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## Keurig: From David to Goliath

### The Challenge of Gaining and Maintaining Marketplace Leadership

On March 17, 2011, the vice president and general manager of Keurig Incorporated's At Home division, John Whoriskey, sat in his office in Reading, Massachusetts, reminiscing about the changes he had been a part of since joining the company in 2002. At that time Keurig was a privately held company with just over \$20 million in revenues and a plan to enter the single serve coffee arena for home consumers, which Whoriskey himself had been hired to head up (see **Exhibit 1**). Nine years later Keurig was a wholly owned subsidiary of Green Mountain Coffee Roasters, Inc. (GMCR), a publicly traded company with 2010 net revenues of \$1.36 billion (see **Exhibit 2**) and a market capitalization of between \$8 and \$9 billion.

In 2003 Whoriskey oversaw the introduction of Keurig's first At Home brewer, at the same time convincing the company's board of directors to take the risky approach of launching design and development of a next-generation brewer before the first brewer had reached the marketplace. That decision turned out to be critical to Keurig, providing the basis for a suite of products that secured Keurig the four best-selling coffee makers, in dollars, in Q4 2010.<sup>1</sup> Its strategy had been to offer a wide variety of coffees compatible with its single serve brewing system. Now, the company had just concluded an agreement with Dunkin' Donuts that would make five flavors of its coffee available in K-Cup® portion packs compatible with Keurig brewers. Starbucks, a company synonymous with super-premium gourmet coffee, had also agreed to offer its coffee and Tazo tea for the Keurig® single-cup brewing system.

In the fourth quarter of 2010, approximately 25 percent of all coffee makers sold in the United States were Keurig-branded machines,<sup>2</sup> and Keurig was recognized as among the leaders in the marketplace. Keurig now faced different challenges than in 2003 when it was a small, unknown marketplace entrant. Among them, Whoriskey considered what impact the impending expiration of key technology patents and the perceived environmental impact of the K-Cup® portion packs could have on the company's growth. Whoriskey wondered what Keurig's growth potential was, and how the new arrangements with Starbucks and Dunkin' Donuts could be leveraged to achieve it.

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<sup>1</sup> From company reports, based on NPD data, which does not include all retailers and is estimated to represent 35 to 45 percent of the total marketplace.

<sup>2</sup> Ibid.

## The Company and Its Products

Keurig had been founded to commercialize an innovative technology that allowed coffee lovers to brew one perfect cup of coffee at a time.<sup>3</sup> Beginning with the company's inception in 1992, the word "keurig," derived from the Dutch word for excellence, had been the guiding principle behind the company's products and services. With its patented single serve brewing system, Keurig first entered the office coffee service, or Away From Home (AFH), marketplace in 1998. In 2003 Keurig became one of the first to enter the At Home (AH) marketplace with a single-cup brewer designed for use in the home.

Keurig's single-portion brewer strategy was built on three key product features: a coffee brewer that perfectly controlled the amount, temperature, and pressure of water to provide a consistently superior-tasting cup of coffee; a unique, patented portion-pack system (marketed under the K-Cup® brand) containing ground coffee beans as well as filter paper; and a varied coffee selection to replicate the choices available in a gourmet coffeehouse.

This varied coffee selection was a key differentiator for Keurig and was achieved through licensing arrangements with a variety of gourmet coffee roasters. A selective but nonexclusive relationship with a coffee roaster enabled the roaster to pack its specialty coffees in the K-Cup® portion pack. Coffee roasters controlled the quality of their coffee and the number of varieties available through portion-pack production lines. A production line was owned or leased and operated by the coffee roaster. K-Cup® portion packs were produced by four North American roasters with more than seventy-five coffee varieties. Roaster partners included GMCR, Diedrich Coffee, Inc., Van Houtte, Inc., and Timothy's Coffee of the World, Inc. The roaster paid Keurig a royalty for each K-Cup sold.<sup>4</sup> Other roaster partners were subsequently added, such as Tully's in 2006.

At the time of Keurig's entrance into the AH marketplace in 2003, the company was privately held, with three significant shareholders. MDT, an investment advisory firm that managed a U.S.-based profit-sharing plan, had served as Keurig's lead venture capital investor since 1995 and led the company's board of directors. GMCR held a 42 percent stake in Keurig, and Van Houtte owned 28 percent. 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, enabling Keurig to maintain a roaster-neutral company strategy.

## At Home Product Introduction

Keurig felt that being one of the first entrants in the product category was critical to its performance. The company's launch of the B100 single-cup brewer in September 2003 coincided with Salton's U.S. launch of the Melitta One:One brewer and Flavia's SB100 brewer. Each brewer differentiated itself by its features, underlying brewing technology, and packaging of the coffee. Both the Keurig and Flavia brewers used a proprietary portion pack, while the Melitta

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<sup>3</sup> Portions of this overview are excerpted from "Keurig At Home: Managing a New Product Launch," Case #5-105-005 (Kellogg School of Management, 2004).

<sup>4</sup> See "Keurig At Home" case. The royalty was estimated to be approximately \$0.04 per K-Cup. The royalty was increased by about \$0.01 in 2008 to support advertising and market development.

brewer used a 44mm pod. All three provided the ability to brew a single cup of coffee at a time (see **Exhibit 3**). The Keurig and Flavia systems (both brewer and coffee) were only available online, whereas the Melitta system was available online and in limited retail outlets.

