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It to excellence takes OCS to next level

OCS operators continue to invest in product, equipment and training, maintaining a 4-year growth trend. Single-cup systems keep expanding.

By Elliot Maras, Editor

More growth and more challenges. That describes the state of the OCS industry as it enters its fourth consecutive year of 5-percentage-point revenue growth driven by higher pricing and a continued commitment to product and service quality.

In 2007/2008, OCS sales surpassed the \$4 billion mark for the first time. The gain continued to be driven by higher prices, the ongoing expansion of single-cup systems that generate higher sales, and the consumer's willingness to pay for good coffee.

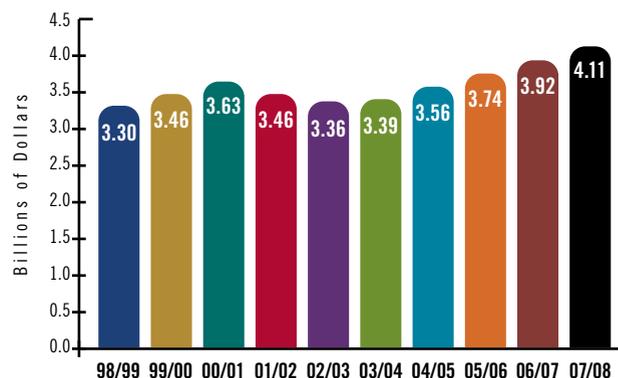
The 2008 *Automatic Merchandiser* State of the Coffee Service Industry Report found that for the fourth consecutive year, the majority of OCS operators raised prices. The 4-year trend is the longest in the industry's history, demonstrating the OCS operator's willingness to charge more in order to provide more. This commitment began in 2004/2005, when average revenue per cup first exceeded the 6-cent mark.

The revenue growth indicates that the OCS industry is gaining a bigger share of the overall coffee market, which has posted a 53 percentage point gain between 2002 and 2007, according to the market research firm, Datamonitor. The market is forecasted to continue to grow an additional 36 points in the next 5-year period.

READY-TO-DRINK COFFEE: A GROWING MARKET

Coffee sales continue to increase in almost all ready-to-drink channels — OCS, restaurants, convenience stores and specialty coffee shops — despite higher prices and declining

CHART 1: OCS REVENUES — 10-YEAR HISTORY



consumer confidence. This demonstrates consumer appreciation for a good cup of coffee and willingness to pay for it.

The State of the Coffee Service Industry Report does not track operating costs, but operators' willingness to raise prices to cover higher costs indicates that operators are protecting their margins, which is necessary to ensure profitability. This year, the report also indicated that more than a third of operators (35 percent) levied fuel charges in addition to higher coffee prices.

This was the first year the survey asked about fuel charges. Fuel charges have become common among product delivery industries as gas prices have reached record highs this past year.

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While OCS revenues have posted consistent increases, it is important to recognize that the State of the Coffee Service Industry Report does not measure operator profitability.

The report does not indicate to what extent higher sales matched higher operating costs. Key cost areas include coffee, salaries, benefits and fuel, most of which increased in the last year.

HIGHER PRICES: BOTH OPPORTUNITIES AND CHALLENGES

The higher coffee prices, indicated in chart 1, presented a double-edged sword to OCS operators. The higher prices eroded operators' profits, but also justified higher prices to customers. While customers often resist higher prices, most operators noted that customers have been more accepting of higher prices than in previous years.

Because green coffee prices rose (indicated in chart 2), retail outlets raised their coffee prices, thereby justifying higher OCS coffee prices in the minds of many if not most customers.

Cost control proved to be one of the major challenges that OCS operators faced in the last 12-month period, with pricing only one of several strategies they used. Operators also adjusted their routes to serve more customers with fewer deliveries, adjusted minimum orders to reduce deliveries, and adjusted schedules to reduce deliveries to smaller customers.

Fuel charges were a key cost control strategy in 2007/2008. Operators that used this strategy charged set fees for deliveries. In some cases, customers could forego a fuel charge by increasing their order. In other cases, fuel charges were only imposed on unscheduled deliveries.

