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Sustainable Finance Track

1st Prize

A BURRITO WITHOUT INTEGRITY: IS THIS CHIPOTLE FOR ME?

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Abstract

This case, developed primarily from secondary sources, describes the founding of Chipotle Mexican Grill (Chipotle, hereafter) in 1993 by Steve Ells and its rapid ascent to popularity as a fast-casual restaurant based on its unique socially responsible *Food with Integrity* strategy. Under the leadership of founder-CEO Steve Ells and co-CEO Montgomery Moran, Chipotle outperformed the S&P 500 as well as its rivals since its IPO in 2006. However, in 2015, the multiple food contamination outbreaks reversed its course, plunging its stock price to an all-time low. In spite of the prompt actions taken by Chipotle's leadership, the company's stock price did not regain its pre-scandal highs in the stock market. However, on September 6, 2016, news of activist investor, Bill Ackman's purchase of 9.9% of Chipotle's stock gave a much-needed boost to Chipotle's depressed stock. This case gives students the opportunity to step into the shoes of a young individual investor, Michael Jacobs, to assess the potential impact of Ackman's investment on the company's strategy and performance and decide whether or not he should divest his Chipotle holdings.

Case

Chipotle Mexican Grill (Chipotle, hereafter) was in the news again. On November 18, 2016 CNBC's *Nightly Business Report* reported that activist investor Bill Ackman of Pershing Capital and Chipotle had signed a confidentiality agreement that would give Ackman a seat on Chipotle's Board.[1]

Ackman invested $1.2 billion on September 6, 2016. This purchase of about 2.88 million shares, or 9.9% of Chipotle's stock by Ackman's Pershing Square Capital, gave an emphatic boost to Chipotle's stock, igniting its rise by approximately 5.8% to $438.27 the very next day. Thus, media analysts and investors began the debate about Chipotle's future.

Among them was 35-year old Michael Jacobs who was a self-made entrepreneur and a diligent investor bent on making millions before retiring in 15 years. He had invested in Chipotle's stock not only because of its unique positioning due to its socially responsible strategy, but also because of the high growth it had demonstrated. But, Ackman's investment in Chipotle raised questions. How would this new investment impact Chipotle's strategy and revival? Would Ackman pressure Chipotle's leadership to severely cut costs in the short term and jeopardize the company's long-term performance, as pundits had postulated? As an entrepreneur with business experience in the restaurant industry in California, USA, Jacobs wondered to what extent Ackman would influence Chipotle's strategy and business model which was built upon a strong foundation of environmental stewardship.

CHIPOTLE'S HISTORY AND DEVELOPMENT

Chipotle was no stranger to being in the limelight. Under the leadership of founder-CEO-Chairman, Steve Ells, and his co-CEO, Montgomery Moran, the Chipotle brand grew into a highly attractive fast casual restaurant chain. Its enviable position in the U.S. was the result of its unique strategy known as *Food with Integrity*, which reflected Ells' passion[2] for sustainable sourcing of quality food supplies locally. At a time when the term "sustainability" was little known, positioning the restaurant using this distinctive strategy gave Chipotle significant first-mover advantages. Sales had grown to $5 billion in 2015 from $820 million since its Initial Public Offering (IPO) in 2006. The overwhelming demand for the company's shares on the first day of its 2006 IPO resulted in the doubling of the stock's value that day, making it the most lucrative IPO since 2000.

Steven Ells, a graduate of the University of Colorado, Boulder, and the Culinary Institute of America in Hyde Park, N.Y., founded Chipotle in 1993 after working at a San Francisco

[1] http://nbr.com/2016/11/18/bill-ackman-could-soon-have-a-say-in-chipotles-boardroom/
[2] See "Back to the Start" (2:19 minutes)
https://www.youtube.com/watch?v=aMfSGt6rHos&nohtml5=False

This short video clip captures the context behind Steve Ells' passion for environmental stewardship and his "Food with Integrity" strategy.

restaurant. As a line cook earning $12 an hour, Ells found himself regularly "dining [on] giant burritos at Taquerias in the Mission District."[3] During his lunch hours, the long line of customers waiting for Mexican food day-in [and] day-out sparked the idea of starting his own Mexican-themed restaurant.

It was not until July 13, 1993 that Ells was able to open his first restaurant. Armed with a loan of $75,000 from his father, Ells leased a space previously occupied by the Dolly Madison ice cream shop near the University of Denver campus in Denver, Colorado, made the renovations himself to the property, and opened his first restaurant. The restaurant was an instant success generating $450 on opening day, $800 the next day, and $1000 on a day shortly thereafter. Within six months, sales per day grew to $3,000.[4] This high growth fueled by Ells' novel concept attracted the attention of McDonald's which took a minority stake in Chipotle in 1998, followed by a majority stake in 2001. The capital infusion from McDonald's allowed Ells to expand from sixteen restaurants in 1998 to over 500 by October 2006, when McDonald's liquidated its equity in the company. McDonald's was rumored to have reaped over 416% return on its $360 million investment in Chipotle.

Socially Responsible Strategy

Ells entered the highly competitive and fragmented quick service dining industry with a socially responsible strategy that he named, *Food with Integrity.* He was the first in the industry to commit to only serving meats from animals that were not raised using non-therapeutic antibiotics and growth hormones. Dairy products, like cheese and sour cream, were obtained from milk produced by pasture-raised cows. Purchasing ingredients from farmers using sustainable farming practices reflected Ells' love for promoting animal welfare and environmental sustainability. Similar high standards were enforced when Chipotle purchased mostly organically-grown produce from farmers within a radius of 350 miles from the restaurant where the produce was served. This combination of serving traditionally cooked food with high quality locally-grown ingredients in a quick service environment while providing an interactive dining experience blazed the path to Chipotle's success. The restaurant chain, which expanded through the strategy of company-owned stores, attracted celebrities and dignitaries, including President Obama. Using the same quick service concept, Chipotle opened thirteen *Chop House Southeast Asian Kitch*en restaurants serving Asian cuisine, as well as three *Pizzeria Locale* restaurants specializing in pizza and Italian foods.

Products

A key advantage that Chipotle had over competition was its fresh ingredients, local sourcing, healthy cooking practices, and ease of ordering. Chipotle offered a variety of menu choices from which customers could choose. When ordering food, patrons could create their own burrito with their choice of meats, vegetables, beans, rice, salsa, guacamole, cheese or sour cream wrapped inside a Mexican-style whole wheat tortilla (a flat bread) rich in fiber. Alternatively, customers who preferred a gluten-free diet could have their food served in a bowl without the tortilla and still receive ingredients of their choice. Other menu choices included crispy corn tacos, soft corn tacos, soft flour tacos or salads. All ingredients were

[3] https://web.archive.org/web/20080403013733/http://rockymountainnews.com/news/2006/dec/23/chipotle-founder-had-big-dreams/; retrieved on March 17, 2016.
[4] *Ibid.*

openly displayed. Several staff members standing on the opposite side of the display counter filled the orders in real time as customers chose the main and side items while moving down the line towards the cash register. This open-kitchen concept not only shortened the wait time, but also gave customers the chance to feast on the attractive display of the fresh ingredients while their taste buds received stimulation from the exciting flavors that drifted from the freshly made menu items. Compared to other American quick service chains, such as Kentucky Fried Chicken (KFC) and McDonald's, the food Chipotle offered was freshly prepared in the restaurant, nutritious, wholesome, and obtained from sustainable sources. This novel menu concept became Chipotle's source of competitive advantage as busy young professionals and millennials were drawn to the convenience of home-style, high-quality food which offered a range of choices at competitive prices without long wait times.

Employees

By the end of 2015, Chipotle had a total 59,330 non-unionized employees, 5,100 of whom were salaried employees. The remaining 54,230 were hourly workers. The company hired only high-performing employees and promoted general managers from within the organization to ensure that employees embraced the corporate culture, passion, and vision while working in a high-performance work environment. Consistent with Ells' passion for sustainability and social responsibility, Chipotle entered into partnership with Loomsdale, a sustainable clothing company that also engaged in socially responsible production methods. Chipotle's employees wore organic cotton tee-shirts and hats made by Loomsdale, which also made Chipotle merchandise (graphic tees, polos, and woven shirts) which was sold online and in the stores.

