IOI ChartBook – Whole Foods Markets (WFM)

The future may be organic, but this pioneer will struggle

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Three Things You Should Know About Whole Foods

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- **Whole Foods' first mover advantages in the organic grocery space are gone.**

  Organic food used to be a niche category, and Whole Foods was the undisputed king of that niche. Part of the secret to its success was the relationship it had with organic suppliers, which made it an almost unique supplier of these items at scale. However, the agricultural community has realized how many profits can be harvested from the trend toward organic items, and the acreage of cropland dedicated to organic production has expanded. This has allowed mainstream competitors (such as Kroger, Wal-Mart, and Target) to develop supply chain relationships and offer organic products in their stores. There are still excess profits to be found in the organic food world, but more and more of these will be soaked up by competitors that have greater scale and reach than Whole Foods, in our opinion.

- **Whole Foods' biggest weakness and threat deals with network dynamics.**

  If Whole Foods' network becomes too dense, its stores will cannibalize each other's sales. If Whole Foods' network remains as dispersed as it is today, there is room for competitors to offer customers organic products more conveniently due to the competitors' much denser networks. How many mainstream grocery stores offering organic tomatoes would you pass up for the privilege to buy organic tomatoes from Whole Foods?

- **Network problems will likely cause the firm to be less profitable in the future.**

  To correct its network difficulties, Whole Foods must do at least two things: 1) it must expand its network in ways that will cause as little cannibalization as possible and 2) it must convince consumers that its organic offerings are superior to competitors'. The firm is embarking on the first strategy with its economy-priced 365 chain – smaller footprint stores designed to attract younger, less-affluent shoppers and compete with the likes of Trader Joe's. It is embarking on the second strategy by making its first forays into traditional marketing, after relying upon word-of-mouth for its entire existence. Needless to say, both of these initiatives cost money. Increased marketing expense is the first thing owners are likely to notice, but longer term, the expense of maintaining a large network of ageing stores will likely also decrease profitability as viewed through the lens of IOI's preferred measure – Owners Cash Profits (OCP).

Valuation Overview

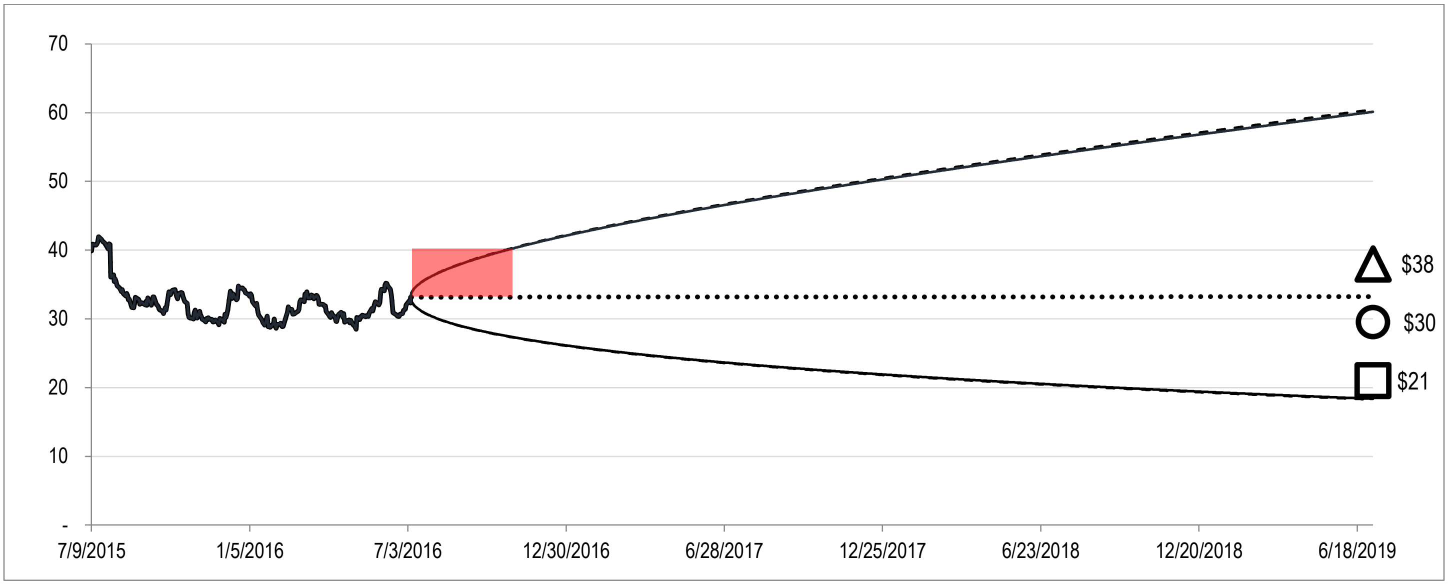


Figure 1. Source: YCharts, CBOE, IOI Analysis. Geometrical markers show IOI's best-case (triangle), worst-case (square), and equally-weighted average value (circle). Cone-shaped region indicates option market's projection of Whole Foods' future stock price. Shaded region represents the sale of what is known as a "call spread" on Whole Foods' stock.

