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Global Coffee Alliance A Case Study on Nestle and Starbucks Licensing Deal 2018

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Abstract: This case study has been undertaken to investigate the strategic objectives and key determinants of the licensing deal that took place between Nestle and Starbucks in the year 2018. The study has conducted an in-depth analysis of the deal and attempted to answer questions like what, where, how, how much and why arising out of the deal in order to understand the intricacies of the deal. An analysis of the returns post the deal has also been conducted to come to a conclusion about the success/failure of the deal and its future prospects. All the sources referred for the study are given due accreditation.

Keywords – Nestle, Starbucks, Licensing, Consumer Packaged Goods, Global Coffee Alliance

1. INTRODUCTION

1.1. Nestle's Coffee Overview-

Nestle is the world's largest hot drinks company, and the global leader in retail coffee and flavoured powdered drinks. Nestle today has roughly 16% of the global hot drinks market and is the leader in instant coffee, pod coffee and flavoured powder drinks (2020). Nescafe continues to grow strongly in developing countries and provides a bulk of Nestle's overall hot drinks growth. However it struggles in developed countries where Nestle's two pod systems – Nespresso and Dolce Gusto - are more than making up for those declines. Historically, Nestle had no major role in fresh coffee beans or standard fresh ground coffee, but the purchase of the rights to Starbucks products at retail makes it a major player in both categories.

1.2. Starbucks' Packaged Food Products Business-

Starbucks is the top premium brand in the US for single serve coffee pods, roast and ground coffee and ready-to-drink coffee. In 2011, Starbucks reasserted control over its consumer packaged goods business, after accusing long-time partner Kraft of mismanaging the brand. The business generates \$2 billion in annual revenue (2018). Starbucks CPGs is a part of its channel development segment which includes roasted whole bean and ground coffees, premium Tazo teas, Starbucks- and Tazo-branded single-serve products, a variety of ready-to-drink beverages. Out of this, Ready-To-Drink is slated to be a pillar of Channel Development followed by Single – Serve coffee. Starbucks enjoy No. 1 brand position in single serve coffee in US and seeks to hold the No. 1 brand position in the segment globally.

2. BACKGROUND OF THE DEAL

In August 2018, Nestle and Starbucks Corporation entered into a licensing deal granting Nestle the perpetual rights to market and distribute Starbucks consumer packaged goods and food service products globally, outside the company's coffee shops. As a part of the deal, Nestle made a USD 7.15 billion upfront payment in May 2018. The agreement covers Starbucks packaged coffee and tea brands, such as Starbucks, Seattle's Best Coffee, Teavana, Starbucks VIA Instant, Torrefazione Italia coffee and Starbucks-branded K-Cup pods (product type: Starbucks labelled coffee beans, roast and ground coffee and single-serve capsules). It excludes Ready-to- Drink products and all sales of any products within Starbucks coffee shops. In addition to the cash payment, Starbucks will also receive revenue from product sales and royalties. Apart from that, approximately 500 Starbucks employees who work in the consumer packaged goods segment in the United States and Europe will join the Nestle's family. With the license, Nestle gets a business that currently generates about \$2 billion in annual revenue and Starbucks will get access to Nestle's distribution in 189 countries and its installed base of single serve Nespresso and Nescafe Dulce Gusto machines.

3. HOW AND WHERE DID THE DEAL TAKE PLACE?

At the end of August 2018, Nestle and Starbucks entered into the license agreement. Nestlé will lead the international expansion of the business from global headquarters in Vevey, Switzerland. The agreement came into effect under the Swiss Law and The Cartel Act that governs licensing agreements in Switzerland.

Licensing agreements are generally deemed to be subject to the general competition law rules. The Cartel Act regulates binding and non-binding arrangements and concerted practices that have as their object or effect the restriction of competition in Switzerland.

