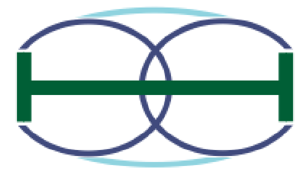
Strategic Report for Starbucks Corporation



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Executive Summary

Starbucks Corporation, formed in 1985, is a leading specialty coffee retailer and one of the best known brands today[i]. In addition to its sale of high-quality coffees, Starbucks retail stores also offer Italian-style espresso beverages, cold blended beverages, complementary food items, coffee-related accessories and equipment, premium teas, and a line of compact discs. Outside of its company-operated retail stores, Starbucks also sells packaged coffee and tea products, ready-to-drink beverages including its bottled Frappuccino® beverages and Starbucks DoubleShot® espresso drinks, ice creams, and other products mainly through licensing relationships. The company's brand portfolio includes Tazo® teas, Starbucks Hear Music® compact discs, Seattle's Best Coffee®, and Torrefazione Italia® coffee.

Throughout its history, Starbucks has been known for its aggressive store expansion, as it seemed impossible to open new stores quickly enough to keep up with demand. However, since its stock falling from about $80 per share near the end of 2006 to its current price of about $18 per share[ii], along with a dramatic decline in the growth of its same-store sales last quarter[iii], it seems that Starbucks may have run out of growth opportunities. Furthermore, as other specialty coffee retailers such as Peet's Coffee and Tea and Caribou Coffee have entered the market, and as competition from fast food chains such as Dunkin' Donuts and McDonald's has increased, Starbucks has lost market share. Therefore, it may appear that the company is in decline.

Despite these conditions, Starbucks remains the strongest company in the industry and it has many opportunities to increase its profits. The major issues facing the company include maintaining the Starbucks Experience for customers, store expansion and real estate issues, competition from fast-food chains and other specialty coffee retailers, specialty operations, generating more demand and penetrating new markets, and lowering input costs. Since the return of Howard Schultz in January 2008, much has been done that addresses the first three issues mentioned. The analysis in this report will help reaffirm those initiatives as well as discover others that address the last three issues and will enhance the company's performance.

Starbucks must seek more licensing relationships that will increase revenues from specialty operations at little cost, and also expose the brand. Existing retail stores must attract more customers and increase sales, especially after the morning rush hours, and can do so by expanding non-coffee beverage options. Finally, the company will drastically reduce its input costs by abandoning purchases of Fair Trade Certified™ coffee, which can be accomplished without drawing negative attention to the brand.

Company History

Starbucks began as a whole bean coffee seller in Seattle, Washington at Pikes Place in 1971[iv]. The original location's name was "Starbucks Coffee, Tea, and Spices," This caused some confusion and was later shortened to the "Starbucks Coffee Company." The name Starbucks comes from the first mate in the Moby Dick book by Herman Melville. Since its inception, the company's goal has been to find the premier coffee in the world and present it to people who would otherwise not be exposed to it.

In 1982 Starbucks acquired the services of Howard Schultz as the director of retail operations and marketing and the company began to expand its businesses by providing coffee to fine restaurants and espresso bars[v]. Starbucks put an emphasis on freshness during this time and would replace coffee it deemed not to be fresh, and thus unfit for consumption, for free so that customers received only the best coffee at these restaurants. A major shift in the Starbucks business plan occurred in 1983 when Schultz traveled to Italy and noticed the popularity of espresso bars in Milan. This gave him the idea that this would work in the United States, and Starbucks began testing this concept in 1985, successfully.

In 1985, Schultz founded Il Giornale[vi], which offered brewed Starbucks products in his Milan espresso bar replicas. Il Giornale succeeded and in 1987 Schultz secured the backing of local investors and acquired Starbucks Assets and changed the name to "Starbucks Corporation". From 1987 to 1992 Starbucks Corporation grew to 165 locations. This also included a mail order

catalog, a new headquarters, airport locations, and deals with several airlines to serve coffee on board.

On June 26th, 1992 Starbucks IPO'd at a price of $17 per share and closed trading on the first day at $21.50 per share[vii]. SBUX common stock is traded on the Nasdaq exchange. Since then, Starbucks has been one of the leaders in stock incentive programs involving even its part-time baristas. Starbucks was one of the first and still the most active companies in granting stock options to its entry-level employees regardless of salary. This is one of the reasons that Starbucks has been able to have such a high level of service over the years, because its employees care about the public perception of the company.

From 1992 to 2000 the Starbucks Corporation continued to grow and flourish by increasing its store total to an astounding 3,501 stores. During this time the company acquired Tazo® teas & Hear Music® in 1999, in hopes that people would view Starbucks as a destination, instead of simply a coffee shop[viii]. Starbucks has continued to acquire companies in order to make the transformation from simple coffee bar to entertainment destination by offering high speed internet since 2001, and starting events for local artists and musicians in the recent years.

Throughout the years Starbucks has grown its core business away from just coffee to a diversified portfolio including many different goods. The company's current product portfolio includes[ix]:

- Over 30 blends and single-origin coffees
- Unlimited combinations of brewed coffee and tea products
- Fresh foods; which includes pastries, sandwiches & salads
- Music, books, and film
- Packaged drinks and Starbucks liqueurs
- The Starbucks Card ($2.5 Billion in activations and reloads since 2001)

In addition to its extensive product offerings, the Starbucks Corporation has many brands which it cultivates including; Starbucks Entertainment, Starbucks Hear Music®, Tazo® Tea, Ethos Water, Seattle's Best Coffee®, and Torrefazione Italia® coffee. The successful management of all of these brands pulled together represents the Starbucks portfolio in most Starbucks locations.

