Illycaffe: the Starbucks threat

Marketing Strategy

Being a single-product company, Illy caffe differentiated its packaging of espresso coffee based only on *format* (from 3 kg. for professional consumption; from 125 gr. to 250 gr. for domestic consumption), on the *form* (ground coffee, beans, or ESE servings), and on the *type* (regular or decaffeinated).

The unique preservation of the product by the use pressurization, allowed the expansion of Illy caffe in strategic areas such as the United States. Europe, and even Japan.

The company's mission. which was "to delight customers around the world with an excellent cup of espresso and to do everything to improve its quality," reflected the high level of specialized experience capable of meticulously evaluating both the product level and the process level. The direction of excellence always made reference not only to the product that left the establishment but also to "the cup of espresso perfectly served. in every moment and in every place in the world."

Illy caffe's positioning strategy in the crowded coffee market was based on the quality concept. In order to maintain high standards, the management had patented a packaging system that was able to guarantee high levels of flavor and aroma. But the quality system was also based on the careful selection and control of the coffee beans used in production. Illy caffe used only 100 percent Arabica beans in production and had contributed to the invention of sophisticated machinery that was able to eliminate any defective beans from each batch used in production. The company also dedicated 3 percent of annual sales to research and quality control.

The advertising and promotion policies also focused on the quality of the product. linking it to the brand name in order to increase brand loyalty. It was difficult for producers to ensure that coffee served in cafes was identified by brand. But because most consumers believed coffee made in bars and restaurants was better than that made at home. a strong presence in this segment was necessary to build the brand's image in the home segment (food retailing). Illy reinforced its brand name in cafes and restaurants by asking the owners to display lily signs and logos both outside the premises to attract customers and inside to recall the brand name. The marketing policies and brand image established by the management helped Illy to get a premium price for its coffee. often even doubling the price of the next highest competitor in this market.

The Quality Problem

One of the company's major problems in maintaining its quality image was the high rate of personnel turnover in the bar and restaurant business. Many employees took on temporary positions as they were looking for other lines of work. This was true in most advanced economies, but it meant that bar operators constantly had to train new personnel in the art of producing a quality cup of espresso.

The quality depended as much on the human input and machinery as on the quality of the coffee used. According to Illy, in fact a good cup of espresso depended on several elements including the quality of the beans, the roasting of the beans, the correct mix of roasted beans, the quantity of coffee powder used to prepare each cup of coffee. the degree to which the coffee was pressed into the filter of the espresso machine, the water temperature. the pressure at which the water was expelled during the preparation, the cleanliness of the filter, the size of the filter holes, and the quality of the water used in preparation.

The company decided that this was a strategic area for innovation and began to offer technical assistance and training/consultancy to its clients. As Riccardo Illy noted, "A good product is not enough in this market .... You also have to teach the operators of the espresso machines how to use them in the best way if you want to guarantee an increase in sales."

Global Strategy

As the company grew to serving about 3 million servings every day worldwide, more emphasis was placed on retail sales. Outside Italy most sales had focused on the professional sector as Illy caffe had looked to restaurant chefs and cafes for the majority of its business. However, the company's marketing director, Franco Di Lauro, indicated that while 63 percent of company sales were still in Italy this was expected to soon change. He stated that sales growing in other countries at 25 percent or more should soon eclipse the current 8-10 percent domestic growth expected in Italy's saturated, caffeine-driven marketplace.

As the firm had grown, its dilemma had become its image as a premium product that people should save for special occasions. This notion was reinforced by an advertising campaign that featured Spanish actress-model Ines Sastra choosing Illy caffe as the perfect perfume. In order to encourage consumption and convey that the extraordinary can be found in ordinary, everyday life, Francis Ford Coppola, the director of the *Godfather* movies, was enlisted to film his first-ever commercial. Coppola also owned a California vineyard and had a store in San Francisco that sold Illy caffe. With a $2 million budget and $4 million cost to run the commercial in Italy, llly caffe was counting on Coppola to craft a coffee story juxtaposing illusion and reality. The result was an homage to the Italian barista, or coffee bar operator, that had distributors in the United States and other markets clamoring to air.

