

Ad-Hoc Memorandum - The Chipotle Opportunity

White Brook Capital (“White Brook”) invests the Model Portfolio (“the portfolio”) in what I believe to be great businesses that should create value over the long term and companies that are solid but suffer from one or multiple misconceptions. Chipotle Mexican Grill (“Chipotle” or “the Company”) falls in the latter category. While the stock has been volatile, the announcement on September 6th that Pershing Square had taken a 9.9% stake in the Company is likely to lead to activist pressure and put the stock in the headlines for months to come. White Brook’s interest predates Pershing’s and while I hoped Chipotle would figure out the steps it needed to profitably grow again on its own, an activist’s arrival should shorten our investment horizon and improve the probability for success. Given the headlines that I assume we, as shareholders, will endure for many months, I thought it appropriate to inform you of the reforms I believe the Company could and should engage in to create value.

By way of background, Chipotle’s stock was down over 40% before our initial investment due to a series of confirmed customer food poisonings between August and December of 2015. The incidents were caused by sick employees working while being infected with a norovirus in two locations, and the company serving a salmonella-contaminated batch of tomatoes in several others. There were also unconfirmed cases of E. coli poisoning. After the food poisoning incidents became public, same store sales declined by over 20% in the quarters following, decreasing from consistent high single digit growth previously.

The relationship between a diner and chef is casual but intimate, and while the affected often feel deeply violated, I believe the issues to be serious but ultimately temporary – both for the infected diners and the larger populace. Despite oft-quoted lofty headline valuation multiples, I believe that Chipotle’s solid economic model, healthy balance sheet and latent growth opportunities translate into a cheap stock. While changes in the operations and the passing of time need to occur to reveal that cheapness, the Company has the ability to more than regain its market share and to return the stock price to previous levels by committing to any one of a number of actions.

Background

In brief, Chipotle is a “Mexican” quick service restaurant specializing in fresh, responsibly sourced food with ~2,000 locations, virtually all located in the United States. The Company operates all of its own stores and leases the real estate. Its store level margins are high for a restaurant, running in the upper 20s before their recent troubles. Its return on invested capital for a new restaurant is healthy, previously running between 60-70% and now 30-40%, while other quick service restaurants without similar issues peak at ~40%. If you visit a Chipotle store, you’ll understand how these high returns can be true. The stores have relatively little expensive preparation equipment, most of the ingredients are fresh, and meals can be fully prepared with a knife, blender, and skillet or oven. In addition, Chipotle’s commitment to locally sourced, wholesome ingredients is on trend with people’s growing eating preferences.

Upon determining it had a food poisoning problem, the Company responded by publicly acknowledging the issue and taking responsibility, examining and cleaning up its supply chain and food handling practices, and establishing state of the art systems to track ingredients from the store to the farm where they were grown. In order to attract customers back into stores and re-establish a personal and public track record of serving without incident, the Company took three key actions: began offering deep promotions and giveaways; introduced the Chiptopia discount program this summer that encourages frequent visits; and most recently, began introducing a new ingredient, Chorizo, to a handful of stores that will likely expand to more stores in coming months.

Opportunity 1 – The Menu

With only a few revisions since inception, Chipotle's limited menu has been an operational boon, limiting customer order variability and improving throughput in its stores. Now the Company hopes that introducing a new ingredient will give customers a reason to more frequently visit their stores. While neither I nor they have certainty, it's probable that the new ingredient will be a modest success. In my opinion however, introducing the new ingredient does not go far enough to drive growth. With menu changes, the Company needs to be increasing customer traffic by expanding to a new category or improving customer spend per visit by adding to or trading up orders. Chorizo only adds slightly more variety to what Chipotle already offers. I believe that the uplift the Company will see is due to a decrease in the probability that a potential patron declines to enter the store (pardon the double negative) rather than an improvement in the probability that a potential patron is attracted to the store. In my view, a new menu item needs to increase affinity for Chipotle, not just decrease rejection.

