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# Out-of-Home Coffee Delivers Growth

*A Look at Innovation Around the Globe*

## RaboResearch

Food & Agribusiness  
far.rabobank.com

### Jim Watson

Senior Analyst – Beverages  
+1 (212) 916-7943

### Sudip Sinha

Senior Analyst – Beverages  
+65 6230 6772

### Stacie Wan

Analyst – Beverages  
+86 189 1875 3025

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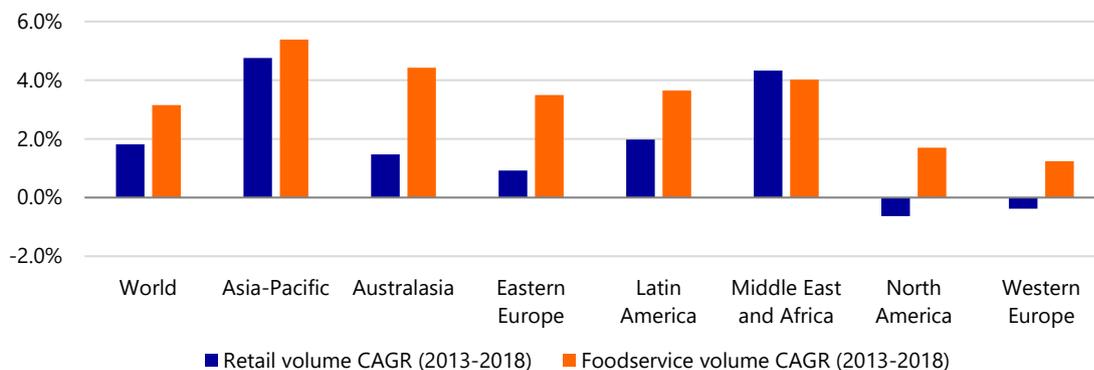
## Summary

Out-of-home coffee is increasingly about brands, innovation, experiences... and then coffee. We believe the next wave of growth in out-of-home coffee will be driven by innovation and expansion outside of the core coffee offering, focusing on areas such as better food (through partnerships), new approaches towards coffee real estate, the growth of digital platforms, and new packages and machines for coffee.

## Three Drivers of Change

The out-of-home (OOH) coffee segment is undergoing a massive shift on a global scale. We are expanding and evolving away from the traditional coffee shop to an ultra-competitive landscape where innovation across product offerings, packages, route to market, and customer connection are crucial to success. This matches the evolution of the consumer who views coffee as a branded good, not just a commodity.

**Figure 1: Foodservice coffee growing faster than at-home coffee, 2013-2018**



Source: Euromonitor, Rabobank 2019

To understand how OOH coffee is changing, we are focusing on three key trends:

The first is the evolution of the coffee shop, which is driven by intense competition within coffee and from established foodservice operators rapidly improving their coffee offerings.

Second, we focus on the joint trends of convenience and technology. Consumers are demanding convenience in every aspect of their lives, including how they get their coffee. While the coffee industry is developing new technologies to meet these needs, the rollout is still in its early stage, and it varies wildly across companies and sub-segments.

Finally, premiumization is always a driver of change in beverages, but we want to highlight a few specific areas in which we expect the biggest changes, especially in emerging markets and less-developed coffee segments.

We have chosen to use examples from around the globe to highlight these trends and have been surprised as to how truly global many of these trends are. Companies should be looking for best practices from around the world, and they should be open to importing creative ideas from abroad. Even if, in the end, coffee preferences remain local, the digital and delivery platform might be global.

## Evolution of the Coffee Shop

At the core of the changing OOH coffee market is the evolution of the coffee shop. We see some types of coffee shops at risk of being subsumed into the broader quick-service restaurant (QSR)/convenience space, and, therefore, the effort needed to stand out from the crowd is increasing. Standing out in this competitive landscape will require capabilities beyond standard coffee offerings: better food, digital connectivity, increased convenience, and speed, among other things.

Many coffee shops are becoming more flexible and creative in how they approach the footprint/locations of their stores. This is mirrored in the new ways retailers/convenience spaces are building out coffee options across their own real estate.

