

oikos Case Writing Competition 2013

Corporate Sustainability Track

2nd Place

**Chipotle Mexican Grill
Inc.: *Food With Integrity***

Ram Subramanian, Montclair State University

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It was late afternoon on October 18, 2012, when Steven Ells, the founder, Chairman of the Board, and co-Chief Executive Officer (CEO) of the Denver, Colorado-based restaurant chain, Chipotle Mexican Grill (CMG), finished the conference call following the release of the company's third quarter 2012 results. While the results reported were positive, analysts picked on the slowing down of same-stores sales (a key metric for restaurant chains), the competition from Yum Brands' Taco Bell and their recent launch of the Cantina Bell menu, and CMG's announcement that food costs were expected to increase in the near future. CMG's stock went down by nearly 12 percent in intra-day trading following the announcement of third quarter results, to finally stabilize at a 4 percent drop over the previous day's priceⁱ. At the end of trading on October 18, CMG's stock price was at \$285.93, a significant decline from a 52-week high of \$442.40ⁱⁱ. CMG had been the darling of both Wall Street and its customer base ever since the company's founding and its 2006 IPO. Investors were attracted to CMG for its fast growth and sizeable profit margins, while customers responded favorably to its "Food with Integrity" mission of serving good quality food with inputs sourced using sustainable farming practices. As Ells conferred with his co-CEO, Montgomery F. Moran following the conference call, both wondered if CMG could continue to compete effectively on differentiation based on quality and sustainability, given the mounting competitive and sourcing challenges.

The U.S. Restaurant Industryⁱⁱⁱ

Profile

The National Restaurant Association projected total U.S. restaurant sales of \$631.8 billion in 2012 (compared to \$379 billion in 2000 and \$239.3 in 1990) that was nearly 4 percent of the gross domestic product. There were 970,000 restaurant locations and the industry employed 12.9 million people (10 percent of the total workforce) in 2012. The restaurant industry's share of the food dollar was 48 percent in 2012 compared to 25 percent in 1955.^{iv}

The restaurant industry consisted of a number of segments such as eating places, bars and taverns, and lodging place restaurants. The three largest segments were: full service, quick service, and fast casual. Full service restaurants offered table ordering and the average check (revenue per customer) was the highest of the three segments. While national chains such as Darden Restaurants (operator of Red Lobster, Olive Garden, and LongHorn Steakhouse) and DineEquity (IHOP and Applebee's) existed in this segment, the majority of operators of full service restaurants were individuals, families, or limited partnerships. This segment accounted for 31.7 percent of industry revenues in 2011.

The quick service segment (which was previously referred to as "fast food") consisted of restaurants that offered fast counter service and meals to eat in or take out. This segment was further broken down into outlets that specialized in selected menu items such as hamburgers, pizza, sandwiches, and chicken. Because of this segment's focus on quick service and price (the average check was the lowest of the three for this segment), large chains tended to dominate. Accounting for about \$168.5 billion in revenues in 2011, this segment held a 28% share of the restaurant market.

The fast casual segment was the smallest of the three, accounting for about 4% in market share and \$24 billion in 2011 revenues. Operators in this segment offered portable,

convenient food, and focused on fresh, healthful ingredients and customizable made-to-order dishes. The average check in this segment ranged between \$7 and \$10, at price points typically lower than the full service segment and higher than the quick service segment. Fast casual was the fastest growing of the three segments, with an 11 percent growth rate between 2007 and 2011. The NPD Group, an industry research firm, indicated that as this segment was in its growth phase, it faced intense competition from both the quick service and the full service segments. Buoyed by the growth in fast casual restaurants, several full service operators had recently entered this segment. For example, P.F. Chang's opened their Pei Wei locations and Ruby Tuesday planned to increase the number of their Lime Fresh eateries to 200 locations by the end of 2012. Panera Bread, Chipotle Mexican Grill, Five Guys Burgers, and Qdoba (owned by Jack-in-the-Box) were the leading fast casual players.

