Whole Foods to Acquire Wild Oats[[1]](#footnote-1)

On February 21, 2007, Whole Foods and Wild Oats executed an agreement whereby Whole Foods would purchase all of the outstanding shares of Wild Oats common stock. Whole Foods has agreed to pay $18.50 per outstanding share of Wild Oats stock, or a total of $565 million. In addition, Whole Foods would assume $106 million in outstanding debt from Wild Oats. On June 5, 2007, the Federal Trade Commission (FTC) filed for and was granted a temporary restraining order and preliminary injunction preventing the completion of the merger.

The United States District Court would now have to decide whether the proposed merger violates U.S. antitrust law. Specifically, the FTC argued that the merger violates Section 7 of the Clayton Act, which states that a merger or acquisition should be prohibited if “…the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly.”

**The Natural and Organic Food Industry**

The natural and organic food market had grown to $57 billion by the end of 2006, and was experiencing growth rates of better than 10% per year. This growth was being driven by a number of factors. More consumers were focusing on a healthier lifestyle and drawing a stronger link between health and natural and organic foods. Additionally, consumers were also becoming more aware of food safety issues and growing more concerned about the use of synthetic hormones and the use of antibiotics in food. Also, the standardization and certification of organic foods, and an increase in the supply of organic products, were making these product choices available. Many felt that affluent and middle class baby boomers would grow more health conscious as they aged, ensuring that the natural and organic food market would maintain high growth rates for years to come.

Natural foods are foods that are minimally processed and largely free of artificial ingredients or preservatives. Organic foods are foods that are produced using stringent agricultural practices and are certified as organic by a federally accredited agency. These agricultural practices include promoting healthy ecosystems, not using genetically modified crops or long-lasting pesticides, using healthy livestock management practices, not using antibiotics or growth hormones, and using food processing that protects the healthfulness of the product.

While organic product offerings had been around for several decades, the U.S. Department of Agriculture (USDA) boosted the industry in 2002 by creating the Organic Rule. The Organic Rule created a clear set of guidelines that define what products could be labeled as organic, and how such products should be grown, handled, stored, and sold. The guidelines include rules that prevent the commingling of organic and conventional products, protect organic products from contact with prohibited substances, and require proper labeling and maintaining proper records of the handling of organic products. In order to be labeled as organic, the products must be certified by a USDA-accredited certifying agency. Of the $57 billion market for natural and organic foods, a little less than half of that was from the sales of actual organic foods.

Customers of natural and organic foods tend to have higher educational levels and higher income levels. They also tend to be more loyal to the products and brands that they eat, and spend more time researching the products that they consume. In addition, many of the consumers have a high degree of concern for the environment and are concerned about the sustainability of the products that they buy.

While there are numerous independent and small regional players, Whole Foods and Wild Oats are the only two natural and organic grocery stores that operate at a national level.

**Whole Foods**

Whole Foods is the largest operator of natural and organic supermarkets in the U.S., with 190 retail locations in 30 states [See Exhibit 1]. The company was founded in 1980 by John Mackey, who still serves as CEO and Chairman of the Board of Directors. Mackey started with a few natural grocery stores in Texas in the early 1980s and then began expanding across the South. In 1992, Mackey had expanded Whole Foods to 12 stores and took the company public. Over the next decade, Whole Foods grew both by opening new stores and acquiring several smaller natural food store chains. As Whole Foods grew, so did the industry as a whole, with growers and producers of organic and natural products having a much greater outlet to reach consumers. In many ways, Mackey is considered one of the founders of the entire natural food movement in the United States.

Whole Foods stores differ from conventional supermarkets in a number of ways. First and foremost, their product focus is on natural and organic foods. Over 70% of Whole Foods sales comes from high quality perishable foods (produce, meat, seafood, bakery, prepared foods), an amount that is significantly higher than conventional supermarkets.

However, providing a wide range of natural and organic products is only part of the success of Whole Foods. As importantly, they offer a premium level of service and selection in their stores. Employees are trained to be knowledgeable and helpful, and the shopping environment is designed to convey an upscale environment. CEO John Mackey describes the key to success as follows: “superior quality, superior service, superior perishable product, superior prepared foods, superior marketing, superior branding, and superior store experience working together are what makes Whole Foods so successful…people who think organic foods are the key don’t understand the business model.”

