Starbucks in China: what lessons can Starbucks learn from Luckin?

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Introduction

It was April 7, 2020. The stock of Luckin Coffee (NASDAQ: LK), which was Starbucks' main competitor in China, had plummeted to $4.39 after it admitted to fabricating much of its 2019 sales. That same day, NASDAQ halted trading of the company's stock. Things had not always looked so bleak for Luckin. At the time of its initial public offering (IPO) in May 2019, Luckin was a fast-growing, two-year-old, Xiamen-based company often referred to as the "Starbucks of China." It was founded in Beijing in 2017. Luckin had followed an aggressive approach to overtake Starbucks as the largest coffee chain in China by using a digital business model and emphasizing a straightforward menu. Luckin offered delivery and frequently discounted its coffee. Customers could only order through the app. Luckin's rapid rise had posed a problem to Starbucks, which saw China and the United States (USA) as its long-term growth markets (Picker, 2019). Luckin's stock reached an all-time high of $50.2 on January 17, 2020.

Meanwhile, the coronavirus pandemic had reshaped the business landscape and had accelerated long-term trends, altering consumer attitudes, behaviors and purchasing habits, many of which were expected to remain after the pandemic was over (Accenture, 2020; Deng, 2020). People were shopping more locally (IBM Institute for Business Value, 2020) and had embraced digital commerce, with a large segment of US consumers buying groceries online for the first time in March (Blue, 2020). Consumers took advantage of options with limited in-store interactions like Buy Online Pick up In Store (BOPIS) or curbside pick-up and they preferred contactless payment options while shopping (IBM Institute for Business Value, 2020). People were concerned about their health and reluctant to visit crowded spaces (Blue, 2020). It was assumed that of all the people working virtually, a portion would continue to do so post-pandemic. These trends were seen worldwide (Deng, 2020; S&P Global Market Intelligence, 2020; The Times of India, 2020).

Starbucks (NASDAQ: SBUX), which saw China as an important growth market, had been forced to exchange its model of being a "third place" between work and home to "grab and go," as it temporarily closed seating areas to promote social distancing (Fortin, 2020). The company had shuttered more than half of its 4,000 stores in China in January of 2020 in response to the COVID-19 outbreak. By February 27, 2020, 85% of Starbucks' cafés in China were operating again, but focusing on delivery and drive-thru customers (Fortin, 2020; Yaffe-Bellany and Scheiber, 2020). Although Luckin's fate had turned in recent months, its rapid rise and popularity in China had not gone unnoticed and had slowed down the growth of Starbucks' same-store sales (Wernau and Jargon, 2019). While Starbucks and Luckin had different approaches to gain and sustain a competitive advantage, what could Starbucks learn to solidify its competitive position in China from a Chinese competitor's strategy and business model?

Disclaimer. This case is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from published sources.

Coffee in China

Although considered the land of green hot tea, China emerged as a prized, untapped market for coffee companies seeking to satisfy newly developed taste buds for caffeine. Coffee consumption in China was estimated to be a 100bn Chinese Yuan a year market (KrASIA Writers, 2018) and grew at an estimated yearly rate of 11.3% (Statista Market Forecast, 2019). The yearly average coffee consumption per capita in China was expected to grow from 6.2 cups in 2018 to 10.8 cups in 2023. Still small compared to the US market with an estimated 388.3 cups a year consumed, the total Chinese population and the growth of its middle class were signs of great potential. The Chinese coffee market, however, was very different from other international markets. According to a Frost & Sullivan Report (*SEC Filing: Luckin Coffee Inc*, 2019), over 70% of unit cup sales in coffee shops in China in 2018 were pick-up or delivery orders and appeared to be less about the coffee ritual or the coffee store as a "third place" and more about a quick fix for coffee. Prior to Starbucks' entry in China, the retail coffee market was driven by instant coffee, with Nestlé being the main player (GMA, 2018).

Starbucks in China

Starbucks had three reportable operating segments as follows:

1. Americas (inclusive of the USA, Canada and Latin America);
2. International (inclusive of China/Asia Pacific, Europe, Middle East and Africa); and
3. Channel Development (inclusive of packaged coffee sales, tea and ready-to-drink beverages to customers in grocery stores, warehouse clubs, specialty retail stores and institutional foodservice companies (Starbucks, 2019)).

