

## Case 5-1

## Starbucks Coffee Company\*

On an overcast February afternoon in 2000, Starbucks CEO Orin Smith gazed out of his office window in Seattle and contemplated what had just occurred at his company's annual shareholder meeting. In prior years, the meeting had always been a fun, all-day affair where shareholders from around the country gathered to celebrate the company's success. This year, however, Smith and other senior Starbucks executives heard an earful from the activist group Global Exchange. A human rights organization dedicated to promoting environmental, political, and social justice around the world, Global Exchange criticized Starbucks for profiting at the farmer's expense by paying low prices and not buying "fair trade" beans. Not only did the activists disrupt the company's annual meeting to the point that the convention hall security police asked the activists to leave, but they also threatened a national boycott if the company refused to sell and promote fair trade coffee. Although Smith strongly disagreed with using the shareholders meeting as a public forum, he knew there was a strong likelihood his company could face serious reprisals if it did not address the issues raised by Global Exchange.

Fair trade began after World War II as religiously affiliated, non-profit organizations purchased handmade products for resale from European producers. During the 1970s and 1980s, the concept evolved further into buying crafts from low-income, third-world producers at a "fair" price and selling those products in

Western markets.<sup>1</sup> Fair trade was an economic model based on fair labor compensation and mutual respect between producers and consumers. By the late 1990s, the fair trade movement had gained a foothold in the United States, and in early 1999, TransFair USA, a third-party certification agency, launched its Fair Trade Certified coffee label. During that summer, Global Exchange began a campaign to educate consumers and the media about labor conditions in the coffee industry, focusing on getting the message out to specialty coffee consumers. Although the activists were successful in educating pockets of consumers, they knew their effectiveness was limited without directing blame for the farmers' woes. Global Exchange decided to take an anticorporation stance and focused its attention on the most visible brand in specialty coffee: Starbucks.

Starbucks Coffee Company grew from a small, regional business into the undisputed leader in the specialty coffee industry by buying only the best quality coffee and providing an unmatched store experience. The company's coffee buyers had built long-standing relationships with farmers and believed it paid the highest prices in the industry for top-quality beans. Adopting the fair trade model would cause serious concerns for Starbucks, as fair trade paid a floor price of \$1.26, regardless of bean quality. Starbucks coffee buyers had to admit that though they paid high prices, they did not always know whether farmers got their fair share. It was virtually impossible to track the flow of money from the importers and exporters back through the supply chain to the individual farmer. By dealing only with cooperatives, TransFair USA bypassed most of

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<sup>1</sup> Chris O'Brien, "2002 Report on Fair Trade Trends in the US and Canada," *Co-op America Business Network*, April 2002, pg. 4.

these problems and added value by producing financial transparency. Yet being a socially responsive corporation was a key tenet of Starbucks' mission statement. The intent of fair trade advocates to raise small farmer incomes was consistent with the company's values. Treating partners (Starbucks employees), customers, and suppliers with dignity and respect was essential to the company. In fact, it came as a shock to many at Starbucks that activist groups were criticizing their company for unfair practices. As he watched the sky darken outside his window, Orin Smith asked himself just how socially responsive his company could be without affecting the fundamental business practices that had been the foundation of its great success.

## HISTORY OF STARBUCKS

In 1971, three atypical businessmen founded Starbucks Coffee, Tea and Spice in Seattle, Washington. Gordon Bowker, Jerry Baldwin, and Zev Siegl shared many interests, but their main reason for starting the company was their love of coffee and tea and their desire for Seattle to have access to the best of it.<sup>2</sup> While attending school in San Francisco, Baldwin discovered Peet's Coffee in Berkeley and fell in love with the rich, dark arabica whole bean coffee. Baldwin introduced his roommate, Gordon Bowker, to Peet's Coffee, and after the two moved to Seattle, they continued to order Peet's by mail. Bowker stumbled upon another great store in Vancouver, Canada, and would often make the three-hour trip there from Seattle to buy Murchie's coffee. While traveling back from one of these trips, Bowker had the idea of opening up a coffee store in Seattle. Baldwin loved the idea, as did Bowker's neighbor Zev Siegl, and Starbucks was born.<sup>3</sup>

