

Wake Up and Sell the Coffee

Howard Schultz is back at the helm of Starbucks and trying to put a jolt into the company that turned coffee into an iconic brand. But with restless customers, new competition and a sagging economy, is the passionate entrepreneur who started it all the right man for the job?

BY BARBARA KIVIAT/SEATTLE



I'M WALKING UP TO A Starbucks with Howard Schultz when we spot a barista standing in the parking lot, passing 11 cups of coffee through a car window. "I've never seen that," says Schultz, who took over

Starbucks in 1987 and transformed it from a six-shop seller of beans into a thread that runs through our social tapestry. He asks the barista what she's doing. She says the drive-through order was so large she decided to bring it out. Schultz waves to the driver to roll down her window—"Where are they going with 11 beverages?" he wants to know—but as he approaches the car, the driver speeds away. Sometimes it's tough to connect with your customers. But Schultz is trying. Very, very hard.

Starbucks has been so successful, it may seem unassailable, untouchable—unavoidable. It's not. In fact, the company has had a very difficult year. Traffic at U.S. stores dropped for the first time in its history, and then comparable-store sales—a key measure of a retailer's health—turned negative too. Its stock has slid some 40% in the past 12 months, shaving more than \$400 million from Schultz's personal bean pile.

But perhaps most hurtful have been the mounting complaints from customers, employees and even Schultz himself that in its pursuit of growth, the company has strayed too far from its roots. As Schultz memorably wrote to the company's top execs on Valentine's Day, 2007, "We have had to make a series of decisions that, in retro-

spect, have led to the watering down of the Starbucks experience and what some might call the commoditization of our brand." The company that taught us that coffee is not a commodity has itself become one.

So Schultz is taking it upon himself to restore the cult of caffeine. On Jan. 7, the passionate entrepreneur—whom employees call Uncle Howie—again became CEO, a position he ceded in 2000 for a seat on the board. He has lured back some apostles from the start-up years, and they've designed a plan to yank Starbucks' focus from gaining efficiency and appeasing Wall Street back to selling exemplary coffee with the kind of service and ambiance that makes a \$4 latte worth the price.

"We are doing everything we can to

STARBUCKS

By the Numbers

294 million lbs.

amount of unroasted coffee bought in 2006

\$1.42

average price paid per pound

15 to 20

clerks it takes to run one Starbucks location

5,969 sq. ft.

