ALTERNATIVE RESEARCH SERVICES, INC.

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Market Cap.	$7.2 bil
Shares Out.	30.3 mil
Short Interest	3.93
Days short	3.21
Avg. Daily Vol.	1.2 mil
St. eps est. 2010	$5.46
St. eps est. 2011	$6.56
Px/book	9.76x
Px/sales	4.32x
Px/ EBITDA	21.1x

Chipotle (CMG) -- $235.70
(down 15 today on downgrade)

Sell Short: Press Rallies

Morgan Stanley Downgrade Today Pre-Empting Us
Commodity prices going up / articles
JACK says credit and real estate environment better
Supply Shell Game
Risk: Demographic trends see "Bull Case" below

Morgan Stanley Pre-empt

- **Morgan Stanley pre-empted our second research report today with a downgrade on valuation. Using Morgan Stanley's earnings model, we wish to draw investor attention to the "Food, Beverage and Packaging Cost" expense line items. We noticed that in 2006, 2007, and 2008 those costs were 31.5%, 31.9%, and 32.4% of revenue, respectively. In 2009 and 2010 those costs fell to 30.7% and 30.4% (assuming Q4 is right at 30.5%). But we question their assumptions for 2011, 2012, and 2013 of 30.7%. 30.5% and 30.5%, respectively.**
- **In the last quarter "FB&P" was 30.6% of revenue down from 30.8% and 30.4% vs. 30.9% for 9 months ended. Management cited, "…favorable food costs, primarily avocados, corn, rice and chicken due to the *switch to commodity chicken in certain markets resulting from supply constraints* which we are working to alleviate as soon as possible." Does this mean management conveniently lowers quality to increase margins when it's convenient? We think so despite their outward altruistic mantra. Nice marketing gimmick, except when running a business w/revenue north of $1.5 billion. Management said in their last 10-Q, "This decrease was partially offset by the increased cost of barbacoa (cheek meat) and steak as we increased the percentage of naturally raised beef in our restaurants." Should supply naturally grown commodities dwindle and prices of commodities they must buy on the open market become meaningfully higher than expected, margins could unexpectedly collapse. The fact they are skilled arbitrageurs of their raw materials behind the scenes works against them over time as the size of the company increases. We would expect FB&P expense to be up a minimum of 200 bps**

over the next 24 months to account for the growing size of the company. Most industries rely on quantity discount pricing to drive margins up given better purchasing leverage. We think for CMG the opposite is true—size will yield lower margins not higher.

- **4Q09 Earnings Call: "For the year, revenue increased 14% to $1.518 billion, with comparable restaurant sales up *2.2%*. Our restaurant-level operating [mgmt. intended to say gross not operating] margins for the year were just about 25%, *up 340 basis points* from the previous year, the highest we've experienced as a company. Net income for 2009 increased *62%* to 126.8 million, leading to diluted earnings per share of $3.95, an increase of 67% over 2008. On our quest to serve Food With Integrity, we have been working to increase our supply of naturally raised beef. As of today, more than 60% of all of our beef is naturally raised, but we expect to have 100% of our barbacoa…"**
- **A higher mix of small stores could indicate a slowing of gross sales despite accelerating the rate of growth of new smaller stores. Ebitda margin in 4Q09 was 17.1%, which then increased to 19% in 1Q10, up from 13% in 2008. 4Q10 is the last easy comparison before comparing against 19%+ in 2011.**

Commodity Prices and Supply Issues[1]

- **We are not attempting to imply that the marketing strategy of socially conscious sourcing is necessarily a bad thing. Rather, we think the odds are greater in a down economy that consumers will push back on higher prices. CMG is willing to put themselves at a competitive disadvantage on pricing for goods by sourcing through local farms/cooperatives, etc, hoping that consumers will absorb the higher prices in return for higher quality. We think this is long-term strategy which will have a few major hiccups caused by highly volatile raw material prices and potentially unreliable sourcing on the front-end, and weak price increases on the back end. As the number of restaurants increases, the exposure to supply issues increases over time. It's easier to overcome supply issues for 730 stores in June 2008 compared to the 1000 they have now and near 1,200 they will have in 2011. That's a 64% increase in stores in 3 years….a logistical accident waiting to happen, in our view.**
- **Jun 07, 2010 – "*Chipotle had been serving naturally raised chicken in all of its restaurants but can no longer get enough chicken to meet its growing demand.* The company hopes to be back to 100% naturally raised chicken by the end of the year."**
- **Jan 07, 2008 – "Chipotle Mexican Grill announced today that it will serve more than 52 million pounds of naturally raised meat in 2008, a 12 million pound or 40 percent increase over last year." Recall in our November 23rd report we wrote, "[i]n all, Chipotle expects to serve more than *75 million pounds of naturally raised meat in 2010*, including all of its pork, more than 80% of its chicken, and 85% of its beef." That's a 44% increase in 2 years.**
- **Sep. 9, 2009 – CMG: "…the chain of burrito restaurants known for serving Food With Integrity, announced that it has reached an agreement with East Coast Farms, one of Florida's largest tomato growers, under which workers who harvest tomatoes for**

