



## United Natural Foods

(NASDAQ: UNFI)

Company Update  
EPS Revision

### Outperform

Above Average Risk

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Price: 21.81      Price Target: 30.00  
 52-Wk High: 26.38      52-Wk Low: 14.25  
 Float (MM): 16.4      Debt to Cap: 46.7%  
 Shares Out (MM): 19.4      Market Cap (MM): 423  
 Dividend: 0.00      Yield: 0.0%  
 Tr. 12 ROE: 13.70%      Est 3-Yr EPS Gr: 20.00%  
 Trading Vol. (MM): 0.200  
 Institutional Own.: 71%

(FY Aug)	2001A	2002A	2003E	2004E
Diluted EPS	0.79	1.10	1.20	1.40
P/E	27.61x	19.83x	18.18x	15.58x

Diluted EPS	Q1	Q2	Q3	Q4
2001	0.18A	0.15A	0.22A	0.25A
2002	0.26A	0.27A	0.29A	0.29A
2003	0.28A	0.28A	0.31E	0.33E
Prev.			0.32E	
2004	0.35E	0.33E	0.35E	0.37E

EPS excludes one-time charges.

All values in USD unless otherwise noted.

### Strong Business Trends

#### Event

EPS of \$0.28 exceeded estimates of \$0.27 and met the high end of guidance (\$0.26-\$0.28).

#### Investment Conclusion

- Strong sales momentum reflects: favorable industry trends, vibrant business with Whole Foods, strong growth in the mass market, and continuing market share gains.
- Successfully managing through business changes (integration of two acquisitions and loss of Wild Oats).
- Trimming Q3 estimate by a penny to \$0.31 (the midpoint of management's \$0.30-\$0.32 guidance), due to fuel prices, impact of acquisitions, and challenges with Hershey's division.
- Believe forecasts for 4Q03 and FY04 are conservative - reiterate Outperform.

#### Valuation

We apply P/E multiple of 20x to our calendar 2004 estimate of \$1.48 to derive a 12-month price target of \$30. At our price target, shares would trade roughly in line with historical averages. Our price target assumes a PEG multiple of 1.0x, which is in line with current forward PEG multiples for conventional distributors and other companies in our healthy lifestyles universe. We believe this valuation is reasonable, given our expectation for accelerating sales and earnings growth and potential for upward revision to our 2004 estimates.

#### Impediment

United's business has changed significantly in a short period of time. The company recently lost its #2 customer, added new capacity, and announced two large acquisitions. Operational challenges resulting from these changes could result in a departure from our price target outlook.

#### Q2 Earnings Recap

United Natural reported strong fiscal Q2 results. EPS of \$0.28 exceeded estimates of \$0.27. Earnings were at the high end of management's \$0.26-\$0.28 guidance and would have reportedly been \$0.015 higher if not for inefficiencies related to its Hershey division. The upside came from higher-than-expected operating income, which resulted from strong top-line

growth. Sales increased 18.6% YOY to \$338 million, handily exceeding our estimate of \$326 million. Internal sales growth of 17.4% accelerated from last quarter and exceeded management's guidance for "high teens" growth. Q2 operating margins were 3.2%, representing a 20 basis point decline sequentially and a 40 basis point decline year-over-year. Operating margins fell 10 basis points short of our estimate due to lower-than-expected gross margins. We believe Q2 was United's most challenging quarter operationally, as it included the integration of two large acquisitions and was the first full quarter without Wild Oats. Going forward, we expect operating margins to improve from Q2 levels.

### Sales Trends

Reviewing sales trends by customer and channel reveals that United is experiencing strong growth trends in each major component of its business. We believe this reflects both favorable industry conditions and continuing market share gains:

**1) Whole Foods (25% of sales):** United's business with its No. 1 customer, Whole Foods Market, remains vibrant. Sales to Whole Foods increased more than 50% in Q2. Excluding acquisitions, sales to Whole Foods grew more than 30%.

**2) Mass Market (14% of sales):** Excluding acquisitions, sales to mass market customers increased 24%. This marks an acceleration from last quarter's 20% internal growth with mass market accounts.

