CBI Beijing

Combat in the Coffee Shops?

Will Coca-Cola's acquisition of Costa Coffee add a new combatant to an already fierce market?

Changing tastes, evolving expectations

The tastes of Chinese consumers have changed fast. Rapid socio-economic change has swept people into the cities and into new professions, drastically altering the attitudes of consumers towards food stuffs, beverages and their wallets.

China's middle class has been expanding exponentially since 2002, and it has been matched by a growing demand for goods and services of a higher quality. Taking these developments into consideration, it is hardly surprising that **China's coffee market has started to gather momentum.**

In 2002, just 4% of China's 1.3 billion population could be considered middle class. Those who lived in the city were still in the minority, and disposable income was for the most part a pipe-dream. By 2012, this figure had risen to 68%, and the number of people living in the city and earning between 60,000 to 229,000 Renminbi (RMB) a year was considerable. The steady rise of incomes in the city became a main casual factor for urbanisation in China, and as the number of people who could be considered middle class steadily climbed, so did China's urbanisation statistics, rising by a steady 1.3% y/y from a base of 44% in 2006.

By 2016, just over 57% of the mainland's population was living in the city, and 68% of Chinese people could be considered 'middle class.'

Urbanisation led to a state-directed infrastructure drive, with Chinese cities exploding as the government took steps to realise the dreams and ambitions of this emerging and wealthy middle class. Infrastructural development extended into telecommunications and internet provision, evolving into an e-commerce market that would go on to post an annual compound growth rate of 110% for every year since 2003.

Despite China having a broadband penetration rate of only 30% across its vast territory, urbanisation was to a point that online sales began to steadily rise to 5-6% of total retail sales in China. Virtual marketplaces such as **Alibaba** began to dominate the Chinese cyberspace, taking advantage of cheap labour and manufacturing costs, allowing the Chinese cosmopolitan consumer an incredibly broad range of goods and services, at a price where the consumer could afford to experiment and 'pick & choose.'

E-commerce allowed the Chinese food and drink industry to take off, with cafes and restaurant being able to advertise and deliver products at ever cheaper rates as e-commerce sites competed through increasing subsidisation.

Coffee was for a long time relegated to just being an option on e-commerce sites, only occasionally taking the fancy of experimental consumers. However, as a new and younger white-collar class came in, with greater disposable income, wanting to socialise and benefit from a caffeine-kick during the working day, coffee came into its own. **It is against this backdrop, that the Chinese coffee market is beginning to enjoy massive growth.**

One China…

The announcement that **Coca-Cola** had acquired **Costa Coffee** from the **Whitbread** group, led to growing speculation that the American F&B giant planned to re-launch the chain in China. The British coffee chain's initial foray had stalled against intense competition from rival Starbucks, not to mention cheaper Chinese home-grown alternatives.

The Chinese F&B market is shifting its focus towards healthy foods, as consumers grow increasingly concerned about the negative effects of the pollution which plagues Chinese inner city living. An Americano coffee, loaded with anti-oxidants and low in fat, serves as a healthy alternative to the previously popular sugar-laden milk teas.

Coca-Cola has misjudged a Chinese health-drive trend once before, when the company's $2.3 billion bid for Chinese juice manufacturer, **Huiyuan** was rejected by the Chinese government in 2009. As a health-trend gathered momentum online, Coca-Cola lost market share to smaller Chinese manufacturers, such as the Chinese herbal tea producer, **Wang Lao Ji** because it was considered a healthier alternative.

Whilst Coca-Cola currently markets bottled water and the orange juice label, Minute Maid, the manufacturer lacks a coffee product that would allow Coca-Cola to take advantage of the growing number of coffee shops appearing on Chinese high-streets. However, Coca-Cola's Costa is coming into the Chinese coffee market whilst it is going through a period of accelerated growth with even established players facing intense competition.

In recent years, Starbucks has dominated the Chinese coffee market, having opened over 3000 stores across China since 1998. Costa had already established itself as the second largest coffee shop operator in China before Coca-Cola's acquisition, but the British rival only operated 450 stores in the mainland.

Chinese rivals have begun to put up a fight, however, with **Luckin Coffee** having made waves in the Chinese coffee market, opening 600 outlets across 13 cities in 9 months and going on to announce a technological partnership with e-commerce platform, **Tencent**.

Two Systems…

The strength and role of e-commerce platforms in the Chinese coffee market cannot be understated, as online ordering from platforms such as **Alibaba**, **Baidu**, **DaDongDianPing**, and **Meituan**, to name a few, become even more entrenched in the lives of Chinese consumers. The impact these companies are having on coffee shops can be seen in Starbucks's revenue report, which noted that revenues increased by 17%, whilst same store sales fell by 2%. Starbucks President and CEO, Kevin Johnson, addressed this statistic by announcing the company's new delivery partnership with Alibaba, and the e-commerce site's delivery platform, **E Le Ma?**

It is the same 'rise of the e-commerce platforms' phenomena which has allowed for Chinese coffee start-up, Luckin Coffee to be valued at $1 billion after a mere 9 months' worth of operations. Acknowledging the role e-commerce platforms play in Chinese consumers daily lives, Luckin Coffee is built around providing service through an APP which incorporates, **Tencent's** popular social media APP **WeChat** and the APP's in-APP function, WeChat-Pay.

Because of Luckin Coffee's initial advantage in utilising digital platforms to drive sales, Starbucks considers Luckin Coffee its principal competition in China. Luckin Coffee has already opened 231 stores specially designed to handle deliveries (rather than rely on the existing model where customers order online and a delivery driver enters the store and orders on their behalf). In addition to this, Luckin Coffee is also cheaper than Starbucks, with an Americano retailing for RMB21 in Luckin Coffee and RMB30 in Starbucks.[1]

Starbucks has announced plans to retaliate. Delivery partner, E Le Ma? will take on an additional 3 million drivers to support a specialist Starbucks delivery system, and the company expects their new Starbucks-Alibaba APP will have a usage of 500 million people.

With such a head start, it is difficult to see how Coca-Cola's new Costa venture can slow either Starbucks or Luckin Coffee's expansions. Starbuck's expansion has already demonstrated that an expansion model based around establishing a far-reaching store presence has limitations and Luckin's success highlights the optimism surrounding a coffee for delivery service.

Coca-Cola lacks a delivery partner of the same scale as either Alibaba or Tencent. The two internet giants boast over 1 billion accounts between them. Admittedly, Tencent's model of taking small stakes in partners, rather than investing heavily in one high-profile partner, as Alibaba prefers to do, does leave Coca-Cola some room. But, even with a delivery partnership with Tencent agreed, the US giant still faces competition from Luckin, a company which has developed a popular following in China as the plucky Chinese upstart, taking on the American giant.

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[1] Luckin Coffee only offers a large size Americano, a Starbucks Venti-sized coffee is the direct equivalent.