

OCS cashes in on specialty coffee

Low coffee prices give OCS operators a chance to sell higher-quality coffee; single-cup brewers make big inroads

"If at first you don't succeed, try, try again." The goal was to cash in on the specialty coffee boom, which in the middle '90s reversed the 30-year decline in American coffee consumption. And while not all OCS operators jumped on the bandwagon, those who tried to market specialty coffee found it rough going. Consumers simply didn't associate OCS with the quality offered by specialty coffee stores.

Today there's good news. In the 12-month period ending in June of 2000, signs of change have emerged. The OCS industry posted its third consecutive 5-percentage-point revenue gain, according to the *Automatic Merchandiser* Coffee Service Market Report. It marked the second straight year that revenue gains were not caused mainly by higher coffee prices. More importantly, the percentage of specialty coffee sold by OCS operators increased for the second consecutive year. The going's been tough, but progress has been made.

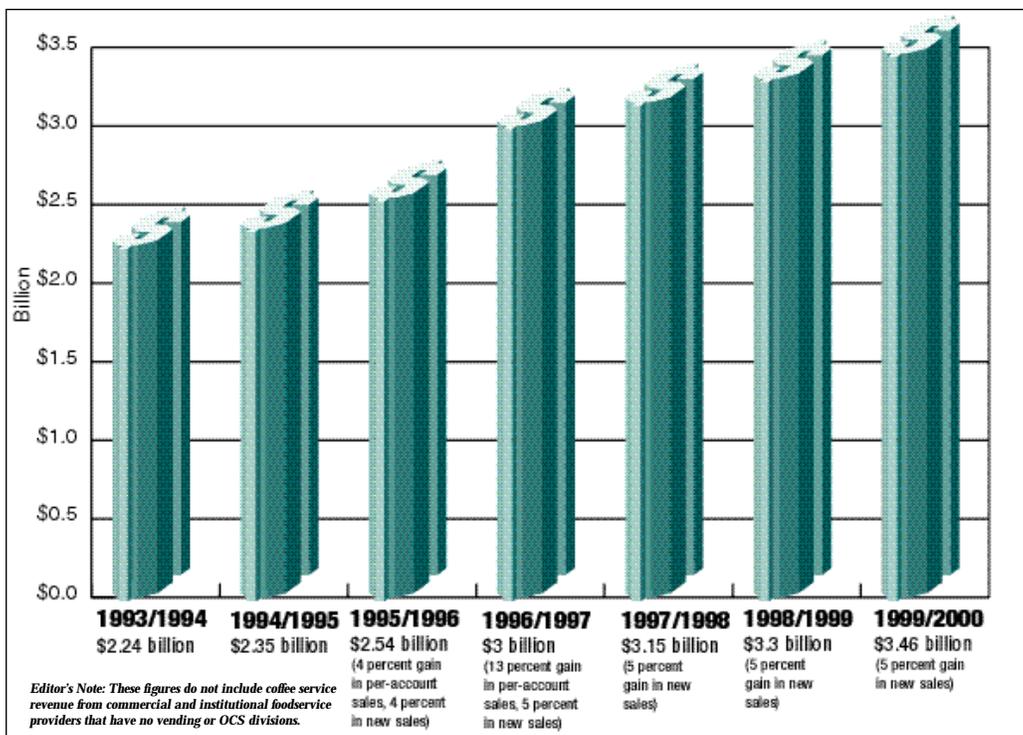
What's also significant is that OCS opera-

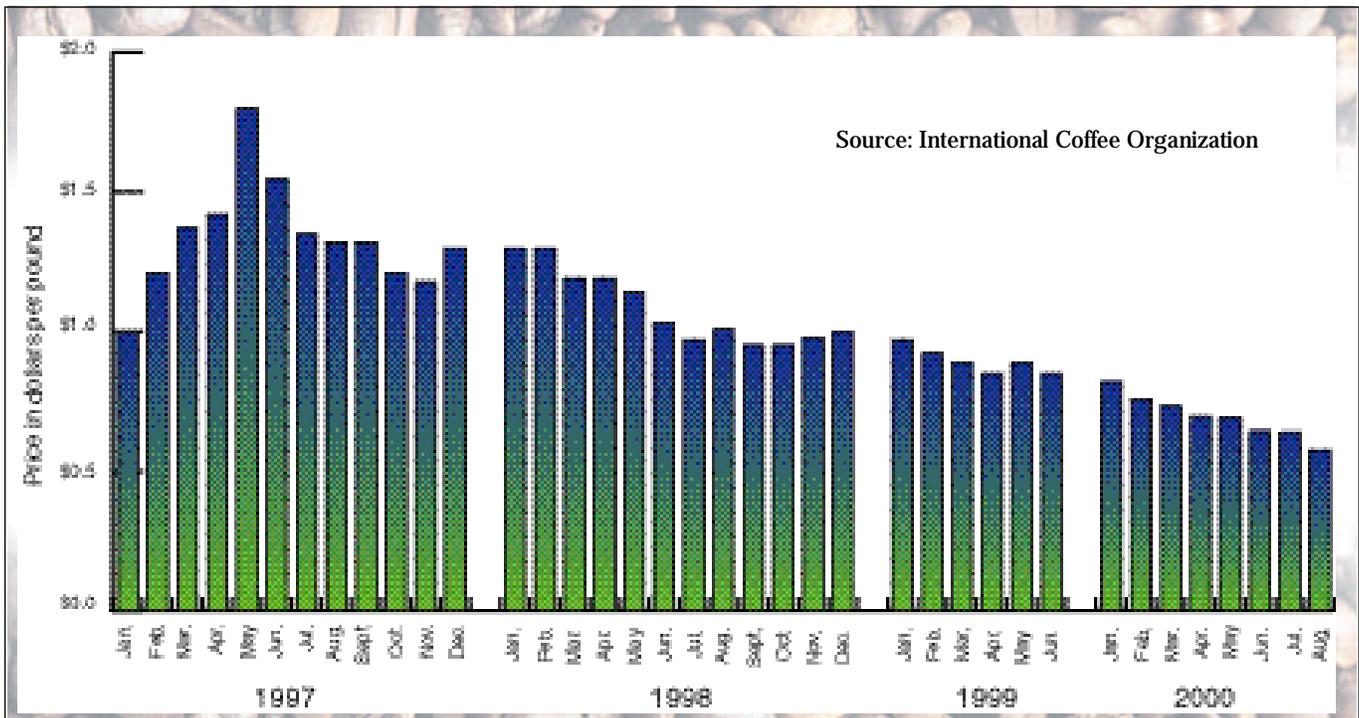
tors' sales continued to grow even as green coffee prices declined. Total OCS revenue reached \$3.46 billion in 1999/2000. Composite green coffee prices fell from \$1.30 per pound in January of 1998 to 57.59 cents in August of 2000, according to the International Coffee Organization. The OCS industry increased sales by adding accounts and building the size of its orders.

