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Siena Market Line
1st week of December 2015

# Dunkin Brands Group, Inc.

NASDAQ:DNKN

**Analyst:** Arthur Jeannerot
**Sector:** Consumer Disc.

## BUY

Price Target: $59

## Key Statistics as of 11/29/2015

| | |
|---|---|
| Market Price: | $42.24 |
| Industry: | Leisure/Restaurants |
| Market Cap: | $3,913M |
| 52-Week Range: | $39.29-56.79 |
| Beta: | 0.65 |

## Thesis Points:

- Dunkin Brands is a leader in the quick service restaurant industry.
- Its franchise-only business model provides better margins than competitors.
- Sell-off into third quarter earnings release provides attractive entry point.

## Company Description:

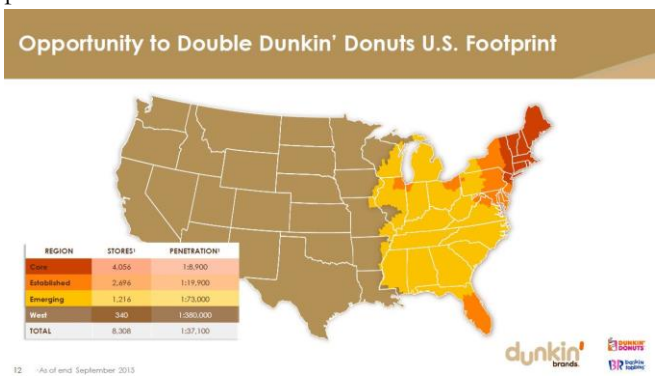
Dunkin Brands Group, Inc. (Dunkin') is the result of the merger of ice-cream maker Baskin-Robbins and coffee and donuts chain Dunkin' Donuts and has been publicly traded since July 2011. It operates in four different segments: Dunkin' Donuts U.S, Baskin-Robbins U.S, Dunkin' Donuts International and Baskin-Robbins International. Dunkin's revenues come from five sources: royalties from franchisees, rental income, sales of ice cream to franchisees, retail sales in company-owned restaurants, and other income. As opposed to most of its competitors, Dunkin owns and operates very few locations, and over 99% of the company's stores are franchises. As a result, the majority of its revenues come from franchise fees and rent income, making this company a cash cow with free cash flow of $176 million on sales of $748.7 in fiscal 2014.

## Thesis

Dunkin' is among the leaders in the quick service restaurants (Q.S.R) industry, with over 19,000 restaurants operating in 60 countries. Thanks to its asset-light business model, the company has effectively been creating value, as evidenced by its positive ROIC/WACC ratio of 37.7, and will continue to do so by increasing its footprint both domestically and internationally. Dunkin' also benefits from strong customer loyalty, great brand awareness, and a lack of substitutes for customers who are used to their morning caffeine shot. The stock suffered from a harsh selloff in the weeks that led to the third quarter earnings call, which I believe creates an attractive entry point for a medium to long-term investment.

## Industry Outlook

The restaurant industry has been enjoying robust growth since 2009, as the global economy started to recover. According to a research report from the National Restaurant Association, industry sales are expected to surpass $700 billion for the first time in 2015, a 20% increase in 5 years. The industry is very sensitive to macroeconomic trends, as consumers do not hesitate to cut down on eating out during recessions. As a result, growth in the industry is highly correlated with GDP growth. Within the industry, the QSR sub-industry is less subject to economic downturns, as it offers more value-oriented products, the demand of which is less elastic. Dunkin' Brands can capitalize on the industry's strong momentum by continuing its expansion both domestically and internationally, as it still has a lot of room to grow its footprint. For comparison, Dunkin' currently has 11,568 locations worldwide, while its main competitor Starbucks has over 23,000. The biggest expansion opportunity lies in the West of the U.S, as we can see on this picture from Dunkin's latest investor presentation.




## Business Model

Dunkin' Brands' particularity and biggest advantage is the fact that it owns and operates very few restaurants (41 out of 18,821 as of fiscal 2014), which allows the company to focus on product innovation and marketing, and to grow with much smaller capital investments. This particularity makes Dunkin' a very attractive investment in the restaurant industry, as it operates much more efficiently than its competitors. Restaurant usually operate on very small margins due to their high operating costs, and they are also very reliant on food costs, which makes them very sensitive to small changes in the environment. On the contrary, Dunkin's almost franchise-only model provides the company with a regular stream of cash flows, which require minimal investment. As a result, the company's return on invested capital was a staggering 304%, while its weighted average cost of capital was only 8.06% according to our proforma valuation.

