FINAL TRANSCRIPT

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KKD - Q4 2008 Krispy Kreme Doughnut Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the fourth quarter 2008 Krispy Kreme Doughnuts earnings conference call. My name is Erica, and I will be your coordinator 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 this 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. You may proceed, Mr. Little.

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

Thank you, Erica. Welcome, everyone, to the Krispy Kreme fourth quarter and fiscal 2008 earnings conference call. Also on the call 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, Jim will comment on Company performance during FY '08, and Doug will review fourth quarter and year-end financial results. As is always the case, we will ask the operator to open the lines and take your questions following their remarks.

I would like to first remind listeners 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 Web site, krispykreme.com. This conference call is being webcast and will be archived and available on our Web site for one year.

A transcript of our conference call today will also be available at our Company Web site. 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.

Today's responses, as well as 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 10-K for fiscal 2008, and other periodic reports filed with the U.S. Securities & Exchange Commission. With that, I will now turn the call over to Jim Morgan, the President and Chief Executive Officer. Jim?

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

Thank you, Brian. Good afternoon to everyone. I too would like to welcome each of you to today's conference call. As many of you know, this is my first quarterly call since taking over as President and CEO, so I'm particularly looking forward to sharing my thoughts with you this afternoon.

I have spent my first several months meeting with our management team, employees, franchisees and other parties who are truly interested in the long-term success of Krispy Kreme. One thing I have learned over the past few months is there are many others out there who share my belief and excitement about our future and the possibilities that lie ahead for our Company.

I have also learned that we do have much more work to do in order to deliver the financial performance we believe is possible, but we are committed to that task. While our fiscal 2008 financial results were not what we would have liked, the year was not without its successes. Doug will address the financial results in more detail in a few minutes.

We are well aware important challenges still exist in key areas of our business, but we believe over time there are many more opportunities than there are challenges. Our goal is to successfully address the challenges without sacrificing any of the opportunities, while at the same time becoming a leaner, stronger, more profitable organization.

Let me now make a few specific comments on each of our major business segments. Our wholesale, or off-premises, business is particularly vulnerable to the rise in fuel costs, the increase in the cost of agricultural commodities and the shrinking margins that our off-premises customers are facing. Nevertheless, we are committed to revitalizing our off-premise business. Even though we may approach it in a very different manner long-term, it remains our goal to have more Krispy Kreme branded products in even more retail locations nationwide over the long term.

As far as our Company stores are concerned, because many of our stores also serve wholesale customers, they too are being negatively impacted by the pressures affecting the off-premises business. However, our goal for Company stores is very simple and clear, to improve them. We are currently addressing everything from physical appearance to increased attention to details that enhance service and that enhance the overall customer experience.

Also, we are taking an already successful international hub-and-spoke model and applying its principals in our Company store markets. Early results from three factory stores recently converted to hot shop satellites are very encouraging. Hot shop satellites still provide the hot Original Glazed doughnut experience by using our tunnel oven technology.

Supplying these smaller satellite Krispy Kreme stores from Krispy Kreme factory stores improves the utilization of the factory store and significantly enhances the return on the satellite shop, which is smaller, simpler to operate, and less costly to build, staff, and run than a factory store. We plan to begin construction of new satellite stores during the course of this year. We are committed to being a world class franchisor with a limited Company store footprint.

As a result of this vision, the opportunity exists to refranchise many of our Company stores that lay outside of our traditional base in the Southeast. This should in time increase the portion of our revenues derived from mixed sales and royalties. Two such refranchising opportunities are currently underway, but this in essence will be a multi-year process.

As we look at our franchise segment, our associates, who operate primarily in the Southeast, are doing okay, but they are also suffering from the same off-premises pressure as we are. Some of our area developers who operate in the remaining of the U.S.

continue to struggle, although some others have made a great deal of progress on a number of fronts this year. Most of our international franchisees are doing well.

