# Analysis of Whole Foods Market

Digging deeper into Whole Foods' valuation drivers

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## Key Takeaways

- **Revenue growth is slowing at Whole Foods due to a slow-down in same-store sales**. This slow-down highlights a structural weakness the firm has in a maturing segment of the grocery industry.
- **Profitability is likely to fall in the future**. We believe the firm will be able to generate profits higher than its larger competitors, but lower than its recent peak.
- **Investment levels are very high and will need to remain high for some time**. Whole Foods is at a disadvantage due to its smaller network of stores, to improve its same-store sales longer term, it needs to site stores that are more convenient to more customers.
- **Medium-term cash flow growth rates will likely remain high**. This assumption is contingent upon a gradual decrease in investment levels (from "very high" to "high").
- **IOI Fair Value Range for Whole Foods implies downside risk for owners or an opportunity for bearish investors**.

## Introduction

For years, Whole Foods Market WFM was known as a Growth Stock. Now that it's trading for around half of its 2013 peak, common wisdom is that it is in the process of becoming a Value Stock.

The truth is that there is no such thing as either a "Growth Stock" or a "Value Stock." Value is created in the same way for all companies, and good value investors value growth.

But to properly value growth, one has to know what growth factor to place a value on. While this point seems obvious, I see article after article that confuse things like growth of an industry or an increase in public awareness with growth of the one factor that really matters to the owner of a business – the growth of cash flows.

Cash flows are created through a process of generating revenues, converting them to profits, and investing some portion of excess profits in investment projects that will allow the firm to continue growing in the future.

Let's take a look at each of these valuation drivers for the case of Whole Foods Market.

# Revenues

## Revenues

Whole Foods Markets' revenue growth has been strong, thanks to secular tailwinds. Competition from larger rivals suggests future revenue growth may be more tepid.

