GLOBAL IDEAS

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Chipotle Mexican Grill: The disrupter

Investment thesis:
Chipotle Mexican Grill (CMG:US) offers investors an opportunity to own one of the great sector disrupters in the US' consumer discretionary space. However, this comes at a price. At the current 12-month forward P/E multiple of 39x, the share is priced for perfect execution of the Group's current growth strategy but, in our opinion, currently offers too much downside risk. The sector, which includes large mature companies like McDonald's Corp, Yum Brands and Burger King averages a forward 24x P/E multiple. The sector is not experiencing any meaningful real, organic top-line growth, measured by the growth in same-store sales (SSS), which has grown at 3.6% over the past 5 years (*Source: Bloomberg)*.

Chipotle has been growing well above that since listing on the New York Stock Exchange (NYSE) in 2006. The brand has become synonymous with many things that the traditional fast food chains haven't including responsible farming methods, organic food produce and freshly prepared meals. All of these are concepts that have contributed to the meteoric rise of the Chipotle brand, so much so, that Chipotle is not considered fast food, but rather pioneering a new sub-category in the US dining sector - **Fast Casual**.

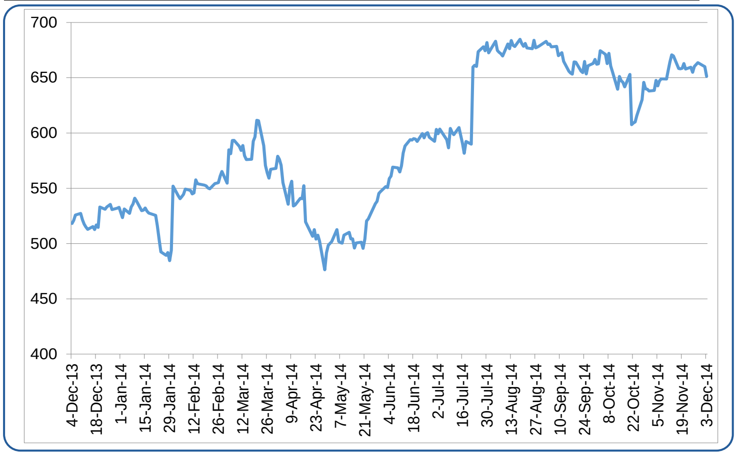
In a recent call with the Chipotle management team, they admitted to being pleasantly surprised at the rate at which the US public have bought into the "Chipotle way". The most recent 3Q14 SSS figure showed 19% YoY growth, including the effects of an above inflation price increase - adjusting for this the growth was 10% YoY in real terms.

Management indicated that they expect the SSS growth to be in the region of 5%-6% in FY15 vs an estimated 15.5% for FY14. This YoY decrease is due largely to the high base from which it will be growing. According to management the growth in new restaurants will be between 190—205 over the next 12 months, resulting in our estimates of revenue growth of 16%. With slight margin leverage, we believe Chipotle will grow adjusted EPS by 20% p.a. for at least the next 3 years, thus maintaining its current premium rating in the sector.

By applying a 27x exit P/E multiple to our FY20 estimate of adjusted EPS, we arrive at a value $1,140/share, add to this a cash value of $40/share and the implied internal rate of return (IRR) is just above 10%. The exit multiple is a 20% premium to the sector, which we believe is justified due to Chipotle's superior growth prospects post FY20.

Overall, we believe the Chipotle brand will continue to go from strength to strength, therefore in times of weakness our strategy will be to reassess the valuation and long-term prospects of Chipotle, using possible price weakness as an entry point.

Figure 1: Chipotle one-year share price performance,$:



Source: Bloomberg. Anchor Capital

Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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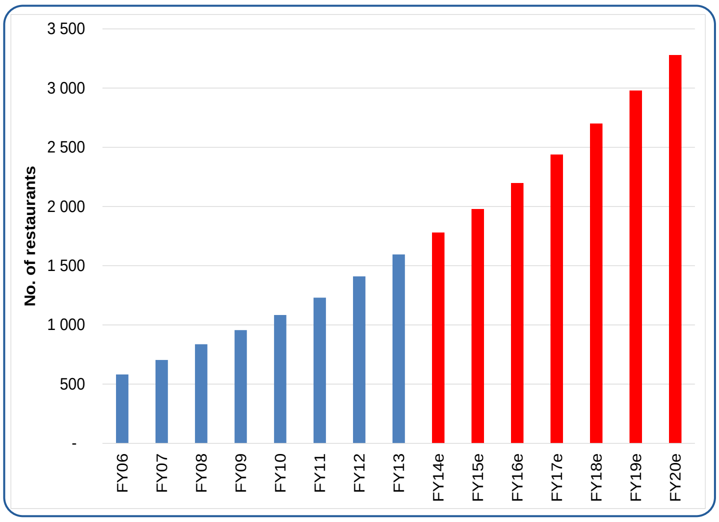
The history:

When Steve Ells, the founder of Chipotle Mexican Grill, left culinary school in 1993 all he wanted to do was open up his own fine-dining establishment in his home town of Boulder, Colorado. Due to financial constraints he soon realised this wasn't going to be possible, so he decided to open up a small and simple Mexican take-away restaurant near the University of Denver's main campus. He took the concept from a Mexican eatery named Zona Rosa where he ate while he was completing his studies and working as a line chef at a high-end restaurant in San Francisco. To do this he borrowed $85,000 from his father, with the intention of saving enough money to finally open up his fine dining restaurant.

When he opened the first Chipotle in 1993, he worked out that he would need to sell 107 burritos each day to break even. After one month, the original restaurant was selling over 1,000. The profitability of the first restaurant managed to finance the opening of the second restaurant, which saw similar success. This led Steve to raise additional capital in order to fund more growth and in 1998 McDonald's expressed interest and became the biggest investor in Chipotle. The success of the restaurants continued and in January 2006 Chipotle filled for an IPO, having to raise the IPO guidance range twice due to high demand from investors.

At the end of 2006 McDonald's sold its stake in Chipotle for approximately $1.5bn, banking a profit of $1.2bn. Over the years McDonald's had built up a 90% stake in Chipotle, an investment that would be worth over $17bn today. At last count there were approximately 1,700 Chipotle restaurants spanning across the US, with 5 in London, Paris, Toronto and Berlin.

Figure 2: Estimated restaurant growth:



Source: Company data, Anchor Capital

The concept:

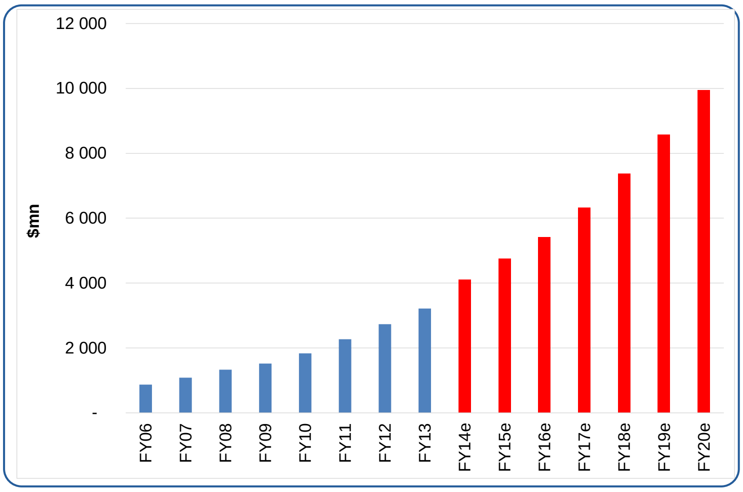
Chipotle operates in the "fast casual" dining sector, positioning itself between a *fast food* and *full-service* restaurant. Fast casual chains offer a more upscale dining environment and food quality, along with higher prices, in the familiar, convenient limited service format of fast food.

With specific reference to Chipotle, the menu is simple with four main offerings, burritos, burrito bowls (burrito without the wrap), tacos and salads. The service is also lightning fast. Patrons walk up to the service counter, choose the item, take a step right choose the protein, take another step right choose the sides (vegetables/beans etc.), one more step and they're paying. The whole process lasts up to about a minute and about three minutes in peak times (usually waiting for a card transaction to process). In addition to this, during February this year the company embarked on a four-pronged plan to make its servicing process faster, with the initial results showing six extra transactions per hour — the fastest throughput they have ever experienced. Management indicated that while they were happy with the results, they believe there is still room to get faster. The average store size is 250m² and seats fifty six people.

