

STRATEGIC ANALYSIS FOR BEST COFFEE CHINA

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ABSTRACT

Best Coffee Canada, a well-known coffee company founded in 1992, has been actively involved with international expansion.

Best Coffee China (CCC), the master franchisee for Best Coffee in China, started building corporate stores in four major cities in early 2003. Since then, CCC is now experiencing aggressive expansion, which unavoidably requires strong resource management and effective corporate system development.

However, CCC is lacking a centralized decision-making team. Furthermore, CCC finds it difficult to maintain a pool of well-trained managers. This also explains why CCC had to spend a higher cost on everything at the early stage.

This graduation paper aims to examine the key successful factors for Best Coffee to thrive in China, and to provide the reasons that hinder Best Coffee's fast growth in China. By using Porter's five forces to analyse external and internal factors, this paper will provide several solutions to existing major problems for CCC.

DEDICATION

To my dear dad, mum and zizi,
The most important people in my life.

Also, to my dear God mother and God father, Lucia
and Frank, together with two lovely god brothers,
Johnson and Jackson.

I love you all.

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TABLE OF CONTENTS

Approval	ii
Abstract	iii
Dedication	iv
Acknowledgements	v
Table of Contents	vi
List of Tables	viii
1 Background – Best Coffee Company	1
1.1 Company History and Culture.....	1
1.2 Founders.....	2
1.2.1 Jerry White.....	2
1.2.2 Martin Dunn.....	2
1.2.2 Lisa Evan.....	2
1.3 Global Expansion.....	3
1.4 Best Coffee China.....	4
1.4.1 Head office of Best Coffee China.....	4
1.4.2 President Dr. Wong.....	4
1.4.3 Expansion Strategy.....	4
2 External Analysis – Five Forces Analysis	6
2.1 Threat of New Entrants.....	6
2.1.1 Economies of Scale.....	6
2.1.2 Product Differentiation.....	7
2.1.3 Capital Requirement.....	7
2.1.4 Switching Cost.....	8
2.1.5 Summary.....	8
2.2 Power of Buyers.....	9
2.2.1 Consumer Groups.....	9
2.3 Threat of Substitutes.....	12
2.3.1 Availability of Close Substitutes.....	12
2.4 Power of Suppliers.....	14
2.4.1 Supplier Pattern.....	14
2.5 Industry Competitors.....	16
2.5.1 Coffee and Specialty Coffee.....	16
2.5.2 Coffee in China.....	17
2.5.3 Franchising in the World.....	18
2.5.4 Franchising Development in China.....	21
2.5.5 Considerations for Franchising in China.....	24

2.5.6 Coffee Houses in China.....	26
2.5.7 Starbucks in China.....	30
3 Key Successful Factors for Best Coffee China.....	34
3.1 Secrets of Success for Starbucks in China	34
3.1.1 Location.....	34
3.1.2 Operational System	36
3.1.3 Finance	37
3.1.4 Marketing Strategy	37
3.2 Key Successful Factors for Best Coffee in China	38
3.2.1 Location, Location, Location.....	38
3.2.2 Sales Solve Everything.....	39
3.2.3 Build Up Good Franchising System.....	40
3.2.4 Strong Logistics System is the Key.....	41
3.2.5 Guerrilla Marketing Works Best	42
4 Internal Analysis	44
4.1 Management Analysis	44
4.1.1 What C Coffee Needs in the Management Level.....	44
4.1.2 Capabilities	46
4.2 Organizational Analysis	47
4.2.1 What C Coffee Needs Organizationally	47
4.3 Resources Analysis.....	49
4.3.1 Resources C Coffee Needs	49
4.3.2 Summary.....	52
5 Recommendations	53
5.1 Management Level	53
5.1.1 Dr. Wong.....	53
5.2 Organizational Level	53
5.2.1 System	53
5.2.2 Structure	54
5.2.3 Culture	54
5.3 Resources.....	54
5.3.1 Human Resources.....	54
5.3.2 Financial	54
References.....	56

LIST OF TABLES

Table 2-1: Comparison table among different teahouses and Best Coffee14

Table 2-2: Comparison table among three types of coffee shops in China.....28

Table 2-3: Comparison table between Best Coffee and other franchising brands
in China.....29

1 BACKGROUND – BEST COFFEE COMPANY

1.1 Company History and Culture

Best Coffee Company was founded in February 1992 by three Canadian entrepreneurs. The first Best Coffee store was opened at the same time on Queen Street West in Toronto, which is now one of the trendiest shopping areas in Toronto. After eleven years, Best Coffee has become the second largest specialty coffee chain in terms of special coffee consumption in the downtown core of Toronto. It has fifty-four Best Coffee stores located in Canada, Japan, China and the Middle East.

Best Coffee Canada uses franchising as an effective way to expand its business locally and internationally. The Best Coffee Canada philosophy is, “Creating an atmosphere that will develop customer loyalty and growth by providing an environment of quality, service and consistency through the development of people, products and attitudes”.

Best Coffee Canada’s founders believe that coffee is only the excuse for people to hang out in the coffee stores, and Best Coffee Canada will provide a good excuse. It sells not only high-quality specialty coffee, but also exceptional quality service. In terms of sales philosophy, Best Coffee believes that sales resolve everything. Three major secrets of the success are: location, good training for store management, and a good store construction team.

At Best Coffee Canada, everyone is dedicated to the coffee shop idea in its entirety. Great coffee, warm smiles and fast, friendly service is what Best Coffee Canada is all about. Best Coffee Canada’s slogan is, “Never Burnt, Never Bitter”, which shows the premium quality of coffee that Best Coffee Canada provides to each customer.

1.2 Founders

The founders of Best Coffee Canada are fascinated by coffee retailing. They believe that with a more complicated world on the horizon and the consumption of alcohol on the decrease, people need a place to socialize that makes them feel special. Hence, Best Coffee Canada provides a premium, fresh product that makes its customers feel special in a warm, distinctive environment.

1.2.1 Jerry White

Mr. Jerry White is President of Best Coffee Canada. He completed his political science degree in Ontario and worked for another coffee company for over ten years before he decided to start his own company. He understands the coffee industry well and knows the secrets to achieve success for specialty coffee chain stores.

1.2.2 Martin Dunn

Mr. Martin Dunn, the Vice President of Real Estate and Finance, is also a founder of Best Coffee Canada. His education includes a bachelor of commerce degree with a major in international business. He is the youngest and most energetic founder and works an average of sixty to seventy hours per week. He has abundant experience in seeking good locations and negotiating with landlords to get the best spots at the lowest prices. He also oversees the finance and legal department, and is good at calculating projected sales and returns on investments.

1.2.2 Lisa Evan

Mrs. Lisa Evan is the only female founder of Best Coffee Canada and is the Vice President of Human Resources, Administration and Franchisee Recruitment. She accumulated

valuable business experience during her career. She is friendly, open-minded and easy going, with over twenty years of local business experience.

These three founders own equal shares in the company and work well together to maximize each other's advantages. It is an amazing combination — three partners working together successfully for over twelve years, and expanding the business globally.

1.3 Global Expansion

In 1996, Best Coffee Canada started to expand to overseas markets, initially in Japan. Afterwards, it ventured into China and the Middle East. By the end of 2003, there were a total of fifty-four Best Coffee stores all over the world: thirty in Canada, ten in Japan, eight in China and six in the Middle East.

Overall, Best Coffee Canada is a comparatively conservative company, with a high standard of success in business. Its philosophy is to try to ensure every single store's success before it opens another new store by carefully selecting the right location, providing the best training to the franchisees, and strictly demanding a high standard store operation. Hence, in the first six years, it only opened one or two new stores every year. However in the latter six years, it expanded much more aggressively, eight to nine times faster than the original pace, especially after Best Coffee Canada signed a master franchisee agreement with Dr. Andy Wong, a very aggressive marketing talent who has wide connections in over twenty cities in China. Dr. Wong has a very ambitious plan to challenge Starbucks in China. Dr. Wong's marketing tagline was featured in promotional campaigns to attract local attention and to help increase Best Coffee's awareness in a new market with a large population of tea-drinking customers and rising demand for coffee consumption.

1.4 Best Coffee China

1.4.1 Head office of Best Coffee China

Best Coffee China is based in Toronto and belongs to C Consulting Services, which has over twenty-eight subsidiaries located in twenty-three cities in both Canada and China. C Consulting Services covers major businesses in six different areas including business consulting, immigration services, education, travel agency, Chinese media and coffee retailing. It was founded by Dr. Wong in 1994 and has grown to employ two-hundred-and-fifty people worldwide.

1.4.2 President Dr. Wong

The president of Best Coffee China is Dr. Andy Wong. He came to Toronto from China in 1992, to complete his PhD degree in Economics. Dr. Wong is a born entrepreneur, with non-stop creative thinking. He is also an outstanding marketer, with numerous new promotional ideas.

1.4.3 Expansion Strategy

Following Dr. Wong's aggressive marketing plan, Best Coffee China plans to open one hundred Best Coffee stores in China in a span of two years. Compared with 65 stores within four years in China for Starbucks, this plan demands strong real estate development support, highly efficient management, and excellent training resources. Using franchising to penetrate the Chinese market will lessen Dr. Wong's need to have a ready cash flow and will strengthen the supporting functions to franchisees, in order to build up standardized high quality specialty coffee stores in China.