A licensor who intends to enter into a license agreement under Swiss law can do so without establishing a subsidiary or branch office in Switzerland. Under Swiss law, there are no form requirements for license agreements. License agreements are valid even if concluded orally or tacitly. There is no legislation governing the nature, amount, manner or frequency of royalty payments or other fees or costs. The parties are, in principle, free with respect to their financial arrangements. Likewise, neither royalty rates nor other fees or costs require regulatory approval in Switzerland.

4. WHY DID NESTLE ENTERED INTO THE LICENSING AGREEMENT WITH STARBUCKS?

The alliance could strengthen Nestle's position as the world's biggest coffee company in a fast changing landscape. Let us look at some of the major reasons driving the agreement lucrative for Nestle:

4.1. Single-Serving up Opportunity –

The coffee industry's single-serve segment, which consists of machines that brew single cups of coffee using pre-packaged pods, is currently the fastest growing segment and is expected to grow at five times the rate of the overall industry. Today, approximately 40% of American households own a single-cup brewer (2020), compared to 7% of households in 2011 (refer to Chart 1).

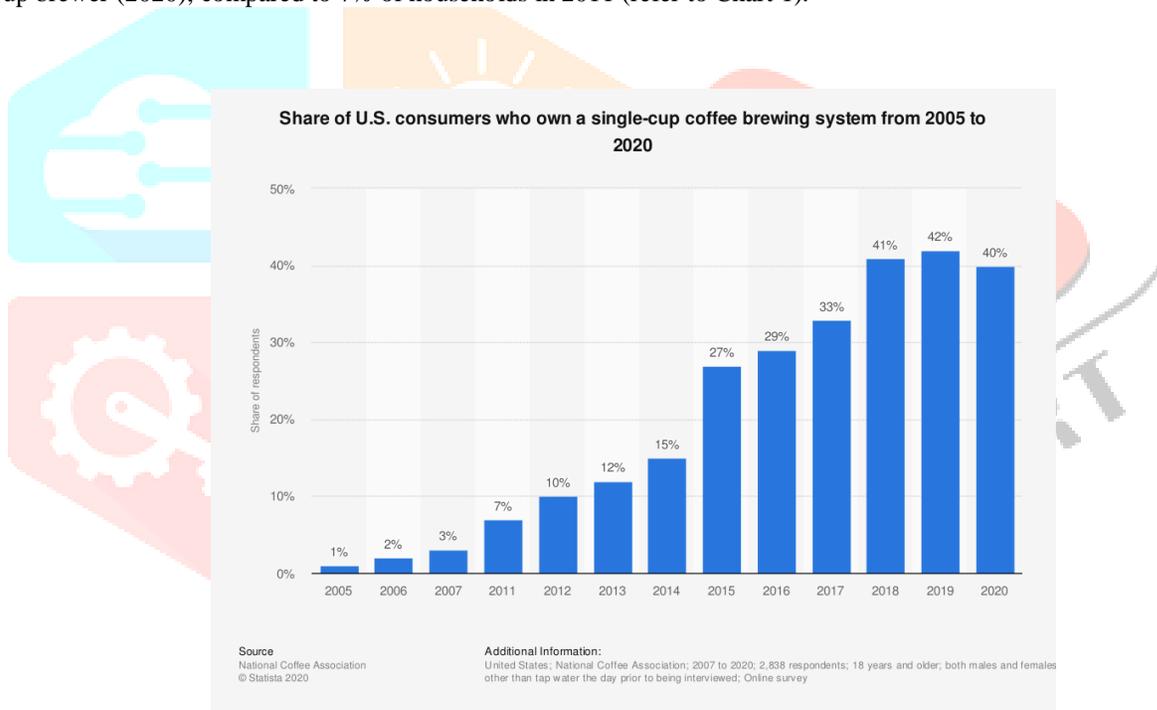


Chart 1. Consumption of single – cup coffee system in US

(Source: Statista)

