

# Higher prices drive up OCS sales for a second year

Operators cash in on higher quality coffee using more single-cup brewers and specialty coffee offerings; aggressive pricing proves a key growth tool in a well saturated market.

By Elliot Maras, Editor

**F**or the second straight year, OCS operators have raised prices aggressively, enabling the third consecutive year of growth. Total OCS revenues hit an all-time high of \$3.73 billion in 2005/2006, eclipsing the previous \$3.63 billion benchmark set in 2000/2001. However, the 5 percentage point annual growth rate has not matched that of the retail competition. The OCS customer base remains stagnant, location populations have not increased, and operators have not significantly added new services to build per-location sales.

The 2006 *Automatic Merchandiser* State of the Coffee Service Industry Report found that OCS operators continued to raise prices to cover higher costs, including product, equipment, raw materials, labor, fuel, benefits and wages.

The last two 12-month periods witnessed some of the most aggressive operator pricing in the OCS industry's history; about 74 percent of all operators raised prices in each of the last two years.

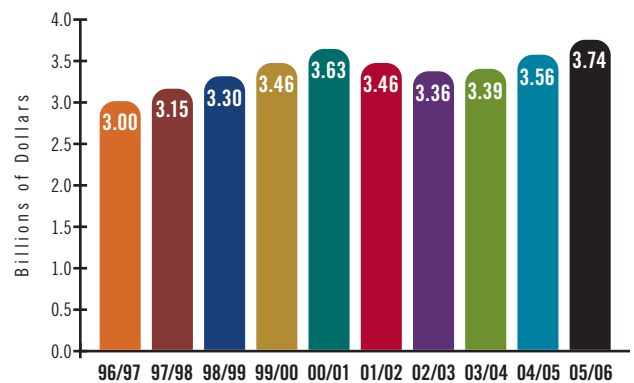
Higher pricing has emerged as the OCS industry's most significant means of increasing revenues to protect bottom lines. Whether or not revenues are keeping pace with cost increases was not certain, since the survey did not measure costs.

Operators found customers willing to accept higher prices due to widely reported increases in business operating costs. Operators found customers were generally sympathetic to their need for higher prices since most customers, also being business people, have experienced similar increases.

## EMPLOYERS WANT BETTER COFFEE

The nation's vibrant economy also created an atmosphere making customers more willing to accept higher coffee prices than a few years ago, when employers were in more of a cost-cutting mood. With the unemployment rate

CHART 1: OCS REVENUES — 10-YEAR HISTORY



reaching historic lows of 4.6 percent, many businesses recognized the need to provide customer perks, and saw OCS one of the least expensive benefits they can provide their employees.

Operators started passing on higher prices in 2004/2005 when roasters began raising coffee prices. The higher green coffee prices encouraged supermarkets to raise coffee prices, creating an environment for OCS operators to follow suit.

Retail coffee prices stabilized in 2005/2006. However, energy prices began to surge, giving operators another incentive to either seek additional price increases or add fuel surcharges. The survey did not ask if operators sought fuel surcharges, but informal interviews indicated many of them did. Those who did this said customers were accommodating. Surcharges were adjusted based on changing fuel costs.

The comparative health of professional and service accounts was fortuitous for OCS operators in the post-9/11 recovery period. Most of the nation's economic growth has been in technology, finance, health care and professional

services; industries that rely on OCS more than manufacturing, which has continued to suffer.

Operators serving markets with high concentrations of financial, high-tech, health care and professional employers, such as the West Coast, East Coast and South Florida, witnessed particularly strong growth in the last 12 months.

#### PER-CUP REVENUE RISES

Per-cup coffee prices in 2004/2005 increased 8.45 percentage points to 7.7 cents, a benchmark, as indicated in chart 3C. Contributing to this comparatively high average has been the continued proliferation of single-cup coffee brewers, the OCS industry's main tool for cashing in on the consumer's appreciation for better quality coffee.

As indicated in chart 9, single-cup placements continued to expand at a rapid clip in 2005/2006. These units provide the combined benefits of ease of use, higher quality product and increased variety. OCS operators found customers willing to pay a higher cost per cup for these benefits.

The last two 12-month periods marked the first time that so few operators reported lowering prices.

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 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 report includes OCS sold to accounts that are primarily vending accounts. The vending report does not include OCS business handled by dedicated OCS organizations within vending companies, or in partnership with a vending company.

