case teaching note 14

Krispy Kreme Doughnuts, Inc.

Overview

With 181 Krispy Kreme stores in 28 states, Krispy Kreme Doughnuts in 2001 was rapidly building something of a cult following for its light, warm, melt-in-your-mouth doughnuts. Sales were on an impressive climb, exceeding 3.5 million doughnuts a day. The company's business model called for 20 percent annual revenue growth, mid-single digit comparable store sales growth, and 25 percent annual growth in earnings per share.

Krispy Kreme had created a flurry of excitement with its expansion into metropolitan markets outside the Southeast—its grand openings in newly entered markets attracted long lines of customers and created traffic jams around its store sites. The first new store in San Diego racked up $365,000 in sales the first week, with 5 TV crews covering the opening day event. The first store in Denver produced first-week revenues of $369,000, drew 50,000 visitors, and had $1,000,000 in sales the first 22 days; the crowds were so large that three off-duty deputy sheriffs were hired to direct traffic from 5 a.m. to 11 p.m. during the Tuesday-Saturday period of grand opening week—one night there were 150 cars in line at the drive-thru window at 1:30 a.m.

But despite the enthusiastic reception that Krispy Kreme stores were getting, a number of securities analysts were dubious whether the company's strategy and growth potential merited a stock price nearly 70 times projected 2002 earnings per share of $0.69 and 85 times actual 2001 earnings of $0.55 per share. The company's stock, which was trading in the $46-$50 range and had been as high as $54, had been a favorite of short sellers for several months—the 2.5 million shorted shares in May 2001 represented nearly 10 percent of the company's outstanding shares.

While there are legions of loyal doughnut-lovers (sales in the U.S. alone amount to an estimated 10 billion annually), the doughnut industry has been growing rather slowly, partly because the product is not "nutritionally correct." Yet several doughnut chains had rather ambitious objectives and strategies to grow revenues and profits. Krispy Kreme believed that its product had global appeal and was laying plans to expand its already nationwide franchising network to foreign countries. And, so far, it had been successful in invading the markets of such long-standing doughnut chains as Dunkin' Donuts, Tim Hortons, and Winchell's Donut Houses.

The case presents students with some fairly challenging issues to analyze:

- While enthusiasm for the company's product is presently strong, will it last? Is it likely that customer infatuation with Krispy Kreme doughnuts could be a passing fad—in today and out tomorrow?
- Can Krispy Kreme compete effectively against Dunkin' Donuts and Tim Hortons, both of which are much bigger and well-established in markets that Krispy Kreme is entering?
- Is Krispy Kreme's strategy grounded in building a sustainable competitive advantage? How long can it continue with the present strategy? What happens when it has stores in all the markets now being targeted—metropolitan areas with 100,000+ households? Will strategy changes soon be needed to begin penetrating smaller markets?
- What size growth rates in revenues and earnings can Krispy Kreme achieve over the next five years? What will have to happen for Krispy Kreme to realize its target of 25% growth in earnings when the company's revenue growth target is only 20%? How can Krispy Kreme hope to continue to grow so fast when the doughnut industry overall is growing very slowly and when the product is nutritionally incorrect?
- Would a drop in the stock price dramatically hurt the company's ability to finance its growth?
- Does international expansion make sense for Krispy Kreme? Will it have to alter some aspects of its strategy to be successful in foreign markets?

Suggestions for Using the Case

This freshly researched case contains rich information and data for analyzing and evaluating Krispy Kreme's strategy, competitive strengths and weaknesses, and growth prospects. It is an excellent follow-on to Chapter 4 (Evaluating Company Resources and Competitive Capabilities); the content of the case is eminently suitable for:

- Giving students practice in identifying a company's strategy, determining how well it is working, and sizing up whether the strategy is capable of producing sustainable competitive advantage.
- Drilling students in SWOT analysis.
- Having students do a serious assessment of a company's financial performance, the profitability of its business model, and its potential for competitive success against larger, well-established rivals.
- Assessing the company's potential for rapid growth in a slow-growing industry—there are plenty of numbers for students to crunch in arriving at future estimates of profitability and in deciding whether the stock price is over-valued.

However, because the case has such strong focus on competitive strategy, it will prove beneficial if you delay assigning the case until you have covered the material in Chapter 5 and perhaps Chapter 6 (since Krispy Kreme is looking at expanding into foreign markets).

As noted in the overview, there are a host of solid, timely strategy issues to explore in assigning this case. We think a full 75-minute class will be needed to cover the main teaching points.

Very likely, this case will prove immensely popular with students and should be a winner in terms of stimulating a lively class discussion—especially if there are Krispy Kreme stores in your area (or even just those of Krispy Kreme rivals). Students will easily identify with the company's product, and the ins and outs of the doughnut business will prove relatively easy for the class to grasp.

This is a Case-TUTOR exercise for this case which aims at helping do the calculations to evaluate KKD's growth potential. The case preparation exercise also guides students through analysis of KKD's strategy and competitive position.

