The Perk Wars:

Starbucks' Quest for World Domination

MBA 211 – Game Theory

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Executive Summary

Starbucks has rapidly expanded from a small local store to a national franchise with a location on every corner based on a well drawn out and executed strategy. Their meteoric ascent has slowed down and reached plateau as they have been forced to shut down unprofitable locations. In addition, significant competition has emerged as McDonalds has entered the coffee business with their own line of premium drinks. By using differentiated strategies, the two firms have been able to peacefully coexist and remain profitable. However, threats exist to disrupt the cooperation and spur competition.

Company History

Three mutual friends with a passion for coffee decided to open the first Starbucks in 1971 as a way to share that appreciation with other coffee-lovers. They grew the company slowly and by 1981 had only six stores, all located in state of Washington. They had no idea that when they hired Howard Schultz as the head of marketing and sent him to Italy to a trade show, they were on the verge of redefining the American coffee shop.

Schultz's vision was to convert traditional American coffee shops into places of gathering where patrons frequent the location daily, or more, to relax in the surroundings. He wanted to recreate the romance of the Italian coffee shop and saw Starbucks as a way to capitalize on that vision. He started by introducing the latte and mocha to Seattle, which quickly became addicted to the high-end taste, and he started to realize his dream when he took ownership of the brand and locations in 1987.[1/2]

Organizational Structure

Starbucks buys and sells coffee beans as well as a variety of coffee and other drinks through its company-owned and licensed stores. As of January of 2010, the company had more than 17,000 stores around the globe. Approximately half of those stores are company-operated and half are licensed. Domestically, stores are split into 60% company-owned and 40% licensed, while internationally the split

is 40% company-operated and 60% licensed. However, 84% of revenue is generated by company-operated retail stores. Further, The Company's operating segments are broken into domestic US (73% of revenue), International (19%), and CPG (8%), which consists of whole beans, ground coffee, bottled drinks, Tazo tea, etc. More recently, Starbucks shifted responsibilities to manage the US foodservice business within CPG rather than within domestic US due to internal management alignments.[3]

Rapid Expansion

To see why in the early years, Starbucks was able to rapidly expand without concern of competitive response, we need to first understand the factors that influenced a typical coffee purchase decision. These included:

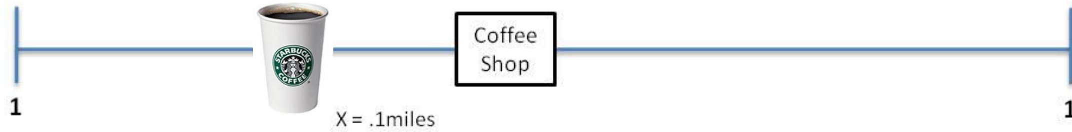
1. Quality Coffee: typically people are willing to pay more for higher quality coffee
2. Customer Service: service quality and well-trained staff affect customer satisfaction and loyalty
3. Brand Factor: A popular brand name and the image it represents are more easily able to attract consumers to purchase their coffee over the competition.
4. Convenience Factor: Location (either from home or at work) is crucial in the buying decision

Before Starbucks became a 'real estate company' with its convenient locations, its early success was built around the first 2 factors: quality coffee and great customer service. This inevitably led to a loyal following of customers.

"When a customer comes in and the person behind the counter says hello and maybe greets you by name, you feel a connection you don't find with most retailers anymore. It makes you feel welcome, and it makes you want to come back." Dave Pace, EVP of Partner Resources

With its great coffee and customer service, Starbucks quickly became a well-known brand across the country, with customers lining up to purchase 'The Starbucks Experience'. Relaxing Hotelling's Law to show the affect of product differentiation in characteristics not geography, the Linear City Model

below illustrates how Starbucks' edge in coffee, customer service and brand allowed it to dominate the local markets without its now famous 'Starbucks on every corner' strategy.



In this model, Starbucks enters a local market with one existing competitor (incumbent). Assuming the market is uniformly distributed, the incumbent is located in the middle to maximize payoffs. We assume the local customer values a cup of coffee at $4 and that they will purchase the coffee that maximizes their utility.

Convenience is the incumbent's only advantage and the further the distance ("x") Starbucks is from the local customer, the less market share it will gain. Assuming location as the only decision factor, Starbucks enters .1 mile to the left and takes 47.5% of the market[4].

However, the 'Starbucks Experience' is its source of market power with its high quality coffee beans, customer service, and brand name making its coffee more desirable than the incumbent's – a conservative estimate of $1 more per cup. In this model, the Starbucks Experience is represented as the transportation cost ("t"); how much utility the customer will lose by not switching to Starbucks[5].

Assuming Starbucks charges a premium over the incumbent ($3 v. $2.50); the customer buying decision is as follows:

Customer Utility Starbucks:	WTP – (P_S) =	$4.0 – ($3.0) = $1.0
Customer Utility Coffee Shop:	WTP – (P_c + [1-x] t) =	$4.0 – ($2.5 + [1-.1]*$1.0) = $0.6

In this formula we can see the market power the 'Starbucks Experience' gives to the company. Given the incumbents location, Starbucks will at least take all of the market to the left. However, if we take the relationship between "x" and "t" to the point of indifference (see below), customers are willing to travel up to ½ mile to get to Starbucks before it will purchase a coffee instead from the incumbent.

