

**ESTABLISHING A COFFEE SHOP CHAIN IN CHINA**

**by**

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## **Abstract**

This essay presents a business plan for establishing a coffee shop chain in China.

Currently, most of the coffee houses in China follow a differentiation strategy.

This is to turn the regular fresh coffee experience into a high-priced luxurious experience.

However, after almost twenty years of customer cultivation, the coffee consumption market in China is getting much more established, and customers want to drink coffee regularly. There is a big market demand for fresh coffee to consume as daily drinks with reasonable prices. This proposal is devoted to developing a coffee shop chain using a low cost strategy to offer affordable fresh coffee to consumers on a daily basis.

The author assesses the competitive environment in the coffee house industry in China, identifies key success factors for the industry participants, and evaluates the viability of this new venture by analyzing the consistency of the strategy proposal and the company's internal capabilities.

The author concludes that this new venture can penetrate the market. The analysis also includes a five-year financial projection and profitability analysis. Assuming the company's revenue growth rate is 20 percent per year, five years later, its annual net profit will be up to 350,316 RMB (CA\$58,000).

**Keywords:** Coffee Shop Chain, China, Low Cost Strategy, Business Plan

## **Dedication**

I dedicate this thesis to my parents and my thesis supervisor, Professor Neil Abramson. Without their patience, understanding, encouragement and support, the completion of this work would not be possible.

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# 1: INTRODUCTION

This report is a business plan for establishing a coffee shop chain in Shanghai, China. Currently, most coffee houses in China follow a differentiation strategy, which means they spend an abundance on store décor while creating a unique environment to build additional value for high-end customers. This strategy turns a typical coffee shop experience into a luxurious one because of its price. However, after almost twenty years of market development, the coffee consumption market in China is getting much more established and many customers want to drink coffee regularly. There is a big market demand for fresh coffee to be a daily drink with reasonable prices. This proposal is devoted to developing a coffee shop chain utilizing a low cost strategy to offer affordable fresh coffee to people everyday. It will also evaluate the viability of this new venture and analyze how the business will be created and strategically developed. Due to start-up funding constraints, this report will focus on the short-term strategies for successfully establishing a flagship store with the consideration of expanding an additional ten shops within five years. The investment will come from three project co-founders, some domestic angel investors<sup>1</sup>, and other financial lending institutions in China.

## 1.1 An Overview of The Coffee Industry in China

The Chinese coffee market started in the 1990s. At that time, there were only 3-in-1 instant mixes (coffee, milk powder, and sugar) in the coffee consumption market. In

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<sup>1</sup> angel investor: affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity

the late 1990s, a small number of cafés were established in grand hotels. After 2000, with improvement of market acceptability, China's coffee industry went through a rapid expansion period. This section will outline China's coffee industry development and current market segment, as well as the coffee consumption status. The target city, Shanghai, will also be introduced.

### **1.1.1 The Booming Chinese Coffee Market**

After entering the 21st century with the economic boom in China, the quality of people's lives has continuously increased and their daily beverages have become much more diverse. Coffee, combining vogue and Western lifestyle, is gaining popularity in China's young generation, and presents an enormous potential in the coffee consumption market. From 1999 to 2005, coffee consumption in China tripled, with an 18.2 percent annual increase, well above the 2 percent growth in the world (He, 2008). Additionally, China has seen double-digit growth in coffee sales within the past couple of years. In 2006, sales hit \$2.4 billion and are predicted to climb to \$3.6 billion by 2011 according to market research firm, Euromonitor International. International Coffee Organization (ICO) also believes that China has 200 to 250 million potential customers that will play a crucial role in the global coffee consumption market (Chen, 2008).

### **1.1.2 Current Market Segments of Coffee Consumption**

Currently, there are three large customer groups for coffee in China, including local urban citizens, returnees, and foreigners (Lee, 2004).

### **1.1.2.1 Local Urban Citizens**

Coffee appeals to the main consumer group in China including the young, fashionable, open-minded and well-educated local urban citizens. Although they grew up in China, they are relatively more exposed to Western influences and tend to look up to Western lifestyles. They see the consumption of coffee as a trend rather than a daily drink.

### **1.1.2.2 Returnees**

Over the last five years, there are up to 320,000 returnees<sup>2</sup> in China, and a large proportion of returnees are also coffee consumers. Specifically, one quarter of them settle down in Shanghai (Lu, 2009). A majority of those returnees have lived in Western countries for many years and have adopted the coffee culture, visiting cafés and drinking coffee has already become part of their daily lives. Thus, upon their return to China, it is very likely that this lifestyle will continue.

### **1.1.2.3 Foreigners**

China's high growth economy and improved investment environment has attracted substantial foreigners to go abroad for education, work, and site-seeing. Shanghai's official statistics illustrates that in 2008, the number of foreign permanent residents living in Shanghai is 152,104 (excluding some 400,000 Taiwanese) and this figure is expected to increase each year (Shanghai Statistics Yearbook 2008, 2009).

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<sup>2</sup> returnees : mainland Chinese students returning from Western countries

### **1.1.3 Current Status of Coffee Consumption**

There are currently two kinds of strategies that exist in China's coffee consumption market. One is the differentiation strategy and the other is the low cost strategy. Fresh coffee is only available from expensive coffee houses that utilize the differentiation approach, because the low cost strategy focuses on using instant coffee, one that does not comprise much quality. In this tea-drinking country, individuals are strongly attracted by coffee in terms of its image and quality. Therefore, there is a relatively unoccupied competitive niche for coffee shops using low cost strategy with drip coffee.

#### **1.1.3.1 High Retail Prices in Coffee Houses**

In China, coffee houses with expensive prices and luxurious environment bear little resemblance to the traditional coffee houses in Western countries. For example, in China, Starbucks offers coffee at 25 to 35 RMB per cup, and some local coffee houses offer coffee from 35 to 55 RMB per cup. However, in Canada, most cafes offer fresh coffee at 1.5 to 4 Canadian dollars per cup, which roughly equal 9 to 24 RMB per cup.<sup>3</sup> Due to the expensive prices in China, consuming coffee is regarded as a luxurious experience for the middle class and students, one that cannot occur on a daily basis.

#### **1.1.3.2 Domination of Instant Coffee**

Instant coffee is widely viewed as an "afternoon-workplace-keep-everybody-awake" drink. In terms of market composition, instant coffee dominates the Chinese coffee market. Although the drink comes with poor quality and cannot meet people's

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<sup>3</sup> Currency in 2009: 1 Canadian dollar equals 6 RMB

increasing requirement for the taste of coffee, it is still popular among white-collar workers due to its inexpensive price, convenient preparation, and easy availability.

#### **1.1.3.3 Limited Access to High Quality Coffee**

Instant coffee is almost the only choice available for the majority of customers since many food chains and local stores only carry instant and canned coffee drinks. In China's coffee market, although most coffee houses employ a differentiation strategy, only some of them with high reputations can really offer high quality coffee to customers. Several local coffee houses will spend huge sums of money in advertisement and luxurious items to label themselves as offering high-quality coffee and food, which in fact, is of poor quality with unreasonable prices, deceiving their customers. Therefore, in China's coffee market, high quality coffee is limited and can be found only in selected coffee stores, expensive foodservice establishments, and hotels.

#### **1.1.3.4 Advantages of Coffee in the Land of Tea and Soft Drinks**

Coffee is supposed to be intrinsically competitive compared to tea and soft drinks in terms of its price and image. Unfortunately, both domestic and foreign retailers have set unreasonably high coffee prices in China. Tea is of equivalence with water in this nation, yet coffee, a symbol of fashionable Western culture, strongly appeals to Chinese customers. Therefore, there are a small number of tea companies to rival against coffee companies, provided that coffee companies offer decent drinks at a decent price.

#### **1.1.4 An Overview of Target City -- Shanghai**

The prospective company will open its coffee shop chain in Shanghai, China.

Shanghai, located in southeast China, is the nation's commercial and financial centre with the highest regional GDP per capita in the country. It owns more than fifty universities and hundreds of leading research institutions. As a world-class cosmopolis, there are roughly 35,000 foreign-invested enterprises, 152,000 foreigners and 400,000 Taiwanese residing in Shanghai. Over 4 million people from overseas enter Shanghai every year, and over 2,000 international conferences and exhibitions are held in Shanghai every year (Shanghai Statistics, 2009). Influenced by the geographic location and historical culture, Shanghai residents have stronger initiatives to accept Western culture and the fancy Western lifestyle than other cities' residents do. In a survey, Shanghai people have highest acceptance of coffee in China (Hao, 2009). White-collar workers and college students in Shanghai like to drink coffee, and middle-agers and youngsters have become the main coffee consumer group. One study has estimated that from 2005 to 2020, the coffee industry will go through a rapid development and expansion period. Coffee companies will be doubled from 1,000 to 2,000, expanding to central business districts, industry districts, office buildings, schools and communities. As estimated, the consumption of coffee per person will be 100 cups annually from 2020 onwards (Hao, 2009).

## **1.2 An Overview of The Proposed Company**

### **1.2.1 Vision and Mission**

The proposed company's vision is to provide affordable fresh coffee to people everyday. The company's major target customers are the young well-educated professionals, returnees, and foreigners. The coffee shops will be of convenience to consumers and be able to refresh an individual's day by a strong and aromatic cup of



coffee. The company's coffee shop chain will build a reputation for good quality coffee with reasonable prices. To fulfil this, the company will use fresh and high-quality raw material, keeping strict food hygiene, and cultivating employees while building on customer loyalty.

The company's mission is to become a leading low cost strategy coffee shop chain in China owning more than one hundred outlets, known for its fresh and convenient food and drink products.

