

**ESTABLISHING A WESTERN COFFEE SHOP CHAIN IN
CHINA**

by

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ABSTRACT

The project presents a business plan for starting up a coffee shop in Nanjing, China. An overview of the competitive environment and the growing market demand for coffee in China is assessed, and the author describes the criteria by which a new entry to the market can compete successfully. The venture is intended to be a flagship operation for what is intended to be the development of a successful chain of coffee shops in China over a five-year period.

The author concludes that a new entrant can penetrate the market based upon a focus on the affluent business and student segments of the population in Nanjing. Three segments have a growing interest in westernized products. The concept will differentiate from competitive brands on the basis of food/beverage pairings, ambience, and service quality. Funding for the venture will be contributed through equity provided by three partners, who also provide operational expertise and experience in China.

Keywords: coffee, China, start-up, Nanjing

Subject Terms: coffee shop, business plan, investing in China

EXECUTIVE SUMMARY

Market

The coffee industry in China is at its growth stage, with huge market potential. With more Chinese accepting coffee drinking as part of their life style, the coffee industry is entering into an accelerated period of growth in China. Local coffee consumption has increased by 20 percent since 2003 and the Chinese coffee market is expected to grow by approximately 70 percent from 2003 to 2008.

While instant coffee dominated the market in early 1990, freshly brewed coffee has gained more and more popularity. Coffee drinking is a passion that many young urban professionals and students wish to cultivate in China because of its close association with sophisticated Western life styles. Coffee drinking is perceived mostly as a sit-in visit to a coffee shop where the drinks, snacks, shop decor and services are provided as a unique coffee experience.

Business Description

With such a market opportunity and large population base, a group of Canadian investors are interested in establishing a new company to open an overseas coffee shop in China, which will hopefully grow into multiple outlets in various cities in China.

The company's flagship shop will be located in downtown Nanjing in Jiangsu Province. It will be a sit-in coffee shop providing on-site fresh roasted coffee products,

fresh juices, and other healthy drinks and snacks. The snacks will be baked at the store with recipes from the Canadian partner's stores.

The flagship shop will provide both in-house and takeout service and will be complemented by catering once the shop and clientele are established.

The flagship shop is scheduled to open in spring 2008.

Business Strategy

The two customer segments of business professional and students will be the targeted market for the flagship store in China. A focus strategy in terms of the customer retention and a differentiation strategy in terms of the coffee shop offering will be the business guideline for this flagship shop's set-up and operation.

Investors and Management

The investors will directly incorporate the company in Nanjing, China. The shareholding structure is a three-partner structure with each of the Canadian partners having a 24 percent share in the business while the Chinese partner will have 52 percent. The majority of the management team will be recruited at the local labor market in Nanjing except the positions of general manager and marketing manager. One of the investors will be stationed in Nanjing to undertake both the aforementioned management roles.

Short-term Business Objectives

The short-term business objective in the first year will focus on penetrating the market in Nanjing and achieving brand awareness. The ROI is targeted at a minimum of

20 per cent after the first year in operation (actual pro forma projects 34% ROI after year one).

Financing

The company's first coffee shop will be completely financed through the investors' private funding. At the start-up stage, two investors will provide 75,000 Canadian dollars each; the third one will provide 175,000 Canadian dollars. Cost overruns or additional funding will also be provided by the investors based proportionately on their ownership share. In conclusion, the first year funding is in the range of approximately 325,000 Canadian dollars to 433,000 Canadian dollars.

DEDICATION

To Wen Wen, my daughter, my angel, my life

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It has been an exciting and challenging journey over the last two years. I have learned more about myself through some wonderful people – my teachers and EMBA classmates.

Thanks to Professor Neil Abramson whose expertise and knowledge enlightened me and guided me through this project.

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GLOSSARY

AFEC	Administration of Foreign Exchange Control.
FIE	Foreign Invested Enterprises
Guan Xi	A unique term used in China indicating a relationship-based business practice
ICO	International Coffee Organization
IMF	International Monetary Fund
Nanjing	Nanjing is the capital of China's Jiangsu Province and one of China's most important cities.
P.R.C.	The People's Republic of China
RMB	The Chinese currency is called Renminbi (People's money), often abbreviated as RMB.
USDA	United States Department of Agriculture
WTO	World Trade Organisation

1: INTRODUCTION

This report is a business plan for starting a coffee shop chain in the Nanjing area of the P.R. China. The report analyzes the viability of this new venture, as well as provides a “roadmap” of how the business will be created and developed. This report plays a critical role as the “blueprint” for project implementation. Because the company has sufficient start-up funding, this report will focus on the strategic planning of establishing the flagship outlet with the consideration to expand it into a coffee shop chain within a 5-year period.

1.1 Purpose of the Report

Through this report, the author will analyze the coffee industry in China and, in particular, how to establish its flagship outlet planned for Nanjing city. Porter’s Five Forces Analysis will be employed to study the industry’s attractiveness and to identify the Key Success Factors to be competitive in China’s coffee industry.

The report compares direct competitors to find opportunities where competitors do not take advantage of a key success factors, and threats where competitors are strong and the company’s new venture must be able to compensate in another key success factor. The report then proposes a plan to take advantage of these opportunities while ameliorating the threats. Following that, the report evaluates the internal capabilities required to put the plan into operation and the costs of doing so. Finally, the report proposes an implementation plan tied to the financial projections presented.

In addition to the above, an extensive study of the market, the foreign business practices and culture, as well as the competitors is necessary for the company to plan its actions strategically. This includes:

- Assessment of market feasibility;
- Assessment of the company's projected profitability;
- Analyzing the company's ability to compete for customers, capital, employees and other resources;
- Introducing the culture and background of a foreign market;
- Proposing optimal product/market match;
- Defining the basis for competitive differentiation;
- Make recommendations for corporate and company strategy for profitable market access in China.

1.2 Structure of the Report

The introduction identifies the background i.e. purpose of conducting this report.

Section two examines the external environment of the industry and competitors, based on which the key success factors will be identified. With the clarification of the target market dynamics and competitors, a competitive strategy is proposed.

Section three is a critical analysis of the company's internal strengths and weaknesses in terms of management preferences, resources and its organizational structure. This section determines what internal capabilities are required to ensure a successful start-up, whether the company has those capabilities and how it will address any gaps.

Section four is an overview of the financial projections for the venture if the above strategy is implemented and provides the exit options for the investors.

Section five is a quick snapshot of the action plan for the start-up of the company's new venture.

1.3 Scope, Methodology and Assumptions

1.3.1 Scope of the Report

This Report is a preliminary business plan to establish a new coffee shop chain in China by Canadian investors. Due to the time constraints and the start-up nature of this venture, the report's emphasis is on the short-term strategies for successfully establishing the flagship coffee shop of the company.

1.3.2 Research – Primary and Secondary

The primary research, including the facts and figures in the report, comes from literature reviews and websites. In addition, secondary research sources include meetings with the potential investors, field trips to coffee shops in Nanjing, a focus group and a survey.

The author conducted a focus group, which consisted of interviews with five potential customers of the new coffee shop. These five individuals were chosen specifically based on their demographic make-up as members of the urban professional community, a key target market for the company. Participants were asked questions regarding price, services, products, branding and food choices; their responses were used to help to determine the correct differentiation strategy.

Following the focus group, the author surveyed twenty-five employees of a local firm in Nanjing. These individuals were chosen specifically because they meet the other target market of the company, new college or university graduates and junior

professionals. These participants were asked the same questions as the focus group and the results were compared to ensure consistency.

Through this extensive research, the author aims to bring a critical, but objective, perspective to investors and demonstrate how to make this start-up venture successful in China.

1.4 An Overview of China's Investment Environment

1.4.1 China's Economy Reform

China is the most noticeable economic power in the current global market. With its drastic changes and achievements in terms of economic development, China has carefully, but gradually, changed its political system to cope with the changing economic system. In 1979, China began its current open policy and economic reform. During the transition of leadership from Mr. Deng Xiaoping to Mr. Jiang Zemin, the Chinese created a series of foreign trade laws and regulations that were favourable to foreign investors.

The living standard of the Chinese people has been improving steadily. During the swift transition from the central planning system toward a mixed economic system of socialism and capitalism in China, both the local leaders and early investors suffered from confusion with respect to how to comply with the different legal systems in foreign countries

1.4.2 The Impact of China's Entry into WTO on Coffee Industry

The transformation caused by China's entry into the World Trade Organization (WTO) has also affected the current state policy related to the coffee industry. China promised to decrease the tariff barrier after joining the WTO in November 1999. As a

result, the import tariff for green bean coffee dropped from 20 percent before 1999 to 8 percent in 2003. Such a policy change will lower the costs of importing coffee, as well as provide the buyers such as the Company's coffee shop more alternatives to select suppliers. The Chinese government supported the WTO framework, as it will be a catalyst to increase the speed of Chinese economic reform, and will fight off local protectionist and bureaucratic behaviour so that these groups will comply with the rules to improve the foreign investment environment.

1.4.3 Tax Advantages for Foreign Investors

Acknowledging that foreign investment is the locomotive that will accelerate China's growing economy, the Chinese government has introduced some tax reduction policies for foreign owned companies. These policies include income tax exemptions in the first three years and another two years with half income tax. Except for a few specific industries, there is no restriction in terms of the foreign investor's share percentage. Wholly owned foreign investment is well protected in China.

1.4.4 Legal Systems

A well-established legal system is the key parameter affecting international investment. In order to establish a well-functioning market economy, the Chinese government has concentrated on drawing up laws. These laws include, among others, "The Law of the P.R.C. (The People's Republic of China) on Joint Ventures Using Chinese and Foreign Investment", "Company Law of P.R.C.". China has a stable government with adequate protection of private property. China also has laws protecting intellectual property, but these laws are not well enforced by the authorities. Starbucks

recently won a case after a more than two-year battle against a Chinese coffee shop chain registered, in Chinese, as “Xi Ba Ke” which is pronounced very similar to “Starbucks”.

1.4.5 Economic Development

China used to be among the world’s poorest countries while operating under its central planning system for many years. Since the 1980s, the government has been encouraging the establishment of privately owned enterprises, which has led to an ongoing economy recovery. The Chinese economy has been booming since then; it survived and kept going after the 1997-1998 financial crisis in Southeast Asia. Being the largest developing country in the world, China has achieved an average annual GDP growth rate above 8 percent in last few years, and has showed no signs of slow down. In fact, experts predict that this growth rate will continue at least until 2009 (see Table 1).

Table 1 - Projected GDP Growth by Country

Economic Prospects				
Real GDP Growth				
	2006	2007	2008	2009
World	3.9	3.5	3.5	3.5
US	3.3	2.4	3.0	3.2
UK	2.7	2.7	2.6	2.9
France	2.0	1.9	1.7	1.7
Germany	2.9	2.2	1.9	1.7
Mexico	4.8	3.4	3.5	3.6
Japan	2.2	2.2	1.9	1.7
S Korea	5.1	4.8	5.8	5.7
China	10.7	10.0	9.0	8.3
Australia	2.6	2.5	2.7	2.7

Source: Global Insight

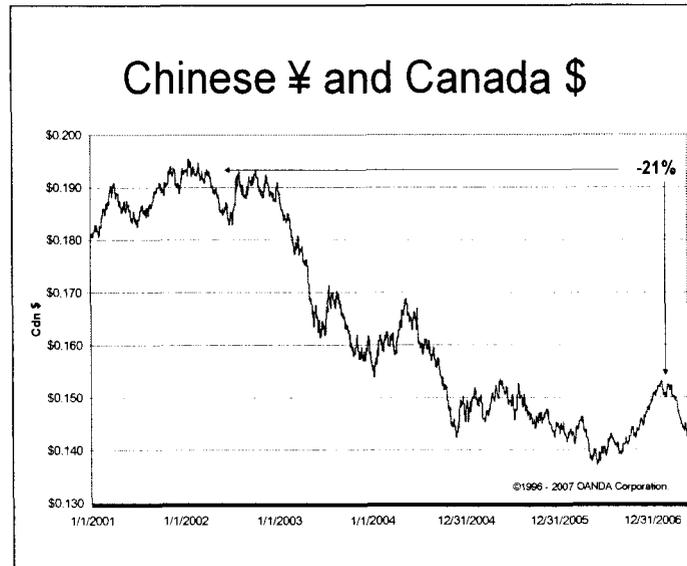
The Chinese foreign exchange reserve is also significant, and had increased to 600 billion US dollars at the end of March 2007, which is the largest of any country of the world¹. This demonstrates strong domestic and foreign confidence in China's current economy.

The Chinese RMB has declined in value by 21 percent since 2002 against the strong Canadian dollar as shown in Figure 1. This indicates a considerable timing advantage for Canadian investors in terms of hard dollar returns. Meanwhile, the Chinese RMB is expected to appreciate gradually up to 20 percent measured against the

¹ IMF data on current foreign exchange reserves of reporting countries

US dollar over the next couple of years, which means a foreign exchange gain of US dollars in addition to the income and capital gain earned from the operation.

Figure 1 - Development of Chinese RMB against Canadian Dollars 2001-2006



There are restrictions on transferring Chinese currency RMB out of the country, although there has been increasing liberalization in this area.

Administration of Foreign Exchange Control (AFEC) will control the expenditure and profit distribution when registered capital funds are injected by foreign investors in the form of foreign exchange. Foreign-invested enterprises (FIEs) are requested to complete foreign exchange registration at the place of business registration, which in our case is in Nanjing area. FIEs can withdraw the foreign currency from the foreign exchange settlement account to make external payments, and can purchase foreign exchange with RMB at designated banks for the purpose of remittance of after-tax profits, bonuses or after-tax dividends payable to the foreign party of an FIE.

Although AFEC controls the foreign currency flow, foreign investors have access to foreign exchange to convert the RMB profit into Canadian dollars to repatriate profits.

1.4.6 Chinese Spending Habits

While world coffee consumption is slowing down, China is emerging as the next biggest consumer market for the coffee industry.

In order to improve consumer spending, and to change Chinese people's habit of saving rather than spending, the government has decreased the interest rate to a nominal one percent for several years. According to a survey conducted by the China Consumers' Association, Chinese's spending on dining out has kept increasing. This phenomenon will benefit the coffee industry if people tend to pamper themselves a bit more.

1.4.7 Summary

Overall, despite certain potential risks, the overall attractiveness of China as an investment vehicle is quite positive.

1.5 An Overview of the Coffee Industry Development in China

Coffee, as the world's second most widely traded commodity after oil, is gaining popularity in Asia. Coffee consumption has increased by 20 percent in China every year since 2003 and the Chinese coffee market is expected to grow by approximately 70 percent in total volume sales between 2003 and 2008 to reach 11,073 tons per year. Moreover, tariffs on coffee imports are going down. With World Trade Organization commitments, the 2003 tariff rate dropped to 10.4 percent and further to 8 percent in 2004.

Industry experts have reason to believe that, with market growth from its small base continuing at this pace, coffee will become an integral part of the country's daily life in next one to two decades.

In retrospect, it has taken a long time for coffee and coffee shops to emerge with such a vibrant presence in China. Few Chinese people had heard coffee in the early 1980's. Much of the early knowledge about coffee that the Chinese had was heavily influenced by its profile in film and mass media, and less by the Chinese people's knowledge of the product itself.

The Swiss-based company, "Nestle", was the pioneer that introduced an instant powdered coffee product into China in the mid-1980's and played a predominant role in educating consumers about the basic knowledge of coffee – its taste and its culture. It did not take long for the fledgling coffee culture to penetrate into modern urban Chinese life after 1989.

The market demand and increasing awareness of coffee in China resulted in a 90 percent increase in total volume sales between 1998 and 2003, when it reached 6,504.5 tons. Demand for coffee more than doubled between 2001 and 2006, and is currently estimated to be growing by 10 percent per year².

Historically strong market growth and growing demand have been the catalysts for many international companies to establish their own coffee shops or franchises in China. Starbucks opened its first store in Beijing in 1999; by 2006, the company had 450

² Statistics from the International Coffee Organization

outlets in the country, with more than 200 stores in 21 cities on the Chinese mainland, including four in Nanjing³.

Coffee shops have become part of the popular culture, and are perceived as trendy social hangouts for increasingly affluent Chinese urbanites. The growing popularity and high profit margin has also attracted many local entrepreneurs to join the competition. The distribution of outlets has been primarily centred in the major metropolitan areas of Shanghai and Beijing, as well as in second-tier cities such as Nanjing and Chengdu.

Most local coffee shops are heavily customized to the needs and culture of the Chinese market. This includes offering a wider variety of food and drink items, including teas and set-menu meals. Starbucks and Blenz are two of the few brand-name coffee shops that primarily sell coffee as their major product. Compared with Starbucks' aggressive expansion, Blenz has expanded at a relatively slower pace opening only slightly more than 80 stores in China, including Nanjing.

It is still questionable whether the current Chinese infatuation towards coffee is a passing "Western" fad or if it is truly to be revolutionized as a beverage of daily choice for the Chinese people - the same loyalty similar to their Western counterparts.

