Case 18 Chipotle Mexican Grill, Inc.: The International Challenge

Since its founding in Denver, Colorado in 1993, Chipotle Mexican Grill had grown to a chain of 1783 fast-food restaurants by the end of 2014. Yet, of these, a mere 17 were outside the US (of which seven were in Canada). Chipotle's US focus was unusual for a major US-based restaurant chain, most of which had sought to exploit growth opportunities in overseas markets relatively early in their development. Table 1 shows the international presence of some of the larger chains. Was Chipotle missing out on a huge growth opportunity and, if so, what strategy should Chipotle adopt to expand its overseas presence?

Chipotle Ventures Abroad

Chipotle first ventured beyond the United States in 2008, when it opened a restaurant in Toronto, Canada. In 2010, it opened a restaurant in London, England. This was followed by restaurants in Paris, France (2012) and Frankfurt, Germany (2013). However, compared to its pace of US expansion, Chipotle's international growth was tentative (Table 2).

The choice of London for Chipotle's first restaurant outside of North America was for cultural and economic reasons: London was perceived as similar to the urban environments where Chipotle had thrived. According to communications director, Chris Arnold:

> When we started in the U.S., we've primarily been in large cities. Almost all of our restaurants are in major metropolitan areas or suburbs of major metropolitan areas ... There's a great appreciation there for local and sustainably raised ingredients. Culturally, that aligns with what we do more than most options here in the U.S. do.[1]

Founder and co-CEO Steve Ells was similarly optimistic about Chipotle's UK prospects:

TABLE 1 The total and international outlets of leading US fast-food chains, 1994 and 2014

	Total outlets		International outlets	
	2014	1994	2014	1994
Subway	42,230	8,450	9,300	179
McDonald's	36,258	15,950	21,919	5,712
Starbucks	21,366	425	9,655	18
KFC	14,197	9,407	9,827	4,258
Pizza Hut	13,602	11,325	5,739	2,925
Burger King	12,947	7,684	6,224	1,357
Domino's	10,913	5,079	5,846	840
Wendy's	6,515	4,411	780	413
Taco Bell	6,199	5,614	278	162
Little Caesars	5,110	4,855	1,238	155
Hardee's	1,721	3,516	274	72

Source: Company websites.

> We are very encouraged by the prospects for Chipotle in the UK. London has become an important food city over the years, especially because of the awareness of and desire for things like locally sourced, seasonal, and artisanal ingredients. These are all core values of Chipotle and we have been instrumental in bringing this kind of thinking to fast food in the U.S. We call it "Food with Integrity" and it is how we are changing the way people think about fast food. We believe Londoners will appreciate our efforts to serve food that is raised right and in a way that is so accessible.[2]

When Chipotle opened on London's Charing Cross Road in April 2010, it followed its US model almost exactly: the same menu, the same assembly line operations, the same grassroots marketing efforts. According to Chris Arnold: "We really don't see why it needs to be any different going into Europe. It will all be the same. Part of the beauty of Chipotle is its simplicity."

Developing a supply chain was not perceived as a major challenge: the European food culture was seen as friendly to Chipotle's policy of "Food with Integrity" policies. However, getting tortillas made to Chipotle's specification proved a challenge.

TABLE 2 Chipotle restaurants by location (at year-end)

	2014	2013	2012	2011	2010
US	1,766	1,556	1,399	1,226	1,079
Canada	7	7	5	2	2
UK	6	6	5	2	1
France	3	2	1	—	—
Germany	1	1	—	—	—
Total international	17	16	11	4	3
Total	1,783	1,572	1,410	1,230	1,082

Source: Company websites.

Chipotle also applied the same human resource policies, particularly with regard to nurturing local talent. Start-up of the London store was led by managers and operations personnel from North America. After an initial period, locally trained staff would replace most of the US-based managers.

Subsequent Chipotle restaurants were opened in Baker Street, Soho, Covent Garden, Islington, and Wimbledon.

