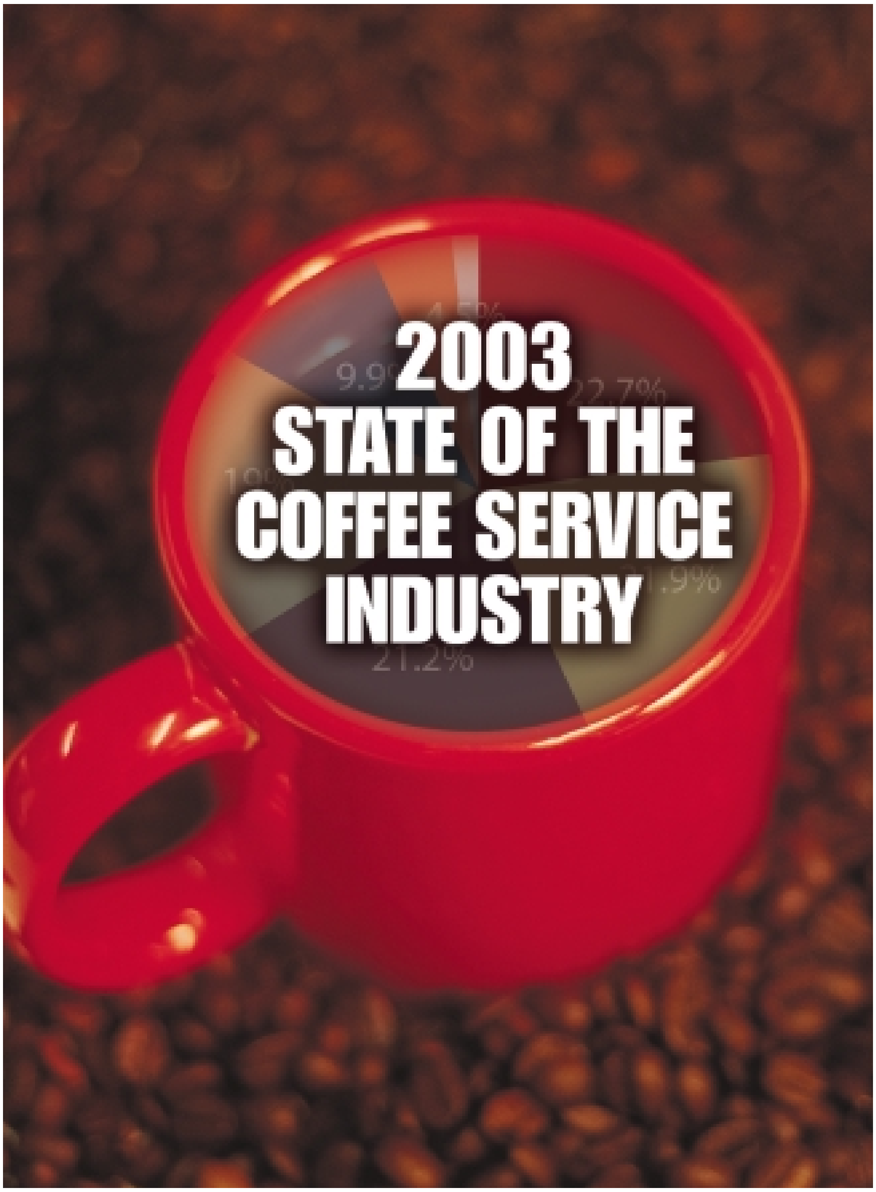
Downsizing clips sales a second year, but quality still drives most buying decisions

Today's OCS market demands stronger business skills as operators must provide better product and equipment to meet the consumer's demand for high-quality coffee.

By Elliot Maras, Editor



Specialty coffee continues to be popular with American consumers. But because businesses are getting more done with fewer employees, fewer consumers are getting their morning coffee at work. That much is evident from the state of the office coffee service industry.

According to the *Automatic Merchandiser* 2003 State of the Coffee Service Industry Report, the OCS industry posted its second consecutive 12-month revenue drop in the period ending in June of 2003. Sales for the period fell 3 percentage points to $3.36 billion, following a 5-point decline in the prior 12-month period. These consecutive 12-month losses represent the first revenue declines in the OCS industry's history.

Effects of a 'jobless recovery'

The U.S. economy in the last year has been characterized by analysts as a "jobless recovery." American companies have collectively produced more with fewer employees. This has been made possible by advances in technology, and with improved management practices.

