FINAL TRANSCRIPT

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KKD - Q1 2009 Krispy Kreme Doughnut Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the first quarter 2009 Krispy Kreme Doughnuts earnings conference call. My name is Emity, and I will be your coordinator for today. At this time all participants are in a listen-only mode. We'll facilitate a question-and-answer session towards the end of this conference. (OPERATOR INSTRUCTIONS). I would now like to turn the presentation over to your host for today's call, Director of Corporation Communication, Mr. Brian Little. Please proceed.

Brian Little - *Krispy Kreme Doughnuts, Inc. - Director, Corporate Communication*

Thank you, operator. Welcome, everyone. As the operator mentioned I'm Brian Little, Director of Corporate Communications for Krispy Kreme. Thank you for joining us for our 2009 first quarter earnings conference call. On the call with me today are: Jim Morgan, Krispy Kreme's President and Chief Executive Officer, and Doug Muir, our Chief Financial Officer. During our time together this afternoon, Jim will comment on company performance for the quarter and Doug will review first quarter results. As is always the case, we will ask the operator to open the lines and take your questions following our prepared remarks.

First, however, I would like to remind that everyone that a 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 is being webcast and will be archived and available on our website for one year. A transcript of this conference call will also be available at our company 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 email at 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 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 10K for fiscal 2008 and other periodic reports filed with the U.S. Securities and Exchange Commission. I'll now turn the call over to Jim Morgan. Jim?

Jim Morgan - *Krispy Kreme Doughnuts, Inc. - President, CEO*

Thank you, Brian. Good afternoon, everyone, and welcome to today's conference call. I hope all of you have had an opportunity to review our 2009 first quarter earnings release. While we are certainly pleased that the hard work of our employees has resulted in improved performance during the first recent quarter, we do caution against drawing overly optimistic conclusions about future quarters. The majority of our strategic initiatives will not gain meaningful traction for another 12 to 24 months. Therefore despite our belief that we are laying the appropriate ground work for long-term success, near-term corporate performance could be somewhat uneven as we continue to address both the internal and external challenges that have faced the company for the past several years as well as the more recent challenge of rising commodity prices. We do believe over time there will be many more opportunities than there are challenges, however. We still have plenty of work to do. We are confident in the strategic plan we are executing and we are moving at what I consider to be an appropriate pace to achieve the outcomes our stakeholders expect.

You might remember that during our last conference call, for those of you that were on that call, I stated that our goal is to successfully address our challenges without sacrificing any of our opportunities, while at the same time becoming a leaner, stronger, more profitable organization. That continues to be our goal. I would also like to reemphasize something else I said during that same call. Krispy Kreme remains committed to delivering positive financial performance on a consistent basis. I am now more convinced than ever that this organization has a bright future and that by working closely with our franchisee as well as our employee, we will strive to continue to improve every aspect of our company's performance. Today, I will speak briefly about our major business segment, and in just a few Doug Muir will address our financial results.

I'll begin with our off-premise business. We continue to be negatively impacted by the rising cost of agriculture commodities and what appears to be an unending rise in the cost of fuel. Like many other organizations, we have had to pass along some of these cost increases to our customers. The skyrocketing cost of fuel has a particularly negative impact on our off-premise business, as we do maintain a fleet of vehicles that deliver our products to stores across the country. However, we continue to search for and find strategic ways to address these rising costs while always remaining aware of the impact on and the needs of our franchisees. While we do not -- excuse me, while we do anticipate that these challenges associated with rising fuel and agricultural commodity cost will have an effect on our off-premises business for the foreseeable future, we believe we have identified a couple of opportunities that allow us to meet our customers needs from -- excuse me -- provide additional sales potential for our partners, and buffer some portion of the burden. Currently, we are testing three varieties of a new packaged snack product in our grocery store channel. Our new Krispy Kreme minisnack packs are individually packaged mini version of our coolers, doughnut holes and Krispy Juniors. These new products are being test marketed at a number of grocery and mass merchant stores across North Carolina. It is too early to gauge the ultimate success of these products, but the initial feedback we have received is encouraging.

