There is nothing quite like the melt-in-your-mouth experience of a fresh Krispy Kreme glazed doughnut dipped in a glass of cold milk. Roy Blount, Jr. of *New York Times Magazine* had it right when he said, "When Krispy Kremes are hot, they are to other doughnuts what angels are to people." Impossibly sweet, addictive, and delicious, it can be hard to stop before devouring an entire dozen. As tempting as that may be, giving into instant gratification and gorging on a dozen of Krispy Kremes will only lead to overexpansion of the waistline and health problems down the road. Vitally important is moderation, which seems to be common sense for most people. However, the aggressive appetite for growth of their firm that Krispy Kreme's leaders displayed for a period of time also led to serious problems. Instead of aggressively seeking to increase sales revenues, Krispy Kreme likely would have been served better through actions oriented to achieving moderate and more manageable levels of growth over a period of time. Indeed, rapid growth that was too aggressive relative to competitive conditions as well as changes in the external environment resulted in a serious amount of overexpansion of the number of Krispy Kreme units. In turn, an excessive number of units resulted in significant challenges to the firm's efforts to operate profitably as the pathway to short- and long-term corporate success. Before describing the issues associated with rapid growth that led to difficulties, we first introduce Krispy Kreme as a firm and consider its initial almost meteoric success. After the Internet bubble burst in the early part of the twenty-first century, many investors sought more tangible investments and very few stocks at the time seemed as promising as Krispy Kreme. Named "America's Hottest Brand" by *Fortune Magazine* in 2003, Krispy Kreme was growing rapidly following its decision in the late 90s to expand from its regional footprint in the Southeast United States. By late 2003, shares were trading at nearly $50, a substantial increase from their IPO value of $9 just three years prior. The meteoric rise of Krispy Kreme in the early 2000s was followed shortly thereafter by its steep fall from grace. The trouble began with a series of accounting missteps and shortcomings within the corporate governance structure. When these troubles were combined with market saturation from overexpansion, changing trends in American diets, and misaligned incentives between franchisees and corporate headquarters, the company found itself on the brink of bankruptcy in 2005. However, Krispy Kreme is now showing signs of a possible resurgence. Implementation of "an emergency turnaround strategy" found the firm closing unprofitable stores, contributing to its ability to avoid filing for bankruptcy in the process of doing so. The company suffered huge losses from 2005 to 2008, but since then, stable leadership has emerged to implement initiatives that focus on improving operational effectiveness by streamlining retail operations and expanding and diversifying the firm's product lines. These initiatives have yielded positive results, and the firm has been able to reduce its substantial debt as a foundation for continuously improving its performance. For the first time since 2005, the company experienced two consecutive years of profitability (2011 and 2012) and intended to open over 100 new stores in 2013. This revamped plan shows that the firm has learned from the over-indulgent mistakes of its past and, potentially, that Krispy Kreme is poised to reclaim its standing as the sweetest doughnut company around.

In 1933, a farmer in Paducah, Kentucky purchased a hand-written recipe from a New Orleans-born French pastry chef named Joe LeBeau. The recipe for yeast-raised doughnuts, believed to contain vanilla and potato flour, would become the foundation of the Krispy Kreme brand. The farmer hired his nephew, Vernon Rudolph, to work as a door-to-door doughnut salesman in the fledgling business. After four years, Rudolph left his uncle’s business seeking to make it on his own. He settled in the North Carolina town of Winston-Salem, and on July 13, 1937, opened a wholesale business selling doughnuts to local grocery stores. Residents walking by the factory could not resist the intoxicating aroma of the doughnut making and soon began to demand hot, fresh doughnuts. So, Rudolph “cut a hole in the factory wall and sold ’em out on the street,” and Krispy Kreme made its first foray into the world of retail.

In the late 1940s, Krispy Kreme’s expansion resulted in the firm becoming a regional chain. To ensure consistency, quality, and to safeguard the secret recipe, a central plant in Winston-Salem produced the doughnut mix before shipping it off to be cooked at the stores. Within twenty years, there were thirty Krispy Kreme shops—a combination of company-owned and franchises—located throughout the Southeast. By the time of Vernon Rudolph’s death in 1973, the thirty-six year old company had grown to ninety-four company stores and twenty-five franchises.

Unfortunately, Rudolph did not adequately plan for his estate prior to his death, and Krispy Kreme had to be sold. Beatrice Foods, a highly diversified conglomerate based in Chicago, purchased Krispy Kreme in 1976 and changed the firm’s strategic direction. Former CEO, Scott Livengood, described the relationship between Krispy Kreme and Beatrice as a “horrible marriage” and said:

“Beatrice didn’t care so much if the stores made money, as long as we sold doughnuts to supermarkets. They didn’t want to invest in stores or grow the company, they just wanted cash. Then they changed the logo to a tacky 70s look. And they actually messed with the doughnut formula.”