4.2. Roast Coffee generates the most revenue within coffee segment globally -

Another reason for Nestle to acquire distribution rights of Starbucks labelled coffee beans, roast and ground coffee and single serve capsules is the burgeoning demand and consumption of roasted coffee. As per Statista, roast coffee generates the most revenue within the coffee segment (73% of \$431 billion) and is expected to increase at a CAGR of 5.7% by 2025 (est. 72% of \$600.3 billion). (See Chart 2 by Statista)

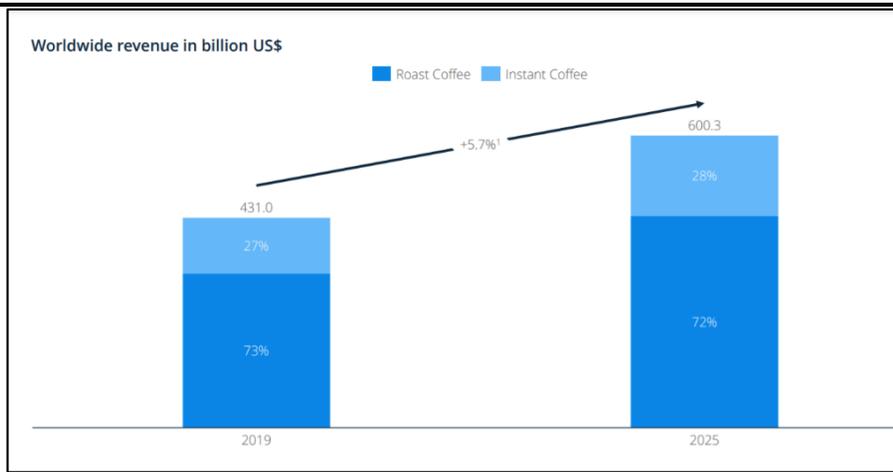


Chart 2. Global coffee revenue by coffee type
(Source: Statista Consumer Market Outlook 2020)

4.3. Nespresso facing trouble brewing in North America –

Nespresso when entering North America believed it could repeat its success by using the same advantages it had when pioneering the market in Europe. However, when Nestle entered North America, the single-serve market was already well-established with industry leaders such as Keurig and Tassimo. Apart from that, Nestle’s products were more expensive than competitors’ products and Nespresso established very few B2B partnerships within North America. The growth of the premium single-serve market within North America is an important opportunity for Nespresso. To maintain its leading position in the single-serve industry, Nespresso must succeed within the North American market.

4.4. Market leadership in North America-

According to Euromonitor, the Nescafe and Nespresso brands commanded 15.0% and 4.5% market share globally in 2017 compared to Starbucks' global market share of 2.4%. However, in the U.S., the two Nestle brands were limited to 2.2% and 2.5% shares with Starbucks accounting for 12.8% (See Chart 3). Starbucks’ major sales in pods come from Keurig compatibles in North America. The purchase of Starbucks coffee products is expected to create a further potential for Nestle in coffee pods. Chart 4 depicts the market share of Starbucks and Nestle in US vs Worldwide and further explains Nestle’s interest in capitalising the opportunity to gain market share.

