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EXECUTIVE SUMMARY

Krispy Kreme Doughnuts, Inc. began in 1937 as a doughnut shop that sold its products out of a store window in North Carolina. Today, the company operates 395 stores worldwide, including 235 in the United States and the rest in 10 foreign countries. The company belongs to the restaurant industry and competes in the fast food and fast-casual sectors, which are subject to high competition. Companies such as Dunkin’ Donuts, Tim Hortons, and Starbucks compete with Krispy Kreme for market share on the basis of pricing, product differentiation, and expansion through franchises.

Krispy Kreme went public in 2000, with one of the most successful Initial Public Offerings of the year. Trading under the ticker symbol KKD, the company stock rose from $21 to its peak of $49.37 in 2003 and then began a tragic slide that lasted through most of 2005. As famous as its successful opening was, Krispy Kreme is more notorious for its overexpansion in the face of declining demand over those two years. The company expanded aggressively across the country as low-carbohydrate diets became popular, and the company’s trademark doughnuts were labeled as health risks. In the years since, the company has closed many of its domestic stores and focused its expansion strategy on overseas locations.

In this report, Gotham Global separates Krispy Kreme’s strategic issues into three parts: Sales, Menu and Brand. The first part targets the company’s expansion policy, both domestic and abroad. Stores are both franchised and company-owned, and can be classified as either a factory store or a satellite store. Gotham Global recommends that Krispy Kreme maintain its franchise-to-company-owned ratio of 67% as it expands abroad, and to consider developing markets like metropolitan China and India. Gotham Global also suggests that underperforming domestic satellite stores be closed and that the satellite store model be discontinued. The company also sells its products to off-site retailers for resale, and 32% of annual sales come from these locations. Krispy Kreme’s products are often poorly represented off-site, and Gotham Global recommends a redesign of the in-store kiosk to incorporate heating technology, so that the trademark Hot Doughnuts Now® experience can be had.
The second part, Menu, evaluates the company’s products on two levels: health and variety. With regards to health, Krispy Kreme should not make sacrifices to its entire menu in order to satisfy certain health guidelines. The majority of its customers come for a doughnut, which is widely regarded as unhealthy in the first place. However, as cities across the United States ban the use of trans fats in restaurants, Gotham Global urges Krispy Kreme to develop new recipes that contain no trans fats. Our company also encourages the company to expand their product offerings without cluttering the menu. Breakfast items, such as bagels, egg sandwiches, and juices are proven successes in the fast food and fast-casual sectors: fast food hamburger chain Jack in the Box saw sales double after they began selling breakfast items 24 hours a day. Their addition to the menu would increase sales (bagels especially, as they are regarded as healthier alternatives). Finally, “premium” coffee sales must be increased to raise profit margins, and up-selling a doughnut to a “combo” that includes coffee can accomplish this.

Finally, Gotham Global recognizes that Krispy Kreme has a strong brand that connotes quality. Traditionally, the company has used grassroots marketing as its main form of advertising, but Gotham Global suggests a new advertising campaign designed to increase store visits. Targeted billboards in high-traffic areas and seasonal promotions for limited-edition products are recommended along the company’s existing strategy of community involvement to promote word-of-mouth. A standard rule on handing out free doughnuts straight out of the machine should be put in place so as to minimize profit losses. Gotham Global suggests coordinating an annual or biannual “Doughnut Day” in which customers receive a free doughnut. This can be tied to community events to strengthen the brand’s reputation.
**Company Background**

In 1937, Vernon Rudolph began selling homemade doughnuts to local groceries for resale in Winston-Salem, North Carolina. His doughnuts were based on a recipe his uncle had obtained from Louisiana, and they were unique in their inclusion of yeast. The yeast allowed the dough to rise, which gave the doughnuts a light, airy composition, different from the usual cake doughnuts. This secret ingredient proved successful and it didn’t take much time before Rudolph started selling doughnuts straight to customers from a hole he cut in his wall. The success of his doughnut operation forced Rudolph to expand, and by the 1950s, it had grown to a small chain of family-owned doughnut shops. Rudolph was committed to quality and consistency. Each doughnut shop used the same original recipe, but the doughnuts were still handmade at each location. To enforce a standard of quality, the company opened a plant dedicated to producing and distributing dry doughnut mix to each shop. The company also engineered and manufactured doughnut-making machinery for regulating doughnut production. This automation allowed the company to enjoy steady growth throughout the 1950s and 1960s in the Southeast. The doughnut machinery, ingredient mix, and corporate image were refined during this period, and are nearly the same today as they were back then.