Aside from products and brands, Starbucks is one of the most globally conscious corporations in America. In 2006 Starbucks donated $36.1 million in cash and products, volunteered 383,000 hours in local communities, required growers to use strict environmental guidelines, used 20% renewable energy in stores, and actively recycled in almost 80% of stores in US and Canada[x]. Starbucks has established itself as the coffee leader in the world and has done so on a socially and environmentally conscious platform. Throughout the years, the company has been the industry leader in promoting conservation in its actions and its preaching to the rest of the world. During this time, the company has surpassed all competition in this market because of its quality products and its focus on service. Starbucks has created a system of business where even the lowest paid employee is still encouraged to take pride in the company for which he works because it is tied to his compensation, which has helped to infiltrate the mission statement of Starbucks into all levels of employees.

Competitive Analysis

Porter's Five Forces Summary for Starbucks

Acting Force	Level of Threat to Profits
Internal Rivalry	Mid
Entry	Low-mid
Substitutes and Complements	Mid
Supplier Power	Low
Buyer Power	Low

Internal Rivalry

As the specialty beverage industry only grows more competitive, Starbucks' dominant positioning with a large market share is continuously under pressure. Since its inception,

Starbucks has stimulated the overall market, creating a positive spillover effect that increased the demand for quality coffee beverages. Therefore, even though Starbucks has rapidly expanded, so have local coffeehouses and 'mom-and-pop' stores. Thus, elasticity has increased with the variety of substitutes available to consumers offering the same product: premium coffee, friendly staff, and a comfortable milieu. For this reason, recent trends indicate industry stagnation within the domestic market as coffeehouses are now ubiquitous. Though the trend has peaked domestically, coffee and coffeehouses are still ingrained in the American culture leaving this market profitable.

Fragmented rivalry is due to the nature of the industry, which is split between national, regional, and local competitors domestically and abroad. Within the U.S., key national competitors include Dunkin' Donuts, McDonalds, and other fast food chains sprucing up and diversifying their beverage menu. However, the targeted customer base differs as Starbucks caters to high-end customers with its gourmet drinks. Nonetheless, the Starbucks Corporation must be conscious of its price point, so as not to exclude too many potential patrons. Regionally, the industry may be divided as follows among top rivals:

West coast: Coffee Bean & Tea Leaf and Peet's Coffee and Tea
Midwest: Caribou Coffee and Panera
East coast: Tim Hortons

These companies are better direct competitors to Starbucks than the national fast food chains as they appeal to the same consumer base and offer similar product selections. Caribou Coffee is the second largest corporation within the domestic specialty beverage industry. However, as of September 30, 2007 Starbucks operated 6,793 stores domestically and 1,712 stores internationally while Caribou Coffee operated 447 stores domestically and 17 internationally[xi]. Lastly, local competitors such as site-specific proprietorships and 'mom-and-pop' coffeehouses vie with Starbucks as well. While they are not threats to general empire Starbucks has created, they do reduce profit margins as they appeal to many coffee drinkers with their more personal character. These smaller proprietorships are Starbucks' greatest competitor abroad, which is

why recent expansion plans have focused on capturing international markets. Clearly, there are a large number of rivals within the specialty beverage industry creating a rather competitive landscape.

Customers do not incur a monetary switching cost in the specialty beverage industry; nonetheless, an emotional attachment to image and reputation keep them loyal to certain brand names. Even though only a superficial difference exists between coffeehouses, firms differentiate their products to capture customers from rival brands. The Starbucks name has acquired a significant status and has ranked as one of the most influential brand names in the American culture. With its well-trained baristas, comfortable atmosphere, and quick service, Starbucks has incorporated important characteristics appealing to customers. In the Starbucks business model, customers are more important than product. However, even though Starbucks is able to sell its goods at a higher price point, it must be conscious of the elastic market. For example, after increases in dairy costs –an input good every coffeehouse model– Starbucks stores felt the need to announce the reason for price increases so as not to shock customers. The company informed its customers of the pricing discrepancy because it did not want to lose their future patronage due to the economic circumstances at the time. This example illustrates the point that even though Starbucks has brand name loyalty, the company is still susceptible to the elastic nature of the market.

Starbucks is able to remain competitive within the market due to its sheer size and business model. As Starbucks takes advantage of economies of scale and scope, it follows a different cost structure than other corporations in the market. First, Starbucks pays less for the products it is able to buy in bulk such as dairy goods, syrups, paper goods, etc[xii]. For this reason, the company reaps higher margins with its specialty drinks, which also help differentiate itself from other coffeehouses. As customers know they can customize their drinks and the quality of the drink is guaranteed based upon reputation, Starbucks is always in their evoke set. Next, as no cooperative pricing exists in this industry, Starbucks prices its drinks based upon the elasticity of its target customer. Appealing to conspicuous consumption, Starbucks prices are higher than

its competitors, lending toward its high trend status. Last, Starbucks is able to differentiate itself due to its commitment to reduce its environmental impact. Again, its size enables the company to seek, incorporate and market these environmentally friendly endeavors. For example, the company replaced cups and cup sleeves with ones that used post-consumer recycled materials[xiii]. Also, Starbucks adheres to purchasing guidelines, The Commitment to Origins, which promote economic transparency in not only buying the best coffee, but also at premium prices to help farmers. These practices further differentiate Starbucks from many of its competitors.