The L.S. Entry

Illy caffe first entered the U.S. market in 1981 after a long history and success in many high-end shops and restaurants throughout the world. At that time, espresso could be found in few places other than Italian stores and restaurants, and the initial American reaction was not very enthusiastic toward the bitter beverage served in a tiny cup. The company began focusing on the foodservice industry, courting top chefs and owners of fine restaurants throughout the country. Statistics clearly showed that Illy caffe was in the right market at the right time. According to the National Coffee Association, Americans drank just 1.87 cups of regular coffee a day in 1993, down from 2.22 cups in 1975. But the Specialty Coffee Association said its industry was booming, doing more than $3 billion in retail business in 1993, with that figure expected to reach $5 billion by 2000. Thus. Illy caffe saw its sales increase by 53 percent in 1992 and another 45 percent in 1993. In 1994, the company expected sales to perk up another 38 percent and increase three Fold from the current level in just four more years.

Initially, IIly caffe faced sizable entry barriers into the U.S. market. For instance, since the 1950s U.S. coffee consumption halved as a result of competition from soft drinks. So Illy caffe not only had difficulty adapting American lifestyle and taste to espresso but also educating and training barmen how to serve a good espresso by handling the machine properly and using consistently the right dose of coffee. But lily caffe saw further growth in the

American market based on sheer numbers alone. In Italy there is one espresso bar for every 400 inhabitants, but in the United States the ratio is about one for every 30,000, according to Andrea Illy. Japan was also viewed as a market where espresso could similarly become a fashionable drink.

The German Entry Problem

Even though successful elsewhere, by the early 1990s Illy faced some difficulties in its German entry. The position of Illy in Germany was somewhat different from its position in other European countries where sales were made through agents and sales subsidiaries. Originally (1974), an exclusive agreement had been signed with a German distributor. Despite the limits of this strategy, the company's sales grew from 10 tons in 1974 to 30 tons in 1978. In 1978, however, one of the major German coffee producers, Hag, approached the management of Illycaffe with a proposal to form a distribution alliance. Hag was a family-owned and family-run business with a long tradition in the coffee industry. The company produced both caffeinated and decaffeinated filter coffee. as well as a line of supplementary products such as sugar and cream. Hag had an extensive distribution network throughout Germany and had noted a growing interest in espresso coffee among its clients. The company had tried to produce its own brand of quality espresso, but had failed and was now looking for an Italian producer who would be interested in an alliance for the German market.

Ernesto Illy realized that any significant increase in sales in Germany would require much greater investments in both sales force and promotion. But 1977 had not been a profitable year in the domestic market, and the company's financial situation would not permit such investments. Nor was the existing German distributor willing to take on further commitments. Ernesto therefore decided to accept Hag's proposal. As he concluded: "This was a great offer from a significant player in the German coffee industry who believed in our product. This was all the assurance that I needed."

The Hag-Goldene Tasse Era

The contract that was signed by the two companies in 1978 gave Hag exclusive rights to the sale of Illy coffee in Germany. Illy's German distributor, in fact, was required to turn over its client lists to Hag. The job of Illy's distribution was reduced to acting as an interface between the two headquarters and to supplying smaller customers.

Illy maintained control over the brand name and the product, while Hag was given responsibility for promotion and distribution decisions in Germany. Rough sales targets were indicated in the contract (80 tons by 1980, 150 tons by 1981, and 250 tons by 1982), although Hag was under no obligation to reach these targets. No provisions were made for Illy to receive any information about the clients.

Three years later. Hag was acquired by another company in the German coffee business, Goldene Tasse. No significant changes were made in the Illy caffe agreement as a result of this acquisition. In fact, the meetings between the two companies during these years were rare and the contract was typically renewed at the end of each period without any direct contact between the two partners.

According to the original contract, Hag had agreed to pay Illy 13.70 DM for each kilo of coffee received. The price was broken down into two parts: one half was pegged to the price of green coffee on the international market, while the other half was pegged to Illy's production costs.

Price changes were provided for only the half related to the raw coffee: These changes could be effected only every three months according to the fluctuations in the trading price established on the international market. Requests for price increases due to rising production costs, on the other hand, could be made by Illy only once at the beginning of each contract year and had to be supported by documentation explaining the actual cost increases.

Following the signing of this agreement in 1978. Illy witnessed a steady increase in sales. But as Riccardo complained as he looked over the records in 1990. "The sales may have been increasing. but we weren't making any money. Our selling price was too low to earn any margins and we had to absorb the high rates of inflation in Italy. Moreover, as the price of green coffee continued to fall on international markets due to the excess in supply throughout the 1980s, we had no way to raise the price of our product to Hag in any substantial way."

