Whole Foods Market Inc (05/01/2015)

5% of the fund's capital is invested in Whole Foods Market Inc (Whole Foods).

We bought this position in May 2014 following the company issuing its fourth downgrade since November 2013. The fund paid US$38.62 for the investment compared to its October 2013 high in excess of US$65. It is currently trading at US$50.

We believe Whole Foods holds a position of genuine integrity and trust with its customers and the broader community regarding food transparency and food sourcing. While we believe Whole Foods has this element of trust, we perceive there to be generally wide held mistrust and uncertainty in the US around issues such as the longer term health and wellbeing impact of GMO products, certain herbicides and pesticides, and what actually goes on behind the scenes in corporate America concerning food preparation. We think this trust is valuable, enduring and very difficult to replicate.

Whole Foods was founded in Texas in 1978 by John Mackey. At 25 he opened a single store with his 21 year old girlfriend called "Safer Way". John and his girlfriend were backed by friends and family with US$45,000 in seed capital. They lived above the store. Today Whole Foods is the leading US based natural and certified organic food retailer. It operates 400 stores, 380 of which are based in the US. We expect that in 2014 the business will generate revenue of around US$14,500 million and EBIT of US$950 million; it has no on balance sheet debt and a current market capitalisation of around US$17,000 million. The company's mission is to promote the vitality and well being of all individuals by supplying the highest quality, most wholesome foods available. John Mackey continues to work in an executive capacity in the business.

We have followed this business and its shopping experience for many years. Until 2012, we would have described Whole Foods as a super premium natural, organic niche food offering with price points so high they make your eyes water. We regarded it as too niche, too high end and too expensive. We perceived it as vulnerable and ultimately an unsustainable (economic) proposition due to these traits.

In 2012 we covered some ground in the US looking at the quick service restaurant segment, including Wendy's, McDonalds, Burger King, Chipotle and Five Guys. Much of this involved a rental car and a GPS and we visited as many restaurants as we could to get a sense for the different offerings, the quality of the store bases and, where relevant, the impact of the various remodelling initiatives. Invariably we would visit the Whole Foods stores that were located in the areas we happened to be. Our overriding impression from these visits was this is a business on which we needed to do more detailed analysis. The shopping experience was great, which was what we expected. The key shift we observed was the business seemed to have extended its range and had far more products that were priced at levels equivalent to similar products in typical supermarkets.

This observation shifted our thinking from Whole Foods being a super premium niche retailer to possibly something that could translate more broadly into the mass market. It was clear from walking through the stores that there had been a meaningful shift in price points. We were impressed by the extent of this change. It is unusual to find businesses that are so adaptive and given the fickle, competitive and dynamic nature of retail, this seems a necessary trait for longer term success.

On subsequent analysis the key points that stood out to us were:

- Its footprint is surprisingly small. Today it has 400 stores compared to mature national US based supermarkets which regularly have in excess of 2,000 stores;
- Whole Foods financial settings and accounting classifications struck us as conservative. We think this is appropriate given the nature of the business. It also reflected well on the internal culture. It is unusual for us to think this. Most of what we look at smacks of management pushing as hard as they can to maximise next quarters "normalised" earnings.
- The financial disclosure is very good;
- Management seem to make genuine long term decisions regarding the business. They look at the business far more holistically than as an entity whose sole purpose is to maximise returns for its owners. Their philosophy seems to be if we treat all stakeholders fairly, including employees, suppliers, customers and shareholders, Whole Foods will be ultimately more successful as we will increase the size of the economic pie for all stakeholders. Another way of thinking about their culture is, if you have genuinely loyal customers, loyal suppliers and loyal employees, these intangible factors mean shareholders will own a pretty special business that is more robust and resilient than generally appreciated;
- There are a number of interesting and unique structures within the business around how staff are organised, how decisions are made on aspects such as employee benefits and how individuals are compensated;
- The company is not rolling out "boxes" for their store expansion program. Stores are tailored with regard to size, design and product selection depending on the particular community where they are located;
- Roughly 25% of each store's product is sourced "locally"; and
- The business has a history of extraordinary financial success. The historic consistent cash generation of the business, and the returns it is earning on its existing asset base and incremental investments are compelling.

Our greatest concern regarding the merits of the Whole Foods investment is the idea that food transparency, food integrity and leadership positions in natural and organics are obvious and highly desirable market positions to hold. Consequently, capital from all fronts is chasing these positions, whether through smaller listed entities that have been funded specifically with a mandate to roll out boxes selling natural and organic groceries, incumbent traditional supermarkets expanding their organic offerings or regional operators that have a footprint and customer loyalty to build from. When an opportunity is so obvious and capital is being aggressively deployed to realise it, returns are only going to decrease.

After spending considerable time working through the historic results, conference calls and evolution of the business it was also very clear the market's expectations for Whole Foods' gross margins and same store sales were materially too high.

Weighing up the situation, we perceived there was a very valuable business in Whole Foods, if we were right regarding the durability of its trusted position relating to food transparency and sourcing. If this observation is correct, there is the opportunity to continue to reinvest free cashflow into new and existing stores earning highly attractive rates of return. Our view was if we could obtain an appropriate entry price then this was a business we wanted to own.

The way we approached the valuation was to determine what the existing store base was worth (i.e. paying zero for the future store rollout opportunity). If we could achieve this entry price, we were prepared to invest.

We framed the valuation of the existing store base as follows:

Simplified investment summary	2013	2014
EBITDA	US$1,220m	US$1,310m
Less capex (pre new store spend)	US$200m	US$260m
Coupon (pre interest and tax)	US$1,020m	US$1,050m
Core business enterprise value (using 8% cap rate)	US$12,800m	US$13,100m
Less net debt (plus net cash)	US$1,080m	US$740m
Implied equity valuation	US$13,880m	US$13,840m
Existing store base value per share	US$38	US$38

We then sat patiently waiting for an appropriate entry point.

In May 2014, the company issued a downgrade which made evident the market's expectations for gross margins and same store sales were too high. This didn't really surprise us as these issues were evident in the prior results and disclosures from the company. However, we were a bit stunned to see the share price fall 20% upon opening the next morning - to the level that we framed as fair value for the existing business. We invested 4% of the fund's capital into Whole Foods that day.

In November 2014, while we were in the US we went through numerous Whole Foods stores and more stores of their various competitors including The Fresh Market, Sprouts, Trader Joes, incumbent traditional supermarkets and various regional (unlisted) stores. This process was constructive however we are reticent to detail our views of the various operators. Our conclusions were the Whole Foods franchise and position is based on significantly more than just a first mover or scale advantage.

We expect Whole Foods will be a long term investment for the fund. It will likely take several years to prove out our investment thesis. Recent share price appreciation has been the result of just one okay quarterly number and doesn't really get us any closer or give us any direction or confidence on whether our long term rationale for the investment will ultimately prove correct. While we have undertaken considerable analysis to understand Whole Foods' financial and general fundamentals, our attraction to the business is quite subjective (albeit supported by the financial progression). This doesn't worry us too much when we are investing in an established retailer. We tend to think that the returns thriving retailers can earn on their incremental capital investment are very attractive and probably sustainable for longer than markets tend to value. Conversely, we can't imagine ever being attracted to a retailer on the basis the valuation looks cheap. We think the dynamic nature of retailing means economic value can shift between retailers rapidly, persistently and quite often unrelentingly.

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