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MWF 9

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Table of Contents

Executive Summary

Krispy Kreme Doughnuts, Inc. (KKD) is a specialty retailer of doughnuts that operates 400 stores in the United States, Canada, Australia, Mexico, and the United Kingdom. As of April 19, 2005, the stock currently trades for $6.48, down from nearly $50 in August 2003 ("Quotes & Info, see Appendix B"). The company is currently facing an SEC investigation related to the restatement of fiscal 2004 financial statements ("Announces"). In addition to accounting problems, Krispy Kreme was at risk of defaulting on $96.1 million in letters of credit and loans (Maremont). However, they received $225 million in new funding on April 5, 2005 ("New Financing"). While net income has increased every year since 2000 (according to flawed financial statements), same-store sales have declined by 25 percent (Walberg). Furthermore, a large percentage of fiscal 2004 earnings are attributable to franchise fees (Annual Report 25). Since same-store sales have decreased by double-digits, franchise fees cannot be counted on for future income. Thus, Krispy Kreme must find a way to increase income resulting from sales.

The drop in same-store sales can be attributed to rapid expansion and dilution of brand image. Between 2000 and 2004, Krispy Kreme added more than 200 stores (Annual Report 19). The dilution of brand image comes from off-site locations selling doughnuts that are not hot or fresh as promised by Krispy Kreme marketing. We suggest that Krispy Kreme close 70 factory stores: 50 company stores and 20 franchises. Through cutting out underperforming stores and stores that are cannibalizing other stores' sales, same-store sales should increase. The average same-store weekly sales should rise from $54,000 to an estimated $64,000 ("Possible Debt"). Because fewer stores will be open and fewer doughnuts will have to be sold to break even, Krispy Kreme can be more selective about the off-site locations where doughnuts are sold. This will remedy the problem of dilution of brand name and will help to increase same-store sales.

As Krispy Kreme's stock has declined, there have been rumors of a possible buyout or merger. Specifically, JP Morgan analyst John Ivankoe suggested interest on behalf of McDonald's Corp. and Triarc Cos. ("Analyst"). If any sort of acquisition would take place, Ivankoe favors Triarc as the optimal buyer. As the owner or Arby's and other "broken brands", Triarc has a history of stabilizing companies with problems similar to Krispy Kreme's. With an estimated takeover price of $742 million and still unsteady stock, the general feeling in the industry is that a full-blown merger remains unlikely ("Looking").

A more realistic possibility for Krispy Kreme is a joint-venture in international markets. A trial relationship of this type is underway with McDonald's in the Canadian markets (Mori). Trial Krispy Kreme locations have set record opening sales in Ontario, and similar joint ventures began in Australia, New Zealand, the United Kingdom, and Ireland in 2003. With the early success of the Canadian locations, there has also been talk of McDonald's taking Krispy Kreme to Japan. International expansion remains a promising option, as these markets are welcoming and profitable for Krispy Kreme (PR Newswire). While the costs and risks of international expansion are high, these could be dissolved by using equipment from domestic store closings as well as partnering with a larger, already established parent firm.

Proposal

Krispy Kreme Doughnuts, Inc. is a retailer of premium doughnuts, known for its "Hot Original Glazed." Founded in 1937 in Winston-Salem, the company now operates 400 stores in the United States, Canada, Australia, Mexico, and the United Kingdom (Press Release). The stock currently trades for less than $6.50, down from an all-time high of $49.74 in August 2003 (Quotes and Info). Krispy Kreme is the restaurant industry's lowest performer in terms of one-year stock price performance with a one-year price decline of 76.76% (Yahoo Restaurants).

Looking at the income statement, it is not obvious why Krispy Kreme's stock has declined. Revenues and net income have increased every year since 2000 (see Appendix C). A closer look, however, shows that the increase in revenues comes largely from selling franchises at a premium, not from selling doughnuts. Krispy Kreme opened 58 new franchises in fiscal 2004 (Annual Report 24). Each one of these franchises had to pay a franchising fee of $40,000 which guarantees franchisees the rights to a particular location for 15 years. Additionally, franchisees pay around $1.35 million to open a Krispy Kreme to cover furniture, fixtures, equipment, and initial inventory (Adler).

Krispy Kreme acknowledges that a large part of the fiscal 2004 increase in sales comes from franchise fees, noting, "the increase in revenue was primarily due to the franchise fees and additional royalties associated with the 58 new franchise factory stores opened in fiscal 2004" (Annual Report 25).

