U.S.News & WORLD REPORT
DECEMBER 4, 2006

The Carlyle Group's Sweet Deal

A neglected Dunkin' Donuts gets the touchy-feely treatment

Dan D'Aniello was all ears in 2005 when Jon Luther, CEO of Dunkin' Brands, called and said he was looking for somebody to buy his company. The parent company of Dunkin' Donuts had long been part of the British conglomerate Allied Domecq, which had just been purchased by French spirits company Pernod Ricard. The new beverage titan planned to focus strictly on its core business, and coffee and doughnuts didn't fit.

D'Aniello, a cofounder of Washington, D.C.'s Carlyle Group, had known Luther for years. Both had been rising stars at Marriott in the 1980s. Luther had earned plaudits for turning around the Popeyes fried-chicken chain in the late '90s. D'Aniello jumped into action.

He called principals at two other private-equity firms, Thomas H. Lee Partners and Bain Capital, who agreed to invest equally with Carlyle and share the risk. The consortium tried to make a fast deal with Pernod but was told it would have to participate in a formal auction. Several other bidders emerged, and the Carlyle team raised its offer at least once. Finally, last December, the Carlyle consortium won its prize, for $2.4 billion.

Carlyle execs say the Dunkin' deal highlights how private money can empower management, open new doors, and help overcome the neglect some businesses suffer from distracted corporate parents—all reasons an increasing number of CEOs have been seeking private buyouts. "Dunkin' had had spotty experiences," D'Aniello says. "The brand was becoming tired. Because Allied Domecq was not investing, there was an opportunity to grow the business."

Unlike some buyout targets, Dunkin' was not a troubled company with assets that could be readily carved up and sold. It didn't come cheap, either—the purchase price reflected an expectation of considerable future growth. What lured the buyers was a strong management team, a predictable flow of revenue from franchise fees, and bright growth prospects beyond Dunkin's home turf in the eastern United States, where most of its 7,100 worldwide stores are clustered. "If one thing sums up the opportunity," D'Aniello explains, "it's that 80 percent of our revenue comes from the geography between Boston and D.C."

Raising the bar. Once the deal was finalized in March, Luther and his new partners began pouring a fresh strategy for Dunkin'. A new 11-person board was formed, with three slots going to each of the private-equity owners. Luther and Chief Operating Officer Will Kussell, who each invested some of their own money in the deal, took the other two seats. Luther began to raise standards for franchisees, hunting for business people capable of handling a network of three to five stores, not just one or two. The team raised growth targets, too. Instead of adding 500 to 600 new stores per year—Allied Domecq's goal—Dunkin' now aims for 800 to 1,000. And Luther has decided to put the Togo's sandwich-shop chain on the block and focus squarely on coffee and doughnuts, along with ice cream sold by the company's other brand, Baskin-Robbins.

Luther is also challenging some cherished traditions. To boost efficiency, the company may outsource doughnut making at some stores. And it's exploring ways to draw more diners for lunch, without souring them on breakfast.

Both sides seem pleased so far. The owners say that Dunkin's revenue for fiscal year 2006, which ended in August, beat their targets. And Luther feels he's getting more support than he used to. When Dunkin' was owned by Allied Domecq, he says, "I used to fly to England to beg for attention. Now I make a phone call and get three calls back within an hour." And Luther still feels as if he's in charge of the Canton, Mass., company: "They haven't camped out here. Most of the time I initiate the conversation."

The new owners should be particularly helpful priming overseas growth. A Taiwan-based company that invests with Carlyle, Mercuries & Associates, asked Carlyle about Dunkin' Donuts franchising opportunities. The lead was passed to Luther's team, and within three months a deal was in place for Mercuries to open 100 Dunkin' outlets in Taiwan, starting in January—the brand's debut there. The new owners could be especially helpful in China and other developing countries Dunkin' hasn't yet dipped into. Carlyle, for instance, has an Asia-Pacific real-estate team that could help find good storefront space. "They bring a dimensional perspective we don't have," says Luther.

Such connections aren't free. Dunkin' pays its owners an undisclosed "management fee," which Luther describes as "moderate," for their time, advice, and overhead. The sudden change has also left some franchisees feeling shut out, with management raising the bar too high, too fast. "They paid a premium price for the brands, and now management is under a lot of pressure to crank up performance," says Mark Dubinsky, president of DD Independent Franchise Owners, which represents about 200 owners with 1,500 stores. One complaint: promotions on coffee and baked goods, which draw traffic to stores but cut into profit margins. Franchisees also tried to purchase a small equity stake in Dunkin' Brands and get a board seat during the sale last year—and were rebuffed. Dunkin' says franchisees are adequately represented on an advisory council that will give input to the board twice a year, starting in 2007.

