STARBUCKS' INTERNATIONAL OPERATIONS[1]

Internationally, we are in our infancy.
(Howard Schultz, Chairman & Chief Global Strategist – Starbucks, 2003)

The expansion strategy internationally is not bullet-proof as it is in the U.S.
(Mitchell J. Speiser, Analyst – Lehman Brothers, 2003)

ALL'S NOT WELL WITH STARBUCKS

In March 2003, *Fortune* came out with its annual list of "Fortune 500 companies". For Howard Schultz (Schultz), Chairman of Starbucks Corp. (Starbucks), this list was special as Starbucks [was] featured in the list (position 465). It was a dream that come true for the Seattle-based entrepreneur.
Though the U.S. economy was reeling under recession and many retail majors were reporting losses and applying for bankruptcy, Starbucks announced a 31% increase in its net earnings and a 23% increase in sales for the first quarter of 2003. Analyst felt that the success of Starbucks showed that a quality product speaks for itself and the fact that Starbucks spent less than 1% of its sales on advertising and marketing strengthened this view. In addition to be a popular brand among customers, Starbucks was also considered the best place to work due to its employee friendly policies (Starbucks was the first organization in the U.S. to offer stock options and health coverage to part-time employees also).
However, analysts felt that the success of Starbucks was due to its profitable domestic operations. It was reported that most of Starbucks' international operations were running into losses. In May 2003, Starbucks' Japanese operations reported a loss of $3.9 million (Japan constituted the largest market for the company outside the U.S.), and the company also performed badly in Europe and the Middle East. Analysts pointed out that Starbucks international operations were not as well planned as its U.S. operations. They also observed that the volatile international business environment made it difficult for the company to effectively manage its international operations.
Many analysts felt that it was important for the company to focus on its international operations. With the U.S. market getting saturated, Starbucks would be forced to look outside the U.S. for revenues and growth.
The history of Starbucks dates back to 1971, when Jerry Baldwin, Zev Siegl and Gordon Bowker (an English teacher, a History teacher and a writer) launched a coffee bean retailing store named Starbucks to sell specialty whole-bean coffee in Seattle. By 1981, the number of Starbucks stores increased to five and Starbucks also established a small roasting facility in Seattle. Around the same time, Howard Schultz (Schultz) who was working with Hammarplast – a Swedish housewares company which marketed coffee makers – noticed that Starbucks, a small company from Seattle, was ordering more coffee makers than anyone else. In order to find out more about the company, Schultz visited Seattle. Schultz was so impressed by the company and its founders that he offered to work for the company.
By 1982, Schultz joined Starbucks as marketing manager, with an equity stake in the company. During his first year at Starbucks, he studied the various types of coffee and the intricacies of the coffee business. The turning point came in 1983, when Schultz was sent to Milan (Italy) for an international housewares show. There he observed that every street in the city had an espresso coffee bar, where people met and spent time. Schultz realized that Starbucks could introduce espresso coffee bars in the U.S. Schultz put forward this idea to his partners. But they did not like the idea of selling espresso coffee. However, after a lot of persuasion from Schultz, they agreed to allow him to sell espresso coffee in their retail shop. The business picked up and by the weekend they were making more money by selling the beverage than by selling coffee beans. Still when the partners refused to venture into the beverage business, Schultz decided to quit the company and start out on his own.

[1] This case study was adapted after K. Subhadra – ICFAI Center for Management Research (ICMR), published in Deresky H., "*International Management: Managing across Borders and Cultures*", 5th Edition, International Edition, Pearson Education International, 2006, pp. 323-330. The case study is intended to be used as a basis for classroom discussion rather than to illustrate either effective or ineffective handling of a management situation.

In April 1985, Schultz opened a coffee bar – *Il Giornale* in Seattle – with a seed capital of $150,000 invested by Jerry Baldwin and Gordon Bowker. The rest of the capital was raised through private placement. Soon, the second and third stores were opened in Seattle and Vancouver respectively. During 1987, when Schultz heard that Starbucks' owners were selling off six stores along with a roasting plant and the Starbucks brand name, he raised $3.8 million through private placements and bought Starbucks. As Starbucks was a more established name, Schultz decided to retain it instead of *Il Giornale*.

