

Why are We Waiting by the Sidelines?

LET'S GO AFTER THE BUSINESS

Starbucks-dominated category wakes up and smells McD's espresso rollout

CEO Schultz brews up customer revival for coffeehouse titan

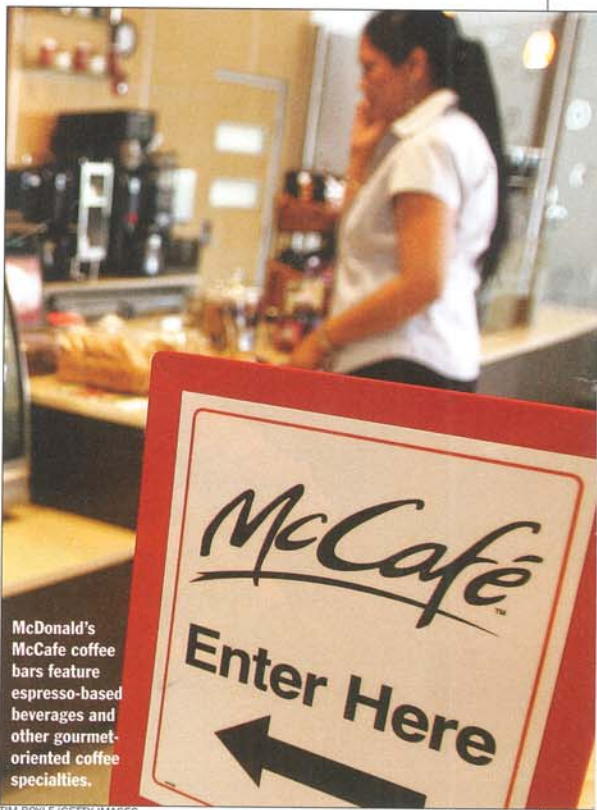
BY GREGG CEBRZYNSKI

With coffee category growth architect Howard Schultz again chief barista at Starbucks Corp., brand strategists say that company and its espresso-driven challenger McDonald's both must address evolving taste trends to maintain or capture market share in the lucrative specialty coffee category.

As the burger giant installs bargain-priced espresso bars chainwide and the coffeehouse titan attempts to revive the "Starbucks experience" to forestall defections of recession-wary loyalists, consumers hold the key to brewing consistently strong financial results, marketing pundits observe.

McDonald's phased rollout of McCafe coffee bars was expected to have surpassed the 1,000-store mark by the start of 2008 on its way to deployment in the chain's nearly 14,000 U.S. units by next year. Complete with baristas working automated espresso machines, McDonald's new program will offer caffe lattes, cappuccinos, mochas

(See *McD*, page 6)



McDonald's McCafe coffee bars feature espresso-based beverages and other gourmet-oriented coffee specialties.

TIM BOYLE/GETTY IMAGES



(Continued from page 1)
and an ice-blended drink called Frappe.

McDonald's, while pricing its espresso-based items at around \$1 less than comparable ones at Starbucks, is projecting an additional \$1 billion in sales from its new drinks and other beverage additions.

Starbucks, meanwhile, has shaken up management just as the chain has seen a rare same-store downturn in customer traffic, though profits, sales and store counts have continued to soar. Schultz resumed the role of chief executive of the 15,000-unit chain this month, replacing the exiting Jim Donald.

As he did so, Schultz — in language reminiscent of a famously leaked internal memo in which he warned last year that cookie-cutter systems could rob Starbucks of its allure — vowed to restore the "connections our customers have with Starbucks, our coffee, our brand, our people and our stores."

However, success for both Starbucks and McDonald's hinges on appealing to a customer who has developed a sophisticated palate for coffee and won't settle for inferior products, said Robert Passikoff, founder and president of Brand Keys, a New York-based branding consulting firm.

He calls such a patron the "bionic consumer of the 21st century" who possesses a more advanced sense of tastes and higher expectations than did coffee drinkers of previous generations.

"They're smarter. They're more sophisticated," Passikoff said. "They all know what lattes are. TV and Starbucks and everyone else that came after Starbucks have institutionalized these beverages."

But as Schultz pointed out to analysts and employees, the "Starbucks experience" — the key to the chain's brand image and sales — has suffered dramatically for a number of reasons. Switching to vacuum-packaged coffee and thus denying customers the store-filling aroma of the beans would be one reason, and growing the chain too quickly would be another.

