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Starbucks Entertainment: Global Delivery of Music

Starbucks Coffee Company has a globally-recognized brand and an impressive record of growth, with an ever-increasing number of stores both in and outside the United States. However, in 2008, the company faces some new challenges. A slowdown in customers' visit frequency to US stores in 2007 is prompting big changes. The company's response includes a shake-up of management and a re-focus on coffee. With Howard Schultz returning to the position of CEO and president, in addition to chairman, Starbucks has decided to slow down the pace of domestic expansion while maintaining the pace of expansion outside the U.S.

Starbucks not only sells coffee but also products that enhance the coffee experience. Since 1999, the company has been selling music CDs in its stores. In 2004, a separate business unit, Starbucks Entertainment, was created, and three years later it launched its own music label, Hear Music™. More recently, Starbucks has branched out into digital downloads.

Where does the Starbucks Entertainment music business fit into the plan to re-invigorate Starbucks? In particular, how can Starbucks Entertainment grow its music business internationally?

Starbucks domestic and international growth

From its first store, established in 1971 in the Pike Place Market in Seattle, Starbucks has grown to over 15,000 stores in 45 countries.¹ Currently the company has more than 200,000 employees ("partners") worldwide. Starbucks has a long term goal of 40,000 stores – 20,000 in the U.S. and 20,000 outside the U.S. Exhibit 1 lists the foreign locations where Starbucks has stores as of April, 2008. See Exhibit 2 for domestic and international store numbers.

Starbucks has three reportable operating segments: United States, International and Consumer Products Group (CPG).² The United States and International segments consist primarily of retail stores. The CPG segment includes Starbucks grocery business as well as branded products sold globally. Exhibit 3 presents revenue by segment, and Exhibit 4 presents revenue components. The Starbucks Entertainment business unit does not report separately; it is included in Specialty/Other Initiatives.

¹ For a detailed company timeline, see http://www.starbucks.com/aboutus/company_timeline.pdf.

² The following descriptions of Starbucks reportable segments for income are taken largely from the company's 2007 10K (for the year ended September 30, 2007) and the 10Q (for the quarter ended December 30, 2007) filed with the SEC.

The United States segment has over 11,000 stores and generates over 75% of total revenues. Since Starbucks has been operating much longer in the U.S. than internationally, the brand is more mature in the U.S. market and average sales per store are higher. In addition, certain costs are lower in the U.S., so this segment has a higher operating margin.

Many of Starbucks international operations are still in the early stages of development and require more extensive support. But the international store base is growing rapidly, and it is making an increasing contribution to total revenue. (See Exhibit 5.) The growth includes both expansion in established international markets and entry into new ones, including emerging markets such as China. The mode of market entry differs by country. Sometimes Starbucks owns and operates the stores (as in, for example, the UK, Germany and Singapore), but many international markets are entered with a partner, either via a joint venture or by licensing. Expansion continues in 2008. The company opened its first store in the Czech Republic in January and has announced plans to enter two additional markets, Bulgaria and Portugal, later in the year.

From the beginning, Starbucks was not just about coffee. The three founders -- English teacher Jerry Baldwin, history teacher Zev Siegel, and writer Gordon Bowker -- derived the store's name from a *Moby Dick* character, Starbuck. Starbucks had a vision of the coffeehouse as a "third place" between work and home. The design of the stores, the products and the atmosphere all had to contribute to the coffeehouse experience. The current CEO, Howard Schultz, still talks about this vision.³

Recent challenges and Starbucks responses

In 2007, Starbucks U.S. sales slowed. The fourth quarter of fiscal 2007 was the first time that Starbucks experienced a decrease in the average number of transactions per store. The stock price fell sharply, and analysts began criticizing the company. They suggested that too-rapid domestic expansion had led to over-saturation, that business would be lost to cheaper competitors like McDonalds, and that Starbucks stores had lost their coffeehouse aura.

