LP Enterprises, Inc.
Hospitality Purchasing Consulting Since 2001

Pro's & Con's of Contracting Commodities

Checks and Balances Series

Over the past several years, we have seen a fairly significant increase in commodity costs … mostly due to weather related issues (drought, floods, etc.). While no one has a crystal ball which provides us a window into the future …. we can look at historical data and get information on what type of buying makes the most sense for each of your operations.

That's why, when this topic arises, I discuss what I consider to be the "pro's & cons" of contracting with my clients. Understanding what your needs are (first and foremost) is critical to the success of any buying strategy. Are you seeing strong usage and volatile costs throughout the year for key ingredients? Has supply been an issue for you? What about maintaining a solid specification? Are you purchasing this product through one primary distributor or a number of bidding parties?

In my professional opinion, contracting (or hedging) can be a fundamentally sound practice when the market makes sense for *protecting your profit*. Key point … the main purpose is not to save money (although this is a desired outcome). Contracting at a set price allows your operation that "window into the future" to be able to fix a key ingredient price in your food cost at a level you feel comfortable with and always be able to make your profit margin without having to raise prices with your customers.

If the needs of your business are more in tune with riding the market and being able to take advantage of the lower swings in pricing, then this may not be an optimal strategy to consider. Commodity costs will rise and fall with the market, depending on supply and demand.

Some of the pro's are as follows:

- The ability to set a fixed ingredient price for a specific period of time and make your profit margin. Note: some produce, like lettuce, have high-low types of contracts available which offer a "floor" and "ceiling" for prices, but still allow pricing to follow the market within those guidelines.
- As mentioned above, taking the volatility out of key ingredient costs.
- Having a committed source for a product, where your operation is guaranteed volume. Especially important during product shortages.

Some of the con's:

- Pricing markets for key commodities typically rise and fall with seasonality, and supply and demand factors. Being able to take advantage of the low points during the year without being locked in at a higher rate.
- The ability to change spec's and volumes mid-stream, and only having to deplete committed inventory levels at your distributor.

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If you find that contracting (where the market makes sense) provides you with peace of mind, then …

- Do your homework beforehand.
  - Work with your distributor to identify these opportunities based on your current volumes. Ask them if they have contracts already in place for these ingredients that you may be able to add on to.
  - Talk with the experts at your distributor(s) … poultry, meat, produce, etc. Ask them to provide historical data of where pricing has been by month or period in previous years. What are the projections for the upcoming year (short supply?). What was last year's average price for those commodities? What times of the year are best to consider contracting, and what time frame makes the most sense without the source adding too much cost based on their risk in the marketplace? Will the distributor hold product for you (if so, is there a cost involved)?

Gathering your information upfront will provide the facts to make informed decisions about your buying strategy and could afford some level of protection for your profits.

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