CONTINUED

CHART 1 OCS revenues—10-year history

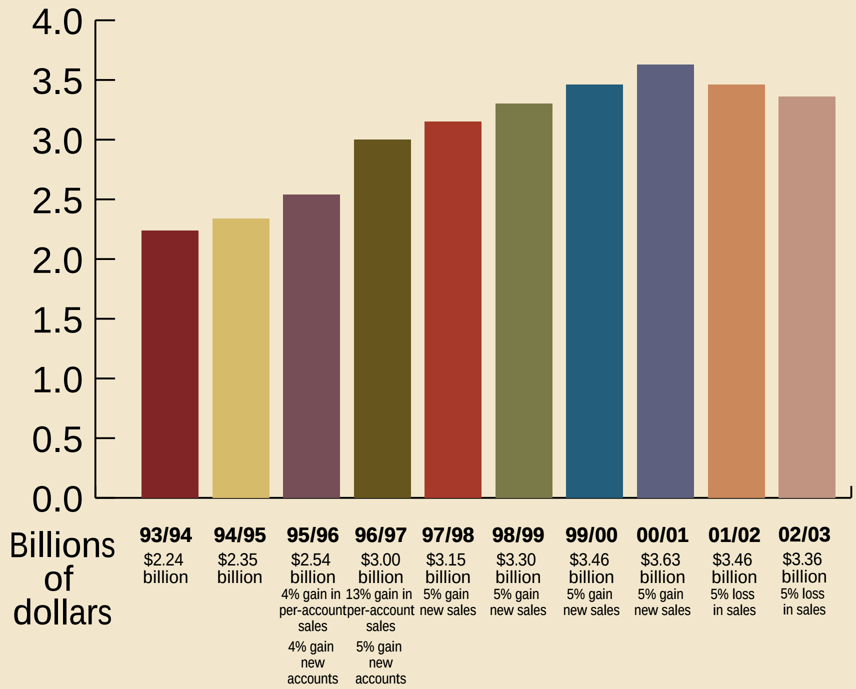
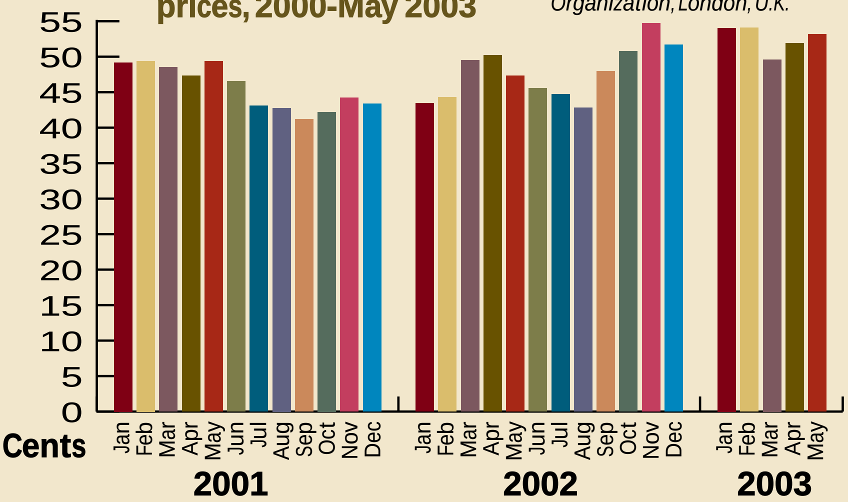


CHART 2 Composite green coffee prices, 2000-May 2003

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



The OCS industry suffered a major fallout in the wake of the “dotcom” crash in 2000. This continued through the Sept. 11 attack on the World Trade Center, which disproportionately affected the Northeast, the largest geographic concentration of OCS customers.

The Washington, D.C.-based Conference Board reported the fourth quarter of 2001 witnessed the largest downsizing in the U.S. in more than 12 years, with more than 1.4 million jobs lost. Half a million telecommunication jobs alone disappeared in the last two years.

In the second half of 2002, businesses were skittish about the economy because of the looming war in Iraq. Many companies were reluctant to add employees because they did not know what impact the war would have on the nation’s economy. The war’s positive outcome in the spring of 2003 alleviated some of this uncertainty, but the nation’s employment remained at the prewar level.

Businesses became more frugal in their spending habits in 2002/2003, largely due to uncertainty about the economy. While most employers continued to seek high-quality coffee, they limited spending to what they considered essentials.

Receivables mount for operators

Another way customer frugality affected OCS operators was a marked increase in the amount of time they took to pay invoices. OCS operators reported 60- and 90-day periods replaced the once common 30-day periods.

This hurt operator cash flow, as did higher operating costs. The rising popularity of airpot and single-cup brewers boosted equipment costs. Employee medical benefits, workers’ compensation insurance and automotive insurance also increased.

The biggest factor of all, however, was account downsizing. Operators claimed downsizing ebbed in 2003, but employers did not rehire.