On January 7, 2008, Starbucks announced that its chairman, Howard Schultz, would take on the additional role of president and chief executive officer, replacing Jim Donald who left the company. Schultz had previously served as CEO from 1985 to 2000.

Schultz has launched a "transformation agenda," the cornerstone of which is a renewed focus on the "coffee experience." According to the company,

Over the coming months, management will focus on building a long-term model to realize a transformation agenda and drive long-term shareholder value. This agenda includes particular focus on delivering what customers want and expect, and providing the Company's partners with the tools to help them exceed customers' expectations. It is expected that this focus will enable the Company to

³ Joe Nocera, "A Double Shot of Nostalgia for Starbucks," *New York Times*, March 3, 2007.

*offer a renewed Starbucks Experience to customers, while systematically building the foundation for strong, sustainable growth in fiscal 2009 and beyond.*⁴

Schultz's new strategy also includes slowing Starbucks expansion in the U.S. and accelerating expansion outside the U.S. Instead of opening 1,600 U.S. stores in fiscal 2008, Starbucks plans to open 1,175. Internationally, the target is 975 net store openings, up from 783 store openings in fiscal 2007. These numbers are aggregates for company-operated retail stores and licensed retail store operations.⁵ See Exhibit 6 for a summary of the transformation plan.

Some aspects of the plan involve forgoing revenue-generating activities in order to focus on the coffee. For example, the company decided to stop offering certain food items, and, on February 26, all U.S. stores were closed for three hours for a training session. The transformation activities have generated a lot of press, such as this item from February, 2008:

In the month since chief executive officer Howard Schultz unveiled plans for regaining the buzz, he's discontinued warmed breakfast sandwiches (the smell interferes with the coffee aroma that customers love), slowed new store openings and reorganized operations.

*And now, he's closing stores for training that he promises will re-energize baristas and enhance the customer experience. Translation: Baristas will learn how to pull the perfect shot again and steam milk to order, not just press a button on the automatic espresso machine*⁶.

Starbucks Entertainment and the music industry

The Starbucks experience has long included music. The music idea came from Timothy Jones, who was the Starbucks store manager in the University Village (a shopping mall near the University of Washington). Jones had owned a record store in the University District in Seattle. When he closed the store, he went to work at Starbucks. In 1995 he started playing his favorite music there and customers asked about it. This eventually led to the sale of music compact discs (CDs) in Starbucks stores. Today Jones is part of Starbucks Entertainment's content team.

In 1999, Starbucks bought a small company called Hear Music that was started by a college student who created music compilations. Hear Music asked musicians to identify the work of other artists that influenced them and made compilations of them. The first compilation was "Blue Note."

⁴ From the 10Q filed with the SEC in February, 2008 for the quarter ended December 30, 2007.

⁵ Ibid.

⁶ Elizabeth Lee, "Starbucks takes a coffee break to train," *The Atlanta Journal-Constitution*, February 26, 2008.

The Starbucks Entertainment business unit was created in 2004, and Ken Lombard was hired as its president.⁷ Lombard, a former University of Washington basketball player, was the president of Johnson Development Corporation/Magic Johnson Theatres, a company created by basketball great Earvin “Magic” Johnson to generate retail development in underserved parts of U.S. cities. The joint ventures that Lombard negotiated with retailers like Starbucks and with the entertainment industry ultimately led to his job at Starbucks Entertainment.

Music was a good fit with the coffeehouse atmosphere of Starbucks stores, and Starbucks Entertainment aimed to support coffee sales. Lombard said, "Music has always been part of the Starbucks experience.... And now our customers will have more reason to come and stay longer. The longer they stay, the more they buy."⁸

In 2004, Hear Music collaborated with Concord Records to release the Ray Charles CD, “Genius Loves Company.” The CD won 8 Grammy® Awards and sold more than three million units worldwide. One quarter of those sales were in Starbucks stores.

