

The turnaround begins for OCS as customer downsizing ebbs

Rising employment allows OCS operators to cash in on customer appreciation for specialty coffee; single-cup brewers surge.

By Elliot Maras, Editor



Prosperity is back on the horizon for the OCS industry. The nation's employment is making a slow but steady comeback, allowing the OCS industry to cash in on the consumer's rising appreciation for a better cup of coffee. To do this, operators are investing

in new delivery systems that allow coffee house quality coffee to be served in the workplace, particularly single-cup brewers.

The *Automatic Merchandiser* 2004 State of the Coffee Service Industry Report tracked a 1 percent revenue gain in OCS sales for the 12-month period ending in May of 2004. Industry revenue totaled \$3.39 billion. This marked the first revenue gain in the last three years, indicating the downturn that began in 2001 has reversed.

OCS operators reported that the work site downsizing that took hold in the fourth quarter of 2001 began to ebb in the last quarter of 2003 and the first quarter of 2004.

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

The solitary percentage point that the OCS industry gained in the recent 12-month period fell several points short of recovering the 8-point loss reported over the prior two years. 2001/2002 and 2002/2003 featured the most severe work site downsizing in more than 13 years.

Employment rises

The mild recovery in 2003/2004 allowed OCS operators to take advantage of the advances in office coffee delivery systems that have emerged in recent years. Brewer manufacturers have developed systems — namely single-cup brewers — to allow OCS operators to provide specialty coffee shop quality coffee in offices. This allowed the OCS industry to begin to catch up with the specialty coffee retail industry, which posted consistent gains in the last 10 years.

The employment gains in the last 12 months were not dramatic, but they were consistent and they signified a reversal of the trend from the previous two years. This change in itself helped strengthen employer confidence in the new year.

Operators raise prices

Forty percent of all OCS operators raised prices in 2003/2004, more than in any 12-month period since 1997/1998, when green coffee prices spiked. Fewer also lowered prices in 2003/2004.

The price increases were badly needed to offset rising cost increases. OCS operators incurred higher costs for wages, benefits, fuel and equipment

CHART 1: OCS Revenues — 10-year history

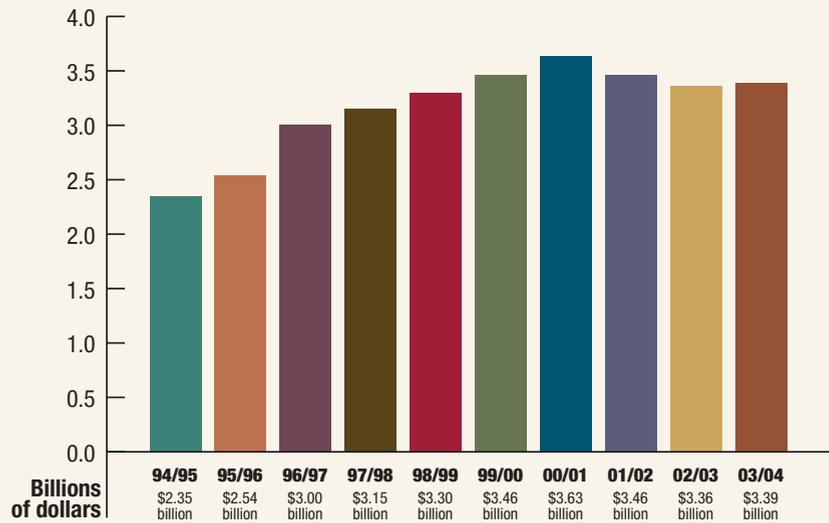
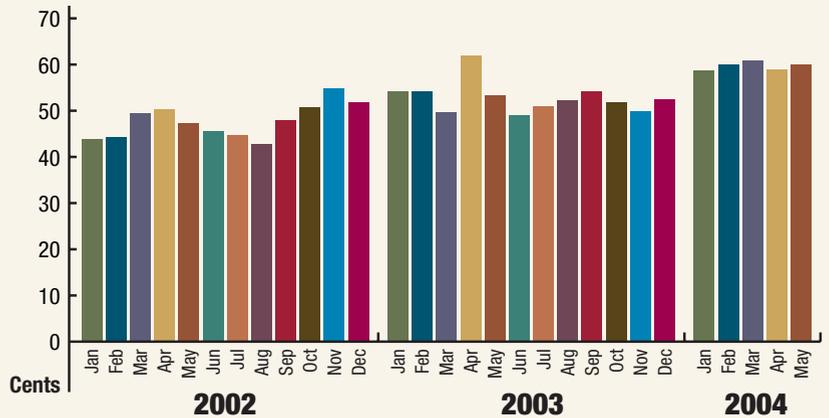