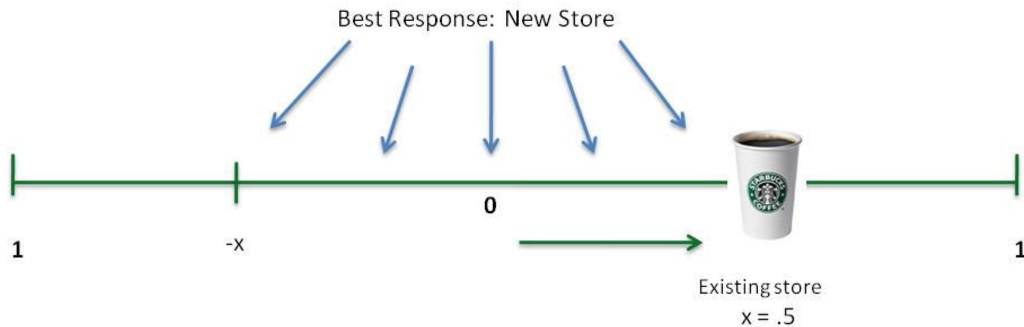
Customer Utility Starbucks:	WTP – (P_S) =	\$4.0 – (\$3.0) = \$1.0
Customer Utility Coffee Shop:	WTP – (P_c + [1-x] t) =	\$4.0 – (\$2.5 + [1-.**5**]*\$1.0) = \$1.0

In this example, Starbucks gained 70% of the market upon entry, demonstrating how the 'Starbucks Experience' allowed Starbucks to dominate the local markets it entered. Fueled by a clear competitive advantage in a fragmented industry, Starbucks' competition was unable to engage in an effective (and coordinated) response. With no clear competitor, Starbucks expanded at will – increasing the number of stores by 20% annually from 2000-2007.

Traditional Hotelling Game

With Starbucks able to effectively drive out competition through its competitive advantage, its coffee shops were soon able to monopolize the micro-markets (local) in which they were located. In order to maximize profits, Starbucks would locate itself central to the local customer base: a deterrent to competition as the new entrant would have to either locate to the left or right side – gaining less than half the micro-market. However, this deterrent of locating in the middle inevitably led to the outcome now known as "a Starbucks on every corner" and can be shown using Hotelling's Law in the following Linear City Model.

An existing Starbucks store is located ½ mile from the center of the micro-market: x_1 = .5. Assuming WTP, P, and t are all equal to one another, the utility gained by the middle customers from the existing store is: "WTP – (P + x_1t)" ➔ $4.0 – ($3 + .5*$1.0) = $.50. Taking this formula to the point of indifference, we can see that the new store can take over the majority of the market so long as their location is less than .5 miles, $x_1 > x_2$ (see below)



This outcome helps explain why Starbucks clustered towards one another over time. Starbucks' existing stores had become strategically located in the center of micro-markets to maximize profits x_1 =0. In this situation, a new entrant's best response is x_2 =0, splitting the market.

However, while this deterred other competitors from entry, Starbucks' continual new store growth strategy meant it was effectively splitting the profits of its existing stores with new stores. While the existing store could respond by closing down and relocating further away, both stores are actually playing their best response (Nash Equilibrium) by splitting the market. This can be interpreted as either both winning or both losing.

The Economic Downturn

Unequivocally, the largest challenge that Starbucks has faced recently is the economic downturn. It has caused the company to close stores and slow expansion. Starbucks has taken a dual approach to mitigating the challenges – reducing operating costs and investing in the maintenance of its customer base. It closed underperforming stores and reduced staffing to increase profit margins across the board. In this way, Starbucks is heading towards a more sustainable business model that may prepare it to survive the economic downturn.

Starbucks is simultaneously refocusing on improving the customer experience from diversified store offerings and raising the standards for food, beverage and customer service by staff members. And indeed, the company has been successful in these efforts and was ranked number 13 on Business Week's annual list of Customer Service Champs in 2010.[6]

The recession also spurred a trend among some consumers to "trade-down" in their consumption choices, thereby largely benefitting Quick Service Restaurants with their lower-priced menu items.[7] In 2007, at the beginning of the recession, it would have been apparent to McDonalds that traditional coffee drinkers were more likely to forgo a $4 specialty coffee in favor of a cheaper alternative. McDonalds always had a coffee presence but had never aggressively sort to compete for premium coffee drinkers. However, as coffee sales in 2007 surpassed soft drink sales as the largest beverage market in the US ($44billion), McDonalds was forced to take notice of this highly-fragmented yet fast-growing industry. Coffee is a very attractive market to enter as a) caffeine is addictive, b) drinking coffee is a morning ritual for many, and c) the unit price of coffee is relatively low to consumers.