Rudolph passed away in 1973, and company growth slowed for a while, until the Beatrice Foods Company acquired Krispy Kreme in 1976. Although some reorganization took place, the company’s headquarters remained in Winston-Salem. The Beatrice Foods Company was a major presence in the food market and a household name until the leveraged buyout raids of the 1980s. The bulk of their brands and assets became ConAgra Foods, which is still today one of the country’s largest packaged foods companies. A group of franchisees bought Krispy Kreme back from Beatrice Foods in 1982, and refocused the company’s energies on the hot doughnut experience. The Doughnut Theatre concept, where customers could watch freshly baked doughnuts roll off the assembly line from behind a glass window, was popularized during this time. The company began to expand again, and it ventured out of the Southeast. In 1996, a store was opened in New York City, and in 1999, a store was opened in California. Krispy Kreme was a national brand at this point, and took the opportunity to go public.
The Initial Public Offering took place on April 5, 2000. The company was traded on the NASDAQ under the ticker symbol KREM. 3 million shares were sold at $21 each, which then increased to $36 the next day. This solidified KREM as having one of the best-performing initial public offerings of the year. A little over a year later, on May 17, 2001, the company switched to trading on the New York Stock Exchange under the symbol KKD. The stock hit its peak of $49.37 in 2003 and then began a slide that lasted through most of 2005. Krispy Kreme’s problematic downfall has been a popular business story for the past couple years. KremeKo, the company responsible for overseeing Krispy Kreme franchises in Canada, filed for bankruptcy in 2005 (whereas the first Canadian store was opened in 2001). This prompted the closing of many other Canadian stores, though some remain open today. A similar situation occurred in New York, when Dynamic Doughnuts, responsible for managing Krispy Kreme franchises outside of New York City, closed most of its stores.

The company has also experienced major closings in the Southwest: the Rigel Corporation, responsible for all franchises in Arizona and New Mexico, filed for bankruptcy in 2006 and closed all its stores. The company terminated its contracts with Great Circle Family Foods, a prominent franchisee in Southern California, in early 2006 on allegations of missed payments. Great Circle countered with a lawsuit later that year, and the settlement resulted in the reinstatement of their contracts. Lawsuits were filed against the company for misreporting profits and “channel stuffing” (delivering more doughnuts to suppliers than ordered at the end of a reporting period, while still booking the increased revenue, then taking the unsold doughnuts back at the beginning of the next reporting period).

Krispy Kreme now produces about 5.5 million doughnuts a day and over 2 billion a year. The company operates 235 United States stores that span 43 states, and offers their doughnuts in mega-chains like Wal-Mart, Target, and major gas stations. They have franchises in 10 foreign countries including Australia, Japan, South Korea, and the United Kingdom. Their menu includes their famous original glazed doughnut, specialty doughnuts, coffee and espresso-based drinks, and frozen beverages.
COMPETITIVE ANALYSIS

INTERNAL RIVALRY

Krispy Kreme competes in two distinct markets. The first, and most obvious, is the restaurant industry, which is broken into three segments: fast food, fast-casual, and full service. The first two are primarily separated by the quality of food and atmosphere. The company’s limited menu offerings and store décor suggest its place in the fast food sector, but the quality of their doughnuts is more in line with the quality of food served at fast-casual locations. This industry has performed well in the last year, despite underperforming the broader market. Restaurants are benefiting from the recent trend away from at-home dining: about half of total food expenditures of the last year were spent outside of the household, and the percentage is expected to increase.

Krispy Kreme’s main competitors in the fast food and fast-casual markets are Dunkin’ Donuts and Tim Hortons. Dunkin’ Donuts is privately held, with over 5,300 stores in 34 states, and foreign locations in 30 countries. Tim Hortons was recently spun off from Wendy’s, going public in March 2006. Its United States presence is modest at 336 stores centered around the Great Lakes region, but its Canadian presence is much more significant: 2,710 stores, more than even McDonald’s. Product differentiation is key in this market. Tim Hortons more closely parallels Krispy Kreme with its product offering of doughnuts, baked goods, and coffee. Dunkin’ Donuts recently introduced a new emphasis on their coffee-based beverages, but continues to enjoy the majority of the doughnut industry’s market share. The coffee segment of fast food and fast-casual restaurants is an important one. Currently, only 15% of Krispy Kreme’s sales come from beverages, which is significantly lower than the industry average. The company sells a “premium” private label brand of coffee under the Krispy Kreme name, allowing the profit margins on coffee to be much greater than the margins on doughnuts. Gotham Global encourages the company to increase coffee sales. At the recent Annual Meeting, the idea of selling a doughnut and coffee “combo” was suggested. Attaching coffee sales to already-healthy doughnut sales is a good idea and should be followed through. The increased focus on coffee sales will put the company up against coffee chains like
Starbucks and Caribou Coffee in addition to direct competitor Dunkin’ Donuts. While these companies represent a strong market force, consumers in the fast food and fast-casual restaurant market have low switching costs, and the unique product mix of high-quality doughnuts and premium coffees can attract customers from rival companies.

Krispy Kreme also sells their donuts to supermarkets, gas stations, and retailers (including Wal-Mart) for resale. In this market of pre-packaged doughnuts, the company faces competition from the likes of Little Debbie, Hostess, and Entenmann’s. These companies have a wide range of product offerings, extending beyond doughnuts to snack cakes, cookies, and pastries. Krispy Kreme’s offerings are less spread out than its competitors, so promoting the Original Hot Glazed™ and other strong sellers in this market would leverage the power of the company’s reputation towards competitive sales.