In 2003, Best Coffee China opened four flagship stores in four major Chinese cities: Beijing, Shanghai, Guangzhou and Nanjing. These were located primarily in high-end office towers or within a high-end shopping mall. The concept is to promote a trendy American lifestyle and coffee culture to Chinese working professionals with stable disposable incomes. Due to the

unexpected disaster of SARS, the original four stores were delayed in opening until the end of July and the beginning of August. Many local and media celebrities, even Canadian Embassy officers, provided their support by attending the opening ceremony. With an effective public relations campaign, Best Coffee China achieved great attention among the local community.

Furthermore, in two consecutive years, Best Coffee China participated in the International Franchising Exhibition held in three cities — Beijing, Shanghai and Guangzhou — which brought additional attention to this special Canadian coffee brand.

Moreover, Best Coffee China also makes good use of its local Chinese media tool, a Chinese newspaper called China Update, distributed widely in the Greater Toronto Area, to promote its brand awareness among the Chinese immigrants and international student community. Results were fantastic for the company and Best Coffee China managed to organize a couple of franchising seminars to provide more detailed information on franchising development in China.

The existing situation in China is that numerous potential franchisees have shown interest and made efforts to join Best Coffee's family; however, sufficient support has not been found to push forward further franchisee development. Thus, a good and consistent management system has to be built up immediately in order to ensure a proper franchising system can be put in place to Best Coffee's satisfaction.

2 EXTERNAL ANALYSIS – FIVE FORCES ANALYSIS

2.1 Threat of New Entrants

As Michael E. Porter described in his book, *Competitive Strategy* (Porter 1980), new entrants to an industry bring new capacity, the desire to gain market share, and often substantial resources. As a result, prices could be bid down or incumbents' costs inflated, hence reduce profitability. Moreover, the threat of entry into an industry depends on the barriers to entry. If barriers are high and/or the new comer can expect sharp retaliation from entrenched competitors, the threat of entry is low.

Nowadays in China, there are three major types of coffee houses; Taiwanese style, specialty coffee houses and North American style specialty coffee chain stores. Best Coffee belongs to the third category. This differentiates itself from the other two categories on many prospects such as economies of scale, product differentiation, capital requirement and so on. For new entry, we mainly analyse the ones falling into the same category as Best Coffee and competing head to head with Best Coffee.

2.1.1 Economies of Scale

In order to have the economies of scale, companies in the specialty coffee industry must expand their stores' quantity rapidly in a short period. However, the fastest way to achieve this goal is to expand through franchising system. Any company utilizing single-store strategy couldn't be able to enjoy the advantage of economy of scale.

If a company wants to gain high margin in China, in order to be able to compete with Starbucks or Best Coffee, it has to gain greater economy of scale.

2.1.2 Product Differentiation

Both Best Coffee and Starbucks position themselves to their clients as the third space to relax, other than work and home. Therefore, customers could indulge themselves into the third place. They both focus on providing a relaxing and special atmosphere to clients. The selling point is not only the specialty product they are selling, more importantly, the setting of the store, the background music, the atmosphere and the environment, all of which differentiate Starbucks or Best Coffee from its local competitors.

Therefore, the copycat of Starbucks or Best Coffee could copy the products, the operational style and the decoration, but it is difficult to copy the atmosphere and the service, which represent the core of western lifestyle. These are the key successful factors and competitive advantages for Starbucks and Best Coffee.

2.1.3 Capital Requirement

The initial investment for a Best Coffee store is estimated at about eight-hundred-thousand to one million RMB Yuan (the equivalent of Cdn\$ 200,000), for the store area of sixty to one hundred square meters. This amount of initial investment is not a big figure for many Chinese investors. Hence, the entry barrier for opening a single specialty coffee store in China is low. However, looking at the challenges after the store opening, there are many capital requirements affecting a store's success.

For instance, there will be no economy scale advantage for a single store to obtain better margin and lower cost. Besides, without investment on strong advertising and PR campaign, with low brand awareness, a new coffee store could hardly gain satisfying sales volume.

2.1.4 Switching Cost

In China, specialty coffee chain stores with a brand name, such as Starbucks and Best Coffee, represent the western lifestyle and fashion; plus, drinking coffee hasn't yet become a daily routine behaviour for most of the consumers. Therefore, visiting the well-known specialty coffee chain store is more like a symbol of strong consumption power for fashion followers to pamper themselves, while consumers couldn't enjoy the same atmosphere in a normal no-name coffee store. In other words, the switching cost from a brand name specialty coffee store to a no name single coffee store is high.

Furthermore, as Starbucks is utilizing area partners to expand its business China, there are only three major local partners of Starbucks are able to open Starbucks coffee stores in China. Plus, the initial investment for other famous western chain store, such as Pizza Hut, KFC and MacDonald's, are so high that not small to medium size investors could afford. Therefore, the switching cost between Best Coffee and Starbucks or other western franchising stores are high.

2.1.5 Summary

In sum, new entrants have to have the economics scale to be competitive, while providing North American-style specialty coffee, unique atmosphere, and high quality client services. In order to compete with Best Coffee, they require an initial investment that is not too expensive but a high switching cost. Hence, the barriers to entrants are medium to high.

The barrier to entry is comparatively low for a company, like Best Coffee or Starbucks, that satisfies most of the above requirements upon entry.

2.2 Power of Buyers

In a tea drinking country, coffee stands for the western culture. Even though at this stage coffee is accepted by certain clients in China, it becomes more and more popular among young generation, especially those who get education overseas.

Because of demographic background and consumption power differences, Chinese drinkers have different perception, understanding and expectations on different coffee houses. Due to the differences, as the representative of new concept of North American stylish coffee store, Best Coffee will target to following consumer groups in China.

2.2.1 Consumer Groups

Occupation

The target audience in China usually has decent jobs, stable disposable incomes, and understands or tries to understand western cultures and lifestyles. Many of them are working in the joint ventures or multinational companies' China branches, which provide more exposure to the coffee drinking culture by their foreign colleagues. In addition, western educational backgrounds make the working professionals familiar with the American style coffee shop concept.

Gender

According to local research by Best Coffee Company, females comprise of at least 60 percent of total clientele base for the coffee business, because women are more easily influenced by fashion trends and are more likely to enjoy the coffee shop atmosphere by themselves or with friends. A similar scenario exists in China.

Chinese women are more sensitive to fashion trends and are always willing to try new things. They treat coffee shops as a special occasion for indulgence and relaxation. While Chinese

males mainly discuss business and meet with clients or colleagues in the coffee shops, they are not price-sensitive because in most occasions, companies will pay for the business expense, or Chinese males do not usually care about high costs in front of their female friends. Thus, Chinese females should be studied and targeted in China.

Age

The target age group falls into the range of 18 to 35. Elderly people feel more comfortable drinking tea due to the deep influence of Chinese traditional culture. On the other hand, youth under 18 have great curiosity about coffee or anything related to western cultures, but they do not have sufficient or stable income to support their regular coffee drinking habit. Therefore, the majority of junior clientele may become first-time drinkers while not necessarily becoming regular visitors to the coffee shops.

The main clientele between the ages of 18 to 35, possess comparatively more stable disposable income and are willing to spend their money on something that can make them feel better and improve the quality of their lives.

Lifestyle

Among Chinese people, coffee stands for western culture and ideology. Sipping a cup of coffee, with a strange foreign name, on a relaxing afternoon represents a higher standard of life in China. In addition, discussing business in a warm and nicely designed coffee shop becomes more popular in China, because of the comfortable environment and casual atmosphere.

China has a huge population of working professionals who completed their post-secondary or graduate education abroad. Therefore, coffee is becoming a normal part of daily life. Many of them drink coffee known by different names. Drinking coffee in a western style coffee shop reminds them of their lives in foreign countries. Whenever they want to get away from work

or reality, or if they want to share something with a good friend, the first choice will be to go to the coffee shop that they always visit.

China's open-door policy of economic and social reforms is fostering increased mobility for citizens. Therefore, greater numbers of Chinese people, especially the young, are eager to improve their English proficiency. They want to land a good job with a multinational company, immigrate to a foreign country or be accepted in a foreign university. Thus, visiting coffee shops and talking to foreigners who are regular customers of the coffee shops is becoming a very effective way to practice English and to learn more about western culture.

Because of the Chinese government's one-child policy, a teenager is usually the only child in a family, spoiled by as many as six adults (two parents and four grandparents). Hence, teenagers are finding more independence and gaining higher consumption power. This generation grew up with McDonald's, KFC, Nike, Disney, Michael Jordan, and many other western names. These teenagers easily accept western food; they prefer western clothing, follow western pop stars, and appreciate western lifestyle. In sum, they are trendy fashion followers. To this generation, coffee is another western concept that can set it apart from its parents' generation. This younger generation likes to talk about fashion and trends, including the new coffee brand and a new coffee shop in town. On top of that, Chinese teenagers also like to choose western-style coffee shops as one of their favourite gathering places, together with karaoke houses, McDonald's, KFC and so on.

2.3 Threat of Substitutes

2.3.1 Availability of Close Substitutes

Teahouse

China is a tea country with a long history of daily tea-drinking, especially for the elders generation, which prefers to drink tea on different occasions and during different time periods throughout the day.

There are generally two types of teahouses in China. One mainly serves typical Chinese tea for the middle-age group to elderly people. It is a common place for gathering and meeting friends. This category can be divided into two kinds of pricing: the economic type for the public, and the high-end luxury teahouse for the wealthy class. However, as Best Coffee mainly targets younger generation and working professionals, who usually are not the major clientele of traditional Chinese teahouse.

Another type of teahouse is the bubble teahouse, frequented by the younger generation. It is greatly affected by the Taiwanese tea drinking habit of drinking bubble tea, a special tea with different flavours and containing gelatine balls or bubbles. It became a common, fashionable drinking style in the middle of the 1990s.