Schultz expanded Starbucks to Chicago, Los Angeles, and other major cities. But with increasing overhead expenses, the company reported a loss of $1.2 million in the year 1990. Schultz was, however, confident of his business plan and continued his expansion spree. He even hired employees from companies such as PepsiCo. By 1991, the number of Starbucks stores increased to 116, and it became the first privately owned company to offer employee stock options. In 1992, Starbucks was listed on the stock exchange at a price of $17 per share.

The strategy adopted by Starbucks was to blanket a region with its new stores. By doing so it could reduce the customers' rush in one store and also increase its revenues through new stores. This helped the company to reduce its distribution costs and the waiting period for customers in its stores, thereby increasing the number of customers. It was reported that on an average a customer visited Starbucks stores 18 times a month, a very high number compared to other American retailers. By 1993, there were around 100 Starbucks stores, which increased to 145 in 1994.

Along with serving coffee, Starbucks also sold merchandise. In 1995, it started selling CDs of its famous in-house music program. It also entered into alliances with various players such as Canadian Airlines, United Airlines, Starwood Hotel, and Barnes & Noble Inc., to serve Starbucks coffee.

Analysts attributed the success of Starbucks not only to its aggressive expansion, but also to its product innovation. Starbucks came out with new products to attract customers. For instance, in 1995, to cater to the needs of diet conscious youngsters it launched *Frappuccino* – a low fat creamy iced coffee. In 1996, it launched ice cream and ice cream bars through its subsidiary Starbucks and Dreyer's Grand Ice Cream, Inc. In the same year it also entered into an agreement with the cola major PepsiCo to launch bottled Starbucks *Frappuccino*. Due to all these initiatives Starbucks has recorded an average growth of 20% per year since 1991, and its store traffic increased to 6-8% per year.

However, in mid-1990s, with the market reaching saturation, Starbucks could no longer depend on the U.S. market for growth. Analysts felt that to maintain its growth rates and to boost revenues, Starbucks should venture abroad. In 1995, Starbucks formed Starbucks Coffee International, its wholly owned subsidiary, to monitor the company's international expansion. In 1996, Starbucks entered Japan through a joint venture with the Sazaby's Inc. (a leading Japanese teashop and interior-goods retailer) and over the years it expanded into South-East Asia, Europe, and the Middle East. By March 2003, Starbucks had 1,532 stores (23% of its total stores) outside the U.S. (Refer to *Table 1* for Starbucks' international presence, although not an exhaustive one).

Table 1: Starbucks' International Presence

Country	Type of Entry	Name of the Partner	Year
Canada	Wholly-owned subsidiary	Starbucks Coffee Canada	1996
Japan	Joint Venture	Sazaby Inc.	1996
Malaysia	Licensee	Berajaya Group bhd	1998
New Zealand	Licensee	Restaurant Brands	1998
Taiwan	Joint Venture	President Coffee Corp.	1998
Kuwait	Licensee	Alshaya	1999
Philippines	Licensee	Rustan's Coffee Corp.	2000
Australia	Joint Venture	Markus Hofer	2000
Israel	Joint Venture	Delek Corporation**	2001
Austria	Licensee	Bon Appetit Group**	2001
Switzerland	Licensee	Bon Appetit Group**	2001
Germany	Joint Venture	Karstadt Qualle AG	2002
Greece	Joint Venture	Marinopoulos Brothers	2002
Mexico	Joint Venture	SC de Mexico	2002
Hawaii	Joint Venture	Cafe Hawaii Partners	2002
Hong Kong	Joint Venture	Maxim Caterers Ltd.	2000
Indonesia	Joint Venture	PT Mitra A Diperkasa	2002
Puerto Rico	Joint Venture	Puerto Rico Coffee Partners LLC	2002
Lebanon	Licensee	Alshaya	N.A.
Spain	Joint Venture	Grupo Vips	2002

** Starbucks closed its operations in Israel and bought out the stakes of its partners in Austria and Switzerland in 2003.

