WILD OATS MARKETS INC
Form 10-Q
August 05, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(**X**) QUARTERLY REPORT PURSUANT TO SECTION 13 OR SECTION 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 26, 2004

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR SECTION 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM __________ TO __________

Commission file number 0-21577

WILD OATS MARKETS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**84-1100630**
(State or other jurisdiction of Incorporation or organization)	*(I.R.S. Employer Identification Number)*

3375 Mitchell Lane

Boulder, Colorado 80301

(Address of principal executive offices, including zip code)

(303) 440-5220

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes (**X**) No ( )

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2):

Yes (**X**) No ( )

As of July 30, 2004, there were 28,441,868 shares outstanding of the Registrant's Common Stock (par value $.001 per share).

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

WILD OATS MARKETS, INC.

Consolidated Balance Sheets

(in thousands, except share data)

	June 26, 2004	December 27, 2003
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 65,771	$ 17,400
Inventories, net of reserves	50,925	46,621
Accounts receivable, net of allowance for doubtful accounts	2,627	4,038
Income tax receivable	98	261
Prepaid expenses and other current assets	2,000	2,192
Deferred tax asset	7,339	6,340
Total current assets	128,760	76,852
Property and equipment, net	145,279	130,989
Goodwill, net	106,084	106,404
Other intangible assets, net	6,764	6,976
Deposits and other assets	6,342	2,932

Deferred tax asset	10,300	12,438
	$ 403,529	$ 336,591

LIABILITIES AND STOCKHOLDERS EQUITY

Current liabilities:		
Accounts payable	$ 53,586	$ 47,529
Book overdraft	21,235	26,727
Accrued liabilities	44,290	42,998
Current portion of capital leases	40	14
Total current liabilities	119,151	117,268
Long-term debt and capital leases	115,192	30,179
Other long-term obligations	13,310	14,058
Total Liabilities	247,653	161,505
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized, no shares issued and outstanding	-	-
Common stock, $0.001 par value; 60,000,000 shares authorized, 30,366,823 and 30,063,421 shares issued, respectively	30	30
Additional paid-in capital	220,983	217,400
Note receivable, related party	(11,112)	(10,815)
Accumulated deficit	(29,057)	(31,777)
Treasury stock, at cost: 1,977,800 shares as of June 26, 2004	(24,999)	-

Accumulated other comprehensive income	31	248
Total stockholders equity	155,876	175,086
	$ 403,529	$ 336,591

The accompanying notes are an integral part of the consolidated financial statements.

WILD OATS MARKETS, INC.

Consolidated Statements of Income

(in thousands, except per-share data) (unaudited)

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	June 26, 2004	June 28, 2003	June 26, 2004	June 28, 2003
Sales	$ 251,697	$ 242,248	$ 515,492	$ 478,235
Cost of goods sold and occupancy costs	178,525	171,026	365,206	336,154
Gross profit	73,172	71,222	150,286	142,081
Operating expenses:				
Direct store expenses	56,271	50,327	113,314	101,191
Selling, general and administrative expenses	14,418	16,797	29,939	32,774
Loss (gain) on disposal of assets	48	(100)	(22)	1,368
Pre-opening expenses	1,626	101	2,101	1,023

Restructuring and asset impairment charges (income), net	(99)	(145)	165	(1,881)
Income from operations	908	4,242	4,789	7,606
Interest income	222	179	408	355
Interest expense	(540)	(842)	(807)	(1,835)
Loss on early extinguishment of debt	-	-	-	(186)
Income before income taxes	590	3,579	4,390	5,940
Income tax expense	227	1,396	1,670	2,317
Net income	$ 363	$ 2,183	$ 2,720	$ 3,623
Net income per common share:				
Basic	$ 0.01	$ 0.07	$ 0.09	$ 0.12
Diluted	$ 0.01	$ 0.07	$ 0.09	$ 0.12
Weighted average common shares outstanding, basic	29,788	29,775	29,982	29,739
Dilutive effect of stock options and restricted stock units	921	487	878	323
Weighted average common shares outstanding, assuming dilution	30,709	30,262	30,860	30,062

The accompanying notes are an integral part of the consolidated financial statements.

WILD OATS MARKETS, INC.