**3) Independents (45% of sales):** Sales to independent natural food retailers increased 11%, excluding acquisitions. By comparison, the company reported high single-digit internal sales growth in each of the past three quarters. Given that independent retailers represent the industry's most mature sales channel, we believe these growth rates indicate both strong industry growth. In addition, we believe the company is gaining share from its primary competitor, Tree of Life, which is experiencing operational problems and derives a large proportion of its sales from independent retailers.

**4) Other "Supernaturals" (6% of sales excluding OATS):** Based on an extrapolation of data provided by management, we estimate that sales to supernatural customers, excluding Whole Foods and Wild Oats, grew at a healthy rate of 10%-11% in Q2.

### Profitability Trends

United's margins were negatively impacted by the integration of two recent acquisitions (Blooming Prairie and Northeast Cooperatives) and inefficiencies related to its Hershey division. Excluding these items, the company stated that its operating margin would have been 3.9%, or 70 basis points higher than reported. We estimate that Hershey inefficiencies hurt margins by 15 basis points, while acquisitions had a 55 basis point impact.

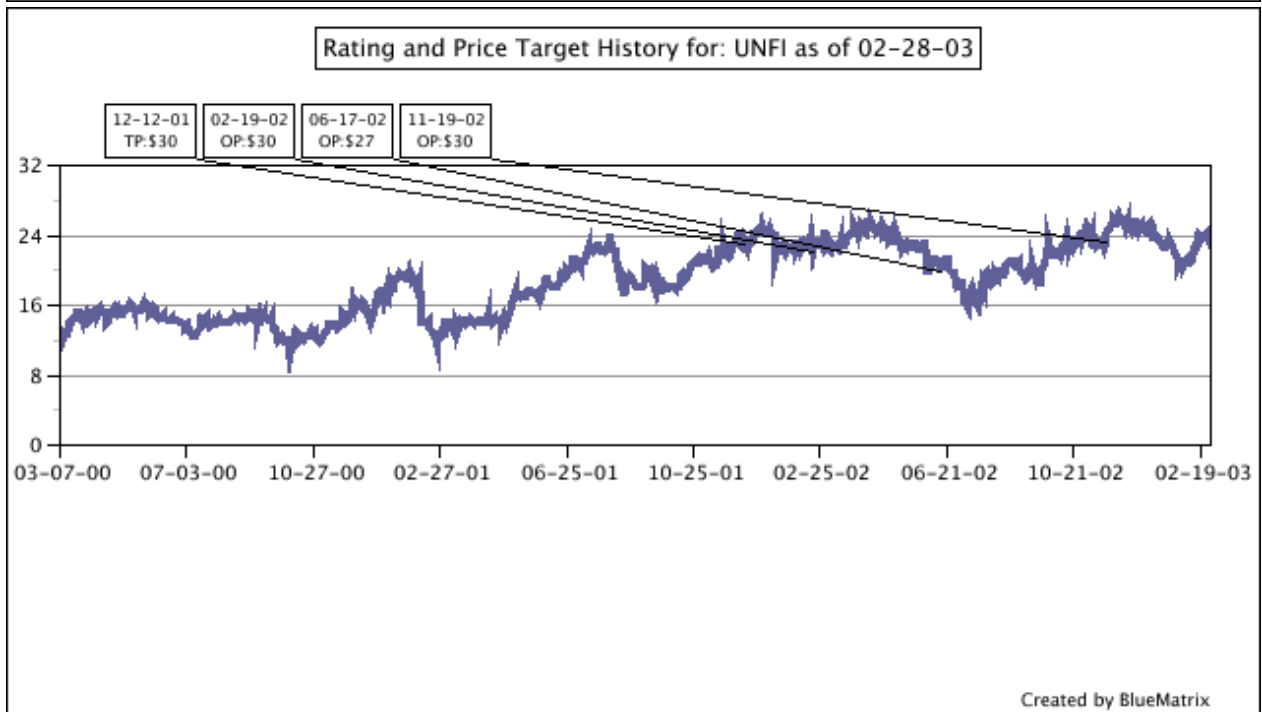
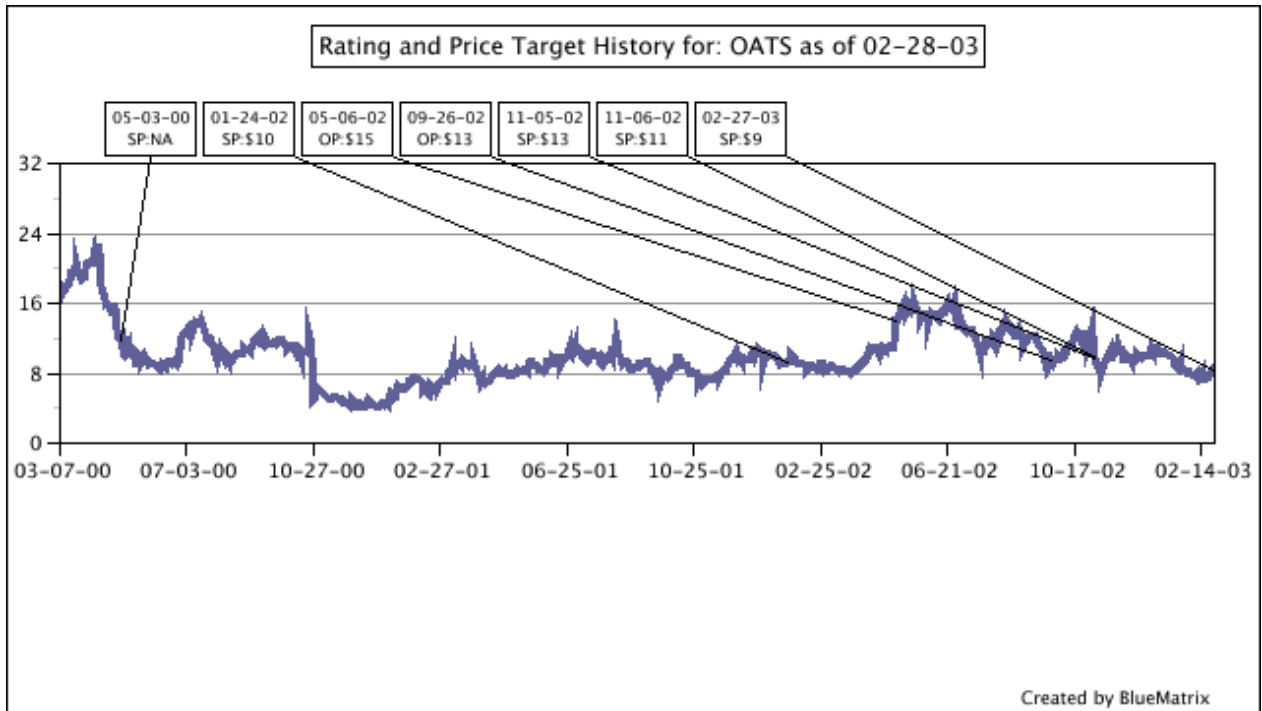
Looking ahead, we believe margins will improve from current levels, as the company progresses with the integration of acquisitions and works to resolve inefficiencies with its Hershey's business. The improvement should be gradual, however, for several reasons. First, the Northeast Coop acquisition only factored into one month of the second quarter. Its full inclusion in Q3 should hurt margins in the current quarter by about 10 basis points. Northeast Coop should be a source of margin improvement beginning in Q4, however, when its operations are scheduled to be consolidated into the expanded Chesterfield, NH facility. Second, rising fuel prices could hurt margins. Fuel accounts for 60-65 basis points of operating expense, and the recent increase in fuel prices could impact margins by about 20 basis points. Third, management noted that Hershey's profitability improvement will take a few quarters. As a result of these factors, we are trimming our Q3 estimate to \$0.31 from \$0.32. Note that our previous estimate was at the high end of management's \$0.30-\$0.32 guidance. We remain comfortable with our 4Q03 and FY04 estimates, given United's strong sales trends and opportunities for margin improvement.

### Company Description

United Natural Foods (Dayville, Connecticut) is the leading natural products distributor in the United States.