### **1.2.2 Company's Strategy**

The company intends to offer low priced products using a low cost strategy while focusing on customer loyalty. As mentioned above, the coffee house industry is a high-end industry in China. Most of the coffee shops employ a differentiation strategy and the average price for a cup of coffee is more than 30 RMB. The prospective coffee shop will control the price range for major coffee products between 10 RMB to 15 RMB, which equates to prices of fresh coffee sold in Canada by Tim Horton's, a famous coffee shop chain in North America. To achieve this goal, the company will focus on offering good quality coffee with competitive prices to attract and maintain a high volume of customers that consume coffee everyday. Since the store will only be 70 square meters with the capacity of 30 seats, it will be able to save expenditure on luxurious store decorations in contrast to larger coffee shops adopting a differentiation strategy. Additionally, the company will adopt a fast expansion strategy to capture a large portion of market share in the next five years.

### **1.2.3 Product Mix Strategy**

The company will supply fresh coffee, milk, juices, and other healthy drinks and snacks. Snacks will be easy-to-go food and there will be combinations with attractive prices. Since the company is competing on price on its coffee, the different product lines will be able to balance the company's overall profit while catering to more customer groups.

The next chapter will review the coffee shop industry's competitive environment and identify several key success factors (KSFs).

## **2: EXTERNAL ANALYSIS**

In market economies, businesses must compete for survival and prosperity by adopting proper strategies consistent with the market forces. They succeed if their strategies address well to customer needs, creating competitive advantages. External analysis, as a critical step to evaluate business strategies, comprehensively analyzes the industry's environment. It has two significant implications. The first is to assess industry attractiveness and the second is to determine industry economics, drivers of profitability and the key success factors (KSFs) (Crossan, Fry, & Killing, 2004)

This chapter will employ Porter's Five Forces Model (Porter, 1979) to analyze the environment of the coffee house industry while identifying the KSFs. Subsequently, a competitive analysis to address the business opportunities and threats will follow. The proposed strategy for the prospective coffee shop chain will then be finalized.

### **2.1 Porter's Five Forces Model**

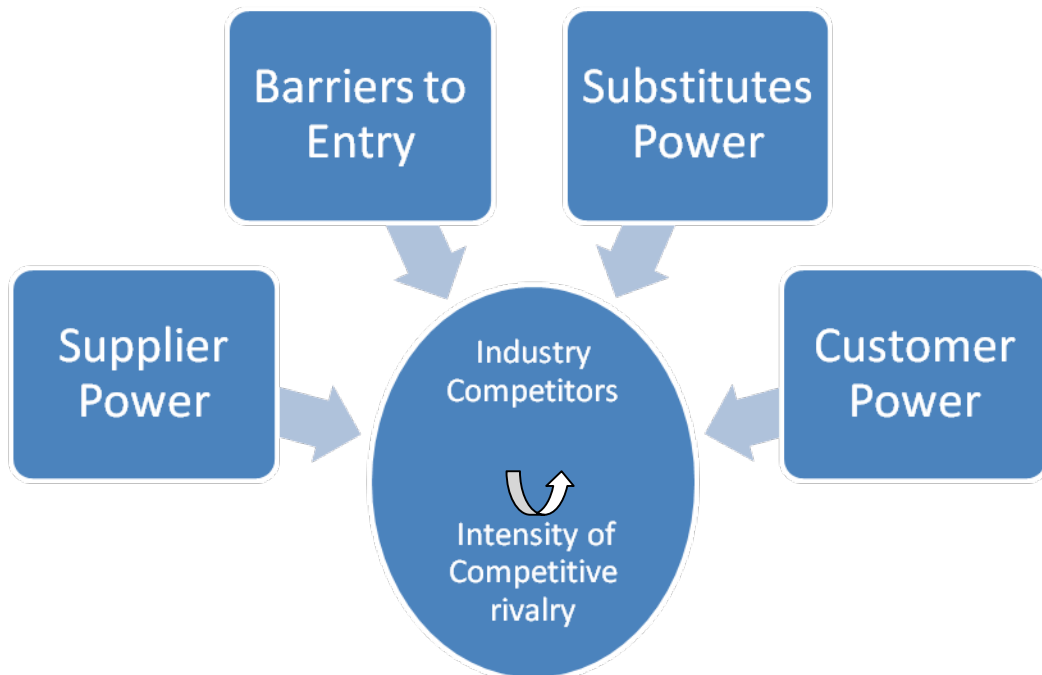
Michael Porter's Five Forces model is one of the earliest models used to examine industry economics and attractiveness. It provides a framework of five forces to determine industry profitability. These five forces include:

- Barriers to Entry
- Supplier Power
- Customer Power

- Substitutes Power
- Intensity of Competitive rivalry

The relationship among these forces is illustrated in Figure 1.

*Figure 1: Porter's Five Forces Model*



In the following sections, these five factors will be analyzed respectively to identify the KSFs in this industry.

## **2.2 Barriers to Entry (Weak to Medium)**

Barriers to entry determine the ease with which a new company can enter the market. The possibility of new companies entering the industry impacts competition. High barriers to entry provide incumbents with advantages to deter new firms from

entering the market. Low barriers to entry bring new firms opportunities to enter the industry and compete and capture market share.

### **2.2.1 Economies of Scale**

Economies of scale are a potentially important component to cost advantage. Firms that produce at larger volumes tend to enjoy lower costs per unit because they can spread fixed costs over more units, employ efficient technology, or negotiate better terms from suppliers. However, the magnitude of this cost advantage varies across industries.

In the coffee house industry, economies of scale are moderate. At the store level, the fixed costs that drive scale economy advantages include equipment and real estate cost. There are also advantages in purchasing ingredients. At the corporate level (e.g., the advantage of a chain of multiple stores vs. a single independent store), economies of scale arise from purchasing (bulk buying of materials through long-term contracts and obtaining lower interest rates on financing), increased managerial specialization, financial (obtaining lower-interest charges when borrowing from banks and having access to a greater range of financial instruments), and advertising.

Since local coffee houses are relatively small, independent and decentralized, it is hard for them to reach such efficient economies of scale. However, most international coffee shop chains, such as Starbucks and Espresso Americano, can take the advantage of economies of scale by fast expansion in some major cities such as Shanghai, Beijing, and Shenzhen in China. Thus, in these major cities, the barrier is high for new entrants.

In this respect, economies of scale are a KSF for coffee shop chain in Shanghai.

### **2.2.2 Customer Switching Cost**

Switching costs are fixed costs that buyers face when they change suppliers. There are few (if any) switching costs for customers to experience different coffee shops. With this low barrier, it is a great opportunity for new entrants to gain new customers while earning a competitive advantage, if they do succeed in getting the customers to switch. A company could try to establish some switching costs, such as when a customer can get every 10<sup>th</sup> cup for free utilizing a store stamp card. Another example is by introducing a reloadable cash card that can be used by customers for purchases at a company's system outlets.

### **2.2.3 Capital Requirements**

Capital requirement to start up a coffee shop includes the investment in coffee making equipment as well as working capital to finance rent, labour, and food ingredient expenses before the business generates enough revenue to cover on-going expenses. In Shanghai, this start-up capital requirement varies depending on the locations, sizes, and levels of services with the range between 500,000 RMB to over 3,000,000 RMB. With such a wide range, new entrants will have more flexibility in customizing their businesses according to their budgets. The barrier of capital requirement in the coffee house industry is low.

### **2.2.4 Access to Distribution Channels**

The new entrant must secure distribution of its products and services. Since coffee shops sell products directly to their customers on site, the location is crucial in

determining consumer traffic. The premium store location can use an effective distribution channel to make the products readily available.

A high barrier exists to new entrants because some incumbents have already pre-empted the most favourable geographic locations, and possess relatively more experience in operational management and promotions.

Based on the above analysis, store location is a KSF for coffee shops.

### **2.2.5 Product Differentiation & Brand Identification**

Most of the coffee houses in China offer coffee to customers as a fashion or as a Western experience. They adopt a differentiation strategy and are continuously enhancing their identification.

For example, Starbucks, the most famous international coffee shop chain employing a differentiation strategy in China, works diligently to create strong brand recognition. External reputation studies consistently place Starbucks at or near the top of the most trusted high-differentiation brands in China. In China, having an iconic brand name directly translates into market share. When Starbucks first entered the Chinese market in the late 1990s, Chinese customers had not developed enough coffee knowledge and did not have the ability to appreciate the taste of fresh coffee. Until this day, they still believe Starbucks charges expensive prices solely because they offer the highest quality coffee in the world.

Although there is intensive competition among the coffee shops employing the differentiation strategy and a high barrier of brand identification, there is a great potential for a firm to succeed in employing a low cost strategy, because the current barrier of

brand identification is low in terms of weak competition. A low priced coffee house with a low cost strategy can take this advantage to develop its unique brand name and leverage it to capture a substantial amount of market share while generating high revenues.

Based on the above analysis, the barrier of brand identification in the differentiated coffee market is high, yet, it is low in the low cost strategy segment. Brand identification is a KSF and presents itself as being the competitive advantage for coffee houses.

### **2.2.6 Competitor's Retaliation**

Currently, there are more than 1,000 coffee houses in Shanghai. Except for some international coffee shop chains, most of the local coffee houses are small, independent, decentralized, and cannot reach certain economies of scale. It is hard for incumbents to unite together and retaliate against new entrants.

On the other hand, China's coffee consumption is relatively new with only 10 to 15 years of development. To prosper in this market, all parties within the industry should be aware of the importance and benefits of reciprocal promotional activities, collective efforts to create coffee culture in the society, and also educating customers the reasons to consume coffee. Considering these two aspects, the threat of retaliation among the competition is weak for new firms entering the market.

