

CASE 12

Chipotle Mexican Grill's Strategy in 2018: Will the New CEO Be Able to Rebuild Customer Trust and Revive Sales Growth?



Arthur A. Thompson
The University of Alabama

Headed into August 2015, Chipotle (pronounced chi-POAT-lay) Mexican Grill's future looked rosy. Sales and profits in the first six months of 2015 were at record-setting levels, and expectations were that 2015 would be the company's best year ever. But a series of events occurred over the next five months that alarmed customers, drove down sales at Chipotle restaurants, and proved frustrating for Chipotle top executives to fix.

- In August, a salmonella outbreak in Minnesota sickened 64 people who had eaten at a Chipotle Mexican Grill. The state's Department of Health later linked the illness to contaminated tomatoes served at the restaurant.
- In August, 80 customers and 18 employees at a Chipotle Mexican Grill in Southern California reported gastrointestinal symptoms of nausea, vomiting, and diarrhea that medical authorities and county health officials attributed to "norovirus." Norovirus is a highly contagious bug spread by contaminated food, improper hygiene, and contact with contaminated surfaces; the virus causes inflammation of the stomach or intestines, leading to stomach pain, nausea, diarrhea, and vomiting. After the reported food poisoning, the restaurant voluntarily closed, threw out all remaining food products, and sent home the affected employees. Employees who tested positive for norovirus

remained off duty until they were cleared to return to work. County health officials also inspected the facility on two occasions and rendered passing grades, despite finding several minor violations. The restaurant reopened the following day, and no further food poisoning incidents occurred.

- In October, 55 people became ill from food poisoning after eating at 11 Chipotle locations in the Portland, Oregon, and Seattle, Washington areas. Medical authorities attributed the illnesses to a strain of *E. coli* bacteria typically associated with contaminated food. Most ill people had eaten many of the same food items, but subsequent testing of the ingredients at the 11 Chipotle restaurants did not reveal any *E. coli* contamination. (When a restaurant serves foods with several ingredients that are mixed or cooked together and then used in multiple menu items, it is difficult for medical studies to pinpoint the specific ingredient or ingredients that might be contaminated.) State and federal regulatory officials reviewed Chipotle's distribution records but were unable to identify a single food item or ingredient that could explain the outbreak. Nonetheless, out of an abundance of caution, Chipotle management voluntarily closed all 43 Chipotle locations in the Portland and Seattle markets, pending a comprehensive review of

Copyright ©2019 by Arthur A. Thompson. All rights reserved.

the causes underlying the food contamination and a check of whether any of Chipotle's food suppliers were at fault. Chipotle management worked in close consultation and collaboration with state and federal health and food safety officials (including personnel from the Centers for Disease Control and Prevention, the U.S. Department of Agriculture's Food Safety and Inspection Service, and the U.S. Food and Drug Administration) throughout their investigation of the incident and also launched a massive internal effort review of the company's food preparation and food safety procedures. These internal actions included:

1. Confirming that more than 2,500 tests of Chipotle's food, restaurant surfaces, and equipment all showed no *E. coli*.
2. Confirming that no employees in the affected restaurants were sickened from the incident.
3. Expanding the testing of fresh produce, raw meat, and dairy items prior to restocking restaurants.
4. Implementing additional safety procedures and audits, in all of its 2,000 restaurants to ensure that robust food safety standards were in place.
5. Working closely with federal, state, and local government agencies to further ensure that robust food safety standards were in place.
6. Replacing all ingredients in the closed restaurants.
7. Conducting additional deep cleaning and sanitization in all of its closed restaurants (followed by deep cleaning and sanitization in all restaurants nationwide).

Meanwhile, the Federal Drug Administration sought to identify a cause for the outbreak. The FDA's investigation revealed no ingredient-related cause and no evidence that particular suppliers were the source of the outbreak. Ultimately, no food item was identified as causing the outbreak and no food item was ruled out as a cause, although fresh produce was suspected as the likely cause.

After health officials concluded it was safe to do so, all 43 restaurants in the Portland and Seattle markets reopened in late November 2015, roughly 6 weeks after the incident occurred.

- Later, it was confirmed that at least 13 people in nine other states became infected with the same strain of *E. coli* linked to the Chipotle restaurants in Oregon and Washington states.
- In early December 2015, five people in three states—Kansas (1), North Dakota (1), and Oklahoma

(3)—became ill after eating at Chipotle Mexican Grill restaurants. Studies conducted by the Centers for Disease Control and Prevention (CDC) determined that all five people were infected with a rare strain of *E. coli* different from the infections in Oregon, Washington, and nine other states. However, investigators used sophisticated laboratory testing to determine that the DNA footprints of the illnesses in the Midwest were related to those in the Portland and Seattle areas.

- In mid-December 2015, about 120 Boston College students became ill after eating at a Chipotle Mexican Grill near the campus, an outbreak that local health officials attributed to a norovirus. Health officials also tested students for *E. coli* infections but the tests were negative.

Extensive reports of the last three incidents in the national media took a toll on customer traffic at most all Chipotle locations. The average decline in sales at Chipotle locations open at least 12 months was a stunning 14.6 percent in the fourth quarter of 2015, causing Chipotle's revenues in Q4 2015 to be 6.8 percent lower than in the fourth quarter of 2014. The company's stock price crashed from an all-time high of \$758 in early August 2015 to \$400 heading into 2016.

2016 AND 2017—GROWING FRUSTRATION IN REVIVING SALES AND RESTORING CUSTOMER TRUST IN THE CHIPOTLE BRAND

In January 2016, the CDC announced that the prior food contamination and food safety issues at Chipotle were “over.” Chipotle management followed up by finalizing plans to install comprehensive food safety procedures at all Chipotle restaurants and establish Chipotle as an industry leader in food safety. In February 2016, Chipotle shut all of its restaurants for a period of four hours to conduct food safety training for all store employees. That same day, in an effort to get customers back into its stores, Chipotle offered a free burrito to anyone who signed up on its website. Recognizing that the task of rejuvenating customer traffic at its restaurants would not be easy, Chipotle

management launched a series of marketing efforts and incentives to entice former and new customers to dine at Chipotle restaurants. For example:

- In March, Chipotle introduced a new online game called Guac Hunter—a digital photo hunt where players saw a series of two images that looked similar and had to spot the differences before time runs out. During a specified 11-day period, players were rewarded for their keen eyesight with a mobile offer good for a free order of chips and guacamole at any Chipotle in the United States and Canada.
- In May, teachers, faculty, and school staff with a valid school ID received a free burrito, burrito bowl, salad, or order of tacos with the purchase of another menu item at all U.S. Chipotle locations from 3:00 p.m. to close in honor of Teacher Appreciation Day.
- All nurses who showed a valid ID were rewarded with a special buy-one-get-one-free promotion on June 8.
- In June, chorizo sausage was introduced as a meat selection.
- A national advertising campaign featured Chipotle's carefully selected ingredients and its longstanding commitment to sourcing, preparing, and serving only the very best ingredients.
- In July, Chipotle initiated a three-month promotion called Chiptopia where customers were rewarded with a free entrée on their fourth, eighth, and eleventh visit and purchase of paid entrée within a given month; customers who registered for the program in July earned a free chips and guacamole with their first entrée purchase.
- Families were offered a free kid's meal with the purchase of an entrée on Sundays during the month of September.
- Also in September, high school and college students with a valid ID received a free fountain soft drink or iced tea with any in-store entrée purchase.
- In October, Chipotle introduced a new online game that allowed players to test their memory skills by matching up real Chipotle ingredients while being careful not to select the imposters (added flavor or added color cards). Anyone who played the game received a limited time mobile buy-one-get-one-free entrée offer redeemable at

any Chipotle in the United States or Canada just for playing.

