Pricier Milk Could Curdle Profit Growth at Starbucks


Will next year be flowing with milk and honey? For some companies, the answer lies partly in dairy prices.

Prices of milk dropped to multiyear lows earlier this year, helping companies that spend heavily on dairy products endure weaker retail spending. At Starbucks, for instance, milk-price declines will contribute at least five cents of an estimated 77 cents in earnings per share in the year ended in September, says David Palmer of UBS.

But now, the tide may have turned. Depressed milk prices have forced many dairy farmers to shut down, reducing output. Benchmark Class III milk futures fell below $10 per hundred pounds earlier this year from a peak above $21 in 2007. In recent weeks, however, the price has recovered to nearly $13 per hundred pounds.

And the run may well continue. On top of farm closures, low prices have forced farmers to sell dairy cows through an industry program called Cooperatives Working Together. Member farms contribute money to the program, which purchases cows and slaughters them. So far this year, the number of working dairy cows in the U.S. has fallen by 170,000 to 9.2 million, says industry expert Jerry Dryer.

Higher milk prices would likely hurt Starbucks's profits. While it is possible to purchase futures for Class III milk, which is used to make cheese, there isn't a well-developed futures market for drinkable milk. Perhaps as a consequence, Starbucks hedges coffee prices but not milk. So even if milk prices held at current levels next year, Mr. Palmer expects that Starbucks would feel a negative earnings impact of a few cents a share, assuming no price increases to offset the cost.

Of course, any milk rally could coincide with stronger consumer demand, which would likely translate to higher sales at Starbucks. And the company may try to pass higher costs on to consumers. But with intense competition in the premium coffee market, price increases might be a losing battle.

The impact of higher dairy prices wouldn't be spread evenly across companies. Take Domino's Pizza. Cheese is the most expensive ingredient in a pizza, but only a fraction of any price increase would immediately hurt the company's profit.

The reason is that 95% of the company's stores are franchised. Domino's charges franchisees the full cost of the cheese plus a fixed dollar amount. That makes Domino's fairly resistant to a rising cost of dairy, even though suffering franchisees could hurt the company over time.

Starbucks, however, should have more reason for concern. With the company's stock trading at 22 times next year's consensus earnings forecast, investors are banking on a near-perfect performance. Even a modest milk rally could spoil the show.