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Keurig At Home: Managing a New Product Launch

A Wednesday afternoon in February 2003 found Keurig Inc.'s president and CEO Nick Lazaris heading south on Interstate 89 back toward his Wakefield, Massachusetts, office and mulling over the day's events in preparation for a briefing with his senior management team (see **Exhibit 1**). He realized that the next two weeks would be critical to the success of the company's newest product initiative in the single-cup coffee market. Lazaris had just wrapped up a presentation to the Green Mountain Coffee Roasters Inc. (GMCR) management team, one of the company's strategic partners and an investor in its business. While reviewing the company's progress toward the launch of its innovative coffee-brewing system into the at-home consumer market, GMCR had asked Keurig to reconsider its decision to use a different version of the coffee portion pack, known as a K-Cup, in the consumer market. In making its request, GMCR had offered a number of compelling reasons for using the existing commercial portion pack in both channels.

As he drove, Lazaris passed a new Starbucks and reflected on how gourmet coffeehouses had helped pave the way for Keurig's single-serve brewing system. The proliferation of soft drinks since the 1960s had caused coffee to lose its place as a central component of social gatherings, spurring a precipitous drop in coffee consumption to an all-time low of 6.1 pounds per capita in the mid-1990s from a peak of 16.5 pounds per capita in the mid-1940s.¹ The entrance of gourmet coffeehouses had reinvigorated the market, developing a distinct subculture of coffee drinkers and educating younger consumers about great traditional coffees as well as espresso and milk-based specialty beverages. As a result, by 2003 an estimated twenty million Americans were drinking gourmet coffee on a daily basis.

Keurig's launch of a single-cup brewing system in the office coffee service market in the late 1990s had benefited from coffee drinkers' increasing sophistication. Office employees could appreciate the greater variety, freshness, and convenience derived from the ability to brew a single cup of coffee on demand. Office managers recognized the advantages garnered from less coffee waste, increased employee productivity, and decreased hassle associated with tending the coffee machine.

February 2003 found Keurig poised to launch its new model B100 system in the at-home segment with hopes of repeating its success in a much larger but more competitive market. With rumors of other single-cup competitors ready to enter the market, Lazaris knew Keurig needed to move quickly in order to obtain its desired positioning in the emerging single-cup consumer

¹ Source: United States Department of Agriculture.

market. Revisiting the decision to proceed with a two-K-Cup strategy had the potential to derail the company's launch efforts and demanded rapid attention by Lazaris and the senior management team. Reevaluation of the K-Cup decision would also force them to rethink other elements of their product plans, including pricing and marketing. With less than six months until the September launch, time was of the essence.

The Company and Its Products

Keurig Inc. had been founded to develop an innovative technique that would allow coffee lovers to brew one perfect cup of coffee at a time. Beginning with the company's inception in 1992, the word "Keurig," from the Dutch word for excellence, had been the guiding principle behind the development of its products and services. The company leveraged investments from venture capital funds to transform its concept for a single-cup brewing system into a commercially viable business with the development and patenting of a single-portion pack and a revolutionary new coffee brewer. The first brewer targeting the office coffee service market, the B2000, was launched in 1998. A licensing agreement allowed GMCR to pack its specialty coffees in Keurig's patented container, the K-Cup (see **Exhibit 2**). Eight varieties of coffee were originally available for sale to offices. Keurig continued to expand its relationships with roasters such as GMCR, using a selective but nonexclusive strategy. This ongoing effort had expanded the number of roaster partnerships to five, resulting in the largest variety of coffees available with a single-cup system in the market in 2003.

In February 2002 the ownership structure of Keurig changed through agreements with two of its roaster partners. Keurig sold stock to Van Houtte Inc. to raise nearly \$10 million to support the launch of the at-home business. This investment provided Van Houtte with nearly a 28 percent ownership stake in Keurig. At the same time, GMCR acquired and executed options to purchase a large number of Keurig shares from existing shareholders, enabling Keurig to consolidate to a smaller number of significant shareholders. GMCR obtained a 42 percent stake in Keurig. With these moves, Van Houtte and GMCR joined Memorial Drive Trust (MDT) as the three largest shareholders of Keurig. MDT, an investment advisory firm that managed a U.S.-based profit-sharing plan, had served as the lead venture investor in Keurig since 1995 and led Keurig's board of directors. As provided for in separate shareholder agreements with MDT, neither GMCR nor Van Houtte was allowed to have a seat on the board of directors. Lazaris reinforced the company's position with respect to these roaster shareholders in a letter to its authorized distributors and other roaster partners:

We do not plan to allow any roaster or other commercial business partner to sit on our board of directors. Our core strategy remains unchanged: we are committed to a multiroaster strategy that relies on strong relationships with selected gourmet coffee roasters who take a great deal of pride in the coffee consumption experience that supports the meaning of their brand to consumers.²

² Internal memo dated February 5, 2002.

Single-Cup Brewing Technology

Keurig's single-portion system hinged on three key elements: a coffee brewer that perfectly controlled the amount, temperature, and pressure of water to provide a consistently superior-tasting cup of coffee; a unique portion-pack system containing ground coffee beans as well as filter paper; and a varied coffee selection to replicate the choices available in a gourmet coffeehouse.

