

Higher coffee prices drive OCS sales to another year of growth in a mature market

The higher coffee prices have allowed operators to raise prices, but the OCS industry continues to play catch-up against its retail competitors in meeting consumer demand for better quality coffee.

By Elliot Maras, Editor



Rising coffee prices are giving OCS operators the chance to drive their sales in a highly saturated market, and most operators are taking advantage of it.

The *Automatic Merchandiser* 2005 State of the Coffee Service Industry Report found that most operators raised their prices in the last 12-month period more than any time since 1997/1998, which was the last time green coffee prices jumped.

The widespread price increases drove per-cup coffee prices past the 7-cent mark, the highest in the industry's history, making the traditional "5-cent-a-cup" OCS slogan obsolete.

As a result, aggregate OCS revenues rose by 5 percentage points to \$3.56 billion in the last 12-month period, building on growth that began the previous year and moving the industry almost to its historic 2000/2001 high of \$3.63 billion.

Coffee prices drive gain

The revenue gain in the last 12-month period was driven more by higher green coffee prices than in any other growth year. The OCS market remains

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highly saturated with few new locations available. Per-location unit sales did not generally increase, as office populations remained largely stagnant.

Work site downsizing ebbs

The federal government's Bureau of Labor Statistics reported that unemployment declined slightly — by three tenths of a percentage point — over the past year. As a result, operators reported the work site downsizing that began at the start of the new millennium ebbed in 2004, but employers were not doing a lot of rehiring.

Operators offered mixed reports on employer willingness to spend on coffee. Some said employers were more confident about their financial position and thus more willing to spend on employee perks.

Whether or not employers were confident in their own situations, several operators noted that most of them recognized the important benefit that on-site coffee service provides, and that quality matters. Coffee service systems that deliver good coffee will keep employees motivated and from leaving the office to get it.

Operators pass on price increases

The last 12-month period was the first year since the decline that began in 2000/2001 that the majority of OCS operators raised prices.

When the major retail roasters announced price increases in 2004, OCS operators began raising prices. This was the first time in the history of the report that no operator surveyed lowered prices. Most operators found that customers were willing to pay higher OCS prices.

And while higher prices may not have allowed operators to offset all of their operating costs, it did allow them to maintain product quality. As indicated in chart 5, OCS fractional pack weights have remained steady in the last four-year period.

Specialty coffee makes inroads

The survey reported that national brand coffee made a comeback in the last two years compared to the two previous years, as noted in chart 6. The gain in national brands reflected the introduction of several specialty retail brands in the last few years. Almost all of the national specialty coffee retailers have introduced OCS fractional packs.

The specialty brand fractional packs were among the highest priced products operators carried. Many operators used them strictly as a defensive measure as they continued to promote their more profitable private label coffee.

With higher costing coffee leading the growth in coffee consumption, most OCS operators did not respond to higher coffee prices by trying to sell customers less expensive coffee. This was the tactic that operators used in the late 1970s and early 1980s in response to a spike in green coffee prices, and it proved to be a losing strategy. The industry has been working hard ever since to improve the reputation of OCS coffee.

Customer population counts drop

The 2005 survey revealed a definite downward shift in OCS customer

population counts, indicated in chart 4. The largest single group of customer work sites in the last 12-month period was 20 to 29 people, compared to 30 to 49 people for the two previous 12-month periods. There were also more work sites served with fewer than 20 people in 2004/2005 than in the prior two years.

OCS operators interviewed unanimously agreed that the price increases in 2004 and 2005 hardly compensated for the loss in unit sales that began in 2000 and 2001.

Most also agreed that charging higher prices did not allow them to recover all of their operating cost increases. Besides higher coffee prices, OCS operators experienced gains in fuel costs, wages, benefits and equipment.