The company grew slowly and, by 1981, had a roasting plant and four retail stores

that sold whole bean coffee in Seattle. That year, Howard Schultz, who was working for a Swedish houseware company in New York, became curious about why Starbucks was buying large quantities of a certain drip coffee-maker. Schultz flew out to Seattle and met with Baldwin and Bowker to learn more about the company. Starbucks captivated Schultz, and by 1982, he had convinced Baldwin, who was running the company, to hire him in marketing. In 1983, Starbucks sent Schultz to Italy. While there, he dreamed of recreating the magic and romance behind the Italian coffee bar culture by serving espresso by the cup.<sup>4</sup> It took Schultz a year to convince Baldwin and Bowker to serve espresso drinks, but he was allowed to test the idea when Starbucks opened its sixth store in downtown Seattle. The concept was a hit, and within 2 months, that store was serving 800 customers a day—three times as many as their best selling whole bean locations.<sup>5</sup>

Schultz urged Baldwin to expand the idea to other stores, but Baldwin felt strongly that selling beverages distracted from the core business of selling top quality, whole bean coffee. With financial backing from Starbucks, Schultz left the company and opened his own coffee bar called Il Giornale in 1985.<sup>6</sup> Before its opening, Dave Olsen, owner of the funky Café Allegro near the University of Washington, called Schultz and expressed an interest in joining forces. As it turned out, the two were a great match: While Schultz focused outward to build the company, Olsen understood the operational realities of running a retail café. As the "coffee conscience of the company," Olsen ensured that Il Giornale served only the best quality coffee using a custom-made espresso roast from Starbucks beans.<sup>7</sup> In 1983, shortly before Schultz left Starbucks, Baldwin and Bowker had bought Peet's Coffee and, by 1987, made the decision to

<sup>4</sup> Ibid., p. 52.

<sup>5</sup> Ibid., p. 60.

<sup>6</sup> Ibid., p. 66.

<sup>7</sup> Ibid., pp. 81–85.

<sup>2</sup> Howard Schultz, *Pour Your Heart Into It* (New York: Hyperion, 1997), p. 29.

<sup>3</sup> Ibid., pp. 29–31.

sell Starbucks' six retail stores, roasting plant, and corporate name so that Bowker could take a break from the coffee business and Baldwin could focus his time on Peet's. Although *Il Giornale* only had three stores, Schultz and a group of local investors bought Starbucks for \$3.7 million and changed *Il Giornale*'s name to Starbucks Coffee Company.

The next few years brought tremendous changes to Starbucks. Using the original *Il Giornale* business plan, Schultz promised investors they would open 125 Starbucks stores in the next five years. Starting from a base of 17 stores in 1987, the company quickly expanded into Chicago, Vancouver, and Portland. During this initial period, Schultz hired seasoned executives to help with the growth of the company. In 1989, Schultz brought in Howard Behar, who was familiar with opening and running several retail stores at once, and the following year, Orin Smith joined Starbucks as Chief Financial and Operations Officer. Both Smith and Behar were 10 years senior to Schultz and brought with them seasoned experience to help build the company's infrastructure. This executive management team, fondly called "H2O," worked tightly together to grow the business. By 1991, Starbucks had ventured into the mail-order catalogue business, licensed airport stores, expanded into California, and had just over 100 retail stores. The company went public in 1992.