An issue with off-premises sales is freshness. One of Krispy Kreme’s strongest brand assets is the Hot Doughnuts Now® sign, signaling fresh and warm products. This sign has proven to be a significant influence on impulse purchases. Doughnuts left on a shelf have no way of recreating the same fresh, hot experience as doughnuts manufactured on-site. Off-premises kiosks should be redesigned to incorporate heating technology, and have a stronger aesthetic tie-in to the corporate brand and image. The company has experimented in the past with such a heating technology, referred to internally as “tunnel ovens.” These heating setups were tested in 2002 in company satellite stores (stores without on-site doughnut production equipment) as a method of providing the Hot Doughnuts Now® experience remotely. All but three were shut down as of February 2006 due to poor financial performance and an unfinished technology. It would be unwise to dive right back in to a proven failure, but refining the tunnel oven and deploying it not just to satellite stores but also doughnut kiosks is recommended.

The issue of consumer preferences for healthy foods is one that will be revisited throughout this report. It is worth noting here that the doughnut industry as a whole has been declining in recent years in part due to health issues. Substitute products such as bagels and English muffins have been on the rise. Panera Bread, which serves premium
breads and bagels in an upscale fast-casual environment, has seen tremendous growth over the past five years. Privately held bagel chains, Bruegger’s and Einstein Brothers, have also seen increased revenues in recent years. These represent another level of competition for the company, which can be combated with an advertising campaign: the average bagel actually contains more calories than the average doughnut. If consumers are abandoning doughnuts for bagels strictly for health reasons, a simple reminder of this point may be enough to bring them back.

**ENTRY**

It is notoriously difficult to sustain a new business in the restaurant industry. However, barriers to entry are relatively low. Small-scale restaurants designed just to capture a local market are easy to start up: only three out of ten restaurants are on a large scale like Krispy Kreme. Many small-scale restaurants start up because of low barriers to entry and high potential profitability, but eventually exit because of the high risk. There is extensive competition in the restaurant industry, and that brings a higher probability of failure. In the fast food and fast-casual sectors of the restaurant industry, there are higher barriers to entry in the form of established brands. Nationally recognizable names like McDonald’s, Burger King and Wendy’s bring in the significant majority of sales in these sectors. These companies have built up smart pricing schemes, corporate images, purchasing power, and economies of scale from years of success. With these business advantages and established market presence, it is hard to start up a new business in this sector.

One strategy to capture market presence is to franchise out stores. This provides a vertical relationship between the company and the franchisees: a business-format franchise where the company provides the system for running a business. Both parties have incentives to succeed: the franchisee keeps a portion of their profits, and the parent company collects a fee based on sales. Krispy Kreme expanded rapidly following their successful public offering with both franchises and company stores, and the result is a well-known slump. Major franchisee Rigel Corporation, responsible for all franchises in Arizona and New Mexico, filed for bankruptcy in 2006 and closed all of its stores. Krispy
Kreme currently operates about 130 out of its 395 stores itself, indicating a franchise rate of about 67\%\textsuperscript{1}. This is relatively high for the industry, but not detrimental. The company has announced plans to open 200 new stores over the next five years in foreign markets. Gotham Global supports this decision, and recommends that the company at least maintain its current ratio of franchise stores to company stores, if not increase it slightly.

It will be interesting to see how rival company Tim Hortons fares as it competes in the doughnut industry on a national level. Since its merger with Wendy’s in 1995, it has opened 336 locations in the United States, compared to the 299 United States Krispy Kreme stores opened since 1937. In its native Canada, Tim Hortons is greater than restaurant giant McDonald’s, both in terms of store locations and annual sales. It went public in March 2006, so its strategy as an emerging public company in the doughnut market will be worthwhile to observe\textsuperscript{3}.

**SUBSTITUTES AND COMPLEMENTS**

Krispy Kreme’s customers are looking for quality doughnuts at reasonable prices. These customers exhibit the same behavior as most fast food and fast-casual customers: price sensitivity and low switching costs. As a result, substitute goods have a substantial influence on firms in these sectors. Advertising and promotions, as well as competitive prices, are key tools to maintain a healthy customer base amidst substitute goods.

As mentioned earlier, bagels and English muffins have seen increased demand in recent years and stolen some of the demand from doughnuts. The bagel industry has many eatery-based firms including Panera, Einstein Brothers, and Bruegger’s. Panera was the second-fastest growing restaurant chain in 2006\textsuperscript{2}, and its product offerings include sweet and sugary bagels that can directly compete with doughnuts. The average bagel contains more calories than the average doughnut, and Panera’s bagels are some of the most calorie-laden bagels widely distributed. While advertising plays a critical role in staving off competitive substitute goods, Gotham Global believes that an aggressive
campaign proclaiming this fact would damage Krispy Kreme’s friendly-neighborhood-store image, and does not recommend that the company pursue this course of action.