Consolidated Statements of Comprehensive Income

(in thousands) (unaudited)

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	June 26, 2004	June 28, 2003	June 26, 2004	June 28, 2003
Net income	$ 363	$ 2,183	$ 2,720	$ 3,623
Other comprehensive income (loss):				
Foreign currency translation adjustments arising during the period	(126)	270	(218)	488
Recognition of hedge results to interest expense during the period, net of tax of $0, $153, $0, and $316, respectively	-	256	-	528
Change in market value of cash flow hedge during the period, net of tax of $0, $0, $0, and $12, respectively	-	1	-	(20)
Other comprehensive income (loss)	(126)	527	(218)	996
Comprehensive income	$ 237	$ 2,710	$ 2,502	$ 4,619

The accompanying notes are an integral part of the consolidated financial statements

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WILD OATS MARKETS, INC.

Consolidated Statements of Cash Flows

(in thousands) (unaudited)

	SIX MONTHS ENDED	
	June 26, 2004	**June 28, 2003**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 2,720	$ 3,623
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,570	10,866
Loss (gain) on disposal of property and equipment	(22)	1,368
Deferred tax expense	1,581	2,094
Non-cash restructuring and asset impairment charges (income), net	127	(1,881)
Other	240	181
Change in assets and liabilities:		
Inventories, net	(4,568)	(455)
Receivables, net, and other assets	1,782	(281)
Accounts payable	8,186	9,185
Accrued liabilities	1,015	(2,884)
Net cash provided by operating activities	23,631	21,816
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(29,498)	(13,297)
Proceeds from sale of property and equipment	964	4
Net cash used in investing activities	(28,534)	(13,293)

CASH FLOWS FROM FINANCING ACTIVITIES		
Net repayments under line-of-credit agreement	(30,179)	(4,100)
Net decrease in book overdraft	(5,492)	(1,988)
Repayments on long-term debt and capital leases	(37)	(37,098)
Proceeds from long term debt	115,150	37,879
Purchase of treasury stock	(24,999)	-
Payment of debt issuance costs	(3,636)	(721)
Proceeds from issuance of common stock, net	2,552	1,343
Net cash provided by (used in) financing activities	53,359	(4,685)
Effect of exchange rate changes on cash	(85)	70
Net increase in cash and cash equivalents	48,371	3,908
Cash and cash equivalents at beginning of period	17,400	11,367
Cash and cash equivalents at end of period	$ 65,771	$ 15,275
NON-CASH INVESTING AND FINANCING ACTIVITIES		
Equipment acquired through capital lease	$ 105	-

The accompanying notes are an integral part of the consolidated financial statements.

WILD OATS MARKETS, INC.

Notes to Consolidated Financial Statements

(unaudited)

1. Nature of Operations and Basis of Presentation

Wild Oats Markets, Inc. ("Wild Oats" or the "Company"), headquartered in Boulder, Colorado, owns and operates natural and organic foods supermarkets in the United States and Canada. The Company also operates bakeries, commissary kitchens and a distribution center that supply the stores. The Company s operations are concentrated in one market segment, grocery stores, and are geographically concentrated in the western and central parts of the United States.

The consolidated balance sheet as of June 26, 2004, the consolidated statements of income and comprehensive income for the three months and six months ended June 26, 2004 and June 28, 2003, as well as the consolidated statements of cash flows for the six months ended June 26, 2004 and June 28, 2003 have been prepared without an audit. In the opinion of management, all adjustments, consisting only of normal, recurring adjustments necessary for a fair statement thereof, have been made.

The financial statements have been prepared by the Company in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to SEC regulations, therefore, these consolidated financial statements should be read in conjunction with financial statements and notes thereto included in the Company's 2003 Annual Report on Form 10-K. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses and related disclosures of contingent assets and liabilities. Examples include accounting for self-insurance reserves, restructuring charges and store closing costs, asset impairment charges, goodwill, inventory valuation, and contingencies. Actual results may differ from these estimates. The results of operations for interim periods presented are not necessarily indicative of the operating results for the full year.

Certain prior period information has been reclassified to conform to the current presentation.

The unaudited information included in the consolidated financial statements for the three months and six months ended June 26, 2004 and June 28, 2003 include the results of operations of the Company for the 13 weeks and 26 weeks then ended.

2. Stock-Based Compensation

At June 26, 2004, the Company has seven stock-based employee compensation plans, which are described more fully in *Note 9 Stock Plans and Options* in our fiscal 2003 Annual Report filed on Form 10-K for the period ended December 27, 2003. These plans allow for awards of both stock options and restricted stock units ("RSUs"). The Company accounts for those plans in accordance with the intrinsic value based method in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Some stock-based compensation expense is reflected in net income for options issued at a discount and for RSUs issued as Board of Directors compensation. All other options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant; therefore, no stock-based compensation expense is reflected in net income for these grants. Also reflected in results of operations for the first six months of fiscal 2004 and 2003 is compensation expense of $315,000 and $182,000, respectively, relating to the extension of the option exercise period beyond Company-imposed blackout periods for previously granted stock options held by retiring members of the Board of Directors.

