Rustic Coffee:
A Strategy for
Challenging Starbucks

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Question

Howard Schultz pioneered the mainstream market for the Italian-style espresso shops in the US after buying the small Starbucks chain in 1987. Since then, the industry has exploded across the US and continues to grow at a phenomenal rate. The retail market for specialty coffee is not yet mature, so moving into it now could still be very profitable.

The strategic question we pose is: How can we successfully and most profitably enter the retail specialty coffee business that is dominated by Starbucks?

Executive Summary

Start a franchised chain of coffee shops that will initially concentrate on the rural areas (the chain will henceforth be referred to under a working title of "Rustic Coffee"). Rural development will serve as a nursery in which Rustic Coffee can grow without competition while establishing a distinctive national brand identity than can later be used to compete directly with Starbucks. We will sell franchises for large areas so that franchisees can follow a more coherent strategy for the stores, such for tactics such as allowing cannibalizing sales like Starbucks.

Raise the quality and business relevance of complementary goods, because many people will stay in the store. Do not try to compete mostly on price, as this will undercut the quality signal for specialty coffee. Extract more concessions from the bean and labor suppliers, because they have minimal bargaining power, and this will generate a comparative advantage over Starbucks.

Strategic Analysis

Entry

Overall, the entry barriers for selling specialty coffee in rural areas are quite low.

The continuing rapid expansion of Starbucks, including into rural areas, offers empirical evidence that on the level of individual stores, entry barriers are low. Since our corporate focus will be on areas underserved by Starbucks, our franchisees will mostly open stores in locations with no close competition.

While we cannot achieve national coverage immediately, we want blanket coverage and heavy marketing in areas that we do enter. Company-owned stores in the start-up area could follow the blanket placement strategy, and then franchisees would imitate it (assuming it is successful). The advantages of scale in this industry are not overwhelming, as shown by the abundance of independent coffee shops and small chains. One of the main scaling advantages is brand recognition. Ubiquitous stores serve as a substitute for expensive advertising. Even without the close spacing of urban markets, being a destination location in every large town in a county would have an analogous effect.

The main axes of differentiation are location, quality, products, atmosphere, and taste. Locating away from Starbucks is central to the rural entry strategy. On quality, we are emulating the quality of Starbucks because of Starbucks's success, though our franchised structure may result in slightly worse quality control. We will offer more food products than Starbucks, because we expect the eat-in-the-store market to be a larger proportion of business in rural areas. The "grab-and-go" market of people who stop in on the way to office jobs will be much less important than it is in urban areas. We will have minor style and taste differentiation from Starbucks, the exact nature of which can be decided by specialists in those areas. Although we will initially be mostly in markets without Starbucks, later expansion into contested markets will require differentiated style and taste to win over some of Starbucks's customers.

Since we will be the vanguard of the specialty coffee industry opening in new markets, customer education will be a necessary part of our marketing. Hopefully some knowledge of Starbucks will reduce the amount of customer education required. Customer familiarity with the market will be a much more important consideration when challenging existing Starbucks locations, where marketing would need to focus on sending a "better than Starbucks" message.

Entry barriers related to experience in the industry are low. The learning curve in specialty coffee is mostly limited to business methods, as opposed to product design. Even much of the business method information can be copied from other retail industries. Selecting franchisees with experience in their regions would essentially outsource expertise to reduce the demands on the central company.

Rivalry

Rustic Coffee will have to compete with the multitude of current competitors in the specialty coffee business. While we hope to minimize this by starting in less saturated areas, it is possible that these companies will respond to entry by erecting stores nearby, creating direct competition. The most serious threat is from Starbucks, which is infamous for creating stores everywhere and has plans to expand in rural areas.

One way to compete with the brand names currently in existence is to create brand loyalty. This can be done by ensuring quality (e.g. with refunds or free drinks if there are problems) and by directly rewarding loyalty (e.g. with membership cards or with "buy 10 drinks get the 11th free" deals). Getting buy-in from the franchisees would be essential for these programs to succeed.

It is unlikely that competitors will change core business strategies in response to Rustic Coffee. Quality competition would be very difficult to achieve, as it would require a restructuring of Starbucks's business structure. Price competition would do too much damage to the businesses and has not been a factor near earlier entrants. It is difficult for consumers to determine the quality of a coffee-shop before purchasing a drink, so the price of the coffee can be used to signal the quality. That is, customers wanting a gourmet drink may be turned off by a store with lower prices simply because of the lower prices. Beyond signaling of quality, there is some status symbol effect to what coffee you are drinking, so that higher prices in and of themselves make the product more desirable to some people. If the quality signaling and status symbol effects are large enough, they may negate price competition even during later stages of the product life cycle.

