MHE-FTR-042
1259927628
REV: JANUARY 4, 2017

TEACHING NOTE

Starbucks Corporation

Case Overview

With more than 25,000 stores in 75 countries and $21 billion in annual revenues, Starbucks is the largest roaster and retailer of specialty coffee in the world.

Howard Schultz's strategic leadership was critical in turning Starbucks around. He is now hoping that his second retirement from the company he built from the ground up will be his final one. In the meantime, Kevin Johnson, the new CEO, faces several challenges. In particular, the question of maintaining core competencies and how to achieve future growth, both domestically and internationally, are central to the case. The case also focuses on diversification, as Starbucks is branching out in new areas such as menu extensions including offering alcohol as well as rolling out coffee bars with high-end offerings such as a $12 cup of coffee.

The case briefly outlines the history of Starbucks since its founding in 1971, describes Starbucks' incredible growth after Howard Schultz acquired the company in 1987, and characterizes some of the factors that contributed to Starbucks' success, specifically: a differentiation strategy built on high quality coffee, personalized customer service, an in-store experience that invites customers to linger, and a commitment to corporate social responsibility.

The case also describes several of Starbucks competitors, including:

1. Competitors that seek to out-differentiate Starbucks; e.g., Peet's Coffee and Tea, Stumptown Coffee, Intelligentsia Coffee, and Panera Bread.
2. Competitors that seek to imitate Starbucks at lower prices; e.g. Dunkin' Donuts and McDonalds.
3. Competitors that seek to substitute the Starbucks in-store experience; e.g. Keurig Green Mountain and Nespresso.

The case concludes by showing how Starbucks' dominance of the North American market may be nearing saturation, as evidenced by declining same-store sales growth. In response to this market saturation, the case provides discussion questions on how Starbucks might grow future earnings through increased digital engagement with customers and further global expansion.

Professor Frank T. Rothaermel prepared this case from public sources. He gratefully acknowledges Eric Erzinger and Tapa Sitaula for research assistance. This case is developed for the purpose of class discussion. This case is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, and all errors and omissions, are entirely the author's.

One additional question that arises given that Starbucks' growth in the United States is maturing and the fact that competitors position themselves both on the higher and the lower end is whether there is a risk for Starbucks become "stuck in the middle." As such, will Starbucks be able to maintain the experience as a "third place," and will its customers continue to pay premium prices? The case ends with Howard Schultz wondering how long his second retirement will last since he was called back after his first retirement in 2008 when the company was in serious trouble.

Key Concepts

- Vision, mission, and values
- Strategic leadership and succession
- Core competencies
- Positioning strategy
- Maturing domestic market
- International growth opportunities
- Diversification
    - Product-market
    - Geographic
- Implementation of strategic initiatives

Suggested Discussion Questions

1. **How did Starbucks create its uniqueness in the first place? Why was it so successful (until the mid-2000s)?**

2. **Why and how did Starbucks lose its uniqueness and struggle in the mid-2000s?**

3. **What strategic initiatives did Howard Schultz put in place to re-create Starbucks' uniqueness after his return in 2008? Detail each strategic initiative. Explain why a specific strategic initiative was successful.**

4. **Is Howard Schultz an effective strategic leader? Why or why not? Buttress your arguments.**

5. **How is Starbucks trying to grow in the future? What are its biggest challenges?**

6. What recommendations would you give the new Starbucks CEO, Kevin Johnson, to address the challenges identified in Question 5? Be specific.

Suggested Answers

1. How did Starbucks create its uniqueness in the first place? Why was it so successful (until the mid-2000s)?

Starbucks' success begins with Howard Schultz's vision of creating a unique experience, or a "third place," between home and work for customers. Outside of bars and public parks, this kind of space did not really exist in American culture prior to Starbucks. By creating an inviting atmosphere where customers could relax and enjoy their coffee beverages, listen to music, use free Wi-Fi, or just hang out with friends, Starbucks created and monetized an underserved retail niche. Furthermore, Starbucks' mission and values were designed by Schultz to serve this vision. Employees are called "partners" to signal their fundamental importance in delivering a high-quality customer experience. Starbucks provides generous employee benefits to attract and retain talented baristas, including healthcare benefits, even for part-time employees, and college-tuition reimbursement programs, among other initiatives.