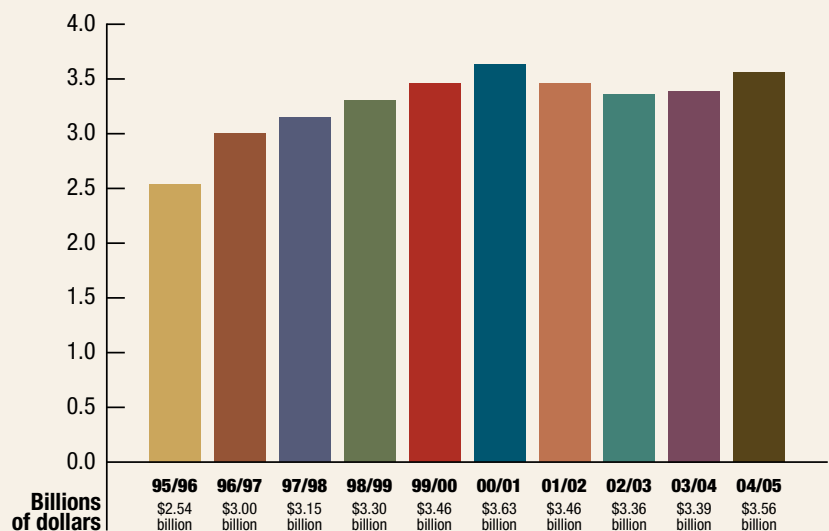
About the survey

The State of the Coffee Service Industry Report is based on the results of a questionnaire e-mailed to 600 dedicated OCS operators and 2,700 vending operators with OCS operations. The survey generated a 10 percent response.

The commentary in this report is also based on telephone interviews with operators, product suppliers, equipment manufacturers and researchers.

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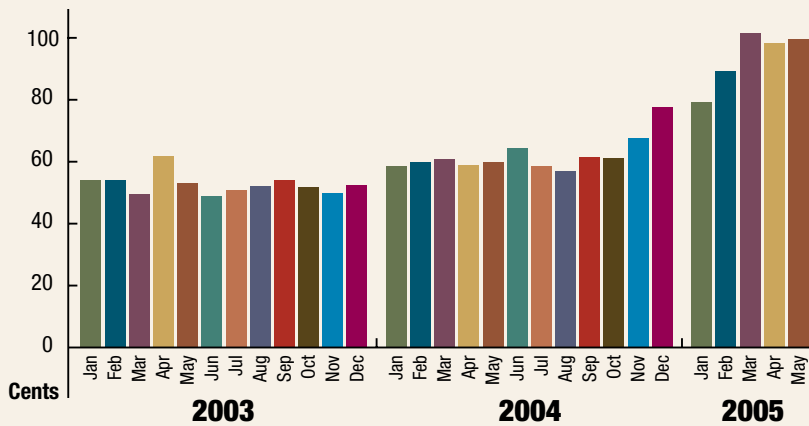
CHART 1: OCS Revenues — 10-year history



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CHART 2: Composite green coffee prices, 2003 to May 2005



Source: International Coffee Organization, London, U.K.

OPERATOR PRICING ACTIVITY

CHART 3A: Raised prices in the last year, 7-year review

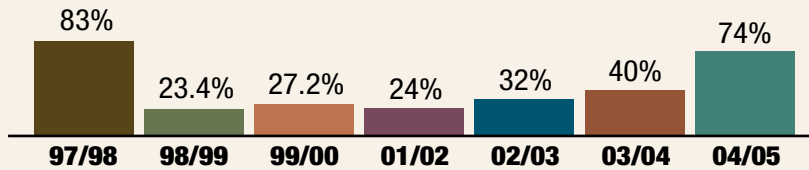


CHART 3B: Operator pricing activity, 4-year review

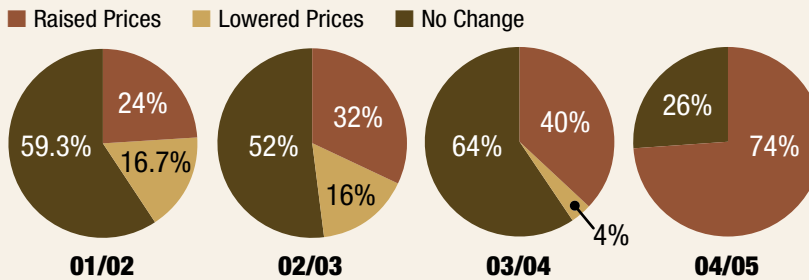
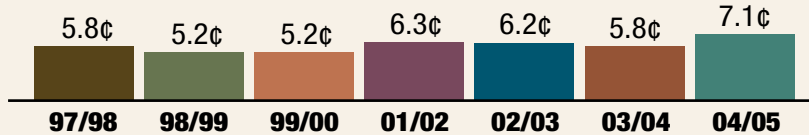


CHART 3C: Revenue per cup in cents per cup, 7-year review



The aggregate OCS revenue reported in this study includes the OCS revenue reported in the State of the Vending Industry Report, which is published in August.

