

WILD OATS MARKETS INC

Form 10-Q

May 09, 2007

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR SECTION 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH
31, 2007.**

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)

**1821 30th Street
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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12-b of the Exchange Act).

Yes No

As of April 27, 2007, there were 29,882,910 shares outstanding of the registrant's common stock (par value \$0.001 per share).

TABLE OF CONTENTS

| | Page |
|--|------|
| <u>PART I.</u> | |
| <u>FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements:</u> | |
| <u>Consolidated Statements of Operations (unaudited), Three Months Ended March 31, 2007 and April 1, 2006</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income (Loss) (unaudited), Three Months Ended March 31, 2007 and April 1, 2006</u> | 5 |
| <u>Consolidated Statements of Cash Flows (unaudited), Three Months Ended March 31, 2007 and April 1, 2006</u> | 6 |
| <u>Notes to Consolidated Financial Statements (unaudited)</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations and Results of Operations</u> | 17 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 24 |
| <u>Item 4. Controls and Procedures</u> | 25 |
| <u>PART II.</u> | |
| <u>OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 25 |
| <u>Item 1A. Risk Factors</u> | 26 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 27 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 27 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 27 |
| <u>Item 5. Other Information</u> | 27 |
| <u>Item 6. Exhibits</u> | 28 |
| SIGNATURE AND EXHIBITS | |
| <u>Signatures</u> | 29 |
| <u>Exhibit 10.3</u> | |
| <u>Exhibit 31.1</u> | |
| <u>Exhibit 31.2</u> | |

Exhibit 32.1

Exhibit 32.2

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

WILD OATS MARKETS, INC.
Consolidated Balance Sheets
(in thousands, except share data)

| | March 31, 2007 | December 30, 2006 |
|---|-----------------------|--------------------------|
| | <i>(unaudited)</i> | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 34,567 | \$ 40,420 |
| Short-term investments | 8,250 | 13,675 |
| Inventories (net of reserves of \$1,062 and \$1,032, respectively) | 69,717 | 67,753 |
| Accounts receivable (net of allowance for doubtful accounts of \$179 and \$288, respectively) | 4,740 | 7,581 |
| Prepaid expenses and other current assets | 9,883 | 10,204 |
| Total current assets | 127,157 | 139,633 |
| Property and equipment, net | 199,274 | 192,061 |
| Goodwill, net | 105,124 | 105,124 |
| Other intangible assets, net | 4,776 | 4,810 |
| Deposits and other assets | 4,980 | 4,831 |
| Deferred tax asset, net | 181 | 179 |
| | \$ 441,492 | \$ 446,638 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 57,622 | \$ 57,147 |
| Book overdraft | 24,133 | 29,888 |
| Accrued liabilities | 60,930 | 64,470 |
| Current portion of debt, capital leases and financing obligations | 500 | 573 |
| Total current liabilities | 143,185 | 152,078 |
| Long-term debt, capital leases and financing obligations | 147,596 | 147,662 |
| Other long-term obligations | 39,147 | 38,302 |
| | 329,928 | 338,042 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.001 par value; 5,000,000 shares authorized, no shares issued and outstanding | | |
| | 32 | 32 |

Edgar Filing: WILD OATS MARKETS INC - Form 10-Q

Common stock, \$0.001 par value; 60,000,000 shares authorized,
32,540,392 and 32,454,554 shares issued; and 29,881,129 and
29,795,291 shares outstanding, respectively

| | | |
|---|------------|------------|
| Treasury stock, at cost: 2,659,263 shares, respectively | (37,181) | (37,181) |
| Additional paid-in capital | 243,568 | 242,322 |
| Accumulated deficit | (96,288) | (97,912) |
| Accumulated other comprehensive income | 1,433 | 1,335 |
| Total stockholders' equity | 111,564 | 108,596 |
| | \$ 441,492 | \$ 446,638 |

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

Table of Contents

WILD OATS MARKETS, INC.
Consolidated Statements of Operations

(in thousands, except per share amounts) (unaudited)

| | THREE MONTHS ENDED | |
|---|---------------------------|--------------------------|
| | March 31, 2007 | April 1, 2006 |
| Sales | \$ 309,942 | \$ 298,357 |
| Cost of goods sold and occupancy costs | 210,776 | 201,297 |
| Gross profit | 99,166 | 97,060 |
| Operating expenses: | | |
| Direct store expenses | 73,078 | 69,821 |
| Depreciation and amortization | 6,716 | 6,687 |
| Selling, general and administrative expenses | 14,022 | 12,978 |
| Loss on disposal of assets | 19 | 90 |
| Pre-opening expenses | 697 | 1,459 |
| Restructuring and asset impairment charges, net | 1,457 | 1,670 |
| Income from operations | 3,177 | 4,355 |
| Interest income | 551 | 589 |
| Interest expense | (1,840) | (1,854) |
| Income before income taxes | 1,888 | 3,090 |
| Income tax expense | 264 | 205 |
| Net income | \$ 1,624 | \$ 2,885 |
| Net earnings per common share: | | |
| Basic | \$ 0.05 | \$ 0.10 |
| Diluted | \$ 0.05 | \$ 0.10 |
| Weighted-average common shares outstanding, basic | 30,005 | 28,970 |
| Dilutive effect of stock options and restricted stock units | 337 | 572 |
| Weighted-average common shares outstanding, assuming dilution | 30,342 | 29,542 |

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

Table of Contents

WILD OATS MARKETS, INC.
Consolidated Statements of Comprehensive Income (Loss)
(in thousands) (unaudited)

| | THREE MONTHS ENDED | |
|---|---------------------------|--------------------------|
| | March 31, 2007 | April 1, 2006 |
| Net income | \$ 1,624 | \$ 2,885 |
| Other comprehensive income (loss): | | |
| Foreign currency translation adjustments | 98 | (44) |
| Unrealized gain (loss) on available-for-sale securities | | (4) |
| Other comprehensive income (loss) | 98 | (48) |
| Comprehensive income | \$ 1,722 | \$ 2,837 |

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

Table of Contents

WILD OATS MARKETS, INC.
Consolidated Statements of Cash Flows
(in thousands) (unaudited)

| | THREE MONTHS ENDED | |
|---|---------------------------|--------------------------|
| | March 31, 2007 | April 1, 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 1,624 | \$ 2,885 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,716 | 6,687 |
| Loss on disposal of property and equipment | 19 | 90 |
| Restructuring and asset impairment charges, net | 1,457 | 1,670 |
| Interest on related party receivable | | (88) |
| Stock-based compensation | 564 | 778 |
| Accretion of debt issuance costs | 156 | 156 |
| Change in assets and liabilities: | | |
| Inventories, net | (1,944) | (2,651) |
| Receivables, net, and other assets | 2,849 | 15 |
| Accounts payable | (1,827) | 3,506 |
| Accrued liabilities and other liabilities | (3,771) | 133 |
| Net cash provided by operating activities | 5,843 | 13,181 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (11,967) | (5,759) |
| Purchase of short-term investments | (37,925) | (21,410) |
| Proceeds from sale of short-term investments | 43,350 | 14,522 |
| Proceeds from sale of property and equipment | 2 | 24 |
| Net cash used in investing activities | (6,540) | (12,623) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net decrease in book overdraft | (5,755) | (760) |
| Repayments on notes payable, long-term debt and capital leases | (139) | (125) |
| Proceeds from issuance of common stock, net | 682 | 4,227 |
| Net cash (used in) provided by financing activities | (5,212) | 3,342 |
| Effect of exchange rate changes on cash | 56 | (40) |
| Net (decrease) increase in cash and cash equivalents | (5,853) | 3,860 |
| Cash and cash equivalents at beginning of period | 40,420 | 35,250 |
| Cash and cash equivalents at end of period | \$ 34,567 | \$ 39,110 |

SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:

| | | |
|--|----|----|
| Equipment acquired through capital lease | \$ | \$ |
|--|----|----|

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

Table of Contents

WILD OATS MARKETS, INC.
Notes to Consolidated Financial Statements
(unaudited)

1. Basis of Presentation and Summary of Significant Accounting Policies

The accompanying unaudited consolidated financial statements have been prepared by the Company in accordance with United States generally accepted accounting principles for interim financial information and pursuant to instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with United States generally accepted accounting principles have been condensed or omitted pursuant to Securities and Exchange Commission's (SEC) rules and regulations. In the opinion of the Company, all adjustments necessary to present fairly the financial position at March 31, 2007 and results of operations and cash flows for all periods presented have been made. The consolidated balance sheet at December 30, 2006 has been derived from the audited financial statements at that date.

These consolidated financial statements should be read in conjunction with the Company's audited financial statements and notes thereto included in the Company's 2006 Annual Report on Form 10-K as filed with the SEC. 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, stock-based compensation, 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 the three months ended March 31, 2007 are not necessarily indicative of the operating results to be expected for any subsequent quarter or for the entire fiscal year ending December 29, 2007. The unaudited information included in the consolidated financial statements for the three months ended March 31, 2007 and April 1, 2006 includes the results of operations of the Company for the 13 weeks then ended.

Pending Tender Offer. On February 21, 2007, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with Whole Foods Market, Inc. (Parent or WFM) and WFMI Merger Co., a wholly-owned subsidiary of Parent (Purchaser).