OCS operators hold their prices

In 1999/2000, most OCS operators, 62.4 percent to be specific, kept coffee prices at the prior year's level. Almost a third, 27.2 percent, raised prices, which was slightly more than the 23.4 percent that raised prices in 1998/1999. This indicates that OCS operators improved consumer acceptance of the products and services they provide.

The 2000 *Automatic Merchandiser* Coffee Service Market Report is based on written responses to an eight-page questionnaire completed by a random sampling of 900 OCS





operators, half of which were dedicated OCS operators, the remainder being vending operators with dedicated OCS operations. About 22 percent of the recipients provided useable responses.

The report is also based on information from telephone interviews with operators, product suppliers and equipment manufacturers, and research organizations.

OCS fights consumer perception

Last year's Coffee Service Market Report noted that OCS operators were frustrated by the fact that many consumers were willing to pay higher prices for coffee served in retail outlets, but were not willing to pay much more than 5 cents per cup for OCS coffee.

The last time the majority of OCS operators were able to raise prices was 1996/1997, when green coffee prices doubled. Due to the amount of attention the consumer media paid to these increases, OCS operators were able to pass their costs on to consumers.

Since then, OCS operators have sought to further improve sales by upgrading the quality of their products. While OCS operators initially encountered resistance to higher-priced coffee, coffee prices began to fall in the second half of 1997. This enabled them to improve profits without raising prices, and at the same time, continue market-

ing better quality coffee. In the last two years, OCS pack weights have risen, indicating their marketing efforts have paid off.

The percent of 1.5-ounce packs sold jumped from 16 percent in 1996/1997 to 22 percent in 1997/1998; the percent of 1.25-ounce packs jumped from 17 to 20.3 percent; and the percent of 1.1-ounce packs fell from 25 to 16.4 percent.

These trends continued in 1999/2000. The percent of under-1.5-ounce packs fell from 58.8 percent of the total to 50.28 percent, while the percent of 1.5- to 2-ounce packs jumped from 21.3 percent to 35 percent, and the portion of 2-ounce and higher rose from 11.6 to 15.78 percent.

Pack weights rise

The rise in pack weights in the last two years in large part reflected the growing amount of specialty coffee being sold by OCS operators. OCS operators almost doubled the number of specialty coffees they offered in 1997/1998 alone.

Sales of espresso-based coffee also posted gains in each of the last two years.

As for flavored coffee, the survey did not specifically measure the amount of flavored coffee sold, but interviews with OCS operators indicated that flavored coffee sales were comparable to that of varietals, or coffees identified as being from specific countries, such as Kenya,

Colombia and Sumatra.

While the report indicated that specialty coffee remains a small portion of the total OCS market, the full amount of specialty coffee on OCS was difficult to measure due to the growth in private label coffee.

Private label gains market share

In 1999/2000, private label posted a 1.5-point gain at the expense of national brands, after jumping 9.1 points the previous year.

The *Automatic Merchandiser* Coffee Service Market Report measured private label as a single entity, as distinguished from national brands. While the survey did not measure how much private label coffee was marketed as specialty coffee, many operators interviewed reported marketing some private label as specialty coffee. The vast majority of national brand coffee, by contrast, was sold as regular coffee.

For many operators, an emphasis on marketing specialty coffee was part of an ongoing effort to promote private label. Many operators viewed private label as a tool to strengthen customer loyalty and at the same time improve their profitability.

The amount of specialty coffee sold by OCS operators remained small in 1999/2000 compared to other retail

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channels, where, according to some sources, it commanded 25 percent of the total market.

