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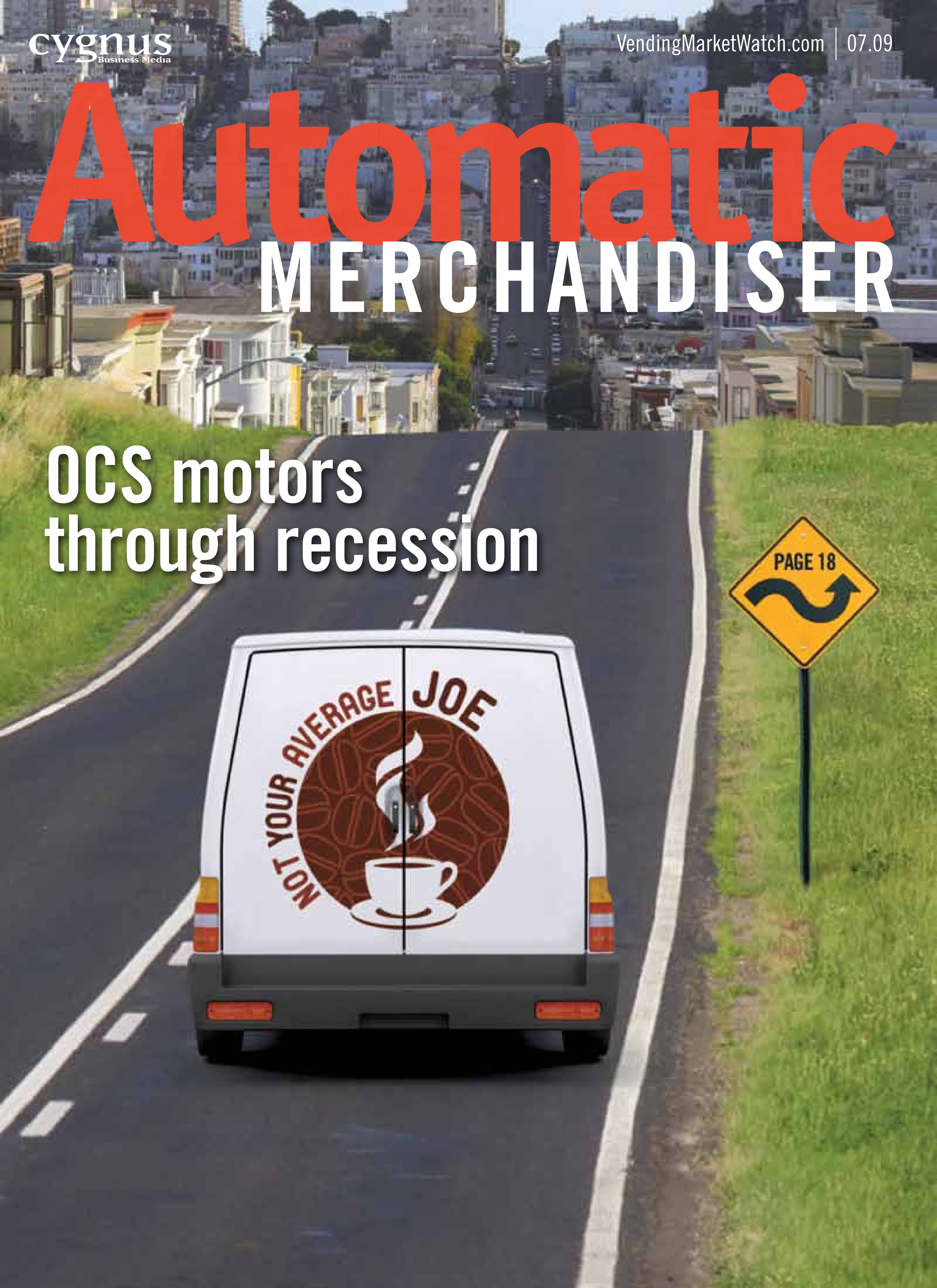
Automatic MERCHANDISER

OCS motors through recession



Recession tests management skills

By Elliot Maras, Editor

OCS sales fall for the first time in five years due to recession. The long-term outlook remains positive as consumers continue to appreciate good coffee.