Industry Economics

Restaurant running costs varied by segment. In addition, costs were a function of size and location. Upscale formats (typically full service restaurants and some fast casual chains) made higher investments in interior design and also incurred higher input costs. Many chain restaurants typically chose locations with high population density or a larger geographic draw. Food and beverage, labor, and real estate cost were the three largest expense categories for restaurants. Typically, both food and beverage and labor costs accounted for around 30 percent each of revenues, while real estate costs were around 5 percent. Marketing and general administrative overhead were the significant non-operating expense categories. The National Restaurant Association reported that in 2010 the average income before income taxes of a restaurant operator ranged between 3 and 6 percent of revenues^v.

To control the cost of inputs, many large national and regional chains negotiated directly with their suppliers (to benefit both company-owned and franchisee-owned restaurants) to ensure competitive prices. Many chains also engaged in forward pricing to ensure stability in input costs. The National Restaurant Association reported that beef prices hit record levels in 2011 and were expected to be even higher when the prices for 2012 were finally tallied. Beef prices rose 53 percent in 2012 above 2009 levels as the three largest exporters of beef to the U.S., Australia, Canada, and New Zealand, all reduced their shipments due to a variety of global factors. While the price of various dairy items (milk, butter, cheese) had remained fairly stable over the last few years, the price of grains such as wheat and corn had fluctuated due to changes in supply and demand as well as due to weather-related factors. The price of a bushel of wheat went up from \$6.48 in 2007 to \$7.30 in 2011, after falling to \$4.87 in 2009. Similarly, while the average price of a bushel of corn was \$4.20 in 2007, it rose to \$6.20 in 2011 after falling to \$3.55 in 2009.^{vi}

Key Competitors

A former CEO of Taco Bell, the Mexican food chain owned by Yum Brands, captured the competition in the restaurant industry in the following observation:

"We are all competing for a share of the customer's stomach."^{vii}

Players in the restaurant industry competed not only with their segment's players, but also with those of other segments. In addition, they competed with meals prepared at home as well as frozen or packaged food items available in supermarkets. While restaurants accounted for about 48 percent of the dollar amount spent on food in 2012, the economy played a major role in this. In a 2011 National Household Survey reported in *Standard & Poor's Industry Surveys*, 21 percent of those surveyed indicated that they would increase their eating out spending in 2012, while 42 percent would decrease it slightly, and 37 percent would reduce it significantly.

CMG faced two major competitors in the Mexican food category of the restaurant industry. While Taco Bell was a player in the quick service segment, Qdoba competed, like CMG, in the fast casual segment.

Qdoba^{viii}

Qdoba was a wholly owned subsidiary of the San Diego, California-based Jack-in-the-Box chain and in 2012 had 600 restaurants in 42 U.S. states and the District of Columbia. Qdoba was founded in Boulder, Colorado in 1995 and grew nationally by featuring Mission-style burritos (made famous first in San Francisco). After Jack-in-the-Box acquired Qdoba in 2003, it expanded the brand rapidly. Of the 600 restaurants in the chain in 2012, around 350 were franchisee-owned and the rest were company owned.

A franchisee spoke about his rationale for launching a Qdoba restaurant:

"What attracted us to the chain was quality. What brought us to this is that everything is hand-crafted and made daily. We consider ourselves to be an artisan fast food chain. We come in every morning about three hours prior to opening and start cooking our meals. We start our slow-roasted pork and shredded beef that cooks for 6 to 8 hours. Our chicken is marinated in adobo spices for 24 hours before we serve it. We have an artisan table where we make our pico de gallo salsa, mix our cilantro with rice and prepare our guacamole as customers watch. What makes us stand out is the quality of the ingredients we use and our signature flavors. I believe being fast, friendly and fresh is what makes us successful in business."^{ix}

The company reported an average check of \$9.74 in fiscal 2011 for company-operated restaurants. The average yearly revenue per restaurant was \$961,000 in 2011, an increase of 5.3% over 2010. Jack-in-the-Box had revenues of \$2.17 billion and net income of \$67.83 million in 2011. The company stated that there was long-term potential to open 1,600 to 2,000 units across the U.S.^x