Nearly $40 million in additional sales can be attributed to first-week opening sales. Krispy Kreme opened a total of 86 new stores in fiscal 2004 counting 28 company and 58 franchise stores (Annual Report 24)." Each of these stores can expect first-week sales as high as $454,000 (Adler) before weekly sales level out to an average of $54,000 ("Possible Debt").

If Krispy Kreme could continue to open 86 new stores per year including 58 new franchises, there would be no problem. However, with same-store sales declining by 25 percent, this high rate of growth is not sustainable (Walberg).

When you subtract the income that is not sustainable, including the $40,000 per franchisee rights payment, the $1.35 million per franchisee initial outlay, and the nearly $40 million attributable to first-week sales, the increase in total revenues for fiscal 2004 becomes less impressive. Combine this with the company's own admission that fiscal 2004 net income was overstated by between $3.8 million and $4.9 million due to accounting errors resulting in an SEC investigation, and the decline in stock price begins to make sense ("Announces Restatement").

The decrease in same-store sales has been attributed to low-carbohydrate diets, but high-carb competitors such as Panera Bread and Dunkin' Donuts continue to thrive: Dunkin' Donuts global same-store sales increased by 13 percent in fiscal 2004 (Allied Domecq), and Panera Bread comparable store sales increased by 2.9 percent (Panera Bread). The decline is more likely due to overexpansion and cannibalization of sales. Krispy Kreme grew very quickly- from 144 stores in January 2000 to 357 in February 2004 (Annual Report 19).

Decreased same-store sales quickly become a financial crisis for Krispy Kreme because stores have such high operating leverage. There are exorbitant fixed costs associated with each Krispy Kreme factory store. The doughnut equipment alone costs $350,000. By comparison, an entire Dunkin' Donuts franchise costs the same amount (Adler). While its uniqueness is a major strength of Krispy Kreme, this "doughnut theater" equipment becomes a weakness due to its great expense if each store is not selling enough doughnuts to cover its cost. Since a glazed doughnut retails for around 70 cents, the volume that must be sold to break even is substantial.

To offset the costs of fixed assets, Krispy Kreme has begun to sell doughnuts in more than 20,000 offsite locations including Wal-Marts, grocery stores, and gas stations (Walberg). This dilutes the Krispy Kreme brand name because rather than getting the hot, fresh doughnuts that are promised, patrons who purchase off-site doughnuts are getting cold, stale doughnuts. These consumers now associate Krispy Kreme with an inferior product and are less likely to go to Krispy Kreme the next time they want a doughnut. This negatively affects same-store sales even further.

Another problem is that stores cannot be easily closed down if they are underperforming. Krispy Kreme Doughnuts, Inc. has guarantees on $24 million in franchise obligations and another $135 million in long-term lease obligations. If franchises are closed, Krispy Kreme will be responsible for their guarantees ("Spit It Out"). Furthermore, there is almost no marketability for the equipment. The doughnut equipment is capable of making one and only one product: a glazed doughnut. This limits the market value of the machine though the book value is substantial. Furthermore, even if selling the equipment were profitable, it would be unwise to sell to competitors because it is part of Krispy Kreme's competitive advantage.

The bottom line of Krispy Kreme's problem is that they have fixed costs that are too high, sales that are too low, and stores that are very costly to close. To remedy these problems, we suggest that Krispy Kreme selectively close stores, and use equipment from closed stores to begin international joint ventures.

Recommendation 1

In order to end same-store sales decreases, Krispy Kreme must close some underperforming stores. To do this, management should develop a triage system where stores are labeled "booming," "sustainable," and "poor." The stores should be categorized by level of sales. Consideration should also be given to stores within the same vicinity, though if all stores in a given area have acceptable sales levels, they should all remain open. Stores categorized as poor should be closed. If two stores within the same area are categorized as poor and it is believed that closing one will improve the sales of the other, the company store should be closed rather than the franchise, which will prevent Krispy Kreme from becoming responsible for outstanding guarantees and lease agreements. If both are franchises or both are company stores, the one with the lower sales should be closed. Booming stores should be kept open, and sustainable stores should be evaluated on a case by case basis.

Krispy Kreme should aim to cut a total of 70 stores: 50 company stores and 20 franchises. By cutting out the stores that are underperforming and stores in the same area that are cannibalizing other stores' sales, same-store sales should increase. JP Morgan analysts believe that same-store weekly sales could rise from $54,000 to around $64,000 as a result of store closures ("Possible Debt"). As same-store sales increase, earnings and net income will increase as well.

