DUNKIN' BRANDS GROUP, INC.
Form 10-Q
November 05, 2014
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FORM 10-Q

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended September 27, 2014
OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from to
Commission file number 001-35258

DUNKIN' BRANDS GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware	20-4145825
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

130 Royall Street
Canton, Massachusetts 02021
(Address of principal executive offices) (zip code)
(781) 737-3000
(Registrants' telephone number, including area code)
(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant has (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨	Smaller Reporting Company	¨

Indicate by check mark whether the Registrant is a shell company (as defined in rule 12b-2 of the Exchange Act). YES ¨ NO x

As of October 31, 2014, 104,583,479 shares of common stock of the registrant were outstanding.

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DUNKIN' BRANDS GROUP, INC. AND SUBSIDIARIES

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Part I. Financial Information

Item 1. Financial Statements

DUNKIN' BRANDS GROUP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands, except share data)

(Unaudited)

	September 27, 2014	December 28, 2013
Assets		
Current assets:		
Cash and cash equivalents	$155,665	256,933
Accounts receivable, net of allowance for doubtful accounts of $2,995 and $2,599 as of September 27, 2014 and December 28, 2013, respectively	49,845	47,162
Notes and other receivables, net of allowance for doubtful accounts of $1,542 and $659 as of September 27, 2014 and December 28, 2013, respectively	12,301	32,603
Deferred income taxes, net	46,052	46,461
Restricted assets of advertising funds	36,201	31,493
Prepaid income taxes	10,285	25,699
Prepaid expenses and other current assets	21,513	21,409
Total current assets	331,862	461,760
Property and equipment, net of accumulated depreciation of $102,001 and $105,834 as of September 27, 2014 and December 28, 2013, respectively	179,073	182,858
Equity method investments	174,129	170,644
Goodwill	890,337	891,598
Other intangible assets, net of accumulated amortization of $215,341 and $200,248 as of September 27, 2014 and December 28, 2013, respectively	1,432,699	1,452,205
Other assets	67,021	75,625
Total assets	$3,075,121	3,234,690
Liabilities, Redeemable Noncontrolling Interests, and Stockholders' Equity		
Current liabilities:		
Current portion of long-term debt	$625	5,000
Capital lease obligations	492	432
Accounts payable	12,112	12,445
Liabilities of advertising funds	46,696	49,077
Deferred income	30,563	28,426
Other current liabilities	178,346	248,918
Total current liabilities	268,834	344,298
Long-term debt, net	1,808,491	1,818,609
Capital lease obligations	7,052	6,996
Unfavorable operating leases acquired	15,258	16,834
Deferred income	13,344	11,135
Deferred income taxes, net	547,606	561,714
Other long-term liabilities	59,992	62,816
Total long-term liabilities	2,451,743	2,478,104
Commitments and contingencies (note 11)		
Redeemable noncontrolling interests	7,164	4,930
Stockholders' equity:		
Preferred stock, $0.001 par value; 25,000,000 shares authorized; no shares issued and outstanding at September 27, 2014 and December 28, 2013, respectively	—	—

Common stock, $0.001 par value; 475,000,000 shares authorized; 106,701,892 issued and 104,562,892 outstanding at September 27, 2014; 106,876,919 shares issued and 106,646,219 shares outstanding at December 28, 2013	107	107
Additional paid-in capital	1,134,459	1,196,426
Treasury stock, at cost	(93,712)	(10,773)
Accumulated deficit	(692,676)	(779,741)
Accumulated other comprehensive income (loss)	(798)	1,339
Total stockholders' equity	347,380	407,358
Total liabilities, redeemable noncontrolling interests, and stockholders' equity	$3,075,121	3,234,690

See accompanying notes to unaudited consolidated financial statements.