Other developments emerged in 1999/2000, however, that indicated OCS operators have positioned themselves to cash in on specialty coffee at a faster rate in the future.

Specialty brands emerge in OCS

One change was the number of better-known consumer specialty brands that became available in OCS packs.

Well-known names such as Starbucks, Timothy's, Peet's, Millstone, Dietrich's and Gloria Jeans became widely available in OCS packs last year. This marked a departure from the past, when name brand, specialty coffee roasters were skeptical about allowing their brands to be sold to the OCS industry, due to the OCS industry's reputation for poor-quality coffee.

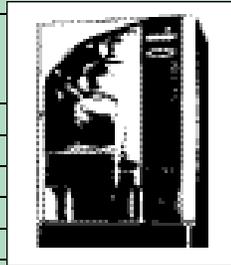
In 1999, Starbucks, regarded by many as the specialty coffee leader in the U.S., made its OCS packs available industrywide through OCS product distributors.

While the percentage of specialty brands sold in OCS was miniscule in 1999/2000, many operators interviewed

OCS brewer count — 3.4 million units on location

# of U.S. locations with 15 to 3.2 million locations	
X 42.8% Percent that use OCS	
= 1.37 million office locations served	
X 2.5 brewers per location	
= 3.4 million OCS brewers	

Thermal and airpot brewers	Estimated 5% of 3.4 million
total	= 170,000



Filterfresh	30,000
Crane	25,000
Avalon	7,500
Brio	5,000
Flavia	8,000
Keurig	13,000
APPART	3,000

reported being surprised by the success of these products.

In conjunction with specialty coffee roasters' new embrace of the OCS channel, major gains were reported in the placement of higher-quality brewing equipment. Some specialty roasters mandated the use of equipment such as thermal brewers, airpot brewers and countertop, single-cup brewers.

Airpot brewers, single-cup both gain

This year, for the first time, the Coffee Service Market Report attempted to

quantify the different types of brewers in the U.S. and to measure the growth of higher-quality systems. Both thermal/airpot and single-cup systems posted major gains in the last two years.

The less expensive, more traditional pourover and plumbed-in automatic brewers accounted for 86.6 percent of the estimated 3.4 million OCS brewers in the U.S. in 1999/2000.

Thermal and airpot brewers were estimated to total 170,000 units while countertop, single-cup systems were pegged at 100,500 units. These figures assume an OCS market of 1.37 million OCS locations and an average 2.5 brewers per location.

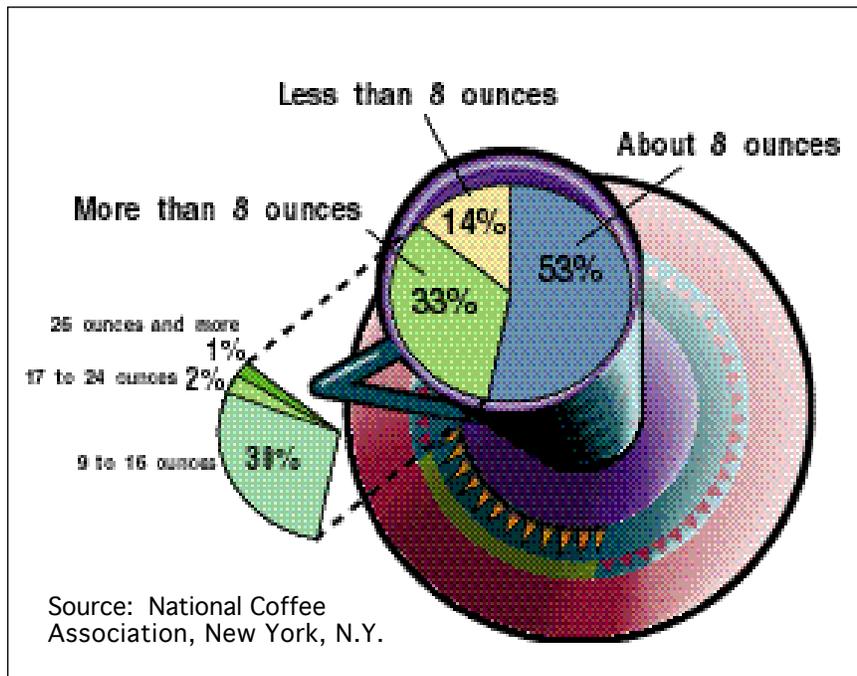
Thermal and airpot brewers, which cost three or four times as much as a more traditional glasspot system, were introduced 10 years ago. The systems were designed to keep brewed coffee at a consistent temperature, reducing waste and improving customer satisfaction.

Airpots support specialty coffee

Thermal and airpot brewers have supported the evolution of specialty coffee in OCS by providing more quality control than glasspots.

When Starbucks entered the OCS market in the early 1990s, it allowed only specially-selected OCS operators to serve Starbucks coffee and mandated they use airpot brewers.