Closing 70 stores will also allow Krispy Kreme to trim its off-premises sales which are declining. In the four weeks ended Feb. 19, 2005, off-premises sales decreased by 8.5 percent. Off-premises sales have been decreasing since October 2004 ("Possible Debt"). After the store closures, Krispy Kreme will have fewer machines producing doughnuts, which means lower fixed costs to recover, which means fewer doughnuts have to be sold off-site. This will allow Krispy Kreme to sell doughnuts only in the off-site locations that are profitable.

These store closures will require large amounts of cash, including paying off leases and franchisee guarantees. Cash has been an issue for Krispy Kreme recently; the company had a net decrease in cash and cash equivalents of $11.2 million in fiscal 2004 (Annual Report 46). The cash crunch became especially dire in March 2005 when Krispy Kreme was at risk of defaulting on $96.1 million in loans and letters of credit (Maremont). The liquidity crisis was relieved April 5, 2005 when Credit Suisse First Boston and hedge fund Silver Point Finance arranged $225 million in new financing ("New Financing"). While $90 million was paid to creditors, the rest has been reserved for "general corporate purposes" (Maremont). This additional funding should be used to fund the store closures.

Recommendation 2

Last fall, in the wake of a rapidly declining stock price, speculations arose regarding the possibility of a Krispy Kreme buyout or merger. The leading voice in these speculations was, and continues to be, John Ivankoe of JP Morgan, the foremost analyst following the company. With names like McDonald's Corp. and Triarc Cos., parent company to Arby's and other restaurant chains, the business community has been waiting and listening ("Analyst"). Fool.com writer Bill Mann, whom our group contacted on the matter, has also been a big advocate of the idea, saying in a fall 2004 article, "[his] fondest hope is that McDonald's buys Krispy Kreme" ("Fair Value").

There has been much discussion over whether Krispy Kreme is looking to be bought, who would want to buy it, and how much they would pay for it. In a September 2004 Equity

Report, Ivankoe writes realistically about the possibility of a buyout for Krispy Kreme, his estimation of the firm's takeover price at $742 million, and his pick of Triarc over McDonald's. He states that McDonald's, while recently full or partial owners of multiple brands including Chipotle, Boston Market, and Pret a Manger, has only been marginally successful with domestic brand management and would likely not be interested in a total buyout. It is his belief that Krispy Kreme would not be eager to sell their entire business to McDonald's, nor would McDonald's be keen to make an offer ("Looking").

Ivankoe feels that Triarc is the more suitable candidate for an acquisition. Triarc has a history of purchasing "broken brands"; as such many feel that the company would be a logical parent for Krispy Kreme. Ivankoe goes so far as to say that "the question is not whether the company would be interested in the Krispy Kreme business, but at what price". While this is true, Ivankoe and others still feel that Krispy Kreme is in too much disrepair to be attractive to and investor looking to acquire the entire firm ("Looking"). Ivankoe later stated in a similar report in November that his speculations were blown out of proportion, that McDonald's had stated publicly an opposition to any major actions in the near future, and that Triarc would only be interested if forecasts for Krispy Kreme improved ("Lowering").

While a full blown merger or buyout remains an extreme and unlikely course of action, the concept of a partnership or joint venture for a company in distress is appealing. Particularly where it comes to its international operation, Krispy Kreme could benefit from a business partner to help bear the burden. The company recognizes this, and has, in fact, begun to partner with established firms in new markets. A promising partnership of this type exists with McDonald's. Recently, McDonald's had begun testing Krispy Kreme doughnuts in traditional storefronts and stores within Wal-Marts in London, Ontario. Early results of these test sites are promising

(“Looking”). For example, the debut of a Krispy Kreme in a Toronto suburb had “record opening-week sales of $712,750,” and even after six months, this outlet’s sales are “slightly ahead of typical Krispy Kreme stores after six months.” (Georgiades). Krispy Kreme also tested similar joint ventures in Australia, New Zealand, the UK and Ireland (Joint Ventures).

With the preliminary success of such a setup in Canada, there has been very unofficial talk of McDonald’s Corp. bringing Krispy Kreme to Japan. Mark Kalinowski, an analyst for Solomon Smith Barney, suggested a Krispy Kreme-McDonald’s joint venture in Japan as far back as 2002 (Mori). At the time, Krispy Kreme was more stable and at the peak of its expansion; however, the company still plans to expand globally.

After Krispy Kreme makes the recommended store closures, it will have 70 stores full of unneeded fixtures, uniforms, and equipment. With very little modification, much of this could be adapted for the international stores. This will considerably lower costs associated with opening these stores.