	IOI Best Case	IOI Worst Case	Historical Median
Year 1-5 Average Revenue Growth	7%	3%	10%, 12% (5-, 10-year)
Year 1-5 Average Profitability	6%	4%	6%, 5% (5-, 10-year)
Year 6-10 Cash Flow Growth	15%	8%	25%

Whole Foods' revenues expanded very quickly as consumer demand for organic foods surged and Whole Foods was positioned to soak up that demand. Its profitability has been much better than that of competitors, as has its medium-term cash flow growth. However, selling groceries is a game of scale and while Whole Foods is the 800-pound gorilla in the organic world, it's a pipsqueak in the grocery world. We think it's very likely that Whole Foods's growth and profitability will fall over the next five years.

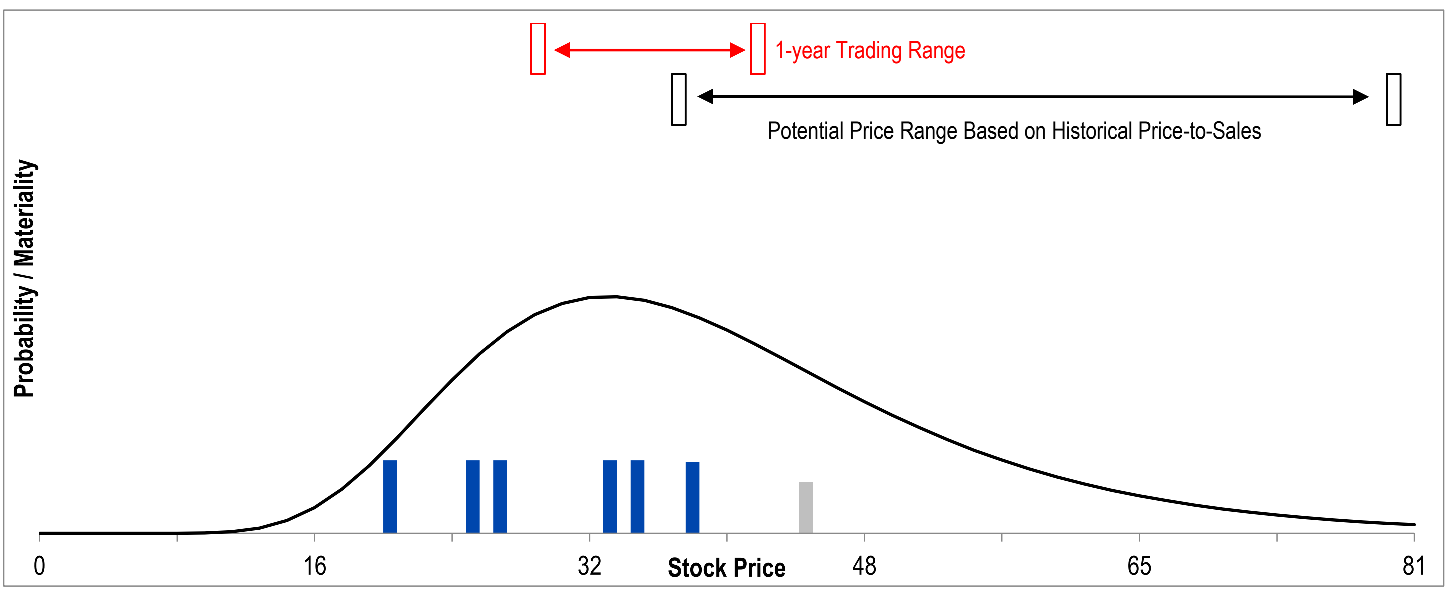


Figure 2. Source: CBOE, IOI Analysis

Both the simple valuation range (figure 1) and the complex range (figure 2) tell the same story – this stock is trading at the upper boundary of the value it is likely to create on behalf of its owners. We lay out our valuation case on the following pages.