### **2.2.7 Summary**

The above analysis suggests that the barriers to entry in the coffee house industry are low, and it is favourable for new firms to enter the market. New entrants will face some challenges on economies of scale, access to distribution channels (in the form of



store locations), product differentiation, and brand identification. Nevertheless, they will have opportunities to gain customers on issues such as low customer switching cost, flexibility on capital requirements, and immunity from competitor retaliation.

Listed in the following are some KSFs retrieved from this section:

- Store location
- Economies of scale
- Effective marketing
- Brand identification

### **2.3 Supplier Power (Weak)**

The evaluation of supplier power will examine supplier-buyer relationship in the industry. If supplier power is strong, buyer will be in a weak position. During the bargaining process, the supplier will seize such an opportunity into gaining more profits from the buyer in the industry.

#### **2.3.1 Labour**

As a developing country with the largest population in the world, China's low labour cost is one of the main attractions for industry investment. In comparison to high-tech companies, coffee shop chains do not need many specifically skilled employees. In comparison to manufacturing companies, coffee shop chains possess a lighter workload and provide better working environment and benefits. This favourable working opportunity will bring intensive competition in the labour market. Therefore, labour, as one of the main suppliers, has low power in its relationship with the coffee shop chains.

### **2.3.2 Food Suppliers**

Coffee beans and other raw food materials are sufficient and readily available domestically and abroad. On the one hand, with China in the World Trade Organization (WTO), the foreign coffee beans (non-roasted bean or green bean) import tariff has dropped from 10.4 percent to 8 percent. On the other hand, coffee beans are widely grown in south China such as Yunnan and Hainan province. Both quality and quantity for domestic coffee beans are able to meet coffee shop chains' requirements. Starbucks China, for example, decided to use domestic coffee beans from Yunnan Province instead of imported coffee beans from South America and other areas in 2008. Therefore, it is not difficult for coffee houses to purchase good quality coffee beans with competitive pricing. If coffee shop chains can reach certain economies of scale, they will not only have a wide selection in different coffee bean suppliers, but also occupy a strong position in the relationship with other food suppliers such as milk, snacks and sugars.

Therefore, the KSF here is the coffee shop chain's size relative to competitors.

### **2.3.3 Equipment**

One of the major equipment investments for coffee shops is espresso coffee machines and roasters. In China, the price of that equipment ranges from 10,000 RMB to 20,000 RMB depending on the country of origin. However, various kinds of coffee business websites and exhibitions offer help to coffee shop entrepreneurs to purchase those equipment in a effective and efficient manner. To sum up, the bargaining power for equipment suppliers is weak.

#### **2.3.4 Real Estate Lease**

Compared to weak bargaining power from other input suppliers, the real estate suppliers possess a strong position in this supplier-buyer relationship. Since price is dependent on traffic and customer's purchasing power, the good locations in the business centre district are very costly and have rare vacancy. Thus, the bargaining power for real estate suppliers is strong for good locations.

#### **2.3.5 Switching Costs**

The coffee house industry participants face low switching costs in changing suppliers. Because suppliers such as food and equipment manufacturers do not highly differentiate their products, shifting suppliers is not difficult for coffee shops. However, for new entrants with limited budgets and small order quantities at the start-up stage, shifting suppliers frequently will bring an unstable supply system and high business risks.

#### **2.3.6 Supplier Resources**

Most suppliers are not willing to have a vertical integration to open a retail coffee shop. For the coffee beans and equipment suppliers, coffee shops are their major customers and revenue source. Therefore, the bargaining power for suppliers is low in terms of supplier resources.

#### **2.3.7 Summary**

The bargaining power for coffee shop suppliers is low overall. The coffee house industry participants are in a better position to choose various alternatives of the inputs such as labour, raw food material, or equipment. Coffee houses should acquire sufficient funding, and develop their scale to lower purchasing prices from suppliers.

## **2.4 Customer Power (Weak)**

Powerful customers can capture more value from suppliers by forcing down prices, demanding better quality or more services (thereby driving up costs), all at the expense of industry profitability. Buyers are powerful if they have negotiating leverage relative to industry participants, especially if they are price sensitive, using their clout primarily to pressure price reductions.

Currently, there are three different groups of customers with strong preferences and purchasing power for low priced fresh coffee as a daily drink.

The first consumer group is the young, fashionable, open-minded, well-educated local urban citizens. After more than ten years of market cultivation, this group is already mature and most of them are professionals. They are currently the major consumers for the high priced differentiated coffee shops yet cannot afford the expensive coffee to freshen up every working day. Thus, they are going to shift from fashionable coffee drinkers to daily coffee drinkers.

Another large proportion of coffee consumers are those returnees who have finished their studies in Western countries and returned back home for work. In the recent five years, the number of returnees dramatically increased. Merely in Shanghai, there are over 80,000 returnees working and living there today. This figure is expected to increase drastically every year. Many of these returnees have lived in Western countries for many years and have become accustomed to the coffee culture. Visiting cafés several times a week and drinking coffee during breakfast is a habit for these consumers. Upon their return to China, they have carried on living in this fashion. However, they are not content

with the price of fresh coffee in China, which is much more expensive than in Western countries.

The third group is foreigners who are studying, working or visiting in China. Most foreigners are from coffee-drinking nations and are used to having coffee on a daily basis. Therefore, they expect to get fresh coffee in China just like at home. However, China's coffee houses only target the tipping-point niche market with high-end customers, thus unable to satisfy this group's needs.

In relation to consumer power, although consumers face low switching costs to change vendors, there are several factors that limit a buyer's bargaining power to coffee suppliers.

First, the coffee house industry is a retail industry that directly deals with individuals that are end customers. These customers usually only buy one or several cups of coffee at a time for personal consumption and thus, there is little to none negotiating leverage for them to bargain with coffee houses.

Second, although fresh coffee vendors are profitable, buyers do not threaten to integrate backwards and produce the industries' products themselves. Although Chinese customers find fresh coffee appealing and want to carry on Western café life style, they are still not a coffee-drinking nation. If the fresh coffee's price is very expensive, individuals can just decrease their coffee consumption and go for other soft drink substitutes such as bubble tea or green tea. Additionally, it is difficult for individual consumers to conduct backward integration because of the lack of experience, funding, and other necessary capabilities.

Third, although the majority of fresh coffee customers are price sensitive and the differentiation strategy dominates the coffee house market, customers cannot easily find equivalently low-priced products to play one vendor against another.

Based on above analysis, customer's bargaining power is weak and low priced coffee shop companies with low cost strategies can seize such large potential market demand.

## **2.5 Substitutes Power (Medium to Strong)**

A substitute performs the same or similar function as an industry's product by a different means. When the threat of substitutes are high, industry profitability suffers. Substitute products or services limit an industry's profit potential by placing a ceiling on prices. If an industry does not distance itself from substitutes through product performance, marketing, or other means, it will suffer in terms of profitability, and often growth potential.

There are a large variety of substitute products for the coffee house industry in terms of functionality.

### **2.5.1 Instant Coffee**

Instant coffee has a first mover advantage and dominates Chinese coffee market by its low price, ready-availability and convenient preparation. Along with the increase in consumers' coffee tastes, the poor quality of instant coffee will not satisfy Chinese customers anymore and this market share will shrink in the future. However, for the white-collar workers that can fully appreciate the taste of coffee, sometimes they have to turn to instant coffee because the availability of fresh coffee is highly limited, and also

the 30 RMB per cup of coffee is not affordable for daily life. Nevertheless, if there is a low cost strategy coffee house offering low price fresh coffee with reasonable quality, customers will much more likely consume fresh coffee rather than instant coffee that comes with poor quality. Therefore, instant coffee, a major fresh coffee substitute, poses a strong threat for those coffee houses adopting a differentiation approach. It is however, not a threat for the firms that utilize a low cost strategy.

### **2.5.2 Coffee in Fast Food Restaurants**

Fast food restaurants, such as Pizza Hut, KFC and McDonalds, offer coffee with relatively low prices. All of these restaurants entered China as symbols of Western culture and gained tremendous economic success within the country. Coffee is only one small product in their food menu that has more than thirty different kinds of food and drinks. The single taste and long-waiting time cannot meet some professionals' needs for fresh coffee. Also, because public media attached labels of unhealthy food to these fast food restaurants, the major coffee consumers, the well-educated professionals with economic capability, avoid consuming food in these restaurants. Consequently, the threat of coffee in fast food restaurants is weak, especially for a low cost coffee store offering good quality coffee with competitive prices.

### **2.5.3 Tea and Other Soft Beverages**

China is traditionally a tea country. The wide range of prices gives tea a competitive advantage to be daily drinks for individuals. Other soft beverages such as bubble tea, energy drinks, fruit juices, sodas, and milk-flavoured drinks are available at supermarkets, restaurants, coffee shops or food stands. Although these beverages hold a

major market share in the soft beverage market, coffee, a modern symbol of Western culture, cannot be replaced in terms of its characteristics such as the function (of providing a stimulant) and taste. If there is a low cost strategy coffee shop which makes good quality coffee, has competitive prices, located in the central business district for the convenience of consumers, the substitute threat of tea and other soft drinks will be weak, at least from the standpoint of the target customer segments described above.

#### **2.5.4 Summary**

Although fresh coffee has a wide range of substitutes, it still strongly appeals to customers because of its unique competitive advantage including Western culture image and special taste. For a low cost strategy coffee store in the central business district offering good quality coffee with competitive prices, the substitute threat is weak. There are several KSFs addressed from the above analysis.

- Competitive prices
- Reasonable coffee quality
- Good store location

#### **2.6 Intensity of Competitive Rivalry (Medium)**

Competitive rivalry is the most important factor that influences the attractiveness of the industry. If the intensity of competitive rivalry is weak, new entrants can secure profits easier. However, if the intensity of competitive rivalry is strong, new firms face difficulties in becoming established and to be profitable.