Barriers to Entry

Within the specialty beverage industry, independent 'mom-and-pop' coffeehouses are able to compete against the larger brands like Starbucks and McDonalds, though on a localized level, because coffee is coffee. As the main input goods are relatively the same for existing and new companies, there are no true barriers to entry. Startup costs are not limiting due to the fact that unit costs do not fall over time within the experience curve, stores do not require a large amount of floor space, and the industry lacks the use technology, which is normally a huge initial cost. Thus, identifying an untapped convenient location or niche positioning with a select consumer base lures companies or individuals to establish their own coffeehouse. Such easy entrance into the market indicates that on a long-term horizon, profit margins will decrease within the industry.

However, there are several factors to consider before entering the market of specialty beverages. First is a general concern all entrepreneurs face: the rule of thumb states that roughly two-thirds of small businesses fail in the first three years. Next, one must consider the post-entry conditions and how to compete against Starbucks. Once a startup differentiates itself and establishes its consumer base, it must continue to fight against the reliability of Starbucks' quality and the Starbucks experience. Thus, a large amount of startup money must be spent on advertising to gain market share. Additionally, it is harder for those stores to grow and develop under the Starbucks shadow. The size and power of Starbucks allow the company to control

brand recognition, prime real estate locations, raw material discounts, and so on. Moreover, the controversial use of predatory practices that Starbucks may or may not utilize also plays a role: store location, exclusive leasing agreements, market saturation, and other efforts to stifle the emergence of rivals into the market.

Nonetheless, Starbucks has also felt the pressures of competition and has had to adapt. For instance, the company is currently revamping its coffee line to offer smaller, cheaper cups[xiv] while using new machines that create one cup of coffee individually so that the taste is fresher[xv]. This act can be seen as another way Starbucks is modernizing in order to maintain its massive market share, and repress others from contemplating entry.

Threat of Substitutes and Complements

Starbucks only holds roughly 10% of the domestic coffee consumption[xvi], therefore product-for-product substitution as well as generic substitution are important to analyze. There is a large variety of beverages available ranging from energy drinks or soda pop to juice or water. If one considers the social aspect of coffee, alcoholic beverages may also be taken into concern. However, Starbucks sells a large selection of these beverages within its stores. While the majority of coffee drinkers do not substitute away from coffee or coffee related beverages such as espresso or blended drinks, the most direct substitute is tea, which Starbucks sells under its own Tazo® Tea brand. Due to current economic conditions and consequently a change in the competitive landscape, Starbucks must be weary of at home production, especially as premium coffeemakers are being built to make single serving cups at a fraction of the cost. Again, Starbucks has covered this segment as it offers Starbucks branded coffee at various grocery store locations and warehouse club stores. Thus, the company has done a good job hedging against the threat of substitutes with the variety of beverages it offers.

The threat of customers substituting away from Starbucks for direct competitors such as Peet's Coffee and Tea or Caribou Coffee is a genuine concern. As they all pride themselves on customer service, specialty drinks, and milieu, they are truly hard to differentiate. On the other

hand, competitors such as McDonalds or Dunkin' Donuts have a negative connotation of being 'cheap', which does not appeal to Starbucks' targeted customer base. Therefore, this demographic will tend not to substitute away from the high stature brand names.

Within its store locations, Starbucks offers food selections to complement beverage purchases. For instance, the menu consists of pastries, confections, and pre-made foods such as salads and sandwiches. When a trial to introduce warm breakfast food provided less than desired results, the company decided to focus more on its core: fresher and tastier baked goods. Starbucks truly does not need to concern itself with diversifying its food selection as its current selection encompasses enough to accompany a coffee drink and satisfy customers. In addition to edible complements, Starbucks also retails coffee related complements such as mugs, coffeemakers, and other merchandise. However, such complements do not boost the demand for specialty beverages enough to be a considerable factor.

Supplier Power

As noted, Starbucks is able to take advantage of its size and benefit from economies of scale. Though it is able to purchase its input goods from relatively any supplier, the company paid 23% more than the market price for all of its coffee in fiscal 2005[xvii]. This was done in an effort to abide by its Commitment to Origins in purchasing Fair Trade Certified™ coffee. Regardless of the power Starbucks possesses due to the volume of goods demanded, suppliers are rather limited because of the conditions within their own markets. As the input markets – comprised of coffee bean plantations, dairy farmers, and the like – sell commodities, price is determined by supply and demand. Therefore, due to the high competitiveness of the market, substitutes are available if Starbucks desires to buy at a different price point. Additionally, suppliers cannot forwardly integrate due to their remote locations and lack of retail capabilities. Basically, Starbucks holds all the power in the relationships is has with its suppliers.

Buyer Power

Starbucks decides the price at which it sells its drinks based upon the price elasticity of its consumers and the current prices at rival stores. As the company offers a vertically differentiated product where the status of higher quality is based upon perception, it is able to sell at a higher price point. Thus, prices are non-negotiable as the customers have no bargaining power with Starbucks. Even though patrons may buy from other coffeehouses or purchase different beverages, due to the high availability of substitutes, Starbucks reacts more to product competition than individual consumer demands to maintain market leadership.

