

Krispy Kreme Doughnuts, Inc.

NYSE:KKD

Analyst: Etienne Lehideux

Sector: Services

HOLD

Price Target: \$22

Key Statistics as of 4/16/2015

Market Price:	\$18.99
Industry:	Restaurants
Market Cap:	\$998.8M
52-Week Range:	\$28.05-42.00
Beta:	2.72

Thesis Points:

- Strong branding and customer engagement
- Aggressive geographical expansion
- New ERP system should reduce costs
- Market overreacted to increase in operating costs

Company Description:

Krispy Kreme Doughnuts, Inc., together with its subsidiaries, operates as a branded retailer and wholesaler of doughnuts, beverages, and treats and packaged sweets. The company operates through four segments: Company Stores, Domestic Franchise, International Franchise, and KK Supply Chain. It owns and franchises Krispy Kreme stores. As of April 2, 2015, the company had approximately 1000 company operated and franchise shops worldwide. It also produces doughnut mixes and doughnut-making equipment. The company was founded in 1937 and is headquartered in Winston-Salem, North Carolina.



Thesis

Krispy Kreme Doughnuts, Inc. operates as a branded retailer and wholesaler of doughnuts, beverages, and treats and packaged sweets. The company has an aggressive growth strategy both in the U.S. and internationally. It has a strong brand recognition and seems to draw a better image than its competitors, Starbucks (SBUX) and Dunkin Donuts (DNKN). The company relies on word to mouth advertising and same store sales growth will be driven by menu expansion, strategic promotions, and customer engagement through mobile apps. The recent implementation of a new ERP system recently impacted the company's operating margins, to which the market overreacted. Finally, operating margins for their biggest but less profitable segment will increase during Fiscal Year 2016, which will drive an increase in Krispy Kreme's stock price. Although the company has many strengths and is largely able to gain market share, its stock's valuation is not particularly attractive for value investors. However, investors looking for a growth play may want take a look at Krispy Kreme.

Segments

Krispy Kreme Doughnuts, Inc. generates revenues from four business segments: Company Stores, Domestic Franchise, International Franchise and KK Supply Chain.

Company Stores

The Company Stores segment is comprised of the doughnut shops operated by the Company. These shops sell doughnuts and complementary products through the on-premises and wholesale channels and come in two formats: factory stores and satellite shops. Factory stores have a doughnut-making production line, and many of them sell products to on-premises consumers and at wholesale to approved retailers of Krispy Kreme products to more fully utilize production capacity. Satellite shops, which serve only on-premises customers, are smaller than most factory stores, and include the hot shop and fresh shop formats.

Domestic Franchise

The Domestic Franchise segment consists of the Company's domestic store franchise operations and the licensing of Krispy Kreme products domestically.

Following its competitors, Krispy Kreme has begun licensing products in the beverage category. It started with branded bagged coffee, and introduced in 2014 branded ready-to-drink coffee beverages in bottles. The company also signed an agreement with Keurig Green Mountain to bring Krispy Kreme branded coffee to the Keurig brewing system.

International Franchise

The International Franchise segment consists of the Company's international store franchise operations. International franchise stores sell doughnuts and complementary products almost exclusively through the on-premises sales channel using shop formats similar to those used in the United States, and also using a kiosk format.

The table below shows the number of Krispy Kreme shops as of February 1st, 2015:

	2013	2014	2015
International	509	574	709
Domestic	239	254	278
<i>Franchise</i>	142	159	167
<i>Company Operated</i>	97	95	111
Total	748	828	987

KK Supply Chain

The KK Supply Chain segment produces doughnut mixes and manufactures doughnut-making equipment, which all factory stores, both Company and franchise, are required to purchase. In addition, KK Supply Chain sells other ingredients, packaging and supplies, principally to company-owned and domestic franchise stores.

The company operated stores are the less profitable segment with only 3% operating margin, which can explain their slower expansion: they grew only +14% in number of stores between 2013 and 2015 versus +18% for the domestic franchises and 39% for the international franchises. The international franchise segment is the most profitable with stable 70% operating margins, closely followed by domestic franchises with 60% operating margins.

Revenues from franchises business are experiencing double digit growth in revenues, with +12% between 2014 and 2015 for the international franchise segment and +14% for the domestic franchises segment. Below is a table summarizing the revenues and operating margins per segment over the past three years.