In bubble teahouses, people not only drink bubble tea, but also eat Chinese delicacies such as snacks or Taiwanese noodles. Customers can either order take-out, or sit down with friends to enjoy tea and food. This kind of bubble tea store is usually decorated in Taiwanese or Hong Kong style, with a more relaxing and youthful appearance. It might also have a simple kitchen. The prices charged to clients are usually moderate, in order to attract more students and the younger generation.

Therefore, customers visiting bubble teahouses are more likely to indulge in Taiwanese or Hong Kong-style culture instead of typical western-style culture. If they want to taste western

culture and atmosphere they have to visit a western-style coffee store, namely Starbucks or Best Coffee.

The teahouse is a very popular social venue for Chinese people. It is part of the food culture, with a history spanning many centuries. It is still an important part of people's social life. Since China promoted the open-door strategy to embrace more western culture and lifestyle, the teahouse's domination has been challenged by the foreign coffee house. Coffee houses have gained popularity in China especially in the big cities and seashore communities.

Therefore, teahouses, especially bubble teahouses, are a threat to coffee in terms of consumers' familiarity with tea and the long history of tea culture. However, with the development of a policy of openness and embracement of western culture, specialty coffee chain stores have great potential to compete with teahouses in China.

Given great power of substitutes, and the small position of coffee as part of total market, coffee is still positioned as a luxury trendy consumer product mainly targeting to young, professional white-collar level of people and entrepreneurs, who are western culture followers. They have stable disposal income and like to explore western culture.

Table 2-1: Comparison table among different teahouses and Best Coffee

	Category	Target Client	Age Group	Serve Meal	Price Range	Kitchen	Area (square meters)	Drink Menu	Self Serve
regular teahouse	Economic	Public	25 +	usually no	Low-medium	usually no	100+	mainly Chinese tea	No
	Luxury	Middle-wealthy class	30 +	usually no	High	usually no	150+	mainly Chinese tea	No
Taiwanese style bubble teahouse	Economic	Younger generation	15 – 30	yes	Low-medium	yes simple kitchen	15 +	bubble tea	No
Best Coffee	Moderate	Young generation, Working Professional, And Businessmen	18-45	No Only pastry	Medium	No	60+	Italian Style, Specialty Coffee	Yes

2.4 Power of Suppliers

2.4.1 Supplier Pattern

The basic coffee supply for Best Coffee China includes coffee beans, cups and lids, dairy products, pastries, straws, napkins, sugar and many other customer service items with the Best Coffee logo. Hence, there are two major types of products that need to be purchased: fixed assets purchased before the store opening, and operational items which are continuously purchased on a daily basis.

For the first category, the fixed assets required such as coffee makers and store furniture, Best Coffee China basically purchases locally. However, Best Coffee China had to get Best Coffee’s prior approval. For instance, Best Coffee China would send the list of different coffee makers — made by foreign companies selling through distributors in China — including brands,

model and origin of production to Best Coffee. Then Best Coffee would choose the most qualified and suitable ones for Best Coffee China. For each new store, Best Coffee China would pick the most appropriate supplier based on its production scale and sales volume. There are many international branded coffee makers competing in China. Therefore Best Coffee China has sufficient options. As Best Coffee China only has less than ten coffee stores nationwide, its bargaining power is still not strong. When it reaches its target of fifty stores by the end of 2004, it will have better economy of scale, hence stronger purchasing power over suppliers.

For the second category, operational products, Best Coffee China had to import the key components from Best Coffee Canada. For instance: coffee beans, cups, lids, ingredients for special drinks, and gift items like coffee grinders and makers are purchased from Best Coffee Canada. Another reason for Best Coffee Canada to sell raw materials to Best Coffee China is that the profit margin of selling coffee supplies is attractive. Therefore Best Coffee will not easily hand over this important function to Best Coffee China. Nevertheless, Best Coffee China and Best Coffee Canada have reached an agreement that, in the long run, Best Coffee China will realize procurement localization step-by-step. As China is a global production base, companies can find all kinds of suppliers who have high standards and qualifications locally and a very competitive price range. It is more reasonable and efficient to locally source suppliers, and even sell them back to the North American market. Until the Chinese operation starts to catch up with western standards, and when the Chinese management team starts to better understand coffee culture and Best Coffee philosophy, Best Coffee will feel more comfortable and confident in outsourcing its production orders on coffee supplies in China.

At present, there is no national dairy or pastry supplier for Best Coffee China, and each store is using its own local brand name supplier. Best Coffee China plans to seek a qualified supplier for different products with brand name nationwide, and draw up a partnership agreement. One of the most important operational challenges for Best Coffee China is negotiating a good

partnership agreement with a supplier so it can decrease costs while maintaining the same quality. Therefore, at this moment, pastry suppliers in different cities in China have more bargaining power than they should possess.

In terms of currency exchange, there is not be any problem or risk for Best Coffee Company Canada because the Best Coffee Company (China) head office in Toronto pays Canadian dollars to Best Coffee Company Canada for the raw materials purchased in Canada.

2.5 Industry Competitors

2.5.1 Coffee and Specialty Coffee

As the coffee industry faces mostly stagnant and somewhat declining numbers globally, the increased popularity of niche coffee drinks, combined with the new demographics of coffee drinkers, offers more diverse product and marketing opportunities. In addition to classic coffee products (e.g. whole bean coffee, ground coffee and instant varieties), coffee manufacturers have looked to expand offerings with other coffee alternatives such as cappuccino, latte, iced coffee and chai tea. Liquid concentrate coffee is another innovation.

According to Beverage Industry (October, 2001), whole bean coffee sales have experienced an overall growth of 4.7 percent. “In terms of trends, the coffee menu continues to expand,” says National Coffee Association Spokesman Gary Goldstein. “That started more than a decade ago at the beginning of the gourmet coffee boom.” Goldstein says iced coffee emerged as a prepared drink in the summer of 1997 and has grown to create a popular trend in ready-to-drink beverage products.

The specialty coffee category has been credited with luring younger consumers into the coffee category and thus creating an increase in the size of the “new drinkers” market (Jill Bruss, April, 2002). Although the gulf between Starbucks and smaller rival chains continues to widen,

the specialty coffee segment presents a wide range of promising channels through which companies can leverage and differentiate their brands.

For instance, several prominent operators are brewing new prototypes and broadening their product offerings by adding dessert-type coffee beverages. These include an emphasis on lunch items or other avenues, such as drive-through windows, that Starbucks has mapped out as prime grounds for growth. Meanwhile, similar to Starbucks, the smaller coffeehouse brand contenders are eyeing expansion into other distribution channels such as grocery stores and international licensing.

In sum, coffee producers are actively seeking international expansion. In order to penetrate an under-developing market on the retailing level, the most effective method to expand is to develop the franchising business.

2.5.2 Coffee in China

China is one of the world's smallest coffee markets. Although it has one quarter of the world's population, China accounts for only 1 percent of world coffee consumption (www.chinadialy.com.cn, February 2003). Annual coffee production in China reaches a mere one thousand tonnes, compared with the 15 billion tonnes churned out by Brazil each year. Before the entrance of instant-coffee brands such as Nescafe and Maxwell House into China in 1995, consumption of coffee was virtually unknown (Business China, May 2002).

However, this is slowly changing. Total coffee imports rose by seventy-five percent in 2001, to some 9,500 tonnes. According to market research firm AC Nielsen, instant-coffee sales in China increased by forty-two percent in 2001 (Business China, May 2002).

In China, it is not surprising that most coffee drinkers are based in cities. Coffee is considerably pricier than other hot beverages, and retail sales in general are concentrated in China's urban centres. Since 1995, retail sales of hot drinks (mainly coffee) have grown seventy-eight percent in the cities. Despite the marked disparity, hot drinks (mainly coffee) sales exhibit

strong growth in China. This is due to the increasing disposable incomes, the introduction of new products and brands, and the migration of sales into food-service outlets including teahouses, coffee shops and fast-food restaurants (Business China, May 2002).

The foreign companies that now dominate China's coffee market may be further encouraged by the fact that retail sales of coffee are predicted to grow more than twenty-five percent in the next five years. Coffee accounts for just 1.6 percent of all hot-drink (including tea) sales in China (Business China, May 2002).

2.5.3 Franchising in the World

Franchising is a method of doing business. It is a method of marketing a product and/or service which has been adopted and used in a wide variety of industries and businesses. In some sense, it is a strategy for market entry. The word "franchise" literally means to be free. In this sense, franchising offers people the freedom to own, manage and direct their own business (www.franchise.org). However in reality, franchising is hardly free. By paying a certain amount of money as the franchising fee, franchisees can have the authority and privilege to operate under certain business models and be able to share the goodwill of certain brands.

As with any freedom, there are responsibilities. In franchising, these responsibilities have to do with the franchisee's commitments and obligations —usually spelled out in a franchise system. The franchise system, sometimes called the franchisor, is the one who owns the right to the name or trademark of the business. The franchisee is the one who purchases the right to use the trademark and system of business.

According to the International Franchise Association (www.franchise.org), there are two different types of franchise arrangements:

- Product distribution arrangements in which the dealer is, to some degree, but not entirely, identified with the manufacturer/supplier;

- Business format franchises in which there is complete identification of the dealer with the buyer.

Best Coffee Company Canada and Best Coffee (China) fall into the second type of franchising model.

