1999 Coffee Service Market Report for the Vending and OCS Industry

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COFFEE SERVICE MARKET REPORT

BY ELLIOT MARAS, EDITOR

Smaller work sites and rising costs slow sales growth

Market conditions complicate OCS operators' attempts to cash in on specialty coffee; trends favor the larger firms

Job description, OCS operator, 1999: "Must know how to swim with lead bricks tied to your hands."

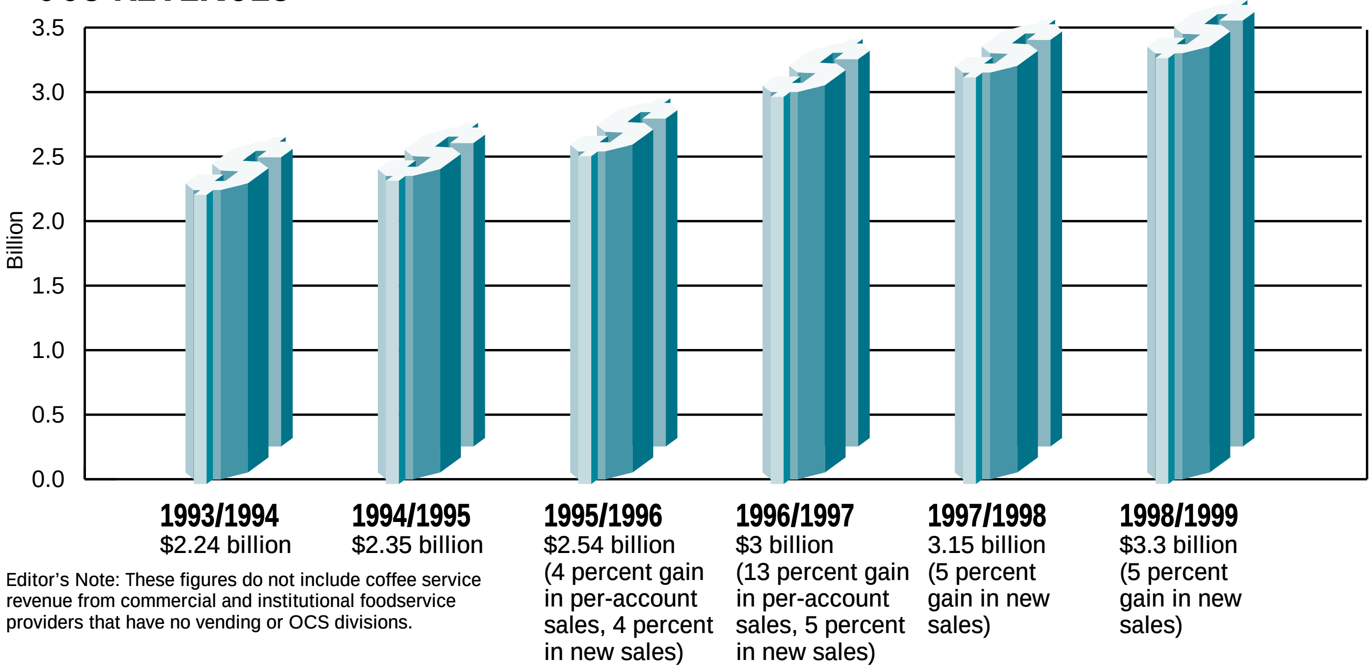
That hardly sounds like a job description for a service business owner in today's bustling economy. But today's OCS operator, like his counterpart in vending, finds himself marketing to smaller work sites at a time when operating costs keep rising.

From mid-1997 to mid-1999, the OCS industry posted a 10-percentage-point revenue gain, according to the *Automatic Merchandiser* OCS Market Report, for a total $3.3 billion in OCS sales. While revenues continue to grow, the rate has slowed.