Starbucks decided to enter the Asia Pacific Rim market first (Asia Pacific Rim markets consist of Japan, Philippines, Indonesia, Thailand, Taiwan, Malaysia, Singapore, China, South Korea, North Korea, New Zealand, Australia, Vietnam, Cambodia, Papua New Guinea). Growing consumerism in the Asia Pacific countries and eagerness among the younger generation to imitate Western lifestyles made these countries attractive markets for Starbucks.
Starbucks decided to enter international markets by using a three pronged strategy – joint ventures, licensing and wholly owned subsidiaries (Refer to *Exhibit 1* for the modes of entry in international markets). Prior to entering a foreign market, Starbucks focused on studying the market conditions for its products in the country. It then decided on the local partner for its business. Initially Starbucks test marketed with a few stores that were opened in trendy places, and the company's experienced managers from Seattle handled the operations.

Exhibit 1: Modes of Entry into International Markets

There are six primary ways to enter a foreign market. They are: *exporting*, *turnkey projects*, *licensing*, *franchising*, *joint venture with a host country firm*, and *setting up a wholly-owned subsidiary in the host country*. Each mode of entry has its advantages and disadvantages. The method a company chooses depends on a variety of factors including the nature of the particular product or service and the conditions for market penetration in the foreign target market.

1. **EXPORTING:** Most firms begin their global expansion with exports and later switch over to another mode. Beginning with 1990s, the volume of exports in the world economy had increased significantly due to the decline in trade barriers. However, exporting still remains a challenge for smaller firms. Firms planning to export must identify foreign market opportunities, familiarize themselves with the mechanics of exports, and learn to deal with foreign exchange risk.
   Advantages: Ability to realize location and experience curve economies
   Disadvantages: High transport costs; Trade barriers; Problems with local marketing agents.

2. **TURNKEY PROJECTS:** In a turnkey project, the contractor handles every aspect of the project for a foreign client, including the training of operating personnel. After the completion of the contract, the foreign client is handed the "key" to the plant that is ready for operation. Turnkey projects are common in chemical, pharmaceutical, and petroleum refining industry.
   Advantages: Ability to earn returns from process technology skills in countries where FDI is restricted
   Disadvantages: Creating efficient competitors; Lack of long term market presence.

3. **LICENSING:** Licensing is an arrangement whereby a company (licenser) grants the rights to intangible property like patents, inventions, formula, process, designs, copyrights, and trademarks to another company (licensee) for a specified period of time. The licenser receives a loyalty fee (royalty) from the licensee. For example, in the early 1960s, Xerox licensed its patented xerographic know-how to Fuji-Xerox. It was initially meant for ten years; but the license was extended several times. In return, Fuji-Xerox paid Xerox a royalty fee equal to 5% of the net sales revenue that it earned.
   Advantages: Low development costs and risks
   Disadvantages: Lack of control over technology; Inability to realize location and experience curve economies; Inability to engage in global strategic coordination.

4. **FRANCHISING:** Franchising is similar to licensing except that it requires long-term commitments. In franchising, the franchiser not only sells intangible property to the franchisee, but also insists that the franchisee abide by the rules of business. In some cases, the franchiser also assists the franchisee in running the business. The franchiser receives a royalty payment that is usually a percentage of the franchisee's revenues. Service companies usually opt for franchising. For example, McDonald's pursues its expansion abroad through franchising. McDonald's sets down strict rules for the franchisees to operate their restaurants. The rules extend to cooking methods, staffing policy, and design and location of the restaurants. McDonald's also organizes the supply chain and provides management training and financial assistance to the franchisees.
   Advantages: Low development costs and risks
   Disadvantages: Lack of control over technology; Inability to realize location and experience curve economies; Inability to engage in global strategic coordination.

5. **JOINT VENTURES:** In contrast to licensing and franchising arrangements, joint ventures allow companies to own a stake and play a role in the management of the foreign operation. Joint ventures require more direct investment and training, management assistance and technology transfer. Joint ventures can be equity or non-equity partnerships. Equity joint ventures are contractual arrangements with equal partners. Non-equity joint ventures are the ones where the host country partner has a greater stake. In some countries, a joint venture is the only way for a foreign company to set up operations.
   Advantages: Access to local partners' knowledge; Sharing development costs and risks; Politically acceptable.
   Disadvantages: Lack of control over technology; Inability to engage in global strategic coordination; Inability to realize location and experience economies.