The business format for franchising offers the franchisee not only a trademark and logo but a complete system of doing business. Indeed, the word “system” is the key concept to franchising. A franchisee receives assistance with site selection of the business, personnel training, business set-up, advertising, and product supply. For these services the franchisee pays an up-front franchise fee and an on-going royalty, which enables the franchisor to provide training, research and development, and support for the entire business. In a nutshell, the franchisee purchases someone else’s expertise, experience and method of doing business. Meanwhile, the franchisee agrees and promises to follow the system to ensure proper operation.

In its infancy merely two decades ago, international franchising has become a major force in the world economy today. Franchising is gaining popularity throughout the world, and is emerging as an effective way to conduct and grow successful businesses. Yet the global marketplace is far from saturated. In fact, the growth potential for franchising worldwide is exponential.

The growth of franchising has been well-documented in strong market economies, including the United States and Western Europe. In the U.S., franchising generates \$1 trillion worth of business in growth sales and represents 50 percent of retail trade (Swartz, November/December 2000). More recently, success stories are emerging from less obvious corners of the world, including Eastern Europe, the Middle East, and South Africa.

Going global, however, still requires extensive research. While franchising has proven beneficial for countless companies in various countries, it is not foolproof. Each country has

different customs, cultures, languages and laws, making cross-border expansion a challenging and unique option. Companies considering new territories must first determine if their products and services are acceptable in the new country. Second, they must identify a well-known partner that is socially and economically appropriate. Finally, they must have the ability to transfer knowledge and to provide support and necessary systems to franchisees.

Companies from near and far are flocking to Asia's ripe market and receiving a warm handshake from natives ready to do business. Although Japan and Australia have taken advantage of franchising for quite some time, many Asian countries are just beginning to discover that franchising is an attractive way to grow their economies.

Asia's mom-and-pop stores are fading fast as franchisors set up shop. Asia is attractive to foreign franchisors for many reasons. First of all, Asia is bursting with consumers. More than half of the world's population lives in the region. A soaring middle class and robust economic growth rates are also attractive to foreign investors. China alone comprises nearly one-quarter of the world's population and is considered the most under-retailed country in the world (Swartz, November/December 2000).

Furthermore, many nations are rolling out the red carpet for foreign investors. Several governments, including those of Malaysia and Singapore, encourage franchising and foreign investment by introducing franchise-friendly laws, establishing organizations, and developing programs to support the effort. In Indonesia, foreign investment approvals have skyrocketed nearly 300 percent since government restrictions were lifted in 1994 (Swartz, March/April 1997). The number of high-level franchise conferences and exhibitions that have been held or are being planned throughout the region is another strong indication of Asia's growing interest in franchising.

2.5.4 Franchising Development in China

About China

Since 1978, when Chinese leader Deng Xiaoping began to introduce market-oriented reforms and decentralized economic planning, output has more than quadrupled and China now has the world's second largest gross domestic product. Indications are that this growth will continue.

The coastal areas and cities support standards of living two to three times higher than the countryside. This leads to a dramatic increase in the urban population. Currently, forty cities have populations in excess of one million. Furthermore, a strong middle class has arisen that is capable of purchasing non-essential goods.

According to the Economist Intelligence Unit (May 2002), retail sales of consumer goods were expected to grow a year-on-year five percent in 2002 in U.S. dollar terms, before accelerating steadily over the next five years. Reflecting rapid growth in household income, the value of consumer spending on food, beverages and tobacco was expected to rise, from US\$214.5 billion in 2002 to US\$295.5 billion in 2006 — or 37 percent over four years.

China's Major Cities

In China, the word “franchise” did not exist until eight or nine years ago. Many foreign companies that have started franchises elsewhere have been waiting for years for China to have the trinity of requirements needed to set up successful franchises: higher incomes, a more developed market and appropriate legislation. According to the China Commercial Information Centre (CCIC), the sales volume of chain store and franchising corporations in 1999 exceeded RMB100 billion (US\$12 billion), up 70 percent from 1997. But this is still a rather paltry sum. Franchises accounted for only 1 percent of the country's retail sales in 1999 (Business China, April 2000).

Franchisers are being too cautious. Since late 1997, China has had a franchising law, albeit a rather loosely worded one. There is now consumer demand for the types of products offered by franchises. And there is a pool of entrepreneurs that wants the opportunity to invest in franchise outlets.

The Chinese government is working hard to establish favourable regulations for franchisors. Investors should not underestimate the challenges presented by the Chinese market. By the same token, they should not be discouraged.

Franchising is clearly making progress in China. Beijing hosted its first international franchise exhibition in 1998. There are now several annual international franchising exhibitions held in three major cities, Beijing, Shanghai and Guangzhou. In 2001, an annual franchise convention run by the China Chain Store and Franchise Association (CCFA) and the China International Franchise Association (CIFA) attracted more than 1,000 people from around China. Nor is there a lack of money to buy franchises (Young, 2002).

In 2003, there were more than three important franchising exhibitions in the province of Guangdong, which attracted over thirty franchisors from all over the world. Over fifty thousand potential franchisees attended this event. It was estimated that the output value of franchising will account for more than thirty-five percent of the country's gross domestic product, and the number of people employed in this field will soon reach two hundred million (Swartz, Nov/Dec 2000).

The conditions for franchising are improving in China as more and more companies are taking the leap. The very visible success of Starbucks, KFC or McDonalds franchises have attracted hundreds of willing Chinese entrepreneurs. According to William Wright, Senior Attorney at the law firm Lehman, Lee and Xu, an advisor to franchise chains in China, almost every well-known fast-food chain from the U.S. is either already in China, or is in the process setting up a venture (Young, 2002). It is not only the fast-food industries that have set up

franchises, but also photo film companies such as Kodak and Fuji, which operate thousands of branded outlets across China through a form of franchising agreement.

However, traditional franchise corporations that have set up shop in China have mostly stuck to joint-venture structures while testing the viability of their products and building their brands. Therefore, at the early stage of franchising development in China, resources were consumed by the requirements of establishing joint ventures and supervising daily operational details instead of being focused on expanding the business through franchising.

Reluctance is also felt from the investor side. Establishing a franchise is not a get-rich-quick scheme. Funding a franchise outlet requires a considerable outlay of time and energy and promises a relatively low rate of return. There are also the basic conceptual difficulties. Many potential investors in China are unfamiliar with the concept of franchising and are not willing to invest in something abstract.

The KFC Company and the Subway Company are using two different franchising strategies to penetrate the Chinese market, each of which has its own advantages.

KFC Case

American fast-food chain KFC has found a way to get around the conceptual problem. The company builds the restaurants itself and works to get them operational. Only then does it sell the working outlet to a franchisee. Because Chinese people like to look at what they are buying, it becomes a comfort to them, and reduces their sense of risk. The franchisor can tell franchisees how the business is going.

KFC signs an inflexible ten-year contract with the franchisee. It helps to train staff and procure supplies as well as offer the support of its restaurant service centre. The franchisee pays five percent of revenue for marketing and six percent for operations training, plus annual

royalties. Obviously, buying an operational store is considerably more expensive than simply buying the rights to the brand. In 2000, the average price of a KFC franchise in China was RMB 8 million (US\$970,000). This eliminates the presence of small-time entrepreneurs for whom franchising in China was generally targeted, and limits the speed at which new outlets can be opened (Business China, April 2000). According to KFC, franchising is still in its educational phase. The company hopes to show potential franchisees how KFC functions, and if all goes as planned, word will spread about the benefits of franchising. Meanwhile, China remains KFC's largest corporate-owned market outside the U.S. Until 2000, only five percent out of more than three hundred outlets in China were franchises.

Subway Case

On the other hand, a major sandwich chain has taken a more conventional approach to franchising in China. All of Subway's stores in China are franchises. The American company claims to be the only corporation doing genuine franchising in China.

Subway charges investors an initial fee of RMB 82,800 (US\$10,000). Franchisees then set up the stores, buy equipment and supplies from Subway, and hire and train staff — all done with Subway's guidance, in order to ensure the consistency of the outlook and the operation system. The franchisees pay 3.5 percent of revenues to an advertising fund and 8 percent in royalties. Subway establishes twenty-year contracts, but allows franchisees to sell their restaurants if they lose interest in running the outlets. The company has expanded slowly since entering China in 1995. In 2000, it only opened five stores in Beijing and one in Tianjin.

2.5.5 Considerations for Franchising in China

China's vast population and low labour and land costs are certainly attractive to potential foreign investors. However, there are a number of issues one should be prepared for, such as inconsistent government policies, inadequate protection of trademarks and intellectual property,

old fashioned Chinese management style, lack of training, high wastage, and numerous hidden costs (Chow, May/June 1994).

Some examples of the above problems are as follows. The franchising law in China is still under revision, which can easily cause confusion to foreign franchising companies. Since franchising is such a new business model in China, it has taken the central government's legal department a long time to complete the laws on franchising to ensure the best practices in China.

Secondly, the violation of intellectual property has been a big problem for foreign investors in the past decade. Though the situation has improved, enforcement of intellectual rights needs to be strengthened.

Thirdly, as a legacy of the old-style planned economy system, Chinese management are not accustomed to focusing on improving efficiency, providing high quality service, enhancing effectiveness and increasing profits. All of the above are key issues for the success of any franchising company.

Fourthly, poor human resources management is a big obstacle for any traditional Chinese company to expand aggressively. Qualified management recruiting, training and ongoing skills development is essential for growth.

Another issue to bear in mind is the complicated taxation system. In 1994, China had a tax reform, which aimed to rationalize the distribution of tax revenues between central and local authorities. Under the reform plan the old system was changed into a two-tier tax system at the central and local levels to clearly define their respective tax-collecting powers. The type of taxes included tariffs, consumption tax, value-added tax, personal and corporate income taxes, business tax, and tax on turnover at railways, banks, and insurance departments (Chow, May/June 1994).