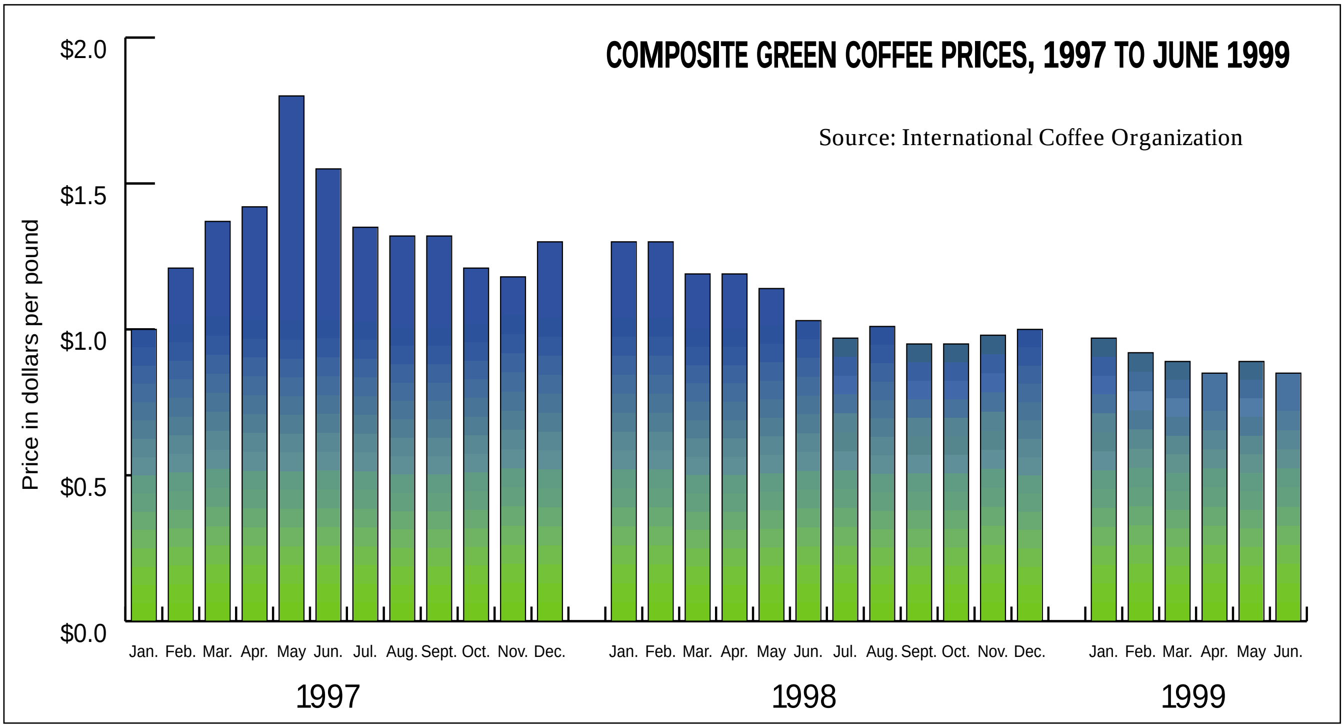
The slowdown can be traced to green coffee prices, which faltered since they spiked in 1997. In 1996/1997, OCS operators successfully passed on higher coffee costs to their customers, reaping an 18-percentage-point revenue gain over the prior year. In the last two years, in contrast, OCS prices, reflecting green coffee prices, remained flat. Since then, most operators have held their prices, even as green prices gradually dipped. A minority did lower their prices in 1998/1999, however. Hence, the average price per cup fell from 5.8 cents reported in the fall of 1997 to 5.2 cents in the summer of 1999. Prices almost dropped to the pre-1998, 5-cents-per-cup level.

The current pricing situation has many operators concerned. Commodities analysts interviewed for this report expected green coffee prices to continue to decline through the remainder of the current year. While OCS operators obviously stand to improve their profit margins, as they have in the last two years, many are concerned that prices could fall too far.

OCS REVENUES



Editor's Note: These figures do not include coffee service revenue from commercial and institutional foodservice providers that have no vending or OCS divisions.



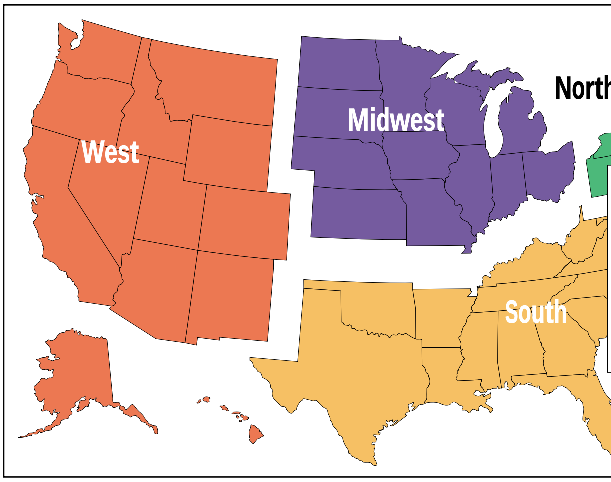
Low prices, OCS veterans have learned, bring lowballers into the market. In addition, recent history has shown that higher prices build consumer appreciation of OCS. The near doubling of green coffee futures in 1994 forced operators to raise prices. The end result was higher net sales, enabling operators to invest more money in the quality of their service. The two-dollar-plus-per-bag green coffee prices in 1994 enabled OCS operators to raise their prices.

Fortunately, OCS operators have not responded to the gradual ebbing in prices with industrywide price cuts — yet. Instead of cutting prices, many operators have sought ways to maintain their current prices. One method has been to introduce a larger variety of coffees to choose from. Greater product variety has also emerged as a favorite selling tool in a market where new customers remain elusive.

Growth mainly in new accounts

The 10 percent revenue gain in the last two years came mostly from new locations as opposed to higher per-location consumption or, as noted above, higher prices. The nation's strong economy provided a steady flow of start up businesses in need of OCS.

Work sites with five to 19 people offered a customer base that is largely immune to competition from vending operators, which require larger populations.



Participants by region

Northeast	24.1%
South	28.2%
Midwest	37.9%
West	9.6%

While the economy in the last two years favored OCS more than vending, the number of new OCS locations was nowhere near 1980s' levels. The report revealed that the average OCS location had 30.6 people in 1998/1999. Work place studies show this size location increasing, but only at a modest rate.

The majority of jobs created since 1994 emerged in locations with 19 or fewer people, according to Cambridge, Mass.-based Cognetics Inc., which studies employment trends. Locations with 19 and fewer people brought thousands of jobs into the economy from 1994 to 1998. Locations with 20 to 99 people, which encompassed the majority of OCS customers, generated far fewer jobs, which indicated that the OCS industry was not focused on the location base that grew the fastest.

About the survey

The 1999 *Automatic Merchandiser* Coffee Service Market Report is based on questionnaires completed by a random sampling of 900 OCS operators, half of which were dedicated OCS operators, the remainder being vending operators that did OCS. The survey netted a 16.1 percent response. Results were tabulated by Delavan, Wis.-based Waller Research Associates. The report also includes information from a nationwide telephone survey of OCS customers conducted by Casper, Wyo.-based Wyoming Research, and from Cognetics Inc.