McDonalds Entry Decision: LFRB

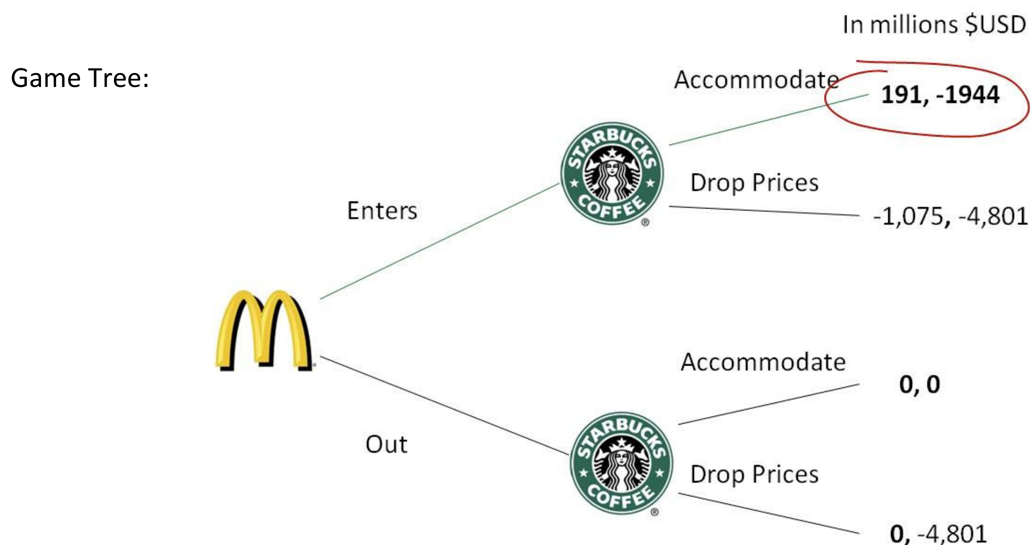
With growing awareness of the economic recession and the new demand for low cost food items, McDonalds piloted ‘premium’ coffee to 7000 restaurants to measure the market response. Based on the performance of the pilot test, McDonalds estimated that the Premium Coffee Market would eventually provide $1billion in US revenue8. The cost of future sales was estimated at the time to be approximately $100,000 per store.9 However, before it could decide on whether to enter the premium coffee market (arguably its biggest menu addition in three decades); McDonalds had to consider Starbucks’ response to their competitive threat.

Game: McDonalds’ entry decision in 2007

Actions: McDonalds’ – entry v. no entry, Starbucks – accommodate v. fight (drop prices)

Payoffs: Payoffs are limited to the maximum portion of Starbucks revenues vulnerable to attack i.e. price sensitive and non-loyal customers (see Appendices) using a 5 year NPV (20% discount rate). For purpose of gauging Starbucks’ response, we have fixed the size of the market to Starbucks’ existing customer base.

Game Tree:



Look Forward Reason Back: McDonalds enters, Starbucks responds.

Starbucks – If we conservatively adjust the 80/20 rule (% of revenue from % of customers) to 80/25, Starbucks’ ‘core’ loyal customers (US) accounted for approximately $4.85billion of 2008 sales.

Assuming the spending habits of the remaining 75% customer base are the same, only $1.2 billion of sales in 2008 came from 'non-core'. According to Mintel, approximately 37% of all coffee consumers are non-loyal – which would mean that in 2008, Starbucks would lose a maximum of $600m (or 10% of total revenues) from non-loyal customers switching to McDonalds. Over 5 years and a discount rate of 20%, the payoff to Starbucks for accommodating would be -$1,944million.

In contrast, Starbucks could choose to fight McDonalds on price, dropping its prices to an average price of $2.25. According to NY Times in 2007, the average transaction at a Starbucks coffee shop was $3.50. In its 2007 Starbucks 10-K, 85% of store sales are for coffee. Therefore, we assume that the average coffee transaction is $3.00 ($3.50*.85 = $2.98). If Starbucks lowers the price of coffee to its existing customers (market size is fixed at existing customer base), Starbucks would reduce the revenues gained from its customers by 24% per year. Over 5 years and a discount rate of 20%, the payoff to Starbucks for dropping prices would be -$4,801million.

Clearly from these two outcomes, Starbucks loses significant revenues from existing customers if it chooses to fight McDonalds. As a result, it makes sense for Starbucks to accommodate and not match McDonalds on price.

<u>Look Forward Reason Back: McDonalds does not enter, Starbucks responds.</u>

Starbucks – Under this scenario, McDonalds decision not to enter means that Starbucks is not at risk of losing their non-loyal, non-core customers. This would mean that Starbucks would keep these revenues, the payoff to Starbucks would be 0. Alternatively Starbucks could lower its prices but with no serious competitive threat to its existing customer base, the payoff to Starbucks using the aforementioned NPV would be -$4.8billion.

In conclusion, Starbucks' dominant strategy is to effectively do nothing and accommodate McDonalds if it chooses to enter. The potential loss of customers from accommodating McDonalds far outweighs the potential loss of revenues by maintaining its customer base through price matching.

Look Forward Reason Back: McDonalds' decision

Given that Starbucks' best response is to accommodate McDonalds, the decision for McDonalds is whether or not they could be profitable in the business. McDonalds has stated that it believes it can generate up to $1billion in annual sales with a $100,000 investment into coffee equipment & training per store (14,000 stores in the US) and $140million in marketing/promotions[10]. Once again, assuming Starbucks' customer base is the only available market for our analysis, we see that over 5 years and a discount rate of 20%, the payoff to McDonalds would be a minimum of $200million. As this number does not include bundling sales possible from existing McDonalds customers or the potential of new customers who were not previously Starbucks customers, this number is the worst-case payoff scenario for McDonalds.