Valuation Drivers

Revenue Growth

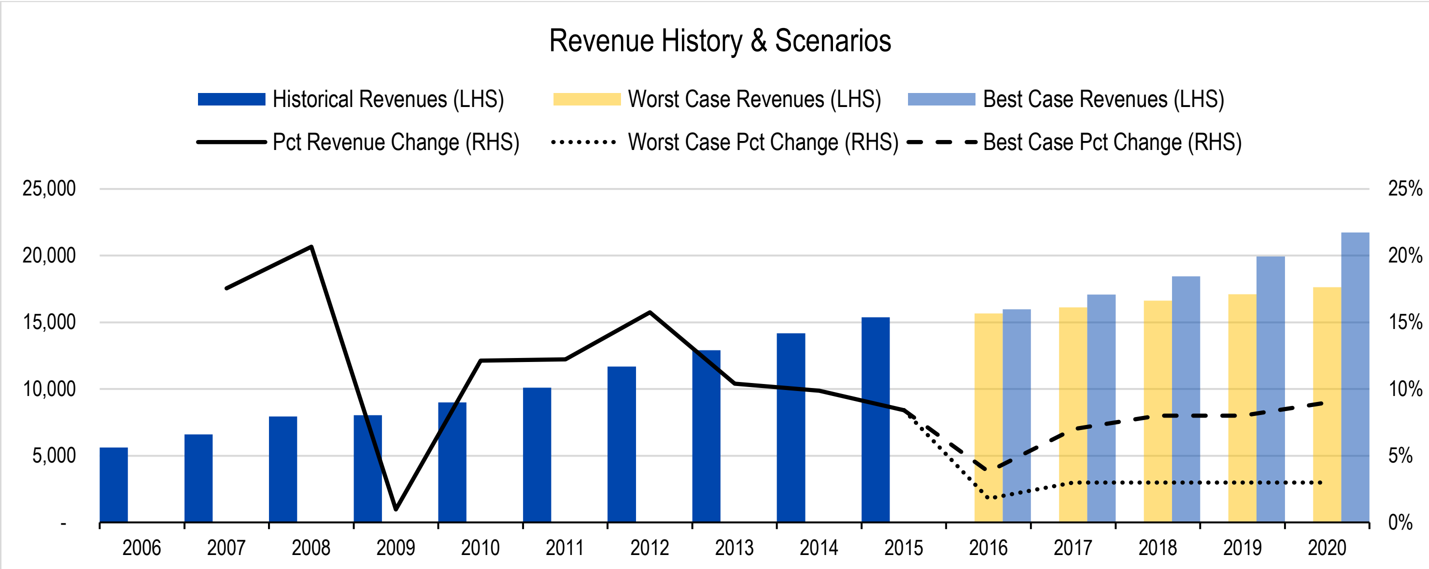


Figure 3. Source: Company Statements, IOI Analysis

Revenue growth post-Great Recession had been robust through 2015, but competitors have latched onto the organic grocery trend and impinged on Whole Foods' turf. Whole Foods has aggressive plans for new store growth (associated in part with its economically priced 365 chain), but same store-sales have turned negative. We believe this is because more competitors are offering organic products and because competitors' store networks are much denser than Whole Foods'. This analyst has to drive past more than a half dozen grocery stores that stock organic foods before finally reaching the closest Whole Foods location. Whole Foods management has begun a marketing campaign to differentiate its stores' products in terms of purity and quality, but for the "casual" organic shopper (as opposed to the true believers), the quality difference may be too small to prompt an extra trip.

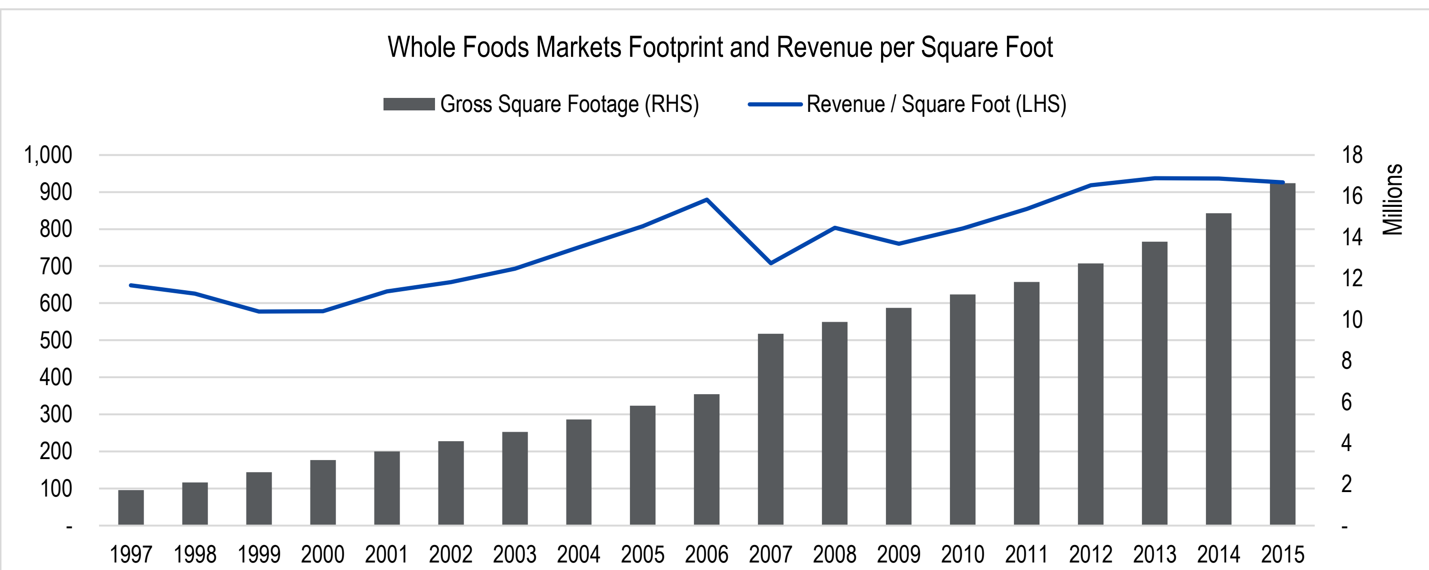


Figure 4. Source: Company Statements, IOI Analysis

Gross square footage has grown at an 11% per year rate over the time period shown (though only just over 8% since 2010) but revenue per square foot has had a much more modest increase of 2%. Our best-case revenue assumption implies that the firm can staunch losses in same-store sales and continues building new locations at about the historical rate. Our worst-case assumption is that falling same-store sales will begin cutting into Whole Foods' overall revenue per square feet. Whole Foods management is attempting to halt falling same-store sales by a focus on fresh meat and seafood and an expansion of deli foods and spur growth with a business to supply restaurants with high-quality organic food. Fresh and deli foods are a good idea, in our opinion; the restaurant provision business less so.