What makes the experience at Chipotle one that would encourage customers to keep returning is the quality of the product. In the US market there are a plethora of fast food restaurants to choose from, however, over time people's awareness of the well documented negative health implications associated with eating deep-fried, processed food on offer from the traditional fast-food chains has increased. In 2013, traffic at fast-food chains was flat YoY, while the average casual dining restaurant saw an increase in traffic of 8% YoY. By comparison, Chipotle's SSS has increased 15% YoY.

Chipotle offers diners an alternative to traditional fast-food, offering unprocessed organic meat and vegetables prepared fresh on site while using zero genetically modified (GM) products. The concept of "farm to table" comes at a premium in the market and the average Chipotle meal is about 20% more expensive than eating traditional fast food. Looking at it from the perspective of many customers who have moved from eating in full-service restaurants to casual dining, the meals are about 40% cheaper than the equivalent food in a restaurant.

Figure 3: Estimated revenue:



Source: Company data, Anchor Capital

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The revenue growth prospects were tempered by managements' guidance of mid single-digit SSS growth for FY15, citing the high base it will be coming off as the main reason for this. Store expansion is expected to be in the region of 10% for FY15, with guidance of 190–205 stores expected to be opened over the next 12 months, taking the total restaurant count to approximately 2,000 by the end of FY15. Management were reluctant to give us an indication of where they believe the saturation point of restaurant count will be, rather saying that initially they thought 3,000-4,000 restaurants was their target. However, since the performance of individual stores has considerably beaten their internal expectations, they believe there could be runway for many more stores than initially thought. We have modelled a conservative 10% annual growth in restaurant count for the next 5 years. We believe that the outlook for SSS is possibly too conservative and offers an opportunity for a positive surprise, but for the purposes of formulating a revenue forecast we have used management's guidance of mid -to high single-digits arriving at mid-teen top line growth for the next 5 years.

Margins are currently under pressure as certain food commodity costs are cyclically high. Management implemented above inflation menu price increases over the past year (included in the SSS growth), which helped offset the higher-than-average food inflation. However, we don't believe menu price increases above CPI is sustainable and if the food costs continue to outstrip CPI there could be slight margin contraction. Margin leverage should be achieved in labour expenses, which management believe should see a 50 bps reduction (labour expense as a percentage of revenue) over the next 2 years. We believe investors should expect to see further margin leverage in the general and admin expenses as many of these costs are largely fixed in nature.

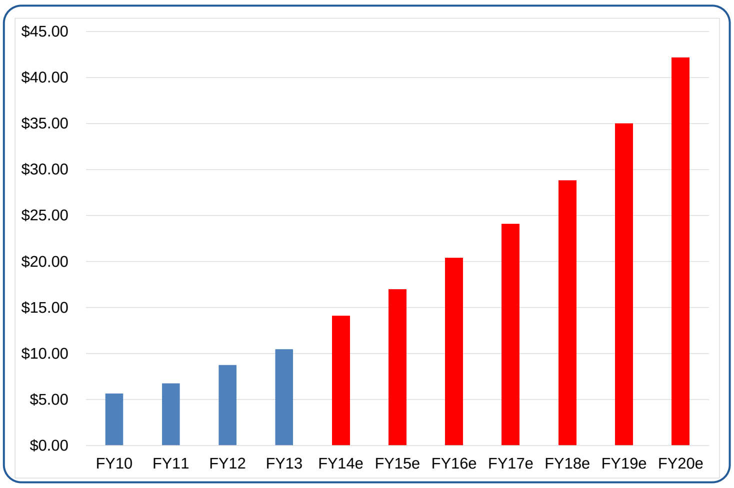
Forecasting the guidance of management as well as making our own assumptions, we arrive at diluted EPS growth of over 20% for at least the next 3 years, with the high base effects implying this level of growth could taper slightly from there.