size of the largest store, in San Antonio

44

number of countries with at least one store

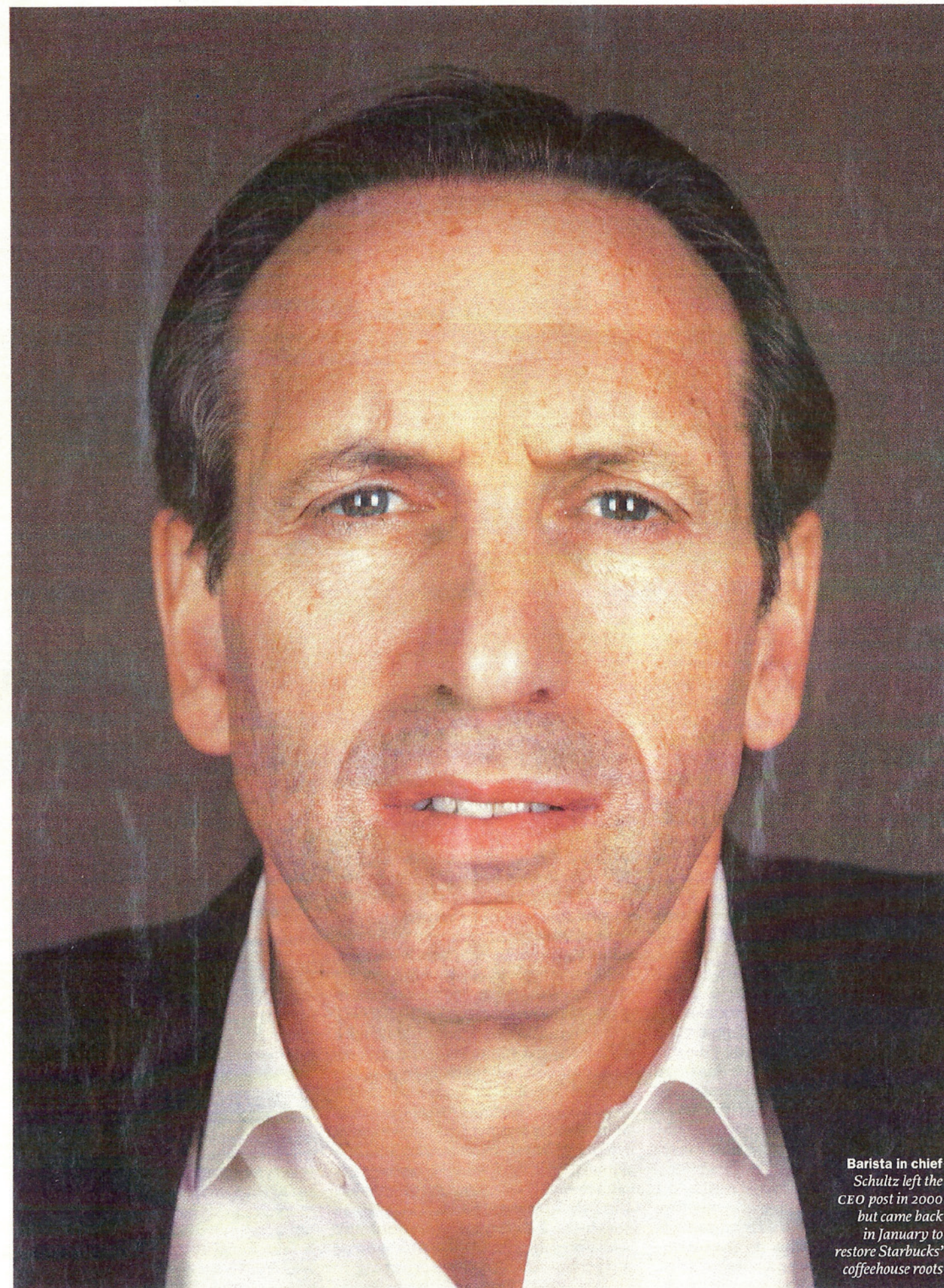
Source: Starbucks

differentiate Starbucks from everyone else that is attempting to be in the coffee business," Schultz said at the company's annual meeting in March, alluding to McDonald's, Dunkin' Donuts and several convenience-store chains that have been making a run at Starbucks' customers. Starbucks will once again grind beans in its stores for drip coffee. It will give free drip refills, offer latte upgrades and provide two hours of wi-fi to anyone with a registered Starbucks stored-value card. Soon the company will roll out its new armor: a sleek, low-rise espresso machine that makes baristas more visible and gives them more control over the process. It has launched MyStarbucksIdea.com for consumers to talk to one another and the company. "This," says Schultz, "is just the beginning."

He says it with the zeal of an empire builder. And that's precisely the issue: having built one, Schultz is trying to alter the momentum of a company with \$10 billion in yearly sales and 16,000 stores in 44 countries. But creating intimacy and authenticity on that scale may be beyond expectation. "They have come about as close as you possibly can to being big yet still retaining some uniqueness," says John Moore, who was a marketing manager at Starbucks until 2003 and now runs the blog *Brand Autopsy*. "I can't think of a company that's done it better—but can it really be done?" We are about to find out.

