



YOUNGME MOON

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## Starbucks: Delivering Customer Service

In mid-2002, Christine Day, Starbucks' senior vice president of administration in North America, sat in the seventh-floor conference room of Starbucks' Seattle headquarters and reached for her second cup of *toffee nut latte*. The handcrafted beverage—a buttery, toffee-nut flavored espresso concoction topped with whipped cream and toffee sprinkles—had become a regular afternoon indulgence for Day ever since its introduction earlier that year.

As she waited for her colleagues to join her, Day reflected on the company's recent performance. While other retailers were still reeling from the post-9/11 recession, Starbucks was enjoying its 11th consecutive year of 5% or higher comparable store sales growth, prompting its founder and chairman, Howard Schultz, to declare: "I think we've demonstrated that we are close to a recession-proof product."<sup>1</sup>

Day, however, was not feeling nearly as sanguine, in part because Starbucks' most recent market research had revealed some unexpected findings. "We've always taken great pride in our retail service," said Day, "but according to the data, we're not always meeting our customers' expectations in the area of customer satisfaction."

As a result of these concerns, Day and her associates had come up with a plan to invest an additional \$40 million annually in the company's 4,500 stores, which would allow each store to add the equivalent of 20 hours of labor a week. "The idea is to improve speed-of-service and thereby increase customer satisfaction," said Day.

In two days, Day was due to make a final recommendation to both Schultz and Orin Smith, Starbucks' CEO, about whether the company should move forward with the plan. "The investment is the EPS [earnings per share] equivalent of almost seven cents a share," said Day. In preparation for her meeting with Schultz and Smith, Day had asked one of her associates to help her think through the implications of the plan. Day noted, "The real question is, do we believe what our customers are telling us about what constitutes 'excellent' customer service? And if we deliver it, what will the impact be on our sales and profitability?"

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<sup>1</sup> Jake Batsell, "A Grande Decade for Starbucks," *The Seattle Times*, June 26, 2002.

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Professors Youngme Moon and John Quelch prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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## Company Background

The story of how Howard Schultz managed to transform a commodity into an upscale cultural phenomenon has become the stuff of legends. In 1971, three coffee fanatics—Gerald Baldwin, Gordon Bowker, and Ziev Siegl—opened a small coffee shop in Seattle’s Pike Place Market. The shop specialized in selling whole arabica beans to a niche market of coffee purists.

In 1982, Schultz joined the Starbucks marketing team; shortly thereafter, he traveled to Italy, where he became fascinated with Milan’s coffee culture, in particular, the role the neighborhood espresso bars played in Italians’ everyday social lives. Upon his return, the inspired Schultz convinced the company to set up an espresso bar in the corner of its only downtown Seattle shop. As Schultz explained, the bar became the prototype for his long-term vision:

The idea was to create a chain of coffeehouses that would become America’s “third place.” At the time, most Americans had two places in their lives—home and work. But I believed that people needed another place, a place where they could go to relax and enjoy others, or just be by themselves. I envisioned a place that would be separate from home or work, a place that would mean different things to different people.

A few years later, Schultz got his chance when Starbucks’ founders agreed to sell him the company. As soon as Schultz took over, he immediately began opening new stores. The stores sold whole beans and premium-priced coffee beverages by the cup and catered primarily to affluent, well-educated, white-collar patrons (skewed female) between the ages of 25 and 44. By 1992, the company had 140 such stores in the Northwest and Chicago and was successfully competing against other small-scale coffee chains such as Gloria Jean’s Coffee Bean and Bernie’s Coffee & Tea.

That same year, Schultz decided to take the company public. As he recalled, many Wall Street types were dubious about the idea: “They’d say, ‘You mean, you’re going to sell coffee for a dollar in a paper cup, with Italian names that no one in America can say? At a time in America when no one’s drinking coffee? And I can get coffee at the local coffee shop or doughnut shop for 50 cents? Are you kidding me?’”<sup>2</sup>

Ignoring the skeptics, Schultz forged ahead with the public offering, raising \$25 million in the process. The proceeds allowed Starbucks to open more stores across the nation.

By mid-2002, Schultz had unequivocally established Starbucks as the dominant specialty-coffee brand in North America. Sales had climbed at a compound annual growth rate (CAGR) of 40% since the company had gone public, and net earnings had risen at a CAGR of 50%. The company was now serving 20 million unique customers in well over 5,000 stores around the globe and was opening on average three new stores a day. (See **Exhibits 1–3** for company financials and store growth over time.)

What made Starbucks’ success even more impressive was that the company had spent almost nothing on advertising to achieve it. North American marketing primarily consisted of point-of-sale materials and local-store marketing and was far less than the industry average. (Most fast-food chains had marketing budgets in the 3%–6% range.)

For his part, Schultz remained as chairman and chief global strategist in control of the company, handing over day-to-day operations in 2002 to CEO Orin Smith, a Harvard MBA (1967) who had joined the company in 1990.

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<sup>2</sup> Batsell.

## The Starbucks Value Proposition

Starbucks' brand strategy was best captured by its "live coffee" mantra, a phrase that reflected the importance the company attached to keeping the national coffee culture alive. From a retail perspective, this meant creating an "experience" around the consumption of coffee, an experience that people could weave into the fabric of their everyday lives.

There were three components to this experiential branding strategy. The first component was the coffee itself. Starbucks prided itself on offering what it believed to be the highest-quality coffee in the world, sourced from the Africa, Central and South America, and Asia-Pacific regions. To enforce its exacting coffee standards, Starbucks controlled as much of the supply chain as possible—it worked directly with growers in various countries of origin to purchase green coffee beans, it oversaw the custom-roasting process for the company's various blends and single-origin coffees, and it controlled distribution to retail stores around the world.

The second brand component was service, or what the company sometimes referred to as "customer intimacy." "Our goal is to create an uplifting experience every time you walk through our door," explained Jim Alling, Starbucks' senior vice president of North American retail. "Our most loyal customers visit us as often as 18 times a month, so it could be something as simple as recognizing you and knowing your drink or customizing your drink just the way you like it."

The third brand component was atmosphere. "People come for the coffee," explained Day, "but the ambience is what makes them want to stay." For that reason, most Starbucks had seating areas to encourage lounging and layouts that were designed to provide an upscale yet inviting environment for those who wanted to linger. "What we have built has universal appeal," remarked Schultz. "It's based on the human spirit, it's based on a sense of community, the need for people to come together."<sup>3</sup>

### *Channels of Distribution*

Almost all of Starbucks' locations in North America were company-operated stores located in high-traffic, high-visibility settings such as retail centers, office buildings, and university campuses.<sup>4</sup> In addition to selling whole-bean coffees, these stores sold rich-brewed coffees, Italian-style espresso drinks, cold-blended beverages, and premium teas. Product mixes tended to vary depending on a store's size and location, but most stores offered a variety of pastries, sodas, and juices, along with coffee-related accessories and equipment, music CDs, games, and seasonal novelty items. (About 500 stores even carried a selection of sandwiches and salads.)