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DUNKIN' BRANDS GROUP, INC. AND SUBSIDIARIES
Consolidated Statements of Operations
(In thousands, except per share data)
(Unaudited)

	Three months ended		Nine months ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Revenues:				
Franchise fees and royalty income	$126,759	117,486	355,738	334,045
Rental income	25,570	25,437	73,650	72,924
Sales of ice cream products	27,357	30,429	88,072	86,818
Sales at company-owned restaurants	5,267	6,250	16,319	18,261
Other revenues	7,687	6,715	21,717	18,615
Total revenues	192,640	186,317	555,496	530,663
Operating costs and expenses:				
Occupancy expenses—franchised restaurants	13,258	13,445	39,830	39,041
Cost of ice cream products	19,530	20,899	62,273	61,187
Company-owned restaurant expenses	5,505	6,222	16,772	17,817
General and administrative expenses, net	56,311	58,454	172,406	177,009
Depreciation	4,960	5,591	14,803	16,961
Amortization of other intangible assets	6,333	6,938	19,122	20,085
Long-lived asset impairment charges	633	92	1,279	447
Total operating costs and expenses	106,530	111,641	326,485	332,547
Net income of equity method investments:				
Net income, excluding impairment	5,366	8,201	12,514	16,070
Impairment charge	—	(873)	—	(873)
Total net income of equity method investments	5,366	7,328	12,514	15,197
Other operating income, net	1,004	233	7,609	9,188
Operating income	92,480	82,237	249,134	222,501
Other income (expense), net:				
Interest income	63	105	201	310
Interest expense	(16,680)	(19,805)	(51,444)	(60,523)
Loss on debt extinguishment and refinancing transactions	—	—	(13,735)	(5,018)
Other gains (losses), net	(584)	12	(670)	(1,191)
Total other expense, net	(17,201)	(19,688)	(65,648)	(66,422)
Income before income taxes	75,279	62,549	183,486	156,079
Provision for income taxes	20,855	22,505	60,263	51,664
Net income including noncontrolling interests	54,424	40,044	123,223	104,415
Net loss attributable to noncontrolling interests	(273)	(177)	(621)	(416)
Net income attributable to Dunkin' Brands	$54,697	40,221	123,844	104,831
Earnings per share:				
Common—basic	$0.52	0.38	1.17	0.99
Common—diluted	0.52	0.37	1.16	0.97
Cash dividends declared per common share	0.23	0.19	0.69	0.57

See accompanying notes to unaudited consolidated financial statements.

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DUNKIN' BRANDS GROUP, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
(In thousands)
(Unaudited)

	Three months ended		Nine months ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Net income including noncontrolling interests	$54,424	40,044	123,223	104,415
Other comprehensive income (loss), net:				
Effect of foreign currency translation, net of deferred tax expense (benefit) of $74 and $(75) for the three months ended September 27, 2014 and September 28, 2013, respectively, and $251 and $299 for the nine months ended September 27, 2014 and September 28, 2013, respectively	(5,074)	5,358	(1,552)	(11,345)
Unrealized gains (losses) on interest rate swaps, net of deferred tax expense (benefit) of $1,358 and $(1,412) for the three months ended September 27, 2014 and September 28, 2013, respectively, and $(709) and $4,887 for the nine months ended September 27, 2014 and September 28, 2013, respectively	2,026	(2,071)	(1,032)	7,145
Other, net	(74)	(296)	447	(177)
Total other comprehensive income (loss), net	(3,122)	2,991	(2,137)	(4,377)
Comprehensive income including noncontrolling interests	51,302	43,035	121,086	100,038
Comprehensive loss attributable to noncontrolling interests	(273)	(177)	(621)	(416)
Comprehensive income attributable to Dunkin' Brands	$51,575	43,212	121,707	100,454

See accompanying notes to unaudited consolidated financial statements.