The survey reported that OCS operators gradually phased in higher quality

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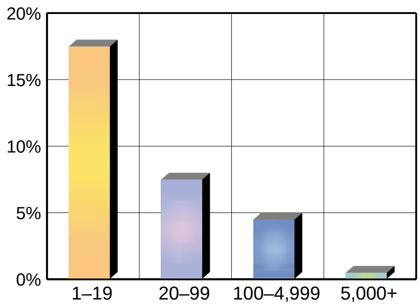
products to meet the expectations of a better educated work force. These included higher pack weight coffees, more varietal coffees, a greater variety of coffee products, thermal and airpot brewers, single-cup brewers and water filtration systems. However, workplace demographics pointed to smaller-size offices, thwarting OCS operators' attempts to offer these higher-ticket items. Hence, it has been hard for OCS operators to compete against other coffee providers for the away-from-home coffee drinkers. Such competitors included coffee bars, restaurants, convenience stores, kiosks and coffee carts.

A typical scenario was reported as follows: the OCS operator shows an attractively packaged, 3-ounce varietal pack of coffee to the manager of a medium-size office. The office manager smiles as he takes in the aroma, then frowns when he hears the price. He tells the operator he'll go with a lower pack-weight coffee. In the weeks that follow, half of the employees get their morning java at a coffee kiosk in the lobby. Hence, what should have easily been a two-case-per-week account for the OCS operator becomes a marginally-profitable, one-case account.

Employment change by work site population, 1994 to 1998 in millions of jobs

Source: Cognetics Inc., Cambridge, Mass.

Total # employees in work site	Jobs created by existing firms	Jobs created by new firms minus jobs lost	Net change in total new jobs
1-4	2,449	4,088	6,537
5-19	817	1,188	2,005
20-99	939	2	941
100-499	639	1,496	2,135
500-4,999	319	1,307	1,626
5,000+	185	-2,311	-2,126
Total	5,348	5,770	11,118



Percent job growth by work site population, 1994 to 1998, for continuous firms

Editor's Note: This does not include jobs lost and created by companies that opened and closed during this period. The numbers in the bar chart are not based on the table above.

Key to growth: specialty coffee

Coffee industry studies for several years have pointed to specialty coffee, defined by the Specialty Coffee Association of America as "highest grade Arabica coffee," as the key to reviving coffee sales.

The *AM* Coffee Service Market Report indicated that OCS operators did increase their share of specialty coffee sales in the last two years, but the growth was nowhere near that of the coffee industry as a whole. Specialty coffee commanded close to one quarter of all prepared coffee sales in 1998, according to coffee industry sources.

Varietals and espresso-based drinks remained a very small portion of total OCS sales. Market share for higher pack weight coffees — 1.75 ounces and above — actually fell in 1998/1999.

Growing market: young people

The inability of OCS firms to market specialty coffee is particularly ominous, given research showing that the younger generation is partial to these beverages. The National Coffee Association's 1999 coffee consumption survey revealed that more young adults have become "occasional" coffee drinkers and are more likely to drink espresso-based beverages. The percentage of Americans drinking espresso-based drinks climbed from 35 percent in 1997 to 40 percent in 1999.

A report by the Specialty Coffee Association of America noted: "Coffee consumers are moving away from price-based purchasing to a purchasing trend that focuses on product variety and quality." One reason for this has been coffee houses, which tripled since 1995 to 12,000 in 1999.

Office survey: flavored coffee down

The OCS industry's difficulty capitalizing on specialty coffee is verified by other research as well. A nationwide survey of 1,200 offices, all with 100 or fewer employees, reported that less flavored or gourmet coffee was purchased by offices in 1999 than in 1997, despite the fact that more offices provided it. The survey was conducted by Casper, Wyo.-based Wyoming Research. Flavored coffee remained the most common type of specialty coffee sold in the office.

On the positive side, the percentage of 1.25- and 1.5-ounce OCS packs grew at the expense of 1.1-ounce packs in the last two years, according to the Coffee Service Market Report. One reason was that more thermal and airpot brewers, which hold higher volumes of coffee than glass pot brewers, were placed in OCS locations. The survey did not break out brewers by type. However, telephone interviews with operators and manufacturers placed these brewers between 10 and 40 percent of all office brewers currently on location.

Thermal and airpot brewers became a necessary tool for operators seeking to build specialty coffee sales. OCS operators found that thermal carafes, which insulate sitting coffee from air, preserve the superior taste of higher-grade coffee. Hence, operators seeking to promote higher-quality coffee found they needed to invest in more expensive brewers.

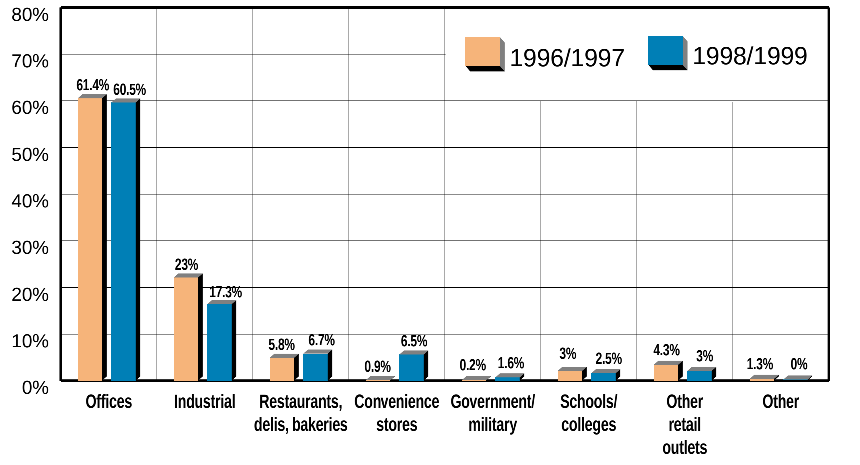
Placing thermal and airpot brewers required a more careful financial analysis of the location than the traditional, glass pot brewers. In addition, operators found they had to teach customers how to check the coffee level, which is harder to see in most thermal carafes than in glass bowls.