The valuation:

On the face of it Chipotle is expensive from almost every valuation metric worth looking at. The company trades on a 1-year forward P/E multiple of 39x earnings, with the sector average at a forward 23x earnings. The market has clearly priced Chipotle for an extended period of growth in a sector where SSS has been struggling to gain traction for some time now. On average, the fast-food sector in the US is not experiencing any meaningful top-line growth with the average restaurant's revenue growing at just 3.6% p.a. for the past 5 years (*source: Bloomberg*).

We believe that in order for the valuation of Chipotle to start looking compelling, investors need to apply fairly aggressive growth assumptions on a company that has expanded very quickly for a number of years. By applying an exit multiple of 27x to our FY20e EPS estimate of $42.20 we arrive at a value of $1,140 in FY20. The exit multiple is a 20% premium to the current sector average, which we believe is justified due to the growth potential Chipotle will still have post-2020 strength, assuming no changes to the current growth model and continuing brand strength.

Figure 4: Estimated adjusted EPS growth

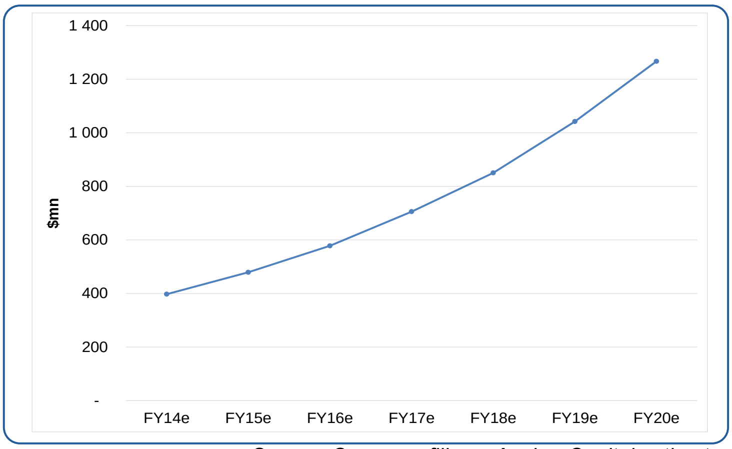


Source: Company filings, Anchor Capital estimates

Over this period, the cash reserves should continue to increase because the business is currently (and expected to continue) generating cash in excess of what it deploys into new stores. In addition to our forecast exit price of $1,140/share the free cash value should be approximately $40/share, assuming no dividends or additional buybacks. This results in a FY20 fair value of $1,180/share, an implied IRR of 10% over 6 years. There is currently no dividend, however management have, over the past few years, been authorised to carry out share buybacks. How aggressive they continue to do this they wouldn't indicate, but we expect that as the cash balance starts to materially erode the RoE of the business, management will feel pressure from shareholders to either increase the buy-back programme or start issuing dividends.

We believe the most pertinent risk to the Chipotle investment thesis is the reputation Chipotle has as the chief promoter of responsible, sustainable farming. The severe reputational damage Chipotle will face, should one of the food producers or farmers be found to have breached the Chipotle mandate, will, in our view, be enough to materially alter the growth prospects of the business. The risk of new entrants also remains high, however the longer it takes for a meaningful competitor to enter the market the stronger the Chipotle brand will become.

Figure 5: Estimated free cash build up



Source: Company filings, Anchor Capital estimates

Conclusion:

While we are bullish on the long-term prospects of the company, we also believe the price at the current level of $660/share offers too much downside risk in terms of short-term disappointments.

We will continue to monitor the progress of Chipotle on a quarterly basis. The market generally looks for 4 or 5 key performance indicators reported on each quarter and we think the chances of Chipotle exceeding expectations on all of these are quite slim. In the latest quarterly filling, management's SSS guidance was the catalyst for a 7% drop in the share price, despite the excellent set of results. We therefore feel that in times of weakness our strategy will be to reassess the valuation and long-term prospects of Chipotle, using possible price weakness as an entry point.

Figure 6: Earnings forecasts:

Chipotle Mexican Grill				
December y/e	**FY13**	**FY14e**	**FY15e**	**FY16e**
Adjusted EPS ($)	10.47	14.09	16.99	20.41
% growth		*35%*	*21%*	*20%*
P/E	63.04x	46.84x	38.85x	32.33x
Share price ($)	660			
12-mnth fwd P/E	39.35x			

Source: Company filings, Anchor Capital estimates

Liam Hechter

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