

# Lessons From Krispy Kreme

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## ABSTRACT

*The recent decline of Krispy Kreme Doughnuts, Inc. raises a natural question: shouldn't investors (and auditors) have been more wary of this Wall Street darling? Weren't there tipoffs that would have allowed investors to avoid another franchisor "crash and burn" situation like Boston Chicken or TCBY frozen yogurt? This paper traces the meteoric rise and fall of Krispy Kreme and discusses a number of advance indicators of future problems: insider share-dumping, conflicts of interest within the Board of Directors and senior management, turnover in the CFO position, the use of synthetic leases, repurchased franchises, disappointing joint venture results, and the problems of earnings management in the quarterly reports of a fairly small publicly-owned business.*

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## INTRODUCTION

Should we be surprised when a Wall Street darling like Krispy Kreme Doughnuts crashes and burns? Shouldn't there be warning signals when a company ranked as the best IPO of the 2000-02 period with a 711% stock price runup in three years loses all of that appreciation over the next 18 months? What causes a company to go from a market capitalization of just under \$3 billion to little more than \$300 million in such a short period?

This paper argues that there were numerous warning signals in the doughnut franchisor's accounting and managerial decisions that investors refused to take seriously as they bid the stock from its (split-adjusted) IPO price of \$5.25 to its eventual peak of \$49.50. The lessons that can be learned from an autopsy of the Krispy Kreme fiasco might well make investors more wary about jumping on the next IPO bandwagon.

## KRISPY KREME: FROM REGIONAL DELICACY TO CULTURAL PHENOMENON

The Krispy Kreme story began Winston-Salem, N.C. in 1937 when Vernon Rudolph began selling doughnuts to grocery stores using a secret recipe from a French chef. Strong demand from customers who wanted to buy their doughnuts freshly made and still warm caused him to open almost 100 retail outlets throughout the South. After Rudolph's death in 1973, his heirs sold the chain to Beatrice Foods, which immediately began to tinker with the successful recipe. By 1982 franchisees were so upset with Beatrice that they joined together to repurchase the chain. This created a franchisor owned and dominated by its own franchisees, which would create serious difficulties later on.

By the mid-1990's Krispy Kreme had escaped its Southern heritage and opened shops in the Midwest and Northeast, even invading Manhattan, home to many influential writers. But instead of deriding hot doughnuts as a provincial culinary fare like hominy or grits, the critics raved. A New York Times columnist even wrote: "When Krispy Kremes are hot, they are to other doughnuts what angels are to people." The product began to appear on TV in sitcoms and late-night talk shows; people bragged about their attempts to "score a dozen" of the treats, and a new cultural phenomenon was born.

## **THE IPO: HOW TO RUIN A GOOD THING**

A part of the plan to escape the South and make Krispy Kreme a national brand was the decision to take the company public. In April 2000, \$65 million was raised through the sale of 26.7% of the company's stock, giving it a market capitalization of \$270 million. By the end of the year, the stock price had almost quadrupled and CBS Marketwatch labeled Krispy Kreme the top performing IPO of the year. The company's ability to meet or slightly exceed the optimistic earnings projections of market analysts combined with news stories describing hour-long lines outside newly-opened stores to push the stock to a split-adjusted \$46 per share by the end of 2001. Investors loved the concept: this was a brand that seemed to combine high quality, exclusivity, and a gimmick – customers could actually watch their doughnuts being made. The opportunities seemed endless, as the company quickly carved up geographic regions for expansion and granted exclusive franchising rights, often to board members and other existing franchisees.

When Krispy Kreme CEO Scott Livengood was named *Restaurants and Institutions* magazine's Executive of the Year and *Forbes* put the firm on its list of "200 Best Small Companies," the momentum became almost impossible to sustain. The stock traded at 65-100 times projected earnings, and the demand intensified to produce earnings gains sufficient to justify such an extreme price-earnings multiple.

In May 2004 Krispy Kreme issued its first-ever profit warning, triggering a series of shareholder lawsuits alleging that the company had attempted to hide year-to-year declines in same-store sales. In fall of that year they announced their first quarterly loss since going public and attempted to blame it on a consumer trend toward low-fat foods. But the damage had been done: by the end of 2004 the stock price had slid from \$40 to under \$10 and the SEC had announced a formal investigation of the company's accounting practices.

In 2005 Krispy Kreme faced default on its main \$150 million credit line as it was unable to produce audited financial statements. Scott Livengood resigned as CEO only a few months after CFO John Tate left the firm, and six other executives were summarily fired for undisclosed improper behavior. By the end of 2005, weekly same-store sales had fallen 20% from the prior year, the firm had closed 25% of its stores, and a bankruptcy filing was rumored to be imminent. The stock price fell back to its (split-adjusted) IPO price of \$5.25 and almost \$2.7 billion of shareholder value evaporated in a dizzying free fall.

