STATE OF THE COFFEE SERVICE INDUSTRY

Downsizing snags sales, but taste for specialty coffee stays hot

BY ELLIOT MARAS, EDITOR

The 2001 recession put a damper on the OCS industry's growth, but the market continues to trade up

Sometimes you need to take one step back to take two steps forward. The start of the new millennium found the OCS industry moving at a fast pace, driven by growing consumer taste for specialty coffee. Then an economic slowdown tripped the industry in its tracks.

The 12-month period ending June of 2002 snatched back the 5-percentage-point revenue boost the OCS industry grabbed in the prior 12-month period. The heavy layoffs in the second half of 2001, exacerbated by the September 11th World Trade Center tragedy, resulted in the OCS industry's first 12-month revenue decline.

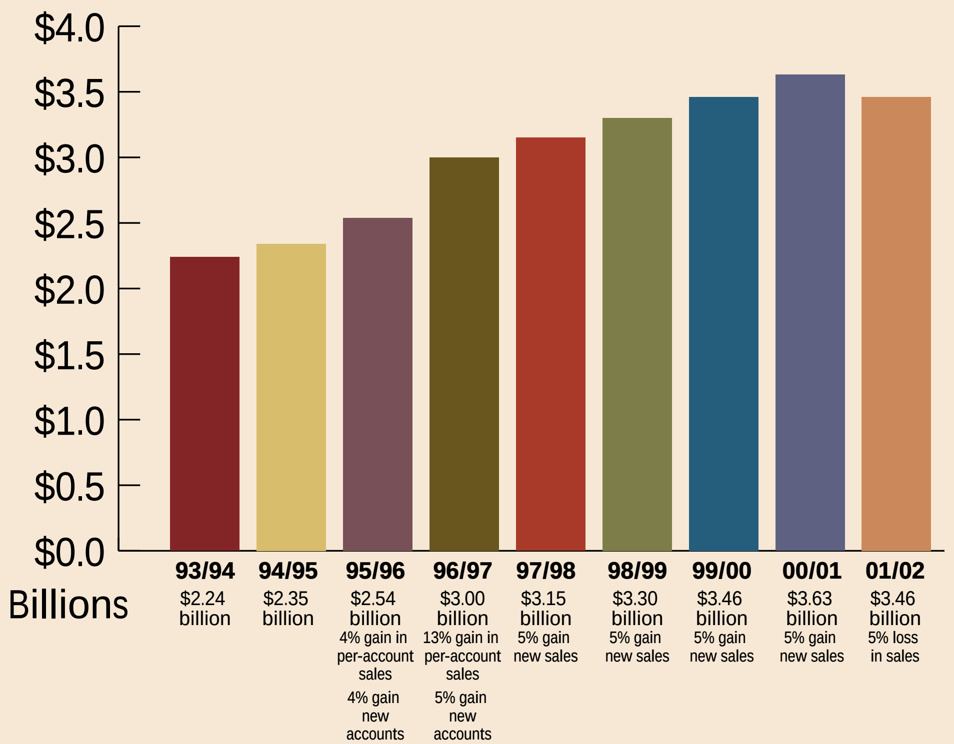
OCS sales in 2001/2002 fell back to $3.46 billion, after climbing to $3.63 in 2000/2001, according to the *Automatic Merchandiser* 2002 Coffee Service State of the Industry Report. The report was based on the results of a questionnaire e-mailed to 1,400 OCS operators. Operators completed questionnaires and e-mailed them back to *Automatic Merchandiser*.

This first e-mail survey generated a 10 percent response. The report is also based on telephone interviews with operators, product suppliers, equipment manufacturers and research organizations.

First one-year decline in OCS sales

The industry's first-ever sales decline undercut a growth spurt fueled by specialty coffee, as noted in the 2000 Coffee Service Market