Meanwhile, the music industry itself was changing. The industry underwent a number of major format changes over the previous fifty years – from vinyl records to tape and then to compact discs. These changes were accompanied by changes in profit margins. Vinyl records and cassette tapes had gross profit margins of around 42%, but CD albums have gross profit margins of around 35%. The advent of digital music formats is altering the industry again. And with it comes another assault on gross profit margins.

Furthermore, the retail landscape has changed. Vinyl records were initially sold by independent music stores, but later were supplemented by national chains like Tower Records. In the CD era, record sales in the U.S. were increasingly made at “big box” retailers like Wal-Mart, Target and Best Buy and also through online retailers like Amazon.

In the words of Beth Tallman of EMT Consulting, and VP of a record company in New York: “The industry is the wild west again.”⁹

The Starbucks music-retail phenomenon comes at an interesting moment in the recording industry... Traditional music retailers have become more selective with their musical choices: These days, there are fewer music CDs, and more film-related DVD and computer-game products in stores. Meanwhile, grocery stores, clothing outlets, department stores, restaurants and even drugstores have jumped in to sell music - often at discounted prices...

⁷ Starbucks Entertainment (www.hearmusic.com) offers music, movie DVDs, and books. The focus in this case is on music products.

⁸ Ann Brown, “What’s Brewing at Starbucks,” *Black Enterprise*, Volume 35, Issue 1, August 2004, p.25.

⁹ Interview with Beth Tallman, March 14, 2008.

"What we saw was the chaos and the confusion the industry was experiencing," says [Ken] Lombard. "We felt we were perfectly positioned to provide a quality retail experience."¹⁰

Starbucks has experimented with different forms of music delivery. It sells CDs, has offered CD-burning in selected stores and now has a partnership with Apple to provide direct downloads from iTunes. In the world of physical CDs, there is a lot of price differentiation among retailers. Starbucks is able to charge premium prices because of their unique retail environment and customer base.

Ray Charles' "Genius Loves Company" is a hot seller -- at your local Starbucks, that is. In fact, the ubiquitous coffee merchant says it has sold more of the late singer's final compact disc than any music retailer, despite charging a steep \$15.99...

"We'll enhance the Starbucks experience while developing a new revenue channel," Starbucks Entertainment President Ken Lombard said in a conference call with Wall Street analysts. "Our customers have told us they want a new way to buy music. They've lost touch with record stores and want music beyond the Top 40 that they're currently exposed to."...

Take Ray Charles' "Genius Loves Company," which is doing better at Starbucks than at many stores selling it for \$9.99. A Sarah McLachlan CD last spring also sold "phenomenally well" at Starbucks, another illustration of how adult consumers who have fallen out of the habit of buying music find it convenient to do so at Starbucks.

Indeed, the coffee-seller said it decided to delve into the record business because of sea changes in the music industry -- a "perfect storm" in Starbucks' eyes. Best Buy Co. became the first national retailer to disregard the suggested retail selling price, marketing music as a \$9.99 loss leader to lure shoppers into the store in hopes they would buy televisions and other big-ticket goods. Other retailers followed suit. That led to a devaluation of music and the homogenization of how it was sold...

Starbucks says those forces have fractured the traditional music industry and diminished the sense of discovery many consumers used to feel about music, giving nontraditional retailers an "in" to capture those consumers.¹¹

With its thousands of stores, Starbucks has the biggest retail distribution network in the music industry. However, Starbucks insists that the focus remain on coffee.

¹⁰ Larry LeBlanc, "Make mine a low-fat latte with a shot of Joni," *The Globe and Mail*, September 22, 2007.

¹¹ Becky Yerak, "Merchants range far beyond their staples," Knight Ridder Tribune News Service, November 11, 2004.

Lombard says, "We never want the customer to feel that Starbucks has turned into a music store."¹²

In 2007, Starbucks Entertainment created the Hear Music™ label in partnership with the Concord Music Group. Glen Barros, president of Concord, said that Starbucks "built-in audience" would be attractive to recording artists. "This is a pretty powerful new platform, when you can reach 44 million customers per week through Starbucks stores."¹³

The first CD released by the Hear Music™ label was Sir Paul McCartney's "Memory Almost Full."