While local entrepreneurs were quick to spot franchising opportunities, most of them still failed to understand the nuts and bolts of running a franchise. Franchisees need to be humble

enough to listen and learn. In China, the entrepreneurs who can put together the money for a franchise are often used to having their own way. They are naturally determined and creative. However, individual innovation by franchisees can be the death of a brand (Young, 2002). Therefore, consistency is everything (Young, 2002).

Franchising is always an attractive way to expand business and increase brand awareness. But franchisors should be very careful as they have to prepare a comprehensive contract that both sides must agree to and follow strictly. This agreement could include numerous details such as procedures on how to cook the food, how the cashiers should behave and how to clean the washrooms (Young 2002).

More Chinese businesses are starting to understand the importance of brand value and some of the biggest Chinese brand owners are active in lobbying the government for stronger trademark protection (Young 2002). For instance, the domestic company Malan Noodles has built a US\$40 million a year fast-food business from sales of one of China's most ubiquitous foodstuffs by branding, quality service and food.

2.5.6 Coffee Houses in China

There are typically three types of coffee stores in China. They are: Taiwanese-style western coffee shops mixed with Chinese eating habits, specialty coffee shops with unique personalized features (e.g. Internet coffee houses, E-business coffee houses, book and coffee houses) and the typical North American-style coffee houses (e.g. Starbucks and Best Coffee).

Best Coffee is positioned as the only competitor to Starbucks in China by promoting the image of an up-scale Italian espresso-based specialty coffee store. Best Coffee differentiates itself from other local or foreign brands by not confusing the clients with a wide variety of food supplies, such as Chinese-style steaks, bubble tea, or Chinese fast food. Instead, it provides high quality coffee beans occupies convenient locations and offers first-class customer service. In

China, drinking coffee is becoming fashionable, yet it's not a regular part of daily life. Therefore, it will take a couple of years to educate Chinese customers on drinking coffee over tea in their daily lives.

Table 2-2 shows the major differences on store operation among three major types of coffee stores in China. Best Coffee, the typical North American-style coffee store, has a flexible requirement on store size which is usually smaller than the typical Taiwanese coffee store. Meanwhile, Best Coffee's theme is coffee, not food; therefore, it provides a lighter menu with less choices, hence no need for a kitchen. Whereas Taiwanese coffee stores act more like a restaurant or café for meals or food. In other words, coffee and atmosphere are not the focus of their business.

In Table 2-3 some major differences between Best Coffee and five other major franchising brands in China are compared. Compared with other franchising brands, Best Coffee requires the lowest franchising fee and initial investment of only RMB 180,000 (approximately CDN\$32,730) and RMB 800,000 (approximately CDN\$145,455). Also, Best Coffee does not require any guarantee fee like other brands. However, there is a big difference between Best Coffee China's operation and its Canadian operation. Best Coffee China operates a flat fee royalty system, using a similar monthly royalty system as other brands. Best Coffee Canada firmly operates a royalty system by percentage of monthly gross sales, which greatly stimulates franchisees' motivation for improving sales and ensuring a higher profit margin as sales grow for Best Coffee. The major reason why Best Coffee China has to implement a different royalty system is because of the greater pressure from its indirect competitors and from the unsatisfying franchising development progress. Because Best Coffee China does not have sufficient management resources and operational support, it is easier to operate the flat fee royalty system. However, in the long run, a flat fee royalty system will be a hurdle for further development and improved sales.

Here is a comparison list for three types of coffee stores in China.

Table 2-2: Comparison table among three types of coffee shops in China

Name	Kitchen	Area	Serve Meals	Self-serve	Drink Menu	Food Menu
Taiwanese (HongKong) Style Coffee Shop	Yes	139 or 186 square meters	Yes	No	Mainly Taiwan or Hongkong style coffee.	regular meals
Special Coffee Shop	Depends	From 14 to 139 square meters	Sometimes	No	local quality coffee.	snacks
North-American Coffee Shop (e.g. Starbucks, and Best Coffee)	No	Various, From 11 to 186 Square meters	pastries	Yes.	high-quality Italian style specialty coffee, tea and some juices.	pastries

Table 2-3: Comparison table between Best Coffee and other franchising brands in China

Product category	Brand Name	Franchisee Fee (RMB)	Initial Investment (RMB)	Monthly Royalty Fee (RMB)	Others
North American Coffee	Best Coffee	180,000	600,000 – 1,000,000	4,000 – 6,000 Flat fee or 6percent of gross sales (royalty) 2percent of gross sales (ads)	No <u>guarantee fee</u> , no design Fee, no <u>management fee</u>
Coffee, Bakery, Café	Japanese Kohikan Coffee	200,000/150 square meters	1,500,000 to 2,000,000	4500/150 square meters	<u>Guarantee fee</u> : 100,000/150 square meters <u>Design fee</u> : 50,000 Supervision fee: 100,000/150 square meters
Bubble tea, snacks, light meals	RBT Bubble Teahouse	150,000	1,000,000	5000/ 120 square meters and above	<u>Guarantee fee</u> : 100,000
Coffee, café, meals	Shangdao Coffee	100,000 for three years	2,000,000	3000/month	
Fast-food chain	Blue and White	50,000 to 800,000	1,000,000 to 1,500,000	2percent to 5percent of monthly gross sales	40,000 to 150,000 <u>design fee</u> : 10,000-50,000
Retailing	Fresh Fruit Place	Equipment Deposit: 50,000	500,000 1,000,000	5percent of monthly gross sales	<u>Guarantee fee</u> : 8,000 <u>Cash flow</u> : 10,000 <u>Logistics fee</u> : 3percent of each month's sales

2.5.7 Starbucks in China

Starbucks is the major competitor to Best Coffee in China. It has a similar product line, decoration style and atmosphere, and operational model as Best Coffee. Therefore, Starbucks China needs to be studied closely.

Since it opened its first location at Seattle's Pike Place Market in 1971, Starbucks Corporation, the largest specialty coffee store chain in the world now operates more than 7,500 retail locations in North America, Latin America, Europe, the Middle East and the Pacific Rim (www.starbucks.com). In 2004, Starbucks plans to add 1,300 stores worldwide, including a boost of 950 stores to its U.S. base of about 5,475. Some outlets are found under the roofs of other retailers, such as retail bookstore chain Barnes and Noble Inc. Having already expanded to 34 countries, Starbucks expects to eventually operate 10,000 outlets in North America and 15,000 abroad (Gary 2004).

Starbucks is committed to offering high quality coffee and the “Starbucks Experience” while conducting its business in ways that produce social, environmental and economic benefits for the communities in which it conducts business. The Starbucks Experience is all about the third place for congregating. According to Howard Schultz, Chairman and Chief Global Strategist, Starbucks offers the third place beyond work and home to its clients as “a refuge, a gathering place, and an extension of a person’s front porch” (Papiernik 1996).

Globally, Starbucks chose Japan as its first overseas market to enter. It formed a joint venture company in Japan in 1995 and opened the first store in Tokyo a year later. In 2003, the 1,000th store in the Asia-Pacific Rim was opened in Beijing.

In traditional tea-drinking countries, such as Japan and China, the company’s strategy of rapid expansion and brand promotion is working well. In a way, Starbucks challenged and changed people’s lifestyle and consumption patterns so that people started to accept coffee culture as a part of their daily lives.

Starbucks' penetration is perhaps the most remarkable of all, given that China is a country of devoted tea drinkers who did not take readily to the taste of coffee. In January 1999 Starbucks opened its first store in the World Trade Center in Beijing. Since that time, Starbucks opened 70 stores in several big cities in China, such as Beijing, Tianjin, Shanghai, Guangzhou, Shenzhen and Hangzhou, including a controversial store in Beijing's ancient Forbidden City (once the residence of China's emperors and still the symbolic centre of the Chinese universe).

The Asia-Pacific region is a cornerstone in Starbucks international business, as it offers some of the fastest growing consumer markets in the world. For instance, Coffee Concepts (Southern China) Limited, a joint venture formed by Maxim (International) Limited and Starbucks Coffee International, opened 26 stores between May 2000 and May 2002 in the Hong Kong market.

The development history for Starbucks falls into two parts. In the early stages, Starbucks' global expansion pattern did not seem to be working in China because of China's long history as a tea-drinking culture. Later on, as China became more open to western culture, and coffee gained more popularity among young working professionals, Starbucks expedited its store opening plans both in major markets, and in second-tier cities, which are less-open and located inside China. One example is Chengdu city in Sichuan province. Starbucks has become a fast-growing *nouveau* fashion statement in China. Some customers admit that drinking coffee is a trend, and they just accept it subconsciously.

Local Partners

Starbucks did not employ franchising. It entered and developed the Chinese market by teaming up with three different regional partners in Eastern China, Southern China and Northern China. In Northern China, Starbucks' partner is H&Q Asia Pacific, an Asia-focused private-

equity firm based in California. H&Q's local partner, Beijing Mei Da Coffee Company, runs the daily operations of the Starbucks stores.

President Group controls Starbucks' 80 outlets in Taiwan, and handles Starbucks' Shanghai and Hangzhou operations. Because of the rapid and positive growth in Eastern China in 2003, Starbucks increased its stake in its Shanghai and Taiwan joint venture with President Coffee from 5 percent to fifty percent, demonstrating its huge confidence in the booming coffee market in China and the strong purchasing power in coffee by the rising middle class professionals.