We think the Krispy Kreme case is very good choice for either written analysis or oral team presentations. Our suggested assignment questions are as follows:

1. Do you agree that the numbers just don't work for Krispy Kreme as concerns its prospects for future growth and profitability? Why or why not? Would you buy stock in this company? Please justify your answer using whatever tools and concepts of strategic analysis you deem appropriate.
2. Scott Livengood, Krispy Kreme's CEO, has employed you as a special assistant to help him do a probing assessment of Krispy Kreme's business model, strategy, and competitive strength. Your assignment is to prepare a 4-6 page report that (a) identifies the major elements of Krispy Kreme's strategy, (b) incorporates a thorough SWOT analysis, (c) compares Krispy Kreme's competitive strength with that of key rivals using the methodology in Table 4.4 on p. 142 of Chapter 4, (d) diagnoses Krispy Kreme's performance in each of its three business segments, (e) identifies the major issues that Krispy Kreme management needs to address, and (f) recommends a comprehensive set of actions to address these issues. Your report should contain whatever supporting tables and exhibits you deem appropriate (in addition to the 4-6 pages of text), and it should definitely reflect solid number-crunching of the financial and operating data provided in determining whether the company's present strategy is or is not working as well as it might.

Assignment Questions

1. What are the chief elements of Krispy Kreme's strategy? What evidence is there to indicate that the strategy is or is not working as well as it might?
2. What is your assessment of Krispy Kreme's financial performance? Is it really as good as it looks on the surface? Why or why not? What is the most profitable part of the business? Do you agree with the statement at the beginning of the case that "the numbers just don't work?"
3. What does a SWOT analysis reveal about the company's overall situation?
4. What is your assessment of Krispy Kreme's competitive strengths and weaknesses in comparison with key rivals? Please use the methodology in Table 4.4 on p. 142 of Chapter 4 in arriving at your answer.
5. On the basis of your assessment above, what do you think of Krispy Kreme's growth prospects? Just how good are they? What evidence supports your answer? What size growth rates in revenues and earnings do you believe Krispy Kreme can achieve over the next five years? What will have to happen for Krispy Kreme to realize its target of 25% growth in earnings when the revenue growth target is only 20%?

6. What major issues do you think that Krispy Kreme management needs to address?
7. What recommendations would you make to Krispy Kreme management to improve upon the strategy or otherwise sustain the company's growth and profitability?
8. Would you buy this company's stock? Why or why not? What size price-earnings ratio makes sense for a company with Krispy Kreme's potential? If 70 times earnings is too big, as some analysts claim, what p-e multiple does make sense? (Some financial analysts believe that the p-e ratio should be roughly equal to the growth in earnings per share—this is a popular metric that securities analysts use to gauge whether a company's stock price is overvalued or undervalued or reflective of "fair value.")

Teaching Outline and Analysis

You might want to preface the evaluation of Krispy Kreme's strategy and growth prospects with a brief summary of what competition is like in the doughnut industry. Several competitive features stand out:

- Competition among doughnut-making rivals is largely fought in local markets—doughnut shops located close to each other or along the same traffic routes are very much in competition for passersby and neighborhood shoppers. Doughnut shops also compete with the bakery departments of supermarkets and with convenience stores that stock doughnuts in their bakery cases. But it is doubtful that a doughnut shop competes with other doughnuts sellers more than 5 miles away. In many respects doughnuts shops are like fast food outlets—people will not typically drive more than 5 miles or go far out of their way to patronize a particular shop or location regularly (although they may do so on special occasions).
- The national chains compete with one another on such factors as:
  - product quality and appeal (who has the freshest, best-tasting doughnuts?).
  - convenience and location (who has the doughnut shop that is easiest for me to get to?).
  - overall menu offerings (what else can I get besides doughnuts?).
  - unit décor, ambience, cleanliness, interest, and street appeal (do I like to go there?)
  - brand reputation/name recognition (is this a place I have heard of before or trust or want to try?)
- Rivalry among existing doughnut shops is relatively moderate at present among the national doughnut chains—only units located within several miles of one another put the chains in strong competition. Thus Krispy Kreme's entry into new markets does not pose an undue threat to existing competitors at this juncture.
- Doughnut makers face very strong competition from substitute products, particularly those that are perceived by consumers to be healthier or more nutritious.

1. What are the chief elements of Krispy Kreme's strategy? Which one of the five generic competitive strategies is Krispy Kreme employing? What evidence is there to indicate that the company's strategy is or is not working as well as it might?

Students ought to have little trouble identifying the main elements of Krispy Kreme's strategy, since they are laid out rather plainly in the case. But going to the board and recording student responses is useful stage-setting for a probing strategy evaluation. The following strategy components ought to be highlighted:

- Rapidly expand the number of stores in the U.S. and parts of Canada, primarily through the efforts of franchisees. (Most of the new stores being opened are franchised as opposed to company-owned—see case Exhibit 8).
- Grant franchises only to candidates who have experience in operating multi-unit food establishments and who have the capital to adequately finance the opening of new Krispy Kreme stores in their territory. Relying upon franchised stores as opposed to company-owned stores conserves the company's capital for other expansion efforts.
- Build a vertically-integrated value chain by supplying doughnut mixes to all stores and by making the doughnut equipment used at all Krispy Kreme stores. Selling ready-mixed ingredients and doughnut-making equipment to franchisees is a major source of revenue and profits for Krispy Kreme—KKD makes money on every doughnut sold at franchised stores (aside from the royalties on franchised store sales) because KKM&D sells them the ingredients for the doughnuts at a profit to the company. Acquiring Digital Coffee is another vertical integration step to enhance sales and profits from the company's supply chain businesses.
- Rely upon free media publicity, product giveaways, and word-of-mouth to attract customers to stores—there's no need to spend money on advertising yet. Store traffic is booming without advertising in many locations—strong evidence of the power of the company's brand name and reputation among consumers and the drawing power of its "hot doughnuts now" strategy.
- Build and strengthen the Krispy Kreme brand name—capitalize on all the publicity and hype by entering new areas without having to spend much to introduce the product and the brand (boosts margins and profits!).
- Grow on-premise sales by attracting new and repeat customers on a regular basis and by enhancing the attractiveness of coffee offerings and adding new hot and cold coffee beverages. The acquisition of Digital Coffee makes it possible to make additional profits on supplying coffee to company-owned and franchised stores.
- Grow off-premise sales by
  - marketing Krispy Kreme doughnuts to area supermarkets and convenience stores,
  - working closely with community groups of all types to promote sale of Krispy Kreme products for fund-raising campaigns, and
  - pursuing new distribution outlets such as sales at sporting events, airports, college and university campuses, high traffic business establishments, and perhaps online sales and delivery (as was being tried by the Las Vegas franchisee).