They could get another chance to become shareholders once the private owners feel it's time to cash out. The most likely "exit strategy" for the private owners is a public stock offering. They could also sell to a "strategic owner" like Yum! Brands or McDonald's. But to reap the market-beating returns private equity promises its investors, Dunkin' must first show that it can grow aggressively, get leaner, and remain stable. It could be a few years before that order is ready.

–Rick Newman

U.S.NEWS & WORLD REPORT
USNews.com

Private Equity: An Expert Tells How It's Done

In 1987, Dan D'Aniello left the Marriott Corp. to start the Carlyle Group, along with cofounders David Rubenstein and Bill Conway. Since then, Carlyle has become one of the world's biggest private-equity firms, with more than $46 billion under management. Carlyle owns all or part of nearly 200 companies, usually holding its stake for four to six years before cashing in. Overall return to investors exceeds 25 percent per year. D'Aniello spoke recently with Deputy Business Editor Rick Newman about Carlyle's purchase of Dunkin' Brands and trends in private equity.

As you know, a lot of people are worried about the growing role of private equity in the economy. Help explain private equity, in plain English.

Private equity is an asset class that allows for companies that are underperforming, or undermanaged, or not part of the core strategy of the owner to be put through a transition that allows us to improve their future, value, utility, and the products and services they offer. Private equity is like the body shop of the capital markets. Then, once you've fixed it, you need to ask, where's the vigorish?

Our mission is to produce returns in excess of what the market might provide. For private equity to earn a premium return, we must manage against heightened risks. And we promise absolute returns, not relative returns.

Explain some of the ways Carlyle adds value to companies.

There are different routes to profitability, such as acceleration of growth or improving the productivity of the assets. Then, once you've stabilized a company, you can ask a higher price. We also tend to put less debt on a company so management can focus on the business and not on statistics. We want the CEO working for the shareholders, not the banks.

So what does private equity offer that a big corporate owner, for example, might not?

You have to ask: Is private equity the right investor? It's more than just money that a private-equity firm can bring. It brings expertise. Business runs on trust, and when you can understand the strategy of a company and you believe management can execute sufficiently against that strategy, that's a powerful incentive to invest. Here again, the power of private equity is that occasionally management teams can get lost in a bigger organization.

Another key element for private equity is the alignment of incentives. We don't make money unless the company makes money and our investors make money. It's all aligned. In a public company, the stock might go up or down but not necessarily based on your actions. That's one of the incentives for management teams to go private. In the private world, reality is where we work, rather than perception. Public perception can add or take away value overnight. Like in the dot-com world. But not in the private world. Your range of movement in dealing with the business issues of a company in the private world is much broader. You don't have to worry about perception, just reality.

What makes a good target?

There must be a reasonable expectation of stability within two to three years. And the private-equity firm must have the capability of fixing specific issues. We also find companies sometimes where the owners are a little bit distracted. Dex [U.S. directories business]: distracted. Avio [Italian jet engine company]: distracted. KDDI [Japanese mobile phone company]: distracted.

So how do you determine when it's time to get out-your "exit strategy"?

Three things create value: paying down debt, increasing earnings, and you can also play the market for the optimal terms. Private equity has a clock on its money, which is, it has to turn the capital.

Time is the enemy of returns. The ways to exit are to do an IPO, sell to a strategic, or do a secondary buyout with another firm. Many times the preferred exit is an IPO. To do that, we have to establish the growability of the company and stabilize new markets. Growth: If people see it happen, then it becomes a very attractive public target.

Some people think there's a bubble in the private-equity market. If there is a bubble and it bursts, what will that look like?

The smart people in private equity are gearing up for a slowdown. The marginal firms will go away. Financial engineering, which is what private equity used to offer, has become a commodity. Firms today need expertise in the businesses they invest in and the infrastructure to deliver. The bulge-bracket PE firms may breathe a bit more, but a lot of them will go away, like the midmarket firms without a lot more than financial engineering. A lot of those will go away.

What you need today, it's connecting people with other people who can bring value on the factory floor. That's what reduces volatility to our investors. And we have a "one Carlyle" policy. We hold no barriers with regard to our resources and skills. We share expertise globally.

How big can these deals get? You mean, could there be a $70 billion deal?

I think there actually could. The appetite for coinvestment remains. On one deal, we were looking for $50 million in coinvestment. Within three weeks, we had $350 million worth of demand.

So why don't you do a massive pro bono project and buy one of the U.S. auto firms and re-engineer it until it's competitive?

Not an auto company! [Laughs.] Autos and airlines, we're a little bit reticent. If they catch a cold, we catch pneumonia.

–Rick Newman

Copyright © 2006, by U.S.News & World Report, L.P. Abridged with permission.
For subscriptions to *U.S.News & World Report*, please call 1-800-436-6520. Visit *U.S.News & World Report* on the Web at www.usnews.com.
For more information about reprints from *U.S.News & World Report*, contact FosteReprints at 800-771-6445.