring about change.
- Striving to buy, sell, and use environmentally friendly products.
- Recognizing that fiscal responsibility is essential to our environmental future.
- Instilling environmental responsibility as a corporate value.
- Measuring and monitoring our progress for each project.

On the Fourth of July weekend in 1997, three Starbucks employees were murdered in the company's store in the Georgetown area of Washington, D.C.; Starbucks offered a \$100,000 reward for information leading to the arrest of the murderer(s). The company announced it would reopen the store in early 1998 and donate all future net proceeds of the store to a Starbucks Memorial Fund that would make annual grants to local groups working to reduce violence and aid the victims of violent crimes. In 2005, Starbucks made a \$5 million, five-year commitment to long-term relief and recovery efforts for victims of Hurricane Katrina and committed \$5 million to support educational programs in China.

Starbucks felt so deeply about its responsibilities that it even developed an environmental mission statement to expand on its corporate mission statement (see Exhibit 8). In 2002, Starbucks also began issuing an annual Corporate Social Responsibility Report (the reports for recent years can be viewed in the Investors section at [www.starbucks.com](http://www.starbucks.com)). Going into 2004, Starbucks had received 20 awards from a diverse group of organizations for its philanthropic, community service, and environmental activities.

## THE SPECIALTY COFFEE INDUSTRY

While the market for traditional commercial grade coffees had stagnated since the 1970s, the specialty

coffee segment had expanded, as interested, educated, upscale consumers became increasingly inclined to upgrade to premium coffees with more robust flavors. Whereas retail sales of specialty coffees amounted to only \$45 million in 1969, by 1994 retail sales of specialty coffees had increased to \$2 billion, much of which stemmed from sales in coffee bars or the shops of coffee bean retailers (like Peet's). The increase was attributed to wider consumer awareness of and appreciation for fine coffee, the emergence of coffee bars featuring a blossoming number of premium coffee beverages, and the adoption of a healthier lifestyle that prompted some consumers to replace alcohol with coffee. Coffee's image changed from one of just a breakfast or after-dinner beverage to a drink that could be enjoyed at any time in the company of others. Many coffee drinkers took to the idea of coffee bars where they could enjoy a high-caliber coffee beverage and sit back and relax with friends or business associates.

Some industry experts expected the gourmet coffee market in the United States would be saturated by 2005. But the international market was much more wide open as of early 2004. The United States, Germany, and Japan were the three biggest coffee-consuming countries.

## COMPETITORS

Starbucks' primary competitors were restaurants, specialty coffee shops, doughnut shops, supermarkets, convenience stores, and others that sold hot coffee and specialty coffee drinks. In 2003, there were an estimated 14,000 specialty coffee outlets in the United States, with some observers predicting there would as many as 18,000 locations selling specialty coffee drinks by 2015.

Starbucks' success was prompting a number of ambitious rivals to scale up their expansion plans. Still, no other specialty coffee rival had as many as 400 stores, but there were at least 20 small local and regional chains that aspired to compete against Starbucks in their local market arenas, most notably Caribou Coffee (337 stores in 14 states and the District of Columbia), Tully's Coffee (98 stores in 4 states), Gloria Jean's (280 mall locations in 35 states and several foreign countries), New World Coffee (30 locations), Brew HaHa (13 locations in Delaware and Pennsylvania), Bad Ass Coffee (about 60 locations in 18 states, Japan, and South Korea),



Second Cup Coffee (the largest chain based in Canada), and Qwiky's (India). Caribou Coffee went public in late 2005, with a stock offering that raised about \$68 million. McDonald's had begun opening McCafés. While it had been anticipated in the late 1990s that local and regional chains would merge in efforts to get bigger and better position themselves as an alternative to Starbucks, such consolidation had not occurred as of 2003. But numerous retail entrepreneurs had picked up on the growing popularity of specialty coffees and opened coffee bars in high-pedestrian-traffic locations to serve espresso, cappuccino, latte, and other coffee drinks. Growing numbers of restaurants were upgrading the quality of the coffee they served.