CHART 2: Composite green coffee prices, 2002 to May, 2004



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

during a period when the customer base was largely stagnant. Charging higher prices for coffee was one way to do this.

The consumers' overall appreciation for coffee in recent years lowered resistance to higher coffee prices, OCS operators reported. Operators were encouraged to raise prices after witnessing some price increases in specialty coffee stores.

The survey did not measure how widespread the coffee price increases were. Findings indicated the price increases were taken selectively, and on an individual customer basis. The average price-per-cup dropped slightly in 2003/2004, for the second consecu-

tive year, as indicated in chart 3c. This finding is consistent with a one-year shift to both lower pack weights and national brands in 2003/2004, indicated in charts 6 and 7.

Price per cup remains high

It is important to keep this one-year decline in per-cup revenue in the last three years in perspective, however. The price-per-cup remains higher than it was in 1999/2000, and has not lost ground to the pre-1996 era, when spiking green coffee prices caused OCS operators to raise prices. The OCS industry has maintained the quality of product and

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service that justifies a close to 6 cents per-cup price.

The contradictory findings of this year's report — more price increases but lower revenue per cup — reflected the degree to which the OCS business has become fragmented in recent years. The push to higher quality coffee has created more upscale offerings (in both product and equipment), but the lackluster economy has diminished customer demand.

OCS operators were able to upcharge in some situations, but were forced to economize in others.

This year's loss in higher pack weight sales also, to an extent, reflected the growth in single-cup business. The single-cup machines, which posted the fastest growth in the last five years (see chart 10), cannibalized some of the higher-ticket fractional pack business. Single-cup brewers represented the highest ticket equipment on the market and typically replaced plumbed-in, automatic units. In response to this growth, this year's study, for the first time, tracked single-cup pods and cartridge sales, shown in chart 6.

The drop in private label coffee at the expense of national brand coffee (which is typically lower-pack weight coffee) similarly reflected some cannibalization of higher-ticket fractional pack coffee by single-cup coffee. However, this change also reflected inroads made by national chain specialty coffee roasters in the OCS market.

Specialty brands enter OCS

Many, if not most, of the leading specialty coffee chains introduced OCS fractional packs in recent years to reach the consumer in the office setting. For many OCS operators, these specialty blends replaced their private label brands as their top choice offerings. The name brand specialty coffees allowed OCS operators to capitalize on well known retail brands.

