



## Wild Oats Markets

(NASDAQ: OATS)

### Sector Perform

Above Average Risk

Company Update  
Price Target  
Downgrade  
EPS Downgrade

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Price: 7.90      Price Target: 9.00 ↓ 11.00  
 52-Wk High: 16.43      52-Wk Low: 6.98  
 Float (MM): 25.4      Debt to Cap: 41.0%  
 Shares Out (MM): 27.7      Market Cap (MM): 219  
 Dividend: 0.00      Yield: 0.0%  
 Tr. 12 ROE: 5.00%      Est 3-Yr EPS Gr: 17.50%  
 Trading Vol. (MM):  
 309.000  
 Institutional Own.: 91%

(FY Dec)	2001A	2002A	2003E	2004E
Diluted EPS	(0.39)	0.25	0.38	0.60
Prev.			0.47	
P/E	NM	31.60x	20.79x	13.17x

Diluted EPS	Q1	Q2	Q3	Q4
2001	0.00A	(0.14)A	(0.10)A	(0.14)A
2002	0.01A	0.06A	0.08A	0.10A
2003	0.08E	0.08E	0.10E	0.12E
Prev.	0.11E	0.13E	0.12E	0.11E
2004	0.12E	0.14E	0.16E	0.17E
Prev.	0.13E	0.15E		0.16E

All values in USD unless otherwise noted.

## Turnaround Taking Longer Than Expected - Lowering Ests/Target

### Event

Lowering estimates and target following Q4 sales shortfall.

### Investment Conclusion

- Turnaround taking longer than expected - lowering estimates for 2003 and 2004.
- Q4 results underscore the limited growth potential of Wild Oats' store base.
- Sustainability of Wild Oats' turnaround rests on the success of its new store format and planned store remodels.
- Lowering price target to \$9 (prev. \$11) based on recent trends and reduced estimates. Maintaining Sector Perform rating.

### Valuation

We are lowering our price target to \$9 from \$11 based on Wild Oats' disappointing sales trends and our reduced earnings estimates. At our price target, OATS would trade at 15x our 2004 estimate of \$0.60, reflecting a 40% discount to industry leader Whole Foods Market (WFMI \$51.11). We believe this discount is appropriate, given Whole Foods' superior performance and Wild Oats' uncertain outlook.

### Impediment

Competitive pressures from Whole Foods Market, among other factors, could impact Wild Oats' performance and create a departure from our outlook and price target objective.

### Q4 Earnings Recap

Wild Oats reported Q4 EPS of \$0.10, excluding a one-time tax charge. Q4 earnings (excluding the one-time charge) were in line with estimates and met the low end of management's guidance of \$0.10-\$0.11. Same-store sales increased 2.9% in Q4, falling short of management's downwardly revised guidance of 3.5%-5.5% and our estimate of 4.5%. Comps were pressured by a 1.9% decline in store traffic (basket size increased 5.0%), due at least in part

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to high out-of-stocks resulting from the company's SKU rationalization and distributor switch. Operating margin improved 30 basis points sequentially and were in line with our estimate of 2.7%. The improvement was driven by 130 basis points of sequential gross margin improvement, partially offset by higher SG&A. .

#### **Uncertain Outlook**

While we are encouraged by Wild Oats' profitability improvement in 4Q02, Wild Oats' Q4 comps reflect a number of challenges, including: the impact of tougher comparisons; a lack of new stores to drive comps; failure attract customers in a healthy industry environment; and increasing head-to-head competition from Whole Foods Market. Overall, we believe Wild Oats' Q4 results underscore the limited growth potential of Wild Oats' store base.

Given these challenges, we believe the sustainability of Wild Oats' turnaround rests on the success of its new store format and planned store remodels. Wild Oats will begin rolling out its new prototype store format for both the Wild Oats and Henry's stores in 2003. The company plans to expand these units aggressively over the next few years, including 10 new stores in 2003, 15-20 new stores in 2004, and 20-25 new stores in 2005. Of these planned store openings, roughly half will be in the Henry's Farmers Market format. Initial response to Wild Oats' new prototype has reportedly been favorable. During yesterday's conference call, management stated that sales/square foot for these stores are trending \$100 higher than the company average of \$425. As we have stated in past research, we believe Wild Oats' prototype format is a noticeable upgrade from its average store. We remain somewhat cautious, however, as these stores have limited history and have not yet been tested by competition. In addition, the new stores will not provide a meaningful benefit to comps until 2005.