Profitability

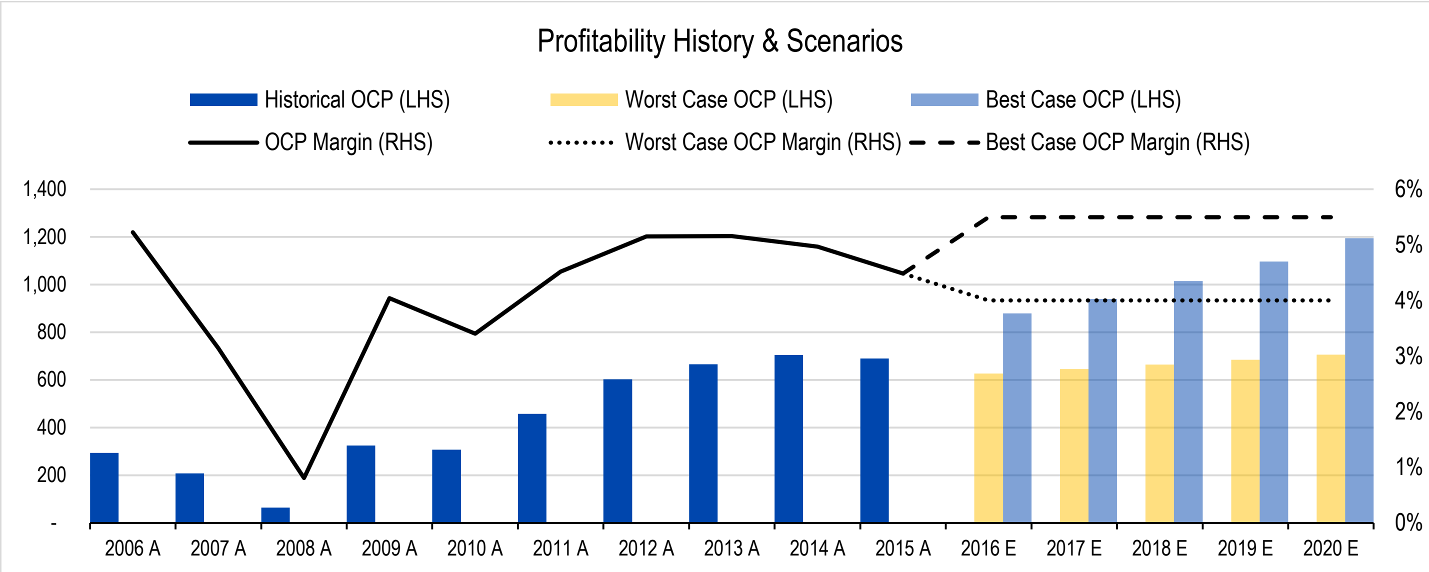


Figure 5. Source: Company Statements, IOI Analysis

Profitability has historically been very high at Whole Foods, but we believe the differential with competitors will continue to narrow. Whole Foods historically did not use many of the same marketing tools that are common among other grocers, such as advertising, coupons, and the like. As competition has heated up, Whole Foods will, we believe, have to dedicate a larger proportion of revenue dollars to paying for marketing campaigns. Whole Foods' management needs to differentiate its company's offerings from the organic offerings available at Target, Wal-Mart, Kroger, and countless smaller chains. Differentiation costs money, and that's money that won't fall through to the company's owners, in our opinion.

In addition to these dynamics, the recent acquisition of organic supplier WhiteWave by Danone signals an important transition in the business of organic foods, in our opinion. Organic is no longer only a niche business, but is large enough for large manufacturers to take an interest. It seems sensible that Whole Foods' negotiating position would be stronger against small, independent WhiteWave than it will be under global behemoth Danone. This dynamic may affect Whole Foods at the gross profitability level in future.

Investment Level

Expansionary Cash Flow is IOI's measure of investment spending net of asset sales and divestments.

