ASSIGNMENT 3

KRISPY KREME DOUGHNUTS

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Presented to

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ANALYSIS

1) Analysts are predicting that Krispy Kreme will be able to perform highly effectively and continue to grow rapidly in the coming two years. Do you agree with their analysis? If so, why? If not, why not?

The aggressive increase in sales is coupled with 100% YoY increase in cap-ex investments. It is likely that such investments on an already profitable operations will generate increases in revenues.

Unfortunately, the analysis was only based on market projections, and did not take into consideration capital requirements (see Q4 for details). The required increases of working capital and capital expenditures will drain the company dry of cash (and max out revolving credit facility). In order for the growth to materialize itself, the company will ABSOLUTELY need to find more cash, somewhere around 100M$, either via issuing debt or approaching private equity investors. Going back to the stock market might not be the best approach since liquidity ratios will have heavily deteriorated and investors might have a lower level of faith in the company.

Note: Increased sales comes with increase in inventory as well, locking up equity into working capital, which generates financing expenses.

From 2001 to 2002, there has been an increase in Days Of Sales Receivables. The company should pay attention to account collection to avoid an increasing trend in receivables.

2) What factors did the CIBC analysts examine to forecast sales growth for KKD in the years ended January 2003 and 2004? What assumptions did they implicitly make about number of new stores and weekly sales per store (for both company and franchise stores)? What are their implicit assumptions about revenue growth from franchise operations and KKM&D? Do you agree with these forecasts?

First forecasted system-wide revenues (for company-owned stores and stores owned by franchise associates and area developers): reflected the company's plans for new store growth and growth in sales from existing stores given company's business model and competitive pressures, a growth of 35% in 2003 and 33% in 2004.

Represented projected earnings growth of 42% and 33% for the next two years.

FY2003: 75 company stores and 143 franchised stores (given in exhibit 4)
FY2003: Company stores sales of 303,206/72wk sales/52wk = 81 stores
Franchised stores sales 533,968/53wk sales/52wk = 194 stores

FY2004: Company stores sales of 334,624/72wk sales/52wk = 89 stores
Franchised stores sales 779,888/53wk sales/52wk = 283 stores

While the company is anticipating to open 62 new stores in 2003, and 200 new stores before 2006, analysts have adjusted sales to include 154 new stores over a 2 year period, which can be seen as aggressive since 77% of the objective would be completed in half the period. From the perspective of sales, the growth could be overstated, putting pressure on the company to increase its investments to build new stores faster than its cash flow can allow and could be risky for the company's reputation in front of shareholders.

3) **What are the NOPAT margins that the CIBC analysts have forecasted for KKD for the years ended January 2003 and 2004? What assumptions were made about specific expense items (e.g., margins, G&A, D&A, taxes)? Do you agree with these forecasts?**

NOPAT margins:

Formulas: *NOPAT margin = NOPAT/Sales*
NOPAT = Operating Profit(1-Tax rate)*

Computations: 2001: 5% (given in excel)
2002: 7% (given in excel)
2003: NOPAT margin = 60489(1-0.38)/494818 = 7.58%
2004: NOPAT margin = 79334(1-0.38)/606197 = 8.11%

The NOPAT margins are increasing according to the analysts' forecasts, therefore they expect the company's operating efficiency to improve over the next 2 years.

Assumptions:

Contribution profit is increasing by over 2% from 2002 to 2004. This is explained by an increase in sales of 53.7% over 2 years, but also by decreasing operating expenses by 2% as well, most probably because of economies of scale that are improving given the company's growth leading to efficiency.

G&A is forecasted to be fairly stable and slightly decreasing, as the company's administration is somewhat of a mandatory cost that cannot be decreased so much except in the case where the company would invest in a new IT system, decreasing the

need for accounting staff for example, but this is not a goal of the firm for the period given.

D&A is somewhat stable but slightly decreasing. This makes sense given the recent investments by the company for an amount of $37M to improve stores and equipment and continuing investments to upgrade them, because wear and tear will not be as significant on new pieces of equipment as it would be on older one, making sense for the analysts to lower the percentage ratio of sales for the next few years. Once the company decreases its capex investments, however, we could expect to see the D&A percentage ratio increase.

Taxes are stable at 38% which makes sense as well for a company of this size. However policies could change in the future, requiring forecasts to be adjusted, but this is not something analysts can easily anticipate, and conservatism recommends to keep this ratio stable, which is acceptable.

4) The CIBC analysts do not forecast KKD'S balance sheet for the following year (ended January 2003). Make your own balance sheet forecasts.

See appendix A for forecasted financial statements, including the balance sheet.

Assumptions:

Working Capital Requirements

- For Receivables, assume Days of Sales Outstanding (DSO) will stabilize at 36 (after increasing from 30 in 2001)
- For inventory, assume Inventory as Days of COGS will continue to increase in order to help generate aggressive sales increase target at the rate of 1 per year (like observed from 2001-2002)
- In order to forecast Other ST Assets, ratio was pegged against LT Assets used instead of Current Assets to avoid Circular reference. The ration was fixed at 6% for both 2001 and 2002, therefore seems like a good point of reference
- Payables as DAys of Cogs has been increasing from 21 to 24. Assumption that it will keep increasing Since purchase volumes will provide negotiating leverage with suppliers
- Accrued liabilities assumed to keep increasing by 2 days of COGS per year because of aggressive expansion

Summary P&L and IS

- There are many inconsistencies between the provided financial statements and forecasts.

- In the provided forecast, 2002 actual sales from various channels: $266,209 + $14,963 + $114,137 = $395,309; whereas both the provided income statement and the analysis forecasts have 2002 Actual sales at $394,354
- Also, in the provided Excel, the 2002 operating profit of $23,507 seem to come from Gross Margins less D&A and SG&A, but $50,014-$6,458-$2,0061=$23,495
- The 2001 minority interest in CF statement for 2001 is $401, from the IS is $716 and from the provided forecast is $600
- In the financial model, NI from the provided forecast was used in order to be coherent with the income forecasting.

Balance Sheet

- Other assets was estimated as a % PP&E.
- Minority interest is assumed to remain constant, although minority investors could come in to help bring cash in the company
- Other LT liabilities were estimated as 3.5% of total assets based on previous years

Debt:

- Assume LTD amortized over 5 years
- Assume Short Term portion is included in other current liabilities
- Although interest is calculated; it is not required since IS forecasts were already prepared
- Assume interest/revenues from revolver debt/cash surplus is already accounted for in revenue projections provided

Noted on forecast Balance Sheet:

- Because of heavy CAPEX requirements and additions in working capital, neither existing cash reserves nor remaining cash will not be enough to cover the forecasted expansion
- Assumption made that the 40M$ revolving credit facility will be completely used up in 2003 in order to keep cash reserves afloat
- An additional ~100M$ in cash will be required in 2004
- With such a low D/E ratio, the company should really consider issuing more long term debt

5) In general, do you expect analysts' forecasts for a company like KKD to be optimistic, pessimistic or unbiased? Why?

We would expect the analysts' forecast for this company to be optimistic.This is because most of the forecasting assumptions are based on the historical performance of the firm as well as on the environmental condition trends.

At the time of this analysis, KKDs' has accumulated a very good performance history in almost all of its business metrics including with year over year growth in sales, margin expansion, returns and operating efficiency. We can also assess that the current environmental conditions in the market are very favorable for KKD, providing a lot of room for market growth and freedom to exercise competitive advantages.

Although some risks are identified and our analysis indicates understated challenges to overcome capital expenditure financing, it remains that the positive starting point greatly influences the general outlook of the forecast. It is then more likely to lead to a more optimistic forecast.