In addition to opening new stores, the company plans to remodel as many as half of its existing stores to conform to its new prototype. Our view toward the store remodels is somewhat mixed. While store remodels can help revive comps and improve the consistency of Wild Oats' store base (both of which are sorely needed), they can also further disrupt service levels and could prove ineffective for stores in unfavorable locations.

#### **Lowering Estimates**

To account for recent trends and management's guidance, we are lowering estimates for 2003 and 2004. Our revisions are as follows:

**2003:** During yesterday's conference call, management stated expectations for comps of 4% and EPS of \$0.36-\$0.40 in 2003. We are lowering our 2003 same-store sales growth and EPS estimates to 3.4% and \$0.38, respectively, from 4.5% and \$0.47, respectively. Due to the effect of store remodels, a new multi-media marketing program, and tough comparisons in the first half of the year, sales and earnings growth for 2003 should be back-end loaded. For example, we expect comps and EPS to trend upward from 2.0% and \$0.08, respectively, in 1Q03 to 5.0% and \$0.12, respectively, in 4Q03.

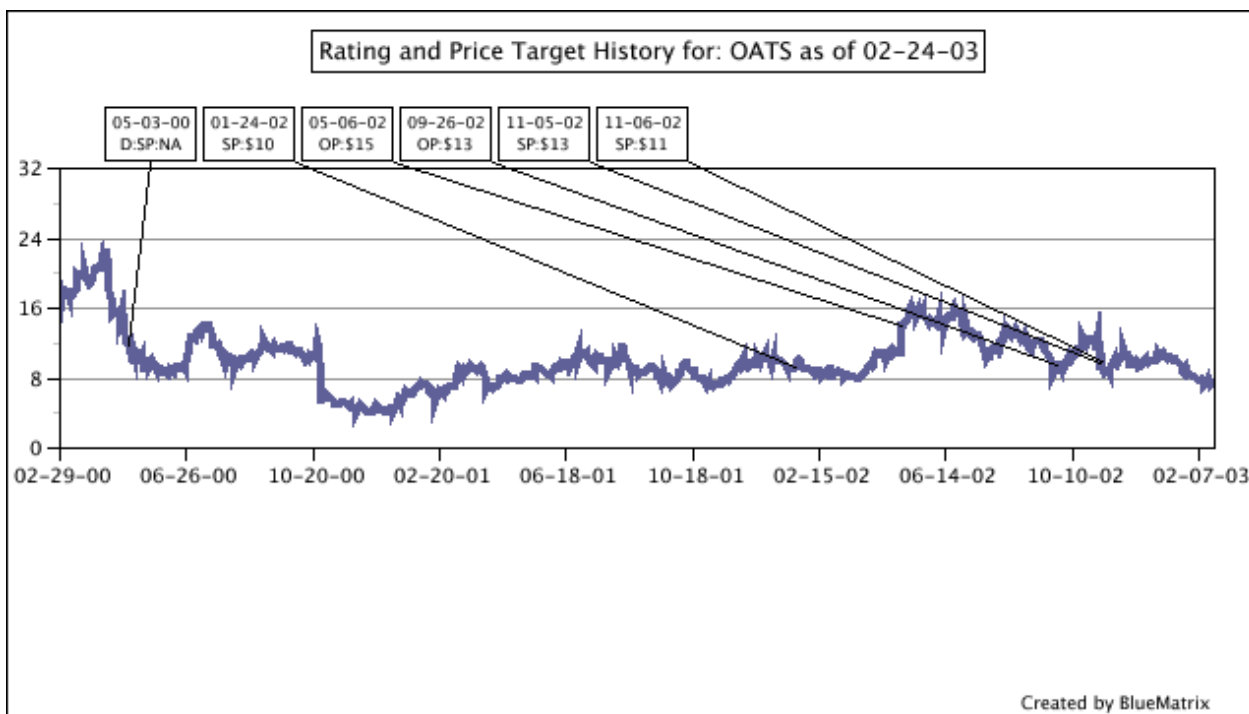
**2004:** We have lowered our 2004 same-store sales and EPS estimates to 5.0% and \$0.60, respectively, from 5.5% and \$0.65, respectively. Our revised earnings estimate falls at the low end of management's guidance of \$0.60-\$0.65 in 2004.

#### **Company Description**

Wild Oats Markets, Inc. is the No. 2 retailer of natural foods.