Chart 1 OCS revenues — nine-year history



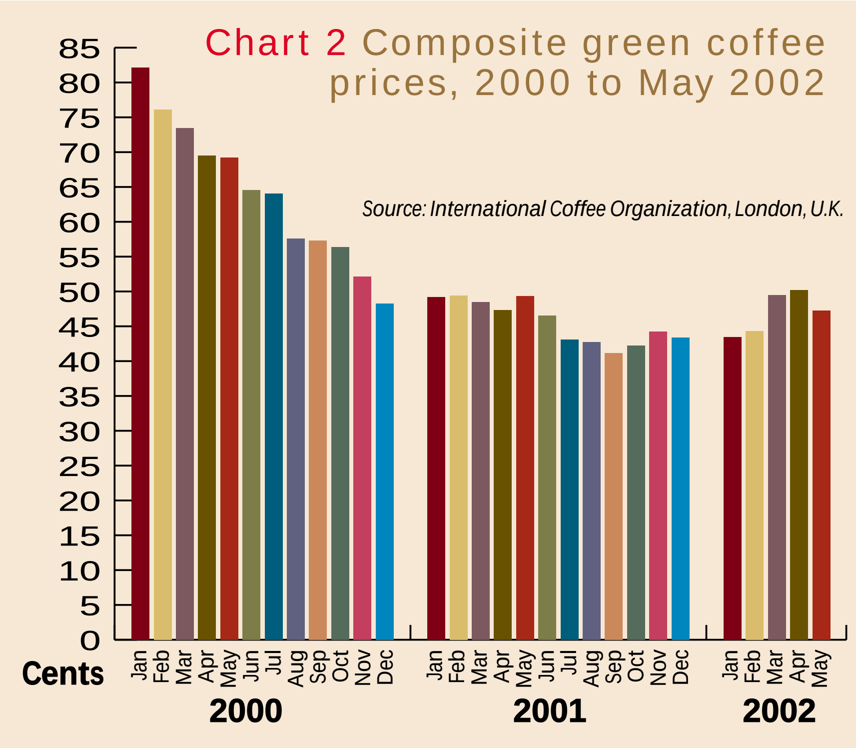


Chart 2 Composite green coffee prices, 2000 to May 2002

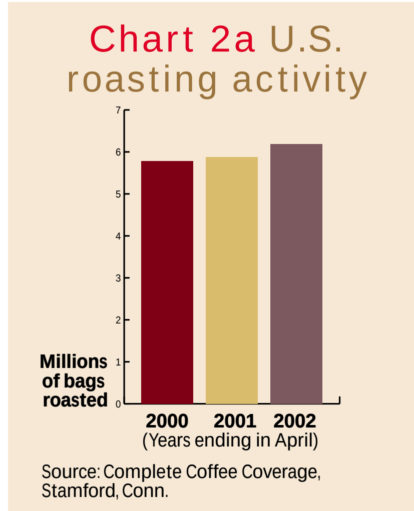


Chart 2a U.S. roasting activity

Report. Rising specialty coffee sales had enabled the industry to post 5-point revenue gains for two consecutive years in 1999/2000 and 2000/2001. Massive customer layoffs in 2001/2002 erased the earlier year's gain.

Employers in the financial and "dot-com" industries were among the largest buyers of specialty coffee products. These companies, concentrated in the mid-Atlantic and Pacific regions, laid off the most employees, according to the Conference Board, a Washington, D.C.-based organization that studies economic trends.

Sept. 11 added to OCS woes

The September 11th tragedy exacerbated the situation, adding the travel and leisure industries to those severely affected, inflicting even more damage on the mid-Atlantic economy. OCS operators serving accounts in Manhattan lost some large customers and in some cases, their OCS equipment as well.

The Conference Board reported that the fourth quarter of 2001 witnessed the largest downsizing in the United States in more than 12 years, with more than 1.4 million jobs lost.

Interviews with OCS operators confirmed that those operators serving the industries most affected by the 2001 recession and September 11th — Internet, telecommunications, aerospace, finance and hospitality — experienced the biggest fallout in same-location sales. These were among the customers that purchased the most specialty coffee.

Regional performances varied

Operators in the South and the Midwest, where specialty coffee has been slower to catch on, suffered less than their counterparts in the coastal regions.

Operators in many rural sections in the East North Central, West South Central, West North Central, West South Central and Mountain regions reported only marginal sales declines compared to those in the coastal states.

The World Trade Center tragedy placed an additional damper on businesses' willingness to spend money nationwide. The tragedy was particularly damaging to the OCS industry since it precipitated the fall buying season.

Compounding the OCS industry's woes in 2001 was an especially warm fourth quarter, when OCS sales typically rise in the Northern states.