## People

Dunkin' brands is led by highly experienced professionals with significant combined experience in the restaurant industry. Nigel Travis, chairman since 2013 and CEO since 2009, previously worked in executive positions at Papa John's (PZZA), where he led the company's international and digital growth, as well as Burger King (QSR) where he was credited with turning around the company's EMEA business. Travis is assisted by Jack Clare, Chief Information and Strategy Officer, who focuses on the company's use of technology to improve profitability and efficiency. Clare previously had similar responsibilities at Yum! Restaurants International (YUM), where he was responsible for the company's IT strategy. Another key person in the organization is Scott Murphy, who joined the company in 2004 and is now Chief Supply Officer and SVP of operations fur Dunkin' Donuts U.S and Canada. Murphy is responsible for driving franchisee profitability by improving supply chain efficiencies, on top of overseeing operations for the more than 8,000 North American Dunkin' Donuts locations.

## Product Differentiation

As opposed to Starbucks, which offers a high-end customer experience, Dunkin' is positioned as a cheaper alternative for people's morning coffee. As evidenced by its slogan "America runs on Dunkin'", the company provides many average working-class Americans their much-needed wake up beverage. As a result, customers are very loyal to the brand, and most people are able to categorize themselves as either a Starbucks or Dunkin' type of person. Furthermore, Dunkin' is more popular for its food offerings than Starbucks, making it a premier destination for breakfast for many Americans. As opposed to Starbucks, whose customers come for the coffee and sometimes end up buying a snack, Dunkin's customers come as much for the coffee as they do for breakfast sandwiches and donuts. As a result, many Dunkin' customers would not consider going to Starbucks for their daily coffee.

## Corporate Responsibility

Dunkin' Brands doesn't only strive to be a profitable and efficient company, it also holds its corporate responsibility very dearly. The company's commitment to its social responsibility is perfectly illustrated by its 4-point motto: "Our guests, our planet, our people, our neighborhoods. The company takes care of its guests by focusing on serving the best quality products in a convenient and friendly environment. Dunkin' uses sustainable sourcing and packaging to minimize its impact on the environment, as well as sustainable building and energy-efficient lighting in its points of distribution. The company's employees and franchisees are one of its key strengths, so Dunkin' strives to maintain a great culture and environment for its workers, as well as to provide them with the training necessary for them to strive. The company is also very active in local communities, notably through the Dunkin' Donuts and Baskin-Robbins Community Foundation (DDBRCF), which was established in 2006 to address three critical issues: hunger, children's health, and children's safety. The foundation's goal is to leverage Dunkin's network of franchisees to raise funds for local charities, to which it has donated over $8 million since 2006.

## Financials

On October 22nd, Dunkin Brands announced its results for the third quarter. The company generated revenues of $209.8M, an increase of 8.9% compared to the same quarter in 2013. In addition, earnings per share increased 6.12% to reach $0.52. When examining the figures more closely, we can see that comparable store sales increased for both Dunkin' Donuts and Baskin-Robbins locations in the U.S, as well as for international Dunkin' Donuts locations. Revenue growth was also fueled by the company's expansion efforts, which resulted in 90 net new restaurants worldwide, including 68 new Dunkin' Donuts restaurants in the U.S. For the full year, the company expects comparable store sales to grow between 2 and 4%, and net unit developments to grow between 4 and 6%. The third quarter was the 45th consecutive quarter in which the Dunkin Donuts branch had positive same store sales growth, which shows that the company is able to retain its customers as well as to attract new ones. As a result, the company has increased its quarterly dividend payment every year since its IPO, raising it from $0.15 in 2001 to $0.29 in 2016, which translates into a CAGR of 24.57%. The company is also returning cash to shareholders via its share buyback programs followed by retirement of common shares. From 2012 to the third quarter of 2015, the company repurchased close to 29 million shares and retired most of them. In addition to its regular share repurchase program, DNKN initiated a $400 million accelerated share repurchase (ASR) program in February 2015, which resulted in the acquisition of approximately 8.2 million shares of the company's common stock. Last month, Dunkin' entered into another ASR for $125 million, which should results in the repurchase of approximately 3.15 million shares. This is a good sign that management believes the company's shares are currently undervalued.

## Conclusion

Dunkin' Brands' asset-light business mode provides a unique investment opportunity in the quick-service restaurant industry. The company is on path to double Dunkin' Donuts' footprint in the U.S, on top of its large international expansion program. In addition, the Baskin-Robbins segment has been performing better than expected lately, helped by a very strong brand momentum in both U.S and international markets. The stock price was recently punished by an overreaction of the market, and I believe it offers compelling value for a medium to long-term investment. I rate DNKN a buy with a 12-month price target of $59, which represents an upside of approximately 40%.