We expect that our international franchisees will open at least 50 additional stores in this fiscal year, and by the end of this next year over half of all Krispy Kreme shops will be located outside of the United States. We are focused intently on working with all of our franchisees to provide them with the tools that will assist them in their long-term success.

As most of you know, our mix sales are a significant source of revenue. This product is our equivalent of Coca-Cola's syrup. These mix sales depend upon the success of our Company stores and our franchisees, and we are currently undertaking a couple of initiatives in that area that should result in more efficient and effective delivery of this product.

To summarize, I would say that Krispy Kreme is a Company that is clearly in transition. We are transitioning from a complex model, in which we owned interest in many franchisees, to a more traditional franchisor role. In the process, we have reduced our guarantee that franchisee obligations from over $70 million to less than $15 million.

We are also transitioning from off-premises being the dominant source of revenue to retail sales being the key driver. We are transitioning from being Company-store focused to being a world class franchisor with a more limited Company store footprint. We are transitioning from large factory store operations to our hub-and-spoke strategy, a smaller, more economical model that brings our signature products closer to consumers.

And finally, with we are transitioning from shrinking the store base to slowly growing the total number of Krispy Kreme stores worldwide. As I mentioned earlier in my comments, Krispy Kreme still faces challenges. We are not naive in our approach. But we are optimistic that we will emerge from these past few years as a wiser, more efficient and more focused Company.

Krispy Kreme products are by and large an indulgence. We believe we can and should be the indulgence of choice among a great portion of the world's population. We also believe that even in difficult economic times families can still enjoy treating themselves to the joy that is a Krispy Kreme doughnut.

Now will I turn the call over to Doug who will outline our financial performance for the quarter and year end. Doug?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Thank you, Jim, and good afternoon, everyone. First, I'll review our results for the quarter and then touch on our financial position. We filed our Annual Report on Form 10-K with the SEC this morning. If you would, take some time to review it, since we can't begin to cover on this call everything that is discussed in the 10-K. And as you review the Annual Report, please remember that fiscal 2008 that we just completed was a 53-week year, and the fourth quarter had 14 weeks instead of 13.

To enhance comparability between fiscal 2008 and last year, we included in the 10-K some supplemental disclosure of many of the year-over-year comparisons on a 52-week basis. Turning now to results for the quarter. We reported a net loss of $31.8 million in the fourth quarter which ended February 3. There were some special charges that reduced earnings in the quarter, and I'll walk through them briefly.

The loss reflects asset impairment charges and lease termination costs of $27.6 million, virtually all of which is non-cash. That $27.6 million consists principally of $22.7 million of write-downs of long-lived assets, and $4.6 million of goodwill impairment.

We also took a $3 million charge in the fourth quarter for potential payments under our guarantees of certain debt and leases of a franchisee in which we own an interest. That $3 million is composed of $2.1 million, representing 100% of our exposure to guarantees of the franchisee's funded debt, and $900,000 representing approximately one year of gross lease payments.

Finally, we took a charge of $2.7 million in the quarter for costs related to the resignation of our former Chief Executive Officer, and of that total $1.1 million is cash.

Looking ahead to next year, as you know, there has been a significant increase in the price of wheat and soybean oil in recent quarters. Wheat and soybean 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 ingredients will be higher in fiscal 2009 than in fiscal 2008, and we have factored that into our plans.

We raised the price of doughnut mix and shortening to our Company and franchise stores in fiscal 2008, and again, in the first quarter of fiscal 2009, in order to recover some of our increased materials costs, but we're also working to find and achieve some offsetting cost reductions wherever we can.

Take a minute to talk about the balance sheet as we head into fiscal 2009. We ended fiscal 2008 at the beginning of February with about $25 million of cash on the balance sheet. During the fourth quarter, we repaid about $11 million of our term loan principal, using the proceeds of the sale of our mix manufacturing and distribution facility in Illinois.

