

The Fall of Krispy Kreme Donuts

MBA 6154 - Dr. Plath

By:

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Introduction

Since its IPO in April 2000, Krispy Kreme grew to be a top pick of Wall Street Analysts. The company's growth seemed unstoppable and Krispy Kreme was able to beat Wall Street's expectations. Krispy Kreme continued to outperform until 2004 when some accounting woes were brought to light and analysts starting noticing other anomalies that indicated that things were not quite as good as they seemed. The firm's stock price quickly plummeted from its peak and lost more than 80 percent of its value in only 16 months.

This case study focuses on the use of financial statement analysis, and other factors that an equity analyst would use to gauge the health of a firm, to help identify symptoms that demonstrate things where not as good as they seemed at Krispy Kreme. The report starts by introducing Krispy Kreme, their history, structure and strategy. We will then discuss Krispy Kreme's financials and other tell tales that were available to predict the demise of the firm. To wrap up the report we will conclude by summarizing all the signs that demonstrated things were amiss and answer the question: "Can financial statement analysis predict the future?"

Krispy Kreme History

Krispy Kreme began as a small business in Winston Salem, North Carolina in 1937 shortly after the company's founder, Vernon Rudolph, purchased a doughnut recipe from a French chef from New Orleans. Krispy

Kreme was initially a doughnut wholesaler that sold its products directly to supermarkets. Krispy Kreme doughnuts were such a hit with consumers that Rudolph decided to make them available at the factory, an idea that led to what many people find so appealing about Krispy Kreme, the factory store concept. Rudolph franchised the business which helped Krispy Kreme to spread into 12 states with 29 shops by the late 1950's.

Krispy Kreme was sold to Beatrice Foods in 1973 after Rudolph's death. Beatrice added more products to their Krispy Kreme menu, such as soups and sandwiches and at the same time enacted cost-cutting measures by changing store design and using cheaper ingredients in the doughnuts. The introduction of new products and lower quality doughnuts was not a hit with customers. The vision Beatrice had for Krispy Kreme was failing and the decision was made to sell franchise.

In 1982 a group of investors led by one of the original Krispy Kreme franchisees, Joseph McAleer, completed a leveraged buyout of Krispy Kreme from Beatrice and quickly began to return it to its roots, mainly by reverting to the original doughnut recipe and signage. Six years later the company was free of debt and beginning to expand. In the spring of 2000 Krispy Kreme, amidst much fanfare and market excitement, went public with a high profile IPO.

The Krispy Kreme Model

The heart of the Krispy Kreme concept is the factory store, or “Doughnut Theater” experience, where customers can see the doughnuts being made and consume one just seconds after it comes off the conveyor belt. The “Hot Doughnuts Now” sign, when illuminated, alerts passersby to the fact that hot doughnuts are available. The average factory store can produce as many as 10,000 doughnuts in a day, most of which are sold off-premises to local convenient stores and grocery stores. Approximately 27 percent of sales revenue are attributed to on-premises sales and 40 percent are attributed to off-premises sales. Figure 1 gives a graphical representation of Krispy Kreme's revenue streams.