1.6 The Market Opportunity in China

1.6.1 The Booming Chinese Coffee Market

A 2000 report by the USDA (United States Department of Agriculture) estimated that coffee consumption in all of China was about 1,200 metric tons – less than 1 gram

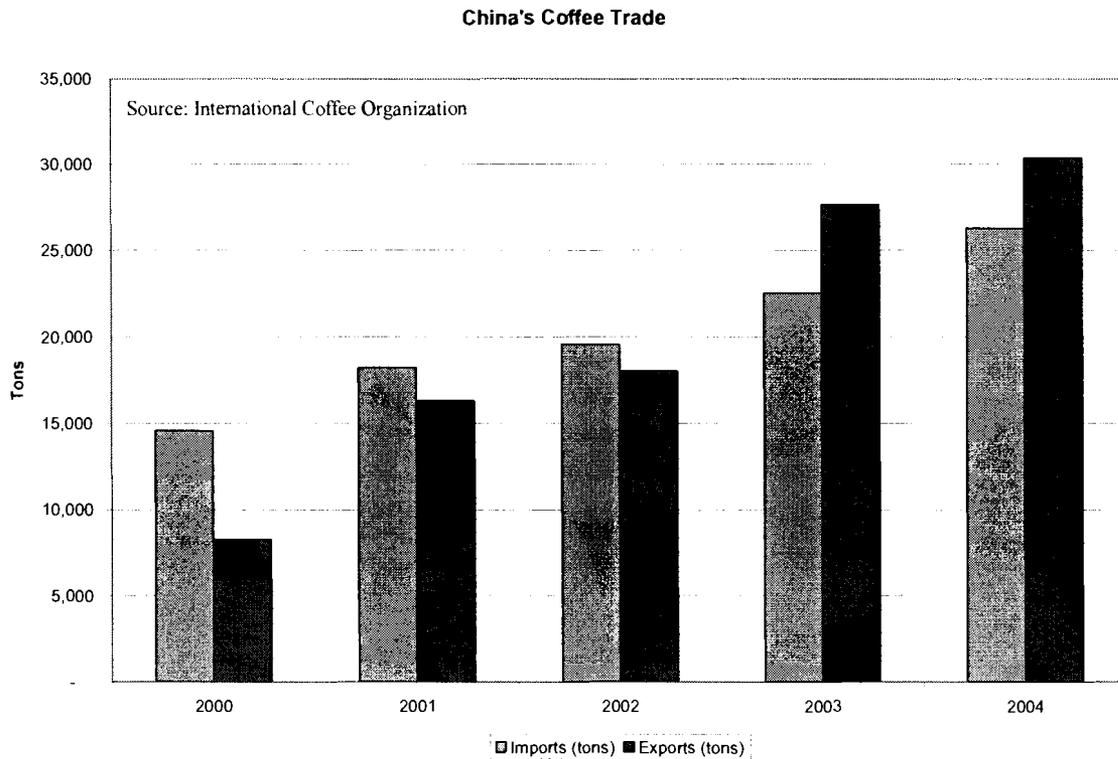
³ www.starbucks.com, www.starbucks.com.cn

per capita⁴. By comparison, per capita coffee consumption in the United States was 4.07 kilograms (and a huge 11.26 kg per capita in Finland!). Even Japan, which has a strong tea-oriented culture, consumed an estimated 3.17 kilograms per capita annually. Interestingly, Japan's annual consumption in 1965 was only 300 grams per capita; it has taken Japan 15-20 years to catch onto the coffee drinking habit. According to the International Coffee Organization (ICO), "The experience of Japan shows that even a traditional tea-drinking country can switch to coffee when its level of development approaches Western levels. However, as was the case with Japan, a strong promotion campaign by both private companies and exporting countries would no doubt help to bring about a substantial increase in coffee consumption in China." Hong Kong may represent the vanguard of that trend in China. Consumption per capita in Hong Kong was 0.8 kilograms per annum – higher than the world's average (0.7 kg). The ICO has since organised coffee festivals in both Shanghai and Beijing several times over the past several years to promote adoption of the beverage.

China's imports and exports of coffee have changed tremendously over the past few years (see Figure 2). China's coffee import dependency has been greatly reduced primarily due to efforts to boost domestic production.

⁴ Friedl Business Information Ltd. 1995-2003; Analysis: The Chinese Coffee Market

Figure 2 - China Coffee Imports and Exports



In conjunction with the growth in domestic production, total volume sales of coffee in China has grown by nearly 90 percent between 1998 and 2003 to 6,504.5 tonnes⁵. The market is expected to grow by 70 percent in sales volume between 2003 and 2008, to reach 11,073 tonnes. This is an urban phenomenon, being driven by increasing prominence of coffee products in conjunction with growing affluence of urban consumers.

According to the Chinese Statistics Bureau, the number of new coffee shops and bars has been increasing at a rate of 20 percent since late 1990's. This staggering growth rate is expected to continue for the next few years, given that the sales revenue from this

⁵ 2005 Franchiseek Limited; Market Trends Coffee China

segment for 2003 was only 2.3 billion RMB, or 4.63 percent of the food entertainment industry.

These facts and figures explain the “coffee fever” phenomenon of recent years. The outlook for China’s coffee industry shows a market with a great potential for growth and a considerable customer base. It is the sheer volume of the market and the current rate of growth that attracts both major international players such as Starbucks and Blenz, as well as the local entrepreneurs who are rushing into this market, in head-to-head competition, to make their mark.

1.6.2 Market Trend of Coffee Consumption

Not surprisingly, coffee consumption is largely concentrated in densely populated urban centres such as Beijing, Shanghai and Guangzhou. It appeals to younger, adventurous, affluent, open-minded, urban consumers. Manufacturers have targeted the young urban professional as the primary target market for coffee. A major challenge is convincing them that coffee represents a beverage to be drunk on an ongoing basis, rather than just being a fad.

Other segments of importance include expatriates working in China from other countries and students returning to China after living abroad for several years. Members of both these segments have become accustomed to the coffee culture, and are comfortable with the coffee shop and café experience. They also have the earnings to allow them to pay a premium price for a lifestyle to which they aspire.

Foreign expatriates are at the high end of coffee consumption because of their cultural background. They also comprise a substantial population base in their own right.

For example, Shanghai's official statistics show that the number of Taiwanese living in the City for at least three months of the year is estimated at 230,000. It is estimated that Westerners and business people from Hong Kong and Taiwan represent 30% of the consumers at chained cafes such as Starbucks.

Coffee drinking is a passion that many young urban professionals in China wish to cultivate because of its close association with sophisticated Western life styles. The earlier local independent coffee shops gained market share despite their inferior coffee product due to the Chinese penchant for Western culture. Foreign expatriates and Chinese nationals, who have returned from studying and working abroad, have championed this burgeoning coffee culture. For Chinese consumers, a visit to Starbucks is as much as about image as it is about the product. Starbucks appeals to the Chinese penchant for anything Western. The stylish and comfortable surroundings and the ability to order gourmet drinks with foreign names that have no specific meaning in the Chinese language are all part of this Western experience.

What is unknown so far is whether China's coffee consumption will be transformed from a passing trend to a stalwart of the country's beverage culture. There is no doubt, with tea drinking being so deeply rooted in China's culture, that coffee companies face an immense challenge in trying to take away from a market that is currently dominated by tea products.

1.7 An Overview of Prospective Market – Nanjing

The prospective market in this report will focus on the Nanjing area in China where the company plans to open its flagship coffee shop.

Nanjing is a city located at the eastern part of China along the Yangtze River in the Yangtze River Delta economic zone. It is the capital city of Jiangsu Province, which is one of the most advanced regions in China.

Nanjing has always been one of China's most important cities. Apart from having been the capital of China for six dynasties and of the Republic of China, Nanjing has also served as a national hub of education, research, transportation and tourism throughout history. It is also the second largest commercial centre in the East China region, behind only Shanghai. Nanjing is comprised of 10 districts and 5 counties, covering an area of 6,516 square kilometres and with a population of about 6.85 million at year-end 2005⁶.

The population has grown at an average rate of 4.7% per year since 2000. GDP per capita is RMB 33,050, a 15% increase from 2003, and the total city's GDP is RMB 191 billion (3rd in Jiangsu). The urban unemployment rate is 4.03%, lower than the national average of 4.2%.⁷

It is one of the most important industrial bases in eastern China, leading in areas such as electronics, automobiles, and chemicals. It is an important transportation hub and communications centre, as well as one of China's four major scientific research and educational central cities. Major industrial giants such as Siemens, BASF, Eriksson, and Ford have established their joint ventures or wholly owned production facilities in Nanjing. Foreign investors coming to Nanjing are from 50 different countries. In the first quarter of 2006 there were 91 foreign-investment enterprises registered with the city

⁶ Statistics from Nanjing Statistics Bureau

⁷ www.wikipedia.com

government, representing a total investment of 6.28 hundred million US. The number of registered enterprises increased by 68.5% compared with the same period in 2005.⁸

Nanjing is also famous for the clustered universities in town. The scale of education and scientific research in Nanjing ranks third, behind only Beijing and Shanghai. There are now 37 universities and the research capabilities of some of the universities lead the nation. There are 724 scientific research institutions, including 18 key labs, 5 state-level labs and 10 engineering research centres. There are 75 academicians, 350,000 research personnel and 300,000 college undergraduates.⁹

These figures lead to some reasonable assumptions: the business environment for foreign investors is generally positive and there is a strong potential customer base of foreign expatriates and their families. Coupled with the large educational infrastructure, there appears to be a strong context for development and introduction of a coffee shop in Nanjing.

1.8 The Investment Opportunity – An Overview of the Company

1.8.1 The Start-up

With such a market opportunity and booming economy in China, a group of Canadian investors are interested in establishing a new company to open an overseas coffee shop in China, which will hopefully grow into multiple outlets in various cities in China. Two of the investors have been in the coffee business since 1992 and have two coffee shops in Vancouver, Canada. The third investor, originally from China, moved to

⁸ The Official Nanjing City Web Site, www.nj.gov.cn

⁹ Statistics from Nanjing Foreign Affair Office website

Vancouver and runs a multi-national import and export company. These three investors will incorporate the company in Nanjing, China.

The business plan calls for a three-partner structure; each of the Canadian partners have a 24% share in the business while the Chinese partner will have 52%. This will facilitate a faster decision process and fewer potential problems with managing the company. Given that the Canadian partners are physically removed from the business, they have no concerns with the structure and see their role as supporting the business through providing training materials, a portion of the start up finding, and ongoing advice.

This will not be a joint venture or licensing structure, but rather a wholly owned separate business. The new company will not adopt the trademark or logo from the existing Vancouver shops. The business is expected to begin operations in spring 2008 and it is anticipated that the start up (the first store) will require approximately 325,000 Canadian dollars in funding, which will be provided fully by the investors. The Canadian investors will provide 75,000 Canadian dollars each, while the Chinese investor will provide 175,000 Canadian dollars. Cost overruns or additional funding will also be provided by the investors, based proportionately on their ownership share. The investors indicate that they have sufficient funds to cover cost overruns up to 35% of the gross start up costs, which is felt to be more than sufficient. In conclusion, the financing budget is between 325,000 – 433,000 Canadian dollars.

1.8.2 Vision and Mission

The company's vision is to convey a healthy life style that will be embraced by the local customers and provide those customers satisfaction through its products and

services. The company's coffee shop chain will build a reputation for high quality products and social responsibility by using fresh and locally produced products wherever possible. As well, the shop will be a significant contributor to the local community and economy by participating and assisting local charities.

The company's mission is to become a leading coffee shop chain in China, known for its fresh and healthy food and drink products. The company will create an image that is synonymous with a social, hip hangout and meeting place for business professionals as well as students.

The company intends to use a differentiation strategy for its products and a focus strategy to attract its desired customer base. For products, the accent will be product freshness and variety; the shop will produce a selection of fresh juice products as well as the coffee products and nutritious food items that are popular in the market but not currently offered by competitors. The company will locate and market with particular attention to its desired customer base, urban professionals and students.

1.8.3 Product(s) & Services

The company's venture will be a sit-in coffee shop providing on-site fresh roasted coffee products, fresh juices, and other healthy drinks and snacks. The company's venture will also provide a website and a newsletter as well as events and classes for the customers to interact and share knowledge regarding healthy life style issues, while at the same time providing a touch of Western culture.

1.8.4 Investors' assumptions

The start-up flagship coffee shop will be located in Nanjing, China as suggested by the potential investors. This plan is for one start-up shop with strategic planning for expansion in next five years.

During initial discussions, the investors expressed strong interest in working on this coffee shop project upon the following conditions:

1. One of the investors will go to China to run the operation in the first year.
2. Some investors' westernized coffee shop experience will contribute to a higher return of profit in China than expanding the coffee shops in Canada.

2: INDUSTRY ANALYSIS

2.1 Porter's Five Forces Model

The first critical step to assess the opportunity of a new investment is an objective review of the attractiveness of the industry. It generally indicates the impact on new entrants in terms of the level of the challenges and profitability. The author will apply Michael Porter's Five Forces of Competitive Position model¹⁰ in this section to analyze the dynamics of the coffee industry in China, i.e. coffee shop establishments.

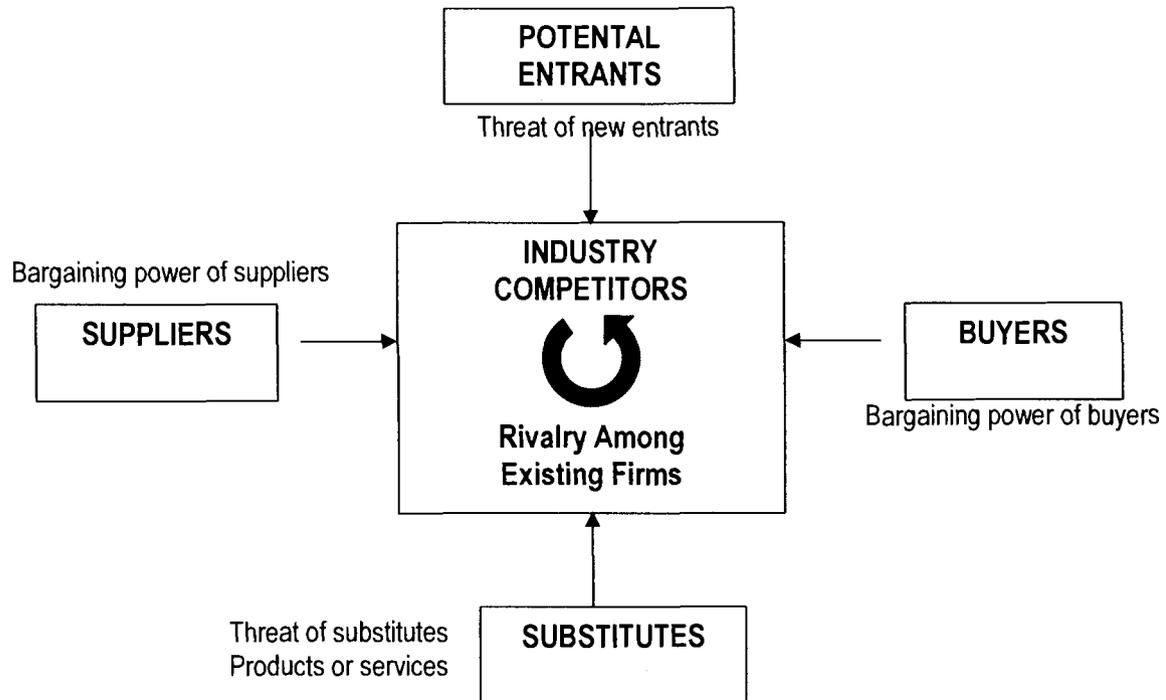
In Porter's model, the five forces affecting the profitability of the firms in this industry are examined; these forces are widely acknowledged as:

- Threat of new entrants
- Bargaining power of suppliers
- Bargaining power of buyers
- Pressure from substitute products
- Intensity of competitive rivalry

The relationship between these forces is illustrated in Figure 3.

¹⁰ Porter, Michael E., *Competitive Strategy, Techniques for Analyzing Industries and Competitors*, The Free Press, a Division of Simon & Schuster, Inc., 1998

Figure 3 - Porter's Five Forces Model



- Source: Michael E. Porter, *COMPETITIVE STRATEGY: Techniques for Analyzing Industries and Competitors*, copyright @1980

2.2 Threat of New Entrants (High)

The threat of new entrants is the level of accessibility for new firms to enter the industry. Industries with high barriers to entry are usually too costly for new entrants to enter. Industries with low barriers are relatively easier for new firms to utilize their limited resources and to compete in acquiring market share. In this section, the report will explore the threat of new entrants by examining the major barriers to entry and the possible reactions of the existing players in this industry.

According to Porter's theory, major barriers to entry include cultural barriers, capital requirements, switching cost, government policy, access to distribution channels,

competitor's retaliation, economies of scale, product differentiation, and cost disadvantages independent of size. In this section, we will explore and identify the impact of such barriers in terms of the industry and the new venture from the company.