Performance

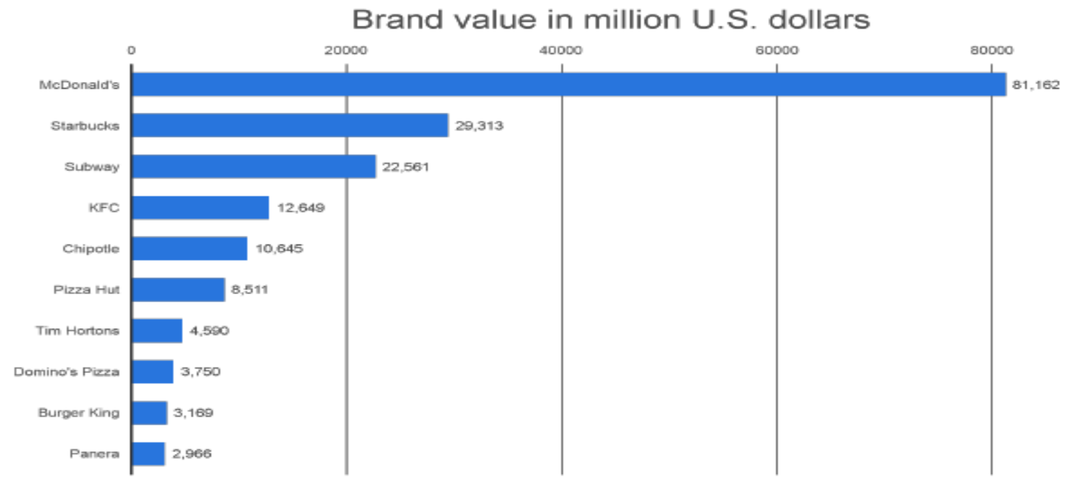
In 2014, Chipotle ranked fifth in worldwide sales, behind McDonald's, Subway, and Yum Brands (see Exhibit 1). With sales of $27.44 billion, McDonald's was the largest player in the industry. Subway ranked a clear second with $20 billion, whereas Yum Brands and Chick-fil-A ranked third and fourth, respectively. Chipotle, which came in fifth in this competitive segment had sales of $4.11 billion in 2014 – approximately 15% of McDonald's revenues. Chipotle was also ranked fifth among the top ten most valuable quick service brands in 2015 (see Exhibit 2). This brand recognition was consistent with its market share in the United States. Statista[5] reported that with a market share of 2.2% in the U.S., Chipotle ranked fifth in 2015, only behind Mc Donals's, Yum Brands, Subway, and Wendy's respectively. This is noteworthy as there were significant differences between Chipotle and its key competitors in strategy and supply chain practices. Additionally, while Chipotle expanded through company-owned stores, companies like McDonald's and BurgerKing became global brands through franchising.

[5] http://www.statista.com/statistics/196611/market-share-of-fast-food-restaurant-corporations-in-the-us/

Exhibit 1:
Global Sales Of Top 10 Quick Service Restaurant Chains
(Source: Statista)

Rank in 2014	Restaurant Chain Name	Sales (Billions Of US$) 2014	Sales (Billions Of US$) 2015	Sales Growth
1	McDonald's	27.44	25.41	-2.03
2	Subway	20.00	19.20	-0.80
3	Yum Brands	13.28	13.11	-0.17
4	Chick-fil-A	6.00	5.70	-0.30
5	Chipotle Mexican Grill	4.10	4.50	0.40
6	Tim Hortons	3.16	2.96	-0.20
7	Wendy's	2.06	1.87	-0.19
8	Domino's Pizza	1.99	2.22	0.23
9	Papa Johns	1.75	1.64	-0.11
10	Jack in the Box	1.45	1.54	0.09

Exhibit 2: Most Valuable Quick Service Brands Worldwide in 2015 (Source: Statista)



Chipotle stood out from its competitors because of its strong commitment to environmental sustainability and social responsibility. Founder Ells' culinary background influenced the way food was prepared at the Chipotle restaurants. It was prepared in the kitchen using high quality fresh ingredients and traditional cooking methods. Despite the high costs of obtaining these ingredients from local farmers who used sustainable practices as well as using organic ingredients wherever possible, Chipotle achieved strong profit performance. The company's indexed performance (see Exhibit 3) indicated that it outperformed the S&P 500 Index and the S&P 500 Restaurants Index from 2010 through 2015. Chipotle's Debt-Equity profile (see Exhibit 4) revealed that, as of 2013, it had raised all the capital needed by issuing stock rather than through debt. This zero-debt strategy was maintained in 2015, as well. The value Chipotle had created for its shareholders was also evident from the Balance Sheet data (see Exhibit 5). This exhibit showed that Chipotle's shareholder equity grew 203.7%, from approximately $1.04 billion in 2011 to $2.13 billion in 2015. The company's

Profit & Loss statement (see Exhibit 6) indicated that cost of revenue (i.e., cost of food and direct labor) were one of the major expenditures in operations. Yet, Chipotle's profits (i.e., Net Income) more than doubled between 2011 and 2015.

Exhibit 3: Comparison of Cumulative Total Returns, 2010-2015
(Source: Chipotle's SEC 10-K filings)

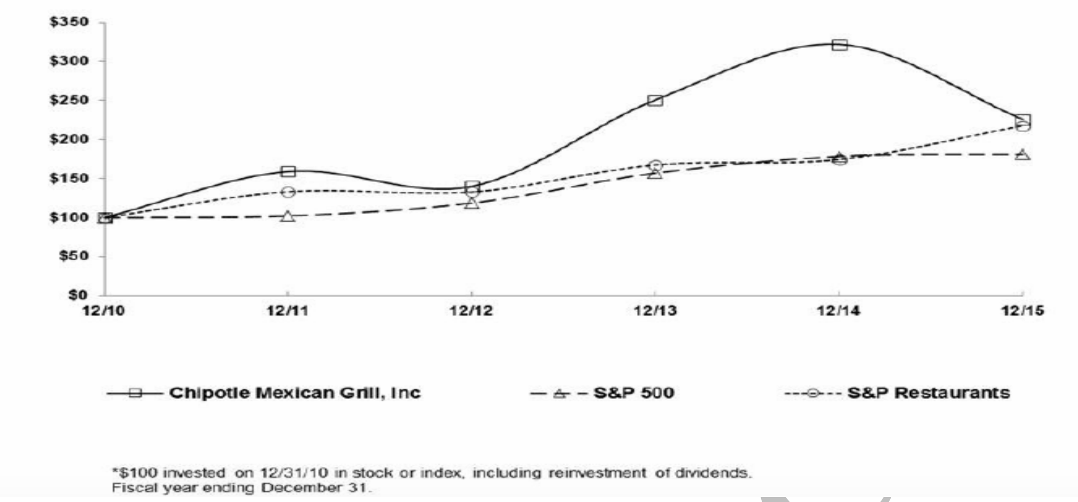
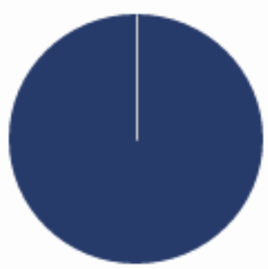


Exhibit 4: Chipotle's Debt-Equity in 2013
(Source: Morningstar Investment Research Center)

Equity and Debt CMG



Type	Mil USD
Equity	1,540.30
Debt	--

Exhibit 5: Chipotle's Consolidated Balance Sheet, 2011- 2015
Source: Morningstar

Fiscal year ends in December. USD in millions except per share data.	2011	2012	2013	2014	2015
Assets					
Current assets					
Cash					
Cash and cash equivalents	401	323	323	419	248
Short-term investments	55	150	255	339	415
Total cash	456	473	578	758	663
Receivables	8	17	24	35	38
Inventories	9	11	13	15	15
Deferred income taxes	6	9	13	19	
Prepaid expenses	21	27	34	35	40
Other current assets		10	4	16	58
Total current assets	501	547	666	878	815
Non-current assets					
Property, plant and equipment					
Gross property, plant and equipment	1122	1312	1491	1721	1938
Accumulated Depreciation	-370	-445	-527	-614	-721
Net property, plant and equipment	752	867	963	1107	1217
Equity and other investments	128	191	314	496	623
Goodwill	22	22	22	22	22
Other long-term assets	22	43	44	43	48
Total non-current assets	924	1122	1343	1668	1910
Total assets	1425	1669	2009	2546	2725
Liabilities and stockholders' equity					
Liabilities					
Current liabilities					
Capital leases	0	0			
Accounts payable	46	59	59	70	86
Taxes payable	16		18	23	16
Accrued liabilities	77	128	91	105	179
Other current liabilities	18		32	48	
Total current liabilities	157	187	199	246	280
Non-current liabilities					
Capital leases		3			
Deferred taxes liabilities	64	49	55	41	32
Deferred revenues	143				
Other long-term liabilities	16	184	216	248	285
Total non-current liabilities	224	236	272	288	317
Total liabilities	381	423	471	534	597
Stockholders' equity					
Common stock	0	0	0	0	0
Additional paid-in capital	677	817	920	1039	1173
Retained earnings	671	949	1277	1722	2198
Treasury stock	-304	-522	-660	-749	-1235
Accumulated other comprehensive income	0	1	2	0	-8
Total stockholders' equity	1044	1246	1538	2012	2128
Total liabilities & stockholders' equity	1425	1669	2009	2546	2725

(1) Data adjusted to conform to the Financial Accounting Standards Board Accounting (FASBA) standards that required deferred tax liabilities and assets to be classified as non-current.

