



Starbucks Wars

How McDonald's and Starbucks Defined their Industry

By Rick Kowalski

One can learn quite a bit about where the coffee house business is headed just by studying how the quick serve restaurant (QSR) industry evolved.

The coffee house business is moving through this evolution much quicker than the QSR business, but the growing pains will be very similar. One fact resonates above all others from QSR evolution: the QSR brands that clung to their original positioning grew into strong competitors. The chains that lost their original positioning found themselves in a steep sales decline that some were able to reverse and others were not.

One very common way that chains lose their positioning is to add a vast new array of products to their menus. Menu proliferation was a buzz-word in the 80s. QSR chains were throwing every new product they could find at their customers without a thought of how it would affect their market position. This almost ruined chains like Jack-in-the-Box and Carl's Jr., and even McDonald's has fallen victim at times to this failed strategy.

Starbucks Captures Breakfast

Recently Starbucks announced its intention to launch breakfast products. Could this be a natural extension of their morning coffee business and add to the value of the Starbucks enterprise? It definitely makes intuitive sense to leverage Starbucks' morning customer traffic and expand on it by offering food items appealing to that day part. Or, is

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this the beginning of Starbucks menu proliferation initiative that will lead to an erosion of its customer base?

Will breakfast items, coffee makers, tea bags, plastic cups, mints and music all begin to erode Starbucks position as the leader in specialty coffee?

Will we be able to find everything from laxatives to frozen waffles in the Starbucks of the future?

And, is Starbucks in danger of aggressively trying to evolve into all things for all people at the ultimate cost of its core business-specialty coffee?

QSR vs. Today's Coffee House

Other complicating factors in this interesting evolution of the coffee house business are the differences between QSRs and coffee houses. The significant differences between a traditional QSR (McDonald's, Burger King, etc.) and a coffee house include service, menu, marketing, and product. These differences are important, yet one difference not yet discussed is the need for that "third place" between home and work. Starbucks founder Howard Schultz had it right when he talked about Starbucks filling this "small luxury" need.

The coffee house is a warm comfortable place where people can go when they want to escape work, and either can't go home or don't want to. QSRs haven't done a great job in filling this need. Their design/décor has been more inclined towards durability and ease of cleaning, supported by colors, seating and hurried atmosphere that turns tables quickly. Their products are targeted towards meal occasions, not spending discretionary time reading, socializing or working.

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Enter the Starbucks wars. Seeing the ease of entry, fierce loyalty of great coffee, and the handsome profit margin, QSRs are rushing to develop specialty coffee programs in an effort to capture more share with better coffee blends.

Dunkin' Not in Third Place

The anomaly to this discussion is of course, Dunkin' Donuts. Dunkin' is a strong regional coffee competitor in the northeastern U.S. The typical Dunkin' customer is also a heavy QSR user, but they are also a heavy coffee drinker. Coffee sales at a typical Dunkin' in the Northeast will represent 65% or more of total sales. Donuts are something that Dunkin' franchisees wish they didn't have to mess around with. They have found that pouring coffee is a much easier and more profitable business.

Dunkin' is clearly a QSR, but is also positioned in coffee. Yet, they don't really fit into that "third place" definition. Dunkin' users are much more inclined to grab and go rather than sit and chat. The typical Dunkin' Donuts store design is not necessarily inviting or warm and welcoming. Both posters hyping new products and washable surfaces are the rule. How will the Dunkin' brand play in markets where a "third place" defines the coffee house?

Dunkin' management has publicly stated they want to expand towards the west coast. The challenge this Dunkin' brand will face is whether customers west of the Mississippi will recognize the chain as a great place for donuts (and maybe other fast options) or a coffee place. This is important because the Dunkin' business model turns on its ability to sell significant amounts of coffee. Supporting the expansion of the Dunkin' brand solely on donuts and breakfast sandwiches will be difficult, especially because they use franchising as their method of expansion.

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Will Dunkin' management fundamentally change the way the store looks and acts in order to put the brand in the "third place" arena, and if they do, will customers buy it?

Dunkin' may also be answering the siren's song of more menu appeal (a.k.a. menu proliferation) by adding Supreme Omelet sandwiches and lunch items that help bolster their weaker day part. With the hiring of a top-notch executive chef to develop new menu items, as well as a team of culinary experts and a multi-million dollar test kitchen, the research and development effort at Dunkin' is a well-oiled machine.

Dunkin's product development efforts appear to be targeted towards the McDonald's customer rather than the more upscale Starbucks customer.

Starbucks is also adding more SKUs with retail merchandise, so while Dunkin' beats a path to the McDonald's customer, Starbucks is apparently looking to take share from big box retailers, QSR and the Internet! Starbucks aspirations are very big, indeed.

While Dunkin' and Starbucks slug it out for more market share, traditional coffee house brands continue their gains with more distribution and friendlier, more comfortable environments. It's A Grind and Diedrich's, for example, provide a very inviting and coffee-focused atmosphere, perfect for socializing and relaxing. These brands that cultivate an inviting atmosphere and continue to focus on coffee as a complex beverage with a variety of flavors appeal to the customer who isn't interested in a QSR environment or the products they serve.

Three Categories Emerge

As the big players and other brands continue their evolution, the following three primary market segments appear to be emerging in the coffee house industry:

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1. The Starbucks segment. This segment is defined by the largesse of the Starbucks brand and all that goes with it. Its direction is flowing towards more products that continue to drive same store sales growth. The relative price/value position vs. coffee house competitors is high.

2. Dunkin' takes charge of the second segment with a more "everyman" approach to coffee. This segment walks and talks much more like QSR than does the Starbucks segment. Its relative price/value position vs. competitors is in the lower-middle area. However, there is no real credible competition in the donut segment. Products and prices are below Starbucks, and this concept is positioned fairly well if economic times become difficult. Merchandise is not part of the product mix at Dunkin' partly because of its market position, and partly because its franchise business model would not tolerate it.

3. Experiential marketing chains and independents. This segment is being defined by quality and customer service, driving higher end coffee house players such as It's A Grind, Caribou Coffee, Diedrich's Coffee and a handful of other chains, as well as many independents, from coast to coast. Products and atmosphere are clearly a cut above Starbucks, and several levels above Dunkin'. Customers tend to be upper income professionals or someone looking for more than a hot cup of drip coffee to grab and go. This segment treats coffee as a rare commodity with mysterious origins and political ramifications. The atmosphere of the coffee house is closer to a club hangout for movie stars like the Pure or Rain in Las Vegas, or the SkyBar in Hollywood. The relative price/value position vs. competitors is only slightly higher than Starbucks.

Other segments may emerge as this industry continues its evolution and the current leaders may inadvertently re-position their brands in a way that enhances value or

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erodes it. One thing is for sure, however, the coffee house industry is evolving in a similar way as the QSR industry, but at a much faster rate.

Being a student of past QSR successes and failures could help coffee house brands avoid serious pitfalls.

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Rick Kowalski is Vice President, Operations for It's A Grind (IAG Coffee Franchisee LLC), based in Long Beach, California. He has an extensive foodservice background, including notable brands such as KFC, Hilton Hotels and Dunkin brands. An accomplished strategist, marketer and operations professional, Kowalski also holds a Masters of Business Administration from Pepperdine University. He and his wife Valerie, along with their two children live in Coto de Caza, California.

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