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Staff Reporters of THE WALL STREET JOURNAL

September 3, 2004; Page A1

When a Krispy Kreme shop opened in Rochester, N.Y., in late 2000, more than 100 people lined up in a snowstorm before 5 a.m. to get one of the first hot, gooey doughnuts off the conveyer belt. Within about an hour, the drive-through lane was choked with 75 cars. Three TV stations and a radio station broadcast live from the scene. Anchors gobbled doughnuts on the air.

The excitement was genuine, but hardly spontaneous. Each local media outlet had gotten an early-morning delivery of 10 dozen free doughnuts from Krispy Kreme. Traffic reporters mentioned tie-ups near the store after a public-relations firm told them about it.

[Krispy Kreme Doughnuts](#) Inc. has used a blend of wily, low-cost marketing and finger-licking irresistibility to grow from a sleepy regional delicacy to a cultural phenomenon. It was dubbed the "hottest brand in America" by Fortune magazine last year as its stock hit nine times the 2000 initial-public-offering price.

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COMPANIESDow Jones, [Reuters](#)[Krispy Kreme Doughnuts Inc. \(KKD\)](#)

PRICE	12.96
CHANGE	0.12
U.S. dollars	9/2



Scott Livengood

But reality has begun to overtake the hype. Revenue growth slowed sharply in the past two quarters. Profit plunged 56% in the quarter ended Aug. 1, the company said last week. Sales at shops open at least 18 months, which used to post double-digit gains, will be flat to slightly down for the rest of the year, it also said last week.

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The biggest problem for Krispy Kreme may be that the company grew too quickly and diluted its cult status by selling its doughnuts in too many outlets while trying to impress Wall Street. The number of Krispy Kreme shops has nearly tripled since early 2000, with 427 stores in 45 states and four foreign countries. Some 20,000 supermarkets, convenience stores, truck stops and other outside locations also sell the company's doughnuts.

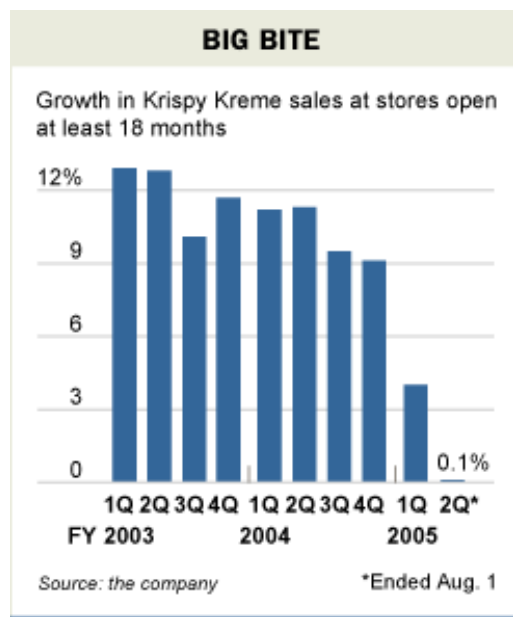
"Where I get my gas tank filled, you can pick up individual Krispy Kreme doughnuts," says Gary Rhodes, a spokesman for Kroger Co. The Cincinnati company recently removed Krispy Kremes from self-serve display cases at 120 supermarkets in Ohio and North Carolina after sales declined. At those stores Kroger now sells its own brand, which it says are larger and cost customers 15 cents less. Kroger reports a "significant" rise in single-doughnut sales in Raleigh, N.C., since the switch.

Another issue is that Krispy Kreme has relied for a significant chunk of profits on high profit-margin equipment that it requires franchisees buy for each new store. Its profits have also been tied to growth in the number of franchised stores, because of the upfront fee each must pay. But there will be fewer store openings. Last week the company said it was cutting back sharply on the number of new stores.

Meanwhile, Krispy Kreme's cash on hand is down to \$19.3 million, less than a third of what the company raised in its IPO in early 2000. The company is using some proceeds from a recent sale of unspecified assets to help fund operations, it confirms. Debt has climbed to \$117.7 million from \$4.6 million in early 2002.