#### NEW TOOLS NET HIGHER PRICES

OCS operators have found higher quality products an important tool in their efforts to remain profitable in a business environment with limited growth opportunities. While the nation's productivity has improved in

the last two years, this growth has occurred without more densely populated work sites.

For the second straight year, the majority of OCS accounts had fewer than 30 people, as indicated in chart 4. Account populations have paradoxically declined as work site productivity has increased, according to labor productivity reports.

#### PRIVATE LABEL DECLINES

The growth in single-cup brewers has contributed to a decline in private label coffee at the expense of national brand coffee in recent years. Private label as a percent of sales has been on an almost steady decline for the past five years, as indicated in chart 6.

The single-cup systems that have posted the fastest growth in recent years have been portion control, brew-by-pack systems that do not use private label coffee.

Some of the gain in national brands has also come from specialty retail brand fractional packs. Most of the nation's large specialty coffee retailers have introduced fractional OCS packs, which represent OCS operators' most expensive fractional pack offerings.

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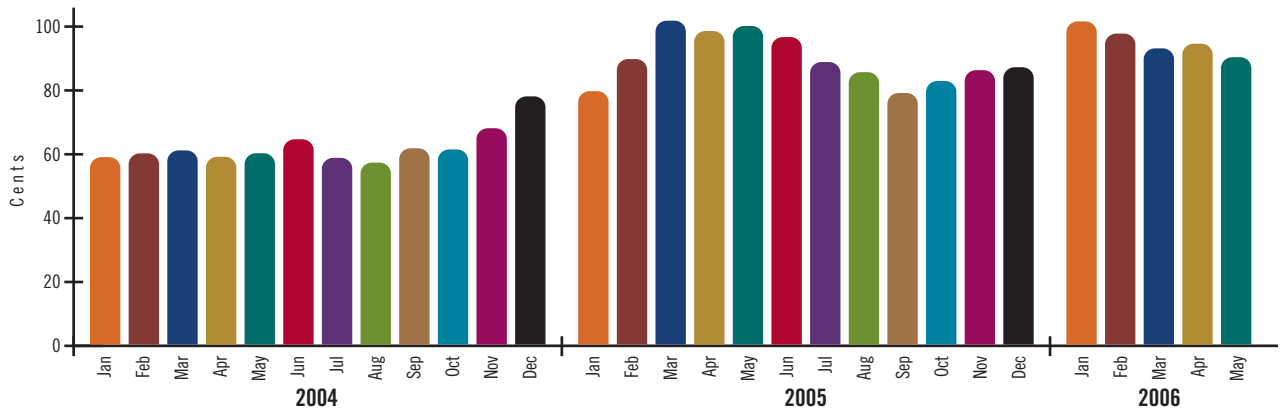
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**CHART 2: COMPOSITE GREEN COFFEE PRICES, 2004 TO MAY 2006**



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

Many OCS operators noted that the specialty retail offerings have performed exceptionally well in the last two years as the retail coffee chains continued to open more stores. The Specialty Coffee Association of America reported that specialty outlets grew another 15 percentage points in 2005 to 21,400 outlets nationwide.

The growth of large specialty coffee retailers has reminded the OCS industry of the importance of brands.

**BRANDS FIND NEW LIFE IN OCS**

Branded fraction packs played a key role in the industry's early development. However, as OCS operators grew in those early years, they expanded into private label coffee. Private label coffee is not only more profitable; it allows an OCS operator to provide a proprietary product, thereby strengthening his customer relationship.

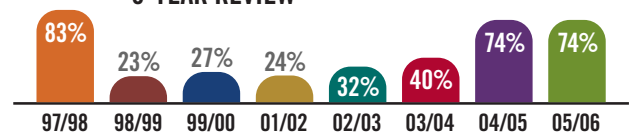
The emergence of specialty coffee brands in recent years has altered this marketing model for many operators. Specialty brands command a higher selling price than private label coffee, and a perception of even higher quality. Where the OCS operator historically downsold customers from a national brand to private label, he or she can now upsell from private label to a specialty brand.

The specialty brand does not provide as high a profit margin as private label to the operator on a percentage basis, but if the selling price is high enough, it can mean a higher net margin.

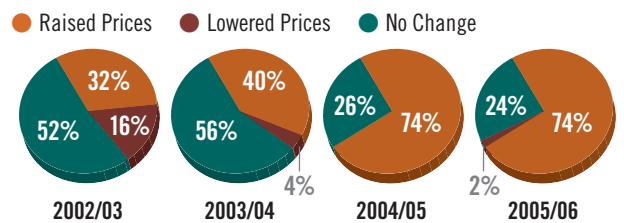
For the first time, the survey attempted to determine operator perceptions about branded brewers, as indicated in chart 7. The majority, 64 percent, do not have brewers that promote a specific brand. However, 57 percent said they believe branded equipment improves sales.