The horrible marriage quickly ended in divorce when, in 1982, a group of 22 franchisees repurchased Krispy Kreme in a leveraged buyout. With the infusion of new leadership who cared deeply about the brand, the firm restored many of the values and strategies that had enabled its success in the firm’s earlier years.

The most important element of Krispy Kreme’s resurgence was a renewed focus on retail operations and the hot doughnut experience. During the late 80s, Krispy Kreme implemented two innovative marketing activities that helped re-launch the brand into prominence. First, it created the concept of “Doughnut Theater.” This concept exposed the doughnut-making equipment to customers so they could watch the doughnut production process. To this day, visitors can observe doughnuts cook for exactly 115 seconds in 365-degree vegetable shortening before travelling along the conveyor to pass through a glaze waterfall before curving around the counter where the salesperson plucks the hot, fresh doughnuts right off the line and puts them into customers’ hands. The second marketing innovation was the installation in every retail branch of the iconic “Hot Doughnuts Now” sign. Whenever hot doughnuts come fresh off the line, the neon sign turns on, letting customers know to come into the store to receive a free glazed doughnut, dependent upon the individual franchise’s policy. The combination of these two clever marketing activities and the infusion of enthusiastic new owners set the stage for future success.

Recent History: Rapid Expansion, Brink of Collapse, and Resurgence

In 1995, Krispy Kreme moved into a new corporate headquarters, reshuffled its management team, and prepared to expand nationwide. To leverage the planned growth, the firm’s leaders decided that the company should rely heavily on franchising instead of opening company-owned stores as a means of growing. This choice would allow Krispy Kreme to receive a steady income flow from royalty fees, expand its customer base for mix and equipment via franchisees, and inflate its brand recognition. Launches in New York, Los Angeles, Boston, and Chicago were huge successes with devoted customers lining up around the block for a hot doughnut. By the end of 1999, the company’s portfolio included 144 shops in 27 states, and revenues had climbed to $220 million—up 40 percent from just two years earlier.

Still, the success of the initial nationwide expansion was accompanied by some major growing pains. When the original 21 franchisees purchased the company from Beatrice Foods in 1982, a governance-related decision was made indicating that financial decisions needed unanimous approval instead of a plurality. By the late 90s, “because of inheritances and gifting of stock, that group of 21 had mushroomed to 183 shareholders, each with veto power.” As then-CEO Scott Livengood put it,
“It was an absolute nightmare,” and the company needed to restructure and go public.20

Krispy Kreme made its IPO in April 2000 with a split-adjusted price of $9.25 Investors flocked to the company, and by the close of 2003, the stock was selling at a price just a bit over $49 per share. Fortune Magazine ran a cover story calling Krispy Kreme the “Hottest Brand in America.” By the close of the 2003 fiscal year, the company had expanded to 433 stores, had reached $700 million in revenues, and had earned $88 million in operating profit.21 This amounted to a four-year store growth of over 200 percent and revenue growth of about 220 percent. The company seemed to have the Midas touch, but the world was about to see the hole in Krispy Kreme’s doughnut strategy.

As it turned out, the rapid expansion of the previous five years had not been carefully or effectively planned. The exponential growth in store locations yielded a huge revenue growth overall, but same-store sales were flat. As new franchises saturated the market and the novelty value of the firm’s products faded, it became obvious that the early success of many stores was not sustainable.22 Many of the once-profitable stores began to flounder and, in May 2004, Krispy Kreme experienced its first unprofitable quarter as a public company. Company leadership blamed the flat sales on low-carbohydrate diets, but it was clear to many that the Atkins Diet was not the only concern.23

The SEC launched investigations of improper buybacks of certain franchises, alleging that corporate leadership had made sweetheart deals to repurchase failing franchises. Additionally, franchisees filed suit alleging “channel stuffing” and accusing the corporate office of double shipping the usual amount of product at the end of quarters so the firm could achieve its revenue estimates.24 Franchisees also alleged that corporate leadership was more concerned with maximizing overall revenue than with the well-being or success of the individual stores. A lawsuit filed by the Milberg Weiss law firm summed up many franchisee concerns, saying:

*Rather than cultivate a steady customer based [sic], the Company instead attempted to capitalize on Krispy Kreme’s “fad appeal” and adopted a business model and strategy for increasing sales that was predicated on the perpetual addition of new stores and the hyping of the Company’s entry into new markets.*25

As a result of these problems, long-time CEO Scott Livengood stepped down in 2004 and was replaced by turnaround specialist Stephen Cooper—who kept his other job as interim CEO of Enron—to end the downward spiral.26 Cooper’s first order of business was to secure over $225 million of financing to stave off potential bankruptcy and install capable financial managers. In the three years prior, Krispy Kreme had seen three different CFOs come and go, two of which had no experience as CFOs of large companies.27 After putting the wheels to recovery in motion, Cooper handed the reins to Daryl Brewster, a former vice president at Kraft, to continue implementing the turnaround strategy he had designed.
In the main, the turnaround strategy called for Krispy Kreme to cut costs to a sustainable level as a path to prevent the firm's bankruptcy. One way cost cutting was undertaken is demonstrated by the decision to close over 240 stores as the company retrenched to its stronghold in the Southeast. These closings resulted in a cost to the firm of almost $300 million in impairment charges and lease termination costs. See Exhibit 1 for a depiction in changes to the number of Krispy Kreme stores between the years 2001 and 2012.