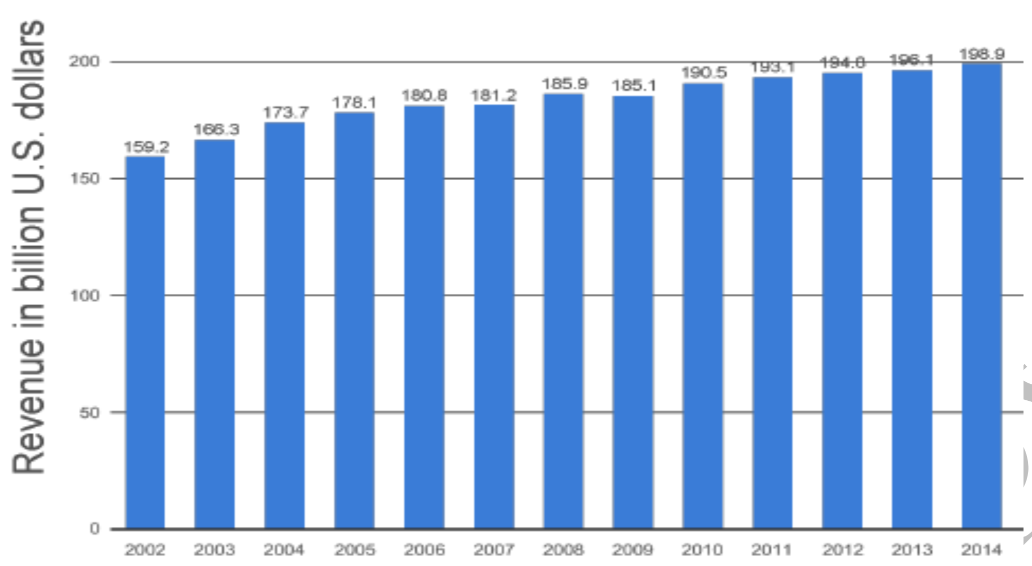
Exhibit 6: Chipotle Mexican Grill Consolidated Profit & Loss Statement, 2011 – 2015

Fiscal year ends in December. USD in millions except per share data.	**2011**	**2012**	**2013**	**2014**	**2015**
Revenue	2270	2731	3215	4108	4501
Cost of revenue	1680	1991	2360	2991	3327
Gross profit	589	740	855	1118	1174
Operating expenses					
Sales, General and administrative	158	195	219	290	267
Other operating expenses	81	89	103	117	144
Total operating expenses	239	284	322	407	411
Operating income	351	456	533	711	764
Interest Expense	3				
Other income (expense)	2	2	2	4	6
Income before taxes	350	458	534	714	770
Provision for income taxes	135	180	207	269	294
Net income from continuing operations	215	278	327	445	476
Net income	215	278	327	445	476
Net income available to common shareholders	215	278	327	445	476
Earnings per share					
Basic	6.89	8.82	10.58	14.35	15.3
Diluted	6.76	8.75	10.47	14.13	15.1
Weighted average shares outstanding					
Basic	31	32	31	31	31
Diluted	32	32	31	32	31
EBITDA	428	540	629	821	894

Source: Morningstar

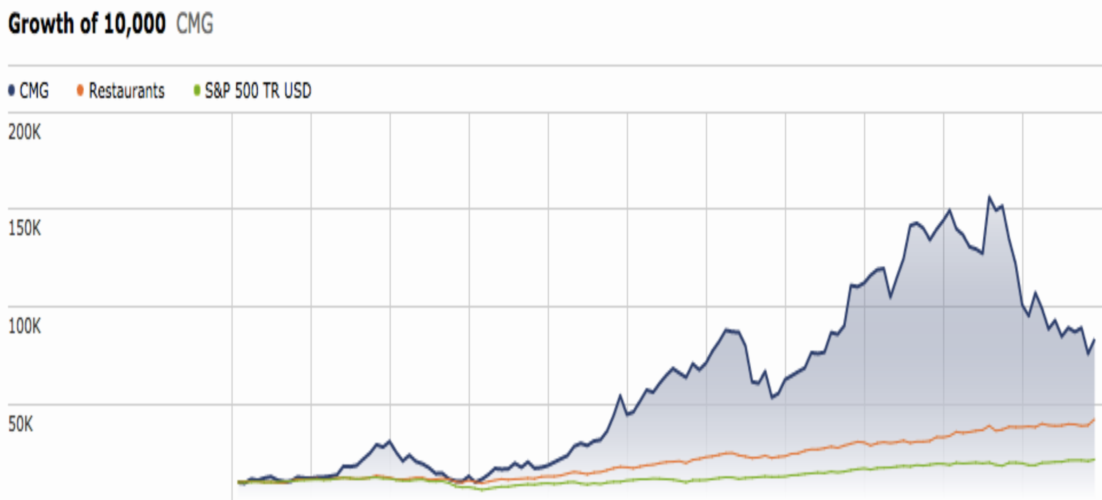
In spite of the highly competitive nature of the industry, industry statistics (see Exhibit 7) indicated that revenues of the quick service industry in the U.S. grew from $159.2 billion in 2002 to $198.9 billion in 2014. This $40 billion revenue growth in the industry may have helped Chipotle become a household name, but the company's strategic site selection also contributed to its success. Chipotle restaurants were located in or near several types of locations including: colleges and universities, strip malls, local and regional malls, downtown business centers, free-standing buildings, food courts, train stations, military bases, and airports. The site selection process was managed by an internal team with the help of local real estate brokers. On-site visits were supplemented by rigorous analyses of trade, business, and demographic data as well as the presence of direct and indirect competitors already located in the area.

Exhibit 7: Revenues of the U.S. Quick service industry, 2002-2014 (Source: Statista)



Chipotle demonstrated strong value to its investors. The 10-year growth of $10,000 invested in Chipotle between 2006 and mid-2016 outpaced growth rates in the restaurant industry as well the S&P 500 (see Exhibit 8).

Exhibit 8: Growth of $10,000 investment from 2006 to Nov 31, 2016

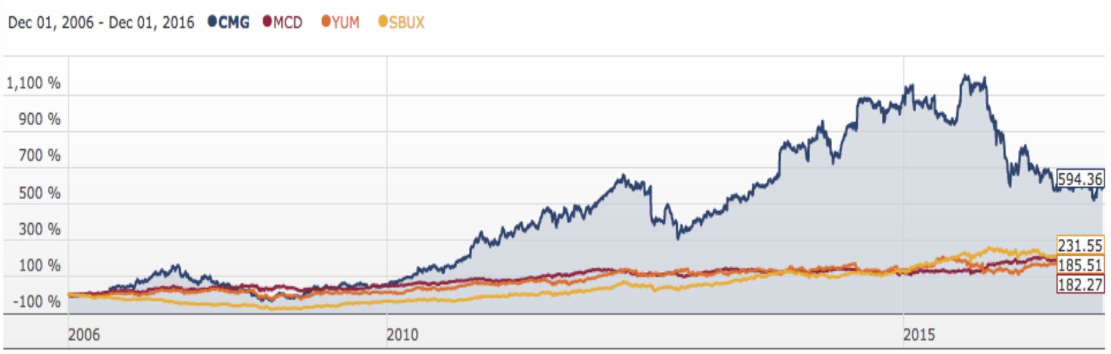


History (11/30/2016)	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	YTD
CMG		158.02	-57.86	42.24	141.22	58.82	-11.93	79.11	28.48	-29.90	-17.41
Restaurants		6.39	-11.96	18.98	35.64	29.44	2.10	30.29	8.55	15.96	10.61
S&P 500 TR USD		5.49	-37.00	26.46	15.06	2.11	16.00	32.39	13.69	1.38	9.79

CMG= Chipotle. Source: Morningstar Investment Research Center

Chipotle's stock price had outperformed competitors like McDonald's and Yum Brands (see Exhibit 9).

Exhibit 9: Stock Price Trends of Chipotle and Competitors, Dec 1, 2006 – Dec. 1, 2016
Source: Morningstar Investment Research Center



CMG: Chipotle; MCD: McDonald's Corp; YUM: Yum Brands, Inc.; SBUX: Starbucks Corp

FOOD CONTAMINATION

In late 2015, Chipotle encountered major food-borne illnesses, including E-coli and Salmonella outbreaks in its multiple restaurants in the U.S. The first contamination occurred on August 20, 2015 in a Chipotle restaurant in California. On the first day, 17 employees at that restaurant were reported to have become ill from the norovirus, which was identified as the source. According to the Environmental Health Division of Ventura County in California, a total of 234 individuals were affected by the food contamination outbreak that surfaced at a Chipotle Restaurant in Simi Valley, California even though the number reported by the news media was considerably less. Health officials who had inspected the restaurant on August 24 found multiple violations which led to "more stringent hand-washing policies" at the restaurant. Similar outbreaks occurred in other states, including Massachusetts on the eastcoast. The news of the contamination sent reverberations through the stock market. Chipotle's stock price plunged from $757 to $475. The sudden loss of $8 billion in value prompted class action lawsuits from investors in June 2016, claiming that Chipotle had failed to reveal that its quality controls were insufficient to safeguard consumer and employee health.