Beverages accounted for the largest percentage of sales in these stores (77%); this represented a change from 10 years earlier, when about half of store revenues had come from sales of whole-bean coffees. (See **Exhibit 4** for retail sales mix by product type; see **Exhibit 5** for a typical menu board and price list.)

Starbucks also sold coffee products through non-company-operated retail channels; these so-called "Specialty Operations" accounted for 15% of net revenues. About 27% of these revenues came from North American food-service accounts, that is, sales of whole-bean and ground coffees to hotels, airlines, restaurants, and the like. Another 18% came from domestic retail store licenses that, in

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<sup>3</sup> Batsell.

<sup>4</sup> Starbucks had recently begun experimenting with drive-throughs. Less than 10% of its stores had drive-throughs, but in these stores, the drive-throughs accounted for 50% of all business.

North America, were only granted when there was no other way to achieve access to desirable retail space (e.g., in airports).

The remaining 55% of specialty revenues came from a variety of sources, including international licensed stores, grocery stores and warehouse clubs (Kraft Foods handled marketing and distribution for Starbucks in this channel), and online and mail-order sales. Starbucks also had a joint venture with Pepsi-Cola to distribute bottled Frappuccino beverages in North America, as well as a partnership with Dreyer's Grand Ice Cream to develop and distribute a line of premium ice creams.

Day explained the company's broad distribution strategy:

Our philosophy is pretty straightforward—we want to reach customers where they work, travel, shop, and dine. In order to do this, we sometimes have to establish relationships with third parties that share our values and commitment to quality. This is a particularly effective way to reach newcomers with our brand. It's a lot less intimidating to buy Starbucks at a grocery store than it is to walk into one of our coffeehouses for the first time. In fact, about 40% of our new coffeehouse customers have already tried the Starbucks brand before they walk through our doors. Even something like ice cream has become an important trial vehicle for us.

### *Starbucks Partners*

All Starbucks employees were called "partners." The company employed 60,000 partners worldwide, about 50,000 in North America. Most were hourly-wage employees (called *baristas*) who worked in Starbucks retail stores. Alling remarked, "From day one, Howard has made clear his belief that partner satisfaction leads to customer satisfaction. This belief is part of Howard's DNA, and because it's been pounded into each and every one of us, it's become part of our DNA too."

The company had a generous policy of giving health insurance and stock options to even the most entry-level partners, most of whom were between the ages of 17 and 23. Partly as a result of this, Starbucks' partner satisfaction rate consistently hovered in the 80% to 90% range, well above the industry norm,<sup>5</sup> and the company had recently been ranked 47th in the *Fortune* magazine list of best places to work, quite an accomplishment for a company with so many hourly-wage workers.

In addition, Starbucks had one of the lowest employee turnover rates in the industry—just 70%, compared with fast-food industry averages as high as 300%. The rate was even lower for managers, and as Alling noted, the company was always looking for ways to bring turnover down further: "Whenever we have a problem store, we almost always find either an inexperienced store manager or inexperienced baristas. Manager stability is key—it not only decreases partner turnover, but it also enables the store to do a much better job of recognizing regular customers and providing personalized service. So our goal is to make the position a lifetime job."

To this end, the company encouraged promotion from within its own ranks. About 70% of the company's store managers were ex-baristas, and about 60% of its district managers were ex-store managers. In fact, upon being hired, all senior executives had to train and succeed as baristas before being allowed to assume their positions in corporate headquarters.

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<sup>5</sup> Industrywide, employee satisfaction rates tended to be in the 50% to 60% range. Source: Starbucks, 2000.

## Delivering on Service

When a partner was hired to work in one of Starbucks' North American retail stores, he or she had to undergo two types of training. The first type focused on "hard skills" such as learning how to use the cash register and learning how to mix drinks. Most Starbucks beverages were handcrafted, and to ensure product quality, there was a prespecified process associated with each drink. Making an espresso beverage, for example, required seven specific steps.

The other type of training focused on "soft skills." Alling explained:

In our training manual, we explicitly teach partners to connect with customers—to enthusiastically welcome them to the store, to establish eye contact, to smile, and to try to remember their names and orders if they're regulars. We also encourage partners to create conversations with customers using questions that require more than a yes or no answer. So for example, "I noticed you were looking at the menu board—what types of beverages do you typically enjoy?" is a good question for a partner to ask.

Starbucks' "Just Say Yes" policy empowered partners to provide the best service possible, even if it required going beyond company rules. "This means that if a customer spills a drink and asks for a refill, we'll give it to him," said Day. "Or if a customer doesn't have cash and wants to pay with a check (which we aren't supposed to accept), then we'll give her a sample drink for free. The last thing we want to do is win the argument and lose the customer."

Most barista turnover occurred within the first 90 days of employment; if a barista lasted beyond that, there was a high probability that he or she would stay for three years or more. "Our training ends up being a self-selection process," Alling said. Indeed, the ability to balance hard and soft skills required a particular type of person, and Alling believed the challenges had only grown over time:

Back in the days when we sold mostly beans, every customer who walked in the door was a coffee connoisseur, and it was easy for baristas to engage in chitchat while ringing up a bag. Those days are long gone. Today, almost every customer orders a handcrafted beverage. If the line is stretching out the door and everyone's clamoring for their coffee fix, it's not that easy to strike up a conversation with a customer.

The complexity of the barista's job had also increased over time; making a *venti tazoberry and crème*, for instance, required 10 different steps. "It used to be that a barista could make every variation of drink we offered in half a day," Day observed. "Nowadays, given our product proliferation, it would take 16 days of eight-hour shifts. There are literally hundreds of combinations of drinks in our portfolio."

This job complexity was compounded by the fact that almost half of Starbucks' customers customized their drinks. According to Day, this created a tension between product quality and customer focus for Starbucks:

On the one hand, we train baristas to make beverages to our preestablished quality standards—this means enforcing a consistent process that baristas can master. On the other hand, if a customer comes in and wants it their way—extra vanilla, for instance—what should we do? Our heaviest users are always the most demanding. Of course, every time we customize, we slow down the service for everyone else. We also put a lot of strain on our baristas, who are already dealing with an extraordinary number of sophisticated drinks.