Substitutes

The market for substitutes is split between in-store and out-of-store points-of-sale. It is likely that by selling beans in-store for at-home coffee-making, the entrant may better pervade the consumers' coffee experience and so build a better name overall. Teas also enhance the reputation, and are relatively simple to incorporate into the store atmosphere and design.

Other upscale coffee shops like Starbucks are obviously close substitutes to Rustic Coffee, but physically locating away from close substitutes lessens the possibility of consumers making the substitution. Low-end coffee sellers like Dunkin Donuts are weaker substitutes, and proper differentiation in quality and atmosphere is necessary to avoid too much overlap with them.

Other non-coffee substitutes, such as colas, energy drinks, or other specialty beverages are not easily compatible with the specialty-coffee model. These markets are huge, and are unlikely to be impacted by the entry of another company into the coffee industry. For this reason their effects are not accounted for in the entry strategy.

Suppliers

The main suppliers in coffee shop chain business are: coffee beans suppliers, equipment suppliers, real estate sellers and renters, and employees.

The price of coffee beans has plummeted because of a rise in the global coffee production, due largely to the emergence of Vietnam as a coffee supplier. This has reduced the cost of beans as a proportion of the total cost of coffee drinks. The current market players have not locked up a large portion of bean suppliers, and any apparent supplier loyalty is likely just the result of economic considerations. Although there is price advantage for buying large quantity as Starbuck does, the massive surplus in supply makes this effect negligible. Moreover, Starbucks's mere 1% of the world's total coffee purchases limits its ability to influence the coffee purchase price. It is hard for Starbucks to strike a purchase price war with a potential entrant in the coffee drink business. Although the high-quality Arabica coffee counts for only 10% of the world's coffee purchases, the oversupply and the lack of concentration in coffee purchase parties eases the challenge in procuring high-quality coffee beans.

Capital equipment in coffee shops includes coffee makers, grinding equipment, and furniture. Buying smaller amounts of equipment than Starbucks might increase the relative price for Rustic Coffee, but the disadvantage will not be too big since these are all commodity goods. The suppliers are not tied to any existing coffee shops. The supply of equipment will neither prevent entry nor create a substantial competitive disadvantage to a small firm.

Starbucks has been picking spots populated with well-educated, well-paid people who are sophisticated enough to appreciate its expensive upscale coffee beverages. They are experienced in playing the real estate market to acquire suitable locations. Since Rustic Coffee will initially be operating in rural areas, the real estate market will be somewhat different, probably to the effect that the retail company will be in an even more advantageous position.

Coffee making expertise and store management experience are not proprietary and can be hired away. Employees and potential employees are benefit sensitive and thus can be competed over. Differentiation in compensation and working conditions will keep us from hiring from exact the same pool as Starbucks. As mentioned earlier, the areas we are going to open shops first are not the high salary regions. The lower rural labor cost favors our side in negotiations with employees. The relatively low skill required for employees will always give the bargaining power to the company. With franchises, workers' compensation (especially health insurance) will probably be lower than for Starbucks, which could compensate for Rustic Coffee's higher costs in other areas.

Buyers

Since we are opening in areas not densely populated with white-collar worker, we will have a lower percentage of "grab-and-go" customers. Our challenge then is to serve enough in-store customers to support our business and especially to assure customers' continued willingness to pay for the upscale coffee. To do this, we have to leverage our interior design for a cozy theme environment and to align the theme with high-quality food items.

Starbucks has a population of buyers for product lines outside its retail coffee business. It sells ground coffee for home brewing, bottled coffee drinks, ice cream, and even coffee liqueur. We will not start with such secondary aspects of the coffee drink business but instead will concentrate on selling beverages and food within our stores.

Complements

In our rural coffee shops, complements are very important. We want to create a homey and cozy atmosphere at our stores to attract local people. The high proportion of the customer base that will stay in the store to eat increases the importance of complements. If they are staying in the store longer, they will pay more attention to the décor and will eat more food. The result is increased complementarity between the coffee and these other factors.

For the places where real estate is cheap, we could provide a garden setting for people to sit down and enjoy coffee. Perhaps an outdoor garden and an indoor garden, to accommodate different weather conditions. Although maintaining gardens would be extremely expensive if the feature were "transplanted" into urban stores later, a scaled-down version could create substantial differentiation from Starbucks that would attract a more lucrative demographic.

For other food and drink, we will provide sandwiches, baked goods, and English teas as complementary products because food and coffee usually go together. We will put some magazines and books on the shelves to attract a more literate customer base. We will encourage franchisees to promote friendliness towards customers. The goal is to make our store an extension of home, so local people like to come.