

Case 10 Chipotle Mexican Grill, Inc.: Disrupting the Fast-food Business

Chipotle Mexican Grill was the most successful new restaurant chain to be established in the US since 1990. From a single restaurant in 1993, Chipotle was expected to have 1988 restaurants by the end of 2015 that would generate sales of about \$1.3 billion. Strong top-line and bottom-line growth—during 2010–2014 revenues had grown by 22% annually and net income by 26% annually—had made Chipotle the best-performing stock in its sector (Figure 1).

Compared with industry leaders such as McDonald's and Yum! Brands, Chipotle was still a small player. Yum! Brands had 41,000 KFC, Pizza Hut, and Taco Bell restaurants generating sales of \$34 billion. Yet, Chipotle's market capitalization was \$21 billion compared to \$34 billion for Yum! Brands: a clear indication of investors' favorable expectations for Chipotle's future growth and profitability.

Chipotle's Founding and Growth

Steve Ells graduated from a New York culinary school in 1990. Working at a San Francisco restaurant, he developed a passion for fresh ingredients and became intrigued by the combination of high-quality cuisine, fast service, and low prices offered by the local *taqueria*—tiny restaurants serving tacos and burritos. He opened his first Chipotle Mexican Grill in a former ice cream parlor in his home town of Denver in 1993. He described the birth of the concept as follows:

The inspiration came from the little *taqueria* in the Mission district of San Francisco. What fascinated me about these burritos was that they were made in this great tortilla and everything was on the inside—the rice, the beans, the meat, the salsas—then wrapped in foil ... So the idea was that I could use these authentic ingredients but then put my own twist to them ... I noticed customers formed a line and how small the place was and how few people were behind the counter. So the economic model that was happening occurred to me.¹

His father provided the initial capital:

Steve said he needed \$75,000. So I said, "OK, you've got to write a business plan." It was one page and it said, "Worst-case, best-case and mid-case." He put down

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FIGURE 1 Chipotle Mexican Grill Inc.: Share Price, 2006–2015 (\$)

“number of burritos sold per day,” and then he went through the cost of the burrito and the cost of electricity, utilities, rent, and repaying my loan. The break-even was he had to sell 114 burritos a day.²

By 1998, Chipotle had 16 restaurants and, for its next stage of expansion, was seeking venture capital. Steve Ells' father recounts:

We sent the business plan to 13 venture capital or investment banker-type companies that specialize in the restaurant business. We got rejected by all 13.³

Venture capital came from a surprising source: McDonald's Corporation invested \$380 million for a minority stake, fueling Chipotle's national expansion. When Chipotle went public in 2006, McDonald's sold its shareholding for \$1.5 billion. Ells' friend and legal adviser Monty Moran joined Chipotle in 2005 and in 2009 was appointed co-CEO with Steve Ells.

Ells' passion for fresh, wholesome ingredients extended to increasing concern over environmental sustainability and animal welfare. The result was the launch of Chipotle's “Food with Integrity” initiative in 2001. This involved sourcing organically produced foodstuffs, including meat from free-range, hormone-free animals, and an emphasis on local sourcing. Chipotle's commitment to humane, sustainable farming became a key theme in its marketing and brand development. In 2011, a commercial video entitled *Back to the Start* featuring Willie Nelson singing a song about a farmer embracing organic farming became hugely popular.

Chipotle explained that its vision “is to change the way people think about and eat fast food. We do this by avoiding a formulaic approach when creating our restaurant experience, looking to fine-dining restaurants for inspiration. We use high-quality raw ingredients, classic cooking methods and a distinctive interior design and have friendly people.” This vision was not necessarily limited to Mexican food. As far as Steve Ells was concerned: “The model is cuisine agnostic. It can be applied

to any kind of food.” Chipotle’s director of concept development, Tim Wilding, was eager to exploit this opportunity:

Hearing Steve say that many cuisines could work in the Chipotle format, I basically pitched him this idea. I said, “Steve, we have to do a Southeast Asian restaurant.” He miraculously said, “OK, let’s do this.” So I set up a trip for us and we went to Bangkok and Singapore, and we spent a little over a week just eating like crazy.⁴

The result was the first Shop House Southeast Asian Kitchen opening in Washington, DC in 2011.

During 2011, Ells began collaborating with Denver restaurateurs Bobby Stuckey and Lachlan Mackinnon-Patterson to create a fast-food version of their gourmet pizza restaurant, Pizzeria Locale. With Chipotle as the major investor, two Pizzeria Locales opened in Denver and a number of other openings were planned for 2015. In February 2015, Chipotle reiterated its belief that:

The fundamental principles on which Chipotle restaurants are based—finding the very best sustainably raised ingredients, prepared and cooked using classical methods in front of the customer, and served in an interactive format by special people dedicated to providing a great dining experience—can be adapted to cuisines other than the food we serve at Chipotle.⁵

Restaurant Operations

Chipotle’s distinctive product offering—based upon freshly prepared, organic ingredients that allowed a maximum of choice within a limited-item menu—required an operational model that was distinctively different from that which operated throughout the fast-food industry.

