



WHOLE FOODS REGROUPS

Falling comps, a slew of new competitors and declining customer satisfaction... The leader of the natural and organic segment responds with a new format and improved efficiencies.

BY DENISE LEATHERS

Despite — or, more accurately, because of — strong growth in the natural and organic space, long-time leader Whole Foods saw comparable store sales drop 1.8% during the first quarter ended Jan. 17, the second straight quarterly loss for the 438-store, Austin, Texas-based chain. Transaction size fell 1.6% while basket size slid 0.2%. And although sales for the quarter grew 3% to a record \$4.8 billion (the chain opened three new stores during the period), net income tumbled 6% to \$157 million.

But it's not all doom and gloom. Whole Foods has some of the highest sales per square foot in the supermarket

industry, trailing only Trader Joe's, and the average store does nearly \$700,000 a week, reports David Livingston, owner of Milwaukee-based DJL Research. "Most grocers would be envious of those results," he adds, citing impressive growth over the long-term. So why the recent downturn? Competition.

"In 1980, only about 20 million consumers, or 8% of the population, was tuned into the natural and organic movement, and Whole Foods pretty much had them to itself," explains Jay Jacobowitz, founder and president of Brattleboro, Vt.-based Retail Insights. Fast forward 35 years, he says, and that figure has swelled to 200 million, or almost two-thirds of the population, prompting the entry of retailers from every corner of the industry. And therein lies the problem.

So not only does Whole Foods have to compete with a growing number of small local players, co-ops and farmer's markets, it also has to contend with chains

like Sprouts and Farmer's Market that offer a similar assortment for less money, says Don Stuart, managing partner at Wilton, Conn.-based Cadent Consulting. But an even better threat is posed by strong mainstream players that have entered the segment in a big way. "Kroger, Costco, Target, even Walmart are all really upping their game in this space," he reports. So while the pie is definitely bigger, a lot more retailers are vying for a piece of it. As a result, differentiation is crucial.

THE BEST OF THE BEST

While Whole Foods' positioning may not be unique any longer, it's generally recognized as the industry leader, the best of the best. "No one sets standards like Whole Foods," says Stuart. "Its knowledge and insights against this market give it a huge competitive advantage." Going forward, he continues, the company will need to leverage its position as leader — not just in organic where its selection is "unparalleled" but in other areas like locally produced, earth-friendly, sustainable, fair trade, GMO-free, fresh, etc. "Whole Foods will never be the lowest

A January survey of more than 1,000 Whole Foods shoppers revealed more than 70% hadn't noticed any change in price during the past three months — while 16% thought they had risen.

cost, so it's got to look for other ways to add more value," Stuart explains. If the company continues to blaze trails beyond organic, "It can own the high ground, bracketing players like Kroger and Costco."

Another key to Whole Foods' future success is continued development of its prepared foods program, says Jon Hauptman, partner at Barrington, Ill.-based Willard Bishop. "Whole Foods has done a masterful job building a robust and differentiated foodservice program with its Italian cafes, grills, hot foods, pizza, etc. It's become a destination for meals to eat on-site or take home." He adds, "Other retailers are matching much of the chain's (center store) product offerings, so it needs to step up and further differentiate in an area for which it's already known."

And while they're at it, they should consider giving the frozen and refrigerated sections a little TLC. "While there's nothing wrong with Whole Foods' frozen and refrigerated offerings, they lack the sizzle that the company provides in other parts of the store," says Hauptman. Yes, it's got some

of "Give me a try, I'm new around here!" shelf tags, we also saw an awful lot that said "Last chance, clearance price," suggesting more is needed.

STILL 'WHOLE PAYCHECK'

Despite a promise by co-CEO John Mackey late last year to lower prices, Whole Foods has been unable to shake its 'Whole Paycheck' image. In fact, a January survey of more than 1,000 Whole Foods shoppers by a Wall Street analyst revealed more than 70% hadn't noticed any change in price during the past three months — while 16% thought they had risen. Even more troubling, only 24% said the chain's organic products were "definitely" higher quality than those offered at conventional supermarkets, and almost half reported shopping at other grocery stores for lower prices. How much lower? *Business Insider* reported in late

2015 that a cart full of nearly identical goods cost almost 45% more at Whole Foods than Kroger. Ouch.