One obvious solution to the problem was to hire more baristas to share the workload; however, the company had been extremely reluctant to do this in recent years, particularly given the economic

downturn. Labor was already the company's largest expense item in North America (see **Exhibit 3**), and Starbucks stores tended to be located in urban areas with high wage rates. Instead, the company had focused on increasing barista efficiency by removing all non-value-added tasks, simplifying the beverage production process, and tinkering with the facility design to eliminate bottlenecks.

In addition, the company had recently begun installing automated espresso machines in its North American cafés. The *verismo* machines, which decreased the number of steps required to make an espresso beverage, reduced waste, improved consistency, and had generated an overwhelmingly positive customer and barista response.

### *Measuring Service Performance*

Starbucks tracked service performance using a variety of metrics, including monthly status reports and self-reported checklists. The company's most prominent measurement tool was a mystery shopper program called the "Customer Snapshot." Under this program, every store was visited by an anonymous mystery shopper three times a quarter. Upon completing the visit, the shopper would rate the store on four "Basic Service" criteria:

- **Service**—Did the register partner verbally greet the customer? Did the barista and register partner make eye contact with the customer? Say thank you?
- **Cleanliness**—Was the store clean? The counters? The tables? The restrooms?
- **Product quality**—Was the order filled accurately? Was the temperature of the drink within range? Was the beverage properly presented?
- **Speed of service**—How long did the customer have to wait? The company's goal was to serve a customer within three minutes, from back-of-the-line to drink-in-hand. This benchmark was based on market research which indicated that the three-minute standard was a key component in how current Starbucks customers defined "excellent service."

In addition to Basic Service, stores were also rated on "Legendary Service," which was defined as "behavior that created a memorable experience for a customer, that inspired a customer to return often and tell a friend." Legendary Service scores were based on secret shopper observations of service attributes such as partners initiating conversations with customers, partners recognizing customers by name or drink order, and partners being responsive to service problems.

During 2002, the company's Customer Snapshot scores had increased across all stores (see **Exhibit 7**), leading Day to comment, "The Snapshot is not a perfect measurement tool, but we believe it does a good job of measuring trends over the course of a quarter. In order for a store to do well on the Snapshot, it needs to have sustainable processes in place that create a well-established pattern of doing things right so that it gets 'caught' doing things right."

## **Competition**

In the United States, Starbucks competed against a variety of small-scale specialty coffee chains, most of which were regionally concentrated. Each tried to differentiate itself from Starbucks in a different way. For example, Minneapolis-based Caribou Coffee, which operated more than 200 stores in nine states, differentiated itself on store environment. Rather than offer an upscale, pseudo-European atmosphere, its strategy was to simulate the look and feel of an Alaskan lodge, with knotty-

pine cabinetry, fireplaces, and soft seating. Another example was California-based Peet's Coffee & Tea, which operated about 70 stores in five states. More than 60% of Peet's revenues came from the sale of whole beans. Peet's strategy was to build a super-premium brand by offering the freshest coffee on the market. One of the ways it delivered on this promise was by "roasting to order," that is, by hand roasting small batches of coffee at its California plant and making sure that all of its coffee shipped within 24 hours of roasting.

Starbucks also competed against thousands of independent specialty coffee shops. Some of these independent coffee shops offered a wide range of food and beverages, including beer, wine, and liquor; others offered satellite televisions or Internet-connected computers. Still others differentiated themselves by delivering highly personalized service to an eclectic clientele.

Finally, Starbucks competed against donut and bagel chains such as Dunkin Donuts, which operated over 3,700 stores in 38 states. Dunkin Donuts attributed half of its sales to coffee and in recent years had begun offering flavored coffee and noncoffee alternatives, such as Dunkaccino (a coffee and chocolate combination available with various toppings) and Vanilla Chai (a combination of tea, vanilla, honey, and spices).

## Caffeinating the World

The company's overall objective was to establish Starbucks as the "most recognized and respected brand in the world."<sup>6</sup> This ambitious goal required an aggressive growth strategy, and in 2002, the two biggest drivers of company growth were retail expansion and product innovation.

### *Retail Expansion*

Starbucks already owned close to one-third of America's coffee bars, more than its next five biggest competitors combined. (By comparison, the U.S.'s second-largest player, Diedrich Coffee, operated fewer than 400 stores.) However, the company had plans to open 525 company-operated and 225 licensed North American stores in 2003, and Schultz believed that there was no reason North America could not eventually expand to at least 10,000 stores. As he put it, "These are still the early days of the company's growth."<sup>7</sup>

The company's optimistic growth plans were based on a number of considerations:

- First, coffee consumption was on the rise in the United States, following years of decline. More than 109 million people (about half of the U.S. population) now drank coffee every day, and an additional 52 million drank it on occasion. The market's biggest growth appeared to be among drinkers of specialty coffee,<sup>8</sup> and it was estimated that about one-third of all U.S. coffee consumption took place outside of the home, in places such as offices, restaurants, and coffee shops. (See **Exhibit 6**.)

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<sup>6</sup> Starbucks 2002 Annual Report.

<sup>7</sup> Dina ElBoghady, "Pouring It On: The Starbucks Strategy? Locations, Locations, Locations," *The Washington Post*, August 25, 2002.

<sup>8</sup> National Coffee Association.

- Second, there were still eight states in the United States without a single company-operated Starbucks; in fact, the company was only in 150 of the roughly 300 metropolitan statistical areas in the nation.
- Third, the company believed it was far from reaching saturation levels in many existing markets. In the Southeast, for example, there was only one store for every 110,000 people (compared with one store for every 20,000 people in the Pacific Northwest). More generally, only seven states had more than 100 Starbucks locations.

Starbucks' strategy for expanding its retail business was to open stores in new markets while geographically clustering stores in existing markets. Although the latter often resulted in significant cannibalization, the company believed that this was more than offset by the total incremental sales associated with the increased store concentration. As Schultz readily conceded, "We self-cannibalize at least a third of our stores every day."<sup>9</sup>

When it came to selecting new retail sites, the company considered a number of criteria, including the extent to which the demographics of the area matched the profile of the typical Starbucks drinker, the level of coffee consumption in the area, the nature and intensity of competition in the local market, and the availability of attractive real estate. Once a decision was made to move forward with a site, the company was capable of designing, permitting, constructing, and opening a new store within 16 weeks. A new store typically averaged about \$610,000 in sales during its first year; same-store sales (comps) were strongest in the first three years and then continued to comp positively, consistent with the company average.

