Raluca-Daniela RIZEA
The Bucharest University of Economic Studies, Romania
Roxana SARBU
The Bucharest University of Economic Studies, Romania
Elena CONDREA
„Ovidius" University of Constanta, Romania
Faculty of Economics Sciences

HOW COFFEE COMPANIES CAN STAY COMPETITIVE

Case study

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Abstract

The coffee shop industry in the U.S. includes 20,000 stores with combined annual revenue of about $11 billion. The industry is highly concentrated at the top and fragmented at the bottom: the top 50 companies have over 70 percent of industry sales. The U.S. is the world's largest importer of green coffee beans and the largest consumer of coffee. The main objective of this study is to investigate the competitive strategies that U.S. coffee franchise companies adopt considering customers' expectations and industry best practices. In order to achieve this objective, a best practice benchmarking analysis was performed taking into account the top U.S. coffee companies. This analysis showed that product and service innovation are necessary in order to stay competitive in the market and attract new or to keep existing customers successfully. Coffee shops have to establish a unique image that prevents customers from buying products from another shop or use home-brewing systems which are also on the rise in American households.

Introduction

The coffee shop industry in the U.S. includes 20,000 stores with combined annual revenue of about $11 billion. Major companies include Starbucks, Dunkin' Donuts, Caribou, Coffee Bean and Tea Leaf, and Diedrich (Gloria Jean's). The industry is highly concentrated at the top and fragmented at the bottom: the top 50 companies have over 70 percent of industry sales. Coffee is one of the world's largest commodities. The top green coffee producing countries are Brazil, Colombia, and Vietnam. Many grower countries are small, poor developing nations that depend on coffee to sustain local economies. The U.S. is the world's largest importer of green coffee beans and the largest consumer of coffee. The main objective of this study is to investigate the competitive strategies that U.S. coffee franchise companies adopt considering customers' expectations and industry best practices. In order to achieve this objective, a best practice benchmarking analysis was performed taking into account the top U.S. coffee companies.

This analysis showed that product and service innovation are necessary in order to stay competitive in the market and attract new or to keep existing customers successfully. Many customers focus on the special atmosphere each store has and which is characterized by the location, music, interior design, seating or whether internet access is provided. Particularly for specialty coffee shops it is important not to sell only the beverage but the whole experience. Coffee shops have to establish a unique image that prevents customers from buying products from another shop or use home-brewing systems which are also on the rise in American households. In addressing the increased level of competition, every company's focus should be on differentiating from the rest of the market in every possible business segment (products, atmosphere, location, image etc.).

1.Literature review: Definition of Industry

The coffee shop industry in the U.S. includes 20,000 stores with combined annual revenue of about $11 billion. Major companies include Starbucks, Dunkin' Donuts, Caribou, Coffee Bean and Tea Leaf, and Diedrich (Gloria Jean's). The industry is highly concentrated at the top and fragmented at the bottom: the top 50 companies have over 70 percent of industry sales.

Coffee is one of the world's largest commodities. The top green coffee producing countries are Brazil, Colombia, and Vietnam. Many grower countries are small, poor developing nations that depend on coffee to sustain local economies. The U.S. is the world's largest importer of green coffee beans and the largest consumer of coffee. With the exception of Hawaii and Puerto Rico, the United States' climate cannot support coffee trees.

The next paragraphs present benchmarking definitions and detail how this type off analysis was applied in the current case.

Benchmarking received many different definitions from various organisations and authors even though there seems to be a consensus regarding its goal. The most widely accepted definition is the one that Xerox gave at the end of 80s which is „the continuous process of measuring our products, services and practices against the toughest competitors or those companies recognized as industry leaders" (Cano et al., 2001).