After the initial public offering, Starbucks continued to grow at a dizzying pace, in terms of both store development and new enterprises. Within five years, the number of Starbucks stores grew tenfold, with locations in the United States, Japan, and Singapore.<sup>8</sup> In addition to opening and licensing retail locations, Starbucks initiated several successful product and brand extensions, including offering coffee on United Airlines flights, selling premium teas through its wholly owned subsidiary Tazo Tea Company, developing a bottled version of its

popular Frappuccino blended beverage with PepsiCo and premium coffee with Dreyers, and distributing whole bean and ground coffee at supermarkets through an agreement with Kraft. Starbucks even sold jazz CDs in its retail stores. In 1999, Schultz made Smith, who had become President and COO in 1994, the CEO, but he remained active in the company as the Chairman and Chief Global Strategist. By 2002, 85 percent of Starbucks' revenue came from company-operated retail stores and the remainder from licensed stores, key partnerships, and specialty operations such as foodservice accounts and mail-order catalog sales.<sup>9</sup> In 2000, Interbrand, a brand-valuation firm, ranked Starbucks 88 in its survey of the 100 Best Global Brands. In the same survey, Starbucks also ranked as the world's fastest-growing brand.<sup>10</sup> What intrigued many was that Starbucks grew its brand into a household name not through advertising but by word-of-mouth. In fact, prior to 1996, Starbucks had spent a total of only \$10 million on advertising.<sup>11</sup> By 2002, the once small, regional roaster claimed over \$3.3 billion in annual revenues and more than 5,800 locations in 30 countries serving approximately 20 million customers a week.<sup>12</sup> (See Exhibits 5.1 and 5.2 for Starbucks Financial Statements)

## STARBUCKS CULTURE

In 1990, Starbucks' senior executive team drafted a mission statement laying out the guiding principles behind the company. The team hoped that the principles included in this mission statement would help partners gauge the appropriateness of their decisions and actions. As Orin Smith explained, "Those guidelines are

<sup>8</sup> Jake Batsell, "Starbucks Achieves Worldwide Renown with Some Costs," *The Seattle Times*, November 4, 2001, p. 1.

<sup>9</sup> "Starbucks Corporation," Standard & Poor's Corporate Descriptions, April 27, 2002, pp. 1-8.

<sup>10</sup> Batsell, "Starbucks Achieves Worldwide Renown," p. 1.

<sup>11</sup> Mark Pendergrast, *Uncommon Grounds: The History of Coffee and How it Transformed Our World* (New York: Basic Books 1999), p. 378.

<sup>12</sup> "Starbucks Corporation," Hoover's Company Profile, 2002, pp. 1-6.



EXHIBIT 5.1 Starbucks Income Statement<sup>13</sup> (in thousands)

	2000	1999	1998	1997	1996
Net revenue	\$2,177,614	\$1,686,828	\$1,308,702	\$975,389	\$697,872
Joint venture income	20,300	3,192	1,034		
Interest income	7,110	7,315	7,134	12,393	11,029
Gain in sales					7,827
Total revenue	\$2,205,024	\$1,697,335	\$1,316,870	\$987,782	\$716,728
Cost of sales	961,885	747,630	578,483	436,942	335,800
Store operating expense	704,898	543,572	418,476	314,064	210,693
Other operating expense	78,445	54,629	44,513	28,239	19,787
Depreciation & amortization	130,232	97,797	72,543	52,801	35,950
General admin expense	110,202	89,681	77,575	57,144	37,258
Merger expense			8,930		
Interest expense				7,282	8,739
Investment losses (internet)	58,792				
Total costs	\$2,044,454	\$1,533,309	\$1,200,520	\$896,472	\$648,227
EBIT	160,570	164,026	116,350	91,310	68,501
Income taxes	66,006	62,333	47,978	36,099	26,373
Net earnings	94,564	101,693	68,372	55,211	42,128

part of our culture and we try to live by them every day.”<sup>14</sup> After drafting the mission statement, the executive team asked all Starbucks partners to review and comment on the document. Based on their feedback, the final statement (see Exhibit 5.3), put “people first and profits last.”<sup>15</sup> In fact, the number one guiding principle in Starbucks’ mission statement was to “provide a great work environment and treat each other with respect and dignity.”<sup>16</sup>