Krispy Kreme's stock trades at barely over a quarter of the peak it reached just over a year ago, closing yesterday at \$12.96 in 4 p.m. trading on the New York Stock Exchange. But earlier, insiders did a lot of selling. They realized nearly \$400 million from sales of Krispy Kreme stock and "forward hedging contracts" in which they agree to transfer shares in the future.

Five weeks ago, the company said the Securities and Exchange Commission had begun an informal inquiry focused on a profit warning Krispy Kreme gave in May and on how the company accounts for repurchases of franchises. The SEC's precise interest isn't known, and the agency won't comment. Among possible issues: Krispy Kreme has spent \$100.5 million to repurchase two franchises owned by corporate insiders. And it accounts for franchise repurchases in a way that largely avoids the need to deduct their value gradually from future earnings.



Krispy Kreme declined to comment for this article. But in the past, it has said its strategy is sound and so is its accounting. It has also said it is cooperating with the informal SEC inquiry.

Even at its slower pace of growth, Krispy Kreme expects to open 75 new stores in the fiscal year ending next Jan. 30. "We have faced tougher situations and come out stronger than before," said Scott Livengood, the chairman, CEO and president, last week when earnings were released. "I personally have never been more engaged and energized by Krispy Kreme's opportunities."

The 52-year-old Mr. Livengood is a true Krispy Kreme devotee. An employee for 27 years and CEO for six, he has said he chose a plate of Krispy Kremes instead of cake for his 16th-birthday party.

Though Krispy Kreme has blamed causes ranging from low-carb diets to high gas prices for its slump, Mr. Livengood conceded that the company has paid too little attention to day-to-day store management. Among his plans: a new sugar-free doughnut for carb counters, a chocolate glazed one for sugar fanatics, and smaller, more comfortable stores. The company may soon launch its first TV ads.

In Winston-Salem, N.C., where the company is based, Vernon Rudolph launched Krispy Kreme in 1937. Company lore says he used a secret recipe an uncle got from a French chef. Mr. Rudolph first sold doughnuts to grocers, but when locals asked to buy them directly, he cut a hole in his bakery wall, creating the first Krispy Kreme shop. There were fewer than 100 when he died in 1973.

Heirs sold the business to Beatrice Foods Co., which changed the recipe. About 20 franchisees, horrified, joined up to buy Krispy Kreme in 1982. The company took on new franchisees, and the first shop outside the Southeast opened in 1995 in Indianapolis.

Coming to Manhattan in 1996 gave Krispy Kreme cult status. Marketers positioned the doughnuts as a taste of nostalgia and promoted "doughnut theater." Customers watched as, behind glass, the equipment used a burst of air to extrude the dough, which was then cooked and doused in a waterfall of white glaze.

Soon lines were forming. Transplanted Southern humorist Roy Blount Jr. gushed in the New York Times that "when Krispy Kremes are hot, they are to other doughnuts what angels are to people." When Krispy Kreme went public in April 2000, its stock soared 76% on the first day, and more than quadrupled in the first five months.

But less than a year after the IPO, a Krispy Kreme executive, director and about 40 franchisees, their relatives and others with ties to the company sold more than \$150 million worth of stock in a follow-on stock offering. In all, Krispy Kreme insiders have sold \$267 million in stock since the IPO, and reaped \$125 million more from hedging transactions in which they received cash immediately in return for pledging to transfer shares at predetermined times in the future.

Mr. Livengood, the CEO, has disposed of about 853,000 shares for \$32 million, according to Thomson Financial. He still had 1.4 million (including 1.3 million in the form of options) as of late March. Mr. Livengood sold 235,500 shares in August 2003, a week after the all-time high, despite having said nine months earlier he wouldn't sell more stock "for at least a year." He said the sale was "totally consistent" with the "spirit" of his pledge.



Like many chains, this one owes much of its fast growth to franchising. Few Krispy Kreme investors understand that this model means that the company front-loads profits, says Donn Vickrey, an accountant and co-founder of Camelback Research Alliance in Scottsdale, Ariz. That's because to set up each store, a franchisee has to pay a franchise fee and also buy high-margin equipment from Krispy Kreme.

