Alternative Research Services, Inc.

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Chipotle (CMG) -- $242.92

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

Sell Short: Be Aggressive

JACK Warns Higher Commodities Call @ 11:30
Increase in small stores in the mix "A model"
Slowing new store growth; difficult comparisons in 11
History of resistance to price increases
Aggressive Repurchasing/Valuation
Risk to the short: timing, accelerated store openings, HSD comp. guidance, buybacks

- **We are beginning coverage of Chipotle. With the stock rallying from $80 to $240 since December of 2009, we thought we would enter the fray. This is our first look at the company. Heading into year end when high performing stocks tend to trade up, now until then may provide an entry for a 2011 investment. In the trailing four quarters, revenues were $1.741 billion off a store base of 1023 at the end of the last quarter with ~120 being new stores in 2010. That's ~$1.7 million of revenue per store; however, with the market cap at $7.5 billion, each store is being valued at $7.4 million, more than 4x sales. Store opening costs are ~$800,000 per unit. Trailing four quarter operating income was $265M, ~15% pre-tax, and net income was $164M, ~10% after-tax. Especially with so many new stores in the mix and heavy weighting of new stores opening 4Q2010, and average stores size going down; by any possible metric, the stock is overvalued and should be sold short in the next few weeks.**
- **We get it. CMG has probably been a painful short squeeze for some in 2010. On October 22, Janney Montgomery writes, "Robust Q3 EPS Drowns Naysayers in a Vat of Guacamole" with the stock at $179, followed by an increase in 2011 estimates from $6.12 to $6.45 and a $225 target price.**

Competition –Qdoba (division of JACK) Call at 11:30

- **JACK's press release last night warns: "Overall commodity costs were approximately 3% higher in the quarter, driven primarily by higher beef, cheese and pork costs which were partially offset by lower costs for poultry, shortening and bakery products…Overall commodity costs are expected to increase by 1 to 2% for the full year, with higher inflation in the first half of the fiscal year.**
- **While it's not a perfect overlap, we think the strong same store sales numbers from JACK's Qdoba division reported last night could be enough to begin to pressure shares of CMG. We examined 20 markets to see if and where CMG and Qdoba compete with**

each other. Qdoba is a lower-end store in lower end markets, which is right where CMG is going to keep growing (see below). Compare the burrito presentation for comparables to quality comparison.[1] For example, St. Louis has roughly 40 Qdoba stores vs. 5 for CMG, Milwaukee 40 vs. zero, Louisville 10 vs. zero, Lexington, KY 10 and CMG's 3, Grand Rapids, Michigan, 20 vs. 1, in Detriot 20 vs. 5. Cities where the two are largely even: Chicago at 25 vs. 30, Denver roughly 25 each. Cleveland 16 vs. 10, Boston 13 v. 9 for CMG, Pittsburgh, Raleigh, Phila/Balt wash out. CMG owns the market in LA, Phoenix, Dallas, and Columbus.

- **Qdoba Mexican Grill (69% franchised) operated 525 stores through October 2010. They expect to open 50 to 60 new restaurants in 2011. Q1 Guidance: Same-store sales are expected to increase approximately *4 to 6%* vs. a 1.7% decrease in the year-ago quarter. 2011 Comp Guidance: up 2 to 4%. In the June quarter, same-store sales at Qdoba restaurants increased 4.6% in the third quarter and 1.8% through 9 months vs. negative comps. Qdoba opened 36 new stores for the year. In the 13 weeks ended October 3, 2010 Qdoba had same store sales of 5.6% vs. negative 3.1% in the prior year and up 2.8% vs. down 2.3% for the 52 weeks ended September. In fiscal 2009, Qdoba had average store sales of $905k and a restaurant operating margin of 15.2%.**

Marketing Strategy Sustainable?

- **From a marketing and practical standpoint it is important to note CMG's strategy of "Food with Integrity." What is that? In their words, "It means serving the very best sustainably raised food possible with an eye to great taste, great nutrition and great value. It means that we support and sustain family farmers who respect the land and the animals in their care. It means that whenever possible we use meat from animals raised without the use of antibiotics or added hormones. And it means that we source organic and local produce when practical. And that we use dairy from cows raised without the use of synthetic hormones."[2]**
- **June: "Chipotle Mexican Grill, the national chain of burrito restaurants, announced today that all of the beef it uses in its barbacoa, a spicy shredded beef, is now naturally raised, bringing its total of naturally raised beef to nearly 23 million pounds, including both steak and barbacoa. The move solidifies Chipotle as the largest restaurant seller of naturally raised meat and underscores its commitment to serving 'Food with Integrity.'"[3]**
- **"In 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. All of its naturally raised meat comes from animals that are raised in a humane way, never given antibiotics or added hormones, and fed a pure vegetarian diet."**
- **That is a nice gesture on their part; however, we wonder if there aren't capacity constraints on those specialized ingredients. Food, beverage and packaging expenses were $528M in the trailing 4 quarters. We would wager those ingredients have extreme high price volatility relative to similar products, longer lead times for delivery, and general lack of infrastructure for supporting a fast food chain. We will save that for another report.**

