WILD OATS MARKETS INC
Form 10-Q
August 12, 2003
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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 28, 2003

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

(State or other jurisdiction of Incorporation or organization)

84-1100630

(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 August 1, 2003, there were 29,882,306 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 28, 2003	December 28, 2002

	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 15,275	$ 11,367
Inventories	47,785	47,175
Accounts receivable	3,087	2,524
Income tax receivable	328	250
Prepaid expenses and other current assets	2,252	2,163
Deferred tax asset	4,910	4,656
Total current assets	73,637	68,135
Property and equipment, net	123,963	122,359
Goodwill, net	106,404	106,404
Other intangible assets, net	7,244	7,415
Deposits and other assets	3,926	3,622
Deferred tax asset	13,050	15,650
	$ 328,224	$ 323,585
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 42,622	$ 34,819
Book overdraft	22,483	22,777
Accrued liabilities	35,955	37,943
Current portion of debt and capital leases	16	146
Total current liabilities	101,076	95,685
Long-term debt and capital leases	39,886	43,075
Other long-term obligations	14,330	17,923
	155,292	156,683
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, 29,826,948 and 29,658,660 shares issued and outstanding, respectively	30	30
Additional paid-in capital	215,175	213,482
Note receivable, related party	(10,482)	(10,200)
Accumulated deficit	(31,745)	(35,368)
Accumulated other comprehensive loss	(46)	(1,042)
Total stockholders equity	172,932	166,902
	$ 328,224	$ 323,585

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

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WILD OATS MARKETS, INC.

Consolidated Statements of Operations

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

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	June 28, 2003	June 29, 2002	June 28, 2003	June 29, 2002
Sales	$ 242,248	$ 236,186	$ 478,235	$ 469,200
Cost of goods sold and occupancy costs	171,026	164,758	336,154	330,129
Gross profit	71,222	71,428	142,081	139,071
Operating expenses:				
Direct store expenses	50,327	51,510	101,191	101,922
Loss (gain) on disposal of assets	(100)	-	1,368	-
Selling, general and administrative expenses	16,797	14,761	32,774	28,934
Pre-opening expenses	101	645	1,023	1,014
Restructuring and asset impairment income	(145)	-	(1,881)	(652)
Income from operations	4,242	4,512	7,606	7,853
Interest income	179	193	355	373
Interest expense	(842)	(2,347)	(1,835)	(4,782)
Loss on early extinguishment of debt	-	-	(186)	-
Income before income taxes	3,579	2,358	5,940	3,444
Income tax expense	1,396	860	2,317	1,278
Net income	$ 2,183	$ 1,498	$ 3,623	$ 2,166
Net income per common share:				
Basic	$ 0.07	$ 0.06	$ 0.12	$ 0.09
Diluted	$ 0.07	$ 0.06	$ 0.12	$ 0.09
Weighted average common shares outstanding, basic	29,775	25,016	29,739	24,919
Dilutive effect of stock options	487	929	323	632
Weighted average common shares outstanding, assuming dilution	30,262	25,945	30,062	25,551

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

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WILD OATS MARKETS, INC.

Consolidated Statements of Comprehensive Income

(in thousands) (unaudited)

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	June 28, 2003	June 29, 2002	June 28, 2003	June 29, 2002
Net income	$ 2,183	$ 1,498	$ 3,623	$ 2,166
Other comprehensive income (loss):				
Foreign currency translation adjustments arising during the period	270	210	488	118
Recognition of hedge results to interest expense during the period, net of tax of $153, $182, $316, and 370, respectively	256	303	528	617
Change in market value of cash flow hedge during the period, net of tax of $0, $194, $12, and $167, respectively	1	(323)	(20)	(277)
Other comprehensive income	527	190	996	458
Comprehensive income	$ 2,710	$ 1,688	$ 4,619	$ 2,624

