Coffee Joins the Beverage Party

What Happens when a Can of Coffee Looks Just Like a Can of Soda?

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Summary

• The lines between coffee and the rest of the refreshment beverage category are blurring. Coffee consumption is moving out of home, away from breakfast and is becoming more premium and more convenient. As coffee becomes a ‘refreshment beverage’, we see increasing opportunities for innovation, branding, and growing into new consumption occasions. The flip side is the increasing competitive and regulatory risk as coffee gets closer to the world of sugared soft drinks.

Two long-term trends and a recent catalyst are moving coffee closer to the rest of the refreshment beverage category. Coffee consumption is slowly, but consistently, moving away from home consumption and moving to later in the day, as consumer lifestyles change. Premiumisation and the consumer desire for novelty are driving change across all beverages. The growth of RTD coffee, especially cold brew, provides a unique catalyst due to its visual similarity and physical proximity to the rest of the beverage world.

This convergence with the rest of the refreshment beverage category affects how, when, and where consumers interact with coffee and shapes the perception of the entire coffee market. Importantly, these trends are driven by the youngest consumers, who are developing a new relationship with coffee.

As consumers increasingly purchase their coffee in retail, next to a line-up of bottles and cans of soda, energy drinks, flavoured water, etc. they are seeing coffee in a different way. This is a significantly more branded presentation, with greater focus on a variety of flavours and on innovation. Looking forward, we expect coffee consumers to increasingly demand branded options during traditionally less or un-branded occasions, such as in-office coffee, and for brand-owners to pursue new flavours, presentations, and packages at a faster pace.

There are big new opportunities as consumption expands outward from drip coffee at home. Not just a morning ritual any more, coffee can be consumed for refreshment and for energy. Coffee can move into the QSR space as a lunch pairing, while cold brew on draft provides a great non-alcoholic offering or mixer at a bar. In third-wave coffee shops, single origin offerings play into existing wine/whisky ideas of what it means to be premium, which expands the price points upward.

Beware the loss of the health halo. Coffee enjoys a favourable image compared to most of the refreshment beverage category—healthier, more natural, more authentic. Putting coffee in a bottle, with calorie counts and added sugar made clear threatens some of this image. And that is before we consider the risk of coffee being grouped with other RTD beverages, as sugar and soda taxes are gaining momentum globally.
Parallel worlds

Coffee has often run parallel to the refreshment beverage category as the difference between hot and cold placed a mental and physical barrier between the segments. Most coffee is brewed at home or purchased in a specialty coffee shop, while other beverages are sold through grocery and convenience channels. The companies driving growth in the non-alcoholic space have largely been separate from dedicated branded coffee companies.

This separation is beginning to disappear. Now when you enter most grocery stores there is an array of RTD coffee beverages right next to the other non-alcoholic beverages. There’s also not always a clean break between the coffee brands and refreshment beverage brands either. We see numerous cross-over products, with brands such as Monster, Califia, and Gold Peak getting into coffee from diverse segments. At the same time, products like Stumptown sparkling cold brew with flavours reads much more as a traditional refreshment beverage.

As the lines between categories blur, we expect that consumers will increasingly view coffee as an extension of the larger non-alcoholic beverage segment as opposed to its own category. This will bring with it a greater desire for branding, innovation, and convenience and will open up new consumption opportunities for coffee.

A number of key coffee trends are helping to drive this convergence

Coffee consumption is moving out of the home, and to later in the day. These two trends are certainly related and are part of the reason behind the decline in traditional drip coffee. Coffee consumption outside of the home is now easier, and the growth of RTD coffee and coffee shop culture offers a much greater array of choices and quality with greater convenience. All of these factors imply that out-of-home consumption will continue to grow.

Breaking the at-home/drip coffee connection opens up great growth opportunities for coffee retailers. Consider the difference between consumers who were introduced to coffee through a pot of Folgers brewed at home versus those introduced through the Starbucks mobile app.