Businesses reluctant to restaff

While mass layoffs began to subside in the second half of 2002, the outlook for the information technology and telecommunications industries — big spenders on refreshment services in the mid to late 1990s — continued to worsen, according to the Conference Board. Only the healthcare software segment was thriving, largely because of the introduction of new legal standards for hospital information security.

Weakness in the financial markets hurt OCS as well.

Coffee’s rejuventation stagnates

Account downsizing put a damper on

CONTINUED

Operator pricing activity

CHART 3a Raised prices in the last year

1997/1998	1998/1999	1999/2000	2001/2002	2002/2003
83%	23.4%	27.2%	24%	32%

CHART 3b Operator pricing, two-year review

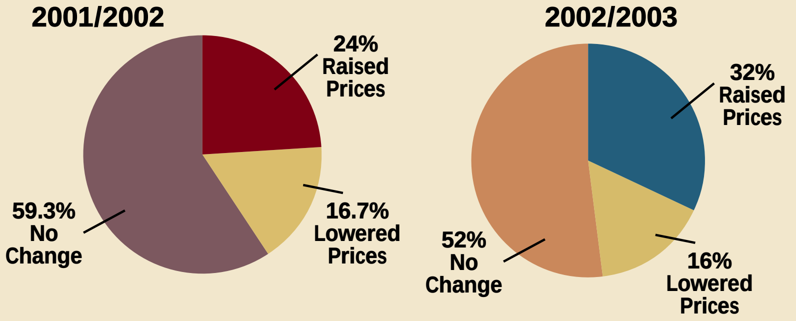


CHART 3c Revenue per cup in cents per cup

1997/1998	1998/1999	1999/2000	2001/2002	2002/2003
5.8	5.2	5.2	6.3	6.2

the revitalization the coffee industry was experiencing with the popularity of specialty coffee. In the late 1990s, the OCS industry was able to cash in on specialty coffee, largely by offering new delivery systems that offered greater variety and the ability to brew one cup at a time.

The Sept. 11 tragedy and ongoing concerns about terrorism in the U.S. brought other problems as well. In the large metropolitan areas, particularly in the Northeast, office buildings implemented stricter security measures. This made servicing these accounts more time-consuming. It also made it harder for salespeople to drop in on prospective accounts unannounced.

Some OCS operators found it more important than ever to have uniformed service personnel. Some even found this to be a strong selling point for security conscious accounts.

The dotcom crash and Sept. 11 struck at the most inopportune time for OCS. It was around this time that the single-cup "revolution" was beginning to take hold. As indicated in chart 11, single-cup placements posted significant gains over the last four years. Undoubtedly, the growth would have been greater had it not been undercut by a recession.

Consumer confidence suffered

Employment uncertainty also affected consumers' willingness to spend money. The Conference Board reported declines in consumer confidence, resulting in flat levels of consumer spending. The board reported that unlike the first year of the current recession, consumer spending dropped in the second half of 2002.

As a result, while consumers had acquired a taste for better quality coffee, they indulged themselves less frequently.

2003: Consumption gains reverse

The New York City-based National Coffee Association reported that 12 percent of Americans considered themselves daily gourmet coffee drinkers in 2003, down one percent from 2002, according to the association's recent National Coffee Drinking Trends report. The NCA credited this decrease to the economy.

Layoffs highest among young adults

The NCA specifically identified the 18- to 24-year-old group as more affected by unemployment. NCA noted that unemployment reached 15.9 percent for 18- and 19-year-olds and 9.3 percent for 20- to 24-year-olds, compared to 5.7 percent of the total population. By comparison, specialty coffee drinking among 18- to 24-year-olds fell from 13 percent to 7 percent in the last year.

NCA is quick to point out, however, that the current level of consumption exceeds the 1999 level by about a third. The decline in the last year did not offset the coffee consumption gains made in the 1990s.

And while customers consumed less coffee, OCS operators interviewed for this report noted that most did not "trade down" to less expensive products. The majority of customers recognized the importance of better quality coffee on worker morale. This was especially important in a depressed economy.