The result: In January 2008, McDonald's made an aggressive foray in the battle for high-end coffee drinkers, announcing that it would install coffee bars in all 14,000 of its U.S. locations[11].

Mental Models

Game theoretic analysis offers an interesting and poignant perspective on the past two years of Starbucks' history. A closer look at Starbucks' actions can be analyzed using game theory tools to determine how Starbucks was viewing (and in many cases continues to view) their own company, the competitors, the coffee consumer, and the broader coffee market.

Customers

While competition certainly is fierce (giving Starbucks much more than just caffeine to keep them up at night), the company's mental model of their consumers governs their actions. According to

Mintel, approximately 50% of Starbucks's consumers are brand loyal and Starbucks accounts for over 50% of total coffee shop revenue in the U.S. Additionally, core Starbucks users visit a Starbucks more than 16 times each month. The combination of these facts heavily influence Starbucks mental model that basically as long as they don't screw anything up, they will be able to maintain a strong segment of coffee users. Furthermore, Starbucks and coffee shops overall represent a fraction of total coffee revenue, so the brand has the opportunity to continue to grow within its existing consumer base and by expanding users.

Starbucks' strategies clearly emphasize their reliance on loyalty as a key component of strategy. With increased competition from all sides, the company has utilized its view that loyal customers contribute a significant proportion of revenue as one of its chief strategies. This means that the company is intentionally committing itself to give more to the loyal customers in order to maintain their loyalty. The company believes that through growing and maintaining loyal consumers, it will be able to deflect competitive pressures.

Starbucks' consumer models and segments also likely include premium, non-loyal customers. These consumers use premium coffee, but not Starbucks. The company is attempting to attract these people to the brand by providing new opportunities for trial and building loyalty. For example, new product launch and store renovation may convince premium users to try Starbucks. Starbucks' mental model of these consumers is that there is a rational reason why this consumer segment is not drinking Starbucks and the company needs to figure out how to provide premium coffee in a format and at a price point that will attract them to the brand.

While Starbucks is often included in the fast food category, which is not known for premium products, the company continues to push for a more premium position in the market. This is a firm indication of how Starbucks is segmenting its customer base and distancing itself from the QSR industry by placing value on the loyalty within their customer mental models.

An additional mental model of consumer likely exists for Starbucks of aspirational users. Growth of the 'value-premium' coffee segment through companies like McDonald's launching latte's may actually help Starbucks grow. If consumers are introduced to lattes at a comfortable place like McDonald's, they may eventually aspire to buy from Starbucks. Starbucks' brand revitalization efforts may strengthen the brand's appeal among non-users.

Competitors

McDonald's: Without a doubt, Starbucks' mental model of McDonald's governs many of Starbucks actions. McDonald's is certainly the largest QSR company Starbucks faces in the Perk Wars, and Starbucks' mental model of McDonald's helps explain many of Starbucks' strategies especially as they relate to Starbucks making commitments to their business and customer value proposition. More than anything, Starbucks views McDonald's as a value player that will be either unwilling or unable to change their business proposition without a major cost to their overall business model. McDonald's has created a global brand that is cost-efficient and well known for what it does well: sell cheap fast food. Interbrand estimates the McDonald's brand to be worth approximately $32B.[12] This kind of brand value comes both with a benefit and a cost of having people globally know what to expect.

McDonald's has achieved over $24B in revenues by focusing their growth efforts and developing a global brand based on value. While, McDonald's has signaled their willingness to commit to premium coffee with the $100MM initial marketing entry, Starbucks' mental model is firmly grounded in their belief that McDonald's will not be able to overcome their value-based brand and focus on food. Starbucks likely believes McDonald's coffee will be an added bonus for people who are already considering McDonald's for breakfast as opposed to people who are ultimately looking for a coffee shop with food as an extra.

With competition heating up in the fast food breakfast market[13], Starbucks' mental model of McDonalds likely sees the QSR giant as trying to win the fast food breakfast battle against other, similar

options such as Burger King, Tim Hortons, and Subway, and less about the coffee shop model. However, Starbucks likely sees McDonald's international rollout of the McCafe coffee shops as a potential threat and is therefore sending signals to avoid an all-out battle in the coffee shop industry.

Dunkin' Donuts (and other value players): Starbucks' mental model of coffee shops like Dunkin' and other value players is that they will continue to be everything Starbucks isn't (on purpose). Research has shown the polarizing effect switching between Dunkin' and Starbucks has on consumers.[14] Many believe Starbucks and Dunkin' are rivals, and Starbucks' will likely use Dunkin' as the mental model of how to continue to keep loyal customers.

Peet's (and other premium coffee shops and brands): Peet's Coffee was the original inspiration for Starbucks but has been much slower to expand, maintaining more of its focus as a coffee bean and tea retailer, rather than a coffee shop like Starbucks. Starbucks' mental models of competitors like Peet's and other premium coffee shops rely on niche strategies. Starbucks sees brands like Peet's establish profitable niches but does not seem to respond too competitively. Many of these brands, Peet's included, may be relying on somewhat of a judo strategy to enter Starbucks' market profitably by focusing on one specific specialty.