![Figure 1: Young coffee drinkers less skewed to home, 2016](image_url)

The growth of RTD coffee is here to stay. For a long time, the RTD coffee segment was broadly an afterthought in the coffee world. In Japan, it is a very large segment, part of a vibrant non-alcoholic drinks space that is heavy on innovation, sampling, and vending. But outside of Japan, RTD coffee is primarily seen in the US—a market that was and is dominated by Starbucks Frappuccino. The category has grown at a 14% CAGR for the last five years in the US (4% globally), but we see the introduction of cold brew as a significant catalyst to the industry.

With cold brew there is a wave of new entrants to the category, with new styles of drinks becoming available, and new outlets will devote more shelf space to the category. Think of RTD coffee in the grocery/convenience channel not as a new, different way to sell coffee, but the
natural path of coffee truly tapping into the most well-established, well-oiled way of getting beverages to consumers.

Figure 2: RTD coffee is for the younger consumer, 2016

Source: National Coffee Association, 2017

So, let’s go ahead and blame the millennials! As we can see in the data, the core of these changes comes from the younger consumer. We view the fact that the youngest cohorts are driving the change as an argument in favour of the staying power of these trends.

New consumption opportunities

Let’s consider the growth opportunities for coffee as it becomes more like the rest of the beverage segment.

In our note on the US non-alcoholic beverages market, we wrote about our belief that consumers are looking for FUN (functional, unique, and natural) beverages. Coffee is clearly functional and natural, while new presentations—not just cold brew, but also pour-over, single-origin, etc.—bring uniqueness to the table.

There are three main caffeinated categories on the market—sodas, coffee and energy drinks. The segments are clearly not perfect substitutes for each other, but the long-term decline of soda (especially cola) leaves a large number of consumers looking for new drinks that provide a pick-me-up. The core opportunity is for coffee to start replacing a portion of cola and energy drink occasions—the natural end-game of coffee moving out of home, to later in the day, and into bottles and cans.

There is significant room for coffee to move to later in the day. We certainly see this at coffee shops, and with RTD. What about restaurants? On a longer-time horizon, we see great possibility for lunchtime food-pairing. Across the QSR channel, soda fountains are often at the core of the beverage offering, and soda, iced tea, and sparkling water are among the default options at almost any lunch spot across the US and Europe.

Figure 3: A slow and steady move towards afternoon consumption, 2010-2016

Source: National Coffee Association, 2017
Why not coffee? Where hot coffee is associated with breakfast occasions, a cold coffee—especially one with bubbles or flavours—may open the door for meal-pairing. For every meal-beverage pairing based on taste, there is another based on tradition (think Bloody Mary and brunch). The cola and lunch pairing isn’t written in stone, and as younger consumers form new relationships with coffee, a new coffee-food partnership could form.

Greater branding in coffee

The liquid refreshment beverage category is driven by branding. Of course, the beverage’s intrinsic qualities matter, but in categories with dozens (or hundreds) of choices, brand equity is core to the final purchase decision. It is no coincidence that Coca-Cola remains in the top ten in global brand strength according to Brand Finance, and was number 1 in total brand value as recently as 2008.

Branding is a powerful force in beverages. As Lidl opens stores in the US, we can see that it is primarily promoting private label products—except for the beer aisle, where virtually everything is a mainstream branded product. Retailers understand that consumers are often hesitant about private label beverages.

Coffee is unlike the rest of the beverage segment in its branding. With a lower reliance on the bottle/can format, the brand plays a lesser role in our consumption. Office coffee may have some branding around single serve packs, but like coffee at home, is probably consumed out of a regular mug. At your next business conference, you may very well get your coffee from a large urn that simply says ‘coffee’.