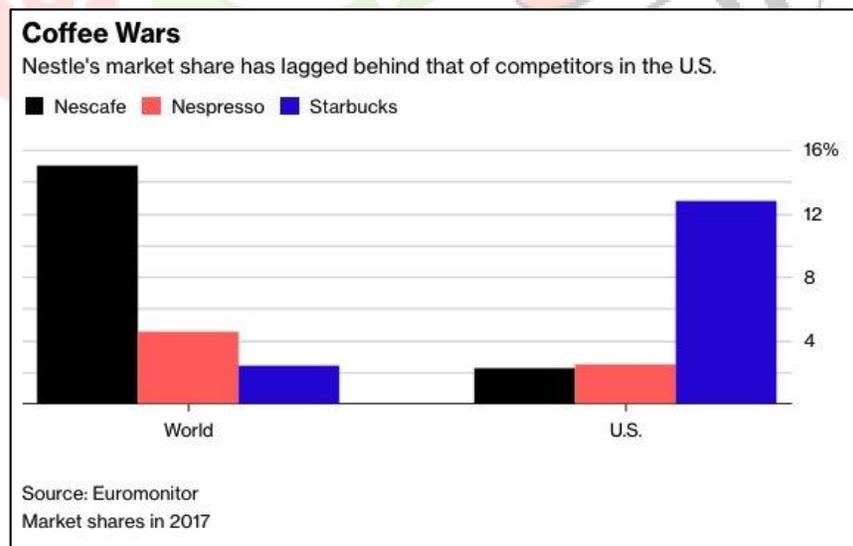


Chart 3. Coffee market share in US vs worldwide
(Source: Euromonitor, 2017)

4.5. Complimentary product portfolio-

The products of Starbucks complements the pre-existing product offerings of Nestle. Starbucks branded pods are compatible with the Nespresso and Dolce Gusto systems and hence the complimentary products are expected to bring a huge growth potential in especially the developed markets. The deal also gives Nestle a presence in beans and standard ground coffee, strengthening its product portfolio.

4.6. Facing the biggest competitor JAB holdings-

According to Euromonitor, the global packaged coffee market is worth \$80 billion and it is growing at an annual rate of 5%. Nestle was the leader in the market with approximately 22.7% of the market share in 2013. With a market share of 16.3%, Jacob Douwe Egberts (JDE), one of the JAB holdings, ranked second in the world’s coffee market (see Chart 4). JAB is seeking to enter into a deal with Keurig. After the deal, JAB’s share in the global coffee market is estimated to reach approx. 20% with the addition of Keurig’s brands and products in portfolio. In such a scenario, the global coffee alliance between Starbucks and Nestle is expected to help Nestle to tackle tough competition in the coffee market from rivals.

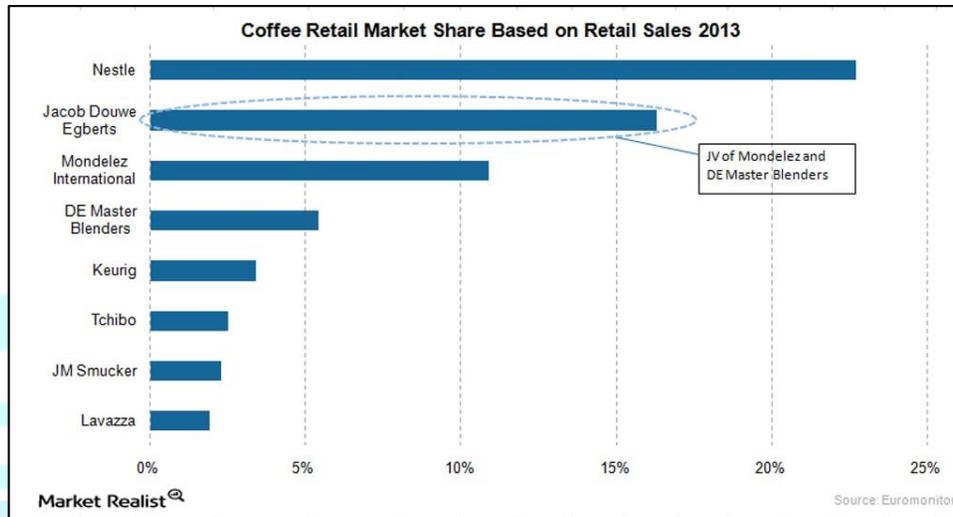
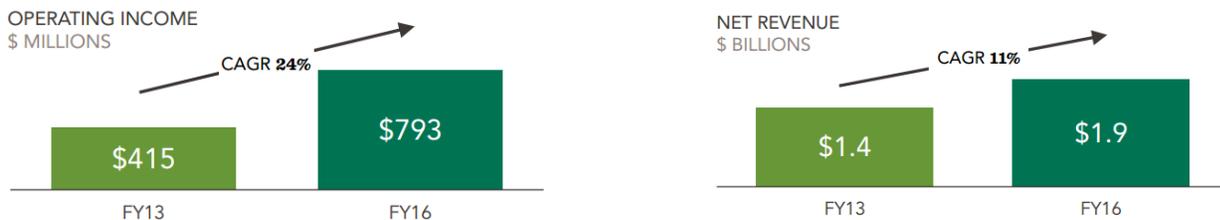