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| Dunkin' Brands Group, Inc. | DNKN | Analyst | Current Price | Intrinsic Value | Target Value | Divident Yield | 1-y Return: 43.2% | BULLISH |
|---|---|---|---|---|---|---|---|---|
| | | Arthur JEANNEROT | $41.92 | $52.72 | $58.98 | 3% | | |

| General Info | |
|---|---|
| Sector | Consumer Discretionary |
| Industry | Hotels, Restaurants and Leisure |
| Last Guidance | October 22, 2015 |
| Next earnings date | February 1, 2016 |

| Market Data | |
|---|---|
| Enterprise value | $6,055.58 |
| Market Capitalization | $3,883.45 |
| Daily volume | 1.31 |
| Shares outstanding | 92.64 |
| Diluted shares outstanding | 100.02 |
| % shares held by institutions | 106.36% |
| % shares held by insiders | 0.50% |
| Short interest | 13.01% |
| Days to cover short interest | 6.97 |
| 52 week high | $56.79 |
| 52-week low | $39.29 |
| 5y Beta | 0.25 |
| 6-month volatility | 27.31% |

| Peers | Market Cap. |
|---|---|
| Starbucks Corporation | $92,042.75 |
| Restaurant Brands International Inc | $7,574.22 |
| The Wendy's Company | $2,890.68 |
| McDonald's Corp. | $104,595.56 |
| Yum! Brands, Inc | $31,377.14 |
| Panera Bread Company | $4,615.42 |
| The Cheesecake Factory Incorporated | $2,243.51 |
| Carrols Restaurant Group, Inc | $398.72 |
| Dean Foods Company | $1,718.43 |
| Krispy Kreme Doughnuts, Inc | $897.77 |

| Current Capital Structure | |
|---|---|
| Total debt/Common Equity (LTM) | 0.63 |
| Cost of Borrowing (LTM) | 4.11% |
| Estimated Cost of new Borrowing | 6.92% |
| Altman's Z | 1.13 |
| Estimated Debt Rating | CC |
| Current levered Beta | 0.37 |
| LTM WACC | 8.06% |

**Management**

| Professional | Title | Comp. FY2012 | Comp. FY2013 | Comp. FY2014 |
|---|---|---|---|---|
| Travis, Nigel | Chairman and Chief Executive Officer | $1,911,278 | $4,288,758 | $10,204,803 |
| Carbone, Paul | Chief Financial Officer and Senior Vice Presid | $1,768,172 | $1,098,949 | $1,373,706 |
| Emmett, Richard | Chief Legal & Human Resources Officer | $0 | $1,279,964 | $1,473,359 |
| Costello, John | President of Global Marketing & Innovation | $868,924 | $1,627,923 | $3,227,905 |
| Twohig, Paul | President of Dunkin' Donuts U S & Canada a | $816,909 | $1,633,834 | $3,831,601 |
| Heckel, Gary | Vice President of Concept Development & R | $0 | $0 | $0 |

**Past Earning Surprises**

| | Revenue | EBITDA | Norm. EPS | Standard Error of "Surprise" |
|---|---|---|---|---|
| Last Quarter | 2.68% | 4.59% | 1.96% | 0.79% |
| Last Quarter-1 | 3.47% | 4.26% | 4.17% | 0.25% |
| Last Quarter -2 | 2.88% | 9.78% | 14.29% | 3.32% |
| Last Quarter -3 | 1.00% | 1.35% | -2.13% | 1.11% |
| Last Quarter -4 | -2.24% | 1.34% | 4.26% | 1.88% |
| Standard error | 1.0% | 1.5% | 2.7% | 1.07% |
| Standard Error of Revenues prediction | 1.0% | | | |
| Imputed Standard Error of Op. Cost prediction | 1.1% | | | |
| Imputed Standard Error of Non Op. Cost predictio | 2.2% | | | |

**Industry Outlook (Porter's Five Forces)**

Bargaining Power of Suppliers (75th Percentile), Bargaining Power of Customers (43th Percentile), Intensity of Existing Rivalry (33th Percentile), Threat of Substitutes (67th Percentile), Threat of New Competition (-33th Percentile), and Overall (64th Percentile).

**Proforma Assumptions**

**Convergence Assumptions**

All base year ratios linearly converge towards the Sub-industry ratios over an explicit period of 5 years

| General Assumptions | |
|---|---|
| Money market rate (as of today) | 0.41% |
| Risk-Free rate (long term estimate) | 3.00% |
| Annual increase (decrease) in interest rates | 0.1% |
| Marginal Tax Rate | 37.5% |
| Country Risk Premium | 6.0% |

| Forecast Year | Revenue Growth Forecast | Revenue ($) Forecast |
|---|---|---|
| LTM | | $800.35 |
| FY2015 | 1.2% | $810.21 |
| FY2016 | 5.1% | $851.67 |
| FY2017 | 5.6% | $899.63 |
| FY2018 | 4.3% | $938.45 |
| FY2019 | 3.7% | $972.78 |
| FY2020 | 3.3% | $1,005.16 |
| FY2021 | 3.2% | $1,036.97 |
| FY2022 | 3.1% | $1,068.93 |
| FY2023 | 3.0% | $1,101.44 |
| FY2024 | 3.0% | $1,134.71 |
| Continuing Period | 3.0% | $1,168.75 |