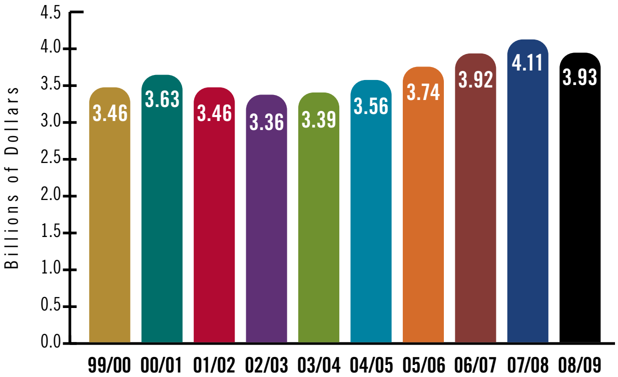
The party is on hold, but it's by no means over. A recession has shaken the U.S. economy and tripped the OCS industry's 4-year growth curve, but operators and suppliers remain hopeful growth will return. In May, some economists claimed there were signs of recovery.

OCS operators have not responded to the economic downturn in a reckless manner. Like many of their customers, OCS operators have adjusted their service schedules, reviewed their operating expenses and reduced overhead to protect profitability.

In 2008/2009, OCS sales posted a 5 percentage point decline from the prior 12-month period, marking the first setback since 2003/2004. OCS revenues totaled $3.9 billion in 2008/2009, according to the 2009 *Automatic Merchandiser* State of the Coffee Service Industry Report.

The 4-year gain from 2003/2004 to 2007/2008 was the longest consistent growth trend in the industry's history, driven by higher pricing and investment in better quality products and equipment. The percent of operators raising coffee prices declined in 2008/2009, but most operators still raised prices, continuing a trend that began in 2004/2005, as shown in chart 3A.

CHART 1: OCS REVENUES — 10-YEAR HISTORY



The use of single-cup brewers, which have played a big role in the industry's growth in recent years, remained high at 18 percent of all brewers in 2008/2009, slightly less than the all-time high of 19 percent the prior year.

OCS sales have fallen as a direct result of declining worksite populations and employer cost cutting. The nation's unemployment hit 9.4 percent in June of 2009, the highest level since 1982. Location managers have mandated across-the-board cutbacks in operating expenses, including OCS.

In addition to reducing staff, many employers cut hours for remaining employees, further reducing the need for OCS.

FINANCIAL SECTOR TAKES A HIT

Layoffs in the financial services sector were particularly devastating to OCS since these employers are better than average OCS customers. Challenger, Grey & Christmas Inc., an outplacement consultancy, reported that financial sector job cuts jumped from 153,105 in 2007 to 260,110 in 2008, after nearly tripling in 2007 from the prior year.

The most common scenario OCS operators faced in the last 12 months was having customers tell them they need to cut OCS expenses by anywhere from 10 to 20 percent. Such a scenario presented a challenge, but not a disaster, since it allowed the operator to still service the account profitably.

Operators claimed that employers still want to provide good quality coffee, reflecting the overall consumer appreciation for coffee that OCS operators themselves helped to build in recent years.

In such situations, operators offered less expensive coffees and/or reduced ancillary products. These actions were evident in the survey results.

The percent of private label coffee sold rose to its highest level in more than five years, shown on chart 5, indicating OCS operators are using private label to offer a good quality coffee at a reduced cost. Private label has always been a tool for operators to provide better quality coffee at less cost than national brands.

OPERATORS HELP CUSTOMERS REDUCE COSTS

An *Automatic Merchandiser* reader survey in March found that switching to a less expensive coffee was the most common way to help customers reduce OCS costs. Close to 40 percent of operators took this approach, followed by 24.8 percent who reduced non-coffee products, 16.8 percent who found other methods, 8 percent who added payment mechanisms, 6.6 percent who lowered coffee prices, and 5.1 percent who lowered prices for non-coffee products.

