

# FINAL TRANSCRIPT

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## **KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call**

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Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

## CORPORATE PARTICIPANTS

**Brian Little**

*Krispy Kreme Doughnut - Director Corporate Communications*

**Jim Morgan**

*Krispy Kreme Doughnut - President, CEO, Chairman*

**Doug Muir**

*Krispy Kreme Doughnut - CFO*

## CONFERENCE CALL PARTICIPANTS

**John Ivankoe**

*JPMorgan - Analyst*

**Barry Posternak**

*Ramsey Asset Management - Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen. Welcome to the second quarter fiscal 2009 Krispy Kreme Doughnut earnings conference call. My name is Stacey, and I'll be your moderator for today. At this time, all participants are in listen only mode. We will be facilitating a question and answer session towards the end of the conference. (OPERATOR INSTRUCTIONS). As a reminder, this conference is being recorded for replay purposes. I would now like to turn the presentation over to your host for today's call, Mr. Brian Little, Director of Corporate Communications. Please proceed.

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**Brian Little** - *Krispy Kreme Doughnut - Director Corporate Communications*

Good afternoon, everyone. Welcome to the Krispy Kreme fiscal 2009 second quarter earnings conference call. On the call with me today are Jim Morgan, Krispy Kreme's President and Chief Executive Officer, and Doug Muir, Krispy Kreme's Chief Financial Officer. During today's call, Mr. Morgan will address the company's performance for the second quarter and Mr. Muir will give an overview of the second quarter results released earlier today. Following our prepared remarks, we will ask the Operator to open the lines to take your question.

I'd like to first remind everyone that a copy of our earnings announcement including financial tables is available in the news release section under the Investor Relations tab at our website, [www.KrispyKreme.Com](http://www.KrispyKreme.Com). This conference call is being webcast and will be archived on our website for one year. A transcript of this conference call will also be available on our website. All SEC filings and press releases are accessible there as well. Investors and analysts are directed to these online public resources for the most up-to-date company information. Krispy Kreme Investor Relations can be reached via e-mail at [IR@KrispyKreme.com](mailto:IR@KrispyKreme.com).

Our responses today as well as our prepared remarks should be considered forward-looking in nature and are subject to various risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize or should underlying assumptions prove to be incorrect, actual results may vary materially from those anticipated, estimated or expected. Key factors that may have a direct bearing on Krispy Kreme's operating results, performance or financial condition are discussed in Krispy Kreme's form 10-k for fiscal 2008 and other periodic reports filed with the US Securities and Exchange Commission.

I'll now turn the call over to Mr. Morgan. Jim?

Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

**Jim Morgan** - *Krispy Kreme Doughnut - President, CEO, Chairman*

Thank you, Brian. Good afternoon, everyone. Welcome once more to our second quarter conference call. As we commented during our conference call last quarter, we expected that our financial results would be somewhat uneven in the near term as we continue to make the necessary organizational adjustments and investments to improve and grow the business over the long term. July is historically our toughest quarter and a weakening economy, rising fuel and agricultural commodity prices combined adversely affected us. Nevertheless, we believe very strongly that it is our task to operate successfully despite the external challenges that may arise and I continue to believe we're on the right track strategically and I remain confident about the future of Krispy Kreme. I might note that one reason for my increased confidence of these past few months, one of several reasons, is my getting to know the employee base better, and if there's one thing I'm sure of now, we do have the people in place at all level of this Company, throughout the Company that can lead this Company to success. It's a committed and dedicated group of individuals.