		2013	2014	2015
Company Stores				
	Revenue	296.5	306.8	325.3
	Operating Income	8.5	11.3	9.3
	%	2.9%	3.7%	2.9%
KK Supply Chain				
	Revenue	215.4	231.2	244.7
	Operating Income	32.5	37.0	41.8
	%	15.1%	16.0%	17.1%
International Franchise				
	Revenue	24.9	25.6	28.6
	Operating Income	17.4	18.0	20.0
	%	69.7%	70.2%	70.0%
Domestic Franchise				
	Rev	10.3	11.8	13.5
	OI	5.6	8.1	8.1
	%	54.1%	68.3%	60.2%
Total (accounting for intersegment sales elimination)	Revenue	435.9	460.3	490.3
	Operating Income	37.7	46.6	48.2
	%	8.6%	10.1%	9.8%

Similarly to competitors such as Starbucks (SBUX) and Dunkin Donuts (DNKN), Krispy Kreme sells its products through two distribution channels.

On-premises sales are sales to customers visiting company and franchise factory and satellite stores, including sales made through drive-thru windows, along with discounted sales to community organizations that in turn sell doughnuts for fundraising purposes. A substantial majority of the doughnuts sold in Krispy Kreme shops are consumed elsewhere.

Wholesale sales are sales of fresh doughnuts and packaged sweets primarily on a branded basis to a variety of retail customers, including convenience stores, grocery stores/mass merchants and other food service and institutional accounts. This channel of distribution is mainly limited to the United States.

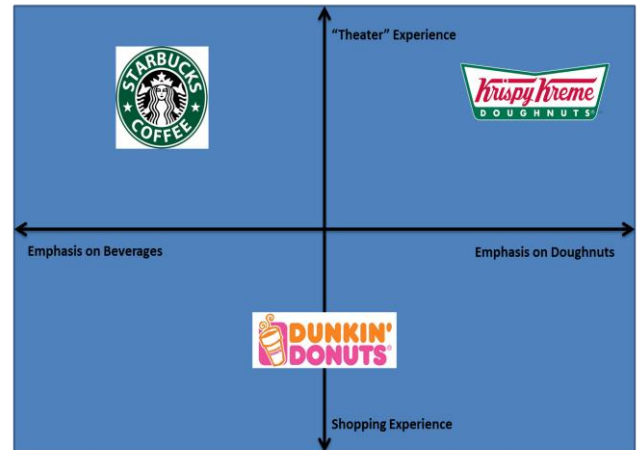
The Krispy Kreme brand

The company has several important brand elements that allow seducing new customers and retaining them.

Krispy Kreme claims to have a “one-of-a-kind” taste. The taste experience is at the core of their customer experience, which is why they use the same recipe since 1937. As a comparison, Dunkin Donuts was created in 1950 and has pushed the donut from the core of their offering. Indeed, the chain now offers more than 1,000 items to include bagels and other baked goods.

The other important element of the Krispy Kreme brand is the “doughnut theater” experience. Their shops are designed to produce a multi-sensory customer experience and establish their brand identity. Their goal is to provide their customers with an entertainment

experience and to reinforce their commitment to quality and freshness by allowing them to see the doughnuts being made. Although Starbucks provides a similar experience with the preparation of their beverages, Dunkin Donuts does not emphasize much commitment to freshness.



Other elements of Krispy Kreme’s branding include sharing and connections, as 55% of their retail transactions are for sales of one or more dozen doughnuts. Also, community relationships are something that the company cares about as their brand was built generations of word of mouth marketing. Krispy Kreme is involved in many communities through fundraising programs and sponsorship of charitable events. They refer to their strategy as “local relationship marketing”, which is less costly than massive marketing campaign and allows to keep the community values associated with the brand. To put it in perspective, Krispy Kreme spent 2% of its revenues in marketing and advertising during Fiscal Year 2015 for a 7% increase in revenues, while Dunkin Donuts spends on average 5% of their revenues in advertising and marketing for a 5.28% increase in revenues.