Taco Bell

Taco Bell was part of Yum Brands, Inc. which also owned the KFC and Pizza Hut chains. Yum Brands was the world's largest restaurant company in terms of units, with nearly 38,000 restaurants in 120 countries. In fiscal 2011, Yum Brands reported revenues of \$12.626 billion and a net income of \$1.319 billion. At the end of fiscal 2011, there were 5,670

Taco Bell restaurants in the U.S., of which 27 percent were company owned. Taco Bell reported a 50 percent market share in the U.S. Mexican quick service segment. For fiscal 2011, the average annual revenues per restaurant were \$1.284 million.^{xi}

In March 2012, Taco Bell began testing a new menu called “Cantina Bell” in 75 U.S. restaurants. It worked with a Miami-based chef and television personality, Lorena Garcia to create a new line of upscale menu items. The new menu items included Chipotle staples such as black beans, cilantro rice, and corn salsa. Greg Creed, Taco Bell’s president talked about the motivation behind Cantina Bell:

“Chipotle is an opportunity because what it’s done has expanded the trial and usage of Mexican food. It’s got people to believe they can pay \$8 for a bowl or a burrito. Taco Bell can make food every bit as good as Chipotle and instead charge less than \$5.”^{xii}

Taco Bell’s target market was an 18-24 year-old value conscious male. Creed saw Cantina Bell as helping Taco Bell appeal to an older and less value conscious group of customers. The Cantina Bell launch (and subsequent expansion nationwide in July 2012) was cited as one of the reasons for Taco Bell’s same-store sales growth of 7% for third quarter 2012 (compared to the similar period in 2011).^{xiii} **Exhibit 1** presents the summary of a Zagat comparison survey of Cantina Bell and CMG in New York City.

Chipotle Mexican Grill’s history and profile

Origin and Early Growth

In 1990, after graduating from the Culinary Institute of America in New York City, the Colorado-born, Steven Eells moved to San Francisco to work as a sous chef at a restaurant. In 1993 he opened a taqueria (a Spanish word meaning “taco shop”) in Denver, Colorado, using \$85,000 as capital obtained from his father. His goal was to reinvent Mexican food. He reflected on the origins of his first restaurant:

“I wanted layers of bold flavors that had nuance and depth, not just hot, not just spicy: cumin, cilantro, cloves, fresh oregano, lemon, and lime. It looked, smelled, and tasted different from traditional fast food. And it didn’t take long before there was a line of people waiting to get in. So I thought, maybe I’ll open one more. I was always quite rebellious and did things my own way. Friends said Mexican food is cheap – you can’t charge \$5 for a burrito. But I said this is real food, the highest-quality food. Friends said you can’t have an open kitchen, but I wanted the restaurant to be like a dinner party, where everyone’s in the kitchen watching what’s going on. They said people have to order their meal by number. But I said no, you have to go through the line and select your ingredients. And everyone gave me grief over the name: Nobody’ll be able to pronounce it.”^{xiv}

Ells opened a second restaurant using the profits from the first, and a third (all in Denver, Colorado) with a loan from the Small Business Administration. When he had opened 16 restaurants by 1998, McDonald's Corporation (the global leader in fast food in terms of revenue) made an initial investment to help fund the company's growth. The company quickly grew to over 500 units in 2005 (primarily using McDonald's \$360 million capital infusion), and on January 26, 2006 made its initial public offering (IPO). In October 2006, McDonald's fully divested its holdings in CMG for a value of \$1.5 billion. Ells talked about CMG and McDonald's:

"They funded our growth which allowed us to open 535 restaurants. We learned from each other, but we use different kinds of food, and we aim for a different kind of experience and culture altogether. So we ended up going our separate ways."^{xv}