Subject to the terms and conditions of the Merger Agreement, on February 27, 2007, Purchaser commenced a tender offer (the Offer) to purchase all of the Company's outstanding shares of common stock, par value \$0.001 per share (the Common Stock), including the associated preferred stock purchase rights (the Rights), issued pursuant to the Rights Agreement, dated as of May 22, 1998, as amended (the Rights Agreement), between the Company and Wells Fargo Bank, N.A., as successor in interest to Norwest Bank Minneapolis, N.A., as rights agent (such Common Stock, together with the associated Rights, the Shares), at a purchase price of \$18.50 per Share in cash (the Offer Price). Upon successful completion of the Offer, Purchaser will be merged (the Merger) with and into the Company, with each outstanding Share being converted into the right to receive the Offer Price in cash, and the Company will survive the Merger as a wholly-owned subsidiary of Parent.

Consummation of the Offer and the Merger are subject to customary closing conditions, including the expiration or termination of any waiting period (and any extension thereof) under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended. The consummation of the Offer is also subject to the tender of a majority of the Shares. On March 13, 2007, the Company and WFM received a request for additional information (commonly known as a second request) from the Federal Trade Commission (FTC) in connection with the Offer. The Company intends to continue to cooperate fully with the FTC and to respond promptly to this request. The effect of the second request is to extend the waiting period imposed by the HSR Act until 10 days after WFM has substantially complied with the request, unless that period is extended voluntarily by the parties or terminated sooner by the FTC.

Under a Tender and Support Agreement, dated as of February 21, 2007 (the Tender Agreement), among the Company, Parent, Purchaser, Yucaipa American Alliance Fund I, L.P. (YAAF), and Yucaipa American Alliance (Parallel) Fund I, L.P. (YAAF Parallel) and together with YAAF, Yucaipa), Yucaipa has committed to accept the Offer and to tender all Shares beneficially owned by it, which represent approximately 18% of the Company's total outstanding Shares.

Table of Contents

Principles of consolidation. The Company's consolidated financial statements include the amounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Inventories. Store inventories are valued principally at the lower of cost or market, with cost primarily determined under the retail method on a first in first out (FIFO) basis. FIFO cost is determined using the retail inventory method for approximately 80% of inventories and using the item cost method for highly perishable products representing approximately 20% of inventories. Under the retail inventory method, the valuation of inventories at cost and the resulting gross margins are determined by applying a cost-to-retail ratio for various categories of similar items to the retail value of inventories. Inherent in the retail inventory method calculations are certain management judgments and estimates, including shrinkage, which could impact the ending inventory valuation at cost as well as the resulting gross margins. Certain other highly perishable inventories are valued primarily at the lower of cost or market on a specific item basis, with cost determined on a FIFO basis.

Reclassifications. Certain prior period information has been reclassified to conform to the current year presentation. This includes a reclassification of the Company's 2006 results of operations to classify depreciation and amortization separately as its own line item. For the three months ended April 1, 2006, approximately \$6.7 million was reclassified to Depreciation and Amortization; \$5.7 million was reclassified from Cost of Goods Sold and Occupancy Costs, \$12,000 was reclassified from Direct Store Expenses, and \$987,000 was reclassified from Selling, General and Administrative expenses.

2. New Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact SFAS No. 159 may have on its financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurement* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. This statement is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact SFAS No. 157 may have on its financial position.

3. Short-Term Investments

The amortized cost of debt securities in this category is adjusted for amortization of premiums and accretion of discounts to maturity computed under the effective interest method. Such amortization and accretion is included in interest income. Realized gains and losses and declines in value judged to be other than temporary on available-for-sale securities are included in interest income. The cost of securities sold is based on the specific identification method. Realized income and dividends on securities classified as available-for-sale are included in interest income. Investments classified as available-for-sale are marked to market each reporting period with the unrealized gain or loss reflected as a component of other comprehensive income (loss).

Table of Contents**4. Stock-Based Compensation**

The following summary presents the impact of recording stock-based compensation on the Company's consolidated results of operations of for the three months ended fiscal 2007 and fiscal 2006 (*in thousands*):

| | THREE MONTHS ENDED | |
|--|---------------------------|---------------|
| | March 31, | |
| | 2007 | April 1, 2006 |
| Cost of goods sold and occupancy costs | \$ 1 | \$ 4 |
| Direct Store expenses | 26 | 94 |
| Selling, general and administrative expenses | 537 | 680 |
| | | |
| Total stock-based compensation expense | \$ 564 | \$ 778 |

At March 31, 2007, the Company had four stock-based compensation plans: the 2001 Non-Officer/Non-Director Equity Incentive Plan (2001 Plan), the 2006 Equity Incentive Plan (2006 Plan), and two individual nonqualified stock option plans. In addition, the 1996 Equity Incentive Plan (1996 Plan), which expired in June of 2006, provided for the grant of incentive stock options to employees (including officers and employee-directors) and nonqualified stock options, restricted stock and restricted stock units (RSUs) and stock bonuses to employees, directors and consultants. Under the 1996 Plan, there are still outstanding nonvested options that will continue to affect the Company's stock-based compensation expense. The 2001 Plan provides for the grant of nonqualified stock options to employees of the Company who are not officers or directors. The 2006 Plan provides for the grant of stock options, restricted stock, RSUs, stock appreciation rights (SARs), stock-based and cash-based performance awards and stock bonuses to employees, directors and consultants. The individual stock option plans were created during 2006 as inducements to certain executives to accept offers of employment with the Company. For all stock-based compensation plans except the 2006 Plan, the exercise price of the options is determined by the Board of Directors, provided that the exercise price for an incentive stock option cannot be less than 100% of the fair market value of the common stock on the grant date and the exercise price for a nonqualified stock option cannot be less than 85% of the fair market value of the common stock on the grant date. For the 2006 Plan, the exercise price of the options is the price per share of common stock as of the close of market on the day prior to date the option is granted. The outstanding options for all four plans generally vest over a period of four years and generally expire 10 years from the grant date. The estimated fair value of the Company's stock-based awards, less estimated forfeitures, is amortized over the awards' expected life on a straight-line basis.

For all of the Company's stock-based compensation plans, the fair value of each grant was estimated at the date of grant using the Black-Scholes option pricing model. Black-Scholes utilizes assumptions related to volatility, the risk-free interest rate, the dividend yield and expected life. Expected volatilities utilized in the model are based on the historical volatility of the Company's stock price. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect at the time of grant. The model incorporates exercise and post-vesting forfeiture assumptions based on an analysis of historical data. The expected life of the fiscal 2007 grants is derived from historical information and other factors. The following summary presents the weighted-average assumptions used for grants issued in the three months ended fiscal 2007 and fiscal 2006:

| | THREE MONTHS ENDED | |
|---------------------------------------|---------------------------|---------------|
| | March 31, | |
| | 2007 | April 1, 2006 |
| Estimated dividends | None | None |
| Expected volatility | 47% | 56% |
| Risk-free interest rate | 4.76% | 4.34% - 4.63% |
| Expected life (years) | 4.0 | 4.0 |
| Weighted-average fair value per share | \$ 6.49 | \$ 5.31 |

Table of Contents

The following summary presents information regarding outstanding stock options as of March 31, 2007 and changes during the three months then ended with regard to options under the Plans:

| | Number of Options | Weighted- Average Exercise Price |
|-------------------------------------|------------------------------|---|
| Outstanding as of December 30, 2006 | 1,597,960 | \$ 12.35 |
| Granted | 37,500 | \$ 15.40 |
| Forfeited | (158,847) | \$ 13.53 |
| Exercised | (56,071) | \$ 9.86 |
| Outstanding as of March 31, 2007 | 1,420,542 | \$ 12.40 |
| Exercisable as of March 31, 2007 | 984,953 | \$ 11.62 |

As of March 31, 2007, the total unrecorded deferred stock-based compensation balance for nonvested shares, net of expected forfeitures, was \$2.8 million which is expected to be amortized over a weighted-average period of 1.4 years.

5. Property and Equipment

Property, plant and equipment are recorded at cost and consist of the following (*in thousands*):

| | March 31, 2007 | December 30, 2006 |
|--------------------------------------|-----------------------|------------------------------|
| Machinery and equipment | \$ 158,435 | \$ 150,005 |
| Buildings and leasehold improvements | 182,771 | 167,276 |
| Construction in progress | 21,142 | 31,740 |
| | 362,348 | 349,021 |
| Less: accumulated depreciation | (163,074) | (156,960) |
| Property and equipment, net | \$ 199,274 | \$ 192,061 |

Depreciation expense was \$6.6 million and \$6.6 million for the three months ended March 31, 2007 and April 1, 2006, respectively.

6. Debt

Contingent convertible senior debentures. In June 2004, the Company issued \$115.0 million aggregate principal amount of its 3.25% Convertible Senior Debentures due May 15, 2034 in a private placement for total proceeds of \$115.2 million. 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. Refer to *Note 8 Earnings per Share* for the potentially dilutive impact of the convertible debentures on future periods.