Coffee drinkers didn't trade down

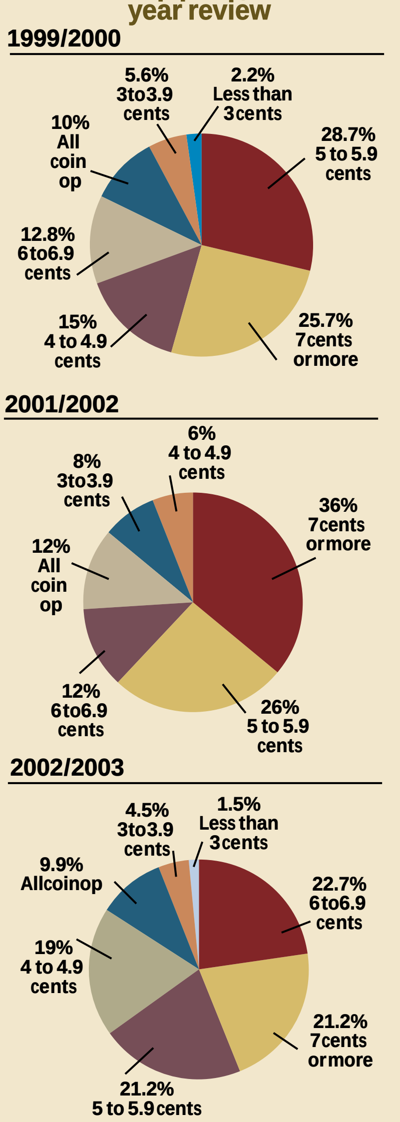
OCS pack weights in 2002/2003 continued to rise, as indicated in chart 7. The percent of over-2-ounce packs increased every year since 1997/1998.

Employers recognized that better coffee helped improve morale when employees were nervous about pending layoffs and the displacement of fellow workers.

Higher unemployment was not entirely bad for the OCS industry. During the prosperous 1990s, OCS operators complained of not being able to find

CONTINUED

CHART 4 Sales by average cup price, three-year review



good help. Worker downsizing improved the supply of qualified employees.

The lower customer head counts resulted in lower sales for all product categories in 2002/2003.

Bottled and filtered water increased as a percentage of sales in the last two years, although the gain reported in 2001/2002 gave back a few points in 2002/2003. Several OCS operators interviewed noted that some customers felt a need to stock up on bottled water following the Sept. 11 terrorist attack.

Creamers and sweetener sales rise

The only ancillary products to post a gain in each of the last two years were creamers and sweeteners and "other hot beverages." The latter category included hot tea, which many operators cited as a growing category. This is consistent with tea's performance in other channels of trade.

According to the Tea Council of the U.S.A., sales rose from $1.84 billion in 1990 to an estimated $5.03 billion in 2002. Much of this was credited to the growth of specialty tea. Some medical studies credited certain medicinal benefits to tea, currying favor with aging baby boomers.

Some of the increase in tea can also be credited to the recent introduction of tea packs specifically designed for single-cup coffee brewers.

Coffee costs remain stable

OCS operators also benefited from stable green coffee prices, as shown on chart 1. Stable costs allowed operators to maintain their gross profit margins on coffee sales without having to raise prices.

The report indicated that offices slightly declined as a percent of total OCS sales in the last two years, as shown on chart 15. Offices nevertheless still represented the majority of accounts. And while the survey did not measure profitability, most operators interviewed claimed that offices continued to be the most profitable account group.

Cold weather helps

One beneficial development was an unseasonably cold winter and spring in 2003, which boosted coffee consumption.

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

With accounts reluctant to add payroll, profitability on a per-account basis became harder to maintain. Operators faced the need to add more accounts in order to offset losses in per-account sales. This required an investment in sales activities.

Customer base stagnant

The report indicated no net gain in

CONTINUED

CHART 5 Typical OCS account

Population in 2002/2003

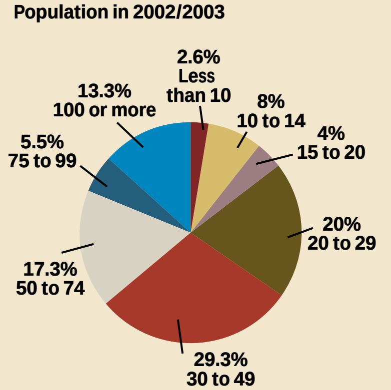


CHART 6 Brewer utilization, two -year review

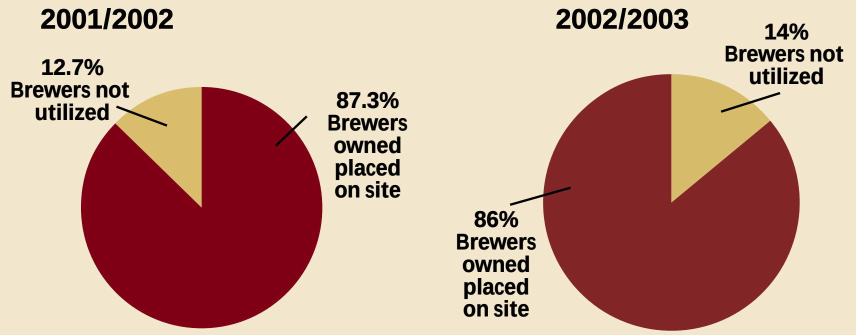
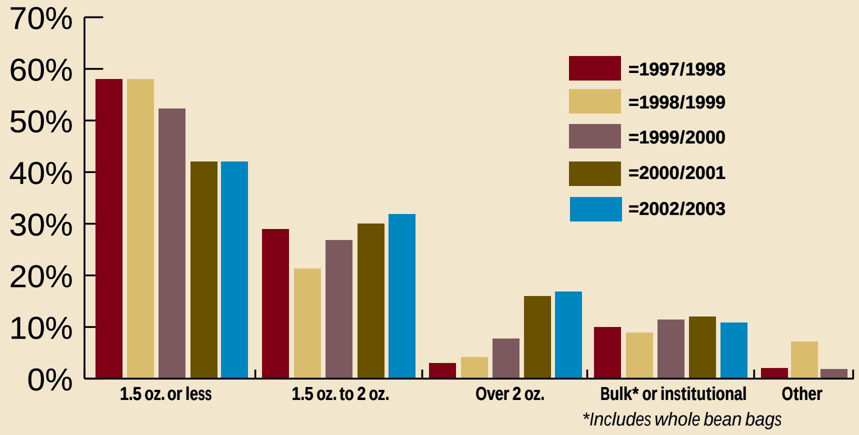