Starbucks also faced competition from nation wide coffee manufacturers—such as Kraft General Foods (the parent of Maxwell House), Procter & Gamble (the marketer of Folger's and Millstone brands), and Nestlé—that distributed their coffees through supermarkets. Both General Foods and Procter & Gamble had introduced premium blends of their Maxwell House and Folgers coffees on supermarket shelves, pricing them several dollars below Starbucks' offerings. But Starbucks' most important competitors in supermarkets were the increasing

numbers of rival brands of specialty coffees—Green Mountain, Allegro, Peaberry, Brothers, and dozens of other brands. Because many consumers were accustomed to purchasing their coffee supplies at supermarkets, it was easy for them to choose whatever specialty coffee brand or brands were featured in their local supermarkets over Starbucks.

## FUTURE CHALLENGES

In fiscal 2006, Starbucks planned to open 1,800 new stores globally. Top management believed that it could grow revenues by about 20 percent annually and net earnings by 20–25 percent annually for the next three to five years. Howard Schultz and CEO Jim Donald viewed China as a huge market opportunity, along with Brazil, India, and Russia. Howard Schultz believed that, to sustain its growth and make Starbucks one of the world's preeminent global brands, the company had to challenge the status quo, be innovative, take risks, and adapt its vision of who it was, what it did, and where it was headed. If the challenge was met successfully, in all likelihood the company's best years lay on the strategic road ahead.

### Endnotes

<sup>1</sup>As quoted in Cora Daniels, "Mr. Coffee," *Fortune*, April 14, 2003, p. 139.

<sup>2</sup>2004 annual report, letter to shareholders.

<sup>3</sup>2002 annual report, letter to shareholders.

<sup>4</sup>*Ibid.*

<sup>5</sup>Howard Schultz and Dori Jones Yang, *Pour Your Heart Into It* (New York: Hyperion, 1997), p. 33.

<sup>6</sup>*Ibid.*, p. 34.

<sup>7</sup>*Ibid.*, p. 36.

<sup>8</sup>As told in *ibid.*, p. 48.

<sup>9</sup>*Ibid.*, pp. 61–62.

<sup>10</sup>As quoted in Jennifer Reese, "Starbucks: Inside the Coffee Cult," *Fortune*, December 9, 1996, p. 193.

<sup>11</sup>Schultz and Yang, *Pour Your Heart Into It*, pp. 101–2.

<sup>12</sup>*Ibid.*, p. 142.

<sup>13</sup>*Ibid.*, p. 129.

<sup>14</sup>As related in *ibid.*, pp. 131–36.

<sup>15</sup>2004 annual report, p. 36.

<sup>16</sup>*Ibid.*

<sup>17</sup>2005 Starbucks 10-K report, p. 67.

<sup>18</sup>Ben van Houten, "Employee Perks: Starbucks Coffee's Employee Benefit Plan," *Restaurant Business*, May 15, 1997, p. 85.

<sup>19</sup>As related in Schultz and Yang, *Pour Your Heart Into It*, p. 168.

<sup>20</sup>As quoted in Ingrid Abramovitch, "Miracles of Marketing," *Success* 40, no. 3, p. 26.

<sup>21</sup>Daniels, "Mr. Coffee," p. 140.

<sup>22</sup>Company press release, May 31, 2005, and October 25, 2005

<sup>23</sup>Company press release, October 25, 2005.

<sup>24</sup>Kate Rounds, "Starbucks Coffee," *Incentive* 167, no. 7, p. 22.

<sup>25</sup>CSR annual report, Starbucks, fiscal 2004.

<sup>26</sup>Fiscal 2005 annual report, p. 14.

<sup>27</sup>David Bank, "Starbucks Faces Growing Competition: Its Own Stores," *The Wall Street Journal*, January 21, 1997, p. B1.

<sup>28</sup>As related in Schultz and Yang, *Pour Your Heart Into It*, p. 224.

<sup>29</sup>Starbucks 2005 form 10-K report, p. 6.