SWOT Analysis

Strengths

- Brand recognition and consumer loyalty
- Diverse product portfolio catering to all tastes and ages, including non-coffee beverages and food items
- Excellent customer service and the value of the Starbucks experience
- Licensing relationships with top-brands such as Pepsi-Cola and Kraft that minimize costs and leverage the strategic advantages of those companies[xviii]
- Strong employee relationships
- Economies of scale providing superior distribution networks and supplier power
- Primly-located retail stores
- Positive image attributed to social responsibility

Weaknesses

- Pay 23% more for coffee than market prices
- Saturation of the market diminishes long-term growth prospects
- No monetary switching costs for consumers
- Negative large corporation image
- Potential limitations of international expansion due to cultural clashes with American coffee experiences

Opportunities

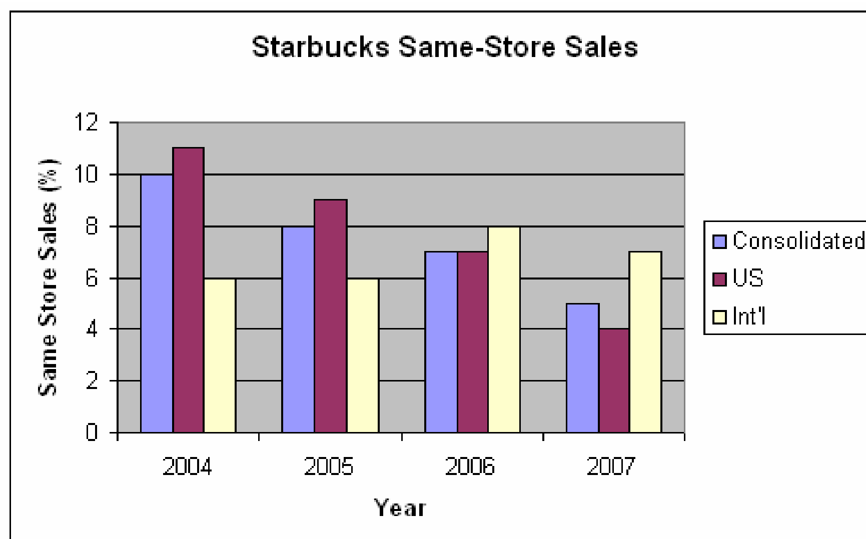
- Have the ability to reduce premiums paid for coffee
- Room for international expansion (78% of revenues came from the United States in fiscal 2007 and international same-store sales growth is strong)[xix]
- Room to compete on multiple fronts including quality and price
- Increase licensing relationships to further utilize brand strength to capture profits at little cost to the company

Threats

- Increasing coffee and dairy prices
- Intense competition in the specialty coffee beverage business
- Unfavorable economic conditions that lower the demand for expensive beverages
- Community resistance to store expansion
- The possibility that the demand for specialty coffee is a fad
- Diverging from the Starbucks experience
- Further diversification of fast food restaurants that cuts into market share

Financial Analysis

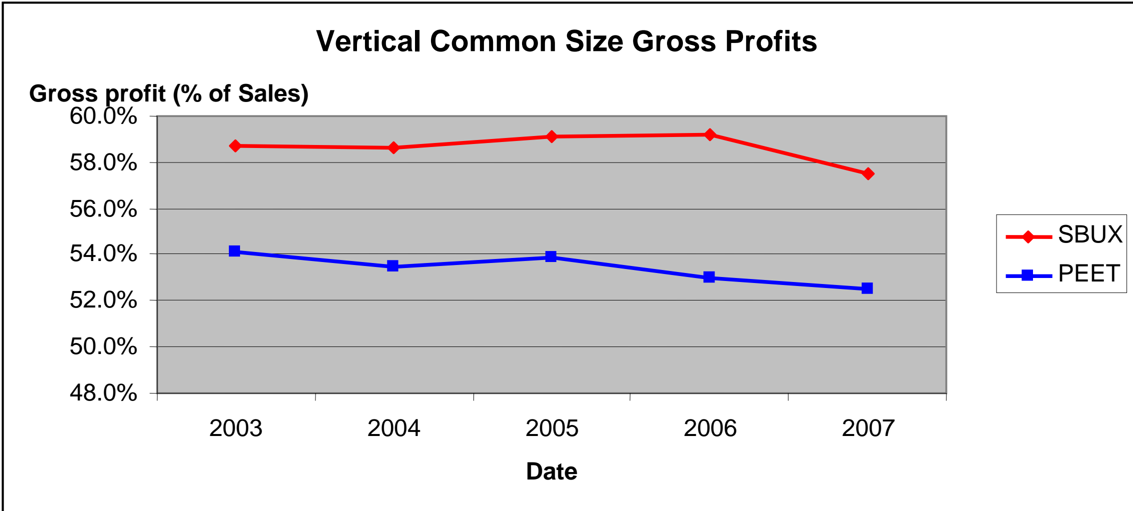
Perhaps the largest financial problem to which Starbucks owes its declining stock price is the slowdown in its same-store sales, which have experienced diminished growth for some time