The Keurig commercial-market brewer included an "always-on" feature, enabling it to brew a cup of coffee in less than one minute at any time of day. Plumbed to a water line, the automatically refillable water reservoir maintained up to twelve cups of water at brewing temperature. After the customer inserted a K-Cup in a drawer, positioned the eight-ounce cup to receive the brewed coffee, and pressed the "brew" button, the brewer would pierce the K-Cup, inject pressurized hot water, and brew the coffee. The K-Cup, evolved from an initial mock-up design based on a modified yogurt cup, contained a built-in cone-shaped filter and the exact amount and grind of coffee to fresh-brew a single eight-ounce cup. K-Cups were impermeable to air, moisture, and light to ensure the contents stayed fresh for at least six months.

A key differentiator for Keurig's brewing system was the broad coffee selection available through licensing arrangements with a variety of gourmet coffee roasters. Coffee roasters controlled the quality of their coffee and the number of varieties available through K-Cup production lines. A production line might be owned by the coffee roaster or leased from Keurig. K-Cups were produced by five roasters with six brands and more than seventy-five coffee varieties.³ Roaster partners included Green Mountain Coffee Roasters, Diedrich Coffee, Van Houtte, Timothy's World Coffee, and Ueshima Coffee Company. For each K-Cup sold, the roaster paid Keurig a royalty of approximately \$.04.

The Art of Cupping

"Cupping" was a method of tasting the finished (or brewed) coffee product used by roasters and many large retailers to evaluate the flavor profile of a coffee. Similar to wine tasting, cupping involved swishing coffee around in the mouth to evaluate elements of the flavor profile. Expert "cuppers" could taste as many as ten to twenty varieties a day and perform an analysis that included taste, brightness (degree of acidity), fragrance and aroma, body, and finish. The process began with the roasting and grinding of a small batch of beans. Once the ground beans were placed in a cup, hot water was poured over them and the analysis process began. The cupping process could be supplemented by state-of-the-art machinery to ensure product consistency.

In the world of gourmet coffees, roasters offered a variety of coffees tailored to the different tastes of gourmet coffee drinkers. For each variety of coffee offered, cuppers had established an expected flavor profile. The process by which that profile was achieved was closely controlled by the cupper during the cupping process. However, those same controls could not always be achieved in the traditional home brewing process. The desired flavor profile could be affected by a number of factors beyond the control of the roaster or cupper: the amount of coffee or water used by the consumer, variations in the temperature throughout brewing, or the amount of time the coffee sat in the coffee pot prior to being consumed. Through close control of critical

³ Currently there were three leased-production lines and an additional eight roaster-owned lines. Three additional lines were planned.

elements in the coffee brewing process, the Keurig system enabled that flavor profile to be recreated on a consistent basis and ensured that the coffee drinker had the same taste experience time after time.

Away-from-Home Market

Keurig's market included two broad target customers: office users and households.⁴ Keurig chose to focus first on the away-from-home commercial segment of office users in the hopes that a successful rollout would provide a springboard for launch into the at-home segment. The groundwork for launching into the away-from-home office coffee service (OCS) market was laid by Starbucks and other specialty coffee purveyors. They had successfully educated consumers about good-quality coffee and made it acceptable to pay \$1.50 or more for a cup of coffee and even more for coffee-based specialty beverages. This behavior opened the door for Keurig and others to offer a single-cup system into offices, capitalizing on people's desire to have the same great taste in the office as they got at a coffeehouse.

In 2002 the OCS market reached \$3.46 billion in total revenues.⁵ At the same time, acceptance of the single-cup brewing technology was evident in surveys of OCS distributors. In 2000 only 14.8 percent of distributors had offered a single-cup system, but that figure had increased to 44.8 percent in 2001.⁶ By 2003 total single-cup brewer placements had reached 143,200 (see **Exhibit 3**).

Since the launch of its first commercial brewer in 1998, Keurig had quickly moved to a leading position in the sales of single-cup brewing systems. After five years in the market at the end of 2002, Keurig had shipped more than 33,000 brewers in North America, equal to 1 percent of all OCS brewers. In comparison to the competition, Lazaris was quick to point out the speed with which Keurig had penetrated the market:

It took Filterfresh twenty years to ship 45,000 units in North America. And in its first five years, Flavia shipped only 8,000 units in North America. In addition, our expansion into Asia at the end of 2001 provided us an added opportunity for growth. In partnership with the top Asian roaster, UCC, our initial sales in Japan and Korea had been more than 2,700 brewers.

A second measure of Keurig's achievements in the OCS market was shipment of its patented K-Cups. In 2002 Keurig's roaster partners shipped more than 125 million K-Cups, bringing total K-Cup shipments since launch to more than 340 million. Also in the works was the launch of an offering of teas in T-Cups, with the first being the "Celestial Seasonings" teas.

⁴ From early trial activities, Keurig had determined its single-serve brewing system was not well aligned with the needs of food service establishments serving a large volume of coffee.

⁵ Source: International Coffee Organization, London, UK.

⁶ Source: *Automatic Merchandiser* 2002 Coffee Service Market Report.

Away-from-Home Channel of Distribution

The office coffee market was served by a network of approximately 1,700 distributors that were responsible for placement and maintenance of office brewers and ongoing coffee supply. Keurig worked with a total of 180 Keurig authorized distributors (KADs) for sales throughout North America. A small number of KADs handled customers throughout the United States or North America, while the majority covered smaller regions.

The purchasing decision was handled by office managers. “Office managers are all about eliminating headaches. The variety of coffees, convenience of brewing, and negligible clean-up of the Keurig system mean fewer employee complaints and greater productivity,” explained Chris Stevens, away-from-home vice president of sales, who was responsible for managing Keurig’s day-to-day relationship with its network of KADs. Customer relationships were managed by the KADs and feedback on problems or desired new features was funneled through the KADs to share with Keurig.