During the second quarter of 2005, the Company made an irrevocable election to pay the principal amount of debentures in cash upon conversion, however, the Company retains the ability to satisfy the remainder of any conversion payment, exceeding the debenture defined principal, in cash or any combination of cash and common stock. According to their terms, the debentures are callable and 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 the Company's common stock is greater than or equal to 130% of the conversion price of \$17.70 per share for at least 20 trading days in the period of

30 consecutive trading days ending on the last trading day of the proceeding calendar quarter; (2) at any time on or after April 1, 2029 if the last reported sale price of the Company's 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,

Table of Contents

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 requests a credit rating for the debentures, at any time when the credit ratings assigned to the debentures are below specified levels. While a credit rating has been issued for the debentures, the rating was not requested by the Company, but initiated by the rating agency. Therefore, a change in the current rating will not trigger a call provision. The debentures are initially convertible into 56,5099 shares of the Company's common stock per \$1,000 principal amount, which is equivalent to approximately \$17.70 per share, for total initial underlying shares of 6,498,639. The conversion rate will be subject to adjustment upon the occurrence of specified events. Pursuant to the underwriting agreement and within 90 days of issuance, the Company filed a shelf registration statement covering resales of the debentures and the common stock issuable upon conversion thereof. The registration statement was declared effective August 26, 2005.

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) upon the occurrence of a fundamental change (as defined in the debenture indenture). In the case of a fundamental change in which all of the consideration for the common stock in the transaction or transactions constituting the fundamental change consists of cash, the Company also will pay to the holders a make-whole premium (as defined in the debenture indenture), the amount of which could be significant but would not be determinable unless and until there were to be a public announcement of such a fundamental change. Any make-whole premium would be payable to all holders regardless of whether the holder elects to require the Company to repurchase the debentures or elects to surrender the debentures for conversion. The purchase of Shares pursuant to the Merger Agreement will enable the holders of outstanding convertible debentures to cause the Company to repurchase their debentures. Purchaser expects to fund all such amounts which may become due and payable by the Company as a result of the purchase of the Shares.

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

There are no financial covenants within the debenture indenture, however, the Company paid penalty interest of 0.25% for the first 90 days of 2005 and paid 0.50% thereafter until the debentures were publicly registered on August 26, 2005. As of December 31, 2005, all \$305,102 in accrued additional interest to debenture holders due to not having an effective registration statement within the specified timeframe had been paid.

Credit facility. On March 31, 2005, the Company entered into a five-year revolving secured credit facility with Bank of America, N.A. (the "B of A Facility"). Concurrent with the execution of the B of A Facility, the Company terminated its existing \$95.0 million credit facility (the "Wells Facility") with Wells Fargo Bank N.A. as administrative agent. The B of A Facility allows borrowings and letters of credit up to a maximum of \$40.0 million, with an option to increase borrowings up to \$100.0 million, subject to a borrowing base determined by the value of certain inventory, credit card receivables, invested cash and, at the Company's discretion, mortgaged leaseholds. The B of A Facility is secured by certain assets including, but not limited to, cash, inventory and fixed assets. Borrowings under the B of A Facility bear interest, at the Company's election, at the prime rate or at London Interbank Offering Rate ("LIBOR") plus a margin ranging from 1.00% to 1.50%, depending on the excess borrowing availability over amounts borrowed. Interest rates are determined quarterly. The Company is charged a commitment fee on the unused portion of the B of A Facility. There are no financial covenants, other than the obligation to maintain a certain percentage of minimum excess availability (as defined in the agreement) at all times. The B of A Facility requires compliance on a monthly basis with certain non-financial covenants, including limitations on incurring additional indebtedness and making investments, the use and disposition of collateral, changes of control, as well as cash management provisions. In conjunction with

the debt refinancing, the Company wrote off approximately \$559,000 related to the remaining unamortized debt issuance cost from the Wells Facility. As of March 31, 2007, the Company has approximately \$200,000 of capitalized debt issuance costs remaining to be amortized over the life of the agreement using the effective interest method. As of March 31, 2007, the Company had letters of credit outstanding totaling \$15.6 million which reduce our borrowing availability to approximately \$24.4 million.

Table of Contents**7. Derivatives and Hedging Activities**

The Company does not have any derivative financial instruments as of March 31, 2007 that meets the criteria of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

8. 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 347,492 and 423,806 for the three months ended March 31, 2007 and April 1, 2006, respectively, were not included in the diluted earnings per share calculations.

The Emerging Issues Task Force of the FASB concluded in Issue No. 04-8, *The Effect of Contingently Convertible Debt on Diluted Earnings per Share* 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. During the second quarter of 2005, the Company irrevocably elected to satisfy 100% of the principal amount of the debentures in cash to be converted on or after July 1, 2005. The Company maintains the right to satisfy the remainder of the conversion obligation to the extent it exceeds the principal amount in cash or common stock or any combination of cash and common stock. In calculating diluted earnings per share for the three months ending March 31, 2007, no shares related to the debentures conversion have been included as the effect would have been anti-dilutive.

9. Goodwill and Intangible Assets

During the first three months of fiscal 2007, and all of fiscal 2006, no goodwill was recorded as a result of acquisitions, the Company concluded goodwill was not impaired, and no other changes in the carrying amount of goodwill occurred.

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

| | March 31, 2007 | December 30, 2006 |
|------------------------------------|---------------------------|------------------------------|
| Leasehold interests | \$ 6,598 | \$ 6,598 |
| Less accumulated amortization | (2,166) | (2,093) |
| Leasehold interests, net | 4,432 | 4,505 |
| Liquor licenses (indefinite lived) | 344 | 305 |
| | \$ 4,776 | \$ 4,810 |

Amortization expense related to finite lived intangible assets was \$74,000 and \$90,000 for the three months ended March 31, 2007 and April 1, 2006, respectively. The estimated amortization of finite lived intangible assets for the remainder of 2007 and each of the fiscal years through 2012 is as follows (*in thousands*):

| FISCAL YEAR | AMORTIZATION EXPENSE |
|------------------------|---------------------------------|
| Remainder of 2007 | \$ 221 |
| 2008 | \$ 295 |
| 2009 | \$ 295 |
| 2010 | \$ 295 |
| 2011 | \$ 290 |
| 2012 | \$ 290 |

Table of Contents**10. Restructuring and Asset Impairment Charges**

During the first quarter of fiscal 2007, the Company recorded restructuring and asset impairment charges of \$1.5 million consisting of the following components (*in thousands*):

| | | |
|---|--------|-----------|
| Change in estimate related to lease-related liabilities for sites previously closed | \$ | (92) |
| Lease-related liability for a site identified for a future store | | 304 |
| Accretion expense on lease-related liabilities | | 462 |
| Severance for employees terminated during the first quarter of fiscal 2007 | | 377 |
| Asset impairment charges | | 406 |
| Total restructuring and asset impairment charges | \$ | 1,457 |

Details of the significant components are as follows:

Changes in estimate related to lease-related liabilities for sites previously closed (\$92,000 of restructuring income) - During the first quarter of fiscal 2007, due to changes in facts and circumstances, the Company adjusted an estimate for a location in Florida that was closed during a previous period.

Lease-related liability for a site identified for a future store (\$304,000 of restructuring expense) During the first quarter of fiscal 2007, the Company determined that a future store location was no longer suitable and recorded an accrual for the net present value of the future expected minimum lease payments.

Accretion expense on lease-related liabilities (\$462,000 of restructuring expense) - During the first quarter, the Company accrued accretion expense on reserves for lease-related liabilities that were calculated using the net present value of the minimum lease payments (net of sublease income).

Severance for employees notified of termination in the first quarter of fiscal 2007 (\$377,000 of restructuring expense) - During the first quarter of 2007, 28 employees were notified of their involuntary termination in connection with a reorganization of the Company's Home Office and regional functions. During the three months ended March 31, 2007, \$723,000 in benefits were paid to employees that were terminated during the fourth quarter of 2006 and the first quarter of 2007.

Asset impairment charges (\$406,000 of restructuring expense) During the first quarter, management wrote off \$406,000 for the net book value of assets related to sites identified for future store locations that were subsequently determined unsuitable.

During the first quarter of 2007, there were no asset impairment charges in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. In determining whether an impairment exists, the Company estimates the store's future cash flows on an undiscounted basis, and if the cash flows are not sufficient to recover the carrying value, then the Company uses a discounted cash flow based on a risk-adjusted discount rate, to adjust its carrying value of the assets, and records a provision for impairment as appropriate. The Company continually re-evaluates its stores' performance to monitor the carrying value of its long-lived assets in comparison to projected cash flows.

The Company incurred charges for accelerated depreciation related to planned store closures of \$68,000 and \$52,000 for the three months ended March 31, 2007 and April 1, 2006, respectively. These costs are included in the Depreciation and amortization line of the Consolidated Statements of Operations.