### ***A New Business Is Brewing***

The AH single serve concept was well received by coffee lovers. Early press and user reviews showed that customers were happy with the ability to brew a single cup of coffee with no mess—no scooping of coffee or dealing with filters—in 60–90 seconds. Feedback among the users of the three initial entrants varied, however, with the selection of coffee varieties a common thread for discussion. Melitta One:One offered only five options and the Flavia system was only slightly better, with a choice of eleven flavors. In addition, both systems' offerings were restricted to a proprietary roaster. Meanwhile Keurig offered a total of more than seventy-five options encompassing a variety of flavors from four different coffee roasters. It quickly became apparent that feedback on a brewing system was often driven by the user's individual coffee preferences, so greater quality and variety of coffee positioned Keurig well in the marketplace. Users complained, however, that all three competitors lacked availability of the proprietary coffee packs in retail stores. Online ordering was the only option and required some advance planning to have a continuous supply of coffee.

Some new, larger players entered the single serve marketplace in 2004. In March of that year, Phillips and Sara Lee International launched the Senseo 7810 in the United States. The pod-based system brewed Sara Lee's Douwe Egberts coffee brand and produced a distinct frothy layer on top of the brewed coffee. The U.S. introduction of the Senseo followed launches in the Netherlands, France, Germany, and Denmark between 2001 and 2003. More than 5 million machines and 2.5 billion pods had already been sold in those countries.<sup>5</sup> The brewer's primarily plastic construction was still viewed as sturdy and overall it received positive reviews for its simplicity and ease of use.

In February 2004 Procter & Gamble announced that it had joined forces with four appliance marketers<sup>6</sup> to launch the Home Café single-cup brewing system in conjunction with a \$50 million-plus marketing campaign. The Home Café pod system would brew Folgers and Millstone coffees. Black & Decker produced the first Home Café brewing system in May 2004, but users frequently complained about the machine leaking, the difficulty of properly placing the pod in its holder, and the volume of plastic used in the brewer construction. In late 2004 the Mr. Coffee Home Café brewer was added to the line and received more positive reviews.

Both the Senseo and Black & Decker Home Café systems were available online and in limited retail outlets, an improvement upon the limited distribution of early products. Across all products, however, reviews of the coffee varied from one extreme to the other, highlighting the challenge of being able to meet the taste requirements of a range of coffee drinkers, from the casual one-cup-a-day drinker to the gourmet coffee snob.

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<sup>5</sup> Phillips/Sara Lee press release, February 2004.

<sup>6</sup> Black & Decker, Krups, Hamilton Beach, and Sunbeam.

Even so, the entrance of P&G marked a turning point for single serve brewing. Extensive ad campaigns, including infomercials and an appearance on the show *Survivor* in September 2004, created awareness of the Home Café product line. In turn, this created spillover recognition for all single serve brewing systems, and the category grew.

### **Managing Brewer Manufacturing Costs**

At the time of Keurig's B100 launch, management knew that its brewer price was very high. Even so, Keurig management felt that it was important to gain experience and consumer exposure in this emerging business. Mark Wood, VP of new business development, explained, "Launching new products stimulates interest in the company and in the category."

When the B100 was introduced in fall 2003, Keurig embarked on an ambitious three-pronged approach to address the brewer's cost structure. The approach consisted of reengineering the existing brewer to reduce cost, evaluating overseas options for brewer manufacturing, and launching a new brewer project in time for the holiday 2004 season, including retail distribution. Kevin Sullivan, VP of engineering, joined Keurig just after the initial launch of the B100 brewer and, after overseeing modest cost reductions on the current design, focused the engineering team's attention on the next-generation brewer, the B50 (see **Exhibit 4**).

The B50 design effort replicated existing Keurig benefits: time, temperature, and volume (TTV) control, use of the existing K-Cup® portion pack, at least two brew volumes (e.g., 6 oz., 8 oz.), and support of a retail price point of \$149. Limiting the variance in the TTV components was key to meeting the taste profile requirements of both the "Cuppers"<sup>7</sup> and Keurig's roaster partners. Engineering evaluated three alternatives in its design process: redesign of the B100 brewer, evaluation of the pod systems in the marketplace to see how they could be modified to achieve the Keurig benefits, and a bottoms-up new design of the brewer. Ultimately Keurig chose to start from scratch when designing the new brewer, balancing the product features with budget and schedule requirements to meet the fourth quarter 2004 deliverable.

In parallel with the B50 design efforts, Dick Sweeney, VP of contract manufacturing and quality assurance, oversaw efforts to select a manufacturer for both the B100 and the new B50 brewers. After narrowing the field down to three companies, Keurig selected a single vendor in late December 2003. Production of the B50 began in September 2004, and in November 2004 the company received the first shipment of brewers via airfreight to meet the goal of holiday distribution.

### **Keurig's Retail Launch Strategy**

Keurig's retail launch strategy included two features central to its success. Whoriskey explained it as follows:

*We recognized that retailers were different and competed in different market segments.  
Selling a single brewer could create conflict among retailers that could limit distribution.*

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<sup>7</sup> "Cuppers" were responsible for tasting the finished coffee product to evaluate the flavor profile of a coffee.