Globalizing the Strategy

As Riccardo Illy took over responsibility for the company's international activities in 1990. he quickly decided to change Illy's strategy in the European market. He was convinced that the move toward a more unified European market provided an excellent opportunity for Illy to appeal to a pan-European consumer through a standardized marketing program in line with the strategy followed in the Italian market. In order to carry out this plan, however, he understood that he needed to create a cohesive team and to bring the various subsidiaries under his direct control. The most effective way he saw to begin this process was to acquire distributors in each major market.

Once the buyout process was completed, Mr. Illy gave one of his export managers, Mr. Giacomo Biviano, responsibility for the company's activities in Europe. Mr. Biviano, a young and decisive manager with a strong background in both international marketing and administration and control, was named CEO for France and Germany, and also appointed to the supervisory board of the new company in Holland. As Biviano described it, "We needed managers who would be loyal to our ideas and would implement a standardized set of policies that were to be decided at the central level."

Ownership Complication

Just about this time, however, Riccardo Illy also learned that Hag-Goldene Tasse had been acquired by General Foods, a diversified multinational in the food industry, which was itself later acquired by Philip Morris International. By 1990, both Kraft, another American-based multinational in the food business, and Jacobs Suchard, a Swiss producer of coffee and chocolate with its own line of espresso, had also come under the wing of the Philip Morris group. As a result, a merger was made between Hag's coffee division. Goldene Tasse, and Jacob Suchard's coffee business in Germany. The new company, called Jacobs-Goldene Tasse, took over Hag's position as Illy's partner in the German market. Riccardo Illy immediately called for a meeting with the ne\v' partners to discuss the potential effects of the changes on the distribution agreement between the companies.

Although Hag-Goldene Tasse had its own line of espresso coffee, and Jacobs Suchard had a line of both espresso coffee and espresso beans, all of which were sold to the bar segment in Germany, Riccardo Illy underlined the fact that none of these products were of the same quality as Illy's brand of espresso coffee. At the meeting the parties agreed to continue the existing arrangement until Jacobs had time to do more research, with one significant change. To protect its quality image, Illy was allowed to have a technical assistant accompany Hag's salesmen during client visits, providing consultancy on the use and maintenance of espresso machines. Although the arrangement lasted only a few months. Illy gained some important insights from these visits. As Biviano noted, "One significant lesson we learned from these direct contacts with the clients was that it was unusual for bar and restaurant operators in Germany to demand trade credit from small suppliers. Such financing was required only from suppliers whose products represented a large share of the business, such as filter coffee and beer".

The Second Meeting

Riccardo Illy and Giacomo Biviano prepared a list of changes that they wanted made in the contract for the subsequent meeting:

1. The selling price of Illy coffee to Hag-Goldene Tasse would be the same as in other European markets, and with the same payment conditions.
2. All marketing activities (especially advertising to the trade, to the consumer, and at the point-of-sales) would be managed and controlled by Illy's new German subsidiary.
3. Hag-Goldene Tasse would be granted exclusive rights to the distribution of Illy coffee in Germany, contingent on the requirement that Hag-Goldene Tasse distribute only Illy's brand of espresso coffee.
4. Clear growth objectives would be stipulated in the contract. These objectives should be in line with Illy's overall objectives for growth. and Hag should be obliged to achieve the stated objectives.
5. A unit to supervise technical consulting/quality control at the point-of-sales would be created and managed by Illy-Germany.
6. A new policy of communication at point-of-sales would be implemented through the use of Illy cups and billboards. Illy should have the authority to control the implementation of this activity through contracts and regular visits to clients.

By the end of the meeting, Jacobs Suchard and Goldene Tasse had agreed to points (1) and (4), but had refused to accept point (3). The companies did not adopt a position concerning points (2), (5), and (6). No new meeting was scheduled between the parties.

Uncertain Future

At the end of the current contract period in June 1991, the manager of my-Germany terminated the contract between Illy and Hag-Goldene Tasse, offering an interim option to renegotiate a new contract. The option was left open until the end of August.

In the meantime, Riccardo Illy and Giacomo Biviano began to study the three major alternatives:

1. Give full responsibility for rules and distribution back to Illy-Germany and work together with the German team to establish an effective sales force.
2. Look for a new partner in Germany who could offer a solid sales network and would agree to the terms outlined in the proposal prepared for Hag-Goldene Tasse.
3. Work toward a new contract with Hag-Goldene Tasse / Jacobs Suchard.