Table of Contents

The following table summarizes accruals related to the Company's restructuring charges (*in thousands*):

| | 2003 and Prior | 2004 | 2005 | 2006 | 1st Qtr 2007 | Total |
|--------------------------------------|---------------------------|-----------------------|-----------------------|--------------------------|-------------------------|--------------|
| EXIT PLANS | | | | | | |
| Balance at December 31, 2005: | \$ 5,949 | \$ 287 | \$ 1,183 | \$ | \$ | \$ 7,419 |
| Severance expense | | | | 809 | | 809 |
| Lease-related expense | 54 | | 724 | 11,811 | | 12,589 |
| Cash paid: | | | | | | |
| Severance | | | | (449) | | (449) |
| Lease-related liabilities | (1,147) | | (824) | (1,195) | | (3,166) |
| Provision adjustments | 20 | (7) | | 936 | | 949 |
| Balance at December 30, 2006: | \$ 4,876 | \$ 280 | \$ 1,083 | \$ 11,912 | \$ | \$ 18,151 |
| Severance expense | | | | 317 | 60 | 377 |
| Lease-related expense | 99 | | 20 | 251 | 304 | 674 |
| Cash paid: | | | | | | |
| Severance | | | | (666) | (58) | (724) |
| Lease-related liabilities | (207) | | (178) | (1,030) | | (1,415) |
| Provision adjustments | | | | 530 | (2) | 528 |
| Balance at March 31, 2007: | \$ 4,768 ⁽¹⁾ | \$ 280 ⁽¹⁾ | \$ 925 ⁽¹⁾ | \$ 11,314 ⁽²⁾ | \$ 304 ⁽¹⁾ | \$ 17,591 |

(1) The restructuring accrual balance consists of lease-related liabilities.

(2) The restructuring accrual balance consists of lease-related liabilities and \$267 for employee termination benefits.

As of March 31, 2007, the Company's restructuring balances consist of \$6.2 million in accrued liabilities and other long-term obligations of \$11.4 million.

11. Income Taxes

On December 31, 2006, the first day of the first quarter of fiscal 2007, the Company adopted the provisions of Financial Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* (FIN No. 48). As a result of the implementation of FIN No. 48, the Company recorded a \$4.0 million decrease in the gross deferred tax assets. The Company did not record any cumulative adjustment to the opening balance of retained earnings and paid-in-capital on December 31, 2006, as no additional net liability for unrecognized tax positions were identified as of that date. The total amount of unrecognized tax benefits as of March 31, 2007, was \$4.0 million. The Company is in discussions with certain state taxing authorities on several open tax positions, and it is possible that the amount of the liability for unrecognized tax benefits could change during the next fiscal year. An estimate of the range of the possible change cannot be made.

In accordance with the Company's accounting policy, accrued interest and penalties related to unrecognized tax benefits are recognized as a component of tax expense. This policy did not change as a result of the adoption of FIN No. 48. The Company's financial statements do not currently include any accrued interest or penalties with regard to uncertain tax positions.

The Company files income tax returns, including returns for its subsidiaries, with federal, state, local, and foreign jurisdictions. The Company is no longer subject to IRS examination for periods prior to 2003, although carryforward attributes that were generated prior to 2003 may still be adjusted upon examination by the IRS if they either have been or will be used in a future period. Various state, local, and foreign income tax returns are also under examination by taxing authorities. The Company does not believe that the outcome of any examination will have a material impact on its financial statements.

Table of Contents**12. Related Party Transactions**

Perry D. Odak. The Company and Perry D. Odak, the Company's former Chief Executive Officer and President entered into an employment agreement, dated March 6, 2001 (the "Odak Agreement"). The Odak Agreement, as amended May 10, 2005, provided for the payment of the existing \$9.2 million supplemental bonus in the event of Mr. Odak's death or disability, as defined in the Odak Employment Agreement, while employed by the Company, and for payment of a bonus of approximately \$1.6 million: (i) in the event Mr. Odak terminated his employment for "good reason", as defined in the Odak Employment Agreement, or (ii) in the event Mr. Odak was terminated without "Cause", as defined in the Odak Employment Agreement. The Company acquired an insurance policy for the benefit of the Company to cover Mr. Odak's death or disability in the approximate amount of the supplemental bonus.

In March 2001, Mr. Odak purchased 1,332,649 shares of Common Stock for \$6.969 per share for an aggregate purchase price of \$9.3 million. Mr. Odak paid \$13,326 in cash and executed a full recourse, five-year promissory note for the balance of \$9,273,905 to the Company, with interest accruing at 5.5% per annum, compounding semiannually. On February 19, 2006, pursuant to the termination of the five-year promissory note, Mr. Odak sold 678,530 shares of Common Stock for \$17.89 per share to the Company. The Company repurchased the shares for \$12,138,902, effectively relieving all debt owed by Mr. Odak and reducing the number of shares outstanding by 678,530. The repurchased shares are reflected as treasury shares in the Company's consolidated balance sheet.

On June 16, 2006, and again on August 14, 2006, the Company and Mr. Odak entered into two consecutive amendments to the Employment Agreement, the Fifth Amendment and the Sixth Amendment, to extend the period during which a notice of non-renewal could be given under the Odak Employment Agreement, which continued on a year-to-year basis after expiration of the initial five year term in March 2006. With respect to the existing one-year term, the amendments changed the dates within which the Company must provide to Mr. Odak notice of non-renewal of the Employment Agreement to not later than, with reference to the Fifth Amendment, August 15, 2006, and with reference to the Sixth Amendment, October 16, 2006 (such extension periods being referred to as the "Extended Notice Period"). The deadline for notice of non-renewal of the Employment Agreement for all years after March 19, 2007 remained unchanged by the amendments. The amendments also provided that Mr. Odak may terminate his employment with the Company for Good Reason (as defined in the Employment Agreement) if (a) the Company, in bad faith, fails to engage in negotiations regarding a new employment agreement or modifications to the Employment Agreement during the Extended Notice Period or (b) during the Extended Notice Period, the Company provides Mr. Odak with a notice of non-renewal of the Employment Agreement prior to, with reference to the Fifth Amendment, August 14, 2006, or with reference to the Sixth Amendment, October 13, 2006. Refer to *Note 14 Subsequent Events* for further details on the status of this Employment Agreement.

As a result of the inability of the Company and Mr. Odak to agree upon a new or modified employment agreement, Perry D. Odak resigned effective October 19, 2006. Consequently, the Employment Agreement dated March 6, 2001, as amended, between Mr. Odak and the Company was terminated as of October 19, 2006, except to the extent incorporated into a severance agreement dated October 19, 2006 between the Company and Mr. Odak (the "Severance Agreement").

Pursuant to the Severance Agreement, in exchange for mutual general releases of any claims by the Company or Mr. Odak against each other and a non-competition covenant from Mr. Odak through October 2009, Mr. Odak will receive continuation of his current base salary for a period of thirty-six months, valued at approximately \$1,534,000, in addition to a payment valued at approximately \$1,978,000 in recognition of the increased profitability of the Company and in light of the termination of the Company's obligations under the Employment Agreement. Mr. Odak will also continue to receive both medical and group life insurance benefits for thirty-six months. He will also maintain the use of the automobile currently provided by the Company for the balance of the term remaining on its lease ending June 16, 2009. The Company has valued the medical and group life insurance benefits at approximately \$33,000, and the use of the automobile through the remainder of the lease has been valued at approximately \$48,000. Approximately \$3.6 million related to the above amounts payable to Mr. Odak were accrued by the Company in 2006. The Company also accelerated the vesting of 4,167 shares of restricted stock granted to Mr. Odak for his performance in 2006 that were scheduled to vest in February of 2007. The Company expensed an additional \$45,000 related to the accelerated vesting of the restricted stock.

Table of Contents

Other. Mark A. Retzloff was a member of the Company's Board of Directors and sat on its Real Estate Committee until the expiration of his term as director at the Company's Annual Meeting of Shareholders on May 3, 2006. As a result of Mr. Retzloff's position as Chief Organic Officer of Aurora Organic Dairy, a vendor that derives 6% of its total revenues from sales of organic milk to the Company under the Company's private label brand, the Company considered the organic milk transactions to include a related party relationship until Mr. Retzloff's term as a director expired on May 3, 2006. Stacey J. Bell, a current member of the Company's Board of Directors, is an employee of Ideasphere, Inc., which sold vitamins and supplements to the Company through the first two quarters of fiscal 2006. Total purchases from these vendors for the three months ended March 31, 2007 and April 1, 2006 were \$0 and \$1.0 million, respectively. A majority of these purchases are made primarily through the Company's primary distributor, UNFI and are therefore indirect in nature. These costs are all for inventory and the related cost of goods sold. As of March 31, 2007 and April 1, 2006, amounts owed to these vendors were \$0 and \$53,000, respectively. Gregory Mays, the Chairman of the Board of Directors and interim CEO, is also on the Board of Directors for Pathmark Stores, Inc. which began carrying the Wild Oats corporate branded products during the fourth quarter of 2006. Total sales to Pathmark Stores during the three months ended March 31, 2007 and April 1, 2006 were \$1.3 million and \$0, respectively.