*A high-end retailer such as Williams-Sonoma did not typically carry the same product assortment as a mass merchant like Target. We also needed to offer assurance to retailers that their support of a premium brewer would be worth their investment.*

As a result, Keurig envisioned producing a suite of brewers—“good, better, best”—that would allow it to offer different products in each retail segment to meet the needs of those retailers’ target customers. The products would match varying retail price points and offer a range of product features. The “better” category of product would provide broader appeal for multiple segments. Initially the B50, with its improved cost structure, fit the better category and was designed to meet a price point of around \$149. In some cases, a “good, better, best” suite of products also allowed Keurig to meet varying retailer margin requirements. As shown in **Exhibit 5**, average profit margins varied between mass merchants such as Target and premium retailers such as Williams-Sonoma.

In launching the B50 brewer, Keurig also needed to address retailer concerns that investments in support of Keurig would not be eroded away. That investment included inventory costs to carry the brewer, shelf space, advertising, and training of in-store staff about the product. To address potential retailer concerns, Keurig created a minimum advertised price (MAP) program.

Premium manufacturers in numerous industries, including Bose, Viking, Sub-Zero, HP, and Nintendo, often used MAP programs. These programs minimized intrabrand price competition by providing incentives to retailers who only advertised prices at or above the MAP price; a common incentive was cooperative advertising dollars that could be used to subsidize retailers’ advertising expenses. A retailer that chose to advertise in a manner inconsistent with the MAP program could lose out on these financial incentives. A retailer that repeatedly violated these terms could eventually lose the right to distribute a manufacturer’s product. From the retailers’ perspective, the MAP price provided some comfort that competing retailers would not undercut them on advertised prices.

In the months leading up to the B50 launch, Whoriskey focused on a number of issues associated with moving into the retail environment, including gaining product placements with retailers, identifying a logistics partner that would manage the fulfillment to retail stores, and introducing new, lower-count-size packages of K-Cup® portion packs. By the holiday 2004 season, ten retailers had agreed to distribute the B50 brewer in about a hundred stores. Keurig selected M. Block and Sons as the exclusive retail distribution partner for the brewer and completed repackaging of K-Cup® portion packs to offer quantities of eighteen at a MAP price of \$9.95. Whereas Sara Lee and P&G focused their marketing dollars on television and print advertising, Keurig devoted its more limited advertising dollars to in-store demonstrations of the product. The television and print coverage by Keurig’s rivals increased consumers’ exposure to the single serve concept and sent them to stores with curiosity about the products. Once in the stores, Keurig hoped its demos would get people hooked on the taste, ease, and simplicity of the Keurig system.

## The At Home Marketplace Heats Up

With the entry of competitors and heavy advertising spending, interest and awareness of single serve brewing increased and sales of Keurig brewers took off. By the holiday 2005 season, Keurig had grown its retail presence to 3,500 stores. Existing competitors were also adding products, with new entrants joining the fray.

## Competitor Activity

Kraft partnered with Braun to introduce the Tassimo Hot Beverage System in the United States in September 2005. Designed by Kraft, the product had been introduced in France, Switzerland, and the United Kingdom in 2004 and was touted as the leading competitor to the Senseo system there. The Tassimo system used a proprietary portion pack, the T-Disc, which included a bar code that provided information to the machine about the appropriate brewing settings (amount of water, brewing time, and temperature). In addition to coffee, the Tassimo offered cappuccino, espresso, café crema, tea, and hot chocolate—a total of about fifteen varieties, featuring Kraft brands such as Gevalia and Maxwell House as well as Kraft-distributed Twinings Tea. The brewer's suggested retail price was \$169.99, with a cost of about \$0.50 per T-Disc. Like P&G, Kraft used its marketing muscle to push the Tassimo system and the entire single serve segment of coffee brewing. The system was featured in an episode of *The Apprentice: Martha Stewart*, in which contestants were tasked with creating a retail space for selling the new system. Kraft reportedly invested \$75 million in marketing the system's introduction.

Kraft subsequently announced a partnership with Starbucks in December 2007, introducing four Starbucks varieties in time for the holiday season. Starbucks positioned it as a natural fit for the company, a “way to provide an authentic Starbucks coffee experience to our customers, and to do so anywhere and anytime they prefer.”<sup>8</sup> This expanded relationship between Kraft and Starbucks (building off a 1998 supply and distribution agreement) came on the heels of a revamped business plan to “spur stronger and more profitable growth”<sup>9</sup> in the Tassimo system. It also expanded Tassimo's beverage offerings to more than sixty worldwide.<sup>10</sup> At the same time, Kraft announced a new brewer alliance with Bosch to replace Braun, which had been acquired by a coffee competitor, P&G.

Additionally, another competitor had appeared on the scene in 2005. Bunn was a manufacturer of drip coffee makers for commercial and AH applications. With the Bunn My Café, the company joined the single serve segment, advertising a patented jet action sprayhead as a differentiator in the brewer's ability to release flavor and aroma. The pod-based brewer used a pour-over method that required the consumer to pour in the desired amount of water, from 4 to 14 ounces, each time a new cup was brewed. The pod drawer was designed to receive a range of pod sizes, enabling the brewer to be used with a variety of different roasters' pods and increasing the variety of coffees available for use with the brewer. The brewer was introduced with a suggested retail price of \$199.95.