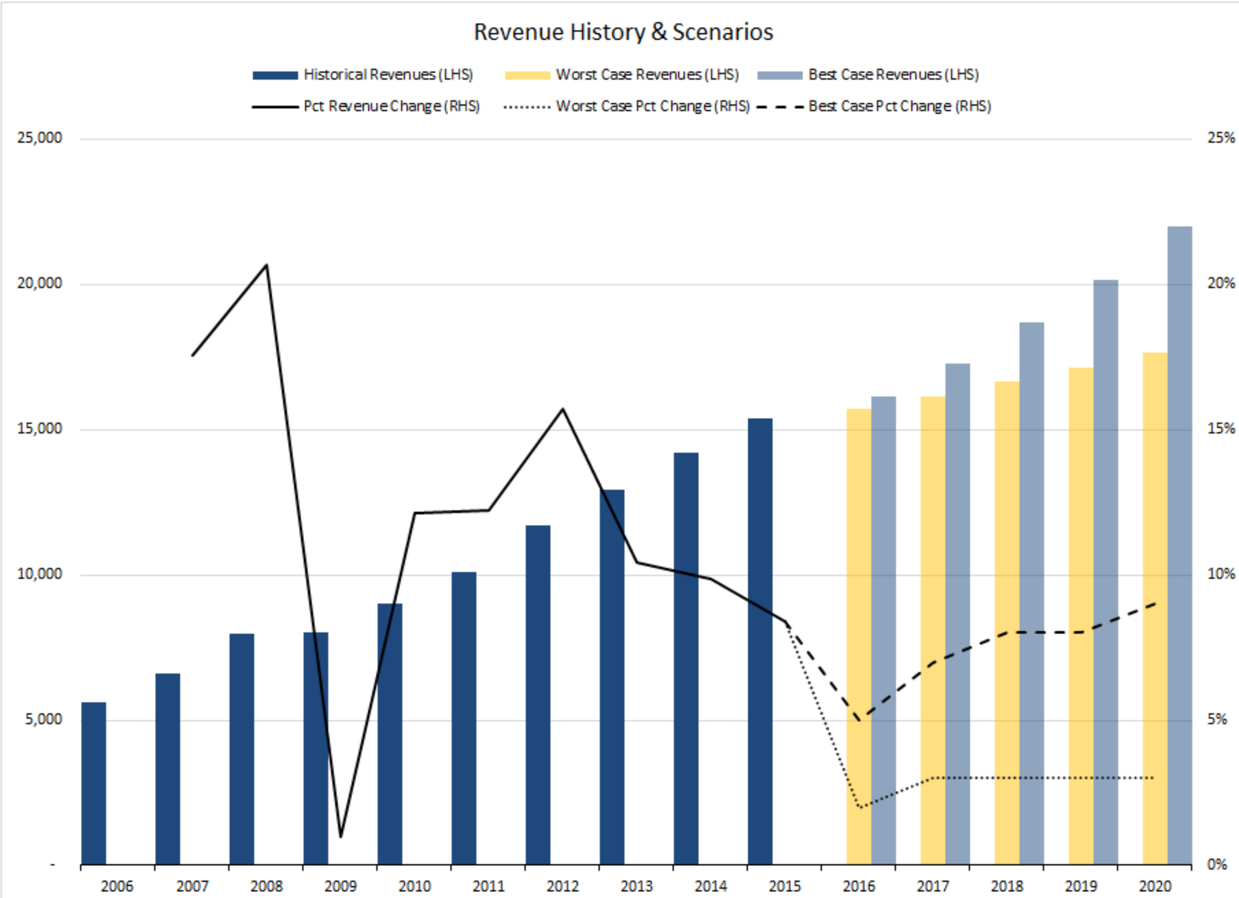



*Figure 1. Source: Company Statements, IOI Analysis and Projections*

We can see from this chart that historical growth at Whole Foods has been brisk, especially when compared with the grocery industry overall. Some of this growth can be attributed to the firm opening new stores, but the more exciting part of Whole Foods' business has been its high "same-store sales" growth. This figure represents sales at locations open for a year or more, and in Whole Foods' case, same store sales has been very strong – in the upper single digit percent per year range.

We believe Whole Foods' strong same store sales was basically a function of scarcity – other supermarket chains' organic selections were not nearly as good as Whole Foods, so if you wanted organic, you passed up a few supermarkets on the way to the closest Whole Foods location.

Same store sales have started to lag at Whole Foods as big competitors like Kroger KR, Wal-Mart WMT, and Target TGT have focused on stocking a wider selection of organic products. We think that, in the worst case, Whole Foods' same store sales will continue to be disappointing, creating low single-digit overall revenue growth. In the best case, Whole Foods' new marketing strategies advertising the quality of their stores' perishable items and prepared foods sections, and a new business supplying fine restaurants are successful in driving more business, causing revenues to grow in the upper single-digit percentage range.

# Revenues

## Revenue Dynamics

Robust sales growth is a good sign for a business owner. It means that the company's products or services are in demand – the first essential step in the value creation process. Whole Foods revenue growth has been very rapid – averaging over 10% per year over the last few years – thanks to its focus on the rapidly expanding organic food niche.

"Growth investors" typically search out situations like this – pioneering companies in expanding industries.

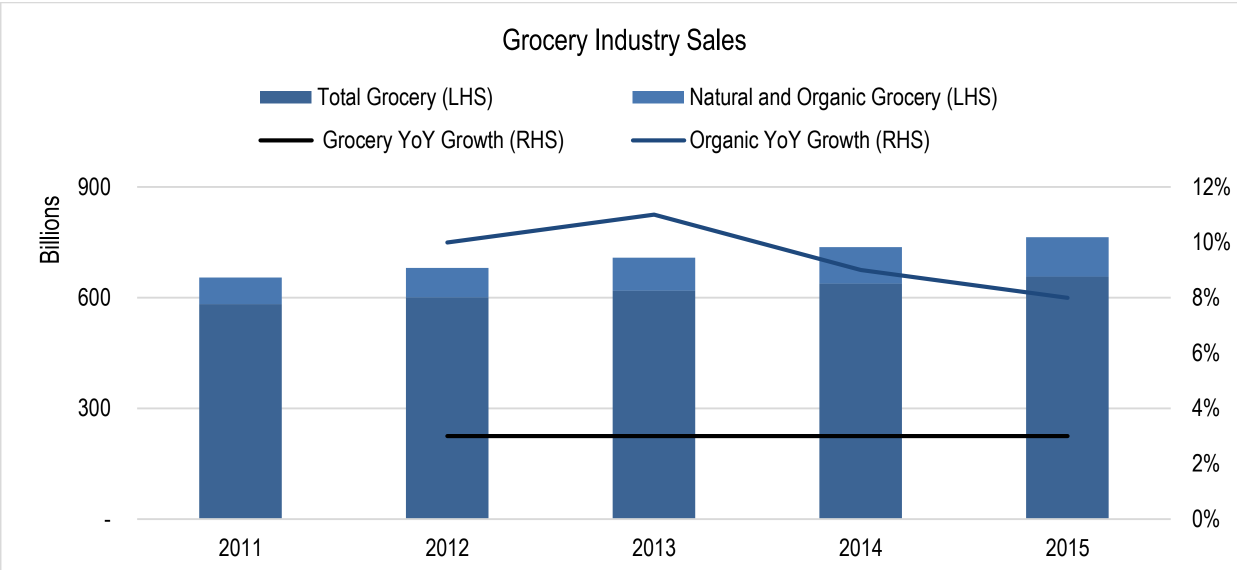



*Figure 2. Source: Company Statements, IOI Analysis*

But revenue growth alone does not generate value for shareholders. As I discuss in my book and training courses, to generate value, a company has to convert its revenues into profits, and reinvest some of those profits to boost cash flows in the future. As we will see in a moment, Whole Foods' profits are good in comparison with most other grocers, but in order to keep growing into the future, the company has to spend a large proportion of its profits to build new stores.