2.2.1 Culture Barriers

China's fast growing economy is attributed to its foreign trade business with the Western world. Nevertheless, the unique and distinctive political and cultural environment in China creates considerable barriers, which are intimidating to many foreign investors, especially the ones with little business experience with China.

2.2.1.1 "Guan Xi" or Connections and Distribution Channels

Cultural sensitivity plays a much more significant role in China than most Western countries where written agreements and laws dictate the business world. It is common in China for a major deal to be concluded verbally, especially between people who have a strong connection or "Guan Xi". Trust-based relationships are still considered to be a major factor in doing business. Since a written agreement is perceived as lack of trust or confidence towards the business partner, local people still seal deals verbally in many cases. Therefore many foreign investors find it hard to draw a boundary when and where to insist that all the details are to be stipulated in a written agreement.

Most Chinese resent aggressive sales approaches. They will only buy from someone who has built and nurtured a relationship in which trust is a critical component. In many ways, the Chinese do business with people rather than with product attributes. In another words, even if the potential partners you approach are not interested in the company's coffee shop, they might still give the business their patronage if the

company's owners or managers have a close connection with those potential partners. This connection or "Guan Xi" has great influence in the Chinese business decision-making process.

Such a business practice may be perplexing, but it can benefit the company if the management understands its objectives and uses it intelligently. This is especially important for the company in its initial stages and marketing campaign; the connection or "Guan Xi" can save considerable marketing dollars in reaching potential customers.

The understanding and ability to utilize the connection or "Guan Xi" in an appropriate way is considered a key success factor to doing business in China.

2.2.1.2 Cultural Sensitivity in Terms of Mass Marketing

Foreign investors must pay attention to subtle local cultural practices. If such elements are ignored, they may cause a market downfall without even being noticed by the investors. The following marketing case is worthwhile of a quick review.

Once at a Chinese New Year's celebration, the hosting company offered green baseball caps as premiums to the invited clients. To many Chinese, a man wearing a green hat is implying that his wife is having an affair with another man. Is it likely that a man receiving this hat is going to wear it or simply throw it away? The answer is self-explanatory.

2.2.1.3 Examples of Cultural Barriers for Foreign Investors

A few more tips are summarized here as a caution to the company when developing marketing activities such as the content of the discount card or any printed promotional materials:

Numbers:

Some Chinese are very superstitious about numbers and their implications. For instance, the number “2” in some Chinese communities is close to the word for “easy”, while the number “4” is close to the word “death”; needless to say, no one would want “easy death”, even if this amount is offered as a form of discounted value.

In contrast, six, eight and nine are considered lucky numbers. Six, pronounced 'Liu' in Chinese, implies that everything about you will go smoothly. Eight means to make a great fortune in the near future. Number nine, pronounced as 'Jiu', implies everlasting, especially in friendship and marriage. Thus, numbers ending with these three digits are considered a lucky sign by Chinese customers and are the favourable digits in arranging events or purchasing certain commodities. Therefore, these three numbers are blessing numbers that the company should take advantage of for date selecting, pricing, or rewards. At the same time, numbers discouraging customers such as a \$24 discount offer should be avoided.

Colour Theme :

In China, red is considered a blessing of luck and happiness and gold is a prestigious colour, historically only allowed for emperors. For any major events, red or gold would be good colours to adopt.

2.2.2 Capital Requirements

Investing in a coffee shop in Nanjing can cost anywhere between 30,000 Canadian dollars (200,000 RMB) to over 350,000 Canadian dollars (2.3 million RMB) depending on size, location and level of services. This magnitude and range of

investment required represents a low barrier and provides a good opportunity for new entrants.

2.2.3 Switching Costs

There is no switching cost for customers to experience a different coffee shop. Brand loyalty in terms of coffee is fragile for local consumers with current limited brands. As tea drinking dominates the country, Chinese people are still in the process of being educated to the growing awareness of premium coffee drinks. Except for well-recognized brands such as Starbucks or Blenz, customers are impulsive to switch to different coffee shops just to experience the different shop decor and drink flavours.

There has been an attempt by some brands to introduce customer loyalty cards but overall this barrier to entry is weak and represents an opportunity for a new entrant to attract and establish its own clientele.

2.2.4 Government Policy

In the past, the government or bureaucracy related barriers to get a location, approvals and business licenses were high. However, with the changes in government regulations, particularly in Nanjing, the process has become much easier. Now, the license and application to open a coffee shop in China is not hard to obtain. There are certain ventilation requirements if the coffee shop provides on-site baking or hot food. Yet, there is no particular restriction regarding the qualification of the applicants. One noticeable advantage for any food establishment in China is that no alcohol license is additional required if the owner wants to include wine or liquors in his or her product offerings. This provides more flexibility and room for profitability for any new entrant.

Despite that fact that the legal system appears to be adequate to protect foreign investment, violation of laws by local authorities or companies is a potential threat to the company's new investment, especially when verbal agreements are a common business practice in China.

2.2.5 Access to the Distribution Channel

Since customers come to the shop, this is not a critical dimension of the coffee shop industry. On the other hand, with limited brand loyalty, coffee drinking is often a serendipitous experience and the coffee shop that is readily accessible will see a benefit.

In this respect, a downtown location in high traffic zone is a critical key success factor given the need for the foreign professional clientele.

2.2.6 Competitor's Retaliation

Since there are many coffee shops at different scales of magnitude serving different markets in major cities in China, retaliation is unlikely on a collective basis. The industry's primary concern would be the threat of a drop in prices, which would hurt overall profitability. This, however, does not pose a threat since the company plans to use a combination of differentiation/focus strategy and will not get into price competition.

From the perspective of a new entrant, the threat of competitive retaliation is low. However, there is a tendency in China for coffee shops to extended more and more in the form of franchise or chain shop. If the franchise or coffee shop chain were to grow and achieve economies of scale, the possibility of a collective retaliation to squeeze out the new entrant would be a greater threat.

2.2.7 Economies of Scale

Economies of scale are important in terms of cost savings, with major suppliers providing such items as coffee beans or equipment. In large cities such as Shanghai or Beijing, Starbucks is quickly expanding their chains near the major shopping centres and universities. Both franchising and joint ventures are important strategies for many international coffee companies wanting to take the advantage of economies of scale and saturate potential markets. This represents a potential threat to new but independent coffee business.

Economies of scale represent a key success factor for coffee shop chain and as such will need to be addressed by any entrant that is looking to expand beyond a single location.

2.2.8 Cost Disadvantages Independent of Size

A good location is critical to the coffee shop business. In big cities, competitors such as Starbucks take advantage of their buying power to set up stores to service the densest commercial and residential areas. This drives up the lease prices and narrows the available location options. The barrier is high for new entrants, as they have to invest a considerable amount for rent and considerable time finding the right location.

2.2.9 Summary

The above analysis suggests that the threat of new entrants is high, which is unfavourable to one seeking to start a new venture in the industry. New entrants will encounter some obstacles with cultural barriers; investors should be careful of the unique business practices in China. New entrants have flexibility in terms of the level of initial

capital needed. Customer loyalty is fragile and there is little switching cost for them visiting different coffee outlets. There is no qualification barrier for new entrants to apply for a license for a coffee shop.

In general, if a force is favourable to the industry, or the barriers are strong, it will take considerable cost and effort for a new entrant to compete. However, in this case, when the force is more unfavourable to the industry, or the barriers are weak, there is a better opportunity for a new venture to tap into the industry.

From the perspective of a potential new entrant, the opportunity for new entrants is higher than the potential threat. The threat to new entrants is moderate to favourable. However, there is an implication of future tough competition, as the easy market entry will attract additional new entrants. While there are some opportunities for the new coffee shop to take advantage of, the new business must also deal with some potential threats or challenges.

The analysis reveals a few key success factors for a start-up coffee shop to be able to compete with existing coffee shops. Getting the right location is the prime key success factor for a new entrant. Key success factors also include economies of scale in the case of coffee shop chains and location, and the ability to make the proper connections for all market participants. Certain economies of scale will accelerate the independent coffee shop's expansion plan to grow into a coffee shop chain. The ability to make connection or "Guan Xi" is critical for a foreign company doing business in China.

2.3 The Bargaining Power of Suppliers (Low-Medium)

The evaluation of the bargaining power of suppliers will examine the resources that are available for companies to compete in this industry. The variety of resources and their associated cost will determine the strength of such bargaining power. The cost of the inputs to operate a coffee shop has a significant effect on the firm's profitability. If the bargaining power of suppliers is strong, the company will be in a weak position, facing a high cost for resources with limited ability to negotiate. The major inputs for a coffee shop include labour, real estate lease, coffee beans, other food supplies, coffee equipments, and utilities. Also examined are the impacts of switching suppliers and supplier's vertical integration.

2.3.1 Labour

Labour costs in China are always an attractive economic factor for foreign investment. The cost of labour in China is relatively lower than in many developed countries because of the abundant labour. The average wage for a service staff member (non-managerial) is around \$160 Canadian dollars per month. From 2006 to 2007, China entered into a peak in terms of the number of students graduating from universities and colleges; therefore, there is a glut in the labour market. This is very favourable for employers wanting to attract skilled workers at a relatively low cost. The bargaining power of suppliers is weak in terms of the quantity of labour resources.

During the rapid development of the coffee industry after late 1999, there are a growing number of better-educated and trained employees for this industry. Therefore, in terms of the quality perspective of the labour input, China has prepared a pool of well-educated and trained people that are able to meet the basic requirements for this venture.

Moreover, China also has a mature human resources system for foreign investment.

2.3.2 Coffee Beans and Other Food Supplies

Coffee beans are the one of the major raw material for a coffee shop. Suppliers are available both at home and abroad; both Western and Chinese companies supply coffee beans grown in China. The total volume sales of coffee in China grew by nearly 90 percent between 1998 and 2003, to 6,504.5 tonnes.¹¹ Domestic production of coffee beans also expanded rapidly. The China Agriculture Yearbook reports that China produced a modest figure of 3,573 tonnes of coffee beans in 1997, but by 2000, this had risen to 11,568 tonnes. In 2001, the coffee production in China was estimated at 18,000 tons although the demand was pegged at about 3,000 tons.

With China joining the World Trade Organization, coffee import tariffs for foreign coffee beans (non-roasted bean or green bean) has dropped from 10.4 percent to 8 percent in 2004. Such a demand situation is favourable to coffee shop operators who have a variety of choices both from local bean producers and from importers. The bargaining power of suppliers is weak.

2.3.3 Equipment

In the exhibitors' list of the 2007 International Coffee Carnival held in Shanghai appear the major manufacturers of coffee equipment from Italy, France, US and other European countries; a few Chinese manufacturers have also entered the market. This range and quantity of suppliers gives an advantage to coffee shop entrepreneurs in terms

¹¹ Euromonitor Report, September 13, 2004,

of choosing equipment and bargaining for price. Espresso coffee machine and roasters will be one of the major investments since on-site roasting will be our product feature. Facing tough competition, and in order to promote the coffee equipment, more and more manufacturers will have to offer discounts. Again, here the bargaining power of suppliers is weak.

2.3.4 Real Estate Lease

Compared to the bargaining power from other input suppliers, the suppliers of real estate have the strongest bargaining power and pose the most difficulty for coffee shop owners who are trying to source a premium location with a good price. Many good locations in the major cities such as Beijing, Shanghai, or Nanjing are already occupied, so it is not only time-consuming to search for a vacancy, but also very costly to lease suitable real estate.

In the Nanjing area, the annual real estate lease in a major commercial zone can quote from a minimum of 100,000 RMB (15,197 Canadian Dollars) to 800,000 RMB (121,580 Canadian Dollars) for approximately 2,000 square feet of space. In most cases, the lease is signed on a 3-5 year basis, and rent can only be locked in for the first two years. Such lessors have a comprehensive criteria list against which to evaluate potential lessees such as lessee's capability to pay off the rent, the size and brand of the shop and whether it is a local or foreign investment venture. In general, foreign joint ventures or wholly foreign invested companies have more advantages and are perceived to have better credibility.

However, the bargaining power of suppliers is very strong in this aspect and leasing an appropriate location is a key success factor.

2.3.5 Switching Cost

For a new coffee business striving to produce quality and service, the switching costs are medium to high due to the relevantly immature supply system and the business risk in changing suppliers. For new entrants with a limited budget and small order quantities at the start-up stage, the bargaining power of the supplier is medium to strong.

2.3.6 Supplier Resources

Most suppliers will not attempt to open a retail shop, i.e. vertical integration. There are sufficient potential suppliers to choose from and therefore a client coffee shop is important to the suppliers. The bargaining power of suppliers in terms of resources is low.

2.3.7 Summary

The bargaining power of the suppliers is overall low to medium. The firms in this industry are in a better position to choose various alternatives of the inputs such as labor, raw material or equipment. However, the bargaining power of the real estate lease is very strong.

The assessment indicates that the force of the bargaining power of suppliers is more favourable to the industry. The industry has more control in negotiating a deal in their favour. For the newly started coffee shop, there are cost advantages in some determinants such as the labour or raw material supply. However, given that the annual real estate lease expense will be at least 50 percent of the overall cost, one of the major challenges and threats to new entrants is how to find and get a high-end premise to boost

the business quickly. The other challenge is that the coffee shop must be financially solid enough to absorb the potential loss in the initial stage beginning as a no-name brand.

The above analysis suggests the following key success factors: an effective local network is critical to locate the available premium premises; a professional lease negotiator is critical to lower the cost and maximize the conditions favourable to the start-up venture; and, last but not least, sufficient financial funding is critical to sustain the start-up venture's growth.

2.4 The Bargaining Power of Buyers (Low-Medium)

The power of the buyers describes the degree to which buyers can influence price and profitability of this industry. Buyers have power if they are large, few in number, or in some way can pit one supplier against the other.

The buyers are customers to the proposed coffee shop. In this section, we will not only assess the overall strength of the bargaining power of buyers in the industry but more importantly, a comprehensive analysis of a customer profile is conducted here to identify the targeted customers for the company's new coffee shop and the potential customer's buying preferences.

2.4.1 General Overview

There are a few aspects where we can argue that the bargaining power of customers is low, which is more favourable to the industry. There are a large number of customers relative to the number of coffee shops available. Taking Nanjing as an example, the independent coffee shops and coffee shop chains can attract a large number of customers, with a potential to grow with a population of over six million people. The

average spending per person is about 40 RMB or about 6 Canadian dollars, which generally means a cup of coffee and a dessert. Purchases are characterized by numerous small transactions rather than large purchases. This indicates that there is a large and growing number of customers who are not price sensitive, the product has status appeal, and there is room for high profit margins. Coffee shops are not dependent on a few customers to make a profit, but will thrive if they retain a large and focused customer base. Therefore, the individual customers' bargaining power is rather weak. The bargaining power of buyers is very favourable to the industry.

However, there are some other elements indicating a stronger bargain power of buyers. Since there are many choices such as small gourmet coffee shops or large outlets such as Starbucks, customers have low brand loyalty to coffee shops and can switch to different suppliers easily. This is a threat to a new business. In addition, the concept of having a cup of coffee in a cosy place in China is not considered a daily need but a pampering luxury. Consumers can stop buying coffee or switch to another popular drink without any difficulty. This is another threat to the coffee industry in general; if the product is not extremely important to the buyer, they can do without it for a period of time.

Therefore, many customers are picky, and customer retention is dependent on offering a whole experience represented by the shop's location, brand, service and product quality and mix. The expense to create this type of shop is relatively high for a new independent entrant who would have to undertake an expensive and effective market campaign to develop and promote the "unique experience" in their shops.

2.4.2 Targeted Market

Unlike most coffee shops in Western countries, drinking coffee in China is a statement of fashion and the retail price is high. In Starbucks, one cup (tall size) of freshly brewed coffee is 16RMB (2.3 Canadian dollars) and 35 RMB (5.1 Canadian dollars) for specialty coffees such as Cappuccino or Latte. In local coffee shops such as C. Straits, freshly brewed coffee (one size only similar to the Tall size in Starbucks) is 18 RMB (2.6 Canadian dollars) and 32 RMB (4.7 Canadian dollars) for specialty coffees. The price level in China is quite similar but it is obviously higher than the pricing in North America.

According to data from the Nanjing Census Bureau, in 2005, the middle class is categorized as individuals with a monthly income above \$456 Canadian dollars (3,000 RMB). In Canada, the minimum monthly income of a full-time employee is at least 1,333 Canadian dollars (8,771 RMB).

Compared to the price of coffee and the monthly income of the middle class, coffee drinking is an indulgence for most consumers. Many Chinese perceive drinking coffee as a way to emulate the Western life style. The customers coming to the coffee shop are not price sensitive.

According to a study from the China Market Database, both education level and family monthly income are positively correlated with coffee spending. In families whose monthly income is below \$303 Canadian dollars (1,999 RMB), the percent drinking coffee is only 7.9, whereas in families with more than \$1,215 Canadian dollars (8,000 RMB), the percent is as high as 42.5.

Therefore, the primary target market is the affluent middle class, business professional such as foreign expatriates, and Chinese nationals who are returning from travel / living overseas.