Not all product introductions were successful, however. P&G experienced slow sales and a smaller adoption of its Home Café line after its initial splash. In June 2006 the company announced it would cut marketing funds for the product, after having spent an estimated \$41 million since the launch of the first brewer in 2004. Similarly, after significant success in Europe, Senseo's sales and product innovation in the United States seemed to trail off.

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<sup>8</sup> Kraft press release, September 4, 2007.

<sup>9</sup> Ibid.

<sup>10</sup> The Kraft-Starbucks relationship was terminated by Starbucks on March 1, 2011.

The stumbles and uncertainty of some of its competitors did not slow Keurig down. In fall 2005 Keurig introduced two new AH brewers to its product line: the Keurig Elite B40 and the Keurig Special Edition B60. With variations in the programmability and features, these products helped the company target the “good” and “best” segments of its distribution strategy, respectively. The B40 was generally offered at a retail price of \$99.95, while the B60 was generally offered at \$199.95. In fall 2006 the Keurig Platinum B70 was introduced with the most robust set of features and functionality to date, including four cup sizes, a programmable LCD display, and a larger water reservoir. Each brewer provided the same user experience in terms of ease of use and brewing of a great cup of coffee, consistent with Keurig’s overall product commitment. By the first quarter of 2007, Keurig had secured a position as one of the market leaders in the small but growing single-cup segment of the broader coffee maker category (see Exhibit 6).

### **Changes at Keurig**

In June 2006 GMCR completed the acquisition of the remaining shares of Keurig, transitioning Keurig from a small, privately held company to a wholly owned subsidiary of a publicly traded company. In doing so, GMCR not only signaled its commitment to single serve brewing but also reaffirmed its support of Keurig’s multibrand strategy, one of the company’s key differentiating features and an important element of its success. This move enabled Keurig to leverage the resources of GMCR to further its growth in the single serve segment. The added financial backing of GMCR was critical to Keurig’s ongoing product innovation and also allowed the company to aggressively protect its design and technology investments.

Ownership by GMCR allowed Keurig to pursue a new avenue for expansion of its robust offering of coffee varieties with its single serve brewers. As an example, Keurig and Caribou Coffee announced an agreement in early 2007 that would make eight flavors of Caribou Coffee available in K-Cup® portion packs. This arrangement represented a new model for production and sales of K-Cup® portion packs.

*Under the terms of the arrangement, Caribou Coffee will blend and sell its gourmet coffee beans to Keurig. Keurig will be responsible for packaging the coffee into K-Cups in accordance with Caribou Coffee’s specifications. Under the license from Caribou Coffee, Keurig will also serve as the wholesale distributor and a direct retailer for all Caribou Coffee K-Cups.<sup>11</sup>*

Rather than requiring a roaster partner to operate its own production line, Keurig could benefit from the manufacturing capabilities of its parent to pursue relationships without upfront capital or leasing costs.

At the same time, tension existed between GMCR and the other roasters over the longevity of GMCR’s commitment to a multibrand strategy. This tension eased as GMCR embarked on a strategy of acquiring the wholesale businesses, including the K-Cup® portion-pack production lines, of each of the original roaster partners, beginning with Tully’s in early 2009, followed by Timothy’s in late 2009, and Diedrich’s Coffee and Van Houtte in 2010. Driving these

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<sup>11</sup> Caribou Coffee, press release, January 8, 2007.

acquisitions was GMCR's desire to become a leader in the highly fragmented coffee industry. GMCR added complementary brands to its portfolio while expanding its geographic presence and manufacturing and distribution capabilities.

With GMCR's backing, Keurig's ongoing success enabled it to expand its marketing and distribution presence. In the holiday 2007 season, Keurig launched a \$3 million television advertising campaign in sixteen cities, coupling it with in-store demonstrations and cooperative advertising support in retail stores. That investment grew close to \$20 million, including a \$6 million national advertising campaign, for the holiday 2008 season. In conjunction with that same holiday season, Keurig and GMCR also launched brewer and twelve-count K-Cup® portion-pack offerings in the grocery channel, adding to the purchase options available to consumers. The total number of retail outlets, including grocery stores, exceeded 16,000 locations by the end of 2008 (see **Exhibit 7**). Keurig brewer sales continued to grow, and in the fourth quarter of 2008 Keurig had captured close to 20 percent of total coffee maker sales in dollars (see **Exhibits 8 and 9**). Keurig further expanded the brewer options available to the consumer, introducing the first third-party brewer designed using Keurig's proprietary and patented brewing technology in 2007.<sup>12</sup>

### **Marketplace Evolution**

A question facing Keurig and all manufacturers of single serve brewing systems was the state of the coffee marketplace and the ongoing role of single serve applications. The marketplace for drip coffee makers in the United States was stagnant, with a decline of approximately 3 percent from 2004 to 2010 (see **Exhibit 10**). Single serve coffee makers, however, had grown to represent about 19 percent of the total sales volume in that same time. Importantly, about 71 percent of the 115 million households in America owned a coffee maker in 2008. In terms of coffee consumption, research showed that 44 percent of all U.S. consumers had a daily cup of coffee and 75 percent of that consumption was done in the home.<sup>13</sup>

