Business pricing strategies for starbucks

Business, Company

Starbucks Pricing Strategy -Introduction

The pricing strategy of Starbucks has become dynamic in the recent years as it attempted to adjust its pricing to meet changes in the cost of raw materials as well as shifts in the purchasing power of the market during the onset and progression of the economic crisis. The dynamism of the pricing strategy of Starbucks emerged from the change in perspective over its pricing. In aninterviewwithTroy Alstead, the executive vice president, chief administrative officer and chief financial officer of Starbucks, he expressed the rigorous and continuous efforts made the company to match its pricing design based on the analysis of customer research.

Factors considered in the analysis are geographical location, costs and margins, and product size preferences of customers or customer groups. This meant price movements upwards or downwards but the benefit to customers is more important than the price shifts. (Seeking Alpha Earnings Call Transcript, 2009) In the succeeding years, Starbucks would likely continue dynamic pricing by considering economic and marketing aspects.

Economic Aspects of the Pricing Strategy of Starbucks

The economic components of the pricing of Starbucks include input costs and other costs transferred to the consumer. Changes in these factors affect the pricing strategy of Starbucks.

The cost of Starbucks coffee is due to the quality of the coffee beans brewed for customers. The low cost of labour in coffee plantations led to the fair-trade movement. This led to long-term direct purchase agreements between Starbucks and its source of raw coffee beans. The benefit for coffee farmers is income security in the long-term benefit for Starbucks is the consistent quality of coffee beans supplied by coffee plantations. (Holmes, 2006) This translated into higher cost for coffee as input.

The fluctuation in the price of dairy products also affects the price of Starbucks. The company has increased its price at least seven times since 1990 and one of the recurring reasons for the rise in price is the increase in the cost of dairy products (Moore, 2007). However, the declines in dairy product cost became a relief to Starbucks since these short-term declines in dairy product cost, unlike price increases, are not likely to affect the price of Starbucks products.

Oil price volatility also affects the pricing of Starbucks because of increases in transportation cost of raw materials to Starbucks and its shops and energy cost included in the operating cost of the company (Holmes, 2006).

Starbucks also determines its price through other costs transferred to customers such as advertising expenses. The quality of experience and brand value also form part of the price of Starbucks. These make its price relatively higher when compared to competitors such as McDonalds and Dunkin Donuts as well as local coffee shops.

Due to the shifts in these cost factors, the pricing strategy of Starbucks moved away from uniform pricing to pricediscriminationbased on knowledge of price elasticity of certain customers (Png & Cheng, 2001). Price is relatively inelastic for the consumer group falling under the 18 to 34 age-range. This group is not so sensitive to price that they remain a stable market for Starbucks even after the company has repeatedly increased price in the previous years.

After the economic crisis, Starbucks focused specifically on direct segment discrimination by setting its price architecture based on the elasticity of certain segments to price (Png & Cheng, 2001). This applied to differentiated pricing across different geographic locations. This means that the price of Starbucks coffee in the United States is different from the price in the United Kingdom. A more recent scheme is indirect segment discrimination for its pricing by structuring products and product pricing based on certain segment-based variables (Png & Cheng, 2001).

Starbucks offered bundles such as its breakfast and coffee bundle for a fair price to attract more price conscious customers. However, the dilemma of Starbucks is ensuring profit margin while at the same time attracting customers (Harford, 2006). Bundling could hurt its brand equity for customers willing to pay the higher price for premium coffee and the Starbucks café experience different from fast foods such as McDonalds, which also apply bundling.

One way that Starbucks addresses this dilemma is through its cup sizing. The price of shorter cups is set in a manner that encourages preference for taller cups. The common preference becomes the 20-ounce venti cup. However, in the case of black coffee or espresso, the shorter cup contains the same amount of espresso as the taller cup. This is because of the difficulty of creating froth in large size cups so milk become an added ingredient to create the desired consistency but dilutes the coffee taste.

However, this does not form part of the standard menu of Starbucks; but upon request, the smaller 8- ounce cup with the same espresso content as the taller cup is available at a lower price. (Harford, 2006) Starbucks does not advertise the low-priced 8-ounce espresso because this could decrease profit margins from customers willing to pay more for the same amount of espresso.

Marketing Aspects of the Pricing Strategy of Starbucks

The marketing considerations of Starbucks include its costs, market demand, and competition. Changes in these marketing factors affect the pricing strategy of Starbucks. Costs formed part of the economic aspects of pricing.

Market demand refers to the shift in its customers, which recently declined by around twenty percent during the onset of the economic crisis. On one hand, Starbucks retained a sizable portion of its market even with the crisis with its remaining market likely comprised on the younger age group not concerned about price. On the other hand, the decline in customers meant declines in revenue and loss of profit. (Mohammed, 2005) Starbucks cannot afford to operate with a static pricing strategy given the need to maintain its current market while tapping into new market segments.

Competition for Starbucks intensified because of the pulling effect that other companies offering cheaper coffee had on Starbucks consumers. Price sensitive consumers comprise the market segment targeted for expansion by Starbucks to boost its competitiveness and boost profits. Starbucks has a range of competitors in its different markets such as McDonalds and Dunkin Donuts for the low-priced consumer segment (Hoovers, 2009), Green

Mountain, Coffee Bean & Tea Leaf and Costa Coffee for the less price sensitive market (Flight, 2007), and Nestle for its roasted coffee beans sold to consumers for home brewing (Hoovers, 2009). Competition along these fronts affects the pricing strategy of Starbucks.

