case study

Stop Squeezing the Jelly Out of My Donuts—Krispy Kreme Case Study

By Michael Parsons and Mahnood Khan

Introduction

Krispy Kreme Donuts was founded in 1937 at Winston-Salem, North Carolina by Vernon Rudolph. Vernon started selling donuts to local grocery stores, but realized that consumers craved fresh donuts. Shortly thereafter, he began making fresh donuts right on the sidewalk. By the 1940s and 50s, the donut business had expanded to a small chain of family owned stores. During this period, Vernon and his engineers were focused on strengthening the donut-making process and developing their own equipment. A Krispy Kreme mix plant and distribution system resulted because of Vernon's efforts. Throughout the 1960s and 1970s, Krispy Kreme was expanding through the southeast and developing a consistent design for Krispy Kreme stores. The green tiles and heritage road signs were now the norm at Krispy Kreme Stores. During this period of time, Krispy Kreme was also going through reorganization and later sold to Beatrice Foods. In the 1980s, Krispy Kreme was bought from Beatrice Foods by a small group of franchisees. The focus continued to be a fresh hot donut experience.

By the 1990s, there was rapid growth. Krispy Kreme expanded from the Southeast and opened their first store in New York. Soon after, their first store opened in California and national expansion had begun. International expansion would soon follow and Krispy Kreme would be recognized as an American Icon. In addition, Krispy Kreme decided to go public in 2000 and was highly successful initially. Soon after their public offering, Krispy Kreme was trading at $50 a share and split twice. During this time, franchisees had benefitted greatly. It wasn't a surprise to see long lines out of the doors.

By the mid-2000s, the success and optimism of the previous decade and a half was gone. Pessimism would take over for the Krispy Kreme brand and franchisees were in trouble. The Securities and Exchange Commission (SEC) was inquiring about the buybacks of franchises and Krispy Kreme was restating their financials. Krispy Kreme's stock which had been as high as $50 a share had plummeted to as low as $4.05 a share (Figure1).

Consumers could find Krispy Kreme donuts at grocery stores and gas stations which led to fewer purchases. Franchisor-Franchisee relations were at a low point and franchises were filing suit against Krispy Kreme. The majority of franchisee growth was now happening internationally. In 2001, Krispy Kreme had opened its first international store in Toronto, Canada. By 2006, a total of 68 international stores were in operation in Australia, Canada, Mexico, South Korea, and the United Kingdom.

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Supply Chain Inefficiencies

Krispy Kreme's supply chain had become costly. With the small amount of franchises, it was more costly and inefficient for Krispy Kreme to distribute goods, per store, than it was for franchisors with thousands of locations. The costs were passed on to franchisees that were required to buy all ingredients and products at marked-up costs. This resulted in higher costs for all Krispy Kreme products and resentment from franchisees. Franchisees were finding the same equipment purchased from Krispy Kreme cheaper at other places. On the other hand Krispy Kreme's competitor, Dunkin Donuts, didn't generally sale equipment and ingredients to franchisees.

Franchise Store Size/Proximity Issues

In the late 1990s, Krispy Kreme required all franchisees buy 4,400 square foot factory stores. The factory stores were very large stores which functioned as both a retail and wholesale outlet. These stores allowed the consumer to experience the donut making process and could make up to ten thousand dozen donuts per day. However, they also required an expensive initial investment of about 1.7 million. Other franchise companies were also building large stores, but had alternative stores. For example, Dunkin Donuts larger stores could be up to 3,500 square feet, but alternative stores and kiosks could be as small as 400 square feet. Krispy Kreme franchisees only had one option. It was very difficult for franchisees to control operating costs and sell enough donuts to account for the cost of the store. In addition, franchisees were required to open multiple factory stores. To make matters worse, the stores were being placed too close together which flooded the market with Krispy Kreme donuts. This made it even more difficult for franchisees to make a profit.

