Exporting a North American Concept to Asia

Starbucks in China

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In the past decade U.S.-based Starbucks has expanded internationally, including opening coffee shops in the People’s Republic of China. Still a tiny part of the Chinese beverage market, Starbucks hopes to trade on the growing popularity of Western brands among China’s growing middle class. By focusing its attention on its employees, Starbucks has created a strong service culture that fits well in China.

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Starbucks Coffee International, a subsidiary of Starbucks Coffee Company, opened its first store in southern China in 2002. The store, located in Shenzhen, is owned by Coffee Concepts, a joint venture between Starbucks and Hong Kong’s Maxim group, which had already opened thirty-two Starbucks stores in Hong Kong between 2000 and 2002. At the opening, Pedro Man, president of Starbucks Coffee Asia Pacific, the Asian division of Starbucks Coffee International, remarked,
As we celebrate the opening of our first store in Southern China today, we mark yet another milestone in the history and tradition of more than 30 years at Starbucks. The heart of the Starbucks brand lies in two cornerstones—our coffee and our people. Our passion for coffee means applying our coffee expertise and the highest standards of excellence to every detail of the coffee, from selecting and roasting the beans, to brewing the perfect cup of coffee.

He added,

At the same time, our people are highly valued partners in creating the unique Starbucks Experience. It is their passion, knowledge, unsurpassed expertise, and enthusiasm which help to create a truly outstanding coffee experience for our customers.²

Starbucks has continued to grow despite near saturation in most attractive U.S. markets and despite sometimes hostile economic conditions. Although international expansion is difficult for many American companies, especially in Asia, somehow the executives at Starbucks have defied the odds—as they have done all along.

### From Inception to
### U.S. Saturation to
### International Expansion

Starbucks Coffee, Tea, and Spice opened its first store in April 1971 in the Pike Place Market in Seattle. Its original owners, Jerry Baldwin and Gordon Bowker, had a passion for dark-roasted coffee, which was popular in Europe but hard to find in the United States at the time. “They founded Starbucks for one reason: They loved coffee and tea and wanted Seattle to have access to the best.”³

Starbucks stood not only for good-quality coffee, especially dark-roasted coffee, but also sought to educate its customers about its products. Jerry, a lover of literature, named the company Starbucks after the first mate in Moby Dick, because it “evoked the romance of the high seas and the seafaring tradition of early coffee traders.”⁴ Recognizing the great potential of the Starbucks concept, Howard Shultz and David Olsen purchased Starbucks in 1987 for $3.8 million. Shultz and Olsen were both veterans of the industry, having owned their own successful coffeehouses. As a private company, Starbucks grew in the next five years from 6 retail outlets and a roasting plant to 165 shops, located primarily in the Pacific Northwest.⁵

Much of this success can be attributed to a focus on the total guest experience and the people employed to create that experience. Schutzl and his team wanted to enlist the hearts of people who would share a sense of pride in the job they were doing. They wanted to attract people who were well educated and eager to communicate their passion for coffee. Schutzl embraced a philosophy that would be vital to attract-
ing and retaining the right kind of employees: “Treat people like family, and they will be loyal and give their all. Stand by people, and they will stand by you.” He and his team viewed people as business partners and not simply a line item. The company provided training to its employees on the subtleties of coffee tasting. Wages and benefit programs were more attractive than what competitors offered. Employees also influenced the company’s direction, as management included them in discussions about plans, decisions, strategies, and concerns. This people-centered operating philosophy continues to this day. Starbucks’ human resources policies have contributed to a turnover rate that is well below the industry average.

Rapid Growth
Building on early successes, Shultz and Olsen wanted to expand Starbucks beyond the Pacific Northwest. They rejected the idea of franchising, however, because they did not want to jeopardize the quality of their products. To raise the additional capital needed for growth, in 1992 Shultz led the company in an initial public offering, raising $29 million. Shortly thereafter, the company opened stores in Washington, D.C., New York, and Boston.

As a supplement to the growth provided by new outlets in the United States, Starbucks has pursued a variety of innovations and joint ventures. Starbucks experimented with new concepts, such as expanded food menus and drive-thru service, but neither of those options was pursued because management felt that they took away from the core business. On the other hand, a cold coffee drink called Frappuccino brought new customers into the shops and also led to coffee sales in a variety of new outlets, including grocery stores, bookstores, schools, airlines, cruise lines, and hotels. Starbucks has also expanded its reach into complementary markets. For example, the company owns Tazo, an Oregon-based tea company noted for its chai.