INVESTMENT IN PERSONNEL MORE CRITICAL

Investment in personnel also proved exceptionally important in addressing a more demanding customer. OCS operators noted that investment in salaries, benefits and employee education were key to improving employee retention, which has a direct bearing on account retention.

Over the years, OCS operators have recognized the importance of employee development. This has become more evident as the OCS products have become higher quality and operators have needed better trained employees to market and service them.

OCS operators also recognized the importance of account retention in a mature market. Operators found that assigning responsibility specifically for customer relations has a direct bearing on account retention.

Operators found the last 12-month period challenging on several fronts.

MEETING CUSTOMER NEEDS BECOMES MORE CHALLENGING

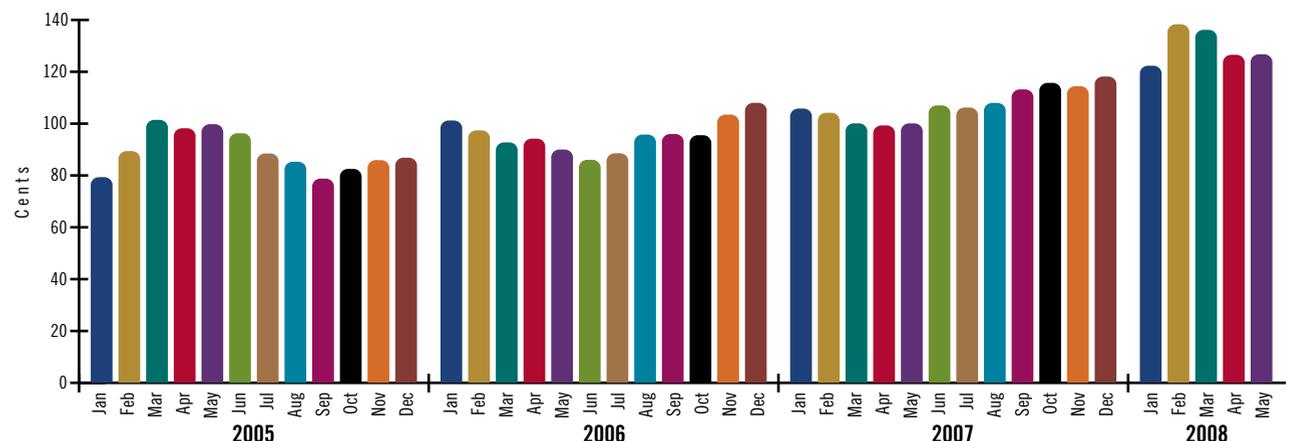
Where most customers were willing to pay more to sustain a high quality OCS service, customers were also more budget conscious than normal. Hence, operators found it necessary to offer customers different options to allow them to economize in some way but still have good coffee.

In some cases, customers opted for less variety. In other cases, they sought a less expensive blend. In still other cases, they asked for fewer allied products.

Because the options varied, there can be no generalizations made about what impact the current operating environment had on any particular product category. Hence, the numbers

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CHART 2: COMPOSITE GREEN COFFEE PRICES, 2005 TO MAY 2008



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

OPERATOR PRICING ACTIVITY

CHART 3A: RAISED PRICES IN THE LAST YEAR, 10-YEAR REVIEW

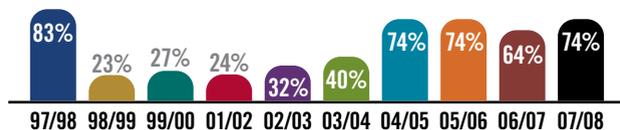


CHART 3C: REVENUE PER CUP IN CENTS PER CUP, 10-YEAR REVIEW

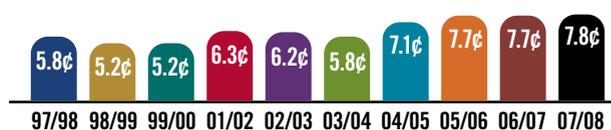
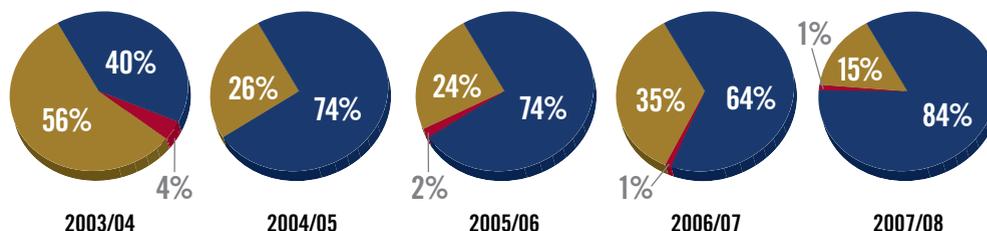