As mentioned, another issue challenging Krispy Kreme in efforts to be successful was a change in the market with the rise of the health-conscious American consumer. In response to this development, Krispy Kreme introduced a variety of healthier doughnuts. A whole-wheat doughnut was introduced, and the entire product line was reformulated to eliminate trans-fats.

Meanwhile, as domestic business plummeted, international business shouldered the load, adding over 400 franchises in twenty countries from 2004 through 2009, geographically diversifying the firm in the process. In 2012, 66 percent of retail stores were located outside the United States with management stating it would like to establish an international presence of 900 stores by the end of 2017.

However, the firm as a whole continued to struggle under Brewster’s leadership. When the stock price bottomed out at less than $4 a share in January 2008 due to the restructuring costs, Brewster was ousted in favor of James Morgan, the Chairman of the Board, who had over 25 years of management experience, including a stint as CEO of Wachovia Securities. Under Morgan's leadership, the firm implemented a number of new ideas, including a smaller factory store model, a hub-and-spoke distribution system, increased coffee offerings, and an enhanced menu that included both healthier options and other product lines such as ice cream. These actions taken as a result of these ideas have positively affected the firm's performance; in fact, 2010-2011 marked the first consecutive profitable years since the firm reached its peak in 2004. Morgan noted that the recent success hinged upon the new actions the firm was taking, saying: “We are certainly pleased with these results, [but] more importantly, we are demonstrating the ability to execute on a strategic plan we believe will allow us to substantially increase revenue, improve margins, and expand the Krispy Kreme system over coming years.”

As revenue continued increasing at the end of 2012, Krispy Kreme looked to open as many as 100 new stores in the near term between domestic and international operations. However, Krispy Kreme seems to have learned its lesson from overexpansion. Morgan promised that going forward "expansion will come at a controlled rate. We have to crawl before we walk, and we may never try to run again.” See Exhibit 2 for a presentation of Krispy Kreme’s net income over time.

Revenue Generation, Product Lines, and the Franchising Structure

Krispy Kreme generates revenue through four main business segments: Company Stores, Domestic Franchises, International Franchises, and the KK Supply Chain. The company stores and domestic franchises operate in a similar fashion—generating revenues through retail operations and wholesaling to grocery stores,
convenience stores, and other large food service avenues. Over half of domestic sales occur through wholesaling channels. On the other hand, international franchises rely mainly on retail operations and do not generate significant revenues from wholesale activities.  

All three retail operations—company stores, domestic franchises, and international franchises—earn the majority of revenue through the sale of doughnuts. In fact, doughnut sales comprise over 88 percent of all retail sales while the remainder comes from selling beverage and complementary items. Each Krispy Kreme branch offers a wide variety of doughnuts, including standard and seasonal varieties. The company realizes it is known as a specialty "sweet treat" producer; therefore, it does not offer bagels and breakfast sandwiches as other competitors have done.  

Krispy Kreme utilizes a variety of unique features to successfully sell a premium doughnut that devoted and loyal customers are willing to seek out and buy. While on the whole there is not a great deal of differentiation throughout the industry, Krispy Kreme is the exception. Unlike the cake-style doughnuts sold by most competitors, Krispy Kreme produces fluffy, yeast-based doughnuts that stand apart from the competition. The unique taste of a Krispy Kreme doughnut comes from a secret recipe that has remained within the company throughout its history. Additionally, "Doughnut Theater®" adds tremendous value to the consumer experience. It "provides customers with an entertainment experience and reinforces the commitment to quality and freshness by allowing them to see the doughnuts being made."  

As is the case with its competitors, Krispy Kreme has made a concerted effort as of late to expand revenues through coffee sales, but the dominant element of the Krispy Kreme business model continues to be doughnut sales. While Dunkin' Donuts generates approximately 60 percent of sales revenue from coffee and other beverages, Krispy Kreme continues to lag far behind in that regard with only 4 percent of its sales coming from coffee. Since the firm underwent national expansion, it has launched three different brands of coffee, but none has truly resonated with customers, preventing Krispy Kreme from becoming a significant competitor in the highly competitive coffee market. However, Krispy Kreme recently announced a re-emphasis on improving coffee sales. While, as noted, coffee only accounts for 4 percent of sales at the current time, Morgan recently told CNBC commentators that he wants to double that within the next two years. This effort began with the launch of three new signature roasts in 2011, and has been bolstered by the introduction of a variety of premium espresso-based drinks in 2012. Morgan hopes to gain a better foothold in the competitive coffee market by first promoting Krispy Kreme's coffee to existing customers. Morgan says, "We've got to get them thinking coffee when they walk in our shops...right now we have a promotion where any size coffee is only 99 cents with the purchase of a dozen doughnuts."  

