BRANDWEEK

Buried in the torrent of media coverage of Hurricane Ike, which tore a $10 billion trench of destruction through Texas on Sept. 13, was the following tidbit:

In the days after the Category 2 storm made landfall near Galveston, some 150 Starbucks stores in the Houston area reopened, providing a refuge for area residents to commiserate over cappuccinos and send e-mails to loved ones courtesy of the chain's complimentary Wi-Fi. Press reports hailed Starbucks as a community leader and praised its employees for helping local resident get back on their feet.

"They're opening up to each other: 'Do you have water' Are you OK? How's your family?'" said one manager in a CNN.com piece, describing the camaraderie he saw in his store. Blogs and other mainstream news outlets were quick to pick up the item.

It was a welcome bit of good news in an otherwise difficult year for Starbucks—one perhaps better symbolized last week by the controversy over its plan to give out free coffee on Election Day. Initially offering a cup of joe to anyone who said he had voted (with help from a national TV spot via BBDO, New York), the company immediately altered its strategy when it became clear that the promo might be construed as an effort to influence voters. "To ensure we are in compliance with election law, we extended our offer to all customers who request a tall brewed coffee," a spokesperson said later.

Even when Starbucks tries to do the right thing, it seems, it gets burned. But make no mistake: Leaving the halo effects of community building aside, the languishing coffee giant needs to do much more than be a good corporate citizen to correct its problems. Given its recent financial struggles—at the core of which are weak sales that have forced the closing of about 600 of its U.S. stores through the first half of fiscal year 2009—the question many people are asking right now is: Can Starbucks get its mojo back?

Among Wall Street analysts, the answers are mixed. Many financial experts expect the company's fortunes to improve in 2009, although they differ on predictions of the strength and timing of the turnaround.

Most observers agree that Starbucks' dizzying pace of growth created redundancies in its vast retail footprint that led to cannibalization of sales. Consider that, from 2003 to 2006, Starbucks doubled its number of domestic locations to 10,684. Internationally, during 2007, it opened an average of six stores per day. While some analysts argue that the ailing economy has had more to do with the Seattle-based company's current problems than saturation, nearly everyone agrees that Starbucks' plan to close 600 of its U.S. stores this year (it still has some 17,000 units worldwide) is a critical first step on the road to recovery.

"They've identified their mistakes and are learning from them," said Matthew DiFrisco, an analyst at Oppenheimer & Co., New York. "Starbucks has embraced licensing growth internationally as a profitable alternative and is committed to slimming down operational costs in the U.S. They know they must reinvest in their existing stores. Everything is on the table."

David Palmer, an analyst at UBS Equity Research in New York, agreed. "You have to ask yourself whether Starbucks has the right business structure, the right incentive program and the right people in its stores," he said. "[CEO] Howard Schultz is focused on all of these issues. He's brought back many of the old guard at senior management levels who created the original in-store experience."

Trouble in Latte Land

Starbucks will want to quickly turn the page on 2008, a watershed year in which the company (led by Schultz, who retook the reigns in January) suffered its first quarterly loss and endured consistent same-store sales declines in the mid single digits. As operating margins continue to shrink at its U.S. retail stores, overall revenue is expected to climb just 4% this year, to $10.45 billion, versus a 20% increase at the end of 2007. The company's stock has plummeted by more than half in the last 12 months, dipping below $10 last month for the first time since 2002.

In July, when Starbucks announced the store closings and further plans to eliminate some 1,000 executive jobs—including the COO post, a move designed to put Schultz closer to the front lines—many analysts interpreted the moves as a tacit admission by the chain that it had become too big. Adding to the casualties, Starbucks cut ties with ad agency Wieden+Kennedy in September. (BBDO would not comment on speculation that it is an imminent replacement; Starbucks declined to participate in this story.)

As it enters a precarious holiday season, Starbucks is relying on a bevy of new products and promotions to lure customers back through its doors. It must also fend off emboldened rivals in a decimated economy that would seem to favor cheaper coffee alternatives. But the principal task facing the company is how to regain the brand's old magic. Starbucks began as a cool, hip, downtown-style hideout serving handmade coffee drinks of Euro-café quality, but clearly lost that élan somewhere on the road to becoming a global coffee behemoth. Getting it back won't be easy.

This past April, it introduced the milder Pike Place blend, named after the Seattle waterfront market where the original store opened back in 1971. Other changes include a revamped food menu rolled out in late August, featuring healthier breakfast items such as oatmeal and whole grain muffins intended to replace the breakfast egg sandwiches that were eliminated from most stores following lackluster sales. There's also a new "power protein" snack plate and Vivanno fruit smoothies. Last month, Starbucks bowed a Gold-card rewards program offering 10% off most in-store purchases for a $25 annual fee.