In addition to grocery items, Whole Foods provided numerous in-store stations where ready-to-eat foods were prepared and sold. As a result of the focus on superior and specialty products, Whole Foods generally charged higher prices and earned much better margins than conventional grocers. In order to make this strategy effective, they have focused on locating in areas where there are high concentrations of college graduates and relatively high incomes. Stores are generally located so that there are at least 200,000 people within a 20-minute drive of the store, with a high density of college graduates. According to Mackey: “We are a lifestyle retailer and have created a unique shopping environment built around satisfying and delighting our customers.”

Whole Foods is widely applauded for its corporate citizenship. They are ranked #5 on Forbes’ list of 100 best places to work in the United States, and have been on the list every year since the inception of the list. For 2006, they have been named the Green Power Partner of the Year by the U.S. Environmental Protection Agency for their leadership and investments in renewable energy. The company has raised millions for its non-profit charitable foundations, both by directly donating a percentage of their profits and by having “Five Percent Days,” days in which 5% of all customer sales are donated to charity. Furthermore, John Mackey recently announced he would be taking an annual salary of $1, and any stock options that he would be eligible for would be donated to the foundations.

As a result of its successful market strategy, Whole Foods was growing quickly. The number of open stores increased by almost 50% over the previous four years, and sales had more than doubled to $5.6 billion. They employed 41,000 and had plans to open 80 new stores in the next year or two. Furthermore, the company earned a profit of $203 million, as both net and gross profit margins continued to increase [See Exhibit 2]. Since 1991, the company’s sales had grown at a cumulative annual growth rate of 31% per year and its earnings at a pace of 21% per year.

However, Whole Foods was not without its critics. Some in the media mocked Whole Foods premium pricing strategy by giving it the nickname “Whole Paycheck.” Furthermore, same-store sales growth had declined from 13% per year to 8% per year, and the company warned that the pace of growth could slow even more. As a result of the disappointment, the stock price of Whole Foods finished the year 39% lower than it started in 2006.

**Wild Oats**

Wild Oats is the second largest natural and organic grocery chain in the U.S., behind only Whole Foods. The company operates a total of 122 stores under four different names. The banner names include: Wild Oats Natural Marketplace (84 stores in 22 states), Henry’s Farmers Market (27 stores, all in Southern California and Arizona), Sun Harvest (8 stores in Texas), and Capers Community Markets (3 stores in British Columbia, Canada). [See Exhibit 3]

Compared to Whole Foods, Wild Oats built stores that were smaller and less expensive to build. Wild Oats Natural Marketplace stores were typically 28,000 to 30,000 square feet compared to 55,000 square feet for a Whole Foods store. In addition, Wild Oats had prices that were lower than Whole Foods, while still being higher than conventional supermarkets. The smaller stores and lower prices allowed Wild Oats to place stores in smaller markets than Whole Foods.

Wild Oats was experiencing financial difficulties. While they earned a $3 million profit in 2005, they lost more than $40 million the year before [See Exhibit 4]. Since 2001, Wild Oats had essentially experienced no growth in the number of stores, as the few new stores opened were offset by store closures.

By early 2007, Wild Oats was also in the midst of significant managerial challenges. In the fourth quarter of 2006, their CEO, Perry Odak, resigned as well as their CFO, Robert Dimond. As of early 2007, neither position had been replaced except on an interim basis. Additionally, they announced they would be closing 8 underperforming stores. Several analysts figured that the loss of top management and weak financial performance made Wild Oats a ripe target for acquisition. Further enhancing this view was the news that Yucaipa Cos., a private equity firm controlled by billionaire investor Ronald Burkle had taken 15% ownership of the common stock. Burkle earned several billion dollars buying and selling grocery chains, and many in the market believed that he would push for a strong turnaround or sell-out of Wild Oats.

**Competition in the Supermarket Industry**

Competition in the supermarket industry has always been intense, and competitors come from a variety of sources. Historically, consumers have been fairly price sensitive in grocery shopping, forcing grocers to maintain low margins and try to compensate with high volumes. Since consumers shop frequently, most grocery shoppers live within a three-mile radius of where they shop. Therefore, the geographic location of a store is an extremely important aspect of how well they compete. Competition in grocery retailing comes from a variety of different types of stores:

*Conventional supermarkets*. The U.S. retail grocery industry contains about 70,000 grocery stores with a large number of firms. Large firms include Kroger, Safeway, Albertson’s, Publix, Aldi, and many others. Kroger, as one of the largest, operated more than 2,400 supermarkets in the U.S., generating more than $57 billion in food store sales. Additionally, thousands of independent grocers compete in the U.S., ranging from small corner stores to 50,000 square foot supermarkets.