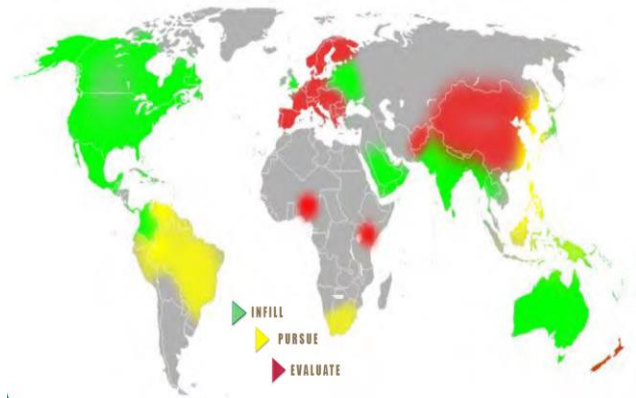
Growth Strategy

Krispy Kreme Doughnuts, Inc. is actively pursuing its geographical expansion, both on the domestic and international markets.

On the domestic side, the company is aggressively opening new shops. During Fiscal Year 2016, 20 to 35 shops will open in the U.S.. As their current footprint is currently mainly in the Southeast, the company expects to infill opportunities in the Southwest and the West Coast moving forward.

On the international side, Krispy Kreme Doughnuts, Inc. currently operates 900 shops in 24 countries, spread across North America, Occidental Russia, and in the

Asia Pacific region. The company projects to enter 6 to 8 new countries in Fiscal Year 2016, mainly in Latin America and Asia Pacific. They project to open between 95 and 110 new shops during the period. Finally, The company wants to complete its global presence in the near term, as they evaluate new countries in occidental Europe, China, and selected countries' in Africa.



The company is also looking at enhancing their menu. Although more selection can attract more customers, Krispy Kreme has to maintain its focus on what it does best: freshly prepared doughnuts. In fact, management recently stated that doughnuts will always be the center of their plate, while keeping the offering exciting and inviting. The company is also organizing a beverage strategy, and hired special staff to do so. The information on their long term beverage strategy is still quite vague, and defined as “exploring customizations and complimentary offerings”.

A unique proposition from Krispy Kreme is the use of technology to directly engage with their guests. The company developed an app that allows them to attract and retain more customers. The “Hot Light” App is a guest engagement platform that allows finding the nearest Krispy Kreme shop and be notified when that Hot Light is on at a specific shop. To date, over 4,000 guests per shop have downloaded this app. A loyalty and rewards program is included in the app, and it also offers stored value, which can be securely loaded and allows our guest to easily pay and go. The company plans to include digital fundraising and digital advanced ordering to the app, which will enhance customer’s engagement and save their time.



Operating Income and market reaction

Krispy Kreme’s last earnings report revealed an 11% same quarter increase in revenues and a 19% increase in gross profit. Adjusted EPS estimates were beaten, with \$0.17 per share versus \$0.165 expected. Although, investors were disappointed with the reduced operating margin. In fact, operating income only increased 5% on a same quarter basis, resulting in a 42 bps decrease in operating margin. The numbers are detailed below:

in \$ millions	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015
Revenues	112.75	121.58	120.52	122.87	125.37
Gross Profit	19.44	26.41	19.43	21.71	23.04
Operating Income (Loss)	9.07	16.18	9.62	12.87	9.56
Gross Margin	17.25	21.72	16.12	17.67	18.38
Operating Margin	8.04	13.31	7.99	10.47	7.63

Shares of KKD dropped almost 7% to \$19.00 per share on the news, as analysts updated their model without digging more into costs. The reality is that the costs causing this decrease in operating margins are related to the implementation of a new enterprise resource planning (ERP) system from Oracle that aims at reducing general expenses on the long term. The \$2.8 million implementation costs incurred during last quarter should be seen as an investment and will be largely offset starting next quarter. Another \$2.5 million in G&A expenses was related to the previously announced charge related to the settlement of the employment contract with our former CEO, Jim Morgan, who transitioned from Executive Chairman to non-employee Chairman at the end of January.

Valuation

The company is generally in line with guidance provided by the management. During fiscal year 2016, total revenues should increase by 8% to 11%, return \$55 to \$59 million in adjusted net income, and spend between \$35 and \$45 million in capital expenditure, a legitimate increase from the \$31.4 million during fiscal year 2015.

Krispy Kreme will work on improving the margins on its company stores segments. This is significant as the segment represents the main part of total sales, with 66% in fiscal year 2015. The margins on its domestic franchise and international franchise segments will stay at current levels. General and administrative costs will be decreased during fiscal year 2016, mainly due renewed IT systems going live, and the stronger dollar versus other currencies should have a \$2 to \$2.5 million impact on international franchise segment revenues.