What a coffee shop means to the parent company is changing as well, especially as more companies feature a wide portfolio of products, spanning both coffee shops and packaged goods. Within a coffee portfolio, the coffee shop stands out as a unique source of brand-building, consumer insights, and innovation testing.

Here are five themes we want to focus on to show the global nature of the changes in the coffee shop world:

### **(Good) Food Is an Increasingly Necessary Part of a Coffee Shop**

Correspondingly, an elevated coffee offering is ever more attainable for bakeries and sandwich shops. We see a convergence between the coffee and bakery segments, as more locations realize the power of combining coffee and food. This echoes the way that ready-to-drink (RTD) coffee is learning from and moving closer to the rest of the soft drink segment.

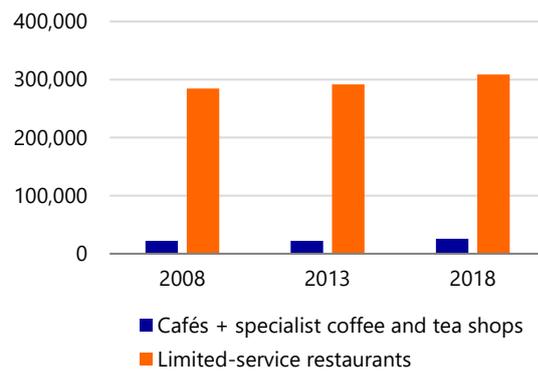
In Brazil, two of the faster-growing coffee chains are Cacau Show and Copenhagen – both confectionary companies that sell coffee. This competition requires a real response from coffee shops. In Mexico, Alsea (the Starbucks franchisee) implemented a baking store project to improve quality across its stores and noted that all upgraded stores “achieved improvements, performance in ticket, and an increase in transactions.” For those coffee chains with the density to support centralized commissary kitchens, we expect a move in this direction.

Expanding the drinks menu is an equally interesting way to attract consumers during different parts of the day. Caffè Nero has partnered with Fever-Tree for espresso tonics – a great refreshing afternoon drink that also leverages the power of a partnership with an outside brand. Partnerships (whether in drinks or with a bakery) are a great way to acquire capabilities outside of core coffee, as well as brand equity.

### **Massive Competition From Quick-Service Restaurants and Even Gas Stations**

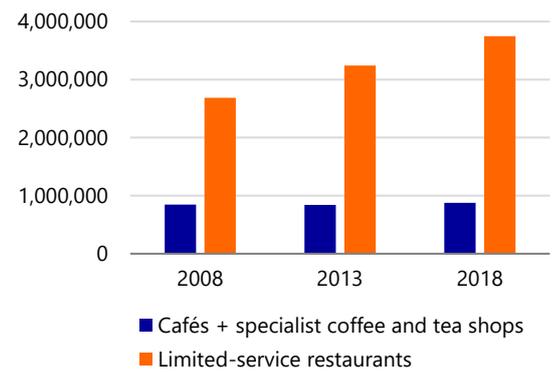
It is getting easier and easier for non-coffee companies to develop a good (to great) coffee menu, and QSRs are quickly figuring this out. The challenge this presents to coffee brand owners is that QSRs greatly outnumber coffee shops.

Figure 2: US outlets by type, 2008-2018



Source: Euromonitor, Rabobank 2019

Figure 3: World outlets by type, 2008-2018



Source: Euromonitor, Rabobank 2019

McDonald's has almost as many locations in the US as Starbucks, and it has a very well established and advertised coffee program. Beyond QSRs, gas stations such as Cumberland Farms already have consumers coming through their doors at peak coffee-drinking hours. They feature a fairly extensive (and premium) coffee selection and can even compete against coffee shops with a monthly subscription service.

This raises the risk of non-coffee companies using coffee as a loss leader and stealing share from coffee-first companies. The best example (scariest if you are a coffee company) is the monthly coffee subscription plan from Burger King. For five dollars a month, consumers get one small coffee per day in-store. QSRs don't need to make money on coffee if it drives traffic during off-peak hours (like breakfast). Using beverages as loss leaders has a long history – like soft drinks in the grocery channel – and this trend is worth watching, even if examples are limited for now.