*Mass merchandise retailers.* Walmart is the largest seller of groceries in the United States, with approximately 31% of its $226 billion in sales at Walmart stores coming from the sale of groceries. Other large retailers (Target and Meier) have increasingly focused on selling more grocery products to compete with conventional supermarkets. While these stores have expanded the number of available grocery products, they often do so by focusing on non-perishable items.

Walmart has begun carrying an additional 200 organic grocery products in many of their higher-end stores, with a plan of having 400 different products at all their stores. While they were experiencing double-digit growth rates in the sales of organic products, they were also running into some difficulties. As the organic market has grown, supplies have become tight and costs have risen. The result is that Walmart finds itself paying more than competitors for the volumes it needs to fill stores, and is having trouble keeping shelves consistently stocked with organic foods.

*Specialty food retailers.* Specialty retailers like Trader Joe’s and Wegmans also compete in the supermarket category. Trader Joe’s offers discounted prices on premium and specialty foods, but generally has little in the way of fresh or non-perishable items and has a much smaller selection overall than Whole Foods or Wild Oats. However, Trader Joe’s does have a strong national presence with 270 stores, many located close to existing Whole Foods locations. Wegmans has grown into a medium size supermarket chain (approximately 70 stores) focusing on large stores with premium products. Their stores are mainly located in New York, Pennsylvania, and Maryland.

There is considerable debate as to how much traditional supermarkets can and do compete with specialty organic and natural grocery stores. The high growth in sales of organic and natural products has certainly caught the attention of more conventional grocers. Wal-mart recently announced efforts to significantly expand its offering of organic products, and supermarkets like Safeway and Kroger are also pursuing expansion efforts that allow them to provide more natural, organic, and perishable food options. However, some of the early efforts of the big stores have been modest at best.

In many cases, Whole Foods and Wild Oats dismissed conventional supermarkets and mass merchandise retailers as a threat to their business. Whole Foods CEO John Mackey stated: “Safeway and other conventional retailers will keep doing their thing-trying to be all things to all people….They can’t really effectively focus on Whole Foods core customers without abandoning 90% of their own customers….Whole Foods core customers will not abandon them because Safeway has made their stores a bit nicer and is selling some organic foods. Whole Foods knows their core customers well and serves them far better than any of their potential competitors do.” Similarly, Wild Oats has documented its belief “that conventional supermarkets lack the concentration on a wide variety of natural and organic products, and emphasis on service and consumer education that our stores offer.”

**Competition between Whole Foods and Wild Oats**

While conventional supermarkets were not viewed as a strong competitive threat to Whole Foods and Wild Oats, it was clear that in many markets competition between the two firms was highly intense. The two grocers compete head-to-head in 21 geographic markets. Furthermore, there are seven additional geographic markets where one of the grocers exists and the other one has targeted the market for entry. Whole Foods has made an explicit effort to target markets in which Wild Oats has a “monopoly,” often opening stores within a few blocks of an existing Wild Oats store.

Often when stores would open in the same geographic area, the incumbent store would spend considerable time, effort, and money trying to maintain its existing market share. Strategies for maintaining customer share included lowering prices, increasing discounts, and renovating and remodeling existing stores. As an example, Wild Oats planned extensive renovation of its Nashville, TN store in response to a planned opening of a nearby Whole Foods store.

These actions were certainly necessary for Wild Oats to maintain its customer base in certain areas. Internal documents indicated that when Whole Foods would open a store in a close proximity to an existing Wild Oats store, that store would experience as much as a 30% decline in revenue.

Furthermore, there also existed a rivalry between the two firms that sometimes went to the personal level. Whole Foods CEO John Mackey was known to have publicly criticized the management of Wild Oats and reportedly threatened to destroy them. When Wild Oats opened a store in Dallas (Whole Foods’ home area), Whole Foods responded by opening a store in Wild Oats home of Boulder, CO, and offering steep discounts at the store.