The OCS revenue reported in the vending industry report includes OCS sold to accounts that are primarily vending accounts. The vending report does

not include OCS business handled by dedicated OCS organizations.

All things considered, OCS operating costs have reached a record high at a time when the customer base remains stagnant.

While the report did not measure profitability, most operators interviewed agreed that profitability is more

challenging today than at any time in the industry's history.

Those operators that did report unit sales increases noted that most of the gains came from either specialty coffee or single-cup brewers, or both. These are significantly higher-cost products than the traditional regular coffee and batch brewers. Hence, the overhead involved is much higher and the profit margins are lower.

Operating costs hit an all-time high

Most OCS operators whose growth outpaced the industry average were heavily involved in these higher cost products. Gains were also stronger in the Northeast, where single-cup is more common.

The success of operators focused on specialty coffee is consistent with the gains reported by specialty coffee shops in recent years. The Long Beach, Calif. Specialty Coffee Association of America, which tracks specialty coffee retailers, has reported consistent gains in specialty coffee sales every year from 1989 to 2004, a period when U.S. coffee consumption overall has declined.

OCS operators have been slower than some of their retail competitors — namely coffee houses and convenience stores — to capitalize on the demand for specialty coffee. One reason is that it has taken longer for OCS operators to become confident in both the equipment and the economic operating model needed to provide specialty coffee in the workplace.

The survey indicated that more operators are investing in the product and technology to serve specialty coffee. In the last four years, thermal/airpot and single-cup brewers have consistently increased at the expense of batch brew systems, as indicated in chart 8.

Operators respond to consumer demand

Single-cup systems in particular offer specialty coffee in addition to regular coffee.

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The increase in higher-cost systems indicated the OCS industry has responded to consumer demand for better quality coffee. More and more OCS operators have recognized that investing in better quality systems is the only strategy that will allow them to recapture sales they have lost to competing retail channels.

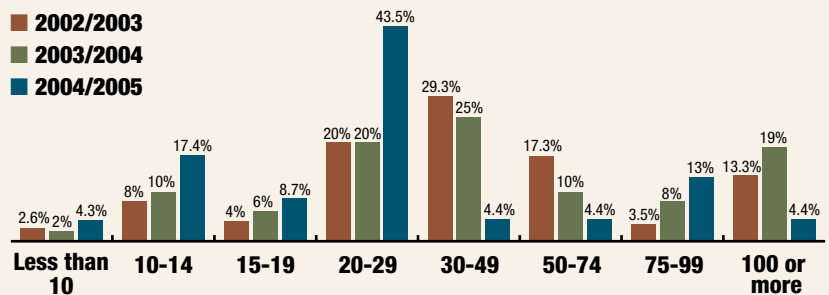
Dedicated sales staff more critical

Product and equipment are not the only areas where increased outlays were necessary. Operators that invested in higher quality systems had to hire more experienced employees to market them. To sell higher quality product and equipment, operators needed dedicated salespeople who could explain the benefits to customers.

Specialty coffee consumers are better educated than other coffee consumers, and the general public's overall awareness of specialty coffee has reached an all-time high.

This finding is particularly significant considering that OCS operators are serving smaller size work sites than in previous years, as indicated in chart 4. OCS operators cannot rely on larger work sites to improve their sales. Instead, they must cater to customers willing to pay more for better quality coffee.

CHART 4: Share of sales by account population, 3-year review



Away-from-home sales increase

The 2005 National Coffee Drinking Trends survey from the New York City-based National Coffee Association confirmed not only that consumers are drinking more specialty coffee, but more of it away from home.