"We got a call saying that Paul McCartney was interested in talking to us," said Ken Lombard, president of Starbucks Entertainment, "and after we picked ourselves up off the floor, we met with him in London and had a pretty in-depth conversation about who we are as a company and about our commitment to music." He added that the company told McCartney it could "bring more exposure to this album than to other projects he's done."¹⁴

Sir Paul said he was impressed by the idea of selling the album in thousands of Starbucks retail stores: "For me, the great thing is the commitment and the passion and the love of music, which as an artist is good to see."¹⁵ Starbucks promoted the album by playing it non-stop in all its stores on the day it was released. Of the first 447,000 copies sold, 45 percent were sold in Starbucks stores.

The philosophy underlying Starbucks Entertainment is to be selective, to act as what is variously called a "filter," an "editor," or a "curator" for Starbucks customers. These customers do not go to Starbucks to buy music; it is an impulse purchase. Sometimes the purchase is motivated by the "overhead music" playing in the store. This can be chosen by the store partners (employees), and thus can be highly localized.¹⁶ To encourage customer awareness, Starbucks has been installing flat screens in selected U.S. stores to display information about the music currently playing.

Martin Coles, Starbucks chief operating officer, notes that, "The intention is not to be a music company. Rather, the customer has given us permission to make some suggestions about music."¹⁷

In a February, 2008 interview, Howard Schultz talked about Starbucks as a filter and the interaction between music and the coffee business:

¹² Interview with Ken Lombard, August 7, 2007.

¹³ BBC News, "McCartney Joins Starbucks Label," March 22, 2007, <http://news.bbc.co.uk/go/pr/fr/-/2/hi/entertainment/6476843.stm> .

¹⁴ Allan Kozinn, "McCartney plumbs ghosts and memories," *International Herald Tribune*, June 5, 2007.

¹⁵ BBC News, op cit.

¹⁶ For example, there is a Starbucks store in Laguna Beach, California that is known for playing mostly reggae music.

¹⁷ Interview with Martin Coles, December 11, 2007.

*I never imagined, honestly, that it would evolve to a point where we would be selling music, downloading music in our stores with Apple, producing records, and have the kind of influence that we've had, but I think it speaks to the trust that our customers have come to expect from us. And I think the entertainment group has done a fantastic job of being a curator of the kind of music that spans many different genres but in a way has a sensibility that has been able to attract such loyal customers. So as we go forward, I think it's an important component, but it's important to state very clearly that we're a coffee company and we're not an entertainment company, that entertainment is part of the strategy that enhances the experience...*¹⁸

Tallman observes that, “Starbucks is a great filter – you know that the music will be good”.¹⁹

Chris Bruzzo, Starbucks chief technology officer, sees filtering as part of a broader trend:

Starbucks doesn't have to be everything to everybody. It can be an editor, have a point of view. Customers today need a trusted editor to be a filter. In the entertainment industry, the traditional filters (such as television networks) have far less control today.

*This [being a trusted filter] is the next big thing on the internet. Web 1.0 was about ubiquity. Web 2.0 was about community. Web 3.0 will be about bringing meaning to the internet.*²⁰

Over time, the music selection process changed so as to appeal to a large enough audience to generate sales volume. Ken Lombard explains:

*Starbucks music side had an early reputation for being very eclectic and very selective. But, to draw people beyond the core Hear Music™ customers, we had to provide a much broader range [of product]. We still have a continued commitment to great music opportunities that are unique and compelling and that customers would not be aware of without us. But, to draw people beyond the core Hear Music™ customers, we had to provide a much broader range [of product]. This is a shift from pre-2004.*²¹

Starbucks music sales in North America have continued to impress. According to *Billboard* magazine:

While Starbucks may be facing some healthy competition on the coffee front, it remains one of the most powerful music retailers in the market, even though it carries only a handful of titles and sells new discs for top dollar...