Krispy Kreme is working to improve current offerings by emphasizing products with a longer shelf life to reduce spoilage and decrease delivery costs. This is especially relevant to the wholesale sector, which accounted for over half of the revenues from domestic store locations in the 2012 fiscal year. Krispy Kreme continues to be innovative with its other product selections. In this regard, the firm continuously experiments with new doughnut varieties including a wide array of crullers, doughnuts with fruit infused "kreme" filling, and seasonal/holiday-inspired doughnuts including doughnuts shaped like Christmas trees, Easter eggs, or footballs. It has experimented with ice cream and doughnut sundaes in some locations, lines of "chillers" (a version of a smoothie), and even doughnut milkshakes. But through it all, it has never lost contact with its identity as a doughnut company. In this way, it has always straddled the line between exploitation of its core product and a willingness to explore other products and areas of growth.  

An interesting development that facilitated Krispy Kreme's international success was its focus on smaller-store footprints with a hub-and-spoke distribution model—a model it has recently started implementing in the domestic market. Historically, Krispy Kreme's domestic stores consisted of one type: the factory store. These stores' large footprints limit location options and are expensive to operate. Utilizing a hub-and-spoke distribution system allows for two types of stores—factory stores and satellite shops. Today, factory stores serve as the hub and continue to function as they have in the past with full production capabilities that supply doughnuts for both retail and wholesale. Satellite shops, located in the same general vicinity of a factory store, serve as the spokes. Satellite shops do not make any doughnuts; instead, the factory store delivers fully cooked but unglazed doughnuts to its satellite locations. The unglazed doughnuts then undergo an abbreviated form of Doughnut Theater® by simply passing under the glaze waterfall. The new factory-satellite format allows Krispy Kreme to position smaller shops in more convenient locations (most are equipped with drive-thru windows for added convenience) and increase the utilization rates of the factory stores.
Part 4: Cases

Krispy Kreme’s final business segment is the KK Supply Chain, which accounts for approximately 25 percent of the firm’s revenues. This segment generates revenue by selling the firm’s doughnut mix and doughnut-making equipment to franchises. Other comparable firms use royalty payments as the foundation of the franchisor/franchisee relationship and allow firms to purchase supplies or ingredients at cost. However, this is not the case at Krispy Kreme. Its structure demands only a small royalty payment but requires that franchisees purchase doughnut mix and equipment at a mark-up with operating margins as high as 20 percent. This structure led to a situation of misaligned incentives where maximizing overall corporate profits through increased KK supply chain revenue came at the expense of the individual franchisee. See Exhibit 3 for a presentation of sales accounted for by Krispy Kreme’s four business segments.

Arenas in Which Krispy Kreme Competes

Krispy Kreme operates in two extremely competitive industries. It primarily competes in the Quick-Service Restaurant (QSR) segment of the restaurant industry. This segment is the industry’s largest and has demonstrated steady growth over a long period of time. Additionally, it competes on a wholesale level in the Baked Goods Production Industry. At present, both industries are experiencing relatively static growth. These industries are characterized by high fixed costs, low switching costs for customers, and relatively low product differentiation.

Both industries are extremely competitive and have a high concentration of competitive rivals. Dunkin’ Donuts, Tim Hortons, Shipley’s Do-Nuts, and countless smaller bakeries are Krispy Kreme’s direct competitors in the QSR category. Despite having fourteen times as many stores as Krispy Kreme, Dunkin’ Donuts is Krispy Kreme’s closest competitor in sales (403.22M versus 628.2M, Krispy Kreme versus Dunkin’ Donuts respectively), product offerings, and worldwide presence (20 countries versus 30 countries). As shown in Exhibit 4, Krispy Kreme outpaces Dunkin’ in many key metrics. The firm is able to generate higher ROA and ROE as compared to Dunkin’ Donuts. Additionally, Krispy Kreme has a significantly lower leverage ratio as compared to Dunkin’s extremely high 195 percent.

The firm also faces less direct competition from companies such as McDonald’s, Starbucks, and coffee shops. The baked goods industry is equally competitive and populated by producers offering both fresh and pre-packaged goods. Pre-packaged goods with much longer shelf lives than Krispy Kreme include national brands such as Little Debbie, Hostess, and Sara Lee. Additionally, there are many freshly baked goods options provided by a myriad of local bakeries. Sales percentages for some firms are presented in Exhibit 5.

The threat of a new doughnut powerhouse emerging is not as worrisome as the problems individual Krispy Kreme stores face from mom-and-pop shop competitors. On a national scale, it would take an extremely large amount of capital to establish a network of stores and capture the economies of scale enjoyed by the QSR industry’s largest firms. In addition, it would take significant investments of advertising dollars and time to develop the brand equity necessary to compete successfully on a national scale. In the wholesale market, distribution

---

**Exhibit 3** Krispy Kreme Segment Revenue 2011

<table>
<thead>
<tr>
<th></th>
<th>Company Stores</th>
<th>Domestic Franchise</th>
<th>International Franchise</th>
<th>KK Supply Chain</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2011</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td>24.6%</td>
<td>67.4%</td>
<td>5.6%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

Source: Data for chart compiled from Krispy Kreme 2011 10-K filing.