6. **WHOLLY OWNED SUBSIDIARIES:** In a wholly owned subsidiary, the firm owns 100% of the stock of the subsidiary. Wholly owned subsidiaries can be established in a foreign country in two ways: a firm can set up new operations in the foreign country (Greenfield investments) or it can acquire a firm and promote its products through that firm (Brownfield investments).
   Advantages: Protection of technology; Ability to engage in global strategic coordination; Ability to realize location and experience economies
   Disadvantages: High costs and risks.

After successful test marketing, local baristas (brew masters) were given training for 13 weeks in Seattle. Starbucks did not compromise on its basic principles. It ensured similar coffee beverage line ups and *No Smoking* rules in all its stores across the globe.
When Starbucks entered into a joint venture with Sazaby Inc. to open Starbucks stores in Japan, analysts felt that Starbucks was unlikely to succeed. They even advised Starbucks to forego its principles such as *No Smoking*, and ensure that the size of the stores would not be more than 500 square feet due to the high rents in Japan. However, Starbuck stuck to its *No Smoking* principle, which attracted young Japanese women to the Starbucks stores, and the size of the stores was 1200-1500 sq ft – similar to the stores in the U.S. Proving analysts wrong, Starbucks became successful and, in the first year itself, it opened more than 100 stores.
According to Starbucks' sources, listening to its local partners also helped. Starbucks took advantage of its local partner Sazaby's knowledge about Japanese coffee drinking habits and introduced new products such as *Green Tea Frappuccino*, which became popular.
Starbucks was successful in attracting a young crowd in all its Asian markets, as young people in these markets were eager to imitate the American culture. It even adapted itself to the local culture to gain market acceptance. For instance, Starbucks offered curry puffs and meat buns in Asian markets as Asians generally prefer to eat something while having coffee.
Analysts felt that the strong coffee drinking culture in Europe posed both challenges and opportunities for Starbucks. It would face tough competition from the sidewalk cafes of France, coffeehouses of Vienna, and espresso bars of Italy, that had developed a strong coffee drinking culture across the Continent, exposing Europeans to the best coffee in the world. However, Starbucks executives commented that Europe used to make great coffees, but, by the late 1990s, the taste had gone away. In 1998, Starbucks opened its first store in England, and soon expanded its presence to Switzerland, Germany, and Greece.
It was generally felt that though old people would stick to the existing coffee houses, the young would be attracted to Starbucks. Helmuth Spudich, editor, *Der Standard* (a Vienna-based paper), said that "The coffeehouses in Vienna are nice, but they are old. Starbucks is considered hip." Another important factor that could lead to the success of Starbucks in Europe was its ambience and *No Smoking* environment, unlike traditional European coffee bars. The self-service mode of operation also attracted the young crowd as it was observed that youngsters did not like to wait for the waiter to come and take orders. According to Starbucks sources, it was successful because it was not just selling coffee but an experience, which was unique only to Starbucks stores. Maslen, President of Starbucks International, said "The coffee id good, but it's just the vehicle. The romance of coffee, the occasion, the community is what Starbucks is selling." In the Middle East, Starbucks went for licensing (except in Israel where it had a joint venture). Respecting the culture in the Middle East, Starbucks stores offered segregated sections for ladies.
In September 2002, Starbucks announced that it would increase the number of international stores to 10,000 by 2005. However, analysts pointed out that it would be difficult for Starbucks to make profits in international markets, and they were soon to be proved right.

PROBLEMS IN INTERNATIONAL MARKETS

From the early 2000s, Starbucks faced many problems in its international operations (Refer to *Exhibit 2* for risks in international markets). The volatile political environment in the Middle East created serious problems for Starbucks. In July 2002, Arab students gave a call for a boycott of American goods and services, due to the alleged close relationship between the U.S. and Israel. The boycott targeted U.S. companies including Starbucks, Burger King, Coca Cola, and Estee Lauder. Starbucks topped the list of companies to be boycotted due to Schultz's alleged closeness to the Jewish community (In 1998, Schultz was honoured with the "Israeli 50th Anniversary Tribute Award" by the *Jerusalem Fund of Aish Ha-Torah*, a group supporting Israel).
The problem was aggravated when it was reported that, in one of his lectures to students at the University of Washington, Schultz had said, "one of my missions is to sensitize you; you should not be immune to what is happening in the world. I travel a great deal and one of the things that I see is the rise of anti-Semitism in Europe, especially France and England." His address to Jewish Americans made matters worse. Schultz said, "What is going on in the Middle East is not an isolated part of the world. The rise of anti-Semitism is at an all time high since the 1930s. Palestinians aren't doing their job; they're not stopping terrorism." These comments from Schultz resulted in angry protests from the Arab countries and pro-Palestinian groups across the Middle East and Europe. Analysts felt that Schultz comments strengthened the feeling that he was acting as an Israeli mouthpiece.