### New Coffee Brands Coming From Unexpected Places

An equal risk to QSRs promoting coffee options is other store (real estate) owners building their own coffee options. When Musgrave wanted to overhaul the coffee offering at its Centra and SuperValu stores in Ireland, it didn't look for a coffee partner – it started its own brand named Frank and Honest. The brand is now available in 630+ franchised locations through self-service automatic coffee machines. Frank and Honest has expanded to numerous types of packaged coffee and opened a number of in-store cafés, and the second stand-alone coffee shop is due to open shortly, all in support of growing the brand.

Café Amazon was started by the leading Thai fuel retailer PTT Group in 2002 to enhance customer experience at the gas station. The brand now has over 2,000 stores across Southeast Asia, and it has expanded the brand beyond the gas station to malls and other locations. Café Amazon also started the forecourt food & beverage trend in Thailand, with other fuel retailers following suit with their brands. PTT Group plans to list the retail business separately and has the ambition to become a global café business. Similarly, BP has taken its café concept global with Wild Bean Cafes across the UK, Europe, Australia, South Africa, China, and Russia.

It's worth pointing out here that the low coffee prices we have seen over the last several years certainly provide a boost for retailers looking to start their own coffee operations, but starting on good footing in terms of rent and foot traffic is probably more important. While these retailers have had success going on their own, we see much more room for collaboration with existing coffee shops, who need to be more aggressive about partnerships. EG Group, an independent fuel station and convenience retailer, provides a great example of a company with a large retail footprint that partners with big brands across the food & beverage landscape.

## Co-Location Partnerships: A New View of Real Estate

Coffee companies are pursuing new avenues to find cost-efficient space, and this goes beyond just limiting the square footage. Peet's Coffee has a deal in the US with Capital One to operate in 40 locations. This is a lower-cost way for the coffee company to open new locations, and a way for the bank to bring in new potential customers and improve its brand image.

In India, Brewberrys works on an 'evergreen model,' seeking partnership with large employers or business parks with access to a large captive audience that ensures high average footfall and sustainable long-term business. An exclusive arrangement allows the business to invest in the supply chain to serve the specific partner's requirement and offer a customized menu.

Partnerships can (and should) be an explicit part of the growth strategy. They lower the cost of expansion and provide access to customers outside of the typical coffee shop occasion.

Thinking outside the typical coffee shop box, Dutch Bros. Coffee chain, located in the western US, is working with drive-thru locations and has attracted funding from TSG Consumer Partners to help its expansion, from 300 stores to 800 by 2023.

Starbucks, which has long been creative about opening differently-sized locations (like kiosks) in high-traffic areas, is going further in support of delivery programs in China. The company is partnering with Hema grocery stores, part of the Alibaba group, to open kitchens to support delivery.

Likewise, Havanna, originally an Argentine sweets company, has invested in the 'store-in-store' concept in Brazil, where coffee shops are based in libraries, hospitals, banks, or commercial buildings.

Combined with the food example above, we could foresee a trend towards divergence in coffee shops moving forward. Those with more standard locations will likely focus more on coffee plus food, while coffee-first offerings will increasingly shift to smaller, more agile locations.

## Coffee Shop as Marketing Tool and Innovation Lab

Out-of-home coffee is where you build brands. Coffee companies are leaning into this explicitly, with a focus on stores meant primarily to raise the image of the broader brand portfolio.

Nespresso was an innovator in the space, and the Starbucks Roastery has taken this to its giant, beautiful 'temple to coffee' conclusion. But for brands like Blue Bottle, Stumptown, and Intelligentsia – who feature a smaller number of shops and a larger at-home/wholesale/RTD presence – upscale, trendy coffee shops provide a way to raise brand equity/awareness with a new set of consumers. This is about finding at-home consumers in a different place (outside of the grocery channel), where the brand fully has the ability to showcase its premium qualities.

For coffee companies with a broader portfolio of packaged goods, coffee shops also serve as innovation and testing labs for new flavors and products. Starbucks utilizes information from coffee shops to be more nimble about picking new flavors for a nationwide rollout of a new RTD coffee product.

## Convenience and New Technology

Waiting for customers to come to you is an outdated strategy. We highlight here how companies are going out to reach the customers where they are. Out-of-home coffee is one of the most innovative areas across the entire beverage category, combining new ideas and technologies to drive innovation in digital platforms, route to market, production, and product format.