Chipotle's Response

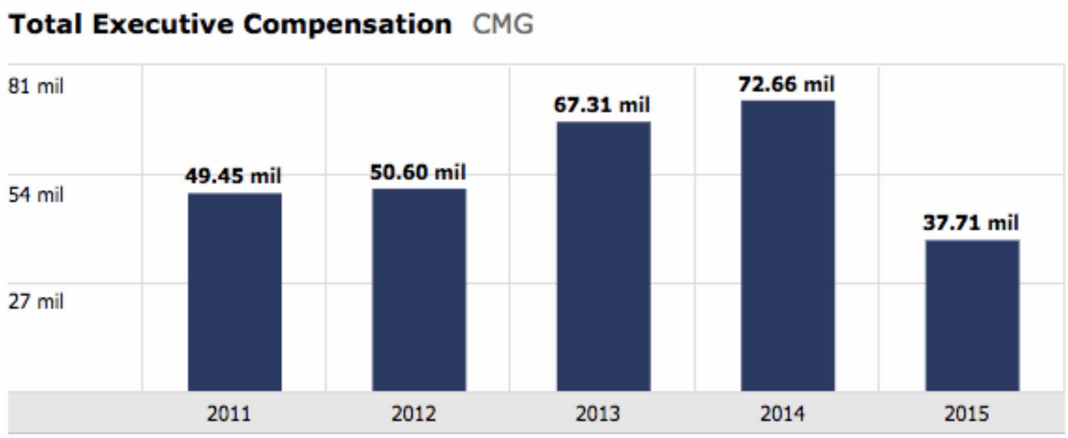
Chipotle's leadership responded swiftly to the food contamination crisis following the receipt of the first e-mail from the ill-fated California restaurant on August 20, 2015. Chipotle's co-CEOs Ells and Moran frantically tried to turn the crisis around through a variety of measures from sending replacements to cover sick employees to restaurant closures, new training procedures implementing stricter handwashing, and food safety procedures at all restaurants. Employees were no longer allowed to bring personal items, including cell phones, near food preparation and handling areas in restaurants. New training manuals were prepared for employees associated with food preparation and serving.

Co-CEO Ells wasted no time. The restaurant chain ran advertisements in major newspapers apologizing for the food contamination that sickened scores of customers and employees in some states. Ells also apologized to those directly affected by the food-borne illness. In his message, he noted: *"From the beginning, all of our food safety programs have met or*

exceeded industry standards…But recent incidents, an E. coli outbreak that sickened 52 people and a norovirus outbreak that sickened approximately 140 people at a single Chipotle restaurant in Boston, have shown us that we need to do better, much better." In an attempt to regain the confidence of its consumers and the public, Chipotle issued coupons for free food and also supplied free food to volunteers of local public radio stations during the stations' fund drives.

Following the watershed in 2015, the top leadership team consisting of the co-CEOs Ells and Moran, CFO John Hartung, and the Chief Creative and Development Officer Mark Crumpacker, took substantial pay cuts (see Exhibit 10).

Exhibit 10: Chipotle's Key Executive Compensation
(Source: Morningstar)



THE NEW INVESTOR

Pershing Capital Management

The fast food industry was a familiar scene to Ackman, who grew Pershing Capital's wealth through investments in large food chains like Burger King, McDonald's, and Tim Hortons. However, a news report[6] indicated that Pershing Capital Management was recovering after a 20.5% loss in value in 2015 and a loss of 14.3% in the first eight months of 2016. Ackman had scaled down his investments in Zoetis,[7] Mondelez International,[8] and Canadian Pacific.[9] Furthermore, his recent failures included J.C. Penney, Herbalife, and Valeant Pharmaceuticals all of which were mired in high profile scandals.

The SEC filing in September revealed that in addition to the purchase of Chipotle's stock, Pershing Capital had obtained the option to acquire approximately an additional 2.3 million

[6] http://www.nytimes.com/2016/09/07/business/dealbook/bill-ackman-chipotle.html?_r=2
[7] Zoetis was the former animal health division of Pfizer, a global pharmaceutical company.
[8] Mondelez makes the popular Oreos.
[9] It was reported that Ackman resigned from his membership on Canadian Pacific's Board following divestiture of his stock holdings of Canadian Pacific.

shares for a price of about $974.3 million[10]. The hedge fund viewed Chipotle as an undervalued company with a “strong brand, differentiated offering, enormous growth opportunity, and visionary leadership.”[11]

Chipotle’s Future

Following the stock purchase, Pershing Square indicated that it would hold discussions about “the governance and board composition, business, operations, cost structure, management, assets, capitalization, financial condition, strategic plans, and the future.”[12] Pershing Capital was following up on its promise as Ackman obtained a seat on Chipotle’s Board.

Investor Michael Jacobs wondered what the future of Chipotle and his personal investment would be. He was a self-made entrepreneur, and at the age of 35, Jacobs was single, co-owned two businesses, and obsessively worked towards his ambition of “becoming a millionaire, buying an island, and retiring at the age of 50.“ He took pride in his ability to achieve his goals. In his own words, “I focus, make money, wake up, and repeat [it all over again].” And he also proclaimed to be “people-oriented.”

Was Chipotle with Ackman on-board going to remain a good opportunity for him? Jacobs speculated about what was going to happen with Chipotle’s *Food with Integrity* strategy, the cornerstone of the company’s corporate social responsibility initiative. A food consumer advocacy group gave Chipotle and Panera Bread high marks for the use of antibiotic-free meats while giving a failing grade to other restaurant chains like Wendy’s, Burger King, Denny’s, and Subway.[13] What if Ackman persuaded Chipotle to abandon its *Food with Integrity* strategy in an effort to cut costs drastically? That would alter the company’s business model significantly!

Jacobs reminisced about what he heard on *Mad Money* in November, where Jack Hartung, Chipotle’s CFO, in his interview with host Jim Cramer had acknowledged that: “the dialogue we’ve had so far with Pershing has talked about driving long-term shareholder value, talks about recovering the business model and from what they’ve said so far, they believe Chipotle is a special brand and we’re going through a tough time right now and they want, just like everyone else, to see us recover our sales, recover our business and if we do that we’re going to get back to our previous stock price and add shareholder value from there.”[14]

While Jacobs was happy to learn about Chipotle’s efforts to increase shareholder value, he was unsure of Chipotle’s prospects for a quick resurgence of its stock price. Knowing Ackman’s propensity for seeking short term gain, could he pose a threat to Chipotle’s innovative, yet costly, supply chain strategy? Would Chipotle succumb to the investors’

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[10] https://www.sec.gov/Archives/edgar/data/1058090/000119312516702094/d233755dsc13d.htm
[11] http://finance.yahoo.com/news/chipotle-expects-meet-soon-ackman-173522106.html
[12] http://www.forbes.com/sites/michelinemaynard/2016/09/07/chipotle-gets-a-1-2-billion-investor-can-he-shake-up-a-stale-menu/?utm_source=yahoo&utm_medium=partner&utm_campaign=yahootix&partner=yahootix&yptr=yahoo#4b7ae4e11fec
[13] As reported on *The Doctors TV* show aired in June 2016.
[14] http://www.cnbc.com/2016/11/09/chipotle-exec-sheds-light-on-conversations-with-billionaire-bill-ackman.html

pressure to cut costs, boost earnings, and drive stock price and make drastic changes to Chipotle's core *Food with Integrity* strategy? He knew that several of his friends were hard-core Chipotle loyalists because of the quality of food that was assured by Chipotle's supply chain strategy. He himself enjoyed the high-quality burritos made with non-GMO ingredients and antibiotic-free meat. He winced at the thought of a Chipotle burrito that would be just like one made at any other fast food restaurant chain. What could happen if *Food with Integrity* was abandoned? Would the Chipotle brand lose its appeal among young professionals and millennials? Jacobs was indecisive. He wondered if Chipotle's distinctive socially responsible strategy no longer sustained the advantages it had originally enjoyed. Was it time for him to divest the Chipotle stock he owned or not?

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Teaching Note

Learning Objectives

After reading and discussing this case in class, students would be able to:

1. **Examine** an organization's strategies and its performance through multiple lenses (i.e., strategic positioning, Corporate Social Responsibility (CSR) performance, and financial perspectives);
2. **Evaluate** the value the company created to its stakeholders through the Triple Bottom Line approach; and
3. **Decide** whether or not individual investors (like Michael Jacobs) should sell their stake in Chipotle Mexican Grill.

