Exercise 3
Krispy Kreme Doughnuts in 2005: Are the Glory Days Over?

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Introduction

Like numerous corporations, Krispy Kreme went through many changes in its first several decades. Changes were witnessed in ownership, management, location, and even the doughnut's recipe. For producing a simple product, Krispy Kreme grew tremendously in terms of size and revenue. Management was passionate about the product, and it appeared that that passion would continue to be translated into profits for Krispy Kreme indefinitely. The company had not experienced economic hardship until 2004.

Pre-decline Strategy (through early 2004)

Prior to 2004, Krispy Kreme was very successful for many years and that success seemed, in large part, to be derived from the company's strategy. The main idea was to expand rapidly into untapped markets. The organization's business model established three sources of revenues and profits: proceeds from sales at company-owned stores, royalties and franchise fees from franchise stores, and sales of supplies, such as doughnut mixes, equipment, and coffee, to the franchise stores. By requiring franchise shops to operate in the same manner as company-owned stores, the corporation could maintain the same standards across all locations. With franchises as an integral part of Krispy Kreme, it was important that they not be financially strained and only be required to have minimal capital. As franchises provided Krispy Kreme with necessary royalties, it was important that successful franchises also take responsibility for other local stores' operations.

Krispy Kreme's strategy extended from franchise operations in a manner that allowed for vertical integration of the supply chain. With doughnut mixes and equipment being manufactured by the corporation, these key components of the operation were sold to franchises. The success of franchising encouraged Krispy Kreme to either close or remodel older, less profitable stores and shift some of the focus to selling the product to convenience stores and supermarkets. Due to the popularity of the brand's doughnuts, Krispy Kreme was able to allocate investment in marketing to other areas. Part of the corporation's strategy then allowed for advertising to happen via word of mouth and local media. With management believing that these elements contributed successfully to the overall strategy, Krispy Kreme, in 2003, purchased the Montana Mills Bread Company. The idea was that the company's success with doughnuts and coffee could be similarly achieved with other baked goods.

Krispy Kreme's management had reason to be concerned with the company's prospects heading into 2004 and should not have been caught completely off guard. Many successful corporations have faced adverse economic conditions, learned from them, and survived, but was Krispy Kreme prepared to do that? Management had not effectively addressed this question by developing a defensive aspect as part of the overall strategy. Based on past performance, management believed Krispy Kreme would continue to thrive and rapidly expand, because it always had. Montana Mills was supposed to create new opportunities for Krispy Kreme. However, in the year following the acquisition of Montana Mills, it operated at a loss of $2 million. Was this really the right time to diversify the business? Krispy Kreme had not invested enough time to understand if selling alternative baked goods under the Krispy Kreme brand, rather than purchasing Montana Mills, would have been lucrative. In other words, Krispy Kreme management had not effectively analyzed the internal environment to determine if the company had the resources to handle expansion into additional baked goods.

Furthermore, Krispy Kreme had not appropriately analyzed the external environment either. Analysis would have shown how competitors fared when offering multiple products to the market. It also would have indicated to Krispy Kreme what customer preferences were. Krispy Kreme's success was due in large part to customers believing their doughnuts were the best in the business. Despite doughnuts generally being considered unhealthy, many customers were hooked on them. Analysis, however, would have shown that the Atkins diet, among other dieting programs, was a driving force that started encouraging many customers to seriously consider healthier alternatives to doughnuts.

Pre-decline Financial Performance (before 2004)

Before 2004, Krispy Kreme had enormous financial success. In the four years prior to 2004, total revenues grew on average by nearly 32% per year, including a high of more than 36% in fiscal year 2001. Although operating expenses comprised a large percentage of revenues during these years (annual average of nearly 81%), the percentage dropped by an average of 2.5% each year. General and administrative expenses were down towards the end of this period as well. The growth in revenues and operating expenses is reflected in the amount of global expansion Krispy Kreme experienced in these years. Net income rose on average by about 1.5% each year during this period. On the balance sheet, total assets grew substantially every year except for fiscal year 2004. Long-term debt increased considerably, especially in fiscal year 2003, when it rose by over 1,200%. This rise could be attributed to the acquisition of Montana Mills or an increased expansion to new stores. Fortunately for Krispy Kreme, total shareholders' equity soared to new highs each year from 2000 through 2003. Cash flow from operations was strong for Krispy Kreme throughout this period. Much cash flow was also used for investing purposes. Business segment results varied during this period. Company store revenues increased each year, while franchise revenues grew as well. However, franchise revenue percentages declined each year from 71% in fiscal year 2002 to less than 24% in fiscal year 2004. Manufacturing and distribution revenues saw similar declines during this period prior to 2004.