DUNKIN' BRANDS GROUP, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine months ended September 27, 2014	September 28, 2013
Cash flows from operating activities:		
Net income including noncontrolling interests	$123,223	104,415
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	33,925	37,046
Amortization of deferred financing costs and original issue discount	2,987	3,586
Loss on debt extinguishment and refinancing transactions	13,735	5,018
Deferred income taxes	(13,638)	(10,893)
Provision for bad debt	2,093	3,008
Share-based compensation expense	8,070	5,750
Net income of equity method investments	(12,514)	(15,197)
Dividends received from equity method investments	7,427	7,226
Gain on sale of joint venture	—	(6,466)
Gain on sale of real estate and company-owned restaurants	(7,446)	(1,519)
Other, net	205	(920)
Change in operating assets and liabilities:		
Accounts, notes, and other receivables, net	16,239	(3,162)
Other current assets	519	1
Accounts payable	(497)	(517)
Other current liabilities	(69,113)	(62,137)
Liabilities of advertising funds, net	(6,320)	4,847
Income taxes payable, net	8,218	(5,010)
Deferred income	4,349	(814)
Other, net	4,389	1,053
Net cash provided by operating activities	115,851	65,315
Cash flows from investing activities:		
Additions to property and equipment	(18,324)	(20,930)
Proceeds from sale of real estate and company-owned restaurants	14,354	2,776
Proceeds from sale of joint venture	—	7,200
Other, net	(1,734)	(2,021)
Net cash used in investing activities	(5,704)	(12,975)
Cash flows from financing activities:		
Repayment of long-term debt	(15,000)	(19,157)
Payment of deferred financing and other debt-related costs	(8,977)	(6,157)
Dividends paid on common stock	(72,756)	(60,707)
Repurchases of common stock	(130,171)	(17,190)
Exercise of stock options	4,847	6,287
Excess tax benefits from share-based compensation	8,938	—
Other, net	1,923	1,906
Net cash used in financing activities	(211,196)	(95,018)
Effect of exchange rates on cash and cash equivalents	(219)	(140)
Decrease in cash and cash equivalents	(101,268)	(42,818)
Cash and cash equivalents, beginning of period	256,933	252,618

Cash and cash equivalents, end of period	$155,665	209,800
Supplemental cash flow information:		
Cash paid for income taxes	$57,507	68,504
Cash paid for interest	47,971	58,997
Noncash investing activities:		
Property and equipment included in accounts payable and other current liabilities	1,241	1,095
Purchase of leaseholds in exchange for capital lease obligations	434	173

See accompanying notes to unaudited consolidated financial statements.

DUNKIN' BRANDS GROUP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

(1) Description of Business and Organization

Dunkin' Brands Group, Inc. ("DBGI"), together with its consolidated subsidiaries, is one of the world's leading franchisors of restaurants serving coffee and baked goods, as well as ice cream, within the quick service restaurant segment of the restaurant industry. We develop, franchise, and license a system of both traditional and nontraditional quick service restaurants and, in limited circumstances, own and operate individual locations. Through our Dunkin' Donuts brand, we develop and franchise restaurants featuring coffee, donuts, bagels, breakfast sandwiches, and related products. Through our Baskin-Robbins brand, we develop and franchise restaurants featuring ice cream, frozen beverages, and related products. Additionally, we distribute Baskin-Robbins ice cream products to Baskin-Robbins franchisees and licensees in certain international markets.

Throughout these unaudited consolidated financial statements, "Dunkin' Brands," "the Company," "we," "us," "our," and "management" refer to DBGI and its consolidated subsidiaries taken as a whole.

(2) Summary of Significant Accounting Policies

(a) Unaudited Consolidated Financial Statements

The consolidated balance sheet as of September 27, 2014, the consolidated statements of operations and comprehensive income for the three and nine months ended September 27, 2014 and September 28, 2013, and the consolidated statements of cash flows for the nine months ended September 27, 2014 and September 28, 2013, are unaudited.

The accompanying unaudited consolidated financial statements include the accounts of DBGI and its consolidated subsidiaries and have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial information. Accordingly, they do not include all of the information and footnotes required in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for complete financial statements. All significant transactions and balances between subsidiaries and affiliates have been eliminated in consolidation. In the opinion of management, all adjustments necessary for a fair presentation of such financial statements in accordance with U.S. GAAP have been recorded. Such adjustments consisted only of normal recurring items. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the fiscal year ended December 28, 2013, included in the Company's Annual Report on Form 10-K.