While it's still too early to gauge the long-range impact of these initiatives, many analysts say Starbucks is at lest headed in the right direction.

"Innovating around coffee is a good idea," said Marc Greenberg, an analyst at Deustche Bank in New York. However, he added, "Starbucks does not have a real compelling value proposition in food. Sure, it generates incremental sales. But an egg sandwich is not going to bring more people into the stores."

Greenberg does not necessarily see the light at the end of the tunnel for Starbucks. "I'm not confident of a turnaround at all," he said, pointing to growing commodity prices and other forces that are beyond the company's control. "A number of things need to happen for this story to look better," Greenberg continued. "First, Starbucks has to meaningfully address costs within its stores, including labor and the high cost of paper, coffee and milk. And second, they've got to become more relevant to consumers again. The desire for consumers to buy expensive items has been severely damaged by this economy. [That trend] probably gets worse before it gets better."

How the Coffee Got Cold

In his now infamous leaked staff memo from February 2007, Schultz warned that various steps the company had taken to improve efficiency (namely, replacing manual shot pulling machines with automated versions) removed the "theater" from Starbucks' selling equation and thereby diluted its customer experience. By that time, ironically, Joseph Michelli's book The Starbucks Experience: 5 Principles for Turning Ordinary into Extraordinary was on its way to becoming a national bestseller.

In his book, Michelli recounts scores of uplifting tales about Starbucks employees' ingenuity in dealing with customer problems and connecting to their lives. In retrospect, his thesis could have been either prescient (i.e., as Starbucks became ubiquitous, it could no longer ensure that those values were adhered to consistently, prompting its recent slide); or, conversely, irrelevant (i.e., Starbucks' vaunted in-store experience isn't enough to overcome stiff competition, particularly during a recession).

Naturally, Michelli prefers the former interpretation. "I feel vindicated by all the recent news about the company," he said. "By the time the Schultz memo came out, Starbucks was pumping out cookie-cutter stores instead of finding historic buildings to put up a new storefront. That's what it had done in the old days to create a positive experience from the moment you walked in the store."

Michelli, who now consults with Starbucks on some of its marketing programs, said a "breakdown in training" became apparent to him last year during a visit to a store in Colorado Springs. There, he met workers who'd never seen (much less owned) the pocket-sized "Green Apron Book" that staff normally kept tucked into their uniforms to help guide them through customer interactions.

"Management stopped having daily conversations about service excellence," Michelli added. "They were so focused on achieving growth, they failed to keep redefining what customers wanted from their experience."

Former Starbucks employee Paul Williams recalls the period when attitudes within the company began to slide. Williams joined Starbucks in 1996 and held a variety of positions in its marketing and customer-service departments until 2005, when he left to start up his consultancy, IdeaSandbox, in Seattle.

"It was around 2002-03 when people started embracing the word 'ubiquity,'" said Williams. "We no longer talked about drive- thrus, 24-hour stores, strip malls and other B locations as if they were bad ideas. That's when I think the emphasis on convenience started to overwhelm our focus on quality."

Williams pointed to Starbucks' first TV ads as a further departure from its original "small and meaningful" marketing formula. That subtle effort from W+K during the 2007 holiday season featured a series of animated Christmas characters urging one another to "pass the cheer" with a cup of coffee. "That was the marketing team saying, 'Let's throw out the old rule book and try something new,'" said Williams, adding: "I don't know if Starbucks truly knows what it wants to be anymore."

Nonetheless, Williams does believe that turning back the clock is still possible for Starbucks, if it takes the right steps. For starters, he suggested the company take to heart the input that customers have been offering on the community blog, MyStarbucks.com, introduced back in March. He also personally recommends a stronger effort by newer stores to position themselves as good corporate citizens. Employees could organize a park cleanup, for example, using flyers, direct mail and other local media to enlist community support. "They've got to get back to their core values of quality and service," he said.

Return to Pike Place

Calls for a return to quality and service at Starbucks become even more urgent in light of data that reveal just how much ground the brand must make up. In fact, Starbucks has fallen behind rivals in some of the very differentiators it established in the first place. According to the 2008 Customer Loyalty Engagement study produced by New York-based consultancy Brand Keys, Starbucks trails both Dunkin' Donuts and McDonald's in the quality-and-taste category, while it's second behind Dunkin' Donuts in service/surroundings. Until 2006, Starbucks had met or exceeded customer expectations in both those areas, plus location/value and variety/ selection.

So what changed? "That's when all stores had coffee grinders replaced by vacuum packed, preground beans. And by then, they'd all stopped pulling shots," said Brand Keys president Robert Passikoff. "It changed the entire paradigm. People stood in line for drinks that were no longer crafted for them."