## **THE WARNING SIGNS**

While the Krispy Kreme fiasco left some investors holding the bag and frantically filing lawsuits, it should not have surprised more astute observers. At least a half-dozen warning signs appeared in Krispy Kreme regulatory filings well before the stock price started to fall:

### **Churning In The CFO Position**

Continued turnover in the CFO position is often a danger signal in a fast-growing public company. Just after the IPO in 2000, Krispy Kreme replaced longtime Chief Financial Officer Paul Beitbach with newcomer John Tate. Breitbach was a traditional conservative CPA, while Tate was a more aggressive financial type who was forced out as CFO of Williams-Sonoma after missing two quarterly earnings forecasts. (Understandably, he made sure not to miss any earnings targets while at Krispy Kreme.) Tate was promoted to Chief Operating Officer in 2002, and longtime controller Randy Casstevens was promoted to the top finance spot. Casstevens lasted less than eighteen months and turned in a "purely voluntary" resignation just five months before the company's first quarterly earnings shortfall. To replace Casstevens, the company brought in Michael Phelan, a key member of the investment banking team that executed Krispy Kreme's IPO and follow-on offering, who in turn lasted less than two years in the position.

A later report filed with the SEC stated that Tate and Casstevens didn't provide the "leadership or supervision over the accounting and finance functions that one would expect from the CFO position." One analyst

suggested that "... the real numbers the CFOs were coming up with were numbers the rest of management didn't want to hear. They were looking for a CFO who was going to tell them good news."

### **Insider Share Dumping**

When Krispy Kreme went public in 2000, about 75% of its shares were "locked up" – insiders who owned them were not permitted to sell for an eighteen-month period. As soon as the lockup period expired, executives and board members sold 1.85 million shares, or 20% of the shares subject to the lock-up agreement. By 2004 CEO Livengood had sold over 1 million shares (about 40% of his holdings) for net proceeds of over \$40 million, despite having previously made pledges that he wouldn't sell company stock. The high level of stock sales by insiders while the company was issuing glowing financial reports should have alerted shareholders to a potential problem.

### **Synthetic Leasing**

Soon after it went public, Krispy Kreme arranged to finance a new \$35 million factory in Effingham, Illinois with a synthetic bank-financed lease, which would allow them to keep a large long-term debt off their balance sheet and avoid raising their debt ratio from 26% to 36%. Criticism later forced them to unwind this lease and borrow the money to purchase this property from the bank. In the annual report, Livengood took the moral high ground: "In the current economic climate, investors understandably are paying closer attention to the financial strength of companies and the way they conduct business. We have taken the position that there is no reason for us to do anything that could be misinterpreted, regardless of how legal and acceptable it may be." Wise investors should not have "misinterpreted" Krispy Kreme's intention, which was clearly to avoid recording debt – at least until financial analysts caught on.

### **Executive Conflict Of Interest**

Outside shareholders often wonder if senior management has a strong ethical or moral compass: can they be relied on to act responsibly as the custodians of a newly-public company? Here two situations tell a tale:

- (1) In early 2003 Krispy Kreme spent \$39 million to acquire Montana Mills, a chain of 30 upscale "village bread stores" based in Rochester, N.Y. Almost \$30 million of the purchase price was allocated to goodwill, although the concept was unproven and Montana Mills had never previously shown a profit. In what appears as an obvious conflict of interest, COO John Tate had served on the Montana Mills Board of Directors for 14 months previous to the acquisition. Not surprisingly for a non-core venture, Montana Mills showed a \$2 million loss in the year after it was acquired, and in mid-2004 the chain was closed down, causing a \$35 million income statement charge.
- (2) In its first two years as a public company, Krispy Kreme had a policy which allowed senior executives to make private investments in newly-established area franchisees, and Scott Livengood eventually had ownership stakes in seven large franchised operations. In an arrangement reminiscent of old-fashioned extortion operations, Livengood and other Krispy Kreme executives were allowed to "muscle in" on new franchise deals – they could purchase equity stakes even when the franchisee group did not want them as partners.

After many complaints and an \$8 million arbitration judgment against them over franchisee rights, this arrangement was terminated in 2002 as Livengood announced "The perception and confidence of our investors is more important to us than any business practice. I really regret the things that have put us in this position, but there's been a tremendous amount of damage done to the credibility of honest people."

### Low Materiality Threshold In 10-Q's

As soon as an interesting young company goes public, attention begins to focus on whether they can meet or exceed the consensus EPS estimates of analysts. As the following table shows, for the first 14 quarters of its public life, Krispy Kreme did not disappoint:

Quarter Ended	Consensus EPS Estimate (Split-Adjusted)	Actual EPS Reported (Split-Adjusted)
4/30/2000	.0575	.0675
7/31/2000	.045	.0625
10/31/2000	.06	.0675
1/31/2001	.065	.075
4/30/2001	.085	.10
7/31/2001	.09	.10
10/31/01	.10	.11
1/31/02	.13	.14
4/30/02	.14	.15
7/31/02	.14	.15
10/31/02	.16	.17
1/31/03	.18	.19
4/30/03	.20	.21
7/31/03	.20	.21

An independent review team later confirmed that this was not an accident, as they accused management of having a “narrowly-focused goal of exceeding estimates by 1 cent each quarter,” and that “...the number, nature and timing of the accounting errors (later discovered) strongly suggest that they resulted from an intent to manage earnings.”