Groceries present substitute goods as well. Food prepared for the home is still a strong market force, as slightly less than half of total food expenditures in 2005 were spent on in-home meals. Increasing gas prices lead consumers to favor home-cooked meals, as they cut transportation to restaurants in order to save money. Local groceries, chain supermarkets, and even big-box retailers all have bakeries that produce substitute bagels and doughnuts. There are also firms that supply private label bagels and baked goods to these retailers. These products threaten to take sales away from Krispy Kreme, in addition to name-brand bagels and other baked goods. Bagels in general have more power in the food industry than doughnuts, and their recent popularity also poses a threat to Krispy Kreme. There is no dearth of bagel supply, and they are priced comparably, if not a little higher, than the typical doughnut. These threats can be managed, however, by promoting the Krispy Kreme brand and advertising the quality attached to the Krispy Kreme name.

Juices, coffees and milk are close complementary goods of doughnuts. The former have become subject to health concerns recently, specifically regarding their sugar content. Research by Deakin University in Melbourne, Australia, has found that the amount of sugar in fruit drinks is roughly the same as in soda. This hasn’t affected demand or industry growth yet, but it may become a problem in the future if health-focused institutions in the United States come to similar conclusions. The coffee industry, on the other hand, is maintaining healthy growth rates. This is particularly evident in the major fast food firms adding premium coffees to their menus. Krispy Kreme sells its own brand of private-label premium coffee, and would do well to bundle cups with doughnut purchases. The profit margins on coffee are much higher than those on doughnuts. Gotham Global supports the “combo” idea put forth in the recent annual meeting.

Complements for the fast food and fast-casual market sectors in general are high-traffic areas like shopping centers, gas stations, and highway exits. Krispy Kreme already capitalizes on these by offering doughnuts for resale in gas stations and convenience
stores. Off-site vending accounts for 32% of total sales, so it is important that the company maintain its presence in these locations. Opening new stores in proven high-traffic areas is not recommended at this time. The company famously over expanded in the past, and new stores in the United States would not improve the bottom line. However, as the company looks to open 200 foreign stores, locating in high-traffic areas will be important.

**Supplier Power**

Krispy Kreme supplies its own mixes and machinery to its franchises. These represent the most costly inputs after labor, and therefore, supplier power is not a significant force. The ingredients for the mixes are obtained from a variety of regional and national suppliers, who have tightened credit terms in the last year. Particularly of note, only one supplier provides the ingredients to the company’s trademarked original glaze. Further changes to contracts could adversely affect the company’s liquidity. To mitigate the risks associated with commodity price fluctuations, the company utilizes forward purchases contracts and futures contracts.

Suppliers have historically charged market prices, even in the face of rising input prices. However, the company’s profitability is still subject to such changes in commodity prices. Price shocks can come from natural disasters, which threaten the supply of a certain crop (sugar being an important natural ingredient). The company’s doughnut-making machinery is only produced at one plant, and if raw materials were cut off to that plant, supplying machines to new stores or parts for maintenance would also become difficult.

Laborers in the fast food and fast-casual industries exercise little supplier power. Most employees are young, part-time workers with less education and smaller skill sets than workers in other industries. Unionization among fast food workers has little to no strength, and as a result, wages are low. Industry-wide, laborer turnover is high. This indicates that employee retention is low and tenure is short, but hiring new and
replacement employees is simple. Supplier power, then, is relatively low for Krispy Kreme.

**BUYER POWER**

Apart from selling doughnuts in its own stores, Krispy Kreme sells its products to retailers for resale. Inside each of these retailer’s stores, there is usually a display kiosk set aside specifically for the company’s products. This allows the company to maintain some power in the form of branding. Off-site stores include Wal-Mart, Exxon/Mobil, Kroeger, Albertson’s, and Speedway, among others. Wal-Mart particularly has the power to siphon profit margins out of their vendors. Their market power is so vast that it hurts a company to be excluded from their shelves. However, they are able to leverage this market power to coerce companies into offering products at extremely small profit margins. It can turn into a lose-lose situation for some companies. Krispy Kreme has developed national accounting systems with these retailers to cut costs of transaction, making for efficient business when prices remain slightly above those at company stores.

Consumer buyer power is considerably smaller in the restaurant industry than that of Wal-Mart. The individual consumer has a low purchasing volume and therefore cannot negotiate product prices. Consumers do, however, have low switching costs and this poses a threat to fast food restaurants. Companies that bait consumers with value menus can easily take market share away from those that maintain marginally higher prices. Franchisee buyer power is similarly small: the relationship between franchisor and franchisee is under contract, and they must meet certain requirements set in these contracts to continue operating.
**SWOT Analysis**

**Strengths**

Krispy Kreme’s breadth of appeal extends across all major demographic groups. The flagship product is affordable and competitive with other firms’ value menu prices; customers can also purchase doughnuts by the dozen. The Krispy Kreme name and brand are tied to the “one-of-a-kind taste” that generations of customers have grown to love. The Hot Doughnuts Now® sign is a strong impulse purchase generator and another component of the strong corporate identity. In these characteristics, Krispy Kreme is similar to western fast food chain In-N-Out, which enjoys fierce customer loyalty. As another strength, the company employs a vertically integrated, automated system to produce doughnuts in an efficient manner: three domestic manufacturing plants, which produce proprietary Krispy Kreme mixes and custom doughnut-making equipment for all retail outlets.