Ingredients formed a much higher percentage of total costs than were typical in the industry, hence, if prices were to be kept low, this required cost efficiencies elsewhere. If each customer was to be allowed to customize his/her order, it required restaurant staff to engage with customers during the preparation of their order.

Chipotle restaurants are all company owned and operated and are between 1,000 and 2,800 square feet—much smaller than a typical fast-food restaurant. Chipotle’s emphasis on simplicity and functionality is reflected in the design and decor of its restaurants. The layout is designed to optimize space utilization and maximize the efficiency of customer service. The decor is minimalist with concrete floors, exposed piping, natural colors, and a plentiful use of wood and stainless steel.

At Chipotle, customers order from a pared-down menu of tacos and burritos, then watch the kitchen staff prepare their meal from fresh, sustainably raised ingredients. “We don’t say on the menu board that we have fresh guacamole,” says founder and co-CEO Steve Ells. “As a customer, you can see it being made right in front of you.”

Chipotle’s menu is based upon the principle of “A Few Things, Thousands of Ways.” The menu comprises only burritos (also served without the tortilla as a “burrito bowl”), tacos, and salads. Because customers can choose among four different meats or tofu, two types of beans, and various extras, the menu offers “countless choices.” The ingredients are freshly prepared, by hand, each day.

The restaurants feature open kitchens and customers form a line which moves along the serving counter, selecting the ingredients for their chosen dish. Speed of service is achieved through focusing upon the “four pillars of throughput”: a dedicated “expeditor,” who works just before the cashier to get drink and side orders and bag to-go orders; a dedicated “linebacker,” who ensures the serving line is always stocked; *mise en place*, meticulous attention to having everything placed and ready for serving; and “aces in their places,” the best employees at each position during peak periods. Chipotle regards itself as an industry leader in speed of service: some of Chipotle’s fastest restaurants run more than 350 transactions per hour at lunchtime.

Human Resource Management

The fact that all employees engage with customers has important implications for human resource management. Chipotle’s 2014 annual report states:

All of our restaurant employees are encouraged to interact with customers no matter their job, whether preparing food or serving customers during our busiest period. We focus on attracting and retaining people who can deliver that experience for each customer. We provide each customer with individual attention and make every effort to respond to customer suggestions and concerns in a personal and hospitable way. We believe our focus on creating a positive and interactive experience helps build loyalty and enthusiasm for our brand among general managers, crew members and customers alike.⁶

Chipotle was committed to training its employees and promoting from within. Its website declared: “No Experience Preferred”:

Many restaurant companies hire “professional” managers to run their restaurants and almost never look to their crews for new leaders. But at Chipotle, most of our general managers were promoted from our crews and because our company is growing, there’s plenty of opportunity.⁷

Chipotle’s focus on developing its managers resulted in its “restaurateur program.” Restaurateurs are general managers specially selected for their management abilities—especially for their ability to develop their staff. When selected, they get a one-time bonus and stock options. And after that they receive an extra \$10,000 each time they train a crew member to become a general manager. Restaurateurs have greater discretion in running their own restaurants and, in some cases, manage more than one restaurant.

Co-CEO Monty Moran identified its approach to human resource management as a key element of Chipotle’s competitive advantage:

Our strong People culture continues to drive our success in attracting loyal customers and delivering exceptional results. Our restaurant teams are ambitious, passionate, and dedicated to delivering the best dining experience possible. Our efforts to hire and develop top performing crews will continue to lead to stronger

future leaders running our restaurants, and ensure our customers will enjoy the best customer service possible.”⁸

Marketing

Chipotle went to great efforts to distinguish itself from established perceptions of fast food. Its corporate profile positioned itself within the “fast-casual” rather than the “fast-food” segment (Exhibit 1). Its distinctive approach extends to its marketing where it eschews most traditional marketing in favor of social media and non-traditional means of promotion. Chipotle emphasizes communicating “what differentiates Chipotle from other fast food companies,” especially with regard to its “Food with Integrity” mission:

[W]e are continuing to explore and pioneer new avenues of branded content aimed at making consumers more curious about issues that are important to us, and explaining why and how we are working to drive positive change in the nation’s food supply. In addition, we continue to generate considerable media coverage...

[W]e have been developing more “owned media,” including new video and music programs, a more visible event strategy that includes our “Cultivate” food, music and ideas festivals, and participation in relevant events in markets around the country. Many of these newer programs allow us to tell our story with more nuance than is afforded by traditional advertising, and help forge stronger emotional connections with our customers.⁹

Within social media, Chipotle was widely viewed as the most engaged and responsive of fast-food companies in terms of frequency of tweets and responses to Facebook posts. This allowed it to build strong one-to-one engagement with its core demographic group of 18- to 24-year-olds.