**Entry in the Natural Foods Supermarket Industry**

One potential entrant in the U.S. market is the British company Tesco, which is in the early stages of expanding into the U.S. Tesco is the largest retailer in the U.K. and is opening a series of Fresh and Easy Neighborhood Market stores. The stores are 10,000 square foot convenience store size shops that focus on fresh produce, organic and natural items, and fresh prepared meals. Tesco entered the U.S. market in 2006 with plans of opening 100 stores per year, a goal which some industry leaders viewed as unrealistic. One industry executive stated, “It takes time to grow a retail chain, the best strategy is like Trader Joe’s, grow at a quiet pace. Then, before you know it, you have 10 stores, then 20, then 200.” The biggest challenge can be finding real estate to purchase or lease that meets the demographic requirements of your customer base. Additionally, each store requires significant upfront capital investment. According to Wild Oats, opening a new store entailed a capital investment of anywhere from $2 to $5 million dollars. In addition, the store would incur inventory costs of around $500,000 and operating losses in the first year. For larger stores, the upfront investment could be considerably higher.

The largest supplier for natural and organic grocery stores and supermarkets is United Natural Foods, a wholesale distributor with sales of $2.4 billion. Of those sales, approximately 26% were to Whole Foods and an additional 10% were to Wild Oats. As the largest customer, Whole Foods reportedly had better pricing than any other customer, including Wild Oats.

In dealing with suppliers, Whole Foods was known to set “ground rules” that prevented their suppliers from also selling directly to Wal-Mart. The intended result was to force Wal-Mart to purchase goods through distributors, a practice that would likely raise their costs.

**Acquisition Strategy**

Internal documents acquired from Whole Foods and Wild Oats about the merger give some insight into the strategy that Whole Foods would pursue upon completion of the merger and some of the purported benefits. Whole Foods had entered into negotiations with a private equity group to divest the Henry’s and Sun Harvest stores (a total of 35 stores). Additionally, Whole Foods management had discussed closing around 30 of the existing Wild Oats stores that compete with existing or planned Whole Foods stores.

Whole Foods estimated that by closing Wild Oats stores within the same geographic market as existing Whole Foods stores, at least 80% of the customers would switch from Wild Oats to Whole Foods. This switch would lead to a revenue increase of anywhere from 90% to 100% at the existing Whole Foods stores.

In addition to closing stores, the two companies would be able to consolidate distribution centers and merge their administrative offices. Further, Whole Foods would look to improve operations at the Wild Oats stores that would remain open. Whole Foods stores generated significantly higher sales per square foot than existing Wild Oats stores, and considerable effort was planned to increase the efficiency of the merged stores.

One of the benefits of the merger would be to ensure that Wild Oats would not be acquired by a stronger competitor that would increase the level of competition between the two firms. Whole Foods CEO John Mackey characterized the benefits of the merger to his Board of Directors as follows:

“By buying [Wild Oats] we will…avoid nasty price wars in Portland (both Oregon and Maine), Boulder, Nashville, and several other cities which will harm [Whole Foods’] gross margins and profitability. By buying [Wild Oats]…we eliminate forever the possibility of Kroger, Super Value, or Safeway using their brand equity to launch a competing national natural/organic food chain to rival us… [Wild Oats] may not be able to defeat us but they can still hurt us…. [Wild Oats] is the only existing company that has the brand and number of stores to be a meaningful springboard for another player to get into this space. Eliminating them means eliminating this threat forever, or almost forever.”

As a result of the FTC investigation into the merger, it was revealed that Whole Foods CEO John Mackey had posted more than a thousand messages on Internet stock message boards over the last eight years using the name Rahodeb, an acronym of his wife’s first name. The postings discussed detailed information about the company and contained attacks on Wild Oats and other competitors. Following the revelation, Whole Foods announced an internal investigation into the conduct of Mackey. The SEC also announced it would be investigating to see whether the postings violated securities law.

It was now up to the United States District Court to determine whether the merger should be allowed to proceed or should be halted.