CHART 7 Sales by pack weight, five-year review



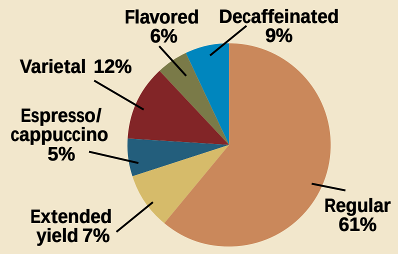
*Includes whole bean bags

CHART 8 OCS sales by product catagory, five-year review

	1997/1998	1998/1999	1999/2000	2001/2002	2002/2003
Private label coffee	19.3%	28.4%	30.9%	26%	25%
National brand coffee	50.8%	33.8%	32.8%	37%	37%
Espresso/cappuccino	1.6%	8.7%	8.9%	4%	4%
Other coffee*	7%	8.7%	8.9%	4%	4%
TOTAL COFFEE	**78.7%**	**77.2%**	**75.5%**	**66%**	**70%**
Other hot beverages	4.4%	3.8%	2.8%	4%	5%
Soft drinks/juices	6.4%	8.3%	8.5%	9%	8%
Bottled/filtered water	0.8%	4.1%	4.3%	8%	5%
Creamers/sweeteners	6.4%	5.1%	5.1%	7%	8%
Cups/paper products	3%	4.5%	4.5%	6%	4%
Other	0.3%	1.1%	1%	0%	0%

*Includes flavored, whole bean and varietal

CHART 9 Coffee sales by coffee category, 2002/2003



accounts served in 2002/2003, and that the typical location remained at 30 to 49 people, which has not changed over the years. Hence, the customer base did not increase.

The most notable change in the last year was the shift to higher cost brewing equipment, a continued trend over the last four years. Airpot brewers and single-cup brewers continued to replace plumbed-in, automatic and pourover brewers, as shown on charts 11 and 14.

The report did not indicate significant gains in coffee selling prices to offset the higher investment costs.

Price hikes weren't widespread

The survey did report that more operators raised prices in 2002/2003, as indicated in chart 3b. This, however, did not indicate how much higher price coffee operators actually sold.

A more telling statistic was the average price per cup, which leveled off in 2001/2002, and actually fell by 0.1 cents in 2002/2003, as indicated in chart 3c.

The increase in cup prices in the last two years largely reflected the popularity of specialty coffee. As noted in last year's report, even a recession did not compromise the consumer's willingness to pay extra for a better tasting cup of coffee.

The Specialty Coffee Association of America reported that total specialty coffee sales and the number of specialty coffee stores continued to grow through 2002. Retail sales rose from $8.3 billion to $8.4 billion while the number of stores grew from 13,500 to 13,700. This represented a slower growth rate than in the past, but growth nonetheless.

Single-cup meets specialty demand

The growth of single-cup brewers was largely responsible for the OCS industry's ability to share in the success of specialty coffee. By brewing one cup at a time, these systems offered improved taste, along with a greater variety that included the newly popular flavored and milk-based drinks.

In addition to single-cup, operators also found success marketing heavier pack weights in the past five years, as indicated in chart 7.

Specialty roasters embrace OCS

Supporting these initiatives were the efforts of some specialty coffee chains to expand into the OCS channel. In 1999, Starbucks introduced OCS fractional packs to OCS product distributors. Several of its competitors followed suit: Timothy's, Peet's, Caribou, Gloria Jeans, Dietrich's, Green Mountain, and numerous regional and local specialty coffee chains.

These efforts resulted in a slight rebound for "national brand" sales in OCS beginning in 2001/2002 and carrying through to 2002/2003, as indicated in chart 8.