Some operators encountered resistance to thermal brewers from customers who prefer to see the coffee in the pot.

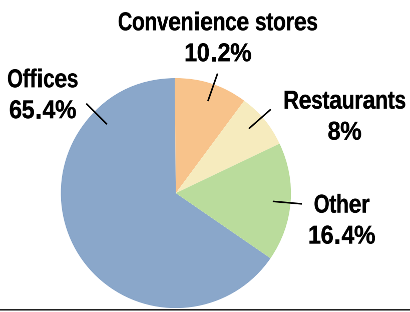
Single-cup brewers, while not specifically designed for providing specialty coffee, are an even higher-ticket item. Whether or not the coffee provided by these countertop machines is better than traditional glass pot systems is a matter of industry debate. However, these units offer superior convenience. An *Automatic Merchandiser* survey earlier this year reported that 44.4 percent of OCS operators offered single-cup machines, and of those that didn't, 16.6 percent planned to add them. A handful of single-cup systems were introduced to the market in the last two years, joining the handful already available.

Single-cup brewers were more prevalent in large urban markets, densely populated with office buildings. Regionally, they were mostly concentrated in the Northeast.

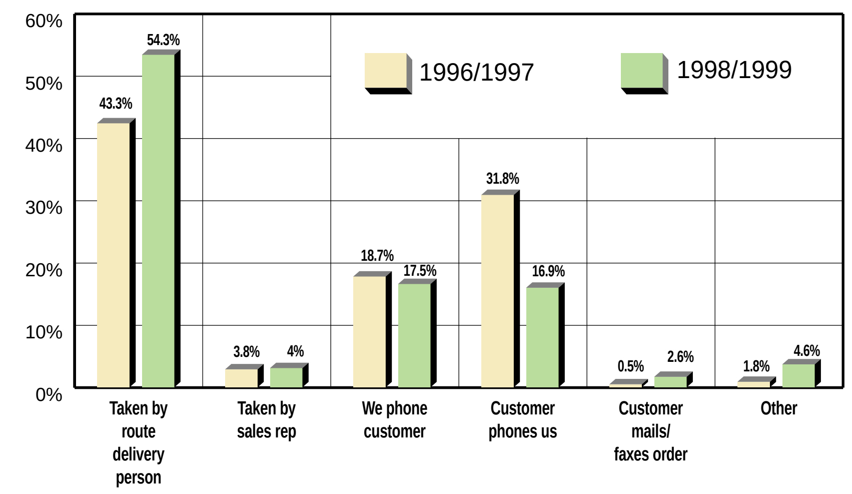
Accounts by type



1998/1999 share of sales by account type



Method of ordering



New focus: c-stores, restaurants

The survey revealed a focus on larger customer sites, such as convenience stores, restaurants, bakeries and delis. As the average office work site grew smaller, many operators expanded into these "resale" accounts, which place larger orders. As a percent of total OCS accounts, convenience stores jumped from 0.9 percent two years ago to 6.5 percent in 1998/1999. Restaurants, delis and bakeries posted about a full percentage point gain as well. The customer segment that dropped the most was industrial plants, which fell by more than five points, while offices, the main base, fell by almost 1 percent.

Convenience stores and restaurants accounted for 10.2 and 8 percent of total OCS sales, respectively, in 1998/1999. When compared to their share of the account base, these outlets presented obvious sales opportunities for OCS operators. These accounts also gave many OCS operators a faster way to expand into the newer equipment, such as electronic airpot brewers, than did the traditional, smaller customer. Once positioned to supply the larger volume accounts, they then offered the higher-cost equipment to office customers.

Offices accounted for 65.4 percent of total sales, indicating that they remained a good opportunity compared to most other types of locations.

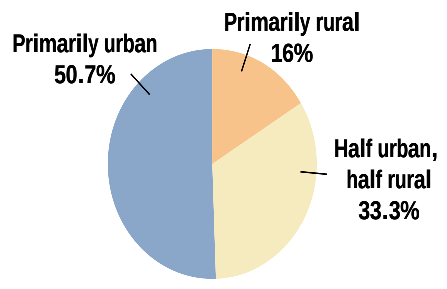
Allied products continued to be a

Operating averages

	1996/1997	1998/1999
Years in OCS business	14.4	17.9
Raised prices in last 12 months	83%	23.4%
Revenue per cup	5.8 cents	5.2 cents
Customer turnover rate*	2.7%	2.5%
Typical account population	NA	30.6
Roast own coffee	2%	9.6%

* Number of accounts lost and replaced divided by the total number of accounts served.

