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# Coffee Shops

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Jennifer Jaw  
Sarah Leslie  
Ian Mattock  
Maxwell Shahinfar

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The coffee shop industry is a near-perfect competitive market because there are many competitors, many consumers, and low costs of entry and exit. However, despite the numerous coffee shops in Canada—including franchises Serious Coffee, Second Cup, and Blenz—Starbucks and Tim Hortons enjoy most market share and market power.

Coffee shops carry products that are affordable and acceptable to extensive consumer segments: house blends and specialty coffee, hot and cold signature drinks, light meals (breakfast, soups, sandwiches), and baked goods (cookies, muffins, bagels). A privately-owned coffee shop in such a competitive market must offer all of the above—and more. We will analyze the performance of small private coffee shops in Canada, competing against Starbucks, Tim Hortons, and many other food service providers, all of which sell coffee, light meals, baked goods, or other substitutes.

## Cost Structure

Entrepreneurs interested in starting a coffee shop must consider entry costs, sunk costs, fixed costs, variable costs, and opportunity costs.

### Entry Costs

Entry costs are the costs required to initiate the business. Securing a location requires paying deposits, insurance, property taxes, and other fees. The more customers that frequent a location, the higher these fixed costs will be. Other entry costs include utilities (water, gas, electricity), furniture (tables and chairs), and equipment (dishes and cutlery).

The legal operation of a coffee shop requires a number of contracts and legal procedures, which demands the services of licensed administrators such as real estate agents and business lawyers, which are costly to obtain in terms of both money and time. The entrepreneur must also spend time networking and searching for wholesale suppliers, such as coffee distributors and bakery vendors, to provide beverage supplies and baked goods.

### Sunk Costs

Many entry costs are also sunk costs, which are investments that, once made, cannot be avoided. The costs of deposits locked in long-term contracts, rent, equipment, renovations, service fees, and time are just a few examples.

### Fixed Costs

Fixed costs are the costs of inputs that do not change with production rate. Again, many entry costs, such as deposits, property taxes, rent, and cost of utilities are also examples of fixed costs. To an extent, some costs—such as wages, equipment, and equipment maintenance—may be fixed or variable, depending on the production rate.

## Variable Costs

Variable costs are the costs of inputs that do change with production rate, as the quantities required fluctuate according to demand. Costs of these inputs include packaging materials (take-out containers, receipt paper, recyclable utensils) and ingredients (dairy products, coffee beans, baked goods). Labor (as well as equipment and maintenance) can also be variable: if there is enough demand to necessitate an additional hour from an employee who has already worked a full shift, that extra hour of labor is a variable cost.

In the case of coffee shops, a large fraction of revenue is paid out in rent, wages, and other fixed costs; the variable costs are relatively low in comparison. Coffee shop owners should thus take advantage of their high-fixed cost structure.

## Opportunities and Threats

### Experience Curve

Although the owner would gain valuable experiences from being immersed in this industry, average costs usually do not fall with cumulative production over time in a coffee shop industry, thus there is no beneficial experience curve.

### Opportunity Costs

The opportunity costs are the net revenue from the best alternative course of action. If the owner does not start the coffee shop and invests the capital in another form of financial investment, the value of the returns is the opportunity cost of starting the coffee shop. Therefore, before pursuing this entrepreneurial venture, the owner should be reasonably confident that the business will generate more profits than the opportunity costs.

At some point of operation, it is common for new owners to renovate shop fronts; the opportunity costs of renovations are not only large sums of money, but also lost time when the shop cannot generate maximal revenue.

### Economy of Scale

Since the coffee shop faces high fixed costs, it has the opportunity to grow into an economy of scale by sufficiently expanding productions. One profitable example would be mass producing and delivering baked goods and light meals from a central kitchen to several retail locations, which could then spare chefs and licensed kitchens. This expansion would thus decrease the average cost of producing each unit while increasing the horizontal boundaries of products available for sale, allowing the owner to expand the coffee shop into a franchise.

