FINAL TRANSCRIPT

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KKD - Q3 2008 Krispy Kreme Doughnut Earnings Conference Call

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CORPORATE PARTICIPANTS

Brian Little
Krispy Kreme Doughnuts - Director of Corporation Communications

Doug Muir
Krispy Kreme Doughnuts - CFO

Daryl Brewster
Krispy Kreme Doughnuts - President and CEO

CONFERENCE CALL PARTICIPANTS

John Ivankoe
JPMorgan - Analyst

Andrew Wolf
BB&T Capital Markets - Analyst

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the third quarter 2008 Krispy Kreme Doughnuts' earnings conference call. At this time, all participants are in a listen-only mode. We will conduct a question-and-answer session towards the end of this conference, at which time (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.

Brian Little - *Krispy Kreme Doughnuts - Director of Corporation Communications*

Thank you, Operator. Good afternoon, everyone. Welcome to the Krispy Kreme third quarter fiscal 2008 earnings conference call. As the Operator mentioned, my name is Brian Little and I am the Director of Corporate Communications for Krispy Kreme.

Joining me on the call today are Daryl Brewster, Krispy Kreme's President and Chief Executive Officer, and Doug Muir, our Chief Financial Officer. During our time together this afternoon, Doug will review our operational and financial results, and Daryl will comment on our progress during the quarter. We'll open the lines and take your questions following their remarks.

First, however, I would like to let you know the copy of our earnings announcement released this morning including financial tables is available in the News Release section under Investor Relations at our website krispykreme.com. This conference call webcast will be archived and available on our website as well.

Today's responses 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 risk or uncertainties materialize or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or expected. The 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 2007 and other periodic reports filed with the U.S. Securities and Exchange Commission.

Now I'd like to turn today's call over to Doug, who will review our financial results for the quarter. Doug?

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Doug Muir - *Krispy Kreme Doughnuts - CFO*

Thank you, Brian, and good afternoon, everyone. I'll first review some operating highlights, then touch on our financial position and cash flows. During the third quarter, 29 new Krispy Kreme stores opened systemwide, of which eight were factory stores and 21 were satellites. 17 stores closed in the quarter, all of which were factory stores. The new stores were principally located internationally and the store closures were principally domestic.

This brings the total number of stores systemwide at the end of the quarter to 423, comprised of 290 factory stores and 133 satellites. Of the 423 total stores, 172 -- over one-third of the total -- were located outside the United States and almost one-third were non-factory, small retail concepts, including hot shops, fresh shops and kiosks.

Let's take a minute and look at the P&L. We incurred a loss of $800,000 in the third quarter compared to a loss of $7.2 million in the third quarter last year. Our bottom-line this year benefited from a $2.9 million reduction in interest expense compared to last year, and that's due both to the refinancing we completed back in February and a $30 million reduction in our debt balance since this time last year. Operating income also benefited from a $5.7 million reduction in asset impairment charges and lease termination costs compared to last year.

On an operating basis, our results didn't show an improvement from last year. Our operating income, exclusive of impairments and lease termination charges, was $1.7 million in the quarter, down from $3.4 million in the third quarter last year. I'll use our segment results to discuss where we slipped and where we improved compared to last year.

As a backdrop, systemwide sales decreased approximately 2.6% year-over-year in the quarter. Systemwide average weekly sales per store fell 9.2%, which was partly offset by a 7.2% increase in store operating weeks. All things equal, our average systemwide sales per unit will fall as a greater percentage of our outlets is made up of satellite locations compared to factory stores. Satellite stores, which have lower average volumes than factory stores, made up 31% of the systemwide store count at the end of October compared to only 23% at the end of October last year.

Total Company store sales fell 11.3% to $73 million for the quarter, basically all of which reflects fewer store operating weeks this year than last year due to store closures, as the average weekly sales per store were basically flat. Same store sales, which includes only on-premises sales, fell 2.9%, virtually all of which reflects stores that have since closed.