Accounting Issues

In the early 2000s, Krispy Kreme repurchased several franchisee stores in Michigan, California, Texas, and Louisiana. However, Krispy Kreme would come under scrutiny for accounting practices related to these repurchases. Krispy Kreme was repurchasing these franchises and booking them under an intangible asset called "reacquired fran-

chise rights" which wasn't common industry practice. Costs associated with closing the stores and paying the owner and operating manager were also being booked under "reacquired franchise rights. Krispy Kreme was also paying inflated prices for some of the stores and not disclosing some of the repurchases were owned by former board members and family members. In 2004, The SEC made an informal inquiry about repurchases that occurred under Krispy Kreme. The informal inquiry quickly became a formal inquiry which was quickly joined by the United States Attorney's Office of the Southern District

Figure1

Krispy Kreme Stock Prices (Sullivan, 2005)

Sugar High

The fall of Krispy Kreme's stock price left investors depressed.

*Monthly close prices, adjusted for dividends and splits.

of New York. Shortly after, Krispy Kreme restated their FY 2004 financial and was under tremendous scrutiny (Figure2). Figure 2 shows accounting adjustments that required modifications to Krispy Kreme's previous annual financial statements.

Aggressive Growth/Limited Menu

At the time of Krispy Kreme's public offering, expectations were high. Krispy Kreme began to grow quickly based on the pressures of being a public company. They built numerous outlet stores without consideration for their franchisees. They might increase their sales in a specific market, but a franchisee's store might lose profit. The market was becoming saturated with Krispy Kreme products.

Krispy Kreme had relied on their signature glazed donut. They believed the fresh donut experience at factory stores would continue to provide large profits. However, during their 1990s and early 2000s Krispy Kreme donuts could be found everywhere. It was not only at the factory stores, but at gas stations and grocery stores. The signature glazed donut that was so popular had lost its appeal because the market was saturated with it. In addition, all of Krispy Kreme's competitors were developing other products and adapting to consumer demand for healthy alternatives. For example, Dunkin Donuts was rebranding itself as a coffee store and offering a number of breakfast items besides donuts. They had developed quality coffee to further differentiate itself from competitors. Dunkin Donuts was also selling a more diverse breakfast menu which was popular with consumer low-carb food demands. It wasn't that consumers no longer craved donuts, but there was a new trend towards healthier options. Krispy Kreme relied on one product and had become complacent. They struggled with marketing the fresh donut experience because their donuts could be bought everywhere.

Franchisees Fight Back

The accounting scandals did nothing but further infuriate franchisees and damage the company/franchisee relationship. In 2005, Krispy Kreme's largest franchise owner, Great Circle Family Foods LLC, sued Krispy Kreme. The owners with California franchises argued that Krispy Kreme had misused marketing money, engaged in deceptive business practices, and lied to franchisees about product costs. The franchise owners also believed Krispy Kreme was trying to force their bankruptcy by requiring that Great Circle pay for all their ingredients in advance. Under their previous six year agreement Great Circle was required to pay within 35 to 45 days of receiving the shipment.

At the same time franchise owner, Sweet Traditions with locations in St. Louis and Chicago was suing Krispy Kreme as well. They argued they were in financial distress because of Krispy Kreme mismanagement. They believed that Krispy Kreme was inflating the costs of supplies and equipment, requiring unreasonable growth, undercutting sales at their stores by selling to grocery stores, and engaged in unethical business practices related to the accounting scandal. In addition, they felt Krispy Kreme was wrongly withholding ingredient shipments because they couldn't pay their royalty fees. It was clear that franchisees understood the problems occurring at corporate headquarters and felt they had to protect themselves.

Krispy Kreme's Dilemma

Krispy Kreme's success was predicated on a fresh glazed donut experience. As part of that success, Krispy Kreme relied heavily on franchisees to distribute the product to its consumers. In return franchisees would own a business which could be very successful and Krispy Kreme would profit off of franchisee success. Unfortunately for Krispy Kreme they became a victim of their own success. Their success led to their initial public offering and rapid expansion. The decisions they made were often at the expense of their franchisees to ensure their stockholders were happy. Krispy Kreme had to walk a fine line to ensure their stockholders and franchisees were happy. If they didn't consistently report quarterly positive results their stockholders may not have been pleased. On the other hand, if they made decisions