Exhibit 2: Types of Risks in International Business

Typically a firm operating internationally is exposed to different types of risks. These can be listed as *environmental*, *financial*, *organizational*, or *strategic* risks.

1. **STRATEGIC RISK:** MNCs typically face a diverse set of risks all of which cannot be assessed quantitatively. Michael Porter defines five forces impacting a firm's competitiveness – threat of substitutes, threat of new entrants in the industry, bargaining power of suppliers, bargaining power of customers, and the intensity of competition within the industry. A firm's strategic decisions to respond to the five forces are a source of risk.

2. **OPERATIONAL RISK:** Operational risk arises out of factors internal to the company such as machinery breakdown, industrial strife, supply and distribution imperfections, excess or shortfall in inventory, and so on. It causes a down-time in the day-to-day operations of the enterprise. Reducing costs by eliminating wastage, reducing variances and lead-time by improving processes are important to bring about global efficiency. The more the number of parts and processes involved in production, the greater the risk of not achieving the desired quality and productivity standards.

3. **POLITICAL RISK:** Political risk refers to political actions that have a negative impact on the firm's value. The process of establishing a cause-and-effect relationship between political factors and business income is called political risk analysis. Political risk is not confined to developing countries. It exists even in highly industrialized economies. While macro-political risks such as war and anti-globalization efforts affect the value of all firms in the country, micro-political risks like regulation of certain industries affect the value of a firm or firms within that industry, adversely.

4. **COUNTRY RISK:** Country risk is a wider concept that encompasses economic conditions, government policies, political conditions, and security factors. The challenge of country risk analysis is in the aggregation of risk factors.

5. **TECHNOLOGICAL RISK:** Technological risk means the probability of adverse effects on business due to factors like obsolescence of an existing technology, development costs of new technology, failure of a new technology, and security concerns of electronic transactions.

6. **ENVIRONMENTAL RISK:** Environmental risk can be of two forms. The company may incur regulators' wrath because it polluted the environment, or there may be a public outcry in the event of an environmental damage caused by the company. Environmental risk management might not provide short-term gains like financial risk management does. But in the long run, it can certainly become a source of competitive advantage and also enhance the corporate image.

Starbucks distanced itself from Schultz's comments, saying that they represented his personal beliefs and not those of the company. Schultz also denied allegations that he was anti-Palestinian and released a personal statement, saying that "my position has always been pro-peace and for the two nations to co-exist peacefully."
In addition to the previously mentioned incidents, the U.S. declaration of war on Iraq in early 2003 made matters even worse for the company. Due to increasing security threats, Starbucks closed down its six stores in Israel.

Starbucks also faced criticism from non-governmental organizations (NGOs) who urged the company to acquire certified coffee beans, ensuring that those coffee beans were grown and marketed under certain economic and social conditions. Starbucks also faced problems due to economic recession in countries such as Switzerland, Germany, and Japan in the early 2000s, where it experienced declining sales and revenues.

Starbucks faced stiff competition, high business development costs, and resistance from customers in international markets. Especially in Europe, it was reported that Starbucks faced stiff competition from well-established local players who offered speciality coffee at lower prices when compared to Starbucks. For example in England, while the Starbucks tall latte coffee was sold at $2.93, the same was available for $2.12 at the local coffee shop.

By the 1990s, Starbucks noticed that store traffic in Japan, its largest overseas market, had been reducing. It was observed that, over a period of time, customers opted for different stores, as they did not like the taste of Starbucks coffee. A customer commented, "I never go to Starbucks if I can help it. The coffee tastes artificial." In 2002, the Starbucks sales in Japan declined by over 17%. In order to boost its sales, it even introduced food items like rice and salmon wraps, and white peach muffins, yet it failed to gain market acceptance.