Airpot and thermal brewers also



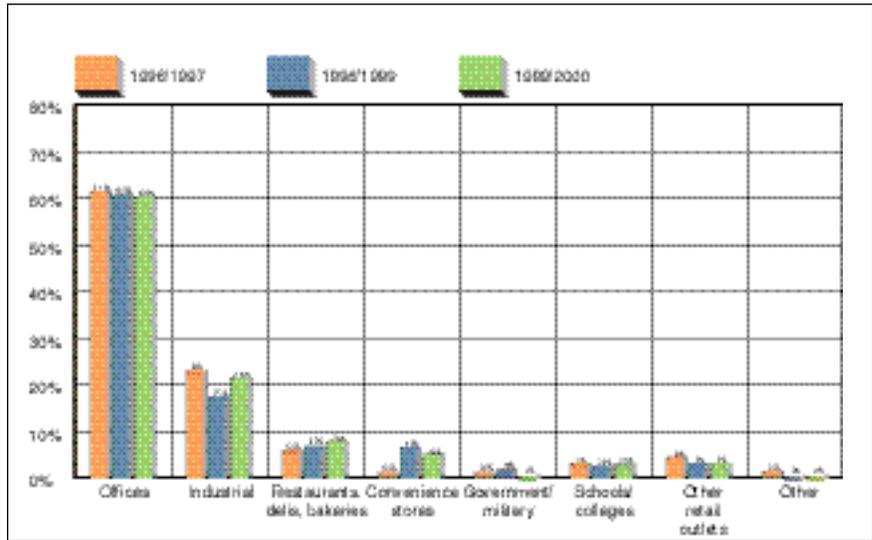
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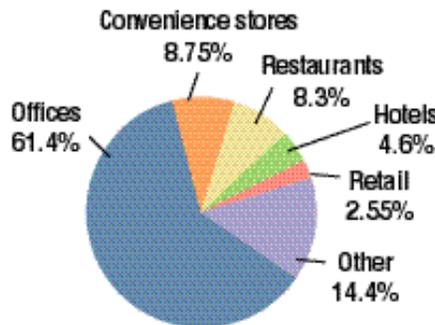
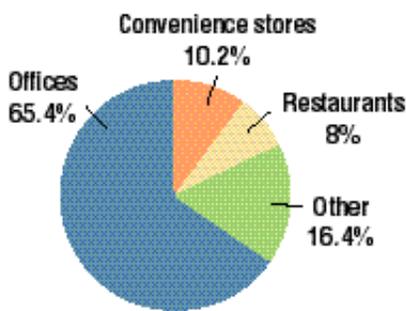
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gained acceptance among OCS operators because they made good sales tools. Prosperity, coupled with a willingness by many employers to offer more employee benefits, supported a higher level of OCS service.

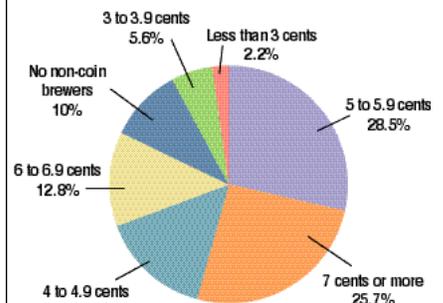
These changes did not leave the OCS industry uniformly sold on the benefits of airport and thermal brewers, however. The systems require more space



Share of sales by account type



Revenue per OCS



and more service, and some operators view the temperature control feature as a negative. This school of operators holds that consumer acceptance is greater when the customer can smell and see the coffee as it is brewed. They also point out there is no need for temperature maintenance in high-volume accounts, since the coffee is consumed quickly.

The market forces supporting the growth of airport and thermal brewers also hastened the evolution of countertop, single-cup brewers, which represent an even higher investment. In the last year, these high-cost units posted the biggest one-year increase in placements in their 13-year history in the U.S.

Big gains in single-cup brewers

Placements of countertop, single-cup units jumped from 40,550 in 1998 to 100,500 in mid-2000, more than doubling in two years. Several factors came into play.

The development of cartridge-based systems as opposed to bulk-hopper

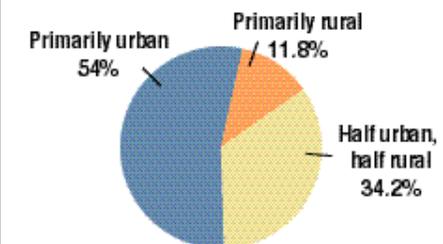
Operating averages

	1997/1998	1998/1999	1999/2000
Years in OCS business	14.4	17.9	15.8
Raised prices in last 12 months	83%	23.4%	27.2%
Revenue per cup	5.8 cents	5.2 cents	
Customer turnover rate*	2.7%	2.5%	
NA			

brew chambers provided lower-cost alternatives thanks to lower maintenance and space requirements. The cartridge- or pod-based systems from Keurig and Flavia accounted for almost 20 percent of all countertop, single-cup systems in 1999/2000.

Filterfresh, the franchise organization that introduced single-cup brewing to the U.S., also continued to drive the single-cup market. In the last two years, Filterfresh almost doubled its brewer placements to more than 30,000, and in the fall of 2000 operated almost as many single-cup machines as comprised the total market two years ago.

Type of market



Customer appreciation improves

Another factor supporting single-cup

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units, as noted with airpot and thermal units, was customer willingness to pay more for better-quality employee benefits. While most OCS operators remained reluctant to expand into single-cup systems because of the higher cost, those that did found customers surprisingly willing to pay the higher costs.