Type of market served 1998/1999



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OCS sales by product category

Category	Percent of sales 96/97	Percent of sales 98/99	Percent of total product cost 96/97	Percent of total product cost 98/99	Projected revenue 96/97	Projected revenue 98/99
Private label coffee	19.3%	28.4%	17.3%	21.9%	$579M	$937.2M
National brand coffee	50.8	33.8	52.9	41.2	1.52B	1.12B
Whole bean coffee	3.4	2.5	2.2	2.5	72M	82.5M
Varietal coffee	2.1	4.3	2	6.1	63M	141.9M
Espresso/cappuccino	1.6	2.2	0.9	2.3	48M	72.6M
Other coffee*	1.5	1.9	1.9	1	45M	62.7M
Total coffee	78.7	77.2	77.2	75	2.36B	2.42B
Other hot beverages	4.4	3.8	4.7	3.9	132M	125.4M
Soft drinks	4.5	7.1	4.6	4	135M	234.3M
Juice	1.9	1.2	1.9	1	57M	39.6M
Bottled/filtered water	0.8	4.1	0.9	1.9	2.4M	135.3M
Creamers and sweeteners	6.4	5.1	6.7	5.6	192M	168.3M
Cups/paper products	3	4.5	3.7	5	90M	148.5M
Other	0.3	1.1	0.4	2.3	3M	36.3M

* Includes flavored coffee.

way to build OCS revenue. The survey reported that allied products — soft drinks, juice, water, creamers, sweeteners, cups and paper products — jumped from 16.9 percent to 23.1 percent of total sales in the last two years. Most allied products brought higher profit margins than coffee. Cups and paper products, however, became less profitable in the last two years, due to higher costs and competition from other retail channels.

Water, both bottled and filtered, emerged as the fastest growing allied product, grabbing 4.1 percent of total sales, up from less than 1 percent two years ago.

The diversification trend did not extend far beyond the traditional allied products, however. Attempts in recent years to expand into office supplies proved unsuccessful. The industry as a whole reported office supplies at less than 1 percent of total sales. A handful of operators attempted to expand into office products in recent years. Most such attempts failed due to the huge number stock keeping units (SKUs) involved and the difficulty of integrating the products into existing billing and accounting systems, and the need to train salespeople about a vast array of new products.

OCS operators first considered expanding into office products several years ago when they noticed office product companies expanding into OCS. The rationale in both camps was that in many accounts, the same decision maker chooses both services. However, the two businesses were not easily integrated. OCS operators could not successfully capitalize on office products, and vice versa. OCS operators interviewed agreed that office supply firms were not a major competitive factor.

Route selling gains ground

In the face of limited account growth, most operators addressed operating efficiencies. The report indicated more operators assigned order-taking responsibility to route salesmen while fewer opted for relying on phone-in orders. While the method of ordering traditionally has been a function of the type of market served — urban, which favored phone orders, and rural, which favored route sales — the survey revealed a shift to route sales. The preference for route selling most likely reflected the trend to more geographically dispersed, less densely populated work sites.

A strategy that many of the more profitable OCS companies used was to eliminate their least profitable accounts and market more and better products to the stronger accounts. Several operators interviewed claimed they were able to sell high-grade, specialty coffees successfully, in some cases more than doubling sales to these accounts.

C-stores and coffee houses were not the only channels to cut into the OCS operator's business in recent years. Vending operators, after losing vended coffee sales to OCS since the 1970s, gradually fought back with their own

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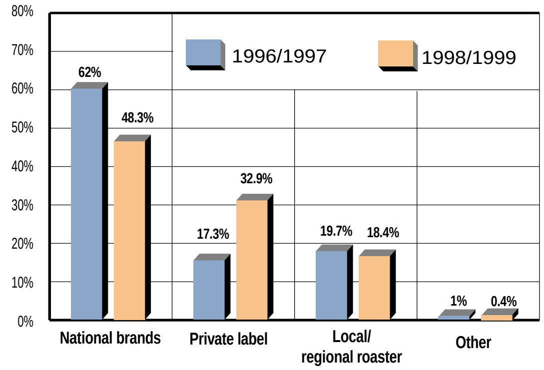
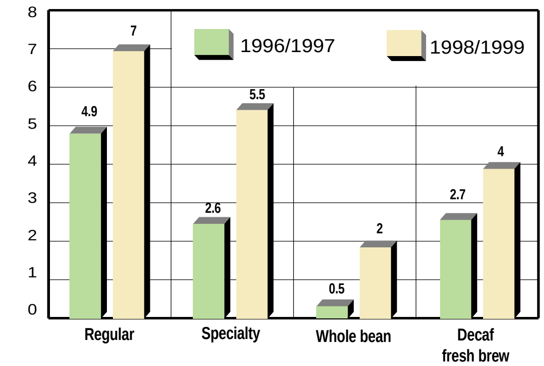
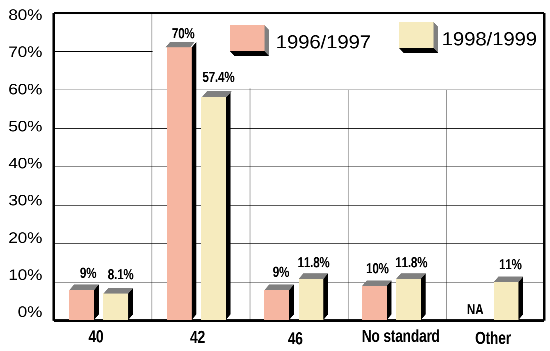
Sources of coffee sales



Number of different coffees offered



Number of packets in standard OCS kit



OCS divisions. In the last few years, approximately 35 percent of all vending companies have operated OCS divisions with dedicated OCS personnel. The rate of vendor expansion into OCS slowed in the last two years.