Some of this is an outgrowth of the rising competition that is forcing coffee shops to find new avenues to compete, and some of this reflects broader changes in the food-and-consumer space being adopted by savvy coffee companies.

## The Digital Revolution Is Just Getting Started

A strong digital presence will be core to running any mass-market coffee shop soon – if it isn't already. New technology provides convenience and speed, as well as customer insights and loyalty. Loyalty apps, especially those tied to mobile order-and-pay capability, are the bedrock of the digital coffee shop. The use is widespread – from Starbucks and Caffè Nero in mass markets to Gregor's Coffee in specialty markets, as just a few examples. The daily habits of a morning coffee drinker align well with the convenience and rewards, while the data going back to the company and the ability to target new promotions is immensely valuable in driving new business. In the US, Starbucks reported that the Mobile Order & Pay feature of their app accounted for 14% of transactions last year.

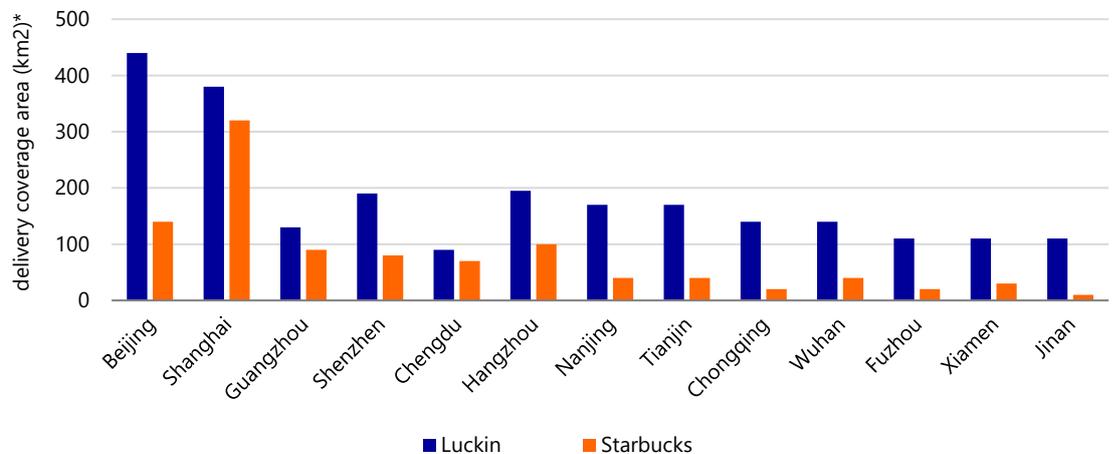
Companies can go even further with digital. In China, Pacific Coffee has teamed up with IBM to outfit its LUXE flagship with digital menus, tabletop ordering, smart shelves, and handheld devices for baristas.

## Is Delivery the Next Phase?

Delivery, at least at a mass scale, is rather new to the coffee world, but the rapid growth of Luckin Coffee has turned delivery into a major area of interest. Luckin has opened up over 3,000 stores in China since the start of 2018 and has a valuation of USD 4.7bn – all on the back of a delivery-centric (low store overhead) business.

And the trend goes beyond Luckin. Coffee is a top delivery item in Mexico through Rappi, and, after partnering with Alibaba inside China, Starbucks is rolling out 16 test markets for coffee delivery outside of China.

Figure 4: Luckin is covering a lot of ground in China, 2018



Source: company data, broker notes, news run, Rabobank 2019

\* coverage area defined as within 2km radius from the delivery station

Café Coffee Day (CCD) has always been pretty savvy on the marketing front, having created the modern coffee shop format in India. With the increasing penetration of mobile phones and low data costs, the company invested in offering delivery services in 2015, beginning with Bengaluru and later expanding to other major cities. Subsequently, CCD has also partnered up with delivery platforms such as Swiggy and Uber Eats, and industry sources indicate that delivery comprises ~10% of sales.

Companies are working to bring this all together. Starbucks is rolling out Starbucks Now stores throughout China that combine infrastructure to support both Mobile Order & Pay and its delivery platform with a small amount of seating in-store. Luckin is also leaning toward combining the use of delivery with an online-to-offline (O2O) strategy, leading consumers from online

(mobile order and delivery) to offline (pick-up stores) to drive in-store sales. This enables Luckin to expand rapidly with low rental costs and to stay close to the target consumers.