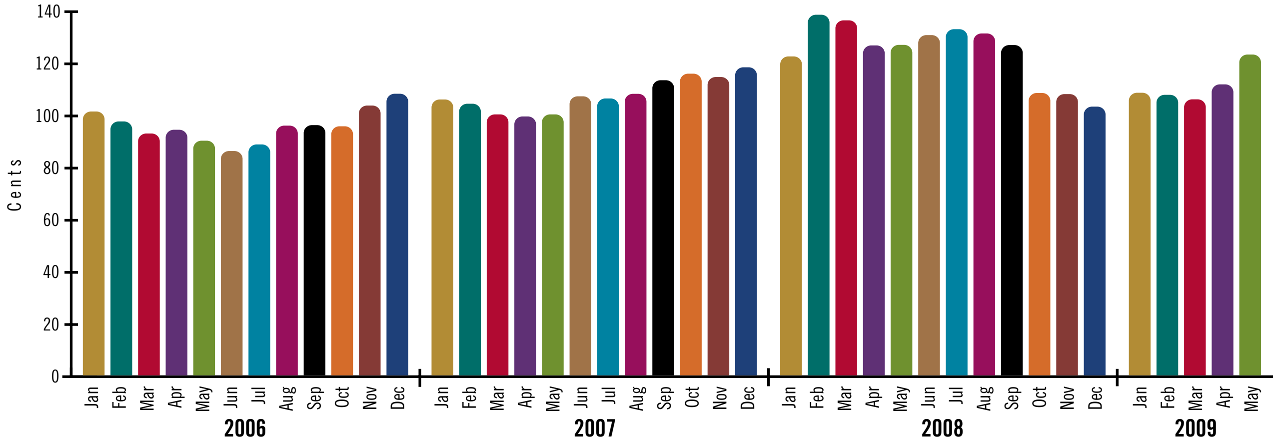
The 3.58-point gain in private label came at the expense of national brand coffee in 2008/2009. National brand coffee posted a decline in all but one of the last five years.

When national brand posted a 2-point gain in the previous 12-month period, some observers noted the impact of national coffee house brands. The coffee house brands introduced in recent years offer a higher selling price than the more traditional national brands.

OCS operators have found coffee house brands a good sales tool since it allows them to offer popular products and also capitalize on retail advertising.

OCS operators have also used coffee house brands as a tool to market less expensive private label coffee. By offering a private label coffee similar in quality to a coffee

CHART 2: COMPOSITE GREEN COFFEE PRICES, 2006 TO MAY 2009



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

OPERATOR PRICING ACTIVITY

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

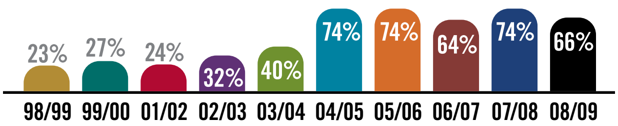


CHART 3C: REVENUE PER CUP IN CENTS PER CUP, 10-YEAR REVIEW

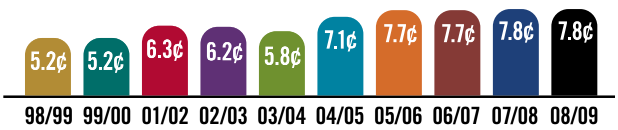
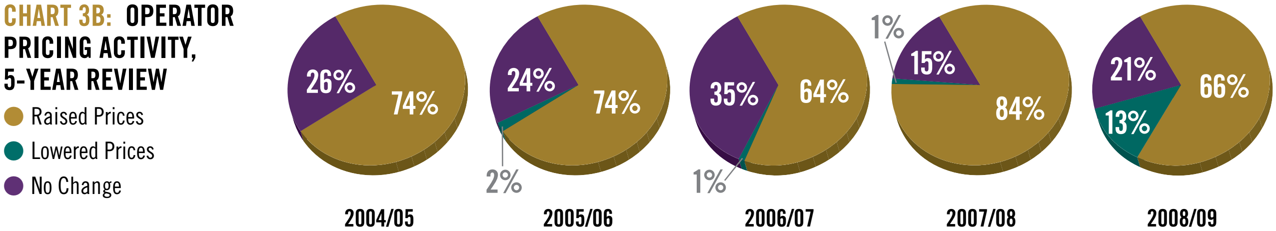