**Weaknesses**

Krispy Kreme expanded across the country at a rapid pace following its public offering, and the losses from overexpansion outweighed the benefits. Stores were closed in many markets during the company’s stock decline, including Canada, New York, Chicago, and the Southwest. Multiple lawsuits have been filed against the company, some even by the Securities & Exchange Commission, for misreporting profits and “channel stuffing” (delivering more doughnuts to suppliers than ordered at the end of a reporting period, while still booking the increased revenue, then taking the unsold doughnuts back at the beginning of the next reporting period).

In 2003, 31% of Krispy Kreme’s total company sales came from its Supply Chain division, which sells the required mix and doughnut-making equipment. KK Supply Chain can have operating margins of 20 percent or greater, which are exceptionally high for their field. Conversely, competitor Dunkin’ Donuts doesn’t sell its own equipment to its franchisees. They instead have a strong royalty stream based solely on store sales, keeping company and franchisee interests aligned. KK Supply Chain should consider
offering equipment and mixes to franchisees at a lower premium to support franchise operations.

Each of the company’s flagship doughnuts contains four grams of trans fat\(^5\), which is especially unhealthy and receiving media attention as it becomes banned across the country. This amount of trans fat is appalling when considering the overall size of each doughnut. Even worse are some of the company’s flavored doughnuts. The apple fritter, for example, contains seven grams of trans fat.

**Opportunities**

The overexpansion may have worn out the mystique of the brand in the United States. However, foreign markets, especially in China, are booming and have not been oversaturated with Krispy Kreme products, let alone been introduced to them. Expanding to foreign locations will certainly be profitable. Although gas stations and supermarkets are already profitable domestic retail channels, focusing resources back onto company stores can leverage the remaining power behind the brand to repair the damage of overexpansion. Same-store sales increased from 2\% to 9\% in 2006\(^1\), indicating that the overexpansion issue has begun to disappear, and that domestic demand remains strong. Many firms in the fast food and fast-casual markets are slowing expansion to free up capital for remodeling stores, and Krispy Kreme would benefit from a similar strategy, combined with a brand-centric advertising campaign.

**Threats**

Competitor Dunkin’ Donuts has introduced a new focus on premium coffees, and has incredible market presence with over 5,000 United States stores\(^6\). Together with Starbucks and Caribou Coffee, Dunkin’ Donuts will make it difficult for Krispy Kreme to package coffee beverages with doughnut sales. Another competitor, Tim Hortons, went public in March 2006, and has seen their stock follow a steady upward trend since July. Also of note, major cities are beginning to ban trans fats in restaurants. New York City and Philadelphia already have the bans in place. Krispy Kreme would have to abandon
their current recipes or stop sales of doughnuts if their stores were located in one of these cities, and that would be costly.

**FINANCIAL ANALYSIS**

**REVENUES AND COSTS**

The majority of Krispy Kreme’s financial struggles stem from its overexpansion in the early 2000s. Capital expenditures on opening new company and franchise stores far outweighed the decreasing revenues on increasingly unproductive stores. The company began to close stores and taper domestic expansion in 2005, and its financials have seen mixed results. The company reported revenues of $461 million in 2006, down 15% from $543 million in 2005. Net income, however, was a loss of $41 million, which is much smaller than the $135 million loss in 2005, signifying an actual increase in net income. These odd statistics reflect the company’s drive to cut costs. Indeed, operating costs in 2006 were $502 million, down 26% from $679 million in 2005 (see figure 1).

**Figure 1: Company Revenues, Costs, and Net Income**

The company evaluates its revenue and cost shares in three areas: pertaining to company stores, franchises, and manufacturing and distribution. Off-site revenues and costs are components of company stores and franchises, as each location with
doughnut-making machinery produces and supplies doughnuts to its local resellers. The growth rates of cost and revenues for each area have been similar over the past four years (see figures 2,3). Company store revenues and costs have decreased significantly, manufacturing and distribution revenues and costs have decreased slightly, and franchise revenues and costs have remained relatively stable.

**Figure 2: Revenue Component Growth**

![Figure 2: Revenue Component Growth](image)

**Figure 3: Cost Component Growth**

![Figure 3: Cost Component Growth](image)
As Krispy Kreme closes stores, it no longer incurs the operating expenses of each location, and costs decrease. However, the company loses the store as a source of revenue, explaining the corresponding decrease. The rate of decay is similar between revenues and costs, although revenues have decreased at a slightly slower rate, indicating that demand remains consistent for the company’s products. This is an important fact to consider. Although it has been discussed that consumers in Krispy Kreme’s market have low switching costs, and that demand can change easily based on price, Gotham Global suggests a modest price increase to raise margins. Depending on the regional market, the company currently sells a Hot Original Glazed for 60¢ - 75¢. Competitive products, such as a Dunkin’ Donuts doughnut or Panera bagel, cost more (79¢ and 89¢ respectively).