Starbucks enjoyed a competitive advantage over many years, especially after Howard Schultz's return in 2008 (see **Exhibit 1** in the case). Starbucks derived its competitive advantage from providing a unique customer experience that was valuable to customers, rare in the retail marketplace until the mid-2000s, and costly-to-imitate for incumbents like McDonald's and Dunkin' Donuts. Furthermore, Starbucks was organized to capture the value it created, driving its extraordinary growth. Since its IPO in 1992, Starbucks experienced normalized stock growth of over 17,000 percent, while the DJIA grew only by a bit over 500 percent.

Starbucks' vertical integration helped facilitate its competitive advantage. While other retailers purchased coffee from third parties, Starbucks roasted its own coffee and carefully managed the inputs to its supply chain. The result was higher quality inputs, resulting in superior-tasting coffee. Combined with providing a unique customer experience, Starbucks was also able to leverage this into an emotional connection between the end-customer and the coffee farmer. All of these elements worked together to differentiate Starbucks from its competition, allowing Starbucks to capture more of the value it created.

2. Why and how did Starbucks lose its uniqueness and struggle in the mid-2000s?

Starbucks lost its uniqueness between 2004 and 2008 because of a variety of factors, both internal to the firm and external reasons.

From 2004 to 2008, Starbucks nearly doubled its number of stores (8,500 to nearly 17,000 stores), branched out into other merchandise (desserts, music, etc.), and strayed from its core business. These factors led to changes in store processes (activities) that were detrimental to the customer's welcoming in-store experience. For instance, to accommodate fast growth, baristas began to grind all the coffee

for the day all at once in the morning instead of when a new pot had to be brewed. The sound of coffee grinding and the aroma of fresh coffee—hallmarks of Starbucks' stores—practically disappeared. Also, new espresso machines, designed for efficiency, were so tall that they interfered with customer interaction. Although Starbucks was reinvesting profits into in-store resources and capabilities, the company was focused on increasing in-store throughput rather than creating a more inviting in-store experience.

To be a source of competitive advantage over time, core competencies need to be honed and upgraded continuously (see framework below). Rather than honing and improving the customer's in-store experience, a (too strong of a) focus on operational effectiveness eroded the customer's in-store experience – Starbucks' most important core competency. This provides an example of how a functional strategy (i.e., operational effectiveness) undermined Starbucks' business strategy (providing a differentiated and superior customer experience).

Furthermore, Starbucks did not have adequate isolation mechanisms to protect its competitive advantages. The largest barrier to imitating the Starbucks experience was the competitor's institutional inertia. While this sustained Starbucks through the 1990s, its competitors were eventually able to imitate the underlying goods (coffee, free Wi-Fi) and redesign store formats to invite customers to stay longer at the stores, and thus to spend more.

The problems internal to Starbucks were compounded by external factors. The 2008–2009 economic recession cut demand for luxury items such as $4 cups of coffee. At the same time, competitors arose that sought to out-differentiate Starbucks (Peet's Coffee and Tea), provide similar products at a lower price (McDonald's), or replace Starbucks' in-store experience outright (Keurig Green Mountain). Starbucks' core competency was not sufficiently isolated from imitation attempts.

From a resource-based view, Starbucks misperceived the value of its intangible resources. During this period, most of Starbucks' strategic initiatives were aimed at improving its tangible resources. But, as previously mentioned, Starbucks most important resource was its intangible brand equity, culture, and reputation as a customer-focused company. The dynamic resource view underlines this point: Starbucks built massive intangible resource stocks through the 1990s and early 2000s, but did not adequately reinvest for the inflows to overcome the natural outflows caused by employees (and senior leadership). As Starbucks grew rapidly, it began to forget its core competency.