For the fiscal year ended last Sept. 30, the Starbucks chain added 1,788 new U.S. coffeehouses, up from 1,543 a year earlier and 1,176 the year before that. Meanwhile, domestic Starbucks units saw their same-store sales

grow last year only 4 percent, after rising 7 percent in 2006 and 9 percent in 2005.

In Passikoff's view, slow service and the loss of theatrics are what is eroding brand loyalty for Starbucks.

The chain lost ground in the "service and surroundings" category of the Brand Keys 2007 Customer Loyalty Engagement Index, he points out.

"It has nothing to do with the ability to deliver product quality," Passikoff said. "It's the consumer



mind-set. You're going to get a great product, but you have to wait, and the theater and entertainment is gone."

McDonald's espresso machines are located in the front of the store so that customers can watch the baristas make their drinks, but Passikoff said theatrics will not be a significant factor in driving beverage sales for the chain because "you know what you get at McDonald's" in terms of ambiance.

However, he expects that some customers who visit McDonald's for an Egg McMuffin will decide to buy their morning lattes there as well.

Although some industry observers view the situation strictly as a McDonald's-versus-Starbucks showdown, marketing expert Tim Hackbart sees McDonald's espresso initiative as a "genius" strategic move by the chain to gain a larger share of the quick-service breakfast market.

As other chains move to increase their breakfast business, McDonald's will be a step ahead of them by offering more coffee varieties than they can, said Hackbart, a former Taco Time and Del Taco marketing executive who founded White Barn Group, a strategic restaurant marketing and ad agency in San Juan Capistrano, Calif.

A "large portion" of consumers decides where to eat a quick-



McDonald's rollout of coffee bar adjuncts was expected to reach 1,000 stores by the start of 2008.

tantly, product sampling," she said. "The best way we can get people to believe in [the product] is to give them a sample," she said.

The sampling program has resulted in return visits and purchase intent that are "so high" that McDonald's is convinced that "this is really what [customers] want," Frick said.

A TV spot for the coffees opens with shots of various people enjoying the drinks. A voice-over says, "Want to treat yourself to something special?" That's followed by scenes of more people having fun while holding the new coffees. The final voice-over says, "Now you're right where you want to be."

The ads are being revised for the systemwide rollout of the coffee bars, but "our premise will not change," Frick said.

"We are not comparing ourselves to anybody," she said. "We are standing on the product we have, which we believe is very high quality."

McDonald's did "a lot" of ethnographic research to determine what drives consumer behavior and then developed the coffee products to fit consumer tastes, said John Roney, its director of U.S. consumer and business insights.

"Coffee is such an emotional product," he said. "We've been tracking reaction to taste as we continue to roll this out. Ultimately where it gets us to is optimizing the product."

Roney said McDonald's is a "much more approachable brand" for consumers who are not "experts" on coffee varieties.

That positions McDonald's to target customers new to the

gourmet-coffee scene, said branding expert Rob Frankel.

"Will they steal customers from Starbucks? No," he said. "But who will they get? All the people who want better coffee and are willing to pay for it but don't yet patronize Starbucks."

Starbucks' Schultz told analysts earlier this month that the chain "built the equity of our brand through the Starbucks experience," but Frankel, who says he has iconoclastic views about branding, disagrees that Starbucks is even a brand.

"Starbucks has never had a brand or a brand strategy," he said. "Starbucks has an identity. If they had a brand, people, including Howard Schultz, would be able to articulate it. Because they can't articulate that, they leave themselves vulnerable to other competitors." Advertising raises a brand's awareness, he said, but Starbucks has never made people understand why it is "the only solution" to their coffee needs. That's what branding does, Frankel said.

"People are not able to explain why they should be loyal to [Starbucks] in a consistent manner," he said.

During the holidays Starbucks broke its first national TV campaign, which ad critics generally praised. But the chain has to be careful that future campaigns stay true to the Starbucks image, said White Barn Group's Hackbart.

New campaigns can harm the brand, "depending on the creative," he said.

"It's more critical for this brand than any other," Hackbart said. "It's got to work with the consumer. It's got to be very unique, very different than you'd normally see." ■

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FOR THE RECORD

"Activist investor Peltz's Cheesecake stake could mean changes for chain," Jan. 7, page 1, stated the terms of a severance agreement for Cheesecake Factory founder, chairman and chief executive David Overton that have been in place with few changes for at least seven years and thus were not enacted specifically because of any concerns about a possible shift in corporate control to Nelson Peltz.