Even with most of the equipment provided, international expansion is extremely expensive, especially for a firm already in distress. Such costs recently forced KremeKo Inc., Krispy Kreme’s Canadian subsidiary, to file for insolvency on April 19, 2005—merely three years after it entered the country. KremeKo attributes “franchise matters” for the default (Crying). Effects of high costs can be seen in the company’s 10K for fiscal 2004 (see Appendix D); while KremeKo shows 2004 sales of $20,926,000, the division posted a net loss of $2,070,000 for the year. The 10K also shows similar effects on numbers across all international divisions (Annual Report 139).

However, record-breaking openings in Canada have displayed a welcoming international market (PR Newswire). In addition, the costs and risks of expanding into a global market would be curbed by an alliance with a larger already internationally-established parent company. Had KremeKo partnered with a locally established parent firm, they would not currently be facing such a cash flow crisis. In this way, Krispy Kreme could benefit from a joint-venture in their international markets, as well as providing growth opportunities and tax benefits to a parent company.

Through strategic store closings and an international joint venture, the increase in same-store sales and expansion of international sales will increase cash flows and net income. These changes will eventually lead to a rise in stock price. Although neither of these proposals are a quick-fix, stockholders should expect a slow incline over the next several years as the changes occur and sales increase.

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APPENDIX A

Overview of the Company

Suppliers— Krispy Kreme Manufacturing and Distribution (KKM&D), which operates three distribution centers, essentially takes care of all supplies crucial to the operation of a Krispy Kreme store. KKM&D's role extends from buying and processing ingredients, to manufacturing the equipment used in each Krispy Kreme store to make doughnuts. The unit buys and sells "all food ingredients, juices, signage, display cases, uniforms and other items." All Krispy Kreme factory stores are required to purchase from KKM&D (Annual Report 22).

Customers— Krispy Kreme's customers include a wide variety of people. However, there are two main groups that support this company—those who buy from the on-premise location and those who buy from the off-premise locations. The main target customers who buy from the on-premise locations are loyal customers who are intentionally a specific Krispy Kreme product; these customers may walk into store location or take advantage of Krispy Kreme's 24-hour drive-thru service. Krispy Kreme's 24-hour service is a source of convenience for those looking to get in, get out, and get on with their lives. Those who buy from the off-premise locations, including gas stations and Wal-Marts, tend to be less brand-conscience and are simply purchasing a product rather than a name. Customers also include those participating in fundraising services; Krispy Kreme partners up with a school or organization and offers their doughnuts at a discount rate to help raise money for non-profit groups. Krispy Kreme serves approximately 7.6 million customers each month (Fox).

Products and Services— Including coffee, specialty beverages and other bakery goods, Krispy Kreme locations offer over 20 types of doughnuts. Their signature product, the Hot Original Glazed, remains the majority of the 4,000 to 10,000 doughnuts each location produces every day. In addition to the free-standing stores, Krispy Kreme offers their products, both fresh and packaged, through many retail customers such as grocery stores and gas stations. The company also offers a line of collectible merchandise ranging from clothing and hats to mugs and toys. Other services offered include the Krispy Kreme Card, a spending card that may be used at any location, and several community fundraising programs (krispykreme.com).

Competitors— Krispy Kreme competes in the small restaurant and fast-food industry including other doughnut shops, bakeries, coffee shops, drive-thrus, bagel shops supermarkets, and convenience stores. Most of their competitors offer a variety of products. The time of the day changes their direct competition; in the mornings their main competition is other coffee, doughnut and breakfast shops, whereas in the evenings the main source of competition is any kind of specialty. Some of their main competitors include Panera Bread, Starbucks, Dunkin Donuts, Cold Stone Creamery, Ben and Jerry's, and Winchell's Doughnuts.

Industry— Krispy Kreme is a specialty retailer of doughnuts in the fast-food industry serving customers in both on and off premise locations. The fast-food industry has become very popular for those in time constraint situations or who need a quick meal. Since the industry is so large and established, many companies, including Krispy Kreme, have had a hard time remaining profitable. Companies in the restaurant industry deal with low profit margin and high competition. Compared with the other restaurants in the industry Krispy Kreme leads the laggards in price performance with a 76.46 percent decline.