Starbucks may be underestimating the potential risk from these competitors in their mental model. Not only has Starbucks attracted much negative media attention, which the smaller players have avoided, but also a small player may overtake Starbucks using a judo strategy to find a profitable new category.

Starbucks Signaling Strategy:

Nowhere is game theoretic analysis more useful when looking at the Perk Wars than in Starbucks signaling strategy. Starbucks has made considerable investments in order to signal to competitors, customers, and investors where the company is heading and why. Even in the face of an

uncertain global economic recovery, Starbucks is making commitments that signal how the company would like to segment the market and remain profitable. Starbucks is utilizing visible, costly, and differentiated signals to show their strategy.

In-store experience: Starbucks has announced and has started working on in-store renovations to differentiate the coffee shop feel and create an inimitable experience. This should send a message to competitors that Starbucks is maintaining focus on the experience of being at a Starbucks. Interestingly, Starbucks has chosen this strategy even when 80% of customers take their coffee to go. Committing to this therefore shows Starbucks' unwillingness to give up the premium coffee shop image and offering customers the 'coffee shop escape,' if only for the moment while they wait for their cup to-go.

Starbucks also announced they are providing free WiFi through using AT&T instead of T-Mobile in their coffee shops. The many food launches and re-launches highlight the importance Starbucks places on ambiance and aroma, as many food items have been discontinued since they disrupt the coffee smell.

New Product Development: Starbucks has firmly signaled their unwillingness to budge from the premium coffee category with their current new product offerings. First and foremost, the launch of Via as a single-serve premium shows Starbucks would rather offer loyal, premium coffee drinkers the ability to trade-down by going to a premium instant as opposed to a value food service-type coffee. Via is priced at just under $1 per single-serve packet, far more than most instant coffee options that typically cost less than $0.10 per serving.[15]

Additionally, Starbucks has spent a considerable amount of money developing a sustainable, environmentally friendly supply chain. This expense (and the marketing of it) serves as a signal to other coffee companies about the direction of Starbucks' business and the importance of maintaining a premium focus. This is also important given the negative press Starbucks has received of being an evil,

large corporation. These efforts send a clear signal to competitors and consumers about the importance of owning the premium market.

Starbucks also has maintained its commitment to specialty and seasonal items, attracting loyal customers to the coffee shop more frequently. These beverages continued to be prepared by the brand's baristas. The product preparation by baristas continues to signify the company's commitment to its core coffee offerings.

Store Expansion: The closure of the 600 U.S. retail locations is well documented. With the appearance of recovery, Starbucks is maintaining its current U.S. store levels in order to not inundate the market with Starbucks again. Instead, the company is focusing strategically on getting premium coffee into the hands of consumers worldwide.[16] CEO Howard Schultz states, "The days of reckless overexpansion and troubling closures have come to an end."[17] Through store rationalization, Starbucks has not only managed a tremendous turn-around, but also is signaling their more focused strategy on premium coffee moving forward.

Leadership: The reinstatement of Howard Schultz as CEO signals to competitors and consumers that Starbucks is back on track and 'drinking beer for breakfast.' It is a clear signal (both literally and figuratively) that the company is returning to its profitable roots. Ultimately, Starbucks is a premium coffee company and bringing Schultz back shows their desire to get back to the basics of how they achieved market leadership.

Cooperation:

Through utilizing mental models and signaling effectively, Starbucks has been able to stage a brilliant turnaround and promote cooperation. However, cooperation in the coffee category may not have all the necessary components to be maintained. As indicated, Starbucks has clearly signaled its

intention of pursuing a premium coffee strategy and therefore threats of punishment may not be seen as credible since they fundamentally would go against what Starbucks is trying to achieve.

Regardless, Starbucks has pursued efforts to promote cooperation by setting its clear strategy. When pressed about competition, Starbucks CMO Terry Davenport responded, “The answer to how we're going to respond to the competition is we're not going to respond. We're going to keep doing what we do and we're going to keep doing it our way."[18] Starbucks is promoting cooperation by indicating they are only going to focus on the premium customer. While it could be argued that Starbucks has over-committed themselves to a premium strategy, many sources cite statistics about the stickiness of premium coffee drinkers.[19] Starbucks is definitely placing a bet on premium, but through promoting cooperation, the company may be able to avoid a costly war.

Starbucks has made some subtle moves to promote cooperation in game theoretic terms. Most importantly, Starbucks has changed some of its pricing structure. It has raised the prices of some of its flavored drinks, like the caramel macchiato, and lowered the price on many of the core staples, like the 12oz latte and brewed coffee.[20] This pricing decision serves two purposes: by raising prices it creates clear differentiation from McDonald’s on premium items, and by lowering prices the company signals the potential for punishment should cheating occur. McDonald’s beverages have proven popular, but Starbucks is trying to promote cooperation with McDonald’s by splitting the market to the detriment of other competitors.

Threats to Peace

While we have seen how Starbucks and McDonalds have been able to peacefully coexist since the McCafe introduction, the question becomes how long can we maintain this java bliss. Ultimately, shareholder sentiment may intervene and the companies may no longer be satisfied with a stratified piece of the market. And while Starbucks is doing all it can to maintain its core of premium coffee

drinkers, it is still unknown if McDonalds is truly happy just playing in the value zone. Let's examine the strategies that the burger giant has at its disposal.