The Push to Sustainable Sourcing

Ells happened to read an article by Edward Behr that told the story of an Iowa farmer who raised pigs without using antibiotics or by confining them. Behr went on to add that the meat tasted much better than the mass market meat that was served in most restaurants. The Behr article led Ells to learn about Concentrated Animal Feeding Operations (CAFOs)^{xvi}. In many developed countries, the dominant method of raising livestock for commercial purposes was through CAFOs, starting with poultry in the 1950s and extending to cattle and pork by the 1970s. A CAFO enabled raising livestock by using limited space. The U.S. Environmental Protection Agency (EPA) defined a CAFO as "an animal feeding operation that confines animals for more than 45 days during the growing season in an area that does not produce vegetation and meets certain size thresholds." CAFO confined large number of animals in a limited space and substituted man-made structures (for feeding, temperature, and manure control) for natural ones. A study reported that while it took one million farms in 1966 to house 57 million pigs, through CAFO it took only 80,000 farms in 2001 to house the same number of pigs. CAFOs had a negative impact on water and air quality and hence were regulated by the EPA. In addition, many commercial CAFOs established agricultural water treatment plants to control manure which had a negative impact on the environment^{xvii}. After Ells visited several CAFOs, he decided to source from open-range pork suppliers starting in 2000, naturally raised chicken from 2002, and naturally raised beef soon after. The company formalized its sourcing policy in 2001 when it launched its "Food with Integrity" mission statement. The company described this policy:

"Food with integrity is our commitment to finding the very best ingredients raised with respect for the animals, the environment, and the farmers. It means serving the very best sustainably raised food possible with an eye to great taste, great nutrition and great value."^{xviii}

CMG owned and operated 1,316 restaurants in June 2012, of which four were in Canada, three in the U.K., one in France, and the rest in the U.S. It reported revenues of \$2.270 billion and a net income of \$215 million in fiscal 2011. It employed 28,370 hourly workers

and 2,570 salaried employees. Steven Ells was CMG's CEO till January 1, 2009, when Montgomery F. Moran (who had been the company's chief operating officer since March 2005) was appointed co-CEO along with Ells. Ells, however, retained his title as Chairman of the Board.^{xix}

Business operations

Restaurant Operations

All of CMG's restaurants were company owned. CMG's restaurants were either end-caps (at the end of a line of retail outlets), in-lines (in a line of retail outlets), or free-standing. A typical restaurant ranged in size between 1,000 and 2,800 square feet depending on the market and cost \$850,000 to open. The smaller restaurants were called "A Model" restaurants, the first of which was opened in 2010 to serve less densely trafficked areas. Restaurants served a limited menu of burritos, tacos, burrito bowls (a burrito without the tortilla), and salads, all prepared with fresh ingredients. Customers placed their order (burrito or taco) at the beginning of a line and added ingredients of their choice as they moved along the line. None of the restaurants had freezers, microwave ovens, or can openers^{xx}.

Given their higher than average food costs, CMG focused on operational efficiency at the restaurant level. Their restaurant size was typically smaller than those of their peers, and they economized on labor by keeping their menu options limited and by using an assembly line system for food preparation. Chris Arnold, CMG's communication director, spoke about the company's efficiency focus:

"We are big believers in what author Jim Collins calls 'the genius of and.'" You can serve great food made with ingredients from more sustainable sources and do it at a reasonable price. You can have higher food costs than your peers and still have strong margins. It just takes the discipline to figure it out.^{xxi}

In 2009, CMG entered into a partnership with a company to install solar panels in its restaurants. CMG aimed to be the largest direct producer of solar energy in the restaurant industry in the next five years. Ells talked about this:

"Our effort to change the way people think about and eat fast food began with our commitment to serving food made with ingredients from more sustainable sources, and that same kind of thinking now influences all areas of our business. Today, we're following a similar path in the way we design and build restaurants, looking for more

¹ Jim Collins was the author of two popular business books: *Good to Great* and *Great by Choice*. In the former book, Collins introduced the notion that most companies are ruled by the tyranny of "or" where they choose between options rather than attempt to do both, the "and."

environmentally friendly building materials and systems that make our restaurants more efficient.^{xxii}

CMG's rationale for using solar panels was to reduce the restaurant's traditional energy consumption during the peak period of 11:00 a.m. and 7:00 p.m. Solar panels also reduced CMG's carbon footprint. Starting with a restaurant in Illinois, CMG began to obtain LEED certification (Leadership in Energy and Environmental Design, a certification program of different levels) by using on-site wind turbines and cisterns for rainwater harvesting. It was the first restaurant to obtain the highest level (platinum) of LEED certification^{xxiii}. By 2012, three of its restaurants were LEED certified.