Chipotle's International Experiences

Chipotle's progress in London was slow in terms of both sales growth and brand awareness. According to Bloomberg, Chipotle's market research showed that only 1% of Londoners was familiar with the brand as compared with 16% for Pret A Manger and 23% for McDonald's. "It looks likely that London will be a developing market for a while, until our awareness is raised there," Steve Ells said during the earnings call.[3]

Chipotle's Chris Arnold attributed Chipotle's low brand awareness in London to its handful of restaurants—six compared to 40 in New York City. He explained that Chipotle's approach was "to build up the business organically, [which] gives us a chance to build up our crews and operations in a new location."[4]

A further challenge for Chipotle was Europeans' lack of familiarity with Mexican cuisine, compared to other non-European cuisines, such as Thai, Indian, Vietnamese, and Chinese. Taco Bell's experience was salutary: it entered the UK market in the late 1980s, only to withdraw some seven years later. In 2010, it made a second attempt to enter the UK, but by March 2015 it had only five UK outlets.

Yet, even in London—one of the world's most multi-ethnic cities with a huge diversity of cuisines—Chipotle had clearly failed to make much of an impact. In Trip Advisor's March 28, 2015 listing of 161 Mexican/Southwestern restaurants in London, Chipotle's highest-ranked restaurant came in at #19. In terms of numbers of outlets, Chipotle lacked the market presence of other chains serving Mexican cuisine: Tortilla had 16 London restaurants and several elsewhere in Britain, Wahaca had 14 London restaurants.

Chipotle's own reservations about its potential for profitable expansion outside the US were apparent from its discussion of "Risk Factors" in its 2014 annual report:

> Our expansion into international markets may present increased risks due to lower customer awareness of our brand, our unfamiliarity with those markets and other factors ... As a result of our small number of restaurants outside the U.S. and the relatively short time we have been operating those restaurants, we have lower brand awareness, lower sales and/or transaction counts, and less operating experience in these markets. The markets in which we've opened restaurants outside the U.S., and any additional new markets we enter outside the U.S. in the future, have different competitive conditions, consumer tastes and discretionary spending patterns than our U.S. markets. As a result, new restaurants outside the U.S. may be less successful than restaurants in our existing markets [they] may take longer to ramp up and reach expected sales and profit levels, and may never do so, thereby affecting our overall growth and profitability. To build brand awareness in international markets, we may need to make greater investments in advertising and

promotional activity than we originally planned, which could negatively impact the profitability of our operations in those markets.

We may also find it more difficult in international markets to hire, motivate and keep qualified employees who can project our vision, passion and culture, and labor costs may be higher in international markets due to increased regulation or local market conditions. In addition, restaurants outside the U.S. have had higher construction, occupancy and food costs than restaurants in existing markets, and we may have difficulty finding reliable suppliers or distributors or ones that can provide us, either initially or over time, with adequate supplies of ingredients meeting our quality standards. Markets outside the U.S. may also have regulatory differences with the U.S. with which we are not familiar, or that subject us to significant additional expense or to which we are not able to successfully adapt, which may have a particularly adverse impact on our sales or profitability in those markets and could adversely impact our overall results.[5]

Chipotle's direct ownership and management of its restaurants also handicapped the profitability of its international operations. Motley Fool questioned whether the Chipotle concept translated well to international markets and observed that:

Chipotle has impressive margins, with its 16.5% operating margin besting that of Panera by about 3.5 percentage points. Looking at McDonald's metrics, it would appear that Chipotle still has plenty of room to grow its margins. McDonald's managed an operating margin in excess of 30% in 2013, nearly twice that of Chipotle. However, McDonald's has a very different business model than Chipotle, with a large portion of its restaurants franchised. Chipotle owns all of its restaurants, so the company will never even come close to McDonald's margins. McDonald's makes a lot its money by collecting franchise fees and rent, not selling burgers, and that's why the company's margins are so high. If anything, the difficulty in sourcing quality ingredients will lead to higher food prices and lower margins for Chipotle in the future.[6]

Overseas Expansion by US Restaurant Chains

The international market offered substantial growth opportunities for US restaurant chains. Among the leading chains—notably Subway, McDonald's, Starbucks, and KFC—international sales accounted for up to one-half of total sales and a growing proportion of total profit. However, the more traditional of the "casual dining" chains—such as Denny's, Applebee's, T.G.I. Friday's, and Tony Roma's—had a much weaker presence outside the US and Canada.