In keeping with economic indicators, OCS operators reported a partial recovery in the second quarter of 2002. Echoing economists, most operators were optimistic that growth will continue through the balance of the year.

The 2001 layoffs gave new urgency to OCS operators' need for more emphasis on sales, even though the economic downturn made it an inopportune time for increasing investment. OCS operators were already relying more on dedicated sales staffs in recent years in response to a mature OCS market. With new customers scarcer than they were in the 1970s and 1980s, operators in the 1990s found they needed dedicated salespeople to demonstrate their points of difference.

Dedicated sales efforts increase

The emergence of specialty coffee, which gave operators new tools to distinguish themselves from competitors, further supported the need for more professional salespeople. New products and equipment required more specialized knowledge.

As indicated in Chart 5 on page 42, the amount of selling handled by visiting sales representatives in 2001/2002 almost doubled since 1994/1995, when route delivery personnel did more of the selling.

The survey also reported a major increase in customers calling, mailing or faxing orders since 1994/1995, as indicated in Chart 12. OCS operators more frequently provided customers with

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order forms to return, as opposed to having the route person write the order at the time it is delivered. The survey also noted that close to 11 percent of the operators had customers e-mail orders.

Customer turnover rises

The layoffs in 2001/2002 increased customer turnover. As indicated in Chart 3, customer turnover, the number of accounts lost and replaced divided by total number of accounts served, more than doubled the rates reported in 1997 through 1999. However, stronger sales efforts enabled operators to more than offset the customer attrition, as indicated on Chart 3a.

The revenue loss in 2001/2002 mostly reflected lower sales in existing accounts.

Fortunately, continued declines in green coffee prices, low interest rates and stable fuel costs supported renewed investment in sales. Other operating costs, such as salaries, benefits and insurance, increased.

Coffee as a percent of total operator sales decreased in 2001/2002, as indicated in Chart 7 on page 44. Operators suffering heavy population drops in their accounts reported coffee sales fell more than noncoffee sales. Sales of cups and paper goods were strengthened by manufacturer price hikes which operators passed on to customers.

Specialty coffee sales stay strong

OCS, like other business services, is traditionally among the first industries to experience the effects of employer downsizing. The most important finding of the 2002 Coffee Service State of the Industry Report is that the recession did not hamper the growth in specialty coffee. The survey reported the following:

- Almost a quarter of all OCS operators raised prices, despite continued declines in green coffee prices.
- Average sales per cup reached 6.3 cents, an all-time high.

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Chart 3 Comparative averages

	1997/1998	1998/1999	1999/2000	2001/2002
Raised prices in Last year	83%	23.4%	27.2%	24%
Customer turnover*	2.7%	2.5%	NA	5.7%
Revenue per cup**	5.8 cents	5.2 cents	5.2 cents	6.3 cents
Roast own coffee	2%	9.6%	7.4%	6%

** Number of accounts lost and replaced divided by total number of accounts served.*
*** Doesn't include coin-op sales.*

Chart 3a Accounts placed and cancelled

Accounts placed in last 12 months	8.2%
Accounts canceled in last 12 months	5.7%

Chart 3b 2001/2002 pricing activity

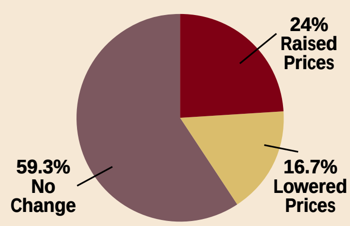
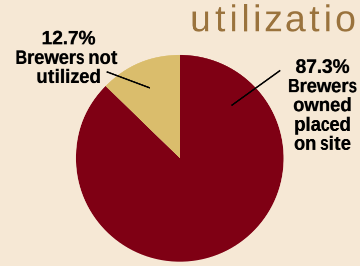