**Exhibit 4** Key Comparisons 2011

<table>
<thead>
<tr>
<th></th>
<th>Krispy Kreme</th>
<th>Dunkin’ Donuts</th>
<th>Tim Hortons</th>
<th>Krispy Kreme (adj.)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit Margin</strong></td>
<td>41.20%</td>
<td>5.50%</td>
<td>13.40%</td>
<td>7.50%</td>
</tr>
<tr>
<td><strong>ROA</strong></td>
<td>49.60%</td>
<td>1.10%</td>
<td>17.40%</td>
<td>9.10%</td>
</tr>
<tr>
<td><strong>ROE</strong></td>
<td>66.70%</td>
<td>4.60%</td>
<td>33.20%</td>
<td>12.20%</td>
</tr>
<tr>
<td><strong>Debt/Equity</strong></td>
<td>10.20%</td>
<td>195.50%</td>
<td>38.80%</td>
<td>10.20%</td>
</tr>
</tbody>
</table>

Sources: Data for table compiled from 2011 Annual Reports of Krispy Kreme, Dunkin’ Donuts, and Tim Hortons.
channels are extremely saturated and existing firms are well entrenched. Nevertheless, the capital requirements for an individual firm on a local business level are not high, and new entrants are a legitimate threat to the viability of individual Krispy Kreme stores.

In addition to the threat of a mom-and-pop shop becoming a sentimental favorite, there are many alternatives to the core doughnut product, which CEO James Morgan calls “an affordable indulgence.” Cakes, biscuits, bagels, muffins, breakfast sandwiches, or any other breakfast food option could replace the demand for doughnuts. One of the largest concerns in the overall competitive environment is the changing demands of consumers. As consumers become increasingly health conscious, the doughnut industry becomes more vulnerable to the threat of substitution, especially considering that each original glazed Krispy Kreme doughnut has 200 calories and 12 grams of fat.

As for its customers, Krispy Kreme doughnuts appeal to individuals in all shapes and sizes, rendering a large but fragmented fan base. In fact, the managing editor of Fortune, Andy Serwer, claims that Krispy Kremes, … are loved equally by 5-year-olds and 75-year-olds. By whites, blacks, Asians, and Hispanics. By New Englanders and Southerners. By Californians and New Yorkers. (Never mind by junkies and cops.) I say only three types of people claim they don’t like Krispy Kremes: nutritionists (your basic glazed has 200 calories and 12 grams of fat), Dunkin’ Donuts franchisees, and compulsive liars. Fortunately for the company, that’s not a large group.

Because they represent such a large portion of Krispy Kreme’s domestic business, the only buyers with the power to shake things up are firms in the wholesale sales channel. But even there, Krispy Kreme maintains wholesale contracts with a wide variety of grocery stores, convenience stores, and other large accounts—including Walmart, Kroger, and Sheetz—that shield it against being sunk by the withdrawal of any single large buyer.

Finally, suppliers hold little sway for the firm. Krispy Kreme’s vertically integrated structure, the wide availability of necessary raw materials, the unlikelihood of suppliers entering the doughnut business, and low switching costs between vendors render the power of suppliers fairly moot.

**Financial Results: Return to Profitability**

Krispy Kreme has achieved two years of profitability after years of being in the hole for six. As discussed, this downturn led to the divestiture of many of the firm’s domestic retail locations. Maintenance of consistent gross profit margins and modest revenue growth of 4.5 and 11.4 percent in 2009 and 2010, respectively, have allowed Krispy Kreme to contribute to its bottom line and return to profitability. In fact, Krispy Kreme showed net income of $166 million and a 41 percent profit margin in fiscal year ending January 2012. However, the majority of this increase stems from the $6.2 million sale of Krispy Kreme Mexico (30 percent interest) and the reversal of a deferred tax asset of $139.6 million, with an offsetting amount to the provision for income taxes.

(See Exhibit 6.)

It should also be noted that management appears to have initiated an aggressive debt retirement campaign and has shown a pattern of debt repayment. Much of this debt was prepaid stemming from the proceeds of sales of assets and discretionary use of cash. All told, Krispy Kreme reduced its debt from $145 million in fiscal year 2005 to a much more manageable level of $27 million in 2011.

As noted above, Krispy Kreme was able to take advantage of a deferred tax asset; therefore, the metrics have been adjusted to remove this tax benefit. Despite this pro forma adjustment, Krispy Kreme appears to be in a healthy state in comparison to its primary competitors.
Part 4: Cases

Marketing

Interestingly, the manner in which Krispy Kreme doughnuts are consumed differs from how its competitors’ doughnuts are consumed. The majority of Krispy Kreme doughnuts are purchased by an individual to be shared with friends, family, co-workers, or classmates. Research conducted by the company has shown that approximately 70 percent of doughnuts purchased at company-owned stores and franchises are for sharing occasions. It should not be surprising then that over 55 percent of transactions are for a dozen or more doughnuts, signaling a high transaction value per customer.