Industry analyst Harry Balzer of the NPD Group commented:

*Coffee consumption per capita is fairly stable in the U.S. So for a coffee company to gain share in the marketplace, it needs to shift share or get consumers to pay more for a cup of coffee. Manufacturers of coffee makers have to address one or more of three key components: novelty, time, or money—is it new, does it save time, or does it save money?*

Analysis of the foreign marketplace could also provide some insight into the U.S. marketplace's potential. Industry analyst Scott Van Winkle pointed to the success of Nespresso S.A., a business of Nestle Group, in Europe as an indicator of the potential for Keurig in the United States: "I could see Keurig's market share for coffee makers grow close to 50 percent based on the precedent set by Nespresso in Europe, where they have reached the 40 percent range." Initially introduced in Switzerland in 1986, Nespresso's single serve espresso machine experienced a slow start until the mid-1990s, when it entered a period of rapid growth. According to the company, Nespresso achieved organic growth of more than 20 percent in 2010 and

<sup>12</sup> Breville was the first third-party manufacturer. Additional relationships with Jarden and Conair were announced in 2009.

<sup>13</sup> Harry Balzer, NPD Group, in interview with the author.

estimated “global market share of around 20 percent in the segment of espresso and filter portioned coffee machines.”<sup>14</sup>

## Choose. Brew. Enjoy.®

### Choose

From its initial entry into single serve brewing, Keurig recognized the importance of choice to allow each person to find a coffee that met his individual taste preferences. Keurig continued on this path by entering into relationships with three key coffee brands, each with its own loyal following: Folger’s Gourmet Selections in 2010, followed by Dunkin’ Donuts and Starbucks in 2011. In February 2011 GMCR entered into a promotion, manufacturing, and distribution agreement with Dunkin’ Donuts that would make five flavors available in K-Cup® portion packs, sold exclusively in its restaurants by the second half of 2011. In addition, Keurig brewers occasionally would be sold in the restaurants. GMCR would be responsible for packaging the K-Cup® portion packs using coffee that was sourced and roasted to Dunkin’ Donuts specifications.

In March 2011 GMCR entered into a manufacturing, marketing, distribution, and sales relationship with Starbucks that would make Starbucks and Tazo tea K-Cup® portion packs available by fall 2011. Starbucks had previously introduced its own portion pack of instant coffee targeted at single serve consumers, Starbucks VIA Ready Brew, which had achieved \$100 million in worldwide sales in under a year.<sup>15</sup> The relationship would enable Keurig to potentially reach the approximately 50 million customers served in Starbucks stores every week, an estimated 80 percent of whom did not have a single serve brewer at home.<sup>16</sup>

The Starbucks relationship presented an exciting opportunity for Keurig to add a super-premium coffee brand to its robust offering of flavors. However, there was some uncertainty concerning the long-term benefit. Starbucks had already announced a strategy to pursue multiple options in single serve brewing.

*“The single serve coffee category in the U.S., and much of the world for that matter, is in its beginning stages of development,” said Jeff Hansberry, president, Starbucks Consumer Products Group. “At this very early stage, there are numerous contenders and no demonstrated long-term winners related to either format or machines. Following our very successful introduction of Starbucks VIA Ready Brew in the U.S. and into a growing number of international markets, Starbucks will continue to explore the many single serve and on-the-go solutions and options available to us, and to participate in those where we can better and more conveniently serve our customers wherever they may be.”*<sup>17</sup>

<sup>14</sup> Nespresso Corporate Backgrounder and Corporate Factsheets, March 2011, [http://www.nespresso.com/mediacenter/xml/int/resources/pdf/CorporateBackgrounder\\_CorporateFactsheets\\_EN.pdf](http://www.nespresso.com/mediacenter/xml/int/resources/pdf/CorporateBackgrounder_CorporateFactsheets_EN.pdf).

<sup>15</sup> Starbucks press release, August 3, 2010.

<sup>16</sup> Starbucks press release, March 10, 2011.

<sup>17</sup> Starbucks press release, February 15, 2011.

The question remained whether Starbucks's relationship with GMCR and Keurig represented an interim solution or whether it would fulfill a key component in Starbucks's overall single serve offering.

In conjunction with expanding their coffee offerings, Keurig and GMCR also continued to grow the grocery presence to enable consumers to easily obtain K-Cup® portion packs. By the end of 2010, K-Cup® portion packs could be purchased in 98 percent of grocery stores in the Northeast and 61 percent of all grocery stores in the United States.<sup>18</sup>

## **Brew**

Its commitment to technological innovation continued to be a key component of Keurig's success. Where appropriate, Keurig obtained patents covering its innovations and vigorously defended them. In January 2007 Keurig filed a patent infringement lawsuit against Kraft Foods Inc., Kraft Foods Global, Inc., and Tassimo Corporation asserting that Kraft's T-Discs infringed upon a Keurig technology patent filed in August 2003. In October 2008 Kraft agreed to settle out of court with a lump sum of \$17 million for a limited, nonexclusive license for applicable Keurig patents related to beverage machines and beverage cartridges.