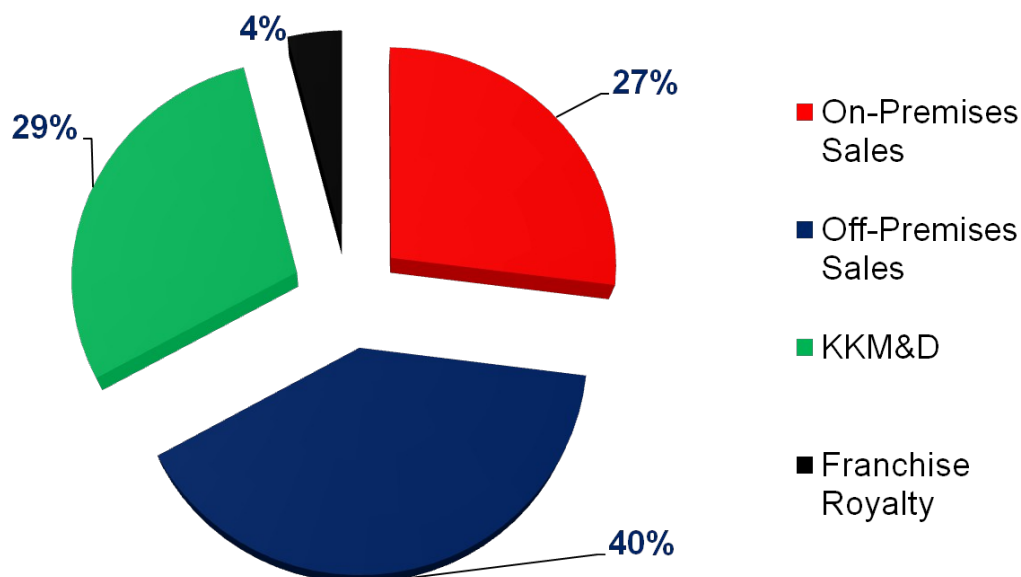


Figure 1

Another large revenue source is the KKM&D division which manufactures and distributes the raw ingredients, doughnut making

machinery, and coffee. All stores, both company owned and franchised owned, must purchase these products from KKM&D. This allows Krispy Kreme to maintain tight control on quality. The KKM&D division accounts for approximately 27 percent of total Krispy Kreme's revenue.

Krispy Kreme is very dependent on franchisees for expansion into new markets. Franchisees that were in business before the IPO are considered as Krispy Kreme associates while new franchisees are considered Area Developers. The associates were able to carry on with business as usual but the Area Developers are responsible for helping to grow the business. Each Area Developers incur a one-time franchise fee of up to \$50,000 then pay up to 6% of sales to Krispy Kreme as a royalty and 1% of annual sales as an advertising fee. The franchise royalties account for approximately 4% of Krispy Kreme's revenue.

Krispy Kreme - By The Numbers: Financial Statement Analysis

Krispy Kreme's investors enjoyed a quick return on their investment after the IPO. By the end of 2000 the stock price had doubled, then shot to a high of 4.5x the IPO price by mid-2001. Krispy Kreme was one of the new glamour stocks on Wall Street, but from the standpoint of an educated investor was it healthy enough to support the success of its stock? An analysis of the Krispy Kreme financials should give some insight into the health of the company.

Krispy Kreme's revenue increased every year between 2000 and 2004, from \$220m to over \$665m. Along with growing revenues, the operating and net profit margins also increased every year. The operating margin increased from just under 4% in 2000 to over 15% by the end of 2004 and the net profit margin increased from just under 3% to over 8% during the same time period. The ROA and ROE though the time period were relatively steady at an average of 8.28% and 12.62% respectively. Krispy Kreme's liquidity remained relatively constant from 2000 to 2002, but quickly increasing. By 2004 Krispy Kreme had quick and current ratios of 2.72x and 3.25x respectively and an interest coverage ratio of 23x. From these numbers it did appear that Krispy Kreme was able to maintain a very liquid position and grow rapidly without the use of much debt.

As with any ratio analysis, the ratios themselves cannot give the insight needed to fully evaluate the health of the company. To properly evaluate the ratios of a particular company the ratios must be compared to those of its peers. In this case Krispy Kreme's metrics are compared to others in the quick service restaurant sector. This comparison shows a few interesting anomalies. Both the quick ratio and current ratio are double those of the other companies'. Furthermore, the Krispy Kreme leverage ratios are out of line with those of its peers; its long term debt to equity is 11.26% compared to an average of 53.1% of its peer's. This fact supports what was seen previously, that Krispy Kreme was growing without taking on much debt. The interest coverage ratio was also much higher 23.15%

compared to 8.25% which also indicates that they were not highly leveraged. While Krispy Kreme's ratios were not in line with the peer averages, they were able to maintain an ROA and ROE that was on par with the competition.