That payment brought the total term loan prepayments this year to $32 million, and the term loan balance has been reduced 30% to $77 million at year end. Last week, we reached agreement with our lenders on some amendments to our credit facilities, which among other things, relaxed the financial covenants in those facilities both for fiscal 2009 and fiscal 2010. The amendments also give us some flexibility to execute some elements of our business plans that we didn't previously have.

We also reduced the size of the revolving facility from $50 million to $30 million, which candidly we were planning to do anyway because it was bigger than it needed to be. The revolver's only function is to support about $20 million of insurance-related letters of credit. We have never drawn on the revolver.

The cost of the amendment included a 200-basis-point increase in the interest rate, the addition of a 3.25% LIBOR floor, and a 35-basis-point amendment fee to the lenders. So the amendments weren't cheap. But in the credit market we are in seemed to us to be a workable outcome, and it is very nice to be squared away with our lenders as we move in to fiscal 2009.

There is one more thing I would like to highlight just briefly, and that is our internal control over financial reporting. 18 months ago, we had identified about 17 material weaknesses in our internal control over financial reporting.

One year ago, we had reduced that number to 11. As of February 3, we had remediated all 11 of the remaining material weaknesses and now we have none at all. And just going forward, it is our intention to stay that way. Erica, I think at this time we are ready to take some questions if you would open the queue.

QUESTIONS AND ANSWERS

Operator

Yes, sir. (OPERATOR INSTRUCTIONS) As a reminder, there will be a brief moment while we compile a list. (OPERATOR INSTRUCTIONS) Sir, at this time, we have no questions.

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

Okay. Thank you, Erica.

Operator

Okay -- sir? Sorry for the interruption. We have a question. Your first question comes from the line of Andrew Wolf from BB&T Capital Markets. You may proceed.

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

Good afternoon.

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

Good afternoon.

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

Couple different questions. To the degree the ingredient inflation is going into pricing, eventually at retail, what -- given the economic climate -- what kind of expectations and, as experience in other recessions and so on taught you, in raising prices as, obviously, you have to do if you are going to maintain some margins.

What do you expect to be the impact on volumes, at the retail stores and at those off-premise locations, where you still have a good business?

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

Andrew, this is Jim. Let me give you our answer on that. We do not have detailed studies on that. We have got some subjective evidence that tells us that we have got room to pass on and the tougher the times are, the more room we have to pass it on, simply because everyone around us is doing the same thing, and we -- it appears, it appears, that we become -- we kind of get a step-down benefit, that people will still go out and indulge in their families by buying them a dozen hot doughnuts. Maybe more likely to do that than going out to dinner and a movie, and certainly more likely to do that than going to Disney World.

So it's sort of -- it looks like right now, that we have been watching the reaction of the two price increases that we put in, and we see a slight decrease in customer count, although that was already taking place before those price increases came, and yet we're seeing ticket averages up, and we're seeing same-store sales that appear to be not only stabilized but maybe slightly picking up a little bit. So that's the best answer we can give you right now.

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

Okay. Well that's -- that's pretty helpful. And the other thing is -- I think you mentioned 50 international store openings. Do you -- two things.

First of all, do you plan -- do you expect some closures either domestically or in any of those 50 stores internationally going to be replacements, or are you actually going to be up 50 stores, or close to that without a lot of domestic closures, number one? So is that 50 stores a gross number or a net number?

Secondly, could you just give us some flavor for those stores? Are they mainly kiosk or fresh stores as opposed to factory stores, kind of mix of store type, and if there's no confidentiality or other reasons, could you tell us about the geographies, which part of the world it's going to be in?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Sure, Andy. It's Doug. The 50 is a gross number, we expect the international franchisees will open at least 50 locations this fiscal year, and they are off to a good start even two months into the year.

As far as closures go, there are inevitably closures in the restaurant business, so, yes, I think there will be some. My expectation is that to the extent we have closures we will have more of them domestically than we would internationally, and we have factored that possibility into our plans and budgets for next year. In terms of what is going to be opened internationally, we think it's going to be -- because we talked to the franchisees and we know what equipment orders are, these will be mostly satellite spoke locations.