Shifts in cost, market demand, and competition caused the restructuring of the pricing scheme of Starbucks by retaining skim pricing for non-price sensitive consumers and incorporated penetration pricing for its expansion into the price sensitive market segments (Holden & Burton, 2008). By implementing skim pricing, Starbucks’ $4 coffee became a popular description for the company (Levine, 2009). It was able to justify its relatively high price by banking on psychological aspects of its price (Holden & Burton, 2008) such as high quality of coffee beans and brewing process and high brand equity of its cafes to create perceptions of fairness in its price. It achieved the objective of maximizing its profit margins.

However, the decline in customers and enhanced competition caused Starbucks to explore penetration pricing by developing products with lower prices to engage price sensitive consumers (Holden & Burton, 2008). The price is lower than its popular $4 coffee, which it wants to deviate from, and at par with the price of its competitors for the price sensitive consumers.

Concurrently, Starbucks utilized product bundle pricing (Holden & Burton, 2008). In March 2009, Starbucks offered breakfast combos for $3. 95. The options include drip coffee in a tall 12-ounce cup that comes with egg sandwich or latte also on a tall cup paired with either coffee cake or oatmeal. The bundling price represents a savings of $1. 20 for consumers in purchasing these products separately. The price is also less then the breakfast meals sold at McDonalds and Dunkin Donuts.

The branding of these meals was ‘ artisan’foodby Starbucks to hike value. (Levine, 2009) This reflected high quality expressed by the Starbucks brand while at the same time providing low-priced options for consumers. With just two months since the introduction of this pricing strategy, this appears to be worth keeping for Starbucks.

Moreover, Starbucks is also applying value-based pricing, by basing price based on the value placed by consumers on alternatives (Holden & Burton, 2008). In February 2009, Starbucks announced its sale of instant coffee at $2. 95 for three packs and $9. 95 for 12 packs. The preparation only involves mixing the coffee in hot water. Starbucks has packaged its instant coffee as ‘ transformational’ because this replicates the taste of its coffee prepared by professional baristas in its cafes. (Kimes, 2009) Starbucks wanted to incorporate its brand message into its cheaper products. Whether this will compete with Nestle, Maxwell House, and other sellers of instant coffee is yet unclear.

In addition, Starbucks also applies promotional pricing (Holden & Burton, 2008) on a café or geographical basis such as discount cards, customerloyaltycards, discounts for repeat purchases in the same day, point system for Starbucks products such as mugs, caps, shirts, and other items, and discounts for occasions such as Valentines and Christmas. In January 2008, Starbucks even introduced its bottomless coffee for $1 in selected Seattle cafes to boost customer visits but this was experimental (Hines, 2008).

Business Pricing Strategy Prospects for Starbucks

Starbucks is already in the right path by developing a dynamic and flexible pricing architecture based on cost factors, geographic and socio-demographic characteristics of the market, and competition. Its range of pricing strategies applied to various products and targeted different market segments. As such, Starbucks adopted price discrimination, as a movement away from uniform pricing, in setting the price its new products as well as direct and indirect segment discrimination in targeting different market segments.

This found expression in the economics of cup size at Starbucks (Harford, 2006). The company also applied other pricing methods apart from skim pricing to expand into the price sensitive market. Starbucks employed penetration pricing and bundle pricing for its breakfast meals (Levine, 2009) and value-based pricing for its instant coffee (Kimes, 2009).

Starbucks would likely keep a significant portion of its non-price sensitive market segment by retaining the prices of its current products by maintaining the value of its products and service for consumers. It could also apply skim pricing for new products offered to the non-price sensitive market segment. However, there is a limit to possible price increases. Given the economic crisis and the likely impact until the end of 2009, non-price sensitive consumers would also become weary of further price increase, especially if unjustified with a corresponding increase in value.

Nevertheless, even with a secured market and retention of skim pricing together with the occasional promotional pricing activities, the market of

Starbucks is highly saturated (Hines, 2008), which means that an option for Starbucks is to use price primarily to increase the frequency of purchases or visits and secondarily to increase non-price sensitive customers.

It could retain its skim pricing but adding value to its products and services. Starbucks could also apply penetration, bundle pricing, value-based, and promotional pricing but integrating factors that attract the non-price sensitive segment. The decrease in price does not even have to be substantial. Starbucks has to package its pricing strategy well for this segment.

The movement towards the price sensitive market segment by using penetration, bundle, value-based, and promotional pricing was the only option for Starbucks in achieving its objective of increasing its market and improving profitability. It offered discounts for its products, implemented promotional activities, offered bundled products, and introduced low-priced versions of its coffee for home consumption.

However, there is a limit to how low Starbucks can decrease its price. It cannot decrease or set its prices so low because this would affect its brand value and likely lose some of its existing market (Levine, 2009). The value of Starbucks to its non-price sensitive consumers is the quality of its products and the café experience. Low prices have high association with low quality products and service. There is also no certainty that its decreased prices would attract the number of price sensitive consumers it needs to raise profitability (Kimes, 2009).

Except for its breakfast bundles, its other products for the price sensitive segment remain higher than the price range of its competitors. The option for Starbucks, which it is attempting to do, is to offer lower prices for products but packaging these products to align with the high quality message of its brand and offer products at higher prices than that of its competitors but lower than its skim pricing but justifying the price through value creation and enhancement. These may not capture the mass market but at the least provide significant expansion.

Conclusion

The business pricing strategy for Starbucks is complex or delicate that uses a combination of pricing methods to balance its brand and profit margin with market expansion as well as balance the demand of its non-price and price discriminating market segments. Starbucks needs to use price to operate in both market segments while retaining brand value and reasonable profit margins.

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