Knowing that so many Krispy Kreme’s doughnuts are often purchased for the purpose of sharing the “eating” experienced with others has shaped Krispy Kreme’s overall marketing approach: word-of-mouth. Despite the absence of a traditional advertising budget, Krispy Kreme enjoys over 65 percent brand recognition. Social media has magnified that effect, and Krispy Kreme’s ability to leverage this new form of media has been extremely important to the company’s resurgence. With over 4.2 million Facebook fans, the company can reach its customers much faster and more efficiently than ever before in its history. The company has even introduced its own smartphone app—“Hot Light”—that alerts customers when a Krispy Kreme location has hot doughnuts coming off the line and gives driving directions from the user’s current location.

The final unique aspects of Krispy Kreme lie in its philanthropic commitment to the community and ability to leverage the power of free. Krispy Kreme offers a wide array of fundraising opportunities through the sale of doughnuts and requires its franchisees to sponsor local charitable events. These efforts help build relationships within individual communities and contributed an estimated $30 million dollars to local charities during the 2012 fiscal year. Furthermore, Krispy Kreme has a longstanding company tradition of leveraging the power of free, such as giving away a free hot doughnut. This drives store traffic and makes it difficult for many customers to resist purchasing at least an entire dozen as well. Additionally, whenever a new store location opens, instead of spending money on advertising, it sends dozens of free doughnuts to local television stations, radio stations, and newspapers, invariably garnering free publicity. A prime example of this tactic occurred when the company opened its first store in New York City. It sent dozens upon dozens of doughnuts to the Today Show and gained immense amounts of national publicity, including a ringing endorsement from Al Roker.

Leadership

The importance of strong leadership cannot be overemphasized. A firm’s ability to achieve an advantage and earn above-average returns is compromised when leaders fail to respond appropriately and quickly to changes in the complex global environment. Krispy Kreme has a strong set of leaders with its CEO, James Morgan, at its center.

James H. Morgan, Chairman—Chief Executive Officer

James Morgan began his career at Krispy Kreme as the Vice Chairman of the Board in 2004. In 2005, he was appointed Chairman of the Board and, after years of losing money, was named CEO. He has assumed duality, vesting in both CEO and Chairman of the Board positions. Morgan provides deep institutional knowledge and...
perspective regarding Krispy Kreme’s strengths, challenges, and opportunities. He also brings extensive public company and financial services industry experience to the table. He has redirected the company’s focus to small retail shops, a more diversified menu, and increasingly collaborative relationships with Krispy Kreme’s franchisees. Upon Kenneth May’s announcement that he was leaving the company for personal reasons in April 2012, Morgan also assumed the interim role of Chief Operating Officer (COO).

Douglas R. Muir—Executive Vice President and Chief Financial Officer (CFO)

After the quick turnover of three different CFOs between 2000 and 2004, it was crucial for the company to find a reliable and experienced CFO. Muir started with the company as a consultant in 2004 and was named Krispy Kreme’s Chief Accounting Officer in June 2005. Prior to his career at Krispy Kreme, he held various senior financial management positions, including Audit Partner at Price Waterhouse Coopers and Executive VP and CFO at Oakwood Homes Corporation. He is also a certified public accountant. Muir became Krispy Kreme’s Executive VP and CFO in June 2007.

G. Dwayne Chambers—Senior Vice President and Chief Marketing Officer

Chambers was appointed the Senior VP and Chief Marketing Officer of Krispy Kreme in September 2010. In his own words, “As the Chief Marketing Officer, I am honored to oversee all aspects of branding, marketing, advertising, and communications for one of the greatest brands on the planet.” Taking the intangible aspects of Krispy Kreme into consideration, Chambers is primarily focusing on spending less on “traditional advertising and marketing” and instead focusing on social media to spread the word. This approach also fits perfectly with the company’s global expansion plans. Through Chambers’ efforts, Krispy Kreme maintains a very active Twitter account and can be found on popular social networking sites including Facebook (with over 4.2 million “likes”).

The Board

Krispy Kreme’s board consists of nine members with each member bringing diverse and extensive backgrounds. Krispy Kreme’s board includes former finance executives, former restaurateurs, and even a former Chief Accountant of the SEC. Most members are independent, have relevant industry experience, and serve on no more than two other boards. Qualifications for board members are individuals “who have achieved prominence in their respective fields and who have experience at a strategy/policy setting level or who have high-level managerial experience in a relatively complex organization.” Another key characteristic of the board is that while many firms do not form succession plans until their companies are in dire straits, part of Krispy Kreme’s governance policies mandates an annual review of succession plans for the CEO and other key executives.