The NCA survey, based on telephone interviews with consumers nationwide, found that the percent that are drinking coffee daily jumped to 52 percent of Americans from 49 percent in 2004 — the first major spike after 10 years of slow increases. Americans who drink traditional coffee rebounded sharply after a 6-year downward trend — up to 49 percent from 44 percent in 2004.

More importantly, the NCA found an 11 percent jump in out-of-home coffee consumption from 2003 to 2004, back to the peak levels observed in 2000.

In the out-of-home segment, the biggest increase was among those who drink their coffee at work. However, while more consumers are drinking coffee in the workplace, they are increasingly getting their coffee from outside the office, NCA noted. This means the percentage of at-work coffee being sourced from within the workplace has, in fact, “declined dramatically,” NCA claimed.

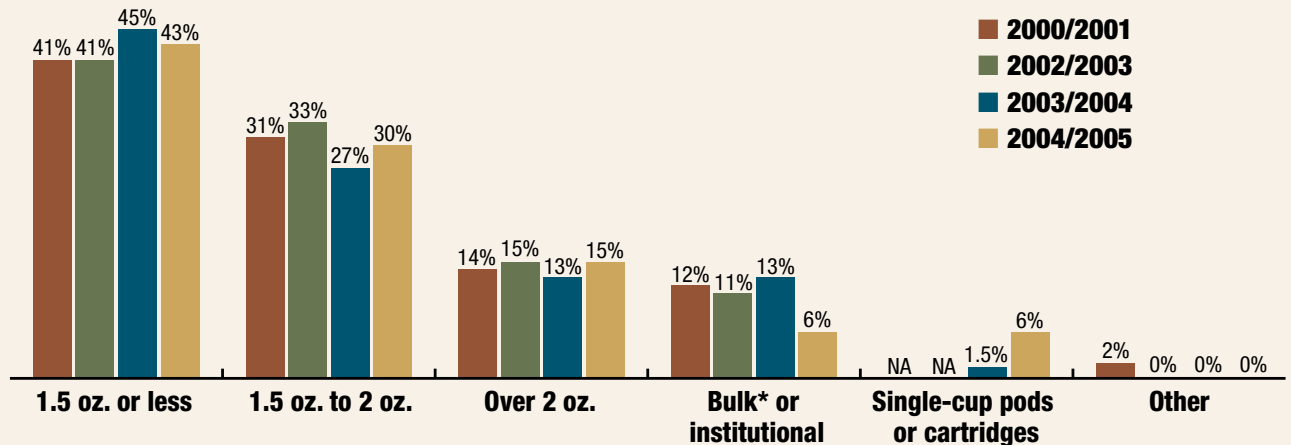
This finding indicates that OCS operators have not responded to the demand for better quality coffee as fast as their retail competitors.

C-stores grab specialty coffee sales

Information from another research organization, Casper, Wyo.-based Wyoming Research Associates, indicated much of the away-from-home

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CHART 5: Sales by pack weight, 4-year review



*Includes whole bean bags

NA = Not asked

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specialty coffee sales are at specialty stores and c-stores. The company's 2005 "Foodservice Intelligence Tracking Study of Specialty Coffees" survey consisted of telephone interviews with 2,250 foodservice operators nationwide.

The Wyoming Research survey revealed that c-stores commanded nearly 70 percent of all foodservice specialty coffee purchases, due in large measure to the penetration of more than 125,000 outlets in the U.S. retail landscape. C-stores increased their share of specialty coffee purchases from 50 percent in 2002 to 67 percent in 2004, the survey found.

Single-cup plays a bigger role

Among those OCS operators that did experience strong results in 2004/2005,

the overriding theme was single-cup systems. Some operators focused all of their energies on selling single-cup machines.

While single-cup systems have been available for many years, the systems have improved significantly. In the past year, customer awareness of these systems has also risen significantly due to the introduction of homeowner units being marketed in retail outlets.

The NCA survey found that six in 10 consumers were already aware of single-cup systems, with highest awareness among 40- to 59-year-olds at 64 percent and among Northeasterners at 63 percent.