Begin to explore international expansion—start screening international franchisee applications and explore what must be done to supply international franchises with doughnut-making equipment and ingredients.

Once the chief elements of the strategy have been identified, then you can poll the class as to which of the five generic strategies that KKD is using. We think the company's strategy is very clearly one of focused differentiation.

The class should have no trouble concluding that the company's strategy is working quite nicely—as indicated by the statistics in case Exhibits 1 and 2. The company is very definitely gaining market share—current sales of 3.5 million Krispy Kreme doughnuts daily translates into sales of nearly 1.3 billion doughnuts annually, equal to about a 13% share of the 10 billion a year volume doughnut industry. More specifics on the company's performance and how well the strategy is working are discussed in question 3 below.

2. How does Krispy Kreme's strategy connect to its business model? Are they well-matched?

Krispy Kreme's business model involved generating revenues and profits from three sources:

- Sales at company-owned stores.
- Royalties from franchised stores and franchise fees from new store openings.
- Sales of doughnut mixes and customized doughnut-making equipment to franchised stores.

It should be clear from the strategy identification exercise above that the strategy flows beautifully from the business model—they are very much in sync. Indeed, it is fair to say that the company's strategy has been crafted around the three pieces of the business model and, so far, management has not drifted from pursuing the model or considered changing the model that it developed in the late 1990s. It is probably worth a couple of minutes of class time to point this out and to further drive home what the term business model means and how it relates to and differs from the term strategy.

3. What is your assessment of Krispy Kreme's financial performance? Is it really as good as it looks on the surface? Why or why not? What is the most profitable part of the business? Does the company's performance indicate that the strategy is working well? Do you agree with the statement at the beginning of the case that "the numbers just don't work?" What numbers ought to be looked at?

It is pretty clear from the data in case Exhibits 1 and 2 that the company's financial performance is quite good. But we think it always best to signal students that such overall judgments must be supported with a host of specifics (number-crunching is essential and is definitely in order here, given the skepticism expressed by analysts in the opening paragraphs of the case).

- From case Exhibit 1, students can calculate that KKD's total revenues have grown at an compound average rate of 17.4% since 1995—the overall percentage increase over the 7-year period from \$115.0 million in fiscal year 1995 to \$300.7 million in 2001 is a very healthy 161.5%.
- Net income has increased from \$4.6 million in fiscal year 1995 to \$14.73 million in 2001—a compound average growth rate (CAGR) of 21.3%.
- The number of stores has almost doubled—from 88 to 174.
- Systemwide sales are up from \$146.7 million to \$448.1 million—a solid 20.5% CAGR.
- Average weekly sales at company-owned stores has jumped sharply from \$42,000 in 1998 to \$69,000 in 2001.
- Comparable store sales growth in 2001 was very impressive—22.9% at company-owned stores and 17.1% at franchised stores, signaling very positive results from recent sales increasing efforts.
- From case exhibit 2 students can determine that profit margins in all three business segments are good and improving rapidly:

Operating Profit Margins by Business Segment (excluding depreciation and amortization)	**Fiscal Years Ending**				
	Feb. 2, 1997	**Feb. 1, 1998**	**Jan. 31, 1999**	**Jan. 30, 2000**	**Jan. 20, 2001**
Company store operations	11.7%	11.7%	12.6%	13.0%	15.1%
Franchise operations	7.8	(3.6)	15.6	27.4	61.4
KK manufacturing & distribution	15.0	12.9	13.8	14.7	15.5
Overall average	12.0%	11.7%	12.9%	13.7%	16.6%

- The profit margin gains suggest that the addition of new stores is giving KKD the volume and scale of operations needed to help lower unit costs in KKM&D—scale economies are apparently being realized. The new state-of-the-art plant in Illinois for mixing and distributing ingredients is expected to lower costs and boost margins still further. What students need to realize here is that KKD makes money on every doughnut that franchisees sell—it gets 4.5% in royalties plus it realizes a profit on ingredient mixes. The data in case Exhibits 1 and 2 make it feasible to estimate just how much profit KKD makes on each dollar of franchise sales.
    - The difference between KKD's sales and systemwide sales equals sales of franchised stores; thus in 2001, with systemwide sales of $448.1 million and corporate sales of $300.7 million, franchised store sales were $146.7 million.
    - KKM&D realized operating income (before depreciation and amortization) of $12.0 million in 2001 on its sales of doughnut-making equipment and doughnut mixes to franchisees. This equates to profits of $.082 per dollar of sales at franchised stores; add to this the 4.5% royalty per dollar of sales (of which about 60% ended up as operating income in 2001), and one can see that KKD realizes about $0.11 in operating income (before depreciation and amortization) for each dollar of sales made by franchisees.
    - And, if past trends continue, these margins should improve in future years. Even so, these margins are not as good as KKD realizes from sales at company-owned stores (just over 15% in 2001).
- KKD used proceeds from its public stock offering to pay off all of its long-term debt—see the Balance Sheet data and Cash Flow data in case Exhibit 1. The company is pretty much debt-free going into fiscal year 2002. Furthermore, the company has a substantially bigger current ratio and working capital balance than in years past, also due to the proceeds of the stock offering.
- KKD's operating expense ratios have declined significantly the past two years and the net profit margin improved sharply in the past year; the encouraging boost in the net profit margin may hint at further increases in future years.