Chart 4. Threat to Nestle’s business by JDE (JAB holdings)

(Source: Euromonitor)

4.7. Starbucks’ CPGs show huge growth potential -

The Consumer Packaged Goods (CPG) business has been a key driver of profit growth for Starbucks. Between fiscal 2013 and fiscal 2016, the net revenue observed 11% CAGR rising from \$1.4 billion to \$1.9 billion while segment’s operating margin observed 24% CAGR.



Starbucks CPGs CAGR (%) from FY13 – FY16

Source: Starbucks Company Filings

5. WHY DID STARBUCKS AGREE TO SELL ITS RIGHTS OF CPG TO NESTLE?

There were a few major reasons that convinced Starbucks to take up this deal-

5.1. The alliance frees Starbucks to focus on its key growth engines –

Starbucks want to focus on US mainstay café business, where traffic growth has stalled amid competition from fast food chains and upscale coffee houses, while also rapidly growing and adding shops in China. China is all the more attractive because of its huge and growing middle class. Starbucks CEO Kevin Johnson has said that the two biggest growth engines for the company are the U.S. (where it focuses on premium sales) and China, where it is introducing the coffee culture to tea drinkers.

5.2. Increase planned stock buybacks -

Starbucks plans to use proceeds to increase planned stock buy backs to \$20 billion from \$15 billion over the next three years. The company further predicts to add to its EPS by 2021.

5.3. Starbucks global expansion in grocery and food service-

Starbucks revenue from retail consumer goods are only a small proportion of Starbucks total revenue. The licensing agreement with Nestle is expected to boost the sales of packaged consumer goods of Starbucks with the strong retail distribution network of Nestle. The deal gives Starbucks access to Nestle's distribution in 189 countries and its installed base of single serve Nespresso and Nescafe Dolce Gusto machines.

6. ANALYSIS OF THE RETURNS POST THE DEAL

As per Nestle's 2019 annual report, within six months of acquiring the license to market Starbucks CPGs, Nestle successfully launched the first wave of new products. In less than 12 months, it launched 29 Starbucks products into more than 40 countries and generated incremental sales of more than CHF 300 million. Nestle also took Starbucks into new territory with the introduction of new creamer formats getting good response from customers. Nestle's coffee portfolio overall saw good momentum led by strong demand for Starbucks products. Nestle's entering into new product formats is proving a great success for the company. The report also highlights that net acquisitions increased its sales by 3.5% with the beverage category witnessing high single digit growth, largely owing to the acquisition of the Starbucks license.

In 2020, as pandemic continued to impact people, Nestle experienced organic growth of 4.1% in developed markets and 1.1% in emerging markets. Starbucks products continued to grow at a double digit rate, driven by further global expansion and launch of new offerings. E-commerce sales also gained momentum driven by Nescafe and Starbucks products.

As per Starbucks Annual Report 2019, revenue from licensed stores account for 11% of the total revenue of Starbucks. The licensed stores revenue grew \$223 million owing to royalty revenues from licensees. However, Other Revenues decreased \$228 million, driven majorly by licensing Consumer Packaged Goods to Nestle (as mentioned in report). Hence, it can be inferred that Starbucks incurred a net decline by 3.7% in revenue in the year 2019 owing to the licensing agreement with Nestle. The company also reported decrease in other operating expenses by \$184 million, primarily due to cost savings related to licensing CPGs and Foodservice businesses to Nestlé easily offsetting the decline in revenue.