Efficient last-mile delivery is a tremendous challenge across food & beverage, and we feel these initial moves are more about testing new business models than generating profitable growth right now.

## Vending Is a Hot Category

Proper, higher-quality vending machines, like the Frank and Honest example above, open up entirely new channels to hot coffee sales at scale. We expect coffee vending – with a push from Coca-Cola’s acquisition of Costa Coffee – to move into a new phase of growth and availability over the next five years. The Coke-Costa example is important, as the channels best served by vending are often ones that play well with existing soft drink distribution, such as travel hubs, universities, hospitals, and convenience stores.

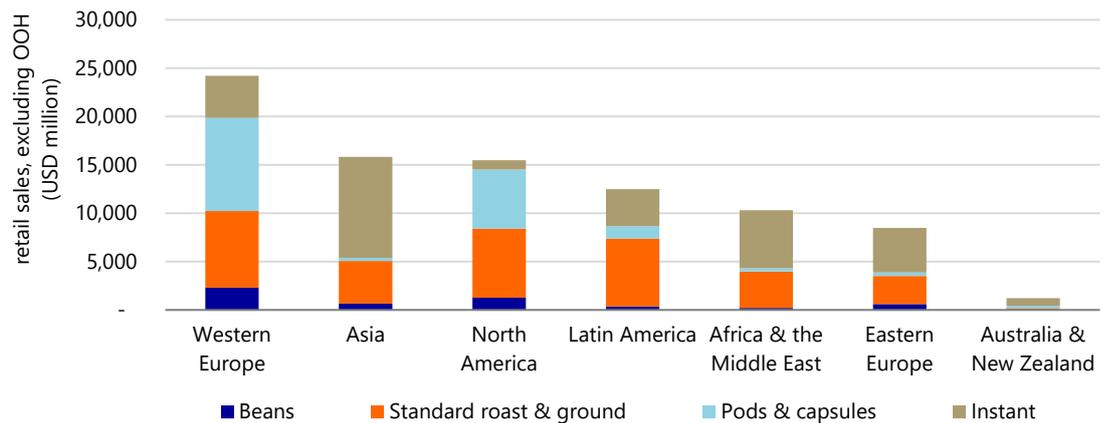
We believe the success (and potential) of the Costa Express vending machine was a key driver of the deal and is an avenue for international expansion. That Lavazza has a significant presence in vending as well only serves to create the competition necessary to speed the rollout of vending platforms – as does the rising cost of labor at coffee shops. Even Luckin plans to launch Luckin Express vending machines in public spaces like campuses in late 2019.

## RTD/Instant

We have written extensively about the potential for [RTD coffee in the US](#). It provides on-the-go convenience with a package and product that supports near endless innovation. It is also a newer space (outside of Japan), where there is significant room for both start-ups and large coffee companies to develop winning brands. (La Colombe saw RTD as a way to compete against Starbucks, where doing so in pure coffee shops would have been too difficult.) With Costa RTD being rolled out in Europe and the announcement of a PepsiCo-Lavazza partnership, we now see investment and excitement coming to Europe, as we have seen in the US for the last five to ten years.

If RTD coffee is leading-edge, then perhaps the instant specialty coffee category is more bleeding-edge. In the US, brands like Voila and Sudden Coffee make clear their specialty coffee attributes, with a view towards getting the best coffee anytime, anywhere. Voila was started from the desire to have better coffee while hiking, but this sort of rising demand for convenience is international. Saturnbird in China is pushing premium instant with beautiful packaging and the ability to make instant cold brew, and this comes on top of renovation in existing instant brands, as seen with Nespresso Gold. Instant coffee is a massive category globally, and we believe younger consumers will readily accept a more premium version.

Figure 5: Can some of the at-home instant market shift to out-of-home?, 2018



Source: Euromonitor, Rabobank 2019

## What About E-Commerce?

We'll make a mention here about e-commerce, even though this channel likely sells much more for at-home consumption. Nonetheless, as technology provides new ways to reach consumers, start-up companies like Trade Coffee Co. are taking advantage by building out a specialty coffee subscription platform. This channel also provides a way for new brands to reach consumers and distribute nationally very quickly, and avoids overdependence on selling through grocery store shelves. For instance, RISE Brewing highlighted on our [podcast](#) the speed at which it was able to grow RTD coffee sales on Amazon.