and grew only 1% in Q1 of 2008[xx]. This leads one to question whether the company's aggressive store expansion has led to cannibalization. Company-operated retail stores have nearly doubled since 2003, with an increase of about 3,000 domestic stores[xxi]. During such rapid expansion, revenue growth rates can only be maintained if transactions are higher at the new locations than the amount that was lost from existing stores, costs such as rent are lower at the new stores, or if the new stores relieve capacity pressures at the existing high volume locations. An ideal scenario would be the opening of a new store in a less visible location, meaning it has lower rent costs, which attracts many customers away from high volume stores, thereby freeing up service capacity at the premium locations, which will attract new customers[xxii]. If such opportunities are scarce, then the company must consider limiting its expansion. While these opportunities may be waning in the United States, the international data is encouraging. Domestic company-operated retail revenues grew by almost 20% between 2006 and 2007. This growth is substantial, however, international company-operated retail revenues grew by more than 30%[xxiii]. In fact, international same-store sales growth has been quite strong[xxiv].

An equally large concern due to the declining same-store sales growth is whether the recent turmoil of the United States economy has made it difficult for consumers to justify paying $4 or more for a cup of coffee in the morning. Furthermore, increasing coffee prices inhibit the performance of the entire industry. A closer look at the financial statements of Starbucks, and a comparison to one of its competitors, will shed some light on these problems and help identify some of the strengths and weaknesses of the company.

The following analysis compares the financial performance of Starbucks to Peet's Coffee and Tea[xxv]. Dunkin' Donuts may have also been a comparison, since it is believed that recent developments in the economy may be causing SBUX to lose customers to DD, but financial information is not available as it is not a publicly traded firm. Nevertheless, PEET is similar to SBUX in many ways and is in many of the same markets. The most concerning information on its income statement shows that the cost of goods sold of Starbucks is outpacing its sales revenues. Although the two year compound annual growth rate of the company's sales revenues is 21.56%, its COGS grew by 23.90% in the same time period (2005-2007). This is troubling further because this may be an industry-wide phenomenon and therefore, little may be done to overcome this problem. The fact that Peet's COGS grew by 21.02% versus a growth of 19.31% in sales revenues over this time period suggests that increasing coffee prices are hurting the industry as a whole. However, the good news is that Starbucks maintains a higher growth rate in gross profits than Peet's (19.91% vs. 17.83% in 2007), although these figures have declined from 25.39% and 20.62%, respectively, in 2005. The figure below shows the trend in gross profits as a percentage of sales revenues for both companies.



Starbucks also looks rather healthy compared to Peet's in that it has a positive, although declining, growth rate in net income in recent years while Peet's has actually experienced negative growth rates in net income.

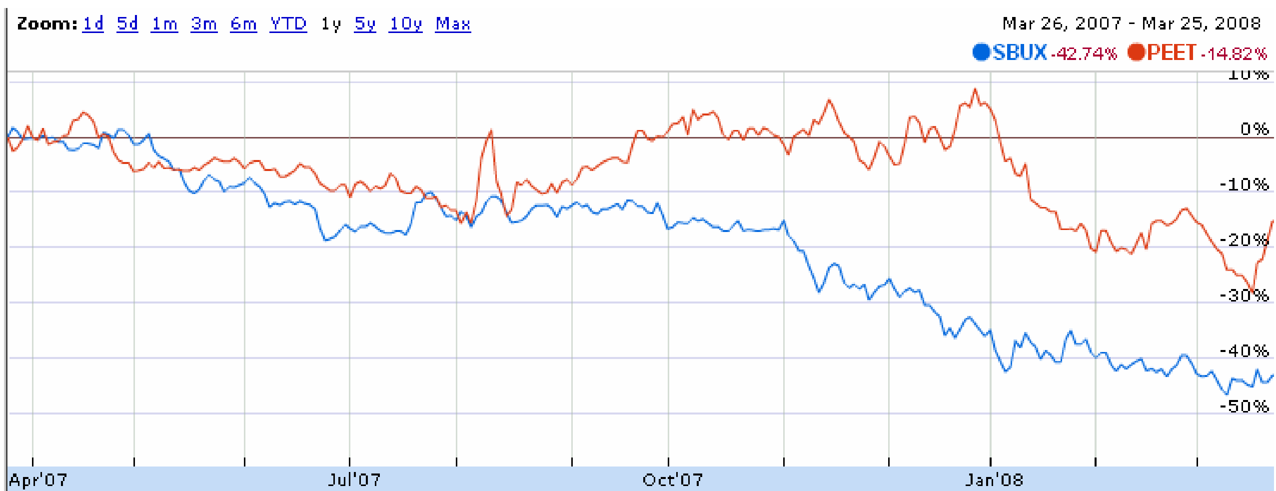
Including the balance sheet in this analysis, there is almost no difference between the companies' net cash conversion cycles. In fact, Starbucks has a very healthy downward trend in the cycle. This means that over the past few years, Starbucks has been able to reduce the time between the day it pays its suppliers and the day it turns that investment into cash. Therefore, it has reduced the time it needs to tie up its capital in the business process, which is better for its bottom line.