- On Halloween, from 3 p.m. to closing at all Chipotle locations, customers dressed in costume could buy \$3 burritos, bowls, salads, or tacos.
- All active duty military, reserves, national guard, military spouses, retired military with a valid U.S. military ID, and veterans with ID were offered a special buy-one-get-one-free with the purchase of an entrée from 3:00 p.m. to close on Veterans Day.

In addition, in October 2016, Chipotle began an “Ingredients Reign” advertising campaign highlighting its carefully selected ingredients and reinforcing Chipotle's commitment to sourcing, preparing, and serving only the very best ingredients. The campaign featured a series of animated stop-motion short films shown in movie theaters across the country and also distributed through various online, digital, and social media outlets. In addition, the company used indoor and outdoor advertising with content showcasing the company's obsession with fresh ingredients.

But the results of all these efforts to revive customer traffic were disappointing. Average sales at Chipotle restaurants in 2016 dropped to \$1.87 million, 22.9 percent below the 2015 average of \$2.42 million. Chipotle's revenues dropped from \$4.5 billion in 2015 to \$3.9 billion in 2016, despite the opening of 240 new restaurants. Net income plunged 95 percent, from \$475.6 million in 2015 to \$22.9 million in 2016.

Chipotle's performance in 2017 was better, but far from comforting to top management or shareholders. Revenue rose 14.7 percent to almost \$4.5 billion, fractionally below the amount for 2015, but with 400 more restaurants in operation than in 2015; net income rose to \$176.3 million. Average restaurant sales climbed 3.9 percent to \$1.94 million, but were still almost 20 percent below the 2015 average. Exhibit 1 presents recent financial and operating data for Chipotle Mexican Grill.

At the end of November 2017, Chipotle Mexican Grill announced that Steve Eells, chairman and CEO—and the founder of the company in 1993—would relinquish the title of CEO and become executive chairman following the completion of a search to identify a new CEO. Eells recommended the change in his role to the company's Board of Directors, indicating it would “allow me to focus on my strengths, which include bringing innovation to the way we source and prepare our food.

EXHIBIT 1 Financial and Operating Highlights for Chipotle Mexican Grill, 2011-2017

In millions of dollars, except for per share items					
Income Statement Data	2017	2016	2015	2014	2011
Total revenue	\$4,476.4	\$3,904.4	\$4,501.2	\$4,108.3	\$2,269.6
Food, beverage, and packaging costs	1,535.4	1,365.6	1,503.8	1,421.0	738.7
As a % of total revenue	34.3%	5.0%	33.4%	34.6%	32.5%
Labor costs	1,206.0	1,105.0	1,045.7	904.4	543.1
As a % of total revenue	26.9%	28.3%	23.2%	22.2%	23.9%
Occupancy costs	327.1	293.6	262.4	230.9	147.3
As a % of total revenue	7.3%	7.3%	5.8%	5.6%	6.5%
Other operating costs	651.6	642.0	515.0	434.2	251.2
As a % of total revenue	14.6%	16.4%	11.4%	10.6%	11.1%
General and administrative expenses	296.4	276.2	250.2	273.9	149.4
As a % of total revenue	6.6%	7.1%	5.6%	6.7%	6.6%
Depreciation and amortization	163.3	146.4	130.4	110.5	74.9
Pre-opening costs	12.3	17.2	16.9	15.6	8.5
Loss on disposal of assets	13.3	23.9	13,194	6,976	5,806
Total operating expenses	4,206.6	3,869.8	3,737.6	3,397.5	1,919.0
Operating income	270.8	34.6	763.6	710.8	350.6
As a % of total revenue	6.0%	0.9%	17.0%	17.3%	15.5%
Interest and other income (expense) net	4.9	4.2	6.3	3.5	(0.9)
Income before income taxes	275.7	38.7	769.9	714.3	349.7
Provision for income taxes	(99.5)	(15.8)	(294.3)	(268.9)	(134.9)
Net income	\$ 176.3	\$ 22.9	\$ 475.6	\$ 445.4	\$ 214.9
As a % of total revenue	3.9%	0.6%	10.6%	10.8%	9.5%
Earnings per share					
Basic	\$ 6.19	\$ 0.78	\$ 15.30	\$ 14.35	\$ 6.89
Diluted	6.17	0.77	15.10	14.13	6.76
Weighted average common shares outstanding					
Basic	28.5	29.3	31.1	31.0	31.2
Diluted	28.6	29.8	31.5	31.5	31.8
Selected Balance Sheet Data					
Total current assets	\$ 629.5	\$ 522.4	\$ 814.6	\$ 859.5	\$ 501.2
Total assets	2,045.7	2,026.1	2,725.1	2,527.3	1,425.3
Total current liabilities	323.9	281.8	279.9	245.7	157.5
Total liabilities	681.2	623.6	597.1	514.9	374.8
Total shareholders' equity	1,364.4	1,402.5	2,128.0	2,012.4	1,044.2
Other Financial Data					
Net cash provided by operating activities	\$ 467.1	\$ 349.2	\$ 683.3	\$ 682.1	\$ 411.1
Capital expenditures	216.8	258.8	257.4	252.6	151.1
Restaurant Operations Data			In thousands of dollars		
Restaurants open at year-end	2,408	2,250	2,010	1,783	1,230
Average restaurant sales	\$1,940.0	\$1,868.0	\$2,424.0	\$2,472.0	\$2,013.0
Average annual sales increases at restaurants open at least 13 full calendar months	6.4%	(20.4)%	0.2%	16.8%	11.2%
Development and construction costs per newly opened restaurant	\$ 835	\$ 880	\$ 805	\$ 843	\$ 800

Source: Company 10-K reports, 2015, 2016, and 2017.

As we work hard to restore our brand, I believe we can capitalize on opportunities, including in areas such as the digital experience, menu innovation, delivery, catering, and domestic and international expansion, to deliver significant growth.”¹ A three-person search committee that included Steve Ells and two directors was formed to identify a new leader with demonstrated turnaround expertise to help address the challenges facing the company, improve execution, build customer trust, and drive sales. As of early February 2018, no new CEO had been announced.

During 2017, there were two more incidents of food poisoning at Chipotle restaurants that were widely publicized. In July, a crowd-sourced website, *Iwaspoisoned.com*, indicated that 133 persons reported becoming ill after eating at a Chipotle restaurant in Sterling, Virginia, a Washington suburb. Chipotle promptly closed the restaurant for a “thorough sanitization” and reopened it two days later. In December, there were reports of sick employees and customers at a Chipotle restaurant in Los Angeles. Chipotle alerted local health officials, held the employees out of work, and instituted heightened preventative procedures. Local health officials promptly began an investigation, inspected the premises, and were pleased with the operations. The restaurant remained open. Both incidents spooked investors, triggered immediate declines in the stock price, and reignited concerns over whether Chipotle had fully resolved its food safety issues.

In announcing Chipotle’s 2017 financial results in February 2018, Steve Ells commented on the company’s ongoing efforts to regain the confidence of customers and restore the appeal of dining at one of Chipotle’s 2,400 locations:

During 2017, we have made considerable changes around leadership, operations, and long-term planning and it is clear that, while there is still work to be done, we are starting to see some success. 2018 marks the 25th anniversary of Chipotle, and I am encouraged by the dedication all of our guests and employees have to this brand. Our focus this year will be to continue perfecting the dining experience, enhancing the guest experience through innovations in digital and catering, and reinvesting in our restaurants. We are making good progress on our search for a new CEO who can improve execution, drive sales and enable Chipotle to realize our enormous potential.²

Ells further indicated that management expected sales increases in 2018 at restaurant locations open at least 13 months would be in the low single digits.