13. Contingencies

Tim Auchterlonie, individually and on behalf of all others similarly situated and the general public, and Roes 1 to 1000 vs. Wild Oats Markets, Inc. and Does 1 through 100, is a suit brought in August 2004 on behalf of six plaintiffs in the Superior Court, County of Los Angeles, for payment of overtime and damages relating to alleged violations of the California Business and Professions Code by a former store director claiming that he should have been classified as an employee paid on an hourly basis, together with other related claims. The Company believes that all of the named plaintiffs were correctly classified as exempt employees based upon their job duties. The Company settled with four of the plaintiffs for an immaterial amount in the aggregate and one plaintiff withdrew his claims. The claims of one plaintiff went to trial, and after a bench trial, the Court found in favor of the remaining plaintiff on the claim for unlawful nonpayment of overtime compensation, and ordered that judgment on damages should enter in the amount of approximately \$43,700, plus attorneys' fees in the amount of approximately \$87,000. The Company has appealed the judgment.

Four cases related to the Auchterlonie suit have been filed. The Company believes that it will prevail in each case, but if liability were to be assessed, the aggregate potential liability in all of these related cases could be material. Ana Marie Hoepfner et al. v. Wild Oats Markets, Inc. and Does 1 through 100, Superior Court, County of Los Angeles, is filed by six California plaintiffs arising from claimed misclassification as exempt employees. Jason Puerto, et al. v. Wild Oats Markets, Inc. and Does 1 through 100, is a suit brought by eight plaintiffs in October 2006 in the Superior Court, County of Los Angeles, with substantively similar claims as Hoepfner. A bench trial of each of the Hoepfner and Puerto cases is set to commence on January 28, 2008 before the judge who presided at the Auchterlonie trial. John Montagne, et al., v. Wild Oats Markets, Inc. and Does 1 through 100, is a suit filed in March 2007 in the Superior Court, County of Los Angeles, on behalf of 14 individuals, with substantively similar claims as Hoepfner. Kelvin Massie, Anne Ress-Lemay and Gary Liss, individually and on behalf of all other similarly situated and the California general public v. Wild Oats Markets, Inc. and Does 1 through 100, is a purported class action lawsuit filed in April 2007 in the Superior Court, County of Los Angeles, arising from claimed misclassification of certain exempt employees while such employees were in a training program. The purported class is small and any potential liability immaterial.

In October 2000, the Company was named as defendant in 3601 Group Inc. v. Wild Oats Northwest, Inc., Wild Oats, Inc. and Wild Oats Markets, Inc., a suit filed in Superior Court for King County, Washington, by a property owner who claims that Alfalfa's Inc., the Company's predecessor in interest, breached a lease in 1995 related to certain property in Seattle, Washington. After trial in fiscal 2002, a jury awarded \$0 in damages to the plaintiffs, and the Company was subsequently awarded \$190,000 in attorneys' fees. The judgment was reversed on the plaintiff's appeal and the matter was remanded to the trial court. After a jury trial in August 2006, judgment was entered against the Company in the amount of \$823,000, inclusive of attorneys' fees, costs and interest. The Company has posted a bond and filed a notice of appeal.

Table of Contents

The Company also is named as defendant in various actions and proceedings arising in the normal course of business. In all of these cases, the Company is denying the allegations and is vigorously defending against them and, in some cases, has filed counterclaims. Although the eventual outcome of the various lawsuits cannot be predicted, it is management's opinion that these lawsuits will not result in liabilities that would materially affect the Company's consolidated results of operations, financial position, or cash flows.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This report on Form 10-Q contains certain forward-looking statements regarding our future results of operations and performance. Important factors that could cause differences in results of operations include, but are not limited to, risks and uncertainties related to the proposed Merger, the timing, execution and performance of new store openings, relocations and remodels; the timing and liability resulting from store closures; the amount of time before new stores become profitable; the timing and impact of promotional and advertising campaigns; the impact of competition; changes in merchandising strategies, product supply or suppliers; changes in management information needs; changes in customer needs and expectations; governmental and regulatory actions; general industry or business trends or events; changes in economic or business conditions in general or affecting the natural foods industry in particular; and competition for and the availability of sites for new stores and potential acquisition candidates. See *Management's Discussion and Analysis of Financial Condition and Results of Operations - Cautionary Statement Regarding Forward-Looking Statements*.

Executive Summary

This Executive Summary section of *Management's Discussion and Analysis of Financial Condition and Results of Operations* provides a broad summary of the more specific and detailed information disclosed in other sections of this report. The context that it provides should be viewed as a supplement to, and read in conjunction with, the details contained elsewhere in this report.

Wild Oats Markets, Inc. is one of the largest natural foods supermarket chains in North America. As of the date of this report, we operated 110 natural foods stores in 24 states and British Columbia, Canada. We operate in the retail grocery industry with two store formats: the natural foods supermarket format, under the Wild Oats Marketplace® name nationwide and the Capers Community Market® name in Canada; and the farmers market format, under the Henry's Farmers Market® name in southern California; and the Sun Harvest name in Texas. Both formats emphasize natural and organic products with a wide selection of products in a full-service environment. The formats share a core demographic customer profile and similar economic characteristics. We manage support services provided to the stores centrally from our Boulder, Colorado headquarters. All of our stores in the United States, regardless of format, purchase from the same primary distributor based on centralized negotiations, merchandising and marketing strategies. Our Riverside, California distribution center (DC) primarily supplies produce, private label groceries, bulk foods, natural living vitamins, minerals, and supplements, and selected other items for the majority of our stores west of the Mississippi River. We continue to identify additional procurement opportunities to maximize efficiencies of the DC.

In 2007, we are focusing our efforts on increasing comparable store sales growth and improving overall merchandising and the store conditions of operating stores. As of the end of the first quarter of fiscal 2007, we had 110 stores located in 24 states and Canada, as compared to 112 stores located in 24 states and Canada at the end of the first quarter of fiscal 2006.

On February 21, 2007, we entered into an Agreement and Plan of Merger (the Merger Agreement) with Whole Foods Market, Inc. (Parent or WFM) and WFMI Merger Co., a wholly-owned subsidiary of Parent (Purchaser). Subject to the terms and conditions of the Merger Agreement, on February 27, 2007, Purchaser commenced a tender offer (the Offer) to purchase all of our outstanding shares of common stock, par value \$0.001 per share (the Common Stock), including the associated preferred stock purchase rights (the Rights), issued pursuant to the Rights Agreement, dated as of May 22, 1998, as amended (the Rights Agreement), between the us and Wells Fargo Bank, N.A., as successor in interest to Norwest Bank Minneapolis, N.A., as rights agent (such Common Stock, together with the associated Rights, the Shares), at a purchase price of \$18.50 per Share in cash (the Offer Price). Upon successful completion of the Offer, Purchaser will be merged (the Merger) with and into us, with each outstanding Share being converted into the right to receive the Offer Price in cash, and we will survive the Merger as a wholly-owned

subsidiary of Parent.

Table of Contents

Consummation of the Offer and the Merger are subject to customary closing conditions, including the expiration or termination of any waiting period (and any extension thereof) under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended. The consummation of the Offer is also subject to the tender of a majority of the Shares. On March 13, 2007, the Company and WFM received a request for additional information (commonly known as a second request) from the Federal Trade Commission (FTC) in connection with the Offer. We intend to continue to cooperate fully with the FTC and to respond promptly to this request. The effect of the second request is to extend the waiting period imposed by the HSR Act until 10 days after WFM has substantially complied with the request, unless that period is extended voluntarily by the parties or terminated sooner by the FTC.

Under a Tender and Support Agreement, dated as of February 21, 2007 (the Tender Agreement), among the Company, Parent, Purchaser, Yucaipa American Alliance Fund I, L.P. (YAAF), and Yucaipa American Alliance (Parallel) Fund I, L.P. (YAAF Parallel) and together with YAAF, Yucaipa), Yucaipa has committed to accept the Offer and to tender all Shares beneficially owned by it, which represent approximately 18% of the Company's total outstanding Shares.

Results of Operations

Our net income for the three months ended March 31, 2007 was \$1.6 million or \$0.05 per diluted share compared with net income of \$2.9 million or \$0.10 per diluted share in the same period in fiscal 2006. The following tables set forth, for the periods indicated, certain selected income statement data expressed as a percentage of sales and in dollars (*in thousands* - percentages may not add due to rounding):

| | THREE MONTHS ENDED | | | |
|---|---------------------------|--------|----------------------|--------|
| | March 31, 2007 | | April 1, 2006 | |
| Sales | \$ 309,942 | 100.0% | \$ 298,357 | 100.0% |
| Cost of goods sold and occupancy costs | 210,776 | 68.0% | 201,297 | 67.5% |
| Gross profit | 99,166 | 32.0% | 97,060 | 32.5% |
| Direct store expenses | 73,078 | 23.6% | 69,821 | 23.4% |
| Depreciation and amortization | 6,716 | 2.2% | 6,687 | 2.2% |
| Selling, general and administrative expenses | 14,022 | 4.5% | 12,978 | 4.3% |
| Loss on disposal of assets | 19 | 0.0% | 90 | 0.0% |
| Pre-opening expenses | 697 | 0.2% | 1,459 | 0.5% |
| Restructuring and asset impairment charges, net | 1,457 | 0.5% | 1,670 | 0.6% |
| Income from operations | 3,177 | 1.0% | 4,355 | 1.5% |
| Interest income | 551 | 0.2% | 589 | 0.2% |
| Interest expense | (1,840) | (0.6)% | (1,854) | (0.6)% |
| Income before income taxes | 1,888 | 0.6% | 3,090 | 1.0% |
| Income tax expense | 264 | 0.1% | 205 | 0.0% |
| Net income | \$ 1,624 | 0.5% | \$ 2,885 | 1.0% |

Income Statement Analysis**Sales**

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 309,942 | \$ 298,357 | 3.9% |

Table of Contents

Sales for the three months ended March 31, 2007 increased 3.9%, as compared to the same period in fiscal 2006. The contribution of seven new stores opened since the end of last year's first quarter drove the overall increase in net sales and more than offset the sales impact of nine store closures in 2006. In addition, sales of the Company's corporate branded products to third parties have increased by approximately \$2.0 million in the first quarter of 2007 over the same period in fiscal 2006. Total square feet of open stores decreased 1.2% over the first quarter of 2006, as the first fiscal quarter 2007 ended with 2.53 million total square feet as compared to 2.56 million total square feet in the first fiscal quarter of 2006. Comparable store sales increased 0.3% for the year to date period ended March 31, 2007 as compared to an increase of 4.1% in the same period last year. Reduced comparable store sales in the first quarter of 2007 relative to last year is attributable to the continued impact of new competition and the year over year comparison of all stores participating in certain promotional activities.