Diluting the Coffee

AFTER THE WOMAN WITH THE 11 COFFEES drives away—running a recognized



Barista in chief
Schultz left the CEO post in 2000 but came back in January to restore Starbucks' coffeehouse roots

brand apparently doesn't mean you get recognized—we head inside and walk through the store with Harry Roberts. Roberts helped Schultz build Starbucks from 1987 to '96 and heeded the call to return as chief creative officer. The three of us stand and look at the area by the cash register—a clutter of CDs, breath mints, chocolate-covered graham crackers, chewing gum and trail mixes. "There's no story," Roberts says. Schultz adds, "We're selling a lot, but the point is to take a step back and ask, Is it appropriate? We've been selling teddy bears, and we've been selling hundreds of thousands of them, but to what end?"

Partly to the alienation of customers. "If I go in there first thing in the morning, it smells like McDonald's, not a coffee shop," says blogger Jim Romenesko, who runs *StarbucksGossip.com*, referring to the egg-based breakfast sandwiches the company started selling a few years ago. When he posted Schultz's Valentine's Day e-mail, Romenesko was shocked by the worldwide media pickup: he thought the things Schultz was saying were obvious since he had heard them so many times before from the Starbucks workers and customers who post to his blog.

Of course, every change that Starbucks has made over the past few years—automated espresso machines, preground coffee, drive-throughs, fewer soft chairs and less carpeting—was made for a reason: to smooth operations or boost sales, two inescapable goals for a publicly traded company. Those may have been the right choices at the time, Schultz wrote, but together they ultimately diluted the coffee-centric experience. "We want to have the courage to do the things that support the core purpose and the reason for being and not veer off and get caught up in chasing revenue, because long-term value for the shareholder can only be achieved if you create long-term value for the customer and your people," Schultz says. "We have to get back to what we do."

The Origin of Café Culture

IN 1981 SCHULTZ WAS WORKING IN HIS native New York City for a housewares company when he first traveled to Seattle and stepped inside Starbucks—a narrow store with a worn wooden counter and bins of coffee beans—which sat across the street from Seattle's waterfront Pike Place Market. The aroma and romance captured his imagination, as the well-told story goes, and after a year of begging for a job, he was hired to do marketing. Two years later, a trip to Milan led to more inspiration. He returned to Seattle convinced that Starbucks should start opening espresso bars and bring café culture to

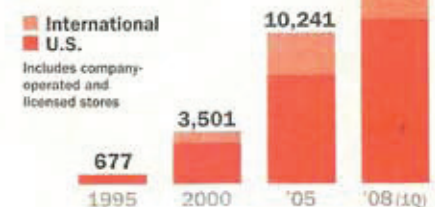
America. The founders of Starbucks, who had been trained by the legendary coffee retailer Alfred Peet, weren't so sure about expansion—wouldn't that obliterate the intimacy they'd established? So Schultz left to start another company, Il Giornale, but he returned in 1987 with \$3.8 million that he'd raised to buy Starbucks and turn it into the company he envisioned.

In 1992 Starbucks went public with 140 stores, and from practically the very beginning, the company expanded at a breakneck pace, growing store count 40% to 60% a year. It wasn't just about coffee. Starbucks took care of its employees as well as its beans. In an almost unheard-of move for a food retailer, the company offered health insurance, a costly policy that Schultz insisted on; as a child, he had watched his family's finances crumble when his father suffered a broken ankle at his job as a delivery-truck driver.

Eventually, though, Starbucks had to

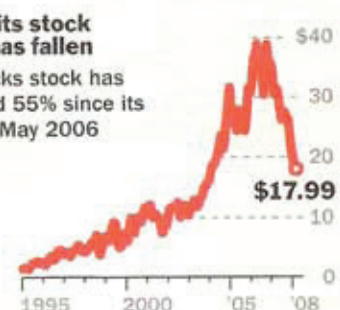
Starbucks keeps adding stores ...

29% of all Starbucks are now outside the U.S.