As suggested by the data from the Nanjing Census Bureau, in 2005, the middle class (monthly income above \$456 Canadian or 3,000 RMB) represents 4 percent of a population base of 5 million. This indicates a base of 200,000 people who have a good potential disposal income. In addition, coffee drinks are becoming increasingly popular with a growth rate of more than 30 percent since 1998.

Only grabbing a fraction of such a large base number of this affluent, middle-classed group will satisfy the company's first flagship store with seat capacity for 60-80 customers at one time. Therefore, the focus strategy to cater to and target this group only at the start-up stage for the company is recommended. Reaching certain economies of scale is a key success factor so that targeted customers can easily access the branches under the same group, which will not only attract new customers but also retain the customer base.

After defining the targeted market, it is therefore critical to understand their buying preferences in order to reach these customers.

2.4.3 Buyer's Preferences

The market research is concentrated on the consumer's behaviour in China, particularly in Nanjing. The task is to identify buyers' preferences in terms of the food and drink taste, food offering, and social reasons to go to a coffee shop.

Coffee products:

In the past, the coffee market has been dominated by inferior, blended-type coffees packaged as an instant coffee package or in a can. The coffee industry is a fairly new industry, arising in only the last decade. As a result, coffee drinkers did not have much product quality knowledge. Today, as coffee lovers have become much more sophisticated and better educated about the coffee choices they have, they gravitate towards better taste, flavour, and aroma.

However, local consumers' flavour preference is very distinctive from the Westerns. People's Net, or Dazhong Wang, is a popular website used to collect individual consumers' review of food establishments. There are three categories under the Coffee Shop section for people to write their comments and provide a score from 1 – 5, with 5 being the most satisfactory assessment. From reviewing this website, the preliminary impression is that brewed black coffee is not very popular; instead, speciality coffees such as latte, cappuccino, and especially the ice-blended coffees (a mixture of coffee, ice, chocolate or vanilla and milk blended together and topped with whipped cream) are preferred by consumers. This would also likely be true for Nanjing, which is extremely hot, and humid in the summer time, which is not conducive to drinking hot coffee.

Many blended “Chinese style” coffee products will start to face the challenge of a deteriorating market share due to consumers' growing appreciation of taste. Increasingly, freshly brewed and tasty coffee will be the competitive product offering.

Product-mix:

According to the study from the International Coffee Organization (ICO), Chinese coffee drinkers tend to eat snacks or pastries together with the coffee; rather than coffee on its own, which is popular in the West.

Starbucks and local coffee shop chains offer a very distinctive product mix. While Starbucks' product offerings focus on mainly gourmet coffee and tea drinks, the local coffee shops that do not have the support of an international brand and recognized coffee drinks choose to offer a more set food menu, even including Chinese cuisine. Most people who visit Starbucks will order a cup of coffee, while most customers who visit the local coffee shop will order a set lunch or dinner with other drinks. It probably seems a bit weird and inconceivable for Western coffee shop owners to have sales revenue from products other than coffee itself. However, the crowded customers and busy orders that the author witnessed during her trip in Nanjing is another reminder to the future investors and managers that understanding the local market is critical.

Figure 4, taken by the author during the field trip to one of the major local brand C. Straits Coffee shops in February 2007 in Nanjing, China, shows a typical food offering customized to cater to Chinese consumers.

The customer tailored product mix is a key success factor that was demonstrated by the successful expansion of above coffee shops in China market.

Figure 4 - Photo of a Typical Meal Offering in a Local Coffee Shop



Brand consciousness:

Due to the limited knowledge of coffee products and interest in big-name brands, most Chinese consumers would prefer to go to a brand that they recognize. For example, Starbucks was an instant hit not only when it opened in Beijing in 1999, but also was overly crowded in Nanjing when it was opened in 2001. While Starbucks are able to provide premium products and services, the reason for most customers' visit is due to its well-know brand, which was perceived as a symbol of the chic Western experience. Starbucks enjoys the benefit of a well-established brand while incurring limited advertising expenses. The mass media reported and followed up on the opening of Starbucks outlet, contributing to this lower advertising expense.

Services offered:

Playing cards or chess with friends is one of the primary reasons for many Chinese consumers to visit the coffee shop; even though some of these consumers are not

interested in drinking coffee, the choice to visit these establishments has to do with the comfortable environment and friendly staff. For this type of customer, the convenience of the location along with the environment and service will play a big part in whether or not these individuals will become frequent customers. In terms of food and drinks, their expectation is for comfortable food with a reasonable price, but not as expensive as the food items from up-scale restaurants.

People-to-People service:

The majority of customers in China regard visiting coffee shops as a little indulgence or treat, to relax or to experience a touch of foreign culture. Unlike most take-out customers, those in-house customers have a high expectation of receiving warm and inviting attention and service from the staff. These customers also expect the staff to have overall knowledge to make recommendations about pairing coffee varieties with pastry choices. The way these customers are treated will have a significant impact on whether or not they could be transformed into repeat customers. A knowledgeable and customer service-oriented staff will make both new customers and regular visitors feel that they are VIP guests frequenting an establishment with high quality and class.

Word of mouth is one of the most effective marketing channels in the food industry. This is especially true in China, where eating out together is a major social event and way to network. For a long time, the standard greeting for two people meeting or coming cross each other has been “Did you eat? Where did you eat?” While every local knows that this question is equal to the “How do you do?” that is used in Western countries (meaning you don’t have to give the specific answer) local people do enjoy sharing their opinion about the food establishment they have been to. Good customer

service will satisfy and create happy customers and, in return, they will promote the establishment by spreading compliments among their friends.

Most people who walk through your door or drive up to your window will expect your employees to be courteous, friendly and professional. They count on special treatment as much as they count on receiving the high-quality product you hand them when you take their money. Next to great coffee, the most important thing you have to sell is excellent service. The right employees sell a great experience that creates repeat customers who tell their friends.

The personal element is critical in a coffee shop business to foster a community that can connect people and keep them coming back to become regular repeat customers. The overall ability to provide excellent customer service is another key determinant for a successful coffee shop business.

Unique experience:

Coffee is regarded only as one facet of the selling point for a coffee shop in China. More importantly, consumers are looking for a full package offering a “unique experience” through coffee shops, which include other key concerns such as the environment and the service. Coffee is considered as an in-house beverage rather than take-away good.

As most consumers are buying the experience beyond the flavour of a cup, the creation of a coffee shop must have a flair tailored to the specific targeted market segment. Successful coffee shops in China such as Starbucks and C. Straits make lots of

effort to provide a comfortable, clean and relaxing environment. For instance, in C. Straits, the ashtray is filled with Coffee powders to offset the odour from smokers.

In order to create a specialty theme and feature, coffee shops are created in many ways, such as the “Zuo Feng” Cafe that the author visited in Beijing; the theme of this coffee shop is a “cat” commercial section. All kinds of arts and crafts portraying cats are displayed and are available for sale. Eventually the “Zuo Feng” Cafe has been recommended among friends as that Cafe with cute cats. Such a unique concept is intriguing and easy to remember.

The ability to create a unique experience is one of the major key success factors being identified.

2.4.4 Market Research

Typically, customer satisfaction leads to customer loyalty. The service quality model by Kay Storbacka, Tore Strandvik, and Christian Gronroos (1994)¹² examined the relationship between customer’s prior expectations compared to the actual performance. One of the conclusions was that a customer is likely satisfied if the performance level meets the expectation level, even if the actual service is mediocre only. Therefore, it can be argued that consistently meeting a customer’s expectation will likely result in a higher level of customer loyalty.

Based upon the above theory, the following comparison charts assess the competitor’s performance against customer’s expectations. The figures are derived from

¹² www.wikipedia.org

the research of 138 consumer's review posted on Dazhong Cuisine Net, a freelance consumer's review of restaurant establishments in Nanjing, China.

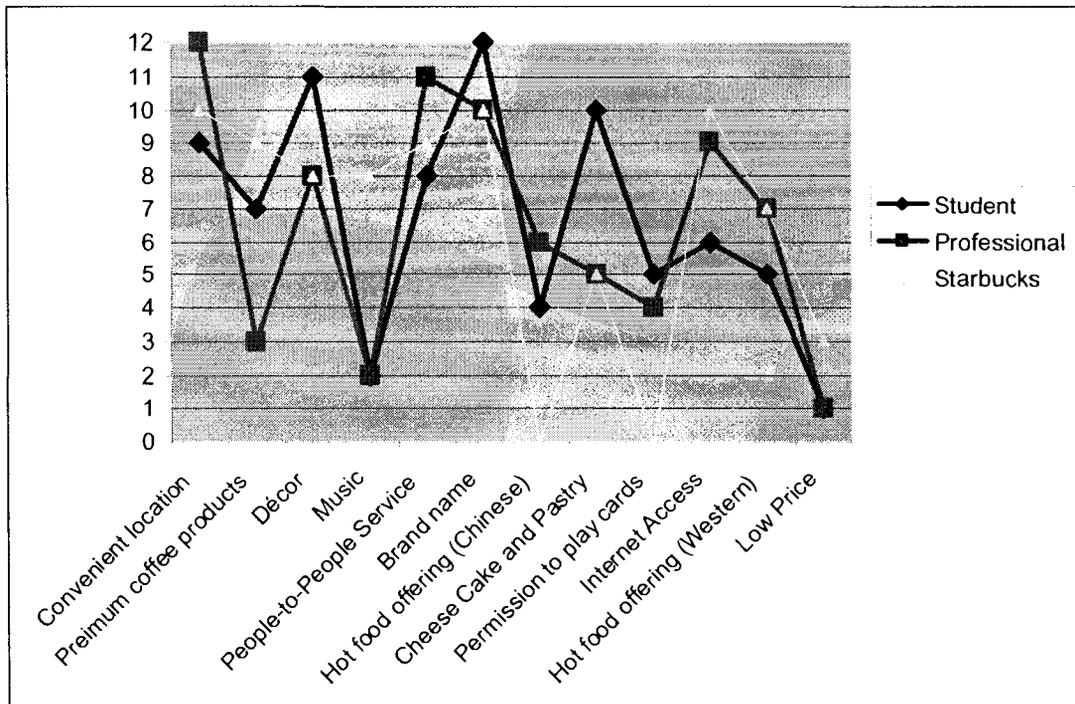
The top three expectation factors for students are brand name, shop decor, and cheesecake and pastries. In all three categories, Starbucks' performance in terms of the brand and shop decor are very close to the expectation line, however the satisfaction levels for cheesecakes and pastries for Starbucks are much lower than the preference levels(see Figure 5).

The top three expectation factors for professionals are convenient location, brand name, and cheesecakes and other pastries. Again, Starbucks demonstrates a strong performance in terms of the convenience and brand familiarity while the cheesecake and pastry scores are again well below expectations.

Findings:

1. Overall, Starbucks' matching level with customer preference is close for the top two factors but is low for food items. As well, Starbucks does not rate well for hot Chinese food offerings and permission to play cards, as these services are not offered but do rate with customers' preferences

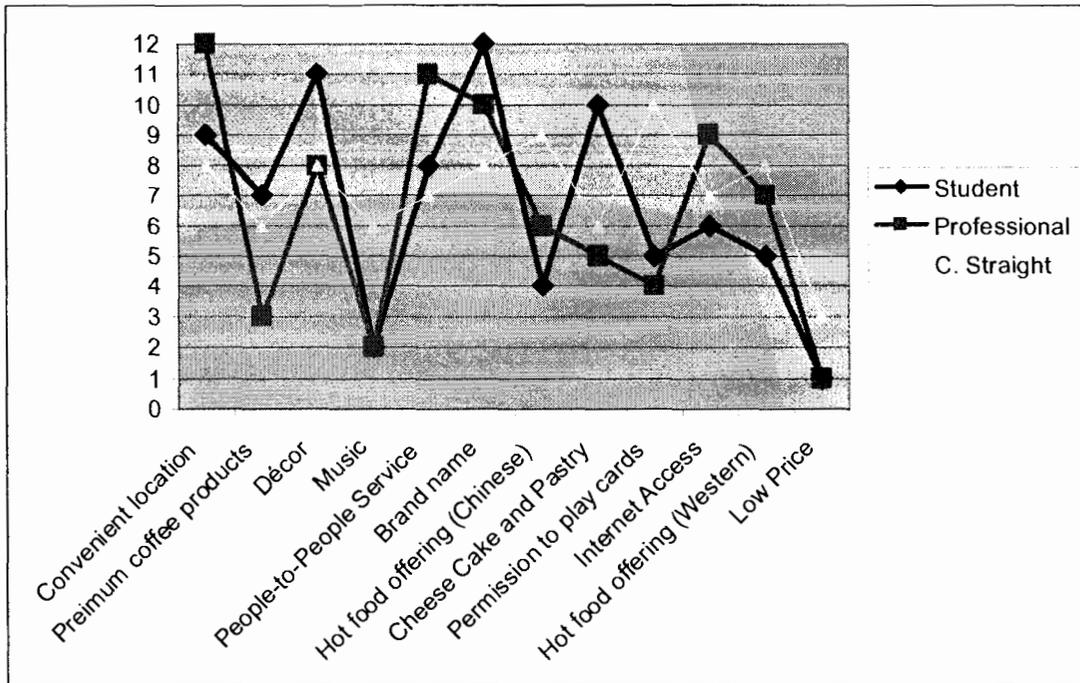
Figure 5 - Consumer Preferences and Starbucks Offering



Data source: Dazhong Cuisine Net, a freelance consumer's review of restaurant establishments in Nanjing, China.

- For C. Straits, the performance line is very close to the consumer's expectation line (see Figure 6). This implies that there will be tough competition for the company's new venture against this strong local player. C. Straits has adapted to embrace local consumer's preference.

Figure 6 - Consumer Preferences and C Straight Offering



Data source : Dazhong Cuisine Net, a freelance consumer’s review of restaurant establishments in Nanjing, China.

2.4.5 Survey Results

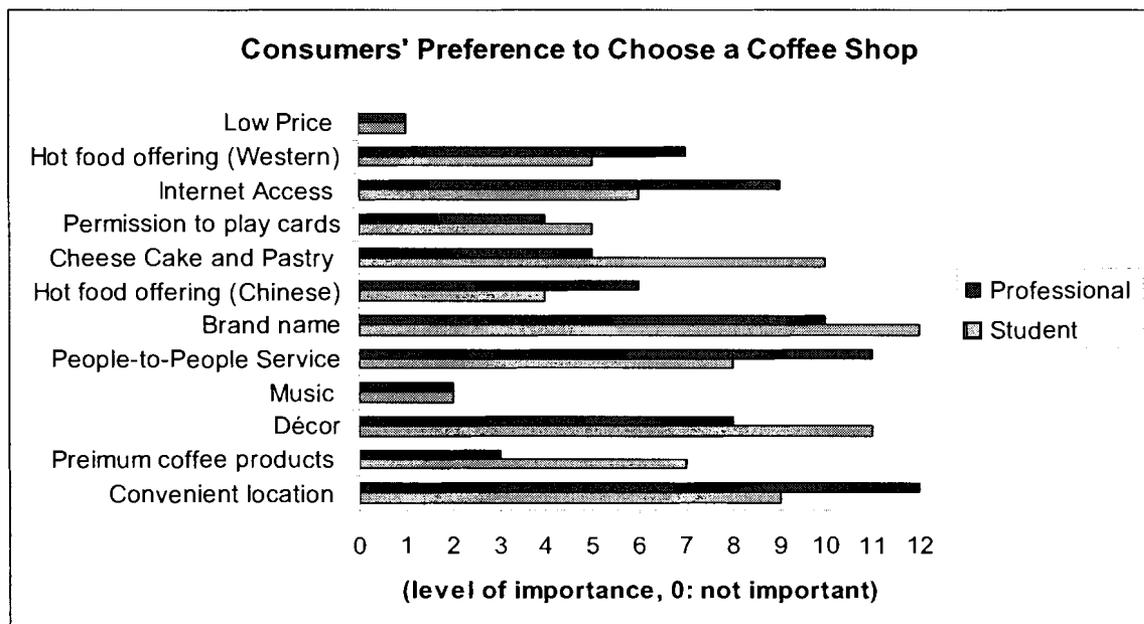
A further survey and telephone interview was conducted with two focus groups – students and professionals, to determine their preference in choosing a particular coffee shop.

A 25-person survey was conducted and included people who represented new graduates aged 20-28, with characteristics that included being adventurous, trendy, and possessing the necessary disposable income. All of them were Nanjing residents working in a corporate setting.

The telephone interview was conducted with five people who were aged 30-45 and were senior managers or professionals living in Nanjing.

The graph in Figure 7, shows what the most attractive factors are for these two groups in choosing a coffee shop. The findings are consistent with the market research of buyer preferences done in the previous section and suggest that brand and location are the most important determinants, which is another affirmation of the two key success factors: the brand and the location.

Figure 7 - Overall Consumer Preferences for Choosing a Coffee Shop



2.4.6 Summary

The overall strength of the bargaining power of buyers is low to medium, which is favourable to a moderate degree for the firms in the industry. There is pricing advantage or opportunities for new entrants to gain a high profit margin in this growing industry. Yet, the major challenge or threat is how to attract new customers and how to create a value proposition that creates customer loyalty.

