

Chipotle Mexican Grill

CMG: NYSE

Analyst: Peter Ostrowski

Sector: Consumer Staples

Short

Price Target: \$337

Key Statistics as of 3/18/2016

Market Price:	\$455.37
Industry:	Consumer Staples
Market Cap:	\$13.7B
52-Week Range:	\$399-\$758
Beta:	.39

Thesis Points:

- Health scare is driving away consumers
- Legal Trouble
- Increasing operating cost due to company's transformation
- Forecasted growth is now entirely uncertain

Company Description:

Chipotle Mexican Grill, Inc. owns and operates quick serve Mexican restaurants. The Company operates restaurants throughout the United States.



Thesis

Investor confidence and consumer confidence are currently taking a severe hit for Chipotle. This is because of the E. coli outbreak associated with Chipotle which occurred between December and February. Chipotle currently market that they serve only fresh ingredients. This is largely due to the very strict requirements there suppliers must comply with. The whole point of Chipotle is that it is clean. And recently they have begun to show us that they are not. The litigations have also been accruing recently; in direct relation to the health concerns. This outbreak will continue to hinder growth for the foreseeable future due to the direct effects it will have on financials. Diminishing the operating and gross margins as well as forecasted growth. Because of all of these concerns and issues it is likely that if another health issue occurred at Chipotle, then a highly unfavorable situation would most likely come about for Chipotle.

Current Business Strategy

Chipotle currently operates 1971 stores across the globe with the majority existing in the United States. Their current strategy is to sell burritos, tacos and salads using only fresh ingredients. The current trademarks are “Food with Integrity”, “Fresh is not enough anymore”, “Responsibly Raised”, and “The Gourmet Restaurant Where You Eat with Your Hands”. This is not marketed as just a fast food restaurant; Chipotle is supposed to represent a higher standard through their food and ingredients. The strict regulations imposed on all of their products are engrained in their business.



FOOD WITH INTEGRITY™



The reason why it is so important to summarize the business strategy is to demonstrate the risk associated with this stock. Any new health concerns that are attributed to Chipotle will decrease the value of the company. They are not currently accomplishing their strategy as this report will demonstrate.

Decreasing Customer Base

The E. Coli Outbreaks caused by Chipotle over the past few months have demonstrated a weakness in the fundamental aspect of their business. Chipotle is losing customers due to this. Chipotle was already on the verge of being written off as a value stock after reporting same store growth percentage as shown below:

12 Months Ending	12/31/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015
Restaurant Sales						
Revenue	1,835.9	2,269.5	2,731.2	3,214.6	4,108.3	4,501.2
Same Store Sales %	9.40	11.20	7.10	5.60	16.80	0.20
Number of Locations	1,084.00	1,229.00	1,409.00	1,589.00	1,772.00	1,994.00

Chipotle nearly had double digit growth in same store sales up until 2015. These demonstrate that increasing the number of locations is beginning to destroy value. The customer base is already there. Adding additional stores risks the chance of cannibalization. So increasing the number of restaurants with a decreasing customer base due to health concerns is a recipe for disaster. The decreasing customer base was shown during the 4th quarter for both loyal customers and less frequent customers. There was a YoY quarterly decrease in revenue of 14.6%. There was also a 700 basis point decline in restaurant operating margins.

It is likely that Chipotle will have at least a year of decreasing revenues. This is all assuming Chipotle is able to avoid health concerns for the rest of the year which is completely skeptical.

Legal Troubles

It is nearly impossible to estimate the litigation and legal fees that Chipotle will receive in 2016. This is due to all of the current cases that are still in progress.

In December 2015, Chipotle was subpoenaed due to an ongoing investigation that was dated back to

January 2013. These matters are related to the norovirus incident that occurred in a Chipotle in August, 2015 and the norovirus incident in December, 2015. These investigations were conducted by the FDA and reported to the state of California. There are currently a broad range of investigations related to this matter that are undisclosed. Future losses that will be paid out in settlements are not estimated on the 10-k.

There is also currently a Shareholder Class Action suit that is being conducted to try to compensate purchasers of common stock between February 4, 2015 and January 5, 2016. These allegations are claiming that the company's stock price was artificially inflated due to a lack of information for "the company's quality controls and safeguards in relation to consumer and employee health." Essentially the reports are claiming that Chipotle should have included more information relating to the risk of their operation.