Going forward, Starbucks did three things to keep the mission and guiding principles alive. First, it provided all new partners with a copy of the mission statement and comment cards during orientation. Second, when making presentations, Starbucks leadership continually related decisions back to the appropriate guiding principle or principles they supported. And third, the company developed a “Mission Review” system through which any partner

could comment on a decision or action relative to its consistency with one of the six principles. The partner most knowledgeable on the comment had to respond directly to such a submission within two weeks, or if the comment was anonymous, the response appeared in a monthly report.<sup>17</sup> As a result of this continual emphasis, the guiding principles and their underlying values had become the cornerstones of a very strong culture.

After buying Starbucks, Howard Schultz had worked to develop a benefits program that would attract top people who were eager to work for the company and committed to excellence. One of Schultz’s key philosophies was to “treat people like family, and they will be loyal and give their all.” Accordingly, Starbucks paid more than the going wage in the restaurant and retail industries, granted stock options to both full- and part-time partners in proportion to their level of base pay, and offered health benefits for both full- and part-time partners.<sup>18</sup> In return, Starbucks had a partner turnover

<sup>13</sup> “Starbucks Corporation,” Standard & Poor’s Corporate Descriptions, pp. 5, 6.

<sup>14</sup> Orin Smith Interview, Starbucks CEO, July 25, 2002.

<sup>15</sup> Schultz, *Pour Your Heart Into It*, p. 131.

<sup>16</sup> *Ibid.*, p. 139.

<sup>17</sup> Smith, interview; Schultz, *Pour Your Heart Into It* p. 132.

<sup>18</sup> Schultz, *Pour Your Heart Into It* pp. 125–37.

**EXHIBIT 5.2 Starbucks Balance Sheet (in thousands)**

	2000	1999	1998	1997	1996
<b>Assets</b>					
Cash	\$70,817	\$66,419	\$101,663	\$70,126	\$126,215
Short-term investment	61,336	51,367	21,874	83,504	103,221
Accounts receivable	76,385	47,646	50,972	31,231	17,621
Inventory	201,656	180,886	143,118	119,767	83,370
Prepaid expenses	18,736	19,049	11,205	8,763	6,534
Deferred income tax	29,304	21,133	8,448	4,164	2,580
Total current assets	458,234	386,500	337,280	317,555	339,541
Joint ventures	52,051	42,718	38,917	34,464	4,401
Other investments	3,788	25,342			
PP&E	930,579	760,289	600,794	488,791	369,477
Other assets	25,403	23,474	15,685	16,342	13,194
Goodwill	21,311	14,191	79		
Total assets	\$1,491,366	\$1,252,514	\$992,755	\$857,152	\$726,613
<b>Liabilities</b>					
Accounts payable	\$73,653	\$56,108	\$49,861	\$47,987	\$38,034
Checks drawn	56,332	63,811	33,634	28,582	16,241
Accrued compensation	69,702	43,872	35,941	25,894	15,001
Accrued occupancy	35,841	23,017	17,526	12,184	7,976
Accrued taxes	29,117	30,752	18,323	12,946	7,114
Other accrued expenses	39,016	32,480	24,190	30,829	20,834
Accrued interest					3,004
Deferred revenue	7,320	484			
Current portion long-term debt	685	673			
Total current liabilities	311,666	251,197	179,475	158,422	108,204
Convertible debentures				165,020	166,749
Long-term deferred income tax	21,410	32,886	18,983		
Long-term debt	6,483	7,018			
Total liabilities	\$339,559	\$291,101	\$198,458	\$323,442	\$274,953
<b>Equity</b>					
Common stock	\$376				
Additional paid-in capital	\$750,496	\$651,020	\$589,214	\$391,284	\$361,309
Retained earnings	408,503	313,939	212,246	142,426	90,351
Accumulated loss	(10,976)	(3,946)	(7,163)		
Total shareholder equity	1,148,399	961,013	794,297	533,710	451,660
Minority interest	3,588	400			
Total liabilities & equity	\$1,491,546	\$1,252,514	\$992,755	\$857,152	\$726,613

rate of 60 percent compared with the restaurant industry average of 200 percent.<sup>19</sup> Furthermore, 82 percent of the partners claimed to be "very satisfied" and 15 percent "satisfied" with their jobs when asked by outside audit agencies.