I also believe, however, that we have to move more rapidly at the same time thoughtfully to implement our key strategic initiatives in order to achieve the positive long term results that we believe are possible and using that as a lead in, let me outline our strategic initiatives for you in a little bit more detail. First, small retail shops. We are going to build new small retail concept shops in select company markets in order to bring our signature donuts closer to consumers and to establish the economics of the domestic hub-and-spoke model. We expect the economics of these shops to be very attractive, simply because they are less expensive to open and operate than our traditional factory stores. Moreover, supplying smaller satellite Krispy Kreme stores from Krispy Kreme factory stores improves the utilization of the factory store as well and significantly enhances the return on those stores. As a part of this project, we have been actively searching in North Carolina and Tennessee for suitable sites for new Company satellite store locations. We began our search in Raleigh, North Carolina and Nashville, Tennessee, and expanding we'll be expanding that search to include the Piedmont Triad and Charlotte North Carolina Markets as well as Memphis, Tennessee. In addition we expect to meet our previously stated goal of opening the first of these locations during this fiscal year. I might remind you that these type shops have already proven to be successful in our international markets and we believe they will set the stage as a model for future domestic growth.

Point number two, shop operations. We are now bringing intense focus to the basics of shop operations in order to improve both the consumer experience and our financial results. The best example of this was in early June we hired a QSR veteran with 25 years of QSR operations experience to spearhead our efforts to deliver an outstanding consumer experience at all of our shops, improve our and insure that we consistently execute the QSR basics. Number three, broader menu offerings. We continue to develop, test, and deploy new menu offerings in order to give consumers more reasons to visit Krispy Kreme.

Probably the most exciting important test they can place now is the test of Kool Kreme, and that's spelled Kool Kreme, a new soft serve ice cream concept. Kool Kreme is truly a delicious proprietary soft serve ice cream and we pair it with an extraordinary toppings bar which includes a toppings bar of fresh fruit. Our Seattle franchisee developed this Kool Kreme concept and they began initial store testing over a year ago. That was recently expanded to include a second location there. We introduced Kool Kreme four weeks ago at one of our Company shops in Greensboro, North Carolina, and Kool Kreme is also being tested at several franchise locations in the St. Louis area. I might also note we're also, we are working on several other products to expand our menu offerings as well as Kool Kreme, but Kool Kreme is the one that's in the stores and test formed and the furthest along.

Point number four, improving all premises economics. We are working to improve how we do business in the all premises channel which has experienced particular revenue and cost pressures and we went into those pressures at some detail in the most recent quarterly call three months ago. We are looking at product assortment, shelf life, price points, delivery frequency, as well as fleet management. All of these have strategic or tactical levers that we hope can improve the profitability of the off premises business. We think the Krispy Kreme brand should be represented in the off premises distribution channel and we feel that very strongly and we're working to formulate the best approach going forward in this ever changing marketplace.

Our fifth initiative is international expansion. We are continuing to build on our success as an international franchise development and we are devoting additional resources to that area. Recently, we announced two international franchise development

Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

agreements, one in the Republic of Turkey, for approximately 25 shops and the other in Malaysia for approximately 20 shops. I might note that the Krispy Kreme's international franchisees opened 30 stores in the second quarter of this year for a total of 58 stores thus far in fiscal 2009. The majority of these shops are satellite shops that occupy less than 2000 square feet, and as I mentioned in my earlier comments these should serve as great models for our domestic growth in both company and franchise markets. We also anticipate announcing additional international development agreements in the months ahead.

My sixth point is it pertains to franchisee operational support. We continue to enhance our franchisee operational support domestically and internationally. Next week we'll be hosting our domestic franchise conference where company and franchise operators come together to discuss our goals and more importantly to share the best practices that will help us attain those goals. We have held and plan to continue to hold more international franchise conferences to tap the experiences and learning of Krispy Kreme operators throughout the world. I would also like to note that something else I've learned in the months that I've been here and that is we have some excellent franchisees and we are deeply committed to delivering to them tools, methods and practices that will improve their shop operations everywhere.

Final point, seventh point is the supply chain support. We are working to provide increased supply chain support to increasingly global business and improving franchisee service levels and economics. Among other things, we have added additional distribution support staff and dedicated personnel to our international franchisees in order to improve our responsiveness to their needs. We are also working with a number of international franchisees to increase the level of local source of ingredients and other materials, when doing so offers them the superior economics or other competitive advantages.

