smartwomansecurities
investment report

Whole Foods (WFMI)

business overview

Whole Foods Market® (WFMI) is the world's largest chain of organic and natural foods. Since its foundation in Austin, Texas in 1980, Whole Foods has expanded to own 184 stores in 31 states, the United Kingdom, and Canada. Whole Foods offers a unique alternative to the typical supermarket. Like any store, it offers produce, dairy, meat, seafood, bakery, and store-prepared foods, but all Whole Foods merchandise strictly adheres to the USDA Organic Rule. Whole Foods also participates in QAI's Organic Certification Program for Retailers, which ensures that Whole Foods offers products that contain no banned or potentially harmful substances (such as pest controllers or artificial sanitation chemicals).

Whole Foods appeals to customers it believes are increasingly aware of both the environmental risks and the health risks posed by non-organic substances in food. It believes that its consumer base, which is typically better-educated, aging, and wealthy, is willing to pay for this difference in preparation and a guarantee that the products are fully natural.

competition

Whole Foods started out in 1980 as a single, small grocery store but spread quickly by buying other small local stores and companies. These stores that Whole Foods bought include health and natural-foods stores Bread & Circus, Fresh Fields, and Mrs. Gooch's Natural Food Markets.

At first, Whole Foods sold primarily dry goods; in fact, Whole Foods lost profits on some of its perishable departments. When Whole Foods purchased Bread & Circus in 1992, it began selling (profitably) high-grade meat, seafood, and produce; these perishables now make up 65% of sales. In terms of expanding its line, it may be profitable for Whole Foods to focus on its vegetarian and vegan options. Whole Foods grew so quickly because of its health-conscious clientele, and if it expands its sale of perishables such as meat, it may lose this loyal group of customers.

Whole Foods has done extremely well compared to the grocery stores that it competes with; it earns annual average sales per square foot that are roughly double those of regular supermarkets. Additionally, Whole Foods is the only supermarket that owns and operates its own waterfront seafood facility; this commitment to freshness and quality helps distinguish Whole Foods from its competitors. Whole Foods owns one such waterfront seafood facility, and it is located in Massachusetts.

A major competitor of Whole Foods is Trader Joe's Company, which has more than 250 stores in about 20 states. Trader Joe's sells upscale groceries including health foods, organic produce, and nutritional supplements. Additionally, Trader Joe's has a line of over 2,000 private-label products (making up 70% of sales), including beverages, soups, snacks, and frozen items. The items sold at Trader Joe's are largely similar to those sold at Whole Foods. However, so that costs are kept at a minimum, Trader Joe's stores do not have service departments. Perhaps Whole Foods' fast and friendly service department helps distinguish it from Trader Joe's and to attract and retain loyal customers.

Another competing organic grocery store is Wild Oats, which began in 1987 with a single store in Colorado and now has 110 stores nationwide. Wild Oats offers local produce; this is an attempt to both help the local economy and also offer the highest-quality selection. Wild Oats attracts consumers who want organic food because of its taste and quality; it also attracts customers by offering a selection of cruelty-free products.

Whole Foods also competes with many more mainstream grocery stores that feature organic foods. However, Whole Foods aims to sell fresh and high-quality products, and often features local selections rather than the standardized, low-cost food that is sold at most of its competing supermarkets.

financials

income statement

There are a number of prominent aspects of the income statement for Whole Foods in the last year. At a cursory level, WFMI has had a steady increase in sales over the past three years. For the quarter, sales increased 16% to $1.3 billion, and for the 52 weeks ending September 24, 2006, sales increased 19% to $5.6 billion from $4.7 billion in fiscal year 2005. This increase translates into average weekly sales for all stores of $584,000, or $880 worth of sales per square foot. Five year growth has been 19.8%. This increase in sales was matched by an increase in revenue, up from $4,701.29M in 2005 to 5,607.38M in 2006. Gross Profit for Whole Foods Market Inc. increased accordingly from 1,649.11M in 2005 to $1,959.64M in 2006. The increased sales and profit drove a significant increase in WFMI's Operating Income, which went up from $229.73 to $319.01M, and Net Income from $136.35 to $203.83M. This increase in net income was partially driven by reductions in cost. For example, adjusted direct store expenses improved 42 basis points to 25.5% of sales and adjusted G&A expenses improved seven basis points to 3.2% of sales. Additionally, the company reported a 14% increase in weighted average square footage, which reflects Whole Food's new store openings.