Courses

This case is suitable for graduate and undergraduate courses in:

- Sustainable Finance;
- Corporate Strategy; and
- Corporate Social Responsibility

Teaching Plan

An earlier version of this case was tested in several courses.
--An undergraduate capstone course in a hospitality management class in Spring 2016 and was received well by students. The popularity of Chipotle Mexican Grill among students makes it a highly engaging discussion.
--An MBA "Enterprise Solutions" (a second-year) capstone course.
-- Four undergraduate capstone strategy courses in two business schools during Summer 2016 in the Western region of the United States. Three of these courses were taught as online hybrid format, with cases discussed synchronously. The fourth course was taught in traditional on-campus (face-to-face) format. It was received well in **all four** courses, including two that were geared to working/non-traditional undergraduate students. Feedback received indicated that students enjoyed reading the case as they were familiar with Chipotle Mexican Grill and the challenges it faced following the food contamination episodes. Students asserted that the case sparked their curiosity and the discussion that ensued was engaging to them. They also indicated that the writing style, including the opening paragraph, piqued their interest. So, they thoroughly enjoyed reading and discussing the case.
This case is intended for a discussion of 90 - 110 minutes. It lends itself well to group presentations, where pre-assigned groups may be asked to present their analysis and recommendations. Instructors may also use it as a final exam case. The case author used it as a final exam case in one MBA course taught in Fall 2016 and three of the above undergraduate capstone Strategy courses taught in Summer 2016. Maximum benefit can also be obtained if this case was paired with a case on McDonalds' or Burger King as students will have the opportunity to compare and contrast the respective business models of competitors with Chipotle and the overall value created by each of them.

In summary, this case lends itself well to all formats, i.e., instructor-facilitated case discussion in both traditional and online formats, student presentations, and a final exam case.
The following discussion was crafted for an instructor-facilitated open discussion of the case in class.

Video Resources:

Instructors may wish to show one or both of the following YouTube videos before discussing the case in class.

1. "**Back to the Start"** (2:19 minutes)
   https://www.youtube.com/watch?v=aMfSGt6rHos&nohtml5=False

This short video clip captures the context behind Steve Ells' "Food with Integrity" strategy, the backbone of Chipotle's business model.

2. "**Chipotle Story - How It All Started**" (5:11 minutes)
https://www.youtube.com/watch?v=wmH73Diqf5Q
This five-minute video provides the background story of how Steve Ells created Chipotle Mexican Grill. The story, narrated by the founder himself, gives an overview of the company and its strategy. It also takes viewers behind the scenes to show how the company was run.

Research Methodology

The case was developed primarily from publicly available secondary sources, including newspaper articles, media reports, SEC filings by the company, and the Ventura County's Environmental Health Division in Simi Valley, California. No names in the case have been disguised, including Michael Jacobs, the millennial investor featured in the case. The author has no relationship with the company.

Theoretical Frameworks

Leadership & Corporate Governance:

1. Cremer & H. Bettignies, "Pragmatic Business Ethics," *Business Strategy Review*, vol. 24, no. 2, 2013, pp. 64-67. Also in in Thompson A.A. et al., *Crafting and Executing Strategy: The Quest for Competitive Advantage*. New York, NY: McGraw Hill Education, 2016 (20th Ed), pp R-114-116.
2. Hamel, G., "Leaders as Stewards," *Leadership Excellence*, vol.29, no. 8, 2012, p. 5. Also in Thompson A.A. et al., *Crafting and Executing Strategy: The Quest for Competitive Advantage*. New York, NY: McGraw Hill Education, 2016(20e), pp R-117-118).
3. Knights, J., "Ethical Leadership: How to Develop Ethical Leaders." http://tandf.msgfocus.com/files/tfinf_tandf/project_662/WP-TL1V2-2016_Transpersonal_Leadership_WP_1_r4.pdf; downloaded on May 30, 2016 @1:15 pm.

Strategy & Financial Analysis

1. Porter, M.E., *Competitive Strategy.* New York, NY: The Free Press, 1980, pp. 34-41.
2. Wheelan, T., *et al., Concepts in Strategic Management and Business Policy: Globalization, Innovation, and Sustainability.*Pearson Education, NJ., 2015
3. Evans, M.H.,*"Evaluating Financial Performance,"*downloaded from www.exinfm.com/training/pdffiles/course01.pdf

TEACHING PLAN

Videos (10 min) (optional)

Discussion Questions

1. ***How did Chipotle succeed in the United States***? (10 min)
2. ***Evaluate Chipotle's success prior to the food contaminations in December 2015.*** (15-20 min)
3. ***What actions did Chipotle's leadership take after the widespread food contaminations occurred in California, Massachusetts, and other States?*** (10-15 min)
4. ***Evaluate Chipotle's leadership and Corporate Governance.*** (15 min) (Only for Strategy courses)
5. ***What are the Strengths and Weaknesses of Chipotle?*** (15 min)
6. ***Conduct a thorough analysis of Chipotle's financial statements. How would you rate the company's performance? (30 min)*** (Optional question for courses in Corporate Social Responsibility as well as Hospitality Management)
7. ***Should Michael Jacobs sell off his stake in Chipotle or not?*** (10 min)

The table below are suggested questions for the various courses included above

Finance	Strategy	Corp Social Responsibility
Questions 1/2/3/6/7	All questions (1 through 7)	Questions 1/2/3/5/7

Teaching Tip 1: Post the above discussion questions at least a week in advance and require students to generate answers to Question # 6. Ask them to do a thorough financial ratio analysis and prepare the common-size statements for Chipotle's Income statement and Balance Sheet in preparation for the discussion of the case in class. This strategy also works well when this case is used in online classes.

Teaching Tip 2 (optional): Let students know that you would give bonus points for those who submit the results before the case is discussed. The bonus points could be based on the depth and breadth of the data, analysis, and synthesis of results submitted by students.

Discussion Questions with Answers:

Q1. How did Chipotle succeed in the United States?

Chipotle succeeded in the highly competitive restaurant industry through a strategy of ***differentiation***. Michael Porter in his seminal book[15] proposed *differentiation* as one of the three generic competitive strategies companies used to compete against rivals. According to him, *differentiation* is the ability of a company to provide unique and superior value tot he buyers in terms of product quality, special features, or after-sales service. Wheelen et al., (2015:170) state that "Differentiation is aimed at the broad mass market and involves the creation of a product or service that is perceived throughout its industry as unique...Differentiation is a viable strategy for earning above-average returns in a specific business because the resulting brand loyalty lowers customers' sensitivity to price."

Founder Jeff Ells implemented this differentiation strategy by positioning the company with a unique concept (fresh Mexican food, with the option for customers to choose their own ingredients), a commitment to environmentally sustainable sourcing practices, and serving high quality wholesome food that was freshly prepared on premises using traditional cooking methods. Additionally, Chipotle delighted its customers by providing an interactive dining experience for its customers. The four pillars that became the foundations upon which Chipotle built its success in the U.S. market are captured below. Instructors may choose to print this exhibit or project it on to the screen in the classroom.

<u>Power Point slides are available for instructors wishing to adopt this case</u>

[15] Porter, M.E., *Competitive Strategy*. New York, NY: The Free Press, 1980, pp. 34-41.

Unique Concept	Sustainability Strategy	Quality Wholesome Food	Interactive Experience
• Fast casual Mexican food	• Priced to reflect quality instead of low cost/value approaches • Company-owned restaurants instead of franchises • Sustainable Financial Strategy	• High quality (mostly organic) ingredients • Fresh locally sourced supplies • Non-GMO & antibiotic-free meats • Traditional cooking methods	• Menu items displayed in buffet style • Service staff preparing the order as customer selects main and side items from food items on display

Q2. *Evaluate Chipotle's success prior to the food contaminations in December 2015.*

Each of the four pillars (displayed above) were practices that did not exist in the industry until Chipotle opened its first restaurant in Denver, Colorado on July 13, 1993. As such, Chipotle was able to garner significant first-mover advantages, which resulted in its high success, as measured by the following metrics.

A. Sales growth
B. Profit growth
C. Number of restaurants
D. Overseas expansion
E. Number of employees
F. Brand recognition and Market share
G. IPO success
H. Value created to its one-time investor (McDonald's)
I. Value created to its shareholders since its IPO

A. Sales Growth:

The case noted that Chipotle was a hit from day one. On the first day of its opening, its sales were $450, followed by sales of $800 the next day, reaching $1000 a day mark shortly thereafter. Furthermore, within six months of its opening, sales per day grew to $3,000. Sales growth continued well into 2015.

- Case Exhibit 1 showed that by 2014, Chipotle's worldwide sales grew to $4.11 billion making it the fifth largest U.S quick service restaurant chains in the world.
- Case Exhibit 6 supports this trend. See annual growth rates given in the table below.