Challenges

The restaurant business is fiercely competitive and Chipotle faced competition on multiple fronts. By 2015, Chipotle had established itself among the leading fast-food chains in the US (Table 1), although among those specializing in Mexican cuisine, Chipotle was a distant second to Yum! Brand’s Taco Bell (Table 2).

Taco Bell’s response to Chipotle’s success was to introduce a new, upscale menu under the “Cantina Bell” name. Second, Taco Bell launched a new chain of casual dining restaurants, US Taco Company. When, in 2012, David Einhorn, founder of hedge fund Greenlight Capital, recommended shorting Chipotle because of Taco Bell’s resurgence, Chipotle’s share price fell by 7%. Einhorn’s case against Chipotle was supported by a Zagat comparison of steak burritos: although Chipotle’s was declared superior to that of Cantina Bell, Chipotle’s was priced at \$10.34 compared to \$5.99 for the Cantina Bell product.

EXHIBIT 1

Chipotle Corporate Profile

When Chipotle (pronounced chi-POAT-lay) opened its first store in 1993, the idea was simple: demonstrate that food served fast didn't have to be a "fast-food" experience. We use high-quality raw ingredients, classic cooking methods and a distinctive interior design, and have friendly people to take care of each customer—features that are more frequently found in the world of fine dining. When we opened, there wasn't an industry category to describe what we were doing. Some 20 years and more than 1500 restaurants later, we compete in a category of dining now called "fast-casual," the fastest growing segment of the restaurant industry, where customers expect food quality that's more in line with full-service restaurants, coupled with the speed and convenience of fast food...

Our focus has always been on using the kinds of higher-quality ingredients and cooking techniques used in high-end restaurants to make great food accessible at reasonable prices. But our vision has evolved. While using a variety of fresh ingredients remains the foundation of our menu, we believe that "fresh is not

enough, anymore." Now we want to know where all of our ingredients come from, so that we can be sure they are as flavorful as possible while understanding the environmental and societal impact of our business. We call this idea *Food With Integrity*, and it guides how we run our business.

- ◆ Using higher-quality ingredients. We use a variety of ingredients that we purchase from carefully selected suppliers. We concentrate on where we obtain each ingredient ... and we continue to investigate using even more naturally raised, organically grown and sustainably grown ingredients...
- ◆ A few things, thousands of ways. We only serve a few things: burritos, burrito bowls (a burrito without the tortilla), tacos and salads. We plan to keep a simple menu, but we'll always consider sensible additions.

Source: Chipotle corporate website, <http://ir.chipotle.com/phoenix.zhtml?c=194775&p=irol-homeProfile&t=&id=&>, accessed July 20, 2015.

Chipotle also inspired a wave of imitators among new start-ups. As *Forbes* magazine noted in 2014:

Chipotle is the most influential and game changing restaurant in America. They are spawning countless imitators... Practically every chain in the United States is trying to be the next Chipotle—or the Chipotle of fried chicken, the Chipotle of pizza, the Chipotle of barbecue.¹⁰

Chipotle's success also encouraged a flood of venture capital into new casual dining start-ups—a segment that had emerged as a result of Chipotle's "reinvention of fast food." When the shares of Shake Shack—billed as the "Chipotle of burgers"—began trading on January 29, 2015, the chain of 63 burger joints was valued at \$1.8 billion, representing a price/earnings ratio of 700. In April 2012, Ruby Tuesday bought Florida-based start-up Lime Fresh Mexican Grill for \$24 million with plans to expand the chain from 15 to 65 outlets—by April 2015 there were only 26 outlets.

TABLE 1

Company

McDonald's C
Starbucks Cor
Yum! Brands

Darden
Restaurants

Chipotle
Wendy's Co.
Panera Bread

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TABLE 1 Leading US restaurant chains, 2015

Company	Principal brands	Total outlets (% company- owned)	Sales, 2014 (\$bn)	Market cap.		Op. margin (%)	ROA (%)	Employees, including part- time (,000s)
				March 25, 2015 (\$bn)				
McDonald's Corp.	McDonald's	14,278 (11)	27.4	94.8	29.0	13.4	420	
Starbucks Corp.	Starbucks	11,457 (62)	17.0	73.0	21.0	22.2	191	
Yum! Brands	KFC, Pizza Hut, Taco Bell	16,027 (11)	13.3	34.4	11.7	12.0	537	
Darden Restaurants	Olive Garden, LongHorn Steakhouse, + 5 others	2,259 (97)	6.5	8.6	4.5	1.9	206	
Chipotle	Chipotle	1,780 (100)	4.1	21.1	17.3	19.6	53	
Wendy's Co.	Wendy's	5,791 (22)	2.1	4.1	12.2	2.9	31	
Panera Bread	Panera	1,777 (49)	2.5	4.3	10.9	13.9	26	

Note: Excludes privately owned chains such as Subway, Burger King, and Dunkin' Donuts.