We are committed to revamping our off-premises business with a long-term goal of increasing profitability and we believe longer that shelf life products could be one of the keys to this future. We have recently taken steps to improve the efficiency of our supply chain operations. By not renewing the lease on our California distribution facility and contracting with BakeMark USA to distribute doughnut mix and supplies to Krispy Kreme stores west of the Mississippi River, we believe we will reduce cost in our supply chain and improve speed of service to many of our franchisees. We also continue to implement delivery improvements in our company stores with the goal of making them among the beest SSRs anywhere.

We are focusing our efforts carefully on the details of improving customer service and enhancing the Krispy Kreme consumer experience. We're increasing customer service training and we're emphasizing the basics of maintaining clean, inviting, and family friendly environments for our customers. We have been introducing our plan to improve company stores now for several weeks, and although we still have much to accomplish, we do believe we are making progress. The company factory stores that have recently converted to smaller shops as part of our small retail expansion strategy continue to produce encouraging results. As you know, these smaller satellite Krispy Kreme stores provide the hot original glazed doughnut experience by using our tunnel oven technology. They also improve the utilization of the factory store that delivers freshly made doughnuts several times a day to these smaller shops for glazing and finishing. This strategy allows us to make our one of a kind signature products more accessible to consumers, and these smaller shops are simpler to operate, and less costly to build, staff, and run. During our fourth quarter call, I stated that we plan to begin construction of new company satellite stores this year. We are actively looking at real estate in North Carolina and Tennessee to identify suitable locations for company satellite stores that are close to existing factory store hubs. Obtaining store sites is a time-consuming process often depending on market factors outside our control, and while we have not yet secured locations for any new satellites, we have identified several potential suitable sites with the objective of starting construction this fiscal year.

In our franchise business, international franchisees continue to grow and add stores. In fact 28 international stores were open in the first quarter. Additionally during the first quarter, Krispy Kreme reopened in Arizona where we refranchised a store in Mesa that opened on May 13th. Going forward we'll continue to consider refranchise opportunities in other parts of the country as we focus our company store operations in our traditional base in the southeast. This refranchising process will be a multi-year effort, but over time we expect the percentage of domestic stores operated by franchisees to increase significantly. A very important part of the transformation of Krispy Kreme is our renewed focus on franchise relations. Although we do expect to maintain a limited company store footprint going forward, it's our goal our be a world class franchiser as we strive to support our franchisees better than ever before. I will conclude now with a thought I shared previously with many of you. Krispy Kreme products are by and large an indulgence, and we quite frankly do not intend to shy away from that reality. I firmly believe that we can and should be an indulgence of choice worldwide and that we should therefore succeed corporately, and financially, regardless of the macro economic environment that surrounds us. I'll now turn the call over to Doug Muir. Doug?

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

Thank you, and good afternoon, everyone. First I'll review some highlights of the quarter and then touch on our financial position and cash flows. On the new store front, we had a big quarter. During the first quarter 28 new Krispy Kreme stores opened system wide of which four were factories and 24 were satellites. Seven stores closed system wide in the quarter, six of which were factory stores. The new stores were all located internationally, and the store closures were principally domestic. This brings the total number of stores system wide at the end of the quarter to 470, comprised to 289 factories, and 181 small retail concept satellites. Of the total stores, almost half are located outside the U.S., and over 1/3 are nonfactory, small retail concepts, including hot shops, fresh shops, and kiosks.

Now turning to results for the quarter. We filed our quarterly report on Form 10Q this morning and I'd encourage you to read through it when you have a chance as there's no way we can cover all of its contents on a conference call of reasonable length. We reported net income of $4 million in the first quarter compared to a net loss of $7.4 million in the first quarter last year. The most significant reason for the dramatic improvement was that last year's first quarter included a charge of $9.6 million related to a refinancing of our credit facility. But there were a few other unusual items that affected earnings in the quarter, some of which you might term nonrecurring in nature, and I would like to mention them and just walk through them very briefly. First off, impairment charges and lease termination costs in the first quarter were actually a credit. This caption normally is an expense item. The credit arose principally from cash proceeds we received on the assignment of a lease for a closed store.

Second, other nonoperating income for the quarter includes a noncash gain of about $930,000 on the disposal of our equity interest in two franchisees. As a result of this transaction, we were released from all of our guarantees of debt and leases of those franchisees, and it's the guarantee reductions that resulted in the noncash gain. Our total guarantee of franchisee debt and leases, the bulk of which is leases, was about $14 million at the end of the quarter. Interest expense declined from the first quarter last year, principally because we had substantially reduced our long-term debt over the past year.