#### **Disclosures**

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Rating	RBC Capital Markets		IB Serv./Past 12 Mos.	
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**Wild Oats Markets, Inc.**  
**Income Statement**  
(In thousands, except per share data)

	1996	1997	1998	1999	2000	Mar-01	Jun-01	Sep-01	Dec-01	2001	Mar-02	Jun-02	Sep-02	Dec-02	2002	Mar-03E	Jun-03E	Sep-03E	Dec-03E	2003E	2004E	
Sales	\$253,606	\$431,974	\$530,726	\$721,091	\$838,131	\$219,499	\$229,383	\$222,168	\$222,129	\$893,179	\$233,013	\$236,186	\$228,102	\$221,828	\$919,129	\$234,773	\$245,091	\$245,326	\$250,419	\$975,609	\$1,180,390	
Cost of goods sold	175,698	301,644	369,475	499,627	581,979	153,090	163,005	158,625	159,909	634,629	165,370	164,758	161,026	153,707	644,861	163,637	171,073	170,502	173,541	678,753	817,397	
<b>Gross profit</b>	<b>77,908</b>	<b>130,330</b>	<b>161,251</b>	<b>221,464</b>	<b>256,152</b>	<b>66,409</b>	<b>66,378</b>	<b>63,543</b>	<b>62,220</b>	<b>258,550</b>	<b>67,643</b>	<b>71,428</b>	<b>67,076</b>	<b>68,121</b>	<b>274,268</b>	<b>71,136</b>	<b>74,017</b>	<b>74,824</b>	<b>76,879</b>	<b>296,857</b>	<b>362,993</b>	
Direct store expenses	58,928	96,448	113,094	155,869	190,987	51,616	54,996	52,128	52,935	211,675	50,412	51,510	48,639	47,825	198,386	51,181	53,430	52,990	53,590	211,191	252,558	
<b>Store contribution</b>	<b>18,980</b>	<b>33,882</b>	<b>48,157</b>	<b>65,595</b>	<b>65,165</b>	<b>14,793</b>	<b>11,382</b>	<b>11,415</b>	<b>9,285</b>	<b>46,875</b>	<b>17,231</b>	<b>19,918</b>	<b>18,437</b>	<b>20,296</b>	<b>75,882</b>	<b>19,956</b>	<b>20,588</b>	<b>21,834</b>	<b>23,289</b>	<b>85,666</b>	<b>110,435</b>	
SG&A	10,558	16,314	20,026	27,939	29,391	9,518	12,654	12,471	11,425	46,068	14,174	14,761	12,708	13,557	55,200	14,791	15,931	15,456	15,276	61,453	71,098	
Pre-opening expenses	1,863	1,149	3,449	2,767	3,289	1,430	85	1	47	1,563	368	645	237	647	1,897	600	300	600	1,500	3,000	6,000	
Amortization of goodwill					3,088	765	722	741	738	2,966												
Non-recurring expenses (1,2,3,4,5,6,7)	7,035		393	12,642	44,126		54,834	776	(704)	54,906	(652)		(174)	(6)	(832)							
<b>Income from operations</b>	<b>6,559</b>	<b>16,419</b>	<b>24,682</b>	<b>34,889</b>	<b>29,397</b>	<b>3,080</b>	<b>(2,079)</b>	<b>(1,798)</b>	<b>(2,925)</b>	<b>(3,722)</b>	<b>2,689</b>	<b>4,512</b>	<b>5,492</b>	<b>6,092</b>	<b>18,785</b>	<b>4,565</b>	<b>4,357</b>	<b>5,778</b>	<b>6,513</b>	<b>21,214</b>	<b>33,337</b>	
Interest expense/(income)	1,232	622	28	4,280	8,851	2,466	2,762	2,044	2,173	9,445	2,255	2,154	2,134	1,432	7,975	556	557	578	654	2,345	3,579	
<b>EBT</b>	<b>5,327</b>	<b>15,797</b>	<b>24,654</b>	<b>30,609</b>	<b>20,546</b>	<b>614</b>	<b>(4,841)</b>	<b>(3,842)</b>	<b>(5,098)</b>	<b>(13,167)</b>	<b>434</b>	<b>2,358</b>	<b>3,358</b>	<b>4,660</b>	<b>10,810</b>	<b>4,009</b>	<b>3,800</b>	<b>5,201</b>	<b>5,859</b>	<b>18,869</b>	<b>29,758</b>	
Income tax expense (8)	2,227	5,501	10,136	12,810	8,650	(68)	(1,404)	(1,268)	(1,619)	(4,359)	167	860	1,225	1,733	3,985	1,563	1,482	2,028	2,285	7,359	11,457	
<b>Net income</b>	<b>3,100</b>	<b>10,296</b>	<b>14,518</b>	<b>17,799</b>	<b>11,896</b>	<b>(118)</b>	<b>(3,437)</b>	<b>(2,574)</b>	<b>(3,479)</b>	<b>(9,608)</b>	<b>267</b>	<b>1,498</b>	<b>2,133</b>	<b>2,927</b>	<b>6,825</b>	<b>2,445</b>	<b>2,318</b>	<b>3,172</b>	<b>3,574</b>	<b>11,510</b>	<b>18,301</b>	
<b>Earnings per share</b>	<b>\$0.32</b>	<b>\$0.53</b>	<b>\$0.63</b>	<b>\$0.76</b>	<b>\$0.51</b>	<b>(\$0.00)</b>	<b>(\$0.14)</b>	<b>(\$0.10)</b>	<b>(\$0.14)</b>	<b>(\$0.39)</b>	<b>\$0.01</b>	<b>\$0.06</b>	<b>\$0.08</b>	<b>\$0.10</b>	<b>\$0.25</b>	<b>\$0.08</b>	<b>\$0.08</b>	<b>\$0.10</b>	<b>\$0.12</b>	<b>\$0.38</b>	<b>\$0.60</b>	
