

Latte Letdown: Starbucks Set to Raise Prices



Coffee giant brewing up first increase in four years that may be too strong

BY STEVEN GRAY AND AMY MERRICK

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That frappuccino fix is about to cost you more.

Starbucks Corp., the coffee giant that acclimated millions of Americans to paying unheard-of sums for a drink once largely made at home, is planning to raise its prices for the first time in four years.

Citing higher costs for milk and other commodities, as well as higher rent and health-insurance expenses, the Seattle company plans to charge more across its beverage menu board. "Prior to the end of the calendar year, Starbucks will be taking a modest price increase," Chairman Howard Schultz said in an interview last week. The company is mum on how much.

Starbucks last raised its prices several years ago, by seven cents on average, an increase of 2 percent to 3 percent. But that pocket change per cup, for a company with more than 8,000 highly trafficked locations world-wide, made headlines from coast to coast.

Given current pricing pressures, some restaurant analysts are anticipating Starbucks will bump up prices 4 percent to 5 percent this time, adding a dime or so to the average \$2 to \$2.50 drink.

Some Starbucks fans detest the thought of any increase. "Ludicrous!" said Laura Napoles, a 44-year-old mother of two, after being told of a looming price hike as she left a downtown Chicago Starbucks, cup in hand. "I have kids, so my money has to go so many different ways," said Napoles, who adds that higher prices could steer her to a small restaurant near her office for her afternoon caffeine fix. "They need to get a grip."

A steeper price could push Starbucks' luck. Earlier this year, roughly two-thirds of regular coffeehouse customers surveyed by market-research firm Mintel International Group said that gourmet-takeout coffee is too expensive. Since many people go to Starbucks every day, they are well aware of exactly what their regular order runs, and some even approach the counter with the exact amount of cash and coins in hand. Some 30 million customers visit Starbucks nationwide each week, shelling out \$3.50 to \$4 a trip on average.

Buzz about a looming price hike was heightened last week when Starbucks reported its first dip in monthly same-stores sales growth at company-owned units in 10 months. Sales at stores open at least a year rose 8 percent compared with 9 percent in the same period last year. Those results, for the four-week period ended Aug. 22, exceeded the company's own 3 percent to 7 percent projections, but trailed those of many restaurant industry analysts. Starbucks and analysts attributed the weak showing to no single factor, but pointed to an apparent slowdown in consumer spending that has impacted other retailers, including restaurants.

Schultz, the chairman, has said in the past he was able to resist a fifth price increase in a decade largely by belt-tightening. But in another interview, he said, "It's clear to us that there are certain financial issues that we can't control."

Ironically, coffee-bean prices aren't among them. Companies like Starbucks and Diedrich Coffee Inc.'s Gloria Jean's Coffees are generally cushioned from shifts in the coffee market, largely because of long-term contracts that lock them into above-market rates. According to the Long Beach, Calif.-based Specialty Coffee Association of America, coffee beans account for just 5 percent to 10 percent of the costs of making a cup of coffee.

The bigger price culprits are rising dairy and operating costs. Starbucks said that it has recently experienced double-digit cost increases in its health insurance plan, which covers all of its 80,000 full- and part-time employees worldwide. Costs for dairy and real estate also escalated, but the company declined to say by how much.

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Pricing at Starbucks has intrigued everyone from consumer-product company executives to comedians. In the last decade, the company mainstreamed the once-edgy specialty coffee market -- making competitors of Allied Domecq PLC's Dunkin' Donuts and McDonald's Corp., among others. Despite being the butt of late-night comics' jokes, Starbucks made it seem normal somehow to spend \$4.02 for a grande Frappuccino, the chain's signature creamy coffee.

Demand for prepared coffee tends to be fairly resistant to price increases, and economics professors often use Starbucks as an example of a company whose product seems to have little price elasticity -- that is, increases seem to have very little effect on consumer demand. By contrast, mass-market grocery brands such as Kraft Foods Inc.'s Folgers and Maxwell House coffees tend to be much more price-elastic, said Burt P. Flickinger III, managing director of Strategic Resource Group, a New York consulting firm that works with retailers and suppliers.

"In the end, Starbucks probably will be able to pass along a price increase without a very big falloff," said Frank Badillo, senior economist at Retail Forward Inc., a Columbus-based consulting firm.

In a spot-check of prices of specialty coffee shops in eight cities this summer, John Glass, a restaurant industry analyst for CIBC World Markets in Boston, found Starbucks coffee was actually cheaper than its cafe competitors by 4 percent for regular brews and up to 30 percent on iced blended beverages. "There's no question that they have room to raise prices," Glass said. "It's how much room they have."

In recent months, competitors like Caribou Coffee Co. also have faced rising commodity costs, particularly for milk. But Michael Coles, CEO of the Minneapolis-based chain, said it has no plans to pass those increases on to customers. However, Diedrich Coffee Inc., the Irvine, Calif., company that owns the roughly 450-unit Gloria Jean's, said its costs for premium coffee have risen more than 20 percent on average since last year. Martin Lynch, chief financial officer, said the company will likely follow Starbucks' lead. "By the end of the year, we're going to see what our costs are -- and how the big guy in the industry is going to handle it," he said.

QUESTIONS FOR DISCUSSION (25 word minimum each)

What are the reasons that Starbucks has decided to raise prices?

What is the possible downside to raising prices?

Why *might* the price increase NOT have a big impact on consumer demand? What is unique about this market?