In our off-premises business, the average weekly number of doors declined 5.7% and the average weekly sales per door fell 7.4%. The decrease in the average doors consists almost entirely of a decrease in the grocery mass merchant channel. The average weekly number of doors in the convenient store channel is virtually unchanged. The average weekly sales per door fell in both channels.

The Company Stores segment incurred a loss of $1.9 million compared to operating income of $2.1 million in the third quarter of last year. Of the total $4 million decline, about $1.7 million of it reflects changes in the way we allocate costs through the business segment and not a fundamental deterioration in operations. The remaining $2.3 million decline reflects three major factors -- first, lower sales volumes principally driven by the off-premises business; two, higher materials costs driven by the run up in commodity prices; and three, higher labor cost per sales dollar. These negatives were partially offset by a decrease compared to last year in losses we incurred at stores that are no longer open.

Looking at the franchise segment, revenues were unchanged at $5.7 million in the third quarter compared to last year. Royalty revenues rose to $4.9 million in the quarter from $4.7 million in the third quarter last year, driven by increased sales by international franchisees.

We continue to see some sales weakness in the domestic area developer franchisees where, as expected, we continue to see store closures in the third quarter as some franchisees rationalize their businesses. The older, smaller associate franchisees by

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and large seem to be doing reasonably well. We believe franchisees will close some additional stores in the foreseeable future, and the number of such closures is likely to be significant.

On the other hand, we continue to see strong year-over-year growth in sales by our international franchisees driven by new store openings. And existing international franchisees have commitments for over 140 additional stores.

Franchise segment operating profit fell to $3.8 million for the quarter compared to $4.7 million last year. The decrease is primarily due to increased costs associated with the recruitment, development and supportive international franchisee. International franchising represents a significant growth area for us and we plan to continue to invest in it. Franchise results also reflect an increase in the corporate expense allocation of about $350,000 compared to the prior year.

Looking at the supply chain, total revenues including sales to Company stores fell about 12% to $48.9 million primarily due to an 11% decline in mix and distribution sales. Supply chain operating income was $5.7 million compared to $9.3 million in the quarter last year. The most significant driver of the decline in operating profit was the effect on gross profit of lower sales volumes.

Operating margin was 11.7% compared to 16.8% last year. Higher selling prices in the third quarter, particularly for doughnut mix and shortening, has not offset the rising cost of raw materials compared to the third quarter of last year. Commodity costs, including the costs of wheat and soybean oil, continue to rise. We currently anticipate that the cost of key ingredients will be higher for the remainder of fiscal 2008 than they were in the third quarter.

We implemented a price increase on shortening during the third quarter to help offset higher costs, and expect to implement additional price increases in fiscal 2009. In addition, operating profit was adversely affected by about a $1 million increase in depreciation related to the decision we made last quarter to divest our Effingham manufacturing and distribution facility. Finally, allocations of corporate costs to the supply chain segment increased about $600,000 from last year.

On the G&A line, expenses benefited from a reduction, an unusual professional fee, from about $750,000 last year to only $160,000 in the third quarter of this year. Other professional fees also were down from the third quarter last year, in part because this time last year, we were incurring costs associated with completing a number of past-due SEC filings, which we have since completed. In addition, increased allocations of corporate support costs, insurance and certain employee benefits out to the operating units reduced G&A by about $2.7 million in the quarter compared to the third quarter last year. All other G&A spending was down about $800,000 year-over-year, and we continue to work on reducing overhead and other support costs throughout the organization.

Looking now to the balance sheet, we ended the quarter with approximately $23 million of cash and $88 million of debt. At the end of the quarter, we had about $11 million of unused borrowing capacity under our credit facility. As I indicated earlier, we've reduced our debt by about $30 million in the past 12 months.