Starbucks' international expansion plans were equally ambitious. Starbucks already operated over 300 company-owned stores in the United Kingdom, Australia, and Thailand, in addition to about 900 licensed stores in various countries in Asia, Europe, the Middle East, Africa, and Latin America. (Its largest international market was Japan, with close to 400 stores.) The company's goal was to ultimately have 15,000 international stores.

### *Product Innovation*

The second big driver of company growth was product innovation. Internally, this was considered one of the most significant factors in comparable store sales growth, particularly since Starbucks' prices had remained relatively stable in recent years. New products were launched on a regular basis; for example, Starbucks introduced at least one new hot beverage every holiday season.

The new product development process generally operated on a 12- to 18-month cycle, during which the internal research and development (R&D) team tinkered with product formulations, ran focus groups, and conducted in-store experiments and market tests. Aside from consumer acceptance, whether a product made it to market depended on a number of factors, including the extent to which the drink fit into the "ergonomic flow" of operations and the speed with which the beverage could be handcrafted. Most importantly, the success of a new beverage depended on partner acceptance. "We've learned that no matter how great a drink it is, if our partners aren't excited about it, it won't sell," said Alling.

In recent years, the company's most successful innovation had been the 1995 introduction of a coffee and non-coffee-based line of Frappuccino beverages, which had driven same-store sales primarily by boosting traffic during nonpeak hours. The bottled version of the beverage (distributed

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<sup>9</sup> ElBoghdady.

by PepsiCo) had become a \$400 million<sup>10</sup> franchise; it had managed to capture 90% of the ready-to-drink coffee category, in large part due to its appeal to non-coffee-drinking 20-somethings.

### *Service Innovation*

In terms of nonproduct innovation, Starbucks' stored-value card (SVC) had been launched in November 2001. This prepaid, swipecard smart card—which Schultz referred to as “the most significant product introduction since Frappuccino”<sup>11</sup>—could be used to pay for transactions in any company-operated store in North America. Early indications of the SVC's appeal were very positive: After less than one year on the market, about 6 million cards had been issued, and initial activations and reloads had already reached \$160 million in sales. In surveys, the company had learned that cardholders tended to visit Starbucks twice as often as cash customers and tended to experience reduced transaction times.

Day remarked, “We've found that a lot of the cards are being given away as gifts, and many of those gift recipients are being introduced to our brand for the first time. Not to mention the fact that the cards allow us to collect all kinds of customer-transaction data, data that we haven't even begun to do anything with yet.”

The company's latest service innovation was its T-Mobile HotSpot wireless Internet service, which it planned to introduce in August 2002. The service would offer high-speed access to the Internet in 2,000 Starbucks stores in the United States and Europe, starting at \$49.99 a month.

## **Starbucks' Market Research: Trouble Brewing?**

Interestingly, although Starbucks was considered one of the world's most effective marketing organizations, it lacked a strategic marketing group. In fact, the company had no chief marketing officer, and its marketing department functioned as three separate groups—a market research group that gathered and analyzed market data requested by the various business units, a category group that developed new products and managed the menu and margins, and a marketing group that developed the quarterly promotional plans.

This organizational structure forced all of Starbucks' senior executives to assume marketing-related responsibilities. As Day pointed out, “Marketing is everywhere at Starbucks—it just doesn't necessarily show up in a line item called ‘marketing.’ Everyone has to get involved in a collaborative marketing effort.” However, the organizational structure also meant that market- and customer-related trends could sometimes be overlooked. “We tend to be great at measuring things, at collecting market data,” Day noted, “but we are not very disciplined when it comes to using this data to drive decision making.” She continued:

This is exactly what started to happen a few years ago. We had evidence coming in from market research that contradicted some of the fundamental assumptions we had about our brand and our customers. The problem was that this evidence was all over the place—no one was really looking at the “big picture.” As a result, it took awhile before we started to take notice.

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<sup>10</sup> Refers to sales at retail. Actual revenue contribution was much lower due to the joint-venture structure.

<sup>11</sup> Stanley Holmes, “Starbucks' Card Smarts,” *BusinessWeek*, March 18, 2002.

### *Starbucks' Brand Meaning*

Once the team did take notice, it discovered several things. First, despite Starbucks' overwhelming presence and convenience, there was very little image or product differentiation between Starbucks and the smaller coffee chains (other than Starbucks' ubiquity) in the minds of specialty coffeehouse customers. There *was* significant differentiation, however, between Starbucks and the independent specialty coffeehouses (see **Table A** below).

**Table A** Qualitative Brand Meaning: Independents vs. Starbucks

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<p><b>Independents:</b></p> <ul style="list-style-type: none"> <li>• Social and inclusive</li> <li>• Diverse and intellectual</li> <li>• Artsy and funky</li> <li>• Liberal and free-spirited</li> <li>• Lingering encouraged</li> <li>• Particularly appealing to younger coffeehouse customers</li> <li>• Somewhat intimidating to older, more mainstream coffeehouse customers</li> </ul> <p><b>Starbucks:</b></p> <ul style="list-style-type: none"> <li>• Everywhere—the trend</li> <li>• Good coffee on the run</li> <li>• Place to meet and move on</li> <li>• Convenience oriented; on the way to work</li> <li>• Accessible and consistent</li> </ul>
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Source: Starbucks, based on qualitative interviews with specialty-coffeehouse customers.

More generally, the market research team discovered that Starbucks' brand image had some rough edges. The number of respondents who strongly agreed with the statement "Starbucks cares primarily about making money" was up from 53% in 2000 to 61% in 2001, while the number of respondents who strongly agreed with the statement "Starbucks cares primarily about building more stores" was up from 48% to 55%. Day noted, "It's become apparent that we need to ask ourselves, 'Are we focusing on the right things? Are we clearly communicating our value and values to our customers, instead of just our growth plans?'" (see **Table B** below).

**Table B** The Top Five Attributes Consumers Associate with the Starbucks Brand

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<ul style="list-style-type: none"> <li>• Known for specialty/gourmet coffee (54% strongly agree)</li> <li>• Widely available (43% strongly agree)</li> <li>• Corporate (42% strongly agree)</li> <li>• Trendy (41% strongly agree)</li> <li>• Always feel welcome at Starbucks (39% strongly agree)</li> </ul>
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Source: Starbucks, based on 2002 survey.