	2011	2012	2013	2014	2015
Sales	2270	2731	3215	4108	4501
Annual Growth	--	20%	18%	28%	10%

B. Profit growth:

In spite of the high food costs stemming from its sustainability strategy, known as "Food with Integrity," and cooking practices, Chipotle remained profitable.

- Case Exhibit 6 shows that the company's profits increased from $215 million in 2011 to $476 million in 2015, a 2.2x growth in profits in five years. Annual growth rates given below are equally impressive, except for 2015 (the year in which the food contamination crisis occurred).

	2011	2012	2013	2014	2015
Net Income	215	278	327	445	476
Annual Growth	--	29%	18%	36%	7%

C. Number of Restaurants:
Chipotle grew in the U.S. through company-owned restaurants instead of franchises. As of 2015, Chipotle had a total of 2010 operating restaurants, excluding the 13 *Shophouse - Southeast Asian Kitch*en restaurants serving Asian cuisine, and 3 *Pizzeria Locale* restaurants serving pizza and Italian food that it owned.

D. Overseas Expansion:
The case stated that Chipotle opened its first foreign restaurant in Toronto, Canada, in 2008. In 2010, it expanded to the U.K., to France in 2012, and to Germany in 2013. By the end of 2015, Chipotle owned a total of 23 restaurants overseas.

E. Number of Employees:
Employment data given in the case indicated that by the end of 2015, Chipotle had a total of 59,330 employees on its payroll. Details are as follows.

Employment type	Number
Salaried Employees	5,100
Hourly Employees	54,230
Total	59,330

F. Brand Recognition and Market Share:
As a differentiator in a highly competitive segment occupied by global giants like McDonald's, Subway, and Yum Brands, Chipotle achieved the impossible. Case Exhibit 1 shows that Chipotle ranked fifth by global sales among quick sevice resturants while Case Exhibit 2 shows that Chipotle ranked fifth worldwide among the most valuable brands in the industry, behind McDonald's, Starbucks, Subway, and KFC. Furthermore, sales growth data displayed in Case Exhibit 1 indicates that Chipotle's sales increased from $4.1 billion in 2014 to $4.5 billion in 2015 in spite of the food contamination crisis whereas sales for 8 of the top 10, including McDonald's experienced decline in sales in the same year. The case also indicates that in 2015, Chipotle ranked fifth in market share in the fast food industry in the United States.

G. IPO Success:
According to the case, Chipotle's IPO (initial public offering) in 2006 was hailed as the "best IPO since 2000." The overwhelming demand for the company's shares on the first day of its IPO on January 25, 2006 sent the stock price soaring. In effect, the stock price on the day of the IPO doubled indicating the enthusiasm and optimism investors had for Chipotle's brand and the company's distinctive positioning.

H. Value Created to Its One-Time Investor, McDonald's:
McDonald's investment in Chipotle signaled the confidence Mc Donald's had in Steve Ells' leadership and the merit of Chipotle's unique business model in the industry. McDonald's would have not invested in the young company unless it saw high potential for returns on its investment. Even though the partnership between McDonald's and Chipotle lasted only from

1998 to October 2006, there was mutual value created. Chipotle gained the capital needed for rapid expansion while McDonald's initial investment of $360 million reaped an impressive 416% return.

I. **Value Created to Its Shareholders**

Since its IPO in 2006, Chipotle created stellar returns to its shareholders. According to case Exhibit 3, even with the declines experienced from 2014 to 2015, Chipotle's cumulative stock returns exceeded both the S&P 500 and the S&P Restaurants returns. Case Exhibit 5 showed that the value created by Chipotle to its shareholders was superior. Earnings per Share rose from $6.89 in 2011 to $15.3 in 2015. The annual growth rates of Chipotle's Shareholders' Equity are displayed below.

	2011	**2012**	**2013**	**2014**	**2015**
Total Shareholders' Equity	1044	1246	1538	2012	2128
Annual Growth rates	--	19%	23%	31%	6%

Q3. What actions did Chipotle's leadership take after the widespread food contaminations occurred in California, Massachusetts, and other States?

In response to the food contamination crisis, Chipotle's leaders engaged in operational and strategic actions to avert the carnage.

Operational Responses to the Crisis:

Chipotle took immediate action after the food contaminations occurred in the various locations. It sent employees to replace those that were sick, closed down restaurants until they were cleared by local health officials, complied with everything they were asked to do, quickly instituted additional food safety policies and procedures to be followed by its employees in an attempt to avert more problems. It also developed stringent training manuals and required additional training for all its employees. New policies prohibited employees from having personal items, such as cell phones, in close contact while preparing or handling food.

Strategic Responses to the Crisis:

In addition to instituting new and stricter internal policies and procedures, Founder CEO Ells sent apology letters to those affected by the food contamination assuring them of higher standards in place. The company also ran advertisements in the local newspapers admitting their mistake and engaged in averting a public relations crisis.

In all, the company's management demonstrated good leadership in crisis and promptly made every attempt to correct their mistakes and keep the public informed of changes being made. They also tried to regain the confidence of the consumers by issuing coupons for free burritos and providing free food for volunteers of local public TV stations during their fundraising drives.

Furthermore, as Case Exhibit 10 shows that Chipotle's executives took pay cuts amounting to $34.95 million in 2015. This signals high integrity on the part of Chipotle's leaders as they take responsibility for the widespread food contamination problem that occurred in 2015.

Q4. Evaluate Chipotle's leadership and Corporate Governance.

Students would have no hesitation in giving high marks to Chipotle's Founder-CEO, Steve Ells and his management team for their success in the following areas.

A. **Positioning** Chipotle in a highly competitive fast-casual dining industry using a socially conscious and environmentally sustainable *Food with Integrity* strategy by sourcing from local farmers who practiced organic and sustainable farming practices long before environmental sustainability became a buzz word in the business environment.

B. <u>**Growing**</u> the company through strong brand management practices and successfully competing in the industry through company-owned restaurants instead of franchising as was the norm in the industry.
C. <u>**Outperforming**</u> the peers in the industry and S&P 500 in stock returns and overall shareholder value created.
D. <u>**Controlling**</u> the economic risks by holding little or no debt in its capital structure.
E. <u>**Instituting**</u> a high-performance culture through careful selection and training human resource practices.
F. <u>**Creating**</u> high value to all its stakeholders and local communities.

Thus, Chipotle's top management team embodied positive leadership as noted by leadership and strategy scholars like Knights (2016)[16], Hamel (2012)[17], and Cremer & Bettignies (2013)[18], who call for a revolution in the values demonstrated by corporate leaders. In a capitalistic world where shareholder value creation reigns supreme in all corporate decisions even at the expense of the general well-being of humanity and the environment, it is refreshing to see how Steve Ells built a successful corporate empire on the foundations of social responsibility and environmental stewardship. Furthermore, the transparency and crisis management operations also command high marks in corporate governance. The fact that the top leadership took a significant pay-cut the tune of 48.1% following the food contamination crisis in 2015 is testament to the strong positive corporate governance and values that form the bedrock of the leadership culture at Chipotle.

Q5. What are the Strengths and Weaknesses of Chipotle?

<u>**Strengths:**</u>

- Clear and consistent business concept with a unique strategy.
- High position as a popular and sustainable U.S. chain brand (see case Exhibit 1).
- Strong brand image (see case Exhibit 2).
- Strong brand management practices.
- Non-franchised model ensures higher customer experience with greater managerial controls.
- Solid Sales and profit performance (see case Exhibits 4&6, and discussion presented earlier).
- Good returns to investors along with high stock performance made this company attractive to investors (see case Exhibits 3, 4, 6, 8 & 9 and discussion presented above).
- Strong track record of attracting capital from investors and the stock market.
- No debt in its capital structure (see case Exhibit 5).
- Management's ability to create a supply chain using local and sustainable sourcing practices
- Leadership expertise in dealing with uncertainties in the supply chain associated with dealing with local small farmers using organic and/or sustainable farming practices.
- Creating value in local communities.
- Unique culture of promoting a high-performance culture as well as environmental stewardship and social responsibility.
- Strong human resource practices, including hiring, training, and promotion from within the organization.
- Mature restaurant chain operations.
- Convenient food service systems that meets the emerging needs of the urban China

[16] Knights, J., "Ethical Leadership: How to Develop Ethical Leaders." http://tandf.msgfocus.com/files/tfinf_tandf/project_662/WP-TL1V2-2016_Transpersonal_Leadership_WP_1_r4.pdf; downloaded on May 30, 2016 @1:15 pm.
[17] Hamel, G., "Leaders as Stewards," *Leadership Excellence*, vol.29, no. 8, 2012, p. 5.
[18] Cremer & H. Bettignies, "Pragmatic Business Ethics," *Business Strategy Review*, vol. 24, no. 2, 2013, pp. 64-67.

