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Food

## Digestion Issues Loom for Whole Foods

By [Marc Lichtenfeld](#)

Senior Columnist

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My technical analysis background has taught me to follow the trend, and I've applied that lesson to fundamental analysis as well. So if management has a track record of doing things right or wrong, I tend to expect those trends to continue.

But **Whole Foods'** (WFMI) proposed acquisition of rival **Wild Oats** (OATS) leaves me struggling with this tenet. Wild Oats simply never achieved the success of Whole Foods, and the larger grocery giant has a long way to go in integrating the former.

Whole Foods' management certainly deserves the benefit of the doubt. The company has grown its business enormously despite the only relatively recent popularity of organic and healthier foods on a mass scale.

For years, Whole Foods posted same-store sales, revenue and earnings growth figures that were unheard of in the grocery business, at a time when the perception of the organic food customer was that of a hemp-wearing, granola-eating hippie wannabe. Either Whole Foods was in the right place at the right time or it helped to make organic foods fashionable.

Whole Foods' management, led by co-founder and CEO John Mackey, has successfully integrated acquisitions before. The company's knowledge of the grocery industry and marketing has allowed it to turn its purchases of businesses such as Bread & Circus and Mrs. Gooch's into positive contributors to the bottom line.

Investors appear to have little doubt that the company can do the same with Wild Oats. Whole Foods' stock recently was up \$5.63, or 12%, to \$51.33.

Nevertheless, this deal increases the risk profile for the stock. While Whole Foods has had previous success with acquisitions, it has never had to integrate a company as large as Wild Oats.

By store count, Wild Oats isn't much smaller than Whole Foods. Wild Oats had 110 stores at the end of its most recent quarter, compared with 189 Whole Foods stores.

But while Whole Foods has not even double the stores of Wild Oats, its annual sales are almost five times higher.

Sales per square foot of \$459 are half those of Whole Foods' \$919 in 2006. Moreover, Whole Foods enjoys perhaps the strongest brand equity in the grocery business, something Wild Oats never came close to achieving.

The deal has a bigger chance for success if Whole Foods can successfully follow through on its plans to make several changes at Wild Oats stores. The company said it aims to improve Wild Oats' perishables sections,

which have long been a Whole Foods' strength. The company also will incorporate its private-label brands, which have been growing (they currently are 17% of grocery and Whole Body sales).

And perhaps most importantly, Whole Foods plans to institute its corporate culture into the chain. Like another best of breed, **Costco** (COST), Whole Foods treats its labor force better than most. The employees' satisfaction is evident by the exemplary service that customers receive.

Dr. Arun Jain, a supermarket industry expert and professor of marketing at the University at Buffalo, argues that the pair are a perfect fit.

"The changes that need to be made at Wild Oats are precisely what Whole Foods is good at," says Jain. "This isn't **General Motors** (GM) taking over Chrysler where the blind [would be] leading the blind," he says.

The deal also could appease Wall Street's obsession with Whole Foods' same-store sales. While Whole Foods posted a respectable 7% rise in same-store sales for its fiscal first quarter, that was down from 13% growth the year before.

Furthermore, stores open eight to 11 years grew comp sales by 4.6%, while same-store sales at stores 11 years or older fell to a 3.8% comp from 7.3% last quarter. Keep in mind, those are numbers that executives at other grocers such as **Safeway** (SWY) or **Kroger** (KR) would sell their first born for.

Sell-side analysts, however, don't like to see those numbers headed lower. Assuming that Whole Foods can improve Wild Oats' comps significantly, it could buoy the declining figures at its own stores.

Whole Foods has stated it plans to reach \$12 billion in sales by 2010. Wild Oats and its more than \$1 billion in annual sales will certainly help to achieve that goal.

The \$700 million, including debt, that it will cost Whole Foods to complete the transaction is a fair price to pay, according to Jain.

"It was very important for Whole Foods to expand quickly," he says. "This frees them of the hassle of looking for real estate and recruiting employees."

Whole Foods has been facing increasing competition in the organic space from ordinary grocers, as well as big-box retailers such as **Wal-Mart** (WMT) and **Target** (TGT).

For the long term, I suspect investors will do just fine in Whole Foods. However, I agree with Bank of America analyst Scott Mushkin's argument that, "The success of the stock now not only depends on the success of the new stores, but also the successful integration of Wild Oats."

On Wall Street, there are currently seven buys, seven holds and one sell rating on Whole Foods, including three upgrades Thursday. That means there is still plenty of room for downgrades should Whole Foods hit speed bumps in the assimilation of Wild Oats.

Though everyone is congratulating the bride and groom on Thursday, the company won't be given a long honeymoon period should it see decreasing margins and slowing growth.

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*In keeping with TSC's editorial policy, Lichtenfeld doesn't own or short individual stocks. He also doesn't invest in hedge funds or other private investment partnerships.*

*Marc Lichtenfeld was previously an analyst at Avalon Research Group and The Weiss Group and a trader at Carlin Equities. He holds NASD 86, 87, 7 and 63 licenses. His prior journalism experience includes being a reporter/anchor for On24 in San Francisco and a managing editor of InvestorsObserver, a personal finance Web site. He is a graduate of the State University of New York at Albany. He appreciates your feedback; [click](#)*

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