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The Coffee Wars Heat Up: New Strategies to Jolt the Caffeine-Conscious Consumer

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Warren Buffett once called the cigarette the perfect product: "It costs a penny to make. Sell it for a dollar. It's addictive."

Much the same could be said about coffee today. Even a costly coffee drink -- Starbucks sells its lattes for about $3.50, depending on the location -- consists of little more than a cup of water, a splash of milk, a spoonful of coffee grinds and 30 seconds of labor. Starbucks has managed to turn its customers' craving for caffeine into a $6.4 billion a year business. It already has about 6,000 company-owned coffeehouses and claims to open five more each day. All of which explains why so many sellers of fast food and drink seem intent on taking away some of its highly profitable market share.

Dunkin' Donuts, for its part, has tried to rev up its business by adding all sorts of new beverages over the last several years and, according to a recent *Wall Street Journal* article, introducing new food varieties and a coffee-house ambience to some of its stores. Its beverage offerings include the Coffee Coolatta and, lately, the Turbo Hot, a cup of coffee stoked with a shot of espresso. The changes, along with a new ad campaign, are intended to tell consumers, "We take our product seriously but not ourselves too seriously," says spokeswoman Susanne Norwitz. "We're not about fancy couches and wi-fi. We're about providing a good value and being convenient." Despite that thinly veiled knock at Starbucks, Norwitz insists that the changes aren't aimed at luring customers from the Seattle chain. "We are doing what we have always done," she says. "We are ... speaking to the plainspoken, no-nonsense Dunkin' patron."

McDonald's likewise has trotted out a new line of upscale coffee, co-branded with Newman's Own food company. And even 7-Eleven has taken to serving cappuccinos and boasting of gourmet beans in its brews.

But marketing experts at Wharton caution that these kinds of efforts may be misguided. Some companies seem so obsessed with swiping business from Starbucks, or so afraid of losing customers to it, that they may be abandoning a niche they could continue to defend and profitably serve. Indeed, Starbucks-envy may be leading some to forsake the customers who made them what they are. "In any mature market, there are always going to be price-sensitive customers, quality-sensitive ones and convenience-sensitive ones," says marketing professor Peter Fader. "There will be some customers who love service and some who love the experience. It's just a question of retailers deciding which of those segments they want to go after. Everyone can do well if they cater to their segment."

Selling coffee today that is at least palatable makes sense for many quick-service eateries. For example, at Dunkin' Donuts, which is owned by Dunkin' Brands, coffee and donuts are as complementary as, well, cops and crullers. If the chain doesn't sell a decent cup of coffee alongside its jelly-filled doughnuts -- and these days, muffins and bagels -- it's inviting customers to shop elsewhere, says Wharton marketing professorXavier Dreze. If customers do that, he warns, "they may not come back."

Made to Order

Starbucks and a host of smaller companies, like San Francisco-based Peet's Coffee and Tea and Minneapolis-based Caribou Coffee, have raised consumers' coffee consciousness, ratcheting up the threshold of acceptability, argues Bill Cody, managing director of Wharton's Jay H. Baker Retailing Initiative. Even people who won't fork over $4 for a flavored latte want something better than overcooked percolator swill. "The average person now expects not just to have a fresh cup of coffee, but to have it hand-tailored to their expectations," he notes.

In addition, coffee is a ritual purchase that drives other purchases, says Rob Price, chief marketing officer for the Wawa convenience-store chain based in Wawa, Pa., and an adjunct professor at Wharton. "It tends to be the unifying beverage around which a lot of other things get sold -- the morning paper, a doughnut or a breakfast sandwich." People also typically buy coffee five or seven days a week, often at the same place. Businesses crave customers with that level of devotion.

And thanks to today's coffee culture, more people are caffeinating throughout the day, which, if you are Wawa, means more selling opportunities. "Good coffee has been really democratized," Price points out. "Some of our competitors on the high end tend to alienate customers by their surroundings and their price, but it's easy to give coffee as an affordable luxury to almost everybody."

His remark is no doubt a reference to Starbucks, as was Norwitz's comments about "fancy couches and wi-fi." Visit Dunkin' Donuts' web site, and you will find even more talk of the company "igniting a revolt against the tyranny of high prices, long waits and confusing sizes." Starbucks, as anyone who has tried to puzzle through its menu knows, calls its sizes 'tall,' 'grande' and 'venti' (although many customers seem to continue to order 'smalls', 'mediums' and 'larges'). Dunkin' Donuts also boasts that its "espresso revolution liberates customers by offering real and authentic espresso drinks at affordable prices in everyday language."

Starbucks, for its part, is little worried about such gibes. In an email, spokeswoman May Kulthol said her company "is proud to be credited with creating the specialty coffee industry in which a variety of coffeehouses thrive today. However, Starbucks believes it is the unique and authentic Starbucks experience as well as our knowledge and passion for quality coffee that differentiates us from other coffee retailers."

Meanwhile, Fader and several Wharton colleagues aren't convinced that Dunkin' Donuts and other coffee purveyors are angling for the same customers or even selling the same thing as Starbucks. Put differently, Kulthol's statement about "the unique and authentic Starbucks experience" is more than just promotional blather. Along with its brews, her firm is peddling a place to hang out with cool music, comfortable couches and free wireless-Internet connections, says marketing professorDavid Reibstein. The premium prices are, in effect, hidden rent for the freebies.