In conclusion, let me say that as we continue to lay the foundation for sustainable growth, we want to caution once more that none of our strategic initiatives will gain significant traction overnight. We still face internal and external challenges. Although we have seen what I consider to be notable progress, progress greater than our numbers might imply in fact, it remains our task to overcome the challenges and capitalize on our opportunities in the years ahead and our intent is to do exactly that.

I'll now turn the call over to Doug who will speak to our financial

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**Doug Muir** - *Krispy Kreme Doughnut* - CFO

Thank you, Jim, and good afternoon (technical issues) for the balance of the year. During the quarter, franchisees opened 31 new Krispy Kreme shops system wide. Five of those were factories and 26 were satellites. There were seven shops closed in the quarter, of which five were factories and two were satellites. All but one of those 31 openings were international and the closures were principally domestic. This brings the total number of stores system wide at the end of the second quarter to 494, comprised of 286 factory stores and 208 satellites, and we crossed a milestone in the second quarter at the end of the quarter, over half the total store count was located outside the United States. And over a third of the store count represents non-factory small retail concepts, including hot shops, fresh shops and kiosks.

Now, turning to results for the quarter, we filed our quarterly report on Form 10-Q this morning, and I'd encourage you to take a read through it at your convenience. We reported a net loss of \$1.9 million or \$0.03 a share in the second quarter compared to a net loss of \$27 million or \$0.42 a share in the second quarter last year. The most significant single reason for the dramatic improvement was that last year's second quarter included impairment charges and lease termination costs of \$22 million or \$0.35 a share. As Jim noted, the July quarter is traditionally a seasonally slow quarter and the July quarter this year was no exception. We incurred an operating loss of \$1 million in the quarter this year compared to an operating loss of \$2.3 million last year, and last year's number is excluding the effect of that \$22 million of impairment charges. We did not produce the financial results in the quarter that our plan called for but we did not miss our number by a huge margin. There were a handful of unusual or one off items in the quarter, all of which are described in the 10-Q, but on balance they largely offset each other. Thanks to significant out performance last quarter, for the year-to-date, our results are ahead of plan.

Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

Let me take a minute to talk about cash flow and what the balance sheet looks like. We generated \$3 million of cash flow from operating activities in the second quarter compared to about \$600,000 in the second quarter last year. We ended the quarter with about \$33 million of cash and we have about \$12 million of unused credit availability under our bank revolver. Our total outstanding debt at the end of the quarter was just over \$75 million.

Now if I may, I'll take a look at the balance of the year. As you know, wheat and soy bean oil are the primary components of flour and shortening, which are our two most significant ingredients, and gasoline is a significant expense item in the company's store segment and gasoline influences freight costs in the supply chain segment. There recently has been some abatement in what for a long time was looking like a constantly rising cost environment and in some cases, there has been significant price retrenchment. This cost relief could have a positive effect on the second half of the year, particularly in the case of gasoline but we are not counting on it.

On balance, our shortfall to planned results in the second quarter makes our point estimate of our results for the full year somewhat less than it was three months ago. There are a number of uncertainties that could affect us, not the least of which are the state of the economy, gas prices, and consumers ability and willingness to spend, and these uncertainties lead to a relatively wide range of possible financial outcomes for the year, but our expectation at this time is that our results for the year will not be significantly different from our original plan. Our major focus is to execute the initiatives Jim described a few minutes ago. If we can do that, then I think we can begin to produce not only better financial results but also results that are more consistent and more predictable.

Stacey, at this time, we're ready to go to Q & A.

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## QUESTIONS AND ANSWERS

### Operator

(OPERATOR INSTRUCTIONS). Your first question comes from the line of John Ivankoe with JPMorgan.

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**John Ivankoe** - *JPMorgan - Analyst*

Yes, hi, thanks. I was hoping you could maybe give us some more specificity around the smaller shops, the satellite shops economics as you're currently planning for company markets, and just a sense of what your capital investment is, what kind of sales per unit you're expecting and if you can give us some margin expectation per box, that would be helpful and if it is possible to apply that relative to what franchisees have been doing, that would be great as well.

