MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the Q2 2010 Krispy Kreme Doughnuts Earnings Conference Call. One note, that today's call is being recorded.

It is now my pleasure to introduce your host today, Brian Little. Please go ahead sir.

Brian K. Little, Director, Corporate Communications

Thank you, [inaudible]. Good afternoon everyone. Welcome to the Krispy Kreme 2010 Second Quarter Earnings Conference Call. Again, my name is Brian Little. I'm the Director of Corporate Communications for Krispy Kreme. On the call with me today are Jim Morgan, President and Chief Executive Officer; Doug Muir, Executive Vice President and Chief Financial Officer; and joining us for the first time today is Anita Booe. She is the new Director of Investor Relations for Krispy Kreme.

As usual, during the call today Mr. Morgan will comment on the Company's performance, and Mr. Muir will give an overview of the financial results released earlier today. Following Doug's comments, the operator will open the lines to take your questions.

Now as a reminder, a copy of our earnings announcement is available in the News Release section under the Investor Relations tab of our website, krispykreme.com. Also, 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 there. Investors, analysts, and shareholders 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.

As always, our comments today 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 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 2009 and other periodic reports filed with the US Securities and Exchange Commission.

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

James H. Morgan, Chairman, President and Chief Executive Officer

Thank you, Brian. Good afternoon everyone, and welcome to today's call. As we mentioned in last quarter's call, in the summer we face a seasonal slowdown, which historically makes the second quarter our most challenging one. Because of this, I am gratified that we reported substantially improved results in the July quarter compared to last year. While we are pleased with the improvements in operating results, we still have a long way to go to produce the revenue growth and financial returns that we believe are achievable. We are committed to building a business that generates consistent and predictable earnings.

Although our actions to achieve that long-term goal may result in some short-term unevenness in our financial results, we intend to manage the business by focusing on our strategic initiatives in order to achieve superior and sustainable returns over the long-term. Our strategic initiatives are the core principles that guide every operational decision made at Krispy Kreme. We remain focused on them, and continue to believe that fiscal 2010 will be the year where it becomes apparent that we have begun to seize the opportunities that lead us to a bright and successful future.

Our team members and franchisees remain dedicated to the success of our brand. And our progress to-date is due in large part to their enthusiasm, their loyalty and their commitment to excellence. Our franchisees and we continue to share our expertise with each other as part of our ongoing efforts to communicate and develop best practices. We know that the success of our Company is directly tied to the success of our franchisees. And we remain committed to maintaining a positive relationship with them, built on mutual respect and dedication to each other and to this incredibly powerful brand.

With this as an overview, I would now like to update you on our progress in the quarter. We continue to move in the right direction, and I'll now speak to just a few of the specific accomplishments. First, the measured growth of our international business continued in the second quarter, as we had net openings of 11 stores for the quarter, bringing us to 28 net openings for the year. As we have previously indicated, we do not expect the number of new openings this year to match last year's number. This year we remain intent on absorbing the substantial international growth of the past two years, and building on the commitment we have made to our international franchisees by dedicating additional resources to operational and marketing support.

Second, in the US the excitement among our franchisees about our potential is growing. Franchisees in Texas, Arizona and New York opened a total of four new small retail locations in the second quarter. We think domestic franchisees will continue to make these commitments as long as we, as the franchisor, commit our own resources to open in new locations and to validating the small retail shop concept.

Third, on the Company store side, we opened another small retail shop which is located in Raleigh, North Carolina market. We have signed lease agreements for stores in Louisville, Kentucky, Colombia, South Carolina and Raleigh, North Carolina. And we are now negotiating on two additional Raleigh sites. That should take us to a total of eight commitments, most of which will result in openings this year.

We are committed to becoming more convenient for our customers by establishing these small retail locations in high traffic areas that allow us to bring our signature products closer to consumers.

The initial sales numbers for the three small retail shops we have opened are very encouraging. But it is sustained performance that counts. And it will be several quarters before we are able to make an informed assessment of these stores' results. However, we believe more numerous, but smaller, retailer shops are critical to our future.