As part of a case he teaches on Starbucks, Reibstein asks his students to draw three pictures of images that come to mind when they think of the company. Their first image is inevitably a cup of coffee. But the second and third almost never refer to other Starbucks' wares, like pastries or newspapers. Instead, "the students always draw something about the furniture and the funky counter clerks with their piercings and tattoos, or maybe tables with people sitting by themselves with computers, or tables with people sitting together," he says.

Dunkin' Donuts, in contrast, isn't a place where people typically hang out. Many of its outlets don't offer much room to sit and savor your apple fritter or "frosted coffee roll." Some offer nothing more than a stand-up counter. "How is it, then, that Starbucks and Dunkin' Donuts compete?" Reibstein asks. "Sure, they both have a lot of stores, and they sell coffee and pastries. But they are not really competitors at all."

Fader agrees, arguing that businesses of all sorts sometimes stress quality and price too much, just as coffee sellers have become obsessed with the bona fides of their beans. But their competitiveness often pivots on other forgotten needs. "It might be that people want to get out of the store in 45 seconds," he says. "Yet businesses keep adding quality or cutting price, even when it's convenience that people are seeking." If customers come for quick service, then giving them a Starbucks-quality coffee but doubling their wait time adds little to a firm's bottom line. It may even subtract from it.

Despite all the copycat talk about quality coffee, breakfast retailers "seem to have at least stumbled into niches," Fader adds. Starbucks owns the high end, while Dunkin' Donuts has traditionally emphasized convenience, and McDonald's and other fast-food outlets, price. "It's not clear that anyone goes to McDonald's for quality," Fader quips. "There it probably should be the price play."

Wal-Mart vs. Target

Other retailing sectors have shown that segmenting the market in this way makes sense. "Look at Wal-Mart and Target," Fader suggests. "They seem to be in the same market, but you can easily shop in both for different reasons." Though both are classified as discounters, Wal-Mart has historically aimed to have the lowest prices, period, while Target tries to combine stylish clothing and house wares with value pricing. (Recent press reports, however, cite efforts by Wal-Mart to experiment in some stores with higher-end clothing and upscale household accessories as a way of competing in Target's niche.) "In the same way, you can go to Dunkin' Donuts in the morning and Starbucks in the afternoon. And Dunkin' Donuts shouldn't be at all bothered by that. Maybe you are looking for different things at different times of the day."

Even Starbucks, for all of its caffeine-fueled success, faces challenges, including the need to continue growing rapidly without undermining its sleek operations or alienating its devoted clientele. As a publicly traded company, Starbucks has to expand to meet Wall Street expectations. Yet its obvious paths seem fraught with peril.

Adding more food to its menu, which the firm has begun doing, risks gumming up operations and lowering margins. "When I heard they were doing that, I thought they were getting desperate," Dreze says. "That's how you start losing your point of differentiation." Installing drive-through windows, which Starbucks is also trying, likewise could endanger the brand. "If they say, 'Here, just take it with you,' it becomes more [like] just a cup of coffee," Reibstein suggests. "And as a cup of coffee, it's fine, but are you willing to pay that much more for it without the experience?"

Mature companies, or those strongly identified with particular customers, often stumble into trouble when they try to expand beyond their core clientele, says marketing professor Barbara Kahn. She points to Talbot's, a seller of conservatively styled clothing for professional women. The company's customers historically tended to be older women, Kahn points out. "But Talbot's wanted to bring in more than just older women, so they introduced younger styles. In trying to do that, they antagonized the older women and didn't get the younger market."

The same sort of demographic "stickiness" prevails among car brands, she notes. Two General Motors' marks -- Buick and Oldsmobile -- long held little appeal among younger buyers, and that partly led to GM phasing out the Oldsmobile line several years ago. While no one is predicting that Starbucks will go the way of Oldsmobile, the company, by wandering too far from its formula, could lose its cachet among urban professionals without attracting new buyers.

The Return of Juan Valdez

A hidden casualty in the coffee wars has been a Colombian coffee farmer named Juan Valdez. Perhaps the world's best-known bean grower, he existed only in ads and was the fictional spokesman for the National Federation of Coffee Growers of Colombia. The group created him to promote its beans in grocery stores -- contending that they tasted better than other grocery store coffee -- and thus secure a premium price from retailers. The Federation even persuaded some retailers to put its logo -- a drawing of Juan and his mule -- on containers of coffee.

The Federation's beans "were among the first grocery-store brands that said, 'We have higher quality,'" notes marketing professor Patti Williams. "And they had remarkably high recognition for Juan Valdez as a character. A tiny little organization developed this brand icon." But the coffee-house revolution eroded the federation's gains. Marketing by Starbucks and regional chains advanced the notion that the best coffee comes from freshly roasted and ground beans, and few grocers offer that. "Now all grocery-store coffee is viewed as bad," Williams adds.

Valdez is fighting back. He, too, has become a "barista" -- an Italian term that many coffee houses use to refer to their espresso makers. The Federation has launched Juan Valdez cafes in New York, Washington, D.C., and Seattle. The Seattle store held its grand opening April 16 and is near Starbucks' original location. But Juan Esteban Orduz, the Federation's president, told *The Seattle Times* that the cafes don't aim to take on the coffee-brewing behemoth. They are intended to serve, in effect, like "billboards," he says, publicizing high-quality Colombian coffee to a new generation of coffee drinkers.