**OPERATOR PRICING ACTIVITY**

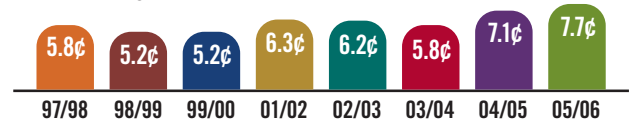
**CHART 3A: RAISED PRICES IN THE LAST YEAR, 8-YEAR REVIEW**



**CHART 3B: OPERATOR PRICING ACTIVITY, 4-YEAR REVIEW**



**CHART 3C: REVENUE PER CUP IN CENTS PER CUP, 8-YEAR REVIEW**

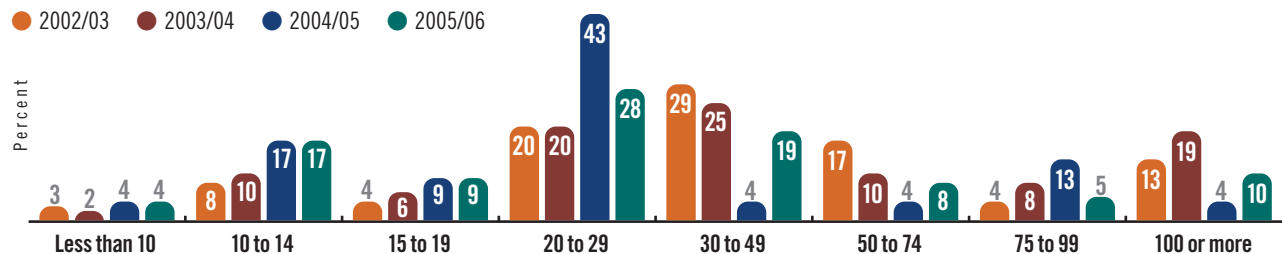


This finding contrasts to sentiments expressed in previous surveys. Traditionally, OCS operators have not believed that branded equipment improved sales, as confirmed by the existing paucity of branded machines.

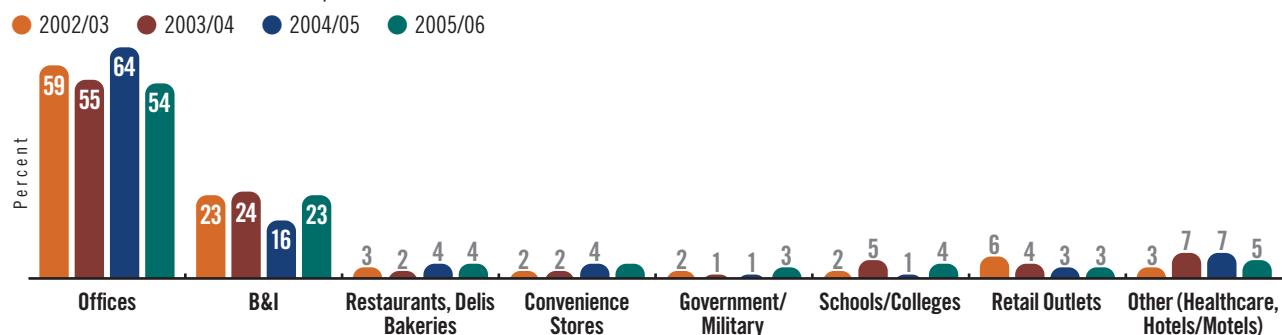
Operators could be changing their view about the benefit of branded equipment due to the rising visibility of specialty retail coffee and the increase in single-cup machines that promote some of these brands.

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**CHART 4: ACCOUNT POPULATIONS BY TYPE OF OCS ACCOUNT, 4-YEAR REVIEW**



**CHART 5: ACCOUNTS BY TYPE, 4-YEAR REVIEW**



(One caveat: the survey did not specifically ask about retail brands. If the respondent assumed the question referred to an OCS industry specific brand, no conclusions can be made about retail brands.)

Specialty coffee has presented a double-edged sword for the OCS industry. While the popularity of specialty coffee has revived consumer interest in coffee, the growth has been monopolized by retailers who increasingly target the away-from-home audience.