The American Productivity and Quality Center also contributes to the definition of benchmarking by saying that „benchmarking is the process of continuously comparing and measuring an organisation against business leaders anywhere in the world to gain information which will help the organisation take action to improve its performance" (Kozak, 2002). In addition, Spendolini (1992) states that "benchmarking is a continuous systematic process for evaluating the products, services and work of organizations that are recognized as representing best practices for the purpose of organizational improvement."

Coffee consumption is highest in the Northeast, where over 60 percent of the population consumed coffee daily in 2005, according to the National Coffee Association

(NCA). Per capita consumption is highest in the Central U.S., where coffee drinkers average 3.7 cups per day (First Research Industry Profile).

Major products sold by coffee shops include beverages as well as complimentary food items. Beverages include brewed coffee and tea; espresso drinks (cappuccinos, cafe lattes); cold blended beverages; bottled water; soft drinks; and juices. Food products include pastries, bakery items, desserts, sandwiches, and candy. Many coffee shops sell whole or ground coffee beans for home consumption. Some coffee shops sell coffee or espresso-making equipment, grinders, mugs, and other accessories. Most coffee shops serve high-quality, premium coffee known as specialty coffee.

The typical and most committed coffee drinkers are 25 to 45 year old, affluent, educated adults. While baby boomers have driven the success of coffee shops, specialty coffee appeals to a diverse adult demographic, including college students and young adults. Larger companies may also sell coffee beans wholesale to commercial customers, such as grocery stores and restaurants(htp://findarticles.com/p/articles/mi_m4021/is_2001_June_1/ai_76579399).

Consumer taste and personal income drive demand. The profitability of individual companies depends on the ability to secure prime locations, drive store traffic, and deliver high quality products. Large companies have advantages in purchasing, finance, and marketing. Small companies can compete effectively by offering specialized products, serving a local market, or providing a personal level of customer service. The industry is extremely labor-intensive: average annual revenue per worker is $40,000.

Coffee shops depend greatly on customer traffic and are most often located in areas with convenient access for pedestrians or drivers. Typical locations include downtown or suburban retail centers, shopping malls, office buildings, and university campuses. Store format and size vary by site, as some locations offer more space than others. Caribou Coffeehouses range from 200 to 3,000 square feet, with an average store 1,200 to 1,600. For small spaces like airports and grocery stores, some chains offer a kiosk format, without seating.

Retail prices for coffee shop beverages vary. The retail price for an espresso-based drink can exceed $4. Due to the cost volatility of green coffee and dairy, retail prices often fluctuate. A pound of roasted coffee beans may retail for between $10 and $20. A pound of high-end or “reserve” coffee, like some Peet’s coffees, can retail for between $50 and $80 per pound (First Research Industry Profile).

Coffee shops depend highly on part-time employees, and most workers require few skills. Many employees make just above the minimum wage, and pay can be significantly below the average for all U.S. workers. Starting wages for Starbucks’ employees are about $8 an hour. Some Starbucks’ employees are forming unions to negotiate better wages, hours, and benefits.

A typical chain coffee shop may have one manager and 10 to 15 workers; independents have six to seven. New employees may go through training courses and receive in-store training to ensure superior customer service and product consistency. Master roasters oversee coffee roasting to develop trademark blends and flavors. Baristas receive training to operate commercial grade espresso machines used to make specialty drinks.

Sales are seasonal, with a peak during fourth quarter, driven by the winter holiday. In addition, poor weather can affect sales by decreasing store traffic. For large companies, inventory amounts to between 40 and 80 days sales. Accounts receivable runs between 20 and 30 days sales, mainly due to commercial customers. Accounts payable runs between 30 and 60 days sales. Companies may use contracts to buy green coffee and dairy products. Gross margins range between 40 and 60 percent, and higher commercial sales tend to decrease margins. Chains use comparable store sales to measure growth.

Most companies lease store locations for a fixed term. Rent for coffee shops in malls may include a fee for shared area maintenance. Companies compete for prime locations, sometimes with other retailers, and negotiating power may be limited. Chains periodically close underperforming stores, and set aside a reserve for remaining lease payments.