Rising to the Challenges

Health Concerns

The wild popularity of the low-carbohydrate Atkins diet that began in 2003 simply marked the beginning of healthier living in America. The decline in sales of the beloved Krispy Kreme doughnut was blamed on the success of the Atkins diet and other diets. Former CEO Scott Livengood stated, “It’s impossible to predict if low-carb is a passing fad or will have a lasting impact.” Today it is clear that it was not a passing fad but, in fact, a paradigm shift being made by Americans toward healthier living despite that—or perhaps because—the United States is the most obese country in the world with 34 percent of the adult population classified as such. Whatever the impetus, the “fad” of carb-counting diets and tracking the number of miles walked, run, or biked is now fully integrated into the lifestyles of many adults. This presents a significant challenge to Krispy Kreme given that its core products have a great deal of sugar, carbohydrates, and fat.

Today, there is a huge demand for all-natural, organic, gluten-free, low-cal, grass-fed, free-range, fresh water, locally grown food options. Clearly, Krispy Kreme does not fulfill any of these demands. Interestingly, despite this trend towards healthy options, by publicizing the quality of its coffee and offering a diverse menu of breakfast items in addition to doughnuts, Dunkin’ Donuts’ sales continue to increase. In 2009, Dunkin’ Donuts stated, “We are paying attention to consumers’ increased interest in low-carb foods.”

In its attempt to move away from the image of being extremely unhealthy, to date, Krispy Kreme has responded to this issue in only a limited manner. First, it has begun to offer alternative menu items to cater to the more health-conscious consumers. For instance, in addition to doughnuts, Krispy Kreme locations in Philadelphia now offer yogurt, oatmeal, soy milk, and Naked brand juices. Other locations have begun selling mini-doughnuts. These small, bite-sized doughnuts cater to people who may be

1 Juices stripped of artificial flavors, sugar, and preservatives.
Restoring Stakeholder Trust in the Top Management Team

Overexpansion, accounting inaccuracies, disregard for franchisees, and issues with corporate governance left a bitter taste in the mouths of investors that the company has not been able to fully shake. While the leaders primarily responsible for Krispy Kreme’s problems have moved on, high turnover and the issue of duality have made restoring confidence a continuing challenge for the firm.

Accounting problems surfaced in 2003 when Krispy Kreme began to reacquire failing franchises. Instead of recording the cost as an expense, Krispy Kreme recorded it as intangible assets under the name “reacquired franchise rights.” These improperly recorded expenses falsely inflated the company’s value. The SEC launched an investigation in 2004 that forced the company to restate its financials from 2002 through 2004. Turnover and lack of experience were the likely culprits for these issues; between 2000 and 2004, the company employed three different CFOs, two with no prior experience as a CFO. Ric Marshall, chief analyst at The Corporate Library, a governance watchdog, said the high CFO turnover rate raised red flags about the company’s financial state. Finally, in 2005, Douglas Muir was installed as the new Chief Accounting Officer (CAO) and was subsequently appointed as the firm’s CFO in 2007. Through his work, Muir brought stability to the company’s financial department, including a successful settlement to the 2009 SEC investigation.

As if these accounting “mistakes” were not enough, Krispy Kreme had problems with lack of disclosure and insufficient corporate governance. During its first few years as a public company, many board members were holdovers from the firm’s days as a private company. Some of these members were franchise owners. This was a problem because it was alleged that the firm might have paid inflated prices for some of the franchises it bought back. These franchises were owned in part by a former Krispy Kreme board member and chairman as well as in part by another longtime director. When pressed by analysts and asked why it paid such a high price for these acquisitions, the company never gave a concrete response and its lack of disclosure led to unfavorable speculation.

Another sign of potential weak and/or ineffective governance was when former CEO Scott Livengood was given a hefty compensation package that was 20 percent higher than the median for similar-sized companies. After Livengood retired, the board also granted him a six-month consulting position that paid $275,000. According to Ric Marshall (as noted above, from the Corporate Library), this type of excessive compensation indicates that the board was not sufficiently independent. With most of the power bestowed upon the CEO, no one dared to question the aggressive accounting during the franchise buybacks, much less the CEO’s compensation package. As Marshall summed up, “It was a classic governance failure.”

Fortunately, James Morgan’s ascension to CEO in 2008 has provided stability and sound leadership for Krispy Kreme. Prior to his arrival, the firm had three different CEOs in less than three years. Morgan has overseen two consecutive years of profitability for the first time since 2004, and the firm has consistently reduced its considerable debt throughout his tenure. However, because of the power he holds within the company, there are still plenty of reasons for investors to be concerned. Since 2008, Morgan has served dual roles as both the CEO and Chairman of the Board, and his influence was recently expanded to include the role of President. Due to the fact that Morgan has significant influence in both a management and an advisory role, effective monitoring by the firm’s board of directors is required to ensure an alignment between an agent’s and the principals’ interests.