Krispy Kreme’s unique doughnut and glaze recipes are what set its product apart from competitors’ as a premium offering. A slight price increase would exceed some customers’ reservation prices and cause them to shop elsewhere, but customers who buy Krispy Kreme products for the unique experience would absorb the price increase as payment for this premium. The cost of doughnut and glaze ingredients, including flour and sugar, has increased over the years, but the company has locked in contracts with multiple vendors that ensure a steady supply at stable prices. With overall costs therefore trending downwards, this price increase would boost revenues.

**Stock Price and Margins**

In the past year, Krispy Kreme’s stock price has, on average, matched or outperformed its competitors Tim Hortons, Panera Bread and Starbucks\(^7\) (see figure 4). The company’s new growth strategy combined with a proven and trusted product offering provide promise for future success, and the market has responded to this. Compared to its status a few years ago, the company is in good shape. The company’s stock price has also outperformed the S&P500 over the past year\(^7\) (see figure 5).
Despite superior stock performance, the company’s ratios compare poorly to those of its competitors (see table 1). Specifically, the trailing Price to Earnings ratio is lower than selected competitors, and a high P/E ratio usually signals a sustainable advantage that lets a company grow earnings over time. However, the figure is retrospective; its low value is due to the company’s past performance. While it promises low future growth, the company can take steps to ensure higher actual growth, and analysts have recognized this potential by assigning Krispy Kreme a higher forward P/E ratio of 23.59.
Table 1: Ratio Comparisons

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<th>KKD</th>
<th>THI</th>
<th>SBUX</th>
<th>PNRA</th>
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<td>Trailing P/E</td>
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Krispy Kreme’s margins are frighteningly below their competitors’ (see table 2). Both its profit margins and return on equity are negative, while each of its selected peer companies’ are positive and healthy. The company’s general and selling operations costs are comparable to competitor Panera, but as a percentage of total operating expenses, Krispy Kreme ranks below its competitors. This suggests that the company needs to cut costs outside of general operations, and one such target area is litigations. Questionable bookkeeping practices and allegations of “channel stuffing” (where sales are artificially inflated by forcing excess products through distribution channels) brought the company several lawsuits in recent years. The hiring of a new CEO in March 2006 and a general rearranging of the board has refocused the company’s financial strategy and aims to minimize such controversy in the future.

Table 2: Margin Comparisons

<table>
<thead>
<tr>
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<th>KKD</th>
<th>THI</th>
<th>SBUX</th>
<th>PNRA</th>
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<tr>
<td>Profit Margin</td>
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<td>15.64%</td>
<td>7.25%</td>
<td>7.10%</td>
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<td>ROE</td>
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<td>Operating Margin</td>
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<td>10.24%</td>
<td>10.95%</td>
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* in thousands.

The company’s low operating margin, however, does indicate that the sales structure must be closely examined. Krispy Kreme can no longer be characterized as in a rebuilding phase, or “survival mode,” as labeled by CEO Daryl Brewster⁸. Instead, the company must focus on growth, or “stability,” to grow profits and increase their margins to a competitive level.
STRATEGIC ISSUES AND RECOMMENDATIONS

Gotham Global believes that Krispy Kreme should focus its strategy into three elements: Stores, Menu, and Brand. These three elements are crucial factors of the company’s business plan.

STORES

Over two thirds of Krispy Kreme’s product sales come from company and franchise stores. In the early 2000s, the company rapidly expanded and opened a number of these stores, only to close some of them years later. Currently, the company has 235 stores open in the United States, with no immediate plans to expand domestically. Gotham Global agrees with this plan of action, and supports the company’s plan to open 200 foreign stores over the next five years. Foreign stores are already open in Australia, Canada, Hong Kong, Japan, Mexico, and United Kingdom. A recent store opening in Tokyo drew 10,000 customers in just three days. Food analysts note that Japan’s attention to health issues has suffered a backlash recently, and fatty, super-sized American brands are benefiting from it. Krispy Kreme should look into additional locations in Japan, particularly in higher population-dense areas. China, too, is an excellent target for expansion. Its growing middle class is an untapped source of disposable income. The Krispy Kreme brand exudes quality and would succeed in metropolitan China. The same applies to India, where the middle class is expected to represent half of its billion-plus population by 2040. Their purchasing power is not to be overlooked.

Two thirds of Krispy Kreme stores are franchised. Gotham Global encourages the company to maintain this franchise ratio company-wide as it expands abroad. This may require a reevaluation of domestic markets and the mix of franchise and company stores within them. Many were closed after the overexpansion, particularly in the Southwest, New York, and Canada. Krispy Kreme currently operates two kinds of stores: factory stores and satellite stores. Factory stores can be franchised out, and each one includes a doughnut-making theater, where customers can watch in-house machinery produce
doughnuts right before they eat them. Satellite stores do not contain any doughnut-making machinery; company trucks deliver doughnuts from the nearest factory store. While these satellite stores provide additional sources of revenue, Gotham Global believes that they do not provide the customer with the full Krispy Kreme experience and as such are in danger of diluting the brand. The company currently operates about 70 satellite stores in the United States. Gotham Global does not advocate the immediate closing of satellite stores, but instead suggests that the company examine the saturation of key domestic markets. Subway, the sandwich chain that only operates franchise stores, has run into problems where stores are in such close proximity that they directly compete with each other. Krispy Kreme does not have this problem now, but if signs of intra-company competition arise, Gotham Global recommends closing the satellite store closest to the problem.