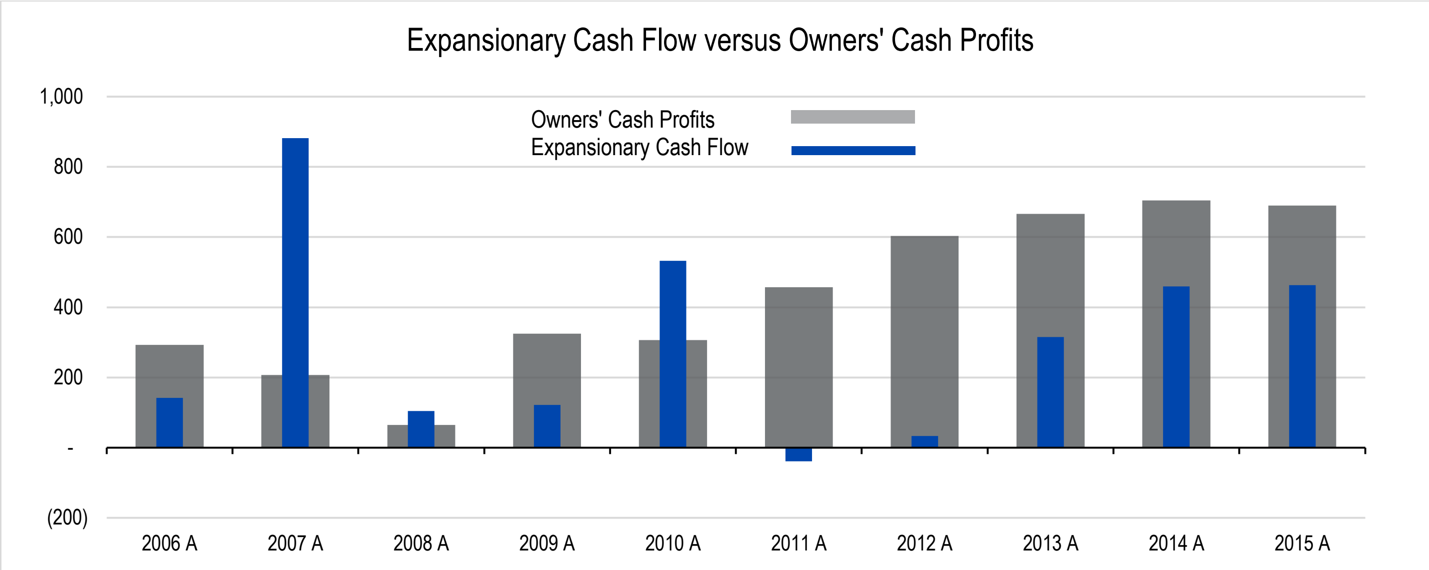


Figure 6. Source: Company Statements, IOI Analysis

Over the last 10 years, Whole Foods has spent a median 57% of its OCP on investment projects. With the push to increase the density of its store network and build out its 365 stores, we believe this high level of investment spending is likely to continue.

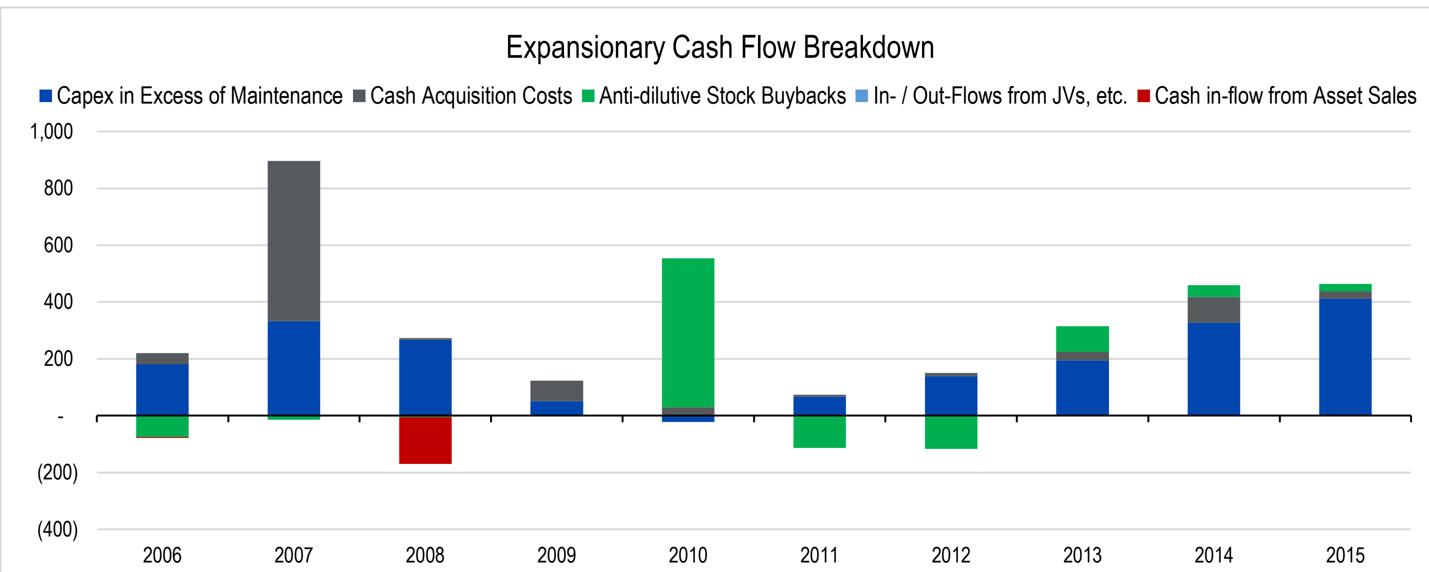


Figure 7. Source: Company Statements, IOI Analysis

We think that spending breakdowns since 2013 are likely to be fairly typical of the breakdowns going forward. The firm will have to spend heavily on expanding its location network, some of which may be the acquisition of smaller competitors with locations in areas with desirable demographic characteristics.