Chart 4 Brewer utilization



Brewers placed in last 12 months	8.2%
Brewers canceled in last 12 months	5.7%

Chart 3c Sales by average cup price, 1999/2000 vs. 2001/2002

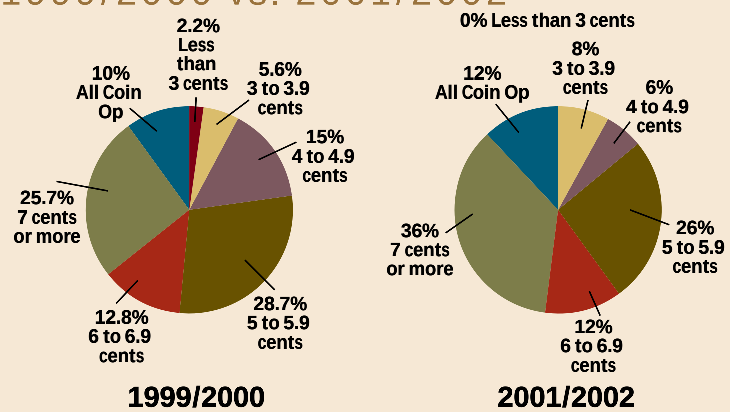
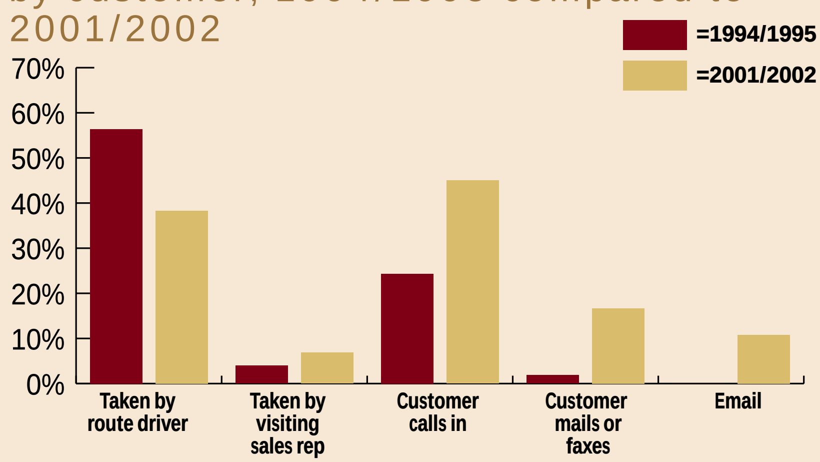


Chart 5 How orders are primarily placed by customer, 1994/1995 compared to 2001/2002



- Higher pack weights continued to grow as a percent of total sales.
- The amount of standard kits has dropped, as shown in the recent four-year comparison in Chart 9.
- Sales of cappuccino, flavored coffee and varietal coffee continued to increase as a percent of total coffee sales.
- The percent of airpot and thermal brewers doubled to 10 percent of all brewers on location since 1999.
- The percent of countertop, single-cup brewers more than doubled to 4 percent of the total since 1999.

Operators interviewed overwhelmingly agreed that consumers did not "trade down" to less expensive coffee, despite the recession. OCS operators serving accounts that could no longer justify the more expensive brewers — thermal/airpot and single-cup dispensers — reported they were able to find other locations for them. These findings reflected the growing popularity of specialty coffee.

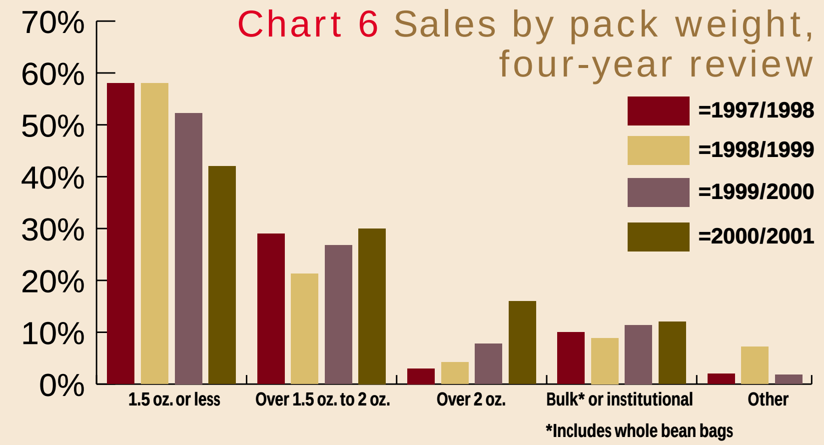


Chart 6 Sales by pack weight, four-year review

Chart 7 OCS sales by product category, four-year review

	1997/1998	1998/1999	1999/2000	2001/2002
Private label coffee	19.3%	28.4%	30.9%	26%
National brand coffee	50.8	33.8	32.8	37
Espresso/cappuccino	1.6	2.2	2.9	3
Other coffee*	7	8.7	8.9	4
Total coffee	**78.7%**	**77.2%**	**75.5%**	**66%**
Other hot beverages	4.4	3.8	2.8	4
Soft drinks/juices	6.4	8.3	8.5	9
Bottled/filtered water	0.8	4.1	4.3	8
Creamers/sweeteners	6.4	5.1	5.1	7
Cups/paper products	3	4.5	4.5	6
Other	0.3	1.1	1	0