There are two other items that affected interest expense in the quarter. While these items offset each other, they are worth taking note of, because they may show up somewhere down the road. First, interest expense for the quarter reflects a noncash credit of about $600,000, resulting from marking to market the liabilities related to our interest rate derivatives. We discontinued hedge accounting for these derivatives as a result of amendments to our credit facilities, and subsequent to April the 9th when the amendments went into effect, changes in the fair value of the derivative contracts will be reflected in earnings as they occur. This may lead to some volatility going forward if market expectations about short-term interest rates change between now and the expiration of the derivatives in April of 2010. Going the other way in interest expense, interest for the first quarter reflects a write-off of deferred financing costs and other costs and expenses related to the credit facility amendment, and those totaled about $550,000 in the aggregate.

Looking downfield a little bit, as you know, wheat and soy bean oil are the primary components of flour and shortening, which are our two most significant ingredients. While prices have been volatile the overall trend of these prices has been up. We currently anticipate that the cost of these key ingredients will continue to be higher during fiscal 2009, compared to last year. Another commodity that we are keeping our eye on is oil. We are a large consumer of gasoline in our off-premise business, and continued high gas prices have an adverse effect on our results of operations.

Take up just a minute to talk about the balance sheet. We ended the first quarter of fiscal 2009 with about $29 million of cash on the balance sheet, and we had about $12 million of unused credit availability under our bank revolver. The liquidity picture right now looks pretty good. As a reminder, we have never made any draws at all on the revolving credit facility. Let me touch briefly last on cash provided by operating activities. The business generated $6.5 million of cash provided by operating activities in the first quarter, compared to $1.3 million in the first quarter of last year. Now last year's number reflects a $4.1 million outflow for a prepayment penalty on that debt we refinanced. But even adding back that $4.1 million to last year's number, cash provided by operating activities increased year-over-year in the first quarter.

Looking forward, as we disclosed back in April, we amended our credit facilities in the first quarter to among other things, relax the financial covenants in those facilities for both this fiscal year and for next year. The cost of the amendments included a 200 basis point increase in the interest rate, which, all things being equal, will increase our interest costs in coming quarters. But we are glad to have the amendments behind us, and the good news is we have about $26 million less outstanding debt today than we did a year ago. That concludes our prepared remarks. And operator, we're now ready to go to Q&A.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Questions will be taken in the order received. (OPERATOR INSTRUCTIONS) And your first question comes from the line of John Ivankoe with JPMorgan. Please proceed.

John Ivankoe - *JPMorgan - Analyst*

Hi. I was hoping if you could update us on some of the things you talked about last quarter, such as changing employees from full time to hourly, and if there's anything else that may have effected either the first quarter or might affect 2009 from a margin perspective, to allow you to offset some of the other headwinds.

Jim Morgan - *Krispy Kreme Doughnuts, Inc. - President, CEO*

John, this is Jim. We have begun the process of that employee change, getting a high percent of the employees to part-time. So that process has begun, it's not nearly complete. And I think -- was part of your question what effect that may or may not have had on us financially this quarter?

John Ivankoe - *JPMorgan - Analyst*

Yes. And that -- and if you are doing anything from a margin per perspective to offset what are obviously inflationary aspects of your business? So did that help the first quarter and is that going to be something measurable in 2009?

Jim Morgan - *Krispy Kreme Doughnuts, Inc. - President, CEO*

It is did not help -- John, excuse me again, it did not have any material affect on the first quarter. I would certainly think it is going to help us by the time 2009 over in two ways. One, it should help us on a direct basis. Our overall labor expense should be down in stores. But secondly, I think it's going to increase efficiencies within the shops themselves. And that's yet to be determined how much we can truly benefit from that, but we probably would not be doing it with the strong commitment as we have toward it, if we didn't think we were going to get both benefits over time.

John Ivankoe - *JPMorgan - Analyst*

Okay. Also a question if I may regarding the off-premise business, which is obviously for company stores over half of your sales. If the numbers I have are right, not only own the average weekly sales per door was down something like 6.7%, and then your actual number of doors, I think was down 8.6%, do I have those numbers written down right?