**The issue of same-store sales growth is linked to its relatively smaller number of locations in our opinion.**

Some might argue that Whole Foods' recent problem is not one of building new stores but rather what is termed "same store sales" – revenue growth for stores that have been in operation for a year or more. From my perspective, these two issues are inextricably interrelated.

Anecdotally, I have a Whole Foods in my area – it is just over six miles from my house, and takes a few minutes to get there by car. Between me and Whole Foods, there are eight other grocery stores that I can recall off the top of my head. When Whole Foods was the only place I could buy organic tomatoes or farm-raised ostrich steaks, I didn't mind going out of my way and passing each of the other grocery stores by. But now, all of the stores carry a pretty good selection of organic products and even a few of them have ostrich steaks. In short, I have stopped going to Whole Foods as often, or when I go, I buy only a few things there and doing most of my shopping at nearer and cheaper alternatives. Looking at Whole Foods same store sale growth in the figure below, I am convinced that I'm not the only person doing this.

# Revenues

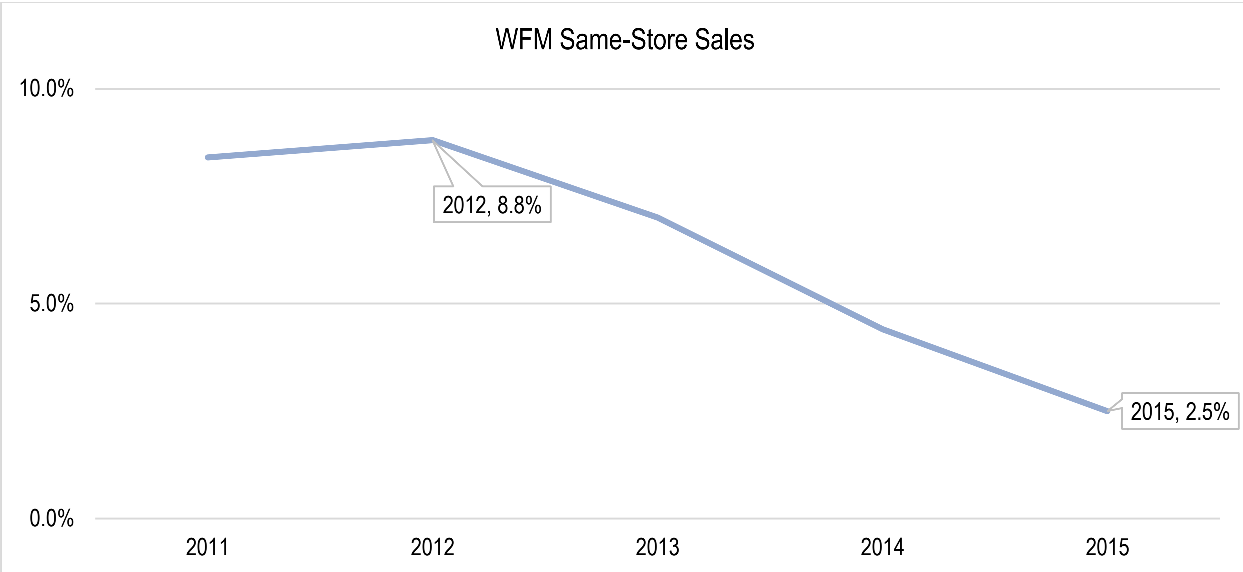



*Figure 3. Source: Company Statements, IOI Analysis*

Nothing has changed in the macro environment – organic foods are still the quickest growing grocery category – but because Whole Foods' locations are not densely packed, many shoppers are opting to shop for organics at a location that is more convenient to them.

Kroger has somewhere north of 2,600 stores – more than six time more than Whole Foods. Not all of these stores are sited in places where Whole Foods would want to build a store, but enough of them are, and enough other chains sell organic and specialty products now that Whole Foods is at a structural disadvantage. Demand for Whole Foods' products is strong, but it does not have sufficient scale to supply that demand. Kroger is just one of many competitors that is soaking up this supply "shortfall."

# Profits

## Profits

Whole Foods Markets' profitability is also much higher than the grocery industry as a whole. We believe that increased marketing expenditures and competition are likely to force the firm's profitability levels down.