Starbucks is viewed as one of the great business success stories in the past two decades. In total returns, it soared more than 2,200 percent over the decade ending in 2001, surpassing Wal-Mart, General Electric, PepsiCo, Coca-Cola, Microsoft, and IBM in total return. Starbucks’ sales have increased an average of 20 percent annually since the company went public in 1992. As of 2001, Starbucks had more than fifty-seven hundred retail locations and fifty-four thousand employees worldwide.

In spite of innovations and joint ventures, Schultz’s team is hard-pressed to grow profits in a home market that is quickly becoming saturated, with thousands of stores across the United States and Canada. In Seattle, there is one Starbucks outlet in every twenty-four square miles, and in Manhattan Starbucks has well over one hundred cafés, or about one for every twelve thousand people. Although total U.S. saturation is expected in the near future, the company is convinced that it can export its American-brewed concept around the world. In July 2000, Schultz showed his commitment to Starbucks’ plan to expand globally by stepping down as CEO and assuming the role of chief global strategist.

Asian Expansion
Starbucks opened its first restaurant outside North America in Tokyo in August 1996. Japan was chosen because it is the third largest coffee importer in the world. Schultz believed that going to
Japan was an essential part of Starbucks International’s expansion plan. For the company’s international operations, Schultz decided that it was best to form partnerships with local operators. The Tokyo outlet was opened as a joint venture with Japanese retailer and restaurant operator Sazabu. In six years, the number of Japanese outlets has grown to 368, beating Starbucks’ own projections.

Starbucks now operates well over 1,000 international outlets, with hundreds more on the drawing boards. A large portion of its international business is in Asia, where it has 850 locations (in Australia, Indonesia, Japan, Korea, Malaysia, the Philippines, New Zealand, Singapore, Taiwan, Thailand, the Chinese cities of Beijing and Shanghai, and the Hong Kong and Macau SARs). Starbucks plans to continue expanding its presence throughout Asia, and Schultz feels that one day it may be operating more restaurants in Asia than it does in North America.

The Chinese Opportunity

The most populous Asian market, and the one that possibly holds the most potential for long-term growth, is China. Understanding the opportunities and challenges that Starbucks faces in China requires an appreciation for the distinctive political, economic, sociocultural, and market forces that have been shaping that country and its demand for coffee.

The Political Situation in China

In spite of China’s recent history, the nation is still a communist country. When the People’s Republic of China was created in 1949, Mao Ze Dong ruled the country in a highly centralized way. Coupons were distributed by each level of the government to the civilians to exchange for daily necessities, for instance. This practice continued until after the “cultural revolution,” which was a ten-year struggle between Mao Ze Dong and other communist leaders. After 1978, with the help of the late premier Zhou En Lai, Deng Xiaoping controlled the country. He gradually introduced market-oriented reforms to China and decentralized economic decision making. Under Deng’s leadership, China abandoned its old planning and distribution system. As a result, the national output quadrupled by 2000.

Successor Jiang Ze Min followed Deng’s ideals and further opened China’s market to foreign trade and investment. China’s economy grew to second largest in the world, after that of the United States (measured by purchasing power parity), even though by the year 2001, its GDP per capita was only US$4,300. From January to September 2002, the amount of foreign investment in China reached US$39.56 billion, up 22.6 percent compared with the same period in the previous year.

At the 16th Chinese Communist Party Conference, held on November 8, 2002, President Jiang stated that the country will manipulate the market only by distributing resources, creating an environment where all the economic players have equal opportunity to use those resources to enhance the movement of merchandise and increase manufacturing. The government will monitor the market, adjust the economy, and manage public services. Reinforcing the idea of an open economic policy, the government’s new policy actions should reduce intervention in privately owned business with the hope of attracting more foreign investment into the country. Provincial leaders, who normally held their positions until age sev-
enty, were replaced. Also, Hu Jintao was elected the new president of China.

