Whole Foods Market – Great Stores, Expensive Stock

Whole Foods Market Inc. (NYSE:WFM) has led the North American consumers' charge towards natural and organic foods. Founded in 1980 in Austin, Texas, the company now has 373 stores, with 107 more planned for development in the near-term. Locally, the company is thriving, which is not surprising, given our west-coast culture of healthy living. Whole Foods has three locations in the City of Vancouver as well as a West Vancouver location in Park Royal Mall. The company is now planning to open a fifth B.C. location in the Brentwood Town Centre area of Burnaby.

Whole Foods stores offer a great selection of products and a pleasant shopping experience; however, it can take time to acclimatize to the premium prices. As a customer, it is sometimes amazing how $100 of Whole Foods groceries can fit in one small bag. Not surprisingly, their premium prices translate into high profit margins. Whole Foods boasts net profit margins around 4 per cent, twice as high as many conventional grocery store competitors. The stock market has recognized the company's success. At the February 18, 2014 closing price of US$51.70 per share, the company's stock market capitalization was just under US$20 billion. On February 12, management projected that 2014 sales growth will be 11 per cent to 12 per cent and diluted earnings per share will be US$1.58 to US$1.65. Assuming they can achieve the high end of that range and earn US$1.65, the shares are trading at over 31 times projected 2014 earnings, which is a high multiple.

If you are familiar with the way we invest, you can probably guess that we are not in a hurry to buy Whole Foods shares. Let us explain further. We do not doubt that the company will continue to grow over the long term. Management expects that Whole Foods will cross the 500-store mark in 2017, and they see long-term demand for 1,200 stores in the U.S. alone. These projections are believable, given that the organic food industry has been growing strongly, yet it still only accounted for 3.5 per cent of U.S. food sales in 2012, according to the USDA.

Whole Foods shares simply appear to be overvalued, given the likely future growth rates, lowering the probability that an investor will earn a good return. Prospective investors must also note the risks to the company's outlook, including the possibility that its results may be more cyclical than those of a conventional grocery store. Not all Whole Foods customers are wealthy, and during the last recession, some of their customers traded down to lower priced competitors. As a result, 2008 earnings were sharply lower than 2007 earnings, and the share price plummeted, before recovering nicely in recent years.

Competition is also a real concern. There are other premium grocery chains, such as Fresh Market Inc. (NASDAQ:TFM), as well as thriving mass-market competitors in the organic space, such as Trader Joe's. Amazon.com Inc. (NASDAQ: AMZN) also looms over Whole Foods' long-term outlook, as the online retailer is expanding into groceries with its AmazonFresh concept.

Grocery retailing is a business with low barriers to entry, and Whole Foods' brand and shopping experience can only take it so far when many customers will always be price-sensitive. To summarize, we would characterize Whole Foods as a high-quality business, but we would require a more attractive valuation in order to invest, especially given some of the risks that the company faces. The natural volatility of the stock market may give us a chance to buy the shares at a more attractive valuation in the future.

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