Two percent of Americans owned a pod single-cup brewer, and 14 percent more said they were likely to buy one,

NCA found. While only 1 percent already gave a single-cup system as a gift, 23 percent said they are likely to do so in the future.

Single-cup systems raise questions

Daily specialty coffee drinkers expressed more than twice the interest in purchasing single-cup brewers compared to traditional coffee drinkers, 31 percent to 14 percent, NCA reported.

While consumer awareness has reached an all-time high, many OCS operators remained uncertain which type of single-cup system to invest in.

Portion-control pack single-cup systems have increased the most in the last several years. These units are more compact than the older, bulk hopper systems, are easier to use, create less mess, and require a lower initial investment.

A key disadvantage to these systems, in many operators' eyes, is that they use only designated portion packs, thus requiring the operator to rely on a sole product source.

Manual pod systems emerge

The last year and a half witnessed the introduction of manual pod systems that incorporate most of the benefits of portion pack systems at lower cost and do not tie the operator to a sole product provider.

The manual pod brewers represent a new wrinkle in the evolution of single-cup brewers, one that has raised more questions than answers for the time being.

Several established equipment manufacturers have introduced manual pod brewers that can accommodate pods from a variety of coffee roasters. As with all new technologies, operators are reluctant to invest in the early versions. Many operators reported testing these systems for reliability in the last 12-month period.

The pod systems, should they prove reliable, have the capability of bringing

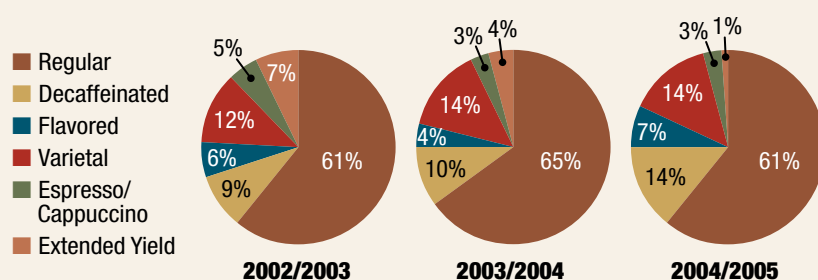
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CHART 6: OCS sales by product category, 4-year review

	01/02	02/03	03/04	04/05
Private label coffee	26%	25%	22%	23%
National brand coffee	37	37	46	45
Espresso/cappuccino	4	4	4	4
Other coffee*	4	4	0	0
TOTAL COFFEE	66	70	72	72
Other hot beverages	4	5	4	0
Soft drinks/juices	9	8	7	4
Bottled/filtered water	8	5	5	6
Creamers/sweeteners	7	8	6	6
Cups/paper products	6	4	5	5
Other	0	0	1	1

*Includes flavored, whole bean and varietal.

CHART 7: Coffee sales by coffee category, 3-year review



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the benefits of older single-cup systems — high product quality, convenience, ease of use and product variety — to a largely untapped audience of small customer locations. Older single-cup systems have thus far been confined to larger locations due to the high investment required.

But ironically, one of the key benefits the manual pod system was designed to provide — versatile sourcing of product — has raised new questions that have caused operators to become more cautious about investing. The variety of both pod brewers and pod products has left operators unsure which systems can accommodate which pods and deliver a desirable product.

The different pod systems tout a variety of benefits; some automatically eject the pod while others do not. There are varying capabilities and several different price points. And the pods, while similar in size, also have variances.

Water soluble and liquid options

Water soluble and liquid concentrate single-cup systems also continued to expand in the last year, although on a much smaller basis.

Roasters have developed new and better tasting water soluble coffees that enabled some OCS operators to provide the benefits of a single-cup system more economically than fresh-brew systems. Some operators also claimed that certain customers prefer water soluble to fresh-brew coffee.

Some operators found it more economical to provide a water-soluble, single-cup system next to a traditional batch brewer, thereby increasing product variety without investing in a higher-cost, fresh-brew, single-cup system.

Manufacturers of liquid concentrate systems also claimed to have improved product quality in recent years. These systems were found to be particularly useful in situations where speed of service was critical, such as catered events.