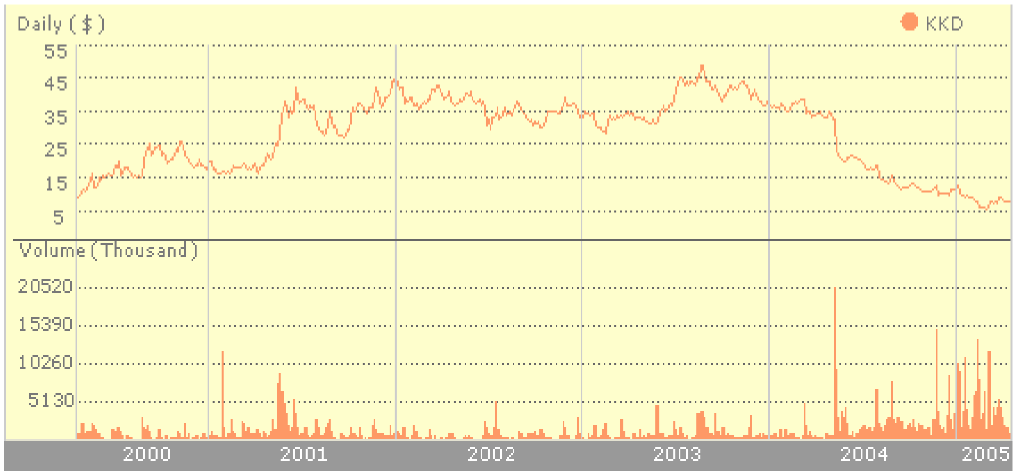
Employees and Facilities—

Krispy Kreme currently has 400 stores in operation, including 180 company stores, 55 associate stores, and 165 area developer stores (JP Morgan). The majority of these stores are located in North America; however, there are several locations in Great Britain, Asia, and Australia. Each traditional store handles the main functions of the business, from production to sales of the company's products; these stores have a daily production capacity of 30,000 to 72,000 donuts (Annual Report).

Approximately 3,900 people are currently employed by Krispy Kreme. In January of 2005, Scott Livengood, CEO since 1998, retired under pressure amid SEC accounting investigations. Subsequently, the Board of Directors hired a turnaround specialist, Stephen Cooper, to take over as Chief Executive Officer. On February 10, 2005, Krispy Kreme decided to lay off more than 125 employees to save $7.4 million in expenses. Another example of internal distress in the company is evident in a current lawsuit. Recently, employees filed a class-action lawsuit against former Krispy Kreme executives alleging that the workers "lost millions of dollars in retirement savings because executives hid evidence of declining sales and profit" ("Workers File").

APPENDIX B

Krispy Kreme Stock Price Since 2000



Morningstar.com

APPENDIX C

Statement of Operations Data

Year Ended	Jan. 30, 2000	Jan. 28, 2001	Feb. 3, 2002	Feb. 2, 2003	Feb. 1, 2004
Total revenues	220,243	300,715	394,354	491,549	665,592
Operating expenses	190,003	250,690	316,946	381,489	507,396
General and administrative expenses	14,856	20,061	27,562	28,897	36,912
Depreciation and amortization expenses	4,546	6,457	7,959	12,271	19,723
Arbitration award	0	0	0	9,075	(525)
Income from operations	10,838	23,507	41,887	59,817	102,086
Interst and other expense(income), net	1,232	(1,698)	(2,408)	749	3,501
Equity loss in joint ventures	0	706	602	2,008	1,836
Minority interest	0	716	1,147	2,287	2,072
Income before income taxes	9,606	23,783	42,546	54,773	94,677
Provision for income taxes	3,650	9,058	16,168	21,295	37,590
Net income	5,956	14,725	26,378	33,478	57,087

APPENDIX D

Summary of Financial Information, 4/16/2004

	NET SALES	NET INCOME/ (LOSS)	TOTAL ASSETS	TOTAL LIABILITIES
A-OK, LLC	13,668	1,466	7,398	7,275
Amazing Glazed, LLC	16,076	666	13,732	12,917
Amazing Hot Glazers, LLC	2,209	(13)	4,690	4,503
Entrepreneurship and Economic Development Investment, **LLC**	911	(269)	1,336	224
KK-TX I, L.P.	3,357	(66)	3,284	3,512
KK Wyotana, LLC (3)				
KKNY, LLC	25,853	(2,688)	18,545	14,330
KremeKo, Inc.	20,926	(2,070)	25,835	12,539
KremeWorks, LLC	28,326	669	28,165	22,373
Krispy Kreme Australia Pty Limited	6,849	(2,692)	12,683	9,467
Krispy Kreme of South Florida, LLC	12,414	624	9,600	9,753
Krispy Kreme U.K. Limited	928	(3,260)	5,834	1,003
Krispy Kreme Mexico, S. de R.L. de C.V.		(647)	4,716	1,785
New England Dough, LLC	13,832	467	13,418	12,316
Priz Doughnuts, LP	306	29	2,298	2,190
Total	145,655	(7,784)	151,534	114,187