In July 2018, Chipotle once again had a food safety lapse; this foodborne illness outbreak sickened over 600 customers at a restaurant just outside of Columbus, Ohio. Health officials attributed the problem to bacteria that formed when certain food items were left out at unsafe temperatures. Upon learning the cause, Chipotle top management immediately announced it would launch retraining of all its restaurant workers nationwide the following week. While the company’s stock price dropped about 7 percent on news of the incident, it recovered quickly since customer traffic at Chipotle restaurants nationwide was largely unaffected and the company’s future performance seemed to be on the upswing remained amid reports that the company was testing a number of new menu enhancements, perhaps to include the addition of a new breakfast menu and earlier opening hours.

CHIPOTLE MEXICAN GRILL’S EARLY YEARS

Steve Ells graduated from the Culinary Institute of America and then worked for two years at Stars Restaurant in San Francisco. Soon after moving to Denver, he began working on plans to open his own restaurant. Guided by a conviction that food served fast did not have to be low quality and that delicious food did not have to be expensive, he came up with the concept of Chipotle Mexican Grill. When the first Chipotle restaurant opened in Denver in 1993, it became an instant hit. Patrons were attracted by the experience of getting better-quality food served fast and dining in a restaurant setting that was more upscale and appealing than those of traditional fast-food enterprises. Over the next several years, Ells opened more Chipotle restaurants in Denver and other Colorado locations.

Ells’ vision for Chipotle was “to change the way people think about and eat fast food.” Taking his inspiration from features commonly found in many fine-dining restaurants, Ells’s strategy for Chipotle Mexican Grill was predicated on six elements:

- Serving a focused menu of burritos, tacos, burrito bowls (a burrito without the tortilla), and salads.
- Using high-quality, fresh ingredients and classic cooking methods to create great tasting, reasonably-priced

dishes prepared to order and ready to be served 1 to 2 minutes after they were ordered.

- Enabling customers to select the ingredients they wanted in each dish by speaking directly to the employees assembling the dish on the serving line.
- Creating an operationally efficient restaurant with an aesthetically-pleasing interior.
- Building a special people culture comprised of friendly, high-performing people motivated to take good care of each customer and empowered to achieve high standards.
- Doing all of this with increasing awareness and respect for the environment and by using organically-grown fresh produce and meats raised in a humane manner without hormones and antibiotics.

In 1998, intrigued by what it saw happening at Chipotle, McDonald's first acquired an initial ownership stake in the fledgling company, then acquired a controlling interest in early 2000. But McDonald's recognized the value of Eells's visionary leadership and kept him in the role of Chipotle's chief executive after it gained majority ownership. Drawing upon the investment capital provided by McDonald's and its decades of expertise in supply chain logistics, expanding a restaurant chain, and operating restaurants efficiently, Chipotle—under Eells's watchful and passionate guidance—embarked on a long-term strategy to open new restaurants and expand its market coverage. By year-end 2005, Chipotle had 489 locations in 24 states. As 2005 drew to a close, in somewhat of a surprise move, McDonald's top management determined that instead of continuing to parent Chipotle's growth, it would take the company public and give Chipotle management a free rein in charting the company's future growth and strategy. An initial public offering of shares was held in January 2006, and Steve Eells was designated as Chipotle's CEO and Chairman of the Board. During 2006, through the January IPO, a secondary offering in May 2006, and a tax-free exchange offer in October 2006, McDonald's disposed of its entire ownership interest in Chipotle Mexican Grill.

When Chipotle became an independent enterprise, Steve Eells and the company's other top executives kept the company squarely on a path of rapid expansion and continued to employ the same basic strategy elements that were the foundation of the company's success. Steve Eells functioned as the company's principal driving force for ongoing innovation

and constant improvement. He pushed especially hard for new ways to boost “throughput”—the number of customers whose orders could be taken, prepared, and served per hour.³ By 2012, Eells's mantra of “slow food, fast” had resulted in throughputs of 300 customers per hour at Chipotle's best restaurants.

From 2011 through 2015, Chipotle's revenues grew at a robust compound average rate of 18.7 percent. Net income grew at a compound rate of 19.4 percent, due not only to sales increases but also improved operating efficiency that boosted profit margins. Growing customer visits and higher expenditures per customer visit drove average annual sales for Chipotle restaurants open at least 13 full calendar months from \$1,085,000 in 2007 to \$2,424,000 in 2015. The average check per customer ran \$8 to \$10 in 2011-2015.

CHIPOTLE MEXICAN GRILL IN 2018

Going into 2018, Chipotle operated 2,363 Chipotle Mexican Grill restaurants in 47 states and the District of Columbia, plus 24 in Canada, 6 in England, 6 in France, and 1 in Germany. In addition to the 2,000 Chipotle locations, the company had experimented with transferring its Chipotle model for Mexican food to other cuisines over the past seven years and currently operated a small fast casual pizza chain called Pizzeria Locale that had seven restaurants in four states, and one burger-fries-shakes restaurant called Tasty Made, giving it a total of 2,408 restaurants. In 2017, Chipotle decided to abandon its efforts to use high-quality, fresh ingredients and classic cooking methods to create great tasting, reasonably-priced Asian dishes; all 15 ShopHouse Southeast Asian Kitchen restaurants opened from 2011 through 2016 were closed after determining that devoting further efforts to perfect the ShopHouse concept and invest capital to expand the number of ShopHouse locations was not justified in light of the current difficulties being encountered in reviving sales and growth at its core Chipotle Mexican Grill business. The Tasty Made location was closed in March 2018, because two years of finetuning and tweaking of operations failed to produce satisfactory revenue-cost-profit economics. Chipotle management planned to open between 130 and 150 additional restaurants in 2018, all of which were expected to be Chipotle restaurants.

Menu and Food Preparation

The menu at Chipotle Mexican Grill restaurants was quite limited—burritos, burrito bowls, tacos, and salads; plus soft drinks, fruit drinks, and milk—the drink options also included a selection of beers and margaritas in all locations except those where serving alcoholic beverages was prohibited. Menu variety was achieved by enabling customers to customize their burritos, burrito bowls, tacos, and salads in dozens of different ways. Options included five different meats or tofu, pinto beans or vegetarian black beans, brown or white rice tossed with lime juice and fresh-chopped cilantro, and choices of such extras as sautéed peppers and onions, salsas, guacamole, sour cream, queso, shredded cheese, lettuce, and tortilla chips seasoned with fresh lime and salt. In addition, it was restaurant policy to make special dishes for customers if the requested dish could be made from the ingredients on hand.

From the outset, Chipotle's menu strategy had been to keep it simple, do a few things exceptionally well, and not include menu selections (like coffee and desserts) that complicated store operations and impaired efficiency. While it was management's practice to consider menu additions, the menu offerings had remained fundamentally the same since the addition of burrito bowls in 2005, tofu Sofritas (shredded organic tofu braised with chipotle chilis, roasted poblanos, and a blend of aromatic spices) as a meat alternative in 2013 and 2014, the addition of chorizo sausage as a meat option in 2016, and the 2017 addition of queso (made of aged cheddar cheese, tomatoes, tomatillos, and several varieties of peppers). So far, the company had rejected the option of opening earlier in the day and offering a breakfast menu.

The food preparation area of each restaurant was equipped with stoves and grills, pots and pans, and an assortment of cutting knives, wire whisks, and other kitchen utensils. There was a walk-in refrigerator stocked with ingredients, and supplies of herbs, spices, and dry goods such as rice. The work space more closely resembled the layout of the kitchen in a fine dining restaurant than the cooking area of typical fast food restaurant that made extensive use of automated cooking equipment and microwaves. Until the food contamination and food safety incidents in Q4 2015, all of the menu selections and optional extras were prepared from scratch in each Chipotle location—hours went into preparing food on-site,

although some items were prepared from fresh ingredients in area commissaries. Kitchen crews used classic cooking methods—they marinated and grilled the chicken and steak, hand-cut produce and herbs, made fresh salsa and guacamole, and cooked rice in small batches throughout the day. While the food preparation methods were labor-intensive, the limited menu created efficiencies that helped keep costs down.