Coffee shops also face threats such as new entries of substitute goods—especially if in close spatial proximity—that could be produced at lower costs, offer intense competition, and consequently decrease revenue for the small coffee shop owner.

## Demand Structure

Location, product quality and availability, atmosphere, customer service, consumer preference, and premium experience are among the most significant demand drivers affecting purchasing decisions.

## Prices

Prices, as long as they are within the market price range, do not play a particularly large role for small coffee shops; without market power, they cannot use prices to significantly increase sales.

## Consumer Preferences & Product Availability

Starbucks has essentially dominated the coffee industry by educating consumers to love and crave Starbucks's products. If privately-owned coffee shops do not offer similar items, they may lose significant market share.

Any other demand driver can also change consumer preferences. For example, increasing demand for new dishes over conventional sandwiches would decrease the coffee shop's performance.

Location is a major determining factor of preference. Populous areas with accessible parking would attract more customers and generate more revenue, justifying the significantly higher costs of rent. Also, customers who have relocated residential or working neighborhoods would choose the convenient coffee shop across the street as opposed to the one across town.

Atmosphere could also affect consumer preferences: younger customers' atmospheric preferences would differ significantly from those of seniors; others may prefer more formal dining experiences found at high-end restaurants or more casual settings such as food courts.

## Consumer Segmentation

The consumer market is segmented according to age as well as preferences. Younger consumers are often willing to spend more on fancy coffee blends and signature drinks; the health-conscious would be willing to pay extra for "healthier" substitutes such as organic products; and older consumers may have thriftier spending habits with preferences for plain black coffee.

## Opportunities & Threats

Opportunities for increased sales arise with holiday specials, such as for Christmas and Halloween. The growing dependence on the Internet offers an inexpensive opportunity for online advertising, while offering Wi-Fi will also attract more customers.

For privately-owned coffee shops, however, the biggest advantage is versatility and independence: the freedom to change menus as desired, whereas franchises must follow a rigid model. This advantage would help coffee shops substantially differentiate their products from

larger chains. Although there is no expected decline in the high demand for coffee, a potential threat is the growing demand for substitute products with less caffeine and more health benefits.

## Final Assessment

The coffee shop industry is seemingly attractive because of low costs of entry and exit. However, this also admits many competitors, putting the market in near-perfect competition, deterring from significant profits.

More than 65% of Canadian adults consume coffee beverages daily—most specialty coffees are now as common as plain black coffee. However, despite high demand and incremental margin, revenue from coffee sales alone is insignificant, unless quantities sold each day are phenomenally high, which may be unrealistic. To generate greater revenue, it is essential to promote the sales of higher-priced meals; otherwise, future profitability is not particularly promising.

Although consumers prefer cheaper prices, price competition does not play a particular role in this industry, since coffee is an inelastic good. The price discrepancy between most coffee sellers is a few dollars at most, and consumers are less likely to care because the numbers are small. Moreover, some consumers value taste more than price, and are willing to pay for the higher quality. The major exception is Tim Hortons, whose market power allows substantial undercutting of prices compared to other coffee shops, thus selling huge quantities of low-quality products each day and claiming large market shares.

Starbucks, notorious for driving out small businesses, poses a particular threat. It is known for buying out smaller businesses by paying off their landlords and for opening multiple shops in the same area to saturate the market, even at the cost of cannibalizing its own shops, just to gain market share. Furthermore, coffee shops compete both directly and indirectly—with other coffee shops selling direct substitutes and with other food service providers, such as gas stations, restaurants, and convenience stores offering meal options in the same price range.

The key elements of cost are those of rent, supplies, and wages. To avoid considerable wage expenses, private shop owners often work themselves overtime. This way, the coffee shop insures the owner a full-time job, rather than a prosperous investment. The heavy workload, low profit returns, and ease of exiting the industry explain the generally short terms of coffee shop ownership.

Location is an important factor of both cost and demand, justifying the costly rent of a site in popular malls. A successful coffee shop must have an attractive location and distinctive products that entice consumers.

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