[1] http://ir.chipotle.com/phoenix.zhtml?c=194775&p=irol-newsArticle&ID=1435288&highlight=

Chipotle will receive an additional penny per pound*, a wage increase of 64 percent*, for tomatoes picked for Chipotle. The agreement between Chipotle and East Coast Farms comes following months of discussion between Chipotle and the Coalition of Immokalee Workers (CIW), a community-based organization that has led a campaign to improve wages and working conditions for Florida farm workers…[u]nder the agreement with East Coast Farms, farm workers who pick tomatoes for Chipotle will see their pay go from $.50 for a 32-pound bucket, to $.82 for each 32-pound bucket of tomatoes they pick."

- **May 18, 2009 – CMG: "will expand its local produce program this summer, purchasing at least 35 percent of at least one bulk produce item in all of its restaurants from local farmers when it is seasonally available. Under its local produce program, Chipotle expects to have more than 25 local farms in its network that will supply some of the romaine lettuce, green bell peppers, jalapeno peppers, red onions and/or oregano served at the 860-plus Chipotle restaurants nationwide."**

Higher Beef[2]

- **Commentary by Richard Yamarone (October 14th): Prices are headed higher, according to The Economist Commodity Price Index --- often referenced by the Federal Reserve in the Green Book, "Current Economic and Financial Conditions." Depending on how long this lasts, the increase could pose challenging for the Fed. Currently there are a number of factors working together to send commodity prices higher. Grain shortages are pushing prices of beef, pork, and chicken. Soaring demand, particularly from China, for rare earth materials and metals are boosting industrial prices. Cotton prices have exceeded $1 per pound for only the second time since the Civil War.**
- **Proteins Slightly Up as Solid Demand Offsets Looser Inventories. Hogs rose 1.8% w/w, with cattle up 0.8% and chicken about flat, as strong holiday demand (beef packers +5.1% y/y) and concerns that cold US weather could restrict animal weights more than offset looser US stockpiles (pork -7% y/y in Oct vs. +20% in Sept, beef -6% vs. -8%, poultry flat vs. -5%)and geopolitical tensions in Korea (S. Korea #5 US beef /veal buyer, #6 for pork). The USDA raised its pork CPI forecast by 50 bps to 5-6% this year as hog prices rose last month, while US beef exports should remain strong.**
- **For some companies such as PF Chang (PFCB), the management has been astute in anticipating higher prices. They have already locked in price for most commodities through 2011 and into 2012. The raw material inflation will be less pronounced than Sonic (SONC), which buys on the open market. The market has rewarded PFCB and penalized SONC.**
- **CMG says, "We work closely with our suppliers and use a mix of forward pricing protocols under which we agree with our supplier on fixed prices for deliveries at some time in the future, fixed pricing protocols under which we agree on a fixed price with our supplier for the duration of that protocol, and formula pricing protocols under which the prices we pay are based on a specified formula related to the prices of the goods, such as spot prices. However, a portion of the dollar value of goods purchased by us is *effectively at spot prices*. Generally our pricing protocols with suppliers can remain in**

[2] SONC Oct 19 call: We expect that commodity costs will be higher in the first through the third quarters, mainly due to higher beef costs and product quality investments… But overall right now, we're seeing some pressure in the commodity items that are attributable to protein with to the increases in corn and wheat prices.

effect for periods ranging from one to 18 months, depending on the outlook for prices of the particular ingredient."

