



ANALYST QUICK NOTES

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Whole Foods Market Inc. (NGS: WFM: HOLD)

Target Price: NA

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What's New?

- Whole Foods is scheduled to report third-quarter earnings after the close on July 29.
- Conference call at 5:00 eastern time.
 - 877-876-9177

My Investment Recommendation is HOLD

- We have become more cautious about the company's competitive environment.
- The shares have declined since our downgrade. We would once again consider raising our recommendation on a contrarian basis.

Recent Performance

- Whole Foods has been a notable underperformer both year-to-date and since our downgrade in mid January.
 - The shares are down 18% this year, lagging the 3% return of the S&P 500 and the roughly 20% return of BUY-rated Kroger.
 - The WFM shares are down approximately 20% since our downgrade.

The Key to the Call

- We believe that the key to the quarterly call is likely to be management's commentary on its efforts to drive sales by offering more competitive prices.
- We believe that investors will want to see signs of improving comp sales and evidence that management has a tested plan to offer the most productive price investments.
 - Believe produce is probably the area where price reductions result in the biggest unit increases.
 - Don't expect many Whole Foods customers to run to Wal-Mart, but retailers including Costco, Kroger, Fresh Market and Sprouts are all giving shoppers the ability to comparison shop.

- Investors are likely to be interested in the trajectory and duration of the price investments.
- WFM has announced plans to open a second store concept named 365, after the company's value-priced house brand.
 - The company expects to open the first 365 stores in the first half of 2016 (probably in Los Angeles.)
 - The company has described the store format as fun, convenient and "quality meets value."
 - WFM has also described the stores as streamlined.
 - The company sees the concepts as complimentary and does not see 365 as diminishing the market for full-line Whole Foods stores.
 - We believe some investors want to know if the company still feels like it has growing, educated, affluent markets that will support a full-line store.
 - We think it is important to note that while there are a limited number of markets like Columbus Circle, in New York City, Tribeca, near Wall Street and Foggy Bottom, near the White House, management is likely to say that there are still excellent locations that offer an attractive level of rent relative to sales volume.
 - We believe investors on the 3Q call will be interested to know how the company will maintain its execution while opening another chain and what the margin structure of the new business is likely to be.
 - There may be some continuing probing about whether the new concept reflects a change in the organic and natural foods market and how 365 will deliver low price and great quality in a way that is different and complimentary to existing WFM stores.

Five strategic initiatives to build business momentum

- Drive sales growth.
- Refresh older stores.
- Launching a national marketing campaign
- Offering new ways to shop, including home delivery, online ordering.
- New affinity program.

Important Market Dynamics

- The company has produced positive earnings surprises in 6 of the last 8 quarters, including a small positive surprise in 2Q.
- Topping expectations for sales growth has been a greater challenge.
 - Total sales have come in below consensus in seven of the last eight quarters, including misses in the last two quarters.
- The shares have recently had a tough time on earnings day, with declines after six of the last eight quarterly reports.

Primed for Moderate Volatility

- Going into the 3Q release, investors are primed for moderate volatility, by company standards.
- Implied move of 7% after the release, based on the pricing of WFM options.
- The average absolute move on the day after the release has been approximately 9.5%.
- The level of short interest has declined this year as the share price has declined.

Competition

- More players are trying to get a share of the growing market for natural and organic foods.
- Challenge for WFM has been that they aren't gaining new customers at the same rate.
- Sources of competition include:
 - Kroger
 - Regional players like Wegmans.
 - Sprouts
 - Fresh Market

2Q Recap

- After the close of trading on May 6, Whole Foods reported fiscal 2Q15 earnings of \$0.44 per share, up 16% year-over-year. The GAAP profit included a benefit of \$0.01 per share from a non-routine credit from suppliers.
 - This isn't a major issue, but with the exclusion of this penny, adjusted profit was just below our estimate of \$0.44 and in line with the Bloomberg consensus forecast of \$0.43.
- The GAAP operating margin was in line with our estimate as a percentage of sales, but investors were disappointed that comparable sales were below consensus.
- The shares were down approximately 10% after the report.
- The company announced that it would launch a new store concept that would be smaller than existing stores and targeted to younger, more value-conscious shoppers.
 - Based on conference call comments, there seemed to be a bit of analyst skepticism about the company's belief that it can operate more than 1,200 Whole Foods stores while also introducing a new line of smaller, value-focused stores.
- Second-quarter net sales rose 10% to \$4.65 billion. Our expectation was \$4.7 billion and the StreetAccount consensus was approximately \$4.7 billion.
- Comparable-store sales rose 3.6% in constant currency based on a 0.8% increase in the number of transactions and a 2.8% increase in basket size. The consensus called for a comp increase of 5.2%, according to StreetAccount, and a 5.3% increase according to Bloomberg.
 - We believe that increasing competition, weather-related issues, and the loss of sales to new Whole Foods stores weighed on comp-store sales.
- The company maintained its FY15 financial targets, including sales growth of more than 9% and an EBITDA margin of approximately 9%.

The Numbers

- We are maintaining our FY15 earnings estimate at \$1.74 per share based on approximately 10.4% sales growth.
- We still expect square footage growth of 9%-10%.
- We continue to project an operating margin of about 6.5%, which is within approximately 10 basis points of consensus, and an EBITDA margin of approximately 9%, in line with the company's guidance.
- We are modeling a roughly 25-basis-point decline in the gross margin, partly offset by a small decline in direct store expenses as a percentage of sales.
- The average analyst estimate is \$1.72 per share, according to Bloomberg, on sales growth of about 10%.

- Our third-quarter estimate is \$0.46 per share.
 - The average analyst estimate is \$0.45.
 - Our sales estimate is \$3.73 billion. The average analyst estimate is \$3.69 billion.
 - The average analyst estimate for comparable sales is growth is 3.15% with a range of 2.3% to 4.5%, according to Bloomberg.
 - WFM said in the 2Q release that 3Q comps could see about 100 basis points of drag from a shift in the Easter holiday and from the timing of a discount day for employees.
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