Supply Chain

CMG's supply chain was closely tied to the company's "Food with Integrity" mission. The company's 22 independently owned and operated distribution centers served restaurants in a specific geographic area. These centers sourced inputs from suppliers who were evaluated on quality and understanding of the company's mission. Key ingredients included various meats, vegetables such as lettuce, cilantro, and tomatoes, as well as dairy items such as sour cream and cheese.

In 2008 the company embarked on a program to increase local (grown within 350 miles of the restaurant) sourcing to 35 percent of at least one bulk produce item. The seasonal produce program was meant to cut down on fossil fuels used to transport produce, give local family farms a boost, and improve the taste of the food served to customers by using ingredients during their peak season. CMG created a network of 25 local farms to supply some of its romaine lettuce, green bell peppers, jalapeno peppers, red onions and oregano to area restaurants^{xxiv}. The local sourcing program resulted in 5 million pounds of produce in 2009 and 10 million pounds by 2012^{xxv}.

In 2012, 100 percent of its pork, 80 percent of its chicken, and 50 percent of its beef were classified as "naturally raised" meat – defined as open-range, antibiotic free, and fed with a vegetarian diet. Forty percent of CMG's beans were organically grown, while all of its sour cream and cheese were made from milk that came from cows that were not given rBGH (recombinant bovine growth hormone). In addition, a substantial percentage of the milk for sour cream and cheese were sourced from dairies that provided pasture access for their cows^{xxvi}.

Organic agriculture² was still in its infancy in the United States in 2012. Less than 1 percent of the total agricultural area was managed organically. Of that, the percentage was highest for produce, followed by livestock, and then poultry. Starting in the 1990s, the demand for

² While the terms "organic" and "sustainable" are used interchangeably, the two are different. Organic products can be unsustainably produced on large industrial farms, and farms that are not certified organic can produce food using methods that can sustain the farm's productivity for a long time. The term "organic" is used to mean products produced or grown at a facility that is certified as such, while sustainable is more a philosophy or way of life. Since organic farming generally falls within the accepted definition of sustainable agriculture and since data is collected on organic rather than sustainable agriculture, most observers believed that organic was a good proxy for sustainable.

organic food drove the conversion of traditional farms to organic at a rapid rate (for example, 14% in 2007-2008). The U.S. Department of Agriculture (USDA) reported that the average annual profitability of organic farms in 2011 was \$45,697 versus \$25,448 for traditional farms. However, the downturn in the economy that started in 2008 slowed down the conversion to organic farming to 6 percent between 2009 and 2011^{xxvii}. Retail chains such as Whole Foods and Trader Joe's competed with full service restaurants and other restaurant chains for organic inputs, often driving up the prices well above those for conventional inputs. Ells commented on the pricing challenges and continuing availability of organic inputs:

"The supply chain has yet to catch up, organic ingredients are still pricey, and supply is limited. What we are doing is an 'incremental revolution.' If we went all-organic and natural now, a burrito would be like \$17 or \$18."^{xxviii}

Marketing

CMG's marketing budget was \$32 million in 2011 versus \$26 million in 2010 and \$21 million in 2009. CMG had reduced its advertising spending over the three years from \$7.9 million in 2009 to \$7.5 million in 2010 and \$5.8 million in 2011^{xxix}. The company stated its policy on advertising in its annual report:

"Our marketing has always been based on the belief that the best and most recognizable brands aren't built through advertising or promotional campaigns alone, but rather through all of the ways people experience the brand. Our main method of promotion is word-of-mouth publicity."^{xxx}

When CMG hired Mark Crumpacker as its first chief marketing officer in 2009, the first decision that he made was bring the company's advertising in-house rather than use the services of an outside agency. He also made the decision not to advertise in traditional media like TV and instead rely on various loyalty programs. He gave his rationale for it:

"The alternative is to switch to the type of marketing that every other fast-food company uses with these new menu items and big ad campaigns to promote them. I think once you get on that model, I think it's very, very hard to get off. I want to try to do this (loyalty programs) as long as I can."^{xxxi}

One loyalty program was called "Farm Team." Farm Team was an invitation-only online program that quizzed users on sustainability, organic farming and humane food sourcing and rewarded them when they shared the knowledge with others via social media. Chris Arnold talked about the program:

"This is a passion program. Through Farm Team, we are looking to identify our most loyal and passionate customers, and giving them tools to share their passion for Chipotle. It's much more about building evangelism than it is about rewarding frequency."^{xxxii}

In August 2011, CMG released an online commercial titled “Back to the Start,” that featured Willie Nelson singing a reworded version of Coldplay’s “The Scientist.” The commercial told the story (in animated form) of a farmer who moved from inhumane industrial farming that used confined spaces to a more humane sustainable farming method. The popularity of this commercial led to CMG releasing it first in 5,700 movie theatres in September 2011 and running it once on television during the 2012 Grammy Awards show^{xxxiii}.

A one day festival called “Cultivate” held in Chicago in October 2011 brought together farmers, chefs, and music bands. The goal of the festival was to promote sustainable family-farms. Other promotional items included iPhone games and local print advertising to accompany store openings^{xxxiv}. A marketing expert assessed CMG’s non-traditional marketing strategy:

“Chipotle has found a “sweet spot” with millennials by solidifying its reputation for freshness, and offering a healthier fare than its competitors. The brand also gains reputation by shying away from traditional media, because younger audiences feel like it’s more authentic, down-to-earth and easy to connect with. Millennials view the lack of TV as more authentic. Millennials are likely to dismiss a lot of claims. They are responding to everything the brand does and says.”^{xxxv}

Finances

Exhibit 2 gives a cost comparison of key expenses for CMG and its competitors, **Exhibit 3** presents CMG’s financial statements, while **Exhibit 4** gives a list of the company’s stock on specific dates. Third quarter 2012 results showed a revenue increase of 18.4% over the same period in 2011, and a net income increase of 19.6%. Same-store sales increased by 4.8% in the quarter compared to 11.3% in third quarter 2011. Revenue growth was attributed to both new restaurant openings and menu price increases. The company launched a system-wide menu price increase in 2011 whose implementation was completed in third quarter 2012^{xxxvi}.

The “Einhorn effect”

On October 2, 2012, Jeff Einhorn, who headed a hedge fund, made a presentation at the Value Investors Conference in New York City. In his presentation, Einhorn said that CMG was an attractive stock for shortsellers because the company faced significant competition, principally from Taco Bell’s Cantina Bell menu, and increased food costs, both due to its sustainable sourcing practices and a global increase in food commodity prices. He said that a survey conducted by his firm found that 75 percent of self-identified Chipotle customers also frequented Taco Bell and that Taco Bell came out on top on both price and convenience. Einhorn stated:

“23% of Chipotle customers had already tried Taco Bell’s Cantina Bell menu – which features burritos and burrito bowls made with fresh ingredients – and two-thirds of those

customers indicated they would return. What's more, the customers most likely to return to Taco Bell were also those most likely to eat at Chipotle, a dynamic that indicates to me that Chipotle is most at risk of losing its frequent customers.^{xxxvii}

Within hours of Einhorn's presentation, CMG's stock began to fall. It fell by more than 4% by the end of the day and stock analyst stated that CMG had been "Einhorned."^{xxxviii}

CMG's challenges

In his conference call with analysts on October 18, 2012, Eells indirectly compared Cantina Bell with CMG (without actually naming his competitor):

"The way Chipotle does its business is not an easy thing to copy, and though a competitor could offer a similar item, it's probably only on the surface. Take a company that sells grilled chicken, for instance. Yet that company does not have a grill, nor do they have knives or cutting boards. So how do they make real chicken and cut it up? And in the end the customers realize the difference. Be careful of those who have a lower cost opportunity. The customer's not easily fooled. Our interactive format – the burrito assembly line that every customer runs through – is an important part of what Chipotle does."^{xxxix}