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OPERATOR PRICING ACTIVITY

CHART 3A: Raised prices in the last year, 6-year review

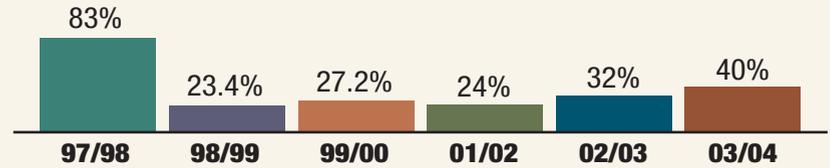


CHART 3B: Operator pricing activity, 3-year review

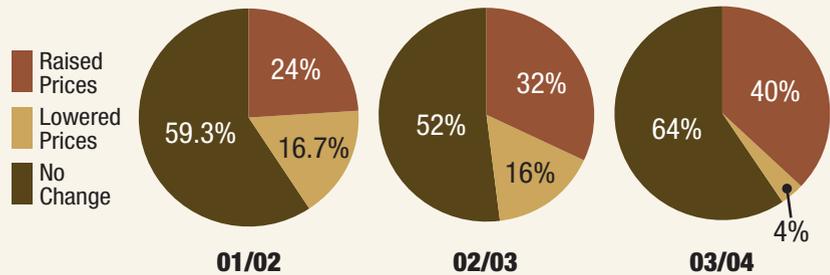


CHART 3C: Revenue per cup in cents per cup, 6-year review

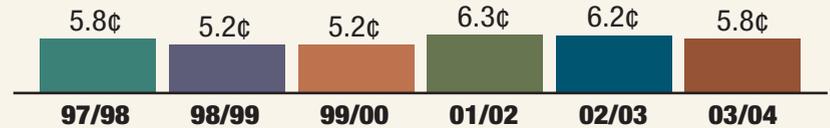


CHART 4: Brewer utilization, 3-year review

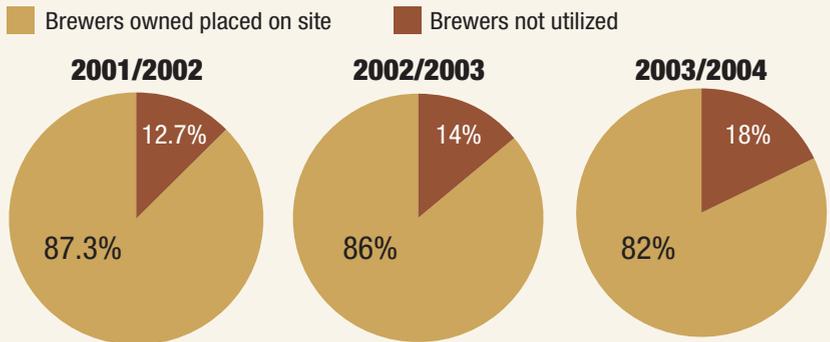
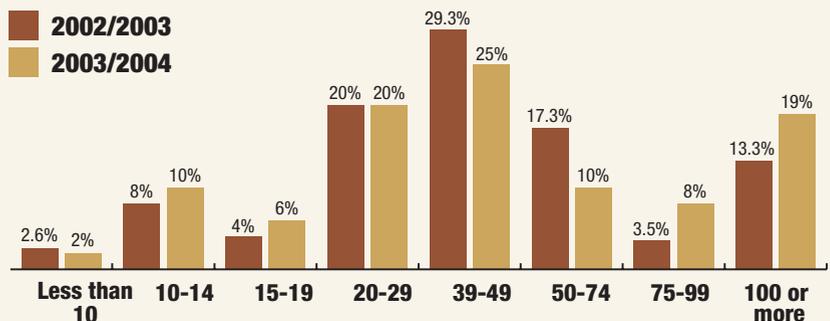