There are more than 1,000 coffee shops in Shanghai in 2009 and this figure is expected to double by 2020. Because most shops employ the differentiation strategy, competition within this market segment is becoming more and more intense. On one hand, international coffee giants with years of experience operating in China became market leaders. They have already acquired premium locations and gained brand awareness from customers. On the other hand, local coffee houses boost to seize market share and benefit from industry profits. Usually, they are relatively small scale, independent and flexible.

Currently, there is not much competition in low cost strategy coffee shop markets because few to none exist in this segment. However, whether it is the low cost or differentiation strategy that the coffee shop employs, there are only two kinds of coffee stores in terms of their different operation models – international coffee shop chains or local coffee houses.

### **2.6.1 International Coffee Shop Chains**

International coffee shop chains sped up their progress to enter into major cities of China by opening more and more outlets in the past years. Starbucks has already expanded their outlet locations from first-level cities to second-level cities. Until 2009, Starbucks owned 360 retail stores across 26 cities in China. Other international coffee shop chains, such as Segafredo from Italy, CITE from France, and KOHIKAN from Japan, joined this battle and opened their outlets in Shanghai, Beijing, Guangzhou and Shenzhen. International coffee shop chains have sufficient funding, a professional management team to ensure efficient operation, ability to acquire business centre locations, and they provide standardized service and food quality. In terms of coffee and food, international coffee shop chains usually offer more than fifteen different tastes of

coffee with cakes, and other foreign food to customers. They differentiated their products by using high quality coffee beans and other raw food materials. In terms of brand identification, except Starbucks and a few other companies that entered China over ten years ago, many international coffee shop chains are new entrants with fewer than three years. These new businesses are still immature and thus, their brand is not well recognized among customers. However, all international coffee chains emphasize their own brand and spend a lot of money on advertisements through different media channels.

### **2.6.2 Local Coffee Houses**

Local coffee houses are usually small and independent. They are following current major market trends which are led by international coffee shop chains to benefit from industry profits. Usually, local coffee houses are located in some residential area near school, public transit and other big institutions. These areas are not the best but still have a lot of traffic. Local coffee houses offer a range of food and drinks, such as coffee, tea, noodles, rice and other Chinese food. The prices of coffee in these local coffee houses are higher than international coffee shop chains because there are relatively fewer customers and they provide customized person-to-person service. Compared to international coffee shop chains, local coffee houses differentiate themselves by luxurious shop décor and environment, and not in terms of coffee quality. Some local coffee houses exploit such advantage and offer poor quality coffee products with expensive prices.

### **2.6.3 Summary**

In China's fresh coffee shop market, both international coffee shop chains and local coffee houses employ differentiation strategies, thus, the rivalry among competition is strong for the differentiation segment but not for the low cost segment. International coffee shop chains offer good quality coffee along with high prices, yet, some local coffee houses offer poor quality coffee associated with high prices as well. Thus, such coffee houses are attempting to reap in the profits without offering the benefit of good quality coffee. As a result, the competitor with a low cost approach that offers good quality coffee without inflated prices will succeed. The KSFs include:

- Competitive prices
- Reasonable coffee quality
- Store location

## **2.7 Overall Assessment and Key Success Factors**

Porter's Five Forces Model provides a perspective in assessing the attractiveness within the coffee house industry. Through the analysis of the five external forces, some KSFs of the coffee house industry in China have been identified. This section will summarize the overall industry assessment and all KSFs previously discussed.

### **2.7.1 Overall Industry Assessment**

The overall attractiveness of the coffee house industry in China is favourable, especially to the low cost strategy coffee shops offering good quality coffee with competitive prices.

The barriers to entry in the coffee house industry are weak to medium. This is favourable to new firms entering into this market not only because it encompasses low customer switching costs and minimal threat from competitor's retaliation exist, but also because of its flexible capital requirement and economies of scale. Moreover, it is not easy for existing coffee companies to defend against new participants. This is because existing firms have to leverage KSFs such as choosing different premium store locations, enlarge economies of scale, and also strengthen their brand identification to further raise the barriers against other participants.

The bargaining power for the coffee shop suppliers is overall low, which is favourable to a coffee company's development. Since China comprises two of the most significant industries in terms of its size and reputation, the agriculture and manufacturing industries, coffee house industry participants are in a better position to select various alternatives of inputs. These inputs can include labour, equipment and raw material. For example, the coffee bean supplier is one of the most important suppliers for coffee shops. After China joined the WTO, the tariffs of imported coffee bean dropped from 10.4% to 8%. The growth of domestic coffee plant is also favourable to coffee shops since good quality coffee beans are widely planted in Yuannan Province and Hainan Province selling at competitive prices. It is easy for coffee houses to lower their purchasing costs.

The bargaining power for coffee house customers is overall weak. Individual customers have little selection for fresh coffee in shops that have the differentiation approach. As a result, low priced coffee houses with the low cost approach poses a huge potential for economic success given the current market demand.

There are multiple substitutes in China's market with a wide range of prices. These include items such as instant coffee in the supermarket, drinks from fast-food restaurants, tea and other soft beverages. Such substitutes pose a strong threat for differentiated coffee houses in terms of low prices, variety, convenient preparation, and easy availability. However, if low cost strategy coffee houses can offer good quality coffee with competitive prices, it can weaken the substitute's threat in terms of a coffee's fundamental values such as taste, quality, and image.

In terms of competitive rivalry, since the differentiation strategy dominates the coffee house market, intensive competition exist between international coffee shop chains and local coffee houses. Hence, it is favourable for low cost strategy coffee houses to enter this market and seize this business opportunities.

The overall assessment is summarized in Table 2.

### **2.7.2 Key Success Factors**

Coffee shops' development in China is at a fast growth stage in the industry life cycle and this directly translates into a rapid increase of market share. This presents opportunities for new entrants to enter and market leaders to expand in order to secure this gain in market share. The overall attractiveness of the coffee house industry in China is favourable which implies there is a great potential in the market, especially for coffee houses adopting the low cost approach.

Table 1: Assessment of Five Forces Rating in Coffee Houses Industry

Five Forces	Strength	Impact to Coffee Houses Industry
Barriers to Entry	Weak to Medium	Favourable to New Entrants
Supplier Power	Weak	Favourable
Customer Power	Weak	Favourable
Substitutes Power	Medium to Strong	Unfavourable to D <sup>4</sup> /Favourable to C <sup>5</sup>
Intensity of Competitive Rivalry	Medium	Unfavourable to D/Favourable to C
Overall Rating		<b>FAVOURABLE</b>

The previous overview of this industry suggests several KSFs that are listed below ranked in order by descending importance<sup>6</sup>:

- Good store location
- Competitive prices

<sup>4</sup> D: Differentiation Strategy Store

<sup>5</sup> C: Low Cost Strategy Store

<sup>6</sup> Criterion of important here is how many times a KSF was identified in Five Forces Analysis.

- Reasonable coffee quality
- Economies of scale
- Effective marketing
- High brand recognition

Store location is the most important issue in the coffee house industry. As a fresh coffee retailer, the targeted customers are the well-educated young professionals, returnees and foreigners. A good store location for coffee houses includes central business districts, high-traffic shopping malls or other suitable transportation centres such as airports and subway stations near the business district. Store location is a direct determinant for a coffee shop's success and has been previously identified as a KSF in the sections of barriers of entrants, substitute power and rivalry competition.

Competitive prices and good quality are KSFs on the second level in terms of its importance. In the current coffee house market in China, the differentiation strategy dominates with fresh coffee priced to be unreasonably expensive. Differentiated coffee houses spend high amounts of money to build up a luxurious brand image, justifying their inflated prices. Some local coffee houses follow this market trend and profiteer from this by offering poor quality coffee with high prices. Competitive prices and reasonable coffee quality are thus imperative in matching market demand and weaken the threat of substitutes. Both factors have been identified as KSFs in the substitute power and competitive rivalry sections.

Economies of scale are another vital KSF in the coffee house industry. This can be depicted when international coffee shop chains, such as Starbucks, rapidly expanded

their outlets in some major cities in China. Economies of scale not only conserve a firm's operating cost, but it also increases their bargaining their power with their suppliers. Since the coffee houses are usually located in high traffic areas, it enhances their brand recognition due to its ease of visibility. It has been identified as a KSF in the barrier to entry section.

Marketing is an effective way to keep a coffee house distribution channel flowing and is also an important KSF in the industry's barrier to entry section. International coffee shop chains' emphasis is on creating and building their brand. Coffee in China is not a highly differentiated product to consumers, thus, brand recognition plays an imperative role for coffee houses to differentiate themselves to increase consumer traffic. It is a KSF and is addressed in the barrier to entry section as well.

## **2.8 Competitive Analysis Based on Key Success Factors**

Based on the above analysis, the following performance evaluation of the two major kinds of competitors is scored over a 5-point scale (See Table 1). A score of 1 indicates the lowest perceived performance while a score of 5 suggests the highest level of performance in the area.

The table indicates international coffee shop chains have a score of 25 out of 30, while local coffee houses have a score of 15 out of 30. The international coffee shop chain model is more successful in comparison to the local coffee house model. There is an inherent nature for this industry to be attractive. The reasons are because of China's magnitude in sizes both geographically and demographically, and the high profit margin



that exist for fresh coffee. This poses various opportunities for new entrants to succeed in this market.

*Table 2: Rating of Competitors on Key Success Factors*

<b>Key Success Factors</b>	<b>International Coffee Shop Chains</b>	<b>Local Coffee Houses</b>
Total	<b>25</b>	<b>15</b>
Location	<b>5</b>	<b>4</b>
Price	<b>3</b>	<b>1</b>
Quality	<b>5</b>	<b>3</b>
Economies of Scale	<b>4</b>	<b>2</b>
Marketing	<b>4</b>	<b>3</b>
Branding	<b>4</b>	<b>2</b>

### **2.8.1 Opportunities**

Firstly, new entrants have a great opportunity to gain customers by offering fresh and good quality coffee at a lower price. International coffee shop chains offer premium coffee at 25 to 35 RMB per cup while local coffee houses offer lower quality coffee with an even higher price. With the coffee beans costing between 1 to 3 RMB per cup of

coffee, opportunities exist for new entrants to offer better quality coffee than local coffee houses yet cheaper than international coffee shop chains.