As required by Financial Accounting Standards Board Statement Nos. 123, *Accounting for Stock-Based Compensation ("SFAS 123"),* and 148, *Accounting for Stock-Based Compensation-Transition and Disclosure ("SFAS 148")*, the following table illustrates the effect on net income and earnings per share if stock-based compensation costs were to be calculated based on the fair value of the options granted and recognized ratably over the vesting period as prescribed in SFAS No. 123 (in thousands):

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	June 26,	June 28,	June 26,	June 28,

	2004	**2003**	**2004**	**2003**
Net income, as reported	$ 363	$ 2,183	$ 2,720	$ 3,623
Add: Stock-based compensation expense included in reported net income, net of tax	60	23	287	155
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of tax	(687)	(771)	(1,275)	(1,409)
Pro forma net income (loss)	(264)	1,435	1,732	2,369
Earnings (loss) per share:				
Basic as reported	$ 0.01	$ 0.07	$ 0.09	$ 0.12
Basic pro forma	$ (0.01)	$ 0.05	$ 0.06	$ 0.08
Diluted as reported	$ 0.01	$ 0.07	$ 0.09	$ 0.12
Diluted - pro forma	$ (0.01)	$ 0.05	$ 0.06	$ 0.08

In March 2004, the Financial Accounting Standards Board ("FASB") issued a proposed Statement, *Share-Based Payment*, which would be an amendment to SFAS 123. This proposed standard would require share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values, and would eliminate the Company's ability to continue accounting for share-based compensation transactions using the intrinsic method in APB Opinion No. 25. The FASB expects to issue a final standard late in 2004, which would be effective for the Company's first quarter of fiscal year 2005 reporting period. Wild Oats has not yet determined to what degree this proposed standard will impact its future earnings and earnings per share.

3. Property and Equipment

As a result of the significant store closings, remodels and resets, the Company undertook a review of all fixtures and equipment in its stores in fiscal 2003, including a physical inventory in conjunction with an asset tagging exercise. During the first quarter of fiscal 2003, the Company substantially completed the review and recorded a $1.5 million loss on disposal of fixtures and equipment that will no longer be used in the stores.

4. Long Term Debt and Liquidity

Contingent Convertible Senior Debentures. In June 2004, the Company issued $115 million aggregate principal amount of its 3.25% Convertible Senior Debentures due May 15, 2034 in a private placement. The debentures bear regular interest at the annual rate of 3.25%, payable semiannually on May 15 and November 15 of each year until May 15, 2011, after which date, no regular interest will be due. Commencing May 20, 2011 and ending November 14, 2011, and for any six-month period thereafter, contingent interest will be due and payable in the amount of 0.25% of the average trading price of the debentures during a specified period, if the average trading price of the debentures equals or exceeds 125% of the principal amount of the debentures.

The debentures are convertible into the Company s common stock prior to maturity at the option of the holders under the following circumstances: (1) during any calendar quarter commencing after June 30, 2004 and before March 31, 2029, if the last reported sale price of our common stock is greater than or equal to 130% of the conversion price of $17.70 per share; (2) at any time on or after April 1, 2029 if the last reported sale price of our common stock on any date on or after March 31, 2029 is greater than or equal to 130% of the conversion price; (3) subject to certain limitations, during the five business-day period after any five consecutive trading-day period in which the trading price per debenture for each day of that period was less than 98% of the product of the conversion rate and the last reported sale price of the Company s common stock; (4) if the Company calls the debentures for redemption; (5) upon the occurrence of certain corporate transactions; or (6) if the Company obtains credit ratings for the debentures, at any time when the credit ratings assigned to the debentures are below specified levels. The debentures are initially convertible into 56.5099 shares of the Company s common stock per $1,000 principal amount, which is equivalent to $17.70 per share, for total initial underlying shares of 6,498,639. Upon conversion, the Company has the right to deliver, in lieu of common stock, cash or any combination of cash and common stock. Pursuant to the underwriting agreement and within 90 days of issuance, the Company intends to file a shelf registration statement covering resales of the debentures and the common stock issuable upon conversion thereof.