The case provides a comparison of Krispy Kreme's 2003 balance sheet to that of the limited service restaurant average. It is immediately noticed that Krispy Kreme has a trade receivables on the order of 10x that of the industry average which appears to be the receivables from the sale of raw material and equipment to the franchisees through KKM&D. Also, the Krispy Kreme intangibles are over 2x the industry average. On the liability side Krispy Kreme has very little short term debt compared to the competitors, 7x less long term debt which indicates a low level of financial leveraging. Upon further review of the Krispy Kreme balance sheets between 2000 and 2004 and comparing year end snapshots there appears to be a trend of franchise "buy backs". The intangible category "reacquired franchise rights" on the asset side of the balance sheet begins to increase during the 2002 fiscal year and grows quickly, especially during the 2004 fiscal year. At the same time, there was no corresponding change in amortization on the income statement. From the analysis of the financials it appears that the very high trade receivables, high liquidity and interest coverage ratio, along with low financial leverage indicate that Krispy Kreme may have been using the franchisees to bankroll the growth of the company.

Krispy Kreme's Franchise Strategy

Many of the ratios and metrics from the financial data analysis points to the fact that Krispy Kreme was doing something different in regards to how it handled franchise relative to other comparable franchise companies. Krispy Kreme's franchise strategy focuses around selling equipment and supplies, including ingredients to their franchises at high margins. This is a stark contrast to the more standard franchising strategy where firms would build the business around franchise royalty payments and receive a percentage of the sales. This more standard strategy clearly aligns the interests of the corporation with those of the franchises. Krispy Kreme's model does have some advantages as they could push all the financing costs of growth onto the franchise owners and off the books of the firm. This is evident in Krispy Kreme's debt ratio's that are far lower than comparable firms and helps explain how they were able to grow so fast. This method also insures that all stores are similar and offers a way to control the quality of its products across all its stores. The disadvantage of this type of model is that it does not tie the interests of the corporation to those of the franchise creating "goal conflict" between the two parties. This propensity was obvious in many moves that Krispy made during its rapid growth during the years of 2000- 2004. Under the pressure to grow quickly, Krispy Kreme took full advantage of its structure and focused heavily at growing profits at the parent-company level while sacrificing performance at the franchise level.



Figure 2

Figure 2 illustrates how Krispy Kreme focused its growth on expanding its number of stores, receiving income from the high margin equipment and supplies, while sacrificing same store sales. The initial equipment package for a store would sell for \$770,000 with a margin on the order of 20 percent. This strategy eventually ended up saturating the market which led to the need to re-purchase struggling stores that couldn't make their payments on the equipment they purchased.

Krispy Kreme took this a step further and took further advantage of this structure. In times where Krispy Kreme was in danger of missing their numbers, they would force franchises to purchase new equipment they really didn't need. Krispy Kreme booked an immediate profit from these sales, but didn't require the franchise to pay for the equipment until it was installed and put to use which would sometimes be months down the road. There were also some examples where the corporation would force the sales of ingredients near the end of quarters and would then allow the franchise to sell it back to them early in the following quarter.

Accounting for Reacquisition of Franchises

Another problem that Krispy Kreme faced was how it handled reacquisition of franchises. In the years leading up to Krispy Kreme's fall, they reacquired several franchises in various locations and used questionable accounting practices to do so. Typically when a company reacquires a franchise they will amortize those costs over time. When Krispy Kreme reacquired several franchises it treated more than 85% of the purchase as "reacquired franchise rights", an intangible, which it did not have to amortize. Accounting for the reacquisition in this manner offered several advantages that boosted the bottom line. First, the acquisition of the franchises created an immediate boost to the income statement as the sales from these stores went straight to income. Secondly, not having to amortize 85% of the purchase meant that Krispy Kreme was not required to charge a portion of the purchase as an amortization expense against the income it received from the stores essentially "super charging" its profits. Thirdly, by accounting for the

purchases in this manor, Krispy Kreme was able to carry the cost of "reacquiring franchise rights" as an intangible that remains on the asset side of the balance sheet, boosting the firms assets.