During the third quarter, we prepaid $7.6 million of the outstanding balance on our term loan. We paid about $2.6 million of this from the proceeds of asset sales and we used $5 million of cash from other sources to make the balance of the pre-payments.

We said on last quarter's call that we thought we would have to prepay about $5 million of term debt during the third quarter in order to stay in compliance with the financial covenants contained in our credit agreements. As things turned out, our performance was better than we anticipated, and we would have been in compliance with our loan covenant even if we had not made the pre-payments on the term debt that we made during the quarter. But we are not unhappy that we wound up with less debt than we had at the end of last quarter.

Going forward, we can't rule out having to make unscheduled debt reductions in the future in order to remain in compliance with the financial covenants. Based on our current outlook, we do not expect to have to make any principal pre-payments on our term debt during the fourth quarter in order to remain in compliance with the covenants. That said, we're not ruling out

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making pre-payments because, as we have indicated before, we would like to continue to reduce our indebtedness going forward.

At this time, I'll turn the call over to Daryl, who will have more to say about the quarter and about our plans going forward.

Daryl Brewster - *Krispy Kreme Doughnuts - President and CEO*

Thank you, Doug. Third quarter results were better than last quarter, but certainly not good enough. While we still face some real challenges in the turnaround from the hangover issues we have discussed in the past -- the surge in commodity costs the industry is facing now -- Krispy Kreme did see a net growth in stores, stable company retail sales, and a sizable reduction in G&A costs in the third quarter. The Company also made progress on the transformation steps we announced in our last quarterly release.

Let me provide to an update on those as well as our key steps for beyond the third quarter.

First, we closed an additional five underperforming Company shops. That makes eight since summer. The losses associated with these closed shops were running about $1 million per quarter. Eliminating those losses should help the coming quarters.

Second, we continued our international expansion. International system sales grew plus 48% versus year-ago in the third quarter, driven by the expansion of the hub and spoke model. International learning on the hub and spoke and doughnut-based product moves is also proving helpful for the U.S. To improve franchise support, we have also appointed on-the-ground managers, both in the Middle East and Asia.

Third, we opened 21 new spokes systemwide as part of our hub and spoke strategy. This included franchisee shops in the U.S. heartland, although the bulk was certainly in international. We also converted one Company factory shop into a non-producing spoke just this past week. Based on the success we have seen internationally and among certain domestic franchisees, we see the satellite hub and spoke concept as key to our strategic goal, to address the consumer need for convenience, to improve our sales to investment ratios, increase Company shop operating margins, and enhance service.

Fourth, we completed an amended Franchise Disclosure Document, which we are filing today. Under the revised Franchise Disclosure Document or FDD, formally known as the UFOC, Krispy Kreme can begin offering new franchisees as well as re-franchising company-owned markets in 38 states immediately. We will be able to commence offering in the remaining 12 states following the completion of each state's review process. The amended FDD build on system learning and focuses on retail franchising of the hub and spoke model.

Fifth, we reduced supply chain costs. As announced earlier, we exited the coffee roasting business, selling certain assets to and entering into a supply agreement with S&D Coffee, a leader in coffee roasting. S&D continues to use our high quality, Krispy Kreme bean specifications, but provides the scale to reduce costs at the Company and franchisees shops. They also provide us with additional beverage expertise; a key skill to drive same store sales growth.

In addition, we are also receiving indications of interest for our Effingham, Illinois mix manufacturing and distribution facility, which we decided to divest and announced last quarter. The resulting rationalization of the mix and distribution network will reduce costs and improve capacity utilization.

Six, as previously noted, we realigned Company shop and franchisee management, appointing proven leaders for each. We held our first all-shop domestic, that included Company and franchisee shops as well as our all-market international franchisee conferences in October. There we shared best practices and announced the framework for new growth incentives.