Food preparation methods at Chipotle's restaurants were overhauled in late 2015 in response to the food contamination incidents. The goal was to develop an industry-leading food safety program utilizing the assistance and recommendations of highly respected experts. Components of the new program included:

- DNA-based testing of many ingredients to evaluate their quality and safety before they were shipped to Chipotle restaurants.
- Changes to food preparation and food handling practices, including washing and cutting some produce items (such as tomatoes and romaine lettuce) in central kitchens.
- Blanching of some produce items (including avocados, onions, jalapenos, and citrus) in each restaurant before cutting them.
- New protocols for marinating meats.
- Utilizing the Food and Drug Administration's Hazard Analysis Critical Control Point (HACCP) management system to enhance internal controls relating to food safety.
- Instituting internal training programs to ensure that all employees thoroughly understand the company's newly imposed standards for food safety and food handling.
- Offering paid sick leave to employees to reduce incentives for employees to work while sick.
- Implementing stricter standards for food preparation, cleanliness, and food safety at all of the company's restaurants.
- Strengthening efforts to ensure that the company remained in full compliance with all applicable federal, state, and local food safety regulations

Quality Assurance and Food Safety Chipotle's quality assurance department was charged with establishing and monitoring quality and food safety measures throughout the company's supply chain. There were quality and food safety standards for farms that grew

ingredients used by company restaurants, approved suppliers, the regional distribution centers that purchased and delivered products to the restaurants, and frontline employees in the kitchen and on the serving lines at restaurants. The food safety programs for suppliers and restaurants were designed to ensure compliance with applicable federal, state, and local food safety regulations. Chipotle's training and risk management departments developed and implemented operating standards for food quality, preparation, cleanliness, and safety in company restaurants.

Chipotle's Commitment to "Food With Integrity"

In 2003 and 2004, Chipotle began a move to increase its use of organically grown local produce, organic beans, organic dairy products, and meats from animals that were raised in accordance with animal welfare standards and were never given feeds containing non-therapeutic antibiotics and growth hormones to speed weight gain. This shift in ingredient usage was part of a long-term management campaign to use top-quality, nutritious ingredients and improve "the Chipotle experience"—an effort that Chipotle designated as "Food With Integrity" and that top executives deemed critical to the company's vision of changing the way people think about and eat fast food. The thesis was that purchasing fresh ingredients and preparing them daily by hand in each restaurant were not enough.

To implement the Food With Integrity initiative, the company began working with experts in the areas of animal ethics to try to support more humane farming environments, and it started visiting the farms and ranches from which it obtained meats and fresh produce. It also began investigating using more produce supplied by farmers who respected the environment, avoided use of chemical fertilizers and pesticides, followed U.S. Department of Agriculture standards for growing organic products, and used agriculturally sustainable methods like conservation tillage methods that improved soil conditions and reduced erosion. Simultaneously, efforts were made to source a greater portion of products locally (within 350 miles of the restaurants where they were used) while in season. The transition to using organically grown local produce and naturally raised meats occurred gradually because it took time for Chipotle to develop sufficient sources of supply to accommodate the requirements of its growing number of restaurant locations. Meats

raised without the use of non-therapeutic antibiotics or added hormones and met other Chipotle standards were branded and promoted as "Responsibly Raised." Chipotle completed a two-year initiative in 2015 to stop using ingredients grown with genetically modified seeds in all of its dishes—to the extent that was possible. In many instances, the naturally raised meats Chipotle used were still being raised on animal feeds containing grains that were genetically modified; moreover, many of the branded beverages Chipotle served contained corn-based sweeteners often made with genetically modified corn.

Nonetheless, Chipotle still faced ongoing challenges in 2018 in *always* using organic products, locally grown produce, and naturally raised meats in *all* menu items at *all* of its restaurant locations because of short supplies. While growing numbers of farmers were entering into the production of these items and supplies were on the upswing, household purchases of these same items at local farmers markets and supermarkets were increasing swiftly, and mounting numbers of restaurants were incorporating organic and locally-grown produce and natural meats into their dishes. Moreover, the costs incurred by organic farmers and the growers of naturally raised meats were typically higher. Organically grown crops often took longer to grow and crop yields were usually smaller. Growth rates and weight gain were typically lower for chickens, cattle, and pigs that were fed only vegetarian diets containing no antibiotics and not given growth hormones. Hence, the prices of organically-grown produce and naturally-raised meats were not only higher but also subject to sharp upward swings where and when supplier could not keep up with rising demand. Consequently, when periodic supply-demand imbalances produced market conditions where certain items that Chipotle used in its dishes were either unavailable or prohibitively high-priced, some Chipotle restaurants temporarily reverted—in *the interest of preserving the company's reputation for providing great food at reasonable prices and protecting profit margins*—to the use of conventional products until supply conditions and prices improved. When certain Chipotle restaurants were forced to serve conventionally raised meat, it was company practice to disclose this temporary change on signage in each affected restaurant so that customers could avoid those meats if they choose to do so.

Despite the attendant price-cost challenges and supply chain complications, Chipotle executives

were firmly committed to continuing the Food With Integrity initiative going forward. They felt it was very important for Chipotle to be a leader in responding to and acting on mounting consumer concerns about food nutrition, where their food came from, how fruits and vegetables were grown, and how animals used for meat were raised. And they definitely wanted customers to view Chipotle Mexican Grill as a place that used high-quality, “better for you” ingredients in its dishes. Given the record of growth in customer traffic at Chipotle restaurants, notwithstanding the recent food poisoning incidents, Chipotle executives believed the company could cope with the likelihood organic and natural meat ingredients would remain more expensive than conventionally raised, commodity-priced equivalents. Over the longer term, they anticipated the price volatility and shortages of organically-grown ingredients and natural meats would gradually dissipate as growing demand for such products attracted more small farmers and larger agricultural enterprises to boost supplies.

Serving Orders Quickly

One of Chipotle’s biggest innovations had been creating the ability to have a customer’s order ready quickly. As customers moved along the serving line, they selected which ingredients they wanted in their burritos, burrito bowls, tacos, and salads by speaking directly to the employees who were assembling the order behind the counter. Much experimentation and fine-tuning had gone into creating a restaurant layout and serving line design that made the food-ordering and dish-creation process intuitive and time-efficient, thereby enabling a high rate of customer throughput. The throughput target was at least 200 and up to 300 customers per hour, in order to keep the numbers of customers waiting in line at peak hours to a tolerable minimum. Management was focused on further improving the speed at which customers moved through the service line in all restaurants, so that orders placed by fax, online, or via smartphone ordering apps could be accommodated without slowing service to in-store customers and compromising the interactions between customers and crew members on the service line. The attention to serving orders quickly was motivated by management’s belief that while customers returned because of the great-tasting food they also liked their orders served fast without having a “fast-food” experience (even when they were not in a hurry). Delivery service was also offered in

many areas through a number of third-party services with whom the company had partnered.

Catering

In 2013, Chipotle introduced an expanded catering program to help spur sales at its restaurants. The menu offerings evolved slightly in succeeding years. As of 2018, the catering program involved setting up a portable version of its service line for groups of 20 to 200 people and a choice of three menu options:

- **The Big Spread**—A choice of three: chicken, steak, barbacoa, carnitas, or Sofritas; plus fajita veggies.
- **Two Meat Spread**—A choice of two: chicken, steak, barbacoa, carnitas, or Sofritas.
- **Veggie Spread**—A choice of two: Sofritas, extra guacamole, or fajita veggies.

All three spreads included white and brown cilantro-lime rice, black beans and pinto beans, four salsas, sour cream, guacamole, cheese, lettuce, chips, crispy taco shells, and flour soft tortillas, plus chafing stands and dishes and serving tools.