### Disclosures

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Rating	RBC Capital Markets		IB Serv./Past 12 Mos.	
	Count	Percent	Count	Percent
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SELL [U]	88	11.61	8	9.09

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**United Natural Foods, Inc.**  
**Consolidated Statement of Operations**  
(In Thousands Except for Per Share Amounts)

	1998	1999	2000	2001	Oct-01	Jan-02	Apr-02	Jul-02	2002	Oct-02A	Jan-03A	Apr-03E	Jul-03E	2003E	Oct-03E	Jan-04E	Apr-04E	Jul-04E	2004E
Whole Foods	116,626	143,119	145,390	168,795	49,616	54,809	58,571	61,851	224,846	70,906	83,935	85,804	88,147	328,792	97,048	103,240	102,964	105,776	409,029
Wild Oats	65,602	94,270	118,129	147,441	40,085	41,106	40,549	41,131	162,871	18,971	7,000	4,000	4,000	33,971	4,000	4,000	4,000	4,000	16,000
Other customers	546,682	619,610	645,168	700,599	190,614	189,546	201,243	206,272	787,675	221,116	247,512	275,046	280,629	1,024,303	292,894	287,313	297,050	303,079	1,180,336
<b>Total Sales</b>	<b>\$728,910</b>	<b>\$856,998</b>	<b>\$908,688</b>	<b>\$1,016,834</b>	<b>\$280,315</b>	<b>\$285,461</b>	<b>\$300,362</b>	<b>\$309,254</b>	<b>\$1,175,392</b>	<b>\$310,993</b>	<b>\$338,447</b>	<b>\$364,850</b>	<b>\$372,776</b>	<b>\$1,387,065</b>	<b>\$393,943</b>	<b>\$394,553</b>	<b>\$404,014</b>	<b>\$412,856</b>	<b>\$1,605,365</b>
Cost of goods sold	578,574	680,301	734,724	818,040	225,314	228,949	242,048	248,466	944,777	250,157	272,360	292,887	298,944	1,114,348	316,187	314,853	322,403	329,459	1,282,903
<b>Gross profit</b>	<b>150,335</b>	<b>176,697</b>	<b>173,964</b>	<b>198,794</b>	<b>55,001</b>	<b>56,512</b>	<b>58,314</b>	<b>60,788</b>	<b>230,615</b>	<b>60,836</b>	<b>66,087</b>	<b>71,962</b>	<b>73,832</b>	<b>272,718</b>	<b>77,755</b>	<b>77,245</b>	<b>78,833</b>	<b>80,483</b>	<b>314,316</b>
Operating expenses	115,342	144,937	166,199	167,093	45,024	46,347	46,815	49,890	188,076	50,269	55,109	59,835	61,173	226,386	64,607	64,312	65,046	66,387	260,352
Amortization of intangibles	1,185	1,075	1,093	1,036	64	13	56	46	179	38	66	66	66	236	66	66	66	66	264
Optimization program (3)		3,869																	
Non-recurring expense (2,6,8,9,11,13)	4,764		2,806	1,034		1,335	720	341	2,396	574	69								
<b>Operating Income</b>	<b>33,808</b>	<b>30,685</b>	<b>6,672</b>	<b>30,665</b>	<b>9,913</b>	<b>10,152</b>	<b>11,443</b>	<b>10,852</b>	<b>42,360</b>	<b>10,529</b>	<b>10,912</b>	<b>12,061</b>	<b>12,594</b>	<b>46,096</b>	<b>13,083</b>	<b>12,867</b>	<b>13,720</b>	<b>14,030</b>	<b>53,700</b>
Interest expense	5,157	5,700	6,412	6,939	1,746	1,643	1,934	1,910	7,233	1,847	2,072	1,978	2,010	7,907	1,934	1,821	1,902	1,846	7,503
Other (4)	(778)	(1,077)	(513)	(405)	44	(158)	225	(392)	(281)	(238)	(183)	(183)	(183)	(787)	-	-	-	-	-
Change in fair value of investments (10)					3,787	(1,358)	(234)	2,136	4,331	1,706	(226)								
EBT	29,429	26,062	773	24,132	8,123	8,667	9,284	9,334	35,408	8,920	9,023	10,267	10,767	38,976	11,149	11,046	11,818	12,184	46,197
Income tax expense (5)	11,990	10,868	(1,526)	9,332	3,249	3,467	3,714	3,734	14,163	3,568	3,609	4,107	4,307	15,590	4,460	4,419	4,727	4,873	18,479
Net income	17,439	15,194	2,299	14,800	4,874	5,200	5,570	5,600	21,245	5,352	5,414	6,160	6,460	23,386	6,689	6,628	7,091	7,310	27,718
Extraordinary item (1)																			