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 28, 2003	June 29, 2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 3,623	$ 2,166
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	10,866	10,528
Loss (gain) on disposal of property and equipment	1,368	(39)
Deferred tax expense	1,983	820
Income tax benefit from employee exercise of stock options	111	
Restructuring and asset impairment income	(1,881)	(652)
Loss on early extinguishment of long-term debt	186	-
Other	(5)	(60)
Change in assets and liabilities:		
Inventories, net	(455)	6,596
Receivables, net, and other assets	(281)	2,746
Accounts payable	7,416	(236)
Accrued liabilities	(2,884)	1,900
Net cash provided by operating activities	20,047	23,769
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(13,516)	(4,644)
Proceeds from sale of property and equipment	4	5
Net cash used in investing activities	(13,512)	(4,639)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net repayments under line-of-credit agreement	(4,100)	(21,000)
Repayments on notes payable, long-term debt and capital leases	(37,098)	(5,730)
Proceeds from long term debt	37,879	-
Payment of debt issuance costs	(721)	-
Proceeds from issuance of common stock	1,343	1,434
Net cash used in financing activities	(2,697)	(25,296)
Effect of exchange rate changes on cash	70	54
Net increase(decrease) in cash and cash equivalents	3,908	(6,112)

Cash and cash equivalents at beginning of period	11,367	18,840
Cash and cash equivalents at end of period	$ 15,275	$ 12,728
NON-CASH INVESTING AND FINANCING ACTIVITIES		
Stock issued in payment of note payable		$ 1,210
Settlement of note payable against accounts receivable		$ 200

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

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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 foods grocery stores in the United States and Canada. The Company also operates commissary kitchens and warehouses 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 28, 2003, the consolidated statements of operations and comprehensive income for the three months and six months ended June 28, 2003 and June 29, 2002, as well as the consolidated statements of cash flows for the six months ended June 28, 2003 and June 29, 2002 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.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These consolidated financial statements should be read in conjunction with financial statements and notes thereto included in the Company's 2002 Annual Report on Form 10-K. The results of operations for interim periods presented are not necessarily indicative of the operating results for the full year.

The unaudited information included in the consolidated financial statements for the three months and six months ended June 28, 2003 and June 29 2002 includes the results of operations of the Company for the 13 weeks and 26

weeks then ended.

2. Implementation of New Accounting Pronouncements

The Company receives allowances from its vendors through a variety of programs and arrangements, including cooperative advertising and markdown reimbursement programs. The allowances are intended to offset the Company s costs of promoting, advertising and selling the vendors products in its stores. Vendor allowances are recognized as a reduction of cost of sales or related selling expense when the intended purpose of the vendor funds is satisfied. Cooperative advertising allowances are reported as a reduction of advertising expense in the period in which the advertising occurs. Markdown reimbursements are credited to cost of goods sold during the period in which the related promotional markdown is taken.

The FASB s Emerging Issues Task Force ("EITF") Issue No. 02-16, *Accounting By a Customer (Including a Reseller) for Cash Consideration Received From a Vendor* addressed the accounting treatment for vendor allowances. The adoption of EITF Issue No. 02-16 in fiscal 2003 did not have a material impact on the Company s financial position or results of operations.

The FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities*, *An Interpretation of ARB 51* ("FIN 46"). The primary objectives of FIN 46 are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("variable interest entities" or "VIEs") and how to determine when and which business enterprise should consolidate the VIE (the "primary beneficiary"). This new model for consolidation applies to an entity which either (1) the equity investors (if any) do not have a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity s activities without receiving additional subordinated financial support from other parties. In addition, FIN 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. As of June 28, 2003, the Company was not party to a VIE; therefore, management believes FIN 46 will not have a material effect on the Company.

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In November 2002, the FASB issued Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45"). FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The Company has adopted the disclosure provisions as of December 28, 2002 and it had no impact.

SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, was issued on July 30, 2002. SFAS No. 146 will require companies to recognize costs associated with exit or disposal activities when they occur rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 became effective for the Company on January 1, 2003 and management believes it will have no material effect on the Company s financial position or historical financial results.

During the quarter ended June 29, 2002, the Company adopted the provisions of SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS No. 145, among other things, rescinds SFAS No. 4, which required that gains and losses from extinguishment of debt be classified as an extraordinary item, net of related income tax effects. SFAS No. 145 is to be applied in fiscal years beginning after May 15, 2002 and encourages early application of the rescission of SFAS No. 4. In connection with the refinancing of its credit facility, the Company incurred a non-cash charge to write off the remaining unamortized debt issuance cost from its prior credit facility in the first quarter of fiscal 2003 of approximately $186,000, which is included in income from continuing operations.