In the latter two cases. given that it was unlikely that all of Illy's requests would be accepted by any partner. it would be necessary to rank the requests in order of importance and to establish the minimum requirements for any agreement.

As the next step, therefore, the two managers had to decide whether or not to attempt to revive the piggyback agreement with Hag, to look for a new distributor, or to create their own network in accordance with their new Euro strategy.

Source: This case was prepared by Pamela Adams, SDA Bocconi, Milano, and revised by Paul Kolesa.

The Starbucks Threat

At the beginning of the new millennium Starbucks seemed to be everywhere. The world's number one specialty coffee retailer, Starbucks operated and licensed more than 7,500 coffee shops (yes, they were referred to as shops rather than coffee bars or coffeehouses) in more than 30 countries. Starbucks owned more than 4.700 of its shops (mostly in the United States), while licensees operated more than 2,800 units (primarily in shopping centers and airports). The company also owned and franchised the Seattle's Best Coffee and the Torrefazione Italia chains in the United States (with more than 100 shops). During 2004, the company planned to open more than 550 company-owned units and an additional 375 licensed locations, primarily abroad.

The shops offered a variety of coffee drinks and food items as well as coffee and coffee accessories. The strategic notion was that the coffeehouses would be destination points, where people could meet friends, drink coffee, chat, and spend time reading, doing homework, or surfing the Internet. Starbucks was one of the first businesses to jump on the Wi-Fi bandwagon, teaming with Hewlett-Packard and Deutsche Telekom's T-Mobile unit to offer high-speed wireless Internet access at 1,200 of its locations in the United States, London, and Berlin. In March 2004, Starbucks and Hewlett-Packard unveiled their Hear Music service that allowed Starbucks' customers to download songs and create custom music CDs in shops. The company intended to offer Hear Music in 2,500 Starbucks stores by 2006. The company offered loyal patrons its Starbucks Card, which allowed customers to prepay up to $500 on a store card, which doubles as a gift certificate. The program's success enticed Visa to team up with Starbucks to offer Visa cards for the same purpose.

The company also leveraged its popularity to extend its brand beyond coffee to a host of home goods and lifestyle products. It partnered with Amazon.com to sell branded kitchenware and coffee supplies. Starbucks also marketed its coffee through grocery stores and licensed its brand for other food and beverage products.

Starbucks' History

Starbucks opened its first location in Seattle's Pike Place Market in 1971, selling quality ground beans over a small counter in an open-air market. It was started more or less as a hobby for three good friends, strong on ideas but not very profit-oriented entrepreneurs. Eleven years later, Howard Schultz joined Starbucks as director of retail operations and marketing. Starbucks began providing coffee to fine restaurants and espresso bars in Seattle.

In 1983 Schultz traveled to Italy, where he became impressed with the popularity of espresso bars in Milan. Seeing the potential to develop a similar coffee bar culture in Seattle (where a young Bill Gates had just started a promising software company named Microsoft), he convinced the founders of Starbucks to test the coffee bar concept in a new location in downtown Seattle. This successful experiment was the genesis for a company that Schultz founded in 1985 called Il Giornale, offering brewed coffee and espresso beverages made from Starbucks' coffee beans. With the backing of local investors, Il Giornale acquired Starbucks' assets and changed its name to Starbucks Corporation in 1987. The company opened coffeehouses in Chicago and Vancouver, B.C.

In the early 1990s, Starbucks expanded headquarters in Seattle and built a new roasting plant. The company also became the first privately-owned US. company to offer a stock option program that included part-time employees.

The company expanded into California. Washington, DC, Minneapolis, Boston, New York, Atlanta, Dallas, Houston. and negotiated contracts to serve Starbucks coffee with Horizon Air, United Airlines, Nordstrom, Barnes & Noble. and ITT/Sheraton/Westin (now Starwood hotels). By then the company had 676 Starbucks locations.

International Expansion

In the late 1990s Starbucks expanded internationally, opening locations in Japan, Hawaii. Singapore, the Philippines, Taiwan, Thailand, New Zealand, Malaysia, China, Kuwait, Korea, Lebanon, and the United Kingdom. They were as aggressive in the domestic retail market, opening more locations in the United States. This was when the strategy known as "a Starbucks on every corner" was developed saturating downtowns with shops sometimes only one block away from each other.