Starbucks was increasingly dependent on its international markets, especially China, to reach its growth targets. Starbucks' total net revenues for the International Operating Segment for the Fiscal 2019 year was $6,191m compared to $18,259m for the Americas Operating Segment. Operating income for the International Operating Segment was $965m versus $3,783m for the Americas Operating Segment (Starbucks, 2019).

Well after opening its first store in China in 1999, Starbucks opened a 30,000 square-foot flagship Starbucks Reserve Roastery in Shanghai, China in December 2017 (Pham, 2017). Given the potential for growth in the Chinese market, Starbucks originally had planned to grow from 2,000 stores in 2017 to 3,000 in 2021, which translated to opening a new store in China every 15 hours (LaVito, 2017). Exceeding these original targets, Starbucks had 3,521 stores open by September 30, 2018, and 4,123 as of September 29, 2019, a net increase of 602 stores in one year (Starbucks, 2019). China was Starbucks' fastest growing market and its second largest market overall, with the Market Business Unit representing China contributing meaningfully to Starbucks' revenues and net profits (Starbucks, 2019). All stores in China were 100% company-owned (Starbucks, 2019). There were several risks Starbucks was exposed to in China, including economic conditions, food-safety-related matters and issues concerning the regulatory environment, but notably also the entry of new competitors to the specialty coffee market in China (Starbucks, 2019).

Starbucks' business model was built on prompt service, quality and the uniqueness of its coffee while providing an in-store experience as your neighborhood's coffee place to hang out at (Starbucks as the "third place" between home and the office). Since Starbucks' founding in 1971 in Seattle, WA, the company had worked hard to build a brand centered around the coffee ritual reinforced by the dedicated dance of the baristas who grounded coffee beans, steamed milk, poured shots of espresso and made cappuccinos while chatting with customers around a bar (Robin, 2013). Staying true to those values, it also strived to keep the fragile balance between profitability and social conscience (White, 2019). Recent efforts by its chief executive officer (CEO), Howard Shultz, to promote social responsibility through a lens of humanity while building the bottom line, were not left unnoticed and had paid off so far. In the USA, the company had invested in opportunities for the youth (generally underemployed), provided a 100% tuition-free opportunity for employees to get a bachelor's degree through Arizona State University and hired veterans and military spouses. Consequently, the company had not suffered from a shortage of talent in a very tight US labor market in 2018 and 2019. The company was similarly committed to its 40,000 employees in China by providing insurance plans to care for their aging parents (ChinaDaily.com.cn, 2017). This commitment raised concerns by many analysts who also noted that Starbucks' average store area was double the size and had more amenities (seats and free Wi-Fi) than Luckin stores, which would affect the bottom-line (Wang, 2019).

The company appeared to be seeking to diversify from Big Coffee to Big Bread with the idea of bringing fresh-baked bread to stores around the world (Kummer, 2013). Over time, the company worked to build its value chain, including a strong network of company-owned roasting plants and distribution centers which allowed them to control both supply and quality internationally. Furthermore, Starbucks developed partnerships to manage the source and quality of coffee through exclusive contracts with growers or by purchasing crops. Starbucks invested in single-serve coffee by building alliances to compete in the at-home or in-office settings (e.g., Starbucks-branded K-cups in partnership with Keurig and Starbucks-branded Nespresso cups in partnership with Nestlé). Starbucks also developed Starbucks VIA Ready Brew, a high quality instant coffee protected by proprietary technology.

In a world that saw technology as a way to promote efficiency and convenience, the identity of Starbucks as the "third place" seemed uncertain. The consumer experience on mobile was increasingly important (Power, 2020). In the USA, Starbucks had the most regularly used rewards app (Palnitkar, 2019). Users of the Starbucks app earned redeemable stars for money spent. As of October 2019, roughly a third of customers used the app to pay in-store, a third used it to order ahead and a third did not use the app (Lock, 2019). Starbucks opened its first pick-up-only store in Beijing, called Starbucks Now, in July 2019 (Starbucks' Stories Asia, 2019) and in New York City at the end of 2019 (Power, 2020).