In his conference call, Eells indicated that CMG would consider raising its menu prices in 2013 to make up for expected higher food costs. As Eells conferred with co-CEO Moran following the call, both men listened in on Chief Financial Officer, Jack Hartung talking to a reporter:

"The company will be patient with its pricing decisions, so as not to deter customers. We could move quickly, but we're going to choose not to be in too much of a hurry. We don't want to be the first ones out of the box with price increases. We'd rather see what happens with the economy, see what happens with consumer spending, see what other competitors do and how consumers respond."^{xl}

CMG faced a host of challenges. While the depressed economy favored quick service and fast casual restaurants over full service restaurants because of lower check prices, consumer sentiment indicated that the majority of them would either curtail their spending on eating or at best maintain it at current levels. In addition, Taco Bell was proving to be a formidable competitor with its 5,670 U.S. restaurants pushing the higher margin Cantina Bell menu through aggressive and large scale advertising. Finally, the expected increase in food costs was bound to affect CMG both in its margins and in its quest to increase its usage of sustainable inputs. Both men recalled a statement made by the company's Chris Arnold to an interviewer a few years ago:

“Chipotle is a good example of what can happen when you buck conventional wisdom. We’ve built a chain of fast food restaurants shirking many of the things the industry was built on -- we spend more on food, not less; we own our restaurants rather than franchising; and we don’t market using lots of price promotions and other gimmicks. Going that route, we’ve built one of the most successful restaurant companies in years.”^{xli}

While both Ells and Moran agreed with Arnold’s assessment of CMG, they wondered if sustainability and the “food with integrity” campaign were luxuries that CMG could ill afford in these difficult economic times. Could CMG continue to use quality and sustainably-sourced inputs as differentiators to justify a higher priced menu?

Inspection Copy

Exhibit 1: Zagat Comparison of Cantina Bell and CMG in New York City

ITEM	PRICE	
	CANTINA BELL	CMG
Burrito bowl with chicken	\$5.99	\$9.88
Steak burrito	\$5.99	\$10.34

Overall Assessment: For practically half the price, the Cantina Bell menu is a definite value, but you get what you pay for, and the overall quality and taste of Chipotle still has an edge over Taco Bell

Source: <http://blog.zagat.com/2012/07/taco-bell-vs-chipotle-taste-testing.html>

Exhibit 2: Selected Cost Comparison – Key Competitors

(costs as percentage of revenues)

	2011	2010	2009
YUM BRANDS¹			
Food & packaging	30.57	29.09	28.62
Labor	30.40	29.63	29.99
Occupancy & other restaurant operating costs	26.97	27.06	27.50
Qdoba			
Food & packaging	29.00	28.30	29.80
Labor	28.00	27.70	28.30
Occupancy & other restaurant operating costs	29.40	30.00	28.90
CMG			
Food & packaging	32.55	30.56	30.69
Labor	23.93	24.71	25.36
Occupancy & other restaurant operating costs	17.56	18.10	19.20

¹ YUM Brands does not breakdown data for each of its three chains – KFC, Pizza Hut, and Taco Bell

Source: Company 10-K's

Exhibit 3: Chipotle Mexican Grill, Inc. Consolidated Statement of Income

(for year ending December 31 in \$ thousands)

	2011	2010	2009
Revenue	2,269,548	1,835,922	1,518,417
Restaurant operating costs			
Food, beverage, and packaging	738,720	561,107	466,027
Labor	543,119	453,573	385,072
Occupancy	147,274	128,933	114,218
Other operating costs (marketing, credit card, etc.)	251,208	202,904	174,581
General and administrative expenses	149,426	118,590	99,149
Depreciation and amortization	74,938	68,921	61,308
Pre-opening costs	8,495	7,767	8,401
Loss on disposal of assets	5,806	6,296	5,956
Income from operations	350,562	287,831	203,705
Net income (after interest and taxes)	214,945	178,981	126,845