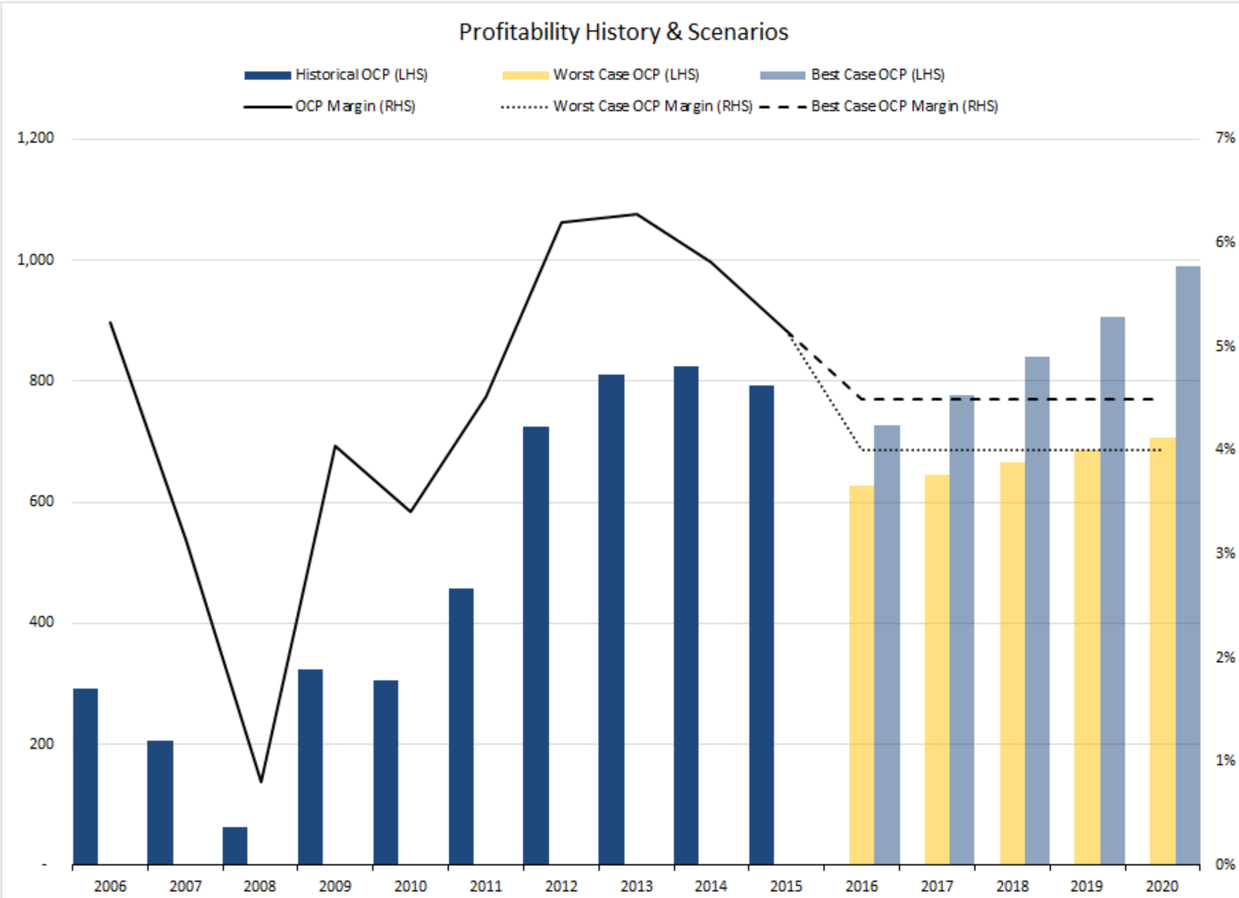



*Figure 4. Source: Company Statements, IOI Analysis and Projections*

Whole Foods is much more profitable than mass-market grocery chains like Kroger. We believe that Whole Foods' profitability is related to pricing power, and that its pricing power is related to the two issues of scarcity and quality. As we discussed above, organic products are becoming more mainstream, so one element of its pricing power – the scarcity – is disappearing. Whole Foods' products are very high quality, but to impart the benefit of higher quality to consumers, Whole Foods has had to start spending more money on marketing.

We believe that in the best case, Whole Foods is likely never to regain the peak profitability it enjoyed in the 2013 timeframe, but will still be better than most of its grocery store competitors. Worst case, profitability will drop substantially from its trailing 5-year average of around 5.5%, but will still be better than competitors'.

# Profits

## Profit Dynamics

Whole Foods displays another feature beloved by growth investors – high profitability – which is also a signal to some that a company has a competitive advantage. In Whole Foods' case, its competitive advantage revolves around its ability to source high-quality organic grocery items.