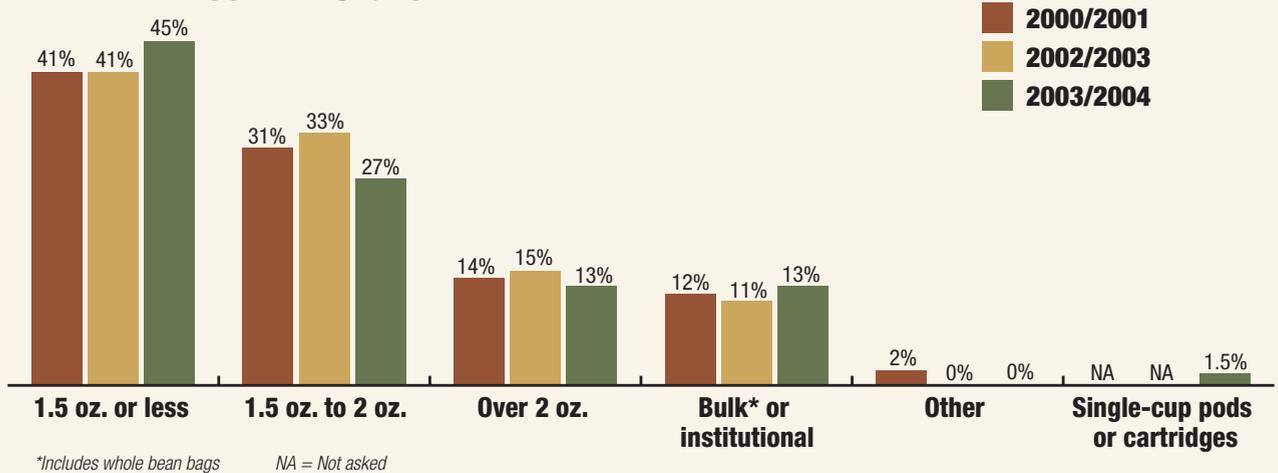
CHART 5: Account populations



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CHART 6: Sales by pack weight, 3-year review



While specialty coffee chains introduced OCS fractional packs and OCS operators are using them to replace private labels, there are few indications that the industry as a whole has fully exploited the opportunity.

However, national brand sales increased at the expense of private label coffee in the last 3-year period.

The decline in higher pack weight sales also reflected some cannibalization by bulk and institutional pack coffee. Bulk and institutional pack coffee gradually gained market share in recent years. Some of this is used for single-cup brewers. Some is also delivered to customers who prefer storing large amounts of coffee in big containers.

Offices remain the primary customer

While offices remained the mainstay of the OCS customer base, the last two years reported an increase in the percentage of business and industry accounts. This is consistent with the gain reported in the number of accounts with more than 100 people, reported in chart 5.

These findings reflected operators' need to find larger locations to justify higher-cost equipment, particularly single-cup brewers.

Improvements in both product quality and brewing technology placed a higher premium on operator education

in recent years. OCS operators found that being able to explain the benefits of their products and services has a major bearing on their ability to sell the more expensive offerings to accounts.

Operating costs rise

The survey did not track profitability, but operators unanimously noted that costs went up in 2003/2004 at the same rate as the previous year. Most notable were increases for wages, healthcare, and fuel. Product cost for the most part remained in check.

Rising consumer confidence supported the demand for specialty coffee this past year, according to the results of the NCA National Coffee Drinking Trends 2004, a nationwide consumer survey conducted by the New York City-based National Coffee Association of the USA. The survey found the percentage of people consuming specialty coffee daily jumped from 12 to 16 percent. This represented a rebound from last year, when a 1-percentage point decrease was reported, due to the economy.

The growth in consumer demand for specialty coffee — particularly in away-from-home circumstances — indicated an opportunity for the OCS industry to grow its specialty coffee business. But there were few clear indications in this year's State of the Coffee Service Industry Report that

the industry has exploited this opportunity. The only finding indicative of this was a slight gain in varietal coffee sales, noted in chart 8.

Single-cup explodes

The biggest change in the last 12 months was the near doubling of single-cup brewers, as indicated in chart 10. Single-cup brewers increased consistently over the last decade, but the last 12-month period witnessed the most dramatic gain of any year to date.

A key observation about the growth in single-cup systems is that it largely occurred at the expense of the more traditional brewers, as reported in chart 9. The chart indicated that airpot and thermal brewing systems also grew market share in the last two years, but in the last year, single-cup systems clearly gained more share than airpot and thermal systems.

There is no question the OCS industry is adapting more expensive delivery systems to provide a more satisfying customer experience.