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Exhibit 1 – Whole Foods Store Locations by State - 2006

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Location** | **Stores** |  | **Location** | **Stores** |  | **Location** | **Stores** |
| Arizona | 2 |  | Maine | 1 |  | Ohio | 1 |
| California | 40 |  | Maryland | 7 |  | Oregon | 1 |
| Colorado | 7 |  | Massachusetts | 17 |  | Pennsylvania | 7 |
| Canada | 3 |  | Michigan | 4 |  | Rhode Island | 2 |
| Connecticut | 2 |  | Minnesota | 2 |  | South Carolina | 2 |
| District Columbia | 3 |  | Missouri | 1 |  | Texas | 13 |
| Florida | 8 |  | Nebraska | 1 |  | U.K. | 6 |
| Georgia | 7 |  | Nevada | 2 |  | Virginia | 7 |
| Illinois | 9 |  | New Jersey | 8 |  | Washington | 3 |
| Kansas | 1 |  | New Mexico | 2 |  | Wisconsin | 2 |
| Kentucky | 1 |  | New York | 6 |  |  |  |
| Louisiana | 3 |  | North Carolina | 5 |  |  |  |

Exhibit 2 – Whole Foods Selected Financial Data (in thousands)

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Statement of Operations Data** | | **2006** | | **2005** | **2004** | **2003** | **2002** |
| Sales | 5,607,376 | | 4,701,289 | | 3,864,950 | 3,148,593 | 2,690,475 |
| Cost of goods sold and occupancy costs | | 3,647,734 | | 3,052,184 | 2,523,816 | 2,070,334 | 1,758,281 |
| Gross Profit | | 1,959,642 | | 1,649,105 | 1,341,134 | 1,078,259 | 932,194 |
| Direct store expenses | | 1,421,968 | | 1,223,473 | 986,040 | 794,422 | 677,404 |
| General and admin. Expenses | | 181,244 | | 158,865 | 119,800 | 100,693 | 95,871 |
| Pre-opening and relocation costs | | 37,421 | | 37,035 | 18,648 | 15,765 | 17,934 |
| Operating income | | 319,009 | | 229,733 | 216,646 | 167,379 | 140,985 |
| Interest expense | | (32) | | (2,223) | (7,249) | (8,114) | (10,384) |
| Investment and other income | | 20,736 | | 9,623 | 6,456 | 5,593 | 2,056 |
| Income before taxes | | 339,713 | | 237,133 | 215,853 | 164,858 | 132,657 |
| Provision for income taxes | | 135,885 | | 100,782 | 86,341 | 65,943 | 53,063 |
| Net income | | **203,828** | | **136,351** | **129,512** | **98,915** | **79,594** |

Exhibit 3 – Wild Oats store locations - 2006



Source: Wild Oats Annual Report - 2006

Exhibit 4 – Wild Oats Selected Financial Data (in thousands)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Statement of Operations Data** | **2005** | **2004** | **2003** | **2002** | **2001** |
| Sales | 1,123,957 | 1,048,164 | 969,204 | 919,130 | 893,179 |
| Cost of goods sold and occupancy costs | 796,396 | 751,314 | 683,480 | 643,769 | 635,615 |
| Gross Profit | 327,561 | 296,850 | 285,724 | 275,361 | 257,564 |
| Direct store expenses | 242,822 | 235,425 | 208,908 | 198,379 | 207,898 |
| General and admin. Expenses | 66,559 | 62,454 | 64,659 | 55,186 | 53,131 |
| Pre-opening and relocation costs | 3,419 | 5,265 | 3,490 | 2,737 | 2,444 |
| Restructuring Expenses (net) | 4,154 | 2,648 | 828 | (754) | 53,535 |
| Operating income | 10,607 | (8,942) | 7,839 | 19,813 | (59,444) |
| Interest expense | (6,294) | (5,239) | (4,966) | (11,077) | (12,152) |
| Investment and other income | (559) | - | (186) | - | (228) |
| Income before taxes | 3,754 | (14,181) | 2,687 | 8,736 | (71,824) |
| Provision for income taxes | 569 | 25,838 | 1,094 | 3,666 | (26,229) |
| Net income | 3,185 | (40,019) | 1,593 | 5,070 | (45,595) |

1. This case was prepared by Kyle J. Anderson, Michael Baye, and Jeffrey Prince to serve as the basis for classroom discussion, rather than to represent economic or legal fact, or the effective or ineffective handling of managerial situations. [↑](#footnote-ref-1)