While Whole Foods offers plenty of unique specialty items not available elsewhere for which they can charge whatever the market will bear (\$14.99 Paleo Bread comes to mind), it's hard to argue that the Saffron Road entree you buy there is any better than the one you buy at Safeway — despite the \$1 premium. Even loyal Whole Shoppers are losing patience with the company, evidenced by a supermarket category-worst 10-point drop in customer satisfaction (to an industry average 73%), according to the 2015 American Customer Satisfaction Index (ACSI) Retail Report. While last summer's overcharging scandal sure didn't help matters, the report places the blame squarely on price gaps that

are becoming more and more obvious.

"Every grocer in the universe understands the concept of key item pricing where you ensure that you're close on easily recognizable items and take your major mark-up on the unique stuff you sell," says Paula Rosenblum, partner at Miami-based RSR Research. "Whole Foods does an absolutely horrible job managing this process. Too often, I've seen something in the store that I can find at another retailer marked 33% higher. Ordinarily, I don't care about \$1 versus \$1.50," she says. "But when the item is something like seltzer, for example, then I feel like a jerk. And that's not a good way for a customer to feel." Despite what consumers think, Whole Foods claims ▶



Industry observers say continued development of Whole Foods' standout foodservice program is one of the keys to its future success.

"exclusives" in terms of sizes and flavors, he continues, but most of the assortment is widely available elsewhere, usually for a lot less (more on that later). Whether under its own label or in partnership with small, local manufacturers, "Continuing to develop innovative new products will be critical to success in the future."

While the frozen section is small (we counted just 30 doors, excluding seafood, at a local Whole Foods), some categories contain a wide variety of brands and SKUs, many with just a single facing. "Whole Foods doesn't seem to have caught on to SKU rationalization," says one manufacturer. "It's difficult to discern why it has so many offerings in some areas and so few in others."

Another laments high shelves in frozen and even higher pack-out, which leads to damaged packages. "Getting promotion execution is also hard." We also heard from some new players who wish the company would do more to support emerging brands. Indeed, while we saw plenty



- ▶ to be working on the problem. In a Feb. 10 first quarter earnings call, president A.C. Gallo said the company had already lowered prices on “a fair number of items” this year, with plans for more cuts as the year goes on. “There are certain very important categories that we know we need to be competitive on every day,” he said. “We’re working to systematically identify those and move pricing...” However, he continued, increased promotional activity will also become a key part of the chain’s approach to pricing. “Our company’s always had a strong high-low strategy; that’s what our customers respond to. So we feel that the best way to show our customers value is to ramp up on the promotional side.” One recent example: last fall’s customer appreciation “Love Fest,” featuring 25-cent cups of coffee and weekly product offers, some at discounts up to 50%.

Going forward, added co-CEO Walter Robb, the company plans more personalized offers using information gleaned from its new loyalty program/mobile app — now featuring digital coupons, as well — which is expected

says it may have to be margins.

“Times have changed,” she explains. “It may well be that Whole Foods just has to accept lower margins as a fact of life. When push comes to shove, it’s groceries. And that’s not a high-margin business.”

Vendors say the problem is exacerbated by Whole Foods’ distribution model. “The margin requirements in frozen and dairy are out of line compared to competitors like Kroger, Walmart and Albertson’s (with their own distribution infrastructures), which often buy direct,” says one. “But Whole Foods has to pay an upcharge to UNFI or KeHe that adds yet another margin layer.”

“Having to work through distributors is a challenge,”

agrees another. “When they make low-low margin, cost-plus deals with Whole Foods...they look to make up the difference from vendors. And that’s not pleasant.” But that’s not suppliers’ biggest beef with the chain. By a long shot. In fact, just about every manufacturer we talked to complained about the difficulty associated with the company’s decentralized approach to buying, a function handled by 11 different regional offices.

While it’s hard enough for small, start-up companies to present to 11 different buyers, manufacturers also say criteria for acceptance varies widely from region to region. “It’s like pitching to 11 completely different companies,” says one. “Everything is seemingly dependent on the whims of the individual buyer.” Moreover, “These buyers seem overwhelmed by the amount of work they’re expected to perform and are often unresponsive to requests from manufacturers

hoping to present a new item” — a sentiment we heard over and over again. For new vendors in particular,

‘It’s like pitching to 11 completely different companies. Everything is seemingly dependent on the whims of the individual buyer.’