The bulk of the factory stores have been built -- at least in the short-term. There will be I think a handful next year, but most of them are going to be spokes, and they tend to be -- I think, fresh shops principally are predominating in the international community right now in terms of what is currently in the pipeline.

In terms of geography, it's all over. As you know, we signed -- oh, gosh -- six or seven international development franchise agreements in 2007. All of those franchisees by and large are working away, and are in -- where they expected to be, so it's not really concentrated anywhere, it's Korea, Indonesia, it's the Philippines, all of the usual places.

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

Okay. On an unrelated follow-up, on the support operations, the profit dollars sequentially have gone down close to franchise operations, it's pretty obvious why they are going up if you are getting some, if the foreign franchisees are opening stores, is the support operations profit dollars -- is the decrease there more a function of not making money any longer on the equipment sales, or is it more just sort of a negative mix shift, that it's more expense to produce, and I guess you've got shipping costs, probably substantial to ship ingredients outside of the United States. Can you give us some flavor on what is going on with the profit in that business?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Sure, I would be glad to. The equipment sales have been less than 15% of the supply chain revenues for about three years. They are not a big contributor to profit because candidly the Company dialed back the margins on those roughly -- gosh, I think it was in fiscal 2006, if I recall correctly. What you see going on in the supply chain, a big driver of supply chain is volume.

It's a very volume-sensitive business, and so we have been adversely affected in the supply chain to the extent that the domestic franchisees have had some store closings, and that has reduced our mix volume. We currently don't ship a tremendous amount of mix across the ocean. We do some of it, but we're increasingly moving to a model in which we ship a concentrate, if you will, overseas, and then that concentrate is mixed with flour and the other ingredients by packers outside of the U.S.

In terms of costs, we have -- in the past, at least in recent years -- had -- I guess, an understanding, perhaps with franchisees that mix pricing would be set once a year. So even though costs went up fairly dramatically during fiscal 2008, we held the line on mix pricing, and that did adversely affect our gross profit margin in the supply chain.

That effect was most pronounced in the fourth quarter, because that's when goods we had purchased earlier at lower prices ran out on us, and we began to have to start paying a little bit closer to the market rate for flour.

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

Okay, just a follow-up on that last point, it's interesting. Given all of the volatility in the ingredient costs, flour and the cooking fats too, is that the arrangement you are going to have going forward, a fixed price for the year? Or are you going to try to get a more flexible arrangement?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Thanks for the tee-up. We had a discussion with the franchisees. Our current plan is to adjust pricing of mix quarterly.

We were candid with the franchisees about it, we can fix a price if we want to go out and hedge flour for the entire year, and the feedback we got from the franchisees was we think we like a quarterly adjustment plan. We have announced to the franchisee group that there is not going to be a mix price increase in the second quarter.

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

And just lastly, sort of housekeeping here, where in the P&L were the two charges, one for the severance arrangement with Daryl, and the other one for the franchise liability? Where should we -- if we want to exclude that?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Sure. The $2.7 million related to Daryl is in the general and administrative expenses line. The $3 million for the guarantees is in the other non-operating income line.

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

Okay. That's it for me. Thank you.

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Thank you.

Operator

(OPERATOR INSTRUCTIONS) Your next question comes from the line of John Ivankoe from JPMorgan. You may proceed.

John Ivankoe - *JPMorgan - Analyst*

Hi, thanks. I have some modeling questions, and I just wanted to see if I understand these things right, or if I'm looking at them right. It seems like on the Company store side, the stores that you closed actually may have been higher volume stores than the average, given the fact that by our calculation that average weekly sales declined while comps were up. Is that true?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

John, I don't have that statistic in front of me. I can't tell you the answer to that question.