RESULTS OF OPERATIONS — FISCAL 2019 COMPARED TO FISCAL 2018

Consolidated results of operations (in millions):

Revenues

Fiscal Year Ended	Sep 29, 2019	Sep 30, 2018	% Change
Net revenues:			
Company-operated stores	\$ 21,544.4	\$ 19,690.3	9.4%
Licensed stores	2,875.0	2,652.2	8.4
Other	2,089.2	2,377.0	(12.1)
Total net revenues	\$ 26,508.6	\$ 24,719.5	7.2%

Starbucks – Results of Operations 2019 and 2018

(Source: Screenshot from Starbucks Annual Report 2019)

On February 27, 2020 Keurig Dr Pepper announced a long term strategic agreement with Nestle USA to manufacture and distribute Starbucks branded packaged coffee in K-Cup pods in the US and Canada. This agreement with KDP enables Nestle to accelerate the growth of Starbucks brand on the Keurig K-Cup platform with its marketing and distribution channels. This deal replaced the pre-existing K-Cup pod agreement between KDP and Starbucks following a transition period.

7. WAS THE STRATEGY SUCCESSFUL?

7.1. Nestle No. 1 globally with three leading brands –

The deal strengthened Nestle's No. 1 position globally and helped it to give tough fight to its major rival JDE (JAB holdings). According to Euromonitor, Nestle's global market share increased to approx.. 24% in 2019 followed by JDE with approx.. 10% market share (See Chart 5). Along with it, Nestle's portfolio now includes the world's most renowned iconic coffee brands – Nescafe, Nespresso and Starbucks.

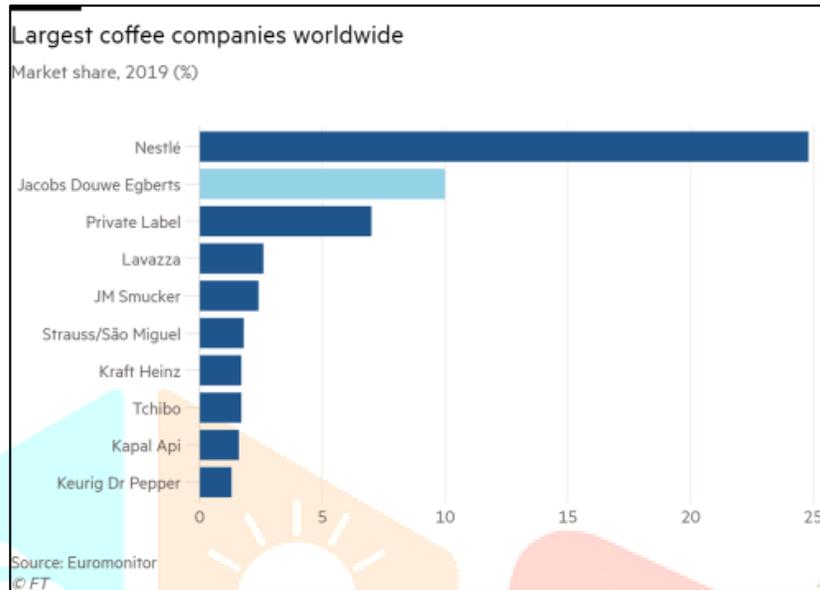
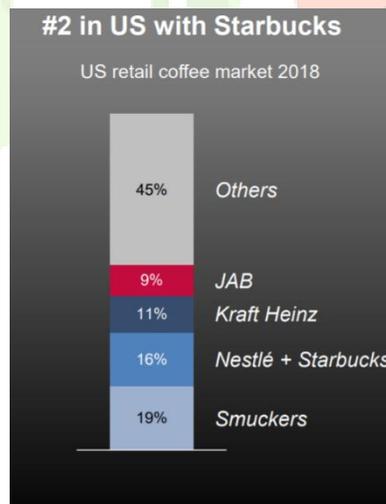


Chart 5. Nestle - largest coffee company worldwide
(Source: Euromonitor, 2019)

7.2. No. 2 position in US with Starbucks –

The licensing deal bolsters Nestle in the United States where it was weak and gives it a presence in “roast and ground” coffee, big in grocery stores and food service outlets. US retail coffee market in 2018 observed 16% market share of Nestle and Starbucks after Smuckers with 19% share.



