The Coffee Industry

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Why the Coffee Industry?

- Coffee is worth over $100 billion worldwide
- Coffee farms are the economic livelihood of over 25 million people
- After crude oil, coffee is the most sought commodity in the world
- Over half of Americans over the age of 18 drink coffee daily
- Coffee is the source of 75 percent of America's caffeine
- Coffee shops are the fastest growing niche in the restaurant business
Cost Structure

Industry Margins (2013)

Percent of Revenue

- Gross Margin: 57.14%
- Operating Margin: 14.82%
- Profit Margin: 0.06%

SBUX
DNKN
YUM
PNRA
MCD
CMG

Introduction Industry Analysis Price Strategies Recommendation
Average price of coffee worldwide from 1998 to 2015, by type of coffee (in U.S. dollars per pound)
Consumers

- Most brewed coffee customers are above the age of 60

- Majority of espresso based drink consumers between 18 and 30
Projected per capita coffee consumption in the United States from 2012 to 2016 (in pounds)
Supply Chain From Coffee Producers

Sourcing: Agricultural Phase
- Cultivate, Harvest, and Treat Coffee Beans
- Farmers from Central America, South America, Indonesia, and Africa

Roasting and Packaging: Production Phase
- Coffee Processing Agreement
- Sort, Clean, Weigh, Roast, Cool, Blend, Grind, and Package Beans

Distribution: Distribution Phase
- Agreement with National Distribution Company
- Warehousing, Distribution

Introduction
Industry Analysis
Price Strategies
Recommendation
Competitive Landscape

- Large Companies
  - Starbucks

- Small Companies
  - Collegetown Bagels

- Over 20,000 coffee shops

- Over $10 billion in revenue
Continued

- Four Firm Concentration Ratio (U.S.)
- Roughly 48.7
- High Concentration
- 70% of sales from 50 top operators

**Market Shares**

- Starbucks: 51.3%
- Dunkin Donuts: 32.6%
- Other: 16.1%
Product Mix

- Hot coffee
- Iced Coffee
- Specialty Drinks
- Food/combos
- Seasonal Drinks
Porter’s Five Forces

- Threat of New Entrants: Moderate
- Threat of Substitutes: High
- Bargaining Power of Buyers: Moderate
- Bargaining Power of Suppliers: Low/Moderate
- Industry Rivalry: Moderate/High
Major Players
Starbucks Corporation

  - Very strong brand loyalty
- # U.S. Stores- 11,000 (October)
- Locations in Ithaca
  - Collegetown
  - Commons
Dunkin’ Brands

- Dunkin’ Donuts- $614 million (2015)
- Baskin Robbins- $164.2 million (2015)

- # U.S. Stores- 8,431 (Dunks)
- # Int. Stores- 3,319
- # U.S. Stores- 2,503 (B.R.)
- # Int. Stores- 5,104

- Locations in Ithaca
  - Collegetown
  - Downtown
  - East Hill Plaza
Local Coffee Shops

- Collegetown Bagels
- Gimme Coffee
- Mannibles
- Ithaca Coffee Company
- Sarah’s Patisserie

Introduction  Industry Analysis  Price Strategies  Recommendation
Pricing Strategies

- Second degree price discrimination
- Third degree price discrimination
- Premium pricing
- Bundling
- Extremeness aversion and Goldilocks Principle
- Decoy Principle
Second Degree Price Discrimination

- In second degree price discrimination, sellers lack information regarding their customers.
- As a result, they design a pricing scheme to induce customers to sort themselves into groups.
- In retail, coffees are almost always sold in small, medium and large sizes. This forces customers to sort themselves by preference.
- Second degree price discrimination can also occur with substitutes.
Third Degree Price Discrimination

- Third degree discrimination occurs when companies already possess information that allows them to sort their customers into groups.
- Different uniform prices are then charged to different groups.
- In the case of coffee retailers, customers can be sorted into groups geographically or by age group.
Premium Pricing