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**Jim Morgan** - *Krispy Kreme Doughnut - President, CEO, Chairman*

John, this is Jim. I think we will be able to do that at some point in the not too distant future. It's a little early. We've done some modeling. We're just now getting the shops up. We're not sure whether the international experience is going to reflect on the domestic experience, because they've gone largely toward fresh shops and we're probably going to go largely toward hot shops, so I think the answer is I'm not quite prepared to do that yet.

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**John Ivankoe** - *JPMorgan - Analyst*

Okay. Now, I know in the past you have, you've discussed various operational initiatives that you're trying at the store level in terms of labor cost savings going from salary to hourly employees. Could you give us an update again at the store level, where

Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

you are in terms of cost controls, whether things have been done or if there's anything we should be looking forward to in the future?

**Doug Muir** - *Krispy Kreme Doughnut - CFO*

John, this is Doug. We are beginning to see a little headway, we think, in shop labor. We're not where we need to be, but we think directional it we're headed in the right direction and making some progress. Generally, we are experiencing operating expenses at shop level running a little favorable to plan, and that's been one of the reasons we've been able to overcome, to some extent higher gasoline and certain commodity costs.

**Jim Morgan** - *Krispy Kreme Doughnut - President, CEO, Chairman*

John, this is Jim. Let me just add something to that. When we mentioned that in June, and I do think that's a significant, could be potentially a significant factor, it was only about a month later that we were fortunate enough to be able to bring in a new head of company store operations and with her experience, 25 or 26 years with a major out of QSR operation, we really, we didn't stop it by any means but we really decided that it was too valuable of an input for us not to give more of her input, give her a chance to get a little bit on the ground before we continue to push forward, so we didn't stop it but we slowed it down a little bit in order to make sure it was in sync with what she saw was most opportune without sacrificing the operational quality that we were trying to generate.

**John Ivankoe** - *JPMorgan - Analyst*

Just one last thing for me. I know the press likes to focus on things like growth of Dunkin' Donuts maybe in some of your markets is one of the reasons that you might not be doing as well as people would have thought maybe a couple of years ago. Is there any way to even anecdotally apply increased competition to some of your sales weakness?

**Jim Morgan** - *Krispy Kreme Doughnut - President, CEO, Chairman*

This is Jim again, John, and I can not give you statistically on that, but I can tell you that so far we have not seen any measurable effect in any of the markets where they open one store or 20 stores. Those stores that are in the same areas of ours do not look any different on relative basis on stores in areas where Dunkin' does not exist so I really don't feel like there's a direct relationship there. The great thing, and this is part of why I was attracted to this Company is I'm not sure, I mean I know this sounds strange but the product is so unique I'm not sure that we have a lot of direct competition. I think the gross competition is ourselves.

**John Ivankoe** - *JPMorgan - Analyst*

Okay, thank you.

**Operator**

Your next question comes from the line of Barry Posternak with Ramsey Asset Management.

**Barry Posternak** - *Ramsey Asset Management - Analyst*

Good afternoon, gentlemen. Just was reading through the 10-Q and a couple questions from there. First one of which it was noted that the \$500,000 decline in stock comp expense due to increased I guess executive officer turnover. Could you comment on that? Was that just in terms of how many or any detail you can provide there?

Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

**Doug Muir** - *Krispy Kreme Doughnut - CFO*

Sure, Barry. This is Doug. The big drivers of that are the departure of Darryl Brewster and Mike Phalen and Jeff Jervik, each of whom had some equity awards particularly in the case of Mike Phalen and Darryl Brewster that dated back to a higher stock price than we have today, and when they left, they forfeited those awards, so we don't have the current P & L hit because candidly the equity is lower today than it was when those forfeited awards were granted.

**Barry Posternak** - *Ramsey Asset Management - Analyst*

Okay, great. And then the second item was the royalty, there was \$440,000 of royalty income not recognized in the quarter principally related to international franchisees. Any color you could provide there as well in terms of whether it was one particular franchisee or which region of the world that was?