Fourth, during the second quarter we continued our Company shop renovation and upgrade projects in order to enhance consumer appeal. These renovated shops also included the installation of our Kool Kreme soft serve menu, which is now being tested in 10 of our Company shops. We continue to believe that Kool Kreme has the potential to provide significant operational leverage by addressing both daypart and seasonal-part challenges.

Fifth, we are ramping up expanded broadcast advertising in the Piedmont Triad region of North Carolina and in metropolitan Nashville, Tennessee because we have now reached sufficient scale to make broadcast advertising economically feasible in these markets. We will soon expand advertising into additional markets. We have also broadened the elements of our marketing mix into social and interactive media, using both Facebook and Twitter.

Finally, we continue to make progress in stabilizing and reinvigorating our off-premises business. We are seeing improvement in our average weekly sales per door in the off- premises channel, and we have seen year-over-year single- to low double-digit sales increases in several of our off-premises customers. Much of this improvement in off-premises follow the implementation of the new off-premises operating model, which we discussed on last quarter's call. In addition, we continue to introduce longer shelf-life, individually wrapped snacks, which we believe will benefit both us and our retail partners.

In summary, we continue to make progress on a number of fronts in the second quarter. The strategic initiatives we instituted during calendar 2008 are beginning to gain traction and yield results. Although there is still much we need to accomplish, we are pleased with our improved performance for the second quarter and the first half of the year. And I'm personally optimistic about our results for the third and fourth quarters. We remain dedicated to improving our performance in the quarters and years ahead by doing what it takes to achieve sustainable, predictable and profitable growth for the benefit of each of our constituencies: our team members, our franchisees, our customers and our shareholders.

I'll now turn the call over to Doug.

Douglas R. Muir, Executive Vice President, Chief Financial Officer and Treasurer

Thank you, Jim and good afternoon everyone. A few minutes ago we filed our Quarterly Report on Form 10-Q, which contains interim financial information as well as management's discussion and analysis of our financial condition and results of operation. We encourage you to give this document a read.

Here are some highlights of the second quarter results. We reported operating income of 2.9 million in the second quarter this year, compared to an operating loss of 1 million last year. Our net loss was a $157,000. And that's a long way from the almost $2 million loss we incurred in the second quarter last year.

Looking at our business segments, the biggest year-over-year improvement was in Company Stores, which had an operating income of 1.4 million in the second quarter this year, compared to an operating loss of 4.2 million in the second quarter last year. Lower prices for doughnut mix and shortening, driven by lower agricultural commodity costs made up a large portion of the gain, as did lower gasoline prices. But management actions in the second quarter and in earlier quarters also contributed to the improvement, including the effects of closing poorly performing locations, our focus on day-to-day shop operations and improved management of our off-premises operations.

The Domestic Franchise segment had an operating profit of 434,000 in the second quarter, compared to a 1.5 million last year. Lower sales by Domestic Franchise stores, resulting in lower royalty revenues for us, as well as some increased spending on franchisee support accounted for much of the change.

The International Franchise segment had an operating profit of 1.9 million, compared to 2.4 million last year. Franchisee sales measured in US dollars fell year-over-year. The majority of the decline was due to a stronger US dollar. And the royalty revenue impact of the stronger dollar was about $450,000 in the quarter, compared to last year. We're also seeing evidence of the honeymoon effect. International franchisees opened a large number of stores over the past two years. And stores typically fall in sales from the very high levels often associated with new store openings as the stores mature. Also, the number of international store openings fell from the second quarter last year, which we expected and we've previously talked about. Fiscal 2009 was a banner year for international openings, and we didn't expect this year's openings to be comparable to last year.

The KK Supply Chain segment posted operating income of 5.7 million this year, compared to 4 million in the second quarter last year. A major reason for the improvement was that last year's number included a non-recurring charge of 1.6 million related to a supply chain vendor. But the segment's results also benefited from cost reduction efforts and close attention to operations.