... but its stock price has fallen

Starbucks stock has dropped 55% since its high in May 2006



JOHN HEATLEY—REUTERS FOR TIME

grow up and get professional managers. In 2000 Orin Smith ascended from president to CEO; Schultz stayed on as chairman of the board. During Smith's five-year tenure, Starbucks maintained its mind-blowing growth, but at the same time, it introduced sophisticated testing and R&D and took steps to boost efficiency and sales, like installing automated Verismo espresso machines. By no longer having to scoop and tamp coffee for each shot, baristas could make a drink 40% faster, moving customers through lines more quickly. Drive-throughs became standard, and the company released its first CD. Smith's successor was a Wal-Mart veteran, Jim Donald, who took the company into books, movie promotions and oven-warmed breakfast sandwiches, which added about \$35,000 to the average store's \$1 million annual sales.

Tensions over what Starbucks was becoming—cluttered, corporate, soulless—were rising within the company even

before the Valentine's Day memo. "These were real conversations we were having," says Michelle Gass, whom Schultz promoted in January to head of global strategy. "A lot of last year was figuring out what really matters to our customers."

At the same time, the slowing economy started to dent sales. "They finally got to the point where their customer base was so broad it wasn't recession-proof," says Bear Stearns analyst Joseph Buckley. The summer of 2007 was particularly bad because of consumers' growing boredom with Frappuccinos, which make up about 15% of sales, according to UBS analyst David Palmer. Then, in the quarter ending in September, traffic at established U.S. stores fell 1%, the first drop ever. The next quarter, traffic dropped again—down 3%—and comp-store sales fell 1%, the first time Starbucks had ever swung negative.

On Jan. 7, the board reinstated Schultz as CEO to revive the coffee empire. "It's a

Starbucks—and its CEO—is ready to take your order

Schultz, who recently covered a shift in a Seattle store to observe customers, serves coffee with his top management team.

- 1) **Martin Coles** After a stint running the overseas stores, he now leads overall operations
- 2) **Chris Bruzzo** Starbucks' technology chief, an ex-Amazon exec, runs MyStarbucksIdea.com
- 3) **Harry Roberts** Long a Schultz confidante, he is back as chief creative officer
- 4) **Terry Davenport** The head of marketing is also charged with jump-starting product development
- 5) **Chet Kuchinad** The risky suggestion to close 7,100 U.S. stores for employee retraining came from his division, human resources
- 6) **Michelle Gass** Leads global strategy; she turned the Frappuccino into a core product
- 7) **Howard Schultz** One insider says the CEO picks executives who make up for his weaknesses
- 8) **Paula Boggs** The company's general counsel came to coffee retailing from Dell in 2002
- 9) **Peter Boclan** Took the chief financial officer post last year and must now explain the company's new strategy to Wall Street
- 10) **Arthur Rubinfeld** Another encore from the start-up era, he runs store development worldwide
- 11) **Wanda Herndon** After leaving in 2006, she accepted Schultz's call to handle communications



Reinventing Starbucks. The java giant's new strategy puts the focus back on the coffee

WHAT'S IN

Grinding beans in stores

Will restore the coffee aroma; the new Pike Place Roast will be the first ground



MyStarbucksIdea.com A site invites customers' gripes and suggestions



The Mastrena You can see the barista over this new espresso machine

Conservation International The group will certify where beans come from—one more sign that Starbucks is about coffee

Loyalty Free drip refills and latte extras for repeat customers



WHAT'S OUT

Breakfast sandwiches

Hot sellers, but they sometimes overpower the scent of coffee



Reporting comp-store sales Too much focus on numbers means less focus on customers

The Verismo The old machine gives baristas less control over the steaming of milk and blocks their view of patrons

Cluttered counters

The mishmash of stuff distracts from coffee



Stores on every corner Unwieldy U.S. growth will slow; the company will still push ahead overseas

the company, and if you don't, there's nothing wrong, but you shouldn't be here," Schultz recalls.

And it's not just Schultz who's back. It was as if he were reassembling the band: Roberts, the merchandising guru; Wanda Herndon, who left in 2006 but returned to run global communications; and Arthur Rubinfeld, the company's first vice president for store development, who has known Schultz since the two were in their 20s. Schultz holed up with them and others he'd promoted from within at the Palace Ballroom in downtown Seattle for three days of 14-hour strategy sessions. The retreat started by listening to Beatles music and talking about how great icons reinvent themselves.