Previous State of the OCS Industry Reports have indicated that vending companies do not do as much OCS business on a per-operation basis as dedicated OCS firms. The average vending company that offers OCS provides it on an as-needed basis to vending customers. Dedicated OCS firms, on the other hand, typically have full-time salespeople and offer a much greater variety of OCS products.

Vending operators' OCS sales grew at about double the rate of the OCS industry as a whole in 1998, based on information from the *Automatic Merchandiser* State of the Vending Industry Report published in August, 1999. In recent years, vendors have grabbed a bigger portion of the OCS market as more and more of them have expanded into it.

In 1994/1995, the last year the OCS State of the Industry Report broke out results for dedicated OCS sales from vending OCS sales, OCS operators held slightly more than half of the business, even though they were less than a third of all companies providing OCS. Dedicated OCS operators, as noted above, do more business on a per-operation basis.

Fewer dedicated OCS firms

However, the number of dedicated OCS operators has dropped to about a quarter of the OCS operator universe, as many dedicated OCS firms have merged or been acquired by vending operations.

The OCS Market Report did not break out dedicated OCS sales from vending OCS sales.

Bottled water companies continued to siphon OCS business, partly in response to OCS operators expanding into the their market. While numbers were not available on the amount of OCS done by water service companies, brewer and water cooler manufacturers both confirmed that more bottled water service companies established OCS operations in the last two years. Suppliers estimated that about 30 percent of the bottled water companies provided OCS in 1998/1999.

OCS operators interested in building specialty coffee sales were more likely to be active in water treatment since water is critical to coffee quality. The logistics of integrating bottled water with OCS didn't seriously challenge OCS companies' internal operating systems, according to those interviewed. However, dedicated water trucks were needed for 5-gallon bottled water. Most OCS operators involved in the water business reported that 5-gallon bottles were preferred over point-of-use, non-bottle coolers.

OCS firms fight back

In the face of all this competition, the survey revealed OCS operators took various measures to strengthen their distinction from other coffee providers.

▶ Operators increased their private label sales (See chart, page 24.). Private label remained a preferred tool to distinguish an OCS operation from the competition, and at the same time, was more profitable than national brand coffee. In 1998/1999, private label coffee accounted for almost 10 additional percentage points over 1996/1997, moving from 19.3 percent to 28.4 percent of total OCS sales.

▶ Operators more than doubled the amount of varietal coffee sold. Varietals still comprised a small percent of total sales at 4.3 percent, but represented a higher ticket item than regular coffee.

▶ Operators sold more espresso/cappuccino. While an even smaller part of the business than varietals, this also represented a higher ticket sale, and also served as a successful selling tool for image-conscious accounts.

▶ Operators carried more coffee SKUs. This was even true for whole bean coffee, which decreased as a percent of OCS sales in the last two years. By carrying more SKUs, OCS operators tried to position themselves as coffee specialists. This marked an attempt to reposition OCS as a value-added service as opposed to being a commodity.

The improved economy brought

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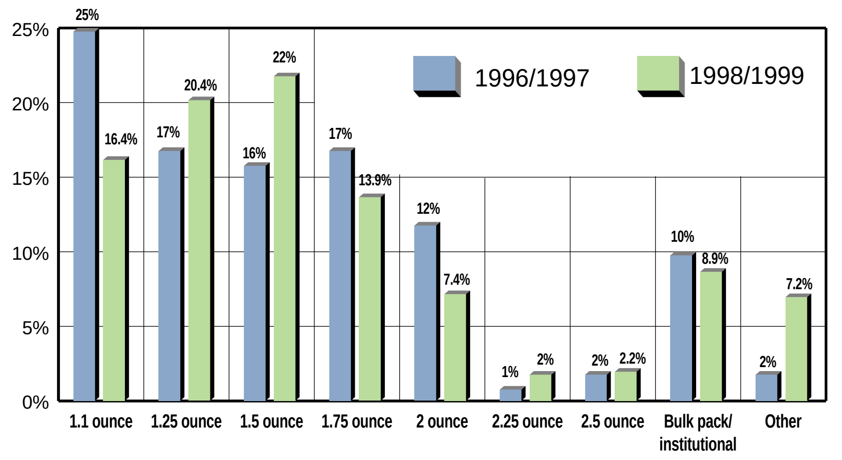
Sales by pack weight



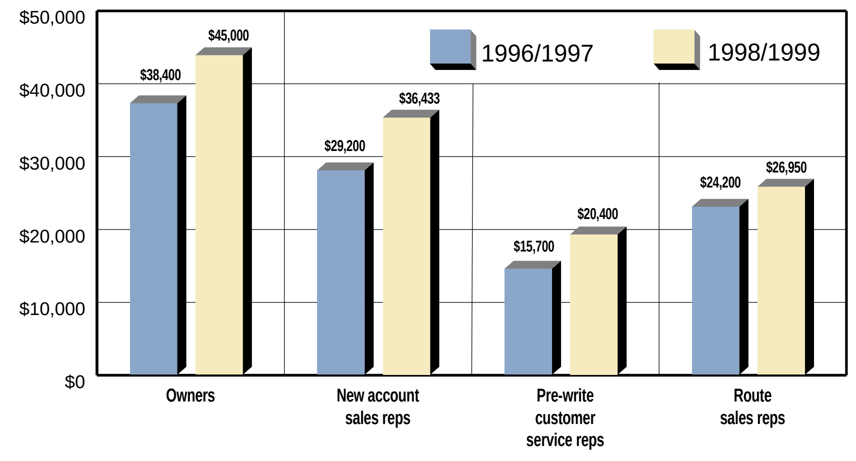
Regional variances: varietals more popular in West, light roast prevails in South

As reported in earlier OCS State of the Industry reports, the use of specialty coffee varied according to region. Offices in the West, particularly the Northwest, used more varietal coffees than offices in other regions. Wyoming Research's office survey indicated the use of varietals in offices in Seattle, San Francisco and Los Angeles was in double digits in 1997 and 1999. No Midwestern or East Coast market reported double digit use of varietals. The National Coffee Association consumer survey noted that while medium roast remained the most prevalent roast of coffee consumed in all regions, dark roast was more popular in the Northeast, North Central and West, while light roast was more popular in the South.