**Items' Forecast Assumptions**

| | Base year (LTM) | Convergence period (Sub-industry) | Adjustment per year |
|---|---|---|---|
| Operating Cash/Rev. | 1.63% | 2.21% | 0.0% |
| NWV/Rev. | 0.00% | 1.58% | 0.1% |
| NPPE/Rev. | 23.40% | 25.00% | 0.1% |
| Dpr/NPPE | 10.82% | 12.37% | 0.1% |
| NOPAT MARGIN | 33.56% | 35.00% | 0.1% |
| Op. Exp./Rev. | 48.28% | 50.00% | 0.1% |
| SBC/Rev. | 1.89% | 2.00% | 0.0% |
| Rent Exp./Rev. | 7.40% | 8.00% | 0.0% |
| R&D/Rev. | 0.00% | 0.00% | 0.0% |
| E&D/Rev. | 0.00% | 0.00% | 0.0% |
| SG&A/Rev. | 28.35% | 30.00% | 0.1% |
| ROIC | 304% | 21.24% | -18.84% |
| EV/Rev. | 8.61x | 2.15x | -0.43x |
| EV/EBITA | 16.99x | 18.00x | 0.07x |
| Debt/Equity | 63% | 106% | 2.9% |
| Unlevered beta | 0.80 | 0.73 | 0.00 |
| Dividends/REV | 12% | 2% | -0.7% |

**Other Assumptions**

| | |
|---|---|
| Tobin's Q | 80% |
| Excess cash reinvestment | Money market rate |
| Other claims on the firm's assets | $0.00 |

**Capitalization**

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
R&D expenses are not capitalized
E&P expenses are not capitalized
SG&A expenses are not capitalized

**Valuation Focus**

| | |
|---|---|
| DCF Valuation | 100% |
| Relative valuation | 0% |
| Distress Valuation | 0% |

**Monte Carlo Simulation Assumptions**

| | |
|---|---|
| Revenue Growth deviation | Normal (0%, 1%) |
| Operating expense deviation | Normal (0%, 1%) |
| Continuing Period growth | Triangular (5.82%, 6%, 6.18%) |
| Country risk premium | Triangular (2.91%, 3%, 3.09%) |
| Intrinsic value σ(ε) | $0.09 |
| 1-year target price σ(ε) | $0.10 |

**Valuation**

| Forecast Year | ROIC | WACC | Invested Capital | Implied Enterprise Value | Net Claims on Assets and Dilution Costs | Shares Outstanding | Price per Share |
|---|---|---|---|---|---|---|---|
| LTM | 303.8% | 8.1% | $134.35 | $6,339.39 | $2,518.79 | 92.64 | $51.55 |
| FY2015 | 293.6% | 8.1% | $146.24 | $6,472.21 | $2,145.90 | 92.64 | $58.32 |
| FY2016 | 200.9% | 7.7% | $184.97 | $6,715.45 | $2,090.40 | 92.64 | $62.13 |
| FY2017 | 167.1% | 7.5% | $229.74 | $6,957.72 | $2,025.09 | 92.64 | $66.04 |
| FY2018 | 139.9% | 7.5% | $267.36 | $7,197.08 | $1,938.18 | 92.64 | $70.21 |
| FY2019 | 124.1% | 7.5% | $301.60 | $7,437.18 | $1,834.26 | 92.64 | $66.48 |
| FY2020 | 113.6% | 7.4% | $329.18 | $7,672.66 | $1,716.05 | 92.64 | $70.78 |
| FY2021 | 107.3% | 7.3% | $356.29 | $7,907.57 | $1,590.01 | 92.64 | $75.19 |
| FY2022 | 102.1% | 7.2% | $383.53 | $8,139.76 | $1,456.73 | 92.64 | $79.68 |
| FY2023 | 97.7% | 7.0% | $411.24 | $8,365.77 | $1,316.45 | 92.64 | $84.20 |
| FY2024 | 93.8% | 6.8% | $439.59 | $8,580.67 | $1,169.16 | 92.64 | $88.70 |
| Continuing Period | 21.2% | 6.6% | $1,926.17 | | | | |

**Monte Carlo Simulation Results**

The 3σ(ε)-adjusted intrinsic value is $52.72; the 3σ(ε)-adjusted target price is $58.98; and the analysts' median target price is $48.43

**Sensitivity Analysis**

Revenue growth variations account for 95.9% of total variance
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total variance
Continuing period growth variations account for 0.2% of total variance