CPKI Nov 11 2010 Call Notes (tracking commodities)

- **<A - Susan M. Collyns>: We've actually seen an increase in our commodity costs, within certain commodities coming off recent contracts then we're in the process of negotiating almost everything else right now actually. I guess at a macro level, I see commodities being up but somewhere between 2% to 3% next year. I've definitely got visibility right now, our packaging and produce has actually come up this quarter and we're seeing 2% to 3% expansion in that line item. Some of our grocery items came up actually in the end of the second quarter, beginning of the third quarter and we saw 1% to 2% increase there. And we have seafood and that meat category coming up in December as well. And we're seeing again to 2% to 3% increases being shaped from what those early indications look like.**

JACK Call Notes (higher beef) – Qdoba Strengthening

- **As of October 3, 2010, the Qdoba system included 525 restaurants in 43 states..Overall we expect commodity costs for the full year to increase by 1% to 2%, with higher inflation in the first half of the year, when we are lapping deflation of nearly 7% in the first quarter and 1% in the second quarter. Specific to our major commodity purchase is beef, which accounts for 20% of our spend, and we are expecting the *full-year beef costs to be up 6% to 7%* versus 2010. *We expect beef costs to be up approximately 9% in the first quarter* compared to a decrease of 19% in the first quarter of 2010."**
- **"With a favorable price spread to import 90s, we are maximizing the use of the domestic fresh 90s with current market prices in the $1.45 to $1.50 per pound range versus $1.37 last year.[3] We have 100% of our import 90s covered through January at $1.58 per pound and 25% coverage through March at $1.50 per pound, versus approximately $1.38 last year and current market prices in the $1.70 range. We expect beef 50s to average in the $0.65 to $0.70 range per pound in Q1 versus $0.67 a pound last year.[4] Pork accounts for about 5% of our spend and is expected to be up approximately 9% for the full year."**
- **"Again, Q1 will be most negative as we compare record-high pork prices at the beginning of Q1 to more seasonal prices last year. Cheese also accounts for about 5% of our spend. It is expected to be up 7% to 8% for the year. Poultry, which is about 11% of our spend, is expected to be down 2% for the year, benefiting from new fixed-price contracts that took effect last February and March which are lower than previous contracts by almost 6%."**
- **For the first quarter we expect same-store sales…to increase approximately 4 to 6% at Qdoba. Same-store sales are expected to increase approximately 2% to 4% at Qdoba [for**

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[3]Current price info: http://www.ams.usda.gov/mnreports/lm_xb459.txt; scroll down to "Ground Beef" section and ones below it. Prices are in $/100 lbs.

[4] http://www.beeffoodservice.com/CMDocs/BFS/BeefU/BeefUFactSheets/17_Glossary.pdf,

page 8 -"FIFTY/FIFTY TRIMMINGS (50/50 OR BEEF 50'S): An example of the composition of beef trimmings generated from fabrication of beef carcasses or primals offered commercially. In this example, the trimmings are approximately 50% lean beef and 50% fat."

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the full year]. Restaurant operating margin for the full year is expected to range from 14% to 14.5%, depending on same-store sales and commodity inflation.

- **"In 2010, we really slowed down the growth of Qdoba, and especially if you compare the 21 franchise locations versus almost 40 in '09 and almost 60 in '08 for Qdoba franchise new-unit growth. And the reason for that was one, a *lack of available credit* for the franchisees. Two, *the lack of available sites* that - because of pull-back in development of those lifestyle centers where it makes sense to put a Qdoba. And three, the sales performance was more challenging four quarters ago, three quarters ago. *Since that time, the credit - the financing is more readily available. There's some secondary commercial real estate that is becoming available and there are some pretty good deals out there.* And then the turn-around in the Qdoba business is really getting the franchisees to feel more bullish about growth with Qdoba. And so that's why Jerry feels very confident in the unit growth for Qdoba franchisees ramping up in fiscal 2011."**
- **We think better access to credit could pose a competitive threat to CMG. Clearly, CMG's balance sheet strength provides a lot of flexibility for opening stores, leasing property, etc. If competitors are able gain increased access to credit, then that may drive up rents that otherwise would've been lower, forcing CMG to pay higher rents or lose the locations they want entirely.**
- **"System same-store sales at Qdoba increased 5.6% for the quarter and 2.8% for the full year…Restaurant operating margins decreased 330 basis points to 12.5% of sales for the quarter. The breakdown is as follows. Food costs were up 90 basis points, driven by *commodity inflation of approximately 3%,* slightly better than our guidance of up 4%, and compared to 5.5% deflation in last year's fourth base is really very - as you look at the trend of sales, both Jack in the Box and Qdoba had six quarters of negative same-store sales. Qdoba we went in about a year before Jack in the Box in terms of the down sales, and Qdoba has come out nicely."**
- **"In fiscal 2010, 36 Qdoba restaurants opened, including 21 franchise locations….[5] Our Qdoba system is primarily franchised and is the largest franchised Mexican-food chain in the fast-casual segment of the restaurant industry… In fiscal 2011, we plan to open 50-60 new company and franchise restaurants."**
- **"*In 2010, lower commodity costs (including beef, shortening, poultry and bakery), margin improvement initiatives and modest selling price increases more than offset the impact of unfavorable product mix and promotions.*"**
- **In 2010, Qdoba had cap ex of $13.5 million, opening 36 stores of which 21 were franchises, implying cap ex per corporate store of $900k, slightly higher than CMG.**