Source: Chipotle Mexican Grill, Inc. 2011 10-K

Chipotle Mexican Grill, Inc. Consolidated Balance Sheet

(condensed for December 31 in \$ thousands)

	2011	2010
Assets:		
Current assets:		
Cash and cash equivalents	401,243	224,838
Accounts receivable (net)	8,389	5,658
Inventory	8,913	7,098
Current deferred tax asset	6,238	4,317
Prepaid expenses and other current assets	21,404	16,016
Income tax receivable		23,528
Investments	55,005	124,766
Leasehold improvements, property and equipment, net	751,951	676,881
Long term investments	128,241	
Other assets	21,985	16,564
Goodwill	21,939	21,939
Total assets	1,425,308	1,121,605
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	46,382	33,705
Accrued payroll and benefits	60,241	50,336
Accrued liabilities	46,456	38,892
Current portion of deemed landlord financing	133	121
Income tax payable	4,241	
Deferred rent	143,284	123,667
Deemed landlord financing	3,529	3,661
Deferred income tax liability	64,381	50,525
Other liabilities	12,435	9,825
Total liabilities	381,082	310,732
Total shareholders' equity	1,044,226	810,873
Total liabilities and shareholders' equity	1,425,308	1,121,605

Source: Chipotle Mexican Grill, Inc. 2011 10-K

Chipotle Mexican Grill, Inc.

Summary Consolidated Statement of Cash Flows¹

(for year ended December 31, in \$ thousands)

	2011	2010	2009
Net cash provided by operating activities	411,096	289,191	260,673
Net cash used in investing activities	(210,208)	(189,881)	(67,208)
Net cash used in financing activities	(24,268)	(94,522)	(61,943)

¹ The company made an adjustment for exchange rates to reconcile opening and closing cash balances

Source: Chipotle Mexican Grill, Inc. 2011 10-K

Exhibit 4: Chipotle Mexican Grill, Inc.

Selected Stock Price Data

(in \$ at close of day)

DATE	STOCK PRICE
January 26, 2006 (<i>IPO</i>)	45.00
January 3, 2007	59.42
January 2, 2008	120.38
January 2, 2009	47.76
January 4, 2010	96.46
January 3, 2011	218.92
January 3, 2012	367.29
April 2, 2012	414.15
April 13, 2012	442.40
May 1, 2012	413.07
June 1, 2012	379.95
July 2, 2012	292.33
August 1, 2012	288.64
September 4, 2012	317.54
October 1, 2012	316.33
October 2, 2013 (<i>Einhorn</i>)	302.96
October 18, 2012	285.93

Source: Yahoo Finance

- ⁱ Yahoo Finance, accessed on October 18, 2012
- ⁱⁱ Yahoo Finance, accessed on October 18, 2012
- ⁱⁱⁱ Unless other indicated, this section was based on *Standard & Poor's Industry Surveys: Restaurants*, June 7, 2012
- ^{iv} "Restaurants by the Numbers," National Restaurant Association, www.restaurant.org, accessed on October 10, 2012
- ^v As cited in *Standard & Poor's Industry Surveys: Restaurants*, op. cit.
- ^{vi} John T. Barone, "Commodity Outlook 2012," National Restaurant Association, www.restaurant.org, accessed on October 10, 2012
- ^{vii} Thomas O. Jones and W. Earl Sasser, Jr., "Why satisfied customers defect," *Harvard Business Review*, November-December 1995, pp. 88-99
- ^{viii} Jack-in-the-Box, 2011 10-K
- ^{ix} Paul Sebert, "Good eats: San Francisco style hits Huntington with Qdoba," <http://www.herald-dispatch.com/entertainment/x1543286410/San-Francisco-style-hits-Huntington-with-Qdoba?i=0>, accessed on October 11, 2012
- ^x Jack-in-the-Box, 2011 10-K
- ^{xi} Yum Brands, Inc. 2011 10-K
- ^{xii} "Taco Bell takes on Chipotle with new menu," <http://www.brandchannel.com/home/post/2012/01/24/Taco-Bell-vs-Chipotle-012412.aspx>, accessed on October 11, 2012
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