## Premiumization

Premiumization is a permanent driving force of change across the beverage world, but it doesn't affect every sub-segment of the industry in the same way and at the same time. In many areas, coffee does not have a premium end as well developed as other beverage categories (especially alcohol), and out-of-home is where we see most room for coffee to move up the value chain.

## Foodservice/Office upgrade

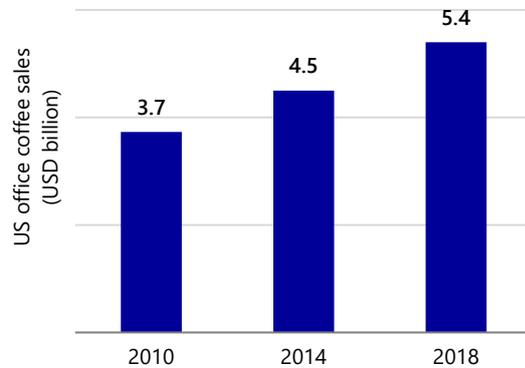
In developed markets, the foodservice and office coffee markets are key places where we see premiumization driving fundamental changes in the consumer experience. We think this will be driven by new machines and technology in the space, as well as by ideas and products imported from the coffee shop/RTD side of the coffee business. The combination of coffee on-tap, bean-to-cup machines, and vending can efficiently cover most of the OOH landscape with premium coffee. The opportunity here is for start-ups with a premium brand to use the upgrades in this channel to help build a new audience and brand equity. As we cover below, the opportunity for larger players is to take share back from private label.

## Machines

New coffee formats are an important way to deliver more premium coffee experiences to consumers. We expect coffee-on-draft to expand rapidly. It's an efficient system that creates an upscale craft beer type of experience (providing novelty to a consumer) that is easier to serve than having a barista pull an espresso. The rollout of illycaffè's new Aria machine in the hotel/restaurant/café (HoReCa) channel is a great example of adding a branded premium option in foodservice that drives the new product segment of nitro cold brew. It also expands coffee into places it doesn't always go – as illy is working with mixologists to use coffee from the Aria in aperitifs and cocktails.

Coffee-on-tap is equally at the forefront of the premiumization of office coffee. However, we think that bean-to-cup machines still have a long way to grow in this market. We have written about this in our note [How Coffee Will Look Different in Ten Years](#) and have seen the emphasis placed on bean-to-cup machines by office-coffee suppliers. The data backs this up.

**Figure 6: Office coffee shows good growth, 2010-2014**



Source: VendingMarketWatch, Rabobank 2019

**Figure 7: Share of office coffee by type, 2018**

Private Label	45%
National brand – value	19%
National brand – specialty	17%
Local coffee (known to consumer)	14%
Espresso coffee	5%

Source: VendingMarketWatch, Rabobank 2018

This just touches the surface of new machines changing the OOH market, where companies like Bellwether Coffee are introducing ventless electric roasters to coffee shops and even grocery stores, as a premium way to show consumers where and how their coffee is being roasted. And, there is a move towards greater automation within coffee shops as a cost-saving initiative, though this runs against the trend of premiumization through personal touch.

### Where Is the Branding in Foodservice Coffee?

Premium beverage experiences generally mean branded experiences – while foodservice coffee leans heavily toward private label in the US and Europe. The traditional ‘cuppa joe’ served at a restaurant is given no extra description on a menu, and the equipment used to make coffee is often hidden from consumer sight. Any occasion where a consumer drinks coffee without knowing anything about it cannot be premium and flies in the face of how virtually every other beverage is consumed.

Many large global coffee players – especially Starbucks, illy, and Lavazza – are pushing hard to premiumize and introduce branding to foodservice coffee. In Europe, we see the next phase, with boutique/specialty coffee roasters supplying their specialty coffee to restaurants and cafés regionally and even internationally.

Certainly, machines with prominent branding that is meant to be displayed to consumers – like the Aria – will help. Coffee-on-draft can use tap handles to show brands to consumers, as is standard in beer. Fundamentally, this is about replacing private-label coffee with branded options, and making sure it is shown in signage and on menus. It’s an obvious, but much underrated growth area for global coffee players.