For customers wanting to accommodate a smaller group of six or more people, Chipotle offered a Burritos by the Box option with a choice of meat, Sofritas, or grilled veggies (or an assortment of these) plus white or brown rice, black beans, mild-spice salsa, and cheese; for each two burritos in the box, a bag of chips and small containers of tomatillo-green chili salsa, guacamole, and sour cream were included.

SUPPLY CHAIN MANAGEMENT PRACTICES

Chipotle executives were acutely aware that maintaining high levels of food quality in the company’s restaurants depended in part on acquiring high-quality, fresh ingredients and other necessary supplies that met company specifications. Over the years, the company had developed long-term relationships with a number of reputable food industry suppliers that could meet Chipotle’s quality standards and understood the importance of helping Chipotle live up to its Food With Integrity mission. Chipotle worked with these suppliers on an ongoing basis to establish and implement a set of forward, fixed and formula pricing protocols for determining the prices that suppliers charged Chipotle for various items. Reliable suppliers that could meet Chipotle’s quality specifications and were willing to comply with

Chipotle's set of forward, fixed, and formula-pricing protocols and guidelines for certain products were put on Chipotle's list of approved suppliers. Chipotle constantly worked to increase the number of approved suppliers for ingredients to help mitigate supply shortages and the associated volatility of ingredient prices. In addition, Chipotle personnel diligently monitored industry news, trade issues, weather, exchange rates, foreign demand, crises, and other world events so as to better anticipate potential impacts on ingredient prices.

Chipotle did not purchase directly from approved suppliers, but instead utilized the services of 24 independently owned and operated regional distribution centers to purchase and deliver ingredients and other supplies to Chipotle restaurants. These distribution centers were required to make all purchases from Chipotle's list of approved suppliers in accordance with the agreed-upon pricing guidelines and protocols.

RESTAURANT MANAGEMENT AND OPERATIONS

Chipotle's strategy for operating its restaurants was based on the principle that "the front line is key." The restaurant and kitchen designs intentionally placed most store personnel up front where they could speak to customers in a personal and hospitable manner, whether preparing food items or customizing the dish ordered by a customer moving along the service line. The open kitchen design allowed customers to see employees preparing and cooking ingredients, reinforcing that Chipotle's food was freshly-made each day. Store personnel, especially those who prepared dishes on the serving line were expected to deliver a customer-pleasing experience "one burrito at a time," give each customer individual attention, and make every effort to respond positively to customer requests and suggestions. Special effort was made to hire and retain people who were personable and could help deliver a positive customer experience. Management believed that creating a positive and interactive experience helped build loyalty and enthusiasm for the Chipotle brand not only among customers but among the restaurant's entire staff.

Restaurant Staffing and Management

Each Chipotle Mexican Grill typically had a general manager or Restaurateur (a high-performing

general manager), an apprentice manager (in about 75 percent of the restaurants), one to three hourly service managers, one or two hourly kitchen managers, and an average of 22 full- and part-time crew members. Busier restaurants had more crew members. Chipotle generally had two shifts at its restaurants, which simplified scheduling and facilitated assigning hourly employees with a regular number of work hours each week. Most employees were cross-trained to work at a variety of stations, both to provide people with a variety of skills and to boost labor efficiency during busy periods. Personnel were empowered to make decisions within their assigned areas of responsibility.

One of Chipotle's top priorities was to build and nurture a people-oriented, performance-based culture in each Chipotle restaurant; executive management believed that such a culture led to the best possible experience for both customers and employees. The foundation of that culture started with hiring good people to manage and staff the company's restaurants. One of the prime functions of a restaurant's general manager was to hire and retain crew members who had a strong work ethic, took pride in preparing food items correctly, enjoyed interacting with other people, exhibited enthusiasm in serving customers, and were team players in striving to operate the restaurant in accordance with the high standards expected by top management. A sizable number of Chipotle's crew members had been attracted to apply for a job at Chipotle because of either encouragement from an acquaintance who worked at Chipotle or their own favorable impressions of the work atmosphere while going through the serving line and dining at a Chipotle Mexican Grill. New crew members received hands-on, shoulder-to-shoulder training. In 2018, pay scales for full-time crew members ranged from \$10 per hour to \$14 per depending on their assigned role; regular compensation and bonuses were in the range of \$20,000 to \$29,000, plus free meals during each shift and benefits for clothes, paid vacation, paid sick leave, tuition assistance up to \$5,250 per year, company-matched 401(k) contributions, and medical, dental, and vision insurance.⁴ In 2018, total compensation (including benefits) averaged \$31,000 for crew members, \$36,000 for kitchen managers, \$39,000 for service managers, \$56,000 for apprentice managers, and \$77,000 for general managers.⁵

Top-performing store personnel typically moved up the ranks quickly because of the company's

unusually heavy reliance on promotion from within—about 84 percent of salaried managers and about 97 percent of hourly managers had been promoted from positions as crew members. In several instances, a newly hired crew member had risen rapidly through the ranks and become the general manager of a restaurant in 9 to 12 months; many more high-performing crew members had been promoted to general managers within 2 to 4 years. Historically, the long-term career opportunities for Chipotle employees had been quite attractive because of the speed with which Chipotle was opening new stores in both new and existing markets.

The Position and Role of Restaurateur The general managers who ran high-performing restaurants and succeeded in developing a strong, empowered team of hourly managers and crew members were promoted to Restaurateur, a position that entailed greater leadership and culture-building responsibility. In addition to continuing to run their assigned restaurant, Restaurateurs were typically given responsibility for mentoring one or more nearby restaurants and using their leadership skills to help develop the managers and build high-performing teams at the restaurants they mentored. At year-end 2013, Chipotle had over 400 Restaurateurs overseeing nearly 40 percent of the company's Chipotle restaurants, including their home restaurant and others that they mentored. In 2018, the average compensation (including benefits) of Chipotle Restaurateurs in charge of a single restaurant was \$120,000; average compensation (including benefits) of Restaurateurs in charge of 2 to 4 locations was \$127,000.⁶ Restaurateurs could earn bonuses up to \$23,000 for their people development and team-building successes and for creating a culture of high standards, constant improvement, and empowerment in each of their restaurants. Restaurateurs whose mentoring efforts resulted in high-performing teams at four restaurants and the promotion of at least one of the four restaurant managers to Restaurateur could be promoted to the position of Apprentice Team Leader and become a full-time member of the company's field support staff.

Chipotle's field support system included apprentice team leaders, team leaders or area managers, team directors, executive team directors or regional directors, and restaurant support officers—over 100 of the people in these positions in 2014 and 2015 were former Restaurateurs. In 2014, over two-thirds of Chipotle's restaurants were under the leadership and

supervision of the company's 500 existing and former Restaurateurs. The principal task of field support personnel was to foster a culture of employee empowerment, high standards, and constant improvement in each of Chipotle's restaurants. One of Chipotle's field support staff members had been hired as a crew member in 2003, promoted to General Manager in 12 months, and—8 years after starting with Chipotle—was appointed as a Team Director (with responsibilities for 57 restaurants and 1400 + employees).⁷

In December 2016, Chipotle overhauled its Restaurateur program, after determining that the 27 measures being used to evaluate Restaurateurs for promotion were far too numerous and distracted them from strongly focusing on customer service and restaurant operations. Steve Ells concluded a major revision was needed because a recently completed survey of nearly 2,100 restaurant locations had awarded a C grade for service to half of the restaurants due to messy soda stations, dirty tables, long or slow-moving serving lines, shortages of various ingredients, and other operational deficiencies. At a January 2017 conference in Orlando, Florida, Steve Ells told the audience that promotions within the Restaurateur program were now based on five performance measures, three of which were customer related. He went on to say, "In the coming months, you will see the return to the kind of restaurant operations Chipotle was known for from the very beginning."