Jim Morgan - *Krispy Kreme Doughnuts, Inc. - President, CEO*

Doug is checking, John, but I think that's correct.

John Ivankoe - *JPMorgan - Analyst*

Okay. And I guess the point is -- I mean, like what do you think is happening at the off-premise channel? And what I'm really trying to get at is some of the accounts being down -- I mean, is it your decision? Is it them saying it's -- selling Krispy Kreme is no longer profitability? And at the individual count level, I mean is it -- I mean, have you taken pricing up such that consumers aren't buying? Just give us a little bit more clarity any terms of what is happening in terms of why your accounts are down, it is you or is it them? And secondly, why you think your values down at the individual accounts?

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

John, this is Doug, just a couple of things. The total door count number, just for information, is not a same-store number, and so you do have the effects of store closures affecting the count year-over-year. Jim, I think will want to add to this, but there's, I think, several things going on in the grocery mass channel. These stores in particular, I have read about this in the press, you have too. I think the average nongas ring -- average check, if you will, in the C-store world, is off fairly substantially. Customers are finding that when they fill up the car there's less left of that I was going to say $20 -- I was going to say that $20, probably should say less left of that $100 to buy Cokes coffee, and doughnuts. While there's several things going on, I think just the economy is probably getting us here, at least in the short term as much as anything. I think Jim has mentioned before, we have also candidly got some product issues that we need to work on in the wholesale channel. We -- the consistency and freshness of the product when it hits the shelf is in all circumstances not what it should be and something that the operators in the company stores are working pretty hard on.

Jim Morgan - *Krispy Kreme Doughnuts, Inc. - President, CEO*

John, it's Jim. I -- Doug has covered most of the reasons, but I just want to be emphatic on that last thing that he said. I would love to tell you it is all part of the perfect storm, and I think that is in effect. I think the consumer and the gasoline prices and we could go on and on. We really -- I don't believe that's our biggest enemy. I think our biggest enemy has been our sales. And the last statement that Doug made, that we are spending a lot of time internally, on making sure we produce a higher-quality product, get it to the store in a fresh and appealing manner, keep the display fresh and appealing, and we go back to cultivate the partners that we have in off-premise business the way we did when we first tried to gain them. Because we had quite frankly have backed away from that to some degree. So I think you are going to continue to see challenging numbers, but I believe that we have the answer it to within our hands, that we cannot blame much longer all of the external conditions for why that's fading away on us.

John Ivankoe - *JPMorgan - Analyst*

Fair enough. And the final question to me is we related to your language about anticipating future store closings, and obviously that's probably just in the United States. Now,I think that language has been in your documents for years now. And the sense I'm trying to get is, how close we are to being done with that? And, if it's possible to answer this question, especially looking at your franchise base. What percentage of your stores are at the franchisee at least cash-flow level break even, versus some improvement has to happen to allow them to stay open? Do you have -- like a real sense in terms of -- especially for modeling and expectation purposes, just kind of giving us a sense how many stores might close in the U.S. over the next year?

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

John, I don't think we have put a number out there. In fact I know we haven't put a number down there. Obviously, every quarter we go along we get closer to the end, wherever that is, I wish I could give it to you. It -- the number may be significant going forward. I'm not saying it will be, but it may be. I do think that most franchisees have closed, to the extent they have obvious losers, I think they have dealt with them. I think -- but I still think people probably continue to evaluate virtually all of their locations in a very fluid environment. We do not have store-level profitability information on virtually any of our franchise locations. So we can get a sense of kind of what the top line looks like, and from that we can make some inferences, but I wouldn't want to quote any percentages of stores that are positive or negative cash flow, except to say I think franchisees have done generally what we have, and that's try to get rid of your bleeders.

John Ivankoe - *JPMorgan - Analyst*

Right. Okay. Fair enough. Thank you.

Operator

Your next question comes from the line of Pat [Gailer]. Please proceed.

Pat Gailer - *- Analyst*

Hi, thanks for taking the call. Two questions, I guess, first, would be the real estate. It is all encumbered by your bank debt, and if so do you have some kind of evaluation? Where the next question would be kind of a run rate for interest expense that you might expect?

Jim Morgan - *Krispy Kreme Doughnuts, Inc. - President, CEO*

Pat, this is Jim -- you were breaking up. Could you -- I hate to ask you to repeat that, but.