Honing in on comparable store sales, most relevant for the grocery store industry, in 2006 comp sales grew 11.0% on top of a 12.8% increase in the prior year. Identical store sales (excluding five relocated stores and one major expansion) increased 10.3%. The company describes a list of factors which explain the lower than expected comp sales growth of 8.6% in the final quarter of 2006. They explain that when the company first started producing double-digit comps back in fiscal 2004, in the midst of the Southern California labor strike, they were prepared to revert to their historical mean upon the termination of the strike. Though five consecutive quarters of double-digit growth rendered them optimistic about the continuation of strong growth in new and existing stores, they were always aware that the reversion to single digit growth was likely to happen. They explain that the reversion is likely to occur in fiscal year 2007, "most likely the result of many factors including the simple math of so many quarters of compounding double-digit comps, heightened competition, fewer relocations in some quarters, a higher degree of cannibalization as well as the continuing impact of Hurricane Katrina." Based on this analysis, the company expects comparable
store sales growth of 6% to 8% for fiscal year 2007.

Given this guidance, and that the company's growth rate fell short of analyst's expectations induced the stock to fall markedly.

balance sheet

Total Current Assets declined slightly to $623.98M from $672.53M, though Total Assets increased from $1,889.30M to $2,043.00M. The decline was largely driven by the great decline in Cash and Cash Equivalents which is explained in the next section. This decline was offset by an almost $200M increase in short term investments. Total Current Liabilities increased significantly, to $509.77M from $418.38M due to an increase in accrued payments. This increase, together with an increase in Accounts Payable drove the increase in Total Liabilities from $523.62M in 2005 to $638.85M in 2006. There was however a notable increase in Common Stock, from $874.97M in 2005 to $1,147.87M in 2006. It is critical to notice that WFMI has very little long-term debt, despite generating much cash flow each quarter. Long-term debt and capital lease obligations, less current installments for 2006 was only 8.6M (down from the previous year's debt of 12.9M).