Starbucks had a Starbucks China app which had a "Starbucks Delivers" program launched in October of 2018 and a "Starbucks Now" (Mobile Order and Pickup) program launched in May of 2019 (Starbucks' Stories and News, 2019). It was also possible, since 2017, to buy coffee and send it as a gift on WeChat (Weixin) [1] (Brennan, 2017; Parisi, 2017). Chinese customers had gotten used to rapid coffee delivery, a feature that was introduced and aggressively marketed by Luckin. Chinese customers increasingly expected fast delivery across product categories and some office and apartment buildings had installed robots to help cope with large delivery volumes of consumer goods, food and beverages (Wernau and Jargon, 2019). Starbucks had teamed up with Ele.me in August of 2018, Alibaba's food-delivery platform, to roll out delivery from an initial 150 stores, after two years of research on anti-spill and anti-cooling lids and packaging (Wernau and Jargon, 2019). Coffee delivery was mostly a money-losing endeavor to coffee stores (Wernau and Jargon, 2019). Starbucks got value from its app by analyzing app data using big data analytics and artificial intelligence to improve the customer experience and business overall. Customer data were used to personalize the Starbucks experience, develop targeted and personalized marketing, determine new store locations, decide what Starbucks products to offer at grocery stores and choose locations to make menu modifications such as Starbucks Evenings (Marr, 2018).

Luckin

Luckin (Figure 1), often referred to as the 7-Eleven of coffee, focused on unleashing technology to boost convenience over experience (Campbell, 2019) and aggressive growth through enticing customers with discounts. Although Luckin priced its coffees at the same level as Starbucks, customers received steep daily discounts of 50% or more

Figure 1 Luckin coffee

Source: Shwangtianyuan (2019)

(Stevenson, 2019). Such discount was not available at Starbucks, with a reported average price of $4.80 a cup compared to $3.50 at Luckin Coffee (Xu, 2019). In Beijing, delivery of a 16-ounce Americano set customers back 37 yuan ($5.52) if ordering from Starbucks and 27 yuan ($4.02) if purchasing from Luckin (Wernau and Jargon, 2019). Luckin, founded in 2017, described itself as having a "disruptive, technology-driven new retail model for providing coffee which has helped fulfill unmet demand in China" (SEC Filing: Luckin Coffee Inc, 2019). Luckin had a simple, small menu with limited customization options (e.g., cup size) and a focus on freshly brewed coffee tailored to Chinese customers' palette, non-coffee drinks and new products such as lunch boxes and snacks (SEC Filing: Luckin Coffee Inc., 2019). The expedited nature of Luckin's operation (quick and easy order, grab and go counter experience, limited choices) emphasized convenience in contrast with the Starbucks coffee ritual approach. The company also offered items that could be sold in high volumes, allowing Luckin to produce these food and beverage items in bulk with standardized processes and consistent quality.

Luckin had three types of stores. As of March 31, 2019, pickup stores formed the majority, representing 91.3% of Luckin stores (*SEC Filing: Luckin Coffee Inc*, 2019). These stores were located in high-demand areas such as office buildings and were small-sized stores with limited seating. 4.6% of Luckin stores were "relax stores," which were generally spacious and built for branding purposes. 4.1% of Luckin stores were delivery kitchens that Luckin opened to achieve broader customer coverage. Delivery kitchens only served delivery orders and could be set up quickly with low costs. This allowed Luckin to expand in a new area with low cost with the idea that the delivery kitchen could be replaced by pick-up stores if successful (Prospectus: Luckin Coffee, Inc., 2019). Luckin guaranteed 30-min delivery, with 99.7% of orders delivered on time in March 2019. Luckin had integrated delivery into its service from the start (Wernau and Jargon, 2019). Delivery was free if the order value met a threshold. By 2019, Luckin had 3,680 stores across urban areas in China. Increasing its market penetration, Luckin further launched two non-attended retail models in January of 2020: Lucking coffee Express (a self-service coffee machine brewing store-serving quality drinks) and Luckin pop Mini (which sold snacks, beverages and quick bites) (Yuan, 2020).