Figure 3 below is a simple example that illustrates the benefits of this style of accounting. In this case the Krispy Kreme accounting method only amortizes 15% of the purchase price while the more accepted approach amortizes 100% of the store purchase price. The result is an increase in profits of \$56,667 which boosts the profit margin of the store from 13% to 19% demonstrating how this type of accounting can "super charge" the profits.

Assume store purchase price 2,000,000

	KK accounting	Standard Accounting
Sales	\$ 1,000,000	\$ 1,000,000
Operating Expenses	\$ (800,000)	\$ (800,000)
Amortization Expense	\$ (10,000)	\$ (66,667)
Profit	\$ 190,000	\$ 133,333
Profit Margin	19%	13%

Assume 30 year amortizing period = $2,000,000/30$

Assume 30 year amortizing period and only 15% of purchased amortized = $(2,000,000 * 0.15)/30$

Figure 3

According to analysts, this accounting is definitely not conservative and stretches accounting rules to the limit (Brooks 2004).

Along with amortization discrepancies Krispy Kreme also mishandled two other facets of reacquiring franchises. Often times they would purchase the franchises for inflated prices so that the franchise owner could use this additional money to pay back debt to Krispy Kreme. This payment could then be booked as an immediate profit on Krispy Kreme's books. The final questionable practice in regards to Krispy Kreme's reacquisition of franchises deals with compensation of franchise owners and the expense of closing stores. In the case of Krispy Kreme reacquiring seven stores in Michigan, Krispy Kreme booked the salary expense of keeping the owner on as a consultant and the cost of closing the store as a intangible cost, part of the "reacquired franchise rights". Handling these charges in this manor allowed Krispy Kreme to boost its assets and decrease expenses.

Signs of demise from Management structure and behavior

Along with the signs that showed that things were amiss on Krispy Kreme's financials, several factors existed within the firm's management

structure. Behavior also showed cause for concern. There were many signs of weak governance at Krispy Kreme that led to a lack of internal controls. The board for one was mainly constructed of board members who were left over from the days in which Krispy Kreme was a privately held company and many of those members owned Krispy Kreme franchises. Secondly the CEO Scott Livengood's total compensation was more than 20 percent higher than the median of companies of similar-size pointed to signs of weak governance. Scott was also awarded a 6-month consultant role upon his retirement where he received a salary of \$275,000 plus benefits.

The compensation of the management team at Krispy Kreme was very heavily weighted on the team meeting EPS guidance. In fact around 2003 the incentives plan for senior executives was modified such that no bonuses to officers would be paid unless the company was able to exceed EPS guidance each quarter by one penny. Coincidentally it has been reported that Krispy Kreme has managed to exceed the consensus EPS quarterly guidance by exactly \$0.01 in seven of the eight quarters leading up to the second quarter of fiscal 2004, along with beating guidance by at least \$0.01 in all thirteen quarters since going public. Table 1 illustrates this point.

Quarter	Consensus		
	EPS Est.	Actual EPS	Difference
4/30/2000	\$ 0.06	\$ 0.07	\$ 0.01
7/31/2000	\$ 0.05	\$ 0.06	\$ 0.02
10/31/2000	\$ 0.06	\$ 0.07	\$ 0.01
1/31/2001	\$ 0.07	\$ 0.08	\$ 0.01
4/30/2001	\$ 0.09	\$ 0.10	\$ 0.02
7/31/2001	\$ 0.09	\$ 0.10	\$ 0.01
10/31/2001	\$ 0.10	\$ 0.11	\$ 0.01
1/31/2002	\$ 0.13	\$ 0.14	\$ 0.01
4/30/2002	\$ 0.14	\$ 0.15	\$ 0.01
7/31/2002	\$ 0.14	\$ 0.15	\$ 0.01
10/31/2002	\$ 0.16	\$ 0.17	\$ 0.01
1/31/2003	\$ 0.18	\$ 0.19	\$ 0.01
4/30/2003	\$ 0.20	\$ 0.21	\$ 0.01
7/31/2003	\$ 0.20	\$ 0.21	\$ 0.01