The key success factors identified include reaching certain economies of scale, creating a unique coffee experience, providing product offering tailored to the targeted market, and branding.

2.5 Threat of Substitutes (Low)

Substitute products are those that can fulfil a similar need to the one provided by the product in question. A threat exists if there are alternative products with lower prices, better performance, or both. There is a large variety of substitute products in the food and drink industry in terms of functionality. The possible substitutes include instant coffee or alternative beverages available from supermarkets. However, those substitutes have performance limitations that are not completely offset by their lower price. In our particular coffee shop project, since the consumers are not price sensitive, the product with the lower price alone will not constitute any threat as a competitive substitute. However, products or food establishments providing similar food tasting or the experience of Western emulation are potential substitutes for coffee shops.

Substitutes or alternative beverages offered against coffee drinks are tea and soft beverages. There is a wide array of beverage products available in the Nanjing market: traditional green tea, black tea and various flavoured teas. Popular drinks also include energy drinks, fruit tea, milk-flavoured tea and ice tea. These beverages are normally offered in bottles and available at restaurants, coffee shops, or food stands. However, coffee drinks are differentiated by usually being labelled as a foreign product. For many consumers, being seen holding a cup of coffee in a shop represents a kind of emotional appeal as well as being a statement of style. So far, the alternative drinks are not strong

substitutes, as they cannot replicate in-house coffee for the implicit representation or value proposition.

Customers' visibility in a hip restaurant with the corresponding atmosphere is the major criteria for them staying with coffee restaurant rather than other substitutes. Again, the premium location and shop decor are the key success factors to exclude any potential substitutes.

Instant coffee products have the early entry advantage, as this was the first experience with coffee for most Chinese people. Instant coffee is available in restaurants and retail shops. Even though the quality standards associated with fresh-brewed coffee are becoming more accepted by Chinese consumers in this fast growing economy, the convenience and cost effectiveness of instant coffee continues to allow this product to dominate a large market share in China. As the targeted market segments for the company's new venture is a non-price sensitive group, instant coffee products pose a weak substitute.

Sit-in food establishments offering similar Western emulations include Pizza Hut, KFC and McDonalds. All these restaurants entered China early, between 1990 to 1998. They used to be symbols of a touch of the Western experience, and gained tremendous economic success in China. However, more and more consumers acknowledge the fast-food nature of those outlets. Nowadays, those outlets attract more family type of customers, but visits from students and especially professionals have shrunk significantly. All of above outlets are poor substitutes in competing with coffee shop as a status symbol or presence of Western experience. It suggests to us from another perspective that

customers are likely switching to a substitute, which has more appeal as a trendy symbol of Western culture.

It is clear that customers will not incur any substantial cost in switching to a substitute. If customers lose their sense of curiosity, there may be a decline in demand. From a positive outlook, we hope the habit of drinking coffee in China will follow the trend similar to Japan and Malaysia where it has evolved into a lifestyle choice for the mainstream consumers, irrespective of whether it was curiosity about Western lifestyle that started the trend.

2.5.1 Summary

The assessment of threat of substitutes is low; it indicates a weak threat from substitutes. Although customers have full access to switch to any possible substitutes without cost, the current available substitutes represent performance limitations that do not completely offset the lower price.

Despite the status quo, the potential threat of substitute both exists with the existing coffee shops and the start-up ones. If the coffee trend was not able to follow the pattern in Western countries to develop into a regular household drink in future but declining as a passing fad, the substitute trendy drinks such as exotic energy drinks or herbal teas can turn into substitutes.

The key success factors revealed in this section include the premium location and Western-style shop decor. It is also important for management to monitor substitutes and to be proactive in finding ways to compete with threatening substitutes. For example, for any emerging substitutes with similar features such as trendy, chic and foreign,

management must not ignore them, but determine whether it is possible to include some of these substitute products in their product offering as compliments.

2.6 Intensity of Competitive Rivalry (Medium-High)

Competitive rivalry is the strongest force and the most influential factor that affects the attractiveness of the industry. If the competitive force is weak, companies can raise prices to increase their profits. However, if the competition is strong, then marketing costs will be driven up while businesses try to find ways to attract and retain customers.

The market size and potential is the primary factor to attract many competitors into the coffee business. Compared to Japan, the world's third largest coffee selling country, the coffee consumption per person in China is less than 1/10 of the consumption in Japan. Yet, the industry has gone from a staggering growth rate of 30 percent before 1998 to 10 percent each year afterwards. The speed of growth may have slowed, but the market potential is huge given the growing acceptance of the coffee culture by ordinary people. There is an opportunity for new entrants in terms of the market size and potential demand.

However, competition is getting intense as more and more coffee giants with years of experience who entered China years ago are becoming market leaders, with numerous outlets in many cities. The threat of rivalry is strong for the new entrant, since the competition has already established a formidable presence in the population centres of most of the large cities. Several brands have become recognized and are well established among consumers.

Another threat to opening a coffee shop is the rising costs associated with real estate leases for desirable locations, and the additional costs for internal décor and creating the desired theme.

There are two types of competitors in the market: the international franchises and local coffee shop franchises

2.6.1 International Coffee Chains

Starbucks is a global corporation with 4,709 total locations in the United States and worldwide¹³. With operations in almost thirty countries, Starbucks reported revenues of over \$2.64 Billion in 2001 (Starbucks Corporation). Starbucks employed over 59,000 people during 2001, with an employment growth rate of 24 percent¹⁴.

The huge market potential is the trigger that Starbucks became the one of the earliest marketers in China's coffee industry. The current coffee consumption of 0.01467KG per person in China is tiny compared to the annual coffee consumption of 4.02 KG per person in United States¹⁵. As said by Martin Coles, President Starbucks Coffee International, "We believe that China will be Starbucks largest market outside the U.S."¹⁶.

Starbucks has been persistent and moved ahead very fast in China's major cities. Since Starbucks' first shop opened in 1999, they have opened about 450 stores, with more than 200 stores concentrated in 21 major cities such as Beijing or Nanjing. So far,

¹³ Starbucks.com

¹⁴ Fortune.com

¹⁵ Statistics from ICO (International Coffee Organization)

¹⁶ Business Wire, November 15,2005

China has become one of the fastest-growing markets for Starbucks and the Chinese market will be a leading revenue source for Starbucks Corporation in the future.

Blenz is another major international brand craving a slice in the Chinese coffee market. In 2003, the first Blenz Coffee shop from Seattle opened in Beijing, followed soon by another 17 outlets.

Starbucks' dominance is also challenged by many newcomers – in addition to Blenz Coffee, there is McCafe, an up-market coffee shop from fast food king McDonalds, and a host of other foreign and domestic coffee houses joining the battle.

So far, there are four Starbucks, two Blenz and one McCafe competing in the Nanjing area.

2.6.2 Local Players

While Western coffee brands are fighting for a share of the lucrative China market, local business entrepreneurs from Taiwan and Hong Kong (considered part of China) have also reacted quickly. The C. Straits coffee chain entered the China market, presenting itself as a local Chinese company and not a foreign brand. With a customized food menu and an emphasis on cosy atmosphere in the shop, companies such as C. Straits have adopted an aggressive franchising strategy. To date, C. Straits has opened more than 400 outlets in over 20 cities across China. There are nine franchises under C. Straits group in Nanjing so far.

2.6.3 Main Competitors

All kinds of so-called “Coffee shops” glut the market in Nanjing. However, most of these small shops will not be able to survive in the market given the inferior coffee and

food products that they offer. As consumers are becoming more informed, in the next few years many of these shops will be driven out of the market.

There are two kinds of competitors that pose a threat in Nanjing:

- Western coffee shop chains introduced by foreign companies. Of these, Starbucks has the most outlets in Nanjing with four. Blenz, another competitor, is also in the market but its progress has been rather slow.
- Local coffee shop chains, mainly serving various hot food menu items with coffee drinks. Of these, C. Straits is the best performer so far with nine locations in Nanjing.

In this section, we will take a close look at Starbucks and C. Straits, the market leaders in these two segments, and examine how they have competed in the current market situation.

2.6.3.1 Starbucks Corporation

Starbucks is the undisputable No. 1 leader in the global coffee shop market. Howard Schultz acquired Starbucks in 1987; since then, Starbucks has aggressively expanded from 11 stores to 190 stores worldwide in addition to its headquarters in Seattle, USA in 1989. The annual retained earning for Starbucks Corp. jumped from 1.3 million USD in 1987 to 40 million USD in 1990¹⁷, a whopping increase of more than 3,000 percent in 3 years. This result set a solid basis for Starbucks to go public in 1992, which was critical to provide the financial guarantee for its aggressive expansion worldwide.

¹⁷ Business Wire, 7.2.2000

Starbucks' Asian expansion strategy was focused on countries where there is a large population base, even if coffee is not a daily drinking habit for most locals (see Table 2). The expansion emphasizes Starbucks' branding commitment and success in selling a cup of coffee as a cultural phenomenon or experience rather than the drink itself. Starbucks' location strategy is to penetrate its stores in the capital or cosmopolitan cities of those countries, such as Tokyo in Japan and Beijing and Shanghai in China, where urbanites are likely to be more adaptable to new products.

Table 2 - Starbucks Overseas Expansion Overview

Year	Country	Number of Stores
1996	Japan	145
	Singapore	25
1997	Philippine	26
1998	Taiwan	53
	Thailand	12
1999	China	21
	South Korea	7

Source: business wire (2000.2.7, 2000.5.31), Starbucks.com

2.6.3.2 C. Straits Coffee Chain

C. Straits Coffee is spreading over most large Chinese cities, with locations in 23 different provinces and over 279 stores opened since 2000. The investors C. Straits Coffee are from Taiwan and Mainland China (Taiwan is considered by the Chinese government to be part of China). The aggressive expansion of C. Straits Coffee uses the business model of franchising. The early-entry advantage and a tailored product offering are the competitive advantages for the rapid growth of this coffee shop chain. In Nanjing,

C. Straits has nine stores located either in the downtown core area or near the most famous Nanjing University.

The rapid expansion of this chain in only a 7-year period is due to the early-entry advantage that C. Straits enjoyed. At the time C. Straits entered the market, most consumers were not familiar with the concept of an authentic coffee shop. The owners of C. Straits adapted most of their trendy food menu from international sources and offer items such as American steaks, Japanese BBQ, and German pork specialities. The food offering is a huge financial success for the chain. Currently, the business in C. Straits appears quite good from an on-site consumer's perspective. The Cafe is completely packed after 8 p.m.

However, the sustainability of this coffee shop chain is questionable. Chinese consumers' learning curve of Western coffee and food is rather efficient. The food quality at C. Straits is inconsistent; the reputation of the coffee shop chain is deteriorating due to the poor supervision and management in terms of the quickly expanded franchisers.

There are two or three rising coffee shop chains that are following in C. Straits' steps and are beginning to provide a wide variety of Western food items on their menu; this additional competition will likely present problems for C. Straits in the future.

2.6.4 Competitive Analysis Based on Key Success Factors

The following performance evaluation (see Table 3) of two major competitors is scored over a 5-point scale. Score of 1 indicates the lowest perceived performance while score of 5 suggest the highest level of performance in that area.

Table 3 - Rating of Competitors on Key Success Factors

Key Success Factor	Starbucks	C. Straits
Location	4	5
Economies of Scale	5	4
Unique Experience	5	1
Service	3	3
Shop Décor	5	4
Food offering	3	3
"Guan Xi" or connection	3	4
Brand	5	3

Both Starbucks and C. Straits have established a strong presence by locating at prime locations in Nanjing, especially Starbucks' two shops that are right in the downtown core, the most expensive commercial area. As discussed earlier, both achieved certain economies of scale to open multiple outlets to penetrate the local market; Starbucks has the further advantage of global sourcing power. Both coffee shops scored high in branding, but there is no doubt that Starbucks has a better global exposure compared to the home-brand C. Straits.

Both Starbucks and C. Straits scored high at 5 and 4 in terms of shop decor. During author's field trip to their coffee outlets in Nanjing in February 2007, it was quite obvious that they make tremendous effort at considerable expense to create a comfortable and impressive ambiance with their shop décor.

The company's new flagship coffee shop will have to overcome the above gaps. While it is difficult for the new venture to compete with a mature brand and multiple outlets in one city, as it is an unknown brand looking for quick growth, finding a

premium location cannot be comprised. This is the primary task for the investors so that they can align their internal resources with their goals and achieve this key success factor.

On the other hand, both Starbucks and C. Straits have some level of deficiencies against the key success factors of unique Western experience, service or food offering.

While offering the unique Western experience is Starbucks' core competence, C. Straits was perceived as a local brand failing to deliver authentic Western food, drinks and lacking in the intrinsic essence of a Western coffee shop.

The service packages are restrained in different ways in these two coffee chains. Most Starbucks outlets in Nanjing have seat capacities of around 20 consumers at one time, therefore it is always overly crowded (Good for them!) and sit-in customers are not allowed to play cards as a game can last for hours. Another issue with Starbucks is that since the majority of its outlets are very small compared to the volume of high traffic, some of the service standard is compromised. During the author's field trip to Starbucks in the downtown, the store was not as clean or tidy as they are elsewhere in the world: cups and tissues were spread over the table. In China, customers are used to being served at any food outlets and therefore the customers are not in the habit of cleaning tables themselves.

C. Straight has 60-80 seats at each outlet and traffic is less of an issue. However, the lack of professional skill and genuine people-to-people service are their weakness.

Dissatisfaction with the food offering in Starbucks is mainly because Starbucks does not serve hot food items, concentrating instead on cold food items that are not suited to Chinese eating habits. As an international brand, Starbucks expects to provide similar

products at each store around the world; therefore, food offering is limited in customization to local taste to keep a uniform corporate identity.

C. Straits, on the other hand, attempted to offer a variety of food items, claiming specialities from France, the United States, Germany, Japan and Mexico, yet none were authentic.

The above weaknesses from the competitors provide opportunities for the company's new venture to build on strengths. The new venture has a potential competitive edge if it can focus on improving those areas such as the offering of authentic Western experience and a consistent high service level. As a coffee shop invested in by Canadian investors, the company has a solid ground to offer an authentic Western experience. Since the coffee shop is independent, it can react to the market quicker with more flexibility to offer an authentic Western experience, tailored food items and top-notch services to satisfy the targeted customers.

2.6.5 Summary

The competitive rivalry is medium to high, which is unfavourable to firms in the coffee shop industry. Due to the geographic scale and large population, the Chinese market still has great potential for new entrants; however, the competition is heated due to the high profit margin for coffee as luxury product. Many mediocre coffee shops can get by with low quality coffee products due to the lack of local consumer knowledge. While the presence of these low quality coffee shops provides an opportunity for quality establishments, such as the company's new venture, to charge a premium price and make

additional profits, the company’s start-up venture will also face the challenge of numerous new entrants and existing big players in the market.

In order to reduce the threat of rivals, the new coffee business must distinguish itself with a product offering that is innovative or offers special features that are relevant to the consumer. The new entrant must also focus on a niche market and try to build strong relationships with its customers to build customer loyalty.

2.7 Overall Assessment and Key Success Factors

The Porter model provided a perspective to assess the industry attractiveness through each of the five external forces how they affect the development of the coffee industry in China. The assessment of the strength of the forces is summarized in Table 4.

Table 4 - Strength of Five Forces and Industry Impact Rating

Five Forces	Strength	Impact to the industry
Threat of new entrants	High	Unfavourable *
Bargaining power of suppliers	Low-Medium	Favourable
Bargaining power of buyers	Low-Medium	Favourable
Threats of substitutes	Low	Favourable
Intensity of competitive rivalry	Medium-High	Unfavourable
Overall Rating		Favourable

* It is unfavourable to the firms in the industry but good for the new entrant.

The overall attractiveness of the coffee industry in China is favourable to moderate which implies a potential market but with growing competition.

The previous overview of the coffee development in China suggests us that the local coffee industry is in a growth stage. The characteristics at this stage of the industry life cycle present the opportunities for rapid market growth rate, a strong market demand, and high profit margins. On the other hand, the underlying threats include increasing new entrants due to the low entry barriers, the quick expansion of market leaders such as Starbucks and Blenz, and the uncertainty of consumer behaviour.

This is an emerging, but highly competitive industry in China. Even though there are many coffee shops in the target area Nanjing, it is still a good time to enter and compete in this market. The current potential of the Chinese market gives the company an opportunity to surpass current market participants and make profits even though the company does not have the advantage of early market entry. Actually, there are some advantages to entering the market late as an independent coffee shop. The company will save considerable marketing dollars that would have been spent to educate local consumers about coffee knowledge and to persuade them to try a completely new product. The company will also benefit from the availability of more skilled workers since the coffee business has been present for the last 5 years in China and there are undoubtedly some experienced individuals in the local employment market.

Overall, the venture appears favourable to potential Canadian investors because of China's stable political environment, established legal system, preferential regulations towards foreign investors, and more importantly, the huge market and strong consuming power. As conclusion, this new venture is feasible with low capital requirements, significant payoffs, is a quick cash generator, and has low risk levels with low exit costs for investors wishing to cash out.