Specialty brands boost OCS's appeal

Operators interviewed noted that these specialty coffee house brands represented their highest ticket coffees.

CONTINUED

CHART 10 Number of packets in a standard OCS kit, five-year review

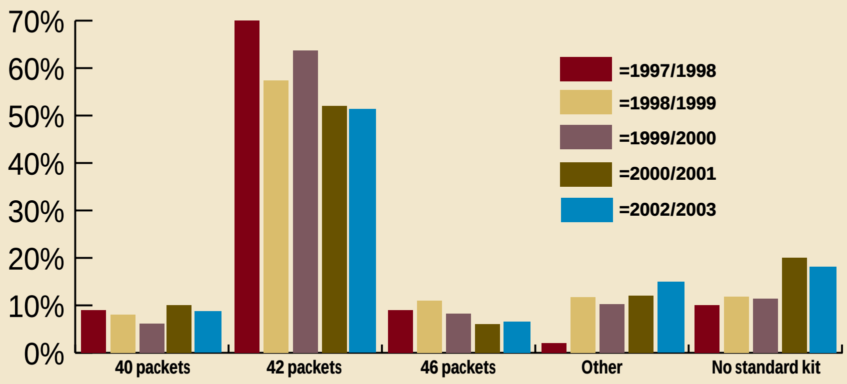
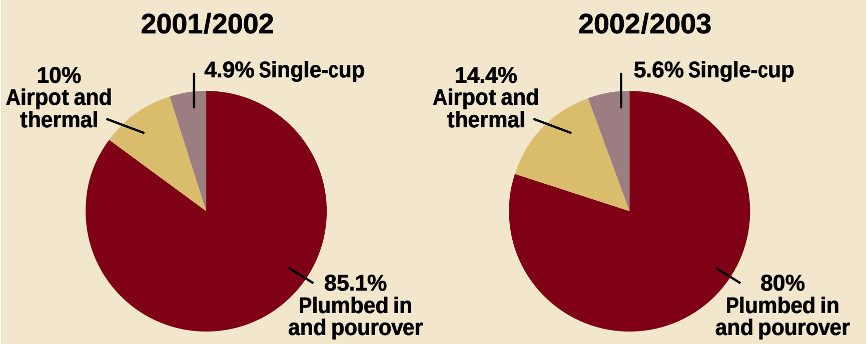


CHART 11 OCS brewer count



Many operators used these high-ticket brands as "top of the line" offerings, to which they compared their own less expensive but still premium private label selections. Stable green coffee prices allowed operators to buy high quality coffee at a price that allowed a good profit margin.

Some operators found that the specialty coffee house brands proved popular with many accounts, despite the price.

CHART 12 Estimated single-cup brewer placements in the U.S.

Company	Products	01/02 units	02/03 units
Filterfresh	Filterfresh/Keurig	26,500*	30,000**
Crane	Café System	11,000***	12,000
Cafection	Avalon	13,000	16,000
Zanussi	Brio, Colibri	8,000	10,000
Progema	Venus	1,000	2,400
Flavia	Flavia	32,000***	40,000
Keurig	Keurig	30,000	33,000
Unibrew	Unibrew	3,200	3,200
Newco	Gevalia	1,200	1,300
Saeco	Saeco	45,000	50,000
Other			3,600
Total		171,416	193,200

* Includes 1,484 Keurig machines
** Includes 2,300 Keurig machines
*** Number adjusted from last year's report.

Brewing systems continue to upgrade

The popularity of better quality coffee also supported a gradual switch to more expensive brewing systems. In the last year, airpot and single-cup brewers continued to replace the traditional glasspot pourover and plumbed-in units, as already noted. While many OCS operators initially welcomed the availability of better equipment, the higher cost proved more of a problem during the last two years as accounts downsized, making these systems less profitable. The increase in these systems continued at a slower rate than in the previous few years.

As both airpot and single-cup brewers became more common, equipment manufacturers introduced a larger variety of systems, including less expensive alternatives. This gave operators more flexibility in placing these systems. Nonetheless, account downsizing slowed the growth rate for these systems in 2002/2003.

Airpots become more versatile

Airpot brewers have never been embraced by all OCS operators. Some operators claimed that nothing beats the taste of freshly brewed coffee, and the customer enjoys the experience of seeing the coffee fill the glass pot.

Other operators claimed the thermal container is needed to maintain the full body of the coffee after it is brewed. And because the stainless steel units are easier to clean than glasspots, customers tend to take it upon themselves to keep the coffee station clean.

The last few years witnessed the introduction of smaller thermal servers that can be used with traditional brewers. This system provides the benefit of the thermal server without the cost of whole new unit. Nor, according to many operators do they take up as much space as most of the brewer-to-server models.