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Steve Lineberger, our Executive Vice President for Company shops has brought a renewed focus on the basics to our Company stores, while Jeff Welch, architect of our Global Strategy, is bringing his strong franchise experience to the U.S. as well. And finally, as Doug noted, we continue to reduce G&A costs. These are driven by resolving legacy legal and accounting issues as well as reducing ongoing administrative spending. In addition to better allocation of costs to the segments is providing improved cost transparency to both the supply chain and Company shops administration.

As we look beyond this quarter, our focus is on four items. [Let] me mention them and then touch base on each. Number one is improving Company shop performance. Two, continuing hub and spoke efforts, both in the U.S. and abroad. Three, readying ourselves to re-enter the franchising business in the U.S. And finally, continuing to drive and reduce system costs further.

First, starting on improving Company shop performance. The closing of underperforming shops will help, but we must turn around our Company shops that exist by expanding margins and growing same store sales. We have invested in an activity-based costing study to better understand our costs across products, customers, and distribution channels. This is providing key learning, upon which we will act.

Also to help offset the run-up in commodity costs, as Doug mentioned earlier, we increased pricing in Company retail stores earlier this quarter. And we're rolling out the [Kronofs] labor management tool, now in a third of Company shops with more added each week.

We are also intensifying focus on the Krispy Kreme basics to drive same store sales. That includes increasing hot light hours in many stores and encouraging the purchase of second dozens by a bounce-back coupon, suggestive selling, and colleague content. Marketing efforts are directed on easy product news like the Snowman, our biggest shape of the year, which is available in shops now. And you will hear about some major product news in early January. Tests continue on several other major initiatives, which we have spoken about previously, with both Company and franchisee shops participating.

As indicated by Doug's comments and previous calls, off-premises is a challenge. While we have leading shares in the channels we serve, our margins are low and our APDs have declined. We have initiated efforts to improve our off-premises businesses by identifying best practices across the system and realigning our organization structure.

Number two, we are continuing our hub and spoke efforts, both in the U.S. and abroad. We are using the model both through the expansion of new stores as spokes around existing hubs as well as converting underperforming factory stores to spokes when they have nearby hubs. In addition to the conversion earlier this week, we plan to convert two additional Company factory stores to spokes by quarter end with more to follow.

Based on franchisee experience, shops converted from factory to spoke or satellites show the potential to retain volume, improve service, and reduce labor and utility costs. We expect international growth in hub and spokes to continue as well.

Number three, we are readying ourselves to re-enter the franchising business in the U.S. with today's filing of an amended FDD. Our focus out of the gate is on re-franchising certain existing company markets rather than opening up new markets. We are especially keen on refranchising with proven retail operators, who we believe can successfully develop a market utilizing the hub and spoke retail model.

And finally, there remains further opportunity to reduce system costs, helping to offset the unprecedented run-up in commodity costs and making us a more streamlined company for future growth. We are benchmarking against the best in the industry. As we have said before, the only things that are sacred are the great Krispy Kreme brand and high quality products.

At this time, I would like to open the line for any questions.

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QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). John Ivankoe, JPMorgan.

John Ivankoe - *JPMorgan - Analyst*

Maybe two unrelated questions, if I may. The first, Daryl, could you walk us through the investment proposition for a new U.S. franchisee? I mean, just give us a sense -- as you had some experience with the fresh shops or the hot shops, would-have-you, but not the factory store? What it costs, what kind of volume could be expected, what kind of the basic store level margin would be on that volume, just so we understand that it makes sense to build?

Daryl Brewster - *Krispy Kreme Doughnuts - President and CEO*

Sure, thanks, John. Did you say you had two questions?

John Ivankoe - *JPMorgan - Analyst*

That's one and then I'll ask -- the second one is different.

Daryl Brewster - *Krispy Kreme Doughnuts - President and CEO*

Okay. Yes. With the filing of the FDD, we have provided a sense of what investment costs would look like by shops. Because we do not operate many of these as a company, we are not providing specific numbers from the Company's standpoint, but will have available various franchisees who can provide what their experiences have looked like with the hub and spoke model.