When you look at the beverage menu at typical local restaurant, you may see that every single beverage is branded with the exception of coffee. This is changing, especially at higher-end restaurants, and we expect coffee to be nearly fully branded in the long run. As younger consumers drink more from RTD packages and at coffee shops, the branding of the coffee will become more important over time. This will spread slowly through the rest of the industry. Office coffee, both in terms of the equipment and actual coffee will be represented by well-known brands. On the restaurant menu, the coffee producer will be listed. Chick-fil-A offers an example from the QSR world, selling coffee drinks co-branded with its partner, THRIVE Farmers Coffee.

Where will these brands come from? Within alcohol, new brands are built primarily through the on-premise offering, with the backing of promotion, placement and bartender suggestion. This points to third-wave coffee shops as powerful brands themselves. Grocery/convenience retail is the typical introduction point for non-alcoholic brands, as a strong display at a Whole Foods is great marketing to consumers. This suggests the creation of brands though RTD coffee introductions. As we have seen throughout the consumer world, large companies have primarily moved to M&A over internal development as a way to cultivate new brands for emerging segments. With the explosion of third-wave coffee chains and new RTD brands, the innovation and equity is already in the marketplace.

Greater innovation in coffee

The roast and ground/traditional drip coffee combo is in long-term decline as new options offer more convenience, quality, novelty, etc. As coffee moves closer to the liquid refreshment beverage world, we expect an increase in the level and prominence of innovation. Throughout the branded beverage world, companies measure themselves as to how much revenue they drive through innovation. Heineken shows this in investor presentations, highlighting that 10.6% of total revenue came from innovation (through new categories, brands, and line extensions) last year.
RTD innovation is straightforward as we already see a growing wide array of choices in carbonation, flavours, sizes, shapes, milk content, etc. In coffee shops, innovation may be a bit slower, but menus do change and seasonal drinks provide new experiences for consumers. Pour-overs can seem like a staple of third wave coffee shops now and new products can be quickly introduced: consider the rapid rollout of nitro cold brew at Starbucks. Even at home, when innovation came in the form of a Keurig offering greater convenience, it quickly transformed the at-home coffee segment.

Different beverage styles open up new opportunities. RTD beverages travel with the on-the-go consumer. Cold brew on draft, whether nitro-infused or not, may fit in well at a pub, where we already see a number of cold brew and beer combo products on shelves—on draft at a bar, mixed in a cocktail, at lunch. We have seen local coffee shops sell coffee-based drinks like a rosemary spritz and a mint julep to appeal to different consumer needs.

Office coffee is an area ripe for innovation. The introduction of bean-to-cup machines are bringing a more premium (though unbranded) experience. Joyride coffee brings branded cold brew on tap, among other things, to offices. Consumer expectations will increasingly be driven by coffee shop and retail experiences, and offices with machines and brands that are less well known to the consumer may come under increasing pressure. We expect offices to move towards a greater array of options including more bean-to-cup machines, more recognisable brands and more cold brew.

What are the downsides?

As the coffee segment converges with the broader beverage category, we see several related downsides.

Are there taxes and regulations on the horizon? Soda (or added sugar) taxes have begun to pop up on a small scale around the US, and we’ve seen taxes in Mexico, Chile, France, and Hungary, among others. A recent tax in Seattle that would add USc 1.75 per ounce also considered taxing the syrup used in coffee shops (though it was unclear how this would be implemented). The more coffee resembles the rest of the RTD beverage world, the more closely consumers and politicians will examine its health properties.

A smaller point is that the increased caffeine in many cold brews could spur a backlash similar to those against certain energy drinks in the past. Many cold brews on the market have higher amounts of caffeine than a regular cup of coffee. A typical cup of coffee has about 90-100mg of caffeine, and 8oz Red Bull has 80mg, while a Chameleon Cold-Brew is between 150-250mg depending on flavour and milk content, with a 120-180mg range for La Colombe drinks.

Much of this leads to losing the health/natural halo around coffee products. Sitting next to soda on the grocery shelf and getting roped in to tax discussions emphasises the sugar/caloric content of the products. While the history of RTD coffee in the US is in the Frappuccino-style/high-calorie model, this has perhaps gone slightly under the radar as a smaller part of the coffee world.