Both the US and Europe have fragmented and regionalized foodservice and office coffee providers. As branding becomes more prevalent, we expect partnerships with branded coffee companies to become a key to driving growth, and global coffee companies will prefer partners with greater scale.

### Identity Coffee: Making Local Cool in Coffee-Growing Countries

We highlight these as an example of how premiumization might affect the OOH segment in emerging markets. Brazil and Vietnam are the two largest producers of coffee (arabica and robusta, respectively) in the world, yet they do not have robust (pun fully intended) coffee-drinking cultures, especially on the higher end.

In Brazil, we recognize that consumers are rapidly moving towards premium coffee. We can see this not only in the data, but also in the emergence of a coffee shop scene that specifically seeks to highlight and feature local specialty coffee. It is the growth of this culture that is encouraging international roasters to step up investments in Brazil, and we believe this is only in the early stages.

Currently, there are around 13,000 coffee shops in Brazil. Most of them have greater relevance in big cities, and are located in the South and Southeast regions, where around 62% of specialty coffee drinkers live. Beyond Starbucks, franchises – such as Grão Espresso, Fran's Café, Café do Ponto (a JDE brand), Suplicy Cafés Especiais, São Braz, and Café Cultura – all work with premium coffee and have shown an interesting level of expansion. However, most premium coffee shops are independent, representing around 66% of the Brazilian coffee shop market.

In the last few years, third-wave coffee chains have emerged across major Asian cities as well, educating and offering consumers local and regional bean experiences.

Hatti Kaapi – colloquially, the village home coffee – is, amusingly, the place for Bengaluru hipsters! The 60-store chain started by the ex-coffee trader US Mahendar uses beans from the native Chikmagalur coffee farms and offers traditional snacks to accompany the coffee. The cafés are run on a strong community approach, and staffed by senior citizens and differently-abled employees.

On the other hand, Trung Nguyên positioned itself as part of the Vietnamese tradition, offering an international experience to the emerging middle class. Appealing to the aspirations of the Vietnamese middle class, Trung Nguyên successfully created a luxury brand in an emerging market. Similarly, Anomali Coffee successfully positioned itself as the third-wave provenance coffee player in the Indonesian market, operating cafes as a coffee supplier/trader and academy. Doi Chang Coffee is the pioneer of this concept in Thailand. The company operates 200 franchised and licensed stores in Thailand, and it has a strong presence in Canada's third-wave coffee.

An increasing plethora of coffee shops offering local bean experience will likely define the Asian coffee trends of the future.

## Conclusion: The Luckin Wake-Up Call

In the midst of a coffee industry that can be cautious about adopting innovative practices, Luckin Coffee has grown voraciously by using mobile order and delivery, and it is looking towards vending and an overseas operation in the Middle East for expansion. That Luckin's growth has happened in one-and-a-half years shows how excited consumers are, and we might argue that it really shows how excited investors are for a new story in coffee.

The growth of Luckin can serve as a wake-up call for the rest of the industry that innovation is necessary and can provide the needed return on investment. We think that speed to market with new products or business models matters too. In this vein, we expect to see more partnerships or M&A, as coffee companies look to bring in capabilities that lie well outside of the core competencies of the traditional coffee company – like food, digital, and real estate.

Just at the end of July, Starbucks made an investment in Brightloom, a digital technology company, to help further build out its digital order and pay, loyalty, and delivery capabilities. As the CEO of Brightloom said: "It went from something that was nice to have to being 'table stakes.'"

# Imprint

## **RaboResearch**

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far.rabobank.com

Jim Watson	Senior Analyst – Beverages	james.watson@rabobank.com +1 (212) 916-7943
Sudip Sinha	Senior Analyst – Beverages	sudip.sinha@rabobank.com +65 6230 6772
Stacie Wan	Analyst – Beverages	stacie.wan@rabobank.com +86 189 1875 3025
Maria Castroviejo	Senior Analyst – Beverages	maria.castroviejo@rabobank.com +31 30 712 3811
Guilherme Morya	Analyst – Beverages	guilherme.morya@rabobank.com

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