Technology was at the center of Luckin's business model. Customers placed their orders and made their payments through WeChat or Luckin's own "coffee wallet." Chinese customers in general adopted digital ordering and delivery at far higher rates than the rest of the world (Rossolillo, 2020). Cash payments were not accepted (Horwitz, 2018). All orders had to be made using personal phones. The customers selected the drink and the store and were issued a QR code to claim their drink with an estimated pick-up time and a notification when the order was ready. This process was designed to save customers time while also building a direct communication channel with the user. Luckin analyzed customer behavior and transaction data using big data analytics and artificial intelligence. Luckin also closely tracked customer feedback through the Luckin app, WeChat and other social media channels and analyzed that feedback to improve its products and services. Luckin further leveraged app push notifications as a tool for customer engagement and to drive sales. The company used it to promote any drink or food item that might be on sale or promote other retail products from partner companies, therefore acting as a marketplace (Figure 2).

Luckin sourced its coffee beans from prominent suppliers and outsourced the production of pre-made beverages and food items (e.g., juices, pastries, lunch sets, etc.) to reputable suppliers. Luckin did not currently roast its own coffee but had established a partnership with Dutch Agricultural commodity merchant Louis Dreyfus Company (LDC) for a joint venture coffee roasting plant in Xiamen with an estimated start of production by mid-2021 (Desk3, 2020; Ferrer, 2020). The Joint Venture with LDC, one of the world's largest producers of coffee beans with a diverse product and regional portfolio, allowed Luckin greater product quality control and was in line with Luckin's focus on diversified coffee flavors and high-quality coffee beans (Ferrer, 2020). Their coffee design team included winners of the World Barista Championship, the preeminent international coffee competition (*Prospectus: Luckin Coffee, Inc*, 2019). Luckin outsourced its delivery services mainly to S.

Figure 2 Luckin user interface

Source: Tatge (2020)

F. Express, which was China's leading delivery services company, as well as various local delivery companies.

Customers with questions could find responses to frequently asked questions (FAQs) in Luckin's self-service tools and via automated customer service chatbots or could contact a dedicated customer service team to address more complicated customer issues. Customer feedback was used as a key performance indicator (KPI) to evaluate individual store performance.

Luckin incurred significant expenses for technology development, branding, marketing and sales to support its business model. Luckin invested heavily in sales and marketing to help increase brand awareness and deepen the relationship with its customers. The company followed a multi-channel branding and advertising approach, which included engaging famous Chinese actors, world-renowned baristas and popular culture icons as brand ambassadors, sponsoring events and movies, increasing the presence of their relax stores, as well as producing marketing and advertising campaigns that were targeted, interactive and had potential to go viral.

Luckin had an aggressive pricing strategy to promote its fast expansion. To acquire and retain customers or promote new products, Luckin used dynamic pricing based on algorithms to offer many coupons and vouchers that allowed customers to purchase products at a deep discount (e.g., buy-two-get-one-free). Luckin also incentivized current customers for bringing in new customers – offering free coffee to both. Luckin admitted that such promotion activities might not be sustainable in the long-term (*SEC Filing: Luckin Coffee Inc*, 2019). The company was currently not profitable with a net loss of $241.3m for the year ended December 31, 2018, and a net loss of $82.2m for the first three months of 2019 (*SEC Filing: Luckin Coffee Inc*, 2019).

Luckin's downfall

Luckin's stock price reached an all-time high of $50.02 on January 17, 2020, about eight months after its IPO. After that, Luckin stock started to go down slightly amid concerns of the impact of coronavirus on the coffee chain's sales growth (Sun, 2020). On Thursday, April 2, 2020, less than one year after its IPO, Luckin Coffee Inc.'s shares sank 81% (Garcia, 2020). The drop in shares occurred after Luckin announced that "it formed a special committee of three independent directors to investigate "misconduct, including fabricating certain transactions" that spanned the second through fourth quarters of 2019 and involved inflated sales of about $310m" (Garcia, 2020). This amount was nearly half of its reported and projected sales from April to December (Yang, 2020). Trading was halted on April 7 (Fox, 2020) when the stock price was $4.39. The faith of Luckin's stock had been in stark contrast with Starbucks' stock, which had remained priced relatively steady from an opening price of $77.66 on May 16, 2019, the day of Luckin's IPO, to a closing price of $68.71 on April 7, 2020.