The Appointment of a Chief Restaurant Officer In May 2017, Chipotle announced the hiring of Scott Boatwright as chief restaurant officer, with responsibility for overseeing operations at all of the company's restaurants. Boatwright came to Chipotle from Arby's Restaurant Group, where he served as senior vice president of operations and was responsible for the success and performance of nearly 2,000 franchised and company-owned restaurants across 22 states. His specific focus at Arby's was operational standards, building and developing teams, delivering an excellent guest experience, and strategic planning to support the company's overall annual operating plan.

In his new position at Chipotle, Boatwright was charged with working closely with the company's two restaurant support officers to oversee restaurant operations, including enhancing the guest experience, developing and leading field leadership teams, developing strong teams inside the restaurants, and enhancing operational efficiency.

MARKETING

Prior to the scares over food safety in 2015, Chipotle's marketing efforts were focused on introducing the Chipotle brand to new customers and emphasizing what the Chipotle experience was all about and what differentiated Chipotle from other fast-food competitors. When Chipotle opened restaurants in new markets, it used a range of promotional activities to introduce Chipotle to the local community and to create interest in the restaurant. In markets where there were existing Chipotle restaurants, newly opened restaurants usually attracted customers in volumes at or near market averages without having to initiate special promotions or advertising to support a new opening. But the company had field marketing teams tasked with connecting its restaurants to local communities on an ongoing basis through fundraisers, sponsorships, and participation in local events.

Chipotle's advertising mix typically included print, outdoor, transit, theaters, radio, and online ads. The company ran its first-ever national TV commercial during the broadcast of the 2012 Grammy Awards and ran a second campaign in 2013 featuring its new catering program. Over the past several years, the company had increased its use of digital, mobile, and social media in its overall marketing mix to better inform the public about Chipotle's differentiating features, most especially its commitment to Food With Integrity and what that commitment entailed—why it used top-quality, freshly prepared ingredients in its dishes; the benefits of organically grown fruits and vegetables; why people ought to consider eating meats that come from animals raised humanely and without the use of antibiotics; Chipotle's avoidance of ingredients grown with genetically modified seeds; and its efforts to ensure its dishes were nutritious and tasty. From 2013 through 2015, Chipotle crafted marketing programs to make people more curious about food-related issues and why Chipotle was working to drive positive changes in the nation's food supply and eating habits—management believed that the more people learned the more likely they would patronize Chipotle Mexican Grill locations.

In 2016, in the wake of the food safety-related incidents that occurred in the fourth quarter of 2015, Chipotle emphasized marketing campaigns to drive traffic into its restaurants and to communicate the changes Chipotle had recently made to establish the company as an industry leader in food safety.

Many of the 2016 actions to boost customer traffic at Chipotle restaurants were continued in 2017, but a number of new efforts were added:

- An online game was introduced where players during a two-week period prior to the Super Bowl were given three rounds to smash avocados and combine ingredients to make their own version of Chipotle's guacamole. Players were rewarded with a mobile offer good for a free order of chips and guacamole, with purchase of an entrée, at any Chipotle in the United States.
- In February, Chipotle announced an expansion of the Chipotle Reading Rewards program, which rewarded young readers with free Chipotle kid's meals for reaching their reading goals in reading programs established by teachers and librarians.
- Also in February, Chipotle completed the roll-out of its "Smarter Pickup Times" technology to all its restaurants that offered digital ordering. The Smarter Pickup technology allowed customers who ordered digitally to benefit from shorter and more accurate pickup times and the ability to reserve a future pickup time. The technology also improved the company's ability to process more digital orders without disrupting service or throughput in its restaurants. In testing the Smarter Pickup Times system in restaurants around the country, the company was able to reduce the wait times for digital order pickup by as much as 50 percent; moreover, customer use of mobile ordering rose to record levels.
- In March, Chipotle, in partnership with Discovery Education and others, unveiled "RAD Lands," an unbranded, educational video series available exclusively on iTunes that was intended to give teachers and parents a means of educating children about food, where it comes from, and the benefits of eating fresh food, the importance of caring for the environment, and how to create healthy, tasty snacks.
- A second online game called "The Real Imposter" introduced in April challenged players to search through Chipotle's 51 real ingredients hunting for commonly used industrial additives—including added flavors, colors, preservatives, gluten and gums—masquerading as real ingredients. Successful players were rewarded with a mobile offer good for a free order of chips and guacamole, with purchase of an entrée, at any Chipotle in the United States,

and a chance to enter the sweepstakes to win other food prizes.

- In celebration of the important contributions made by teachers, in May Chipotle again offered a special, one-day, buy-one-get-one-free to all teachers, faculty, and staff at schools and universities across the United States with a valid school ID.
- In June, to celebrate their hard work and contributions, as in 2016, nurses with a valid ID were offered a one-day, buy-one-get-one-free at any Chipotle Mexican Grill restaurant nationwide or in Canada.
- In September, queso (made of aged cheddar cheese, tomatillos, tomatoes and several varieties of peppers and containing no industrial additives, natural flavors, colors, or preservatives) was introduced as a new menu item at all Chipotle restaurants. Following numerous customer complaints about the grainy texture of the queso, Chipotle quickly modified the recipe to broaden its appeal.
- On Halloween, from 3 p.m. to closing at all Chipotle locations, Chipotle continued its recent tradition of offering customers dressed in costume the opportunity to buy \$3 burritos, bowls, salads, or tacos.
- Active military and veterans were offered offering a special buy-one-get-one-free promotion from 3:00 p.m. to close on November 7, a week before Veterans Day.
- Also in November, Chipotle announced a new mobile app available for download on Apple and Android devices with such features such as quick reorder of favorite meals, streamlined payment options, and the ability to receive, store, and redeem Chipotle offers. The app was expected to drive substantial growth in customer use of digital ordering.

In April 2017, Chipotle began an “As Real as It Gets” national TV advertising campaign, supplemented with radio, outdoor, digital video and banners, and social advertising, to highlight the company’s ongoing commitment to using only real ingredients in the food it served. The launch of the campaign followed on the heels of the company’s announcement that by eliminating the use of preservatives and dough conditioners in the tortillas used for its tacos, burritos, and chips, Chipotle had become the only national restaurant brand that did not use artificial colors, flavors, or preservatives in any of the 51 ingredients used to prepare its food (although lemon and lime juice used to flavor some ingredients did have some preservative value as well).

To enable and facilitate public knowledge about the ingredients used to prepare the dishes on its menu, Chipotle posted a new section on its website devoted to the 51 ingredients it used.

All of the marketing, promotional, and advertising activities Chipotle undertook in 2016 and 2017 to revive customer traffic at its restaurants resulted in increases of more than 50 percent in Chipotle’s marketing and advertising costs. The company’s expenditures for marketing and advertising totaled \$106.3 million in 2017 and \$103.0 million in 2016, versus \$69.3 million in 2015, \$57.3 million in 2014, and \$31.9 million in 2011 (these costs are included in “Other operating costs” in Exhibit 1).

The marketing and promotional blitz was continuing in early 2018. In January, Chipotle announced continuation of its Reading Rewards program that included free kid’s meal cards for younger readers and buy-one-get-one free entrée cards for teen readers. In February, Chipotle partnered with Postmates, a company that delivered anything from anywhere in 40 major metropolitan areas, to offer people free delivery by Postmates when they placed their orders online at Chipotle.com or on the Postmates app anytime during regular Chipotle hours Friday through Sunday of Super Bowl weekend.