<b>E.P.S.</b>	<b>\$0.99</b>	<b>\$0.82</b>	<b>\$0.13</b>	<b>\$0.79</b>	<b>\$0.26</b>	<b>\$0.27</b>	<b>\$0.29</b>	<b>\$0.29</b>	<b>\$1.10</b>	<b>\$0.28</b>	<b>\$0.28</b>	<b>\$0.31</b>	<b>\$0.33</b>	<b>\$1.20</b>	<b>\$0.34</b>	<b>\$0.34</b>	<b>\$0.36</b>	<b>\$0.37</b>	<b>\$1.40</b>
Weighted average s/o	17,467	18,196	18,264	18,818	19,074	19,371	19,493	19,423	19,340	19,434	19,526	19,585	19,643	19,547	19,683	19,722	19,761	19,801	19,742
<b>% Growth</b>																			
Whole Foods - Excl. Blooming Prairie		22.7%	1.6%	16.1%	25.4%	30.4%	36.5%	39.7%	33.2%	37.2%	33.4%	28.0%	25.0%	30.5%	23.0%	23.0%	20.0%	20.0%	21.4%
Whole Foods - Total		22.7%	1.6%	16.1%	25.4%	30.4%	36.5%	39.7%	33.2%	42.9%	53.1%	46.5%	42.5%	46.2%	36.9%	23.0%	20.0%	20.0%	24.4%
Wild Oats		43.7%	25.3%	24.8%	11.7%	16.0%	6.0%	8.7%	10.5%	52.7%	83.0%	30.1%	90.3%	-79.1%	78.9%	42.9%	0.0%	0.0%	-52.9%
Other customers - Excl. Blooming Prairie		13.3%	4.1%	8.6%	13.0%	13.5%	13.5%	10.0%	12.4%	13.0%	11.0%	11.0%	11.0%	11.5%	10.0%	8.0%	8.0%	8.0%	8.4%
Other customers - Total		13.3%	4.1%	8.6%	13.0%	13.5%	13.5%	10.0%	12.4%	16.0%	30.6%	36.7%	36.0%	30.0%	32.5%	16.1%	8.0%	8.0%	15.2%
<b>Total Sales</b>	<b>14.8%</b>	<b>17.6%</b>	<b>6.0%</b>	<b>11.9%</b>	<b>14.8%</b>	<b>16.8%</b>	<b>16.2%</b>	<b>14.7%</b>	<b>15.6%</b>	<b>10.9%</b>	<b>18.6%</b>	<b>21.5%</b>	<b>20.5%</b>	<b>18.0%</b>	<b>26.7%</b>	<b>16.6%</b>	<b>10.7%</b>	<b>10.8%</b>	<b>15.7%</b>
Pro forma sales (7,12,15,16)	11.4%	7.6%	12.1%	14.8%	15.3%	14.8%	13.0%	14.4%	16.5%	17.4%	14.8%	14.2%	16.7%	13.2%	11.8%	10.9%	10.9%	10.9%	11.6%
Pro forma - retroactive for OATS (7,12,15,17)	8.2%	5.4%	10.3%	15.4%	15.2%	16.3%	13.7%	16.5%	16.5%	17.4%	14.8%	14.2%	15.7%	13.2%	11.8%	10.9%	10.9%	11.6%	
Gross profit	18.1%	17.5%	-1.5%	14.3%	14.5%	18.3%	17.4%	14.1%	16.0%	10.6%	16.9%	23.4%	21.5%	18.3%	27.8%	16.9%	9.5%	9.0%	15.3%
Income from operations	51.4%	-9.2%	-78.3%	359.6%	41.5%	58.9%	39.0%	20.1%	38.1%	6.2%	7.5%	5.4%	16.0%	8.8%	24.3%	17.9%	13.8%	11.4%	16.5%
Net income	67.7%	-12.9%	-84.9%	543.7%	49.3%	89.4%	36.4%	19.1%	43.5%	9.8%	4.1%	10.6%	15.3%	10.1%	25.0%	22.4%	15.1%	13.2%	18.5%
<b>EPS</b>	<b>56.8%</b>	<b>-16.8%</b>	<b>-84.6%</b>	<b>523.9%</b>	<b>45.8%</b>	<b>83.6%</b>	<b>31.8%</b>	<b>16.6%</b>	<b>39.8%</b>	<b>7.8%</b>	<b>3.3%</b>	<b>10.1%</b>	<b>14.1%</b>	<b>8.9%</b>	<b>23.4%</b>	<b>21.2%</b>	<b>14.1%</b>	<b>12.3%</b>	<b>17.4%</b>
<b>% of Sales</b>																			
Whole Foods	16.0%	16.7%	16.0%	16.6%	17.7%	19.2%	19.5%	20.0%	19.1%	22.8%	24.8%	23.5%	23.6%	23.7%	24.6%	26.2%	25.5%	25.6%	25.5%
Wild Oats	9.0%	11.0%	13.0%	14.5%	14.3%	14.4%	13.5%	13.3%	13.9%	6.1%	2.1%	1.1%	1.1%	2.4%	1.0%	1.0%	1.0%	1.0%	1.0%
Other customers	75.0%	72.3%	71.0%	68.9%	68.0%	66.4%	67.0%	66.7%	67.0%	71.1%	73.1%	75.4%	75.3%	73.8%	74.3%	72.8%	73.5%	73.4%	73.5%
<b>Total Sales</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
Gross margin	20.6%	20.6%	19.1%	19.6%	19.6%	19.8%	19.4%	19.7%	19.6%	19.6%	19.5%	19.7%	19.8%	19.7%	19.7%	19.6%	19.5%	19.5%	19.6%
Operating expenses	15.8%	16.9%	18.3%	16.4%	16.1%	16.2%	15.6%	16.1%	16.0%	16.2%	16.3%	16.4%	16.4%	16.3%	16.4%	16.3%	16.1%	16.1%	16.2%
Pro forma operating margin	4.6%	3.6%	0.7%	3.0%	3.5%	3.6%	3.8%	3.5%	3.6%	3.4%	3.2%	3.3%	3.4%	3.3%	3.3%	3.3%	3.4%	3.4%	3.3%
Net margin	2.4%	1.8%	0.3%	1.5%	1.7%	1.8%	1.9%	1.8%	1.8%	1.7%	1.6%	1.7%	1.7%	1.7%	1.7%	1.7%	1.8%	1.8%	1.7%
Tax rate	40.7%	41.7%	NM	38.7%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%