CHART 8: Share of brewers by brewer type, 4-year review

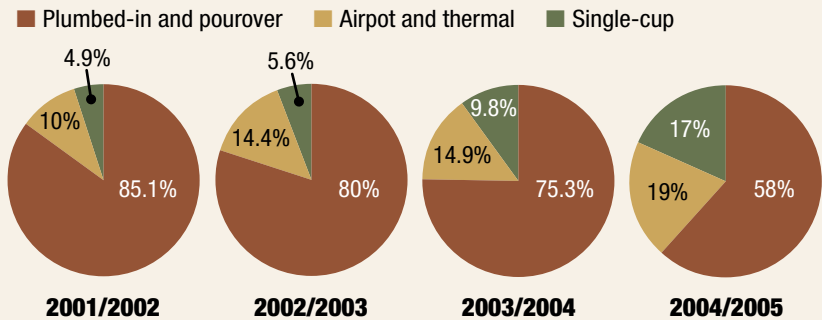


CHART 9: Estimated single-cup brewer placements in the U.S., 4-year review

(EDITOR'S NOTE: Each number represents the total accumulated placements for the date. The totals for all prior years have been revised since last year's report.)

Marketer	Product(s)	01/02	02/03	03/04	04/05
Filterfresh	Filterfresh/Keurig	26,500*	30,000**	35,000***	40,000****
Crane	Café System	11,000	12,000	12,000	12,000
Cafectation	Avalon	13,000	16,000	19,500	20,020
Vendors Exchange International Inc.	Venus, Cypris	1,000	2,400	3,600	5,000
Vendors Exchange International Inc.	Brio/Colibri	8,000	10,000	12,500	25,000
Flavia	Flavia	32,000	40,000	62,000	90,000
Keurig	Keurig	30,000	33,000	60,000	93,651
Kraft	Gevalia	1,200	1,300	1,600	2,200
G.P. Rossi	Robopod	0	0	350	400
Saeco USA	Saeco, Estro	8,000	13,000	18,000	20,000
Sara Lee	Douwe Egberts	0	0	200	500
Rheavendors	Lionness, Cino	516	1,000	1,500	2,694
Aquabrew	Cafejo	0	0	0	1,700
Starbucks	Starbucks	0	0	NA	1,300
DeJong Duke	Essence	0	0	0	600
Café Excellence LLC	Café X Milano	0	0	130	146
Newco	Smartcup	0	0	0	300
Absolute Coffee	Le Petit	0	0	0	30
Other		0	0	3,600	3,800
TOTAL		129,732	143,400	217,900	307,341

* Includes 1,484 Keurig units

** Includes 2,300 Keurig units

*** Includes 12,000 Keurig units

**** Includes 12,000 Keurig units

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CHART 10: Accounts by type, 4-year review

