Dunkin' Donuts Is Expanding In The Right Direction

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Summary

- Dunkin’ Donuts is slated to open 4-5 units in California in 2014.
- Dunkin’ will be welcomed by the many coffee drinkers and Hispanic consumers in the region.
- The brand’s mainstream positioning can leverage an opening in the value end of the market.

Dunkin' Donuts (DNKN) is expanding westward and all indicators show that's the right direction for the company.

Dunkin' opened its first new store in San Diego back in March and has slated 4-5 stores to open in California later this year. All told, it plans to expand to more than 1,000 stores in the state.

On the surface, a donut chain expanding into one of the country's healthiest regions may seem doomed for failure. But Dunkin's strong suit is actually its coffee. Last year Dunkin' CFO Paul Carbone explained, "We're a beverage company," and reported nearly 60% of its sales were beverages.1 Coffee is a higher margin, higher purchase frequency product than other menu items - and coffee is what makes California an attractive market for the company. California is like a coffee mecca. The state is home to three out of the top 12 "most caffeinated" cities in the U.S., as reported by The NPD Group.2 The state is also home to more coffee chains than any other (more on that in a moment.)

The large Hispanic population in California also bodes well for Dunkin'. Latinos drink more coffee than do other ethnic groups. According to the National Coffee Association, 76% of Hispanics reported drinking coffee yesterday (13 percentage points above the total population) compared to 47% of African-Americans and 64% of Caucasian-Americans.3 Also, baked goods seem to play an important role in Latino lifestyles and diets, as evidenced by the popularity of panaderias in Mexican neighborhoods and cities.

The penetration of other coffee chains provides further evidence of the strength of coffee's appeal in California. Starbucks (SBUX) operates over 2,000 stores in the state, twice as many stores per capita than states on the East Coast like Massachusetts, for example. California is also the birthplace of Peet's Coffee & Tea (PEET) (which currently has approximately 180 units in the state) and The Coffee Bean & Tea Leaf (approx. 300 units in CA.)

Although the large number of coffee shop brands might suggest a saturated market, a closer look actually reveals an opening to leverage. Chart the existing coffee outlets on a continuum from premium/high-end to value/low-end and you'll find the market skews upscale. There are plenty of high-end independents like Intelligentsia and Cafecito Organico as well as the aforementioned $5-a-latte chains, but the only real value player is McDonald's (MCD). And that chain has struggled to attract a loyal following for its McCafe offerings even though it operates over 600 locations in Southern California alone. Value-minded coffee drinkers in New York, Boston, and other Northeast markets may be served by sidewalk vendors, local diners, and bodegas in those locales, but in the Golden State they have no convenient option other than McDonald's. For folks living in a region where recession recovery remains slow, Dunkin's reasonable price points and mainstream positioning could offer quite an appealing alternative.

To make this appeal, though, Dunkin's approach can't be as laid back as California's surfer population. Californians are used to customizing their orders here, particularly their coffees. This means Dunkin' will need to offer the range of choices people have become accustomed to (e.g., more milk options that just regular or skim) and employees will need to execute on customers' demands while maintaining accuracy and speed of service.

Also, some Californians may only associate Dunkin' with donuts and other sweet treats. California is home to a sizable contingent of East Coast transplants who eagerly await the brand's entry into their markets. But those who don't know the brand well will need to be educated about the range of Dunkin's menu. Marketing needs to focus on building awareness about the brand's extensive beverage offerings in order to generate the necessary trial.

Most importantly, Dunkin' will face significant real estate challenges because West Coast fast feeders are very dependent on drive-thru service, and drive-thru locations have become very difficult to secure. Particularly in the Southern regions of California, lifestyles are largely centered on commuting by car. People tend to make decisions about which fast food location to visit based on which side of the road it's on, especially during the morning rush hour. Securing A-locations are critical. But at the same time, many localities are making it difficult, if not impossible, to open new drive-thru locations due to their environmental concerns. And competition for existing sites is at an all-time high.

Bottom line, Dunkin's westward expansion comes with some risks, but it also holds considerable reward. Since it blamed its most recent poor results on weather conditions in the East, it seems like the company could use some California sunshine to brighten its outlook.

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1 http://www.forbes.com/sites/clareoconnor/2013/06/20/dunkin-donuts-now-calls-itself-a-beverage-company-as-it-aims-for-starbucks-and-heads-west/

2 www.cnbc.com/id/43896943

3 www.ncausa.org/custom/headlines/headline...