3. What strategic initiatives did Howard Schultz put in place to re-create Starbucks' uniqueness after his return in 2008? Detail each strategic initiative. Explain why a specific strategic initiative was successful.

Coming out of an eight-year retirement, Howard Schultz worked to re-create Starbucks' uniqueness by bringing back the customer experience and shifting to a more customer-oriented focus. This process began with the closing of 7,000 stores and training baristas to make sure they knew the perfect way to make coffee. Additionally, baristas would be limited to making no more than two drinks at a time, instead of making multiple drinks at a time. This brought back greater customer interaction that was reinforced through the adoption of social media platforms like Facebook and Twitter. Further, Schultz shifted Starbucks' product diversification to focus on complementary food and wine to make Starbucks more of an evening destination, rather than just offering lunch and breakfast items. This

reinforced Starbucks' core competence of being a "destination" and deemphasized "coffee," a word dropped from its logo (in 2011, see **Exhibit 3** in the case). Finally, Schultz also focused on expanding overseas with plans to have more than 3,000 stores in China by 2019.

4. Is Howard Schultz an effective strategic leader? Why or why not? Buttress your arguments.

The preponderance of evidence supports the claim that Howard Schultz was a great strategic leader. Before even acquiring Starbucks from its founders, Schultz had the vision of creating a "third place", a destination beyond work and home that customers would seek out and pay a premium to experience. Schultz bolstered this vision with a mission and supporting values that attracted employees that brought the mission to fruition. These values were supported by strategic commitments such as granting stock options to nearly all employees, extensive partner training and re-training, and contributions to employee college education.

The claim that Howard Schultz was a great strategic leader is buttressed not only by creating the Starbucks phenomenon in the first place, but also by his successful turnaround of Starbucks upon his return from retirement in 2008. Moreover, based on objective performance criteria such as creating shareholder value, Howard Schultz was an extremely successful strategic leader (see **Exhibit 1** in the case, and also **Exhibits 2** and **4**).

The case also gives a glimpse of Schultz's progression up the Level-5 Pyramid of Strategic Leadership (see framework below). Schultz was certainly an Effective Leader (Level 4) when he first bought Starbucks and grew it from a niche coffee supply shop to a coffee retailer. Starbucks' sustained success after its IPO show that Schultz grew into a successful strategic Executive (Level 5). The case details Schultz humble upbringing, resulting in an executive that combined vision and willpower with humility and sincere desire to make society a better place.

Starbucks' evolving logo also provides evidence of strategic leadership (**Exhibit 3**). By eliminating the word "coffee," Starbucks signaled a continuing shift from a product-focused vision to a customer-oriented vision; e.g., from a coffee shop to the "third place."

As competition from other coffee providers increased during Schultz's hiatus as CEO, Schultz (upon his return) re-emphasized what made Starbucks unique and offered complementary products (food and wine) to extend customer association with Starbucks beyond their morning coffee. The hope is to draw more customers to the stores in the afternoon and evening, traditionally the slowest business time for the retailer. Starbucks has also expanded into offering tea.

There is also some evidence, however, that Starbucks' success is uniquely dependent on Schultz, suggesting that Schultz (and Starbucks) may have a strategic weakness in executive leadership succession planning. The primary evidence of this is that Starbucks stagnated and even went into decline during Schultz's absence. Starbucks' struggle after Howard Schultz' first departure is similar to Microsoft's challenges after Bill Gates stepped down from day-to-day business, Dell Computer after the first retirement of Michael Dell (now back), Walmart after the retirement of Sam Walton, and Apple after Steve Jobs left in 1985. Although technically speaking, Howard Schultz is not a founder of Starbucks, he is the one that created the company as we know it today.

Starbucks' dependence on Schultz is also illustrated by the advent of the Frappuccino. Invented by a store manager, the Frappuccino was initially panned by Schultz who stated "We do coffee, we don't do iced drinks." The Frappuccino is now a billion-dollar business for Starbucks and, at one point, brought in more than 20 percent of Starbucks' total revenues.