The KADs purchased commercial brewers from Keurig at a wholesale price that ranged from \$500 to \$1,000. The brewer was placed in offices free of charge or with a low monthly rental in exchange for ongoing coffee sales. Typically there was no formal contract between the KAD and the office manager, although the KAD established expected volumes based on the number of employees in the office. If volumes fell below expected levels, the KAD could remove the brewer from the office or raise the price of the K-Cups. The KAD was also responsible for ongoing repairs of the brewer.

The KAD provided a variety of coffees to offices, based on their individual consumption profiles. KADs entered into direct relationships with one or more licensed roasters for the purchase of K-Cups. Typically, KADs paid roasters \$0.25 per K-Cup and sold K-Cups to office managers for \$0.40–\$0.50. Roasters then paid Keurig a royalty of \$0.04 per K-Cup sold.

Away-from-Home Single-Cup Competition

There were two primary competitors in the away-from-home market.

FILTERFRESH

Hopper-based single-cup technology was pioneered by Westwood, Massachusetts-based Filterfresh Coffee Service Inc. in the late 1980s. Filterfresh was a U.S. subsidiary of Canadian-based Van Houtte (a Keurig shareholder), a leading gourmet coffee roaster, marketer, and distributor in North America. The Filterfresh commercial single-cup system was based on the “French press” method of brewing. Ground coffee beans were loaded into a storage hopper in the machine. Once a button was pressed for a cup of coffee, an amount of ground beans would be measured from the hopper and mixed with hot water. The mixture would then be strained to remove the grounds and a single cup of coffee resulted. No brewed coffee was left to sit and become waste as was common in a traditional glass pot system, and a person enjoyed a freshly brewed cup of coffee each time. Regular tending of the coffee system was required to remove used coffee grounds and reload ground beans into the storage hopper. Filterfresh established its relationship with Keurig in October 2001 to market Keurig’s commercial brewer and offer a system that could provide a greater variety of single-cup coffees and teas.

FLAVIA

Flavia was owned by Mars Inc. It introduced its first single-cup brewer to offices in Britain in 1985 and expanded to Europe and Japan before introducing its “Brew-by-Pack” system in the United States and Canada in 1996. Similar to the Keurig brewer, the S350 commercial brewer utilized a single-serving pack. Each Filterpack contained its own filter and the appropriate measure of ingredients, which were foil-sealed, protecting them against air and moisture. A selection of twenty-four coffee varieties was available with the system.

At-Home Market

Building on its success in the OCS market, Keurig viewed the at-home consumer market as a logical extension to its business strategy. John Whoriskey joined Keurig as general manager and vice president of the at-home division in 2002. He brought with him more than twenty years of experience in consumer goods sales and marketing. “I fell in love with Keurig and its brewing system,” he commented. “I don’t consider myself a gourmet coffee drinker, but I do like a good cup of coffee. I would drive a mile out of my way to work to pick up a good cup of coffee. With a Keurig brewer, we can offer convenience benefit with taste assurance, in the comfort of your own home.”

The at-home market represented an enormous opportunity for Keurig. Leading market research firms estimated the total size of the retail coffee market at approximately \$18.5 billion in 2000. At-home retail consumption was a \$6.9 billion market, with at-home gourmet coffee accounting for \$3.1 billion (see **Exhibit 4**). Away-from-home gourmet coffee represented a \$3.9 billion market and was typically sold by the cup at cafes such as Starbucks or in other food service venues such as restaurants. At the same time, estimates showed 157 million Americans drank coffee, with 60 percent predominantly drinking previously ground coffee and another 10 percent using freshly ground whole bean coffee.⁷ Profiles of coffee drinkers varied by product type, with consumers of whole-bean coffee exhibiting an upscale profile (see **Exhibit 5**). In addition, about eighteen million coffee makers were purchased annually in the United States, representing about \$450 million in retail sales. Coffee makers represented one of the largest-volume small appliances sold for home use.⁸

Previously the purview of upscale outlets—coffee/tea stores, gourmet/specialty stores, kitchenware stores, and coffeehouses—gourmet coffees had increasingly been sold in mass-retail outlets. At the same time, the growing popularity of whole-bean coffee had been driving the launch of a variety of roasts, blends, and flavors. Starbucks, for example, showed growth of whole-bean sales in excess of 100 percent in 2000.⁹

Coffee advertising centered on two major themes: good taste and positive stimulation. Taglines such as Maxwell House’s “Good to the last drop” reflected the emphasis on the taste experience. Positive stimulation focused on the benefits caused by drinking a particular cup of coffee. As an example, the well-known tagline “The best part of waking up is Folgers in your cup” suggested that the stress and challenges in your life could be overcome by taking that first sip.

⁷ Simmons Market Research Bureau (2000).

⁸ Source: Keurig company information.

⁹ *The U.S. Market for Freshly Brewed Coffee Beverages*, Packaged Facts, March 2004.

At-Home Single-Cup Market Research

Keurig commissioned a variety of market research studies on the at-home product concept from 1999 to 2001 prior to moving ahead with any significant development efforts. “We wanted to get an understanding of the acceptability of the single-cup approach, gain some insight into pricing of the K-Cup and the brewer, and profile our prime consumer prospects,” explained Lazaris. This research was executed in a variety of formats, including intercept surveys, Internet-based surveys, surveys of current OCS users, and surveys and focus groups of home use testers.