### The Changing Customer

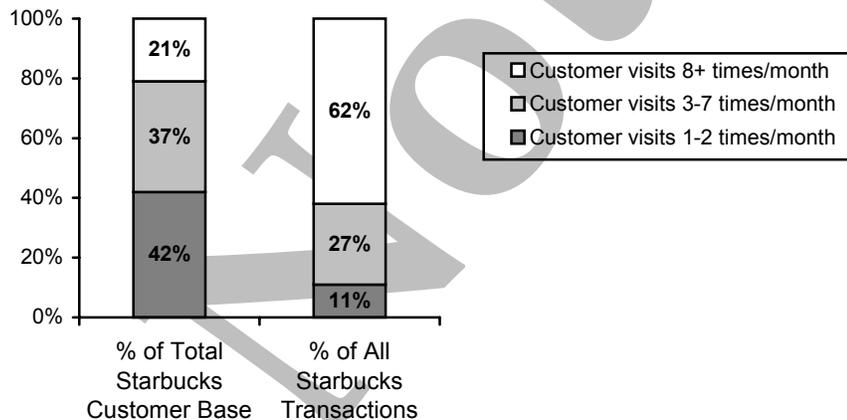
The market research team also discovered that Starbucks' customer base was evolving. Starbucks' newer customers tended to be younger, less well-educated, and in a lower income bracket than Starbucks' more established customers. In addition, they visited the stores less frequently and had very different perceptions of the Starbucks brand compared to more established customers (see Exhibit 8).

Furthermore, the team learned that Starbucks' historical customer profile—the affluent, well-educated, white-collar female between the ages of 24 and 44—had expanded. For example, about half of the stores in southern California had large numbers of Hispanic customers. In Florida, the company had stores that catered primarily to Cuban-Americans.

### Customer Behavior

With respect to customer behavior, the market research team discovered that, regardless of the market—urban versus rural, new versus established—customers tended to use the stores the same way. The team also learned that, although the company's most frequent customers averaged 18 visits a month, the typical customer visited just five times a month (see Figure A below).

**Figure A** Customer Visit Frequency



Source: Starbucks, 2002.

### Measuring and Driving Customer Satisfaction

Finally, the team discovered that, despite its high Customer Snapshot scores, Starbucks was not meeting expectations in terms of customer satisfaction. The satisfaction scores were considered critical because the team also had evidence of a direct link between satisfaction level and customer loyalty (see Exhibit 9 for customer satisfaction data).

While customer satisfaction was driven by a number of different factors (see Exhibit 10), Day believed that the customer satisfaction gap could primarily be attributed to a *service gap* between Starbucks scores on key attributes and customer expectations. When Starbucks had polled its customers to determine what it could do to make them feel more like valued customers,

“improvements to service”—in particular, speed-of-service—had been mentioned most frequently (see Exhibit 11 for more information).

## Rediscovering the Starbucks Customer

Responding to the market research findings posed a difficult management challenge. The most controversial proposal was the one on the table before Day—it involved relaxing the labor-hour controls in the stores to add an additional 20 hours of labor, per week, per store, at a cost of an extra \$40 million per year. Not surprisingly, the plan was being met with significant internal resistance. “Our CFO is understandably concerned about the potential impact on our bottom line,” said Day. “Each \$6 million in profit contribution translates into a penny a share. But my argument is that if we move away from seeing labor as an expense to seeing it as a customer-oriented investment, we’ll see a positive return.” She continued:

We need to bring service time down to the three-minute level in all of our stores, regardless of the time of day. If we do this, we’ll not only increase customer satisfaction and build stronger long-term relationships with our customers, we’ll also improve our customer throughput. The goal is to move each store closer to the \$20,000 level in terms of weekly sales, and I think that this plan will help us get there.

In two days, Day was scheduled to make a final recommendation to Howard Schultz and Orin Smith about whether the company should roll out the \$40 million plan in October 2002. In preparation for this meeting, Day had asked Alling to help her think through the implications of the plan one final time. She mused:

We’ve been operating with the assumption that we do customer service well. But the reality is, we’ve started to lose sight of the consumer. It’s amazing that this could happen to a company like us—after all, we’ve become one of the most prominent consumer brands in the world. For all of our focus on building the brand and introducing new products, we’ve simply stopped talking about the customer. We’ve lost the connection between satisfying our customers and growing the business.

Alling’s response was simple: “We know that both Howard and Orin are totally committed to satisfying our retail customers. Our challenge is to tie customer satisfaction to the bottom line. What evidence do we have?”

**Exhibit 1** Starbucks' Financials, FY 1998 to FY 2002 (\$ in millions)

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
<b>Revenue</b>					
Co-Owned North American	1,076.8	1,375.0	1,734.9	2,086.4	2,583.8
Co-Owned Int'l (UK, Thailand, Australia)	25.8	48.4	88.7	143.2	209.1
Total Company-Operated Retail	1,102.6	1,423.4	1,823.6	2,229.6	2,792.9
Specialty Operations	206.1	263.4	354.0	419.4	496.0
<b>Net Revenues</b>	<b>1,308.7</b>	<b>1,686.8</b>	<b>2,177.6</b>	<b>2,649.0</b>	<b>3,288.9</b>
Cost of Goods Sold	578.5	747.6	961.9	1,112.8	1,350.0
<b>Gross Profit</b>	<b>730.2</b>	<b>939.2</b>	<b>1,215.7</b>	<b>1,536.2</b>	<b>1,938.9</b>
Joint-Venture Income <sup>a</sup>	1.0	3.2	20.3	28.6	35.8
<b>Expenses:</b>					
Store Operating Expense	418.5	543.6	704.9	875.5	1,121.1
Other Operating Expense	44.5	54.6	78.4	93.3	127.2
Depreciation & Amortization Expense	72.5	97.8	130.2	163.5	205.6
General & Admin Expense	77.6	89.7	110.2	151.4	202.1
<b>Operating Expenses</b>	<b>613.1</b>	<b>785.7</b>	<b>1,023.8</b>	<b>1,283.7</b>	<b>1,656.0</b>
<b>Operating Profit</b>	<b>109.2</b>	<b>156.7</b>	<b>212.3</b>	<b>281.1</b>	<b>310.0</b>
<b>Net Income</b>	<b>68.4</b>	<b>101.7</b>	<b>94.5</b>	<b>181.2</b>	<b>215.1</b>
<b>% Change in Monthly Comparable Store Sales<sup>b</sup></b>					
North America	5%	6%	9%	5%	7%
Consolidated	5%	6%	9%	5%	6%

Source: Adapted from company reports and Lehman Brothers, November 5, 2002.

<sup>a</sup>Includes income from various joint ventures, including Starbucks' partnership with the Pepsi-Cola Company to develop and distribute Frappuccino and with Dreyer's Grand Ice Cream to develop and distribute premium ice creams.

<sup>b</sup>Includes only company-operated stores open 13 months or longer.

