

## **EPIC ADVISORS, LLC**

Weekly Market Commentary

May 27, 2008

Sean Hannon, CFA, CFP

---

I am always interested in what can be learned from reading financial statements. At their core, certain information must be discussed. A company will provide their financial results, accounting assumptions and various details about how their core business is operating. Outside of those numbers, management is given great latitude. Management is given the ability to present information in a fashion that tells their story and persuades current and prospective owners to buy the stock. A clear example of how information can be framed is when the strengths of the business are discussed and the order in which each of the three key financial statements is presented (Balance Sheet, Income Statement and Statement of Cash flows). Generally, the management discussion will focus upon what makes a company better than its peers and the first financial statement provided will attempt to direct an investor's attention away from areas in which management would rather not discuss.

When interpreting information, many people use mental short cuts. Doing so allows us to process vast amounts of data quickly and arrive at informed decisions in short periods of time. Knowing this, people who present information often frame it in a way to influence the recipient. By influencing a person's perception of information, the conclusion reached will support the message being delivered.

For years I have believed that companies use their financial reports to frame a story they would like to present to the investing public. To most people a company's annual financial statements are bland documents filled with facts and figures. Since a company presents hard data, there must not be any latitude in what we see. After all, facts are facts, right? The question is straightforward yet the answer is a more nuanced yes and no.

As an example of how different companies frame their financial results, examine the annual reports from Amazon.com (Ticker: AMZN) and Whole Foods Markets (Ticker: WFMI). AMZN offers us an in-depth look at their operating business, many non-GAAP metrics they use to manage and evaluate their business performance and a thoughtful discussion of the risks they face. Turning to the financial statements, AMZN starts with the Statement of Cash flows. Since the entire report has discussed how cash flow is a better measurement than earnings, the financial statements are consistent with the message that has been delivered. While I am not in favor of AMZN's reliance upon non-GAAP financial performance, I can appreciate the fact that their message focuses upon their operating business and is consistent throughout the report.

So what do we find with WFMI? Within the management discussion, little attention is given to their operating business and why shopping in their store is better than buying organic food from a larger supermarket. Instead, we are treated to pages of descriptions detailing how they have shaped the

## **EPIC ADVISORS, LLC**

Weekly Market Commentary

May 27, 2008

Sean Hannon, CFA, CFP

---

organic industry, benefited local farmers and created a positive environment for their employees. Far less attention is given to how 67% of all inventories are perishable, their prices are higher than competitors and how a slowing economy may alter consumer behavior.

Turning to the financial statements, WFMI leads with the balance sheet. This is an interesting choice. When you bring off-balance sheet liabilities into the equation, WFMI has a negative book value. Also, as a growth stock most of their investor base would rather look at an income statement or cash flow statement to discern future growth and the ultimate stock price. Could it be that management would rather not have us look upon diminishing growth prospects?

Given the mixed message in the report, what are the investment implications? Looking at the numbers, WFMI has some great attributes. Cash earnings have outperformed GAAP earnings the last 3 years and the cash conversion ratio has remained steady. Operating margins have been improving and turnover metrics remain strong. All together, the business is well run and efficient.

Now we turn to the negatives. By financing the purchase of Wild Oats with cash as opposed to stock, interest expense is set to increase from \$4mm to \$35-40mm. At the same time, growth is slowing as consumers have less discretionary income to purchase expensive, prepared organic food. Since 67% of WFMI's merchandise is perishable, any fall in sales caused by an over strapped consumer will lead to increasing shrinkage and lower margins.

The market has started to recognize this fact as the shares have dropped from a high of over \$74 in late 2005 to the current price of \$27.62. While this decline has been brutal, the shares are still priced for perfection. If you assume WFMI can maintain operating profits of 4% during 2008 and then steadily expand those margins over the next 5 years, you can make an argument that the shares are fairly valued. All in, you would be assuming 30% earnings growth over the next 5 years with a terminal growth rate of 26%. While possible, I find this scenario unlikely. More realistic would be a slight compression in margins during 2008 followed by a five year growth rate of 15%. Under this assumption, the shares are worth \$15 - a number that is in line with both a P/E model and a dividend discount model.

From a technical perspective, the shares are weak with no discernable support in place. Having recently traded below \$30, a price last seen in 2003, we must watch for consolidation. Guessing where that may occur is futile at this point, but the charts indicate the stock may trade down toward \$20 in the future.

## **EPIC ADVISORS, LLC**

Weekly Market Commentary

May 27, 2008

Sean Hannon, CFA, CFP

---

In summary, WFMI is a trend setting company that is adjusting to a period of lower growth. To me, it is reminiscent of where Starbucks has been over the last few years. As the price drops and multiples contract, sell side analysts race to say how cheap the stock is relative to where it has traded in the past. While this statement is true, the shares become cheaper as the business struggles and the market reacts. Instead of trying to catch the bottom, I would rather wait to see if the price reaches a level I find attractive. Were the shares to trade to \$15, I would be a buyer under the belief that I am finally being compensated for the risks I have taken. Since I have taken the time to understand the company, model various valuation ranges and indentify the drivers of future stock prices, I am content with knowing that any decision to buy the shares will be informed and disciplined. As the stock price then moves, I will not be forced to question my analysis or beliefs. Instead, I can wait for their business to evolve and then determine how to best profit from my investment.