Oftentimes, a significant challenge of managing a restaurant chain is that menu additions are subject to individual franchisees under their Master Franchise Agreement and, without a proven return on investment, the franchisees resist items that complicate operations or require equipment to be purchased for their sale. Chipotle restaurants are fully company owned currently (another latent opportunity in my opinion), however, and therefore new items, including any that require new equipment, can be introduced easily. For instance, an item like fries, which would require adding a deep fryer, could be introduced quickly and easily across stores and could either be the basis of a new meal - driving store visits - or be an accompaniment - increasing customer spend per visit. That is the kind of preferred menu introduction that will drive increased sales and store traffic in my view. Regardless of the specific item, I believe Chipotle still has considerable potential to drive growth with menu revisions, while adding little operational complexity and that is consistent with its highly relevant responsibly sourced, natural food positioning.

Opportunity 2 – Technology Investment

One of Chipotle's fixable problems is that its extensive customer research is based on panels and point of sale data, but the Company lacks the deep data set that an ongoing customer loyalty program can provide. The Company therefore is neither able to analyze its customer set with the granularity and sophistication available to other retailers, nor offer tailored promotions and build loyalty that could help them more quickly recover from the current crises. Chiptopia – the current, temporary discount program that rewards frequent purchases within a month – is based on the right foundational idea but lacks the type of implementation needed for the Company's long term health given the focus on immediacy of consumption. An everyday, ongoing loyalty program in my view would better capture customer data and insights, build customer loyalty and relationships beyond discounts, and have a longer and more substantial impact.

Opportunity 3 – Store Expansion through Franchising and New Concepts

While some have focused on the Company selling its existing store base to franchisees, the Company currently has only ~2,000 stores with the ability to double before fully penetrating the domestic market. Beyond that the Company is incubating new restaurant concepts. Some have argued that investment to be a waste, but in my view, the two issues can be married. Given the high return of the Company's stores, potential franchisees would be attracted to the concept and the Company can and should sell the ability to open a *new* franchised Chipotle location *with* a new restaurant concept – removing the future capital commitment and balance sheet hold for both while also de-risking further expansion.

Internationally, the Company can preserve control or partner with established large franchisees of other brands to launch and expand Chipotle across markets. The Company has already identified Canada as a



good geography for continued expansion and can conservatively double current operating units through international expansion.

Opportunity 4 - Management and Board Additions and Balance Sheet Options

The above mentioned deficiencies and the crises itself point to a management team spread thin or unfocused prior. Over twenty years ago, they had a fantastic insight and built a great product. Even in the midst of the crises, management acted respectably and credibly, moving quickly to enact reforms to address their contaminated supply chain. However, two key challenges have arisen along with the recent incidents: The Company's chief marketing officer has been put on leave following an alleged drug charge arrest, and other potentially competitive "Mexican" quick service restaurant chains are investing in new store growth. The future for Chipotle requires a larger, not a smaller, management team to competently deal with the issues it will face and successfully deliver on the growth opportunities. Like a small business that has experienced tremendous success and is likely to continue to do so, the Company needs an Operations expert who will be empowered to competitively run the current business in the modern age to help anticipate and deal with potential issues while freeing up the co-CEOs, who have done an admirable job growing the company, to continue to focus on that aspect of the business.

Chipotle's Board of Directors is long tenured but also seems to be unengaged. In my view, a Company's board has three major responsibilities, to: 1) Develop a multi-faceted long-term strategy, 2) Ensure that management is building the company for the long term and executing on that strategy, while developing internal talent, and 3) Optimize the balance sheet. It's difficult to judge the Company's long term strategy at this time, but the lack of institutional technological capability and the crises itself as well as the significant net cash position suggest the Board has not successfully delivered on the second two responsibilities. While the Board can act today by raising ~\$1.2bn in debt to buy back ~10% of the Company without imperiling the balance sheet, I also believe adding diversity to the Board will enhance its perspective, particularly for an ethnic food establishment.

Pushback

The pushback on Chipotle is that consensus Wall Street estimates already bake in a return in customer traffic and margin improvement and that those targets seem difficult to achieve - while the stock already trades at a healthy multiple.

White Brook's position is that consensus estimates do a poor job of accounting for the potential for Chipotle to pull on any of the levers detailed above and that it's a question of when - and not if - customer traffic returns and margins improve. I further believe that the Company has multiple levers to propel it past its previous highs. I hope that Pershing sees the opportunity similarly and that Chipotle management will drive value similar to that prescribed.

As always, if you'd like to discuss any of the analysis underlying these views or would like to discuss your investments in any way, please don't hesitate to reach out. I always enjoy hearing from clients.

Regards,

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