statement of cash flows

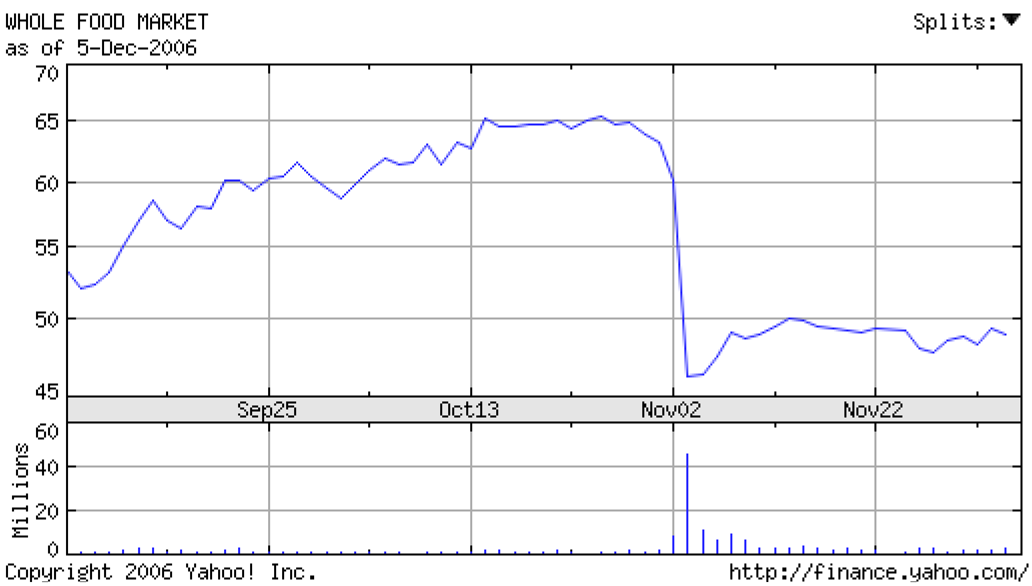
For the fiscal year, the Company produced $453 million in cash flow from operations and received $222 million in proceeds from the exercise of stock options. While cash from operating increased only slightly from $410.82M in 2005 to $452.66M in 2006, cash from investing declined tremendously, down to ($569.25M) from the previous year's ($322.24M). One of the most striking changes for WFMI's fiscal year 2006 was a huge reduction in its cash flow. Net Change in Cash for 2006 was ($306.27M), down from last year's $113.78M. This change can be explained by a host of factors. Capital expenditures for the fiscal year totaled $340 million of which $209 million was for new stores, up from 2005's $324.1M. The Company paid approximately $358 million to shareholders in cash dividends and repurchased approximately two million shares, or $100 million, of common stock on the open market. In turn, net cash on financing activities declined $189.68M dollars. Dividends per Share went up to $ 2.45 from $0.47. This payout of dividends also explains why earnings per share went up 41 cents, from $1.05 in 2005 to $1.46 in 2006. Similarly, diluted earnings per share went up from $.99 to $1.41. The decreased liquidity of Whole Foods likely stems from this $100 million increase in its stock repurchase program, which its BOD announced in November, bringing the current authorization to $200 million over the next three years. Nevertheless, as WFMI generates much cash through its operations, and does not have much long-term debt to put this cash towards, this decrease should not be of much concern for the viability of the company.

valuation

Since the first store opened in 1980, Whole Foods has grown and has become a retail success. The current stock price is 46.48 and the stock has been one of the strongest performers in the industry. The enterprise value is 6.55B and the current market cap is 6.9B. These suggest that WFMI is in mid to large market cap as it exceeds 5 billion. The profit margin is 3.64% which shows strong profitability.

The Price/Earnings tells us the current price of Whole Foods divided by its trailing 12-month earnings per share. For comparison, we also show the average price/earnings ratios for the company's industry, and the S&P 500. Comparing WFMI to the industry and S&P 500, we can see that WFMI has a higher P/E ratio. When we look at comparable grocery stores in the industry such as Kroger with a P/E of 16.0B or Safeway with a P/E of 19.2, we can see that Whole Foods sets itself apart from other companies it its industry. From a valuation standpoint, this P/E ratio might suggest that is not very attractive to investors. However, we could also interpret that investors value WFMI highly and are willing to pay a lot for it. This also suggests that investors can expect high earnings growth in the future. Either Whole Foods will experience an exceptionally bright future or perhaps WFMI may be the subject of a speculative bubble.

Whole Foods currently has almost 200 stores worldwide with new leases signed on approximately 53 stores under development. Also, the company's goal is to have about 400 stores worldwide by 2010. The company's business model seems to be that it finances growth in stores from the cash flow that it generates. In the last five years, cumulative cash flow from operations has been $923 million. In the same time period, Whole Foods used $877 million to develop new stores, acquire other companies, and upgrade existing stores. Because we conclude that Whole Foods Market's growth prospects are still intact, we suggest that it is not overvalued, as the organic foods industry is predicted to grow almost 10% every year. Whole Foods is a fairly trusted name in this industry and does not seem to be threatened by too much competition. As the P/E ratio for WFMI has been as high as 70.6 and as low as 20.2, we can predict that because the growth prospects seem promising, the P/E might be a bit higher than it is now, perhaps a P/E multiple of 39.



key metrics

	WFMI	Industry	S&P 500	Stock's 5Yr Average*
Price/Earnings	35.09	28.00	20.6	51.7
Price/Book	4.7	3.0	4.1	6.3
Price/Sales	1.3	0.4	2.9	1.5
Price/Cash Flow	16.4	9.5	14.7	19.9
Dividend Yield %	1.2	0.8	1.7	---

* Price/Cash Flow uses 3-year average.