In 2001, with entrance into the World Trade Organization (WTO), China began to conduct business under some of the same rules that apply to its largest trading partners. Internal policy making will be more transparent, and the government function will be constrained by the guidelines of the WTO. Because Starbucks entered the Chinese market before the WTO accession, the company had to deal with the nation’s rigid business policies. Going forward, Starbucks may be able to take advantage of the “WTO effect,” which includes such policies as lower tariffs for foreign investors.

Economic Factors in China

The Chinese market is considered one of the most important in the world due to its growth and size. Investment in that market has come in waves, however. From 1978 to 1992, although the amount of investment increased every year, the accumulated amount was only US$23.4 billion. From 1992 to 1995, foreign investment in China entered a phase of rapid development. This was followed by an adjustment period of two years and a low period of three years. Total foreign investment dropped from $45.5 billion in 1998 to $40.7 billion in 2000, a decline of 10.5 percent. After the adjustment period, direct foreign investment in China experienced a record increase of 14.7 percent during the first nine months of 2002.

The development of the Chinese economy has provided great opportunities for foreign investors like Starbucks. However, economic policies that are peculiar to China mean that investors have to be flexible and understand the special difficulties associated with investment. For example, special government investment licenses are still necessary and obtaining them is sometimes difficult, especially in some smaller cities where bribery is common.

The Chinese Sociocultural Environment

With the adoption of market-driven economic policies, more Western companies have been entering the Chinese market. U.S. food companies such as McDonald’s, KFC, and Pizza Hut have been able to capture the Chinese customers’ taste. The young generation of Chinese customers are the most susceptible to the Western trend. Because of rigid governmental legislation that allowed Chinese couples to have just one child, young couples have considerable purchasing power. They want to spend their money on leisure activities, such as going to American-style fast-food restaurants. Only a few decades ago, in a less open China, almost nobody had heard of American icons such as McDonald’s. Today, the lives of Chinese people are full of foreign names. A girl wants a Barbie for her birthday gift. Couples celebrate their wedding anniversary in a Korean restaurant. Busy office workers order a pizza for lunch. The increasingly wealthy Chinese people are willing to pay more for new experiences and better-quality products and services.

The change of culture influences many aspects of people’s lives. For example, China has traditionally been a tea-drinking country. Most people started to recognize coffee in 1980s from Nestlé’s slogan, “tastes great!” However, twenty years later, a new Chinese generation not only drinks coffee but requires that it be of high quality. They want gourmet coffee instead of instant coffee, especially those in the wealthy classes. The typical consumers of the expensive foreign brands are a part of
an expanding middle class comprising wealthy and educated young people who are enthusiastic about chasing “taste” and “fashion.” They use Gucci bags, Rolex watches, and Chanel perfume. They frequent bars, enjoy vintage wines, and travel abroad once a year. Spending money on expensive things helps these consumers establish themselves as part of their social group.

Like many rapidly developing countries, the income distribution in China is unbalanced. The income of people in the cities is much greater than in the villages. Also, in the cities and villages there is great disparity between the richest and poorest citizens. Finally, income levels in the rich provinces of Guangdong, Jiangxi and Zhejiang are significantly higher than in other provinces.

The Chinese Beverage Market
Tea, the classic Chinese beverage, represents more than 40 percent of the total market volume for beverages (see Exhibit 1). With more than twenty-five hundred tea-processing companies active in the country, production of loose tea in 1998 came to some 665,000 metric tons, of which approximately one-third was exported. It was estimated that per capita tea consumption in 1999 was 27.5 liters (7.25 gallons). Tea bags, and diet and instant teas constitute only about 1 percent of the market, while packaged ready-to-drink tea is becoming more popular in China, with more than one hundred brands.

Coffee competition. There is only one competitive domestic coffee producer in China—Li Shen. Due primarily to weather patterns that are hostile to coffee growing, total domestic production per year is only one thousand tons, compared to more than 1.5 million tons for Brazil, for example. Because it does not rely on domestic sources, Starbucks does not have problems supplying coffee beans to its Chinese outlets. One of the sources of competitive advantage for Starbucks is its ability to contract with coffee producers anywhere. To sell a distinctive espresso coffee, for example, Starbucks buys the best coffee beans from Africa, South
America, and Indonesia, regardless of price or transportation difficulties. Annual sales of coffee in the Chinese market in 1990 were only 25,537 standard bags (60kg/bag). This figure increased to 159,000 standard bags in 1995, and by 2000 it reached 318,000 standard bags. On a per capita basis, this amount (0.01467 kg) is tiny compared to the annual coffee consumption in the U.S (4.02 kg per person). Nevertheless, China is still considered to have high market potential because of the young generation of wealthy coffee drinkers.