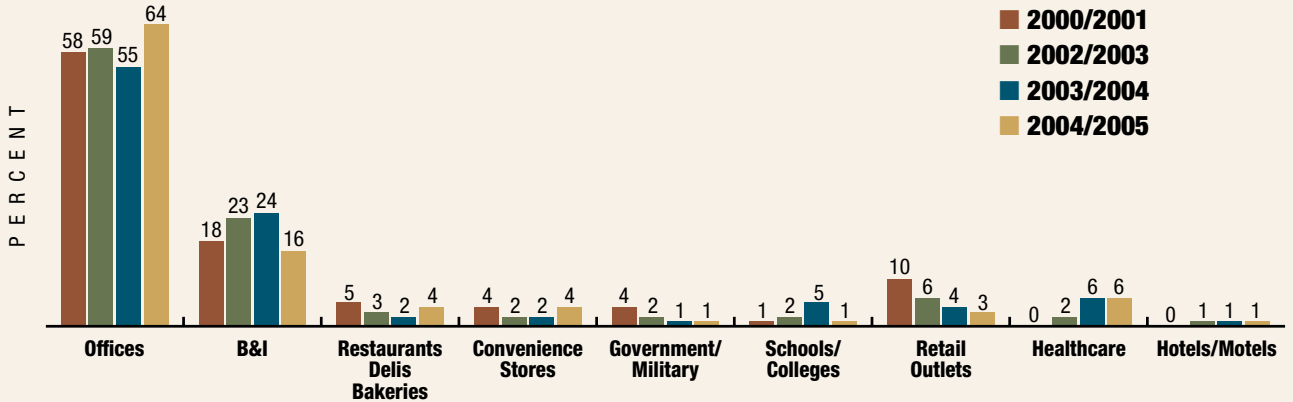
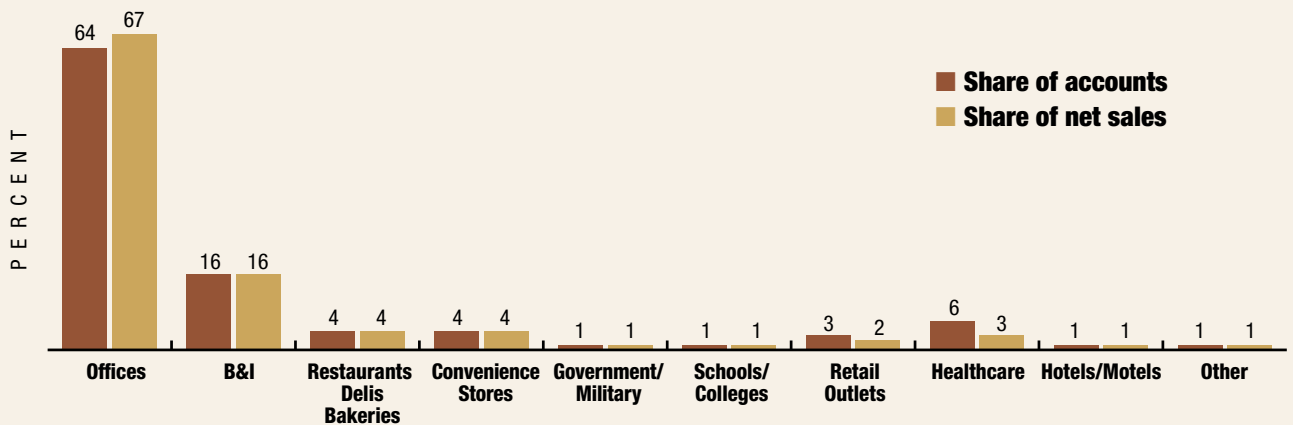


CHART 11: Accounts by type in 2004/2005, share of accounts versus share of net sales



Airpot systems gain

Thermal and airpot systems also posted gains in 2004/2005. Airpot servers that can be used with traditional brewers in recent years sustained an increase at the expense of glass bowl systems in 2004/2006. Like the thermal dispenser and thermal carafe systems, the airpot systems offered the benefit of keeping the coffee warm for a longer period of time.

But for all of the benefits of the newer delivery systems, few operators were willing to acknowledge the death of the traditional glass pot. Many operators interviewed said there are a lot of customers who simply don't want to drink coffee out of anything else.

Some operators maintained that no system can duplicate the taste of coffee freshly brewed into a glass pot.

Glass pots also have the advantage of forcing consumption; when the pot gets old, the customer dumps it in the sink and opens another fractional pack.

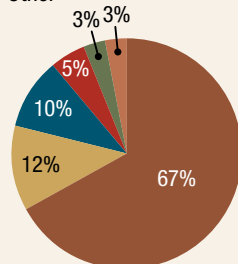
The OCS industry in recent years has responded to a changing customer by investing in better product and equipment. As the OCS market has become saturated, investing in the best quality product and equipment has proven to be the only strategy that sustains sales in existing accounts.

OCS operators continue to find more and more products and equipment that allow them to provide a high-quality service. As a group, however, operators have not upgraded their offerings as quickly as their retail competitors, such as convenience stores and specialty coffee shops. ■

CHART 12: Specialty coffee consumption by food service segment, 2004

(Annual use of specialty coffee in pounds)

- Convenience stores
- National chain quick-serve restaurants
- Full-menu, sit-down restaurants
- Non-commercial foodservice
- Independent and regional quick-serve restaurants
- Other



Source: Foodservice Intelligence Tracking Study of Specialty Coffees, Wyoming Research, Casper, Wyo..