¹⁸ Douglas Wolk, “The Billboard Q&A: Starbucks’ Howard Schultz,” *Billboard*, February 16, 2008.

¹⁹ Interview, op cit.

²⁰ Interview with Chris Bruzzo, March 25, 2008.

²¹ Interview, op cit.

Glen Barros, president/CEO of Starbucks' Hear Music™ partner Concord Music Group, notes that Starbucks' limited choice of titles is part of both companies' strategy of selling to older music buyers who still purchase CDs. "We've always focused on the adult music audience," Barros says. "Music is still an important part of who they are, but there are other priorities that come first. To reach that adult consumer, you have to make it easy for them to make the decision of what to buy, and you have to make it easy for them to get." ...

In the past few years, Starbucks has managed to avoid the price wars and loss leaders that have pummeled the profit margins of nearly every other kind of physical music retailer...²²

Starbucks Entertainment's successes have been good for recording artists and the music industry more generally:

"The Starbucks deal," says Toronto-based entertainment lawyer Susan Abramovitch, "is the Holy Grail for artists right now." Indeed, for a recording industry in the throes of a sickness that may well be terminal, Starbucks - which sold an estimated 3.6 million albums in North America in 2006 - offers a distribution channel that might become one of the music industry's most important lifelines.

"What they do is brilliant, and they are amazing marketers," says Vancouver-based Terry McBride, president of Nettwerk Group, and manager of Avril Lavigne and Sarah McLachlan...

*"A lot of the major labels have been floundering a bit, and it's shown in some of their results," noted [Paul] McCartney this past April, in the U.S. music-trade publication *Billboard*. "You don't want to stay in a gang of mates who don't know where they're going. I'd rather have people who say, 'We're going there.' And you know what, it's worked. Starbucks are really keen."²³*

While Starbucks is seen as providing successful marketing for an ailing recording industry, some have criticized Starbucks Entertainment for becoming too mainstream in its "editing" or "filtering." A March, 2008 article in the *New York Times* claims:

The ardor for Starbucks has gone the way of yesterday morning's grounds. Critics in the music industry say the company squandered its cachet by mismanaging the effort to broaden its music mix. The choices that reflect its early taste for the offbeat -- like an album from Lizz Wright, a torchy pop singer -- are now squeezed in with offerings not unlike those at Wal-Mart, including the latest releases from Alicia Keys and James Blunt...²⁴

²² Douglas Wolk, "Something's Brewing: Starbucks' Entertainment Play," *Billboard*, February 16, 2008.

²³ Larry LeBlanc, "Make mine a low-fat latte with a shot of Joni," *The Globe and Mail*, September 22, 2007.

²⁴ Jeff Leeds, "Does this Latte Have a Funny Mainstream Taste to You?" *New York Times*, March 17, 2008.

Digital music – can it be profitable?

One thing is clear in 2008: physical music sales have collapsed. Digital sales are growing (see Exhibit 7), but digital revenues do not completely make up for the decrease in CD sales.²⁵ Similar trends are apparent worldwide.²⁶

With the world's biggest wi-fi network, Starbucks is well-positioned to offer music digitally. Lombard comments:

As you look at where the music business is going, you can see the shift from physical CDs to digital. Probably digital won't take over completely. How do you predict what the balance will end up being?

*Starbucks wants to offer both physical product and also world class digital. We can't over-invest in physical, in case the balance shifts more towards digital.*²⁷

In September 2007, Starbucks and Apple reached a strategic partnership agreement to make the Hear Music™ catalog available in a dedicated area of the iTunes store and to give Starbucks customers access to 2 million iTunes songs.

*Each time an owner of an iPhone, or new iPod Touch enters a Starbucks, a button will appear on their device that enables them to buy music from the Wi-Fi library. They can download a song--without having to log in--by whatever artist Starbucks is featuring at the time, or music playing on the store's sound system or any other they can find in the library.*²⁸

Chris Bruzzo describes it this way: "This is about being able to get music where you are inspired by it."²⁹

The digital revolution means that the world is changing for recording artists, record companies and retailers. Record labels spend considerable amounts, varying from artist to artist, to produce and promote albums and they reap the profits if these costs were covered.