Cartridges versus bulk hoppers

The per-cup cost for the "brew-by-pack" systems is higher than the other systems. Typically, operators pay well over 20 cents per cup for these systems, versus 6 cents for bulk hopper units. But there is also less mess, and most of

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these brewers are less expensive than the traditional bulk hopper systems, meaning there is a lower initial capital outlay. Most brew-by-pack units are also smaller than bulk hopper systems, enhancing their versatility.

The bulk hopper units boast their own advantages. They allow the OCS operator to adjust gram throw and water flow to meet a taste profile. This is an advantage in that it allows the operator to customize the product to meet a particular customer's needs. Some operators noted that the brew-by-pack systems don't meet every market's particular taste profile.

In addition, bulk hopper units satisfy the growing demand for milk-based beverages such as cappuccino, café mocha and French vanilla.

Another disadvantage of the brew-by-pack systems is that, to date, most require the operator to buy product from a specific supplier. This limits the operator's choice of supplier and gives him or her less leverage in negotiating a price.

Homeowner units emerge

Several equipment manufacturers introduced brew-by-pack homeowner models

in the last year. These are downsized models with fewer features and lower price points. The impact on OCS, if any, was uncertain at this writing.

For some OCS operators, the new homeowner models created an opportunity to sell the units to individual customers for home use. The manufacturers did not advertise these units aggressively, promoting them primarily over the Internet.

Some of the newer, less expensive homeowner units, however, have been introduced to chain retail stores and advertised on television.

The pods for these new, downscaled homeowner units can be used in some commercial single-cup machines. This has caused some OCS operators concern about competition from retailers.

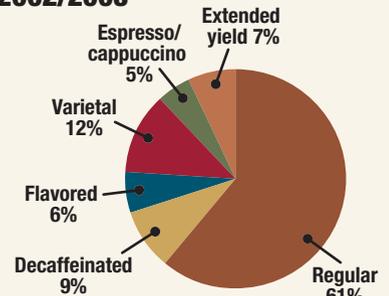
Operators naturally consider the impact warehouse clubs have had on allied product sales and wonder if the pods will follow this pattern.

Still another concern is whether consumers with homeowner systems will be

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CHART 8: Coffee sales by coffee category, 2-year review

2002/2003



2003/2004

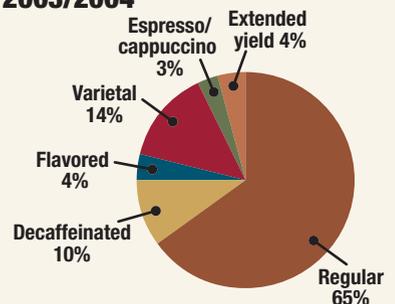


CHART 7: OCS sales by product category, 3-year review

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

*Includes flavored, whole bean and varietal.

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tempted to pilfer pods from the office. One equipment manufacturer has already introduced a pod vending machine to address this potential problem.

Most OCS operators do not see the homeowner products as having much of an impact on their business. They are quick to point out that homeowner

machines are not capable of meeting the requirements of the office environment.

However, the compatibility of homeowner pods with office machines could cannibalize the OCS operator's pod sales if office managers opt to buy pods at the wholesale club. It could also affect the pricing operators will be able to charge for pods.

Homeowner units could further influence consumer perception of brew-by-pack office systems, for better or for worse.

If consumers find these single-cup units deliver unsatisfactory coffee, it could affect their willingness to want them in the office. Perception of pods could be clouded by the experience of having pods go stale at home.

Or the reverse could happen. Positive experiences with homeowner systems could build demand for these systems in the work place.

Most operators insisted that the OCS industry will maintain a perception of offering a sufficiently higher level of quality and service than what consumers buy for their home use.

Brew-by-pack wasn't the only single-cup innovation to make headway in 2003/2004. Water soluble and liquid concentrate systems continued to expand as well.