Finally, we had impairment and lease termination costs of 1.5 million in the second quarter. Most of that charge relates to two stores, which we intend to close and then sell the related real estate.

On balance, we think the year-over-year comparisons of operating income are positive. And we are pleased by the improvement in our bottom line results. But as Jim said, there is still much work to be done, particularly in restoring growth to the revenue line.

I'd like to take just a moment to speak to our financial position and liquidity. We generated 10.1 million of cash flow from operating activities in the first six months of fiscal 2010, compared to 9.5 million in the first six months of last year. We ended the quarter with 19.6 million of cash on the balance sheet, even after paying over $2 million in the quarter in rents and settlements on unexpired leases related to closed stores, and after stepping up capital spending for small store expansion. There is also 10 million of unused borrowing capacity available on our revolver. So right now we feel pretty good about our liquidity, and about our financial ability to execute our plans.

[Inaudible], at this time we're ready to begin Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll go first to Boniface Zaino from Royce & Associates.

<Q – Boniface Zaino>: Good afternoon. Most restaurant companies seem to be reporting declines in comparable store sales, and you've had this nice increase. To what do you attribute that? Is there price increases involved here?

<A – Douglas Muir>: There is a little, Buzz. We are doing a price test in about 24 Company stores, that started in the quarter. Of the total 5.9 comp store sales increase, my guess is about two points of that relate to the price test, and that 4% is what I'd call real growth. What's behind it? Gee, a lot of things. Some of it, I think, is lower gasoline prices. Customers maybe are getting out more, I think our shop operators are really focusing on hospitality and the customer experience, and making Krispy Kreme an increasingly attractive place for customers to go.

<Q – Boniface Zaino>: Okay. If you look at the operating line, the non-recurring, I would assume, of costs of over a million dollars would lead you to operating income on an adjusted basis of over $4 million. Will you have continuing non-recurring adjustments during this – it's almost – [inaudible] during the following quarters?

<A – Douglas Muir>: Could you give me an example? Everybody has a different view of what's recurring and non-recurring. If you can sharpen up the question, I'll try and give you an answer.

<Q – Boniface Zaino>: Well, there was, I know, among some of these adjustments of 1.2 million before the operating income line, for closing of stores or – will there be continuing charges of that size?

<A – Douglas Muir>: We did report – you're talking about the 1.4 million of impairment and lease termination costs?

<Q – Boniface Zaino>: Correct.

<A – Douglas Muir>: Ah. There may be. In fact, there will be. The accounting rule on lease termination cost is that you record the cost of getting out of the lease, assuming you have a lease, in the quarter in which the store goes dark. So we might have a store that we close down the road that we've already taken an impairment charge on, but the lease termination cost is a trailing cost because of the accounting rule. The stores that we said we're going to close and sell the real estate, we own that real estate. We've taken the write-down. So I don't see a charge coming for those. But again, restaurateurs are always looking at stores. And as long as you're closing stores, there's – you should consider some amount of lease termination costs as an ongoing cost of business.

<Q – Boniface Zaino>: Going forward, quarters, will you have positive cash flow that could be used to pay down debt?

<A – Douglas Muir>: We don't make any projections about future results. I think we're on the record – well, the business is cash flow positive now, and more so than it was last year. And I think we're well on the record as saying we think we ought to have less debt than we have.

<Q – Boniface Zaino>: Okay. Thank you very much.

<A – Douglas Muir>: Thank you.

Operator: [Operator Instructions] And Mr. Little, there are no further questions at this time.

Brian K. Little, Director, Corporate Communications

Thank you, [inaudible]. As a reminder, this webcast conference call will be archived and available on the Krispy Kreme website, krispykreme.com. There will also be an archived telephone replay available shortly following the call. You will find dial-in numbers and the access passcode in our earnings release. We thank you very much for joining us this evening. Have a good evening.

Operator: That does conclude our conference everyone. We thank you for your participation. You may now disconnect.