CHART 3B: OPERATOR PRICING ACTIVITY, 5-YEAR REVIEW

- Raised Prices
- Lowered Prices
- No Change



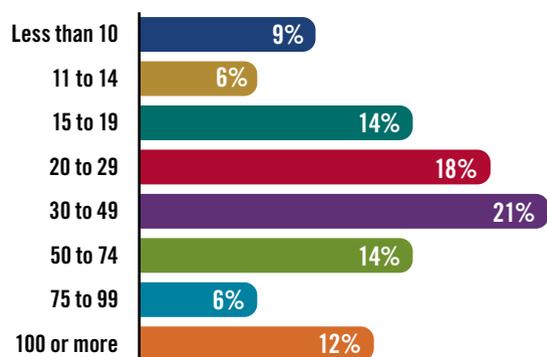
in revenue by category in chart 5 do not indicate any particular trends. Customers continued to seek variety, good quality and ancillary products (such as single-serve cold beverages), but they also sought ways to economize on an individual basis.

The economy created challenges. Overall unemployment rose about a half of a percentage point to 5 percent of the work force in the period, trimming head counts in customer locations. The impact varied by geographic region. Some industries were disproportionately affected by the housing market collapse, such as banks, real estate firms and mortgage companies.

FINANCIAL SERVICE SECTOR SUFFERS

Challenger, Grey & Christmas Inc., an outplacement consultancy, reported that employers laid off 9 percent more workers in the first four months of 2008 than 2007. The financial services sector suffered the most layoffs, followed by telecommunications and automotive.

CHART 4: ACCOUNT POPULATIONS BY SIZE, 2007/2008



The survey, in tracking the sales by location type, indicated a gain this year in "other" accounts. These included hotels and health care institutions.

There is no clear reason for this change. Because the sample of respondent changes each year, variances such as this are not uncommon.

One possible explanation is that some of the big single-cup manufacturers marketed aggressively to hotel chains.

Declining consumer confidence, as measured by The Washington, D.C.-based Conference Board, which reported no growth in consumer spending in the first half of 2008, did not erode OCS sales. This is largely because the service is not paid for by consumers.

Location managers recognized the benefit that OCS provides as an employee motivator. The current economic environment enhances the value of OCS to both the end user (consumer) and the location manager.

Rising operating costs, combined with weakening productivity, resulted in less investment for future growth by U.S. employers, the Conference Board reported. Hence, OCS operators cannot count on any near term gain in account populations.

WAGE PRESSURE INCREASES, IMPACTING OCS OPERATORS

One of these rising costs is wages, which bears down on OCS operators' bottom lines as much as that of their customers. The Bureau of Labor Statistics reported close to 1 percent gains in its "employment cost index" for every quarter in 2007 and the first quarter of 2008, sustaining a trend from the prior six years.

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CHART 5: OCS SALES BY PRODUCT CATEGORY, 5-YEAR REVIEW

	2003/04	2004/05	2005/06	2006/07	2007/08
Private label coffee	22%	23%	20%	23%	23%
National brand coffee	46	45	38	33	35
Espresso/cappuccino	4	4	4	3	3
Other coffee*	0	0	9	8	8
TOTAL COFFEE	72	72	71	68	69
Other hot beverages	4	0	6	7	5
Soft drinks/juices	7	4	7	6	4
Bottled/filtered water	5	6	4	5	5
Creamers/sweeteners	6	6	5	6	7
Cups/paper products	5	5	5	6	6
Other	1	1	4	3	3

*Includes varietal, flavored and whole bean coffee. In 2007/2008, 2.23% of the 8% was for whole bean coffee.