CHART 3B: OPERATOR PRICING ACTIVITY, 5-YEAR REVIEW



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house brand, the operator can provide coffee house quality coffee at a lower cost.

Renewed customer interest in cost management made OCS operators more cognizant of the need to maintain good customer relations in the past 12-month period. Customer relations has always been a key point of difference in OCS. Customer service gives OCS a point of distinction against retail coffee outlets.

Operators have always pointed to customer service as a value that customers cannot get from a retail channel that doesn't offer it.

This point of difference — customer service — proved critical in the recession as more competing outlets — membership warehouse clubs and office supply retailers — offered more coffee products.

DECISION MAKERS FOCUS MORE ON COSTS

Operators noted the recession did bring some new factors to consider when selling their service to customers. Decision makers were more focused on cost. Hence, it was necessary for operators to communicate the full value of their service, as well as offer lower cost options.

The recession did affect the premium that many customers have historically placed on employee satisfaction. Many operators noted that higher unemployment made some employers feel it was less important to provide employee perks. Operators understood this customer sentiment since they themselves, as employers, experienced the same thing in their own operations: employees were more concerned about their job security and therefore demonstrated more commitment to their employers.

Operators had to remind account decision makers that OCS directly impacts employee productivity. They also needed to point out that OCS provides a tangible benefit and is less expensive than other employee benefits.

Single-cup brewers, the OCS industry's key tool for meeting the demand for coffee house quality in a convenient manner in the workplace, continued to gain placements in 2008/2009, despite the recession.

Operators in large urban markets where single-cup has been well established reported less growth in single-cup placements than did rural markets. Equipment manufacturers reported placing more machines in rural markets where single-cup is less established.

CHART 4: ACCOUNT POPULATIONS BY SIZE, 2008/2009

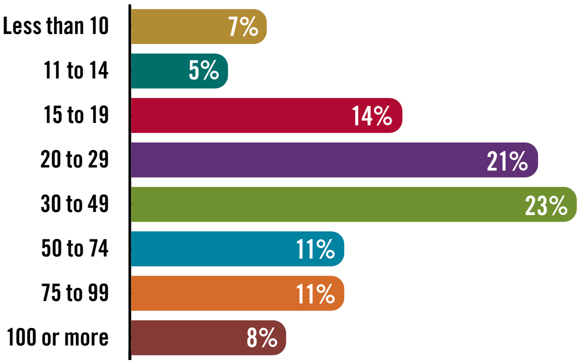

CHART 5: OCS SALES BY PRODUCT CATEGORY, 5-YEAR REVIEW

	2004/05	2005/06	2006/07	2007/08	2008/09
Private label coffee	23%	20%	23%	23%	27%
National brand coffee	45	38	33	35	31
Espresso/cappuccino	4	4	3	3	2
Other coffee*	0	9	8	8	9
TOTAL COFFEE	72	71	68	69	69
Other hot beverages	0	6	7	5	6
Soft drinks/juices	4	7	6	4	3
Bottled/filtered water	6	4	5	5	5
Creamers/sweeteners	6	5	6	7	7
Cups/paper products	5	5	6	6	6
Other	1	4	3	3	4

*Includes varietal, flavored and whole bean coffees.