Intercept interviews were conducted in three cities in the summer of 2000. Lazaris explained the study’s focus: “We were interested in speaking with regular gourmet coffee drinkers so respondents were selected based on coffee brewing habits and coffee consumption.” To qualify for the intercept survey, consumers had to drink gourmet coffee, which included coffee from freshly ground whole beans, from gourmet coffee roasters, and from premium coffee cafes such as Starbucks, Dunkin’ Donuts, Seattle’s Best, or Caribou Coffee. All participants had to drink at least one cup of coffee per day.

While nearly 94 percent of respondents indicated that they were satisfied with the coffee they drank at home, 88 percent expressed an interest in the product concept. Interest focused primarily on convenience, particularly quick brewing, ease of use, and minimal clean-up, sources of the most dissatisfaction with current home brewing systems. Based on explanation of the product alone, more than three-quarters of respondents said they would be likely to purchase a system like the one proposed. The product demonstration had a huge impact on this figure. More than 90 percent of respondents indicated that the demonstration increased their likelihood of buying the product. Key factors rated highest in the demonstration included the time it took to prepare coffee and the time it took to clean up.

Keurig had gained some initial insight into brewer pricing from previous market research (see **Exhibit 6**). It now wanted to explore product pricing with consumers who considered the system (brewer and K-Cups) and also experienced a product demonstration. Among intercept respondents, the self-reported daily consumption rate of coffee was an average of two to three cups. When asked about their willingness to pay for a cup of coffee like the one they tasted, 44 percent indicated they would pay \$0.55 (see **Exhibit 7**). Later in the survey, respondents were asked about their willingness to pay for both K-Cups and the brewer. More than 30 percent of respondents who were interested in the system were willing to pay \$0.50 or more for a K-Cup. Before obtaining input on brewer pricing, respondents were told that high-quality coffee makers sold in the range of \$69 to \$149. Approximately one-fourth of the respondents were willing to pay more than \$130 for the brewer. Consumers who drank more coffee were more willing to pay for both the K-Cup and the brewer.

An Internet-based survey used as its basis a Keurig system summary (see **Exhibit 8**) that was shown to people who drank coffee on a daily basis. It found that the concept had strong appeal, with 67 percent of respondents expressing interest. The main differentiating factor revolved around the speed of brewing a cup of coffee. Of second highest importance was the convenience of no preparation or clean-up. As part of the study, a price point of \$149.99 was tested. The 9 percent of respondents who indicated that they “definitely would buy” or “probably would buy” the coffee system at this price were classified as “core customers.” These respondents tended to be younger and most were male. Follow-up survey questions revealed that the average price core customers were willing to pay for the coffee system was \$125.

For the home use test, a commercial model brewer was placed in the homes of gourmet coffee drinkers. The testers were then required to purchase K-Cups at a retail price of \$0.50 via fax, e-mail, or phone for their own individual coffee consumption. Subsequent interviews and focus groups found that users consistently referenced great-tasting coffee with a system that was fast and convenient. Additional attributes of the product highlighted included taste consistency, coffee variety, and cleanliness of preparation. Of particular note was the fact that coffee consumption at home increased with the presence of the Keurig brewer. On average, 2.25 cups of coffee were consumed per day at home. Not only were participants drinking more coffee in the morning, but they were purchasing less coffee outside the home. An acceptable price range for the brewer was determined to be in the \$129–\$199 range, with a price exceeding \$200 triggering a reaction that the item would become a luxury purchase for which more consideration would be required. K-Cup pricing, however, did not appear to be an issue.

At-Home Single-Cup Competition

A key element of Keurig's strategy in the at-home market was being one of the first entrants in the product category. In establishing itself as a pioneer in the upscale single-cup brewing category, Keurig envisioned that subsequent press coverage would naturally include a reference to the Keurig system as a single-cup pioneer and enhance its visibility in the upscale market.

In the traditional consumer coffee market, Procter & Gamble (P&G) and Kraft were the market share leaders with distribution largely through grocery stores (see **Exhibit 9**). In advertising expenditures, the two companies represented 84 percent of total expenditures of \$163 million.¹⁰ In the coffee maker appliance market, appliance brands targeted either upscale or mass market retailers. In the upscale segment, Cuisinart, Krups, Braun, DeLonghi, and Bunn had strong distribution. In the mass channel, through which about 70 percent of all coffee makers were sold, Mr. Coffee, Black & Decker, Sunbeam, and Hamilton Beach had strong positions.

Market indicators had led Keurig to believe that a number of these large established consumer products companies were preparing to enter the emerging single-cup market. In addition to the growth of the single-cup system in the away-from-home market, recent trends in Europe were showing the adaptation of traditional espresso pod systems for American-style coffee brewing. In each case, including Keurig, the systems were proprietary, with individual brewers working only with compatible coffee pod systems.

Salton, with 2002 sales of \$922 million, was a leading domestic designer, marketer, and distributor of a broad range of branded, small appliances. Under its licensed brand name, Melitta, it had formally announced plans for a May 2003 launch of a new brewing system: One:One. The One:One brewer would brew coffee utilizing Javapods, small round packets of filter paper in which the grounds were sealed. Salton's expected retail brewer pricing was \$49 with pod pricing of about \$0.25 per pod.

Sara Lee, a U.S.-based consumer packaged products company with sales of \$17.6 billion in 2002, had been active primarily in the European coffee market, but, through a series of acquisitions completed in 2000, had become a stronger force in the U.S. market. Its two best-known brands were Chock Full o' Nuts and Hills Brothers. Sara Lee had stated that the Senseo-

¹⁰ *Packaged Facts Market Profile: The U.S. Coffee and Tea Market*, September 2001.