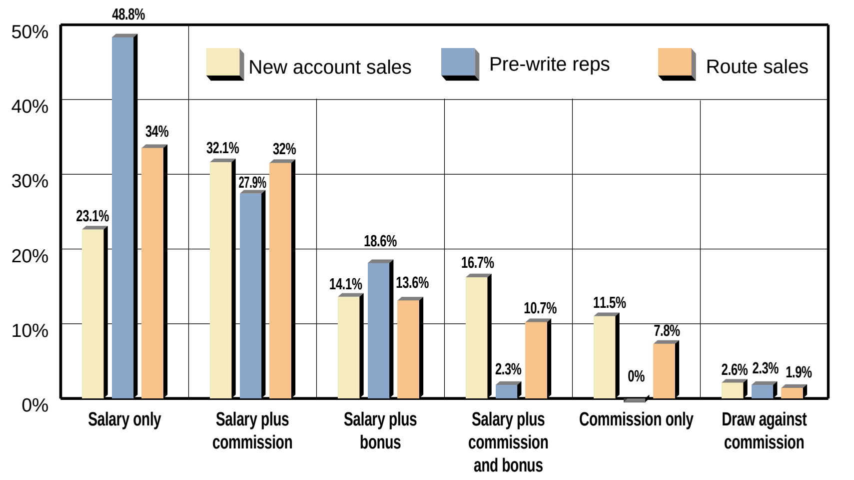
both benefits and setbacks. On the plus side, it created new customers. On the minus side, labor became harder to find. The labor market, however, carried a plus side as well as a downside. The low unemployment stalled the rate of entries to the OCS business.

One unique characteristic of the early ’90s recession was the job instability it brought to the white collar sector of the work force. Laid-off managers frequently sought opportunities to own their own businesses. Hence, the recession created a steady flow of newcomers to OCS and other industries with low-capital start-up costs.

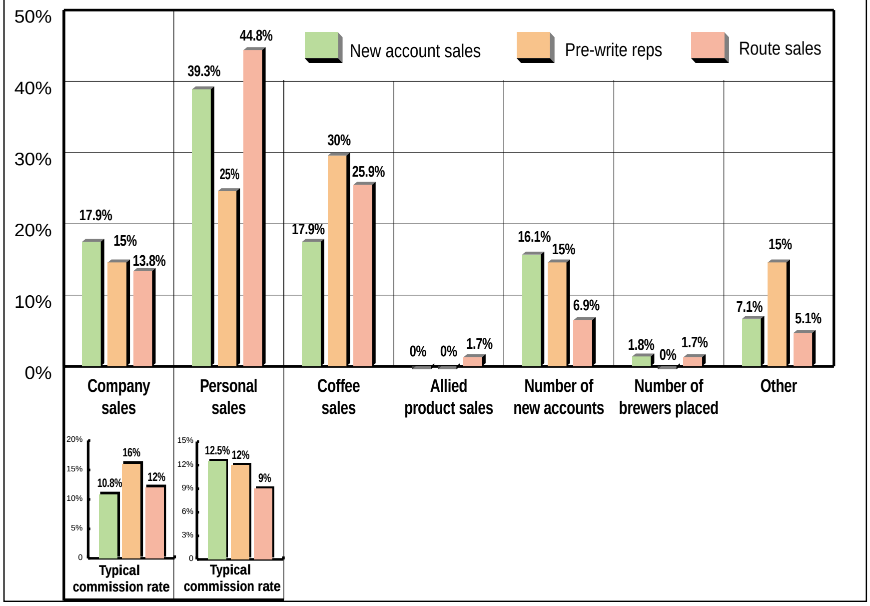
Average annual compensation



1998/1999 pay plans for sales personnel



How 1998/1999 commission was based



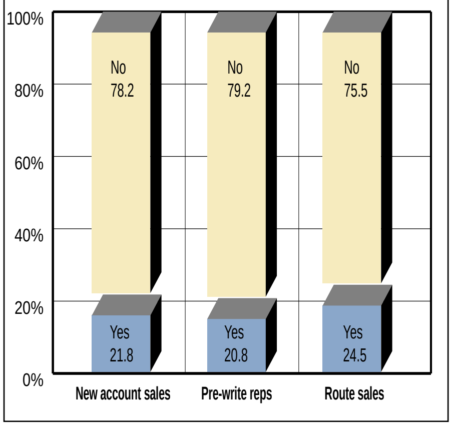
Higher OCS start-up costs

As the millennium approaches, OCS no longer attracts entrepreneurs like it used to. In some major markets, the Yellow Pages carry less than half the number of OCS operations as they did 10 years ago. The availability of more stable employment in other industries is one reason. Another is that with the exception of some rural markets, OCS is no longer the low-cost start-up business it used to be. Higher brewer costs and the need to provide a wider range of products have raised the industry's entry fee.