RESTAURANT SITE SELECTION

Chipotle had an internal team of real estate managers that devoted substantial time and effort to evaluating potential locations for new restaurants; from time to time, the internal team sought the assistance of external brokers with expertise in specific local markets. The site selection process entailed studying the surrounding trade area, demographic and business information within that area, and available information on competitors. In addition, advice and recommendations were solicited from external real estate brokers with expertise in specific markets. Locations proposed by the internal real estate team were visited by a team of operations and development management as part of a formal site ride; the team toured the surrounding trade area, reviewed demographic and business information on the areas, and evaluated the food establishment operations of competitors. Based on this analysis, along with the results of predictive modeling based on proprietary formulas, the company came up with projected sales and targeted returns on investment for a new location. Chipotle Mexican Grills had proved successful in a number

of different types of locations, including in-line or end-cap locations in strip or power centers, regional malls, downtown business districts, freestanding buildings, food courts, outlet centers, airports, military bases, and train stations.

DEVELOPMENT AND CONSTRUCTION COSTS FOR NEW RESTAURANTS

The company's average development and construction costs per restaurant decreased from about \$850,000 in 2009 to around \$800,000 in 2011, 2012, and 2013 (see Exhibit 1), chiefly because of cost savings realized from shifting to a simpler, lower-cost restaurant design. However, the costs of new openings jumped to an average of \$843,000 in 2014, due to opening more freestanding restaurants (which were more expensive than end-caps and in-line sites in strip centers) and opening proportionately more sites in the northeastern United States where construction costs (and also sales volumes) were typically higher. Construction and development costs for new store openings in 2015 dropped to \$805,000, rose to \$880,000 in 2016, and dropped to \$835,000 in 2017.

Total capital expenditures were expected to be about \$300 million in 2018. About \$120 million was expected to be used for opening 130 to 150 new stores; construction and development costs for these stores was expected to be above 2017 levels because of upgrades to accommodate the expected growth in mobile orders for pickup. The company expected that a big majority of its capital spending for 2018 would consist of investments in remodeling and improving existing restaurants, upgrading the lines for preparing pickup orders, and new restaurant equipment. Capital expenditures in prior years are shown in Exhibit 1. Senior executives believed the company's annual cash flows from operations, together with current cash on hand, would be adequate to meet ongoing capital expenditures, working capital requirements, possible repurchases of common stock, and other cash needs for the foreseeable future.

CHIPOTLE HIRES A NEW CEO

In mid-February 2018, Chipotle announced the appointment of Brian Nicol as chief executive officer and member of the Board of Directors, effective

March 5. At the time, Nicol was CEO of Taco Bell; he had been at Taco Bell since 2011, served as president in 2013 and 2014, and became Taco Bell's CEO in January 2015. Under his leadership, he had fostered an environment of creative and consistent menu innovation, and he was a strong advocate of advertising with a strong message that captured consumer attention. Nicol was credited with being the driving force behind boosting average sales at Taco Bell restaurants, percent in the past six years, restarting the opening of more Taco Bell locations, and growing Taco Bell's systemwide revenues from about \$8.1 billion in 2013 to \$10.15 billion in 2017. He also transformed Taco Bell into a leader in using social media and mobile ordering/payment. While at Taco Bell, Nicol had gained experience in converting company-owned locations into franchised operations.

In announcing the Chipotle's performance for the first quarter of 2018, Nicol said:

Chipotle is a purpose driven brand with loyal customers, passionate employees, industry-leading economic potential, along with incredible brand equity, and craveable food with integrity, all built over the last 25 years. While the company made notable progress during the quarter, I firmly believe we can accelerate that progress in the future. We are in the process of forming a path to greater performance in sales, transactions, margins, and new restaurants. This path to performance will be grounded in a strategy of executing the fundamentals while introducing consumer-meaningful innovation across the business. It will also require a structure and organization built for creativity, action, and accountability. Finally, Chipotle will have a culture that is centered on running great restaurants, putting the customer first, innovating for today and tomorrow, supporting each other, and delivering on commitments.⁸

On May 23, 2018, a little over 10 weeks after taking over as CEO, Nicol announced that Chipotle would close both its Denver headquarters and a New York office and relocate all functions to either an existing Chipotle office in Columbus, Ohio, or to a new corporate headquarters to be located in Newport Beach, California. The move would affect some 400 employees. In making the announcement, Nicol said:

We have a tremendous opportunity at Chipotle to shape the future of our organization and drive growth through our new strategy. In order to align the structure around our strategic priorities, we are transforming our culture and building world-class teams to revitalize the brand and enable our long-term success. We'll always be proud of our Denver roots where we opened our first

restaurant 25 years ago. The consolidation of offices and the move to California will help us drive sustainable growth while continuing to position us well in the competition for top talent.⁹

COMPETITION AND INDUSTRY TRENDS

Restaurant industry sales in the United States in 2017 were approximately \$800 billion at close to 1.1 million food establishments.¹⁰ According to recent survey data, 60 percent of consumers said that the availability of environmentally friendly food would make them choose one restaurant over another; 56 percent said their primary reason for preferring locally sourced food was that it supported farms and producers in their communities; 42 percent of consumers said the ability to order online would make them choose one restaurant over another; and 63 percent of millennials said they were more likely to eat a wider variety of ethnic cuisines than they did two years ago.¹¹

The restaurant industry was highly segmented by type of food served, number and variety of menu selections, price (ranging from moderate to very expensive), dining ambience (quick-service to fast-casual to casual dining to fine dining), level of service (mobile ordering to drive-through to place and pick up order at counter to full table service), and type of enterprise (locally owned, regional chain, or national chain). The number, size, and strength of competitors varied by region, local market area, and a particular restaurant's location within a given community. Competition among the various types of restaurants and food service establishments was based on such factors as type of food served, menu selection (including the availability of low-calorie and nutritional items), food quality and taste, speed and/or quality of service, price and value, dining ambience, name recognition and reputation, and convenience of location.

One category of restaurants was a hybrid called “fast-casual.” Fast casual restaurants—which included Chipotle Mexican Grill and its two closest competitors, Moe’s Southwest Grill and Qdoba Mexican Eats—had average check sizes of \$9 to \$14 and were perceived to have better quality menu offerings, provide a slightly more upscale dining experience, and in some cases have enhanced service (like delivering orders to tables or even having full table service) as compared to “quick-service” or “fast-food” restaurants like McDonald’s and Taco Bell. Fast-casual

restaurant brands had estimated sales of \$47 billion in 2016, with forecasted growth to \$74 billion in 2021.¹² Chipotle Mexican Grill was considered to be in the fast-casual category because of the fresh, high quality ingredients in its dishes and because customers could customize their orders. Other chains considered to be in the fast-casual category included Panera Bread, Jimmy John’s, Panda Express, Noodles & Company, Firehouse Subs, Shake Shack, Newk’s, Jersey Mike’s, Cane’s, and Five Guys Burgers and Fries.

Like most enterprises in the away-from-home dining business, Chipotle had to compete for customers with national and regional quick-service, fast-casual, and casual dining restaurant chains, as well as locally owned restaurants and food-service establishments. However, its closest competitors were the myriad of dining establishments that specialized in Mexican cuisine—Mexican food establishments accounted for an estimated 19 percent share of the fast-casual sales in 2016.¹³ The leading fast-food chain in the Mexican-style food category was Taco Bell. Chipotle’s two biggest competitors in the fast-casual segment were Moe’s Southwest Grill and Qdoba Mexican Eats. Other smaller chains, such as Baja Fresh (165 restaurants in 26 states) and California Tortilla (51 locations in 9 eastern states and District of Columbia), were also relevant competitors in those geographic locations where Chipotle also had restaurants. The following are brief profiles of Taco Bell, Moe’s Southwest Grill, and Qdoba Mexican Eats.

Taco Bell

As of 2005, Taco Bell locations were struggling to attract customers. From 2005 through 2011, the total number of Taco Bell restaurants, both domestically and internationally, declined as more underperforming locations were closed than new Taco Bell units were opened. In late 2011, Taco Bell’s parent company, Yum! Brands (which also owned Pizza Hut and Kentucky Fried Chicken), began a multi-year campaign to reduce company ownership of Taco Bell locations from 23 percent of total locations to about 16 percent; a total of 1,276 company-owned Taco Bell locations were sold to franchisees in 2010–2012. In 2012–2013 expansion of Taco Bell locations resumed, with the vast majority of the new additions being franchised.