Approximately one third of Krispy Kreme’s doughnut sales are off-site, in supermarkets, gas stations, and convenience stores. This is a key revenue source and should be maintained as such. In this sector, the company competes with Hostess, Entenmann’s, and Little Debbie, among others. The Krispy Kreme name is a strong competitive advantage and can be used as leverage. Currently, the company’s doughnuts are sold off-site on retailer shelves or from a Krispy Kreme-branded kiosk. Gotham Global believes that the company should redesign these kiosks to capitalize on the strength of the brand name. Visual cues, like the trademark red and green colors of the logo, should outline the edges of the kiosks to let customers know that the same familiar high-quality product sold in company stores is available in the kiosk. The edges should be simple and straight, so the focus remains on the products inside. The company’s logo should be prominent on the boxes of doughnuts inside and on the kiosk itself.

Besides enhancing the kiosk’s aesthetics, Gotham Global recommends that Krispy Kreme install heating technology in each one. The company has used a technology referred to internally as “tunnel ovens” to keep doughnuts warm at satellite stores. In 2002, the company experimented with a third kind of store, comparable in scope somewhere between a satellite store and an off-site kiosk, called a “Doughnut and Coffee Shop,” or DCS. Most DCS locations were closed due to poor financial performance, due
in part to a still-young tunnel oven technology. Krispy Kreme’s internal manufacturing division, KK Supply Chain, should not abandon the tunnel oven. Instead, a research and development team should be assigned to refine the technological aspects and financial efficiencies of the technology, and roll it out to off-site kiosks. This allows the company’s products to stay fresh and competitive. Stale doughnuts are not appealing to customers and therefore detrimental to the company’s image. Once the tunnel oven technology is successfully implemented, miniature Hot Doughnuts Now® signs can be installed at each kiosk, enhancing the impulse buy allure of a box of warm Krispy Kreme doughnuts.

**Menu**

Health concerns are a relevant issue for any firm in the restaurant industry. Krispy Kreme’s stock slide was a result of overexpansion at a time when health concerns were widespread. The Atkins diet, which advocated low-carbohydrate foods, became wildly popular just as Krispy Kreme was expanding and promoting its carbohydrate-heavy doughnuts. Customers concerned with diet restrictions and health issues avoided restaurants like Krispy Kreme, with so many of its products laden with sugar. Being healthy may appear to follow a trend of popularity—as when fad diets become mainstream for a while—but overall it remains a constant issue. However, this is not to say that all customers come to Krispy Kreme expecting healthy products. Hardee’s saw burger sales increase 20% after the introduction of their Thickburger product line. The sandwiches contain over 1,000 calories, 2,500 milligrams of sodium, and 100 grams of fat each, placing them as some of the least healthy fast food products available. Their success, however, is undeniable, and it proves that a market remains for unhealthy foods. For Krispy Kreme, moving too much of the menu to low-sugar, low-fat products would compromise the world-famous taste and quality linked to the company name, and alienate existing customers rather than bring in new ones.

That said, there is one nutritional aspect of the company’s doughnuts that must be addressed: trans fat. In July 2003, the Food and Drug Administration announced that nutrition labels would be required to display the trans fat content for every product, beginning in January 2006. This was an indirect result of a lawsuits filed against Kraft
and McDonald’s in 2003. The lawsuit against Kraft claimed that the food giant was marketing its Oreo cookies to children, without cautioning them against the dangerous levels of partially hydrogenated oils (trans fats) in each cookie. After the lawsuit received a massive amount of media attention, Kraft announced that they were going to reduce or eliminate trans fats in the Oreo and 650 other products. The lawsuit against McDonald’s claimed that although the restaurant had promised to switch to a less trans-fatty cooking oil by February 2003, it had run into operational issues and not completed the transformation. However, it failed to properly notify its customers, who thought they were then eating healthier foods when they actually weren’t. McDonald’s settled, and donated an addition $7 million to the American Heart Association to educate the public on trans fat and to promote the switch to safer fats to other food companies. McDonald’s competitor Wendy’s began switching its deep-frying oils to trans fat-free varieties in August 2006.

On December 5, 2006, New York City enacted a ban on all trans fats from its restaurants, to be fully enforced by June 2008. On February 8, 2007, Philadelphia enacted a similar ban. There is current legislation to ban trans fats throughout the entire state of California, as well as other major United States cities. It is clear that Krispy Kreme must follow Kraft’s example and eliminate trans fats from all of its products. This is a cost-intensive process, but one that must be made to ensure future success. Gotham Global recommends internal product testing with new recipes that do not include trans fats but retain the familiar taste, texture and quality of Krispy Kreme doughnuts. The company released a whole-wheat doughnut in February 2007 that has 20 fewer calories than the Original Hot Glazed™, and comes with the added benefits of whole-wheat flour, such as more fiber. Gotham Global believes this is an excellent first step for the company. Trans fat-free doughnuts are the next step. Krispy Kreme should not, however, turn into a company solely based on providing healthy products. It built its success on the sugary glaze of its doughnuts, and its success will continue.