CHART 5A: DEDICATED OCS OPERATORS

	2007/08
Private label coffee	20%
National brand coffee	25
Espresso/cappuccino	3
Other coffee*	15
TOTAL COFFEE	63
Other hot beverages	7
Soft drinks/juices	4
Bottled/filtered water	6
Creamers/sweeteners	10
Cups/paper products	8
Other	2

CONSUMPTION RISES

But while the economy remained challenged, the demand for good coffee remained alive and well. According to the National Coffee Association (NCA) 2008 National Coffee Drinking Trends survey, daily consumption of specialty coffee beverages jumped to an unprecedented high with 17 percent of the overall adult population, up from 14 percent in 2007. Preliminary data also revealed that total coffee consumption reached 47 percent of adults age 25 to 39, again matching the decade's high set in 2006 and up three percentage points from 2007.

Among consumers age 25 to 59, specialty coffee consumption surged to new heights in 2008, with 19 percent now daily drinkers. Dramatic increases since 2007 of six

percentage points among consumers age 25 to 39 and four percentage points for those 40 to 59 were shown.

Even among consumers 60 and older, specialty coffee drinking jumped four percentage points, overtaking a high set in that group in 2006. Specialty coffee includes espresso-based beverages as well as those that consumers perceive as "gourmet" based on the variety of coffee options available in the marketplace.

Last year was the first year that the NCA survey found that daily coffee consumption among adults surpassed soft drink consumption.

Coffee is one of several beverages that has emerged as a refreshment of choice at the expense of carbonated soft drinks, which was, until recently, the dominant beverage of choice.

While the OCS industry was slower than some of its retail competitors to introduce specialty coffee, the last four years witnessed significant investment by OCS operators in better quality delivery systems, products and variety.

OCS operators carried the unique advantage of offering a product free to the end user. In addition, as the demand for variety grew, OCS operators were also able to offer more variety than their competitors for ready-to-drink coffee.

ABOUT THE SURVEY

The state of the Coffee Service Industry Report is based on the results of a questionnaire emailed to 600 dedicated OCS operators and 2,700 vending operators with OCS divisions. The commentary in this report is also based on interviews with operators, product suppliers, equipment suppliers and researchers.

The aggregate OCS revenue reported in this study includes OCS revenue in the State of the Vending Industry Report, released in August. The OCS revenue reported in the vending report includes OCS sold to accounts that are mainly vending accounts. The vending report does not include OCS business handled by dedicated OCS organizations within vending companies, or in partnership with vending companies.

SINGLE-CUP CONTINUES TO LEAD GROWTH

The key tool in the OCS industry's arsenal to meet customer demand for coffee house quality coffee in a convenient manner at a competitive price continues to be the single-cup brewer. Single-cup brewers have grown at an accelerated pace since they were introduced in the mid 1990s, and have gained market share at the expense of traditional batch brewers.

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Airpot and thermal carafe systems also gained at the expense of traditional pourover and automatic batch brew systems, indicated in chart 7.

For many operators, single-cup systems raise existing location sales by as much as 30 percent when they replace a more traditional brewer.

Single-cup systems have expanded in high double digits every year for the last several years, as indicated in chart 6. While the rate of growth slowed in 2007/2008, this was largely due to the fact that placements must expand exponentially to sustain a high growth rate as the numbers get bigger.

The actual number of new single-cup placements in the last 12-month period was comparable to the prior period, and now surpasses 800,000 units.

Leading the growth in the single-cup category for the sixth straight year were cartridge-based systems, which represent more than three quarters of all single-cup systems.

The cartridge-based systems, which are more compact than hopper-based systems and require a smaller initial investment, are expanding at a faster rate than hopper-based systems.

The two main cartridge-based systems are supported by organizations that assist with marketing and operator training. The unique benefits of the cartridge-based system include user-friendliness, product variety and consistent quality control. The two leading manufacturers have introduced new products aggressively, further enhancing operator sales, and have secured brand awareness among both operators and customers.