CHART 9: OCS brewer count, 3-year review

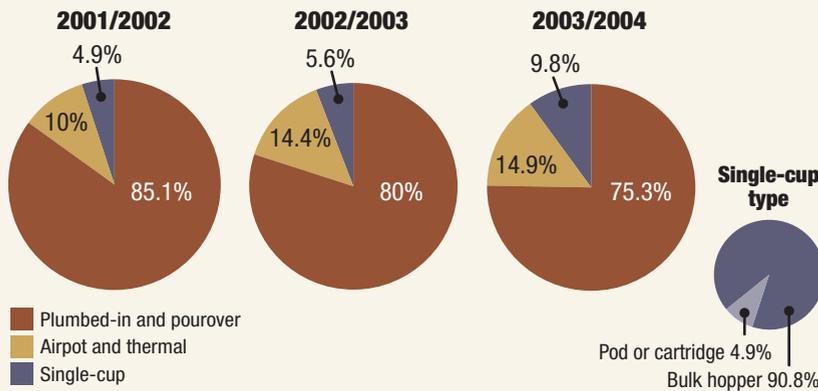


CHART 10: Estimated single-cup brewer placements in the U.S., 3-year review

Manufacturer	Product(s)	01/02	02/03	03/04
Filterfresh	Filterfresh/Keurig	26,500*	30,000**	35,000***
Crane	Café System	11,000	12,000	12,000
Unibrew	Unibrew	3,200	3,200	3,200
Cafection	Avalon	13,000	16,000	19,500
Progema	Venus	1,000	2,400	3,600
Zanussi	Brio/Colibri	8,000	10,000	12,500
Flavia	Flavia	32,000	40,000	62,000
Keurig	Keurig	30,000	33,000	60,000
Newco	Gevalia	1,200	1,300	1,600
G.P. Rossi	Robopod	0	0	1,200
Saeco USA	Saeco, Estro	45,000	50,000	55,000
Sara Lee	Douwe Egberts	0	0	200
Rheavendors	Lionness	516	1,000	1,500
Café Excellence LLC****	Café X Milano	0	0	206
Other		0	3,600	2,600
TOTAL		171,416	193,200	270,106

* Includes 1,484 Keurig units

** Includes 2,300 Keurig units

*** Includes 12,000 Keurig units

**** Café Excellence LLC is the marketer, not the manufacturer. The company did not want the manufacturer identified.

Water-soluble grows

Since one of the major benefits of single-cup is the ability to offer more product variety, water soluble systems found a following. These systems featured the milk-based offerings that have become increasingly popular with consumers. Many OCS operators noted that younger consumers in particular have no interest in drinking regular coffee, only flavored and milk-based coffee drinks.

Water-soluble coffee, for its part, made significant improvements in recent years in taste quality. Some operators insisted that many consumers can no longer distinguish between it and fresh-brew coffee.

Because water-soluble, single-cup systems are easier to manage, they offer lower product cost and oftentimes less waste than fresh-brewed coffee. Some operators found it made sense to simply place a water-soluble, single-cup system next to a traditional pourover brewer.

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This provided the product variety and convenience without the cost of a fresh-brew, single-cup system.

Liquid coffee increases

The liquid concentrate systems, for their part, worked well in large public locations where the major concern was speed of service. Some OCS operators said these systems allowed them for the first time to meet the occasional request for a system that can do what a customer has seen in a fast food restaurant.

Liquid concentrate systems were also helpful for catering and special events, where again, the need is more for speed of service.

Brewer technology continued to evolve beyond the single-cup systems. Brewers have been introduced with more sophisticated electronic sensors that maintain the water level, the temperature and the coffee extraction. This is particularly important for the higher pack-weight, full-bodied coffees that have become more prevalent in OCS.

Operators did not report any significant change in allied product sales in 2003/2004, as indicated in chart 7. While most operators reported a greater willingness to spend money on employee perks in the last 12-month period, this did not translate into any gain in allied product sales. OCS operators continued to have a difficult time trying to match the pricing warehouse clubs and office product companies offer for most allied products.