2004 Downturn and Accounting Practices

The financial downturn experienced by Krispy Kreme in 2004 actually began in the preceding years. Fiscal years 2003 and 2004 saw large increases in long-term debt that Krispy Kreme did not appear to be accustomed to in previous years. Another piece of evidence can be seen in the continual decline in annual percentage of both franchise revenues and manufacturing and distribution revenues. Although the revenues increased each year, the percentage increases were dwindling.

These concerns were exacerbated in 2004 (fiscal year 2005) when earnings failed to meet management's expectations. The Montana Mills acquisition proved to be a disaster for Krispy Kreme. Growth at store locations slowed considerably and some locations were closed due to underperformance. Krispy Kreme's stock price dropped sharply as well. As plans for expansion were scaled back, the SEC began probing into the Krispy Kreme's accounting practices. In the latter part of 2004, the company lost money instead of its typical positive returns.

Examination of Krispy Kreme's downturn in 2004 reveals that the company was not strategically prepared for adverse conditions. The corporation's strategy hinged a lot on rapid global expansion. Management seemed to be counting on the early crowds at store openings to continue rather than dissipate. As this phenomenon formed the basis for Krispy Kreme's strategy, the company was not robust enough to handle a major setback like the Montana Mills acquisition. Management was overconfident in its ability to do things the "Krispy Kreme way". The fact that the SEC decided to investigate Krispy Kreme indicates that management was willing to take unethical steps to prevent any negativity from affecting the public's opinion of the company's performance. Perhaps the board of directors was not critical enough early on in its evaluation of the company's performance. The accounting tactics employed by top management could be considered aggressive or very covert. Evidence of questionable accounting practices was found in the ways Krispy Kreme bought back franchises. The company tended to repurchase units that were performing poorly. Further evidence can be seen by the company's announcement in December 2004 that accounting errors did take place in the repurchased of certain franchises.

SWOT Analysis

Despite the downfall that Krispy Kreme experienced in 2004, its weaknesses do not necessarily outweigh its strengths. The Krispy Kreme brand is very recognizable throughout the United States and in other countries. Although the company's lack of effort in advertising could be considered a weakness, the strength lies in the fact that capital is not spent in that capacity. Krispy Kreme effectively relies on customers to advertise for them by word of mouth. As mentioned previously, Krispy Kreme's strategy could be seen as a weakness. Even though the company has expanded rapidly, tremendous opportunities remain in various markets around the world. However, Krispy Kreme is likely to face external threats, as the Atkins Diet phenomenon has shown the company that many customers are willing to give up doughnuts in pursuit of low-carbohydrate diets. As of early 2005, Krispy Kreme's stock price was at about $6, indicating that the company's situation was not as favorable as in recent years. However, the company was in the hands of the board of directors and a consulting company reputed for being able to turn around other companies. The attractiveness of this situation is that the company has already gotten through the downfall, and now, it would be able to evolve its strategy to experience more fundamental success. Market studies would likely be improved in an effort to craft a better strategy.

Rivals and Turnaround Prospects

Krispy Kreme's main rivals include Dunkin' Donuts, Tim Hortons, Winchell's Donut House, and LaMar's Donuts. Both Dunkin' Donuts and Krispy Kreme have the most recognized names in doughnuts, which is a distinct competitive strength. As well, the two companies have dominated the national doughnut business for years. In contrast to Krispy Kreme, Tim Hortons controls the Canadian market and is larger, especially in terms of revenues. Winchell's and LaMar's competitive strength is similar to Krispy Kreme in that each doughnut-maker has a loyal following. Each company is looking to expand into geographic areas that will bring in additional profits. In comparison to its competitors, Krispy Kreme may have expanded too much too quickly. As the company proved unable to diversify, this strategy could be considered a competitive weakness. Conversely, this same strategy could be what drives Krispy Kreme to mount a serious and sustained comeback. The company continues to have a strong customer base, and new store openings generate much revenue.

Recommendations

In order to return Krispy Kreme to profitability in 2005 or 2006, several actions can be taken. First of all, it would be advisable that the company adhere to ethics that the SEC, its shareholders, and other stakeholders view as acceptable. Covering up poor financial performance at franchise locations is no longer an option. Secondly, the expansion into new markets should be continued but at a less rapid pace than before. To avoid poor performance, more careful market research is required at potential store locations. Management must be more willing to reject a potential location if the research does not support expansion. Another recommendation would be to make the company's strategy more robust. In this way, should Krispy Kreme face another downfall like it did in 2004, it would be able to better continue to prosper despite financial losses.

Reference Section

Thompson, A., Gamble J., & Strickland, A. *Strategy Winning in the Marketplace* (2nd ed.). New York: The McGraw-Hill Companies, Inc.

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Paul, you did a fine job in analyzing a very difficult case. Your SWOT was on point as was your set of recommendations.