The big four music companies in the world are the Universal Music Group, Sony BMG Music Entertainment, Warner Music Group, and EMI Group. Each of these companies in turn owns many smaller labels. For example, the EMI Group distributes music products through the labels Capitol, EMI Records, and Virgin. There are also

²⁵ Detailed sales data for the U.S. are provided by the Recording Industry Association of America at www.riaa.com.

²⁶ See <http://www.ifpi.com/content/library/MUSIC-MARKET-DATA-2007.pdf>.

²⁷ Interview, op cit.

²⁸ <http://www.apple.com/pr/library/2007/09/05starbucks.html>

²⁹ Interview, op cit.

many independent record companies, such as Concord and V2.³⁰ Often a smaller company distributes its products through a larger one.

The economics of music products can be rather complex. As a starting point, consider the traditional CD. On average, the cost to produce a CD is around \$5.50 - \$6; this includes royalties and physical costs. Royalties for well-known artists can drive the cost higher. Often there is a distribution fee on a sliding scale up to around \$2.65. Retailers then mark the CD up about 50%, to a typical price of \$13.99.³¹

Note that Starbucks realizes a larger profit on CDs than the average record company. In some cases, Starbucks, with their label Hear Music™, is the producer of music, as with Paul McCartney's "Memory Almost Full." Starbucks also provides its own distribution and serves as the retailer (with minimal marketing costs).

With the advent of digital music, large servers store the music once it is produced, and the cost of selling it is minimal. The standard retail price to download a song has become 99¢; a whole album is about \$10. This leaves little scope for the profit margins that record labels had become accustomed to on a per unit basis.

This isn't great news for the record labels... Things will be miserable for them until they concoct new ways to sell tunes, and those won't be as lucrative as the old ways. That's why a number of artists are abandoning traditional labels to sign with companies that have other agendas than selling music. Paul McCartney now records for Starbucks. Madonna-nothing if not a barometer for where the business is going-has inked a 10-year recording contract with concert giant LiveNation... in a sense, it's irrelevant to argue what music is worth. Technology wants to make it close to free.³²

Chris Bruzzo says, "One of the big business challenges around digital is the economics. How do you maintain your profit margin? There's not a lot of margin in a 99¢ download. In this 'a la carte' model, you need a lot of volume."³³

Financial details of the deal between Apple and Starbucks are proprietary. For present purposes, one can speculate that, when Apple sells a Hear Music™ song (or one from another record producer) on iTunes, they pay the label something like \$.65 per song. Furthermore, one can assume that Starbucks has an affiliate relationship with Apple and receives a "commission" reflecting the business they steer to iTunes from their highly desirable customer demographic.

³⁰ For a more extensive list, see http://www.ifpi.com/content/section_links/member_sites.html . A range of independent labels is described in "State of Indies: An indie who's who," *Music Week*, January 27, 2007.

³¹ An undated pie chart showing another breakdown of CD costs can be found at <http://www.cnn.com/interactive/entertainment/0101/cd.price/frameset.exclude.html> .

³² Steven Levy, "How Much Is Music Worth?" *Newsweek*, October 29, 2007.

³³ Interview, op cit.

Since there are still customers in older age groups who have not yet totally embraced downloads, Starbucks Entertainment is trying iTunes album cards as a “bridging product” between CDs and digital downloads. Titles are selected (filtered) by Starbucks and a plastic card, about CD size, is made. When the “album” is purchased at a Starbucks store, a code on the card is activated to enable downloading from iTunes. The John Lennon album, for example, has some bonus tracks and also has video to differentiate it from a typical iTunes album. It retails for \$24.95. The cards cost perhaps \$.25 each to produce, so inventory costs are minimal.