US retail coffee market 2018

(Source: Nestle data and estimates of coffee sales, 2018)

7.3. Increased demand for Starbucks products -

On the Starbucks front, the demand for Starbucks at-home coffee soured during the pandemic. Due to the negative impact of the pandemic, the customers had adjusted themselves to at-home coffee routines. This had turned to be a favourable position for Starbucks which was able to increase its market share through the alliance with Nestle selling its packaged coffee business online and offline.

7.4. Starbucks fulfil its strategic objectives from the deal –

7.4.1. Starbucks's café business in US –

Starbucks aim to focus on the mainstay café business where growth had stalled amid competition from coffee houses, also seem to have ripe positive benefits after the deal. Starbucks has achieved the largest market share in coffee chains (by number of outlets) in US as of October 2019 as per Statista. (See Chart 6)

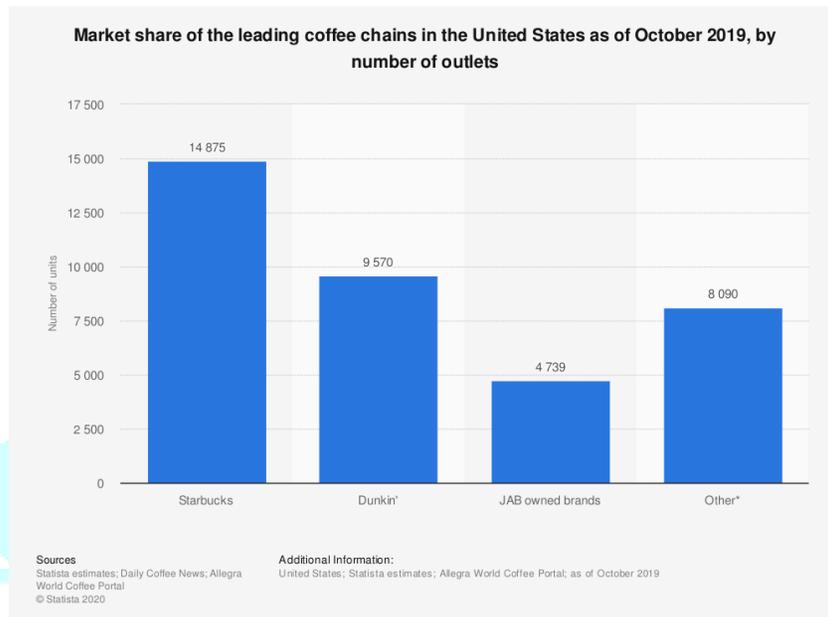


Chart 6. Starbucks – leading coffee chain in US as of Oct, 2019

(Source: Statista, 2020)

7.4.2. Reaping long term licensing revenue from the Alliance -

Starbucks expects to earn good amount of royalty revenue with increased sales resulting from Nestle's strong distribution and global reach. In an interview with Nestle's head of coffee brands, David Rennie informed that Nestle improved the \$2 billion in annual revenue made by Starbucks consumer packaged products before the deal by 15% via the alliance at the end of the first fiscal year after the deal.

8. CONCLUSION

To conclude, Nestle's licensing agreement with Starbucks turned out favourable for both the companies. Licensing the retail operations out to Nestle allowed Starbucks to focus better on its key growth engines while helping to build brand awareness in other tea drinking populations like India where the Nestle brand is strong. The Global Coffee Alliance combined the strengths and affinity of the Starbucks brand with the global reach of Nestle and its iconic coffee brands. It enhanced Nestlé's retail and foodservice presence in coffee, complementing its position in instant coffee and premium single serve with Starbucks branded K-cup pods. Simultaneously, it created new growth opportunities for Starbucks in the established North American market and unlocked expansion in international markets. Nestle now boasts to be the largest coffee portfolio. With Starbucks, Nescafe and Nespresso, Nestle has brought together the world's most iconic coffee brands.

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