	Starbucks Corporation				**Peet's Coffee & Tea**		
Financial Ratios	**9/30/2007**	**10/1/2006**	**10/2/2005**		**2007**	**2006**	**2005**
AR Turn	36.75	37.52	33.39		32.98	35.11	34.01
Days AR	10	10	11		11	10	11
AP Turn	11	11	12		11	10	9
Days AP	33	32	31		33	36	39
Inv Turn	6	5	5		5	5	5
Day Inv	61	68	77		68	67	77
Net Cash Conversion Cycle	37	45	57		46	42	49
ROE	29.81%	26.93%	23.65%		6.10%	6.15%	8.49%
Growth in Book Value	104.53%				107.73%		

Although the cash conversion cycle displays a healthy trend, the most dramatic difference between these companies is their returns on equity. Compare the ROE of Starbucks of 29.81% in 2007 versus 6.10% for Peet's. This means that Starbucks is much better at generating profits with the money invested by shareholders.

Although most this news thus far, with the exception of the growth rate of its COGS, at least as compared to its competitor has been rather positive, the stock price of Starbucks has been declining, for the most part, since October 2006. On October 6, 2006, SBUX traded for $38.41 per share, compared to March 2008, where it has fluctuated between $17 and $18 per share. In the past year, SBUX has underperformed the S&P 500, as evidenced by the graph below[xxvi].

SBUX has also underperformed PEET in the last year, which is especially surprising in light of the previous analysis. This news does not necessarily mean SBUX is undervalued, but it also may indicate that PEET is overvalued.



Despite rising coffee prices and economic downturn, Starbucks' problems are rooted in declining same-store sales, which may have other contributors such as cannibalization from aggressive store expansion. Furthermore, although it is true that coffee prices are on the rise, it is also true that Starbucks pays a premium for Fair Trade Certified™ coffee. In fact, in 2005, Starbucks paid on average 23 percent more for its coffee than market prices. If management decides this is an issue with which the company is ready to deal, Harkness associates will

perform a more rigorous analysis that compares the gross margins of the company's operations including purchases of the Fair Trade coffee to those expected gross margins where the company pays market prices for all coffee.

Strategic Issues and Recommendations

Since the return of Howard Schultz as the company CEO, Starbucks has made many changes to its retail stores. Schultz believed that many of the company's struggles came out of its diverging from what customers expected out of the Starbucks experience. Changes included plans to phase out hot breakfast items that took away from the coffee smell in stores, lower machines that allow customers to see their drink being made, and giving baristas more control over each individual drink. The company has also decided to experiment with a $1 refillable cup of coffee in order to take market share away from competitors like McDonald's and Dunkin' Donuts, whose customers have more price elastic demand. Also to deal with the real estate effects on declining same-store sales, the company decided to cut back domestic store expansion, while focusing on international store expansion to keep up with demand abroad. While many of these initiatives are steps in the right direction, there are other strategic issues that the company has yet to address.

Many critics of Starbucks claim that the company has spread itself too thin in recent years by selling products like chocolate and ice cream that haven't performed that well and hurt the company's bottom line. It should first be noted that these specialty operations, which include all operations outside of company-operated retail such as the packaged coffee and tea which is sold in the grocery store, bottled ready-to-drink beverages, chocolate, ice cream, coffee liqueur, and its entertainment business, constitute only 15% of the company's business[xxvii]. Furthermore, most of these operations are conducted through licensing relationships with other companies. For example, the packaged coffee and tea products available in grocery stores are sold through a licensing relationship with Kraft Foods. Kraft manages all distribution, marketing, advertising and promotion of theses products. Starbucks sells its ready-to-drink beverages such as the bottled Frappuccino® beverages and DoubleShot® espresso drinks through a joint

venture with Pepsi-Cola. Additionally, Dreyer's sells the Starbucks ice cream and Hershey sells its chocolate.

Thus, since these specialty operations are such a small portion of the business and since they require little capital investment, it is clear that Starbucks does not have much to lose by maintaining these relationships. In many cases, the company is just selling its brand name and collecting royalties. In others, such as the joint venture with Pepsi-Cola, Starbucks is leveraging the strategic advantages of its partner in the soft drink industry to sell products in a market in which it might otherwise not be able to compete. Therefore, not only does Starbucks have the advantage of incurring few costs in these relationships, but it also stands to gain significant revenues from their operations. Additionally, these licensing relationships put the Starbucks name further into the public eye, which helps marketing and increases brand recognition. For these reasons, the Harkness Consulting team recommends that the company further seek such licensing relationships. It is preferred that the Starbucks looks for those that require as little capital as possible invested on its own part, such as those that simply license the brand name and allow the company to collect royalties at no cost, unless it is believed that substantial returns will be gained from a joint venture. Furthermore, Starbucks should only seek licensing relationships in adjacent markets, or those that go along with the Starbucks experience, to prevent negative brand image. For example, the consulting team is confident that management will not pursue a licensing relationship to create a Starbucks hamburger.