On or after May 20, 2011, the Company may redeem for cash some or all of the debentures at any time and from time to time, for a price equal to 100% of the principal amount of the debentures plus accrued and unpaid contingent interest, if any. Holders have the right to require the Company to repurchase any or all debentures for cash, at a repurchase price equal to 100% of the principal amount of the debentures, plus accrued and unpaid interest on: (1) May 15, 2011, May 15, 2014, and May 15, 2024; and (2) the occurrence of change in control (as defined in the debenture).

The debentures are unsecured and unsubordinated obligations, and rank equal in priority with all of its existing and future unsecured and unsubordinated indebtedness and senior in right of payment to all of our subordinated indebtedness. The debentures will effectively rank junior to any of our secured indebtedness and any of our indebtedness that is guaranteed by our subsidiaries. Payment of principal and interest on the debentures will be structurally subordinated to the liabilities of our subsidiaries.

Total proceeds from the issuance were $115.2 million. The Company used $25.0 million of the net proceeds to repurchase 1,977,800 outstanding shares of its common stock, $31.2 million to pay the outstanding balance on its credit facility, and approximately $3.6 million to pay related debt issuance costs.

Credit Facility. The Company s credit facility has a $95.0 million limit, and a three-year term with a one-year renewal option. Under the credit facility, the Company has the option to increase the total facility to $135.0 million through the addition of new lenders and through the agreement of the current lending group to increase their total commitments.

As part of the credit facility, the Company has given its lenders collateral in the form of cash, equipment and fixtures, inventory and other assets. The Company has also granted leasehold mortgages in those leasehold interests previously mortgaged to secure our former credit facility, although we have no obligation to provide a security interest in any new leaseholds. In connection with the private debt offering in June 2004, the credit facility was amended in the second quarter which, among other things, (1) increased the maximum allowable leverage ratio, (2) permitted the repurchase of the Company s common stock, within specified limits, (3) increased the annual limits on capital expenditures and new leases, (4) raised the limit on the value of acquisitions and divestitures the Company can make without the consent of the lending group, and (5) increased the maximum interest rate to either prime plus 1.0% or one month LIBOR plus 2.5%. The credit agreement was subsequently amended in August 2004 to increase the maximum allowable leverage ratio. The amendment requires that the Company maintain a minimum cash balance, net of letters of credit and outstanding borrowings under the credit facility, of $25 million through the end of the second quarter of fiscal 2005.

The interest rate on the facility is currently either prime plus 1.0% or one-month LIBOR plus 2.5% at our election, and the rates modify depending on the ratio of average total funded debt, as defined under the credit facility, plus six times rent expense, to earnings before interest, taxes, depreciation, amortization and rent ("EBITDAR") for the four fiscal quarter periods then ended, as calculated on the Company s quarterly compliance certificate. Additionally, the Company is charged a commitment fee on the unused portion of the line ranging from 0.25% to 0.5% based on performance objectives as defined in the credit agreement. The outstanding balance on the credit facility was repaid in June 2004 from the proceeds of the private debt issuance. There were no outstanding borrowings under the credit facility and three letters of credit outstanding totaling $7.3 million as of June 26, 2004. The balance outstanding on the credit facility as of June 28, 2003 was $39.9 million. As the Company s new store growth accelerates, it expects its cash requirements for 2004 and 2005 will be primarily satisfied from the proceeds of the private debenture issuance as well as cash generated from operations.

The Company is currently, and expects to continue to be, in compliance with the monthly and quarterly financial covenants in the credit agreement, as amended. In the event that business conditions worsen, management has identified contingency actions to enable the Company to remain in compliance with the financial covenants. Even if the Company remains in compliance with its monetary covenants, a technical default could result due to a breach of the financial covenants. In the absence of a waiver or amendment to such financial covenants, such non-compliance would constitute a default under the credit agreement, and the lenders would be entitled to accelerate the maturity of the indebtedness outstanding thereunder. In the event that such non-compliance appears likely, or occurs, the Company will seek approval, as it has in the past, from the lenders to renegotiate financial covenants and/or obtain waivers, as required. However, there can be no assurance that future amendments or waivers will be obtained.

5. Derivatives and Hedging Activities

In accordance with the Company s interest rate risk-management strategy and as required by the terms of the Company s prior credit facility, in September 2000, the Company entered into a swap agreement to hedge the interest rate on $30.0 million of its borrowings as of March 29, 2003. The swap agreement locked in a one-month LIBOR rate of 6.7% and expired in August 2003. There was no obligation to renew the swap under the current facility. No interest rate swap agreements are outstanding as of June 26, 2004.