Secondly, local coffee houses are fairly undeveloped in terms of economies of scale, branding, and marketing. Thus, it is easier for new entrants to surpass them by reaching certain economies of scale, building a strong brand name while promoting through marketing campaigns.

### **2.8.2 Threats**

The first challenge for new entrants is that some competitors are already located in the most favourable geographic locations. Most of the international coffee shop chains are located in crowded shopping malls or other business centres. The high real estate lease cost and infrequent vacancy associated with these favourable locations are threats to new entrants.

The second challenge is that some international coffee chains have already been established in China's market for more than ten years. They have built up a reputable brand name to customers as can be seen by Starbucks, a symbolic word used by those that live a luxurious lifestyle.

The third challenge is the economies of scale for the international coffee shop chains. Most international coffee shop chains have several outlets within the same city, decreasing their business risks while lowering their operation costs.

Last but not least, there is a potential threat coming from international coffee shop chains with low cost strategy. Although the prospective company can leverage its first mover advantage including establishing a stable and low-cost supplier chain, building

high brand recognition up, etc, low cost international coffee shop chains still will be strong competitors by their substantial management experience, huge financial resources and economies of scale to obtain volume discounts on ingredients,

## **2.9 Strategy Proposals**

In the previous sections, we made an overall assessment of China's coffee industry and outlined the external environment for the industry as a whole. I now present a strategy proposal for the prospective coffee shop chain.

### **2.9.1 Vision and Mission**

The company's vision is to provide affordable fresh coffee while making coffee a daily drink and not a luxurious experience in China. The company's mission is to become the leading low cost strategy coffee shop chain in China, initially with one store but expanding to own more than one hundred outlets, highly recognized for its fresh and convenient food and drink products.

### **2.9.2 Strategic Goals**

The strategic goals of the company are fulfilling the company's vision, achieving its fast expansion and revenue growth, and making fresh coffee a part of people's daily lives. In the short term within five years of development, the company's number of outlets will increase from 1 to 10, and the company's market share will reach at least 30% in the coffee house industry in Shanghai. In the long run, the company will be a leading low cost fresh coffee shop chain, and be able to develop its business to all the provinces within China.

### **2.9.3 Product Market Focus**

Shanghai has a large population of professionals, returnees, foreigners. There is great potential for these three groups of customers to consume fresh coffee as their daily drinks. Therefore, the product market focus will be on these three consumer segments in Shanghai.

### **2.9.4 Value Proposition**

The vision of the prospective coffee shop chain is offering affordable fresh coffee to people on a daily basis. Therefore, the value proposition of the company is being a leading low price fresh coffee shop chain in China.

### **2.9.5 Core Activities**

The prospective company will employ a cost leadership strategy. This strategy requires that the cost of providing the product or service to the consumer is low, by gaining efficiencies, reducing costs and controlling overhead.

The company's customer strategy is three-fold. First, it will acquire new customers. Second, it will try to retain existing ones. Third, it will seek to increase the number of times that existing customers visit the shop.

The company's product strategy is to offer a mix. The main products are comprised of roughly ten different tastes of coffee. The supplementary drinks will be fresh fruit juice, milk, and hot chocolate. The company's supplementary food will encompass the classic Western snacks such as cakes, bagels, breads, and also some special Chinese easy-to-go food such as rice rolls and congees.

The company will be located in the central business district, focused on effective marketing and other promotional activities that increase brand awareness.

### **3: INTERNAL ANALYSIS**

The recommended strategy proposal for the prospective coffee shop chain has been presented at the end of the last chapter based on the evaluation of the coffee house industry's external environment. This chapter will develop a conceptual proposal of the company's flagship store and provide a Diamond E-Framework (Crossan et al, 2005) analysis to determine whether the company's internal capabilities are sufficient to implement the proposed strategy.

#### **3.1 Conceptual Proposal of The Company's Flagship Store**

As an independent start-up company, the prospective coffee shop chain will first centralize its funding and resources to develop a successful flagship store. It will then expand in a rapid manner in an attempt to achieve economies of scale

##### **3.1.1 Structure and Funding**

The prospective flagship store will adopt a centralized organizational structure, which means the company can consolidate power and decision-making abilities at the top of the organizational chart. Top managers making the organization's key decisions will be beneficial for the low cost strategy start-up retailer because of its easiness for control and coordination and efficiencies through economies of scale.

The funding consists of private capital and lending from some financial institutions. Private capital funding comes from the company's co-founders, encompassing over 50% in the total required capital. It will be able to provide the

company more flexibility for development rather than being driven by the initiative of maximizing profit to pay off borrowed money as soon as possible.

### **3.1.2 Location**

A premium store location is the most important KSF in the coffee house industry. The target customers of the company are the young professionals, returnees and foreigners who have the potential to consume coffee everyday. For the flagship store, it is ideal to be located in the central business district. It is better than shopping malls because the area can provide a steady flow of traffic while bearing the potential to cultivate regular customers that may visit the store several times a week.

Shanghai has a large population and encompasses many business districts. As a result, there are a lot of options for the prospective company to reside that vary in terms of intrinsic and extrinsic values. Some first-tier business districts such as Nanjing Road and Huaihai Road are too expensive for the start-up store while customers there are usually not price-sensitive. Low cost strategy companies, therefore, cannot fully leverage their advantages in comparison to the differentiation strategy companies. The second-tier business districts such as Wujiao Square in Yangpu are good for the prospective company because of several advantages. First, real estate lease is cheaper for the second-tier business centres in comparison to the first-tier ones. Second, it also comprises of a big population that includes professionals, returnees, and foreigners for whom coffee appeals but more importantly, who are price sensitive. Third, it is a high-traffic commercial zone located near public transit centres such as the subway stations and buses. Lastly, it is near some famous universities such as Fudan University and Shanghai Jiaotong University.

### **3.1.3 Business Area**

The company will occupy 50 to 100 square meters as its flagship store's business area. In contrast to the differentiated coffee houses that spend huge sums of money on 200 square meters of business area, the prospective firm is not focused on creating a luxurious atmosphere but simply to offer affordable fresh coffee to mature coffee consumers. Such consumers are not craving for the Western experience, but want coffee to freshen up their busy schedules. Thus, most customers will take coffee to-go. The business area will be divided into two sections, one for sit-in guests and the other for take-out orders. Recognizing that the business entails high traffic, the two sections will be separated, free of interruptions, while the staffs can accommodate for both the needs of sit-in and take-out customers. This tactic will effectively save some fixed costs for the company while satisfying different customer groups.

### **3.1.4 The Name, Logo and Corporate Identity**

Brand is another significant KSF for the start-up coffee house. The business image such as the name, logo, and corporate identity are critical in making a concentrated and compact marketing statement for the company. The primary corporate identity will be much like an international coffee chain's. The brand and logo will be simple to remember and fit suitably well with the company's vision and mission. Store décor will be elegant yet simple.

### **3.1.5 Reloadable Cash Card**

The company will promote reloadable store cash cards to customers. This reloadable cash card will require customers to deposit initial sums of money that can be



used at any of the company's outlets for the ease of convenience. The cardholders will enjoy several benefits such as the ability to order food via internet or the self checkout machine, point collections for a free coffee, and other membership promotion and awards.

### **3.1.6 Operating System**

The prospective company will employ an integral operating system to improve efficiency, reduce cost, and provide convenience to customers. The target customers for coffee shops are the professionals that are rushed for time and want to acquire a cup of coffee through a relatively quick and easy process. It is imperative for this operating system to keep an accurate inventory record, daily sales, and other supplementary information such as employee and customer information. The advanced operating system not only offers check-outs by cashier quickly, but it also allows customers to conduct self-checkouts in store or via internet easily. The coffee shop will select such an advanced operating system that meets all the requirements described above to better satisfy a customer's tangible and intangible needs.

### **3.1.7 Products**

The company will deploy a strategy of having a wide product mix to provide a comprehensive nutrition menu while satisfying different consumer food preferences. Since the company is competing by selling coffee on price, the different product lines will balance the company's profit and cater to more consumer groups. The main beverage for the firm is hot or cold fresh coffee with different tastes. Other beverages include hot chocolate, milk, and some fresh juices. In terms of food, there are some classic Western

snacks such as cakes, bagels, and sandwiches, and also some Chinese classic snacks such as rice rolls, soups, and meatballs.

To better fulfil such product-mix strategy, the company will promote different combinations of food and drink with attractive prices. On one hand, combinations can help customer select food based on different nutrition preferences. On the other hand, sales through combinations can directly increase the company's revenues.

### **3.1.8 Services**

The company will place emphasis on the convenience of customers. There will be traditional staff services for both sit-in and take-out customers. All the staffs in store are well trained in providing professional customer service and it is their first priority to ensure customers are fully satisfied throughout the entire shopping process.

Additionally, the company will offer different kinds of services for a consumer's convenience.

First, the company will promote a self-checkout system. Customers can use self-checkout machines in the store to purchase a product quickly via the company's reloaded cash card. Subsequently, they can obtain the food directly in the picking-up area. Second, if customers that are in close proximity to the store order more than 200 RMB, they can use the internet check-out service and receive free delivery. Third, the prospective company can offer catering services for particular business meetings or other various business events.