Prior to being named Schultz's successor as CEO, Kevin Johnson spent the prior year on a "listening tour" with employees in order to better understand their concerns and views on Starbucks' future.

5. How is Starbucks trying to grow in the future? What are its biggest challenges?

Starbucks is attempting to grow by expanding its engagement with customers beyond morning coffee to offer products consumed later in the day, such as wine and beer. This related diversification move would leverage Starbucks' existing economies of scale in its nearly ubiquitous U.S. presence in order to increase same-store sales. The Starbucks ambiance and brand equity may also attract customers that would not otherwise go out for drinks in the evening at a traditional bar or pub. This diversification strategy, however, may dilute brand value of Starbucks as a coffee shop and allow for competitors in its strategic set to take share from Starbucks–similar to what happened in the mid-2000s.

Additionally, with a saturated U.S. market, Starbucks is looking overseas with an emphasis on China. This geographic diversification gives Starbucks the opportunity to benefit from the growing middle and upper classes of an underserved country. Here, Starbucks seeks to leverage its existing core competency in an existing market for future growth (see Market-Core Competency framework below). At this point, it is unclear, however, how large Starbucks can grow in this market. China remains a tea-drinking country with a history of foreign companies being supplanted by local, and sometimes state-backed, firms. On the other hand, parts of the increasingly affluent Chinese population place a premium on foreign luxury goods, which Starbucks may be able to tap into.

Starbucks is also seeking to grow customer engagement through the use of digital and mobile technologies. The Starbucks smartphone app, for example, provides the opportunity to tailor promotions to individual customers based on their previous shopping behavior. Approximately 20 percent of all Starbucks transactions are now performed through the mobile app, substantially reducing the cost and time to serve that customer. However, this may also degrade the long-term relationship with the customer and lead to a commoditization of the Starbucks experience.

Starbucks remains vulnerable because of its fundamental dependence on its customers' disposable income. An economic recession could once again see Starbucks customers gravitate to lower-cost competitors. Independent of the business cycle, Starbucks also faces increasing competition in the U.S. and abroad. The strategic acquisitions by JAB Holding represent a formidable challenge if those companies were to begin successfully coordinating their attempts to steal Starbucks competitors through out-differentiation (Peet's Coffee and Tea), low-cost imitation (Krispy Kreme) and substitution (Keurig Green Mountain). Finally, changing consumer tastes and many other factors could keep Starbucks from being successful going forward.

6. What recommendations would you give the new Starbucks CEO, Kevin Johnson, to address the challenges identified in Question 5? Be specific.

Traditional Starbucks stores risk becoming "stuck in the middle" between ultra-premium, highly differentiated competitors that offer higher customer experience and low-end commoditized competitors that offer a similar product quality at a lower price. The Starbucks Roastery concept is one method for combatting this strategic positioning problem. The Roasteries offer ultra-premium experience to the customer beyond a simple cup of coffee. However, these stores represent a significant capital investment that is not easily scalable across all geographic markets. Investors may be unwilling to place a large, multi-billion dollar bet on this new concept, wondering if Howard Schultz's gut feeling will be correct a second time (after the initial creation of Starbucks).

As such, Starbucks might try bringing elements of the Roastery to traditional Starbucks stores that would not require a massive capital investment but would add an extra element of differentiation. Freshly brewed single-cup, pour-over coffee, for example, would require little additional investment and partner training, but could command higher premium prices from customers.

Starbucks must continue to expand abroad in order to achieve profitable revenue growth. Although many U.S. companies have failed to gain a foothold in China, Starbucks has profitably grown its footprint in China with plenty of room to grow. Speaking to a critical aspect of Starbucks' growth in China, Schultz said in an October 19, 2016 interview with CNN, "If you look five years ago, most of our business, believe it or not, was expats and tourists in China. Today, it's mostly Chinese." As China's economy continues to shift towards consumer-driven purchases, Starbucks remains positioned to succeed. Strategies to take advantage of this position include increasing the number of Chinese stores and tailoring its menu to Chinese-specific preferences, making Starbucks more appealing to locals.