Still another factor supporting single-cup evolution was the gradual expansion of vending operators into the OCS business. Vending operators have always been more comfortable with higher-cost equipment. Their presence in OCS, which has grown significantly in the last 20 years, supported the use of machines that can carry 10 times the price tag of traditional OCS brewers. Approximately 40 percent of all vending operators had OCS operations in 1999, while the number of dedicated OCS operators dropped in half over the last 20 years.

Single-cup stakes a claim in OCS

The growth in countertop, single-cup units emerged as the single biggest change the OCS industry has seen in the last 20 years. Whether this trend will change the nature of the OCS industry for the long term is not for certain, as conceded even by those operators who reported success with these units.

No one can assume that the economic conditions that contributed to the recent growth in single-cup brewers — a prosperous business environment and

OCS sales by product category

Category	Percent of sales			Projected revenue		
	96/97	98/99	99/00	96/97	98/99	99/00
Private label coffee	19.3%	28.4%	30.9%	\$579M	\$937.2M	\$1.069B
National brand coffee		50.8	33.8	32.8	1.52B	1.12B
1.134B						
Whole bean coffee	3.4	2.5	2.8	72M	82.5M	96.88M
Varietal coffee	2.1	4.3	5.1	63M	141.9M	
176.46M						
Espresso/cappuccino	1.6	2.2	2.9	48M	72.6M	
100.34M						
Other coffee*	1.5	1.9	1.0	45M	62.7M	34.6M
Total coffee	78.7%	77.2%	75.5%	\$2.36B	\$2.42B	\$2.61B
Other hot beverages	4.4	3.8	2.8	132M	125.4M	96.8M
Soft drinks	4.5	7.1	7.5	135M	234.3M	254.5M
Juice	1.9	1.2	1.0	57M	39.6M	34.6M
Bottled/filtered water		0.8	4.1	4.3	2.4M	135.3M
141.7M						
Creamers/sweeteners		6.4	5.1	5.1	192M	168.3M

low unemployment — will continue indefinitely. Many operators are waiting to see what effect different economic conditions will have on customer willingness to pay for single-cup systems.

Nevertheless, the popularity of specialty coffee is expected to continue, and many OCS operators have come to view the single-cup machine as the OCS industry's most important tool for providing specialty coffee. Single-cup systems in particular offer more product variety, which typically includes flavored coffees and cappuccino, in addition to regular coffee. As already noted, specialty coffee is credited with recent gains in total coffee consumption.

Specialty coffee positioned to grow

Most coffee industry observers agree that specialty coffee is here to stay, thanks in large part to demographic changes in American society.

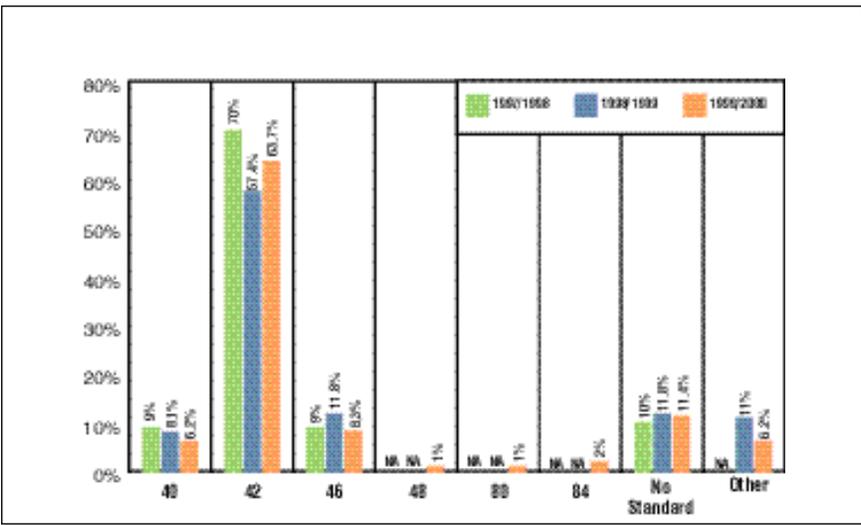
Younger consumers are more inclined to drink specialty coffee than their parents, according to the New York City-based National Coffee Association.

The NCA's 2000 National Coffee Drinking Trends report found that consumption of gourmet coffee was highest among 30- to 39-year-olds, followed closely by 40- to 49-year-olds and 25- to 29-year-olds. Consumption of espresso-based beverages was highest among 40- to 49-year-olds, but followed closely by 25- to 29-year-olds.

Many OCS operators overcame the investment hurdle posed by single-cup systems by taking advantage of manufacturer leasing programs. By allowing the account to lease the machine from a leasing company, the OCS operator relieves himself of the financing burden and at the same time incurs no extra tax liability on account of the extra assets. At the end of the lease period, the operator can buy the equipment back from the customer at a lower market value.

Expansion into foodservice continues

These more sophisticated brewing systems — airpot and single-cup brewers — also supported OCS operators' contin-



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ued expansion into foodservice accounts, a trend that became evident in last year's Coffee Service Market Report.

In particular, airpot and thermal systems supported expansion into the booming convenience store coffee business, while single-cup systems enhanced operators' efforts to serve restaurants, delis and institutional accounts.

