

Coffee wars

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Starbucks ousts its boss and brings back its founder as a new threat emerges

HOWARD SCHULTZ once said that he finds it painful when people compare his firm, Starbucks, to McDonald's. The founder of the world's biggest chain of coffee shops thinks a visit to Starbucks should involve "romance and theatre", a far cry from the pit-stop-like experience of eating a meal at the world's biggest fast-food chain. Yet in its efforts to expand and attract less affluent customers over the past couple of years, Starbucks has started to become more like McDonald's—even as McDonald's, for its part, has been moving upmarket to become more like Starbucks.

Going head to head Starbucks is now struggling with the most serious crisis in its history—much as McDonald's did at the beginning of the decade. Last year Starbucks' share-price fell by 42%, making it one of the worst performers on the NASDAQ exchange. In the last quarter of 2007 Starbucks recorded its first ever year-on-year decline in customer visits in America, easily its biggest market. When analysts at Bear Stearns, an investment bank, downgraded the firm's shares on January 2nd, they plunged by another 12%. This sealed the fate of Jim Donald, the chief executive since 2005. On January 7th the company said it would replace him with Mr Schultz, who stepped aside in 2000 to become chairman.

Mr Schultz is not trying to pass the buck. His company is in trouble, and much of it is self-inflicted. "I'm here to tell you that just as we created this problem, we will fix it," he promised. He wants to slow down the pace of expansion and improve the "customer experience" in America, while accelerating expansion overseas. But he says there is no "silver bullet".

Analysts agree that Starbucks' main problem is overexpansion—as it was at McDonald's in 2001, when the chain crossed the 30,000-store mark and struggled with a dearth of innovation, market saturation and poor control over restaurants. Howard Penney, an analyst at Friedman, Billings, Ramsey in New York, thinks Starbucks needs to cut its rate of expansion in America by half. "They are growing too fast in a mature market," he says. The firm has more than 10,600 coffee shops in its homeland, and another five or so open every day. Starbucks had been aiming for 20,000 shops in America and 20,000 abroad, but that goal is now in doubt.

Not all of Starbucks' poor performance is of its own making. Prices for food commodities are at all-time highs, prompting the firm to increase prices twice in the past year. This has scared off customers, who have been defecting to fast-food chains such as Dunkin' Donuts or Panera Bread, which sell reasonable coffee for as little as a quarter of the price of a fancy Starbucks brew. In November Starbucks launched its first national television-advertising campaign in an effort to win them back.

Adding to Starbucks' woes, and further emphasising its similarity with McDonald's, the burger chain is about to launch a direct attack of its own. This year McDonald's plans to add Starbucks-style coffee bars to nearly 14,000 of its American restaurants—the biggest diversification ever attempted by the company. McDonald's has already made smaller forays

into the coffee market, and with some success. Last year Consumer Reports, a trade magazine, rated its filter coffee more highly than that offered by Starbucks.

Starbucks should be worried, says Mr Penney, though he thinks McDonald's is taking a big risk. About 65% of its sales in America are made in drive-through restaurants where customers stay in their cars, placing their orders and then receiving their food through a window. It is impossible to make a Starbucks-style "double-tall decaf hazelnut latte", which takes time, when impatient motorists are queuing. In Germany, a test market, some 300 McCafés are doing well, but they are not attached to drive-throughs.

Mr Schultz saw his firm's crisis coming. In February 2007 he warned of the "commoditisation" of the brand in an internal memo to senior executives that found its way onto the internet. "Over the past ten years...we have had to make a series of decisions that, in retrospect, have led to the watering down of the Starbucks experience," he admitted. He cited the switch from hand-pulled espresso machines to the automatic variety, which helped to speed up service but diminished the spectacle of coffee-making. The result, he conceded, was that some customers found Starbucks coffee shops sterile places that no longer reflected a passion for coffee.

Analysts and investors welcome Mr Schultz's return because it shows the company is taking action to correct its drift. The main architect of Starbucks' expansion is seen as the best person to lead a return to the firm's roots as a specialist coffee shop with a local touch. McDonald's, by contrast, having just recovered from its own overexpansion, is venturing into a whole new market. May the best latte win.

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