The thermal brewers did not, however, deliver all of the benefits of the brewer-to-server units. While they kept the coffee warm for an extended period of time, they did not completely insulate it from air. In most locations, however, this was not a disadvantage because most of the coffee was consumed in less than a few hours.

Some operators emphasized the

CONTINUED

safety benefit of automatic power shut-off when using thermal servers.

Cartridges lead single-cup growth

Among single-cup units, some of the biggest growth occurred in the cartridge systems, also known as pod-based or brew-by-pack systems. (“Cartridges” in this report is a generic term covering pods, brew packs and brew cups, etc.)These systems brew coffee using a one-time brewing cartridge. Hence, there is less mess and less cleaning required. While the product typically costs more per-cup than in bulk hopper systems, the cost of the brewer is typically lower. Hence, a single-cup unit can be placed for a lower start-up cost. The cartridge-based systems are also smaller; hence, many operators view them as more convenient and more versatile.

In the last year, some of the leading specialty tea manufacturers introduced tea cartridges designed for single-cup brewers, helping the OCS operator cash in on the rising popularity of specialty tea.

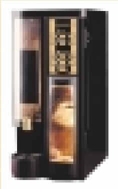
Bulk hopper units: more throw control

The bulk hopper units had their supporters as well. Some operators noted that depending on the market, these units offered a better gross margin on a per-cup basis, even with the higher equipment cost. Some also noted that these units can adjust the gram throw and the water throw to customize the coffee taste. This was particularly important for operators who are cognizant of variances in client tastes.

In addition, most of the cartridge systems tied the operator to specific coffee suppliers, which many viewed as a disadvantage.

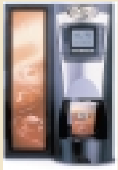
The growth in hopper style single-cup brewers was most likely responsible for the gain in bulk and institutional coffee sold in the last three years, indicated in chart 7.

Top selling single-cup drinks by brewer

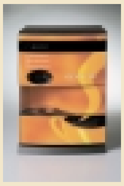


13a Filterfresh
1) Regular
2) Hot chocolate
3) Café mocha
4) Powdered cappuccino
5) Regular decaf

13b Keurig
(Green Mountain)
1) Columbian Supremo
2) French Roast
3) Regular Decaf
4) Hazelnut
5) French Vanilla

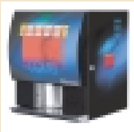


13c Flavia
1) Cappuccino
2) Columbian
3) French Roast
4) Tea
5) Hot chocolate

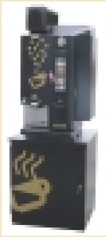


13d Gevalia
1) Cappuccino
2) Vanilla
2) Columbian
4) House Blend Decaf
5) Hazelnut
6) Dark Roast
7) Hot Chocolate
8) Espresso
9) House Blend Regular
10) Earl Grey Tea
11) Light Roast
12) Black Tea

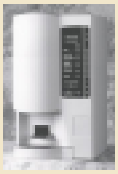
13e Brio
1) Regular
2) Caffe latte
3) French vanilla
4) Cappuccino
5) Café mocha
6) Hot chocolate
7) English toffee



13f Venus
8) Regular
9) Caffe latte
10) French vanilla
11) Cappuccino
12) Café mocha
13) Hot chocolate
14) English toffee



13g Avalon
1) Regular
2) Café latte
3) French vanilla
4) Mochaccino



13h Crane Café System
1) French vanilla cappuccino
2) Regular coffee
3) Hot chocolate
4) Decaf coffee
5) Espresso
6) Café latte
7) Decaf/regular mix
8) Decaf latte

13i Saeco
1) Espresso
2) Regular
3) Mocha
4) French vanilla

Altnernative systems emerge

Water soluble and liquid concentrate-based single-cup systems introduced in recent years also made headway in 2002/2003.

The water soluble systems were particularly popular with operators serving locations where milk-based coffee drinks were popular. The growth in coffee con-