More recently, Keurig had filed a lawsuit against Sturm Foods:

*The Sturm portion packs that we've seen appearing on several retailer shelves contain instant coffee and state they are intended for use in Keurig brewers. As our complaint notes, our lawsuit asserts that Sturm's portion packs infringe two patents, which cover certain technologies relating to the use of brewers and portion packs.*<sup>19</sup>

Keurig was looking for similar success in this suit. However, the longevity of some of the existing patents still could pose a problem. Certain patents associated with the current generation of K-Cup® portion packs were set to expire in 2012 and 2017, while brewer patents had expiration dates out to 2023. Pending patent applications associated with the current generation of K-Cup® portion packs, if issued, could extend those expiration dates to 2023 as well. Without patent protection, the door could be opened to competitors such as Sturm Foods, which would look to market a product to compete with the K-Cup® portion pack, thus eroding GMCR's own coffee sales as well as royalties from other roaster coffee sales using the Keurig technology.

Another issue facing Keurig lay in the patented K-Cup® portion pack itself. Key to the quality and freshness of its coffee, the K-Cup® design included materials and a heat-sealing process that made recycling difficult. Keurig had introduced the My K-Cup® reusable filter assembly in 2006, a reusable filter designed to work with the Keurig single-cup brewing system. Although it was initially targeted for use by consumers wanting to use their own gourmet coffee instead of a prepackaged portion pack, it could also provide a solution to environmentally conscious users who were concerned with the disposal of the used K-Cup® portion packs, which contained plastic and other nonrecyclable materials. That solution did not address those consumers interested in the convenience of the traditional K-Cup portion pack, however.

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<sup>18</sup> From GMCR first quarter 2011 earnings release based on IRI data for the latest twelve weeks ended December 26, 2010.

<sup>19</sup> GMCR, "Prepared Remarks for Fourth Quarter and Year-End Fiscal 2010 Results," December 9, 2010, p. 2.

Keurig's competitors were facing the same challenge. In December 2010 Bunn My Café had introduced a new brewer that used pods that could be composted. In Europe, Nespresso had introduced dedicated portion-pack collection points to facilitate capsule recycling, and in 2009 it committed to tripling its recycling capacity by 2013. A similar issue had arisen in the bottled water industry. The convenience of bottled water, together with consumers' desire for a healthier alternative to soda, had resulted in rapid growth in sales of bottled water. But concerns about the volume of empty plastic containers in landfills threatened the industry and caused sales to slow, leaving bottled water manufacturers scrambling to find solutions to their environmental challenge.

Concerns about the environmental impact of the K-Cup portion pack had started to surface in user comments on websites and in newspapers such as the *New York Times*.<sup>20</sup> Estimates of the amount of nonrecyclable material from the K-Cups appearing in landfills had some users contemplating use of another, more environmentally friendly single-cup brewing system. Keurig's own life cycle analysis compared a number of environmental factors of the Keurig single-cup brewing system to traditional drip brewing. The analysis had shown that product-packaging disposal contributed only a fraction of its total environmental impact as compared to the production of the packaging itself.<sup>21</sup> As a result, the company was working with its packaging suppliers to improve the environmental dimensions of the packaging production process. The introduction of nested packaging to reduce the size of a box of K-Cup® portion packs and experimentation with a tea-based K-Cup® portion pack made with paper were additional environmental initiatives undertaken by the company. With the increasing popularity of the Keurig single-cup brewing system, the K-Cup® portion-pack packaging was one of the company's most significant environmental challenges and needed to be addressed to prevent erosion of its position in the marketplace.

## **Enjoy?**

By March 2011, Keurig was in an enviable position. In the fourth quarter of 2010 it had shipped a record number of products, and Keurig models were the four best-selling brewers, in dollar sales, in the United States. The company had also just announced the agreements with Dunkin' Donuts and Starbucks, which would strengthen its multibrand approach and penetrate a new retail outlet.

But Whoriskey and the rest of the senior leadership team at Keurig and GMCR couldn't help but turn their attention to the future. Whoriskey was eager to begin writing the next chapter in Keurig's success story, but questioned the potential size of the single serve opportunity, the impact of expiring technology patents and environmental concerns, and how to maximize the effectiveness of Keurig's relationships with its coffee-roasting partners.

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<sup>20</sup> See "A Coffee Conundrum," *New York Times*, August 3, 2010, and "Keurig K-Cups: How Green Is Green Mountain?" *Coffee Amp*, January 27, 2010, <http://www.coffeeamp.com/single-cup-coffee/keurig-k-cups/keurig-k-cups-how-green-is-green-mountain>.

<sup>21</sup> "Reducing Our Environmental Impact: The Keurig® Brewing System," <http://www.gmcr.com/csr/ProtectingTheEnvironment/TheKeurigSingleCupBrewingSystem.aspx>.