By the year 2000, Howard Schultz transitioned from chairman and CEO to chairman and chief global strategist. Orin Smith was promoted to president and CEO. Within the three years that followed. the company continued to push for more retail locations abroad, launching shops in Dubai, Hong Kong, Shanghai, Qatar, Bahrain, Saudi Arabia, Australia, Switzerland, Israel, Austria, Oman, Indonesia. Germany, Spain, Puerto Rico, Mexico. Greece, southern China, Turkey, Chile, and Perù!.

EXHIBIT 1: Starbucks Sales and Income

	2003	**2002**	**2001**	**2000**
Annual Sales ($ mil.)	4,075.5	3,288.9	2,649.0	2,169.2
Annual Net Income ($ mil.)	268.3	215.1	181.2	94.6

In 2004, Starbucks Coffee International opened in Paris. its first shop in the bastion of lovers of strong coffee.
As of mid-2004, the count of Starbucks locations around the world was at 7,569. Each of these locations was focused on providing the Starbucks experience: making various incarnations of coffee drinks available to people for enjoyment in the coffeehouses and for "to-go" consumption or takeout trade.
Starbucks' international expansion had not gone completely smooth. High startup costs and cultural resistance to the Starbucks brand were obstacles in some countries. Tensions in the Middle East forced the company to pull out of Israel in 2003. Some of the licensees did not perform as well as expected or

encountered unforeseen difficulties. In June 2004 Starbucks decided to buy 35 stores from its Singapore licensing partner. Bonvests Holdings Limited. and in July 2004 the Company agreed to acquire a 49.9 percent equity stake in its Malaysian licensee.

Financial Performance

Starbucks Coffee Company is the leading retailer. roaster. and brand of specialty coffee in the world. The company is committed to offering the highest quality coffee and the Starbucks experience while conducting its business in ways that produce social, environmental. and economic benefits for communities in which it does business. Its sales and profits have been growing steadily as the international expansion has occurred (see Exhibits 1 and 2).

Illy versus Starbucks

Summarizing the Starbucks information after making several personal visits to the shops. CEO Andrea Illy had come to some conclusions. He thought the United States chain, which measured its sales in billions of dollars, not millions, over-roasted its coffee and concentrated too heavily on takeout trade. But he also voiced admiration for what Starbucks had achieved.

EXHIBIT 2: Financial Overview

Share price: Close 23-Jul-2004	$47.06
52-Week High	$47.87
52-Week Low	$26.00
Basic Earnings per share	$ 0.87
Price/Earnings Ratio	54.09
Current Ratio	1.76
R&D Expenses (mil.)	$ 5.40
Advertising Expense (mil.)	$49.50
% Owned by Institutions	72.90%

"Starbucks piggy-backed on the Italian concept of the coffee bar" he said. "They were able to internationalize espresso as no one else had done. We see them as an opportunity for us, not a threat. After they're educated about coffee by Starbucks and others, we think they'll want the real thing. Us."

As opposed to the Starbucks shops, Illy did not have an "Illy-shop" or "Illy-coffeehouse" to speak of. Illy however, had successfully pursued co-branding relationships with restaurants, cafès, hotels, and coffeehouses, where Illy provided equipment and coffee to augment the establishments' existing menu. It was very common to see the trademark red Illy logo, usually outside these cafes and restaurants underneath the cafe's or restaurant's own sign. These co-branding arrangements were similar to the "Intel Inside" strategy adopted by Intel in the personal computer field. It was also common to see Illy signage inside the establishments.

Also, Illy's product line was more limited than Starbucks. Illy tended to stress its espresso roots, playing down the mochas and cappuccinos that masked the true quality of the coffee. Furthermore, Illy espressos were always served in specially designed small porcelain cups and saucers.

Andrea Illy shuddered at the thought of having Illycaffe served in a paper cup. Still, he could not deny the strengh in Starbucks' numbers, both in terms of sales figures and store locations. To what extent should Illy concern itself with the Seattle giant? Was there a need for a defense strategy? Was Starbucks expansion really an opportunity for Illy. or was that just wishful thinking'?

Sources: This case was developed by Cipriano De Leon from the following sources: R. W. Apple, "Discovering La Dolce Vita in a Cup," *New York Times,* October 24,2001; "Starbucks Timeline and History," *Starbucks The Company;* Internet Online, available from http://www.starbucks.com/aboutus!timeline.asp [2004]; "Starbucks Celebrates Five Years in South Korea With the Opening of its 100th Store," *Business Wire,* july 26, 2004; "Starbucks Corporation," Hoovers Online, Internet Online, available from http://premium.hoovers.com/subscribe/co/fin/factsheet. xhtml?COID=15745.