What investors apparently did not realize was how little additional earnings it took to beat the estimates by a penny. In the first two years, a one-cent increase in quarterly EPS could be generated by only a \$150,000 – \$200,000 increase in net income, which could be (and was) achieved by asking just one franchisee to accept early delivery of their doughnut-making equipment. Even as late as the summer of 2003, Krispy Kreme was able to increase quarterly EPS by a half-cent through an interesting agreement under which it sold \$700,000 of new equipment to a franchisee which was under an existing contract for repurchase, while simultaneously agreeing to increase the repurchase price by \$700,000 to cover the additional cost.

While the ability to “beat the estimates by a penny” created a very high price-earnings ratio, it also enriched senior management, who had an Incentive Compensation plan worth almost \$18 million annually which began to kick in if EPS performance exceeded estimates by 4 cents per year. Investors who were sensitive to (1) how much management compensation was at stake and (2) how small a profit change it took to exceed EPS projections by a penny would have placed significantly less importance on quarterly EPS results.

### Joint Venture Results

As it expanded rapidly, Krispy Kreme began to finance franchisees by taking minority ownership interests in their stores. By the end of fiscal 2003, they had investments in 14 different area franchises with annual sales volume of \$145 million. Since Krispy Kreme was required to use the equity method of accounting for these investments, their financial statements indirectly give evidence of the financial performance of a selected sample of their franchisees. As the following table shows, these franchisees reported losses in all but one of the 16 quarters between 2000 and 2003, and Krispy Kreme reported equity method losses of \$5.1 million over the four year period.

QUARTER	EQUITY-METHOD PROFIT/(LOSS) REPORTED BY KRISPY KREME
Q1 2000	\$(245,000)
Q2 2000	(355,000)
Q3 2000	(64,000)
Q4 2000	(42,000)
Q1 2001	(171,000)
Q2 2001	(33,000)
Q3 2001	(8,000)
Q4 2001	(390,000)
Q1 2002	(198,000)
Q2 2002	18,000
Q3 2002	(639,000)
Q4 2002	(1,189,000)
Q1 2003	(694,000)
Q2 2003	(802,000)
Q3 2003	(33,000)
Q4 2003	(301,000)

While these were “paper” losses and had no direct effect on the financial stability of Krispy Kreme, they did provide evidence of a serious problem – in spite of the favorable publicity and long lines outside newly-opened outlets, a lot of the company’s franchisees were not making any money.

### Repurchase Of Franchise Rights

While it is not unusual for franchisors to occasionally repurchase franchises from disgruntled or underperforming franchisees, few attempt it on such a large scale. From the second quarter of 2001 through the end of fiscal 2003 (February 2, 2004), the company spent about \$210 million in cash and stock to buy out the stores and future franchising rights of a number of area franchise developers. Critics found a number of troublesome issues here:

- Why would so many large franchisees of a supposedly-successful chain want to get out of their investment when operations seemed to be going so well?
- The largest single franchise buyout (\$67 million) was owned by two present and past Krispy Kreme Board members. Analysts following the company immediately suspected a “sweetheart” deal for former corporate insiders.
- The price paid for most of the buyouts seemed outlandish, reaching a peak of \$11.2 million per store at a time when a new franchise could be set up an equipped for about \$1.5 million.
- About 85% of the purchase price for franchises (\$175 million) was allocated to “repurchased franchise rights,”- the right to build new outlets within a given territory- yet by this time the company was discovering that further expansion to smaller and less desirable locations within existing franchise areas was usually not profitable.
- Once acquired, these franchise rights were treated as an intangible asset not subject to amortization, which was contrary to the established practice of other franchisors who had made similar repurchases. Amortizing these rights over a 10-year period would have cut the company’s reported fiscal 2003 profit by 30%.
- They bought out a struggling Michigan franchisee and agreed to raise the purchase price from \$26 million to \$32 million so that the franchisee could afford to close two stores and to settle its overdue debts owed to Krispy Kreme, thus avoiding a bad debt loss.

### CONCLUSION

During the Krispy Kreme stock price run-up of 2000-03, a series of early warning signs appeared, but investors seemed to ignore them. While each of these signs individually do not presage a coming disaster, when

taken as a whole they should have served as a warning to investors. Publicly-available documents show extensive insider share-selling, significant conflicts of interest among senior managers and the Board of Directors, an unwise investment in a non-core business, high turnover in the CFO position, a willingness to buy out the franchise rights of insiders at premium prices, a history of operating losses at the franchisee level, a willingness to use accounting games to avoid putting debt on the balance sheet, and a disturbingly consistent trend of beating quarterly EPS targets by just enough to earn significant bonuses for executives. Wise investors should not have been surprised when the stock price began to fall precipitously in 2004 and the company (followed quickly by the SEC) began an investigation into its management decision-making and accounting practices.

**NOTES**