Gotham Global feels that Krispy Kreme can be accurately compared to western fast food chain In-N-Out Burger. One of the reasons for In-N-Out’s success is its simple menu: a limited product offering allows the company to specialize in its products and
consistently sell high-quality burgers and fries. Krispy Kreme has a similarly simple menu now, offering varieties of doughnuts and beverages. A recent trend in the restaurant industry is to provide breakfast offerings. Starbucks and Subway are among the firms introducing hot egg sandwiches and other items to compete with McDonald’s and Burger King in this growing market segment. Jack in the Box recently began providing its breakfast menu at all operating hours, and its sales doubled as a result\(^1\). It can be argued that doughnuts are already breakfast items, but Gotham Global suggests that Krispy Kreme experiment with a limited breakfast menu in certain markets. Bagels would be the foundation of the new menu; sold alone, with cream cheese spreads, or as breakfast sandwiches with egg, cheese, and pork products. To keep the company menu traditionally simple, breakfast items should be limited to a few products, and doughnut varieties that produce lackluster sales should be phased out.

Juice products could be bundled with the sale of breakfast items to increase beverage sales, something Krispy Kreme needs to focus on. Its “premium” coffees have high profit margins, and the company can take advantage of this. The company offers packages of roasted coffee beans in some markets already, and this is a fine idea to boost sales. However, creating a “combo meal” not unlike the traditional fast food combo of burgers, fries and a soft drink is a strategy to increase on-site coffee sales. One such doughnut-coffee combo was suggested at the company’s recent annual meeting, and Gotham Global strongly suggests that it be adopted in every store. Also, as mentioned earlier, increasing the base price of doughnuts by a few cents would boost profit margins in the same manner as increasing coffee sales.
BRAND

Krispy Kreme has been in business for 70 years. This has allowed the company to build up its image: a brand that exudes high quality and a one-of-a-kind experience. There are three crucial components of the company’s image: the logo and color scheme, the Hot Doughnuts Now® sign, and the Original Hot Glazed™ doughnut. The company’s current marketing strategy is mostly based on grassroots campaigns: fundraising programs for schools, sponsorship of local events and organizations, and free doughnut giveaways on special occasions. The opening of a new Krispy Kreme store is usually a large media event: customers line up outside the doors, eager to receive a free doughnut. These events reflect positively on the company and attract media and public attention.

Gotham Global encourages Krispy Kreme to maintain community ties. School fundraising programs are an excellent way to build a good reputation and a strong customer base. The company currently promotes its fundraising program on boxes of doughnuts, and this practice should continue. Gotham Global suggests that the company begin a series of “Doughnut Days,” where free products are handed out to consumers. These events can vary by time, based on the location, to coincide with local holidays. Ice cream chain Ben & Jerry’s holds an annual Free Ice Cream Day that is incredibly successful, despite the lack of a limit on free ice cream per customer. Krispy Kreme is known to hand out free doughnuts fresh off the assembly line, but the guidelines on how many per day or per customer are inconsistent from location to location. Although it would have an initial negative reaction, Gotham Global recommends the company set a limit on doughnut giveaways at every store, and instead advertise free-doughnut days once or twice a year.

The company has not often used traditional advertising, such as newspaper inserts, television promotions, and product placement. Gotham Global believes that, in moderation, such traditional advertising methods can boost revenues. Many company stores are located in high-traffic areas such as strip malls. A billboard near the store’s location can direct traffic towards the store that would otherwise pass it by. Billboards promoting the company in general could be erected on rush-hour routes, encouraging
businessmen and businesswomen to grab some coffee and a doughnut on their way to work. Gotham Global believes static print advertising works in parallel with the company’s traditional roots and simple business practices. Magazine and newspaper inserts promoting seasonal items would increase sales around holidays, when revenues have historically decreased. Internet, television, and radio ads are certainly effective means of marketing, and the company has used them in the past. Gotham Global views the Krispy Kreme brand as standing for a time-tested recipe for quality, and the dynamic nature of these modern media cannot exude the same traditional feeling as print media.

As mentioned earlier, In-N-Out Burger is a model that Krispy Kreme should follow. In-N-Out only operates in three states, which is not feasible for Krispy Kreme, but it creates for them an element of scarcity. In-N-Out has a simple but focused menu which is known for its superior quality. Similarly, their corporate brand is simple and recognizable, representing high quality and excellent service. As a company, In-N-Out is regarded for treating their employees remarkably well, relative to the rest of the fast food industry. All of these characteristics are tied to their brand, which induces a strong customer loyalty. Gotham Global encourages Krispy Kreme to study In-N-Out in this regard. The two companies are similar in their simple menus of high quality products, and also in the mysticism of the unique excellence their products possess. In-N-Out makes great burgers, and Krispy Kreme makes great doughnuts. When promoting the Krispy Kreme brand, Gotham Global advises the company to keep this in mind above all else.
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