Gross profit

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 99,166 | \$ 97,060 | 2.2% |
| As a percent of sales for the three months ended: | 32.0% | 32.5% | (0.5)% |

Gross profit consists of sales less cost of goods sold and store occupancy costs. Occupancy costs include rent and utilities. As a percentage of sales, gross profit decreased to 32.0% for the three months ended March 31, 2007 from 32.5% for the same period in fiscal 2006. The decrease in gross margin relative to last year can be attributed to increased occupancy costs related to the new store locations, more aggressive promotional activities, and a mix shift to higher sales in lower margin product categories.

Direct store expenses

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 73,078 | \$ 69,821 | 4.7% |
| As a percent of sales for the three months ended: | 23.6% | 23.4% | 0.2% |

Direct store expenses include payroll, payroll taxes and benefits, marketing and advertising, regional store support services, store supplies and maintenance, and other store-specific costs. As a percentage of sales, direct store expenses increased to 23.6% from 23.4% in the three months ended March 31, 2007 and April 1, 2006, respectively. Direct store expenses as a percent of sales increased as a result of higher inventory service costs and an upgrade in stores information technology systems. Further, in the first quarter of 2007, in order to better support our stores, we have increased the regional presence of management.

Depreciation and amortization expense

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 6,716 | \$ 6,687 | 0.4% |
| As a percent of sales for the three months ended: | 2.2% | 2.2% | 0.0% |

Depreciation and amortization expense for the quarter ended March 31, 2007 remained constant at 2.2% of sales, compared to the same period in the prior year.

Selling, general and administrative expenses

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|--|---------------------------|--------------------------|--------------------------------------|
| | | | |

Edgar Filing: WILD OATS MARKETS INC - Form 10-Q

| | | | |
|---|-----------|-----------|------|
| For the three months ended (<i>in thousands</i>): | \$ 14,022 | \$ 12,978 | 8.0% |
| As a percent of sales for the three months ended: | 4.5% | 4.3% | 0.2% |

Selling, general and administrative (SG&A) expenses include corporate administrative support services and purchasing. SG&A expenses for the quarter ended March 31, 2007 were 4.5% of sales, which is a slight increase over prior year. SG&A expenses in the first quarter were higher as a percentage of sales due to transaction costs related to the pending Merger. These expenses totaled \$3.5 million during the first quarter of 2007. Excluding the transaction costs, SG&A expenses were 3.4% of sales, a decrease of 0.9%, due to improved operating efficiency and expense management.

Table of Contents**Pre-opening expenses**

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 697 | \$ 1,459 | (52.2)% |
| As a percent of sales for the three months ended: | 0.2% | 0.5% | (0.3)% |

Pre-opening expenses include labor, rent, advertising, utilities, training, supplies and certain other costs incurred prior to a store's opening. Pre-opening expenses for the first quarter of fiscal 2007 decreased from \$1.5 million in the first quarter of 2006 to \$697,000 during the same period in fiscal 2007, due to the timing of the opening of new stores, in addition to the costs related to future planned store openings.

The number of stores opened is as follows:

| | THREE MONTHS ENDED | |
|------------|---------------------------|----------------------|
| | March 31, 2007 | April 1, 2006 |
| New stores | 1 | 1 |

In the first quarter of fiscal 2007, we opened a new Wild Oats Marketplace in Naples, Florida.

Restructuring and asset impairment charges, net

Restructuring and asset impairment charges consist of the following components (*in thousands*):

| | THREE MONTHS ENDED | |
|---|---------------------------|----------------------|
| | March 31, 2007 | April 1, 2006 |
| Change in estimate related to lease-related liabilities for sites previously closed | \$ (92) | \$ 66 |
| Lease-related liabilities during the current period | 304 | 1,362 |
| Accretion expense on lease-related liabilities | 462 | 128 |
| Severance for employees terminated during the period | 377 | 114 |
| Asset impairment charges | 406 | |
| Total restructuring and asset impairment charges | \$ 1,457 | \$ 1,670 |

Restructuring and asset impairment charges include lease termination costs, severance for employees notified of termination, accretion expense on reserves for lease-related liabilities that were calculated using the net present value of minimum lease payments (net of sublease income), and non-cash charges for asset impairments. Restructuring and asset impairment charges of \$1.5 million for the first quarter of 2007 decreased from \$1.7 million in the same period ended April 1, 2006 due mainly to a decline in the number of stores closed during the first quarter of 2007, offset by an increase in accretion in the first quarter of 2007 as a result of the closure of eight stores during the fourth quarter of 2006. In addition, both severance and asset impairment charges increased in the first quarter of 2007 over the first quarter of 2006 due to the reorganization of our Home Office and regional staff functions and the write off of the net book value of assets related to sites identified for future store locations that were subsequently determined unsuitable. Refer to *Note 10 Restructuring and Asset Impairment Charges* for more details.

Interest income

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 551 | \$ 589 | (6.5)% |
| As a percent of sales for the three months ended: | 0.2% | 0.2% | 0.0% |

Table of Contents

Interest income was \$551,000 for the three ended March 31, 2007 compared to \$589,000 for the same period in fiscal 2006. The decrease of 6.5% is due to a decline in the average balance of cash invested year over year.

Interest expense

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 1,840 | \$ 1,854 | (0.8)% |
| As a percent of sales for the three months ended: | 0.6% | 0.6% | 0.0% |

Interest expense during the first quarter ended March 31, 2007 remained relatively consistent compared to the same period in 2006.

Income tax expense

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 264 | \$ 205 | 28.8% |
| As a percent of sales for the three months ended: | 0.1% | 0.0% | 0.1% |
| Effective tax rate for the three months ended: | 14.0% | 6.6% | 7.4% |

For the quarter ended March 31, 2007, we recorded \$264,000 of income tax expense, as a result of taxable foreign income during the period. The tax benefit resulting from the loss in previous years on domestic operations has been fully offset by a tax valuation allowance that was established at fiscal 2004 year end. We have determined that any expected federal or state income tax expense for the current quarter and fiscal year will be expected to be fully offset by deferred tax assets that are currently subject to a 100% valuation allowance.

Earnings before interest, taxes, depreciation and amortization, loss on early extinguishment of debt, loss (gain) on asset disposals, net, restructuring and asset impairment charges (income), net, and stock-based compensation expense, as adjusted (EBITDA, as adjusted)

| | March 31, 2007 | April 1, 2006 | % Change 2006 to 2007 |
|---|---------------------------|--------------------------|--------------------------------------|
| For the three months ended (<i>in thousands</i>): | \$ 11,933 | \$ 13,580 | (12.1)% |
| As a percent of sales for the three months ended: | 3.9% | 4.6% | (0.7)% |

We believe that the reconciliation of earnings before interest, taxes, depreciation and amortization (EBITDA) and EBITDA, as adjusted, provides meaningful non generally accepted accounting principles (GAAP) financial measures to help management and investors understand and compare business trends among different reporting periods on a consistent basis, independently of regularly reported non-cash charges and infrequent or unusual events as determined by management. Readers are cautioned not to view EBITDA or EBITDA, as adjusted, as an alternative to GAAP results or as being comparable to results reported or forecasted by other companies, and should refer to the reconciliation of GAAP net income (loss) results to EBITDA and EBITDA, as adjusted, for the three months ending March 31, 2007 and April 1, 2006, respectively. For an explanation and reconciliation of EBITDA, and EBITDA, as adjusted, see *Non GAAP Financial Information*.

Liquidity and Capital Resources

Our primary sources of capital have been cash flow from operations (which includes trade payables), bank indebtedness, and the sale of equity securities. Primary uses of cash have been the financing of new store development, new store openings, relocations, remodels and acquisitions, repurchase of common stock and repayment of debt.

Table of Contents

Net cash generated by operating activities decreased by \$7.3 million to \$5.8 million during the first three months of fiscal 2007, as compared to \$13.2 million during the same period in fiscal 2006. This decline is primarily due to lower net income of \$1.3 million, in addition to a decrease of \$5.7 million in the change of assets and liabilities.