PRIVATE LABEL REMAINS DOMINANT

Cartridge-based single-cup has the potential to reduce the importance of private label in the OCS industry and revive the importance of nationally recognized consumer brand coffee. Cartridge systems do not use private label

CHART 6: ESTIMATED SINGLE-CUP BREWER PLACEMENTS IN THE U.S., 6-YEAR REVIEW

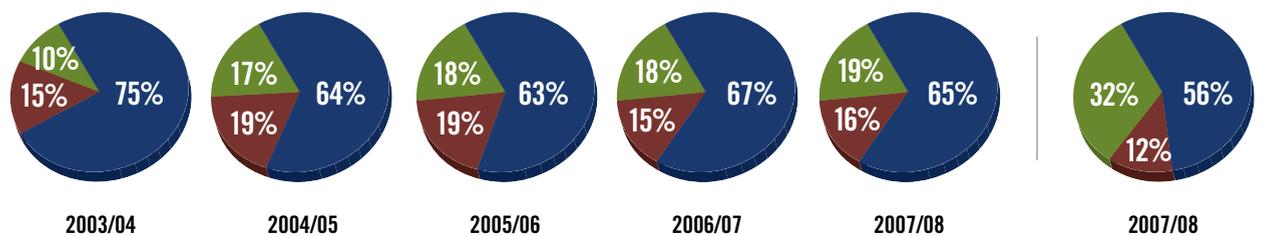
Editor's Note: Filterfresh operates 14,750 to 15,054 Keurig units, depending on the year. The total brewer count does not include these twice.

MARKETER	PRODUCTS	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Bodecker Brewed	Bodecker	0	0	0	300	2,100	2,600
Café Excellence LLC	Café X Milano	0	130	146	250	250	250
Cafection	Avalon	16,000	19,500	22,500	24,350	28,150	32,150
Cafejo	Cafejo	0	0	1,700	5,250	11,250	16,250
Crane	Café System, Genesis	12,000	12,000	12,000	11,150	12,150	13,150
Filterfresh	Filterfresh, Keurig	30,000	35,000	40,000	33,337	33,337	33,337
Keurig	Keurig	33,000	60,000	93,651	140,000	192,080	244,238*
Kraft	Gevalia	1,300	1,600	2,200	3,500	3,500	3,900
Lavazza	Espresso Point, Lavazza Blue	NA	NA	NA	NA	NA	17,000
Mars Drinks	Flavia	40,000	62,000	90,000	140,000	250,000	362,500
Newco	Smartcup	0	0	300	1,000	1,800	1,800
Rheavendors	Lionness, Cino	1,000	1,500	2,694	3,194	3,644	3,644
Saeco USA	Saeco, Estro	13,000	18,000	20,000	22,000	24,200	26,400
Sara Lee	Douwe Egberts	0	200	500	775	775	2,325
Starbucks	Starbucks	0	NA	1,300	2,000	5,000	7,500
VE Global Solutions	Venus, Cypris, Juno, Prosyd	2,400	3,600	5,000	9,500	12,500	16,500
VE Global Solutions	Brio, Colibri, Koro, Korinto, Konvivo	10,000	12,500	25,000	34,000	42,000	51,500
Wolfgang Puck	Wolfgang Puck	NA	NA	NA	NA	NA	1,000
Other		0	3,950	4,200	6,800	6,800	6,800
Total		143,400	215,230	306,441	422,656	614,786	827,790

* Includes 15,054 units operated by Filterfresh; Does not include homeowner units, which total 1,303,825.

CHART 7: OCS BREWER BREAKOUT BY TYPE, 5-YEAR REVIEW

● Plumbed-in and Pourover ● Airpot and Thermal ● Single-cup



coffee. More importantly, they bring the specialty brands that customers have learned to associate with quality coffee to the OCS environment.

Based on the survey results indicated in chart 5, however, this has not yet happened.

At the present time, not all cartridge systems use nationally recognized coffee, but as those particular systems grow, they become brands specifically associated with the office environment.

Another critical benefit that cartridge systems have provided is a means to offer product variety in the office.

OCS operators have found that variety builds sales. The cartridge brewer has been nothing short of revolutionary on this count. The manufacturers of these systems have utilized this versatility to continue to offer new products, including varietals, well known retail labels, hot tea, hot chocolate, blends, cappuccino, organic coffee, and Fair Trade coffee.