The attraction of overseas markets was that their restaurant markets were typically less saturated than those of the US and most of the local competition was made up of independent, family-owned restaurants rather than large chains. In overseas markets it was anticipated that market trends would follow those of the US, in particular that greater affluence and a declining role of family life would result in increased eating away from home.

By contrast, the US restaurant market appeared mature and saturated—it was estimated that there were 192,000 franchised fast-food and restaurant outlets at the beginning of 2014.[7]

However, overseas markets also represented a substantial management challenge. These included:

- *Market demand*: The extent to which market demand existed for a particular type of restaurant depended on levels of disposable income, urbanization, demographics, and a host of other social, economic, and lifestyle factors. Most critical to a specific company were national preferences with regard to cuisine and dining conventions. Even McDonald's, whose name had become synonymous with global standardization, had made substantial adaptations of its menu and business practices to local conditions.
- *Cultural and social factors* are critical influences on customer preferences with regard to menus, restaurant facilities, and overall ambiance; they are also important with regard to employee management practices and entrepreneurial potential.
- *Infrastructure*: Transportation and communication, basic utilities such as power and water, and locally available supplies were important elements in the decision to introduce a particular restaurant concept. A restaurant must have the ability to get resources to its location. Easy access to the raw materials for food preparation, equipment for manufacture of food served, and mobility for employees and customers were essential.
- *Raw material supplies*: Overseas restaurant chains needed local supplies of food and drink. In 1995, the US International Trade Commission noted that: "International franchisers frequently encounter problems finding supplies in sufficient quantity, of consistent quality, and at stable prices. Physical distance also can adversely affect a franchise concept and arrangement. Long distances create communication and transportation problems, which may complicate the process of sourcing supplies, overseeing operations, or providing quality management services to franchisees."[8] In 2015, these problems remained critical challenges to fast food chains seeking to expand internationally. While a franchiser could develop its own supply chain (e.g., McDonald's when it entered the Soviet Union), the investment of management time and money could be substantial.
- *Regulations and trade restrictions*: The principal challenges were national regulations relating to food standards, business licensing, and business contracts. Establishing new businesses in most countries involves far more regulation than within the US. Franchise agreements are an especially difficult area because they involve complex contractual agreements between franchisor and franchisee regarding trademark licensing, royalty payments, and requirements for quality control and quality monitoring. In some countries some usual terms of franchise agreements have been viewed as restraints on commerce. Employment law was also important, particularly with regard to restrictions on employers' ability to dismiss or lay off employees and requirements for union recognition and national collective bargaining arrangements over wages and working conditions.

US-based chains also faced powerful local competitors when they entered overseas markets. For example, in the UK, Chipotle's leading competitor was Tortilla, UK's largest Mexican fast-casual chain with 21 restaurants in March 2015. It was founded in 2007 by American-born Brandon Stephens and backed by private equity investors Quilvest and Clapham House Group.

Notes

1. "Chipotle: London Calling," http://www2.qsrmagazine.com/articles/features/138/global_growth-3.phtml, accessed July 20, 2015.
2. "Chipotle Finalizes London Location," Chipotle Mexican Grill, Inc., press release (November. 17, 2009), http://ir.chipotle.com/phoenix.zhtml?c=194775&p=irol-newsArticle&ID=1356314, accessed July 20, 2015.
3. "Why Chipotle Sales Lag in London," http://www.bloomberg.com/bw/articles/2013-02-26/why-chipotle-sales-are-low-in-london, accessed July 20, 2015.
4. Ibid.
5. Chipotle Mexican Grill, Inc., 10-K report for 2014: 13.
6. "Why Chipotle Is Severely Overvalued," http://www.fool.com/investing/general/2014/03/31/why-chipotle-is-severely-overvalued.aspx, accessed July 20, 2015.
7. IHS Global Insight, *Franchise Business Economic Outlook for 2014* (January 2014).
8. *US International Trade Commission, Industry and Trade Summary: Franchising* (Washington, DC, 1995): 15–16.