	Stock	Industry	S&P 500
Forward Earnings Yield	3.13	6.64	5.49
Forward P/E	32.0	15.1	18.2
Price/Cash Flow	16.4	9.5	14.7
Price/Sales	1.3	0.4	2.9

investment opportunities

There are a variety of ways for Whole Foods to increase sales, the most important of which is continued increases in square footage, both by creating new stores and expanding existing stores. It has historically benefited from acquisition of smaller retailers, because such acquisitions eliminate competition and allow Whole Foods to open locations on these sites. Since its consumer base is currently suburban and well-educated, Whole Foods also has the potential to open stores in urban locations and potentially innovate products that are more suited to a different demographic. Whole Foods also has the opportunity to increase its square footage through further internationalization. According to management, "natural and organic foods are one of the fastest growing segments of food retailing today," and Whole Foods also hopes to use the momentum of an increasingly health-conscious public to raise its profits.

investment risks

priced for growth

With a P/E ratio of 34.9, Whole Foods is priced with expectations of a lot of growth. There is a huge risk of the P/E ratio coming down if same-store sales growth does not meet expectations. As it is now, the P/E ratio has been decreasing for a while. 52 weeks ago, the P/E ratio was 74.7; 26 weeks ago the P/E ratio was 61.3; one month ago, the P/E ratio was 45.7. The P/E ratio has been steadily declining as expectations adjust to decreasing growth, and could continue to go down if growth declines.

limited opportunity for long-term growth

Whole Foods caters to a wealthier clientele, which means that there are only a limited number of areas within the United States in which stores can be profitable. However, having only 189 stores, and projecting footage growth between 15% and 20% in 2007, there is room for expansion in the immediate future. Still, there is a long-term risk of market saturation. Due to the long-range limits to the growth Whole Foods can achieve by opening new stores, growth in same-store sales is an increasingly critical indicator of the growth possible in the future. Whereas Whole Foods experienced double-digit growth in same-store sales in the past, it was announced in a Nov. 2 report that growth in same-store sales fell to 8.6 percent.

vulnerable to competition

Whole Foods will face, and has faced, increasing competition due to the demonstrated profitability of the organic and gourmet foods market. There are very low barriers to entry in the consumer sector, though Whole Foods has attempted to increase these barriers by expanding the square footage of individual stores. Additionally, Walmart announced in March 2006 that it would aggressively expand into the organic food market. There is a very real threat of Walmart and like companies undercutting prices and damaging sales for Whole Foods. However, the magnitude of the possible damage done to sales is questionable, as Whole Foods has a wealthier clientele than Walmart, which might not start frequenting Walmart in order to save a few dollars.

success dependent on health of economy

As Whole Foods is a retailer of organic and gourmet foods, it is heavily dependent on the level of discretionary spending in the U.S. economy. Should economic conditions, such as tax rates or levels of unemployment, prove unfavorable to consumer disposable income, consumer spending would diminish and less wealthy consumers, whose demand for Whole Foods is more elastic, would be more likely to shift their business to competitors. Thus, a recession could hurt sales, particularly at the margins.

limited suppliers of organic perishables

Whole Foods depends heavily on independent farmers to supply organic perishables, such as fruits, meats, and frozen goods. As the business continues to grow, it will become increasingly difficult to find more suppliers, while maintaining high standards of quality. If Whole Foods cannot find additional suppliers to bolster its growing sales, it will face increasing input costs, which will diminish the overall profitability of the business. With this risk in mind, Whole Foods has allocated $10 m annually to encourage local agriculture in the proximity of its stores. It remains to be seen, however, whether this initiative will succeed or Whole Foods will find other suppliers to supplement continuing expansion.