Crema pod system might be in the U.S. market in the second half of 2003. Previously introduced in Europe, the Senseo Coffee Pod System used coffee pods of a different size than the Salton Javapods. The Sara Lee pods were bulk-packed in a bag made with a very thin layer of aluminum to preserve freshness. Sara Lee had placed almost two million Senseo pod systems in Europe since the product's introduction. The company's experience in the consumer market gave it the potential to be a formidable competitor. Senseo's European pricing suggested a U.S. retail price of about \$70 and a pod price of about \$0.20 (with two pods required to deliver an eight-ounce serving).

There were also rumors that P&G had partnered with an appliance marketer to launch its own proprietary pod system. It was expected that P&G would focus on mass channel distribution of both its pod brewers and pods, given P&G's strength in the grocery channel. P&G's pricing and distribution were expected to be similar to Salton's and Sara Lee's.

Nespresso, developed by Nestlé, was a European capsule-based single-cup espresso brewing system. It offered similar benefits to the Keurig system including taste, variety, and convenience. Since its introduction in 1987, more than 500,000 units had been sold, largely in Europe, using direct fulfillment via phone, fax, and Internet. Keurig wondered whether Nestlé would decide to enter the American-style single-cup coffee market, based on its experience with single-cup espresso.

Is the Cup Half-Full or Half-Empty?

Keurig did not have the resources to launch its B100 brewing system through the retail channel. However, it felt it could develop a direct marketing approach using an e-commerce-enabled Web site to sell both the brewer and K-Cups in conjunction with leveraging the distribution capabilities of roasters and KADs. In pursuing this strategy, Keurig had encountered a number of channel issues that could jeopardize its established business in the away-from-home OCS market. Chris Stevens explained the challenge of balancing the needs of the OCS channel with the development of the new at-home business:

Feedback from our KADs indicated that they would interpret our entry into the at-home market with a direct sales approach as a first step towards a direct approach in the OCS market in the long term. Concern about this would diminish the KADs' marketing efforts in both the OCS and at-home markets, resulting in erosion of our installed base and revenue stream from our core OCS segment and a less effective launch in the at-home market. At the same time, we were worried about loss of pricing control with KADs underpricing Keurig and the roasters because they had no brewer investment to recover. In addition, there was concern that the office managers would not support our at-home marketing efforts for fear of theft of K-Cups for use in the home brewer.

Given these issues, Keurig's goal had been to introduce a controlled distribution of brewers and portion packs that would maximize the launch of the at-home business while protecting the away-from-home OCS channel. Key in this strategy had been the introduction of a second portion pack as the basis for production differentiation—a new Keurig-Cup for the at-home market—and that decision had driven its development efforts to date. The K-Cup would work only in the commercial brewer, while the Keurig-Cup worked only in the at-home brewer (see **Exhibit 10**). Further distinction was made with the color of the two portion packs: the K-Cups were white while the Keurig-Cups were tan. These two portion packs would be manufactured on the same

packaging lines. Design of the necessary tooling to thermoform the new cup bases had been completed at a cost of about \$400,000. In addition, new parts for the packaging lines at licensed roasters had been manufactured by Keurig at a cost of just under \$60,000 per packaging line to enable the lines to manufacture both the Keurig-Cups and the K-Cups. While the new B100 brewer was targeted for both lower-volume OCS customers and for at-home use, different cup holder inserts and different color drawers would differentiate the brewer products in the two markets.

Building off this product differentiation, Keurig's controlled distribution strategy allowed roasters to sell Keurig-Cups in direct and indirect markets and KADs to sell them in direct markets, assuming certain volume commitments were met on sales of the associated brewer. KAD brewer volume commitments ensured that parties selling Keurig-Cups would be equally vested in brewer sales and focused on marketing an entire system. Roasters would manufacture Keurig-Cups for Keurig to resell directly to at-home users over the Internet. In addition to providing necessary assurances to KADs about Keurig's future plans, the two-portion-pack strategy eliminated office manager concerns over the potential theft of portion packs for use in home brewers, increasing the likelihood of their participation in in-office promotions of the Keurig system.

Unfortunately, the plan had reached a roadblock at that afternoon's meeting with GMCR. Lazaris later summed up GMCR's concerns to the senior management team in an e-mail, "We reviewed the controlled distribution structure with GMCR's management team. GMCR responded that it was complicated and resulted in doubling the number of portion pack products they would have to manufacture and warehouse. There could also be the potential for customer dissatisfaction resulting from using a portion pack in the wrong brewer. GMCR preferred the one-cup model based on long-term simplicity and the desire to move quickly because of the competitive systems coming to market. Clearly, GMCR has the same interests we do—it has the largest share of the OCS K-Cup business and can't afford to alienate the channel. It has an ownership interest in Keurig and wants to see long-term value creation. But going back to the board to discuss a major change at this point will not be easy."

At-Home Product Pricing

Another issue being wrestled with by the senior management team in early 2003 was determination of the pricing strategy for the Keurig-Cup and B100 brewer for the at-home market. A decision on the one-cup vs. two-cup approach challenged by GMCR would have a direct impact on Keurig's portion pack pricing strategy. One benefit of the controlled distribution strategy utilizing two distinct portion packs was increased control of the pricing, specifically for the Keurig-Cup. "We were interested in using a direct sales model for the at-home market," explained John Whoriskey. "With the Keurig-Cup, we could set pricing for the consumer market without having to worry about erosion of our established revenue base in the OCS market." Without the product distinction, office managers would have the opportunity to purchase portion packs from their current KAD or directly from the Keurig Web site, potentially drawing away sales from the KADs and jeopardizing their relationships with their accounts. Regardless of the one-cup vs. two-cup approach, Keurig needed to set a price for its direct sales of coffee.

