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DRI Looks Washed Out

By Scott Rothbort
RealMoney Contributor
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Updated from Dec. 18 with earnings results

Darden Restaurants (DRI) got the thumbs down from investors today, dropping more than 20%.

When you tune out the acquisition noise, DRI delivered a disappointing quarter, as cost increases and poor management decisions cut into profits despite delivering revenue in line with expectations. On top of that, the company appears to be guiding lower for FY08. Finally, the Rare acquisition, while accretive may have come at too high a cost to DRI.

I have never been a fan of DRI, and frankly, cannot understand the company's strategy. DRI is a case study in poor strategic planning and management. The company put so much time and effort into the Smokey Bones and Bahama Breeze concepts, only to hit the eject button on Smokey Bones and still tinker around with the laggard Bahama Breeze unit.

Then DRI goes out and buys Rare, which includes the sluggish Longhorn concept. I questioned the Rare acquisition when it happened, and now it appears to not have been the best deal at least in the near term. What DRI needs -- are you listening Clarence Otis? -- is to forget domestic concept diversification and extensively export Olive Garden and Red Lobster to international markets.

As I have cautioned for some time, the casual dining segment of the restaurant industry is one area to avoid, and the DRI earnings release and conference call was proof positive of my position. Can DRI go lower? Maybe a little, but the stock looks washed out. However, it could be dead money for a while.

Earnings Details

Darden had EPS of 30 cents per share on net revenue from continuing operations of $1.52 billion. Acquisition and other costs contributed to 12 cents of charges within the bottom line EPS. These charges were broken down as follows: 9-cent charge related to the Rare Hospitality acquisition and integration; incremental financing costs of 4 cents; 3 cents offsetting tax benefits from the acquisition; and, litigation charges of 2 cents. When you add these net charges back in you arrive at an adjusted EPS of 42 cents. However, personally, the additional financing charges could be excluded from that adjusted calculation, depending on your opinion of such analytical treatment.

While total sales rose 17%, $163 million of the sales increase was attributed to the Rare acquisition. Excluding the acquisition, DRI sales growth year over year was 4.6%. Same-store sales rose 3.2% and total sales rose 8.2% at Olive Garden. Same-store sales rose 0.1% and total sales rose 0.6% at Red Lobster.

Longhorn Steakhouse (part of the Rare acquisition) sales decreased 3.9% in October/November (since DRI took ownership) and declined 2.5% for the full quarter. The Capital Grills (another part of the Rare purchase) generated same store sale increases of 0.7% for Oct/Nov and 1.2% for the entire quarter. Bahama Breeze same store sales were 0.1% for the quarter. For the industry as a whole, excluding DRI, were down 2% in the period.

Food and beverage costs rose 30 basis points year over year. Dairy and wheat costs have improved dramatically in the past few months and for October/November in particular. While DRI hedged some of its wheat-related exposure, those contracts were removed during the quarter at somewhat higher levels.

Commodity costs were passed on in the past year in the form of higher menu pricing, and DRI will do so again in 2008 if necessary. Labor expenses rose 60 basis points year over year. The cost of carrying additional managers that were transferred from the closed Smokey Boney units cost DRI 10 basis points or 1 cent in the quarter. Restaurant expenses rose 50 basis points in the quarter. SG&A rose 20 basis points year over year.

Revised 2008 Guidance

- Same-store sales from Red Lobster, Olive Garden and Longhorn to be in the middle of an expected 2%-4% range
  New restaurant opening of 65 units including growth at Longhorn and Capital Grill
- Total sales growth of 19-20% including the acquisition
- Food and beverage costs will be 30% of sales or 100 basis points greater than expected.
- EPS growth from continuing operations will rise 2-4% including costs related to the Rare acquisition and integration. Excluding the Rare related costs, EPS will rise 7-9% in FY08.
- DRI will repurchase $125 - $175 million in stock

Preview

Darden Restaurants (DRI) is scheduled to release second-quarter 2008 results after the market closes on Tuesday and follow up that report with its quarterly conference call on Wednesday morning.

Analysts are expecting Darden to earn 50 cents per share on revenue of $1.51 billion. In the year-ago quarter, Darden earned 41 cents on sales of $1.39 billion.

Darden has been making itself over this past year by buying Rare Hospitality for $1.2 billion and selling off its Smokey Bones unit for $80 million. In addition, the company has restructured its Bahama Breeze and Rocky River units.

The Rare deal closed in time for the quarter, while the Smokey Bones deal was announced after the quarter ended. As the quarter will include the Rare results and related acquisition costs, comparisons the prior year will be skewed, and I will be looking for a better pro forma presentation for the combined companies.

Costs associated with the Bones sale and restructuring of the Bahama Breeze and Rocky River units were accrued in prior periods, and any associated charges in the current period are likely to be de minimis.

Operationally, I believe that this quarter was likely challenging for Darden. Consumer spending and weather patterns should have worked against the casual dining industry, and Darden is squarely in the middle of that segment of the restaurant sector. Recently, the stock has broken down to a new 52-week low, and unless the company provides a surprise or upbeat guidance, I suspect more weakness for shareholders.

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At the time of publication, Rothbort had no positions in the stocks mentioned, although positions can change at any time.

Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele.

Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.

Rothbort holds an MBA in finance and international business from the Stern School of Business of New York University and a BS in economics and accounting from the Wharton School of Business of the University of Pennsylvania. He is a Professor of Finance and the Chief Market Strategist for the Stillman School of Business of Seton Hall University.

For more information about Scott Rothbort and LakeView Asset Management, LLC, visit the company's Web site at www.lakeviewasset.com. Scott appreciates your feedback; click here to send him an email.

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