Focus on core customer

But the survey indicated that for the most part, OCS operators focused on their core service offering in another challenging year. This strategy makes sense given the OCS industry's unique ability to meet the office customer's need for a better cup of coffee with minimum hassle. And given the better tools they now have at their disposal for accomplishing this. ■

Office Services Study: just over half of all offices used an OCS service in 2003

Wyoming Research Associates' Office Services Study (OSS), revealed that 51 percent of U.S. offices used an OCS service in 2003. The study is based on interviews with office managers regarding trends in the consumption of products and services purchased by U.S. offices. The results were provided exclusively to *Automatic Merchandiser*. The report is a syndicated study conducted periodically by Wyoming Research Associates Inc., based in Casper, Wyo. The objective of the study is to measure and report categorical information, on several criteria, including but not limited to, market size, consumption rates, brand penetration, market share, satisfaction and brand loyalty of offices in the U.S. Further, Wyoming Research Associates' historical data bank and interactive reporting tool enables analysis of market trends along with category growth forecasts to provide a comprehensive view of the services in the office market. Electronic browsable PDF reports are also available and include over 300 graphs and tables.

In 2003, the study was conducted with a random sample of offices generated from 22 metropolitan areas stratified by geography and office size; small (10 to 20 employees), medium (21 to 100 employees) and large (101 to 500 employees). The sample selection was limited to offices in the 22 metro areas to provide for reliability and projections of research results. For information on obtaining the full report, call 307-234-1863.

CHART 11:
Percent of U.S. offices that provide coffee to employees, based on size of office

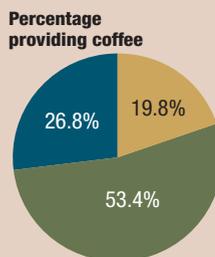
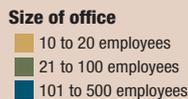


CHART 14:
Type of appliance provided to employees ranked by prevalence

Ranking	Appliance
1	Refrigerator
2	Microwave Oven
3	Coffee Pot
4	Water Cooler
5	Hot Water Pot
6	Vending Machine
7	Toaster Oven
8	Soda Machine

CHART 12:
Percent of U.S. offices that use an OCS service, by company size

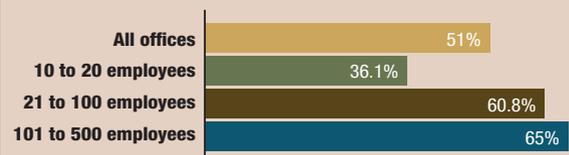


CHART 13: Where U.S. offices buy coffee for their employees

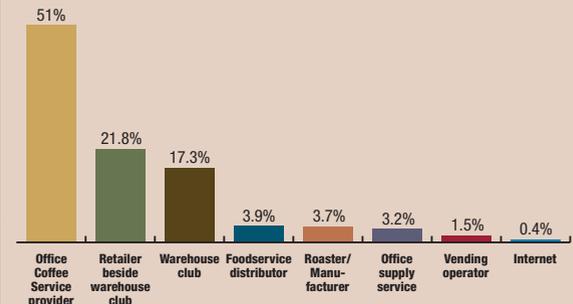
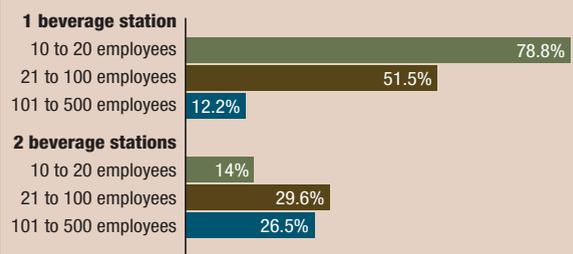


CHART 15: Percent of U.S. offices with 1 beverage station and 2 beverage stations, by size of office



Source: Wyoming Research Associates Inc. 2003 Office Services Study.