Schultz moved swiftly. On Jan. 30, he announced that Starbucks would close 100 underperforming stores and curtail U.S. store openings to about 1,175 in 2008, down 34% from the prior year. The breakfast sandwiches were toast in North America. To

get focused on the long term, it would stop reporting comp-store sales to Wall Street. Then, at the March 19 annual meeting, the company laid out its initiatives to reinvigorate the "coffee experience." Some of the projects had been kicked around, but with Schultz back in the CEO chair, everything started to get done more rapidly. "The rate at which we're making these moves is far and away faster than anything I've experienced the last few years," says COO Martin Coles.

Some of the changes Starbucks is making are big, risky bets. By giving people with a registered Starbucks card free upgrades on lattes, for instance, the company could be leaving as much as 30¢ to 70¢ per drink on the table. When I ask Coles how much that program, which also includes free drip refills, will cost the company overall, he simply says, "We believe it's worth it."

The Founder's Dilemma

ONLY A FIGURE LIKE SCHULTZ CAN PULL off such bold action, says Rüdiger Fahlenbrach, an assistant professor of finance at Ohio State University's Fisher College of Business who has studied the return of founder CEOs. "A founder may come in, and because he started the company, people more readily accept these things," says Fahlenbrach. That's clearly what's happening at Starbucks. "Howard, frankly, is the only person who could do what we needed to do," says global strategy head Gass. That courage was on full display on Feb. 26, when Starbucks closed all 7,100 of its company-owned U.S. stores (4,000 licensed

locations remained open) for three hours to retrain 135,000 baristas. Part of the training involved the correct way to pull an espresso: into a shot glass, not a paper cup, a shortcut that had evolved to move the line more quickly. It was a strong statement that Starbucks cares about quality—with a clear shot glass, a barista can make sure the espresso correctly settles into three layers—and isn't led by a fast-food-style obsession with throughput.

By restoring the smell of freshly ground coffee to stores and working in visual cues about how Starbucks sources its coffee—Roberts is jazzed about a series of prints from artists in Rwanda, where Starbucks is opening a regional farmer-support center—the company is trying to re-emphasize its heritage. "We haven't been as good at telling our story as we once had in the past," says Schultz. "The good news is, unlike many other companies, this is not a story that has to be invented. It's real."

But is it what customers really want? Are most people looking for an experience, the "third place" community feel that Schultz likes to talk about, or do most of them just want a good cup of joe, pronto? "Howard is a brilliant visionary and a genuinely compassionate human being, but he runs the danger of being trapped by his past," says Jeffrey Sonnenfeld, a professor at the Yale School of Management who has extensively studied CEOs. "Entrepreneurs sometimes don't grow with the business. You shouldn't pretend the model can't keep evolving." Schultz is fond of saying that the current energy and optimism reminds him of the early days, when Starbucks was "fighting for survival." It is a nostalgic way to look at things, and that, says Sonnenfeld, is a big problem.

To Schultz, keeping in touch with the past is key to future success. Remembering who you are is the first step to becoming who you should be. Sometimes in the morning, he goes down to the original Starbucks at Pike Place. Before the store opens, Schultz lets himself in. He puts his hands on the wooden counter and thinks about how he felt at the beginning, what it was he was trying to do. Over the past few months, Schultz has also taken to passing around a memo he wrote in 1986. The letterhead says *Il Giornale*—Starbucks would come later—but the vision was the same. "We recognize this is a unique time; when our coffee bars will change the way people will perceive the beverage," he wrote 22 years ago. "It's an adventure and we're in it together." He signed it the same way he signs the company-wide memos he's taken to writing since coming back as CEO: "Onward, Howard." Starbucks turned out to be a beautiful adventure. Will it be a single or a double? ■

'We've been selling teddy bears, and we've been selling hundreds of thousands of them, but to what end?'

—HOWARD SCHULTZ, CEO OF STARBUCKS