Cascading

During the time of its rapid growth, Starbucks used its products as a status symbol to grow into the role of an elite and premium product. By putting its product in the hands of the masses in major metropolitan cities and countless celebrities, the Seattle brewer became the "it" coffee to have. From there, the masses quickly followed suit (in part and parcel because that they were everywhere!). Starbucks laid out the classic plan for mass distribution by using a cascading effect. This would be similar to a restaurant artificially filling up seats in its establishment to give the impression of high quality food and/or atmosphere to attract more patrons from entering. The question here is whether or not Starbucks's blueprint for success can be mimicked and played back on them.

McDonalds certainly does not lack point of distribution to compete against Starbucks. In order for them to have an effective cascading approach, they will need to take on a marketing strategy that gets their cups into the right hands. So far, their campaign has been centered around "free drink mondays" and using the giveaways to attract the massive crowds. With excess marketing funds to use, continual promotions may lead to increased consumer adoption, resulting in more regular and steady sales while taking share from Starbucks. The key is how many customer need to be in the "restaurant" (or see the cups) before an individual realizes the cascading effects? And why isn't Starbucks doing anything to counteract? This again will lead us back to the mental models.

Imagine back to our Urn example that was filled with either blue or red balls. Here the signaling after two consecutive pulls spurred the cascading effects for the remaining players. What we do know is that for years the Starbucks "ball" has been pulled time in and time again. They have years of pulled balls on their side to signal to consumers, despite that McDonalds maybe even or ahead currently.

Those recent activities do not make up for their history. And that is exactly what McDonalds is hoping for. Starbucks is valuing their past balls significantly more than their rivals. It is their hope that customer loyalty will prevail from the past and that their customers are stickier. McDonalds is betting on the opposite. By appealing to a different crowd, they feel that the past is of no concern and it is about today's balls. As opposed to previous discussions about valuing the future, this is an interesting debate on how to value the past.

Judo Strategies

While McDonalds has been able to stay in the market as a small player, there is no reason to think that they will be satisfied with their market share long into the future. Starbucks has a very large and inflexible model by catering to current core of customers so that they cannot trade down the value chain. Additionally, one could argue that they have put too many stakes in the ground (by way of a Starbucks on every corner) and do not have the possibility to counter a McDonalds store opening. We certainly would not expect a franchise that closed 500 stores to suddenly re-open them amidst of drastic renovations. The message inconsistency and capital requirements do not make it plausible. Instead there are a variety of points that McDonalds can use to judo Starbucks.

Product Assortment- One of the ways that McDonalds has been able to stay small is to limit the products available that could compete with Starbucks. A McCafe carries a limited assortment: straight-up brewed and iced versions of Mocha, Cappuccino, and Latte in addition to the basic coffee. Starbucks has a drastically expanded market by offering flavored varieties, additional types, teas, and blended drinks. Starbucks remains the place for a triple soy macchiato, but McDonalds could enter this market as well. By only competing on a few products, Starbucks can effectively lower prices here to compete head on but take in fatter margins in the drinks that come unopposed. A McDonalds entry

could force more direct competition and further erode profitability. This can be further substantiated through another judo strategy below.

McDonalds Premium Play- As we have discussed, McDonalds has done the bulk of their damage playing in the "Value" space. This has kept Starbucks intact since their core premium market has remained largely unaffected. However, a McCafe entry into true "Premium" coffee could create a highly intense and competitive situation for Starbucks. By creating or acquiring a second, premium line of coffee drinks, McDonalds could take advantage of two-tier pricing and use its current array of products to hit the value customers and the new one to take the high priced market. This would be a maneuver that allows McDonalds to squeeze more profits from its biggest competitor and force Starbucks to undertake a massive haircut. McDonalds could pursue this avenue a couple different ways. First, it could acquire Peet's Coffee. Peet's is small enough (currently $560M market cap) that McDonalds could buy the chain and gain instant access to the grocery chain to further eradicate Starbucks share. However, significant funds would have to be invested to expand the brand outside of the west-coast. Conversely, they could also create an outside brand removed from a McDonalds location that would create delinking from the McDonalds value-concept. This strategy leads into our next concept.

Establishment Flexibility- McDonalds is in the unique spot of having a 2nd mover advantage. Starbucks's locations are firmly entrenched, we do not expect them to close a location and move a block to counteract a possible McDonalds entry. Further, having saturated the market over the last decade, they are pulling back and closing stores, signaling that further expansion is not a reasonable move. This has left McDonalds with a Hotel game of their own to play. McDonalds first looks at a competing Starbucks and for the nearest McDonalds within the vicinity. They can use the same concepts that Starbucks implemented before to determine whether the current McDonalds spot would attract the Starbucks customer based on value of product and time/distance traveled to obtain the product. We've

outlined a single play of this game in Appendix 3. If an a current McDonalds location is more likely to draw in the customer based on preferences, they can simply establish a “Bolt-On” McCafe and do an in store renovation. However, if customer preference takes them to Starbucks, McDonalds then has the option of opening a new “Stand-Alone” McCafe in a better location to capture the customer (Note: we have assumed that McDonalds has saturated the traditional burger restaurant and has no desire to open up more in crowded areas such as NYC, SF,etc that would cannibalize existing restaurant business). In this case, the appendix shows that there is an opportunity to create a Stand-Alone establishment to get better reach than simply converting an established location. This additional flexibility of business models gives McDonalds a true game-theoretic advantage against their rival.