Franchise and license agreements typically include an upfront fee, payments or royalties based on percentage of sales, and renewal options. Master license agreements may allow licensees to grant sublicenses to third parties within a territory.

2. Competitive positions and possible strategic moves of key companies

2.1. Starbucks

Starbucks, the world's number one coffee retailer, has over 13,000 coffee shops in more than 35 countries. The outlets offer coffee drinks, food items, beans, coffee accessories and teas. Starbucks owns about 17,500 of its shops, which are located in about 10 countries (mostly in the U.S.) while licensees and franchisees operate the remaining outlets. Starbucks does 78% of its store volume in beverages, with 12% in food, and 5% in whole beans. The companydoes not compete on price but rather on the complete experience customers get while visiting the coffee shop. Embracing its value beyond extraordinary coffee, Starbucks tries to make a business out of human connections, and celebration of diversity and culture.

Starbucks focuses its retail selection on the "best places in town" and its outlets can be found in the centre of almost every famous city in the world ranging from Cologne to Los Angeles. As mentioned, the firm focuses on high-traffic, high-visibility locations. While Starbucks selectively locates stores in shopping malls, it tries to focus on places that provide convenient access for pedestrians and drivers (Starbucks' Financial Statements 2004).

Starbucks' strategy

Starbuck's overall goal is to establish its brand as one of the most recognized and respected ones in the world. Therefore the enterprise plans to continue the rapid expansion of its retail ~ and grow its specialty operations and to selectively pursue other opportunities to leverage the brand through the introduction of new products and the development of new channels of distribution.

In continuance with its history of partnerships, Starbucks and Concord Music Group announced on March 12th of this year the formation of a new record label "Hear Music" which will distribute recordings at Starbucks locations. This partnership is another step in Starbucks' entertainment strategy that links to the company's focus on atmosphere and image (In February 2007 Howard Schultz (Starbucks' chairman) wrote a memo to top company managers of the company that soon became public. He lamented the cumulative effect of company decisions associated with expansion: more efficient automatic machines that diminish the "romance and theatre" of the earlier-era and block the visual sight line the customer previously had for the intimate experience with the barista. -"The Starbucks Stops Here").

Last fall, addressing McDonald's attempts to lure customers away, Starbucks announced its plans to offer hot breakfast sandwiches in an appeal to fans of the Egg McMuffin and establish them also in the breakfast and afternoon snack segment ("Supersize that Latte? McDonald's to Offer Upscale Coffee Drinks" - http://retail.seekingalpha.com/article/28359 [1] McDonalds' Homepage;).

2.2 McDonald's

McDonalds (which history began in 1954) is the leading global foodservice retailer with more than 30,000 local restaurants serving nearly 50 million people in more than 119 countries each day. In 2006 the company reached a record high of $21.6 billion in revenues. McDonalds competes on price, ubiquity, convenience, service and through offering quality food products.

Besides hamburgers McDonalds is also proud on its hot coffee and believes that the high temperature (brewed at 195-205°F) is a major reason for the billion cups sold per year for $1.35 each.

McDonald's' strategy

Recent strategic changes within McDonald's are increasing its potential for rivalry with pure coffee house retailers like Caribou and Starbucks. First, McDonald's improved the quality of its coffee and launched a premium roast version on March 6th 2006. Furthermore McDonalds is looking into "day-parts" penetration as a growth strategy. While currently owning the breakfast segment the company wants to take over the afternoon segment. That is also the reason why, on March 1st 2007, McDonalds has announced that it will serve specialty coffee beverages like vanilla lattes and caramel cappuccinos at outlets across the U.S. It is pricing espresso-based drinks between $2 and $3, undercutting Starbucks offerings. This move is consistent with McDonald's overall strategic shift away from its traditional burger-and-fries offerings and toward more "upscale" food. The specialty coffee drinks will be served from push-buttons machines, which are faster than Starbucks' labor intense hand-made approach. Even further threatening to coffee competitors is McDonald's recent ability to increase its service and improve its stores by slowing down its expansion and reallocating funds.