Starbucks ready-to-drink (RTD) and make-at-home products sold in third-party grocers and retailers represent an opportunity to partially isolate the company to some extent from economic downturns. If those categories can grow into substitutes for traditional soft drinks, Starbucks would have a reliable backstop against declining in-store sales. By partnering with PepsiCo, Starbucks is well positioned to overturn Coca-Cola's long-term dominance of this market.

Howard Schultz may be the largest challenge facing Kevin Johnson. Schultz has already shown his willingness to take back the CEO role if the company he created begins to struggle. Moreover, Schultz is not truly retiring, instead retaining an operating role as Executive Chairman responsible for the Starbucks Reserve expansion strategy. Schultz will remain Chairman of the Board of Directors as well as the largest individual shareholder, with only five institutional investors holding more shares than Schultz. The lack of a clear split may create factions in the Starbucks leadership between Schultz loyalists and Johnson supporters. Moreover, the distinction between traditional Starbucks and the new, upscale Starbucks Reserve stores may create internal tension and cause the company to lose focus on strategy implementation. By all accounts, Schultz and Johnson have a good working relationship and Schultz has recognized missteps in his previous attempt to step down from day-to-day operations. However, Johnson should seek to clearly define the scope of Schultz's responsibilities around Starbucks Reserve while also building credibility with his staff and Starbucks board members.

Recent Updates

On December 7, 2016, Starbucks detailed a new five-year plan that detailed several strategies aimed at growing revenue by 10 percent and opening an additional 12,000 stores around the world by 2021. These strategies can be grouped into "premiumization" of the in-store experience, digital engagement, global growth, and expansion of at-home and ready-to-drink products.

"PREMIUMIZATION" STRATEGY

Starbucks is attempting to establish a new brand of "Starbucks Reserve" stores that offer ultra-premium coffee and food products, in an effort to thwart competitors that would out-differentiate Starbucks. This strategy is analogous to automakers that offer basic and luxury marques; i.e., Honda and Acura.

The anchor of this strategy is the Starbucks Reserve Roastery. In December 2014, Starbucks opened its first Reserve Roastery in Seattle, WA–a 15,000-square foot coffee roasting facility and high-end retail space. Starbucks Vice President of Concept Design, Liz Muller, was quoted at the opening "We have designed a space that will heighten all the senses. This is a real-life Willy Wonka experience with coffee as the heart and soul, where customers will see coffee being moved through the roasting process right before their eyes. We have opened up the world of sourcing, roasting and brewing so that our customers at any one point are only feet away from the theater and artistry in a sophisticated yet relaxed environment. Each visit will bring new discoveries while setting the standard for what customers can expect for the future of retail."

In December 2016, Starbucks announced the opening of four additional roasteries: Shanghai in 2017, Tokyo, New York City, and Milan, Italy in 2018. In addition to ultra-premium coffees, the Roasteries would also offer unique food menus through a partnership with the premium Italian restaurant, Princi. Starbucks plans to open more than 1,000 stand-alone Reserve stores, and add a Reserve "tasting bar" to at least 20 percent of its traditional retail stores. Moreover, Starbucks organized all of its Reserve efforts under the new "Siren Retail" group, led by Cliff Burrows.

While these efforts seem to address a strategic threat to Starbucks, they also pose strategic challenges. First, customers may become confused by the two brands; according to this strategy, a city may have three different types of Starbucks stores: a traditional Starbucks, a traditional Starbucks with a Reserve bar, and an outright Starbucks Reserve store. Second, if the strategy is successful, the traditional Starbucks stores could become stigmatized by customers who view it as second-tier or low-quality, accelerating the commoditization of this market. Moreover, with Schultz leading the Reserve strategy and remaining as Starbucks Executive Chairman, Kevin Johnson may be hamstrung in his efforts to lead Starbucks in concert with Starbucks Reserve.