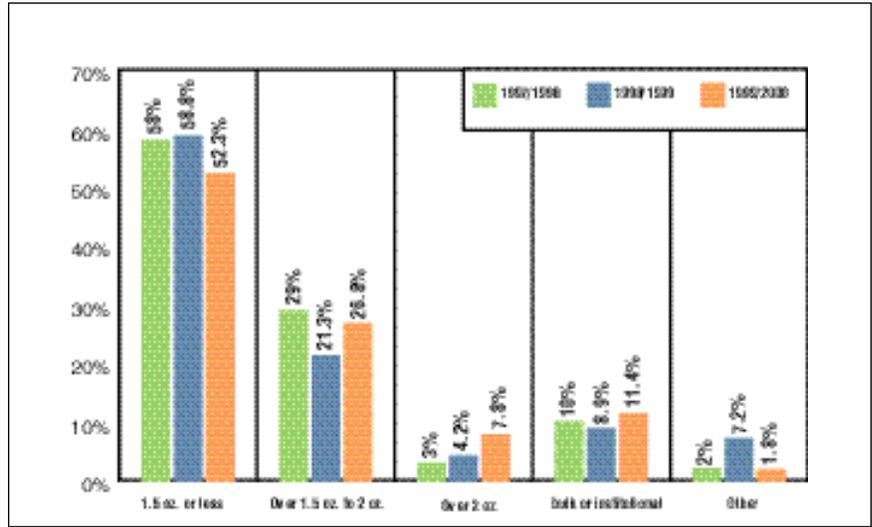
The report did not measure the number of thermal, airpot or single-cup systems placed in foodservice accounts. However, most OCS operators active in these "resale" accounts reported that these accounts required more versatile brewing systems, along with more ancillary equipment such as thermal dispensers and grinders.

Foodservice keeps growing

Foodservice accounts represented a natural expansion opportunity for OCS operators as the foodservice industry grew at around 5 percentage points per year on average, according to the Washington, D.C.-based National Restaurant Association.

For OCS operators, the foodservice market required not only different and more expensive equipment, but more frequent service and financial operating standards that were different from what they were used to.

The payoff to operators willing to



make the investment included a broader customer mix, which made their business less reliant on one customer base, and higher revenues, even though the gross profit was lower on a per-order basis.

Foodservice accounts also enabled OCS operators to capitalize on the popularity of larger cups, particularly in take-out sales.

According to cup suppliers, OCS operators did not introduce larger-size cups to office accounts, the mainstay of their business. Foodservice accounts, by contrast, sold more 16-, 20- and 24-ounce cups in 1999/2000.

Foodservice coffee: outlets expand

While foodservice still represented a small portion of the OCS industry's customer base in 1999/2000, many operators saw expansion into foodservice as a way to recover coffee sales lost to both

foodservice and retail coffee outlets. Driven by a prosperous economy and more consumers eating on the run, foodservice outlets multiplied in recent years.

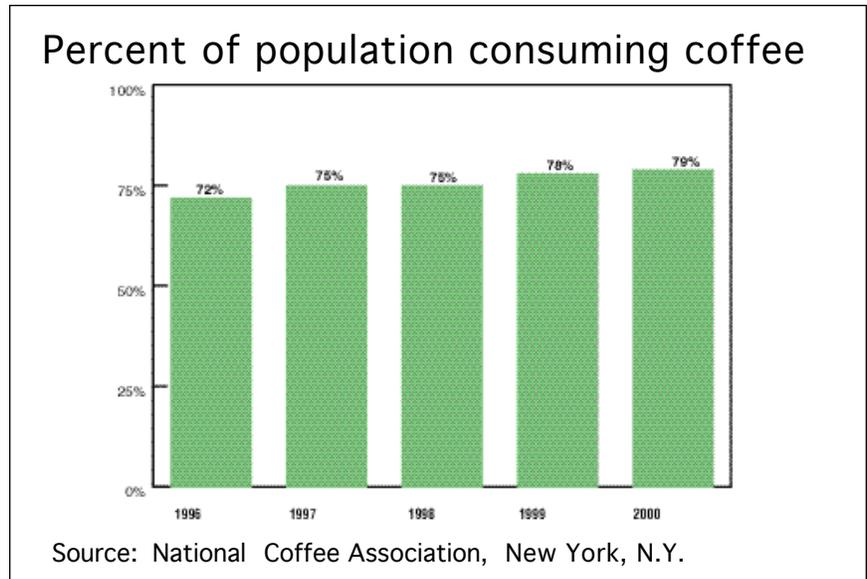
According to the Specialty Coffee Association of America, there were 6,000 free-standing coffee shops in the U.S. in 1999, along with 2,700 coffee kiosks and 2,100 coffee carts. The 6,000 coffee shops included a small but growing number of restaurants with areas specially designated as mini coffee shops.

The number of restaurants offering mini coffee shops is expected to climb from 300 in 1999 to 5,400 in 2015, according to SCAA. This bold projection is based in part on McDonald's recent announcement to roll out "McCafé" coffee shops in its U.S. restaurants. McDonald's noted the success of 50 such store-within-a-store shops in Australia.