TAST – Rejects Idea of Price Increases Despite Higher Costs

- **Carrols Restaurant Group, Inc. (TAST), announced financial results for the 3Q ended October 3, 2010. Comparable restaurant sales increased … 1.0% at Taco Cabana®….[a]s of October 3, 2010, the Company [had] 156 Taco Cabana restaurants, and franchised 33 restaurants. "Comparable restaurant sales increased at both our Hispanic Brands from continued momentum in customer traffic. Taco Cabana revenues increased 1.1% to $63.7 million during the third quarter of 2010 compared to $63.0**

[5] JACK 10-K Filed 11/24/2010

million in the third quarter of 2009. Taco Cabana comparable restaurant sales increased 1.0%. Taco Cabana comparable restaurant sales are expected to be flat."

- Taco Cabana sales were $63.7M vs. $63M for 3 months ended September and $189.9M vs. $189.5M for nine months ended.
- Nov 1[8th] Merrill Conference: Taco Cabana [revenue] is between 1.6 million and 1.7 million….[i]t fits in the fast casual segment, very attractive price value propositions…Taco's largest daypart is dinner. So we do have a pretty good breakfast business, lunch as well, but dinner is still -- is the largest single daypart. Taco is experiencing increased sales of ~ 5 to 7%. However, in the case of Taco we haven't really gotten through the whole -- about halfway through Dallas right now
- <A>: … I think we're looking probably next year about a 1% to 2% cost increase at Pollo and Taco, and I think given our outlook on beef cost, we expect cost increases in the Burger King side probably going to be a little bit higher than that…Obviously, *we don't want to be taking price increases in this environment*, but I think given the commodity increases, I'm hearing more discussion from other chains in terms of taking commodities, which had price increases, which I think will sort of gives other companies like us permission to do that I think, if you will. I think we're also going to see some natural increase in our average check, simply as we see mixes in the sales, or shifts in the sales mix move back a little bit off the value side of the equation.

Supply Issue Publications and Articles

- Livestock up; meat prices will follow.[6] The surest sign that the recent rallies in hog and cattle prices are for real is a prediction of higher meat prices at the supermarket counter. Meat eaters have had two good years of reduced prices because of the slump in cattle and hog markets. Both steak and pork prices fell by 15 percent or more through 2009, with the Thanksgiving/Christmas holiday season last year turned into a strong discount season for hams. Hog prices fell from around $90 per hundredweight to less than $50 per hundredweight by late summer of last year. But since that trough demand has improved, particularly on the pork side, and hog producers are reducing their herds. The U.S. Department of Agriculture reports slaughter down as much as 7 percent through February 2010. Beef cattle on feed are at their lowest levels in 50 years. Hog prices have recovered on the futures markets, moving up from under $50 per hundredweight in September to as high as $72 per hundredweight by this week, with futures contracts for June deliveries as high as $80 per cwt. Meanwhile cash hogs have bounced up from less than $40 per hundredweight to $50 per cwt or more. The rise in cattle has been just as steady. Live cattle have gone up from $83 per hundredweight in November to $95 this week. Feeder cattle, those taken off grass and sent to feedlots for the final fattening to 1,300 pounds before slaughter, are up from $91 per hundredweight in December to $102 this week.
- CATTLE PRODUCERS SEEING GREEN[7] *Jun 28, 2010 12:46 PM, Source: Des Moines Register:* Fewer hogs, along with a recent rally in cattle prices, is likely to continue upward price pressure for both livestock and meat prices, recent reports show. The likelihood of the first profitable year for livestock producers since 2007 will help farm incomes rise by an average of 10% this year, USDA said.

[6] http://blogs.desmoinesregister.com/dmr/index.php/2010/03/16/livestock-up-meat-prices-will-follow/

[7] http://beefmagazine.com/sectors/cow-calf/0629-cattle-producers-seeing-green/

Consumers so far have seen only single-digit increases in meat prices, according to the USDA, despite price increases for live cattle and hogs and finished cuts of meat. Analysts said demand for beef, which lagged in 2009 under the weight of the poor economy, is picking up.