Net cash used in investing activities was \$6.5 million during the first three months of fiscal 2007 as compared to \$12.6 million of cash used in investing activities during the same period in fiscal 2006. The \$6.1 million decline in cash utilized is due to an increase of \$12.3 million in the net sale of short-term investments, offset by a \$6.2 million increase in capital expenditures during the first three months of 2007 compared to the same period in 2006.

Net cash used in financing activities was \$5.2 million during the first three months of 2007 compared to \$3.3 million of cash provided by financing activities during the same period in fiscal 2006. The change in cash flows from financing activities is the result of a decrease of \$3.5 million in proceeds from the issuances of common stock due primarily to option exercises and a \$5.0 million decrease in book overdraft.

EBITDA. EBITDA was \$9.9 million for the three month period ended March 31, 2007, as compared to \$11.0 million for the three months ended April 1, 2006. The decrease in EBITDA is primarily attributable to the decrease in gross margin as well as lower pre-tax income of \$1.2 million. For an explanation and reconciliation of EBITDA, see *Non GAAP Financial Information*.

As of March 31, 2007, we had no off-balance sheet arrangements, unconsolidated subsidiaries, commitments or guarantees, except as disclosed in the notes to the consolidated financial statements. As of March 31, 2007, we have a working capital deficit of \$16.0 million, a decrease of \$14.9 million over the three months ended April 1, 2006.

Capital expenditures. We spent approximately \$12.0 million during the three months ended March 31, 2007 for new store construction, remodels and other capital expenditures. During 2007, we continue to experience higher construction and related costs due to increased construction material and labor costs, and partially due to an increase in the size of our store prototype. Our average capital expenditures to open a leased store, including leasehold improvements and equipment and fixtures, has ranged from approximately \$2.0 million to \$5.0 million historically, excluding inventory costs. We anticipate that the average capital expenditures to open a natural foods supermarket format store will be \$3.0 million to \$4.0 million in the future, on a turnkey lease basis. Under turnkey leases, the landlord constructs the building to our specifications, and installs equipment we purchase. Average capital expenditures for non turnkey leases are expected to be between \$5.0 million and \$7.0 million. Our average capital expenditures to open a farmers market format store are estimated at \$2.5 million to \$3.0 million in the future. Delays in opening new stores may result in increased capital expenditures and pre-opening costs, as well as lower than planned sales for the Company.

Based upon the current level of operations, we believe that cash flows from operations and other sources available such as cash from our available line of credit will be adequate to meet anticipated requirements for working capital, capital expenditures, interest payments and future debenture payments in the foreseeable future. However, there can be no assurance that the business will continue to generate cash flows from operations at current levels or that we will be able to maintain our ability to borrow under the line of credit.

New Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact SFAS No. 159 may have on our financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurement* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. This statement is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently assessing the impact SFAS No. 157 may have on our financial position.

Table of Contents**Critical Accounting Policies and Estimates**

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect reported amounts and related disclosures. We have discussed those estimates that we believe are critical and require the use of complex judgment in their application in our 2006 Form 10-K. Due to the implementation of Financial Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109* (FIN No. 48) in the first quarter of 2007, we identified a new critical accounting policy related to income taxes, which is listed below. There have been no changes in the application of the Company's other critical accounting policies and estimates in 2007.

Income taxes. On December 31, 2006, the first day of the first quarter of fiscal 2007, we adopted FIN No. 48. FIN No. 48 is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes* (SFAS No. 109), which requires management to implement a recognition threshold and measurement attribute for financial statement recognition of a tax position that requires significant emphasis on management estimates and judgment. Under the provisions of this interpretation, the financial statement impact of a particular income tax position must be analyzed from the perspective of whether the taxpayer would be more likely than not to prevail if such position were to be challenged by the relevant tax authority. Furthermore, management is required to estimate the likelihood of various outcomes (ranging from resolution 100% in favor of the taxpayer to 100% in favor of the tax authority) and the resulting range of potential impacts on the financial statements.

Cautionary Statement Regarding Forward-Looking Statements

This Report on Form 10-Q contains forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, which involve known and unknown risks. Such forward-looking statements include statements that are not historical facts, such as to the number of stores we plan to open or relocate in future periods and the anticipated performance of such stores; the impact of competition; the sufficiency of funds to satisfy our cash requirements through the remainder of fiscal 2007; the impact of changes resulting from our merchandising and marketing programs; our ability to benefit from past supply chain modifications; expected pre-opening expenses and capital expenditures; and other statements containing words such as believes, anticipates, estimates, expects, intends and words of similar import or statements of management's opinion. These forward-looking statements and assumptions involve known and unknown risks, uncertainties and other factors that may cause our actual results, market performance or achievements to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Important factors that could cause differences in results of operations include, but are not limited to, risks and uncertainties related to the pending Merger, the timing and execution of new store openings, relocations, remodels and closures; new competitive impacts; changes in product supply or suppliers and supplier performance levels; changes in management information needs; changes in customer needs and expectations; changes in government regulations applicable to our business; changes in economic or business conditions in general or affecting the natural foods industry in particular; cost and stability of fuel and power sources; and competition for and the availability of sites for new stores. We undertake no obligation to update any forward-looking statements in order to reflect events or circumstances that may arise after the date of this Report.

Table of Contents**Non GAAP Financial Information**

The following is a reconciliation of EBITDA and EBITDA, as adjusted, to net income (*in thousands*):

| | THREE MONTHS ENDED | |
|---|---------------------------|---------------|
| | March 31, | |
| | 2007 | April 1, 2006 |
| Net income | \$ 1,624 | \$ 2,885 |
| Interest expense, net of interest income | 1,289 | 1,265 |
| Income tax expense | 264 | 205 |
| Depreciation and amortization | 6,716 | 6,687 |
| EBITDA | 9,893 | 11,042 |
| Loss on asset disposals, net | 19 | 90 |
| Stock-based compensation expense | 564 | 778 |
| Restructuring and asset impairment charges, net | 1,457 | 1,670 |
| EBITDA, as adjusted | \$ 11,933 | \$ 13,580 |
| EBITDA, as a percentage of sales | 3.2% | 3.7% |
| EBITDA, as adjusted, as a percentage of sales | 3.9% | 4.6% |

EBITDA and EBITDA, as adjusted, are measures used by management to measure operating performance. EBITDA is defined as net income plus interest, taxes, depreciation, and amortization. EBITDA, as adjusted, excludes certain non-cash charges and other items that management does not utilize in assessing operating performance or for purposes of corporate and regional level bonuses. The items included in the reconciliation from EBITDA to EBITDA, as adjusted, are either (a) non-cash items (e.g. asset impairments and stock-based compensation expense) or (b) items that management does not consider to be relevant to assessing operating performance (e.g. restructuring, gain/loss on sale of assets, net). Regarding the non-cash items, management believes that investors can better assess operating performance if the measures are presented without such items. In the case of the items that management does not consider relevant to assessing operating performance, management believes that investors can better assess ongoing operating performance if the measures are presented without these items because their financial impact has no continuing relevance to our ongoing business. The above table reconciles net income to EBITDA and EBITDA, as adjusted. Management believes that EBITDA and EBITDA, as adjusted, are useful to investors because securities analysts, lenders and other interested parties frequently utilize them to evaluate our peer companies and us. Neither EBITDA nor EBITDA, as adjusted, are recognized terms under GAAP and do not purport to be an alternative to net income as an indicator of operating performance or any other GAAP measure. Not all companies utilize identical calculations; therefore, the presentation of EBITDA and EBITDA, as adjusted, may not be comparable to other identically titled measures of other companies. In addition, EBITDA and EBITDA, as adjusted, are not intended to be measures of free cash flow for management's discretionary use since they do not consider certain cash requirements, such as interest payments, tax payments and capital expenditures.

Comparable stores sales. We deem sales of new or acquired stores comparable commencing in the thirteenth full month of operations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

In the normal course of business, the Company is exposed to fluctuations in fossil fuel commodity prices, interest rates and the value of foreign currency. Fossil fuels commodity prices directly impact the costs the Company pays for utilities and distribution, and are subject to fluctuation due to availability and other natural causes. The Company attempts to balance retail price increases against lost profits without losing customer loyalty. The Company will employ various financial instruments to manage certain exposures to foreign currency and interest rate risk when considered practical.

The Company is exposed to foreign currency exchange risk. As of the date of this report, the Company owns and operates four natural foods supermarkets and a commissary kitchen in British Columbia, Canada. The commissary supports the four Canadian stores and does not independently generate sales revenue. Sales made from the Canadian stores are made in exchange for Canadian dollars. To the extent that those revenues are repatriated to the United States, the amounts repatriated are subject to the exchange rate fluctuations between the two currencies. The Company does not hedge against this risk because of the small amounts of funds at risk.

Table of Contents

Should we begin drawing on the B of A Facility for additional capital, our exposure to interest rate changes would be primarily related to our variable rate debt issued under the B of A Facility. The total commitment available is \$40.0 million under a revolving line of credit, with a five-year term expiring March 31, 2010. The interest rate on the credit facility is prime or LIBOR plus 1.25%, at our election, and the rates modify depending on the excess borrowings availability over amounts borrowed. Because the interest rate on the facility is variable, based upon the prime rate or LIBOR, the Company's interest expense and net income would be affected by interest rate fluctuations.