Includes flavored, whole bean and varietal

Retail specialty industry grows

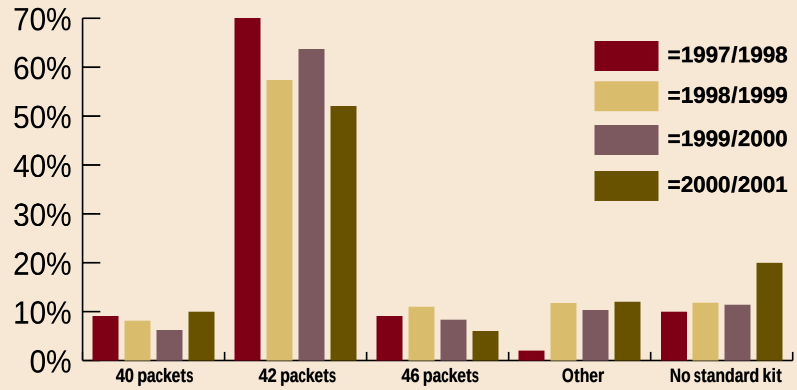
Representatives of the Specialty Coffee Association of America interviewed for this report noted that to their surprise, the retail specialty coffee industry experienced no sign of recession in 2001/2002. The number of specialty coffee stores and sales through these stores reached new highs in 2001 and even outpaced the previous year's growth rate.

Furthermore, the 2002 National Coffee Association Coffee Drinking Trends Survey reported that specialty coffee continued to build the coffee drinking population. The study, based on telephone interviews with 2,950 people 18 years old and older, reported that both consumption and the number of coffee drinkers grew this past year despite the recession. It further noted that in the last five years, the number of "daily gourmet coffee drinkers" increased from 7

Chart 8 Coffee sales by coffee category, 1994/1995, 1995/1996 and 2001/2002 comparisons

	1994/1995	1995/1996	2001/2002
Regular	69.3%	69.6%	60%
Decaffeinated	8	7.7	7
Flavored	2.8	2.7	4
Varietal	7.3	7	13
Espresso/cappuccino	0.6	0.8	3
Extended yield	8	7.7	7
Other	0.3	0.3	1

Chart 9 Number of packets in standard OCS kit, four-year review



million to 27 million.

The 2002 *Automatic Merchandiser* Coffee Service State of the Industry Report reflected a continuation of trends reported in the 1999/2000 survey, published in November 2000. When green coffee prices began to fall in the second half of 1997, OCS operators invested in higher quality coffee and brewing equipment to cash in on rising consumer acceptance of specialty coffee. (By 1999/2000, specialty coffee grabbed 25 percent of the U.S. retail coffee sales.)

Specialty stores drive the market

In 1999, Starbucks, the single biggest driving force of specialty coffee, introduced OCS fractional packs to OCS product distributors. Other specialty coffee retailers followed suit.

OCS operators used Starbucks and other name brand players such as Millstone, Timothy's, Peet's, Caribou, Barnie's, Gloria Jeans, Dietrich's and Green Mountain to promote specialty coffee to their customers.

Leading with these well-known name brands as premium offerings, many OCS operators offered high-pack-weight, private label brands as less expensive, specialty coffee alternatives.

As Chart 7 indicates, 2001/2002 witnessed more than a 4-point gain for national brand coffee following two consecutive years of decline. This finding, in conjunction with the increase in higher pack weight coffee, indicated that the gain in national brands reflected a growth in specialty name brand coffee as opposed to more traditional, national brand coffee. The survey did not distinguish specialty, national brands from traditional, low-pack-weight, national brands.

The increase in "bulk " coffee, shown in Chart 6, reflected a growth in bagged, whole bean coffee as well as single-cup coffee. Several OCS operators interviewed reported selling bagged, whole bean, specialty brands. Besides providing a connoisseur image, the bean bags also helped the customer minimize location pilferage.