Unlike many chains, Krispy Kreme began buying back some of its franchises. Executives have said that the parent company is better equipped than franchisees to operate stores as markets mature, and that it buys only when the price is right. In two cases, though, the sellers were people close to the company.

In a deal 15 months ago, Krispy Kreme paid \$67.5 million for franchise rights for Dallas and Shreveport, La., from Joseph A. McAleer Jr., a former Krispy Kreme chief executive and

director, and Steven D. Smith, an emeritus director.

The price raised eyebrows because the franchisee had just five stores and one "commissary," or wholesale facility. A Krispy Kreme outlet typically costs about \$2 million to build. The company had to take on debt to cover the cost. Krispy Kreme executives have said the price was reasonable as a multiple of cash flow, and also because of the huge untapped potential in Dallas in particular. They also say the price matched what an outside bidder would pay.

Each time Krispy Kreme reacquired a franchise, it assured investors the deal would immediately add to income. One reason was the accounting. Krispy Kreme typically assigned more than 85% of the purchase price to an intangible asset category called "reacquired franchise rights." This was a category it didn't have to amortize -- write off over time. That meant Krispy Kreme was acquiring profit-producing stores while not fully reflecting the costs on its books, giving an automatic boost to earnings. If it had amortized the full cost, this would come off its bottom line.

Mr. Vickrey, the accounting analyst, says his firm surveyed 18 other franchise operators. Of the four that recorded reacquired franchise rights, all amortized those costs over time. Krispy Kreme's method, Mr. Vickrey says, "is definitely not conservative" and is stretching accounting rules "to the limit and maybe beyond."

Last October, Krispy Kreme repurchased its Michigan franchisee, called Dough-Re-Mi Ltd., for \$32.1 million. Part of the price went to pay past-due interest Dough-Re-Mi owed to Krispy Kreme. Krispy Kreme booked this sum as immediate profit. Some outside experts have said the company appeared to be taking money from one pocket, putting it into another and calling it income. Krispy Kreme officials have steadfastly defended their accounting and handling of franchise buybacks.

By the time of the Dough-Re-Mi buyback, Krispy Kreme shares had peaked and there were early signs that the fad was cooling, or reaching saturation in some markets. Sales at stores open at least 18 months, called "same store" sales, continued to post double-digit yearly rises. But overall average sales per store were falling. Mathematically, that could happen only if newer stores were performing poorly.

The New York franchise, which is partly company-owned, has lost money in the last three fiscal years. The biggest franchise, in Southern California, last year had a sharp fall in same-store sales. It put itself up for sale last year but remains unsold.

But at a 12-store franchise mostly in the Northwest, called KremeWorks LLC, sales have exceeded expectations and the stores are very profitable, says franchise CEO Gerard Centioli, who says he supports

Krispy Kreme management. Still, the franchise told its investors in April they weren't likely to begin receiving projected returns on their investments because store-opening costs had soared. It had designed a high-cost store format with terrazzo floors, but it's now developing a less costly one, Mr. Centioli says.

Some of Krispy Kreme's profit growth in the last couple of years has come from bigger margins on sales to its franchisees. The company imposed a price increase for dough mix early last year, which it said was for raw-material costs. Some franchisees said they felt squeezed to help the parent's bottom line. Operating margins on Krispy Kreme's sales of dough and equipment to franchises grew to 23.9% in the first fiscal quarter, the company said, compared with 17.4% a year earlier.

Krispy Kreme also boosted revenue by introducing new equipment that it classified as "standard"-- meaning franchisees had to buy it for all new stores. A computerized extruder meant to cut the amount of dough used cost franchisees \$70,000 for each store. "You'd look at it and say: 'How in the world could it cost \$70,000?'" said one franchisee. Several franchisees said the required package of equipment to open a full-sized new Krispy Kreme store had crept up to \$770,000 by last year from \$500,000 in the late 1990s, though they said the machinery was also larger and more durable.

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