In 2002, Hong Kong-based Maxim's Caterers, which runs the 26 Starbucks outlets in Hong Kong, expanded its territories to Guangdong and Hainan provinces as well as Macau. Fall 2003, Maxim opened its first store in Guangzhou, the heart city for Southern China, increasing to three stores in the Guangdong area, and two in Shenzhen.

Marketing Strategies

In general, Starbucks does not implement a fancy marketing plan, such as running advertisements on TV or in newspapers. Starbucks did not spend a lot of money on traditional advertisements in order to attract local customers. On the contrary, it used every single store as the best promotional tool to demonstrate Starbucks' high-quality, fresh coffee concept from North America, and to provide good coffee and service to impress young professionals and businessmen. When the first Starbucks outlet opened in China it mainly attracted foreign visitors or expatriates. However, they were not the targeted clientele for Starbucks in China. Strategically, Starbucks chose local Chinese people as its target clients in the long run.

In a country with over 5,000 years of tea-drinking history, Starbucks is not selling coffee, but the experience and the western lifestyle of coffee drinkers. The goal was to build hip hangouts

that tap into a new taste for China's emerging middle class. According to Starbucks' tea drinking customers, it is all about attitude.

In order to merge into Chinese customers' daily life, Starbucks not only chose high-end office towers and crowded shopping malls, but nightclub and bar districts and residential areas as locations for their stores. Therefore, choosing a high-profile location was the most important factor to the success of Starbucks.

3 KEY SUCCESSFUL FACTORS FOR BEST COFFEE CHINA

3.1 Secrets of Success for Starbucks in China

3.1.1 Location

Real-estate know-how is a hallmark of Starbucks, but the computerized mapping databases that the company uses to test a potential street corner in the United States would be little help in the China. Therefore, Starbucks needed to combine its traditional site-seeking approach with Chinese market information and clientele background.

Nevertheless, the most important secret of success for Starbucks to open hundreds of stores in China is not in the coffee beans, but in the location. Nonetheless, due to cultural differences, consumption patterns, drinking habits and social variables, Starbucks' location-scouting skills and marketing savvy was put to the test. Locations were carefully studied and the company was often willing to wait up to two years for desired vacancies.

Generally there are four key criteria to determine a good location:

High Visibility

High visibility will attract attention and increase brand awareness. In other words, the store itself is the best advertisement for the brand.

High Traffic

High traffic will bring in high volume of customers. Furthermore, high capture rate is essential to the evaluation of a location based on the high traffic situation. Traffic counting is the first and most important step in the evaluation process. Starbucks has its own criteria and

evaluation system for selecting potential clients, which is the secret weapon for its success in China. This system is based on abundant market research and surveying, combined with the local partners' successful experience in the retailing industry from serving local clients.

Seating

The amount of seating directly reflects the volume of in-store clients at peak times. Therefore it will determine the in-store sales. Seating includes inside and outside seating. For instance, in Beijing's Oriental Plaza, a high-end shopping mall, a Starbucks store is located in the hallway with an external seating capacity of around 20 to 30. Yet in Shenzhen, a Starbucks store outside Shenzhen Kerry Center has 30-to-40 nicely designed North American-style, outdoor seats underneath fancy wooden umbrellas.

Signage Display

Signage is an important part of Starbucks' branding strategy. It attracts attention and helps increase brand awareness, especially in high population density areas, such as China. Therefore, Starbucks erects good quality eye-catching signage, with its green, white and black mermaid logo in a good size hanging outside its high profile locations. In Northern China, Starbucks' local partner, Beijing Mei Da Coffee Company registered the Chinese name of Starbucks, which was directly translated into Chinese as Xing Ba Ke – Xing means “star” and Ba Ke sounds like “buck”. Therefore, several outdoor signs are in Chinese, with big Chinese characters for Xing Ba Ke. As a result, local Chinese people, such as taxi drivers, can easily recall the Chinese name of Starbucks. However, Starbucks' local partners in Shanghai and Southern China do not share the same resource since the Chinese name was registered by Beijing Mei Da Coffee Company already. This situation provides huge potential for instances of branding inconsistency or confusion, potentially creating internal conflict and inconvenience between Starbucks' local partners.

Currently there are four major types of store locations in China as shown in the following:

1. Shopping malls
2. High-end (high-tech) office towers
3. Nightclub and bar districts
4. Residential areas

In China, Starbucks is most commonly found in busy shopping malls and office towers.

3.1.2 Operational System

According to Pedro Y.K. Man, Starbucks' Senior Vice-President and President, Asia Pacific, Starbucks' business expansion approach is focused on opening one store at-a-time, and serving one customer at-a-time (www.SiamFuture.com, 2002). Thus, it lays out the important role of strong day-to-day operation in the overall China penetration plan. The daily operation consists of various aspects including sales, customer service, inventory management, equipment maintenance, labour management, stock ordering, cost of goods control, and so on. Using its global service standard, Starbucks China implemented its globalized coffee making and serving system to maximize the customers' coffee experience. Baristas receive professional training before serving clients. Impressively, the first seven baristas in China were sent to Seattle to study the corporate credo and coffee-making skills and to soak up western culture. In order to ensure the high quality of customer service and specialty coffee products, Starbucks sends inspection crews to visit the outlets nearly every other month (Business China, 2002). Inside the store, Starbucks also offers client service surveys and questionnaires to evaluate service levels.

Moreover, Starbucks offers innovative, value-added services in selected stores in China to attract more working professionals. For instance, Starbucks started to provide T-Mobile

HotSpot high-speed wireless Internet service in some stores, so that customers can surf the Internet, check email and download multimedia programs while enjoying coffee.

Furthermore, in order to localize its operation and provide tailored service to local clients, Starbucks amended its menu according to local customers' needs and tastes. For example, to increase its sales in food, it decided to provide moon cakes and other Chinese-style food during the autumn festival.

3.1.3 Finance

In terms of financial management, Starbucks' local partner, Beijing Mei Da Coffee Company developed the most effective financial software, which provides the best business solution to the company's general management and business development. Beijing Mei Da Coffee Company chose Qizheng Software Company to design tailored financial software to assist daily operations management, which includes accounting, inventory management, sales reports and analysis, and store operation management. The software is made up of different modules and can link different stores via the Internet. The head office can have real-time reports on any store's operation and sales information by logging onto the Internet. Furthermore, the software can produce two sets of accounting reports for the local Chinese government and for the head office in Seattle (both in English and Chinese), as the software is compatible with local tax policy and other generally accepted accounting principles.

3.1.4 Marketing Strategy

Starbucks implements its global marketing strategy while also adapting to the local market. It mainly promotes itself through coupons, office visits, and free samples to customers. Starbucks spends little on domestic advertising. It considers the store itself the best advertising tool to promote Starbucks.

Seasonal Promotions

Starbucks offers various seasonal promotions based on holiday themes across the year. Staff dress up for special holidays, decorate the store, broadcast selected background music, and put up specially designed banners, brochures or other promotional materials.

Regular Promotions

From time-to-time, Starbucks launches new promotions to highlight certain products. This kind of promotion always brings freshness and creativity to clients, which makes clients' visits more enjoyable and exciting. Keeping a new and updated store image is one way of maintaining loyal customers and enhancing repeat sales.

Starbucks also offers educational services to its clients on ordering coffee and drinking coffee. Furthermore, Starbucks baristas distribute free coffee samples to people passing by stores in order to attract new clients.

3.2 Key Successful Factors for Best Coffee in China

3.2.1 Location, Location, Location

Generally speaking, location directly decides the fate of any Best Coffee store. Choosing a high profile corner location means a high possibility of success for the store. In contrast, a poorly selected location takes double or even triple effort for management to achieve satisfactory sales. Best Coffee will rarely choose an in-street location. A corner location attracts traffic from four directions, while an in-street store can only attract traffic passing by in two directions. Best Coffee believes that a good location can fix operational problems or compensate for other disadvantages.

In China, because of the rapid development of infrastructure and urban expansion, many buildings, shopping malls, and office towers might have different positions and traffic flows in a

few years. Even though there are some guidelines in choosing an ideal location, finding locations that embody the right lifestyle, provide high visibility, and capture high walk-in rate, involves more luck than science.

As location itself is a major advertising medium for Best Coffee, the wrong location may not impress clients and could directly cause poor sales performance. In addition, stores with bad locations will have poor visibility and may not demonstrate strong sales that can attract potential investors and franchisees.

3.2.2 Sales Solve Everything

Best Coffee's sales philosophy is that sales can solve everything. As an illustration, high and increasing sales could assist managers in solving operational problems. The ultimate goal for any store is to increase sales and profitability. Thus, increasing same-store sales and attracting repeat sales are top priorities for the store manager. In the same way, store managers should consider increasing sales as a higher priority than cutting costs.

There are many methods to increase sales. Best Coffee focuses on selling coffee over pastries and related products, because it does not want to confuse clients. Best Coffee is positioned as a specialty coffee chain or a coffee expert providing high-quality coffee, instead of positioning as a coffee café, which provides a full line of food, drinks and coffee.

When training baristas, Best Coffee offers an "eight steps to sale" procedure to enhance staff wide sales and customer service skills in order to increase sales and attract repeat sales. The sales training includes not only basic selling skills, but also up-sale skills. For instance, selling coffee beans, offering bigger size drinks, offering specialty coffee instead of brewed coffee, selling pastries and so on.

Knowing every client, especially loyal clients by name, is one of the important sales skills for Best Coffee staff. It will make clients feel more comfortable and enjoy a more home

feeling towards the store. In addition, Best Coffee promotes its Best Coffee Card which offers one free drink for every seven cups of coffee purchased. Visiting neighbours is also part of the store manager's routine work. Sampling coffee and talking to clients are two other essential ways to promote sales.