- Consumers could have beef with high prices[8] **August 23, 2010: Beef prices at the supermarket are 6 percent to 7 percent higher than last year, said Rich Nelson, director of research at commodities research firm Allendale Inc. in McHenry. The retail price for choice beef was $4.44 per pound in July, up from $4.18 a year earlier, according to the U.S. Department of Agriculture. "Meat prices are trending up, probably to the highest they've been in a few years," said Bob Goldin, executive vice president at food industry consulting firm Technomic. The beef industry has been contracting since 2006 for a number of reasons, including higher feed-grain prices and lower demand from cost-conscious consumers. The supply of beef for sale in the U.S. is down about 4 percent, Nelson said. Commodity spike seen boosting food costs in 2011[9] October 27, 2010: Consumers are enjoying the lowest food-price inflation in nearly two decades, but the skyrocketing prices of corn and other commodities is expected to take a bigger bite out of paychecks in 2011, according to the government. Food costs are expected to rise 2 to 3 percent in 2011, which would be the largest jump since the 5.5 percent increase in 2008, the last year there was a big jump in the price of corn and other commodities. The price jump in 2008 brought a torrent of criticism on federal biofuel policies.**
- **U.S. beef cow numbers expected to continue decline[10] Nov. 17, 2010: The U.S. beef cow herd is expected to continue to decrease in the coming months and year, primarily due to a lack of profitability, high production costs, competing meats, and alternative uses of land. The lack of profitability by the majority of cow-calf producers can be attributed to weak demand caused by the severe recession, says Walt Prevatt, Auburn University Extension economist.**
- **U.S. cattle farmers clearly are continuing to decrease their inventory of cattle and calves, he adds. In the mid-year July 1, 2010 Cattle Report, cattle producers told USDA they had about 500,000 fewer beef cows that had calved (-1.6 percent) than a year ago. Beef cow replacements were down 100,000 head (-2.2 percent) from a year ago at 4.4 million head.**
- **“A smaller inventory of cattle and calves and smaller calf crop during 2010 will likely limit the growth in beef production during 2011. USDA projects U.S. beef production during 2011 to be about 25.1 billion pounds or 2 percent less than a year earlier. This level of beef production will be influenced by any adjustments in average carcass weights and the level of feeder and live cattle imports from Canada and Mexico,” he says.**
- **We have plenty more articles but we think the point is made. Ask for other articles.**

The Bull Case[11]

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[8] http://articles.chicagotribune.com/2010-08-23/news/ct-talk-0824-beef-prices-20100823_1_beef-industry-meat-prices-frantic-trading

[9] http://blogs.desmoinesregister.com/dmr/index.php/2010/10/27/commodity-spike-seen-boosting-food-costs-in-2011/

[10] http://southeastfarmpress.com/livestock/us-beef-cow-numbers-expected-continue-decline

[11] http://www.agmrc.org/media/cms/MexicanFoodRev_04568355C1D1F.pdf

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- **Hispanics are the biggest minority group in the United States. They numbered approximately 43 million people in 2006, or 14.4 percent of all U.S. residents. Of that, 64 percent are Mexican. Chicago-based consumer research firm, Mintel, estimates that by 2011 Hispanics will grow to 49 million people.**
- **Hispanics' median household income in 2004, the most recent year for which data was available, was $34,000, well below the $44,000 for all U.S. households**
- **Hispanics also spend a smaller portion of their income on dining out than non-Hispanics —35 percent and 43 percent, respectively…The combination of lower income and bigger households means that Hispanics are more likely than other ethnic groups to visit fast food and fast-casual restaurants**
- **Hispanic consumers are much more receptive to advertising and marketing messages than is the general population….most experts suggest that Mexican food is undergoing a process much like Italian food has done over time. Namely, all Italian food is not alike. Mexican foods offer greater convenience.**
- ***By any statistical measure, Mexican food consumption is increasing faster than any other segment* of the restaurant industry.**
- **A 2004 Packaged Facts study titled *The U.S Market for Hispanic Foods and Beverages* said as much: "Many U.S. consumers have accepted mainstream Mexican foods as part of American culture." The study also says that "Hispanic convenience foods" grew by 104 percent between 1999 and 2004. Expo Comida Latina, which bills itself as "The Hispanic Food and Beverage Show," puts the total U.S. market for Latin food and beverages at $4.3 billion.**
- **The U.S. Hispanic segment made up more than 50% of real growth in the midst of a stagnant U.S. consumer economy between 2005 and 2008, with $52 billion of new inflation-adjusted Hispanic spending outpacing $40 billion of new spending by non-Hispanics. This growth can be attributed primarily to an increase in the number of U.S. Hispanic households, and secondly to an increase in consumer spending among U.S. Hispanics.**[12]

[12] http://www.prnewswire.com/news-releases/us-hispanics-propel-real-growth-in-food-beverage-and-restaurant-sectors-according-to-latinum-network-90222677.html

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