The production of organic food tends not to be as efficient from a cost perspective as "factory farming" operations. It also tends not to scale as well. Whole Foods, as a first mover in this segment, was able to build supply chain relationships that allowed it to source items in a way that was not easily reproducible by larger chains. The scarcity of the items it sold allowed it to charge a higher price in the way that De Beers can sell diamonds for a higher price than the price at which Vulcan Materials can sell gravel.

**One of Whole Foods' competitive advantages in the past, sourcing of high-quality organic food, has begun to erode as adoption of organic products has increased.**

However, as time has passed and organics have become more mainstream, larger competitors have realized it is worth their while to figure out the sourcing issues. As they have sorted out the sourcing issues, what had once been rare is now becoming more commonplace. In addition, because Whole Foods' competitors are larger, they have greater advantages of scale in negotiation, distribution, and marketing. If a large competitor such as Kroger or Wal-Mart drops their prices on organic tomatoes by 10%, they are still able to generate better profits than they would on non-organic tomatoes but would still be able to easily undercut prices at Whole Foods. This is likely another reason for Whole Foods' declining same-store sales.

Whole Foods is not defenseless against this assault. Arguably, Whole Foods' organic products are higher quality than those sold at my local Target; however, in order to generate consumer demand for its higher quality products, Whole Foods will have to educate consumers about its products' benefits in a systematic way. This process is called marketing, and it doesn't happen for free.

Comparing Owners' Cash Profits – our preferred measure of profitability at IOI – at Whole Foods and Kroger, here is the picture we get:

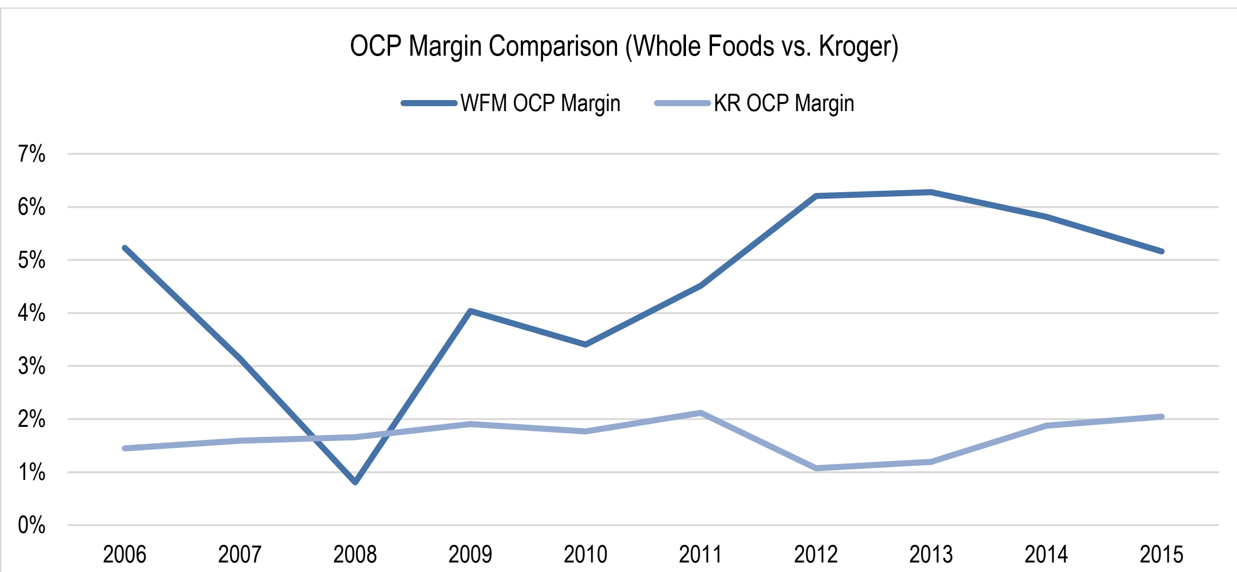



*Figure 5. Source: Company Statements, IOI Analaysis*

Whole Foods has been able to maintain its profitability thus far, but my bet is that this over the next five years, Kroger's profit line is going to draw closer to Whole Foods', and it's unlikely that this will be completely due to Krogers' margin increasing.

# Medium-Term Growth

## Medium-Term Growth

As a first mover in its segment, Whole Foods' historical investment efficacy has been good. Future efficacy is also likely to be good.