	Fiscal Years Ending						
	Jan. 29 1995	**Jan. 28, 1996**	**Feb. 2, 1997**	**Feb. 1, 1998**	**Jan. 31, 1999**	**Jan. 30, 2000**	**Jan. 28, 2001**
Operating expenses as a percentage of revenues	85.7%	88.3%	88.0%	88.3%	88.4%	86.3%	83.4%
General and administrative expenses as a percentage of revenues	6.6%	5.7%	5.8%	6.0%	6.0%	6.7%	6.7%
Net income as a percentage of revenues	4.0%	0.1%	1.8%	1.7%	(1.8)%	2.7%	4.9%

- Using the average weekly sales data in case Exhibit 1, students can calculate and compare sales at company owned store versus franchised stores:

	Average weekly sales per store		Average annual sales per store	
Fiscal Year	**Company-owned**	**Franchised**	**Company-owned**	**Franchised**
1995	$45,000	$22,000	$2,340,000	$1,144,000
1996	39,000	23,000	2,028,000	1,196,000
1997	39,000	22,000	2,028,000	1,144,000
1998	42,000	23,000	2,184,000	1,196,000
1999	47,000	28,000	2,444,000	1,456,000
2000	54,000	38,000	2,808,000	1,976,000
2001	69,000	43,000	3,588,000	2,236,000

- Compound average growth rate of company owned stores, 1995-2001: 7.4%
- Compound average growth rate of franchised stores, 1995-2001: 11.8%
- Sales averages for franchised stores are well below those for company-owned stores because many of the franchised stores are older, "associate" stores that were built well before the new strategy and expansion effort was put in place. The much lower sales levels at these stores are pulling the overall franchised store average down and make it a less valid indicator of what is happening at the newer franchised stores.

You may wish to ask the class whether they think these financial performance results confirm "the numbers just don't work." Why would stock analysts not be impressed by KKD's performance? However, we would not press for complete answers to these questions here; the best time to push on whether the numbers work is closer to the end of the period after more analysis is out on the table.

4. What does a SWOT analysis reveal about the company's overall situation?

Krispy Kreme's Resource Strengths and Competitive Assets

- The passion that customers have for Krispy Kremes and the valuable word-of-mouth advertising it provides.
- The company's growing brand image and reputation.
- Joe LeBeau's secret recipe for yeast-raised doughnuts has given the company a high quality product with strong buyer appeal (in comparison to some competitors).
- Proprietary doughnut-making equipment, and the capability to supply it to franchisees at profitable prices.
- The company's integrated value chain (the company makes money selling ingredients and doughnut-making equipment—which should extend to coffee products in the near future); vertical integration is a solid competitive strength for KKD and could prove to be a major competitive advantage.
- The ability of the company to garner so much valuable free publicity and thereby avoid having to spend monies for advertising to introduce its products in new markets.
- It is easy to attract top caliber franchisers because of the profitability of Krispy Kreme stores.
- KK has no long-term debt and a strong balance sheet; KKD's capital requirements to finance expansion via franchises are not particularly large and seem well within the company's means (despite its relatively small size vis-à-vis some of its competitors).
- The company's strategy and business model seem very well-conceived and are running on all cylinders—all 3 business segments are rather profitable and seem likely to become more profitable as franchisees add more new stores.

Krispy Kreme's Resource Weaknesses and Competitive Liabilities

- Several rivals are larger and well established in their markets—Krispy Kreme may find it tougher to compete with them head-to-head once the newness and excitement over KK products wears off some. Dunkin' Donuts has 7 times the sales of KKD.
- The company has no experience in foreign markets.
- The company's core product does not appeal to health/weight conscious consumers.
- Given that the overall doughnut market is growing slowly, KKD's sales and market share gains will have to come at the expense of rivals.

Market Opportunities

- Add more stores in current target markets (100,000+ households) to make it convenient for all metropolitan area residents to get to a Krispy Kreme store—having to drive more than 3-4 miles or travel more than 10 minutes will keep many people from being regular customers
- Attract a broader range of customers and sell more products to existing customers by enhancing present menu offerings (especially gourmet coffees and coffee drinks)
- Developing a somewhat smaller store format to enable penetration of towns with less than 100,000 households
- Expansion into international markets

External Threats to Krispy Kreme's Well-Being

- Consumers continue to be health and nutrition conscious, causing many to avoid doughnuts and resulting in continued slow/stagnant overall market growth for doughnuts; flat sales for doughnuts marketwide would pose threats to KKD's growth. Stagnant doughnut sales (at around 10 billion per year in the U.S.) would mean that for KKD to continue to gain market share and grow unit sales as rapidly as it has been growing them, it would have to take market share away from other doughnut sellers. KKD's U.S. market share is already up to 13% of the market (1.3 billion out of 10 billion). Ideally, consumer enthusiasm for Krispy Kremes would have the effect of stimulating overall buyer demand and consumption, upping it over time to 11 or 12 billion annually and thus moderating the need for KKD to grow its sales at the expense of other industry participants.
- Rivals, concerned about Krispy Kreme's rapid growth and market share gains and erosion of their own market positions, may well be compelled to rejuvenate their menus, product quality, and strategies so as to make it much tougher for Krispy Kreme to gain sales and market share at their expense—this could precipitate a lively and perhaps costly battle for market share that erodes profit margins and cuts into overall profitability.
- The "fad" of Krispy Kreme doughnuts begins to dissipate, customers turn their attention to other "in" products, and the local media coverage of KKD drops off—without so much free publicity, KKD may have to spend monies on advertising to maintain/grow sales levels at stores.