Within the foodservice segment, full-service restaurants posted the biggest market share gain in 1999, according to the National Restaurant Association, reflecting consumers' willingness to spend more for quality. The number of full-service restaurants grew by 6.7 points, compared to 4.9 points for limited-service restaurants.

C-store expansion continues

OCS operators also continued their expansion into c-stores, which posted even greater growth in 1999 than foodservice outlets. In 1999, the number of c-stores in the U.S. increased by 5 percentage points, (5,700 more units) while total dollar sales jumped an unprece-



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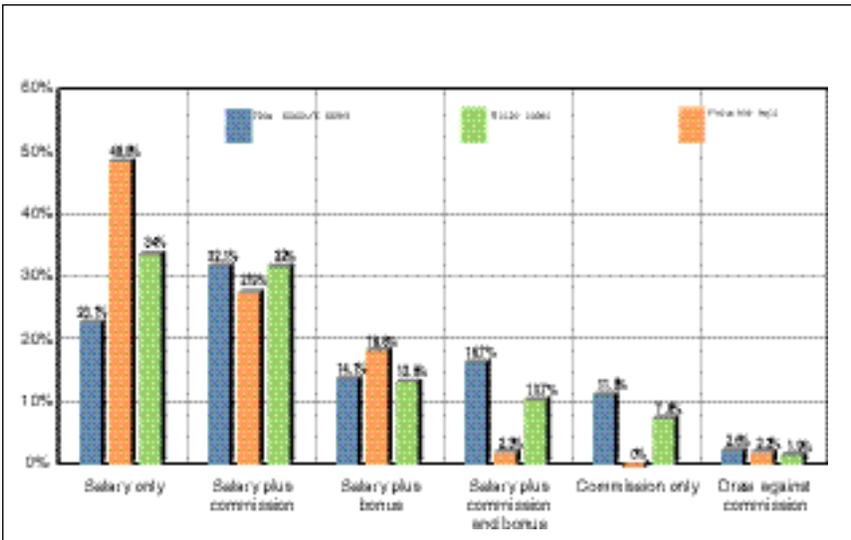
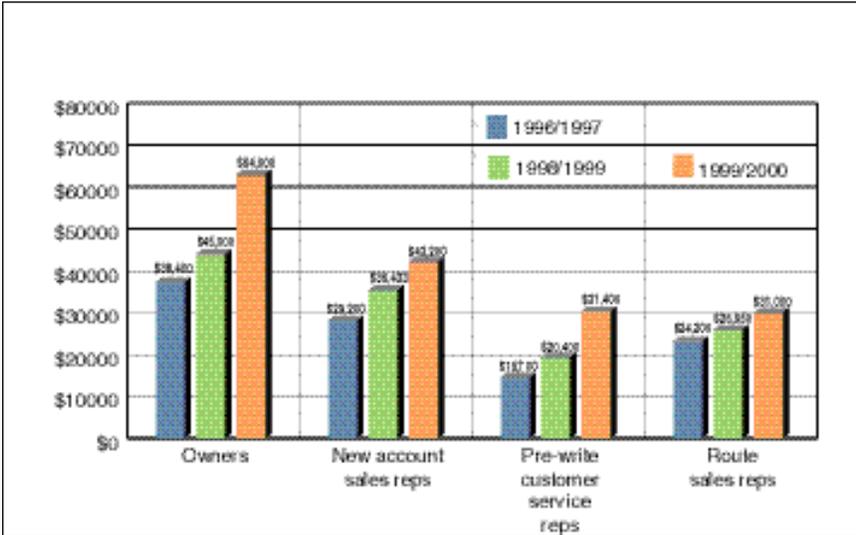
denoted 25.8 percentage points, according to the National Association of Convenience Stores.

C-stores also posted a big gain in 1998/1999 as a percent of OCS operator

sales, jumping from 0.9 to 6.5 percent. In 1999/2000, the percentage slid slightly, to 4.9 percent, but nevertheless represented an increase over earlier years.

C-stores, like foodservice, represented a high-volume but low-profit opportunity for OCS operators when compared to office accounts. The growth of this channel in recent years has been such that many OCS operators found it worth their effort.

While only a minority of OCS operators expanded into the c-store business, those who did reported finding more opportunities to increase sales through point-of-sale materials, along with larger-size cups. C-stores led all retail channels in the sales of larger-size cups, cup manufacturers reported. The NCA reported that a third of all coffee sales are in cup sizes larger than 8 ounces, which is the standard OCS cup size.



Typical commission rate for commission based on a percentage of company sales for 1999/2000

New account sales reps	18.6%
Prewrite customer service reps	8.5%
Route sales	18.7%

Typical commission rate for commission based on a percentage of personal sales for 1999/2000

Office customers still fuel growth

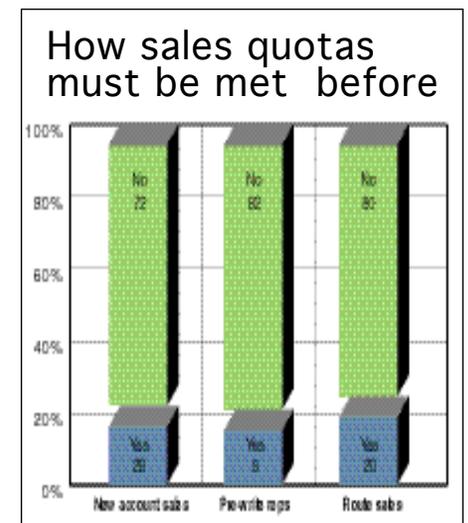
Offices, the largest and most profitable OCS customer segment, staged a noticeable comeback in 1999/2000, largely in response to the growth in the nation's service sector. As a percent of total customers, offices rebounded to 67.2 percent after slipping from 6.14 to 60.5 percent in 1998/1999.

