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Some Restaurants Find Spot Market Tasty For Near-Term Buying

By Paul Ziobro,

NEW YORK -(Dow Jones)- Some restaurant chains are buying more ingredients on the volatile spot market, with suppliers reluctant to sign long-term contracts while commodity markets are in a demand-based swoon.

Buying from the spot market can help profits if prices stay low, but it also clouds earnings visibility since restaurants can't predict what price they'll pay for steaks, seafood or pasta on their next shopping trip.

Chain restaurants may be willing to expose themselves to such volatility, especially as some expect prices will only come up with increased demand. For an industry starving for sales growth, such a prospect would outweigh any drawback from higher costs. Last week, Darden Restaurants Inc. (DRI) Chairman and Chief Executive Clarence Otis said on an earnings call that the company would prefer to see its sales improve "than to have depressed commodity costs."

Darden, parent of Olive Garden, Red Lobster and other brands, has locked in prices for nearly 90% of its main ingredients through its current quarter, but only 30% of ingredients beyond that to take advantage of low spot prices. DineEquity Inc. (DIN), which runs IHOP and Applebee's, is also buying more ingredients through the spot market, a spokeswoman said.

Morton's Restaurant Group Inc. (MRT) in August said it was buying all of its beef on the spot market, even though historically the high-end steakhouse operator had relied on contracts to minimize risk from fluctuating prices. A year ago, Morton's was buying 70% of its prime beef and about half of its filets with contracted prices.

More restaurant chains could follow Darden in shopping the spot market, said Tom Forte, restaurant analyst with Telsey Advisory Group, hoping any rise in ingredient prices will come with better same-store sales.

"The hopeful upside to a strengthening commodity market is improving demand for dining out," Forte said. "The risk is that if you don't lock prices in, you have a strengthening commodity market without an uptick in sales."

While buying from the spot market when prices are low may seem like calculated gamble, restaurant chains may not have a choice. Few suppliers are entering into long-term purchasing contracts with commodities

prices low. "We're looking at higher prices for next year, so you're not going to lock in on low prices right now," said John Nalivka, president of Sterling Marketing Inc., an agriculture research and advisory firm.

Last year, suppliers and restaurant chains were at a similar standstill over contracts, but for different reasons. Many ingredient prices were near record highs after a run-up in fuel prices, causing chains to shun long-term contracts.

As the recession ate into sales, restaurants took the knife to their operations, cutting labor hours, reducing portions and scaling back development. Stocks rallied, as cost cuts helped restaurant chains turn in profits better than anticipated. Investors are now clamoring for more robust sales to fuel a further gain in stocks.