CHART 6: OCS BREWER BREAKOUT BY TYPE, 5-YEAR REVIEW

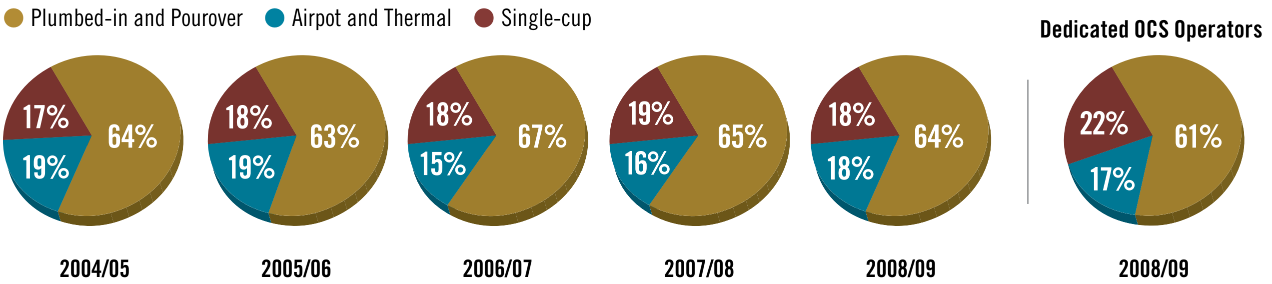

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CHART 7: ESTIMATED SINGLE-CUP BREWER PLACEMENTS IN THE U.S., 5-YEAR REVIEW

Editor's Note: Each number represents total accumulated placements as of the given date.

MARKETER	PRODUCTS	2004/05	2005/06	2006/07	2007/08	2008/09
Bodecker Brewed	Bodecker	0	300	2,100	2,600	3,100
Café Excellence LLC	Café X Milano	146	250	250	250	250
Cafection	Avalon	22,500	24,350	28,150	32,150	36,500
Cafejo	Cafejo	1,700	5,250	11,250	16,250	23,000
Crane	Café System, Genesis	12,000	11,150	12,150	13,150	13,150
Filterfresh	Filterfresh	25,000	18,030	18,040	18,050	18,100
Grindmaster	Grindmaster	0	0	NA	NA	10,000
Keurig	Keurig	87,244	130,629	211,821	345,712	378,420
Kraft Foods	Gevalia	2,200	3,500	3,500	3,900	3,900
Lavazza	Espresso Point, Lavazza Blue	NA	NA	NA	17,000	21,000
Mars Drinks	Flavia	90,000	140,000	250,000	362,500	362,500*
Newco	Smartcup	300	1,000	1,800	1,800	1,800
Rheavendors	Lionness, Cino, NOI	1,500	2,694	3,194	3,644	4,373
Saeco USA	Saeco, Estro	20,000	22,000	24,200	26,400	27,705
Sara Lee	Douwe Egberts	500	775	775	2,325	3,000
Starbucks	Starbucks Interactive	1,300	2,000	5,000	7,500	8,000
VE Global Solutions	Venus, Cypris, Juno, Prosyd	5,000	9,500	12,500	16,500	18,800
VE Global Solutions	Brio, Colibri, Koro, Korinto, Konvivo	25,000	34,000	42,000	51,500	59,600
Wolfgang Puck	CafeXpress	0	0	0	1,000	5,000
Other		4,200	6,800	6,800	6,800	3,500
Total		298,590	412,228	633,530	929,031	1,001,698

* Includes at-home brewers.

In some cases where locations downsized, operators removed single-cup machines and replaced them with batch brewers.

Most operators claimed they were able to maintain single-cup machines in spite of downsizing. This demonstrates the value that customers place on single-cup. Single-cup brewers generally deliver a better quality coffee and are easier for employees to use.

Airpot and thermal carafe systems also gained at the expense of traditional pourover and automatic batch brew systems, as indicated in chart 6.

CARTRIDGE SYSTEMS CONTINUE TO LEAD SINGLE-CUP

The cartridge-based single-cup systems continued to lead the growth in single-cup. Cartridge-based systems are more compact than hopper-based systems and require less initial investment. They also offer considerably more product variety.