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[1] http://www.chipotle.com/en-US/menu/menu.aspx http://www.qdoba.com/MenuBurritos.aspx
[2] http://www.chipotle.com/en-US/fwi/fwi.aspx
[3] June 7th 2010 press release

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- **Back in February 2008 the following story came out, "Chipotle declined … as much as 12 percent…*Higher costs for beef, chicken, cheese and wheat have* hurt earnings at Chipotle and other restaurant companies as consumers facing gasoline hovering around *$3* a gallon limit eating out. If oil makes another run toward $100 the gas impact could be meaningful again.[4]**
- **If we can anticipate a margin squeeze from one or more of these factors then the short thesis has merit. The last time that CMG instituted meaningful price increases was in FY08. from 4Q08 earnings call: "Our comps for the fourth quarter were 3.5% and we ended 2008 with full year comps of 5.8%. Menu price increases were about 7% overall in the quarter, with about 3.5% coming from previous increases and 3.5% coming from price increases during the quarter. We actually increased prices by about 6%, which was done market-by-market throughout the quarter, which resulted in the effective 3.5% incremental increase for the quarter…*we have seen resistance to the most recent price increases*. Though is impossible to identify how much of the loss traffic is the effect of general economic conditions and how much is due to price resistance, and net effect seems to be that we've been able to retain a little less than half of the incremental 6% price increase in the quarter."**
- **There is also a potential issue of slowing new store growth despite management accelerating the rate of new stores on the last conference call. At just over 1000 stores, management indicated that they are experiencing some level of saturation in finding viable properties, causing them to open "A-model" stores in less than ideal markets. While the margins are largely the same, the per store revenue is likely to be lower in the secondary and tertiary markets. Management indicated on the call their new store openings are limited by a lack of newly developed property; implying older locales are not as profitable. Yet, in order to expand, the A-models will become an increasingly larger part of the mix. Further, as they grow into secondary and tertiary markets, CMG is likely to experience increased competition from JACK, limiting growth.**

Conference Call Oct 21

- **At the end of Q3 CMG had 1,023 restaurants, and expect to reach our goal by opening between 120 and 130 total new restaurants for the 2010 calendar year. During the quarter, CMG opened 22 new restaurants, bringing the total number of new restaurants this year to 67. Five of these openings were A models, bringing the total number of A models to 15. In 2011, we expect *to escalate our rate of restaurant openings*, in part because of our move to include A model locations in the mix.**
- ***New developments* provided the majority of our sites just a few years ago, but the recession has significantly curtailed those, which has caused us to intensify our efforts to find the very best existing developments that we can find.**

[4] Nov. 18 (Bloomberg) -- Gasoline gained the most since July, outperforming heating oil and crude, as U.S. East Coast inventories slipped to a two-year low and imports declined to the lowest level since February 2004. Imports fell 30 percent, according to data from the Energy Department…Regular gasoline at the pump, averaged nationwide, fell 0.4 cent to $2.888 a gallon yesterday, AAA said on its website.