2.3 Dunkin' Donuts

Dunkin' Donuts (founded 1950, headquarter in Canton, Massachusetts) is the world's largest coffee and baked goods chain, serving over 3 million customers a day. 2006 the enterprise had revenues of $4.7bn ($4.3 bn in the U.S.). There are more than 7,000 shops worldwide (5,300 in the U.S.). The company is opening 700-1000 additional shops every year.

Dunkin' Donuts has forged a b identity as a coffee destination with ample seating and a diverse menu that grows incrementally following its slogan: "America runs on Dunkin". Already, 57% of the chain's sales, and the most profitable product group, are beverages. The company sells about 500 million cups of coffee a year for $1.65 each. Dunkin' Donuts is pursuing the following key strategies: multi-branding concept development, Dunkin' brand vitalization, product innovations, accelerated brand development, improved operational effectiveness and talent acquisition. Dunkin' Donuts retail outlets are operated in a franchise format either through operating agreement, license agreement or joint venture.

Dunkin' Donuts' strategy

The company's current plans are to widen its specialty coffee offerings and offer them on a broader basis nationally. Therefore Procter & Gamble signed an agreement with Dunkin' Brands on March 1st 2007, to launch Dunkin' Donuts coffee at U.S. retailers (e.g. grocery stores, mass merchandisers, club stores).

Additionally Dunkin' Brands CEO Jon Luther emphasizes the company's strategy to be a faster, cheaper, user-friendlier alternative to Starbucks. He is convinced that there is a market opportunity especially among a younger audience that is enamored with Starbucks frothy beverage menu but daunted by its prices. Addressing this issue Dunkin' Donuts installed espresso machines in prime locations, capable of delivering inexpensive coffee in 44 seconds. The company purposely leaves the fancy CD burning stations, mood lighting and comfortable chairs to the competition and focuses, instead, on speed. The company tries to reach a rate of one shop to every 15,000 - 20,000 people in their target markets. According to the CEO Dunkin' Donuts coffee business industry is basically a "game" that relies on ubiquity. However, that is an important, but not the most critical, issue because high margins in the coffee business will allow the company to buy key sites

Additionally the enterprise aims at improving its level of service and cross shop consistency in service; a goal that is especially challenging because of the franchising structure. CEO Luther in 2003 to his 2700 franchisees: " We're changing this game, we're raising the stakes, if you don't like it, get out."

2.4 Caribou Coffee

Caribou Coffee was founded in 1993 and its headquarters is located in Minneapolis (Minnesota). Today it is the second largest specialty coffee company in the U.S. with 416 outlets (2005) in 18 states and the District of Columbia. The revenue in 2005 totaled $198 million. Caribou′s cafes feature mountain-lodge-style decor with exposed beam ceilings, leather chairs, and roaring fireplaces. The company's motto is " Life is short. Stay awake for it." Caribou Coffee successfully competed against the omnipresent Starbucks in a number of U.S. states.

Caribou's strategy

The company emphasizes the quality and freshness of their products (Coffee is packaged immediately after roasting, and it is not sold more than 21 days after roasting or more than seven days after the opening of the package). Caribou competes by offering a slightly different roast of coffee and a warmer, more relaxing in-store environment compared to the Starbucks shops with a rather sleek, urban atmosphere.

The Middle East is the first region Caribou Coffee is seeking to expand internationally. The company believes that there is a small but growing market for American branded coffee houses(Caribou's Financial Statement; 2006). Another strategic approach has been to develop partnerships with other retailers, such as Eatzi′s, or building stores next to Bruegger′s Bagels, Blockbuster Video and Border′s Books. The company also sells its coffee in upscale grocery stores, such as Lund′s and Byerly′s in the Twin Cities and Heinin′s in Cleveland. Furthermore, Frontier and Maxjet airlines serve Caribou coffee, and the company recently inked a deal with Life Time Fitness („Grinding Out Success Next to Starbucks").