**Jim Morgan** - *Krispy Kreme Doughnut - President, CEO, Chairman*

Let me try and answer that this way. The international royalty question is tied, let me start over. The royalty revenue is related principally to a single franchisee. There is also a charge of about \$1 million in the franchise segment in the quarter related to the same franchisee. What we are seeing here, we think, is the fact that the credit market situation that we see domestically is also prevalent in other parts of the world.

This franchisee is basically in a situation not too dissimilar from the one we were in a couple of quarters ago in which we were having some trouble complying with financial covenants and a credit agreement that had been negotiated some time earlier. The franchisees profitable. The cash flow looks good but they are going through the same experience we went through a couple of quarters ago of renegotiating in a very difficult credit environment. It's been our practice, I think in the past year since I've been here is that when in doubt of whether we need to take a charge, we like to try and take them sooner rather than later. But we don't see this as a long term problem for this franchisee or for the international community generally.

**Barry Posternak** - *Ramsey Asset Management - Analyst*

Okay and was that \$440,000 the full amount of royalty that would be owed by that franchisee for the quarter or was it a portion of it?

**Jim Morgan** - *Krispy Kreme Doughnut - President, CEO, Chairman*

It was a portion of it.

**Barry Posternak** - *Ramsey Asset Management - Analyst*

Okay. A majority?

**Jim Morgan** - *Krispy Kreme Doughnut - President, CEO, Chairman*

Yes.

Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

**Barry Posternak** - Ramsey Asset Management - Analyst

So would you expect that there would be additional revenue amounts not recognized in future quarters or is this maybe a one quarter type of thing?

**Jim Morgan** - Krispy Kreme Doughnut - President, CEO, Chairman

It is possible, but that is not my expectation.

**Barry Posternak** - Ramsey Asset Management - Analyst

Okay. And then just finally on the system-wide comp or same-store sales on premise growth rate of negative 9.2 for the quarter, I heard you guys I guess Jim talk about the strategic initiatives and new products, one of which being the soft serve. Just in terms of the rest of the year outlook, what do you see, is there, are there any initiatives that could materially help drive improvement in that number in the back half of the year?

**Doug Muir** - Krispy Kreme Doughnut - CFO

This is Doug, Barry. I don't expect that number to change terribly dramatically in the next six months. A big thing that we are seeing that's influencing that number is in the international community, because what we're tending to see is not unexpectedly as you open the second and third store in a market, you do tend to have some cannibalization occurring in the revenue of the first store. That tends to occur more or less at about the same time the honeymoon on the first store ends, and that is some of the pressure that we're seeing in the system wide same-store number is just the effect of expansion by franchisees in existing markets.

**Barry Posternak** - Ramsey Asset Management - Analyst

Okay. Could you tell us if the system, if the international franchise same-store sales is better or worse than the domestic franchisee same-store sales?

**Doug Muir** - Krispy Kreme Doughnut - CFO

Barry, I'm sorry. I don't have that number right in front of me but I'll be glad to circle back with you on that.

**Barry Posternak** - Ramsey Asset Management - Analyst

Okay, sure thing. Thanks very much.

**Operator**

(OPERATOR INSTRUCTIONS). With no further questions in the queue, I'd like to turn the call back over to management for closing remarks.

Sep. 11. 2008 / 4:30PM, KKD - Q2 2009 Krispy Kreme Doughnut Earnings Conference Call

**Doug Muir** - *Krispy Kreme Doughnut - CFO*

This is Doug Muir again. Somebody has been kind enough to look up the number so we'll answer Barry's question now. International same-store sales in the quarter were off about 18%. That's your driver and that is principally, we think, cannibalization going on, as international franchisees penetrate these markets.

**Brian Little** - *Krispy Kreme Doughnut - Director Corporate Communications*

Thank you, Doug. Thank you, Stacey as well. I'd like to remind everyone that this webcast conference call will be archived and available on our website. There will also be an archived telephone replay available following the conclusion of our call. You'll be able to find the dial in numbers and access code in our earnings release released earlier today. Also there will be, again, a transcript of today's call available at our website. Thank you for joining us. Have a good evening.

**Operator**

Thank you for your participation in today's conference. This does conclude your presentation. You may now disconnect and have a great day.

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