### **3.1.9 Open Hours and Staffing**

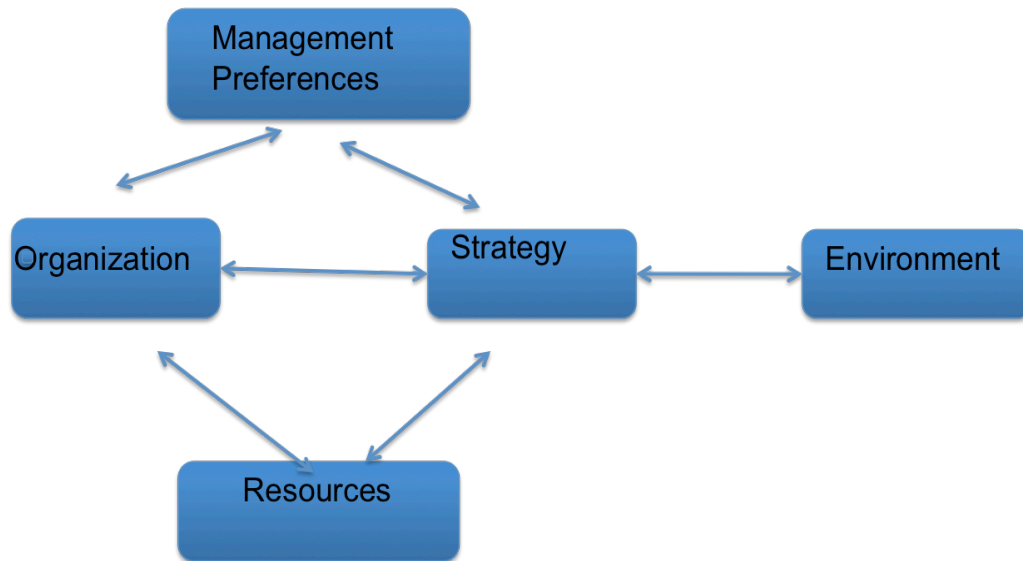
At the start-up stage, the flagship store will be scheduled for daily operation from 8:30 am to 8:30 pm for a total of 12 hours. In Shanghai, most coffee houses open after 10:00 am and close at 10:00 pm because they focus on customers' leisure time. However, the prospective company focuses on customers' working time, and thus, the open hours should be earlier than China's legal start-work time of 9:30 am, and later than the end-work time of 5:30 pm. The shop will provide fresh breakfasts to customers as such are rare occurrences in the current coffee house market.

The flagship store will employ both full-time and part-time staff to save costs and ensure effective operational requirements. Staff loyalty is of significance to any business and as such, the company will adopt a flexible, respectful, and trust-based working environment for them. All the employees will be treated equally and an effective reward system will be established.

## **3.2 Diamond-E Framework**

In the previous section, some concept proposals of the flagship store were introduced. This section, the Diamond-E framework (Crossan, Fry, Killing, 2004) identifies key conditions that a company must achieve to be successful. In addition, it defines the interconnections between them while providing a road map to examine whether such variables are consistent. High consistency will lead to successful performance, while inconsistencies will lead to poor performance. The model is presented below (see Figure 2).

Figure 2: The Diamond-E Framework



The following sections will apply this framework to assess the alignment of the prospective coffee shop chain's strategy, management preferences, resources, and organization internal capabilities. It also identifies the gaps that the company needs to focus on in the business plan.

### 3.3 Management Preference Analysis

Managers are authors and implementers of a company's strategy. Their preferences denote specific strategic actions and constraints just as much as an organization's capital and capacity (Crossan et al, 2005). Such preferences may reflect upon personal and/or professional beliefs, personality temperaments and the level of experience in the management team. If all the senior managers possess relatively little working experience, it is difficult to fully implement a successful company strategy.

This section will introduce the company's management team and assess whether their leadership, preferences, and work experience are consistent with requirements of the company's strategy implementation. If conflict does exist, the possible solution for it will also be discussed.

### **3.3.1 Management Values**

There are three co-founders in the company. They contributed a total of 600,000 RMB for the initial start-up funding, and thus, will all be on the board of directors as well as being members of the management team. They are friends with each other and two of them are undergraduate classmates. They all highly appreciate the Western coffee shop chain's business model and are deeply inspired by the goal of offering affordable fresh coffee to Chinese customers. All three co-founders firmly believe that their company will eventually succeed in the Chinese market, given that a firm like their's – a coffee shop that offers good quality coffee with a low cost approach – is non-existent, and there is a high market demand for such product.

### **3.3.2 Management Decision Criteria**

The three co-founders are all achievement-oriented people. They will make relentless efforts in developing the firm to be a leading low cost strategy company in China's coffee house industry. They also possess the desire to convert individuals' consumption habit and behaviour. This can be illustrated through an example where people stop going for the luxurious coffee experience, but instead consumes it daily as a permanent habit. Their short term goal is to establish a successful flagship store whereas

their long term goal is owning a coffee shop empire with more than one hundred outlets in various cities across China.

### **3.3.3 Current Management Experience**

Co-founder A is a MBA graduate from Ivey Business School. He has five years of work and study experience, two of which are in Singapore and the other three are in Canada. He also possesses five years of senior sales management work experience in the semiconductor industry in China and Southeast Asia.

Co-founder B is a MBA graduate from Segal Business School. She has two years of work and study experience in Canada. She also possesses three years of leadership work experience in the Chinese government, and is experienced in talent management skills such as recruiting, employee training, motivating staff, and also coordinating staff schedules and rotas.

Co-founder C is living in Shanghai and used to work for a private equity firm located also in Shanghai. He is familiar with accounting and finance management, possessing the skills to administer payrolls, develop and manage budgets, achieve sales targets and maximize profits. Additionally, he has a good network with bankers and investors.

### **3.3.4 Managers' Specific Functions**

The store managers consist of three co-founders. Based on the three different co-founders' working experiences, the managers' specific functions will be defined.

Co-founder A will build up good relationships with suppliers to ensure a fluent supply chain. He will supervise the company's overall development strategy. An

example of such is whether the company should integrate backward to lower the costs of raw materials, or whether it should franchise or merge with other companies.

Co-founder B will be responsible for the company's human resources. Her work responsibility includes staff recruiting, training, coordinating, cultivating employee loyalty, creating a good working environment, and supervision of employee's working performance. She will be in charge of the company's relationship with different government departments such as the Commerce and Industry Bureau and also the Tax Bureau.

Co-founder C will be responsible for the company's finances. His job responsibility includes conducting financial analysis on the company, supervising daily cash flow, and addressing the firm's financial development problems. He is also responsible for the company's relationship with other investors and lending institutions, ensuring the financial channel is operational.

### **3.3.5 Gap in Management Experience**

To achieve the company's strategic goals, an operations manager is very important for the company to ensure that the retail stores deliver high-quality food and drinks; the ability for the staff to provide excellent customer service are also his prime concerns. He is in charge of the common activities associated with business managers across any sector, including the oversight of sales, promotion, operations, finance, and human resources.

A closer look at the current company's management experience reveals that all three co-founders possess no prior relevant work experience. They have not worked in

restaurants or other service industries, and thus, lack specific operational management experience. Operational management is a crucial factor in determining whether the company succeeds. It is therefore, a key determinant for a business's success.

### 3.3.6 Suggested Gap-Bridging Solution

The suggested gap bridging is employing a professional operations manager who has relevant working experience. This manager's major responsibilities include:

- Working to ensure standards of hygiene are maintained and that the coffee shop retail store is complying with the health and safety regulations;
- Overseeing general maintenance of the shops such as its hygiene and safety;
- Ensuring high standards of customer service are observed at all times;
- Devising promotional marketing campaigns.

As estimated, an experienced operation manager's salary range is 50,000 RMB per year.

## 3.4 Organization Analysis

Organization is a configuration of individuals that cooperate collectively to ensure corporate strategies are properly implemented. Organization analysis includes its structure, system, and culture.



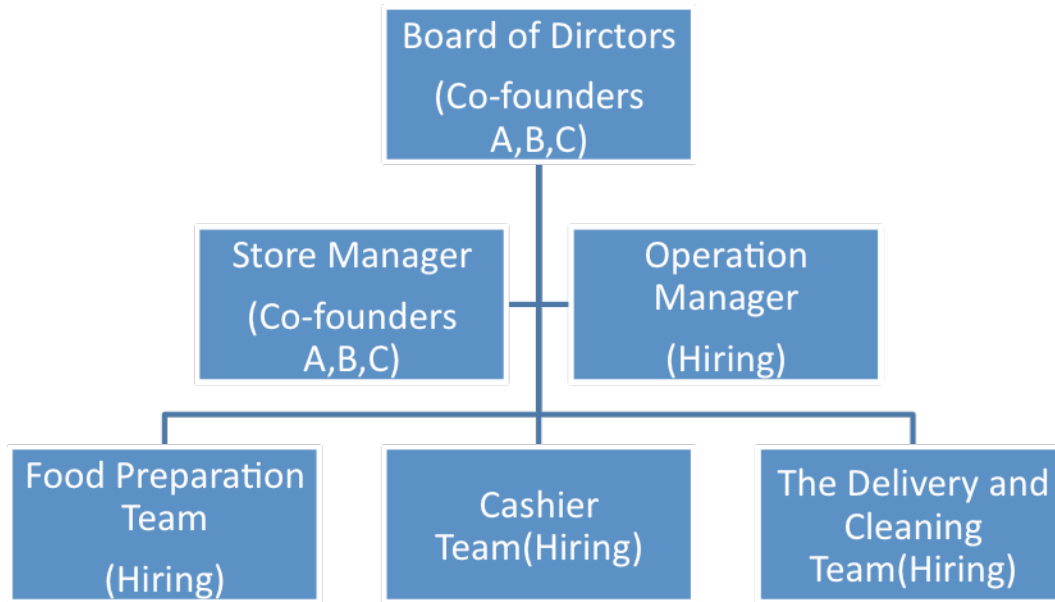
### **3.4.1 Structure**

The prospective coffee shop chain will be structured as a limited company legal corporation structure. The major benefit of this form is the limited liability of shareholders and the long-term financing available from the lending institutions.