The growth of high-ticket brewer systems in 2001/2002 offered no sign of an economic recession. As noted above, airpot and thermal systems doubled as a percentage of all brewers while single-cup units more than doubled. OCS operators found it made sense to use better delivery methods to serve higher quality coffee.

In a saturated market, operators have found it costs less to upgrade an existing customer to a higher-cost sys-

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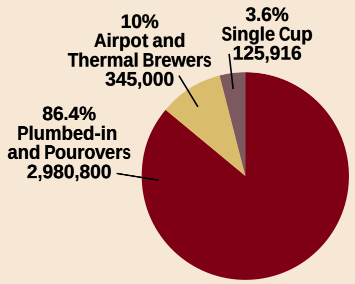
Chart 10a
OCS brewer count



3.45 million units on location in U.S.

Chart 10b
Estimated single-cup brewers in U.S.

Company	Product(s)	Placements
Filterfresh	Filterfresh	26,500*
Crane Merch. Systems	Café System line	23,500
Cafection Enteprises	Avalon	13,000
Zanussi	Brio, Colibri	8,000
Progema	Venus	1,000
Flavia	Flavia	19,000
Keurig	Keurig	30,000
APPART	bistros, Lionness	2,000
Unibrew	Unibrew	3,200
Newco	Gevalia	1,200

**Includes 1,484 Keurig machines*

Chart 10c Single cup brewer growth, three-year trend

1999	83,000
2000	112,200
2001/2002	125,916

tem than it does to replace that customer with a less expensive setup.

More equipment choices

Innovation in both thermal/airpot and single-cup systems continued to offer OCS operators more choices to work with. Several less expensive options became available, giving operators the chance to place higher-quality dispensers in more locations than before.

Stainless steel, thermal decanters were introduced that could be used with traditional coffee burners. Hence, OCS operators could offer the benefits of thermal decanters — the ability to maintain coffee temperature and preserve quality over long periods of time — without having to invest in a whole new brewer. These benefits have become more important as operators have sold more heavier pack weights.

Airpot/thermal brewers grow

These retrofitted systems, like some of the new thermal brewing systems with additional features, also allowed thermal/airpot brewers to find placement in smaller serving spaces than the earlier thermal/airpot systems.

One thermal/airpot selling feature that went over particularly well in this past year was the ability to reduce coffee waste. By maintaining a consistent temperature, these systems eliminated the waste normally created by burned coffee.

The quality debate created by temperature-controlled dispensers continued, however, with some OCS operators claiming the best coffee does not need an insulated dispenser to maintain its quality, even as it sits on a burner.

Another long-standing argument for traditional glass pots — the ability to see and smell the coffee as it brews — persisted.

Single-cup units post gains

As a greater variety of thermal/airpot brewers became available in 2001, so did the even higher-ticket, single-cup systems. Single-cup units posted the biggest gain of all OCS equipment types, supported by an increase in new products.

Single-cup choices encompassed an unprecedented range of costs and features. Like thermal/airpot brewers, single-cup systems became available offering the concept's essential benefits — enhanced variety, high product quality, convenience and ease of use — at lower cost and in smaller serving areas than were previously available.

Portion-controlled systems expand

As noted in a special report on single-cup brewers in February 2002, portion-controlled pod systems gave an extra boost to the single-cup category in the late 1990s. These systems brought a new level of convenience and ease of use. With no residue left on the brewer, the systems guaranteed good quality, were more compact, and cost less than the older, bulk hopper models.

In the last two years, more cartridge- or pod-based models were introduced, giving operators an even wider choice of products and features. All systems included some specialty coffee selections in addition to regular coffee, luring the younger coffee drinkers particularly fond of nontraditional coffee.

OCS operators recognized that the pod systems allowed them, for the first time, to place single-cup brewers in locations with as few as 15 coffee drinkers. This marked a major improvement over the older, bulk hopper systems that required a minimum of 50 coffee drinkers.

Bulk hopper units also grow

While pod-based systems drove a lot of the single-cup growth since 2000, the traditional, bulk hopper units continued to gain placements as well. These larger units proved especially suitable in resale accounts, where pod pilferage would otherwise be an issue. As indicated in Chart 11, OCS operators served more retail accounts this past year other than restaurants, delis and convenience stores. Such accounts included supermarkets, auto dealerships, and health care establishments.