The New York City-based National Coffee Association (NCA) has reported for the past two years that more at-work coffee is being brought in from out of the workplace. This indicates that coffee retailers are winning business from both OCS and vending operators.

The NCA, which conducts telephone surveys with consumers, found that coffee consumed at work increased to 18 percent in 2006, marking a 5 percentage point gain in a three year period. More importantly, the percentage of at-work coffee brought from outside the office increased to 48 percent in 2006 from 45 percent in 2005, 43 percent in 2004 and 36 percent in 2003. In-transit consumption increased from 4 percent in 2003 to 7 percent in 2006.

Large coffee retailers upped the ante big time in 2005/2006. Some of the national fast food chains introduced new coffee products supported by major media advertising and free coffee samplings. One even offered free taxi rides.

Convenience stores also continued to market coffee aggressively in 2005. According to The National Association of Convenience Stores, retail sales of dispensed hot beverages in convenience stores increased from \$5.2 billion in 2004 to \$5.47 billion in 2005, a 14 percentage point jump.

NCA also found that overall coffee consumption has increased, giving OCS operators more of an opportunity to increase coffee sales. NCA reported that daily coffee consumption among U.S. adults increased for the second

**CHART 6: OCS SALES BY PRODUCT CATEGORY, 4-YEAR REVIEW**

	2002/03	2003/04	2004/05	2005/06
Private label coffee	25%	22%	23%	20%
National brand coffee	37	46	45	38
Espresso/cappuccino	4	4	4	4
Other coffee*	4	0	0	9*
<b>TOTAL COFFEE</b>	<b>70</b>	<b>72</b>	<b>72</b>	<b>71</b>
Other hot beverages	5	4	0	6
Soft drinks/juices	8	7	4	7
Bottled/filtered water	5	5	6	4
Creamers/sweeteners	8	6	6	5
Cups/paper products	4	5	5	5
Other	0	1	1	2

\*Includes varietal, flavored and whole bean coffee.

straight year in 2006, rising to 56 percent from 53 percent in 2005 and 49 percent in 2004. Overall consumption reflected a similar trend: 82 percent of adults drank coffee in 2006, compared to 80 percent in 2005 and 79 percent in 2004.

## To market more sophisticated products successfully, operators need better trained and compensated employees.

At the end of 2005, the National Automatic Merchandising Association (NAMA) released some groundbreaking research on how consumers view OCS coffee at this critical time in the industry's history. The survey, the most comprehensive OCS consumer survey ever conducted, found that most consumers largely view OCS as a convenience, not as a high-quality product. This underscores the challenge that OCS operators confront in the face of an increasingly competitive marketplace driven by well-capitalized retail competitors.

Key findings of the NAMA survey, reported in detail in the February 2006 *Automatic Merchandiser*, were:

- Forty percent of consumers have no opinion about whether access to coffee makes people more productive.

- Coffee purchased outside the office benefits from perceptions of "taste" and "quality."
- OCS is driven by perceptions of "convenience" and "price."
- Three quarters of consumers do not believe OCS provides specialty beverages.
- About 70 percent of consumers rank OCS coffee as average in quality.

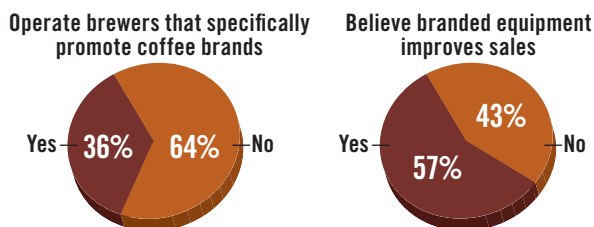
To change customer perception about the benefits they provide, OCS operators need to invest in the better quality product and equipment that manufacturers have made available to them in recent years. This mandates a higher upfront capital investment in product, equipment and personnel. To market more sophisticated products successfully, operators need better trained and compensated employees.

### SINGLE-CUP GROWTH CONTINUES

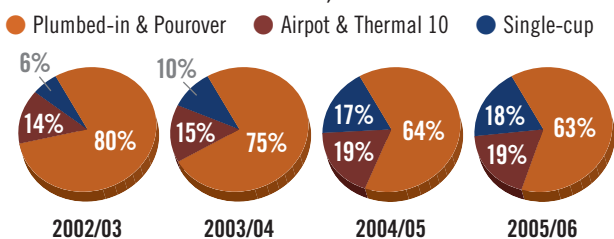
The continued expansion of single-cup systems marks the most promising development for the OCS industry's future. The rate of expansion has increased in recent years, particularly for the portion-control, brew-by-pack systems

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### CHART 7: BRANDED BREWER PERSPECTIVES



### CHART 8: OCS BREWER COUNT, 4-YEAR REVIEW



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that are more compact than the bulk hopper systems and require a lower initial investment.