The music industry is wrestling within itself over how the meager per unit profits on digital products should be split among producers, artists, and digital media. Looming over the whole argument is the big concern about digital media piracy. In the U.S., music producers want the royalties they pay to be reduced to 8% of wholesale revenues from 9%. (This royalty is usually split between the publishers and the songwriter.) Digital media want the royalty rate lowered even further, to around 4% on downloads. They argue that higher royalty rates worsen the piracy problem.

Global delivery of music

Starbucks Entertainment does not presently have a significant business outside the U.S., aside from some limited CD sales (primarily in the UK, Japan, and Canada). The next step is a broader international roll-out of music sales. Ken Lombard observes:

The international opportunity is there, but internationally we are where we were in the U.S. three years ago.

Do we have the same ability to select relevant music internationally as domestically? Probably yes – content people are pretty easy to find.

But there are a lot of challenges. For example, how do we get mindshare of the baristas? In terms of pricing, there is a challenge – most labels are set up so that the international group makes its own decisions.³⁴

Herman Uscategui, director of International Business Development for Starbucks, adds:

The brand is well established internationally, so now we don't have to wait to get to the music business. The music business is international from the starting line. The Sergio Mendes and Herbie Hancock CDs were global launches. In fact, the Herbie Hancock CD was the first global launch of any Starbucks product.

But there are complications in international expansion. There's the localization of music preferences and distribution channels. Intellectual property is so complex. We are not doing anything major in China with music because of piracy and

³⁴ Interview, op cit.

*regulations. The Ray Charles CD was being sold in the Forbidden City before it was even released!*³⁵

Starbucks Entertainment is just beginning to look at how to create an international digital strategy. Chris Bruzzo notes:

Some relationships with customers around the Starbucks brand can only occur once the brand is established and mature...

Music is a highly local phenomenon. It is localized by country and maybe also by region. Not only is music local, but technology is local, and so is the store experience. While Starbucks is a coffee store and not a music store, the music does have to add to the Starbucks experience and to the bottom line in some sense.

*The progression to digital is different in the U.S. and the rest of the world. Should the international strategy skip physical CDs? Is going straight to digital the right strategy?*³⁶

Chris Bruzzo also distinguishes among three kinds of products that might be offered internationally. The first one is music by artists that have global appeal, such as Paul McCartney. The second is more locally relevant music. An example might be working with Japanese partners to identify music to offer in Japan. The third is at a micro level, by store. Just as there is the “art wall” program in Starbucks stores, where local visual art is displayed, local musical artists could also be played in certain stores. This micro-level approach would help make Starbucks a relevant part of the local community.

In mid-2008, Starbucks faces a number of questions about its international music strategy. How can the Starbucks Entertainment unit contribute to the Starbucks bottom line? How can international customers’ store experiences be enhanced by music while still maintaining the core focus on coffee? What music products should be sold internationally, and how should they be sold? How much money can Starbucks expect to make in the next five years from offering music internationally?

³⁵ Interview with Herman Usategui, August 7, 2007.

³⁶ Interview, op cit.

Exhibit 1: Worldwide locations of Starbucks stores as of April, 2008

Australia
Austria
Bahamas
Bahrain
Brazil
Canada
Chile
China
China – Hong Kong, Macau S.A.R.
Cyprus
Czech Republic
Denmark
Egypt
France
Germany
Greece
Indonesia
Ireland
Japan
Jordan
Kuwait
Lebanon
Malaysia
Mexico
Netherlands
New Zealand
Oman
Peru
Philippines
Puerto Rico
Qatar
Romania
Russia
Saudi Arabia
Singapore
South Korea
Spain
Switzerland
Taiwan
Thailand
Turkey
United Arab Emirates
United Kingdom
United States

Exhibit 2: Breakdown of stores by type and location

	Number of stores open as of December 31, 2007	Number of stores open as of December 31, 2006
United States:		
Company-operated stores	7,087	6,010
Licensed stores	4,081	3,391
Total US	11,168	9,401
International:		
Company-operated stores	1,796	1,511
Licensed stores	2,792	2,256
Total international	4,588	3,767
Total stores	15,756	13,168