At the same time that Luckin's fraud had been unveiled, a worldwide pandemic was raging. The novel coronavirus COVID-19 had first been identified in Wuhan, China and several areas in China had been under severe lockdown restrictions in the early months of 2020 with 35 million people in 12 cities quarantining as of January 2020 (Buckley & Hernández, 2020) and 760 million people by March 2020 (Hessler, 2020). In January 2020, the World Health Organization (WHO) declared the outbreak a public health emergency of international concern and in March 2020 a pandemic.

Despite the COVID-19 pandemic, Starbucks increased its investment in China by committing to building its largest overseas coffee roaster near Shanghai and renewed its aim to operate 6,000 stores by 2022 (Tan, 2020). Belinda Wong, chairman and CEO of Starbucks China, said: "Starbucks has always taken a long-term view in China and our commitment to the market has never been stronger." (Starbucks' Stories Asia, 2020)

Other competitors in the Chinese coffee market

Luckin was not the only company seeking to take advantage of the growth in coffee consumption in China and to challenge Starbucks' dominance. Competition in the Chinese coffee market was heating up, with a significant number of Chinese and international new entrants. Luckin was the best-known homegrown competitor to Starbucks, but other Chinese companies with different positioning strategies had emerged (Table 1). In terms of international competitors, the main competitors that had entered China by 2018 were Starbucks, UK-based Costa Coffee (acquired by Coca-Cola in 2019), Taiwan-originated UBC Coffee and US-based McDonald's McCafé (GMA, 2018). Canadian coffee-and-doughnut chain Tim Hortons entered China in February 2019 with Tencent as an ally and had about 50 locations in China early in 2020 (Liao, 2020).

Table 1 Starbucks compared to top five Chinese coffee companies

	Positioning	*No. of locations (December 2019)*
Starbucks	Sit-down café	Over 4,300
Luckin Coffee	Fast coffee pick-up and delivery	Over 4,500
Coffee Box	Fast coffee pick-up and delivery	Over 400
Pacific Coffee	Sit-down café, similar to Starbucks	Over 500
Greybox Coffee	Focus on specialty, high-end coffee	23 stores
Fisheye Café	Focus on specialty, high-end coffee	18 stores

Note: Composed based on information from Henan (2020)

Chinese versus US culture

Businesses like Starbucks, who were native to the USA but sought to grow organically in other countries like China, had to consider their consumers' cultural backgrounds because differences in American versus Chinese culture had an impact on consumer behavior (Krishen & Hu, 2018; McGregor, 2000). Cross-cultural research suggested that consumers reacted differently to advertising and brands (Pollay *et al.*, 1990; Sung & Tinkham, 2005) and service (J. Zhang *et al.*, 2008). For example, in a study on attitude toward complaining (Ekiz & Au, 2011), Chinese respondents tended to forgive and forget service failures and remained loyal to businesses even after shortcomings in service, whereas Americans sought a remedy from third parties such as consumers agencies or local newspapers.

There were six generally accepted dimensions of culture (Hofstede *et al.*, 2010). The cultural dimension that seemed to be particularly relevant to explain differences in consumer behavior was the dimension of individualism, the degree of interdependence a society maintained among its members (Hofstede Insights, 2019). With a low score of 20 on "individualism," China was a highly collectivist culture where people were supposed to act in the best interests of the group over their personal interests. On the contrary, the USA had a very high individualism score of 91 where people looked to personal rewards and benefits. The collectivist nature of the Chinese culture encouraged a larger emphasis on information-seeking-and-giving by consumers. Indeed, Doran (2002) found that Chinese consumers searched more and relied more on personal information sources than American consumers when evaluating products for purchase. American consumers made purchase decisions individually, whereas Chinese consumers made purchase decisions influenced by others. In a comparative study between the USA and China (2018) that looked at the effect of culture on accepting social media commerce [2] and purchase intentions, Chinese social media users had higher perceived enjoyment and sense of community using social media commerce. This was consistent with prior research, which found that collectivist culture consumers relied more on social media to collect information for purchase decisions than individualistic culture consumers (Goodrich and Mooij, 2014).