2.5 Coffee Bean & Tea Leaf

Coffee Bean & Tea Leaf was founded in 1963, with its headquarter is located in Los Angeles. In 2005 the company had 400 outlets and revenues of $150 million. The strategy of Coffee Bean is "Keep Innovating". The company is known for its extensive selection of coffees and teas, as well as its reputation for innovation, e.g. the ice-blended coffee drink and the chai latte. Coffee Bean has also made a push overseas, finding niches in Starbucks-free markets such as Israel. With nearly all of its drinks certified as kosher, the company has opened several locations in that area.

2.5 Peet's Coffee

Peet's Coffee, whose headquarter is situated in Emeryville, California, was founded in 1996. In 2005 the company had 120 outlets and revenue of $175 million. Peet′s strength is the taste of its coffee, which appeals to java connoisseurs. The company roasts its beans in small batches, replaces brewed coffee every 30 minutes, and never re-steams milk. " Peetniks" often drink Peet′s at home too, and about half the company′s sales come from whole beans, which carry higher margins. Peet′s beans are also sold in more than 4,000 grocery stores.

Though no chain has approached Starbucks global scale, the **coffee shop industry is increasingly competitive**. While many consumers still favor Starbucks coffee, it's rather the in-store experience than the product portfolio that makes the company stand out. With the coffee selection improving elsewhere it is unclear how many customers will continue to pay premium prices if that experience is no longer unique.

Experts expect the price-value equation of the competitors to change in the future.

3. Key factors that determine success in the future

3.1 Product and Service Innovation in the Future

Several key factors within the coffee shop industry are essential components that will likely lead to success or failure of market participants. As already highlighted in the "Driving Factors" product and service innovation are necessary in order to stay competitive in the market and attract new / keep existing customers successfully. Many customers focus on the special atmosphere each store has and which is characterized by the location, music, interior design, seating or whether internet access is provided. Particularly for specialty coffee shops it is important not to sell only the beverage but the whole experience. Coffee shops have to establish a unique image that prevents customers from buying products from another shop or use home-brewing systems which are also on the rise in American households. In addressing the increased level of competition, every company's focus should be on differentiating from the rest of the market in every possible business segment (products, atmosphere, location, image etc.)

3.2 Technology

Furthermore it is important to have state-of the art technology in the shop in order to serve high quality and differentiated products. Advantages of high level technology and machines are shorter waiting times for the customers and the ability to create a variety of fresh, new and unique flavors.

On the other hand it is essential that the level of automation and machinery is well chosen and that there is a clear plan how to integrate the new machinery into the business. Even though there is an increase in efficiency it might mean a loss of identity and differentiation for some stores, such as Starbucks, which focuses on a special spirit in their shops (http://www.forbes.com/business/2007/02/26/starbucks-dunkin-donuts-biz-cx_tvr_0227starbucks.html)

3.3. Education About Coffee

Coffee shop companies should start or continue to educate the consumers about coffee, its ingredients, quality differences, and about the movements in the market, such as "Fair Trade" or "organic coffee". This could be beneficial for developing a relationship with the customers which in turns leads to greater brand loyalty. Informed customers are able to make educated decisions and will be less likely to switch just based on gut feeling. Furthermore this education might motivate coffee buyers to pay a higher price for better products.

3.4 Cooperation

Several companies have proven already that a key factor in the future will be the ability and willingness to cooperate with other market participants without losing control of the business. Therefore it is important to pursue a full range of alliance opportunities: partnerships for innovation and cost reduction but also geographic expansion and co-marketing deals. Finally such partnerships might become tickets to the "global game" as Coca-Cola and Microsoft already proved.