Product Bundling- A distinct advantage for McDonalds is their superior operating margins (29% vs. 11%). This gives them significant room to be creative with their pricing. And while we discussed that the firm would like to avoid a price war at all costs, there is a way around the war: product bundling. McDonalds has perfected bundling for decades with their Value and Happy Meals. Now, using the McCafe line is also an item within reach. By leveraging their fatter bottom lines (excuse the fast-food pun), McDonalds can bundle their products together at a better value to where Starbucks can not profitably match it. Let’s take for example a Medium Mocha (retail price of $3.00 MCD vs. $4.00 SBUX) and an Egg Sandwich (same price). Let’s also assume that they are adequately priced to a consumers willingness to pay. That leaves McDonalds with a margin of $1.80 and Starbucks with $.80. As a result, McDonalds has an extra $1 more than Starbucks that they can discount the package and attract further customers. While it is not a direct price cut, it is a smaller game that can be played. McDonalds has the flexibility of using this combination at all hours during the day, with breakfast, lunch/dinner, and snack times to pair with various items and draw incremental sales. Soon, we may be hearing, “would you like a triple soy latte with that?”

Conclusion

While Starbucks and McDonalds have been able to coexist in the industry, there are imminent threats to disrupt to peace. McDonalds has the ability to take advantage of Starbucks's inflexible model and judo the giant chain. With a long time horizon for repeated games, the threat of one of these companies exiting the market is virtually zero, thus both realize that a war of attrition is impractical. Despite this, McDonalds can leverage its toolkit to create selected and targeting pricing while avoiding an all-out price war.

For Starbucks to survive, they will need to combat these strategies. Simply trying to hold on to the premium market will prove to be a futile attempt to retain share, as McDonalds and others have means to access the channel. While Starbucks is attempting to diversify income by diving deeper into the grocery retail market, they will still need to invest in efforts to not only retain existing customers, but be able to attract value customers without sacrificing profitability. In other words, it needs to build flexibility into its model to leave it less susceptible to a judo strategy that will turn its streams of cash flows into a slow percolating drip.

Appendix 1 McDonalds Entry Payoffs

No. of US stores	*14000*
Investment per store	$0.1
Operating margin	*60%*
Est Annual Revenue $M	*1000*

LFRB: McDonalds Entry Decision (SBUX accomodates)

	2007	2008	2009	2010	2011	2012
Percent of store roll-out		*75%*	*25%*			
Renovations & New Equipment		($1,050)	($350)			
Maintenance Cost			($85)	($90)	($95)	($100)
Marketing		($50)	($50)			
Percent of Revenue		*80%*	85%	90%	95%	100%
Revenues		$800	$850	$900	$950	$1,000
COGS		$320	$340	$360	$380	$400
Gross Margin		$480	$510	$540	$570	$600
Profit		**($620)**	**$25**	**$450**	**$475**	**$500**
NPV	**$191**					

LFRB: McDonalds Entry Decision (SBUX lowers prices)

	2007	2008	2009	2010	2011	2012
Percent of store roll-out		75%	25%			
Renovations & New Equipment		($1,050)	($350)			
Maintenance Cost			*$0*	*$0*	*$0*	*$0*
Marketing		($50)	($50)			
Percent of Revenue		*5%*	*6%*	*7%*	*8%*	*9%*
Revenues		$50	$60	$70	$80	$90
COGS		$20	$24	$28	$32	$36
Gross Margin		$30	$36	$42	$48	$54
Profit		**($1,070)**	**($364)**	**$42**	**$48**	**$54**
NPV	**($1,075)**					

…it would not enter

Appendix 2 Starbucks Payoffs

LFRB: McDonalds does not enter, 5% growth

	2007	2008	2009	2010	2011	2012
Starbucks Sales (4 Qtrs) $B	$9.8	$10.2	$9.9	$10.4	$10.9	$11.5
% in US	*82%*	*79%*	*80%*	80%	80%	80%
US Sales (4 Qtrs) $M	$7,997	$8,078	$7,890	$8,285	$8,699	$9,134
% Coffee Shop Sales	*85%*	*85%*	*85%*	*85%*	*85%*	*85%*
Starbucks Store Sales	$6,797	$6,867	$6,707	$7,042	$7,394	$7,764
% Coffee Sales	*85%*	*85%*	*85%*	*85%*	*85%*	*85%*
Starbucks Coffee (store) Sales	$5,778	$5,837	$5,701	$5,986	$6,285	$6,599
5% Avg. Growth of Sales	**$5,778**	**$6,067**	**$6,370**	**$6,688**	**$7,023**	**$7,374**
Total Payout Loss	**0**					