The variety that the OCS operator can now offer has emerged as one of the most strategic advantages in the highly competitive ready-to-drink coffee market. Even as

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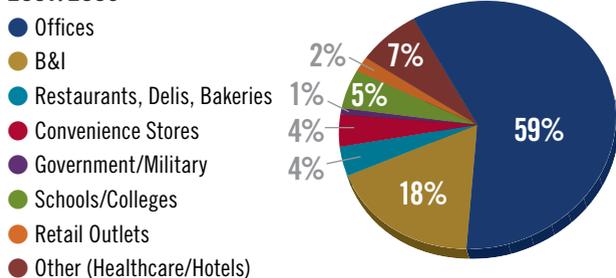
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CHART 8: ACCOUNTS BY TYPE, 5-YEAR REVIEW

	2003/04	2004/05	2005/06	2006/07	2007/08	Dedicated OCS Operators
Offices	55%	64%	54%	63%	54%	68%
B&I	24	16	23	20	24	7
Restaurants, Delis, Bakeries	2	4	4	3	3	8
Convenience Stores	2	4	4	2	4	8
Government/Military	1	1	3	1	1	2
Schools/Colleges	5	1	4	5	6	4
Retail Outlets	4	3	3	2	2	1
Other (Healthcare/Hotels)	7	7	5	5	6	3

CHART 8A: PERCENT OF SALES BY LOCATION TYPE, 2007/2008

customers look for ways to reduce costs, the improved variety has given operators more options to allow them to do this.

No other channel that sells ready-to-drink coffee has the means to offer the same variety as OCS. This, in combination with the fact that OCS is free to the end user, could be key to the OCS industry's ability to continue to grow in an economy that has been characterized as a recession.

HOMEOWNER SINGLE-CUP ARRIVES

While the cartridge-based systems continued to dominate the growth in single-cup, the other single-cup systems — hopper-based, the manual pod, and the liquid concentrate-based — also continued to grow, although at a slower pace.

The cartridge-based systems also witnessed significant growth in the consumer market in recent years, a development that raised new concerns among OCS operators, mainly in regard to product pricing.

One of the same cartridge manufacturers that dominates the OCS business emerged as a leading consumer cartridge system manufacturer in the last few years. Because both the OCS and homeowner models use the same

cartridge, the cartridges became available from a variety of sources, including retail outlets, office supply delivery firms and Internet Websites.

Many OCS operators pointed out that the growth of the homeowner single-cup system supports the OCS demand. Consumers are more likely to want the same product in the office that they use at home.

In addition, some OCS operators noted that the homeowner systems create a new source of revenue for them: in some cases, consumers buy the cartridges from OCS operators.

But OCS operators also recognized that not all cartridge system manufacturers remained loyal to the OCS business. In pursuit of the much larger consumer market, one manufacturer has not protected the OCS operator's exclusive right to sell the cartridges, many operators claim. As a result, these operators claim they have less control over cartridge pricing and their profits have suffered.

These perceptions were not uniform nationwide; they varied by geographic market. Markets in which single-cup systems are more common, such as major metropolitan areas, reported the most complaints.

The growth of the consumer market also raised concerns about employee pilferage of cartridges. Some operators reported customers were concerned about employees taking cartridges home.

The full impact of the homeowner market on OCS remains to be better understood, as the consumer market continues to evolve. Should these concerns grow with time, they could create new opportunities for alternative single-cup systems.

The alternative systems — hopper-based systems, pod systems and liquid-concentrate systems — also offer the advantage of sustainability, which is a growing customer concern. Because they don't use disposable cartridges, the

hopper-based systems, pod systems and liquid-concentrate systems do not contribute to landfill waste.

The pod systems offer some of the benefits cartridge-based systems provide — portion control convenience and ample product variety — at a lower cost. The pods also have the advantage of being compatible with a variety of brewers. Hence, the OCS operator has the option of shopping for pods from a variety of sources. This could prove to be an important issue if coffee prices continue to rise.

Many observers noted that since single-cup units still only represent a minority of all OCS brewers, the growth will continue for several more years. Many observers believe that single-cup could eventually account for more than half of all OCS systems.

ENVIRONMENTAL CONCERNS AFFECT CUSTOMERS

Rising consumer awareness about the environment created opportunities in recent years for recyclable products, such as cups and filters made from recyclable materials. This same concern increased demand for sustainable and organic coffee in some markets.