DIGITAL ENGAGEMENT

Starbucks Rewards membership grew to more than 12 million customers in 2016, an 18 percent growth over 2015. In 2016, eight million customers paid using a mobile device, with one third of those customers using the Starbucks app and the remaining two-thirds using other mobile apps. In 2017, Starbucks will be implementing an artificial intelligence-driven "My Barista" feature on the app that

will respond to voice or message commands from the customer. This feature is aimed at increasing customer engagement and drawing customers to the Starbucks app.

Starbucks is also continuing to expand its use of promotions tailored to the individual customer's shopping habits. A 2016 hyper-personalized email campaign utilized more than 400,000 variations and doubled the customer engagement over previous segmentation efforts

GLOBAL GROWTH

In addition to the Shanghai Reserve Roastery, Starbucks has aggressive growth goals in a very profitable country. In December 2016, Starbucks announced that its "newest class of stores in China are delivering the highest AUVs [Average Unit Volume, calculated as total store sales divided by total number of stores], ROI and profitability of any store class in the company's 17-year history in the market." With these impressive numbers as the backdrop, Starbucks is "opening over a store a day" and is on pace to double its number of stores in China from 2,500 today to 5,000 by 2021. In addition to this incredible store growth, Starbucks ready-to-drink products are now distributed in 37 Chinese cities with more than 7,100 distribution points.

AT-HOME AND READY-TO-DRINK

In December 2016, Starbucks announced the goal of growing its Channel Development business unit (comprised of Consumer Packaged Goods, licensed stores and foodservice, and ready-to-Drink (RTD) products) by $1 billion in revenue, increasing operating income by 75 percent, and doubling RTD sales outside the U.S. Starbucks enjoys a strong partnership with PepsiCo to distribute its RTD coffee products around the world, generating more than $2 billion in annual sales.

Additional Resources

1. Articles

    - "Starbucks details five-year plan to accelerate profitable growth,"

      https://news.starbucks.com/news/starbucks-details-five-year-plan-to-accelerate-profitable-growth

    - Jargon, J. (2016), "Howard Schultz stepping down as Starbucks CEO to focus on higher-end shops," The Wall Street Journal, December 1.

      http://www.wsj.com/articles/howard-schultz-to-step-down-as-starbucks-ceo-1480626061

    - Lubin, J.S. and J. Jargon (2016), "At Starbucks, CEO transition plan includes vow not to hover," The Wall Street Journal, December 7.

      http://www.wsj.com/articles/at-starbucks-ceo-transition-plan-includes-vow-not-to-hover-1481112001

- Sorkin, A.R. (2016), "Howard Schultz to step Down as Starbucks chief next year," The New York Times, December 1.

  http://www.nytimes.com/2016/12/01/business/dealbook/starbucks-chief-howard-schultz-to-step-down-next-year.html

- Vara, V. (2016), "Howard Schultz says goodbye to his Starbucks empire," The New Yorker, December 3.

  http://www.newyorker.com/business/currency/howard-schultz-says-goodbye-to-his-starbucks-empire

2. Videos

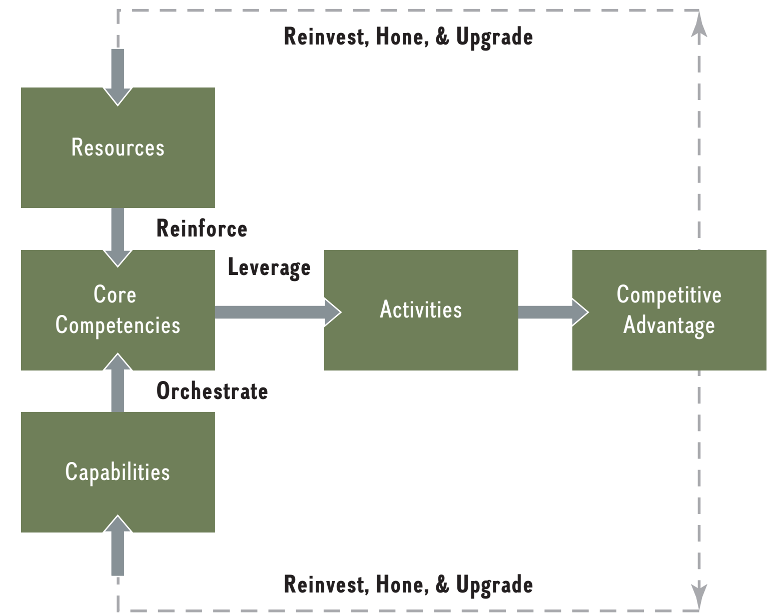
- "Howard Schultz to step down as Starbucks CEO," The Wall Street Journal, December 2, 2016 [1:32 min]