As a summary, the following key success factors are important for any new entrant who wants to be successful in the China market:

- Getting the right location;
- Understanding the unique business practices such as “Guan Xi”;
- Reaching Economies of Scale;
- Creating the unique coffee experience;
- Providing the product offering tailored to the target market;
- Shop Decor;
- Effective marketing and branding;
- Sufficient Financing.

2.8 Recommended strategies

The earlier section described a large residential population in Nanjing as well as the concentrated universities and corporations in various industries. This provides a substantial customer base for the company’s new coffee shop. A focus strategy is recommended - aimed specifically at the professional and student segments in Nanjing.

From customer surveys, we have gained some substantial information about the buyer’s preferences. Such a comprehensive understanding from these two groups will guide the company in employing a strategy of differentiation in terms of the products and services it will introduce since the target market segments relate coffee products to a luxurious or status experience and are not overly price sensitive. Ongoing marketing and branding will be employed to distinguish the company’s value proposition and product mix from that of the competition.

Our unique “coffee experience” and adoption by a sustainable customer base over time will determine the long-term prospects for this venture and our ability to expand to

multiple cities. A sustained ongoing commitment to marketing and branding is required from the earliest stage and throughout the life of the company. The shop décor, packing boxes, cups, and menus will be aligned with a unique, distinctive design, colour, and logo.

The key to overcoming customer inertia is in offering products or services that have tangible advantages over those of the competitors. We also need to stimulate trial and introduction by finding innovative ways for customers to experience and get to know our offerings. Product pairings, a unique visible aesthetic, commitment to service, and high quality will all be used to stimulate trial by consumers who may not initially feel compelled to make a change to a different brand.

The company's marketing goals should be specific with several layers: getting new customers, retaining existing customers, and getting existing customers to spend more. The profitability of the company's new coffee shop is dependent on both volume and yield per customer; with yield becoming more important as the market matures.

2.9 Concept Proposal of the Company's Flagship Shop

2.9.1 Structure and Funding

The company is a start-up independent company incorporated in Nanjing, China. The business will be financed solely by three private investors with no additional financing required. The legal identity of the company in China is a wholly foreign-owned company

Private capital funding has the advantage of bypassing the time-consuming paperwork and applications required to obtain financing from banks for an offshore business. Since expansion is an integral part of the whole business proposal, the private

financing will provide flexibility to invest in a marketing campaign and brand building in the first year rather than being driven by profit maximization to pay off borrowed money.

With an investment in the range of 2.14 and 2.89 Million RMB, the company will be capable of initiating the venture. Even with this level of investment, the company will face financial constraints in the first year such as costly rent, expenses related to the new business learning curve, and a limited budget for marketing.

2.9.2 Location

The earlier sections confirmed that the right location is the pivotal key success factor for the company's start-up coffee shop. The product characteristic of coffee as a low cost product with many substitutes means that many of its consumers tend to switch to alternatives if the favourite coffee shop is not easily accessible. One compelling reason why location is critical in this business is that while people love coffee, research indicates they will rarely go more than a block and a half out of their way for it¹⁸.

On one hand, getting a premium location is costly; on the other hand, it is vital to be in a high-traffic commercial zone to reach the target customers (middle class group of business professionals and students). With such a location, the company's coffee shop can attract the maximum amount of customers, catching them on their way to work in the morning, taking a break from where they work during the day, or on their way home, and for a quick stopover when they are shopping.

The concept for the company's coffee shop is a chic, trendy, and upscale sit-down coffee bar promoting a healthy life style and offering fresh food pairings with coffee

¹⁸ Bellissimo Coffee InfoGroup

beverages. The size of the shop is in the range of 200 square meters with seating capacity of 60-80 customers.

The most desirable location would be in the proximity of a large population of target middle-class customers i.e. business professionals and newly graduated students.

2.9.2.1 Site Selection Alternatives

An appropriate site would fall into one of two categories in a high traffic area: a high-migratory location or a captive-audience location.

High-migratory locations feature a high-traffic flow such as shopping malls, transit hubs, sports arenas, theatres, parks, zoos, or other tourist attractions. Even though the customer base is quite different in this category, (i.e. local residents or tourists) the locations are much more visible as large numbers of people pass by these locations daily and consumers tend to stay a shorter length of time. While loyalty might be fragile in most of these locations, the dynamic business flow and volume in this category will greatly benefit the take-out component of the business and comprise a large customer base for the company's coffee shop.

Captive-audience locations include large office buildings, business /industrial parks, hospitals, medical centres, colleges, university campuses, core downtown sites, and densely populated neighbourhoods. Captive-audience locations are more appealing for the company's middle-size coffee shop as the chance of repeat customer is much greater than for the high-migratory sites. It is also more effective to focus on developing a tailored product and service offering with a well-defined solid customer base.

2.9.2.2 Proposed Locations in Nanjing

In order to achieve the goal of capturing the growing market demand, quick market penetration will be critical to build a loyal customer base and maximize profitability. High visibility will help to create future brand recognition. After preliminary research, the budget for an optimal location in the center of the commercial area will be approximately 300,000 RMB (45,592 Canadian dollars) to 600,000 RMB (74,850 Canadian dollars) per year for a 200 square meter retail store.

Xin Jie Kou, the name of the downtown core in Nanjing, is one of the target sites to search for a location for the company's start-up coffee shop. There are four major hotels/office complexes including two five-star hotels (Jinling Hotel and Golden Eagle Hotel) within a 500-meter walking distance, as well as several major shopping malls. The average number of visitors to this downtown area is 400,000 to 500,000 daily. During the holidays, this number increases to above 1 million people¹⁹.

The downside of this premium location is the expensive rent and timing. Most of the vacant locations in this area grant less than one month's grace period for renovations to the site, which would create pressure for a brand-new coffee shop to be ready with all of their supplies in place. It is also rather difficult to secure a location for more than three years. Obtaining the appropriate location in a timely manner is the most important determinant of whether the coffee shop will quickly establish the new brand and make a profit in the first year of operation.

Location is the most critical key successful factor for many coffee shops, especially new entrants. A coffee shop located in a visible area, with convenient access

¹⁹ News, Nanjing Foreign Affairs Office, 02.06.2007

and close to the right demographic target will receive high traffic and this can compensate for other potential weaknesses (e.g. inconsistent service, inventory shortages and ongoing aesthetic improvements) during the start-up stage.

2.9.3 Value proposition

Starbucks' success in non-coffee drinking countries emphasizes that the success of a coffee shop depends on its value proposition. It should be unique and attractive to the mass or target market.

The value proposition of the company consolidates the tangible and intangible benefits that the company provides with the company's production mix to retain and develop customers. The objective is for the company's coffee shop to offer its customers tangible and intangible benefits that will differentiate the coffee shop and its products from its competitors.

The tangible benefits that the company's coffee shop will offer include fresh food, a unique and comfortable decor, and great service. The intangible benefits include a strong sense of community, a sense of contribution to the community, a sense of health and wellness, and a sense of environmental stewardship.

2.9.4 The Name, the Logo and the Corporate Identity

By making a concentrated and sustained marketing effort early in the process, the business will have the necessary start-up exposure. As brand is the key success factor to fast growth, the design of the corporate image is critical before the coffee shop is even opened. The name, logo, and colour theme will create a concise business image. The

name and the logo will have a foreign connotation, will be easy to remember and will fit well with the company's vision and mission – a healthy life style and fresh products.

2.9.5 The Icon of the Shop – An On-site Roaster

To date there are no coffee shops in Nanjing that roast their coffee beans on-site. A stylish roaster will not only proclaim the freshness of the coffee shop's coffee products, but it will also convey a sense of originality. In addition, the shop can also sell its own unique brand of coffee bean products, as well as create custom orders for customers.

2.9.6 Product-mix (food pairing)

A differentiation strategy will be deployed by the company in choosing the product-mix to satisfy students and professionals' tangible and intangible needs. Since the company's new venture is not competing on price but on value, the product selection will be based on the value perceived by local consumers. Customers are willing to pay a premium price if a drink or food item can bring them a unique experience and feeling.

The company's product line will be designed to highlight the how the coffee shop is unique compared to others in the market except for the standardized coffee drinks that are the staples of coffee shops. The ultimate goal is to provide consumers with healthy food they enjoy and to create a sense of community, so that the consumers will identify the company's coffee shop and product offerings as different from others. The company product mix is an opportunity to stand out as a potential market leader.

In terms of the coffee product, since we will have an on-site roaster, freshly brewed coffee drinks will be one of the company's signature products.

Brewed coffee has a high profit margin and it requires less skill from the barista. However, preference for brewed coffee in China is an acquired taste. In order to stimulate trial and to boost sales of freshly brewed coffee, the company's coffee shop must develop and promote complementary pastry combinations on the menu; for instance, a set offer of recommended desserts paired with the appropriate type of coffee drinks.

Freshly squeezed juices are the other major drink products. Combinations of fresh juice products with described nutrients will intrigue the health-conscious Chinese consumer, i.e., Apple and Celery Juice (rich in Vitamin C and fibre). Nutritional supplements could be provided on an a la carte basis (e.g. ginseng, ginkgo extract, etc.).

Cheesecakes with recipes provided by the investors' Canadian coffee shop will be featured as the major dessert in the start-up company. Cheesecakes and other pastries will be freshly cooked in-house.

Hot food items will be included in the menu but not the Chinese food set menu similar to the C. Straits chain. The hot food items will be grilled snacks such as sandwiches or wraps.

2.9.7 Shop Décor

The layout of the company's store and its ambiance are critical elements to create a unique coffee experience. The right ambiance can be one of the best marketing tools. As shown in the market survey, ambiance is one of the most important criteria for customers when they choose which coffee shop to go to.

The ambience of the company's shop will be consistent with the brand and the product offering. Great ambience begins with an efficient layout, which includes a welcoming entrance and a simple but artistic menu that is easy to read and understand.

Ergonomics, or human engineering, is also important when considering the store's layout. Good ergonomic design will allow staff to do things with the fewest steps and less reaching, performing their jobs quickly without colliding with others or creating hazards. Good ergonomics will increase convenience, raise efficiency, and reduce wasted effort. The company will use ergonomics to maximize safety and help prevent accidents, while reducing frustration and fatigue, and increasing staff comfort. The ambience should convey the message of freshness and healthiness through the layout of the shop and the flavours and aromas of the food and beverages.

In Nanjing, many shops' décor appeared to be homogenous or to emulate the interior of Starbucks. This lack of individuality in the décor is inconsistent with the value proposition of these coffee shops. The company's new coffee shop will be decorated with Western elements that reflect a unique, stylish décor and fit with the concept of being healthy and fresh.

The company's coffee shop will be divided two sections for sit-in guests and take-out customers. Typically, coffee shops in Nanjing do not offer take-out service and have entrances crowded with customers patiently waiting in line during peak periods throughout the day. The company's new coffee shop layout must consider the large traffic in a day so that the waiting guests will not interrupt the inside guests, and staff can accommodate the needs of both take-out and sit-in customers.

Adequate ergonomics will differentiate the company's new shop with many others. It is not uncommon in a Chinese coffee shop to have to sit on an uncomfortable chair or have to sit at an awkward counter.

The selection of colour theme in the store will consider Chinese culture sensitivities and convey a feeling of comfort and relaxation. With meticulously selected background music such as jazz or blues, customers can easily spend hours chatting or browsing on-line.

Smokers are prevalent, since smoking is allowed in almost all restaurants and coffee establishments in China. This is a potential problem for customers, and the company's coffee shop will solve it by designing a non-smoking section or by taking the bold step of banning smoking altogether since the smell of tobacco smoke will adulterate the coffee aroma, especially given the on-site roasting. The company's competitors' mixed performance in this area will provide an opportunity for the company to attract customers by creating a unique and consistent ambiance.

2.9.8 Services

The company will differentiate its coffee shop as a "chic, trendy hang-out and meeting place" for business people and students.

The company will have a display of foreign books, magazines and bulletin boards to introduce the coffee culture around the world. A coffee shop website will be set up incorporating with the in-house newsletter in which discount coupons, the marketing of new products and the information-exchange among members will prompt coffee shop as a bridge to connect professionals and students in local community.

The company will provide ample electrical outlets providing free electricity for patrons using or charging their portable music devices or laptop computers. Free wireless Internet access, as both an unsecured and secured (with a client) Wi-Fi connection will be provided.

Card playing will be a service item offered in a limited space such as in a chartered room.

Inside and takeout service will be complemented by catering once the shop and clientele are established. With a strong, secure central location and low labor cost, the company can expand through a telephone ordering service, on-line catering, and a coffee delivery service.

2.9.9 Open Hours and Staffing

Excellent service has two components: professional skills and a genuine attitude to help people. As has been said many times, the people you hire will make or break your operation. Understanding the importance of employees and emphasizing the necessity of a planned, structured, and continuous training process will ensure success. This includes not only the training of barista and serving staff, but the managers who will run the operation as well. The goal is to hire, train, and retain great employees.

At the start-up stage, the coffee shop will be scheduled for daily operation from 10 a.m. to 10 p.m. for a total of 12 hours. Two shift working system will be appropriate with the earlier shift arriving one to two hours in advance for food preparation.

The initial staff complement will be 17 people with roles as follows: 1 general manager/marketing manger, 1 financial manager, 10 waiter/waitress, 3 baristas/roaster master and 2 bakers.

3: INTERNAL ANALYSIS

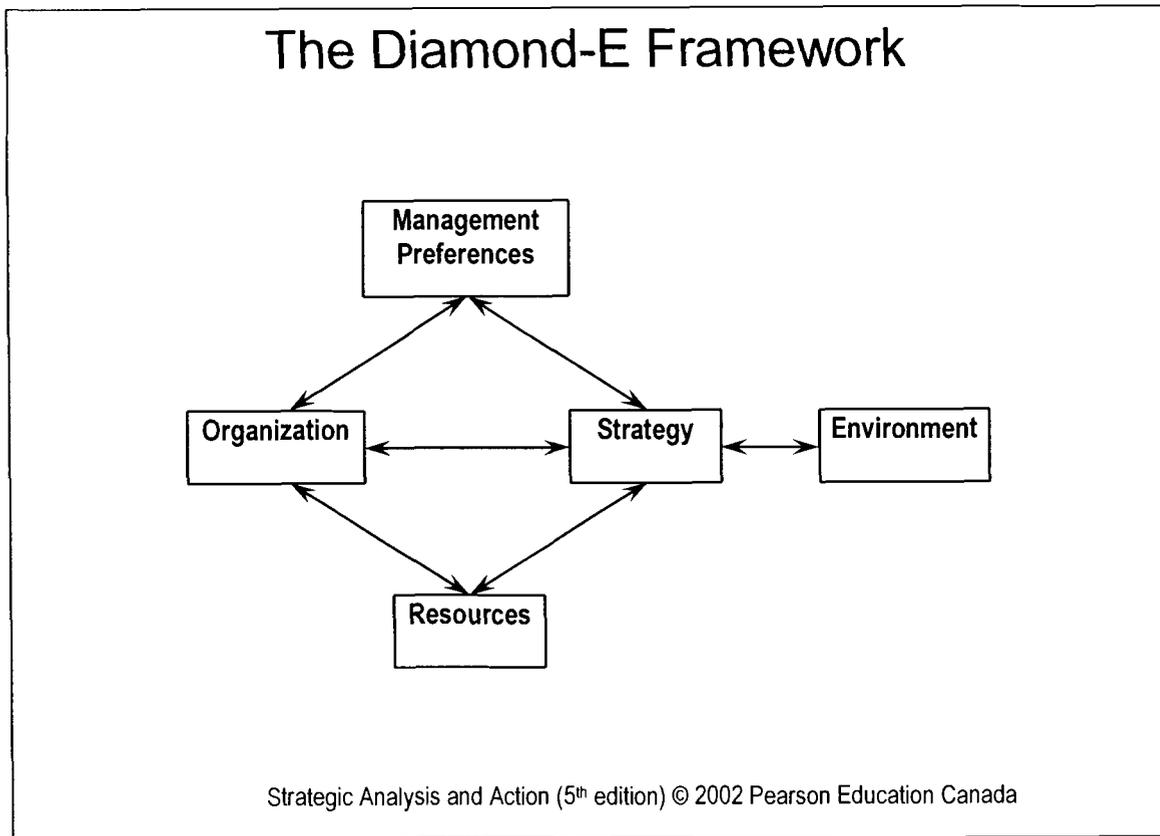
3.1 Diamond E-Framework

Now that the characteristics of the coffee industry in China have been identified and a detailed proposal for the company's flagship coffee shop in Nanjing China has been presented at the end of the last chapter, this chapter will provide an analysis of whether the company's business strategy is achievable given the current and anticipated capabilities. Since the company has not yet been established, this internal assessment is directional in terms of being both a catalyst and a guideline for implementation.