While attention to detail is important, further recommendations will focus on the company-operated retail segment, since it constitutes 85% of the business. Furthermore, 75% of retail sales come from coffee[xxviii]. As noted in the financial analysis section of this report, one of the largest problems on the company's financial statements is that its COGS are increasing faster than its sales revenues. If Starbucks could find a way to lower its input costs, then the company would be in a much healthier financial position and would have much more flexibility in dealing with its competitors. Fortunately, Starbucks is in such a position. In fiscal 2005, although only a small fraction of the coffee the company purchases is Fair Trade Certified™,

those purchases caused Starbucks to pay 23% more on average for all of its coffee than market prices. The consulting team recognizes that the Fair Trade certification puts a positive mark on the already scrutinized brand image of the company. However, current research shows that Fair Trade practices do not have a positive impact on coffee farming communities in third world countries[xxix]. Therefore, the consulting team recommends that the company discontinue its purchases of Fair Trade Certified™ coffee, along with a PR campaign that divulges the facts about Fair Trade practices and Starbucks' commitment to world justice. The company may even decide to start a program or charity such as one that builds schools or hospitals in coffee farming communities. The main point is that discontinuing purchases of Fair Trade Certified™ coffee will dramatically lower the company's input prices, and that this can be done without tarnishing the company's corporate image.

Not only will paying less for coffee directly increase the company's profits, but it will also give Starbucks more room to compete with other companies on prices. Although Starbucks claims that it strives to compete on quality, due to recent economic conditions, many consumers have been turned on to buying cheap coffee at McDonald's and Dunkin' Donuts, and lowering prices may have a dramatic impact on sales. Therefore, the team recommends that Starbucks lower its prices on coffee in stores, while maintaining current price levels on add-ins and other products, since it is believed that consumers are most price-elastic in their demand for coffee, but the customers who add four pumps of flavored syrup will pay about anything to do so.

Another area in which the retail segment of Starbucks should focus is its offerings of non-coffee beverage options. Although Starbucks is a coffee retailer, many customers are drawn to the Starbucks experience without actually liking coffee. Therefore, expanding these non-coffee beverage options and increasing their promotion will allow the company to serve a larger market. Furthermore, while a large portion of a store's business is concentrated in the morning hours before customers go to work, there are substantial growth opportunities in increasing business in the later hours of the day. This strategy will increase sales during the late mornings and early afternoons, when parents taking care of their kids during the day and adolescents

hanging out after school are likely to frequent a Starbucks location. These small children and students don't like coffee but will drink the juices offered in stores. The company should pay special attention to its line of Frappuccino® Blended Crèmes. Since the stores make these items themselves, they allow for customization, which produces higher profit margins. Also there are no close substitutes for these products and they provide these younger customers a good transition to the coffee offerings[xxx].

Appendix

Starbucks Income Statement Tables

Vertical Common Size	9/30/2007	10/1/2006	10/2/2005	10/3/2004	9/28/2003
Sales revenues	20.9%	22.3%	20.3%	29.9%	
Cost of goods sold	42.5%	40.8%	40.9%	41.4%	41.3%
Gross profit	57.5%	59.2%	59.1%	58.6%	58.7%
Selling, general and administrative expenses	39.4%	40.7%	39.7%	39.6%	39.9%
Depreciation and amortization expenses	5.0%	5.0%	5.3%	5.5%	6.0%
Other operating expenses	3.1%	3.3%	3.0%	3.2%	3.5%
Total operating expenses	47.5%	48.9%	48.0%	48.3%	49.3%
Operating income	10.1%	10.3%	11.1%	10.3%	9.4%
Other gains and losses	1.2%	1.4%	1.5%	1.4%	1.2%
Pretax income	11.2%	11.6%	12.5%	11.7%	10.6%
Tax expense	4.1%	4.2%	4.7%	4.4%	4.1%
Income before extraordinary items	7.1%	7.5%	7.8%	7.3%	6.5%
Extraordinary items or accounting change	0.0%	0.0%	0.0%	0.0%	0.0%
Net income	7.1%	7.5%	7.8%	7.3%	6.5%

Compound Annual Growth Rate	9/30/2007	10/1/2006	10/2/2005
Sales revenues	21.56%	21.28%	25.01%
Cost of goods sold	23.90%	20.44%	24.47%
Gross profit	19.91%	21.87%	25.39%
Selling, general and administrative expenses	21.08%	22.97%	24.75%
Depreciation and amortization expenses	17.19%	15.71%	17.91%
Other operating expenses	23.60%	21.58%	16.71%
Total operating expenses	20.81%	22.08%	23.39%
Operating income	15.93%	20.88%	35.40%
Other gains and losses	9.27%	20.53%	38.05%
Pretax income	15.17%	20.84%	35.70%
Tax expense	12.73%	18.38%	34.42%
Income before extraordinary items	16.64%	22.28%	36.49%
Extraordinary items or accounting change			
Net income	16.64%	22.28%	36.49%

Peet's Coffee and Tea Income Statement Tables

Vertical Common Size	2007	2006	2005	2004	2003
Sales revenues	18.5%	20.1%	20.3%	21.6%	
Cost of goods sold	47.5%	47.0%	46.1%	46.5%	45.9%
Gross profit	52.5%	53.0%	53.9%	53.5%	54.1%
Selling, general and administrative expenses	43.5%	44.1%	40.7%	40.6%	43.8%
Depreciation and amortization expenses	4.4%	4.1%	4.2%	4.0%	4.1%
Other operating expenses	0.0%	0.0%	0.0%	0.0%	0.0%
Total operating expenses	47.9%	48.2%	44.8%	44.5%	47.9%
Operating income	4.7%	4.8%	9.0%	8.9%	6.3%
Other gains and losses	0.6%	1.2%	1.0%	0.6%	1.0%
Pretax income	5.2%	5.9%	10.1%	9.6%	7.2%
Tax expense	1.9%	2.2%	3.9%	3.6%	2.9%
Income before extraordinary items	3.4%	3.7%	6.2%	6.0%	4.3%
Extraordinary items or accounting change	0.0%	0.0%	0.0%	0.0%	0.0%
Net income	3.4%	3.7%	6.2%	6.0%	4.3%