Equally challenging was the pricing of the B100 brewer. Early market research suggested that consumers paid greater attention to the pricing of the brewer and it would have a direct impact on their decision to invest in the Keurig system. In price testing, upscale consumers appeared to react

favorably to pricing in the \$149 to \$170 range, providing Keurig with the target price for its product development and business plan forecasts. With an estimated launch of September 2003, Keurig had forecasted at-home brewer shipments of about 20,000 through year-end. Just under two-thirds of those sales were expected to be through direct Keurig sales activities, with the remainder being driven by roasters and KADs either selling B100s to at-home consumers or driving leads to Keurig by referring potential customers to the Keurig Web site. Additionally, Keurig expected KADs to buy about 3,000 B100 brewers for placement in small offices in the OCS channel. Keurig-Cup and K-Cup sales were expected to follow the same at-home/away-from-home distribution split as the brewers.

Yet another issue was the manufacturing costs of the new brewer. Development efforts on the at-home brewer were put on hold in 2002 to speed development of a smaller commercial brewer called the B1000 that was launched in December 2002. Under the leadership of engineering development vice president Dick Sweeney, development of the new B100 at-home brewer was restarted after the B1000 brewer was launched. While the B100 could also be used in offices, it was targeted at the at-home consumer market. The B1000 brewer had costs greater than \$300 and some significant design issues. Sweeney explained, "Product development always has the dark cloud of unexpected consequences. What distinguishes a company is how it resolves issues and moves on. In this case, our experiences with the B1000 brewer provided valuable insight into the development of the B100 at-home brewer." Even so, the latest reports from the manufacturing partner had projected costs at \$220. Additional engineering efforts were focused on reducing those costs to \$200.

As a result, Keurig's senior management team and board of directors were struggling with the pricing of the B100. The three key price points being reviewed were \$199, \$249, and \$299. The company could simply not afford to sell at the desired \$149 price point and it was too late to redesign the brewer for lower costs. At \$299, there would be a small profit margin to apply toward marketing and infrastructure costs. At \$199, there would be a large immediate loss on brewer sales, but marketing research had shown the \$199 price to be more attractive than \$200 or more. While Keurig's business model allowed the recovery of losses on the brewer through the royalties on K-Cups, the degree of losses impacted cash. Lazaris wondered, "If we price high, we can always lower the price, but we may not have the time to correct the pricing, given competitive pressures."

Marketing Plan for At-Home Launch

Unlike the OCS market, the at-home market did not include a single source for both brewer and coffee sales. Traditionally, consumers made separate purchases. Brewer distribution was through small appliance retailers like department stores, mass merchants, and kitchen specialty stores, while coffee distribution was through grocery stores, gourmet food retailers, and coffee shops. Each product was promoted independently and essentially all brewers worked with all coffees. The Keurig brewer and its patented single-portion pack presented unique distribution challenges. To accomplish a Keurig system sale would require either direct distribution or a great deal of investment to develop traditional channels and to place enough brewers to pull portion packs through retail shelves. To complicate matters, market research had made it clear that the Keurig system was a "demonstration-driven product." The question was how best to demonstrate the system to the target market of gourmet coffee drinkers.

"Based on the market research and the unique challenges of the Keurig system, leveraging our current OCS penetration was a primary focus of our at-home launch strategy. We planned to

target Keurig office users, people already familiar with the benefits of the Keurig system, and convert them to at-home buyers in order to build critical mass to support channel expansion,” explained VP of away-from-home marketing Dave Manly. With more than 30,000 commercial brewers in place, Keurig had about one million people to focus on in its direct marketing efforts.

Critical to the success of direct marketing efforts to “Keurig-aware” coffee drinkers was the support and involvement of the Keurig authorized distributors. The KADs maintained relationships with office managers where commercial brewers were placed and had knowledge of each office’s size. Keurig would not be able to market to coffee drinkers in the offices without the KADs’ assistance. As a result, Keurig had designed a KAD referral program that gave them attractive incentives to support the marketing of the new brewer.

The KAD referral program was to be driven by point-of-sale (POS) advertising that had been developed for display on or near the office brewer (see **Exhibit 11**). In exchange for placement of the POS materials, the KAD would be compensated \$15 for each home brewer sale attributed to that KAD’s OCS accounts and would be paid a two-cent-per-K-Cup (or Keurig-Cup) annuity on subsequent coffee sales that Keurig made to that customer for three years. Chris Stevens outlined the company’s expectations: “We anticipated that about 60 percent of our KADs would participate in our joint marketing program with sales of two brewers for each office where advertising was placed. We estimated that the remaining 40 percent would already be planning their own marketing program and would want to maintain more control of their customers.”

A second avenue for marketing to “Keurig-awares” would be via an Internet direct marketing campaign. Since the launch of the commercial brewer in the OCS market, Keurig had received unsolicited e-mails from more than 12,000 users of its office system who wanted to know when a similar system would be available for home use. Keurig planned to market to these people directly and expected 20 percent of them to purchase a home brewer in the first three months of the launch. Finally, a public relations campaign coupled with additional marketing activities by roasters such as placement in their retail stores, catalogs, and Web sites would provide additional avenues for sales to gourmet coffee drinkers.