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

I heard the first question I think. Go ahead. The answer is yes, all of our real estate fee-owned properties, and lease-hold interest for that matter, are within the scope of the lean of the credit facility. The credit facility is secured by substantially all of the company's assets. In terms of the valuation of all of that real estate, we have not put out in public any numbers on appraised values of any of that real estate.

Pat Gailer - - *Analyst*

Okay. How old is the plant?

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

The -- you -- I think you are referring probably to the plant at Ivy Avenue in Winston, Salem --

Pat Gailer - - *Analyst*

Yes.

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

-- where we manufacture our mix and we have a distribution center. That plant was built by Mr. Rudolph in its original form I believe in -- right around the second world war. We have done a fair amount of maintenance on it. And the equipment has been upgraded. In fact we are putting in a new bagging and packaging line in the mix plant over the summer. So it is old. It is in good repair. The machinery is considerably younger than the building is in most cases.

Pat Gailer - - *Analyst*

Okay. And the distribution facility, is it the same age?

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

It is considerably younger, but a distribution center is really nothing but a big -- it's an over-grown metal shed, if you will. It's not an elegant fancy piece of real estate. It doesn't have a whole lot in it, except shelving where you can move pallets of materials around.

Pat Gailer - - *Analyst*

Okay. And my second question is the run rate that you kind of expect for interest expense going forward?

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

If you take the -- just -- here is how I might estimate it if I were the analyst, I'm not the analyst. But here is what you might want to approach it. If you look at where we are in the first quarter, the one-off items kind of pretty much push their push one way or another, offsetting each other. We have basically one month in the quarter reflects the higher interest rates of the credit facilities. If you want a ballpark going forward, you know you are missing two quarters that don't reflect the credit facility amendments. The higher interest costs on the facilities applies to about $75 million of outstanding indebtedness, that's funded debt. The 200 basis point increase also applies to the fees we pay the lenders to back-stop outstanding letters of credit. In the first quarter, there was $20 million of LCs outstanding the entire quarter. Just recently, we have been able to reduce those outstanding LCs to $18 million. So I think with the [12C], you can kind of do the math from there.

Pat Gailer - - *Analyst*

Sure. Thank you so much.

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

Thank you.

Operator

(OPERATOR INSTRUCTIONS) And you have a follow-up question from the line of Pat Gailer. Please proceed.

Pat Gailer - - *Analyst*

Yes, the last question I had is, if you could talk about the popularity and growth of your product on the international side? And maybe what countries and regions that you are perhaps more optimistic about, and I'm trying to get a feeling on what kind of growth we might expect going forward with those international operations.

Doug Muir - *Krispy Kreme Doughnuts, Inc. - CFO*

This is Doug. The rate of growth internationally in percentage terms is going to fall because it's kind of just on a rocket, happiness is a small base. The international appeal of the product appears to be pretty broad. If you look at the older markets, you have got Mexico, Australia, and the UK, where the brand appears to be pretty well established and where each of those franchisees continue to open additional outlets. The most rapid area of growth, after you take out those through, is originally Korea, that has been followed by other development by franchisees in the Pacific rim area, including the Philippines, Tokyo, Indonesia, and American brands are pretty hot in southeast Asia and the Pacific right now. We have, I think, interest in a number of other geographies in that general area of the world. It's premature for me to talk about where and how many. We see it as a very, very exciting opportunity. Again, right now, mostly in the Pacific, but I wouldn't rule out more in the Middle East. I think western Europe may be a little bit further down the road.

Pat Gailer - - *Analyst*

Thank you.

Operator

And you have no further questions at this time.

Brian Little - *Krispy Kreme Doughnuts, Inc. - Director, Corporate Communication*

Okay. Thank you, operator.

Operator

Ladies and gentlemen, thank you --

Brian Little - *Krispy Kreme Doughnuts, Inc. - Director, Corporate Communication*

I'm sorry. Before we end the call today, I would like to remind that everyone this conference call has been webcast and will be archived and available on our website. There will also be an archived audio replay available shortly following the conclusion of our call. You will find dial-in numbers and access pass codes in our earnings release. We appreciate you joining us this afternoon. I hope you have a good evening. Good night.

Operator

Ladies and gentlemen, thank you for your patience. Your conference call has now concluded.