While economic conditions varied by region, the nation's office market posted significant growth in the current economic cycle. As reported in the *Automatic Merchandiser* State of the Vending Industry Report in August, work sites with fewer than 100 people grew at a much faster rate than larger-size work sites. This benefited the OCS industry almost as much as it hurt the vending industry.

The target account size for OCS is 15 to 100 employees, compared to the 100 minimum for vending. Only 6.9 percent of all OCS accounts had more than 100 people in 1999/2000.

Small locations add more jobs

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Benefits offered to full-time employees 1999/2000

	Fully covered	Employee pays part	Employee pays all	Not provided
Hospital/surgical only	35.2%	40.1%	2.1%	22.5%
Major medical	40.1	37.6	1	20.5
Dental insurance	17.3	15.7	9	57.8
Vision care	13.4	17.1	5.2	64.2
Life insurance	36.2	7.9	4.3	51.4
Long-term disability	18.6	8.2	5.9	67.1
Short-term disability	23.8	11.5	4.6	60
Pension	15.6	17.9	3.1	63.3
401K	10.1	29.7	5.5	54.3

According to Cambridge, Mass.-based Cognetics Inc., which studies employment trends, companies with 100 or fewer employees created 85 percent of all new jobs from 1994 to 1998.

Firms with 20 to 99 employees, which many OCS operators regard as their target customer base, achieved an 8.1-point job growth rate in the 1994-to-1998 period. This represented far less than the 18.7-point job gain job achieved by companies with 1 to 19 employees, but nonetheless represented significant growth.

Service firms, which tend to employ white collar workers, created more jobs than any other employer group. This includes the legal, accounting, engineering, advertising, hospitality, health care, equipment leasing, education, social services, and other industries.

Economy creates more customers

The swelling population of office workers also drove at-work coffee consumption, according to the National Coffee Association. The NCA reported gains in 1999 for both away-from-home and at-work coffee consumption, particularly among young adults.

More than a third (34 percent) of young adults (25 to 29) drank coffee at work versus 18 percent of all coffee drinkers. Consumers 18 to 29 drank more coffee than those over 30 and were more likely to use a cup larger than 8 ounces, the NCA noted.

Despite all of these factors, coffee as a percentage of total OCS sales fell slightly in 1999/2000. The OCS industry has only begun to capitalize on specialty coffee, which, as already noted, accounted for a big percentage of the new coffee sales. Soft drinks and bottled and filtered water, by comparison, posted gains in OCS.

Bottled and filtered water grow

Bottled and filtered water continued to lead noncoffee product growth in 1999/2000. OCS operators initially

expanded into water service as a defensive measure against water service companies.

A third of the nation's bottled water companies are in the OCS business, according to the Alexandria, Va.-based International Bottled Water Association.

As noted in previous Coffee Service Market reports, OCS operators' efforts to expand into office supplies have not led to a significant OCS presence in the office supply industry. The National Coffee Service Association (which merged with the National Automatic Merchandising Association in 1999) and the National Beverage Products Association both sponsored programs to help OCS operators expand into office supplies in recent years. The NBPA has since introduced a program to help OCS operators market office supplies over the Internet.

Few OCS firms add office products

The handful of OCS operators who expanded into office supplies found it necessary to establish dedicated operations to market office supplies.

Most OCS operators were discouraged from adding office supplies by the low profit margins and the need to sell a much larger number of products than they were used to selling.

They became even more reluctant when they realized office supply companies weren't taking away much of their OCS business. While many office supply retailers offered coffee in their catalogs, few actually provided coffee service.

The higher cost of operating an OCS business significantly curbed the flow of

OCS business startups in the last two years. In addition, the pace of consolidations among OCS operators also ebbed. The leading acquisition players — ARA Services Inc. (now known as ARAMARK), Standard Coffee Service Co. and U.S. Office Products Inc. — all curtailed acquisition activity significantly to focus on improving their existing operations.

Compensation improves

The survey reported gains in compensation for OCS owners and employees. While the survey did not measure profitability, OCS operators interviewed reported no major product cost increases, although most noted increases in wages, health care, fuel, and paper and plastic products.

The report indicated OCS operators are providing fewer benefits than they did last year. While different sample bases were surveyed in 1998/1999 and 1999/2000, the responses nonetheless indicated that fewer companies offered as much in the way of dental care, life insurance, long-term disability, short-term disability, profit sharing and maternity leave in 1999/2000.

The higher cost of benefits, particularly medical benefits, is a logical explanation for this change.

OCS positioned for strong future

The results of the Coffee Service Market report for 1999/2000 indicate positive trends carried over from the previous two years. The OCS industry has learned from its past mistakes and has committed itself to a better quality product.