Conclusions

Krispy Kreme situation is highly favorable at present. Its resource strengths and competitive assets easily outweigh its resource weaknesses and competitive liabilities. The company has plenty of opportunities it can pursue to continue to growth rapidly—the company should have little difficulty opening several hundred more stores (Dunkin' Donuts has 3,600 in the U.S. alone, versus just over 180 for KKD. KKD's strategy is a solid one, with competitive advantages in product quality, product appeal, brand reputation, and ability to attract high caliber franchisees (because of the attractive store economics), and backward vertical integration into doughnut-making equipment, doughnut mixes, and coffee. The threats are lurking in the background, but have not so far reared their heads. The product excitement being created by Krispy Kreme could end up helping grow the market for doughnuts and help overcome the relatively flat demand for doughnuts that has prevailed. If so, a costly battle for market share among industry participants can be avoided.

5. What is your assessment of Krispy Kreme's competitive strengths and weaknesses in comparison with key rivals? Please use the methodology in Table 4.4 of Chapter 4 in arriving at your answer.

There is ample data in the case for students to do a solid competitor strength assessment using the methodology described in Table 4.4 of Chapter 4. It is well worth 10-15 minutes of class time to drill students on proper use of this analytical tool and thereby put some punch behind their "opinions" as to whether KKD has adequate resources and competitive capabilities to take market share and sales away from other doughnut industry rivals.

Our unweighted and weighted competitive strength assessments are shown in Table 1 of this note. We think product quality/appeal and brand name reputation are probably the two most important measures of competitive strength in the doughnut industry. Most everyone knows about doughnuts—so the trick to getting people to buy them and to do so regularly will have a lot to do with their taste, freshness, and word-of-mouth reputation among doughnut enthusiasts. KKD focus on "hot doughnuts now" has very high appeal among consumers, judging by all the reactions and comments in the case.

Table 1 | Competitive Strength Assessments of Selected Doughnut Industry Rivals

Key Success Factor/ Competitive Strength Measure	**Weight**	**Krispy Kreme Rating**	**Krispy Kreme Score**	**Dunkin' Donuts Rating**	**Dunkin' Donuts Score**	**Winchell's Rating**	**Winchell's Score**
Breadth of product line	0.15	4	0.60	8	1.20	7	1.05
Reputation/image	0.20	9	1.80	8	1.60	5	1.00
Product quality/appeal	0.25	10	2.50	6	1.50	5	1.25
Geographic coverage	0.15	4	0.60	9	1.35	5	0.75
Supply chain capabilities	0.10	9	0.90	5	0.50	5	0.50
Financial strength	0.15	8	1.20	10	1.50	5	0.75
Sum of the weights	**1.00**						
Totals of Ratings/Scores		**44**	**7.60**	**46**	**7.65**	**32**	**0.00**

Key Success Factor/ Competitive Strength Measure	**Weight**	**Tim Hortons Rating**	**Tim Hortons Score**	**LeMar's Rating**	**LeMar's Score**
Breadth of product line	0.15	9	1.35	4	0.60
Reputation/image	0.20	8	1.60	3	0.60
Product quality/appeal	0.25	6	1.50	9	2.25
Geographic coverage	0.15	6	0.90	3	0.45
Supply chain capabilities	0.10	5	0.50	5	0.50
Financial strength	0.15	7	1.05	4	0.60
Sum of the weights	**1.00**				
Totals of Ratings/Scores		**41**	**6.90**	**29**	**5.00**

(Rating Scale: 10 = Very strong; 5 = Average; 1 = Very weak)

Conclusions: Students can differ in their competitive strength evaluations because of different weightings, different strength measures, and different rating scores. But we think they should conclude that KKD has the resource strengths and capabilities to do well against other industry participants. We see KKD as quite strong vis-à-vis competitors with regard to product quality/appeal (especially on the hot doughnut factor), supply chain capabilities, and brand name/reputation. It lacks the geographic coverage of Dunkin' Donuts (in terms of outlets); geographically, Tim Hortons is very strong in Canada but is well behind KKD in building a national presence across the U.S. (and is unlikely to pursue such expansion). Hortons and Dunkin Donuts have menu lineups that increase their appeal to customers not expressly wanting doughnuts, which in some respects is an advantage (particularly in attracting store traffic for lunches and snacks). LaMar's apparently has a great doughnut, but the nutritional content of LaMar's products would seem to be a serious disadvantage vis-à-vis KKD. While KKD is a smaller company than the parent companies of Dunkin Donuts and Tim Hortons, it definitely has the financial strength to fund its expansion program—so it is not at a size disadvantage that would seem to matter from a competitive and strategy execution standpoint. On the whole, we see KKD as being in very good shape to take on the rivals that it confronts and be successful. There would seem to be no reason to locate new

Krispy Kreme stores so close to the stores of rivals that head-to-head competition at the local store level would prove to be a serious detriment to KKD's expansion and franchising efforts.