<sup>19</sup> Pendergrast, *Uncommon Grounds*, p. 374.

While such a high satisfaction rate could be found in many small, companies, it was virtually unheard of for a large, publicly traded corporation of over 55,000 employees.<sup>20</sup> All of this satisfaction had fostered a strong culture that

<sup>20</sup> Smith, interview.

**EXHIBIT 5.3 Starbucks Mission Statement**

Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles as we grow. The following six guiding principles will help us measure the appropriateness of our decisions:

- Provide a great work environment and treat each other with respect and dignity.
- Embrace diversity as an essential component in the way we do business.
- Apply the highest standards of excellence to the purchasing, roasting and fresh delivery of our coffee.
- Develop enthusiastically satisfied customers all the time.
- Contribute positively to our communities and our environment.
- Recognize that profitability is essential to our future success.

employed a predominately young and educated workforce who were extremely proud to work for Starbucks. Their pride came from working for a very visible and successful company that tried to act in accordance with the values they shared. According to Smith, "It's extremely valuable to have people proud to work for Starbucks and we make decisions that are consistent with what our partners expect of us."<sup>21</sup>

**BEING A RESPONSIBLE CORPORATION**

Just as treating partners well was one of the pillars of Starbucks' culture, so was contributing positively to the communities it served and to the environment.<sup>22</sup> Starbucks had made this commitment not only because it was the right thing to do but also because its workforce was aware and concerned with global environmental and poverty issues. In addition to sustaining and growing its business, Starbucks supported causes "in both the communities where Starbucks stores were located and the countries where Starbucks coffee was grown."<sup>23</sup>

**CONTRIBUTING TO COMMUNITIES**

Starbucks firmly believed that when it opened a store, the company added immediate value to that community because the store "becomes an instant gathering spot, a Third Place that draws

people together."<sup>24</sup> Additionally, store managers were granted discretion to donate to local causes and provide coffee for local fundraisers. One Seattle store donated more than \$500,000 to Zion Preparatory Academy, an African-American school for inner-city youth.<sup>25</sup> In 1998, Starbucks and Erwin "Magic" Johnson's company, Johnson Development Corporation, formed a joint partnership and created the Urban Coffee Opportunities. Subsequently, 28 stores opened in urban communities, providing new employment and revitalization opportunities in several U.S. cities.<sup>26</sup>

Howard Schultz personally believed that literacy had the power to change lives and foster hope for young children who lived in underserved neighborhoods. Accordingly, Schultz used the advance and ongoing royalties from his book, *Pour Your Heart Into It*, to create the Starbucks Foundation, which provided "opportunity grants" to nonprofit literacy groups, sponsored young writers programs, and partnered with Jumpstart, an organization helping Headstart children. While it was completely separate from the company, Starbucks made an annual donation to the foundation.<sup>27</sup>

**CONTRIBUTING TO PRODUCING COUNTRIES**

In 1991, Starbucks began contributing to CARE, a worldwide relief and development

<sup>21</sup> Ibid.

<sup>22</sup> Schultz, *Pour Your Heart Into It*, pp. 139, 293.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid., p. 281.

<sup>25</sup> Ibid.

<sup>26</sup> "Corporate Social Responsibility [CSR] FY01 Annual Report," Starbucks Coffee Company, February 2002, p. 14.