OCS operators were quick to point out, however, that competition has not let up. Consolidation has created larger, more formidable players in every geographic market.

Consolidation among OCS operations is expected to continue as the cost of providing service makes the business less profitable on a per-customer basis. Better capitalized OCS firms are also in a better position to meet the growing demand for specialty coffee in the work place.

How sales quotas must be met before commission earned



The NCA survey showed that in 1999, coffee consumption increased for the first time in several years. Consumption dropped from 1979

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through the current decade as baby boomers were conditioned by the big cold drink marketers to prefer cold beverages. The NCA's 1999 telephone survey of 3,300 consumers indicated that the average number of daily cups consumed per drinker grew from 3 to 3.5. About a third reported using a cup larger than 8 ounces, up 10 percent over 1998.

Morning coffee: a wider window

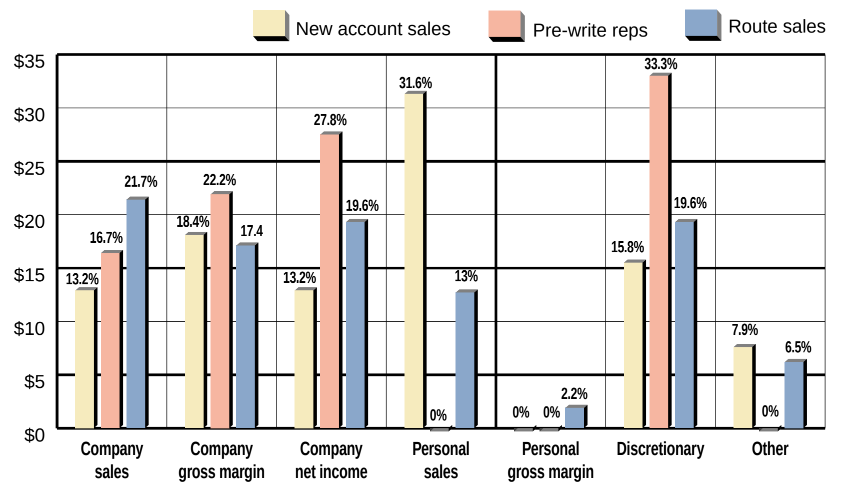
One finding was particularly optimistic for the away-from-home market, which includes OCS: The percentage of coffee consumed at breakfast declined from 66 percent in 1998 to 57 percent in 1999 while the share for the rest of the morning increased from 13 to 19 percent. This means consumers are drinking coffee throughout the morning, giving them a longer time to drink coffee.

The NCA study further revealed there are more daily coffee drinkers and more occasional drinkers, and that the latter group is growing faster: From 1991 to 1999, daily drinkers increased from 105 million to 113 million while occasional users grew from 34 million to 63 million.

Of particular importance to OCS is the extent to which young adults are drinking coffee. The 18- to 24-year-old group consumed 4.8 cups per day, followed by the 20-29 group at 4.2 cups, 30-59, 3.8; 60 and over, 2.8. More 18- to 24-year-olds became daily consumers, up from 19 percent in 1998 to 23 percent in 1999. The NCA noted that this group drinks more coffee away from home, more between meals, and more specialty beverages.

The survey included several questions about how sales personnel are compensated. Compensation plans for three types of salespeople were considered: 1) new account sales, 2) pre-write sales, and 3) route sales.

How 1998/1999 bonus was based



Sales compensation: many plans

As expected, most new account sales reps were paid on commission or bonus or a combination of the two. About half of the companies surveyed paid their pre-write sales reps a straight salary, while the other half used some type of incentive plan. Most route sales reps were paid an incentive; in fact, the percent that were paid straight salary, 34 percent, came close to the number paid a salary plus commission, 32 percent.

Commissions varied according to the type of sales job. They were usually based on personal sales, coffee sales or the number of new accounts. New account salespeople and route sales personnel commissions were most often based on personal sales.

Bonuses, when used, were usually based on personal sales for new account sales reps. Pre-write sales reps' bonuses were most often based on a discretionary basis, followed by company net income. Route sales reps' bonuses were most often based on company sales, followed closely by company net income or on a discretionary basis.

Trends favor bigger firms

Market forces affecting OCS as it approaches the millennium parallel those of vending: work sites are becoming smaller while the cost of service is rising. As with vending, these factors favor the larger, better capitalized firms.

Larger OCS companies, armed with the best products and equipment, can serve a more segmented market more economically. The improved technology of today's coffee brewers give these operators the tools to meet the demands of a more competitive market. AM

Years of service needed for full-time employees to earn vacation

Length of service	Vacation earned
1.3 years	1 week
2.7 years	2 weeks
7 years	3 weeks
12 years	4 weeks
15 years	More than 4 weeks

Average 1998/1999 paid holidays: 6

Benefits offered to full-time employees 1998/1999

	Fully covered	Employee pays part	Employee pays all	Not provided
Hospital/surgical only	36.6%	37.6%	3.2%	22.6%
Major medical	41	37	3	19
Dental insurance	17.1	25.6	6.1	51.2
Vision care	11.3	19.7	4.2	64.8
Life insurance	40.7	16.5	1.1	41.8
Long-term disability	32.9	7.9	5.3	54
Short-term disability	30.7	9.3	4	56
Pension	7.4	14.7	0	77.9
401K	19.3	32.5	2.4	45.8
Profit sharing	24.4	7.7	0	68
Maternity leave	30.1	11	2.7	56.2
Vacation with pay	80.8	4.8	0	14.4
Sick leave with pay	63.2	7.4	0	29.5