Figure2

Krispy Kreme Estimated Restated Financial Adjustments in millions (Krispy Kreme, 2005)

Description Readjustment	FY00 and earlier	FY ended 1/28/2001	FY ended 2/3/2002	FY ended 2/2/2003	FY ended 2/1/2004	Nine months ended 10/31/04
Compensation Expense associated with Michigan Acquisition					$(3.4)	
Items improperly accounted for as part of Michigan Acquisition					(1.1)	
Profit reversal related to pre-acquisition sales to Michigan franchise					(1.8)	
Compensation Expense associated with Northern California franchise					(1.0)	
Charge to expense a portion of the consideration paid for the North California franchise					(1.9)	
Reverse management fee related to North California acquisition					(0.6)	
Reverse profit related to pre-acquisition equipment sales to Dallas franchise					(0.6)	
Charge to expense a portion of the consideration paid for Charlottesville					(0.5)	
Asset impairment provision					(1.0)	$1.0
Defer or reverse profit recognition on certain equipment sales		$(0.1)		$(0.3)	(1.3)	(0.8)
Mark-to-market adjustments on derivatives				(0.1)	1.2	(1.1)
Accounting for leases and depreciation of leasehold improvements	$(1.7)	(0.4)	$(0.8)	(1.1)	(1.4)	(1.6)
Accruals related to employee vacation pay	(2.0)	(0.4)	(0.5)	(0.3)	(0.5)	(0.4)
Accruals for charitable contributions		(0.5)		(0.5)	(0.7)	
Other items	0.3	0.3	(0.6)	0.2		0.4

based on their franchisees, success may have occurred at a slower rate than what stockholders were accustomed to. In short, the dilemma was could Krispy Kreme have managed the stockholder/franchisee relationship more effectively?

Conclusion

This case study highlights the effect corporate mismanagement can have on franchisees. Sound management and an effective business model are needed in times of remarkable growth. Management also mustn't be complacent and continue to follow market trends. For companies that rely on franchises to maintain success, they must consider franchisees when making decisions. As we have seen, lack of consideration for franchisees can have a detrimental effect on a company. What should Krispy Kreme have done?

Krispy Kreme's Resurgence

The early 2000s was a dark time for the Krispy Kreme brand, but there would be a revival. Shortly after SEC scrutiny and restatement of FY 2004 financials, Krispy Kreme released the CEO and several executives. James Morgan, a former security executive, was tapped as the new CEO to lead Krispy Kreme and diagnose the problems that were plaguing the company. One of the first issues he tackled was the need for less factory stores. He dropped the factory store idea all together and implemented smaller neighborhood stores. These stores were half the size and located near high population traffic areas. He also understood to be competitive with other franchises they would need more stores in other locations. James decided to expand aggressively internationally. In 2010, international Krispy Kreme stores doubled and international revenue was up 15%. There were over 600 international

locations in 20 countries.

As part of the Krispy Kreme resurgence, James began efforts to roll out additional menu items including oatmeal, yogurt, fruit juice, and coffee. There was an understanding that if Krispy Kreme was to be successful they needed healthy products and more choices. Coffee was also more profitable than donuts. By the first fiscal quarter of 2010, Krispy Kreme had doubled quarterly profit from the previous year to $9.17 million dollars in sales, their stock price was headed back up at $9 a share, and stockholders were optimistic about Krispy Kreme's future.

Discussion Questions

1. 1. As an executive, what would you have done to prevent the downward spiral at Krispy Kreme?
2. 2. Should Krispy Kreme management be held responsible for franchisee failure?
3. 3. Should franchise owners have more flexibility with store size and product to ensure a better chance of success? Should franchise owners have more rights when corporations mismanage the business?
4. 4. How could Krispy Kreme have diversified their menu to compete with competitors?
5. 5. What would you have done as a franchisee owner if corporate mismanagement caused your franchise to fail?
6. 6. What changes could Krispy Kreme of made to appeal to health conscious consumers?
7. 7. Are the unethical decisions made by Krispy Kreme management consistent with what we have seen during the economic downturn? What can be done to prevent such unethical behavior?

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