While cartridge-based systems require less initial investment, the cost on a per-cup basis is higher than for a hopper-based system. Some operators noted that with customers looking for ways to reduce expenditures, the hopper-based systems offered a solution. The hopper system allows an operator to continue providing high quality coffee to the account at a lower cost to the account.

However, the leading cartridge systems have gained strong brand equity in recent years, which has made operators reluctant to switch to other systems.

HOMEOWNER SINGLE-CUP SYSTEMS CONCERN OPERATORS

The expansion of some of the cartridge systems into the consumer market has concerned some operators. Single-cup consumer units, which are mostly cartridge systems, rose from $66 million in 2004 to $225 million in 2008, and are the only growth segment of the homeowner coffeemaker market, according to *Homeworld Business,* a magazine which tracks homeowner appliances.

On one hand, the growth of the consumer single-cup market has supported the demand for these systems in the office.

On the other hand, this growth has raised concerns about consumers pilfering cartridges in the office as well as concerns about customers buying their office coffee from other sources.

Veteran operators note that such concerns are not new in OCS. Customer location managers have always had

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CHART 8: ACCOUNTS BY TYPE, 5-YEAR REVIEW

	2004/05	2005/06	2006/07	2007/08	2008/09	PERCENT OF SALES BY LOCATION TYPE, 2008/09 All respondents	Dedicated OCS operators
Offices	64%	54%	63%	54%	58%	54%	61%
Business and industry	16	23	20	24	18	20	5
Restaurants, delis, bakeries	4	4	3	3	4	5	11
Convenience stores	4	4	3	4	5	5	5
Government/military	1	3	1	1	1	2	3
Schools/colleges	1	4	5	6	4	6	8
Retail outlets	3	3	2	2	1	1	0
Other (health care/hotels)	7	5	5	6	8	7	6

to make sure employees don't steal coffee, and operators have always had to make sure customers don't buy product elsewhere.

MOST OPERATORS RAISE PRICES

While customers wanted to cut costs, operators still protected their margins, as indicated in the number that raised prices.

Fewer operators raised prices and more lowered them in the last 12-month period than in any of the previous four years as shown in chart 3B, but 66 percent still raised prices.

While OCS pricing was competitive, the retail environment helped OCS operators raise prices. Major retail roasters raised prices early in 2009 in response to higher costs of Colombian coffee.

More than a fifth of the respondents, 22 percent, reported adding payment mechanisms to brewers. This is the first year the survey asked the question, making it impossible to measure any change in the level of this activity.

Most operators indicated a slight increase in the number of customers asking for payment mechanisms in 2008/2009. Operators usually try to discourage this because it cuts consumption, as well as increases service calls and, in cases where the OCS operator services the brewer, requires currency collections and accounting.

In response to these requests, some operators provided the payment mechanism but let the customer collect the money. This frees the operator from dealing with collections and allows the customer to recover some of the cost.

OPERATORS PASS ON FUEL CHARGES

Operators passed on fuel charges for the second straight year in 2008/2009. More operators introduced fuel charges than last year, as indicated in chart 9A: 13 percent more operators charged for deliveries in