**Exhibit 1: Members of Keurig and GMCR Senior Management Teams**

## KEURIG SENIOR MANAGEMENT TEAM

- Michelle Stacy, President
- John Whoriskey, Vice President, General Manager At Home Division
- Dave Manly, Vice President, General Manager Away From Home and Consumer Direct Divisions
- Kevin Sullivan, Vice President, Engineering
- Ian Tinkler, Vice President, Brewer Engineering
- Bob McCall, Vice President, Packaging, Equipment, and R&D
- Dick Sweeney, Co-Founder, Vice President, Contract Manufacturing and Quality Assurance
- Basil Karanikos, Vice President, Packaging Special Products
- Chris Stevens, Vice President, Corporate Relations and Customer Development
- Mark Wood, Vice President, New Business Development
- Mike Degnan, Vice President, General Counsel
- John Heller, Vice President, Finance

## GMCR SENIOR MANAGEMENT TEAM

- Larry Blanford, President and CEO
- Howard Malovany, Vice President, Corporate General Counsel and Secretary
- R. Scott McCreary, President, Specialty Coffee Business Unit
- Frances Rathke, Chief Financial Officer
- Stephen J. Sabol, Vice President, Development
- Michelle Stacy, President, Keurig

**Exhibit 2: Green Mountain Coffee Roasters Financial Performance (\$ in thousands)**

| Fiscal Year | Net Sales | Gross Profit | Net Income |
|-------------|-----------|--------------|------------|
| 2005        | 161,536   | 56,975       | 8,956      |
| 2006        | 225,323   | 82,034       | 8,443      |
| 2007        | 341,651   | 131,121      | 12,843     |
| 2008        | 492,517   | 174,040      | 21,669     |
| 2009        | 786,135   | 245,391      | 54,439     |
| 2010        | 1,356,775 | 425,758      | 79,506     |

Note: Net income for 2005 and 2006 is after equity in losses of Keurig, Inc., net of tax benefit. GMCR acquired Keurig in June 2006.

Source: GMCR Annual Reports.

**Exhibit 3: Comparison of Early Single-Cup Brewing Systems**

| Features                    | Keurig B100       | Melitta One:One | Flavia SB100           | Senseo       | Home Café HCC100     |
|-----------------------------|-------------------|-----------------|------------------------|--------------|----------------------|
| Manufacturer                | Keurig            | Salton          | Filterfresh            | Phillips     | Black & Decker       |
| Coffee packaging            | Proprietary K-Cup | 44mm pod        | Proprietary Filterpack | 62 mm pod    | 62 mm pod            |
| Brewing sizes               | 8 oz.             | 5 oz., 8 oz.    | 5 oz., 8 oz.           | 4 oz., 8 oz. | 7 oz., 9 oz., 14 oz. |
| Water reservoir             | 64 oz.            | 28 oz.          | 96 oz.                 | 50 oz.       | 34 oz.               |
| Shortest time to first cup  | < 1 min           | 1 min           | < 1 min                | 2+ min       | 1 min                |
| Shortest time to second cup | Immediate         | 45 sec          | 40–45 sec              | 30 sec       | 10 sec               |
| Number of flavors           | 75+               | 6               | 15                     | 4            | 9                    |
| Suggested retail price      | \$249.99          | \$49.99         | \$99.99                | \$69.99      | \$59.95              |

Source: Singleservecoffee.com, company analysis.

**Exhibit 4: Keurig B50 Brewer and K-Cup® Portion Pack**

**Choose**  
Only Keurig has over 70 coffees and teas from the world's finest brands.

**Brew**  
Just open the lid. Place the K-Cup® portion pack in the brewer and press the button. No grinding, no measuring, no mess.



**Enjoy**  
Experience your own perfect cup of gourmet coffee or tea in less than a minute. No grinding, no measuring, no mess.

**Deliciously Simple®.**

**KEURIG**  
www.Keurig.com 1.866.KEURIG

**Introducing a coffee lover's dream machine.**

The new Keurig® Gourmet Single Cup Brewing System.  
Finally, all of you coffee lovers can enjoy exactly the taste you want.  
Brewed to perfection one cup at a time right in your own kitchen.



Unlike multi-pack coffee "pods" used in other brewing systems, K-Cups are airtight, locking in ultimate freshness and flavor.

And, because brewing takes place inside the K-Cup, water temperature and pressure are precisely controlled. No messy drips to clean up. And no flavor residue left behind to spoil the next cup.



- Airtight (unlike pods) to lock in freshness and flavor.
- Hot water flows through the K-Cup with pressurized precision.
- The ideal grind and measure of 100% Arabica bean coffee.
- A pure paper filter for optimum flavor extraction.
- Fresh-brewed from the K-Cup to your cup.

**Exhibit 5: Retailer Annual Gross Margins (%)**

| Retailer          | 2006 | 2007 | 2008 | 2009 | 2010 |
|-------------------|------|------|------|------|------|
| Amazon.com        | 22.9 | 22.6 | 22.3 | 22.6 | 22.3 |
| Bed Bath & Beyond | 42.8 | 41.5 | 39.9 | 41.0 | 41.4 |
| Kohl's            | 36.4 | 36.5 | 36.9 | 37.8 | 38.2 |
| Macy's            | 39.9 | 40.4 | 39.7 | 40.5 | 40.7 |
| Target            | 30.3 | 30.2 | 29.8 | 30.5 | 30.5 |
| Williams-Sonoma   | 39.9 | 38.9 | 33.8 | 35.6 | 39.2 |

Source: RetailSails data.