3.2.3 Build Up Good Franchising System

China is in its early stage of franchising industry development. The Chinese government is revising and updating its franchising legal regulations. With the rapid development of the economy and the fast growth of small business by private owners, franchising is becoming a promising business model for entrepreneurs. Hundreds of local and foreign brands are offering franchising opportunities across various industries, such as food and beverage, retailing, laundry, film development, and education. Some of these do not require huge initial investments or monthly royalty fees, but they also do not offer sufficient training or services. Very few of them provide complete and tested franchising systems for Chinese entrepreneurs to follow; hence, their products and services are very localized to Chinese tastes and preferences.

Franchising is the expansion vehicle for Best Coffee to thrive in China. As the Master Franchisee for Best Coffee in China, Best Coffee China needs to develop a very strong franchisee recruitment and development manual in China. This should be based on Best Coffee's existing system, combined with local regulations and market situations, in order to hasten opening more stores while fitting into the local market.

During the process of recruiting franchisees, it is very crucial to require franchisees to follow the proper evaluation process, educate them to understand the specialty coffee concept and to buy into Best Coffee's philosophy. Best Coffee will not choose stubborn candidates as franchisees, as they will usually challenge the franchising system or insist on following their own opinions, thus potentially destroying the consistency and uniqueness of the Best Coffee system.

Instead, Best Coffee usually picks flexible, cooperative, people-oriented, team players to join their teams.

3.2.4 Strong Logistics System is the Key

High sales are very important for the company's growth and development. Cutting costs while increasing profitability may be crucial to the cash flow and healthy financial status of the company's operation. Therefore, in order to decrease operational expenses and improve efficiency, an effective and strong supply chain needs to be built in order to lower costs and maximize profitability. The logistics system includes the following aspects:

Centralized Purchasing Center

Best Coffee China needs to set up a centralized purchasing centre to handle all the orders from various areas across the country. The major responsibilities of this national logistics centre include:

- Consolidate and finalize orders from different stores;
- Place the master order to Best Coffee Canada to import coffee beans along with other key items, such as cups and lids, or ingredients and additives which cannot be produced locally in China;
- Maintain sufficient materials in warehouses to ensure enough supply for all the stores in China for 45 to 60 days;
- Allocate and distribute spare items among different stores, in order to avoid expiration of beans and other products;

Without a good centralized national purchasing centre, which can handle import issues smoothly, the Chinese customs agency claims procedure and stocking issues may produce inefficiency, added costs and an expanded supply period.

Effective Inventory Management System

Best Coffee China needs a very effective inventory management system in order to forecast purchasing quantity, provide accurate data for daily sales analysis, and prevent inventory pilferage. Good inventory management software can fulfil the task of predicting purchase orders and allocating resources effectively.

In the early stages, the store accountant should collect two inventory reports from the store manager before and after the store operation on a daily basis. Monitoring the usage of coffee beans is a good way to prevent wastage and losses.

Localized Products Procurement

More and more items should be sourced locally in order to cut costs and improve profit margins. This can be an effective way for multinational companies to thrive in China. It is very unreasonable to import many small things that are used in daily operations, such as tissues, mixer sticks, sugar, cream and other dairy products.

As China is the biggest production centre in the global setting, it has a strong production capability and technology to produce many high quality items that are needed for daily operations, and that meet with high international standards. In the long term, Best Coffee China could even supply Best Coffee Canada and its other franchising stores around the world with daily operational materials at a competitive pricing level.

3.2.5 Guerrilla Marketing Works Best

Both Starbucks and Best Coffee do not invest a huge part of their budgets on traditional advertising, such as print media, TV or radio. Neither would they launch big discount promotions. In contrast, they usually use guerrilla marketing strategies. Without spending big bucks, they can still increase brand awareness, launch products and enhance sales.

A well-operated store can present a good image for the brand; hence, it is a good way to attract clients or to increase repeat sales. Below are examples of guerrilla marketing methods that the company can use:

- Product sampling and testing
- Best Coffee China Royalty Card promotion, e.g. buy seven get one free
- Best Coffee China seminars to educate clients on what coffee is, how to drink coffee, what coffee culture is, and what Canadian culture is
- Organize joint promotions with a TV station to provide the store as a site for certain TV shows or series, while promoting different coffee products
- Host a radio program sponsored by Best Coffee China to introduce Best Coffee, its coffee culture, and Canadian culture
- Visit neighbourhoods regularly to distribute promotional brochures and promote walk-in and delivery services

4 INTERNAL ANALYSIS

4.1 Management Analysis

4.1.1 What C Coffee Needs in the Management Level

C Coffee needs a number of key management factors in addition to those it already has in order to succeed in China.

Resources

Best Coffee China needs a well-trained management team. Managers should understand coffee, coffee culture, Best Coffee's culture and philosophy, China's local culture, consumers' attitude, and the local market situation. Specifically, Best Coffee China needs a very strong franchising management team to ensure the rapid development of Best Coffee's system across the country.

Franchising Team

The centralized franchising team's major responsibilities include:

1. Understand the criteria of choosing appropriate candidates, and be able to evaluate candidates properly;
2. Be familiar with franchising recruitment procedures and ensure following the right procedures and maintaining consistency and uniformed image;
3. Train franchisees on Best Coffee culture and operational philosophy;

Real Estate Team

Location is the key to success. A professional real estate team is the most crucial factor. This team must be very familiar with the guidelines of seeking a good location, and then analyse

the potential site's surrounding commercial criteria to make a judgment on the possibility of opening a store by conducting an effective traffic count, combined with in-depth understanding of the local market and consumer habits.

Marketing Team

A well-planned marketing strategy can help a company enter a new market easier and faster. Hence, Best Coffee China needs to finalize an overall standardized marketing plan for all the stores across the country. This marketing plan can include seasonal promotions and regular promotions. Different stores can be allowed to have their own marketing plans to be more flexible, satisfying local clients' needs. Again, it enhances Best Coffee's brand awareness and ensures brand consistency.

Training Team

Franchisees not only purchase the brand, the system, and the product, but also the training opportunities to successfully build and run the stores. Therefore, a powerful training team is essential to promote quicker expansion in the market.

The final decision-making belongs to Dr. Wong, the President of Best Coffee China. To a certain extent, Dr. Wong understands the Chinese market and consumer behaviour, but he has never received any formal training on coffee retailing, coffee culture and Best Coffee's philosophy, including the operational system, franchising development or training program. In other words, Dr. Wong doesn't understand thoroughly the key successful factors for Best Coffee's success in China. Furthermore, his business background is more on the service and consulting field, therefore he has little experience in managing an operation-based chain store company, which requires sufficient operational experience and knowledge on how to build sales and set up franchising systems.

Under Dr. Wong's direct supervision, there is not a national management team that ensures the standardized Best Coffee China system. The majority of existing managers haven't received any training from Best Coffee Canada on coffee and related topics. This status brings tremendous difficulties when implementing B Canada's operational strategies and franchising expansion plan. In other words, implementation of Best Coffee's franchising system in China is weak and management of Best Coffee China is not committed to it.

4.1.2 Capabilities

Best Coffee China should also set up a head office either in Guangzhou or Beijing. The head office can centralize national operational, marketing, promotional, financial, franchising and training issues. Each section can have a task force that will visit different areas and provide on-time problem-solving solutions. Meanwhile, the head office also needs to work out the operational standards to ensure consistency, which is the most important part in franchising.

Best Coffee China did not set up a centralized head office in China to handle standardization on different variables such as franchising development, marketing, planning, operation, and real estate development. Thus, every branch of Best Coffee China deals with its own daily operational business and is also in charge of franchising development and location-seeking. Nobody is overseeing the general development strategy and summarizing the lessons and experiences gathered during the period of operating corporate stores and opening up new stores.

Therefore, under the existing system, Best Coffee China may not be fully utilizing its limited resources and maximizing the benefit of central control and experience sharing. For instance, the marketing team should work on the national promotional plan for different holidays or different product launches.

4.2 Organizational Analysis

4.2.1 What C Coffee Needs Organizationally

C Coffee needs a number of key organizational factors in addition to those it already has in order to succeed in China.

System

A key success factor for franchising is consistency. Following the franchising system in Canada, Best Coffee China needs to implement the same standard and policy on operations and expansion. In China, it has two types of Best Coffee stores, the corporate flagship store and the franchise store. Both of them operate under the same brand umbrella and promote the same product line at the same pricing level. Best Coffee China is responsible for training store staff to become experts in both the business concept and operational style of making coffee and serving clients.

However, Best Coffee China does not have a national training centre to provide professional training on Best Coffee culture, coffee making skills, daily operation, and marketing and sales skills. Nor does it have a training team travelling from store-to-store to provide standard training. Hence, even though each store has a standardized operational manual to follow all the stores in China cannot maintain the same level of service quality, production quality or even the same promotional plan due to insufficient training. This inconsistency will bring confusion to customers and potential franchisees. Eventually it might damage the brand image.

Two examples of Dr. Wong not following Best Coffee's concept are; firstly; implementing a flat fee royalty system to franchisees, which could not motivate franchisees to push sales; secondly, selling unapproved menu or combo items to clients, which may confuse clients, such as rice, hot dogs, and other food which does not match with Best Coffee's image and positioning.