FUEL CHARGE ACTIVITY

CHART 9A: COMPANY HAS BILLED CUSTOMERS FOR FUEL

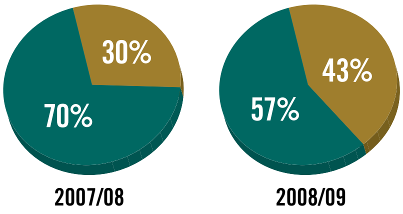


CHART 9B: HOW MANY CUSTOMERS WERE BILLED FOR FUEL

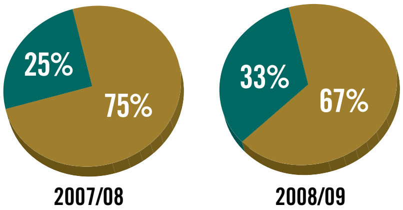


CHART 9C: HOW OFTEN CUSTOMERS WERE BILLED FOR FUEL

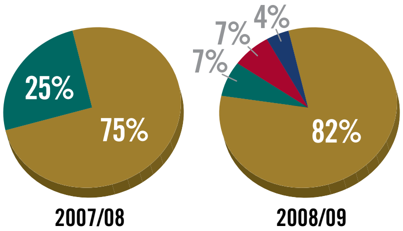


CHART 9D: AMOUNT CHARGED FOR FUEL PER DELIVERY

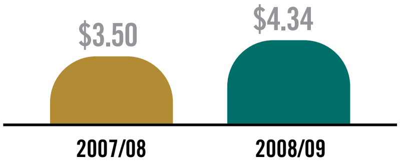
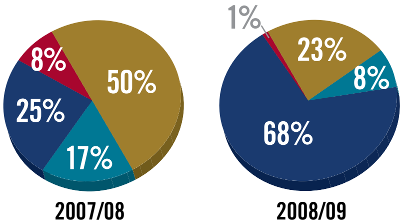


CHART 10: HOW RISING COSTS ARE BEING HANDLED



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2008/2009 than the prior year. This represents a significant cost recovery action, given the decline in fuel costs over the past year.

Operators also charged an additional 76 cents per delivery this year, as indicated in chart 9D.

Price increases were one of several cost recovery actions in 2008/2009. Most OCS operators reported raising prices and absorbing higher costs, as indicated in chart 10.

Staff reductions were fairly common among operators: 45 percent reduced staff while 14.5 percent added staff and 40.5 percent reported no change.

Staff reductions mostly affected delivery personnel, as indicated in chart 11B. This is consistent with the earlier reader survey, which reported less frequent deliveries as the most common action to improve account profitability. Close to half (46.8 percent) of the operators who took action reduced deliveries, compared to 34.3 percent who added products and services, 13.6 percent that took other methods, and 5.3 percent who added brewers.

Among the 14.5 percent who added staff in 2008/2009, most (56 percent) added sales personnel while 44 percent added delivery personnel. Operators recognized the need to maintain good customer communication to protect sales.

EMPLOYEES SHOW MORE COMMITMENT

Like their customers, operators noticed stronger employee commitment as workers valued their jobs more in a recession. In 2008/2009, many operators noticed a reprieve from the perennial problems of high employee turnover.

Operators welcomed improved employee commitment as the demands of OCS have become more challenging in recent years due to the need to become knowledgeable about more products and equipment.

Staffing actions were one area of difference found between dedicated OCS operators and vending operators with OCS operations. (Vending operators who do OCS represent the majority of both the number of operators and amount of sales, but dedicated

CHART 11A:
HAVE ADDED OR REDUCED STAFF IN THE LAST 12 MONTHS

- Added
- Reduced
- No change

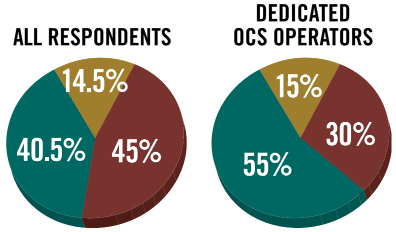

CHART 11B:
IF ADDED STAFF, IN WHICH AREAS?

- Sales
- Delivery

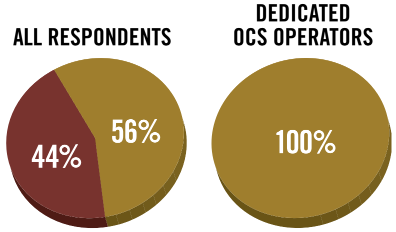

CHART 11C:
IF REDUCED STAFF, IN WHICH AREAS?