Chipotle is also currently being investigated in relation to labor laws. There are currently allegations claiming that Chipotle did not pay employees for overtime in certain locations. This was first discovered during an inspection in 2010 and has had subsequent complaints since then.

Valuation

Because of the current situation that Chipotle is now experiencing; it is necessary to discuss certain assumptions for the future. The two value drivers that are being hurt include operating costs and growth.

The operating margin is going to shrink for this year due to the increased expenditures related to the reforms being instated to decrease the chances of foodborne illness to consumers. I am estimating the operating costs to increase to 84% this year. An increase of 4% YoY.

In the earnings call the CEO stated that he did not expect a YoY increase in revenue for at least 5 quarters. This leads me to assume there will be a decrease in growth this year. I was conservative in my estimate of -2%.

Conclusion

I recommend a sell for Chipotle. A company that markets fresh and clean products is inclined to deliver on their proposals. Over the past few months; Chipotle has fallen short of this. This is largely due to the uncertainty associated with the possibility of future health concerns. In order to combat potential health concerns; Chipotle will be forced to increase operating expenses and will also have abnormal losses. These will hinder margins further as revenues shrink due to a decrease in customers eating at Chipotle. It will take Chipotle a while to recover from this; but for the current year I believe they will destroy shareholder value.

Chipotle Mexican Grill, Inc.
(CMG)

Analysis by Peter Ostrowski
3/19/2016

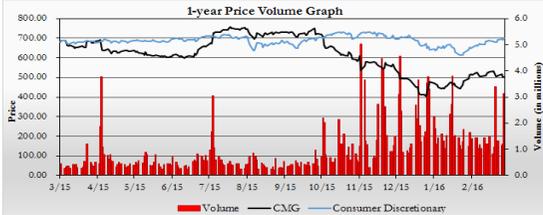
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Target 1 year Return: -21.64%
Probability of Price Increase: 4.33%

Current Price: \$455.37
Dividend Yield: 0.0%

Intrinsic Value: \$337.77
Target Price: \$356.84



Description
Chipotle Mexican Grill, Inc., together with its subsidiaries, develops and operates fast-casual fresh Mexican food restaurants.

General Information

Sector	Consumer Discretionary
Industry	Hotels, Restaurants and Leisure
Last Guidance	November 3, 2015
Next earnings date	April 26, 2016
Estimated Country Risk Premium	6.53%
Effective Tax rate	40%
Effective Operating Tax rate	39%

Market Data

Market Capitalization	\$13,681.25
Daily volume (mil)	2.88
Shares outstanding (mil)	30.04
Diluted shares outstanding (mil)	31.49
% shares held by institutions	55%
% shares held by investments Managers	85%
% shares held by hedge funds	7%
% shares held by insiders	1.57%
Short interest	10.68%
Days to cover short interest	1.81
52-week high	\$758.61
52-week low	\$399.14
Levered Beta	0.58
Volatility	31.79%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
12/31/2014	-0.48%	-1.89%
3/31/2015	-1.53%	7.09%
6/30/2015	-1.48%	1.49%
9/30/2015	0.00%	-0.15%
12/31/2015	-1.17%	10.85%
Mean	-0.93%	3.49%
Standard error	0.3%	2.4%

Management

Management	Position	Total compensations growth	Total return to shareholders
Ellis, M.	Founder, Chairman of the Board	35.15% per annum over 5y	22.64% per annum over 5y
Moran, Monty	Co-Chief Executive Officer	38.33% per annum over 5y	22.64% per annum over 5y
Hartung, Jack	Chief Financial Officer	33.56% per annum over 5y	22.64% per annum over 5y
Crumphorn, Mark	Chief Creative & Development	19.63% per annum over 5y	22.64% per annum over 5y
Ganser, Curt	Chief Information Officer	N/A	N/A
Salfridge, Gretchen	Restaurant Support Officer	N/A	N/A