Again, our focus out of the gate is very much on re-franchising in areas and markets where we have a factory store and where the opportunity is to build spokes around that shop that could be served from that factory store. I can say, based on the experience we've seen, the economics are considerably better than a factory store alone.

John Ivankoe - *JPMorgan - Analyst*

Okay. And just -- I guess, I asked you the question, maybe you don't choose to answer it on this call, but just give us a sense of what the investment costs would be for one of those boxes. I mean, in other words, the spoke, if you will. I mean, what would a franchisee expect to pay just for the overall package?

Daryl Brewster - *Krispy Kreme Doughnuts - President and CEO*

Okay. Since we've just filing the FDD today, we want to make sure we get these numbers right. Really we look at these at three different ranges. If you were to add a hot shop, that -- or a tunnel oven, as we have called it, that number -- double-check this, make sure we get it right -- that number can be anywhere from $350,000 up to $986,000, depending upon what type, whether it's going to be a freestanding unit or whether it's in-line. So it's a pretty good range of where those would be.

As we get to a fresh shop, the costs are substantially lower than that. Kiosks would be lower yet. Fresh shops, we're looking at about $250,000 to $475,000. And kiosks are roughly half those costs, if not less, depending upon whether it's a mall location, various transport hubs and the rest. Substantially lower costs than we have had clearly in our factory stores. And if, obviously,

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a key is there from a revenue standpoint, and what we are trying to do is work market by market with franchisees to help them to understand what the appropriate projections would be.

John Ivankoe - *JPMorgan - Analyst*

And will the Company be making money on equipment sales to franchisees?

Daryl Brewster - *Krispy Kreme Doughnuts - President and CEO*

No. We may need to cover cost of capital and things along those lines, but basically we are out of really the profit-making part of the equipment business, as we've announced previously, and have several programs, which we have laid out to our franchisees. If it's products that we're -- equipment that we're not making, we'll just do that through the supplier on a direct basis. We believe the real game here is not selling the old Gillette game of not necessarily selling the razor but selling the blades and the ongoing, the mix and royalties less the upfront dollars. We really want to make sure those folks are successful; both our current franchisees, as they may look to expand, as well as others as they would look to come in, and try to reduce that upfront cost.

John Ivankoe - *JPMorgan - Analyst*

Okay. Very good. And second question, what's your sense on the off-premise business? The numbers -- the declines are fairly high in terms of doughnuts sold per door. What's your sense as to what's going on there and what can you do to reverse it?

Daryl Brewster - *Krispy Kreme Doughnuts - President and CEO*

Yes. I think you really have two different businesses here. One is the grocery mass business. In there we lost doors as well as saw a decline in our APDs. We think the biggest driver of the loss in APDs, going back several years ago, Krispy Kreme had built a pretty big business on doing the in-store bakeries, the single-serve parts within a grocery store. And Krispy Kreme supplied that to many accounts while also supplying the boxed product that Krispy Kreme has been selling for quite some time.

Much of that business -- and that has turned out to be a fairly low margin business -- much of it now has sort of changed; technology to be frozen, thaw and serve types of products within the bakery section, that changes every few years. Much of that business has disappeared. We're down to only a limited number of accounts. And as that business disappears, you really take out a significant part of a shop that might have had -- essentially two businesses with one drop now really comes back to just the box or the packaged good products. That's really the big factor on grocery stores.

When you get to the c-store business, a little different story there. Really two factors there; we've held doors pretty constant. We have seen a fall off on the average per doors, really attributing that based on conversations that we're having with folks in the industries. A year ago, we saw kind of some very, very strong numbers in convenience stores as gas prices fell. This year, as we face higher gas prices -- and we've seen, I think, throughout the convenience store business -- as higher gas prices come in, A, less trips to the gas station; B, less dollars in your pocket after you pay for the gas. And we're seeing a fall off attributed to that.