Compound Annual Growth Rate	2007	2006	2005
Sales revenues	19.31%	20.20%	20.92%
Cost of goods sold	21.02%	20.79%	21.28%
Gross profit	17.83%	19.69%	20.62%
Selling, general and administrative expenses	23.42%	25.40%	16.51%
Depreciation and amortization expenses	22.32%	21.97%	22.12%
Other operating expenses			
Total operating expenses	23.32%	25.09%	17.00%
Operating income	-14.42%	-12.10%	45.40%
Other gains and losses	-9.59%	63.21%	23.33%
Pretax income	-13.93%	-5.24%	42.64%
Tax expense	-17.34%	-5.19%	40.20%
Income before extraordinary items	-11.83%	-5.27%	44.25%
Extraordinary items or accounting change			
Net income	-11.83%	-5.27%	44.25%

Starbucks Balance Sheet Tables

Vertical Common Size	9/30/2007	10/1/2006	10/2/2005
Cash	5.3%	7.1%	4.9%
Short-term Investments	2.9%	3.2%	3.8%
Accounts receivable	5.4%	5.1%	5.4%
Inventory	12.9%	14.4%	15.5%
Other current assets	2.8%	2.9%	2.7%
Total current assets	31.7%	34.5%	34.4%
Property, plant and equipment	54.1%	51.7%	52.4%
Investments	5.2%	5.1%	7.4%
Other assets	4.1%	4.2%	2.1%

Accounts Payable	7.3%	7.7%	6.3%
Accrued Liabilities	14.2%	14.9%	15.7%
Total current liabilities	40.3%	43.7%	34.9%
Long-term debt	10.3%	0.0%	0.1%
Warranty payable	0.0%	0.0%	0.0%
Other liabilities	6.6%	5.9%	5.5%
Total liabilities	57.3%	49.7%	40.5%
Preferred stock	0.0%	0.0%	0.0%
Common stock	0.0%	0.0%	0.0%
Treasury stock	0.0%	0.0%	0.0%
Retained earnings	41.0%	48.6%	55.2%
Other comprehensive income	1.0%	0.8%	0.6%
Other equity adjustments	0.0%	0.0%	0.0%
Total shareholders' equity	42.7%	50.3%	59.5%

Peet's Coffee and Tea Balance Sheet Tables

Vertical Common Size	**2007**	**2006**	**2005**
Cash	8.6%	5.0%	13.9%
Short-term Investments	4.5%	12.8%	21.8%
Accounts receivable	4.7%	4.5%	3.5%
Inventory	13.8%	12.8%	11.4%
Other current assets	2.4%	2.5%	2.3%
Total current assets	35.6%	38.8%	53.9%
Property, plant and equipment	55.9%	53.9%	31.1%
Investments	4.4%	3.9%	11.4%
Other assets	4.1%	3.4%	3.7%
Accounts Payable	5.7%	7.2%	5.7%
Accrued Liabilities	5.0%	4.2%	3.7%
Total current liabilities	14.0%	14.4%	11.8%
Long-term debt	0.0%	0.0%	1.2%
Warranty payable	0.0%	0.0%	0.0%
Other liabilities	3.1%	2.3%	1.7%
Total liabilities	17.1%	16.7%	14.7%
Preferred stock	0.0%	0.0%	0.0%
Common stock	58.9%	60.9%	67.6%
Treasury stock	0.0%	0.0%	0.0%
Retained earnings	24.0%	22.4%	17.7%
Other comprehensive income	0.0%	0.0%	-0.1%
Other equity adjustments	0.0%	0.0%	0.0%
Total shareholders' equity	82.9%	83.3%	85.3%

[i] Starbucks 10-K 2007
[ii] finance.google.com: SBUX
[iii] Financial Alchemist, "Starbuck's Traffic Decline Due to Cannibalization," http://financial-alchemist.blogspot.com/2008/02/starbucks-traffic-decline-due-to.html
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[xvii] www.starbucks.com: Fair Trade and Coffee Social Responsibility
[xviii] Starbucks 10-K 2007
[xix] Starbucks 10-K 2007
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[xxi] Starbucks 10-K 2007
[xxii] Financial Alchemist, "Starbuck's Traffic Decline Due to Cannibalization," http://financial-alchemist.blogspot.com/2008/02/starbucks-traffic-decline-due-to.html
[xxiii] Starbucks 10-K 2007
[xxiv] Graph from www.wikinvest.com: SBUX
[xxv] The following statistics are compiled from the financial statements listed in the company's 10-K (2005-07)
[xxvi] Stock charts from finance.google.com
[xxvii] Starbucks 10-K 2007
[xxviii] Starbucks 10-K 2007
[xxix] Alan Boise lecture, Senior Seminar 2008
[xxx] In addition to the aforementioned references, the following book was instrumental for this analysis:

Michelli, Joseph. The Starbucks Experience: 5 Principles for Turning the Ordinary into Extraordinary. McGraw-Hill, New York, NY: 2006.