Profitability

	CMG (LTM)	CMG (5 years historical average)	Industry (LTM)
ROIC	25.0%	26.58%	27.46%
NOPAT Margin	14%	13.66%	12.6%
Revenue/Invested Capital	1.76	1.95	2.18
ROE	18.5%	22.22%	35.13%
Adjusted net margin	14%	13.06%	10.8%
Revenue/Adjusted Book Value	1.35	1.70	3.26

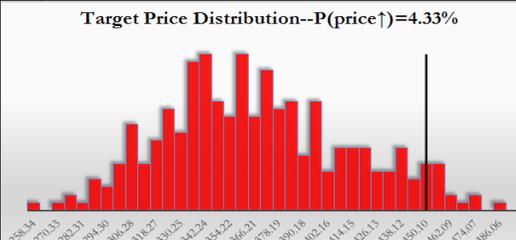
Invested Funds

	CMG (LTM)	CMG (5 years historical average)	Industry (LTM)
Total Cash/Total Capital	16.5%	19.9%	19%
Estimated Operating Cash/Total Capital	3.2%	5.7%	N/A
Non-cash working Capital/Total Capital	-3.2%	-4.1%	-41%
Invested Capital/Total Capital	71.5%	74.0%	85%

Capital Structure

	CMG (LTM)	CMG (5 years historical average)	Industry (LTM)
Total Debt/Common Equity (LTM)	0.11	0.07	0.31
Cost of Existing Debt	2.41%	5.53%	4.56%
Estimated Cost of new Borrowing	2.41%	2.41%	4.14%
CGFS Risk Rating	2.41%	AA	BB
Unlevered Beta (LTM)	0.00%	0.77	0.90
WACC	2.41%	8.23%	8.21%

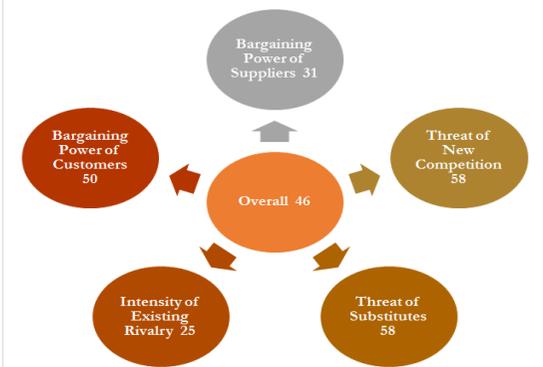
Target Price Distribution--P(price↑)=4.33%



Sensitivity Attribution Analysis

Revenue	47.2%
Operating Expenses	43.5%
Dividends	0.1%
NWC	0.5%
CAPEX	7.8%
Operating Cash	0.9%

Porter's 5 forces (scores are out of 100)



Period	Revenue growth	Valuation NOPAT margin	ROIC/WACC
Base Year	9.6%	14.2%	3.89
12/31/2016	-3.4%	7.4%	1.73
12/31/2017	18.3%	10.9%	2.33
12/31/2018	17.3%	12.9%	3.01
12/31/2019	9.0%	10.8%	2.25
12/31/2020	12.5%	10.7%	2.16
12/31/2021	10.9%	10.7%	2.13
12/31/2022	9.3%	10.7%	2.04
12/31/2023	7.8%	10.8%	1.96
12/31/2024	6.2%	10.8%	1.88
12/31/2025	4.6%	10.8%	1.80
Continuing Period	3.0%	10.8%	1.72

Period	Invested Capital	Net Claims	Price per share
Base Year	\$1,061.60	\$768.10	\$333.29
12/31/2016	\$1,381.98	\$1,162.97	\$358.23
12/31/2017	\$1,888.29	\$709.19	\$387.20
12/31/2018	\$2,176.61	\$603.65	\$418.35
12/31/2019	\$2,560.65	\$352.73	\$453.71
12/31/2020	\$2,875.11	\$117.52	\$487.38
12/31/2021	\$3,649.06	-\$88.40	\$523.44
12/31/2022	\$3,846.47	-\$387.26	\$562.09
12/31/2023	\$4,634.03	-\$793.51	\$603.37
12/31/2024	\$5,267.09	-\$1,319.35	\$647.25
12/31/2025	\$5,867.59	-\$1,973.66	\$693.67
Continuing Period			