6. Earnings Per Share

Earnings per share are calculated in accordance with the provisions of SFAS No. 128, *Earnings Per Share ("*SFAS No. 128"). SFAS No. 128 requires the Company to report both basic earnings per share, which is based on the weighted-average number of common shares outstanding, and diluted earnings per share, which is based on the weighted-average number of common shares outstanding and all dilutive potential common shares outstanding, except where the effect of their inclusion would be anti-dilutive. Anti-dilutive stock options of 351,081 and 1,212,503 for the three months and 351,081 and 1,701,874 for the six months ended June 26, 2004 and June 28, 2008, respectively, were not included in the earnings per share calculations. The contingently convertible debt described in *Note 4 - Long Term Debt and Liquidity* has no impact on diluted earnings per share until all conditions necessary for issuance have been satisfied.

In July 2004, the Emerging Issue Task Force ("the Task Force") of the Financial Accounting Standards Board reached a tentative conclusion on Issue No. 04-8, *The Effect of Contingently Convertible Debt on Diluted Earnings per Share*. The Task Force tentatively concluded that contingently convertible debt should be included in diluted earnings per share computations using the if-converted method regardless of whether any of the conversion contingencies have been met, which would represent a significant change in current accounting practice. Issue No. 04-8 will be discussed further by the Task Force at its September 2004 meeting. If the Company had used the if-converted method in calculating diluted earnings per share for the quarter and six months ending June 26, 2004, the effect would have been anti-dilutive.

7. Goodwill and Finite Lived Intangible Assets

During the second quarter of fiscal 2004, no goodwill was recognized as a result of acquisitions, no goodwill was impaired, and no other changes in the carrying amount of goodwill occurred.

Other intangible assets consist of the following (in thousands):

	June 26, 2004	December 27, 2003

Leasehold interests	$ 8,905	$ 9,045
Less accumulated amortization	(2,359)	(2,240)
	6,546	6,805
Liquor licenses	218	171
	$ 6,764	$ 6,976

Amortization expense related to finite lived intangible assets was $122,000 and $121,000 for the three months and $251,000 and $243,000 for the six months ended June 26, 2004 and June 28, 2003, respectively. The estimated amortization of finite lived intangible assets for each of the five fiscal years ending in fiscal 2008 is as follows (in thousands):

FISCAL YEAR	**AMORTIZATION EXPENSE**
2004	$ 481
2005	$ 491
2006	$ 475
2007	$ 471
2008	$ 461

8. Restructuring and Asset Impairment Charges (Income)

During the second quarter of fiscal 2004, the Company recorded net restructuring and asset impairment income of $99,000 consisting of the following components:

Change in estimate related to lease-related liabilities for sites previously identified for closure or sale	$ (922,000)

Lease-related liability for site closed during the quarter	40,000
Severance for employees terminated during the second quarter of fiscal 2004	63,000
Accretion expense on lease related liabilities	203,000
Asset impairment charges	517,000
Total restructuring and asset impairment income	$ (99,000)

Details of the significant components are as follows:

- Changes in estimate related to lease-related liabilities for sites previously identified for closure or sale ($922,000 of restructuring income) During the second quarter of fiscal 2004, the Company secured a viable subtenant for a vacant site in Missouri, resulting in a reversal of $1.5 million of the net restructuring charge previously recorded. Also, additional information received during the quarter relating to a previously subleased site in California indicates that the likelihood of receiving continued sublease income from the current subtenant is remote, resulting in an increase to the estimated reserve of $298,000. During the second quarter, the Company determined that additional time will be needed to dispose of certain lease obligations for three vacant sites. This determination was largely driven by results of current disposition efforts by the Company as well as continuing difficulties in finding subtenants that are deemed acceptable by the existing landlords. As a result, the Company increased its estimated reserves for these sites by $316,000. Based on these changes in facts and circumstances and the related changes in estimates, the Company adjusted or reversed the remaining lease-related liabilities previously recorded for these locations and recognized net restructuring income of $922,000 during the second quarter of fiscal 2004.

- Lease-related liability for site closed during the second quarter ($40,000 of restructuring expense) - During the second quarter of 2004, the Company closed a store in Oregon with a remaining lease obligation through October 2004. As a result, the Company recorded a restructuring charge of $40,000.

- Severance for employees notified of termination in the second quarter of fiscal 2004 ($63,000 of restructuring expense) During the second quarter, 22 employees were notified of their involuntary termination in conjunction with the closure of a store in Oregon, and as of June 26, 2004, all benefits had been paid