The second is we're seeing some accounts change the type of programming they do with us from a one-way program to a two-way or guaranteed sale program. And that can lead to some revenue changes as we convert from one to the other.

We do see this as an area that needs to be fixed. And we're looking at a number of different alternatives to improve our performance, both ways that we can reduce the cost of delivery as well as opportunities for us to improve revenues here.

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John Ivankoe - *JPMorgan - Analyst*

Would you care to share any of the revenue driving initiatives that you might have?

Daryl Brewster - *Krispy Kreme Doughnuts - President and CEO*

Yes. We are looking at our promotion calendar, number one, as a key area. The other is -- this has been a -- was a key area at our franchisee conferences, especially just our domestic conference, and looking at sharing best practices; things that certain franchisees or parts of the country doing well. But I really don't want to get any further data on that until we take that out to our customers.

John Ivankoe - *JPMorgan - Analyst*

Okay, all right. Thanks, Daryl.

Operator

(OPERATOR INSTRUCTIONS). Andrew Wolf, BB&T Capital Markets.

Andrew Wolf - *BB&T Capital Markets - Analyst*

I wonder, in your press release you mentioned that some of the franchisees have had exacerbated financial pressure and that they'd still have to close a significant amount of stores. Could you put a -- maybe to help us with some of the segment modeling -- could you give a range estimate or guesstimate as to what that might be?

Doug Muir - *Krispy Kreme Doughnuts - CFO*

Andrew, sorry, no. I would point out, though, that franchisees closed about a dozen locations in the second quarter -- excuse me, in the quarter just ended in October, rather. So, I think perhaps the exposure might -- one might conclude that the exposure is less than it was a quarter ago. But there are still a couple of big franchisees that are in bankruptcy and are restructuring. And they would hold the key to the severity of the number and I just couldn't speculate.

Andrew Wolf - *BB&T Capital Markets - Analyst*

Okay. And then a couple just more accounting-related questions. On the $1 million of -- my words, not yours -- was that accelerated depreciation? Or was that for Effingham? And is that taken care of?

Doug Muir - *Krispy Kreme Doughnuts - CFO*

You will see it again in Q4.

Andrew Wolf - *BB&T Capital Markets - Analyst*

Okay, so, it's going to stay at about the same level and then the run rate on D&A comes down to --?

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Doug Muir - *Krispy Kreme Doughnuts - CFO*

Yes. Assuming that we were -- let's say for a second, that the increase in depreciation for Effingham is about $1 million in Q3; it should be about $1 million again in Q4. Assuming we were to divest the facility or otherwise qualify as held for sale under the accounting rules, then the depreciation would go away, either because we had stopped depreciating it under the held for sale accounting model or because we've divested it. If we don't divest it or meet held for sale, then $1 million run rate would continue; as best I can tell.

Andrew Wolf - *BB&T Capital Markets - Analyst*

Okay. And lastly, on the $1.7 million change in the cost allocation into the Company stores -- where was that cost reported in the year-ago period?

Doug Muir - *Krispy Kreme Doughnuts - CFO*

It was in G&A. Yes, both the changes in the corporate overhead allocations and the changes related to benefits and insurance costs, where we've tried to capture the appropriate costs in the segment, the offsetting credits, or good guys, if you will, are in the G&A line.

Andrew Wolf - *BB&T Capital Markets - Analyst*

Got it. Thank you very much.

Operator

Gentlemen, there no further questions at this time. I would now like to turn the presentation back to Brian Little for closing remarks.

Brian Little - *Krispy Kreme Doughnuts - Director of Corporation Communications*

Thank you, Operator. Before we end the call today, I would like to remind everyone that this conference call webcast will be archived and available on our website. There will also be an archived audio replay available shortly following the conclusion of the call. You will find dial-in numbers and access pass codes in our earnings release.

Thank you for joining us this afternoon and have a good evening.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes your presentation. You may now disconnect. Good day.

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