While not reflected in the graph above, it's worth mentioning that Whole Foods' management has also been spending a good deal of cash buying back shares. So much so that our valuation range shifted up over the six months between our first analysis and this more recent one. This fact, and the fact that there is a large aggregate short position in the company's stock highlights the risk of attempting a bearish investment in this stock. A better-than-expected earnings report may cause a pop in the share price that would lead to a short squeeze. This possibility is exacerbated by the buy-back program.

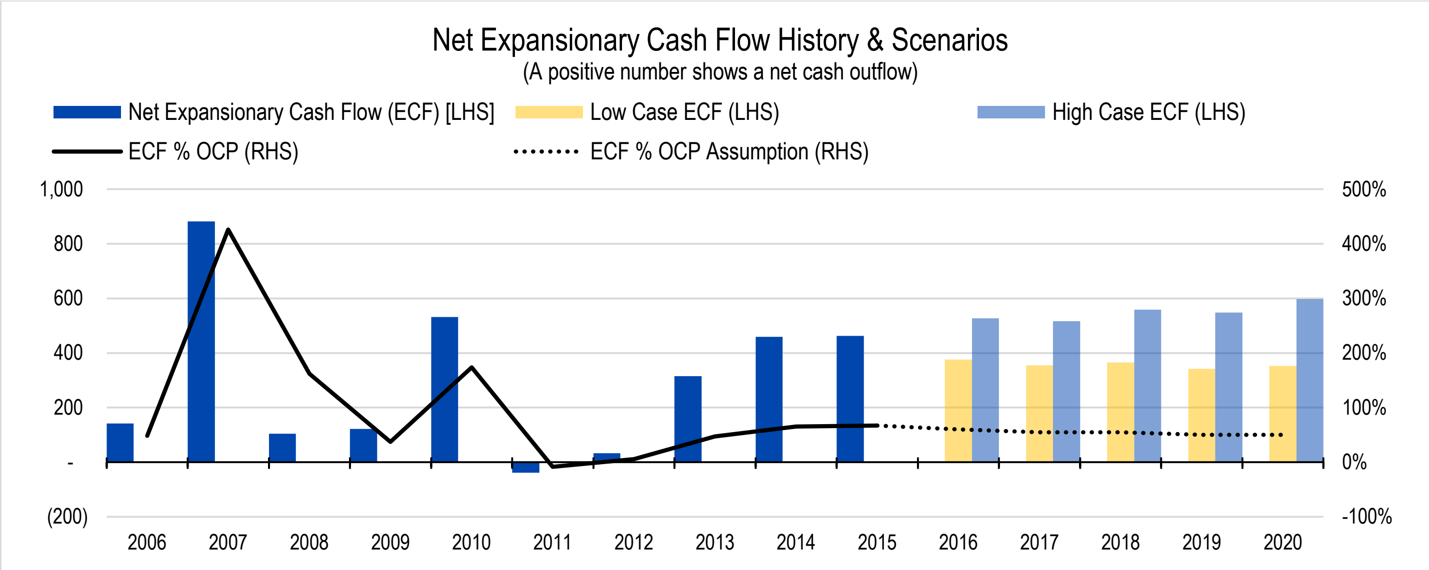


Figure 8. Source: Company Statements, IOI Analysis

The grocery business typically spends a large proportion of its (small) profits on investments. We think it is unlikely that Whole Foods' investment spending will dip below 50% of its profits for years to come.

Investment Efficacy

Corporate investments lead to profit growth. IOI measures profit growth versus the standard yardstick of nominal GDP growth to assess the efficacy of the company's past investments.