**Exhibit 2** Starbucks' Store Growth

	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
<b>Total North America</b>	<b>1,755</b>	<b>2,217</b>	<b>2,976</b>	<b>3,780</b>	<b>4,574</b>
Company-Operated	1,622	2,038	2,446	2,971	3,496
Licensed Stores <sup>a</sup>	133	179	530	809	1,078
<b>Total International</b>	<b>131</b>	<b>281</b>	<b>525</b>	<b>929</b>	<b>1,312</b>
Company-Operated	66	97	173	295	384
Licensed Stores	65	184	352	634	928
<b>Total Stores</b>	<b>1,886</b>	<b>2,498</b>	<b>3,501</b>	<b>4,709</b>	<b>5,886</b>

Source: Company reports.

<sup>a</sup>Includes kiosks located in grocery stores, bookstores, hotels, airports, and so on.

**Exhibit 3** Additional Data, North American Company-Operated Stores (FY2002)

	<b>Average</b>
Average hourly rate with shift supervisors and hourly partners	\$ 9.00
Total labor hours per week, average store	360
Average weekly store volume	\$15,400
Average ticket	\$ 3.85
Average daily customer count, per store	570

Source: Company reports.

**Exhibit 4** Product Mix, North American Company-Operated Stores (FY2002)

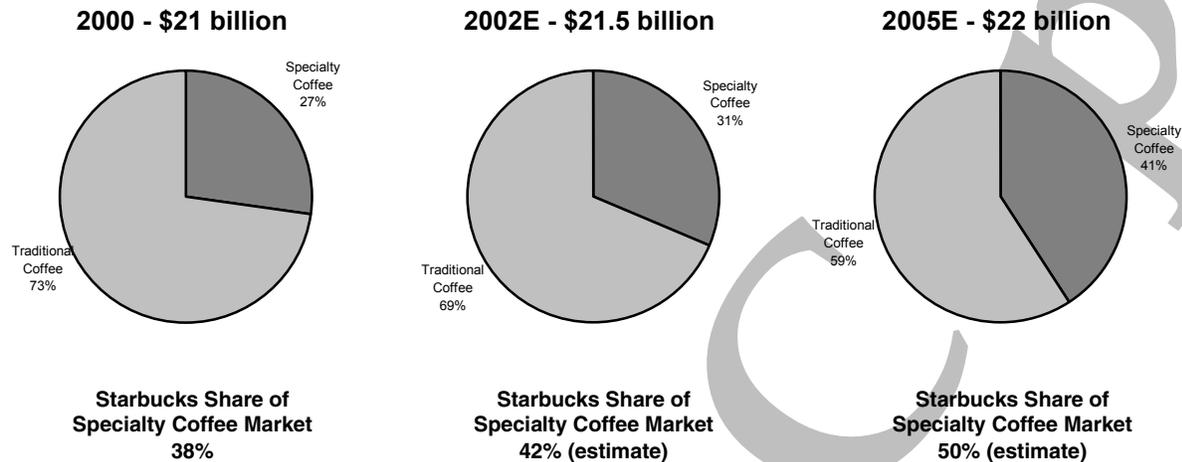
	<b>Percent of Sales</b>
<b>Retail Product Mix</b>	
Coffee Beverages	77%
Food Items	13%
Whole-Bean Coffees	6%
Equipment & Accessories	4%

Source: Company reports.

## Exhibit 5 Typical Menu Board and Price List for North American Company-Owned Store

<b>Espresso Traditions</b>	<b>Tall</b>	<b>Grande</b>	<b>Venti</b>	<b>Brewed Coffee</b>	<b>Tall</b>	<b>Grande</b>	<b>Venti</b>
<b>Classic Favorites</b>				Coffee of the Day	1.40	1.60	1.70
Toffee Nut Latte	2.95	3.50	3.80	Decaf of the Day	1.40	1.60	1.70
Vanilla Latte	2.85	3.40	3.70				
Caffe Latte	2.55	3.10	3.40	<b>Cold Beverages</b>	<b>Tall</b>	<b>Grande</b>	<b>Venti</b>
Cappuccino	2.55	3.10	3.40	Iced Caffe Latte	2.55	3.10	3.50
Caramel Macchiato	2.80	3.40	3.65	Iced Caramel Macchiato	2.80	3.40	3.80
White Chocolate Mocha	3.20	3.75	4.00	Iced Caffe Americano	1.75	2.05	3.40
Caffe Mocha	2.75	3.30	3.55				
Caffe Americano	1.75	2.05	2.40	<b>Coffee Alternatives</b>	<b>Tall</b>	<b>Grande</b>	<b>Venti</b>
<b>Espresso</b>	<b>Solo</b>		<b>Doppio</b>	Toffee Nut Crème	2.45	2.70	2.95
Espresso	1.45		1.75	Vanilla Crème	2.20	2.45	2.70
<b>Extras</b>				Caramel Apple Cider	2.45	2.70	2.95
Additional Espresso Shot			.55	Hot Chocolate	2.20	2.45	2.70
Add flavored syrup			.30	Tazo Hot Tea	1.15	1.65	1.65
Organic milk & soy available upon request				Tazo Chai	2.70	3.10	3.35
<b>Frappuccino</b>	<b>Tall</b>	<b>Grande</b>	<b>Venti</b>	<b>Whole Beans: Bold</b>	<b>½ lb</b>	<b>1 lb</b>	
<b>Ice Blended Beverages</b>				<b>Our most intriguing and exotic coffees</b>			
Coffee	2.65	3.15	3.65	Gold Coast Blend	5.70	10.95	
Mocha	2.90	3.40	3.90	French Roast	5.20	9.95	
Caramel Frappuccino	3.15	3.65	4.15	Sumatra	5.30	10.15	
Mocha Coconut	3.15	3.65	4.15	Decaf Sumatra	5.60	10.65	
(limited offering)				Ethiopia Sidame	5.20	9.95	
<b>Crème Frappuccino</b>	<b>Tall</b>	<b>Grande</b>	<b>Venti</b>	Arabian Mocha Sanani	8.30	15.95	
<b>Ice Blended Crème</b>				Kenya	5.30	10.15	
Toffee Nut Crème	3.15	3.65	4.15	Italian Roast	5.20	9.95	
Vanilla Crème	2.65	3.15	3.65	Sulawesi	6.10	11.65	
Coconut Crème	3.15	3.65	4.15	<b>Whole Beans: Smooth</b>	<b>½ lb</b>	<b>1 lb</b>	
<b>Tazo Tea Frappuccino</b>	<b>Tall</b>	<b>Grande</b>	<b>Venti</b>	<b>Richer, more flavorful coffees</b>			
<b>Ice Blended Teas</b>				Espresso Roast	5.20	9.95	
Tazo Citrus	2.90	3.40	3.90	Decaf Espresso Roast	5.60	10.65	
Tazoberry	2.90	3.40	3.90	Yukon Blend	5.20	9.95	
Tazo Chai Crème	3.15	3.65	4.15	Café Verona	5.20	9.95	
				Guatemala Antigua	5.30	10.15	
				Arabian Mocha Java	6.30	11.95	
				Decaf Mocha Java/SWP	6.50	12.45	
				<b>Whole Beans: Mild</b>	<b>½ lb</b>	<b>1 lb</b>	
				<b>The perfect introduction to Starbucks coffees</b>			
				Breakfast Blend	5.20	9.95	
				Lightnote Blend	5.20	9.95	
				Decaf Lightnote Blend	5.60	10.65	
				Colombia Narino	5.50	10.45	
				House Blend	5.20	9.95	
				Decaf House Blend	5.60	10.65	
				Fair Trade Coffee	5.95	11.45	