Table 1

Monitoring inside trading was also a sign that things were not as good as they seems at Krispy Kreme. In total, insiders have sold \$267 million in stock since the IPO and Livengood sold 235,500 shares in August 2003. A week after the all-time high a few months after saying he wouldn't sell more stock for at least a year (the exact order was a limit order for \$40/share generating over \$9.4 million). Another point that should have been suspicious was the turnover of the CFO position that the firm experienced during 2000-2004. A total of four CFOs moved through the company at that time that should be us that something was amiss at the corporation. Most likely the CFO wasn't coming up with numbers that the rest of management didn't want to hear.

Krispy Kreme - Where are they now?

In the years since 2004 Krispy Kreme has struggled and the stock price has never recovered. There was a glimmer of hope through 2006 and the stock showed steady increase in price but then it took a turn for the worse in 2007. Figure 4 shows the Krispy Kreme compared to the S&P 500 index. As of this writing the stock was trading at \$3.01/share and experienced a 52wk low of \$1.01/share which is a far cry from its high of nearly \$50 in August of 2003. The annual net profit over the past 3 years has been negative and although there has been an improvement in operating profit as of FY ending Feb. 2009 Krispy Kreme still shows a net loss. As of the second quarter of 2009 the outlook was not much better as they were still operating with a net loss.

Things have also gotten worse for the Krispy Kreme leadership who were in command during the time of the case. In March of 2009 the SEC charged Scott Livengood, John Tate, and Randy Casstevens in a complaint that alleged the three men intentionally overstated profit in order to meet certain EPS targets, which their bonuses were depended upon. None of the men named in the complaint remain employed by Krispy Kreme.



Figure 4

Conclusion

As a publicly held company Krispy Kreme was able to consistently exceed the expectations of analysts and investors until its collapse in 2004. From the beginning of their journey as a publicly traded company Krispy Kreme's financial statements exhibited some clear differences compared to those of its peers. As the firm continued to grow even more suspicious behavior was identifiable in Krispy Kreme's financials. By the time Krispy Kreme announced its earnings in May 2004 many clues existed that things were not as good as they seemed. Examining same store sales growth vs. store opening identified that Krispy Kreme was clearly saturating the market. The high liquidity, high trade receivables, and low financial leverage brought

to light the fact that the debt was pushed onto the franchisees and that their franchise strategy created a conflict of interest between the goals of the corporate team and the franchisees. The growing intangible "reacquired franchise rights" and the fact that other franchises used much more conservative accounting for these types of transactions also threw up a red flag.

In addition to the financial statement clues, other behaviors by management also pointed to issues with their company. The management compensation structure including a high CEO compensation package along with a high CFO turnover, the executive bonus structure, and the fact that they suspiciously beat Wall Street's expectations for EPS by one penny pointed to issues at Krispy Kreme. Combining these with the fact that many of board members were left over from the days when Krispy Kreme was a private firm and that many owned franchises point to the fact that there was little internal control. If an insightful analyst was able to identify all of these facts early enough in time they would have been able to inform their customers of disaster at hand and could have saved their customers lots of money.

To answer the question can financial statement analysis predict the future, the answer is no, but it can raise some flags that something is amiss. The use of financial statement analysis and ratio analysis is a tool that can be use to spot symptoms of problems within the company. When interesting

time trends in key accounting metrics are identified or key metrics differ considerably from other firms it is a sign that the company should be investigated further to get to the root cause of the anomalies. A good example from this case is that the low debt ratios of Krispy Kreme leads you to the discovery that the company relied on franchises to finance the companies rapid growth. From this finding a savvy analyst could start to see the problem with their business model.

Another import note to make is that when foul play in accounting is spotted and poor internal control is identified it's a good practice to stay away from the firm. In the majority of situations when one problem is spotted in a companies financials it often leads to others. Very seldom does a firm turn around quickly when accounting tinkering is identified, so the best practice is to cut your losses and get out as soon as any problems are identified in a company's finances.

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