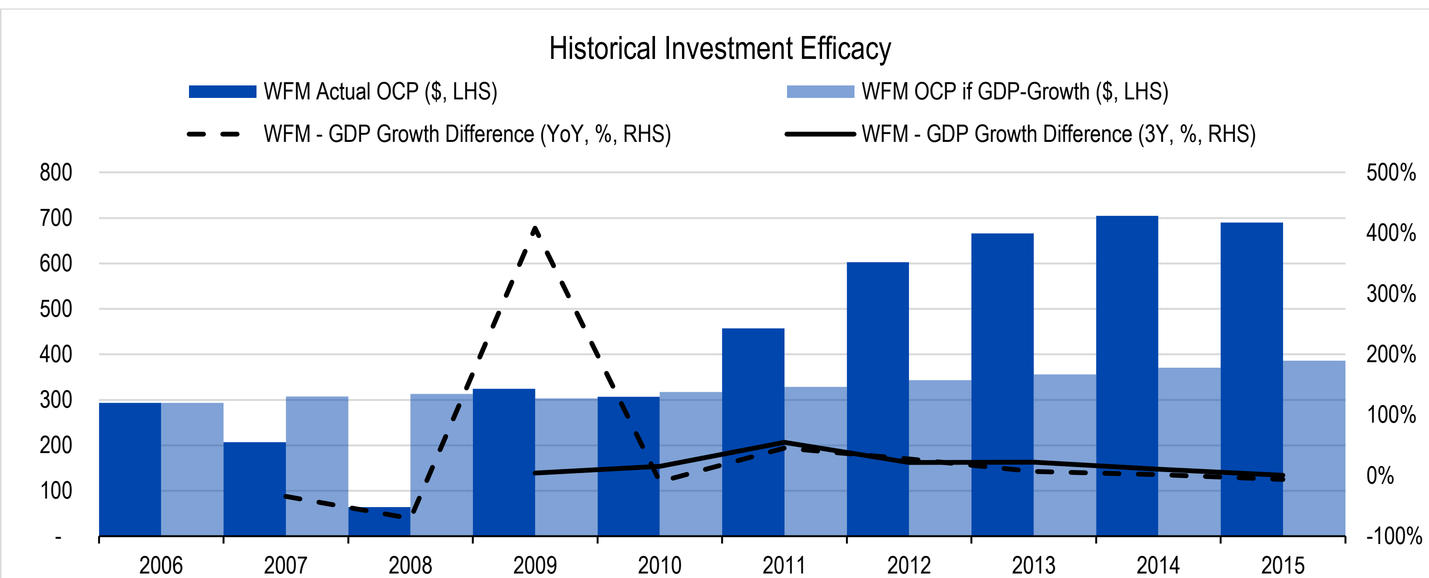


Figure 9. Source: Company Statements, Bureau of Economic Analysis, IOI Analysis

Being the dominant first-mover in a growing segment is a very nice place to be in terms of profit growth. Whole Foods' profits have grown much faster than the economy at large, even with the notable downturn at the depth of the Mortgage Crisis. That said, it is hard for us to believe that future investment efficacy at Whole Foods will be nearly as good as its history has been. The 365 chain will likely do well, but it is competing in a field that already has a strong incumbent – Trader Joe's. An investment in a business to distribute foodstuffs to restaurants strikes us as less compelling, given what is many times long, personal relationships between restaurant buyers and local suppliers. The business of selling organic food is growing quickly, and Whole Foods will certainly be a player, but we think other chains will reap more of the benefits of this growth.

Free Cash Flow to Owners

Free Cash Flow to Owners (FCFO) is the metric IOI uses to value companies. It equals Owners' Cash Profits less Net Expansionary Cash Flow.

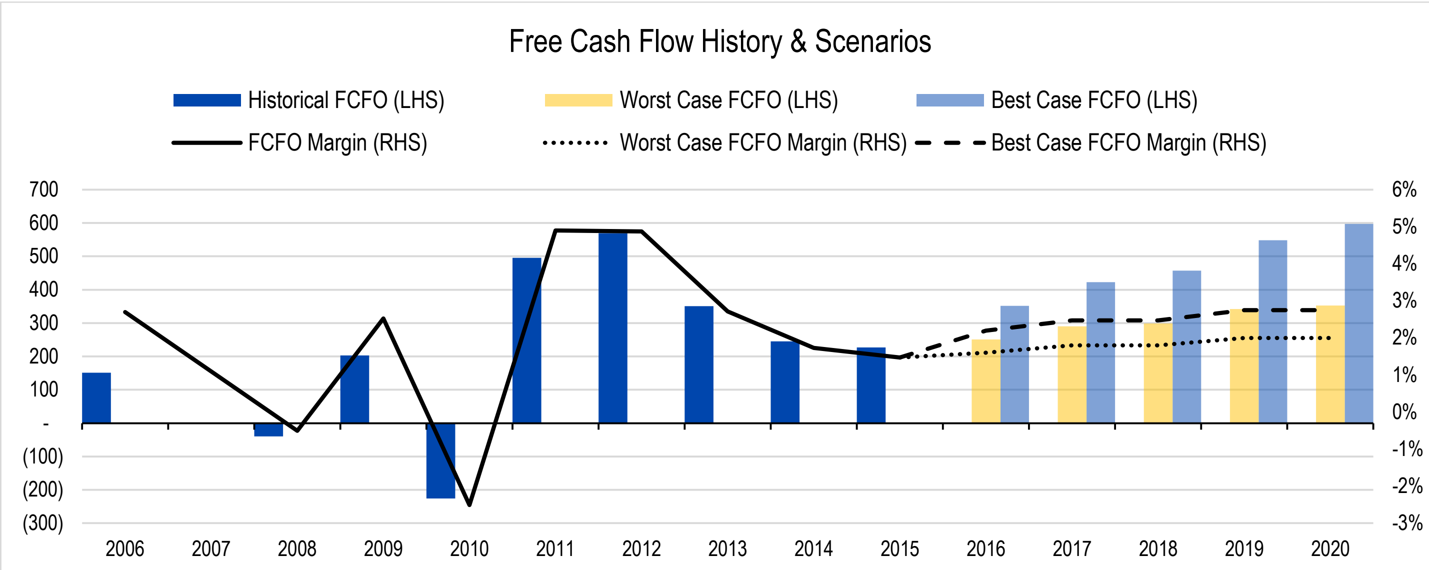


Figure 10. Source: Company Statements, IOI Analysis

Considering the level of investment spending the firm will likely have to do and the lowered profitability stemming from increased competition, we have a hard time seeing Whole Foods generate much more than $0.03 of FCFO for every dollar of revenues.