- Affordable pricing strategy of quick casual restaurant along with high quality local non-GMO, organic, and antibiotic-free meats is attractive to young professionals and millennials.
- The menu variety provides wide choices for customers with different tastes.
- Effective order line can serve more customers during the busy rush hours.
- Quick response by executives to the food contamination crisis and significant executive pay cuts demonstrates responsible leadership.

Weaknesses:

- The presence of two (co-) CEOs increases costs, duplication, bureaucracy, and constrains the company's ability to react quickly to changing market trends.
- High labor costs (as a percentage of sales): ranging from 22% to 24%. Taken in the context of the large proportion of hourly employees (91.4%) in comparison to salaried employees (8.6%), it signals the existence of a potential labor problems in the form of high labor turnover.
- The high-performance culture in the organization may increase stress levels at work, thus potentially leading to the risk of high labor turnover.
- Promoting from within the ranks of the organization constrains the ability of the company to hire the staff and talent required to pursue high growth as well as hiring managerial staff with the necessary expertise and experience to seek aggressive expansion.
- Non-franchised model inhibits growth.

Q6. Conduct a thorough analysis of Chipotle's financial statements. How would you rate the company's performance?

Assign this question in advance to students and consider giving bonus points to elicit a thorough preparation. See *Teaching Tips* included earlier.
I require my students to answer this question in three steps. In step 1, I ask them to translate the financial statements into Common-size statements and analyze the results based on the data trends. In step 2, I ask them to generate a complete set of ratios for all the five years of data included in the financial exhibits and evaluate the trends in the data 2.
In each of the two steps, I require them to systematically present their conclusions for each ratio or group of ratios.

Step 1: Analysis of CMG's Common-size statements

CHIPOTLE'S COMMON SIZE (INCOME) STATEMENT (Source: Morning Star)					
Fiscal year ends in December.Data for 12 months.	2011	2012	2013	2014	2015
Revenue	100.00%	100.00%	100.00%	100.00%	100.00%
Cost of revenue	74.04%	72.89%	73.41%	72.79%	73.91%
Gross profit	25.96%	27.11%	26.59%	27.21%	26.09%
Operating expenses					
Sales, General and administrative	6.96%	7.15%	6.82%	7.05%	5.93%
Other operating expenses	3.56%	3.26%	3.20%	2.86%	3.19%
Total operating expenses	10.52%	10.42%	10.02%	9.91%	9.12%
Operating income	15.45%	16.69%	16.57%	17.30%	16.96%
Interest Expense	0.13%				
Other income (expense)	0.09%	0.07%	0.05%	0.09%	0.14%

Income before taxes	15.41%	16.76%	16.63%	17.39%	17.10%
Provision for income taxes	5.94%	6.58%	6.44%	6.55%	6.54%
Net income from continuing operations	9.47%	10.18%	10.19%	10.84%	10.57%
Net income	9.47%	10.18%	10.19%	10.84%	10.57%
Net income available to common shareholders	9.47%	10.18%	10.19%	10.84%	10.57%
Earnings per share (EP					
Basic	6.89	8.82	10.58	14.35	15.3
Diluted	6.76	8.75	10.47	14.13	15.1
Weighted average shares outstanding					
Basic	31	32	31	31	31
Diluted	32	32	31	32	31
EBITDA	18.84%	19.77%	19.56%	19.99%	19.86%

Comments and Conclusions:

1. Inspite of some volatility, the cost of revenue has trended downward from 74.04% in 2011 to 73.91% in 2015.
2. This declining trend is evident in all operating expenditures, including SG&A.
3. Gross profit, operating income, net income, and EBITDA show an increasing trend between 2011 and 2015 despite the small dip from 2014 to 2015 resulting from the contamination crisis.
4. The two items that are noteworthy are the absence of interest expense since 2012 and the consistent rise in EPS, year-after-year.

CHIPOTLE'S BALANCE SHEET IN COMMON SIZE FORMAT					
Fiscal year ends in December.Data for 12 months.	**2011**	**2012**	**2013**	**2014**	**2015**
ASSETS					
Current assets					
Cash					
Cash and cash equivalents	28.15%	19.33%	16.09%	16.47%	9.10%
Short-term investments	3.86%	9.01%	12.69%	13.30%	15.24%
Total cash	32.01%	28.34%	28.78%	29.77%	24.34%
Receivables	0.59%	1.01%	1.20%	1.37%	1.40%
Inventories	0.63%	0.66%	0.65%	0.60%	0.55%
Deferred income taxes	0.44%	0.53%	0.66%	0.74%	
Prepaid expenses	1.50%	1.64%	1.70%	1.37%	1.47%
Other current assets		0.58%	0.18%	0.65%	2.13%
Total current assets	35.16%	32.76%	33.16%	34.50%	29.89%
Non-current assets					
Property, plant and equipment					
Gross property, plant and equipment	78.73%	78.60%	74.19%	67.58%	71.12%
Accumulated Depreciation	-25.97%	-26.66%	-26.25%	-24.10%	-26.45%
Net property, plant and equipment	52.76%	51.94%	47.94%	43.47%	44.67%

Equity and other investments	9.00%	11.44%	15.62%	19.48%	22.86%
Goodwill	1.54%	1.31%	1.09%	0.86%	0.81%
Intangible assets					
Other long-term assets	1.54%	2.55%	2.19%	1.68%	1.77%
Total non-current assets	64.84%	67.24%	66.84%	65.50%	70.11%
Total assets	100.00%	100.00%	100.00%	100.00%	100.00%

Comments and Conclusions:
1.Cash and cash equivalents declined significantly from 28.15% of Total Assets in 2011 to 9.1% in 2015. This is not bad in light of the fact that short-term investments rose dramatically 3.86% to 15.24% during the same period. However, Total Cash declined approximately 24% in five years, from 32.01% in 2011 to 24.34% in 2015. This may be cause for some concern as Receivables more than doubled, from 0.59% in 2011 to 1.4% in 2015. However, overall the decline of Total Current Assets is only approximately 15% between 2011 and 2015. These trends do raise some red flags and Chipotle's liquidity would need further scrutiny.
2.While Chipotle's Fixed Asset base (Net Property, Plant, and Equipment) has decreased from 52.76% of Total Assets in 2011 to 44.67% in 2015, the company's equity and Other Investments as a percentage of Total Assets rose sharply, from 9% in 2011 to 22.86% in 2015. This increase has been steady, also occurring in 2015. Overall, data shows a gradual shift from investments in current assets to non-current assets from 2011 to 2015.

CHIPOTLE'S BALANCE SHEET IN COMMON SIZE FORMAT (continued)					
	2011	**2012**	**2013**	**2014**	**2015**
LIABILITIES & STOCKHOLDERS' EQUITY					
Liabilities					
Current liabilities					
Capital leases	0.01%	0.01%			
Accounts payable	3.25%	3.52%	2.94%	2.73%	3.15%
Taxes payable	1.15%		0.87%	0.90%	0.57%
Accrued liabilities	5.37%	7.67%	4.54%	4.13%	6.55%
Other current liabilities	1.26%		1.57%	1.89%	
Total current liabilities	11.05%	11.20%	9.92%	9.65%	10.27%
Non-current liabilities					
Capital leases		0.20%			
Deferred taxes liabilities	4.52%	2.93%	2.76%	1.59%	1.19%
Deferred revenues	10.05%				
Other long-term liabilities	1.12%	11.00%	10.77%	9.73%	10.45%
Total non-current liabilities	15.69%	14.14%	13.53%	11.32%	11.64%
Total liabilities	26.74%	25.33%	23.44%	20.97%	21.91%
Stockholders' equity					
Common stock	0.02%	0.02%	0.02%	0.01%	0.01%
Additional paid-in capital	47.47%	48.94%	45.78%	40.80%	43.03%
Retained earnings	47.11%	56.90%	63.55%	67.64%	80.65%
Treasury stock	-21.36%	-31.25%	-32.87%	-29.41%	-45.31%
Accumulated other comprehensive income	0.01%	0.06%	0.08%	-0.02%	-0.30%

Total stockholders' equity	73.26%	74.67%	76.56%	79.03%	78.09%
Total liabilities and stockholders' equity	100.00%	100.00%	100.00%	100.00%	100.00%

Comments and Conclusions:

1. Total Current Liabilities, expressed as a percentage of Total Liabilities and Stockholders' Equity showed a gradual declining trend until 2014, but rose slightly in 2015, mainly due to a small increase in Accounts Payable from 2014 to 2015. Total Liabilities show a similar trend.
2. It appears that Chipotle has increased its pool of Retained Earnings from 47.1% of Total Assets in 2011 to 80.65% in 2015 while scaling back its Treasury Stock. The net effect has been a steady growth in Total Stockholders' Equity from 2011 to 2015 in spite of a slight decline in 2015.