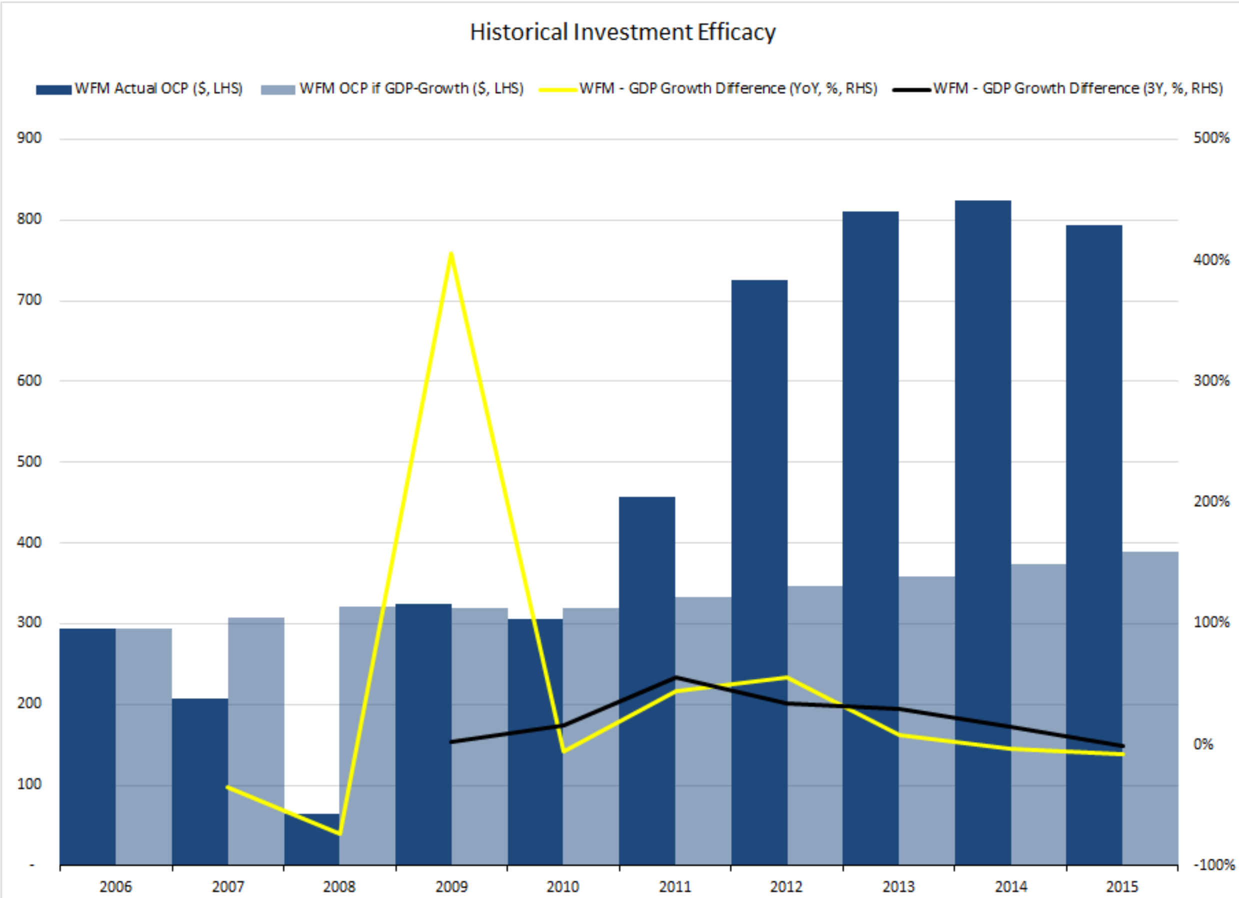



*Figure 6. Source: Company Statements, IOI Analysis*

Whole Foods invests around 70% of its owners' profits in expanding its operations. This is a very high investment level, but these investments have paid off very well – this is demonstrated in the graph above by the fact that the dark blue bars (WFM actual profits) are much taller than the light blue bars (representing what WFM profits would have been if they had grown just at the rate at which nominal GDP grows).

We believe that Whole Foods' future investment efficacy is also likely to be high as it experiments with smaller footprint stores (the "365" chain) and continues to expand its flagship stores. Worst case, we have medium-term cash flow growth at around 8% per year; best case, we project it to be in the 15% range. These projections assume that the firm spends less and less on new store growth over the next five years, until its investments on expansions hit around 50% of profits (roughly the same as what Kroger spends).

# Medium-Term Growth

## Investment Dynamics

As discussed in The Intelligent Option Investor, medium-term growth in cash flows is a function of how successfully the company's investment projects work out. Whole Foods' investment projects revolve around building new stores – some of which will be full-sized, full-priced Whole Foods locations, some of which will be smaller, discount "365" stores.

I have no doubt that these investments will boost Whole Foods' future revenues and ultimately its cash flow, but in the meantime, they will cost Whole Foods' owners a lot of money.

Right now, Whole Foods spends around 70% of its prodigious profits on expansionary projects – projects that, as we showed in the revenues section, are absolutely necessary to be spent if it wants to maintain even tepid growth in its same-store sales.