3. New Accounting Pronouncements

During April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This statement amends and clarifies financial accounting and reporting for derivative instruments and hedging activities, resulting primarily from decisions reached by the FASB Derivatives Implementation Group subsequent to the original issuance of SFAS No. 133. This Statement is generally effective prospectively for contracts and hedging relationships entered into after June 30, 2003. Management believes that adoption of SFAS No. 149 will have minimal impact on the Company.

During May 2003, the FASB issued SFAS No. 150, *"Accounting for Certain Financial Instruments With Characteristics of both Liabilities and Equity."* This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability, or an asset in some circumstances. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted. The Company currently has no financial instruments falling within the scope of this Statement, therefore, management believes that adoption of SFAS No. 150 will have minimal impact on the Company.

4. Stock-Based Compensation

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* ("SFAS 148"). The statement amends SFAS 123 to provide alternative methods of transition for voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS 148 improves the prominence and clarity of the pro forma disclosures required by SFAS 123 by prescribing a specific tabular format and by requiring disclosure in the "Summary of Significant Accounting Policies" or its equivalent. In addition, SFAS 148 improves the timeliness of those disclosures by requiring their inclusion in financial reports for interim periods. SFAS 148 is effective for financial statements for fiscal years ending after December 15, 2002.

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At June 28, 2003, the Company has seven stock-based employee compensation plans, six of which are described more fully in *Note 10 Stock Plans and Options* in our fiscal 2002 Annual Report filed on Form 10-K for the period ended December 28, 2002, and one of which was created in the second fiscal quarter of 2003 as an inducement to employment for a new executive. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees, and Related Interpretations*. Some stock-based employee compensation cost is reflected in net income for options issued at a discount 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 other employee compensation cost is reflected in net income.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation,* as amended, to stock-based employee compensation:

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	June 28, 2003	June 29, 2002	June 28, 2003	June 29, 2002
Net income, as reported	$ 2,183	$ 1,498	$ 3,623	$ 2,166
Add: Stock-based employee compensation expense included in reported net income, net of tax	23	117	155	131
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(771)	(709)	(1,409)	(1,198)
Pro forma net income	1,435	906	2,369	1,099
Earnings per share				
Basic as reported	$ 0.07	$ 0.06	$ 0.12	$ 0.09
Basic pro forma	$ 0.05	$ 0.04	$ 0.08	$ 0.04
Diluted as reported	$ 0.07	$ 0.06	$ 0.12	$ 0.09
Diluted - pro forma	$ 0.05	$ 0.03	$ 0.08	$ 0.04

5. 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, 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. This loss approximates a 1.2% write-down of the fixed assets carrying value.

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6. Debt Covenant Compliance and Liquidity

In February of 2003, the Company completed the refinancing of its credit facility with Wells Fargo Bank N.A. The Company s new facility has a $75.0 million limit, with a three-year term with a one-year renewal option. Under the new 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 new credit facility, the Company gave the lenders collateral in the form of security interest in accounts, equipment and fixtures, inventory and other assets. The Company has also granted a leasehold mortgage in those leasehold interests previously mortgaged to secure the former credit facility, although it has no obligation to provide an interest in any new leaseholds. The new credit facility contains limitations on capital expenditures and the signing of new leases. The interest rate on the facility is currently either prime plus 1.0% or one-month LIBOR plus 2.25%, at the Company s 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 EBITDAR for the four fiscal quarter periods then ended, as calculated on the Company s quarterly compliance certificate. The Company believes that cash generated from operations and available under its credit facility will be sufficient to meet its capital expenditure requirements in fiscal 2003.

The Company anticipates that it will comply with the monthly and quarterly financial covenants in the credit agreement. 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.

7. 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 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 locks in a one-month LIBOR rate of 6.7% and expires in August 2003. The fair value of the swap at June 28, 2003 was ($136,000), which has been recorded in the accompanying balance sheet in accrued liabilities. There is no obligation to renew the swap under the refinanced facility.

8. Earnings Per Share

Earnings per share are calculated in accordance with the provisions of SFAS No. 128, *Earnings Per Share.* 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 1,212,503 and 1,420,861 for the three months and 1,701,874 and 1,288,177 for the six months ended June 28, 2003 and June 29, 2002, respectively, were not included in the earnings per share calculations.

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