Structure

As China is a huge country, it becomes more difficult for any franchising company to manage franchisees or provide supervision and troubleshooting services in different areas across the country. Therefore, what Best Coffee Canada originally proposed to Best Coffee China on its market penetration and franchising development plan was to develop regionally, then expand nationally. Therefore, they should not expand nationally before Best Coffee China builds up a strong operational and training team. It will be more appropriate and efficient to expand to other areas after Best Coffee China gains success and experience in certain areas first. In sum, the structure will be regional first, then national.

Best Coffee China took a different approach to developing the local market. First it built up four corporate flagship stores in four major cities, Beijing, Shanghai, Guangzhou and Nanjing. Each city also has a branch office to handle Best Coffee business. Except for Nanjing, the other three offices are responsible for franchising development in their regions in China. For instance, the Beijing office is responsible for northern China, the Shanghai office is responsible for eastern China, and the Guangzhou office is responsible for southern China. Under the circumstance that Best Coffee China does not have a strong, well-trained management team, Best Coffee China started to expand aggressively by presenting the corporate stores and recruiting local franchisees across the country. Each branch office is running independently, without centralized supervision and monitoring. Obviously, under such a structure, the worst outcome turns out to be lack of consistency, which greatly damages the franchising system, and furthermore, the company's image and reputation.

Culture

The three founders of Best Coffee Canada have various business backgrounds, and they have their own specialties in different areas. However, they are all familiar with the local Canadian market, consumer behaviour, retailing systems, and, most importantly, franchising

systems. Furthermore, all of them have operational backgrounds so that they know how to run a store successfully and how to choose the right franchisee candidates.

Therefore, Best Coffee China was supposed to copy Best Coffee's system to China, and do minor modifications and localization based on local market conditions. Best Coffee China was not supposed to change the core business or operational system without Best Coffee's approval.

Best Coffee China, the master franchisee for Best Coffee in China, is one of the subsidiaries of the C Consulting Company, which started its business in the immigration consulting industry. Thus, it has abundant experience in the legal service industry, with little exposure to the retailing and food and beverage industry in China. This history brings with it some obstacles in better understanding the local market and consumers; hence, extending the learning curve for Best Coffee China to build up the best practices in the coffee industry and in the franchising field.

Management Preference

Moreover, C Consulting Company was founded and controlled by a successful Chinese entrepreneur, Dr. Wong, who has the absolute power and authority on daily management decisions. However, Dr. Wong has not accepted any professional training on Best Coffee's management and daily operation; therefore, there is a high possibility that Dr. Wong might not follow Best Coffee's system.

4.3 Resources Analysis

4.3.1 Resources C Coffee Needs

C Coffee needs a number of key resources in addition to those it already has in order to succeed in China.

Human Resources

Best Coffee China needs to set up and implement a good Human Resources system, in order to recruit, train and maintain talent, especially franchising experts who understand the core of franchising, and who are familiar with Chinese franchising law and regulations. Under an effective human resources system, the management team could be expanded, staff trained, promoted, motivated, and monitored properly. Moreover, all the management and staff should be evaluated on their performance regularly, in order to improve working efficiency, enhance effectiveness, and eventually form the most suitable human resources system for the Chinese market.

However, there is no human resources strategy or policy in place, for any branch office. Furthermore, no national human resources system exists. There is no hiring or training plan and no incentive or promotion system to stimulate motivation or passion towards serving the company in the long term. In other words, staff do not have the feeling of belonging. Therefore, the outcome is low morale and a high turnover rate.

For instance, Best Coffee China originally dispatched from head office in Canada 10 people for store operation training, marketing training and other related training to introduce the Best Coffee system to China. However, only three of them still work for the company. Other key personnel in the management team did not get professional training from Best Coffee. Thus, in a sense, it is difficult to ensure that Best Coffee's philosophy and franchising system is promoted in the same way without misunderstanding.

Best Coffee China is contractually obligated to strictly follow Best Coffee's standard of operation and present its coffee culture to Chinese customers. However, there are a couple of reasons why Best Coffee China does not follow all the standards. First of all, Best Coffee China has an agreement with Best Coffee Company for adjustments and amendments at the initial development stage in penetrating China's market. Best Coffee Company understands and accepts

some degree of adjustments, under the understanding that Best Coffee China gets the approval for any changes it wants to make in China. Secondly, Best Coffee Company does not have sufficient staff and resources to monitor Best Coffee China's real time operation and expansion, so that it gives Best Coffee China more leeway to play around the requirements and standards. Thirdly, the legal system in China has not enough clout to protect every foreign franchisor's benefits and profits maximally.

Financial

In the initial stage, Best Coffee China needs to build up corporate flagship stores to demonstrate Best Coffee's image and attract potential franchisees. For a one hundred square metre store, the initial investment is about RMB1 million. The estimated break-even period is about one-and-a-half-to-two years. Ideally, Best Coffee China needs to have strong financial support to operate the four corporate stores until the stores start to make profits or some franchisee is interested in buying any or all of them.

For currency exchange issues, Best Coffee China's head office in Toronto pays Best Coffee Canada in Canadian dollars for coffee beans and other materials. Thus, there will not be any currency problems or risks.

In order to solve initial cash flow problems, Best Coffee China should expand its franchising business rapidly. However, rapid expansion cannot occur without a good franchising system, a qualified franchising recruitment team and a good real estate team in place.

In Canada, the royalty system is ten percent of monthly gross sales, which includes eight percent as a royalty fee, and two percent as the marketing and advertising fee. This system has proven effective to stimulate sales. However, in China, the coffee chain store industry is under a totally different situation. The majority of competitors are executing the monthly flat fee royalty system, so that Chinese investors get used to the fixed system. As a new brand entering the

Chinese market, Best Coffee China could not be competitive unless it demonstrates a very attractive financial model to make profits in a reasonable time period.

Best Coffee Canada is operating a strong financial model, while Best Coffee China is not. Without a good operational system and a strong sales-building team, any good financial model cannot be implemented. Therefore, under the pressure of fierce competition, Best Coffee China is also running a flat fee royalty plan, without the pre-approval of Best Coffee Canada.

Among four corporate stores, only the Guangzhou store is operating as well as expected, meeting the monthly sales target. The reasons for the other three unsuccessful stores are mainly poor location and poor store operation. Due to very low traffic and sky-high rent costs, the Shanghai store was even closed at the beginning of 2004 in order to decrease the continuing huge operational loss and cash flow pressure. All the above phenomenon imply that Dr. Wong has a lack of commitment to Best Coffee's system.

4.3.2 Summary

From both the human resources perspective and financial perspective, it is not hard to conclude that Best Coffee China does not have what it needs for success in China, and it is not fully committed to the franchising and operational development for Best Coffee in China. At this stage, Best Coffee China is not showing any signs of success, and it will take a long time for Best Coffee China to gain both short-term and long-term success under the current management style.

5 RECOMMENDATIONS

5.1 Management Level

5.1.1 Dr. Wong

Dr. Wong should not be involved with daily operational management. He should hire a country manager who has abundant retailing or franchising experience, and who also gets training in Best Coffee Canada about coffee and company culture. The country manager would be responsible for overall management and strategic planning for Best Coffee China's short term and long-term objectives. Meanwhile, this person should be able to lead a big management team across the country, and communicate well with Best Coffee Canada.

Someone has to convince Dr. Wong that either (1) he has to give up daily operational management; or (2) that it is more profitable to cooperate with the Best Coffee franchising system.

5.2 Organizational Level

5.2.1 System

System building is very crucial in order to maintain high quality, standardized service levels consistently. The head office of Best Coffee China should set up a standardized store management system by copying the Canadian manual and adapt it with local features. Then each store in China should strictly follow the system, which includes the operational system, financial system, inventory management system and procurement system. Regular training and random monitoring are two important methods to ensure the execution of the system.

5.2.2 Structure

Best Coffee China needs to set up a national headquarters either in Beijing or Guangzhou. In the head office, there should be one national team for different functions, such as franchising development, finance, operation, marketing and so on. The national teams would be responsible for overall budgeting and planning, building up the standardized management system, training and performance monitoring, national logistics arrangement, creating marketing and advertising campaigns. Therefore, decisions could be made more efficiently and quickly, corporate image could be maintained, and service level could be guaranteed consistently.

5.2.3 Culture

The franchising business is still in its infancy in China. Best Coffee China needs to stick to the essentials and basic requirement of franchising; hence, it must train potential candidates to duplicate the typical Best Coffee store in China.

5.3 Resources

5.3.1 Human Resources

Building an effective human resources management system is the priority for Best Coffee China's central management team. This system should be implemented nationwide, consisting of incentive and promotion programs, in order to build up loyalty, maintain a low turnover rate and increase morale.

5.3.2 Financial

Follow Canada's standard and do strict store projection analyses. Try to follow the financial model that ensures making profits. Store location analysis must be done carefully and be approved by Best Coffee Canada to guarantee a store's success.

In sum, Dr. Wong becomes the biggest obstacle for building and maintaining a good management team. Therefore, he needs an experienced National Manager who can look after day-to-day business, and implement Best Coffee's strategies and standards. Dr. Wong should follow Best Coffee's operating and franchising systems more strictly by performing more cooperatively. By doing so, Best Coffee China could build up a standardized store management system to monitor the whole operation's performance. Furthermore, setting up a centralized management structure is crucial to improving standards, and maintaining effectiveness and consistency. Coffee culture is western culture. For a developing country like China, it must stick to the basics and satisfy customers' curiosity and trendy demand. In terms of resources to develop Best Coffee in China, a standardized national human resources management system is essential for a high retention rate. Sufficient financial investment is required to ensure the proper store operation. Moreover, cautious store location is the key to success.

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