Source: Starbucks location: Harvard Square, Cambridge, Massachusetts, February 2003.

**Exhibit 6** Total U.S. Retail Coffee Market (includes both in-home and out-of-home consumption)

Other estimates<sup>a</sup> for the U.S. retail coffee market in 2002:

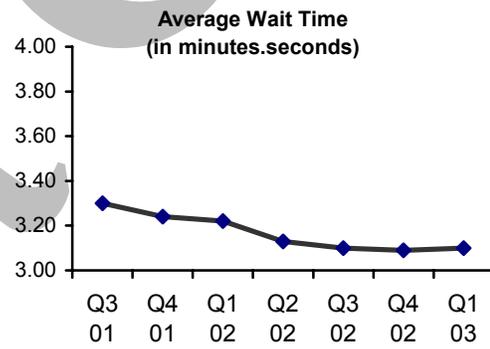
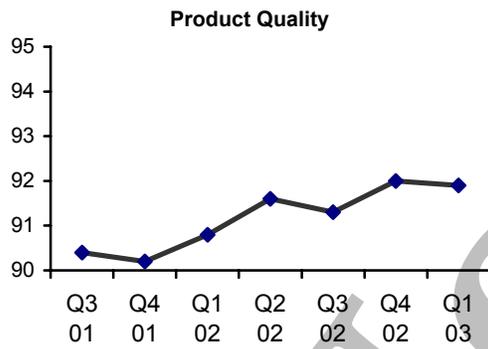
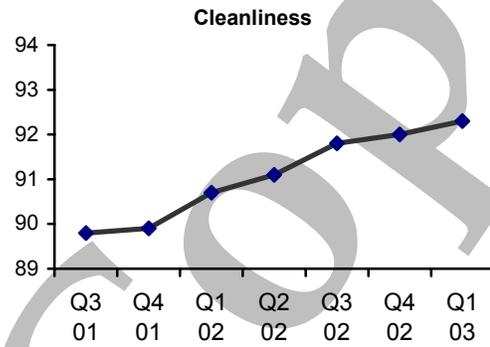
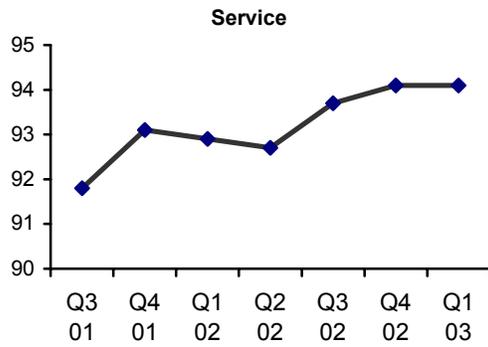
- In the home, specialty coffee<sup>b</sup> was estimated to be a \$3.2 billion business, of which Starbucks was estimated to have a 4% share.
- In the food-service channel, specialty coffee was estimated to be a \$5 billion business, of which Starbucks was estimated to have a 5% share.
- In grocery stores, Starbucks was estimated to have a 7.3% share in the ground-coffee category and a 21.7% share in the whole-beans category.
- It was estimated that over the next several years, the overall retail market would grow less than 1% per annum, but growth in the specialty-coffee category would be strong, with compound annual growth rate (CAGR) of 9% to 10%.
- Starbucks' U.S. business was projected to grow at a CAGR of approximately 20% top-line revenue growth.

Source: Adapted from company reports and Lehman Brothers, November 5, 2002.

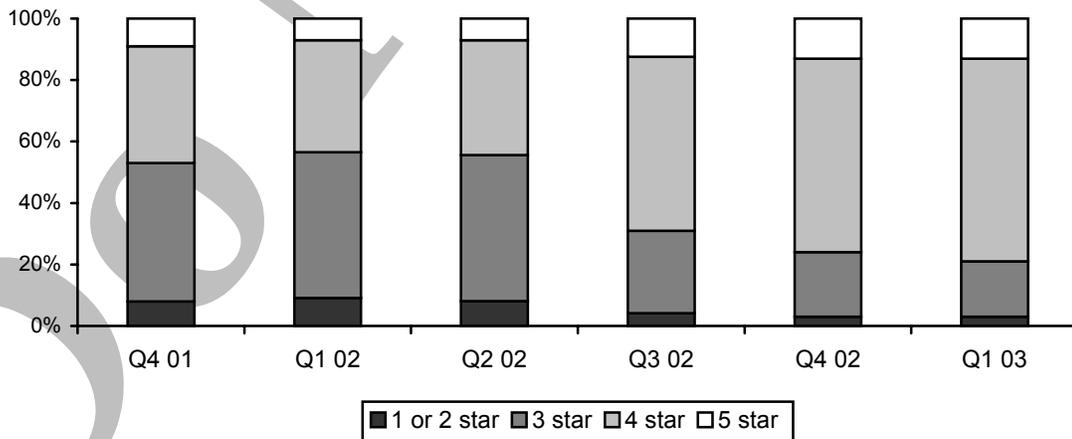
<sup>a</sup>The value of the retail coffee market was difficult to estimate given the highly fragmented and loosely monitored nature of the market (i.e., specialty coffeehouses, restaurants, delis, kiosks, street carts, grocery and convenience stores, vending machines, etc.).

<sup>b</sup>Specialty coffee includes espresso, cappuccino, latte, café mocha, iced/ice-blended coffee, gourmet coffee (premium whole bean or ground), and blended coffee.

Exhibit 7 Customer Snapshot Scores (North American stores)



Legendary Service Scores



Source: Company information.