The assessment of the company's internal capabilities is conducted using a strategic model called a Diamond-E framework²⁰. The Diamond-E drill will provide an insight of what the company needs to do given its competitive and market environment (Environment Analysis), what it wants to do given the values and preferences of management (Management Preference Analysis), and finally what it can do given its resources and capabilities (Organization Analysis and Resource Analysis). These key variables relate to the proposed strategy as illustrated in Figure 8 on the following page.

²⁰ Crossan, Fry, Killing; Strategic Analysis and Action. Sixth Edition, P.42

Figure 8 - The Diamond-E Framework



This section will provide a frame of reference for assessing the company's internal capabilities within the context of the preliminary agreement between the three partners to date. As this is a start-up venture, the assessment will be directional in terms of identifying gaps that the company needs to focus on as the partners finalize their business plan.

3.2 Issues Related to the Environment Analysis

A comprehensive environment analysis was completed in the earlier external analysis.

Overall industry attractiveness was demonstrated to be favourable for a start up “boutique” coffee shop with a seemingly huge potential for market development in spite of the growing competition. It is described as “boutique” in the context of providing a level of intimacy and differentiation that allows the consumer to see clearly how the company stands apart from the competition. The company’s competitive advantage is closely correlated with the degree to which it can capitalize on the key success factors identified as location, Chinese business practices such as “Guan Xi”, unique coffee experience, food offering, décor and aesthetics, branding, and financing. Implicit in the success of the venture will be a focused approach to market segmentation and development, and differentiation of the product offerings to allow the brand to be positioned as a unique and distinctive from established competitors.

Critical issues yet to be resolved in the context of the environmental analysis include the following:

- Choice of location – *the* critical success factor. Location needs to be finalized and will be the primary determinant of early success in terms of attracting customers.
- Leasehold relationship needs to be negotiated and optimistically on a long-term basis with an option to renew. A fixed cost relationship is preferable to one involving a fixed and variable cost structure.
- Regulatory approval – the business of setting up a foreign venture in Nanjing needs to be better understood.
- Supplier relationships – accessing quality baked products, through either a contracted relationship or direct employment is a critical success factor. Sourcing coffee from a reputable supplier also needs to be confirmed.
- Aesthetics, theme, style and décor needs to be confirmed.

Outstanding issues will need to be resolved within the first year and certainly prior to leasehold negotiations being concluded.

Next step of the Diamond-E model is to see if management preferences are consistent with the strategic proposal.

3.3 Management Preference Analysis

3.3.1 Company's Short-term and Long-term Business Objectives

The short-term business objective in the first year will focus on penetrating the market in Nanjing and achieving brand awareness. The ROI is targeted at a minimum of 20 per cent after the first year in operation (actual pro forma projects 34% ROI after year one). The 5-year business objective is to gain substantial market share through a unique product offering and to become one of the major market players. By that time, the company should have opened at least 10 outlets in Nanjing and begun the expansion to selected cities in inland and in the Yangtze Triangle Area.

For the start-up company, the focus in the first year will be balancing between marketing and promotion to build up the brand identity while confirming the relevant product mix that will allow the company to achieve its revenue and yield objectives.

3.3.2 The Investors and Management Responsibilities

There are three Canadian investors for this foreign investment project. These three investors agree to contribute the start-up funding in a range of \$325,000 Canadian dollars. They will also be actively involved in supervising the management at least in the first year of the operation of this new coffee shop.

Two of the investors have been in the coffee industry in Canada since 1992 and currently own two coffee shop outlets in Vancouver, Canada. The quality of their gourmet coffee and cheesecakes are widely recognized by the local community. The intention is to retain and extend this model with its existing product mix and quality for the coffee shop in China. The investors are committed to train the baker and barista in China in order to maintain the high standards of the product offering. These two investors will not deal with the daily management issues with the Nanjing outlet since they will remain in Canada but they did agree to travel to China on a bi-monthly basis in the first year to support the critical training program on the premises. The general manager who is a Chinese native will be the translator during these programs so that she will get the necessary coffee shop skill training at the same time.

The training program includes coffee roaster training done by one of the investors himself who is a certified roast master. They will also arrange for the baker from the Canadian coffee shop to travel to Nanjing and train the staff to operate the baking program. A staff training manual from the Canadian coffee shop will be translated into Chinese to form the basis for the staff training program for the Nanjing operation. They will also be involved in the shop design and the sourcing of raw material and equipment suppliers. The role of these two investors is pivotal for the new coffee shop to guarantee the offering of authentic Western drinks and pastries, as well as the presence of a Western style shop decor.

The third investor will move back to China and be directly involved in supervising the daily operations and act as the general manager as well as marketing manager for the first year. This individual grew up in the Nanjing area and has a ten-year

history of business networking relationships in the city. As a successful entrepreneur in another unrelated industry, her management experience and understanding of Chinese business practices will provide an important competitive advantage for this foreign venture. Her lack of coffee expertise will be compensated for by on-site training in the coffee shop in Vancouver as well as by taking a training program offered by a professional coffee consultant. As well as being an equity investor, this individual will be compensated separately with a monthly management fee (based upon a percentage of sales) as the general manager.

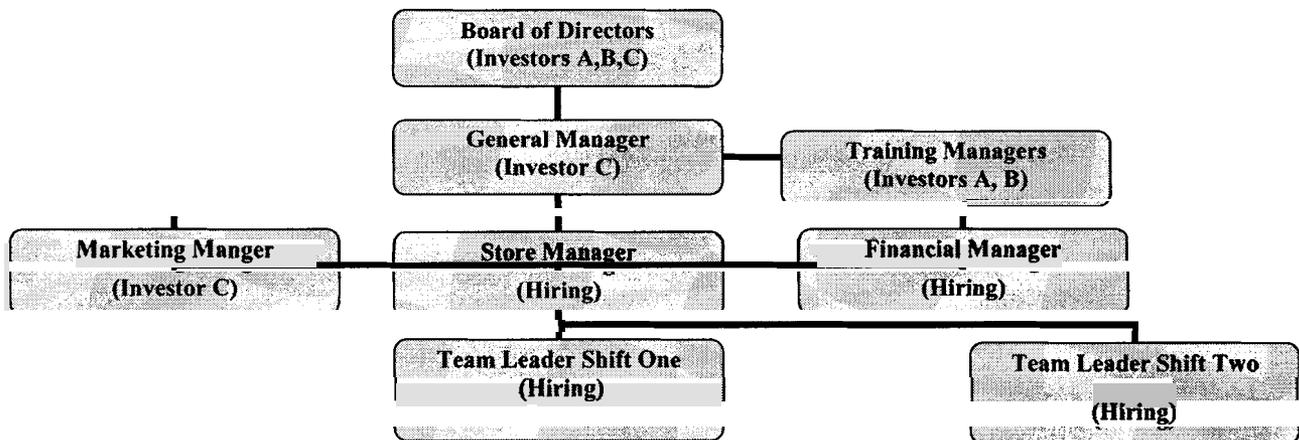
3.4 Organization Analysis

3.4.1 Structure and Staff Complement

There are three forms of legal structures that the company could use: sole proprietorship, partnership, and limited company. Comparing the pros and cons of these structures, incorporation as a limited company is the preferred entity mainly due to the limited liability of shareholders and the long-term financing that is available from the lending institutions for this form of business.

The total staff complement will be 17 persons given the proposed size of the shop, the opening hours and the funding budget. The management team for the Nanjing operation in the first year operation will consist of a general manager, a marketing manager, a store manager and a financial manager. Please find the organizational structure illustrated in Figure 9.

Figure 9 - Organization Structure Year One



The roles and responsibilities of key staff are as follows:

The Board of Directors will be responsible for outlining the strategic direction of the company and approval of funding and budget. They will also receive sales reports and ongoing marketing activity updates on a regular basis.

The general manager will ensure that the operational and marketing decisions are aligned with the strategic objectives. The general manager will be in charge of recruiting for the start-up operation and for all ongoing operational decisions.

All marketing activities will be the responsibility of the marketing manager and will employ channels of distribution and messaging appropriate to the Chinese culture and the desired target markets. A highly skilled marketing manager is extremely important at the start-up stage to build brand recognition with the limited marketing budget. The marketing manager will also be responsible for the contract and relationship with the advertising agency of record, and for development of annual campaigns with specific accountable objectives.

The management preference is to have a marketing manager who has strong communication skills and local connections to forge alliances with other channels such as bookstores, local radio stations, and trendy magazines to promote the coffee shop. Existing experience, an extensive business network, and agency experience would be desired qualifications for the position.

As mentioned in the earlier section, both the role of the general manager and the role of the marketing manager will be undertaken by one investor.

The store manager is critical for guaranteeing a consistent commitment toward quality of product and service. The store manager will be responsible for achieving the sales objectives as defined by the general manager. Supervision of staff and cost control will be key obligations. In addition, the shop manager will negotiate with suppliers, outline the job description of shop employees, and supervise the daily operation of the outlet.

The financial manager is essential part of the management team to monitor working capital and cash flow and to assist with forecasting. The financial manager will also ensure that regulatory and tax obligations are satisfied.

3.4.2 Commitment to Service and Quality Control

The service level of competitors appears to satisfy customers, but only a basic level is provided. Competitors do not provide a warm greeting and the extra attention that the customers deserve. Many of the staff working for competitors lack professional skills such as product knowledge of different coffee drinks or what appropriate food pairings might be. This means that service standards and quality control is another area

where the company's coffee shop can execute a differentiation strategy to stand out in the marketplace. Knowledgeable service staff will increase the product's value and demonstrate to customers that the company's coffee shop is up-to-date and contemporary.

A variety of services targeted at the focus groups are designed in the shop proposal. However, they must be tested by the market and consumers, through which the optimal alternatives will be retained and less-satisfying service items will be adjusted.

There are a few questions which can only be clarified when the shop is open. For example, what kind of the webpage content will be appealing to professionals and students? What kinds of promotions are perceived as chic and trendy? What kind of on-site activities will create a strong sense of community? Developing a relationship with an appropriate promotional agency prior to start-up will be an important tactic to allow us to build momentum once we become operational.

Providing customers with an opportunity for feedback and responding in a timely professional manner is also an important tactic to develop customer loyalty and to fine-tune product offerings.

3.5 Resource Analysis

3.5.1 Human Resources

Getting the right location is of sufficient importance that it should not be delayed. Given that none of the investors are skilled or available to scout a location and engage in lease negotiations, the company will need to hire a local lease agent for the commercial lease to negotiate favourable terms for the investors. The local leasing agent is an

additional person that is not a member of the management team or recruited as a permanent employee during the start-up stage but is nonetheless an important resource.

Even though one of the strengths of this venture's management team is that one of the investors is from Nanjing and can provide some objective perspective in terms of the area and location, a leasing agent will be indispensable for finding an appropriate location quickly.

If the company achieves its business objectives as scheduled, it will give the new venture the opportunity to expand aggressively within the first five years. The company will have to consider hiring their own employee to constantly search for optimal locations and to provide management with a cost/benefit analysis of the locations proposed.

The flagship shop will require a winning team with a great attitude and professional skills to establish customer loyalty. The shop manager will be high on the priority list of the people to hire and he or she will assist the general manager to recruit the shop employees. The management team will work out a systematic and standardized hiring process with clearly defined evaluation criteria.

The most popular recruiting channel for hiring in the food industry in Nanjing is through the Nanjing Labor Market or by newspaper advertisement. The Nanjing Labor Market holds a weekly job fair for all levels of positions. The budget for renting a booth is below 3,290 RMB (\$500 Canadian dollars) per occasion. The *Yangzi Evening Newspaper* is one of the most popular daily newspapers with a nationwide circulation of over 2.1 million copies. The recruitment column is a weekly update published each Wednesday. A quarter-page ad costs in the range of 1,800 – 2,340 RMB (\$273-355 Canadian).

Even though a large labour pool is an advantage for the company's coffee shop, selecting the right employees in terms of skill-set and compatibility will be a demanding task. This will be a challenging task, and will require that the employee team be fully educated with knowledge of western coffee drinks and pastries and the communication skills to deliver what the customers want.

A training program will be designed by two investors who have more than 10 years experience in this industry. Getting the staff complement in place in time for training at least 3-4 weeks in advance of opening will be essential.

3.5.2 Operational Resources

Negotiating a reasonable lease rate and confirming contractual relationships with key suppliers are critical issues. Sourcing a regular supplier of coffee, food products, supplies and equipment will be primary obligations of the general manager on the ground in China, and will have to be secured in advance of opening.

The abundant availability of the supply resource will support the company's new venture in getting satisfactory store supplies in a reasonable timeline and price range. Chinese Coffee Business Net (www.21coffee.net) and International Coffee Business Net (www.coffeetob.com) are the major distribution channels to connect the buyers and suppliers of coffee industry in China. Chambers of Commerce, the China/Canada Business Council office in Nanjing and Shanghai, and industry associations are other international resources that can provide relevant contacts.

The partners stationed in Canada will provide substantial counsel and perspective on specific candidates, especially in terms of the supplies of coffee beans and equipment,

but finding the sources of supply that can guarantee ongoing support and quality control will require time and networking, considering this is a new business and the lack of coffee experience of the general manager.

After securing the location, designing the store, business logo, menu, and staff uniform in alignment with the business identity, the location layout with a genuine touch of Western-ness is another key area.

The design of the store with authenticity of a western theme is a challenging job considering all the design and construction will be executed by local companies. A Canadian design company is not in consideration, due to the expensive cost and the language barriers to convey the design prints to the local construction company in China.

Three different teams will be subcontracted to build the store – a marketing company, a store design company and a construction company. The general manager will utilize her network to find a qualified marketing company with whom she will work closely to outline the corporate identity for the overall coffee shop.

Another initial task is to register the business name and logo trademark both for Nanjing and for the country. It takes about 2-3 weeks before the Industrial and Commercial Bureau will approve the business name. The business logo will take a different procedure through the Jiangsu Patent Bureau, which is not considered an obstacle by the coffee shop owners. This will allow the company to start carrying on business and build brand equity, and provide a basis for future expansion. The shop manager will undertake this procedural work.

3.5.3 Financial Resources

To compete in this low barrier market, a reasonable level of funding will be required to differentiate the company's coffee shop from the competition. The amount of funding allotted to the venture will also affect the timing of the market entry. Sufficient funding will facilitate obtaining the right location, the proper size of the shop, and the ability to create an appealing interior design. Access to sufficient financial resources will accelerate the company expansion and enable it to carry out the extensive marketing campaign that will be required both prior to start-up and later in the expansion stage.

With regard to financial resources required for the venture, the company will require a considerable budget for obtaining a suitable location. Based on the cost analysis, an annual rent budget of 600,000 RMB (\$74,850 Canadian) is considered adequate. This amount will ensure that the company can secure a premium location in Nanjing. The investors have access to sufficient funding to enter into such a lease agreement, and this lease will result in any negative financial consequences for the individual investors.

As the old saying goes, "good people do not come cheap." The company has set aside a budget sufficient to cover the anticipated expenditures related to the staffing. This includes the salaries for the higher end personnel that are required at the beginning of the operation.

4: FINANCIAL PERFORMANCE ANALYSIS

Even though the market potential is enormous, heated competition will further erode profit potential. The new investor must undertake a meticulous and thorough 5-year financial plan to ensure that the necessary capital is in place and that cash flow requirements can be satisfied during the critical first few years. A healthy and liquid working capital budgeting is the guarantee of operating the outlets.

The funds from investors are being treated as a note payable by the company at a rate of interest of 8 percent per year, compounded semi-annually (see Table 5). Retained earnings will be used to finance expansion of the chain after five years. There will likely be an option for the (on site) operating partner to buy out the other partners after five years, although this is still being negotiated. The operating partner will oversee management of the location and will receive a management fee accordingly. The management fee would be a variable cost (see Table 6).

Table 5 - Initial Investment Payable Schedule

Year	Total Payments	Principal Paid	Interest Paid	Ending Principal Balance
				2,060,000
2008	499,693.92	350,021.82	149,672.10	1,709,978.18
2009	499,693.92	378,583.59	121,110.33	1,331,394.59
2010	499,693.92	409,476.01	90,217.91	921,918.58
2011	499,693.92	442,889.27	56,804.65	479,029.31
2012	499,694.22	479,029.31	20,664.91	0
Loan amount 2,060,000.00				
Amortization period 5 years				
Loan will be paid off after 5 years				
Interest rate 8.000%				
Mortgage payment 41,641.16 monthly				
Total payments 2,498,469.90				
Total interest 438,469.90				

4.1 Financial Performance Projection

A 5-year projected pro forma of income and expenses for the company, balance sheet, and break-even analysis are calculated based on above analysis and the following assumptions behind this scenario. The projections are based on a conservative calculation of discounted sales revenue and a high expense budget. The purpose is to provide an attainable and realistic projection for the investors regarding the viability of this new venture.

4.1.1 Pro Forma Income and Expenses

The income scenario is based upon the following assumptions:

- The exchange rate of 1 Canadian Dollar = 6.58 Chinese RMB as of June 2007 was used for the financial performance analysis.