- Another practice coffee retailers engage in is premium pricing.
- This pricing strategy allows a firm to charge a premium on a product that is differentiated in some way.
- Coffee retailers often use premium pricing to charge significantly more for specialty espresso-based beverages.
- The average brewed coffee price in the United States is $2.38, while the average price for an espresso based drink is $3.45.
Bundling

- Bundling allows for the maximization of consumer surplus when there is negatively correlated consumer demand and heterogeneity in tastes.
- For example, Dunkin Donuts sells a combo meal in which a medium hot coffee and a bagel with cream cheese can be purchased for $3.99.
- Unbundled, the price for a medium coffee is $1.99 and the price of a bagel with cream cheese is $2.29, bringing the total to $4.28.
- This is mixed bundling, which is the most profitable form
Extremeness Aversion & Goldilocks Principle

- In extremeness aversion, consumers have the tendency to pick the middle of three choices.
- The Goldilocks principle states that a product must fall within certain margins rather than reaching extremes.
- The implications of this are that when offered three sizes of coffee cups, consumers are most likely to choose the middle option.
- Coffee retailers know this, and will charge the highest mark-up on the medium size.
Decoy Pricing

● Sometimes, retailers like Dunkin Donuts will offer an extra-large size.

● This tactic is known as decoy pricing. Decoys are products that firms do not necessarily want to consumer to buy, but instead use to make another product look better.

● In Dunkin’s case, the extra-large size was introduced in order to increase sales of the large size.
Data Collection

● Method 1: Collected price and size data for iced coffee, hot coffee and cappuccinos at 20 coffee retailers in Ithaca

● Method 2: Peer survey
Result 1: Differences in Price Deltas

![Price Deltas across Coffee Types](image-url)
Result 2: Premium Pricing

![Graph showing pricing for medium-sized coffee drinks at 20 stores. The graph compares the price per ounce of iced coffee, hot coffee, and capuccino across different store numbers. The prices range from $0.05 to $0.50 per ounce.]
Result 3: Third Degree Discrimination

- All of the chains in Ithaca have the same prices at all of their stores.
- No store offers age-based discounts like student or senior discounts.
- Third degree discrimination does not exist in the Ithaca market.
Survey Question 1

- Testing extremeness aversion and the Goldilocks Principle
- Customers chose the medium coffee most when given 3 options
Survey Question 2: Brand Loyalty

Do you consider yourself loyal to a certain coffee shop?

- Yes, Collegetown Bagel
- Yes, Starbucks
- Yes, Mandibles
- Yes, McDonalds
- Yes, Sarah’s Patisserie
- Yes, Dunkin Donuts
- Yes, Ithaca Coffee Co.
- Yes, Gimmie Coffee
- Yes, Panera
- Yes, Wegman’s Bakery
- No, I don’t care where I get my coffee from
Survey Question 3: Bundling

Are you more inclined to buy food if there coffee is included as a combo?

- Yes, the combo would get me to buy food too
- No, I just get the coffee
- Other (please specify)
Survey Questions 4-6: WTP and Anchoring

We had different orders for the questions in each version of the survey to test anchoring.

On average customers are willing to pay at least 50 cents more for Starbucks than Dunkin Donuts.
Median Household Income of Tompkins County

- Looked at whether Ithaca/Tompkins County coffee shops use 3rd degree price discrimination
- Results show that there was no 3rd degree price discrimination in the coffee industry in Ithaca/ Tompkins County
Investment

- Heading towards growth
- Consumer Trends
  - Health Consciousness
  - Cater to younger audiences (on-the-go)
- Technology
  - Mobile Orders
  - Loyalty Programs
Recommendations

- Our results show that extremeness aversion and the Goldilocks Effect are real!
- All retailers should take advantage of this.
- Currently, no companies in Ithaca employ third degree price discrimination but they should.
- As the map shows, there are significant differences in median income in Ithaca.
Questions?