Step 2: Financial Ratio Analysis

Profitability	**2011**	**2012**	**2013**	**2014**	**2015**
Net Margin %	9.47	10.18	10.19	10.84	10.57
Asset Turnover (Average)	1.78	1.77	1.74	1.8	1.71
Return on Assets %	16.88	17.97	17.81	19.55	18.04
Financial Leverage (Average)	1.36	1.34	1.31	1.27	1.28
Return on Equity %	23.17	24.28	23.52	25.09	22.97

Comments and Conclusions:
Overall, Profitability ratios have shown steady growth from 2011 to 2015. However, the decline shown in 2015 is clearly a result of the food contamination crisis experienced that year.

Liquidity/Financial Health	**2011**	**2012**	**2013**	**2014**	**2015**
Current Ratio	3.18	2.93	3.34	3.58	2.91
Quick Ratio	2.95	2.67	3.04	3.29	2.71
Financial Leverage	1.36	1.34	1.31	1.27	1.28

Comments and Conclusions:
In spite of the fluctuations in the liquidity ratios, the sharp decline in 2015 is consistent with the conclusions presented earlier in the discussion of Chipotle's common-size statements. However, the high liquidity in this company is due to the zero-debt strategy it employed. In other words, Chipotle has financed its growth through internally generated funds rather than debt or equity.

Efficiency	**2011**	**2012**	**2013**	**2014**	**2015**
Days Sales Outstanding	1.13	1.68	2.32	2.61	2.96
Days Inventory	1.74	1.83	1.87	1.73	1.67
Payables Period	8.7	9.63	9.1	7.85	8.52
Receivables Turnover	323.14	216.86	157.52	139.61	123.12
Inventory Turnover	209.9	199	195.51	210.78	219.06
Fixed Assets Turnover	3.18	3.37	3.51	3.97	3.87
Asset Turnover	1.78	1.77	1.74	1.8	1.71

1. Comments and Conclusions:

2. Note that the Days Sales Outstanding has steadily increased from 1.13 days in 2011 to 2.96 days in 2015. This may be symptomatic of increasing competition, maturity of the market and industry or a change in the customer base from individuals to other businesses. Overall trend in the Days inventory is favorable since it has declined from 2011 to 2015 (despite some fluctuations) indicating efficient inventory management.
3. Trends in the Payables period also declined modestly in spite oft he fluctuations. This low number is in the single digits which indicates how quickly Chipotle pays its suppliers. This low number is consistent with the company's socially responsible strategy of treating its local suppliers well by paying them promptly. The increase from 7.85 days in 2014 to 8.52 days is modest considering the severity oft he food crisis experienced by Chipotle.
4. The Receivables Turnover data and trends are consistent with "Days Sales Outstanding."
5. The continuous increase in Fixed Asset Turnover is consistent with sales growth as well as the decline in fixed assets discussed earlier.
6. Overall, the company appears to be operating efficiently.

Q7. *Should Michael Jacobs sell off his stake in Chipotle or not?*

This question allows to bring the discussion to a conclusion by highlighting the key pros and cons of divesting Chipotle's stock.

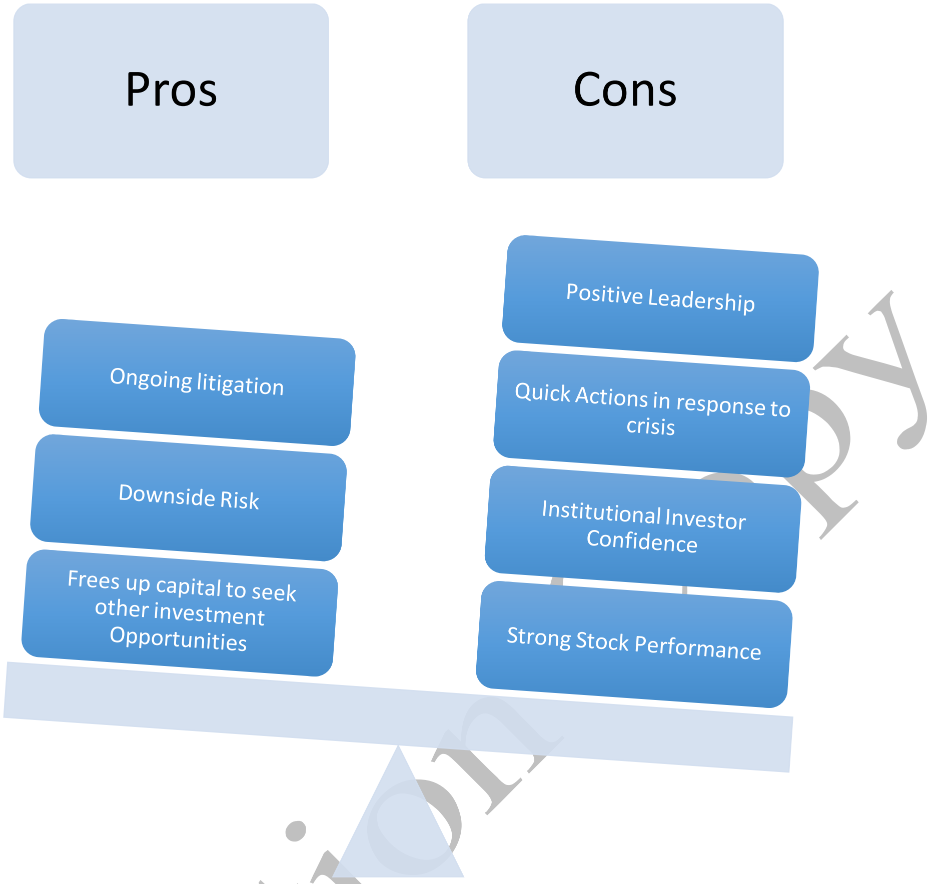
Arguments in Favor of Divesting:

- It is risky for Michael Jacobs to continue owning Chipotle's stock pending the Justice Department's probe and class action lawsuits the company currently faces.
- Divesting will minimize the potential downside risk of unfavorable outcomes from pending litigation.
- Divesting will free up Jacobs' investment dollars to seek less risky investment alternatives.
- Jacobs should divest immediately if Chipotle decides to focus on cutting costs without taking appropriate steps to grow revenues simultaneously.
- Jacobs should divest if he senses that the *Food with Integrity* strategy would be discontinued as that would not only erode Chipotle's brand but do irreparable damage to the company's future. Chipotle's business model without this unique supply chain strategy would wipe out its distinctive differentiation advantage in this highly competitive fragmented industry. A Chipotle burrito *sans Integrity* would tantamount to an expensive burrito à la Taco Bell or McDonald's!

Arguments Against Divesting:

- Strong stock performance from the beginning as well as continuing strong performance as indicated in Case Exhibits 8 and 9 as well as the others discussed earlier.
- Continuing strong stock performance as compared to rivals even after the food contamination crisis as seen from case Exhibit 9.
- Sales increase in 2015 when major competitors like McDonald's had decline in sales.
- Rally in the stock market following activist investor, Ackman's stock purchase. In addition to a positive impact on Chipotle's cash flow, it signals optimism that Ackman could bring new insights and bring about the necessary changes in an expeditious manner.
- The fast and appropriate responses to the food contamination crisis that occurred in late 2015 demonstrates that Chipotle's leadership has sound crisis management skills. Additionally, the fact that Chipotle's top management took significant pay-cuts speaks to the remarkable corporate governance mechanisms in place at Chipotle.
- Under Ells' leadership, the company continues to demonstrate positive and responsible leadership through its socially responsible strategy of *Food with Integrity*, earning it the respect of consumer advocacy groups like The Consumer Union. The Consumer Union, as was the Center for Disease Control (CDC), was concerned with the adverse effects of elevated levels of antibiotics in the American food supply chain.

Below is an exhibit summarizing the pros and cons discussed above.



At the end of this discussion, take a vote and record how many students are in favor of Chipotle keeping the *Food with Integrity* strategy. 90% of both undergraduate and graduate students voted in favor of Chipotle continuing its *Food with Integrity* strategy and Jacobs keeping his Chipotle stock ownership. However, they pointed out that Jacobs should divest Chipotle's stock if the company was forced to abandon its unique supply chain strategy.

Epilogue

As of February 2017, the case against Chipotle was continuing in the Courts. There was no decision handed down by the Department of Justice. Chipotle tried to engage in quick damage control through aggressive marketing, spending about $2 million in giving coupons and free food to lure back its customers, and posted new videos about the safety of its food. As the case points out Chipotle's stock is on the upswing and Ackman's investment was seen as a welcome move, but there is uncertainty around the future of the *Food with Integrity* strategy, which of fueled the birth health-food consciousness and a movement in the US against the use of GMO and antibiotics in the food supplies procured by the restaurant industry.

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