Overexpansion

One of the most significant challenges growing companies must overcome is increasing their size too quickly. At least for a period of time, Krispy Kreme failed to successfully manage this challenge. After going public in 2000, the company felt enormous pressure to sustain its growth. It decided that adding more locations would increase sales, but this move quickly oversaturated the market. J.P. Morgan analyst John Ivankoe stated that Krispy Kreme’s “returns declined as [the] incremental appeal of each new retail store fell upon market penetration.” Increasing the number of store locations was not the only issue. On the wholesale front, the number of grocery stores, gas stations, and kiosks carrying its product grew exponentially and within a short amount of time, the company became ubiquitous. In addition, while Krispy Kreme’s “Doughnut Theater” and neon “Hot Doughnuts Now” signs provided novel advantages, these features were absent at its offsite wholesale locations. The focus on the hot doughnut experience that reeled in drooling customers was forgotten and the novelty of a warm Krispy Kreme doughnut was lost.
Since James Morgan accepted the position as CEO in 2008, the company has acted aggressively to restructure the organization and the results have been positive. However, overexpansion issues have begun to occur on the international level. After teetering on the brink of bankruptcy and closing a number of stores in Australia, CEO and Director of Krispy Kreme Australia stated in December 2010:

The remaining retail outlets all have strong sales and customer support, and the company can now continue trading without underperforming stores adversely affecting the business... The process has demonstrated the strength of the Krispy Kreme brand and now that this period of restructuring is behind us, we will be focused on the ongoing development of the Krispy Kreme brand in Australia.  

Given that Krispy Kreme is on a promising path to recovery, a vital issue the company faces domestically and internationally is how to avoid its past mistakes of overexpansion. Krispy Kreme must carefully examine each site on an individual basis to ensure every site—both new and old—can be profitable.

Franchisor/Franchisee Relationships

Ironically, Krispy Kreme’s revenues started declining when the firm began concentrating on growing revenues and profits at the parent-company level. The overemphasis on corporate profits caused many of its franchised outlets to struggle. When the company decided to expand nationwide in 1995, it made the decision to do so primarily through franchising instead of opening company-owned stores. This allowed Krispy Kreme to more easily fund its ambitious growth plans while minimizing risk to the company.

The company’s overexpansion was created in part by misaligned incentives between the franchisor and franchisees. A goal conflict always exists within franchisor/franchisee relationships: franchisors try to maximize franchisees. A goal conflict always exists within franchisor/franchisee relationships: franchisors try to maximize revenue from franchisees while franchisees try to minimize expenses. Most franchisors maximize revenue from franchisees through royalty payments. For example, Dunkin’ Donuts’ CFO Kate Lavelle stated, “We have a strong royalty stream that is based solely on store sales... the franchisor is more likely to succeed by building profitable franchisees that can make royalty payments.”

Krispy Kreme, on the other hand, not only collects franchise fees and royalty payments, but also requires that its franchisees buy doughnut-making equipment and its proprietary doughnut mix from headquarters at marked-up prices. Because the company was earning profits from its sales of raw ingredients and equipment, it was inclined to increase the number of stores (and thus, new customers for equipment and mix) without regard for the well-being of existing franchisees. Put simply, it got greedy, and its franchisor/franchisee relationships suffered as a result.

Today, the problems of misaligned incentives and unsupported franchisor/franchisee relations are still major concerns that Krispy Kreme is taking steps to address. In the company’s latest 10-K report, it stated, “In fiscal 2013, we intend to add a Vice President of Franchise Development, a new role designed to lead our U.S. expansion efforts.” This statement indicates that the company recognizes its relationships with its franchisees are crucial to the company’s growth and sustainable success. The 10-K also states that it is “committed to devoting additional resources and providing an even higher level of support to both our domestic and international franchisees.” Some of these resources include new and refined management tools, training manuals, and increased staffing. The company is sending a clear message that it is making an investment in its human capital, an asset that some argue is the most important a firm can have.

Conclusion

After posting huge losses from 2005-2008, Krispy Kreme began to stabilize under the leadership of James Morgan and posted only moderate losses in the 2009 and 2010 fiscal years. In 2011 and 2012, the champions of the Krispy Kreme brand persevered and were rewarded with profitability. Much of the turnaround can be attributed to how the leaders of this company recognized and responded to the mistakes made along the way.

N O T E S

4. Ibid.
17. O'Sullivan, K. op cit.
20. Ibid.
24. Ibid.
25. Ibid.
29. Ibid.
30. Ibid. 31. Ibid.
32. Ibid.
33. Ibid.
36. Ibid.
39. Ibid.
42. Beller, M. D. op cit.
44. Beller, M. D. op cit.
45. Ibid.
48. Ibid.
49. O’Sullivan, K. op cit.
55. Ibid.
56. Ibid.
57. Ibid
64. Dwayne Chambers: Chief Marketing Officer at Krispy Kreme. Linked In. http://www.linkedin.com/in/dwaynechambers
69. Nowell, P. op cit.
70. Morrison, M. op cit.
72. Nowell, P. op cit.
73. O’Sullivan, K. op cit.
74. Ibid.
76. O’Sullivan, K. op cit.
77. Ibid.
78. Ibid.
79. Ibid.
82. Ibid.
87. Ibid.