Based on the previous analysis, the company will employ a centralized functional structure which is good for low cost strategy firms since staffs are not allowed to initiate on their own authority, thus, limiting costs. As Figure 3 shows, there is a board of directors consisting of three co-founders, which are also the heads of the management team. The three co founder managers, along with the operation manager, supervise all businesses and employees. The total employees will be divided into three groups – food preparation team, cashier team, and the delivery and cleaning team. The management team will address and handle with problems in relation to daily operations. They will also be responsible for the creation and implementation of store policies.

In Shanghai's food restaurant industry, the average salary is 6 RMB/Hour for full-time employees and 5 RMB/Hour for part-time employees. Such rates will be utilized for the three different groups – food preparation team, cashier team and the delivery and cleaning team. Given the prospective size of the flagship store, there will be 5 full-time workers and 10 part-time workers.

Figure 3: Flagship Store Organization Structure



### 3.4.2 Systems

#### 3.4.2.1 Information Technology System

The company will employ the Windows Embedded for Point of Service System (WEPOS) which will cost 1,400 RMB to optimize its operational capabilities, increasing efficiency while saving costs. As the first Microsoft operating system, WEPOS is designed specifically for point-of-service systems used by retail and hospitality organizations. There are several advantages for this system.

First, it integrates all the inventory records, sales records, financial analysis and customer information together. It is easier for the staff to use the system within their scope of responsibility. A cashier can use it to input all daily sales records; an inventory analyst can use it to check the supplier's status; an accountant can retrieve financial information and cash flow from it; a store manager can process all store cash card holders' information.

Second, it is empowered by self-service function. The customer can use its terminal checkout machine to order food independently. It will also decrease a customer's waiting time and save labour costs.

Third, this low retail point-of-servicing has a long life cycle and an easy learning curve also save the company's costs.

#### **3.4.2.2 Recruiting System**

The company will adopt a systematic recruiting process to ensure its employees have good personalities and high working qualities. First, it will post recruiting advertisements on job-hunting websites and collect all applicants' resumes. Second, recruiters will select the qualified resumes and contact those applicants. Third, the company will organize interviews to all the prospective employees and then decide which individuals will be suitable to work for the firm.

#### **3.4.2.3 Training System**

All the employees need to be trained according to the company's performance standards. The standards apply equally to behavioural communication – which includes the attitude and conduct of an employee – and also the ability to perform specific skills related to their work. This mandatory training will be completed before the flagship store's opening ceremony. After the official opening, the store manager will continually hold regular training sessions to cultivate employee's loyalty and create a friendly working environment.

#### **3.4.2.4 Reward System**

The company will produce a detailed reward system to encourage employees. The reward system includes sales quota, customer feedback, distinguished achievements, etc. Official rewards will be held on a quarterly basis, and the outstanding employee will be awarded by the board of directors.

#### **3.4.3 Organization Culture**

The impact of culture is of great significance when it comes to achieving personal and business goals. Organizational cultures are the characteristics that are based on morals, values, traditions and personal behaviours. The prospective company's organization culture will promote the following as its core set of values.

- Provide a great work environment and treat each other with the utmost respect, fairness, compassion and loyalty;
- Apply the highest standards of purchasing, roasting and fresh delivery of coffee and other food under low cost strategy;
- Ensure customers are satisfied throughout the entire shopping process;
- Keep business ethics such as fair trade and be environmentally friendly; contribute positively to our community through donations to children's education and cancer patients;
- Realize that profitability is essential to our future success.

### **3.5 Resources Analysis**

Resources provide businesses with the potential to act. To successfully implement a strategic proposal, it needs to draw on financial resources for the required investment, operating resources to supply the product or service, and so on.

This chapter will assess the company's resource from three aspects which are human resource, operational resource and financial resource.

#### **3.5.1 Human Resource**

As mentioned, one of the biggest attractiveness for business in China is its low cost but high quality human resources. The company's flagship store will recruit one operation manager, five full-time employees and ten part-time workers. It will conduct employee-training programs, with key focus on coffee knowledge education, skills training, customer services, and employee loyalty. This program will last about 4 weeks before the flagship store is opened.

The most popular recruiting channel in Shanghai is through the Shanghai Labour Market or posting advertisements on popular comprehensive recruiting websites. The average recruiting websites quotation is 300 RMB/Year, which allows a company to post 50 job positions and download 300 pieces of applications' resume.

#### **3.5.2 Operational Resource**

Negotiating a reasonable real estate lease rate for store's location is critical. Currently, the rental price per square meter in Shanghai's central business district costs 10,000 RMB/Year. If the flagship store has 70 square meters, the lease cost will be

around 700,000 RMB/Year. Because Co-founder C has a great network with real estate developers and business people in Shanghai, this rental cost will be 600,000 RMB/Year.

The high competition of suppliers makes raw materials and equipment for coffee shops readily available. Annual exhibitions of international coffee businesses and other coffee trade institutions, clubs, and websites provide excellent distribution channels to connect buyers and suppliers in the coffee industry in China.

A close friend of Co-founder B is a senior manager in a top advertisement company located in Shanghai. Thus, branding promotional materials such as business logos, menu designs, shop décors, and staff uniforms will be a relatively straightforward process at a cost-effective manner for the coffee shop.

### **3.5.3 Financial Resource**

As estimated below:

- Total employee salary costs: 250,000 RMB/Year;
- Real estate lease costs: 600,000 RMB/Year;
- Equipment costs: 100,000 RMB;
- Raw materials will costs: 150,000 RMB;
- Marketing costs: 150,000 RMB;

Including utilities and other expenses, the total budget for this coffee shop flagship store in the first year will be up to 1,400,000 RMB, combining both on-going expenses and one-time expenses.

There is a high possibility to lend or finance another 1,000,000 RMB from some angel investors and/or other institutions based on two reasons. First, an initial start-up funding of 600,000 RMB is already invested from the three co-founders. Second, co-founder C has useful connections with bankers and investors he met from his previous employment.

## 4: FINANCIAL PERFORMANCE ANALYSIS

This chapter will evaluate the feasibility of the prospective coffee shop's profit capability by presenting a five-year financial statement projection.

The funding from co-founders and other institutions are being treated as a note payable by the company for five years at a 7% compounded yearly interest rate (see Table 3). The co-founders will be paid from general and administration expense for their supervision of management work. Retained earnings will be used to reinvest for the company's expansion.

*Table 3: Initial Investment Payable Schedule*

Year	Total Payment	Principal Paid	Interest Paid	Ending Principal Balance
				1,400,000
2010	392,714	294,714	98,000	1,570,858
2011	392,714	282,754	109,960	1,178,143
2012	392,714	310,244	82,470	785,429
2013	392,714	337,734	54,980	392,714
2014	392,714	365,224	27,490	0
<b>Total</b>	<b>1,963,572</b>	<b>1,590,672</b>	<b>372,900</b>	
Loan amount: 1,400,000				
Loan will be paid off after 5 years				
Interest rate: 7%				
Total payment:				
1,963,572				
Total Interest Paid: 372,900				



## 4.1 Financial Performance Projection

This section will display a five-year projected financial statement for the company's flagship store and evaluate the company's profitability by sensitivity analysis.

### 4.1.1 Ratio and Driver Assumptions

The five years financial statement projections are based on the previous analysis along with the following assumptions:

- A 70 square meter store with a 30 seat capacity;
- Store operation are 12 hours/day, 365 days/year;
- In the first year, there are 500 customers visiting the store everyday,<sup>7</sup> (and this number will grow about 20 percent annually);
- The average revenue per consumer per order is 20 RMB which includes a cup of coffee (10 RMB-15 RMB) and food (5 RMB-10 RMB);
- Cost of goods sold and operation expense, which includes employee costs, utilities, etc, are variable costs. Their first year percentage rates in the total sales were estimated based on the industry average ratios;
- The prospective projection is financed by notes payable to all stakeholders. Principle and interest repayments are on an annual basis. The co-founders receive management administration fee rather than a fixed salary;

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<sup>7</sup> Estimation based on the current average number of customers in food and drink stores located in centre business district of Shanghai.

- The revenue is assumed to grow at the rate of 20 percent per year over the five-year period. This is lower than the current coffee shop industry growth rate of 25%;
- Real estate lease cost is assumed to grow at the rate of 3% percent per year over the five-year period.

#### **4.1.2 Projected Income Statement**

As indicated in the following income statement (see Table 4), the coffee shop chain's flagship store is expected to have a steady growth in profitability over the first five years operation. In 2010, the net profit is 668,036 RMB. In 2014, the store's net profit is up to 2,375,712 RMB.

#### **4.1.3 Projected Balance Sheet Statement**

The following projected balance sheet presents the difference from beginning of year 2010, and the end of year 2014 (see Table 5). It depicts a significant improvement with a substantial increase in retained earnings. The notes payable has been paid down through earnings over five years with a considerable amount of cash on hold. This favourable statement demonstrates that the co-founders have solid capabilities to improve the company's internal capabilities and conduct further business expansion.