Lazaris’s Dilemmas

As Lazaris reflected on Keurig’s strategy for the launch of its at-home brewer in preparation for the senior management meeting, he wondered:

1. How should we respond to GMCR’s request to switch to the single K-Cup approach? What do we really need to know to make this decision? How will our other roasters and the KADs respond? Can our team really implement a new game plan at this late date and still launch in six months? Can we afford the write-off on the new Keurig-Cup and packaging line tooling?
2. What is the right price for the brewer? Is there a way to afford a \$149 price point on the brewer that we have not thought of?
3. How should we price the at-home portion pack? If we have one cup in all markets, what pricing is optimal? If we have both the K-Cup and the Keurig-Cup, what pricing makes sense and optimizes our market opportunity?
4. Have we taken the necessary steps for our marketing plan to succeed? Is there another avenue that we are overlooking?

Exhibit 1: Keurig Senior Management Team**NICK LAZARIS: PRESIDENT, CHIEF EXECUTIVE OFFICER, AND DIRECTOR**

Lazaris joined Keurig in 1997. His more-than-twenty years of business experience includes president/CEO- and VP-level experience in marketing, sales, finance, and business development in the home furnishings and office products industries. Prior to Keurig he was president/CEO of MW Carr, a photo frame manufacturer/marketer, and VP and divisional GM for Tech Specialists, a contract professional staffing firm. Earlier in his career, Lazaris served as chief of staff for West Virginia Governor Jay Rockefeller. In 2001 and 2003 he was a regional finalist for Ernst & Young's Entrepreneur of the Year. He received his BS from MIT and his MBA from Harvard Business School, and is a licensed CPA.

DICK SWEENEY: CO-FOUNDER AND VICE PRESIDENT, ENGINEERING AND OPERATIONS

Sweeney co-founded Keurig in 1993 and joined the company full time as VP of engineering in 1996. He brought to Keurig more than twenty-five years of experience in manufacturing, product development, and consulting for industrial and consumer appliances, including espresso machines. Prior to Keurig he was VP of manufacturing for Canrad-Hanovia, a manufacturer of scientific and UV lighting. Before that he was VP of operations for V-M Industries, a consumer appliances manufacturer and importer. Sweeney received his BS from New Jersey Institute of Technology and his MBA from Fairleigh Dickinson University.

CHRIS STEVENS: VICE PRESIDENT OF SALES

Stevens joined Keurig in 1996. He brought to Keurig more than twenty years of experience in consumer goods sales and marketing, as well as general management. After beginning his sales career with seven years at Procter & Gamble, he became president of the August A. Busch Co., a subsidiary of Anheuser-Busch. After also serving as a divisional manager with A-B, he was executive VP and general manager for United Liquors before becoming executive director of the Sports Museum of New England. Stevens received his BS from Notre Dame and completed the Executive Education program at Columbia Business School.

DAVE MANLY: VICE PRESIDENT OF MARKETING

Manly joined Keurig in 2002. He brought to Keurig more than twenty years of experience in consumer goods sales and marketing. His experience included VP and GM positions building well-known consumer brands in the food products and consumer goods industries via innovative marketing approaches. Manly has held marketing positions at Nexus EnergyGuide, EnergyUSA, LoJack Corporation, Boston Whaler Boat Company, and Procter & Gamble (food products division). Manly received his BS from DePauw University and his MBA from Purdue University.

JOHN WHORISKEY: VICE PRESIDENT, GENERAL MANAGER—AT-HOME DIVISION

Whoriskey joined Keurig in 2002. He brought to Keurig more than twenty years of experience that included president- and VP-level experience in marketing and sales in the home furnishings, gift, and consumer products industries. Prior to Keurig he was president of Fetco Home Décor and president of Optelec Inc. Prior to that, he worked in VP-level positions for Honeywell Consumer Products, Tucker Housewares, The First Years, and Polaroid. Whoriskey received his BS and an MBA from Boston College.

Exhibit 2: B2003 Commercial Brewer and Keurig K-Cups**Exhibit 3: U.S. Single-Cup Brewer Placements by OCS Distributors**

Manufacturer	Product(s)	1999/2000	2000/2001	2001/2002	2002/2003
Cafecton	Avalon	7,500	11,000	13,000	16,000
Crane	Cafe System	22,500	23,000	11,000	12,000
Filterfresh	Filterfresh/Keurig	23,000	24,000	26,500 ^a	30,000 ^b
Flavia	Flavia	8,000	19,000	32,000	40,000
Keurig	Keurig	13,000	23,000	30,000	33,000
Newco	Gevalia	0	1,000	1,200	1,300
Proforma	Venus	0	0	1,000	2,400
Unibrew	Unibrew	3,200 ^c	3,200	3,200	3,200
Zanussi	Brio/Colibri	5,000	6,400	8,000	10,000
Other		1,100	1,600	516	4,600
<i>Total</i>		83,300	112,200	126,416	143,200

^a Includes 1,484 Keurig units.

^b Includes 2,300 Keurig units.

^c Available to Filterfresh franchisees only.

Note: Table has been modified to exclude espresso machine sales.

Source: Automatic Merchandiser, February 2002, July 2004.

Exhibit 4: U.S. Retail At-Home Coffee Market

Year	Mass Market Coffee Sales (\$ in millions)	Pound Volume (in millions)	Gourmet Coffee Sales (\$ in millions)	Pound Volume (in millions)
2000	3,815	840	3,100	320
1999	3,800	850	3,000	310
1998	3,975	830	2,800	290
1997	4,205	845	2,500	270
1996	3,905	850	2,200	255

Source: *Packaged Facts Market Profile: The U.S. Coffee and Tea Market*, September 2001.