“Getting an appointment is extremely difficult.”

But even for those lucky enough to be granted an audience, meetings are a challenge. “Whole Foods only allows vendors to present once a year,” says another ▶



A robust prepared foods program helps differentiate Whole Foods from its competitors.

to expand beyond a single test market during the third quarter. “Coupons have been the top request among [early app] users,” said Robb. “This is a win for customers and a win for us as well as we will gain actionable customer data on a national scale.”

MARGIN OF ERROR?

Whether through key item price reductions or increased promotion, lowering prices comes at a cost, and industry observers say the chain must be careful not to sacrifice the service and local flavor for which it’s become known. But something’s gotta give, right? Rosenblum

- ▶ manufacturer. “You’re given 30 minutes or less to present — one buyer actually set a timer and stopped us when it went off, regardless of where we were — and you’re asked to put everything on one page, which allows very little insight into the category or the brand. Most often, they don’t even have time for sampling.... Good luck to a new vendor dealing with those kinds of constraints!”

It’s no surprise, then, that most manufacturers applauded Whole Foods’ announcement last month that responsibility for buying packaged foods, detergents and other non-perishables would shift from regional buyers to a team in Austin, a move designed to reduce costs and boost clout with vendors. While some worry the shift will weaken the chain’s ability to tap into the unique needs of individual marketplaces, “I think it makes sense in center store,” says Cadent’s Stuart. “You don’t want to lose that local touch, that connection to the community, but Whole Foods can leverage the perimeter for that. I think it’s a good balance and represents a big step forward.”

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In addition to centralized buying for certain categories, Whole Foods is also cutting costs by investing in software designed to simplify labor-intensive tasks like scheduling and shelf replenishment. It’s also replacing four separate checkout systems — holdovers from past acquisitions — with a single system that will allow the kinds of targeted discounts the company hopes to offer in the near future.

‘QUALITY MEETS VALUE’

The other big change at Whole Foods is the rollout of its new 365 by Whole Foods format, “a streamlined, quality-meets-value shopping experience” that the company says will bring fresh, healthy food to a broader

audience, i.e. Millennials who like what the company stands for but can’t afford to shop there. Expected to offer a “curated mix of products that adhere to the company’s industry-leading quality standards,” the new store will feature a strong selection of the company’s 365 private label products in a smaller footprint, leading many analysts to characterize it as a response to Trader Joe’s.

“But it’s clear to me that it’s really intended to block Sprouts,” which some have called an everyman’s version of Whole Foods, says Jacobowitz. And it all hinges on location. During the 20 or so years Whole Foods had the natural and organic segment largely to itself, he explains, the company set up shop primarily in top-tier, high-rent locations where affluent, well-educated consumers were willing to pay a premium for top quality. The problem is there’s not a lot of room left to expand in that type of location. And the next generation of natural and organic consumers can’t afford to live there anyhow. “In order to move the needle, Whole Foods needs to get into the next-best locations, those B and C trade areas — with a more relevant offering — before Sprouts does. But Sprouts has a good 200-store head start,” says

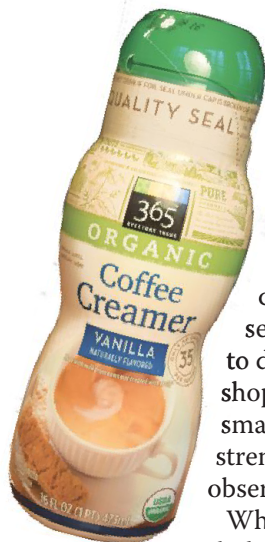
WHY THEY CHOOSE WHOLE FOODS

In its Monthly Consumer Survey, Worthington, Ohio-based Prosper Insights & Analytics (www.goprosper.com) asks consumers why they choose to buy their groceries at a particular store. Our chart compares Whole Foods against other highly regarded purveyors of natural and organic foods. Yellow highlighted numbers show where it scored significantly higher than average; green numbers show where it scored significantly lower.