Operators noted that recyclable, sustainable and organic products carry a higher price tag, but many customers are willing to pay the extra cost. While these are not major sellers, they offer high profit margins and do a lot to enhance customer satisfaction.

Operators did not report as much demand for Fair Trade or shade grown coffees, which are also “cause” related coffees like sustainable and organic. Some operators noted, however, that customers interested in these products tend to be loyal to their causes and buy accordingly, consistently.

Another area in which environmentalism has been evident is the use of water filtration as a substitute for both 5-gallon water and single-serve bottled water. Operators noted that the demand for water filtration is more commonly driven by concern for water quality, which varies by geographic region, but environmental concerns are rising.

Rising activism against bottled water as a contributor to landfill waste has not affected consumer demand for

bottled water in any measurable way; bottled water sales continue to climb at a steady pace.

Environmental concern has also been voiced over depletion of groundwater and the fuel spent transporting bottled water.

The growth in water filtration is also driven by improved filtration technology, which has proven to be a selling point with many customers.

DEDICATED OCS OPERATORS DIFFER FROM VENDING OPERATORS

This year, *Automatic Merchandiser* segregated results of dedicated OCS operators from the total respondent base to identify unique characteristics of this operator group. OCS began as an independent industry, but became dominated by the larger vending industry as vending operators expanded into OCS.

The State of the OCS Industry Report stopped tracking the two operator groups separately in 1994/1995. At that time, dedicated OCS operators accounted for about a third of all operators involved in OCS and slightly more than half of the sales.

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FUEL CHARGE ACTIVITY

CHART 9A:
COMPANY HAS
BILLED CUSTOMERS
FOR FUEL

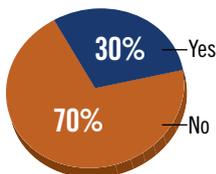


CHART 9B:
HOW MANY
CUSTOMERS WERE
BILLED FOR FUEL

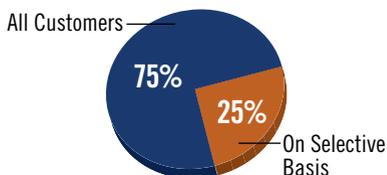


CHART 9C:
HOW OFTEN
CUSTOMERS WERE
BILLED FOR FUEL

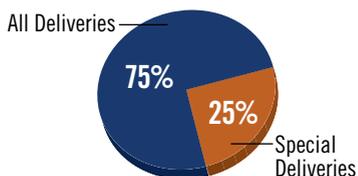


CHART 9D:
AMOUNT CHARGED
FOR FUEL PER
DELIVERY
(AVERAGE = \$3.50)

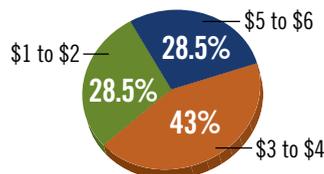
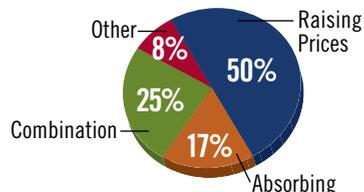


CHART 9E:
HOW RISING
COSTS ARE BEING
HANDLED



While vending operators now account for most of the OCS sales, dedicated OCS operators continue to do more OCS business on a per company basis.

The survey revealed the following characteristics of dedicated OCS operators:

- They served considerably more offices. Offices accounted for 68 percent of dedicated OCS operators' customers, versus 52 percent for all OCS operators.
- They raised prices more aggressively. (86 percent versus 74 percent).
- They charged more per cup; more than half charged more than 8 cents per cup.
- They carried more "other types of coffee," which includes whole bean and varietals.
- They used more single-cup brewers. Where single-cup reached a record 19 percent of all brewers industry-wide, dedicated OCS operators were 32 percent single-cup.
- More of them handled higher costs by raising prices, 50 percent versus 40 percent.
- They sold more allied products.

The OCS environment continues to offer great growth opportunities as the coffee consumer remains willing to pay for better quality. Given the fact that single-cup systems remain a minority of OCS brewers, single-cup will continue to expand for the next several years.

The OCS operators overall have recognized the opportunity to build sales by investing in better quality product and equipment. | ◀

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