Weighted average s/o	9,717	19,425	23,079	23,467	23,642	23,587	24,641	24,669	24,720	24,404	25,101	25,945	27,185	30,124	27,083	30,124	30,244	30,365	30,487	30,305	30,670	
<b>Operating Information</b>																						
Existing stores	27	49	62	73	110	106	109	109	109	106	107	103	101	100	107	99	101	102	104	99	109	
(+) New stores	9	5	8	9	11	4	-	-	-	4	1	-	-	-	1	2	1	2	5	10	20	
(+) Acquired stores	13	9	7	35	2																	
(+) Relocations				7	3																	
(-) Closed or sold stores		1	4		20	1	-	-	2	3	5	2	1	1	9							
Remodeled stores					14					15						6	6	7	6	25	8	
Total stores	49	62	73	110	106	109	109	109	107	107	103	101	100	99	99	101	102	104	109	109	129	
<b>Comp. Store growth</b>	<b>6.0%</b>	<b>5.0%</b>	<b>4.0%</b>	<b>6.0%</b>	<b>-2.6%</b>	<b>1.0%</b>	<b>3.9%</b>	<b>5.5%</b>	<b>5.7%</b>	<b>4.0%</b>	<b>7.3%</b>	<b>5.2%</b>	<b>5.6%</b>	<b>2.9%</b>	<b>5.3%</b>	<b>2.0%</b>	<b>2.5%</b>	<b>4.0%</b>	<b>5.0%</b>	<b>3.4%</b>	<b>5.0%</b>	
<b>Growth Rate</b>																						
Sales		70.3%	22.9%	35.9%	16.2%	3.9%	7.8%	7.2%	7.4%	6.6%	6.2%	3.0%	2.7%	-0.1%	2.9%	0.8%	3.8%	7.6%	12.9%	6.1%	21.0%	
Gross profit		67.3%	23.7%	37.3%	15.7%	-0.2%	0.1%	2.1%	1.9%	0.9%	1.9%	7.6%	5.6%	9.5%	6.1%	5.2%	3.6%	11.6%	12.9%	8.2%	22.3%	
Store contribution		78.5%	42.1%	36.2%	-0.7%	-26.0%	-39.1%	-17.5%	-26.6%	-28.1%	16.5%	75.0%	61.5%	118.6%	61.9%	15.8%	3.4%	18.4%	14.7%	12.9%	28.9%	
Income from operations		150.3%	50.3%	41.4%	-15.7%	-71.4%	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	-3.4%	5.2%	6.9%	12.9%	57.1%	
Net income		232.1%	41.0%	22.6%	-33.2%	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	48.7%	22.1%	68.6%	59.0%	
EPS		NM	18.7%	20.6%	-33.0%	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	33.1%	20.7%	50.6%	57.1%	
# of stores			17.7%	50.7%	-3.6%	-4.4%	-5.2%	-4.4%	0.9%	0.9%	-5.5%	-7.3%	-8.3%	-7.5%	-7.5%	-1.9%	1.0%	4.0%	10.1%	10.1%	18.3%	
<b>Margin Analysis</b>																						
COGS	69.3%	69.8%	69.6%	69.3%	69.4%	69.7%	71.1%	71.4%	72.0%	71.1%	71.0%	69.8%	70.6%	69.3%	70.2%	69.7%	69.8%	69.5%	69.3%	69.6%	69.2%	
<b>Gross margin</b>	<b>30.7%</b>	<b>30.2%</b>	<b>30.4%</b>	<b>30.7%</b>	<b>30.6%</b>	<b>30.3%</b>	<b>28.9%</b>	<b>28.6%</b>	<b>28.0%</b>	<b>28.9%</b>	<b>29.0%</b>	<b>30.2%</b>	<b>29.4%</b>	<b>30.7%</b>	<b>29.8%</b>	<b>30.3%</b>	<b>30.2%</b>	<b>30.5%</b>	<b>30.7%</b>	<b>30.4%</b>	<b>30.8%</b>	
Direct store expense	23.2%	22.3%	21.3%	21.6%	22.8%	23.5%	24.0%	23.5%	23.8%	23.7%	21.6%	21.8%	21.3%	21.6%	21.6%	21.8%	21.8%	21.6%	21.4%	21.6%	21.4%	
<b>Contribution margin</b>	<b>7.5%</b>	<b>7.8%</b>	<b>9.1%</b>	<b>9.1%</b>	<b>7.8%</b>	<b>6.7%</b>	<b>5.0%</b>	<b>5.1%</b>	<b>4.2%</b>	<b>5.2%</b>	<b>7.4%</b>	<b>8.4%</b>	<b>8.1%</b>	<b>9.1%</b>	<b>8.3%</b>	<b>8.5%</b>	<b>8.4%</b>	<b>8.9%</b>	<b>9.3%</b>	<b>8.8%</b>	<b>9.4%</b>	
SG&A	4.2%	3.8%	3.8%	3.9%	3.5%	4.3%	5.5%	5.6%	5.1%	5.2%	6.1%	6.2%	5.6%	6.1%	6.0%	6.3%	6.5%	6.3%	6.1%	6.3%	6.0%	
Amortization of goodwill				0.0%	0.4%	0.3%	0.3%	0.3%	0.3%	0.3%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Pre-opening expense	0.7%	0.3%	0.6%	0.4%	0.4%	0.7%	0.0%	0.0%	0.0%	0.2%	0.2%	0.3%	0.1%	0.3%	0.2%	0.3%	0.1%	0.2%	0.6%	0.3%	0.5%	
<b>Operating margin</b>	<b>2.6%</b>	<b>3.8%</b>	<b>4.7%</b>	<b>4.8%</b>	<b>3.5%</b>	<b>1.4%</b>	<b>-0.9%</b>	<b>-0.8%</b>	<b>-1.3%</b>	<b>-0.4%</b>	<b>1.2%</b>	<b>1.9%</b>	<b>2.4%</b>	<b>2.7%</b>	<b>2.0%</b>	<b>1.9%</b>	<b>1.8%</b>	<b>2.4%</b>	<b>2.6%</b>	<b>2.2%</b>	<b>2.8%</b>	
Tax rate	41.8%	34.8%	41.1%	41.9%	42.1%	-11.1%	29.0%	33.0%	31.8%	33.1%	38.5%	36.5%	36.5%	37.2%	36.9%	39.0%	39.0%	39.0%	39.0%	39.0%	38.5%	
Net margin	1.2%	2.4%	2.7%	2.5%	1.4%	4.8%	5.0%	3.9%	4.1%	-1.1%	0.1%	0.6%	0.9%	1.3%	0.7%	1.0%	0.9%	1.3%	1.4%	1.2%	1.6%	