Source: SEC 10Q filing for quarter ending December 30, 2007

Exhibit 3: Fiscal 2007 revenue by segment (in thousands)

	<u>United States</u>	<u>International</u>	<u>Global CPG</u>	<u>Unallocated</u> <u>Corporate</u>	<u>Total</u>
<i>Fiscal 2007:</i>					
Net Revenues:					
Company-operated retail	\$ 6,560,864	\$ 1,437,401	\$ —	\$ —	\$ 7,998,265
Specialty:					
Licensing	439,161	220,832	366,345	—	1,026,338
Foodservice and other	348,968	37,926	—	—	386,894
Total specialty	788,129	258,758	366,345	—	1,413,232
Total net revenues	7,348,993	1,696,159	366,345	—	9,411,497

Source: SEC 10K filing

Exhibit 4: Fiscal 2007 revenue components

Revenues	% of Total Net Revenues	% of Specialty Revenues
Company-operated retail	85%	
Specialty:		
Licensing:		
Retail stores	7%	47%
Grocery and warehouse club	3%	23%
Branded products	1%	3%
Total licensing	11%	73%
Foodservice and other:		
Foodservice	4%	26%
Other initiatives (includes Starbucks Entertainment)	<1%	1%
Total foodservice and other	4%	27%
Total specialty	15%	100%
Total net revenues	100%	

Source: SEC 10K filing

Exhibit 5: Fiscal 2007 store information

As of and for the Fiscal Year Ended(1)	Sept 30, 2007 (52 Wks)	Oct 1, 2006 (52 Wks)	Oct 2, 2005 (52 Wks)	Oct 3, 2004 (53 Wks)	Sept 28, 2003 (52 Wks)
STORE INFORMATION					
Percentage change in comparable store sales					
United States	4%	7%	9%	11%	9%
International	7%	8%	6%	6%	7%
Consolidated	5%	7%	8%	10%	8%
Stores opened during the year:					
United States					
Company — operated stores	1,065	810	580	521	514
Licensed stores	723	733	596	417	315
International					
Company — operated stores	277	233	171	158	136
Licensed stores	506	423	325	248	236
Total	2,571	2,199	1,672	1,344	1,201

Source: SEC 10K filing

Exhibit 6: January 2008 transformation plan

- Improving the current state of the U.S. business by refocusing on the customer experience in the stores, new products and store design elements, and new training and tools for the Company's store partners to help them give customers a superior experience;
- Slowing the Company's pace of U.S. store openings and closing a number of underperforming U.S. store locations, enabling Starbucks to renew its focus on its store-level unit;
- Re-igniting the emotional attachment with customers and restoring the connections customers have with Starbucks® coffee, brand, people and stores;
- Re-aligning Starbucks organization and streamlining the management to better support customer-focused initiatives and reallocating resources to key value drivers; and
- Accelerating expansion and increasing the profitability of Starbucks outside the U.S., including redeployment of a portion of the capital originally earmarked for U.S. store growth to the international business.

Source: SEC 10Q filing for quarter ending December 30, 2007

Exhibit 7: Digital music growth

Reinventing an Industry – The Digital Difference Over 5 Years			
	2003	2007	
Number of legal services	Less than 50	Over 500	A legal digital music market has been created from scratch over the last five years, with consumers now able to shop around more than 500 legal services.
Licensed tracks	1 million	6 million +	Consumers can now legally access more than six million tracks through legal services.
Value of digital music sales	Around US\$20 million ¹	Around US\$2.9 billion	Record labels have created a digital music industry worth approximately US\$2.9 billion in just five years, a rate of growth many industries would envy.
Digital as a percentage of overall recorded music sales	0%	15%	Almost a sixth of music sales already come through digital channels just five years after legal options opened up and this figure is set to grow.

Source: The IFPI Digital Music Report 2008,
<http://www.ifpi.com/content/library/DMR2008.pdf>