(b) Fiscal Year

The Company operates and reports financial information on a 52- or 53-week year on a 13-week quarter basis with the fiscal year ending on the last Saturday in December and fiscal quarters ending on the 13th Saturday of each quarter (or 14th Saturday when applicable with respect to the fourth fiscal quarter). The data periods contained within our three- and nine-month periods ended September 27, 2014 and September 28, 2013 reflect the results of operations for the 13-week and 39-week periods ended on those dates. Operating results for the three- and nine-month periods ended September 27, 2014 are not necessarily indicative of the results that may be expected for the fiscal year ending December 27, 2014.

(c) Fair Value of Financial Instruments

Financial assets and liabilities are categorized, based on the inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to the quoted prices in active markets for identical assets and liabilities and lowest priority to unobservable inputs. Observable market data, when available, is required to be used in making fair value measurements. When inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement.

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Financial assets and liabilities measured at fair value on a recurring basis as of September 27, 2014 and December 28, 2013 are summarized as follows (in thousands):

	September 27, 2014			December 28, 2013		
	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Total
Assets:						
Mutual funds	$—	—	—	1,012	—	1,012
Interest rate swaps	—	8,469	8,469	—	10,221	10,221
Total assets	$—	8,469	8,469	1,012	10,221	11,233
Liabilities:						
Deferred compensation liabilities	$—	8,138	8,138	—	7,181	7,181
Total liabilities	$—	8,138	8,138	—	7,181	7,181

The deferred compensation liabilities primarily relate to the Dunkin' Brands, Inc. Non-Qualified Deferred Compensation Plan ("NQDC Plan"), which allows for pre-tax salary deferrals for certain qualifying individuals. Changes in the fair value of the deferred compensation liabilities are derived using quoted prices in active markets of the asset selections made by the participants. The deferred compensation liabilities are classified within Level 2, as defined under U.S. GAAP, because their inputs are derived principally from observable market data by correlation to hypothetical investments. The Company holds assets, which may include mutual funds, to partially offset the Company's liabilities under certain benefit plans. The changes in the fair value of any mutual funds held are derived using quoted prices in active markets for the specific funds. As such, the mutual funds are classified within Level 1, as defined under U.S. GAAP.

The Company uses readily available market data to value its interest rate swaps, such as interest rate curves and discount factors. Additionally, the fair value of derivatives includes consideration of credit risk in the valuation. The Company uses a potential future exposure model to estimate this credit valuation adjustment ("CVA"). The inputs to the CVA are largely based on observable market data, with the exception of certain assumptions regarding credit worthiness which make the CVA a Level 3 input, as defined under U.S. GAAP. As the magnitude of the CVA is not a significant component of the fair value of the interest rate swaps as of September 27, 2014, it is not considered a significant input and the derivatives are classified as Level 2.

The carrying value and estimated fair value of long-term debt as of September 27, 2014 and December 28, 2013 were as follows (in thousands):

	September 27, 2014		December 28, 2013	
	Carrying Value	Estimated fair value	Carrying Value	Estimated fair value
Financial liabilities				
Term loans	$1,809,116	1,777,291	1,823,609	1,836,212

The estimated fair value of our term loans is estimated based on current bid prices for our term loans. Judgment is required to develop these estimates. As such, our term loans are classified within Level 2, as defined under U.S. GAAP.

(d) Derivative Instruments and Hedging Activities

The Company uses derivative instruments to hedge interest rate risks. These derivative contracts are entered into with financial institutions. The Company does not use derivative instruments for trading purposes and we have procedures in place to monitor and control their use.

We record all derivative instruments on our consolidated balance sheets at fair value. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative instruments is reported as other comprehensive income (loss) and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Any ineffective portion of the gain or loss on the derivative instruments for a cash flow hedge is recorded in the consolidated statements of operations immediately. Cash flows associated with the Company's interest rate swap agreements are classified as cash flows from operating activities in the consolidated statements of cash flows which is

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consistent with the classification of cash flows of the underlying hedged item. See note 5 for a discussion of the Company's use of derivative instruments, management of credit risk inherent in derivative instruments, and fair value information.