Still another development was the introduction of water-soluble, single-cup systems. While some OCS operators questioned the quality of water soluble coffee, others pointed to the disproportionate growth of nontraditional, coffee-based beverages, such as “powdered

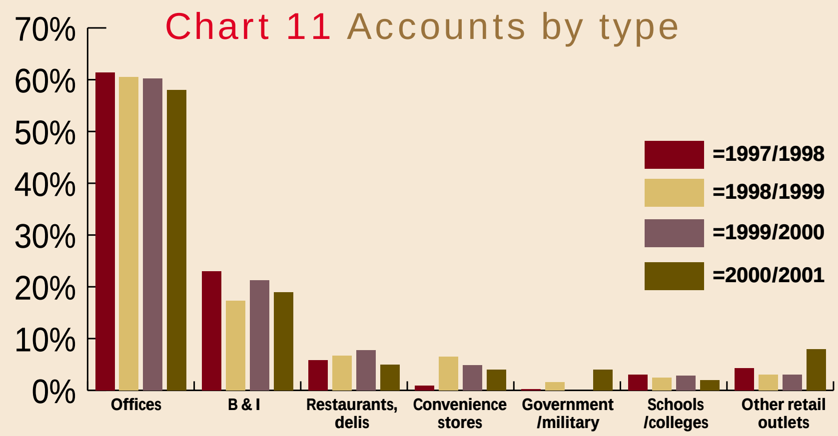
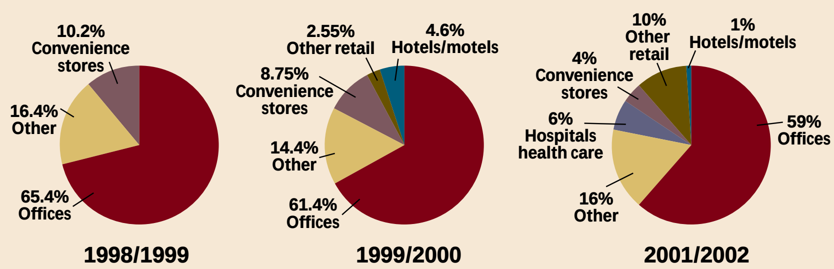


Chart 11 Accounts by type

Chart 12 Share of sales by account type



cappuccino," mocha and flavored coffee, as documented by the National Coffee Association.

Water soluble solutions increase

OCS operators serving locations frequented by a lot of young people were more favorably disposed to water soluble solutions. Others operating in areas where water soluble coffee has long been popular, such as many rural markets, were similarly inclined.

Still another option recently introduced is the frozen concentrate system, adapted from the foodservice arena. Some operators found this feature made sense in areas where customers wanted to fill large containers at a time, in addition to single cups.

Recession doesn't halt single-cup

The continued success of specialty coffee and high-ticket brewing systems in the face of an economic recession answered a long-standing question in recent years: Specialty coffee is here to stay. OCS operators interviewed unanimously agreed that even those customers looking to cut costs did not want to compromise quality.

As business became more challenging in the last 12 months, most OCS operators sought to improve their profitability by scrutinizing costs and revenues, keeping focused on their target office customer. With more products and equipment available, most operators found themselves too busy trying to manage the demands of their existing business to expand into new customer categories.

As Chart 11 indicates, the customer mix has not shifted dramatically in the last four years, even though the office segment has slipped slightly as a percent of total sales.

While many offices shed head counts in the last year, most OCS operators recognized the traditional office customer to be more profitable than the obvious alternatives — restaurants, delis, and convenience stores. However, OCS companies active in these secondary markets noted they were less volatile than office customers during the recent recession. This finding is supported by the National Restaurant Association, which reported that foodservice sales grew 3.9 points in 2001, not too far off of the 4.4 points reported the previous year.

Foodservice accounts: less profit

Foodservice accounts, nevertheless, represented a less profitable scenario for OCS operators. Operators serving the foodservice market have long noted these customers 1) demand more service and 2) are more price-driven than office accounts. OCS operators who expanded into this market were often attracted by its high volume purchases.