Item 4. Controls and Procedures

Disclosure Controls and Procedures. The Company's management, with the participation of the Company's interim Chief Executive Officer and interim Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of March 31, 2007. Based on such evaluation, the Company's interim Chief Executive Officer / interim Chief Financial Officer has concluded that, as of March 31, 2007, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act and are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including the Company's interim Chief Executive Officer / interim Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting. There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II. OTHER INFORMATION**Item 1. Legal Proceedings**

Tim Auchterlonie, individually and on behalf of all others similarly situated and the general public, and Roes 1 to 1000 vs. Wild Oats Markets, Inc. and Does 1 through 100, is a suit brought in August 2004 on behalf of six plaintiffs in the Superior Court, County of Los Angeles, for payment of overtime and damages relating to alleged violations of the California Business and Professions Code by a former store director claiming that he should have been classified as an employee paid on an hourly basis, together with other related claims. We believe that all of the named plaintiffs were correctly classified as exempt employees based upon their job duties. We settled with four of the plaintiffs for an immaterial amount in the aggregate and one plaintiff withdrew his claims. The claims of one plaintiff went to trial, and after a bench trial, the Court found in favor of the remaining plaintiff on the claim for unlawful nonpayment of overtime compensation, and ordered that judgment on damages should enter in the amount of approximately \$43,700, plus attorneys' fees in the amount of approximately \$87,000. We have appealed the judgment.

Four cases related to the Auchterlonie suit have been filed. We believe that we will prevail in each case, but if liability were to be assessed, the aggregate potential liability in all of these related cases could be material. Ana Marie Hoepfner et al. v. Wild Oats Markets, Inc. and Does 1 through 100, Superior Court, County of Los Angeles, is filed by six California plaintiffs arising from claimed misclassification as exempt employees. Jason Puerto, et al. v. Wild Oats Markets, Inc. and Does 1 through 100, is a suit brought by eight plaintiffs in October 2006 in the Superior Court, County of Los Angeles, with substantively similar claims as Hoepfner. A bench trial of each of the Hoepfner and Puerto cases is set to commence on January 28, 2008 before the judge who presided at the Auchterlonie trial. John Montagne, et al., v. Wild Oats Markets, Inc. and Does 1 through 100, is a suit filed in March 2007 in the Superior Court, County of Los Angeles, on behalf of 14 individuals, with substantively similar claims as Hoepfner. Kelvin Massie, Anne Ress-Lemay and Gary Liss, individually and on behalf of all other similarly situated and the California general public v. Wild Oats Markets, Inc. and Does 1 through 100, is a purported class action lawsuit filed in April 2007 in the Superior Court, County of Los Angeles, arising from claimed misclassification of certain exempt employees while such employees were in a training program. The purported class is small and any potential liability immaterial.

Table of Contents

In October 2000, we were named as defendant in 3601 Group Inc. v. Wild Oats Northwest, Inc., Wild Oats, Inc. and Wild Oats Markets, Inc., a suit filed in Superior Court for King County, Washington, by a property owner who claims that Alfalfa s Inc., our predecessor in interest, breached a lease in 1995 related to certain property in Seattle, Washington. After trial in fiscal 2002, a jury awarded \$0 in damages to the plaintiffs, and we were subsequently awarded \$190,000 in attorneys' fees. The judgment was reversed on the plaintiff's appeal and the matter was remanded to the trial court. After a jury trial in August 2006, judgment was entered against us in the amount of \$823,000, inclusive of attorneys' fees, costs and interest. We have posted a bond and filed a notice of appeal.

We also are named as defendant in various actions and proceedings arising in the normal course of business. In all of these cases, we are denying the allegations and are vigorously defending against them and, in some cases, have filed counterclaims. Although the eventual outcome of the various lawsuits cannot be predicted, it is management's opinion that these lawsuits will not result in liabilities that would materially affect our consolidated results of operations, financial position, or cash flows.

Item 1A. Risk Factors

This Item 1A should be read in conjunction with Item 1A. Risk Factors in our Form 10-K for the fiscal year ended December 30, 2006.

Failure to complete the proposed Merger could negatively affect us. Consummation of the Offer and the transactions contemplated in the Merger Agreement are subject to customary closing conditions, including the expiration or termination of any waiting period (and any extension thereof) under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended. The consummation of the Offer is subject to certain conditions, including the tender of a majority of the Shares, and the approval of a majority of the shareholders if less than 90% of the Shares are tendered. There is no assurance that the Federal Trade Commission will approve the Merger, when or if the Merger Agreement and the Merger will be approved by our stockholders, and there is no assurance that the other conditions to the completion of the Merger will be satisfied. In connection with the Merger, we may be impacted by the following risks:

the current market price may reflect a market assumption that the Merger will occur, and a failure to complete the Merger could result in a decline in the market price of our common stock;

the occurrence of any event, change or other circumstances that could give rise to a termination of the Merger Agreement;

the outcome of any legal proceedings that may be instituted against us, members of our Board of Directors and others relating to the Merger including any settlement of such proceedings that may be subject to court approval;

the inability to complete the Merger due to the failure to obtain stockholder approval or the failure to satisfy other conditions to consummation of the Merger;

the failure of the Merger to close for any other reason;

our remedies against Whole Foods Market, Inc., the Purchaser and other affiliates with respect to certain breaches of the Merger Agreement may not be adequate to cover our damages;

the proposed transactions disrupt current business plans and operations;

the proposed Merger may create difficulties in attracting employees;

the number of days during which the Merger transaction is pending may create difficulties in retaining key employees;

the effect of the announcement of the Merger on our business relationships, operating results and business generally; and

the costs, fees, expenses and charges we have and may incur related to the Merger.

Except for the additional risks described above, there have been no other material changes in the risk factors provided in Item 1A. Risk Factors in our Form 10-K for the fiscal year ended December 30, 2006.

Table of Contents

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

The Company previously disclosed an amendment of the compensation arrangement with Samuel Martin, Senior Vice President, under Part II, Item 9(B) Other Information of its Annual Report on Form 10-K for fiscal year ended December 30, 2006. A portion of the compensation amendment related to relocation expenses was reduced to writing and is filed herewith as a material contract due to Mr. Martin's position as senior executive officer of the Company. The disclosure made in the Annual Report on Form 10-K for the fiscal year ended December 30, 2006, is reprinted below.

Effective January 7, 2007, the Company modified the compensation of Samuel Martin, Senior Vice President of Operations to provide for: (1) an increase in annual salary to \$350,000, and (2) subject to certain conditions of sale, the Company's payment of an amount equal to the remaining balance due, if any, on a loan secured by a mortgage on Mr. Martin's prior residence, after application of the net proceeds from sale of the residence to the amount due under the loan, plus an amount approximately equal to the income taxes arising as a result of such payment; and (b) the Company's payment of \$25,000, together with closing costs of sale of Mr. Martin's prior residence, plus an amount approximately equal to the income taxes arising as a result of such payment.

Table of Contents

Item 6. Exhibits

| Exhibit Number | Description |
|----------------|---|
| 2.1** | Agreement and Plan of Merger, dated as of February 21, 2007, by and among Whole Foods Market, Inc., WFMI Merger Co., and Wild Oats Markets, Inc. (1) |
| 4.1** | Amendment No. 3 to Rights Agreement, dated as of February 21, 2007, between Wild Oats Markets, Inc. and Wells Fargo, N.A., as successor in interest to Norwest Bank Minneapolis, N.A., as rights agent. (1) |
| 10.1** | Tender and Support Agreement, dated as of February 21, 2007, by and among Whole Foods Market, Inc., WFMI Merger Co., Wild Oats Markets, Inc., Yucaipa American Alliance Fund I, L.P., and Yucaipa American Alliance (Parallel) Fund I, L.P. (1) |
| 10.2#** | Incentive Bonus Agreement between Wild Oats Markets, Inc. and Gregory Mays, dated February 20, 2007. (2) |
| 10.3#+ | Memorandum dated March 7, 2007, confirming amendment to the relocation expenses portion of the Employment Agreement between Samuel M. Martin and Registrant. |
| 31.1+ | CEO Certification under Section 302 of Sarbanes-Oxley Act of 2002 |
| 31.2+ | CFO Certification under Section 302 of Sarbanes-Oxley Act of 2002 |
| 32.1+ | CEO Certification under Section 906 of Sarbanes-Oxley Act of 2002 |
| 32.2+ | CFO Certification under Section 906 of Sarbanes-Oxley Act of 2002 |
| # | Management Compensation Plan. |
| ** | Previously filed. |
| + | Included herewith. |
| (1) | Incorporated by reference from the Registrant's Form 8-K dated February 22, 2007 (File No. 0-21577). |
| (2) | Incorporated by reference from the Registrant's Form 8-K dated February 26, 2007 (File No. 0-21577). |

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Boulder, County of Boulder, State of Colorado, on the 9th day of May, 2007.

Wild Oats Markets, Inc.
(Registrant)

By: /s/ Gregory Mays
Gregory Mays
Interim Chief Financial Officer
(Principal Financial and Accounting
Officer)