On the multiples side, KKD trades at 21.7x its NTM earnings, versus 24.5x and 28.6x for Dunkin Donuts (DNKN) and Starbucks (SBUX), respectively. Its Price to Book value is also lower than its peers, with 4.6x versus 13.7x and 12.5x for Dunkin Donuts (DNKN) and Starbucks (SBUX), respectively. Its EV/EBITDA is 14.1x versus 15.1x and 15.5x for Dunkin Donuts (DNKN) and Starbucks (SBUX), respectively. Finally, Krispy Kreme trades at 2.55x its sales, versus 6.79x and 4.28x for Dunkin Donuts (DNKN) and Starbucks (SBUX), respectively.

	KKD	DNKN	SBUX
NTM P/E	21.7x	24.5x	28.6x
P/B	4.6x	13.7x	12.5x
EV/EBITDA	14.1x	15.1x	15.5x
P/Sales	2.55x	6.79x	4.28x

Although the multiples valuation reveals a slight undervaluation of the stock, the DCF shows that the stock is overvalued by \$5. I advise investors to wait for the price to decrease before investing in it, as Krispy Kreme has many element that make it a great company with a bright future ahead.

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Krispy Kreme Doughnuts, KKD		Analyst Etienne Lehideux	Current Price \$18.86	Intrinsic Value \$10.89	Target Value \$21.15	Divident Yield 0%	Target Return 1-y Return: 12.13%	NEUTRAL
General Info		Peers	Market Cap.	Management		Comp. FY2013	Comp. FY2014	Comp. FY2015
Sector	Consumer Discretionary	Denny's Corporation	\$981.68	Professional	Title	\$990,670	\$1,996,134	\$0
Industry	Hotels, Restaurants and Leisure			Chambers, G.	Chief Marketing Officer and Senior Vice Pr			
Last Guidance	Mar-11-2015	Dunkin' Brands Group, Inc	\$4,695.73	Bay, Cynthia	Senior Vice President of US Franchises and	\$1,042,843	\$913,504	\$0
Next earnings date	6/8/2015			Thompson, Anthony	Chief Executive Officer and President	\$0	\$0	\$0
Market Data				Cooper, G.	Chief Financial Officer and Executive Vice	\$0	\$0	\$0
Enterprise value	\$1,183.26			Booe, Anita	Director of Investor Relations	\$0	\$0	\$0
Market Capitalization	\$1,224.54			Marsch, Darrel	Senior Vice President, General Counsel and	\$0	\$0	\$0
Daily volume	0.81			Historical Median Performance				
Shares outstanding	64.93	BJ's Restaurants, Inc	\$1,370.03	Growth	KKD	Peers	Industry	All U.S. firms
Diluted shares outstanding	68.93	Starbucks Corporation	\$72,348.20	2.9%	2.9%	9.4%	6.1%	7.4%
% shares held by institutions	88.81%	Current Capital Structure		ROIC	8.9%	11.2%	14.7%	14.3%
% shares held by insiders	1.32%	Total debt/market cap	0.79%	NOPLAT Margin	5.5%	10.1%	7.1%	10.4%
Short interest	7.42%	Cost of Borrowing	7.74%	Revenue/Invested Capital	1.61	1.11	2.06	1.37
Days to cover short interest	9.52	Interest Coverage	10.1x	Excess Cash / Rev.	9.2%	7.5%	13.5%	12.9%
52 week high	\$22.32	Altman Z	10.13	Total Cash / Rev.	9.2%	9.1%	12.3%	15.2%
52-week low	\$14.82	Debt Rating	AA	Unlevered Beta	1.31	0.92	0.97	0.95
5y Beta	1.42	Levered Beta	0.97	TEV/REV	1.2x	3.1x	1.7x	2.5x
6-month volatility	31.81%	WACC (based on market value weights)	7.71%	TEV/EBITDA	16.8x	30.5x	14.1x	13.1x