It was observed that Starbucks was unable to earn more revenue from its international operations due to its complex joint ventures and licensing agreements. While the company invested huge amounts in imparting training to the employees and promoting its products, it earned only a percentage share in total profits and royalty fees. It was further felt that the company did not have any control over the operational costs.

In addition to its problems in international markets, Starbucks experienced operational problems due to lack of a trained workforce and suitable real estate for its stores. Commenting on the operational hindrances faced by

Starbucks, Maslen said, “If we could train the people and find the real estate, the expansion could happen tomorrow, almost. There is demand.”

FUTURE PROSPECTS

In order to have better control over operational costs, Starbucks decided to go for new suppliers for items such as mugs. It was reported that the company was thinking of sourcing mugs from low cost Japanese vendors rather than importing them from the U.S. and planning to source its paper goods (such as plates and cups) from Southeast Asia.
Starbucks also announced that it would slow down its pace of expansion by opening around 80 stores in 2003 (compared to the 115 stores opened in 2002). Company sources also revealed that Starbucks would close down its loss making stores. However, analysts pointed out that closing down the loss making stores and adopting cost cutting will increase profitability only in the short run and not drive future growth.
Analysts pointed out that Starbucks should rethink its entry strategy in international markets and focus on pricing. They also felt that the company being relatively debt free, and with around $300 million in free cash flows, it should be able to rebuild its foreign operations.
However, they cautioned Starbucks against the external risks resulting from volatile political and business environments across the world. They felt that with increasing tensions between America and the rest of the world, the business environment, especially in the Middle East and South East Asian regions, was becoming increasingly volatile. Acknowledging the risks involved in the international markets, Schultz said, “We’re not taking our success for granted. We also understand that the burden of proof at times is on us given the fact that a lot is being written and there’s more sensitivity than ever before about America and American companies. These are the very early days for the growth and development of the company internationally. Clearly, there’s a big world out there for Starbucks to expand in.”
Only the time can tell whether Starbucks will be able to brew its success in the international markets.

QUESTIONS FOR DISCUSSION:

1. Analysts felt that MNCs can mitigate some of the risks in international markets by deciding on a suitable mode of entry into these markets. Analyze the entry strategies adopted by Starbucks for its international expansion.
2. Careful analysis and management of risks not only mitigate losses but also provide superior returns. In the light of this statement, do you think Starbucks did not analyze and manage the risks involved in the different markets it entered?
3. A company faces a diverse set of risks in international markets. What were the risks faced by Starbucks in its international operations? Explain how Starbucks can reduce risks in its international business.

Other information about Starbucks nowadays:

- Starbucks serves filter coffee, espresso-based hot drinks, ice tea and cold drinks. Pastries, salads and sandwiches are added to all these. Through the *Starbucks Entertainment* division and *Hear Music* brand, the company was also launched in the music, movie and book industry.
- Starbucks chain now has 7,521 wholly-owned coffee shops and 5,647 licensed coffee shops or joint ventures in 39 countries.
- Starbucks wants to get to operate 40,000 stores worldwide, including 20,000 outside the U.S. (a great part of them in China).
- According to the official justification of the company, in Starbucks stores the smoking is prohibited to ensure that the coffee flavour is not compromised. For the same reason, Starbucks has also asked its employees not to wear strong perfumes.
- Starbucks is sometimes considered, especially by the members of anti-globalization movement, as a symbol of the challenges posed by globalization. Several activists have made websites criticizing the company’s policies, working conditions and environmental impact, considering Starbucks a good example of U.S. cultural and economic imperialism.

Figure 1: Evolution of Starbucks' logo during the years

Legend:
A) Engraving of a mermaid with two tails (15th century);
B) First Starbucks logo (1971-1987);
C) *Il Giornale* logo;
D) The merger between Starbucks and *Il Giornale* (1987-1992);
E) Redesigned Starbucks logo (1992-up to present);
F) Current Starbucks logo, an update of the original.
Source: http://www.seriouseats.com/2008/04/the-changing-face-of-starbucks.html