<sup>27</sup> Ibid., p. 21.



foundation, as a way to give back to coffee-origin countries. By 1995, Starbucks was CARE's largest corporate donor, pledging more than \$100,000 a year and specifying that its support go to coffee-producing countries.<sup>28</sup> The company's donations helped with projects like clean-water systems, health and sanitation training, and literacy efforts.<sup>29</sup> Over the years Starbucks has contributed more than \$1.8 million to CARE.<sup>30</sup>

In 1998, Starbucks partnered with Conservation International (CI), a non-profit organization that helped promote biodiversity in coffee-growing regions, to support producers of shade-grown coffee. The coffee came from cooperatives in Chiapas, Mexico, and was introduced as a limited edition in 1999. The cooperatives' land bordered the El Triunfo Biosphere Reserve, an area designated by CI as one of the 25 "hot spots" that were home to over half of the world's known plants and animals.<sup>31</sup> Since 1999, Starbucks had funded seasonal promotions of the coffee every year, with the hope of adding it to its lineup of year-round offerings. The results of the partnership had proven positive for both the environment and the Mexican farmers. Shade acreage increased by 220 percent, while farmers received a price premium of 65 percent above the market price and increased exports by 50 percent. Since the beginning of the partnership, Starbucks made loan guarantees that helped provide over \$750,000 in loans to farmers.<sup>32</sup> This financial support enabled these farmers to nearly double their income.

In 1992 Starbucks developed an environmental mission statement to articulate more clearly how the company interacted with its environment, eventually creating an Environmental

Affairs team tasked with developing environmentally responsible policies and minimizing the company's "footprint."<sup>33</sup> Additionally, Starbucks was active in using environmental purchasing guidelines, reducing waste through recycling and energy conservation, and continually educating partners through the company's "Green Team" initiatives. In 1994, Starbucks hired Sue Mecklenburg as the first director of environmental affairs.

Although Starbucks had supported responsible business practices virtually since its inception, as the company had grown, so had the importance of defending its image. It was Mecklenburg who developed the idea of using paper sleeves instead of double cupping.<sup>34</sup> At the end of 1999, Starbucks created a Corporate Social Responsibility department, and Dave Olsen was named the department's first Senior Vice President. According to Sue Mecklenburg, "Dave really is the heart and soul of the company and is acknowledged by others as a leader. By having Dave be the first Corporate Responsibility SVP, the department had instant credibility within the company."<sup>35</sup> Between 1994 and 2001, Starbucks' CSR department grew from only one person to fourteen.

## THE COFFEE INDUSTRY

Coffee, in all forms, was an \$80 billion industry by the late 1990s.<sup>36</sup> The largest consuming regions were the European Union (35 percent), the United States (25 percent), and Japan (9 percent).<sup>37</sup> The industry could be broken into two main categories on the consumption side: mass-marketed and specialty coffee. The four largest companies and their brands—Procter & Gamble (Folgers), Philip Morris (Maxwell

<sup>28</sup> Pendergrast, *Uncommon Grounds*, p. 375.

<sup>29</sup> Schultz, *Pour Your Heart Into It*, pp. 295–96.

<sup>30</sup> "CSR FY01 Annual Report," p. 5.

<sup>31</sup> Robert McClure, "Starbucks Soon to Have It Made in the Shade," *Seattle-Post Intelligencer*, August 3, 1999, p. 2.

<sup>32</sup> Ben Packard, "Sustainability Practices Presentation," National Recycling Coalition Conference, January 16, 2001.

<sup>33</sup> "CSR FY01 Annual Report," p. 8.

<sup>34</sup> Schultz, *Pour Your Heart Into It*, pp. 303–304.

<sup>35</sup> Sue Mecklenburg, interview, Starbucks VP Business Practices, July 25, 2002.

<sup>36</sup> Pendergrast, *Uncommon Grounds*, p. 418.

<sup>37</sup> "Product Profile: Coffee," Third United Nations Conference on the Least Developed Countries, May 16, 2001, pp. 4–6.