Valuation Waterfall

Revenue Growth

Our best-case revenue assumptions imply that same-store sales losses can be slowed, such that revenue from newly opened stores drives growth. Our worst-case assumption suggests that competitors' offerings will continue to eat away at Whole Foods' same store sales growth and those losses will offset new store growth.

Profitability

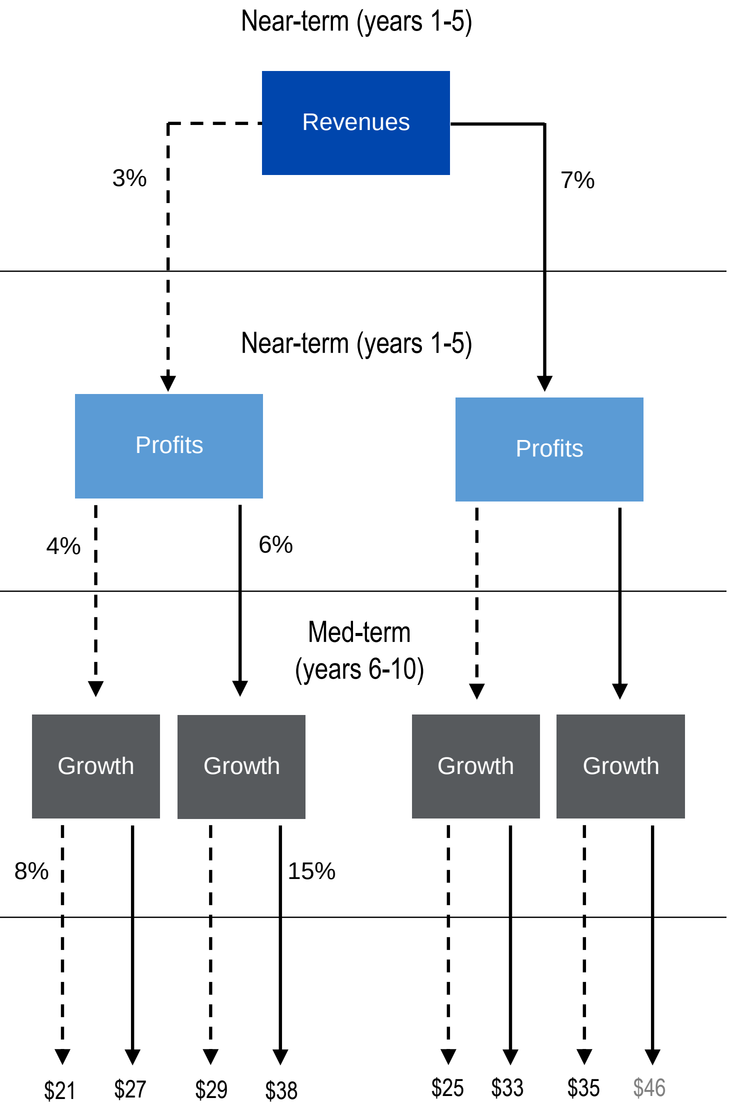
Maintaining recent high levels of profitability (in the 6%+ range) will be difficult, in our opinion, but not impossible. Perhaps the restaurant supply business and high-profit deli sales will offset the cost of marketing mentioned in this report. We believe the lower, worst-case profitability is more likely, given the strength of Whole Foods' competitors.

Medium-Term Cash Flow Growth

A 15% best-case medium-term cash flow growth is difficult to imagine, but some combination of cost cutting and secular industry growth may contribute to it becoming a reality. Eight percent growth of medium-term cash flows implies cost-cutting combined with a more affluent society willing to spend more on premium grocery items.

Fair Value Range

Our fair value range extends from $21 to $38 / share and excludes the best-best-best case fair value of $46 / share. We think that organic food will continue to be a profitable and rapidly growing segment in the grocery business, but do not believe that Whole Foods' dominance can continue given its stronger, more entrenched mainstream competitors.



Methodology

IOI analyses focus on three main valuation drivers: revenue growth, profitability, and medium-term cash flow growth. We estimate a best- and worst-case scenario for each of these drivers resulting in a total of $2^3 = 8$ fair value scenarios based on discounted cash flow methodology. Profitability is measured by Owners' Cash Profit (OCP) margin. We use a discount rate of 10% for large capitalization stocks.

A wide spread of lowest and highest fair values indicates a firm whose value is uncertain. Risk depends on the stock price's relationship to the valuation range.

Best-case scenarios are represented with a solid line; worst-case scenarios, with a dotted one.

Options involve risk and are not suitable for all investors. For more information, please read the Characteristics and Risks of Standardized Options.

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