**Exhibit 6: Single Serve Coffee Maker Sales by Brand****By Dollar Volume (\$)**

| Brand          | Jan.–Mar. 2005 | Jan.–Mar. 2006 | Jan.–Mar. 2007 |
|----------------|----------------|----------------|----------------|
| Keurig         | 152,730        | 1,154,135      | 2,293,802      |
| Braun          | 0              | 1,622,884      | 2,166,536      |
| Phillips       | 1,379,242      | 1,120,567      | 1,172,441      |
| Flavia         | 0              | 0              | 170,719        |
| Mr. Coffee     | 60,017         | 249,363        | 168,508        |
| Krups          | 0              | 222,310        | 152,419        |
| Melitta        | 1,040,165      | 525,173        | 35,214         |
| Bunn           | 41,408         | 62,593         | 24,424         |
| Black & Decker | 608,635        | 645,033        | 24,168         |

**By Unit Volume**

| Brand          | Jan.–Mar. 2005 | Jan.–Mar. 2006 | Jan.–Mar. 2007 |
|----------------|----------------|----------------|----------------|
| Keurig         | 1,022          | 8,813          | 17,995         |
| Braun          | 0              | 9,925          | 15,029         |
| Phillips       | 22,730         | 18,905         | 18,881         |
| Flavia         | 0              | 0              | 1,648          |
| Mr. Coffee     | 1,173          | 3,471          | 3,456          |
| Krups          | 0              | 1,771          | 4,109          |
| Melitta        | 27,252         | 11,279         | 634            |
| Bunn           | 212            | 337            | 115            |
| Black & Decker | 11,535         | 11,376         | 969            |

*Note:* Total coffee maker category includes all coffee makers and espresso makers. NPD data does not include all retailers and is estimated to represent 35 to 40 percent of the total marketplace.

*Source:* NPD data.

**Exhibit 7: Keurig Retail Presence**

| Year Ending   | No. of Retail Stores | No. of Supermarkets | Total Retail Locations |
|---------------|----------------------|---------------------|------------------------|
| December 2004 | 200                  | 0                   | 200                    |
| December 2005 | 3,500                | 0                   | 3,500                  |
| December 2006 | 7,000                | 200                 | 7,200                  |
| December 2007 | 10,000               | 1,300               | 11,300                 |
| December 2008 | 13,800               | 2,600               | 16,400                 |
| December 2009 | 17,900               | 10,000              | 27,900                 |
| December 2010 | 19,000               | 14,400              | 33,400                 |

*Source:* GMCR earnings releases.

**Exhibit 8: Cumulative Keurig Single-Cup System Sales (in thousands)**

| Year Ending    | Keurig-Branded Brewers | K-Cup Portion Packs |
|----------------|------------------------|---------------------|
| September 2004 | 124                    |                     |
| September 2005 | 226                    | 312,405             |
| September 2006 | 474                    | 448,880             |
| September 2007 | 953                    | 638,298             |
| September 2008 | 1,936                  | 1,650,654           |
| September 2009 | 2,342                  | 3,300,532           |
| September 2010 | 4,543                  | 6,185,532           |

Source: GMCR earnings releases.

**Exhibit 9: Keurig Coffee Maker Sales Share****Dollar Sales by Quarter**

|                 | 2007 | 2008 | 2009 | 2010 |
|-----------------|------|------|------|------|
| Q1 (Jan.–March) | 2.8  | 6.7  | 14.1 | 24.5 |
| Q2 (Apr.–June)  | 3.5  | 7.3  | 16.9 | 24.8 |
| Q3 (July–Sept.) | 4.1  | 7.9  | 17.3 | 26.5 |
| Q4 (Oct.–Dec.)  | 8.4  | 17.8 | 36.4 | 45.3 |

**Unit Sales by Quarter**

|                 | 2007 | 2008 | 2009 | 2010 |
|-----------------|------|------|------|------|
| Q1 (Jan.–March) | 0.9  | 2.3  | 5.7  | 10.8 |
| Q2 (Apr.– June) | 1.1  | 2.6  | 7.4  | 11.1 |
| Q3 (July–Sept.) | 1.3  | 2.7  | 6.8  | 11.3 |
| Q4 (Oct.– Dec.) | 3.1  | 8.1  | 18.6 | 25.1 |

Note: Total coffee maker category includes all coffee makers and espresso makers. Derived from NPD data. NPD data does not include all retailers and is estimated to represent 35 to 40 percent of the total marketplace.

Source: GMCR's NPD data from its earnings releases.

**Exhibit 10: Automatic Drip Coffee Maker Sales**

|      | Unit Volume | Single Serve Share (%) | Dollar Sales (\$) | Single Serve Share (%) |
|------|-------------|------------------------|-------------------|------------------------|
| 2004 | 26,705,000  | 5.5                    | 804,878,390       | 8.4                    |
| 2005 | 27,250,000  | 5.7                    | 870,138,800       | 9.5                    |
| 2006 | 27,148,060  | 5.2                    | 918,040,600       | 11.2                   |
| 2007 | 26,101,870  | 5.0                    | 903,635,800       | 11.9                   |
| 2008 | 23,281,190  | 7.0                    | 825,397,700       | 17.1                   |
| 2009 | 25,482,840  | 12.6                   | 976,260,400       | 29.6                   |
| 2010 | 25,870,160  | 19.4                   | 1,099,732,000     | 42.9                   |

Note: Drip coffee makers include automatic drip coffee and pod machines. Restatement of data post-2004. Volumetrics derived from presumed trend 2005 vs. 2004.

Source: NPD Group, Inc./Consumer Tracking Service.