**Notes:**

- (1) Non-recurring charges in FY-96 relate to merger expenses associated with the Alfa's transaction
- (2) Non-recurring charges in 1998 of \$393 are merger related charges associated with two pooling-of-interest transactions in 1998
- (3) Q1-99 non-recurring charge of \$10,894 million relates to closure of two Farm to Market stores (\$4,500) and refocusing resources on continuing operations (\$6,400 million)
- (4) Q3-99 and Q4-99 non-recurring charges of \$645 and \$1,103, respectively, are merger expenses associated with the Henry's and Sun Harvest pooling of interests
- (5) Q2-00 non-recurring charge of \$22,701 relates to restructuring initiatives:
  - a) closure of three stores (\$4,700)
  - b) planned sale or closure of seven stores during the remainder of 2000 (\$9,900)
  - c) exit costs of previously closed or abandoned sites (\$5,600)
  - d) discontinuation of e-commerce activities (\$2,500)
- (6) Q4-00 non-recurring charge of \$21,425 relates to restructuring initiatives - write-down of fixed and intangible assets
- (7) Q2-01 non-recurring charge of \$54,834 relates to restructuring initiatives - impairment of fixed (\$25.8 mil.) and intangible (\$0.3 mil.) assets; severance (\$2.5 mil.); asset impairment for five operating stores (\$15.9 mil.).
- (8) Q4-02 excludes \$362,000 of non-recurring tax expense.

Source: Company reports and RBC CM estimates