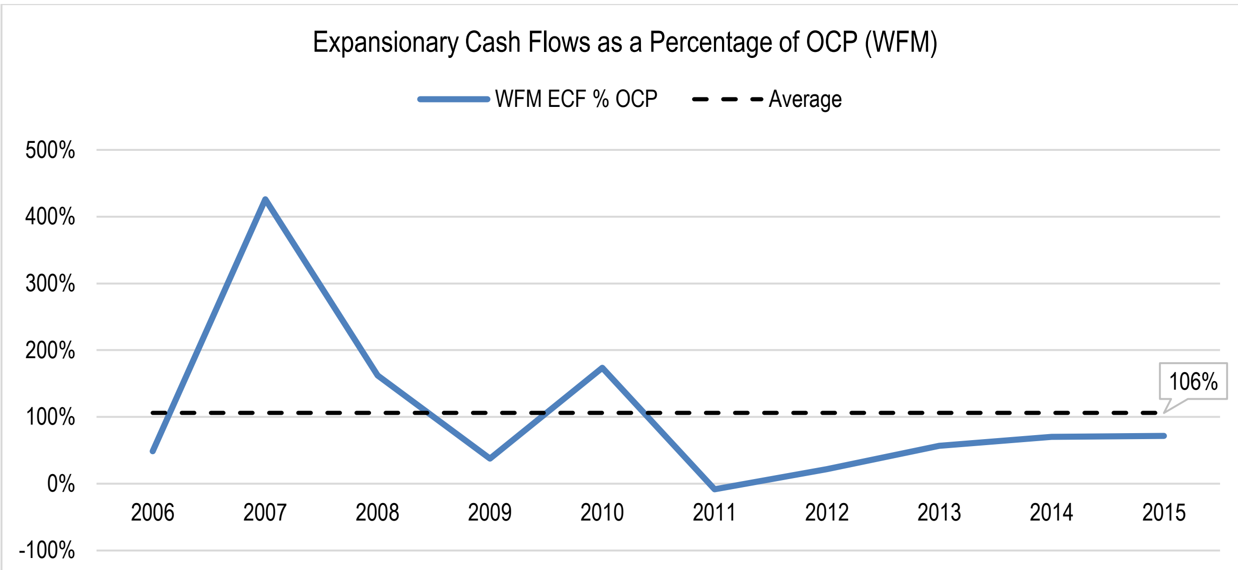



*Figure 7. Source: Company Statements, IOI Analysis*

When my partner, Joe, and I started looking at Whole Foods, I thought that eventually Whole Foods' investment spending was going to normalize at a much lower level. However, when we looked at investment spending at a more mature competitor – Kroger's – we found that investment levels, even for mature firms, are very high. For Kroger, roughly 50% of its profits are spent on investments (see figure below).