- A 200 square meter café, with a seating capacity for 60-80 persons. This report is based on the operation of a 60 seat café operating 12 hours per day, 365 days a year.
- The minimum customer turnover at Starbucks is at least 8 – 12 for the large take-out business. C. Straits can reach about 5-8 turnovers a day. On a realistic basis, the company's operation is assumed as 4 turnovers per day on average – a total of 240 customers consuming food and beverages on the premises. Take-out customers are a function of the total number of in-store customers, with the assumption that they represent repeat visitors who are developing loyalty for the establishment.
- The average cheque per order is 30 RMB (all currency is stated in Chinese RMB or ¥) which represents a cup of coffee (18 RMB) and a small snack (12 RMB). According to the Dazhong consumer's website, the average spending in most Coffee shops is between 35 – 80 RMB.
- Raw material (cost of goods sold), employee costs, utilities, marketing and management fees are all variable costs. These were estimated base on the cost analysis for the franchises of YiNong Cafe.
- The operation is financed by a note payable to all shareholders. Principal and interest repayment is on an annual basis. The operating partner on site receives a management fee rather than a fixed salary.

- The customer base is assumed to grow at a rate of 10 percent per year over the five-year period. This is lower than the actual industrial growth rate of 20 percent.

Compared to an equivalent operation in North America, the cost of goods sold and labour is relatively low. Labour cost is the huge advantage for the company's new venture and allows them to provide various services within a limited budget. This allows the operation to generate a positive return on investment within the first year.

4.1.2 Breakeven Analysis

As shown below in Figure 10. Based on assumptions about revenue and expenses, the level of business required to breakeven is 170 customers per day (both in-house and take-out). This is 39 percent less than the customer volume anticipated but still represents a formidable amount of daily traffic. This underscores the need for the cafe to be in a high-traffic location, offering high quality, uniquely positioned products that will encourage a strong loyalty base. This also suggests that after one year in successful operation, the company will be in a good financial position to open a second shop in year 2, which is significantly ahead of the targeted year 5. The market potential for the venture is very encouraging.

Figure 11 also indicates A 5 RMB fluctuation in an average cheque will have a profound effect on the breakeven analysis. All other factors being constant, a 5 RMB decrease yields a breakeven of 204 customers, while a 5 RMB increase yields a breakeven of 146 customers. Yield management will be an important consideration in making this venture profitable.

Figure 10 - Break Even Analysis

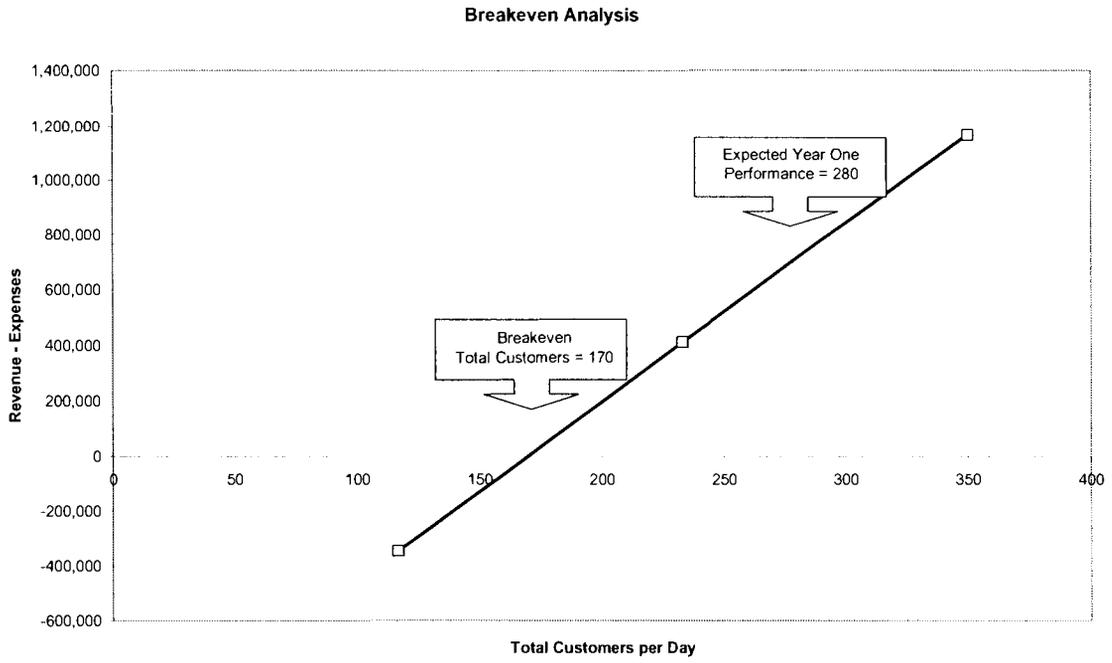
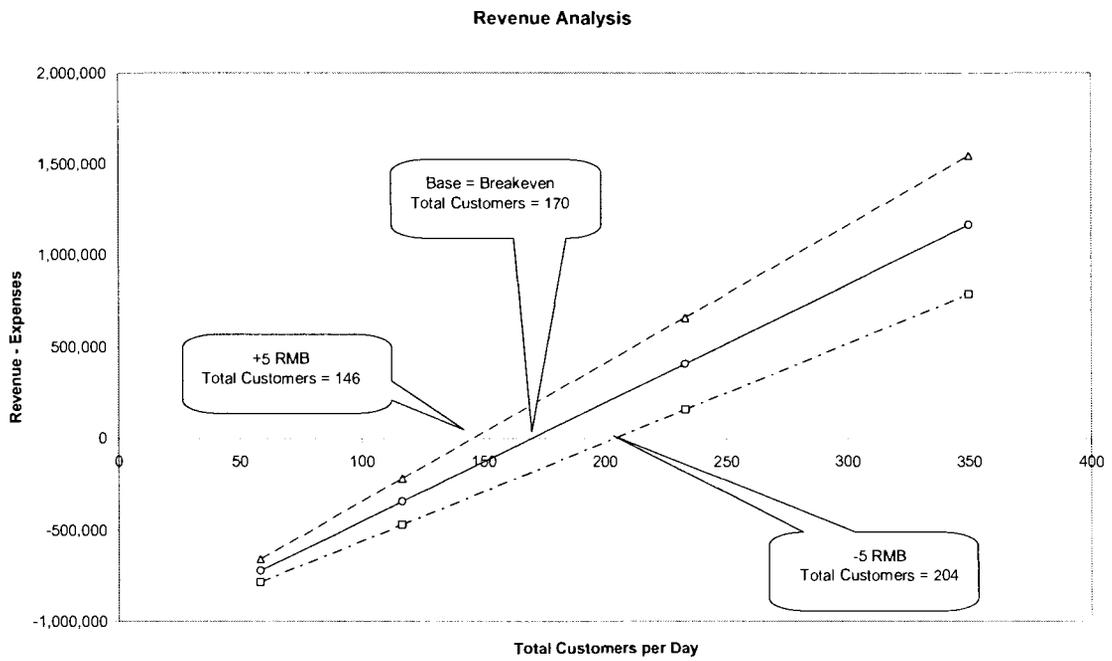


Figure 11 - Revenue Analysis



4.1.3 Projected Income Statement

As indicated in the following income statement (see Table 6), the company's coffee shop is expected to have a steady growth in profitability over the first 5-years in operation.

Table 6 - Projected Income Statement

Pro Forma Income Statement

		2008	2009	2010	2011	2012
Revenue						
Sales - In-house		¥ 2,629,800	¥ 2,892,780	¥ 3,182,058	¥ 3,500,264	¥ 3,850,290
Sales - Take-out		438,300	482,130	530,343	583,377	641,715
Total Revenue		¥ 3,068,100	¥ 3,374,910	¥ 3,712,401	¥ 4,083,641	¥ 4,492,005
Expenses						
Rent		¥ 600,000	¥ 600,000	¥ 660,000	¥ 679,800	¥ 700,194
Raw Material	16%	504,000	554,400	609,840	670,824	737,906
Staff	7%	229,200	252,120	277,332	305,065	335,572
Utilities	4%	120,000	132,000	145,200	159,720	175,692
Marketing	5%	153,405	168,746	185,620	204,182	224,600
Total Expenses		¥ 1,606,605	¥ 1,707,266	¥ 1,877,992	¥ 2,019,591	¥ 2,173,964
EBIT		¥ 1,461,495	¥ 1,667,645	¥ 1,834,409	¥ 2,064,050	¥ 2,318,041
Mgmt fee	5%	¥ 153,405	¥ 168,746	¥ 185,620	¥ 204,182	¥ 224,600
Taxes	3%	96,000	105,600	108,768	112,031	115,392
Interest		149,672	121,110	121,110	121,110	121,110
Principle		350,022	378,584	409,476	442,889	479,029
Net Profit (¥)		¥ 712,396	¥ 893,605	¥ 1,009,435	¥ 1,183,838	¥ 1,377,910
Cummulative Earnings ¥		¥ 712,396	¥ 1,606,001	¥ 2,615,436	¥ 3,799,274	¥ 5,177,183
Net Profit (\$CDA)		\$108,267	\$135,806	\$153,410	\$179,915	\$209,409
Cummulative Earnings (\$CDA)		\$108,267	\$244,073	\$397,483	\$577,397	\$786,806

4.1.4 Balance Sheet Analysis

A review of the balance sheet after five years of operation, compared to the opening balance sheet at the start of operations, shows a much-improved position and a significant increase in retained earnings. The note payable has been paid down through earnings over five years and there is a significant amount of cash on hand. This should provide the partners with the resources to finance plans for expansion with internal

capital. Although there are capital improvements required at the existing establishment, they would be fairly nominal compared to the cash on hand, and should not impede the intended strategy to expand the coffee shop chain after five years. Figure 12 shows the year one and year five balance sheets.

Figure 12 - Balance Sheet Year One and Year Five

THE COMPANY'S START-UP COFFEE SHOP

Opening - Beginning of Year One

Current Assets		Current Liability	
Cash in bank	24,000	Notes, short-term (due within 12 m)	499,694
Inventory (3 months)	126,000		
Prepaid expenses	100,000	Long Term Liability	
Application	10,000	Notes payable to stockholders	2,060,000
		LESS: Short-term portion	-499,694
Fixed Assets		Owners Equity	0
Shop Décor	650,000		
Equipment	650,000	Retained Earnings	
Lease	<u>500,000</u>		
Total Assets	<u><u>2,060,000</u></u>	Total Liabilities and Equity	<u><u>2,060,000</u></u>

Closing - End of Year Five

Current Assets		Current Liability	
Cash in bank	4,335,877	Notes, short-term (due within 12 m)	499,694
Inventory (3 months)	126,000		
Prepaid expenses	0	Long Term Liability	
Application	0	Notes payable to stockholders	499,694
		LESS: Short-term portion	-499,694
Fixed Assets		Owners Equity	0
Shop Décor	650,000		
Less: Depreciation	-260,000	Retained Earnings	<u>5,177,183</u>
Equipment	650,000		
LESS: Depreciation	-325,000		
Lease	<u>500,000</u>		
Total Assets	<u><u>5,676,877</u></u>	Total Liabilities and Equity	<u><u>5,676,877</u></u>

4.2 Exit Alternatives for Investors

There are three exit alternatives for the investors to consider:

1. Dividend payout to all partners, based on a proportional split of the retained earnings after all other capital obligations (such as reinvestment in equipment and décor) has been satisfied.

The advantage of this option is that the investors bear minimum risk and will get the portion of the investment back annually with an 8 percent interest rate and a possible additional dividend.

2. Reinvest the retained earnings with the existing partners to expand the shops and build the chain.

The advantage of this option is that the company will have much more financial flexibility to expand.

3. Buy-out agreement with the operating partner after 5 years, and further development of the chain as a sole proprietorship.

The advantage of this option is that the investors can remove their investment and invest in other business opportunities.

5: RECOMMENDATIONS AND CONCLUSIONS

The proposed business strategy is illustrated in Figure 13. It provides a frame of reference for summarizing the assessment of the external variables influencing the industry and the market, and our own internal capabilities relating to our ability to secure and build on an opportunity relative to the competition. On the basis of this strategy, we believe that a coffee shop can successfully penetrate the market in Nanjing, and ultimately develop enough critical capacity to allow for expansion both within Nanjing and in other areas of China.

Figure 13 - Coffee Shop Business Strategy



5.1 Internal Capabilities

During the internal analysis, the author identified several business issues related to the start-up stage such as getting the right location, organization structure, staff recruitment, shop design and last, but not least, financing. There is tremendous work required both before and during the opening of the shop. A systematic stepwise action would be an important tool to develop so that the shop can be opened according to the plan. Location and menu design are particularly important – the former because it will be a determinant of the ease of access by which potential consumers can visit our shop, and the latter because it represents that unique combination of products and the positioning that will allow us to differentiate our store from the competition.

5.1.1 Location

The survival or success of a new coffee shop through the first year is largely determined by its location. Even with the large dense population base in cities such as Nanjing, detailed site-specific research is important to better understand factors such as traffic flow, commuting patterns, and possible impediments to visitation such as poor aesthetics, construction, noise levels, etc.

A comprehensive survey is compulsory for the company to evaluate the available options. A site scorecard is recommended to include the following criteria:

- Meeting demographic requirement minimums (household income, population)
- Visibility of the site
- Site market position (residential area, shopping mall, school, hospital)
- Traffic count (morning and daily)
- Other coffee shops within visual distance
- Other coffee shop enhancement factors (theatre, park, subway, bus stop)

5.1.2 Menu Design

The menu is one of the most important aspects that affects the impressions of new customers. The menu should be designed and planned to highlight healthy and fresh products that will appeal to the trendy, affluent clientele (business professionals and students) that the shop hopes to attract as customers. The local consumers' preference for westernized products should be catered to and expanded. The shop will retain customers by satisfying their curiosity to experience new tastes and provide new menu items so that customers can discover their individual favourites.

No matter how extensive the menu is, the business will first and foremost be a coffee operation - i.e. the primary product is coffee. The shop will be known as THE coffee operation in the area, the one that serves on-site freshly roasted coffee with both house and custom blends. To achieve this, staff and management of the shop will fully understand the nuances of the product and its pairing with food products suitable to the palate of Chinese consumers.

5.2 Action Plan before the Grand Opening

There are a number of tasks that need to be undertaken at least six months before the scheduled opening date:

Six months before: The primary tasks will be the further meetings internally among the investors to settle the partnership agreement. The investors will also review the business plan and identify job responsibilities from each one of them. The investors will start to design a detailed training program including translation, scheduling and

timelines. The option of filming the operation process in Vancouver store will also be considered.

Five months before: The investors should plan a trip to China to incorporate the company; hire the land negotiation agent, check the location alternatives, and meet with the candidates for the shop design and creation of the visual identity. Supplier relationships need to be sourced and expressions of interest made in terms of supplying product on an ongoing basis. Finding the right location and negotiating a long-term lease agreement are the major tasks at this juncture.

Four months before: The investors will hire the shop manager and financial manager. The financial manager will set up the company's financial records and arrange the funding transfer from Canada. The shop manager will be the contact person for all the suppliers.

Three months before: Upon the condition that the shop location is secured, the investors will hire the design company and construction company. Meanwhile the shop manager will assist the general managers to prepare the supply checklist – food products, equipment, and coffee beans. Supplier contracts will be finalized and confirmed.

Two months before: Start the hiring of the staff, schedule training sessions, supervise the work schedule for site renovation and construction.

One month before: Delivery of initial orders of equipment and other supplies, test all the equipment, especially the on-site roaster.

Half a month before: Plan the grand opening as a low-key but targeted marketing activity – the invitation list will include local dignitaries, media, and guests from the businesses and institutions in the surrounding area that match our target market.

5.3 Some Thoughts after the Grand Opening

Most coffee shops in Nanjing open after 10 a.m. Since coffee is not considered part of the typical Chinese breakfast, it is not popular for customers to visit coffee shops early in the morning. The company's coffee shop initially will also plan its opening hours after 10:00 a.m. in accordance with accepted practice.

However, after opening for half a year and having established a certain reputation, the company may consider opening the store as early as 7:30 a.m. to 8:00 a.m. to take advantage of the fact that there is less competition, and to target time-pressured business people who would normally go to other coffee shops later in the day. In order to deal with the challenge of changing the local consumer's buying behaviour, the breakfast menu will be creatively tailored to business professionals and students. The food offering will be fast, tasty, hot, and healthy. As an example, breakfast combo boxes featuring selections including grilled sandwiches, yogurt, fresh fruit, and trail mix will give the local Chinese a healthy boost in the morning. This tactic is considered both as an extension of our differentiation strategy as well as an attempt to expand the customer base.

5.4 Conclusion

The focus of this business plan covers the major strategic planning issues as a first step to open a new coffee shop in a foreign country. The flagship operation is a critical precursor to the longer-term goal of developing a chain of coffee shops in China.

The next step will be a meticulous and prioritized implementation plan addressing in detail the tasks, the major stakeholders, the performance measures, and level of alignment with our strategy. Execution must flow from strategy, and in turn, the lessons learned from execution will allow us to adjust our strategy as necessary. Only a close interrelationship between the formulation of our strategy and its execution will lead to the successful operation of this start-up coffee shop.

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