The Ginsu Knives Are Out for Whole Foods Market

A major stakeholder reveals its dissatisfaction with the Austin-based grocer. We examine the shareholder's recipe for change.

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Perhaps you're old enough to remember the famous "Ginsu Knife" TV ad, which launched the modern infomercial. If not, you've undoubtedly heard some version of its signature phrase -- "Wait, there's much, much more!" -- which has morphed into a contemporary shorthand for signaling any over-the-top sales pitch.

The "Ginsu" moniker was actually a rebranding of a high-quality knife manufactured in Arkansas, which had previously been known by the unimaginative name "Quikut." The kitschy spot, which first aired in the late 1970s, has become a case study in persuasion: A Japanese chef is shown using a Ginsu to slice through frozen spinach, saw a beer can in two, and chip away at wood blocks, while demonstrating how the blade always remains razor sharp after such imaginative punishments.

I was reminded of this commercial after reading about the angst of one of **Whole Foods Market**, **Inc.**'s (<u>NASDAQ:WFM</u>) largest shareholders, <u>as reported</u> by Bloomberg News earlier this month. The shareholder, as yet unnamed, is said to have held meetings with activist investors to effect major change at the natural foods grocer, which could include a replacement of current management and/or exploring a sale of the company.

Such news shouldn't completely surprise anyone. Whole Foods has struggled to reverse a comparable-store-sales decline that's now roughly two years old. Company stock, stuck in a thick paste of investor skepticism given rising competition, has lost roughly half its value since February 2015. What does this institutional shareholder, who prefers anonymity and would have others do its heavy lifting, want specifically? According to the obligatory "people familiar with the matter," who were present at discussions but also with to remain anonymous: "The investor cited Whole Foods' poor inventory and vendor management, high costs, and failure to make the most of its unique appeal to millennial shoppers among the key issues."

Aimed at an aggressive hedge fund activist or two, these points form a seductive sales pitch. The identified issues lend themselves to wide-scale changes, which, if enacted by a capable agitator, aim to send shareholder value on a sharp upward tack.

Of course, knowing that change needs to happen doesn't ensure that you'll be able to put your index finger on the correct problems. In this case, the complaints relayed to Bloomberg don't appear to be connected with the company's current reality. And selling the business, or ridding Whole Foods of executives who built an industry-leading value proposition, makes for an extremely sharp knife to wield. Let's take a look at these grievances.

Inventory is a strength, not a shortcoming, of Whole Foods Market

Grocers work incessantly to avoid shrink (wastage), and also to move inventory faster. Cycling inventory through a company quickly has tangible benefits, including the reduction of inventory holding costs, and a faster conversion of products for sale into cash.

Whole Foods' management team realizes that opportunities exist to reduce shrink, especially in perishables such as fruit and vegetables. It's also dedicated to moving packaged goods out of back areas and on to store shelves more quickly. In the spring of 2016, executives disclosed an initiative to set up standard operating procedures to optimize inventory handling across all of Whole Foods' stores. Individual locations have previously enjoyed autonomy in this area.

Yet everything's relative: One company's benchmarks for improvement may well prove out of reach for another in the same sector. Believe it or not, inventory management is one of the unsung, signatory achievements of Whole Foods Market. You can see this in a calculation that seeks to measure a combination of inventory efficiency and profitability: the "Turn/Earn" index. This is found by multiplying the number of times a company replenishes its aggregate inventory annually (inventory turnover) by gross margin. I've compared Whole Foods to a broad range of competitors:

Grocer	Inventory Turnover	Gross Margin	Turn / Earn Index (Rounded)
Whole Foods Market	30.92	34.41	1,064
Casey's General Stores	35.41	22.66	802
Sprouts Farmers Market	23.31	29.27	682
Kroger	18.53	22.16	411
Weis Markets	12.27	27.35	336
Natural Grocers	9.38	29.15	273
Wal-Mart Stores	10.76	25.13	270
Supervalu	17.36	14.74	256

INDEX CALCULATED BY AUTHOR BASED ON YCHARTS DATA. NOTE THAT GROSS MARGIN PERCENTAGES ARE CONVERTED TO WHOLE NUMBERS TO ARRIVE AT AN INDEX VALUE.

You'll observe that the organic-foods pioneer has the second fastest inventory turnover in the group, and the highest gross margin. Whole Foods has many issues to work on, but inventory management really isn't one of them. The company's indexed measurement of efficiency and profitability is 33% higher than that of its nearest competitor, and its score is simply out of reach of the rest of the peers in the table. This has more than a little to do with the fact that Whole Foods is extremely good at converting the same meats, dairy, and greens it sells on shelves and counters into prepared foods and hot bar items, incurring relatively little waste, which customers then buy at an even higher margin.