  http://www.wsj.com/video/howard-schultz-to-step-down-as-starbucks-ceo/1BA722E3-C97F-40D0-BBC0-4C98B925A62E.html

- "Starbucks chief to step aside," CNBC, December 2, 2016 [25:06 min]:

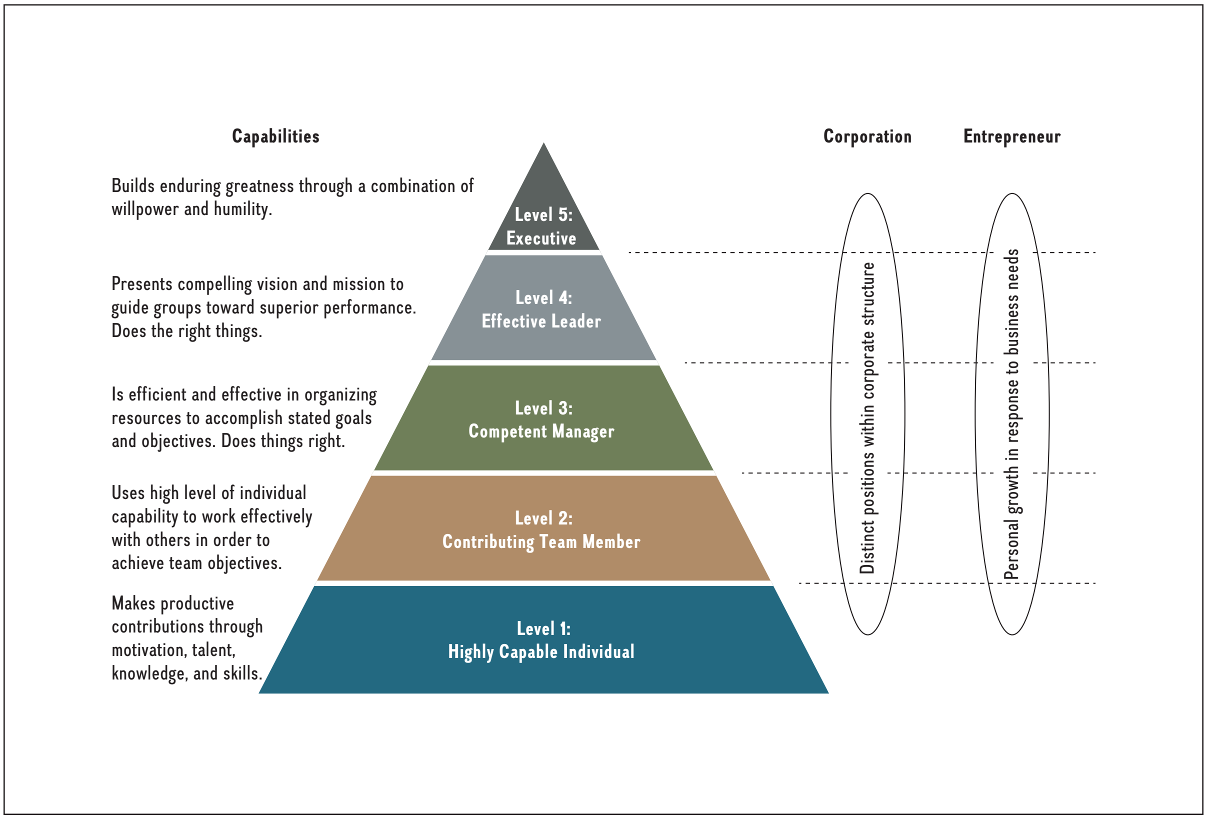
  https://www.nytimes.com/video/business/dealbook/100000004800732/starbucks-chief-to-step-aside.html

