



## Falling Starbucks

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Starbucks is struggling under its 'cafe on every corner' policy. Has Britain gone cold on coffee?

Britain may have turned into a nation of coffee drinkers but for the company synonymous with the boom there are growing pains.

Starbucks' expansion since it landed in tea-loving Britain more than 10 years ago has been stellar. It has opened 710 coffee shops: 675 company owned and 42 licensed.

But this has now ground to a halt. It must shut 50 unprofitable UK outlets or return them to profit. For this it has hired CB Richard Ellis to dispose of the stores or agree cheaper rents.

The global coffee conglomerate has suffered a fall in trade worldwide, coupled with rising labour, rent and energy costs, so it is now trying to undo some of the damage caused by its 'cafe on every corner' policy.

While Starbucks and its two biggest rivals, Costa Coffee and Caffe Nero, are undoubtedly being affected by the slowdown in consumer spending, the company's problems in the UK run deeper.

Starbucks entered the UK in May 1998 when it bought 65 Seattle Coffee Company stores.

It planned to repeat its US success by opening in prime shopping and employment areas, taking the best space to ensure its success.

But top locations demand top prices.

Starbucks completed a series of lettings, paying hefty rents for the best shops. The rents might have been sustainable had it not been for the fact that all its rivals also began to expand and populate next-door and adjacent units for slightly cheaper rents, stealing business away.

One retail property agent familiar with Starbucks says: 'All these coffee stores went head to head on prime shops. Once Starbucks had secured the best location, two more chains would turn up and take

nearby space. A high rent can be justified if you are the only coffee chain in the area but not if you are one of five.'

Jeffrey Young, managing director of London-based management consultancy Allegra Strategies, which publishes the most comprehensive research on the European and UK branded coffee shop market, agrees.

'Starbucks' problem was too high rents on locations. It may be that Starbucks may have lost more trade in this downturn than others, and its high rents haven't helped. But Starbucks will still continue to expand here.'

He adds: 'An area of particular difficulty has been the City of London, where there is a lot of coverage [see map, opposite] but, as footfall went down because of people being unemployed, trade has also gone down.'

### **Going skinny**

As Starbucks struggles under the weight of its massive rent bill, the slowdown in consumer spending cannot have helped its sales.

'The cafe and coffee shop sector has fared better than the restaurant sector and has seen only modest downturns in trade of around 0.5%,' says Young. 'And some have done even better: Costa has seen its sales hold up well.'

'Coffee is a "small ticket" item and not as affected by the recession as items such as furniture. People still want to buy themselves a small treat to console themselves and coffee is one of these items. Most coffee drinkers continue to buy their coffees on a regular basis. The recession has not deterred most people.'

Greg Feehely, head of research at Altium Securities, claims the British are now 'hooked' on buying a coffee regularly. 'People might not buy a new car or washing machine, but they will keep buying their coffee,' he explains.

The UK coffee shop market will have an estimated turnover of £1.6bn in 2009 and is estimated to grow to £2.1bn by 2012. In June the branded coffee sector had a total of 3,790 coffee outlets in the UK and Costa, Starbucks and Caffe Nero – the top three chains – account for 70% of the sector, Allegra Strategies reports. The wider coffee market – including independent operators and non-specialist coffee sellers – has doubled in the past 10 years (see graph, overleaf). In 1999 there were 5,400 outlets and in May 2009 there were more than 10,360 outlets.

Coffee experts suggest the market could grow to 5,000 branded coffee outlets before it reaches saturation. Research company Mintel estimates the market will be worth £1.3bn by 2013.

'Although it is a competitive market, it is also a young market and there is still room for growth for the branded coffee sector,' says Young.

Costa, which is part of Whitbread and has 965 outlets in the UK, believes there is still room to grow and, despite acknowledging the recession has had an impact on sales, it reported same-store sales were up 2.6% in the 13 weeks to 28 May.

Clive Bentley, property director at Costa, says: 'We are one of the most acquisitive retailers and we still plan to expand with hopes for 100 this financial year.'

“Starbucks has no specific evidence that consumers are moving from drinking their coffee in coffee shops towards drinking their coffee at home”

Starbucks spokeswoman

‘You need to have a key differentiator.

We have worked on marketing and our recent poll and marketing campaign showed seven out of 10 coffee lovers prefer Costa.