To make matters worse, the automated machines also created some unexpected quality-control problems. Back in February, in what amounted to a very odd PR move, Starbucks locked the front doors on more than 7,000 U.S. locations for one evening so it could give a crash-course to baristas on how to use the new equipment. Trainers reminded them to adjust the grind carefully so the shots were neither too watery nor too bitter. Baristas also were told to check the purity of the espresso by pouring the shots into glasses first. The move, however, did little to reassure skeptics that Starbucks could win back the customers it had lost. "They've moved on," Passikoff said flatly.

Competing chains have been all to happy to welcome them. McDonald's has been widely testing espresso drinks in preparation of a national rollout of its in-store McCafes next year. Dunkin' Donuts, meanwhile, is claiming taste superiority over Starbucks in an online ad campaign, taking direct shots (as it were) such as: "Friends Don't Let Friends Drink Starbucks."

All of which leaves Starbucks officials with an especially bitter brew to swallow. After all, this is the company that created the market for specialty coffees out of what had been primarily a commodity product in the U.S. And that market continues to grow. Retail sales of specialty coffee reached $13.5 billion in 2007, a 10%

increase over the previous year, and consumers are now drinking an average of more than two-and-a-half cups of specialty coffee per day, according to the Specialty Coffee Assn. of America.

As Starbucks faces the prospects of rivals taking a heartier gulp of its market share, Schultz has dismissed any notion of direct competition. "Don't believe the media hype," he told analysts during a conference call back in March. "There is no coffee war going on."

Sharon Zackfia, an analyst with William Blair in Chicago, backs him up. She noted that Starbucks' strongest markets are in the Northwest and Northeast, places that also happen to support concentrations of independent coffee houses and, in the case of the latter region, is the home turf of Dunkin' Donuts. "The problems that Starbucks is having are the same that all retailers are having today: It's the economy, stupid," she said.

Yet Dunkin' Donuts has a "very loyal" following, countered Ron Paul, president of restaurant consulting firm Technomic, Chicago. As for the McCafes—which serves up a Starbucksesque array of specialty coffee drinks including lattes and cappuccinos—Paul said that "the concept will work in some markets but not others. McDonald's still has a much different type of experience than Starbucks. Whether consumers accept McDonald's [as their coffee destination] remains to be seen."

Time for a New Brew

Meanwhile, Starbucks is still in the early stages of what might be called its self-reformation movement and, clearly, there's plenty left to be figured out. Asked for suggestions, experts from various industries volunteered a litany of ideas. Among them:

• Close select stores in the afternoon. Starbucks has been losing most of its foot traffic during weekday afternoon hours, prompting this summer's $2 off iced drink promotion for same-day repeat customers. Some see afternoon shutdowns as the next logical step.

• Consider franchising. Starbucks grew to its present size without it, but UBS analyst Palmer said franchising would go a long way toward finding experienced, highly motivated management for the units. "It's not something the company has considered," he said. "But it would take a lot of pressure off Starbucks at the store level."

• Keep the quality—but keep the line moving. "They've got to become more conscious of work flow," said Joe Buckley, a restaurant analyst with Banc of America, New York. As a comparison, he noted that a six-second improvement in drive-thru service usually equates to a 1% lift in same-store sales for McDonald's and Wendy's.

• Figure out the food. But don't install a kitchen. There's a rather healthy debate (literally) going on over Starbucks' food. Some see the new, wholesome menu alternatives like oatmeal as veering too far from the brand's core proposition as an indulgence. Others say the items that required finishing (such as the egg sandwiches) were not as fresh as even those of fast food competitors—and indeed brought Starbucks "down" to that level. "It didn't drive business during off-peak hours, and added an unnecessary complexity to an already busy time," said Oppenheimer's DiFrisco.

• Ditch the mass advertising, and ignore competitors. "Starbucks owns the category. If they jump into this Coke versus Pepsi back-and-forth battle, it'll kill them," said Peter Sealey, founder and CEO of The Sausalito Group in California.

• Cut 2,000 more stores. "Sometimes, companies [in Starbucks' position] think: Once we get through a difficult period, we'll be OK.' That's a dangerous notion," said Deustche Bank's Greenberg.

Not all the recent news on Starbucks is so glum. Viewed in the context of the current credit crunch, for example, the company's healthy cash flow is a very good sign. And here's another: Starbucks actually jumped three spots (to No. 85 out of 100) on Interbrand's 2008 Best Global Brands, an annual benchmarking list based on financial reports and overall earnings potential.

Even amid the current recessionary climate, "for many Starbucks' customers, that $4 afternoon treat is not an expensive purchase," said Interbrand president Andy Bateman. "If you take the long view, we do think Starbucks will get its mojo back."