LFRB: McDonalds enters, SBUX accomodates

Customer Loyalty	
% Loyal (customers)	63%
% Non-loyal (customers)	37%

	2007	2008	2009	2010	2011	2012
Starbucks Coffee (store) Sales	$5,778	$6,067	$6,370	$6,688	$7,023	$7,374
% Core & Loyal (customers) - visit 16x/mth	*25%*	*25%*	*25%*	*25%*	*25%*	*25%*
a) Core and Loyal (sales)	$4,622	$4,853	$5,096	$5,351	$5,618	$5,899
Non-core (sales)	$1,156	$1,213	$1,274	$1,338	$1,405	$1,475
Remaining Non-core but Loyal (customers)	38%	38%	38%	38%	38%	38%
% of Non-core	*51%*	*51%*	*51%*	*51%*	*51%*	*51%*
b) Non-core but Loyal (sales)	$585	$615	$645	$678	$712	$747
Total Loyal Revenues: a) + b)	**$5,208**	**$5,468**	**$5,741**	**$6,028**	**$6,330**	**$6,646**
Max. Potential Revenue Lost		**($599)**	**($628)**	**($660)**	**($693)**	**($728)**
% Exposure to Existing Revenues		-10%	-10%	-10%	-10%	-10%
Total Payout (Loss)	**($1,944)**					
Customer Base	**63%**	**63%**	**63%**	**63%**	**63%**	**63%**

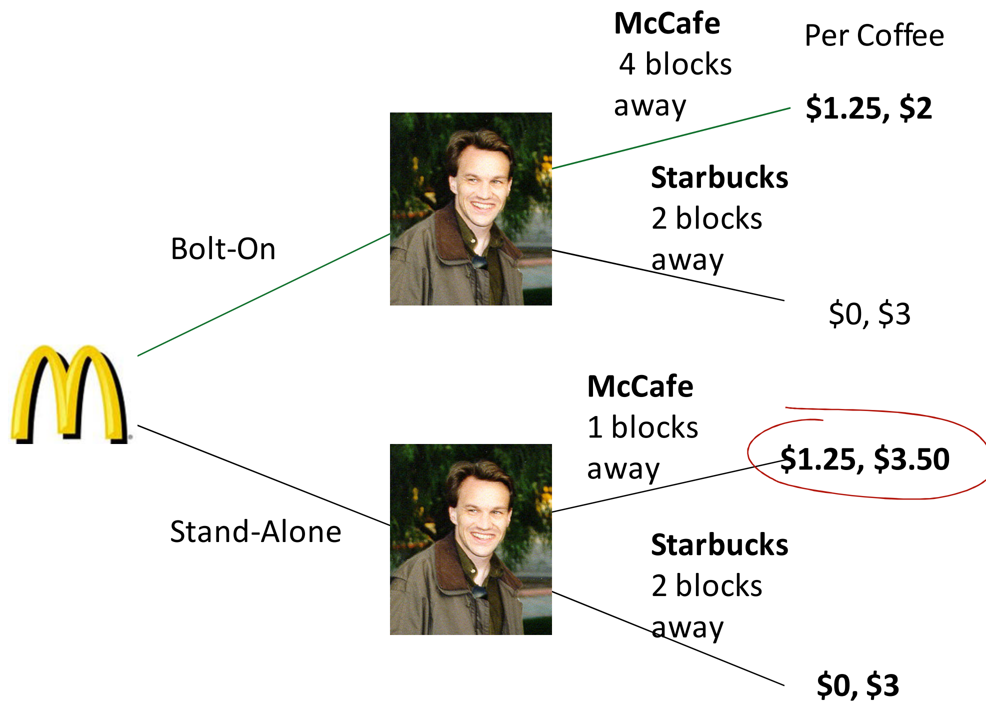
Starbucks: Fight McDonalds (reduce Prices)

	2007	2008	2009	2010	2011	2012
Avg. SBUX Coffee Store Transaction	$3.50	$3.50	$3.50	$3.68	$3.86	$4.05
% Coffee Sales	*85%*	*85%*	*85%*	*85%*	*85%*	*85%*
Avg. Coffee Price Per Cup	$2.98	$2.98	$2.98	$3.12	$3.28	$3.44
Fight: Match McD $ Price per cup	2.25	2.25	2.25	2.36	2.48	2.60

	2007	2008	2009	2010	2011	2012
Starbucks Coffee (store) Sales $billion	$5,778	$6,067	$6,370	$6,688	$7,023	$7,374
Reduction in Revenues from Fight	-24%	-24%	-24%	-24%	-24%	-24%
Total Revenues	$4,370	$4,588	$4,818	$5,058	$5,311	$5,577
Max. Potential Revenue Lost		**($1,478)**	**($1,552)**	**($1,630)**	**($1,711)**	**($1,797)**
Total Payout (Loss)	**($4,801)**					
Customer Base	**100%**	**100%**	**100%**			

Appendix 3

McDonald's repeated LFRB model on store location



Endnotes

[1] http://www.catalogs.com/info/food/the-history-of-starbucks.html
[2] http://www.starbucks.co.uk/en-GB/_About+Starbucks/History+of+Starbucks.htm
[3] Starbucks 10k, 2009
[4] SBUX will capture everything to the left of its store and 50% of the market between the 2 stores
[5] This can be viewed as the market power of the 'Starbucks experience'
[6] http://images.businessweek.com/ss/10/02/0218_customer_service_champs/14.htm
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