CONTINUED

CHART 14 Single cup brewer growth, four-year review

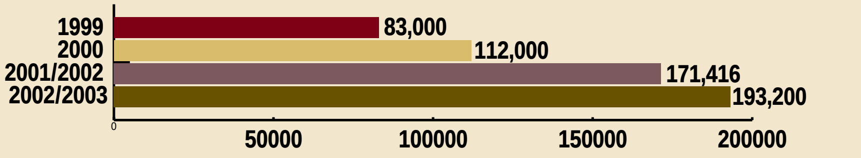


CHART 15 Accounts by type, five-year review

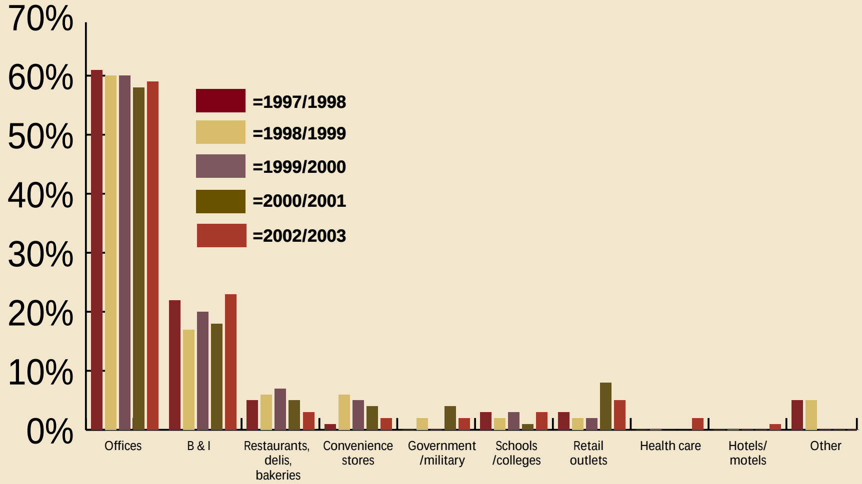
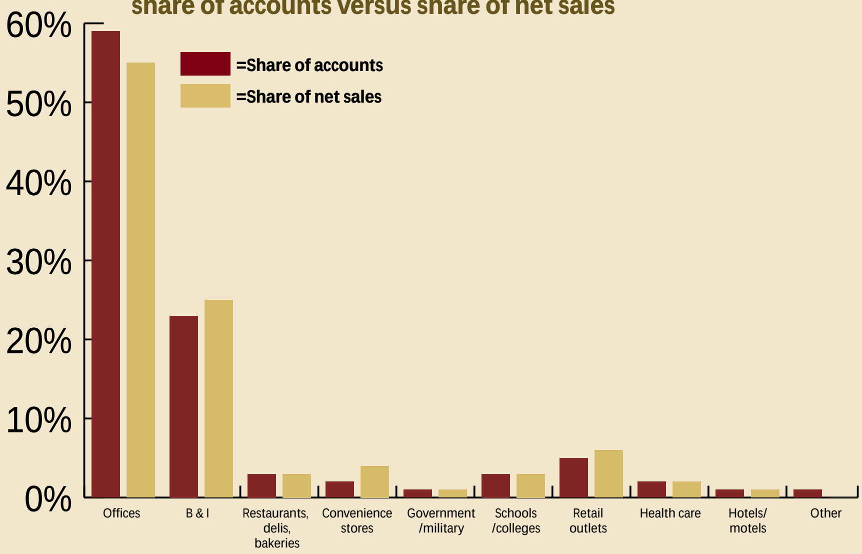


CHART 16 Accounts by type in 2002/2003: share of accounts versus share of net sales



sumption in recent years has been driven, after all, by milk-based drinks that younger consumers tend to prefer.

Single-cup drinks ranked

For the first time this year, the survey identified top selling products in each of the single-cup manufacturers' machines, as indicated in charts 13a through 13i.

When an account's population could no longer support a single-cup brewer, operators typically sought a lease payment from the location. This allowed the location to keep the machine.

Coin mech options address a need

Another alternative was to place a coin mech on the machine and require the employees to pay for their own drinks. This was the less profitable scenario; operators reported coin-op machines could at best only generate half the sales of the free-vend option.

Fresh-brewed office espresso with real milk remained a niche specialty for OCS operators, confined mainly to immigrant audiences that prefer espresso to regular coffee. Espresso machines also found a place in executive offices that use espresso to impress clients.

Espresso seeks a place in the office

The amount of espresso served in OCS slightly decreased in the last years, as indicated in chart 15. This corresponded to a decline in convenience store and restaurant accounts in the same period, indicated in chart 15. Convenience store and foodservice locations typically offered more espresso-based drinks than office and industrial locations.

The survey did not distinguish between powder-based cappuccino, and cappuccino made with real espresso and real milk, sometimes known as "true" cappuccino. Both types of cappuccino were sold in the office; the cappuccino served by most single-cup brewers was powder-based, except for some dedicated single-cup espresso brewers that utilized a portion-controlled espresso pod.

Operators interviewed generally expected better times to return in 2003. Most claimed that sales began to rebound in the spring, partially on account of an unusually cool spring. Some noted that businesses are beginning to feel more confident about the economy and are thus more willing to spend more on refreshment service.

The National Coffee Association noted that the growth in coffee consumption should resume once the economy stabilizes.

Given the fact that single-cup brewers remain a small portion of the OCS brewers, the market promises continued growth for this service enhancing innovation.

The key achievement of the last few years is the consumers clearly demonstrated preference for better quality coffee. ●