GENERAL	Average	Whole Foods	Walmart	Kroger	Costco	Trader Joe’s
Price	73.4%	11.3%	88.3%	76.4%	91.4%	80.5%
Selection	55.6%	55.9%	54.9%	64.6%	57.0%	74.5%
Location	69.7%	32.8%	67.0%	78.0%	51.0%	61.1%
Quality	48.1%	83.3%	31.6%	53.6%	73.8%	83.6%
Service	24.9%	26.4%	12.9%	27.7%	26.0%	48.2%
DEPARTMENTS						
Bakery	14.1%	13.2%	12.2%	15.1%	16.1%	1.6%
Deli	14.7%	8.6%	12.2%	16.1%	10.2%	3.2%
Ethnic Foods	4.9%	11.2%	3.6%	3.1%	8.7%	15.1%
Fresh Produce	32.7%	56.2%	25.3%	35.9%	44.0%	47.4%
Gluten-Free Foods	3.8%	13.0%	3.4%	2.8%	5.9%	11.6%
Meat/Seafood	20.7%	30.8%	13.8%	24.5%	36.3%	17.0%
Organic/Whole Foods	8.3%	70.8%	3.9%	8.7%	19.3%	52.9%
Prepared Meals	6.7%	15.4%	7.3%	5.4%	10.3%	18.7%
SERVICES						
Frequent Shopper Card	14.6%	0.0%	2.4%	38.2%	6.8%	0.8%
Knowledgeable Employees	8.8%	12.3%	5.2%	9.5%	9.1%	24.6%
Promos (sales, coupons, etc.)	24.2%	4.0%	13.4%	37.7%	23.3%	2.3%
In-Store Experience	19.1%	20.9%	14.2%	20.1%	23.6%	43.0%
Trustworthy Retailer	22.6%	25.6%	15.7%	24.3%	40.4%	46.4%
Unique Products	5.7%	21.3%	4.5%	3.2%	19.5%	49.5%
NET PROMOTER SCORE*	31.7%	52.2%	21.2%	48.0%	63.0%	69.3%

*Indicates likelihood a consumer will recommend a store to a friend or colleague. Net Promoter, NPS and Net Promoter Score are trademarks of Satmetrix Systems Inc., Bain & Co., and Fred Reichheld.

Source: Prosper Insights & Analytics, Monthly Consumer Survey, Aug. 2015



Jacobowitz, listing a dozen other players also going after those same down-market locations.

To further boost the appeal of 365 among Millennial shoppers, Whole Foods is also inviting complementary businesses — “from food and drinks to fashion, body care products, services, and more” — to set up shop under the same roof. Intended to drive traffic and create a more exciting shopping experience, partnerships with small businesses and start-ups would also strengthen the chain’s ties to the community, observers say.

While it’s “crystal clear” to Jacobowitz that Whole Foods needs to get into those second- and third-tier spaces ASAP, he is a bit concerned that some of the first 365 stores are for leases originally obtained for “regular” Whole Foods Markets. (Thirteen locations have been announced so far, with the first scheduled to open this spring in Silver Lake, Calif.) While that’s good news for affluent shoppers who reside in those areas, it doesn’t really help the chain reach its new target consumer. It also puts 365 in direct competition with Trader Joe’s, which already has the high-end, small-format, own-brand niche locked up. “And I’m not sure it’s a great idea to attack a competitor at its strength,” notes one industry observer.

There’s also a risk that 365 could cannibalize existing Whole Foods Markets, says Kaitlin Wolcott, senior

business analyst at Cadent Consulting. “But if the chain moves into locations once considered too risky because they’re too small or too low-income, 365 could be a great way for the company to hedge its bets.”

That said, running two businesses with different price points, different value propositions and different cultures from one corner office won’t be easy, says Jacobowitz. “It’s not a challenge I’d want to take on,” he adds. “But I wouldn’t bet against them either.”

Neither would Livingston of DJL Research. “The execs at Whole Foods are smart people. Really smart people. And like most good ol’ boys from Texas, they’re very clever. I can almost imagine J.R. Ewing running the company.”

In fact, he says he wouldn’t be surprised if the chain is faking a limp to lure competitors into a trap. “Giving rivals like Sprouts and The Fresh Market — whose 52-week results don’t look too pretty either — a dose of overconfidence is old trick. You get them to think you’ve fallen on hard times, they over-invest, they fail and then you pick up the pieces at a discount,” he explains. “When everyone is getting up out of the pile, (I think) Whole Foods will be holding the football.” ■

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