Table 4: Projected Income Statement

		2010	2011	2012	2013	2014
<b>Sales</b>	100%	<b>¥ 3,650,000</b>	<b>¥ 4,380,000</b>	<b>¥ 5,256,000</b>	<b>¥ 6,307,200</b>	<b>¥ 7,568,640</b>
<b>Costs and expenses</b>						
Cost of sales	30%	1,095,000	1,314,000	1,576,800	1,892,160	2,270,592
Operating expenses	15%	547,500	657,000	788,400	946,080	1,135,296
Administrative expenses	5%	182,500	219,000	262,800	315,360	378,432
Real estate Lease		600,000	618,000	636,540	655,636	675,305
Asset impairment	1%	36,500	43,800	52,560	63,072	75,686
Other expenses	0.50%	18,250	21,900	26,280	31,536	37,843
<b>Total</b>		<b>2,479,750</b>	<b>2,873,700</b>	<b>3,343,380</b>	<b>3,903,844</b>	<b>4,573,155</b>
Notes payable		392,714	392,714	392,714	392,714	392,714
<b>EBT</b>		<b>777,536</b>	<b>1,113,586</b>	<b>1,519,906</b>	<b>2,010,642</b>	<b>2,602,771</b>
Income taxes	3%	109,500	131,400	157,680	189,216	227,059
<b>Net income</b>		<b>668,036</b>	<b>982,186</b>	<b>1,362,226</b>	<b>1,821,426</b>	<b>2,375,712</b>

Table 5: Balance Sheet Year One and Year Five

<b>Balance Sheet of The company's Flagship Store</b>		
	<b>Opening - Beginning of Year One 2010</b>	<b>Closing - End of Year Five 2014</b>
<b>Current Assets</b>		
Cash in Bank	100,000	7,000,000
Inventory	150,000	150,000
Prepaid Expenses	250,000	250,000
Application	70,000	100,000
<b>Fixed Assets</b>		
Lease	600,000	675,305
Equipment	150,000	100,000
Shop Décor	80,000	80,000
Depreciation	-	-90,000
<b>Total Assets</b>	<u>1,400,000</u>	<u>8,265,305</u>
<b>Current Liability</b>		
Notes, due within 1 year	392,714	392,714
<b>Long Term Liability</b>		
Notes Payable	1,007,286	-
<b>Owners Equity</b>		
<b>Retained Earnings</b>	-	<u>7,872,591</u>
<b>Total Liabilities and Equity</b>	<u>1,400,000</u> -	<u>8,265,305</u>

#### **4.1.4 Sensitivity Analysis**

Sensitivity analysis is a technique used to determine how different values of an independent variable will impact a particular dependent variable under a given set of assumptions. This technique is used within specific boundaries that will depend on one or more input variables, such as the effect that changes in real estate lease cost will have on the net income.

Sensitivity analysis is a way to predict the outcome of a decision if a situation turns out to be different compared to the key prediction(s). In this section, we will evaluate the company's profit capability based on the worst market scenario assumption.

First, it is possible that in the next five years, China will experience an economic downturn. Although the company kept a low cost strategy, its revenue will still be influenced and the sales growth rate ranges from 5% to 8%.

Second, the raw material's price increases dramatically because of inflation. The cost of goods sold took 40% of total revenues as opposed to the original 30%.

Third, the new government policy requires the company to increase employees' salaries which cause an increase in operation expense from 15% to 20%.

In this scenario, the company's projected income statement is below (see Table 6).

This income statement displays that even in the worst market scenario; the company still can make a profit of at least one hundred thousand RMB per year.

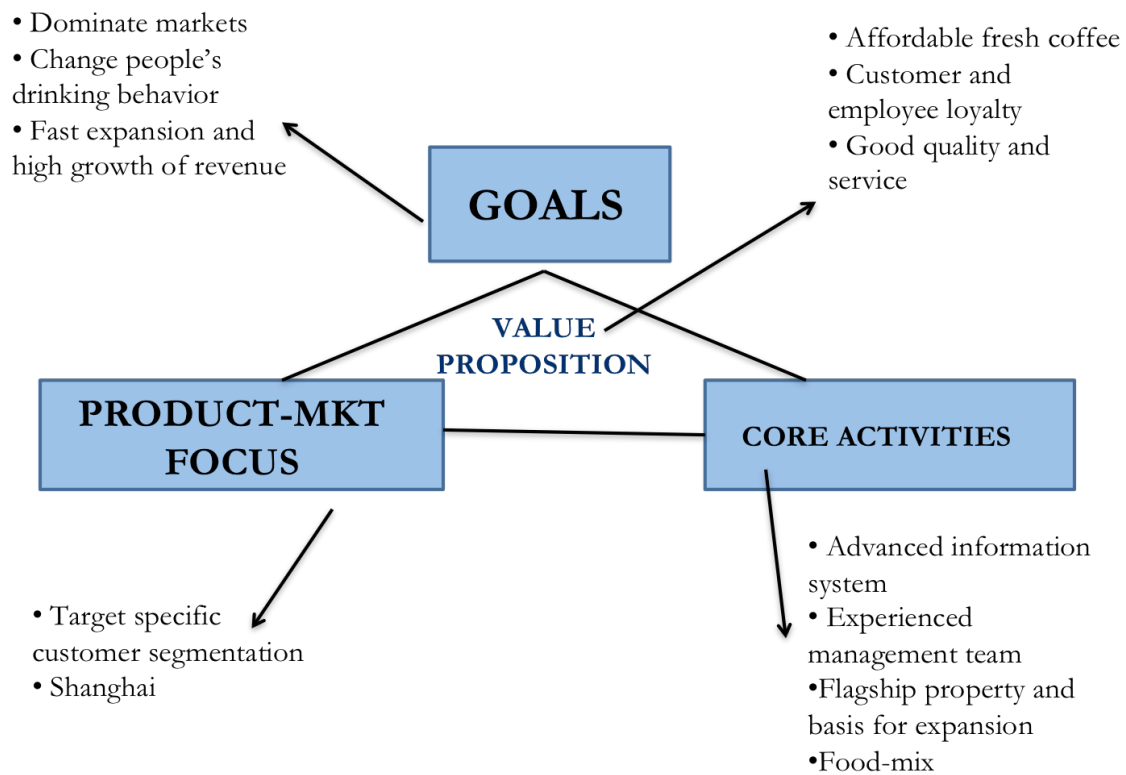
Table 6: Projected Income Statement in the Worst Scenario

		2010	2011	2012	2013	2014
<b>Sales</b>	100%	<b>¥ 3,650,000</b>	<b>¥ 3,832,500</b>	<b>¥ 4,024,125</b>	<b>¥ 4,305,814</b>	<b>¥ 4,650,279</b>
<b>Costs and expenses</b>						
Cost of sales	40%	1,460,000	1,533,000	1,609,650	1,722,326	1,860,112
Operating expenses	20%	730,000	766,500	804,825	861,163	930,056
Administrative expenses	5%	182,500	191,625	201,206	215,291	232,514
Real estate Lease		600,000	618,000	636,540	655,636	675,305
Asset impairment	1%	36,500	38,325	40,241	43,058	46,503
Other expense	0.50%	18,250	19,163	20,121	21,529	23,251
<b>Total</b>		<b>3,027,250</b>	<b>3,166,613</b>	<b>3,312,583</b>	<b>3,519,002</b>	<b>3,767,741</b>
Note payable		392,714	392,714	392,714	392,714	392,714
<b>EBT</b>		<b>230,036</b>	<b>273,174</b>	<b>318,828</b>	<b>394,097</b>	<b>489,824</b>
Income taxes	3%	109,500	114,975	120,724	129,174	139,508
<b>Net income</b>		<b>120,536</b>	<b>158,199</b>	<b>198,104</b>	<b>264,923</b>	<b>350,316</b>

## 5: RECOMMENDATIONS AND CONCLUSIONS

After the overview of prospective coffee shop's environmental competition and internal capabilities, the recommended strategy is illustrated in Figure 4.

Figure 4: Coffee Shop Chain Business Strategy



## 5.1 Action Plan Before The Flagship Store Opening

There is a timeline for the implementation of the recommendations in the most efficient and cost effective way.

Ten months before:

- Optimize business plan;
- Finalize a partnership agreement and identify job responsibilities ;
- Choose a premium location in CBD Shanghai and start negotiating a lease rate;

Six months before:

- Settle down the first amount of investment (600,000 RMB) as start-up funding from co-founders;
- Present business plan to potential investors and do financing activities for another 1,000,000 RMB;
- Sign real estate lease contract.

Four months before:

- Start shop décor;
- Develop relationship with suppliers.

Three months before:

- Post recruitment advertisements and start recruitment process;



- Confirm all prices of products in supplier list, such as equipment, coffee beans, food materials, etc;
- Contact an advertisement company to design company logos, staff uniforms, etc.

Two months before:

- Plan promotional campaigns for opening ceremony;
- Review budget;

One month before:

- Delivery of initial orders of equipment and other supplies;
- Test all equipment;
- Staff training;
- Branding to target customers.

## **5.2 Business Expansion Plan**

The company will invest its retained earnings in the business expansion.

First, leveraging this amount of money to will attract more investment. The exceptional profitability from the company will give investors more confidence to support this business. With almost 8,000,000 RMB in retained earnings, it is easy for the company to finance another 8,000,000 RMB investment. Then the company will have sufficient funding to expand its business.

Second, invest in real estate. Real estate in China is a good investment with low risk. Purchasing the company's own real estate will ensure no threat from the real estate developer shall he terminate the lease contract. Also, real estate can raise the entry barrier for the coffee house industry.

Third, open additional outlets. As the coffee shop chain, the more outlets up and running, the lower the operation costs in regards to economies of scale. Also, additional outlets can help company capture market share, increase brand recognition and distribute business risks.

### **5.3 Conclusion**

The purpose of this business proposal is to offer affordable fresh coffee to individuals on a daily basis. This business plan comprehensively analyzed the environment of the coffee house industry in China and examined the consistency and connection of the internal capabilities. It developed the strategic plan as a first step to opening a flagship store, which is a critical precursor to the long-term goal of developing a low cost coffee shop chain in China. The next step will be putting this business plan into practice, and only a close interrelationship between the formulation of the strategy plan and its execution will lead to the successful operation of this start-up coffee shop.

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