- Sales
- Delivery
- Repair
- Warehouse
- Office

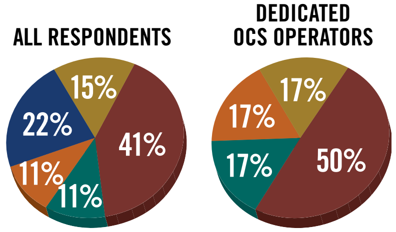

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CHART 12: ADDED PAYMENT MECHANISMS TO BREWERS

Yes · No · Don't know

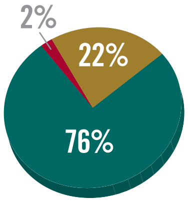


CHART 13A: HAVE ADDED PRODUCTS THAT ADDRESS ENVIRONMENTAL CONCERNS

- Yes
- No
- Don't know

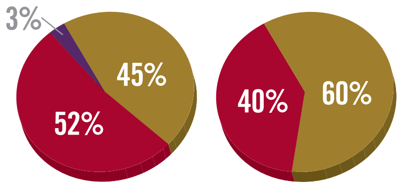
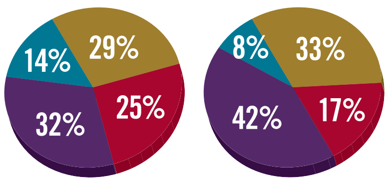


CHART 13B: PRODUCTS ADDED THAT ADDRESS ENVIRONMENTAL CONCERNS

- Recycled products (cups, filters, pods, utensils)
- Water filtration devices to reduce bottled water
- Coffee with sustainability features
- Other



OCS operators continue to do more OCS business on a per-company basis.)

Dedicated OCS operators sustained staffs more than vending operators with OCS operations, which indicates dedicated OCS companies have a better chance of maintaining and adding sales.

In comparison to the overall respondent base, more dedicated OCS operators added staff (15 percent compared to 14.5 percent) while only 30 percent reduced staff.

Operators offered mixed views on the importance of environmental benefits. Some claim customers are interested in these benefits, while others claim customers are not willing to pay additional costs for them.

OCS OPERATORS ADDRESS ENVIRONMENTAL CONCERNS

Dedicated OCS operators were more active in offering environmental benefits than vending operators with OCS operations in 2008/2009. Sixty percent of dedicated OCS operators added products to address environmental concerns compared to 45 percent of all respondents.

Environment-enhancing products include recycled products (cups, filters, pods and utensils), water filtration devices to reduce single-serve bottled water, and coffee with sustainability features (organic, Fair Trade, or bird friendly).

Sustainability is one of the benefits of the coffee pods that have been on the market for several years. Pod-based systems were introduced as an economic alternative to cartridge-based single-cup systems and also offered sustainable coffee packaging.

Many operators are reconsidering pods as an economic alternative to cartridge and hopper systems. Pods offer the product variety of cartridges and cost less. In addition, an operator can source pods from a variety of roasters, whereas with cartridges, he can't.

Many operators believe that environmental benefits will become more important when the economy improves and customers become less concerned about costs.

APPRECIATION FOR GOOD COFFEE REMAINS STRONG

Helping operators argue their case for providing good quality coffee is the fact that consumer appreciation for the product remains strong, according to consumer research.

Daily consumption of coffee beverages among consumers remained consistent in 2009 with 54 percent of the overall adult population partaking, according to the National Coffee Association (NCA) 2009 National Coffee

Drinking Trends survey. This is statistically on par with the 2008 figure.

Additionally, cups-per-drinker and cups-per-capita continued to hold at the level from 2008 and the previous four years. The NCA reported the number of consumers who drink coffee at work remained consistent at 18 percent, while fewer are partaking in restaurants (5 percent) than in 2008 (8 percent).

If the economy does improve, OCS operators will find a stronger demand for their services, and the positive sales trend of the previous four years will return.

In the meantime, OCS operators must continue to invest in their staffs and their products and equipment. The retail coffee environment has become more competitive than ever, with retail and foodservice operators competing more aggressively for consumer coffee sales.

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 operations.