6. On the basis of your assessment above, what do you think of the company's growth prospects? Just how good are they? What evidence supports your answer? What size growth rate do you believe Krispy Kreme can achieve over the next five years?

While it is easy for students to say that the company's growth prospects are "good" (it is hard to come to any lesser conclusion), the really substantive issue is just what size growth rate appears to be sustainable over the next several years.

- Can the company reasonably expect to achieve its stated targets of 20 percent annual revenue growth, mid-single digit comparable store sales growth, and 25 percent annual growth in earnings per share? Can it do even better? Might it well come up short?
- And what evidence supports what conclusion?
- What will have to happen for Krispy Kreme's earnings to grow 25% annually while its revenues are growing only 20% annually?

Here is a golden opportunity to press the class for some number-crunching evidence and to arrive at some solid, educated estimates of KKD's growth prospects. Here's some of the number-crunching that can be done:

- The table below, based on store sales data provided in the case, is a better indicator of the annual sales volumes at the newer stores that form the core of KKD's strategy and expansion program and that provide the best signals of the company's future growth potential.

	Average weekly sales in 2000 (as per info in case)	**Annual sales in 2000**
Stores opened in 1997 and 1998	$40,000	$2,080,000
Stores opened in 1999	$69,000	$3,588,000
Stores opened in 2000	$79,000	$4,108,000 (annualized—all of these stores were not open all year)
All company-owned stores	$69,000	$3,588,000
All franchised stores	$43,000	$2,236,000

- The average annual sales of all KKD stores, both company-owned and franchised, in 2000 was $2,575,000 (calculated by dividing systemwide sales of $448,129,000 by 174 stores—case Exhibit 1).
- Rough estimates of KKD's potential systemwide sales growth are shown in Table 2. Based on the indicated assumptions about the number of new store openings (well in line with what KKD ought to be able to achieve, assuming the present favorable reception for the company's products continue), and assuming ongoing existing store sales increases of as much as 10% annually (somewhat optimistic) or as little as 6% annually (fairly realistic and in line with the company's estimates of single-digit growth), then KKD should be able to show systemwide revenues of $1.04 to $1.2 billion by the end of fiscal year 2006.

Table 2 | Sales Projections for Krispy Kreme Doughnuts, 2002-2006

	Estimate of KKD's total sales assuming 10% increase in sales at existing KKD stores (in millions)	**Estimate of KKD's total sales assuming 6% increase in sales at existing KKD stores (in millions)**
KKD's systemwide sales in 2002		
Sales of $448.1 million at existing 174 stores (year-end 2001)	$492.9	$475.0
+ sales at 36 new stores 2002 @$3.6 million per store times 50% (to adjust for fact that not all new stores are open all 52 weeks)*	64.8	64.8
2002 sales total for 210 stores	$557.7	$539.8
KKD's systemwide sales in 2003		
Sales at existing 210 stores (as of year-end 2002)	$613.5	$572.2
+ sales at 40 new stores @$3.6 million per store times 50% (to adjust for fact that not all new stores are open all 52 weeks)*	72.0	72.0
2003 sales total for 250 stores	$685.5	$644.2
KKD's systemwide sales in 2004		
Sales at existing 250 stores (year-end 2003)	$754.0	$682.9
+ sales at 45 new stores @$3.6 million per store times 50% (to adjust for fact that not all new stores are open all 52 weeks)*	81.0	81.0
2004 sales total for 295 stores	$835.0	$763.9
KKD's systemwide sales in 2005		
Sales at existing 250 stores (as of year-end 2004)	$918.5	$809.7
+ sales at 50 new stores @$3.6 million per store times 50% (to adjust for fact that not all new stores are open all 52 weeks)*	90.0	90.0
2005 sales total for 345 stores	$1,008.5	$899.7
KKD's systemwide sales in 2006		
Sales at existing 345 stores (as of year-end 2005)	$1,109.4	$953.7
+ sales at 50 new stores @$3.6 million per store times 50% (to adjust for fact that not all new stores are open all 52 weeks)*	90.0	90.0
2006 sales total for 395 stores	$1,199.4	$1,043.7

*The assumption here is that new store openings will be evenly distributed across the year such that new stores, on average, will be open 26 weeks, thus generating new revenues on average of $1.8 million, instead of the full $3.6 million.

- If we assume, for simplicity, that 100% of the new stores opened are franchised stores, then KKD's corporate revenues from company store sales in 2006, which totaled $213.7 million in fiscal year 2001, should rise to between $286.0 million (assuming comparable store increases of 6% annually) and $344.2 million (assuming comparable store increases of 10% annually) in fiscal year 2006. Subtracting estimated sales at company stores from the systemwide store sales estimates means that franchised store sales in 2006 should range between $754 million and $856 million. But KKD will have additional revenues from royalties and from the sales of ingredients.
- Since KKD earns royalties of 4.5% on sales at franchised stores, its royalty stream from franchised store sales should be somewhere between $33.9 million (given company store sales of $286 million) and $38.5 million (given company store sales of $344 million). To this royalty stream can be added the franchise fees of $20,000 to $40,000 per store (say an average of $30,000). Opening 50 new stores in 2006 should generate franchise fees of $1.5 million and produce total royalties from stores sales of between $35.4 and $40.0 million.
- KKD reported systemwide store sales of $448 million in 2001 (case Exhibit 1) and company stores sales of $213.7 million (case Exhibit 2); it follows then that franchised store sales were $235.7 million in fiscal 2001. KKD's sales of equipment and ingredients to franchised stores totaled $77.6 million in fiscal year 2001, equal to 32.9% of franchised stores sales. If this ratio continues to hold over upcoming years, given the estimates of franchised store sales in 2006 of between $754 million and $856 million, then KKM&D's revenues in 2006 could come in the range of $248 million to $282 million.
- The foregoing revenue estimates for KKD for 2006 are summarized below:

	Estimate of KKD's total sales in 2006, assuming 10% increase in sales at existing KKD stores (in millions)	**Estimate of KKD's total sales in 2006, assuming 6% increase in sales at existing KKD stores (in millions)**
KKD's systemwide sales in 2006		
Sales at company-owned stores	$344.2	$286.0
Royalty revenues	40.0	35.4
KKM&D	$282.0	$248.0
Total	$666.2	$569.4

The $666.2 million sales estimate translates into a 17.2% CAGR for the 2001-2006 period; the $569.4 million estimate translates into a CAGR of 13.6%. KKD could beat these estimates by adding company-owned stores (the calculations above assumed that all new stores opened were franchised stores, which made the calculations simpler).

What these estimates indicate is that KKD will indeed have to open some company-owned stores to hit its 20% revenue growth target or else it will have to up the number of franchised store openings.

One other concern should be noted. As more and more franchised stores are opened, the average sales per store may begin to erode some, since sales at some newly-opened stores may come from drawing customers away from existing stores. Furthermore, locating stores in less populated areas may result in lower sales per store.

The addition of new coffee drinks should help boost KKM&D sales, as well as store sales.

Conclusion: KKD can hit its growth targets of 20% annually, but it will be pressed to beat that target by very much.

7. What major issues do you think that Krispy Kreme management needs to address?

Based on the points brought out in the above assessment, students ought not to have undue difficulty in zeroing in on the key issues confronting KKD management. We see the following issues as paramount:

- Whether to push franchisees to accelerate the speed at which they are opening new stores in their franchised areas?
- How many new company-owned stores to open and where to locate them?
- How fast to pursue upgrades and expansion of the company's coffee offerings?
- Whether and when to begin to expand the menu offerings beyond doughnuts and coffee? What products, if any, might it make sense to consider?
- Whether and when to begin opening stores in markets with fewer than 100,000 households? When should KK start to experiment with smaller stores sizes?
- Whether and when to begin pursuing international expansion? What countries to enter first?

We like to go to the board and record all the issues that the class believes management needs to address. This list then becomes the basis for making action recommendations. Normally, there should be action recommendations for each of the issues and problems identified.

8. What recommendations would you make to Krispy Kreme management to improve upon the strategy or otherwise sustain the company's growth and profitability?

Based on the issues identified above, we think actions along the lines indicated below are in order:

- KKD management should meet with franchisees and explore again the plans for opening new stores—it would seem to make sense to accelerate the pace of new store openings, at least in those areas where the enthusiasm for Krispy Kreme products has been so great.
- The new coffee products should be tested in company stores (and perhaps select franchised stores) and, as quickly as support systems can be put in place, the new coffee menu offerings should be rolled out systemwide before the end of 2001.
- KKD management should begin immediately to explore stores sizes and designs appropriate for markets of fewer than 100,000 households. This could be done when older associate stores in areas with fewer than 100,000 households need to be closed and relocated. However, it doesn't really make sense for KK to turn its attention prematurely to smaller markets before it completes efforts to "build out" or scatter stores throughout the larger metropolitan markets where new store openings are already planned.
- KKD should proceed with efforts to locate units in foreign countries. Canada is a natural place to start foreign expansion (a Canadian franchisee is already opening stores in the eastern portions of Canada), but entering other country markets needs to be high on the action agenda for the 2002-2003 period.

- We would strongly caution against expanding the menu offering beyond coffee and doughnuts at this time. The company's focus on doughnuts is a strength, not a weakness. Menu expansion may come later, but this is not the time for KKD to wander outside the market niche for coffee and doughnuts.
- We think the company should proceed with opening 2-4 company-owned stores per year. KKD margins on selling its products through company-owned stores are somewhat better than on sales to franchised stores.

9. Would you buy this company's stock? Why or why not? What size price-earnings ratio makes sense for a company with Krispy Kreme's potential? If 70 times earnings is too big, as some analysts claim, what p-e multiple does make sense?

In financial circles, there's a fairly widespread conviction that one good way to judge whether a company's stock price is "too high" or "a good value" or representative of "fair value" is by comparing the price-earnings ratio to the growth rate in a company's earnings. Thus a company growing its earnings 25% annually should command a p-e ratio of about 25; a company growing earnings at 50% annually should command a stock price of about 50 times current earnings per share. Such logic further implies that if a company's stock price entails a p-e ratio much above its earnings growth rate then its stock price is "overvalued." If a company's stock price is below its earnings growth prospects, the its stock is allegedly "undervalued."

Thus one way for students to judge whether Krispy Kreme's stock price makes it a good stock to buy or a risky stock to buy hinges upon how they answer the question about the company's growth prospects in question 6 above. Our calculations showed that 20% growth in revenues is reasonable; the recent strong improvements in the company's net profit margin, the new plant for mixing ingredients (said to lower costs), and the potential for scale economies would seem to make 25% growth in earnings an attainable target. Our estimates would thus support a p-e ratio of 25.

But there's nothing in our calculations that would lead us to believe that Krispy Kreme could grow its earnings at a 70% annual rate over the next five years, which would imply that a stock price in the high 40s does indeed signal that Krispy Kreme stock is overvalued (assuming one buys the importance of the PEG ratio as a valid indicator of stock price valuation).