EXHIBIT TN-1 Linking Core Competencies, Resources, Capabilities, and Activities to Competitive Advantage and Superior Performance



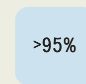
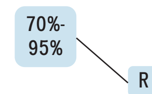
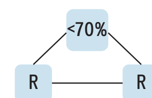
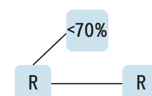
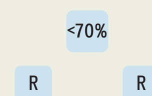
Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-2 Strategic Leaders: The Level-5 Pyramid



Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

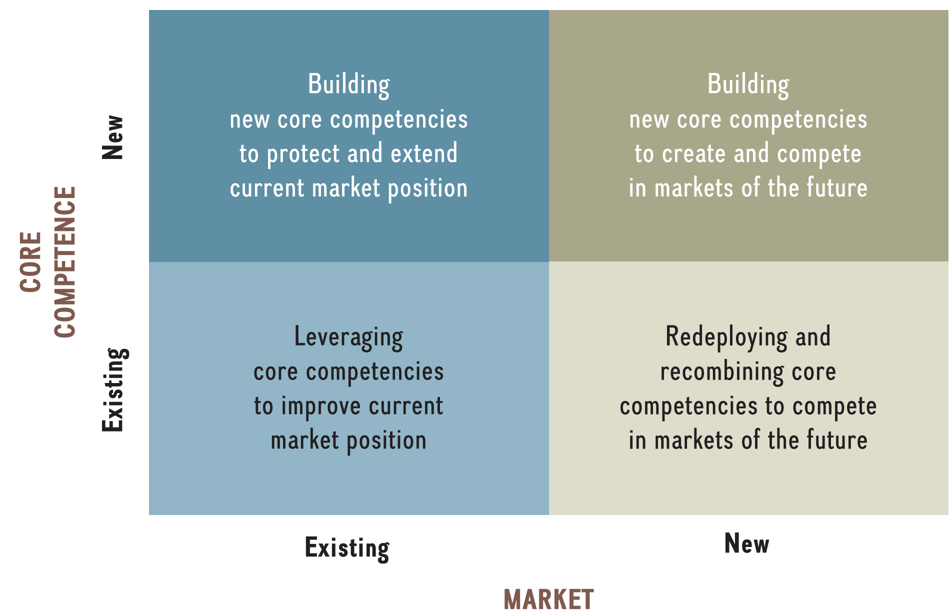
EXHIBIT TN-3 For Main Types of Diversification

Revenues from Primary Business	Type of Diversification	Competencies (in products, services, technology or distribution)	Examples	Graphic
>95%	Single Business	Single business leverages its competencies.	Birkenstock Coca-Cola Facebook	
70%–95%	Dominant Business	Dominant and minor businesses share competencies.	Harley-Davidson Nestlé UPS	
	Related Diversification			
	Related-Constrained	Businesses generally share competencies.	ExxonMobil Johnson & Johnson Nike	
<70%	Related-Linked	Some businesses share competencies.	Amazon Disney GE	
	Unrelated Diversification (Conglomerate)	Businesses share few, if any, competencies.	Alphabet Berkshire Hathaway Yamaha	

Note: R = Remainder revenue, generally in other strategic business units (SBUs) within the firm.

Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-4 The Core Competence-Market Matrix



Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

Endnotes

1 http://money.cnn.com/2016/10/19/investing/starbucks-howard-schultz-china-growth/

2 “Starbucks Presents its Five-Year Plan for Strong Global Growth,” https://news.starbucks.com/news/investor-day-2016-press-release

3 “Debut of Starbucks Reserve Roastery and Tasting Room in Seattle Will Redefine the Retail Experience,” https://news.starbucks.com/news/starbucks-reserve-roastery-and-tasting-room