Sources: Company websites, company 10-K reports, and Financial Times.

Stock analysts were largely positive about Chipotle's potential to generate continuing value for shareholders. In March 2015, 18 of the 30 investment analysts covering Chipotle recommended the stock as a "buy" or "strong buy"; the remaining 12 rated the stock as a "hold." Beyond the brokerage community opinions were more diverse. Seeking Alpha noted that "Chipotle's brand is the source of its intangible asset moat with its uniquely customizable menu structure and upscale restaurant environments." Also its sustainably sourced, organic produce allowed it to "attract a largely affluent clientele."¹¹ Similarly, NYU Stern Investment Management and Research observed that "CMG's total addressable market is still huge," and predicted that "Brand equity and unique business model should preserve pricing power and ROIC over the long term."¹² Others were less sanguine, pointing to the difficulty that Chipotle would have to sustain its remarkable earnings growth in the face of increased competition and the challenges of managing its increased size

TABLE 2 Leading US restaurant chains specializing in Mexican cuisine, 2015

Company	Headquarters and start year	Approx. no. of outlets
Taco Bell	California, 1962	6,500
Chipotle Mexican Grill	Colorado, 1993	1,900
Del Taco	California, 1964	547
Qdoba Mexican Grill	Colorado, 1995	641
Moe's Southwest Grill	Georgia, 2000	540
El Pollo Loco	California, 1980	410
On the Border Mexican Grill & Cantina	Texas, 1982	122
Green Burrito	California, 1980	300
Rubio's Coastal Grill	California, 1993	159

Source: Companies' websites.

and complexity (especially in relation to food sourcing), and the risk of consumers becoming bored with its limited menu.

There were also signs of shareholders becoming less infatuated with the management team: in 2014, shareholders voted down a remuneration package for the co-CEOs, Ells and Moran, which would have paid them \$285 million over three years.

Appendix 1

TABLE A1 Chipotle Mexican Grill, Inc. financial data, 2010–2014

	2014	2013	2012	2011	2010
Sales (\$mn)	4,108	3,215	2,731	2,269	1,836
Operating income (\$mn)	710	533	456	351	288
Net income (\$mn)	445	327	278	215	179
Total assets (\$mn)	2,546	2,009	1,669	1,425	1,122
Shareholders' equity (\$mn)	2,012	1,538	1,246	1,044	811
Operating margin (%)	17.3	16.6	16.8	15.5	15.7
Net margin (%)	10.8	10.2	10.2	9.5	9.7
Operating income/average total assets (%)	31.2	29.0	29.5	27.6	28.3
Return on average equity (%)	25.1	23.4	24.3	23.2	23.4
Current ratio	3.6	3.3	2.9	3.4	3.3

Source: Chipotle Mexican Grill, Inc. 10-K report for 2014.

TABLE A2 Performance comparison: Chipotle vs. Yum! Brands, 2014

	Chipotle Mexican Grill	Yum! Brands, Inc. ^a	Taco Bell ^b
Number of restaurants	1,780	41,000	926
Revenues (\$mn)	4,108	13,279	1,452
Gross margin (%)	65.4	72.3	70.3
Operating margin (%)	17.3	11.7	18.5
Net margin (%)	10.8	7.9	n.a.
Food, drink, packaging/operating cost (%)	41.8	31.4	36.6
Labor costs/operating cost (%)	26.6	22.0	35.1
Occupancy costs/operating cost (%)	6.8	15.4 ^c	12.6 ^c
General and admin/operating cost (%)	8.1	12.2	15.7 ^d
Depreciation and amortization/operating cost (%)	3.2	8.7	4.5 ^d
Advertising/operating cost (%)	1.7	5.1	n.a.
Sales/total assets	1.61	1.59	n.a.
Sales/fixed assets	3.71	2.95	n.a.
Sales/inventories	26.8	37.7	n.a.
Long-term debt/equity	0	1.92	n.a.

Notes:

^aThese corporate data relate to Taco Bell, Pizza Hut, and KFC.

^bThese data (unless otherwise indicated) relate to the company-owned restaurants of Yum! Brands' Taco Bell division.

^cThis ratio is for "occupancy and other operating expenses."

^dThis ratio is for the Taco Bell division as a whole (both company owned and franchised restaurants).

n.a. = not available.

Source: Chipotle Mexican Grill and Yum! Brands' 10-K reports for 2014.

Notes

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Notes

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