Exhibit 5: Demographic Characteristics by Product Form

Factor	Ground	Instant	Whole Bean
Age	55–64	NS	45–54
Race	NS	Black; Hispanic	Asian; Other
Marital status	NS	Widowed	Married
Household income (in thousands)	NS	\$10–\$15	\$75+
Education	NS	Not high school graduate	College graduate
Employment status	Retired	Homemaker	Full-time
Occupation	NS	NS	Professional/managerial
Household size	NS	NS	NS
Region	Midwest	NS	West

Notes: U.S. adults. NS is no statistically significant differences.

Source: *Packaged Facts Market Profile: The U.S. Coffee and Tea Market*, September, 2001.

Exhibit 6: Initial Market Research

Brewer Pricing	Awares % (N=170)	Nonawares % (N=601)
\$199	6	1
\$149	9	7
\$99	31	18

Note: Results from early street intercept testing were segmented between "Keurig-awares," people familiar with the Keurig system, and "Keurig-nonawares."

Source: Company-sponsored market research.

Exhibit 7: Intercept Testing Market Research

Table 7A: Willingness to Pay for Coffee

Survey respondents were asked how much they would be willing to pay for a cup of coffee like the one they tasted. Interviewers guided the respondents and started the price point inquiry at \$0.55. The percentages of respondents represent the cumulative percentages of people willing to pay each price.

Initial Pricing	Percentage of Respondents (Cumulative)
\$0.55	43.8
0.50	53.5
0.45	60.0
0.40	69.5
0.35	79.3
0.30	87.3
0.25	97.8

Source: Company-sponsored market research.

Table 7B: K-Cup Pricing Based on Coffee Consumption

Survey respondents were asked how much they would be willing to pay for a K-cup. The percentages of respondents represent the cumulative percentages of people willing to pay each price. Responses include only customers who were very or somewhat likely to purchase system.

K-Cup Pricing	1 Cup/Day ^a (N=78) %	2+ Cup/Day ^a (N=446) %
\$0.55+	5.1	14.6
0.50–0.54	16.7	30.7
0.45–0.49	20.5	33.6
0.40–0.44	22.0	41.5
0.35–0.39	28.2	48.2
0.30–0.34	41.0	58.5
0.25–0.29	60.3	75.6

^a Coffee consumption per weekday.

Source: Company-sponsored market research.

Table 7C: Brewer and K-Cup Pricing Based on Coffee Consumption

This table reflects the percentages of respondents willing to pay certain prices for the brewer. Information is segmented based on their previously stated K-cup pricing and coffee consumption. Responses include only customers who were very or somewhat likely to purchase system.

K-Cup Pricing	1 Cup/Day ^a (N=78) %			2+ Cups/Day ^a (N=446) %		
	< \$100	\$100–\$129	\$130+	< \$100	\$100–\$129	\$130+
< \$0.30	34.1	9.4	5.9	22.2	8.9	6.3
0.30–0.39	7.1	8.2	2.4	6.2	5.3	5.2
0.40–0.49	2.4	2.4	4.7	5.7	2.5	1.9
0.50+	10.6	5.9	1.2	9.9	9.5	10.1
Don't Know	5.9			6.3		

^a Coffee consumption per weekday.

Source: Company-sponsored market research.

Exhibit 8: Internet Survey Concept Description**Introducing a Revolutionary New Home Coffee-Making System****Coffee House Taste by the Cup™**

Fresh
Fast
Convenient
Delicious

- *The System*—A revolutionary coffee-making system that uses individual portion packs of freshly roasted and ground coffee with a unique coffeemaker designed to brew GREAT cups of coffee, one cup at a time. Each user picks the brand and variety of coffee they want and makes a fresh, piping hot cup in just 30 seconds.
- *Delicious and Fresh*—Individual portion packs come in over 36 varieties of branded coffees from Green Mountain Coffee Roasters, Diedrich Coffee, and Gloria Jean's Coffees. The coffee is roasted, ground, and packed at the roasters' facilities into an individual portion pack where freshness is sealed in. The pack provides an oxygen, light, and moisture barrier to ensure fresh-ground quality that is guaranteed for six months. Whether you prefer light roasts, dark roasts, blends, decafs, or flavored coffees, this system serves you the coffee you prefer, brewed to perfection every time.
- *Convenient*—The entire brewing process takes place in the portion pack. There is no waste, no pot or filters to clean, and no hassle. Just discard the used portion pack after brewing.
- *Fast*—Just press a button and in 30 seconds you'll have a fresh cup of hot coffee. The machine is always plugged in and powered on with hot water ready to brew your cup of coffee.

Exhibit 9: Coffee Market Share

Company	Market Share (%)
Procter & Gamble ^a	36.9
Philip Morris/Kraft	31.8
Nestlé ^b	5.0
Starbucks	3.7
Chock Full o' Nuts ^c	3.1
Tetley ^d	2.1
Community Coffee	1.8
Private Label	7.5
Other	8.1
<i>Total</i>	100.0

^a Includes sales of Folgers and Millstone ground regular.

^b Nestlé sold its ground brands to Sara Lee in late 2000.

^c Chock Full o' Nuts sold to Sara Lee in 2000.

^d Tetley sold off its coffee brands in 2000.

Source: *Packaged Facts Market Profile: The U.S. Coffee and Tea Market*, September 2001.

Exhibit 10: K-Cup (left) and Proposed Home Keurig-Cup (right)

Note: Cups are shown upside down to illustrate difference in design.

Exhibit 11: Point-of-Sale Display