Chinese consumer behavior

Research on Chinese consumer's attitudes, behavior, preferences and purchase patterns and motivations (Atsmon *et al.*, 2010) concluded that Chinese consumers behaved gradually more similar to their counterparts from developed markets. They increasingly looked beyond product features, showed a willingness to pay for better value and quality and spent more time researching and exploring product nuances. However, Chinese consumers also had distinctive tastes and priorities and specific ways of choosing and buying products, setting them apart from consumers from developed markets. More specifically, the needs or interests of their families had greater importance for them. Word of mouth was a more significant source of product information, thanks largely to the fast-growing use of the internet, which Chinese consumers considered to be a credible information source. Chinese consumers remained brand conscious but, unlike shoppers elsewhere, they tended to focus on value intensely causing brand loyalty often to be secondary (Atsmon *et al.*, 2010). Actually, with exception of product categories driven by loyalty (e.g. infant formula), a typical Chinese shopper usually engaged with three to four brands for any given category (G. Zhang, 2012).

More recent research by McKinsey conducted in 44 cities (Ho *et al.*, 2019) suggested that consumers in expensive urban centers and larger cities were adjusting their expectations across a variety of categories. The report also found that China's growth engine was mostly composed of young, free-spending consumers in lower-tier cities and that consumers increasingly adjusted their spending habits by being more discerning, savvy and frugal (Ho *et al.*, 2019). Finally, Chinese consumers indicated a greater preference to connect with their cultural heritage and a willingness to see Chinese brands as desirable and high quality in contrast with earlier perceptions of Chinese brands as inferior. Foreign companies in China, therefore, could consider to introduce Chinese elements to their products and branding in sophisticated and authentic ways (Ho *et al.*, 2019). Ironically, many Chinese customers perceived global brands with a longstanding presence in China to be local brands (e.g. 7-Up), whereas international Chinese brands were often mistaken as foreign (Ho *et al.*, 2019).

In terms of coffee, Chinese consumers preferred sweet and fun options, with black coffee, Espresso and Americanos not being popular, emphasizing the need for localization in the coffee shop market in China (Daxue Consulting, 2020). The majority of coffee consumption existed of espresso drinks, not drip coffee. Finally, the pricing strategy was seen as critical and it was recommended that coffee stores attempted to be perceived as high quality while also keeping coffee prices affordable (Daxue Consulting, 2020).

What can Starbucks learn from Luckin?

Starbucks coffee was still perceived to be of better quality than Luckin's coffee (Cavish, 2018). Starbucks had monetized their reputation in the form of a more expensive average cup of coffee (Xu, 2019). Starbucks appeared to be banking on the coffee ritual and the rise of the middle class in China, whereas Luckin – which competed with Starbucks as well as convenience stores- was counting on a technology-centric business model and affordability. Prior to the accounting scandal, Luckin, which had expanded from a single trial store in Beijing in October of 2017 to over 4,500 stores in China by December of 2019, was perceived as a threat to Starbucks through its rapid expansion. Luckin had grown significantly faster than Starbucks in terms of the number of stores and cups of coffee sold (*SEC Filing: Luckin Coffee Inc*, 2019).

The changing consumer preferences in the food and drink industry in China had important implications for Luckin and Starbucks alike. Starbucks was perceived as a company with immense international brand appeal among Chinese Consumers. This made Starbucks a status symbol among China's middle-class millennials who were willing to pay a premium for good quality coffee (Fitch Solutions, 2019). On the other hand, Luckin's internet business model was appealing to Chinese collectivist consumers who valued social media to collect information and who perceived enjoyment and a sense of community through social media commerce. The pandemic had also caused an acceleration in reliance on contact-less ordering and pick-up.

Should Starbucks stick to its current business model or modify it using elements of Luckin's? What strategy do you recommend for Starbucks in China?

Notes

1. WeChat was one of the world's largest standalone mobile apps (>1bn monthly active users) which was very popular in China. It had a wide range of functions including mobile payments.
2. E-commerce conducted on a social media site without the consumer having to leave the site to complete a commercial transaction.

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