**Notes:**

- (1) Loss on early extinguishment of debt, net of income tax benefit of \$662.
- (2) Non-recurring expense in FY-98 includes \$4.1 million in merger costs associated with the acquisition of Stow Mills and \$0.7 million in relocation and startup costs for the new Denver facility.
- (3) Optimization program includes associated costs: closing of facility, severance, retention, and inventory transfer.
- (4) Other income in 1999 excludes gain of \$1.4 million from sale of four retail stores.
- (5) Income tax expense in Q3-99 is adjusted by \$0.3 million from settlement of IRS audit.
- (6) Non-recurring expense in FY-00 includes \$2.4 million restructuring and asset impairment charges in Q2-00 and \$0.4 million in non-recurring charges associated with the closure of the Chicago facility.
- (7) 1999 - 2000 excludes the effect of Albert's acquisition, divestiture of retail stores, and closure of Chicago facility.
- (8) Q2-01 non-recurring expense relates to moving costs associated with the expansion of the New Oxford facility.
- (9) Q3-01 non-recurring costs relate to expansion of New Oxford facility, accounting charge for derivatives and asset impairment charge for underperforming retail store.
- (10) Non-cash charge to account for change in the value of UNFI's swap contract.
- (11) Q2-02 items include restructuring and asset impairment charges.
- (12) Q2-02 - Q1-03 excludes revenue from Boulder Fruit Express acquisition and opening of a retail store.
- (13) Q3-02 excludes non-recurring charge related to startup of Fontana, CA facility.
- (14) Q4-02 excludes non-recurring charge related to relocation of Hershey facility in New Jersey.
- (15) Excludes acquired revenue from Blooming Prairie acquisition.
- (16) Excludes loss of Wild Oats.
- (17) Nets out all past revenue from Wild Oats.

Source: Company reports and RBC CM estimates