In short, we think Krispy Kreme is a fine company, with a solid focused differentiation strategy, and solid growth prospects. But we would not be a buyer of its stock at these lofty price-earnings multiples. In our view, there is more downside risk to buying the stock in the high 40s than there is upside potential. We think this is what the stock analysts cited in the case meant when they said that, "It [the stock] has had a good run, but the numbers just don't work" and "the odds are against this stock for long-term success."

Epilogue

Growth at Krispy Kreme continued to be brisk throughout 2001. New store first week sales continued to climb throughout the year, reaching an average in excess of $189,000 for the full fiscal year of 2002. This represents an increase of 21% over last year's average of $155,596. The opening week record was set in this fourth quarter, with a new store in Seattle registering more than $454,000 in first-week sales and a new store in Toronto achieving first-week sales of $465,000 (in Canadian dollars). Although the Toronto sales figure was in Canadian dollars, the number of dozens sold was nearly four percent higher and the number of customer transactions was over 10 percent higher than in Seattle.

An estimated 5 million Krispy Kreme doughnuts were being sold everyday, equal to more than 2 billion annually.

The company's stock split 2 for 1 on June 15, 2001 and began trading at the new split value of $42 ($84 per share prior to the split); it dropped to a low in the high 20s following the 9/11 terrorist attacks and then trended upward to about $45 per share at year-end 2001. In March 2002, Krispy Kreme's stock was trading in the high 30s, with a very lofty price-earnings multiple of about 100 to 1.

Company revenues increased 40.3% in the fourth quarter of fiscal year 2002 to $114.9 million, while on a full-year basis, revenues were up 30.4% to $392.2 million. System-wide sales for the fourth quarter of 2002 were $182.6 million, an increase of 46.3%, while company store sales increased 31.9% to $75.4 million. For 2002, system-wide sales were $621.7 million, up 38.7% over 2001. Company store sales for 2002 increased 24.6% when compared to the full fiscal year of 2001. The Company noted that the results for 2002 reflected 53 weeks, an event that occurred every fifth year. As a result, the fourth quarter of fiscal year 2002 contained fourteen weeks.

The Company indicated that top line growth and business momentum continued to be very strong, as measured by the three major drivers of system-wide sales growth—average new store first-week sales, new store openings, and comparable store sales growth. The second major driver of system-wide sales growth, the pace of new store openings, continued to exceed expectations. KKD opened 48 stores in fiscal 2002, bringing total stores at the end of the year to 218. Additionally, the Company opened three doughnut and coffee shops (stores featuring the new hot doughnut technology) in Charlotte, Greensboro, and Winston-Salem, North Carolina.

Preliminary store opening expectations for fiscal 2003 called for 59 new stores and 10 to 15 doughnut and coffee shops.

KKD management expressed comfort with its latest earnings guidance of $.44 per diluted share for fiscal year 2002 and $.61 per diluted share in fiscal 2003. As of February 3, 2002, KKD had cash and investments on hand in excess of $45 million, outstanding debt of approximately $8.3 million and availability under of a line of credit of approximately $32 million.

KKD CEO Scott Livengood said, "Fiscal Year 2002 has been an exceptional year for the Company. Our new initiatives, including the small-format doughnut and coffee shop, international opportunity and expanded beverage program, combined with the continuing early stage build-out of our factory store network in North America create exceptional growth opportunities for Krispy Kreme for years to come. We are excited about the coming year."

The new manufacturing and distribution facility, under construction in Effingham, Illinois, was scheduled to open in April 2002. It would supply proprietary doughnut mix and other supplies to the growing number of stores in the Midwest, West, and Canada.

In September 2001, Krispy Kreme announced the development of a new proprietary doughnut technology which had the potential to substantially increase the number of stores featuring its signature "hot doughnut now" experience. The Company called this technology the "Krispy Kreme Hot Doughnut Machine." The new machine, a conveyor oven and glazing system, closely resembled Krispy Kreme's current doughnut production equipment manufactured by the company. The Hot Doughnut Machine, however, was designed to finish cooking and glazing doughnuts that had been prepared to a certain point at a factory store and delivered fresh to a store employing this technology. The result was a hot doughnut virtually identical to that experienced in Krispy Kreme's traditional factory stores. Since this system was only finishing the doughnut making process, it required much less space, direct labor and investment than the full production process. An additional benefit of the new system was the ability to offer multiple varieties of hot doughnuts throughout the day.

In October 2001, KKD announced that it would construct three new outlets in North Carolina (the previously mentioned stores in Charlotte, Greensboro, and Winston-Salem) to test the Company's new Hot Doughnut Machine technology as well as introduce a new store design developed to reflect and enhance the brand's core values. These stores also featured Krispy Kreme's new expanded beverage program. The new look for these stores combined historical references (copies of 50-year-old company posters that were archived in the Smithsonian Institution) with modern elements including stainless steel and light woods. The new store format entailed a warm, inviting and updated environment, with colorful menu boards and employee uniforms complementing the decor. Krispy Kreme's expanded beverage program featured three drip coffees ranging from light and smooth to deeper, more intense blends. It also included a line of flavored milks, espresso beverages, frozen coffee beverages, and other frozen beverages prepared with a variety of proprietary flavors.

For the latest information on Krispy Kreme's performance, please consult the periodically updated Case Epilogue Updates in the Instructor Center at www.mhhe.com/thompson. You might also wish to have your student visit the company's website at www.krispykreme.com.