Vendor management, also cited by the anonymous investor, is a key part of the company's brand proposition. Whole Foods cultivates its vendors within extremely long-lasting relationships, pushing them to improve scores on its various sustainability rating scales, an important process in the eye of its socially conscious customers. Sure, the company could see some efficiency improvements in this area. Yet overall, without extremely well-managed relationships within its supply chain, Whole Foods simply wouldn't be able to achieve its breakneck inventory turnover of nearly 31 times annually.

As for the high costs mentioned in the Bloomberg article, these are concentrated in Whole Foods' sales, general, and administrative expenses. It's a valid area of improvement that management has only

recently addressed in a dedicated manner. I've discussed results of initial cost-cutting in an analysis of the company's Nov. 9 quarterly report, which you can read here.

Whole Foods doesn't have a unique opportunity with millennials

The anonymous shareholder is also correct to point out that Whole Foods has a millennial problem. But so does nearly every other grocer in the business. A recent article by Derek Thompson of *The Atlantic* -- "Why Do Millennials Hate Groceries?" -- suggests that millennials, and their elders for that matter, are booking fewer visits to grocery stores because they're eating a higher percentage of their meals at restaurants.

To this insight we should add the well-documented tight-fistedness of this demographic. Many millennials came of age and formed thrifty habits during the Great Recession, which means that dollar stores and discount chains grab a disproportionate share of their shopping budget.

Accordingly, several marketing research reports over the past three years have indicated that millennials' grocer of choice isn't Whole Foods, Trader Joe's, or some other forward, hip chain. Rather, it's the ubiquitous and cheap **Wal-Mart Stores, Inc.** (NYSE:WMT). Wal-Mart's own data tends to support this research. In March 2016, Chief Merchandising Officer Steve Bratspies told analysts at an industry conference that fully one-third of U.S. millennials between 20 and 35 had shopped at a Wal-Mart in the past month.

While it may be counterintuitive to realize, millennials, who do tend to favor sustainably sourced, natural and organic products, and share affinity with the Whole Foods brand, don't inherently present any "unique opportunities" to the company as a shopping consortium. To state so reveals a lack of understanding that this demographic is currently price-driven over any other single shopping consideration.

There is one characteristic grocers and shareholders understand and probably agree upon regarding this group: Millennials use technology to shop to a much higher extent than older generations. The following graphic, from the Food Marketing Institute's 2016 U.S. Grocery Shopping Trends report, demonstrates how much more actively millennials exhibit technology-centric purchase behaviors versus any other group:

Shopper Online Activities: Occasionally/Frequently	Total	Millennial	Gen-X	Boomer	Mature
Use digital coupons	49%	59%	45%	44%	18%
Look up recipes	47%	66%	47%	24%	8%
Check weekly sales specials at your primary store	46%	55%	41%	41%	25%
Read reviews of products and brands	32%	41%	31%	22%	17%
Scan QR codes or traditional barcodes of grocery type items to compare pricing across stores (for example, with Amazon)	23%	29%	22%	15%	10%
Use the in-store item locator	21%	29%	19%	15%	7%
Scan QR codes or traditional barcodes of grocery type items to learn more about their nutritional value	20%	23%	19%	18%	13%

IMAGE SOURCE: HARTMAN GROUP / FMI.ORG.

Whole Foods' attempt to appeal to these digital natives' purchasing habits while offering lower prices has of course materialized in its "365 By Whole Foods" concept. With a handful of these tech-sawy, discount-friendly stores in operation, and 19 in its development pipeline, the company is actually pretty actively courting the youngest U.S. shoppers, while taking care to avoid cannibalization of its core business.

A dubious course of action?

To be clear, Whole Foods' central issues remain its market positioning against new competition, maintenance of pricing power, and top-line growth. None of these can be righted overnight, though each is currently being addressed. And none of these problems is likely to be solved by an activist investor who chooses to attack inventory or costs, or get rid of the same management team that's built what remains one of the most profitable grocery operations in the industry.

Selling the business doesn't seem a viable option at present to me, either. I'm not sure any single competitor big enough to buy Whole Foods -- of which there are but a handful -- has a better solution to the company's core problems. This imbues a fairly large potential transaction with risk.

Forcing constructive change in an enterprise shouldn't be frowned upon. But attempting to push questionable initiatives out of frustration may end up destroying more value than it creates. And it's worth noting that the company, as of the last two quarters, is showing concrete signs of a reversal of its comps trend decline. Activists, are you listening to a persuasive sales pitch and being asked to wield an extremely sharp knife? Be careful what you saw through.

10 stocks we like better than Whole Foods Market

When investing geniuses David and Tom Gardner have a stock tip, it can pay to listen. After all, the newsletter they have run for over a decade, *Motley Fool Stock Advisor*, has tripled the market.*

David and Tom just revealed what they believe are the <u>ten best stocks</u> for investors to buy right now... and Whole Foods Market wasn't one of them! That's right -- they think these 10 stocks are even better buys.

<u>Click here</u> to learn about these picks!

*Stock Advisor returns as of Nov. 7, 2016

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