**Exhibit 8** Starbucks' Customer Retention Information

% of Starbucks' customers who first started visiting Starbucks . . .	
In the past year	27%
1–2 years ago	20%
2–5 years ago	30%
5 or more years ago	23%

Source: Starbucks, 2002. Based on a sample of Starbucks' 2002 customer base.

	New Customers (first visited in past year)	Established Customers (first visited 5+ years ago)
Percent female	45%	49%
Average Age	36	40
Percent with College Degree +	37%	63%
Average income	\$65,000	\$81,000
Average # cups of coffee/week (includes at home and away from home)	15	19
<b>Attitudes toward Starbucks:</b>		
High-quality brand	34%	51%
Brand I trust	30%	50%
For someone like me	15%	40%
Worth paying more for	8%	32%
Known for specialty coffee	44%	60%
Known as the coffee expert	31%	45%
Best-tasting coffee	20%	31%
Highest-quality coffee	26%	41%
<b>Overall opinion of Starbucks</b>	<b>25%</b>	<b>44%</b>

Source: Starbucks, 2002. "Attitudes toward Starbucks" measured according to the percent of customers who agreed with the above statements.

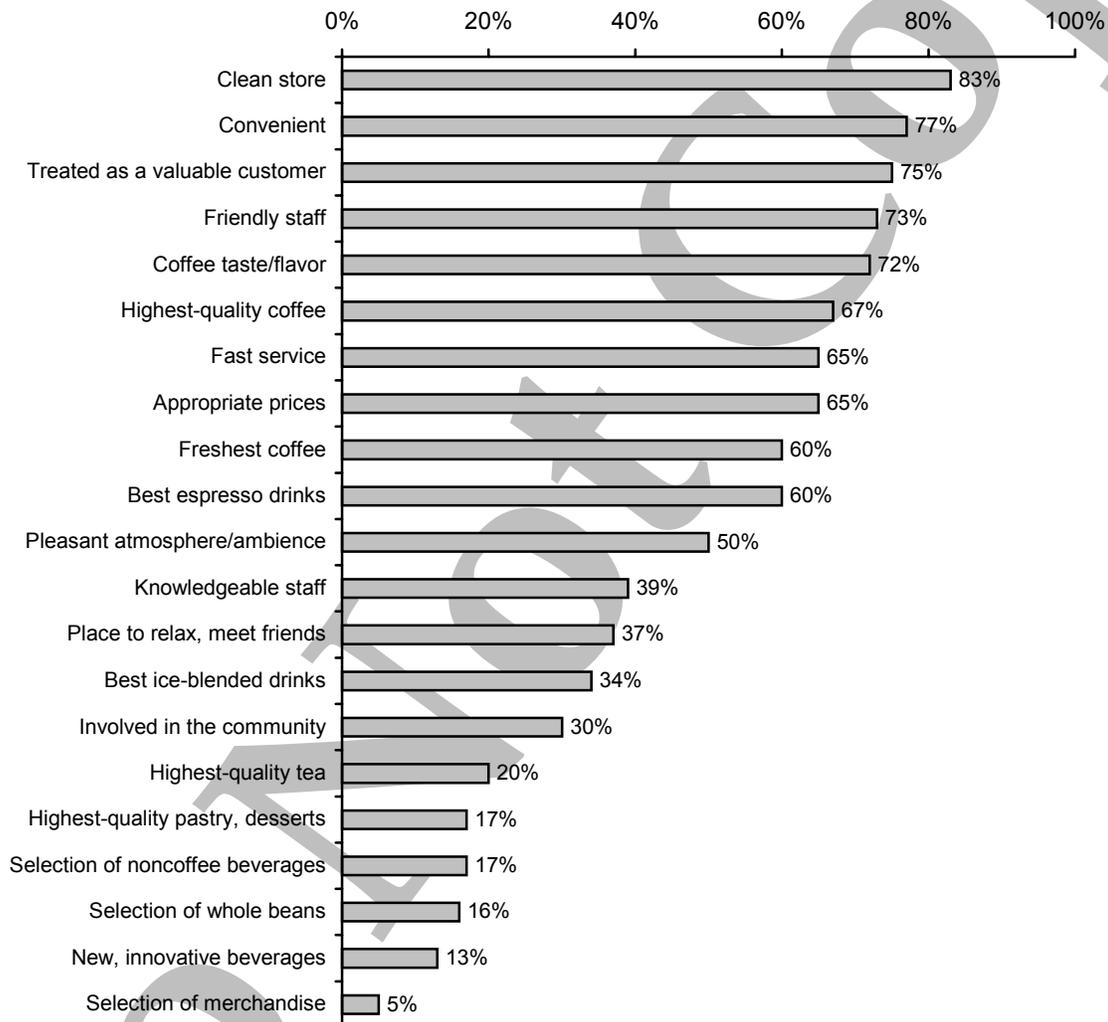
**Exhibit 9** Starbucks' Customer Behavior, by Satisfaction Level

	Unsatisfied Customer	Satisfied Customer	Highly Satisfied Customer
Number of Starbucks Visits/Month	3.9	4.3	7.2
Average Ticket Size/Visit	\$3.88	\$4.06	\$4.42
Average Customer Life (Years)	1.1	4.4	8.3

Source: Self-reported customer activity from Starbucks survey, 2002.

**Exhibit 10** Importance Rankings of Key Attributes in Creating Customer Satisfaction

To be read: 83% of Starbucks' customers rate a clean store as being highly important (90+ on a 100-point scale) in creating customer satisfaction.



Source: Self-reported customer activity from Starbucks survey, 2002.

**Exhibit 11** Factors Driving “Valued Customer” Perceptions

<b>How could Starbucks make you feel more like a valued customer?</b>	<b>% Responses</b>
<b>Improvements to Service (total)</b>	<b>34%</b>
Friendlier, more attentive staff	19%
Faster, more efficient service	10%
Personal treatment (remember my name, remember my order)	4%
More knowledgeable staff	4%
Better service	2%
<b>Offer Better Prices/Incentive Programs (total)</b>	<b>31%</b>
Free cup after x number of visits	19%
Reduce prices	11%
Offer promotions, specials	3%
<b>Other (total)</b>	<b>21%</b>
Better quality/Variety of products	9%
Improve atmosphere	8%
Community outreach/Charity	2%
More stores/More convenient locations	2%
<b>Don't Know/Already Satisfied</b>	<b>28%</b>

Source: Starbucks, 2002. Based on a survey of Starbucks' 2002 customer base, including highly satisfied, satisfied, and unsatisfied customers.