(e) Concentration of Credit Risk

The Company is subject to credit risk through its accounts receivable consisting primarily of amounts due from franchisees and licensees for franchise fees, royalty income, and sales of ice cream products. In addition, we have note and lease receivables from certain of our franchisees and licensees. The financial condition of these franchisees and licensees is largely dependent upon the underlying business trends of our brands and market conditions within the quick service restaurant industry. This concentration of credit risk is mitigated, in part, by the large number of franchisees and licensees of each brand and the short-term nature of the franchise and license fee and lease receivables. At September 27, 2014 and December 28, 2013, one master licensee, including its majority-owned subsidiaries, accounted for approximately 25% and 17%, respectively, of total accounts and notes receivable, which was primarily due to the timing of orders and shipments of ice cream to the master licensee. For the nine months ended September 27, 2014, one master licensee, including its majority-owned subsidiaries, accounted for approximately 10% of total revenues. No individual franchisee or master licensee accounted for more than 10% of total revenues for the three months ended September 27, 2014 or for the three or nine months ended September 28, 2013.

(f) Recent Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board ("FASB") issued new guidance which requires management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern. This guidance is effective for the Company in fiscal year 2017 and early adoption is permitted. The Company has not adopted this guidance as of September 27, 2014, and based on the Company's financial condition as of September 27, 2014, the Company does not expect the adoption of this guidance to have any impact on the Company's consolidated financial statements.

In May 2014, the FASB issued new guidance for revenue recognition related to contracts with customers, except for contracts within the scope of other standards, which supersedes nearly all existing revenue recognition guidance. The new guidance provides a single framework in which revenue is required to be recognized to depict the transfer of goods or services to customers in amounts that reflect the consideration to which a company expects to be entitled in exchange for those goods or services. This guidance is effective for the Company in fiscal year 2017 and early adoption is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is currently evaluating the impact the adoption of this new standard will have on the Company’s accounting policies, consolidated financial statements, and related disclosures.

In July 2013, the FASB issued new guidance which requires presentation of an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except in certain circumstances. This guidance was adopted by the Company in fiscal year 2014. The adoption of this guidance did not have any impact on the Company’s consolidated financial statements.

(g) Reclassifications

The Company has revised the presentation of certain income generating transactions that historically were recorded within general and administrative expenses, net in the consolidated statements of operations. Income from these transactions totaling $751 thousand and $2.7 million have been reclassified into other operating income, net, for the three and nine months ended September 28, 2013, respectively, in the consolidated statements of operations to conform to the current year presentation. There was no impact to total revenues, operating income, income before income taxes, or net income as a result of these reclassifications.

The Company has also revised the presentation of certain asset captions within the consolidated balance sheets to conform to the current period presentation, including combining 'assets held for sale' with 'prepaid expenses and other current assets' and combining 'restricted cash' with 'other assets'. The revisions had no impact on total current assets or total assets.

Additionally, the Company has revised the presentation of certain captions for the nine months ended September 28, 2013 within the consolidated statements of cash flows to conform to the current period presentation. The revisions had no impact on net cash provided by operating, used in investing, or used in financing activities.

(h) Subsequent Events

Subsequent events have been evaluated through the date these consolidated financial statements were filed.

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(3) Franchise Fees and Royalty Income

Franchise fees and royalty income consisted of the following (in thousands):

	Three months ended		Nine months ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Royalty income	$113,614	106,327	324,945	305,803
Initial franchise fees and renewal income	13,145	11,159	30,793	28,242
Total franchise fees and royalty income	$126,759	117,486	355,738	334,045

The changes in franchised and company-owned points of distribution were as follows:

	Three months ended		Nine months ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Systemwide Points of Distribution:				
Franchised points of distribution in operation—beginning of period	18,376	17,597	18,122	17,333
Franchised points of distribution—opened	363	360	944	904
Franchised points of distribution—closed	(169)	(140)	(506)	(420