# Medium-Term Growth

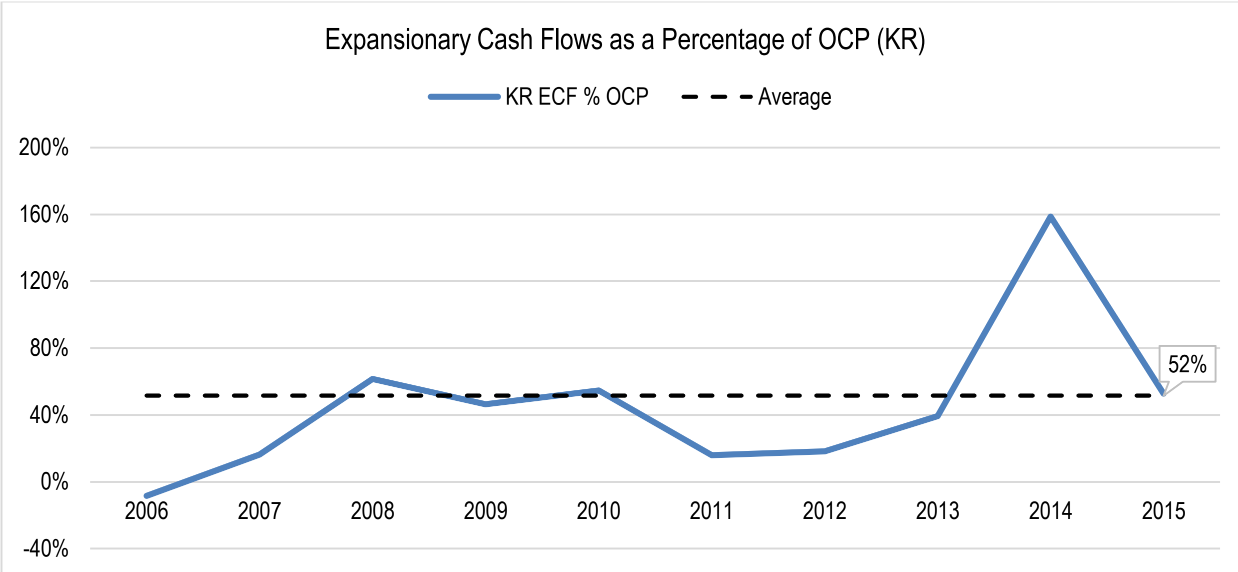
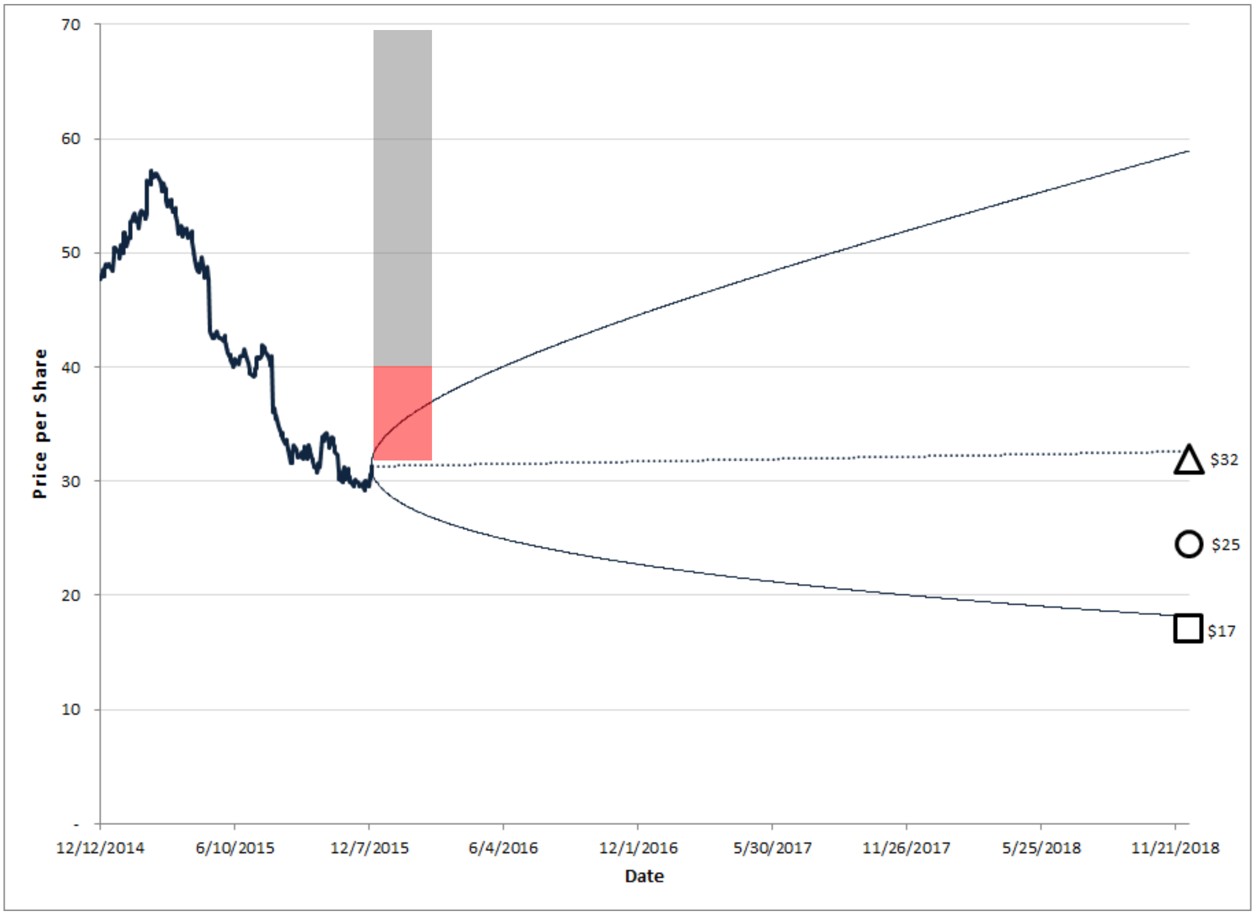



*Figure 8. Source: Company Statements, IOI Analysis*

# Fair Value Range

## Whole Foods Markets Fair Value Range

From this analysis, we believe there may be the opportunity for a bearish investment in this company.




In this diagram, we are selling a call option struck at $32 and expiring in February, 2016. We create a call spread by buying a call of the same tenor to cover at $40. This strategy would generate a credit of $1.74 per share on the sale of the 32-strike call and a debit of $0.22 per share on the purchase of the 40-strike call for a net credit of $1.54 per share ($154 per contract before fees and commissions).