‘We have also introduced a “meal deal” at £4.95, which signals that customers can come to Costa for a full lunchtime offering. We have heavily promoted this and other initiatives to show Costa is a first choice for coffee lovers.’

### **Image problem**

Starbucks problems lie not just with the top rents it is paying for its locations and the drop in consumer spending, but also the perception that its brand has suffered and lost popularity with the public, experts say. They criticise Starbucks’ brand for having a lack of substance of identity, being more about the name and the empire rather than the coffee and the service.

Starbucks’ executives are now working hard to ‘go back to their roots’ and reposition the brand. In its home town of Seattle, the company has responded by rebranding one outlet to 15th Ave Coffee and Tea in an attempt to appear more community focused.

It said it had ‘reimagined the coffee house experience’ and ‘in the true spirit of a traditional coffee house, this store will serve beer and wine’. This might go some way to changing its image locally but it has an entire global empire to manoeuvre back into favour.

Starbucks embarked on a massive cost-saving programme this year and its latest results – for the quarter to 28 June – showed it had gone some way in improving its lot. Its operating margin improved to 8.5%, up from the previous quarter’s -0.8%. Its US operating margin rose to 11.2%, up from -1.4% in the first quarter.

Net revenue rose to \$2.4bn, down on the previous quarter’s \$2.6bn but it made cost savings of around \$175m. Comparable store sales fell by 5%, which was an improvement on the previous quarter’s decline of 8%.

A spokeswoman says Starbucks is still expanding in the UK, especially in different formats with the help of Montagu Evans.

‘In addition to our existing estate of more than 700 UK coffee houses, we are looking at new types of locations and format,’ she says.

‘In 2008 we opened two new formats, Drive Thru and Drive To. We opened our first European Starbucks Drive Thru in Cardiff, Wales, and also Drive Tos on the A3 near Wisley and in Hooley [in Surrey]. Feedback from customers has been extremely positive and we’re continuing to look for new locations throughout the UK.’

In the increasingly crowded coffee market, this will be a tough journey. A straw poll of coffee-drinking friends and colleagues suggests widespread disapproval of Starbucks. On top of complaints about its overpriced products, poor facilities, such as grubby toilets, and unhelpful, uncommunicative staff, there is aversion to a chain that is on every street corner.

Even in the property world Starbucks carries a stigma. Many believe the company to be difficult to deal with and indecisive on locations and its target customer profile. Some landlords have even decided that a coffee shop that appeals to the masses is a more preferable tenant than Starbucks, which has not quite sorted its brand identity, they say.

There is a growing threat to all the branded coffee chains from other areas of the food and beverage world.

'Coffee has got better across the UK in a number of outlets, from fast-food outlets to shops, such as Marks & Spencer's cafe,' says Allegra Strategies' Young.

'It is a very competitive market. Food outlets such as Pret A Manger and Eat, which sell lots of coffee, and are being joined by Le Pain Quotidien, Patisserie Valerie and Paul, which are all expanding. These all do good coffee.

'And the coffee sector has been competing by growing their food offer.'

McDonald's, for instance, has developed its McCafé range to compete head to head with the branded sector. In the US it sells espressos and mochas in its existing stores, and in the UK and Europe it is opening separate McCafé counters, in or next to its restaurants. It plans 1,200 McCafés in Europe by the end of the year.

Not only are food and beverage chains competing, but also the quality of instant coffee and coffee sold in the supermarkets is improving, so much so that Starbucks has launched its own instant coffee. Datamonitor, the market research company, found that in the year to February, sales of coffee in supermarkets were up 2.9% by value.

But a Starbucks spokeswoman plays down the concern: 'Like many other companies we are seeing some softness in the UK business during the economic downturn but have no specific evidence that consumers are moving from drinking their coffee in coffee shops towards drinking coffee at home,' she says.

The key challenge for Starbucks and the coffee chains is coping with the fact that consumers will continue to have less disposable income and will be more choosy about where they spend it for at least the next four years. With so many coffee chains to choose from, those with the best service and the best coffee at reasonable prices in good locations will win.

The next growth could come from those chains offering a combination of a coffee chain and a bar. As more and more pubs close down and the traditional greasy spoon cafes begin to disappear, the winners could be the clever coffee shops that can bridge the gap and offer consumers something that a pub, greasy spoon cafe and traditional coffee shop did not.