Past Earning Surprises				PE (normalized and diluted EPS)	38.0x	29.9x	25.7x	23.5x
	Revenue	EBITDA	Norm. EPS	P/BV	3.3x	7.9x	3.2x	2.2x
Last Quarter	-2.1%	-17.0%	6.3%	GAAP Adjustments in estimates computations				
Last Quarter-1	-1.2%	-7.3%	0.0%	Operating Leases Capitalization	100%	Straightline	10 years	
Last Quarter-2	2.0%	-17.2%	-18.8%	R&D Exp. Capitalization	100%	Straightline	10 years	
Last Quarter-3	-3.2%	-5.7%	0.0%	Expl./Drilling Exp. Capitalization	0%	N/A	N/A	
Last Quarter-4	-5.1%	-12.8%	-7.7%	SG&A Capitalization	0%	N/A	N/A	
Proforma Assumptions		Forecast						
			Rev. Growth	Adj. Op. Cost/Rev	Invested Capital	NOPLAT Margin	ROIC	WACC
Money market rate as of today	0.60%	LTM	6.5%	86.4%	\$368.03	7%	9.7%	7.7%
Annual increase (decrease) in interest rates	0.1%	NTM	12.2%	80.0%	\$401.63	14%	20.6%	7.8%
Yield Spread acceleration	1.2	NTM+1	12.0%	79.4%	\$438.72	13%	20.3%	7.9%
Marginal Tax Rate	37.5%	NTM+2	12.0%	78.7%	\$479.99	13%	20.7%	8.0%
Risk-Free rate	2.6%	NTM+3	11.9%	78.1%	\$525.73	13%	21.5%	8.1%
Tobin's Q	0.80	NTM+4	11.9%	77.5%	\$576.35	14%	22.4%	8.2%
Op. Cash/Rev.	7%	NTM+5	11.8%	76.8%	\$632.19	14%	23.4%	8.2%
Growth in PPE	NPPE Growth follows Revenue Growth	NTM+6	11.8%	76.2%	\$693.55	14%	24.5%	8.3%
Long term Growth	6.0%	NTM+7	11.7%	75.6%	\$760.42	15%	25.7%	8.4%
Base Year Unlevered Beta	is equal to 0.92	NTM+8	11.7%	74.9%	\$831.95	15%	26.9%	8.5%
Long term Unlevered Beta	0.92	Continuing Period	11.6%	74.3%	\$1,263.79	15%	10.0%	8.6%
Valuation		Pricing Model			Monte Carlo Simulation Results			
Period	Invested Capital x (ROIC-WACC)	Total Debt	Other non-interest bearing claims	Shares Outstanding	DCF (Weight = 0%)	Relative (Weight = 100%)	Distress (Weight = 0%)	Weighted Average Price Per Share
LTM	\$0.00	\$9.69	\$126.83	64.93	\$15.01	\$11.85	\$14.91	\$11.85
NTM	\$46.99	\$9.69	\$81.28	64.93	\$17.04	\$21.90	\$16.99	\$21.90
NTM+1	\$49.91	\$9.69	\$24.42	64.93	\$18.54	\$26.47	\$18.58	\$26.47
NTM+2	\$55.92	\$9.69	-\$16.25	64.93	\$19.98	\$31.35	\$19.95	\$31.35
NTM+3	\$64.33	\$9.69	-\$80.94	64.93	\$21.68	\$37.11	\$21.66	\$37.11
NTM+4	\$74.90	\$9.69	-\$141.43	64.93	\$23.37	\$42.95	\$23.27	\$42.95
NTM+5	\$87.59	\$9.69	-\$214.67	64.93	\$25.06	\$49.62	\$24.95	\$49.62
NTM+6	\$102.52	\$9.69	-\$317.09	64.93	\$27.03	\$57.46	\$26.90	\$57.46
NTM+7	\$119.95	\$9.69	-\$423.94	64.93	\$28.89	\$66.19	\$28.71	\$66.19
NTM+8	\$140.29	\$9.69	-\$554.06	64.93	\$30.43	\$76.21	\$30.55	\$76.21
Continuing Value	\$401.96							
Monte Carlo Simulation Assumptions		Distribution				Monte Carlo Simulation Results		
	Base	Stdev	Min	Max		Intrinsic Value	1y-Target	
Revenue Variation	0	10%	N/A	N/A	Normal	Mean est.	\$11.85	\$21.90
Op. Costs Variation	0	10%	N/A	N/A	Normal	σ(s)	\$0.32	\$0.25
Country Risk Premium	6%	N/A	5%	7%	Triangular	3 σ(s) adjusted price	\$10.89	\$21.15
Long term Growth	6%	N/A	3%	9%	Triangular	Current Price	\$18.86	
						Analysts' median est.		\$24.83