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As OCS operators trade up in quality, the restaurant and c-store business oftentimes became less attractive. Operators active in these markets noted these accounts tend to be hard to sell high quality coffee to. Restaurants and c-stores that are quality-driven reap higher sales and profits, they noted, but they tend to be a minority.

Hence, foodservice and c-stores, like offices, represented an educational challenge for those operators inclined to pursue this business.

Management more challenging

OCS operators certainly had their hands full this past year. As accounts lost population, it became necessary for operators to review the overhead of maintaining the account, in relation to sales and profits. In some situations, operators replaced single-cup brewers with plumbed-in automatics. In accounts that were won with the higher-ticket brewer to begin with, this required an understanding on the customer's part.

OCS operators found once again that when accounts downsize, the quality of the customer relationship, or lack of, comes to bear heavily on account profitability. Operators who maintain good will with customers during prosperous times find they are better able to maintain these accounts — profitably — during more challenging periods.

Investment in personnel rises

Hence, the biggest investment many OCS operators considered during the 2001/2002 recession was in personnel. Operators needed personnel capable of servicing equipment properly, maintaining rapport with decision makers, explaining new products to existing and prospective customers, and recruiting new customers.

Overall, OCS operators were cautiously optimistic about 2002/2003. Economic indicators improved in the first quarter of 2002, although employment has not picked up significantly. AM

Chart 13 Pay plans for sales personnel, 1999/2000 compared to 2001/2002

1999/2000	New account sales rep	Route sales	Pre-write rep
Salary only	23.1%	34%	48.8%
Salary plus commission	32.1	32	27.9
Salary plus bonus	14.1	13.6	18.6
Salary, commission, bonus	16.7	10.7	2.3
Commission only	11.5	7.8	0
Draw against commission	2.6	1.9	2.3

2001/2002	New account sales rep	Route sales rep	Customer service rep
Salary only	41.6%	45.24%	65.63%
Salary plus commission	25	19.05	6.25
Salary plus bonus	2.78	9.52	21.88
Salary, commission, bonus	19.44	4.76	6.25
Commission only	11.11	21.43	0
Draw against commission	0	0	0

Chart 14 How bonuses are based

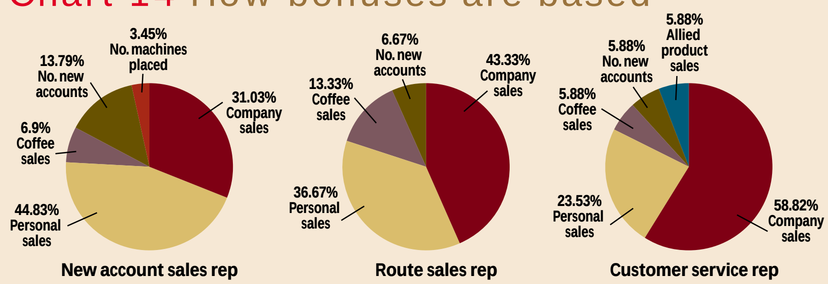

Chart 15 Benefits offered to full-time employees, 1999/2000 compared to 2001/2002

	1999/2000		2001/2002	
	Full coverage	Partiall coverage	Full coverage	Partial coverage
Medical	40.1%	37.6%	12.24%	22.58%
Dental	17.3	15.7	6.12	12.12
Vision	13.4	17.1	5.1	10.75
Life insurance	36.2	7.9	7.14	8.6
Disability*	42.4	19.7	7.14	5.38
Pension	15.6	17.9	2.04	4.3
Retirement**	10.1	29.7	2.04	16.13
Profit sharing	13.1	9	5.12	5.38
Maternity leave	17.8	5.7	6.12	5.38
Paid vacation	81.5	1.4	28.57	4.3
Paid sick leave	62.6	4.3	18.37	4.3

**2002 Includes both short- and long-term disability*
***Includes 401k plans*

Chart 16 2002 coffee consumption trends

77 percent of all adults over 18 years old drink coffee on a weekly or daily basis.

- 1.8 million new daily coffee drinkers, a total of 108.7 million.
- 10.2 million new weekly coffee drinkers.
- 27 million daily gourmet coffee drinkers.
- 25 percent of adults drink coffee on an occasional basis.

Source: National Coffee Association 2002 Coffee Drinking Trends Survey.
For information, call 212-766-4007.