Direct Competition in China

Zhen Guo Coffee, a Japanese chain, entered China in 1998. Its first store was located in Yi Wu because the residents there owned many automobiles. Indeed, people drop by Zhen Guo Coffee on their way to work. Following Zhen Guo, Starbucks, Yi Shi, Xian Zong Lin of Taiwan, and Jie Rong of Hong Kong opened stores in Shanghai.

Once the battle started, choosing the right location became the strategic issue for each competitor. In choosing locations, Zhen Guo focused only on the least expensive venues, while Starbucks chose the most expensive locations. Zhang Jianhui, the general manager of Starbucks Shanghai, believes that a good location can maximize market share. Starbucks China has applied the same strategy used in the United States to the Chinese market: the coexistence of several Starbucks locations in the same area, which stimulates consumption. In Nanjing’s central business district, for instance, three Starbucks shops are already in place.

In May 2001, Taiwan’s Wang Wang Group and Seattle Supreme Coffee aligned to invest in the Chinese mainland. The first Seattle Coffee chain store under Wang Wang Group opened in Shanghai in October 2001. Another Taiwanese food chain, Ding Hao, is said to be interested in opening a chain coffee store as well. Even McDonald’s is attempting to enter the coffee business and has opened its own coffee shop in Beijing.

Starbucks’ Strategy in China

Consistent with its expansion to other countries, Starbucks entered the Chinese market through a joint venture. In Beijing, Da Wei Sun is the manager of Starbucks’ outlets. Sun grew up in Hong Kong and obtained a bachelor’s degree in business at a Taiwan university. After graduation he went to the United States, where he started working as a computer programmer in Texas. In the early 1980s, he became infatuated with the McDonald’s business model, concluding that it had potential in Asia. In 1984, Sun opened the first McDonald’s in Taiwan to great success. From 1993 to 1994, Sun opened a Hard Rock Café in Taiwan. After two years of successful operations, Sun sold the Hard Rock Café and moved his career to the Chinese mainland. On November 11, 1999, Sun opened the first Starbucks in Beijing International Trade Center.

Sun believes that Starbucks’ success in China is associated with two major issues: “One is to integrate the Western brand with local environment, and the other is to give your client a psychological space.” That is how Starbucks introduced its coffee to China—by giving people in the cities a “third space” beyond work and home. Starbucks has chosen to build its brand image first among its employees and then convey this image to consumers. Rather than mass advertising from the beginning to introduce its products as other food and
beverage companies have done, Starbucks hires enthusiastic people who can build good relationships with customers. This Asian-influenced marketing strategy is consistent with the company’s approach in North America.

Starbucks’ Future in China

Starbucks now adds eight to nine new shops per year each in Beijing, Hong Kong, and Shanghai. These affluent locations have high concentrations of young, upwardly mobile workers who are relatively open to Western products. With a population of more than a billion people, China is a major opportunity for Starbucks. However, the Chinese market is drastically different from the U.S. market. The question of whether Starbucks can flourish there as it has done in the United States rests in part on the following issues:

- Coffee is by no means a mainstream beverage on the mainland. Compared with tea, coffee is a relative newcomer. The average annual coffee consumption is only one cup per person. Will coffee companies, including Starbucks, be able to shift demand enough to provide a fertile market for their products?
- Starbucks is not alone in China. As direct competitors continue to expand, many with Asian pedigrees, will Starbucks be an effective competitor?
- The Starbucks strategy that led to its early successes was crafted for the U.S. market. Will this strategy be as successful in the Chinese market? Where is the company vulnerable to attack?
- Finally, Starbucks offers premier products at premier prices. At present, it is targeting segments of the population that can afford its products; however, economic disparity among classes and regions means that the market in many places is limited. What should Starbucks do, if anything, to reach out to a larger percentage of the population in China?

Endnotes

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