3.5 Quality Control, Consistency

Besides the cooperation with other partners in the industry the coffee shop companies have to ensure that the quality of products and services as well as the cleanliness of the location are consistent and at the desired level from shop to shop (including especially franchisees and licensees) so that the consumers can build trust in the brand. Furthermore the role of the "barista" should not be underestimated and great commitment should be recognized and rewarded. The barista is the personality and sole representative of the specialty coffee supply chain to the consumer. They not only can make drink suggestions or recommendations, but their skill can be the difference between an everyday latte and an amazing specialty coffee experience.

3.6 Meeting Demand

In addition to that companies in the coffee shop industry have to make sure that they can meet the increasing future demand. Per capita consumption of total volume is predicted to reach 2.9kg by 2010, up from 2.8kg in 2005. Constant value retail sales are expected to grow 10% over the forecast period to reach over U.S.$ 6.5 bn. Therefore the market participants should support their suppliers in providing differentiated, quality beans and focus on business strategies that try to prevent farmers from running into debt and poverty. In addition to that companies are supposed to pay attention to the growing demand for specialty coffee, which means they have to ensure that the right product innovations are added to the revised product portfolio at the right time. The compound annual growth rate 1992-2002 was 10% for specialty coffee and therefore over 3 times the rate of the total coffee production (2.9%). However, shifting into the specialty segment is no panacea, since it is a rather small part of the overall market – only 7.8% of the total production volume in 2002.

3.7 Role of Regulations

The trend of stricter regulations in the coffee industry started already, e.g. with new organic rules (Organic coffee is grown without prohibited synthetic substances. The regulations require an organic plan, correct use of land and a very strict, detailed record keeping. Retailers have to change their labels and identify their certifier. The financial load per pound could be 2 to 4 cents up towards 17 cents for a small roaster. The organic rules went into full effect in Oct 2002. Customers will now have a higher level of confidence in knowing the product is organic. - www.foodnavigator.com/news/ng.asp?id=45324-organic-rules-impact) and is expected to become even more severe in the future which underlines the fact that coffee shops have to cooperate with their suppliers in order to control the quality of their products along the value chain. Companies should participate mainly for ethical reasons in campaigns such as "Fair Trade" (www.foodnavigator.com/news/ng.asp?id=45324-organic-rules-impact). In addition to that, if these social movements gain more attention in the market, the companies could also benefit from the positive public relation associated with the social commitment and engagement.

To sum it up, coffee shops have to target their customers effectively in terms of product portfolio, company image and atmosphere as well as advertising and coffee shop location while paying attention to the partners along the value chain and look out for beneficial cooperation within and between industries.

4. Conclusions

Based on the analysis above we conclude that the coffee shop industry is a very attractive market (high margins, growing demand) for the companies that are already established, such as Starbucks or Dunkin' Donuts, however, smaller independent companies may not be able to compete significantly.

As indicated, Starbucks brand is likely to weaken in the future due to its high growth and efficiency focused strategy which eliminated the "romance" of coffee brewing. Starbucks' stock price in the last 5 months (www.finance.google.com):

This strategy has commoditized its high price point product and likely will drive consumers to other competitors such as Dunkin' Donuts who offer a more favorable consumer price-value ratio. Therefore the other "big" market participants, who now offer a similar experience at a lower price, will be able to increase their market share and lure away Starbucks' customers.

One can also say that there exist a strong competition within the industry for new customers, premium locations, etc. but overall the industry is saturated, settled and stable which allows almost all of the competitors to yield very good margins (40 to 60 percent). Regarding the bariers to entry in the coffee industry we can conclude that there exist small barriers to entry for small regional chains / cafés, but their expansion is relatively slow due to the increasing speed of the expansion of the major players. But also exist high barriers to entry into the industry for big players due to high industry concentration on top, huge brand recognition of major brands and high up-front investments are needed.

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