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- **We plan to increase the amount of new restaurant openings in 2011, to 135 to 145 new restaurants, up from the 120 to 130 restaurants this year. (Even at 135 to 145, growth is going to slow to the teens from the 20's).**
- **We expect about *30%* of those new restaurants next year will be A models. A model locations offer lower development, operating and occupancy costs, which allow us to operate in areas with lower densities, but still generate superior returns. Some of next year's A model openings will be built in developing markets, and will have occupancy costs which are a *little higher*, as in those markets we expect to open these restaurants in Tier 1 trade areas.**
- **Sales increased 23% to 476.9M, driven by opening new restaurants along with a comp increase of 11.4%. The comp resulted in our average restaurant volume exceeding *1.8 million* for the first time. The comp was primarily driven by increased traffic during the quarter.**
- **The average check did increase slightly around 1.4%, with about 0.4% of the check increase due to a small price increase and about 1% of the higher check is due to increased group size per check as our fax and online sales have moved slightly past pre-recession levels.**
- **For the year, sales increased 19.7% to $1.35 billion, which was again driven by new restaurant openings and a comp increase of 8.3%, and a comp increase for the year also was driven mostly by traffic.**
- **Comps have continued to hold up well so far in October, although we will begin to compare against tougher transaction trends in the fourth quarter of last year.**
- **Our comp transactions turned slightly positive in the fourth quarter of 2009, while transaction comps were down about 2.5% in Q3 of 2009.**
- **Guidance for comps 2010: increased *from mid- to high-single digit comps to an expectation of high-single digit comps for the full year. As we look to 2011, we expect comps in the low single digit range, which assumes these trends will continue, but level off each quarter as we compare against higher comp trends.***
- **Diluted EPS for the quarter was $1.52, an increase of 40.7%, and $4.18 for 9 months, an increase of 41.2%. Margins were 27.7% an increase of 220 basis points. For the year, restaurant level margins increased 180 basis points to 26.9%. These margins are the highest we've ever delivered. Food costs were 30.6% for the quarter, which is down 20 basis points from last year. Prices for avocados, corn, rice and chicken were slightly lower in the quarter, which were partially offset by increases in barbacoa and steak due to the continued rollout of naturally raised beef.**
- **Expect modest *increases in our food costs for the fourth quarter* as we continue to invest in increasing our supply of naturally raised chicken and as prices for avocados increase due to a Chilean freeze.**
- **We plan on opening between 135 and 145 restaurants in 2011 with about *30% of those being A models. Most of the A models in 2011will open in proven markets* while we'll explore opening a few A models in new or developing markets. (That's 42ish in 2011 up from 15 in 2010).**
- **For 2010, development costs were $800,000. As CMG moves to a larger percentage of A models and incorporate the new design elements Steve talked about into all new restaurants, anticipate development costs to decline to under $800,000. ~$110M capex.**
- **Early in the quarter, CMG completed our second $100 million buyback and began**

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a third $100 million buyback. Through today we've repurchased almost $24 million worth of stock under the current buyback plan at an average price of around *$154* a share. Our total buyback of *$224M over the past two years* have been at an average price of around $80 a share.

Q&A

- **A: We will open restaurants as quickly as we can find great real estate and run those restaurants with great managers. In 2007, 70% of our restaurants were built in new developments. In 2010, 70% of our new restaurants were built in existing developments; that is to say, only 30% were built in new developments. So we've seen a giant decline in the amount of new restaurant space being built …that's curtailed our ability to build as many restaurants as we otherwise would have built.**
- **A: The A model, which allows us to go into Tier 2 trade areas and other sites that we had formerly not been…Could we go faster? Well, sure. I mean, if more new developments are coming out of the ground and if we find more great sites or if we continue to be pleasantly surprised by the success of our A model strategy even in developing markets, in addition to the proven markets where we're going full steam ahead, that would help us to add restaurants. *Also, as the economy gets better* [hopefully] and there's more developments…**
- **Q: Could you talk a little bit about how you're thinking about pricing and your willingness to take it at this stage and maybe think more broadly about your pricing power?**
- **A: It's been two years now since we've raised prices in most of our markets…we're going to be patient about it. We don't have any pre-determined plans to raise prices.**
- **Q: And much like last year, it looks like Q4 will be pretty heavy in terms of the pace of unit openings. Could you give us a little update on that? And did some move from Q3 into Q4?**
- **A: We're still guiding towards *120 to 130* for this year, so that means it would be *53 to 63* restaurants that we would need to open in the fourth quarter in order to hit that guidance. And we're confident we're going to hit that number. We've got many sites being built now and everything's on course to do that….The volumes in *our A model restaurants*, are just sort of *slightly below* what our traditional restaurants are.**
- **If you take an A model location and a traditional location, and if they have a similar sales volume, the crew labor will be in the same ballpark. It might be slightly less in the A model because it is a smaller restaurant and it does require a little bit less effort in terms of maintaining that restaurant. But crew labor is at least in the same ballpark between the two. But the big difference on the labor line is going to be we typically are going to run the A model with one salaried manager, not two.**
- **New restaurants are coming in because of the A model and because in general *there's a little bit of softening*, even in traditional new restaurants where occupancy on those are coming in a little bit more favorable. Also, the A model strategy is working very well so we estimate that about 30% of our stores next year will be A models. We've got the inventory so we have a high level of confidence in reaching that 135 to 145 number.**
- **Q: It sounds like you can find sites you need. I guess that's my question was, you haven't been able to actually open them, and are you saying that the pace of openings has been**

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more about availability? Or more about your manpower ability, your ability to actually open the site once you have it? In other words, what is slowing...

- **A: No, it's been about availability.**
- **Q: Okay. I think the marketing spend for this year as a percent of sales is a little bit lower than you initially expected. Is that just because sales are so much higher and you didn't have a chance to adjust the budget? Should we expect it to be more in the 1.7% to 1.8% of sales next year again?**
- **A: …marketing put together a budget before the year begins and we didn't plan on the comps that we're experiencing today and yet marketing has stayed to the original budget so that's the main driver of why we're spending right around 1.5%.**

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