While single-cup units continued to increase at a rapid clip in 2005/2006, the percentage of these systems as a share of total brewers did not grow as much as in earlier years, as indicated in chart 8. The main reason is that more operators added single-cup units as a complement rather than a replacement to automatic batch brewers.

**ENHANCED PRODUCT VARIETY IMPROVES SALES**

Operators recognized that for many customers, the single-cup unit’s greatest selling point is the product variety it offers. As indicated in chart 6, the percentage of “other coffee” products posted an increase in 2005/2006. This includes varietal, flavored and whole bean coffee.

Operators recognized that many customers prefer to use the automatic batch brewers out of personal preference. In many locations where a single-cup unit attracts new customers, the traditional brewer still has a place. In addition, there is no incentive to remove the traditional brewer if new locations are not readily available.

While the portion control, brew-by-pack system can be profitable in accounts with as few as 50 people, the economics still limits the opportunity to an account base that is not growing.

2003/2004 witnessed the introduction of manual pod brewers that offered the possibility of overcoming this minimum population barrier. Besides requiring a lower capital investment, the pod systems incorporate most of the benefits of portion control, brew-by-pack systems but do not require a proprietary product.

Pod brewers can brew pods from a variety of roasters. Several well established equipment manufacturers introduced such systems.

**POD BREWERS CHALLENGE OPERATORS**

But pod brewers have not gained a significant presence in the two years they have been available, leading some to conclude the systems are not reliable.

Others believe the growth will come with time; operators are naturally reluctant to invest in unproven machines, and

they have been no slower to embrace pod systems than they were to invest in other single-cup systems when they were first introduced.

The key benefit the pod system was designed to provide — versatile product sourcing — has proven to be its (possibly temporary) stumbling block. Operators want to be sure that machines will brew a consistent tasting product, and given the diversity of pods available, many feel they lack this assurance at the present time.

The growth of single-cup systems represents the OCS industry’s strongest effort to respond to the consumer’s rising taste for better quality coffee. While the rate of expansion has been consistent, the percentage of operators using these systems remains small in relation to the opportunity at hand, as indicated by the faster growth in foodservice coffee sales.

For OCS operators to gain their fair share of the rising coffee market, more operators need to invest in the product, equipment and personnel that state-of-the-art delivery systems require. | ◀

**CHART 9: ESTIMATED SINGLE-CUP BREWER PLACEMENTS IN THE U.S., 4-YEAR REVIEW**

(Editor’s note: Each number represents total accumulated placements as of the given date.)

MARKETER	PRODUCT(S)	2002/03	2003/04	2004/05	2005/06
Absolute Coffee	Le Petit	0	0	30	28
Aquabrew	Cafejo	0	0	1,700	5,250
Bodecker Brewed	Bodecker	0	0	0	300
Café Excellence LLC	Café X Milano	0	130	146	250
Cafectation	Avalon	16,000	19,500	22,500	24,350
Crane	Café System	12,000	12,000	12,000	11,500
Filterfresh	Filterfresh	27,700	23,000	28,000	33,337*
Flavia	Flavia	40,000	62,000	90,000	140,000
G.P. Rossi	Robopod	0	350	400	1,000
Keurig	Keurig	33,000	60,000	93,651	140,000**
Kraft	Gevalia	1,300	1,600	2,200	3,500
Newco	Smartcup	0	0	300	1,000
Rheavendors	Lionness, Cino	1,000	1,500	2,694	3,194
Saeco USA	Saeco, Estro	13,000	18,000	20,000	22,000
Sara Lee	Douwe Egberts	0	200	500	775
Starbucks	Starbucks	0	NA	1,300	2,000
VE Global Solutions	Venus, Cypris, Juno	2,400	3,600	5,000	9,500
VE Global Solutions	Brio, Colibri	10,000	12,500	25,000	34,000
Other		0	3,600	3,800	5,800
<b>TOTAL</b>		<b>143,400</b>	<b>217,980</b>	<b>309,221</b>	<b>437,784</b>

\* Does not include 14,750 Keurig units Filterfresh operates.

\*\* Includes 17,000 homeowner units