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McDonald's Takes on Starbucks

JANUARY 08, 2008 -- McDonald's is gearing up to capture Starbucks customers with the biggest addition to its menu in 30 years, reports *The Wall Street Journal*. Starting this year, the company's nearly 14,000 U.S. locations will install coffee bars with "baristas" serving cappuccinos, lattes, mochas and the Frappe, similar to Starbucks' ice-blended Frappuccino.

Internal documents from 2007 say the program, which also will add smoothies and bottled beverages, will add \$1 billion to McDonald's annual sales of \$21.6 billion.

The confrontation between Starbucks Corp. and McDonald's Corp. once seemed improbable. Hailing from very different corners of the restaurant world, the two chains have gradually encroached on each other's turf. McDonald's upgraded its drip coffee and its interiors, while Starbucks added drive-through windows and hot breakfast sandwiches.

The growing overlap between the chains shows how convenience has become the dominant force shaping the food-service industry. Consumers who are unwilling to cross the street to get coffee or make a left turn to grab lunch have pushed all food purveyors to adapt the strategies of fast-food chains.

It also shows how the chains' efforts to adapt to a changing market have had drastically different results on their bottom lines. McDonald's is entering the sixth year of a successful turnaround, while Starbucks has begun struggling after years of strong earnings and stock growth.

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Still, the new coffee program is a risky bet for McDonald's. It could slow down operations and alienate customers who come to McDonald's for cheap, simple fare rather than theatrics. Franchisees say that many of their customers don't know what a latte is.

The program attempts to replicate the Starbucks experience in many ways — starting with borrowing the barista moniker. Espresso machines will be displayed at the front counters, a big shift for a company that has always hidden its food assembly from customers. McDonald's says it wants customers to see the coffee beans being ground and baristas topping the mochas and Frappes with whipped cream.

"You create a little bit more of a theater there," says John Betts, McDonald's vice president of national beverage strategy.

Ads for the espresso drinks running in the Kansas City area, where the concept is already being tested, say you don't get a "condescending look" for mispronouncing the size of the drink at McDonald's — a jab at the "grande" and "venti" sizes at Starbucks. (At McDonald's, you just ask for small, medium or large.)

Today, about 80 percent of the orders purchased at U.S. Starbucks are consumed outside the store. The average income and education levels of Starbucks customers have gone down, the company has said. As part of a big push into food, Starbucks sells lunch at more than two-thirds of its company-owned locations in the U.S.

Starbucks's rapid store and menu expansion have slowed traffic at older locations and gummed up operations behind its counters. After years of downplaying threats from rivals, Starbucks executives now say they're preparing for competitive encroachment.

"We understand all too well that we have built a very attractive business for others to look at and try and take away," Howard Schultz, Starbucks's chairman, told investors on a conference call this November. "We are up for the defense and we are going to get on the offense." Starbucks declined to make executives available for this story or specifically address competition from McDonald's.

McDonald's executives say they aren't launching espresso drinks to go after Starbucks, but instead to cater to consumers' growing interest in specialty drinks. And although McDonald's is encroaching on the business that Starbucks invented, analysts say McDonald's may pose more of a threat

to Dunkin' Donuts, which has a more similar customer base. Analysts also point out that McDonald's overall beverage expansion, which includes bottled drinks, is as much aimed at taking business from convenience stores and vending machines as it is from specialty cafes.

Starbucks increased its sales even in parts of the country where Dunkin' Donuts has a strong presence. Some analysts say Dunkin' and other fast-food competitors actually have helped Starbucks by expanding the total market for upscale coffee drinks.

McDonald's executives watching the growth of Starbucks at the beginning of this decade realized that they were missing out on the fastest-growing parts of the beverage business. Data showed that soda sales had flattened while sales of specialty coffee and smoothies were growing at a double-digit rate outside McDonald's. Customers were buying food at McDonald's, then going to convenience stores to get bottled energy drinks, sports drinks and tea, as well as sodas by Coke competitors.

Early on, Starbucks didn't see the Golden Arches as a competitor "because McDonald's was selling hot, brown liquid masquerading as coffee," says John Moore, who spent almost a decade in Starbucks's marketing department before leaving in 2003.

McDonald's move into upscale coffees dates back to a concept that is unfamiliar to most of its customers: the McCafé. It started in Australia in 1993. McDonald's brought the cafes to the U.S. in 2001 by carving out a corner of the restaurant, decorating it with leather couches and adding a counter that sold cappuccinos and sweets. But the cafes never took off here because they didn't feed into McDonald's drive-through business, where two-thirds of sales take place, says Don Thompson, president of the chain's U.S. business.

In 2003, McDonald's initiated a turnaround strategy called Plan to Win. Among other things, it included a total remodeling at thousands of U.S. locations. Molded plastic booths were replaced with oversized chairs, lighting was softened and muted tones took the place of bright colors. Wireless Internet access was also added.

In recent years, Starbucks started to see fast-food chains as more of a threat, according to former employees and people close to the company. In parts of the Northeast, store managers told baristas their biggest competition was Dunkin' Donuts, now a unit of Dunkin' Brands Inc., which made a national push into espresso drinks in 2004.

At McDonald's, the success of its upgraded drip coffee emboldened the chain. In 2005, it began testing drinks sold under the McCafé banner at a handful of franchises in Michigan. It sold lattes and cappuccinos from the front counter so it could pass them to the drive-through windows.

McDonald's researchers contacted customers of Starbucks and other coffee purveyors, and conducted three-hour interviews where they videotaped the customers talking about their coffee-buying habits. The researchers got in the cars of the customers and drove with them to their favorite coffee place, then took them to McDonald's and had them try the espresso drinks.

"There was a surprise factor," says Patrick Roney, a director of U.S. consumer and business insights at McDonald's. "The people who were on the fence ... there was an opportunity to get those."

Management advised restaurant operators to hire baristas who are "very friendly" and show a "willingness to learn about the competitor's product," according to a 2006 internal memo about how to start selling the drinks. "For example, a typical Starbucks customer would ask for a Grande Latte; our Baristas need to know that this is a medium size drink," the memo says.

Unlike at Starbucks, where baristas steam pitchers of milk then combine it with the espresso, McDonald's process is more automated. It uses a single machine to make all the components of each drink. Espresso is brewed using beans with a darker roast that are more finely ground than those for drip coffee, resulting in a concentrated form that's usually mixed with hot milk to make lattes and cappuccinos. McDonald's has three flavors it adds to its espresso drinks, a significantly narrower lineup than Starbucks, which boasts thousands of drink combinations.

During testing, plain shots of espresso were taken off the menu and more whipped cream was added to some drinks. The company also moved the espresso machines to the front counter from the back after realizing the drinks undersold when employees made them with their backs to the customer.

Drinks are priced from \$1.99 to \$3.29 and come in vanilla, caramel and mocha flavors. In advertisements in test markets, McDonald's tells customers those are 60 cents to 80 cents less than competitors' prices.

Only about 800 of McDonald's U.S. restaurants have the specialty coffee drinks now, and some may not get the full beverage program until 2009. Executives and franchisees will not give specifics on how well the espresso drinks have sold in tests.

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