John Ivankoe - *JPMorgan - Analyst*

Okay, yes, that's the way -- and there could be reasons why we're kind of seeing that and it's not necessarily true with operating weeks, so I was just curious. Secondly, again, I don't think this is exactly the way you look at it, but it's the way we look at it.

Company segment EBIT, I guess primarily related to the stores, is actually up fourth quarter 2008 versus fourth quarter 2007, and, obviously, we're -- when we talked about commodity costs and presumably labor costs and some other factors being higher, could you walk through how much cost savings at the store, as might have been one time in the fourth quarter, or if it's something that might be recurring throughout 2009 that we actually -- or even in the next fiscal year, that we might be actually expecting to see margin improvement at the Company store level, even if comps don't accelerate materially?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Let me come at that this way, John. I'm trying to think of one-off items that would have affected the Company store segment. I believe, if I'm correct, in the fourth quarter last year there was charge of about $1.3 million related to the settlement of a purported wage and hour class action out in California.

John Ivankoe - *JPMorgan - Analyst*

Okay.

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

In terms of going into fiscal 2009, the answer is, yes, we do currently plan and expect and budget that the operating margin in the Company store segment will improve over 2008.

John Ivankoe - *JPMorgan - Analyst*

And how -- how is that -- especially with commodities are where they are in the consumer environment and spending is not great, I mean, why is that that happens? It seems like when we talk about improving the customer experience that typically requires investment at the store level, not savings at the store level. Can you provide a little bit more color in terms of what you are actually doing to allow for improved margins at the Company store level?

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

I think I can do maybe a couple of them.

John Ivankoe - *JPMorgan - Analyst*

Okay.

Douglas Muir - *Krispy Kreme Doughnuts Inc. - EVP, CFO*

Number one is we have taken a little bit of retail pricing that we took in the first of November, if I recall correctly. So we'll get some benefit from that next year. We have -- we have not taken a wholesale price increase into the grocery mass channel, gosh, in -- years. And so we have finally -- with the cost of commodities, we have been forced to go in to the G-mass market, and take some pricing increase. If there is volume runoff from that, which I -- there may be, we have factored that into our plans.

One of the big things that's going on in terms of costs in the stores is a real focus on labor. I think candidly labor got away from us last year. We -- among the things we have done to attack it are -- we have put in a Kronos timekeeping system which a lot of the restaurant guys use. We'll be putting in the second phase of that this year which is a scheduling module.

The other thing we're doing on the store side is historically Krispy Kreme in the stores has been largely a full-time employer. It's the only restaurant concept I know around that doesn't use much part-time labor. That is something we expect to be a big change as we move to part-time labor as a much bigger part of our work force going forward.

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

John, this is Jim. In the end that will not be a small factor. You know our business and you understand the surges we have at certain hours, and we're 80% plus full-time out of the 100% employee base, and I don't know whether it should be all the way to 20/80, but 80/20 is way off where we should be. And in the next year or two that will make a big difference in the efficiency that we have in our stores.

John Ivankoe - *JPMorgan - Analyst*

And truthfully, I never knew that. I didn't know that in terms of your total hours at the store level that it was anywhere close to 80% full-time. That does seem very high. How much do you think that that just in and of itself, I mean if you could kind of reverse the clock in calendar 2007, how much do you think that could have been helped you relative to what may be the potential of full-time to part-time? Have you gone through that exercise?

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

Not to a level of granularity we would want to talk about it, sorry.

John Ivankoe - *JPMorgan - Analyst*

Okay. No. That's helpful though. I appreciate it. Thank you.

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

Thank you.

Operator

(OPERATOR INSTRUCTIONS) This concludes the Q&A portion of the call. I would now like to hand the call over to Mr. Brian Little for closing remarks.

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

Thank you, Erica. 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 our call. You will find dial-in numbers and the access passcode in our earnings release. We appreciate you joining us this afternoon. Have a good evening.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You play now disconnect, and have a wonderful day.