To counter stagnant sales and begin a strategy to rejuvenate Taco Bell, during 2010 and 2011 Taco Bell restaurants began rolling out a new taco with a Doritos-based shell called Doritos Locos Taco,

which management termed a “breakthrough product designed to reinvent the taco.” The launch was supported with an aggressive advertising campaign to inform the public about the new Doritos Locos Taco. The effort was considered a solid success, driving record sales of 375 million tacos in one year. Brian Nicol, Taco Bell’s Chief Officer of Marketing and Innovation at the time, was a strong advocate for menu innovation supported with creative advertising. In March 2012, Taco Bell began introducing a new Cantina Bell menu, a group of upgraded products conceptualized by celebrity Miami chef Lorena Garcia that included such ingredients and garnishes as black beans, cilantro rice, and corn salsa.¹⁴ In addition to the upscaled Cantina Bell selections, Taco Bell also introduced several new breakfast selections.

The upscaled menu at Taco Bell was a competitive response to growing consumer preferences for the higher-caliber, made-to-order dishes they could get at fast-casual Mexican-food chains like Chipotle, Moe’s, and Qdoba. From 2013 through 2017, Taco Bell’s upscaled menu continued to evolve and grow in number and variety of offerings. Taco Bell’s 2018 menu contained 15 versions of tacos with a choice of 3 shells, 14 versions of burritos, 19 specialty items (including quesadillas, gorditas, chalupas, nachos, taco salads, a veggie power bowl, Mexican pizza, and rollups), 23 combos, 3 types of party packs, and a selection of over 20 beverages, freezes, and sweets. The various versions of tacos, burritos, specialty items, and combos on Taco Bell’s menu could be customized by selecting any of 25 upgrades that included chicken, shredded chicken, beef, sauces, guacamole, pico de gallo, sour cream, cheese, and accompaniments (seasoned rice, pinto and black beans, potatoes, tomatoes, onions, jalapenos, lettuce, and red strips). Prices (without custom upgrades) ranged from \$1.69 to \$6.69; party packs of 12 tacos ranged from \$12.99 to \$16.99. In early 2016, Taco Bell launched a \$1 morning value breakfast menu featuring 10 items. In 2018, Taco Bell had a 17-item breakfast menu that ranged in price from \$1 to \$4.59, not including beverage options.

At year-end 2017, Taco Bell had 6,849 company-owned, franchised, and licensed restaurant locations mostly in the United States, up from 6,210 at year-end 2014. Just over 90 percent of Taco Bell’s locations were franchised or licensed at year-end 2017. Systemwide sales at Taco Bell were \$10.15 billion in 2017, equal to average sales per location systemwide of almost \$1.5 million, up from about \$1.35 million in 2014. Taco Bell’s 653 company-operated locations

had average sales per location of \$2.1 million in 2017; average sales at Taco-Bell’s 885 company locations in 2016 were \$1.74 million (during 2017, Taco Bell refranchised or closed 232 formerly company-owned locations). Sales revenues at Taco Bell restaurants systemwide grew 5 percent in 2017, 6 percent in 2016, 8 percent in 2015, 4 percent in 2014 and 2013, and 7 percent in 2012. Taco Bell’s mobile app, introduced in 2015, had contributed significantly to higher sales revenues at Taco Bell restaurants.

Moe’s Southwest Grill

Moe’s Southwest Grill was founded in Atlanta, Georgia, in 2000 and acquired in 2007 by Atlanta-based FOCUS Brands, an affiliate of Roark Capital, a private equity firm. FOCUS Brands was a global franchisor and operator of over 4,500 ice cream shops, bakeries, restaurants and cafes under the brand names Carvel[®], Cinnabon[®], Schlotzsky’s[®], Moe’s Southwest Grill[®], Auntie Anne’s, and McAlister’s Deli[®]. In early 2018, there were more than 700 fast-casual Moe’s Southwest Grill locations in 40 states and the District of Columbia. All Moe’s locations were franchised. Average annual sales at Moe’s locations were an estimated \$1.2 million.

The menu at Moe’s featured burritos, quesadillas, tacos, nachos, burrito bowls (with meat selections of chicken, pork, or tofu), and salads with a choice of two homemade dressings. Main dishes could be customized with a choice of 20 items that included a choice of protein (sirloin steak, chicken breast, pulled pork, ground beef, or organic tofu); grilled peppers, onions, and mushrooms; black olives; cucumbers; fresh chopped or pickled jalapenos; pico de gallo (handmade fresh daily); lettuce; three varieties of queso; and five salsas. There was a kids’ menu and vegetarian, gluten-free, and low-calorie options, as well as a selection of five salsas, four varieties of queso, guacamole, chips, cookies, brownies, cinnamon chips, soft drinks, iced tea, and bottled water. Moe’s used high quality ingredients, including all natural, cage-free, white breast meat chicken; steroid-free, grain-fed pulled pork; 100 percent grass-fed sirloin steak; and organic tofu. No dishes included trans fats or msg (monosodium glutamate—a flavor enhancer), and no use was made of microwaves. Moe’s provided catering services; the catering menu included a fajitas bar, a taco bar, a salad bar, a nacho bar, three sizes of burritos, a burrito box meal, guacamole, chips, salsas, quesos, dessert items, and drinks.

Moe's had introduced a "Rockin' Rewards" mobile app that not permitted mobile ordering at all locations, but also rewarded users with points on each order. For each 1,000 points earned, the user received a \$10 Moe's credit. As users moved to higher points-earned plateaus, they unlocked special offers in addition to the \$10 Moe's credit. At the 6,000-point plateau level, users were automatically entered into a Rockin' prize sweepstakes and gained more such entries for each additional 1,000 points earned.

The company and its franchisees emphasized friendly hospitable service. When customers entered a Moe's location, it was standard practice for employees to do a "Welcome to Moe's!" shout-out.

Qdoba Mexican Eats

The first Qdoba Mexican Grill opened in Denver in 1995. Rapid growth ensued and in 2003 the company was acquired by Jack in the Box, Inc., a large operator and franchisor of 2,250 Jack in the Box quick service restaurants best known for its hamburgers. Jack in the Box had fiscal year 2017 revenues of \$1.55 billion (the company's fiscal year was October 1 through September 30).¹⁵ In 2016, management changed the name of Qdoba Mexican Grill to Qdoba Mexican Eats to better reflect the flavors and variety of its menu offerings.

In October 2017, there were 726 Qdoba restaurants in 47 states, the District of Columbia, and Canada, of which 385 were company-operated and 341 were franchise-operated. Management believed Qdoba had significant long-term growth potential—perhaps as many as 2,000 locations. A total of 23 new company-owned and 19 franchised Qdoba restaurants were opened in fiscal 2017; 15 underperforming units were closed. Plans for opening new Qdoba locations in fiscal year 2018 were on hold, pending a decision by the parent company's Board of Directors regarding various strategic alternatives for Qdoba going forward.

In 2017, sales revenues at all company-operated and franchise-operated Qdoba restaurant locations averaged \$1,156,000, versus \$1,179,000 in fiscal 2016, \$1,169,000 in fiscal 2015, and \$1,070,000 in fiscal 2014. Sales at all Qdoba restaurants open more than 12 months dropped 1.5 percent in fiscal 2017, versus increases of 1.4 percent in fiscal 2016, 9.3 percent in fiscal 2015, and 6.0 percent in fiscal 2014. The average check at company-operated restaurants in fiscal 2017 was \$11.69.

Menu Offerings and Food Preparation Qdoba billed itself as an "artisanal Mexican kitchen" where dishes were handcrafted with fresh ingredients and innovative flavors by skilled cooks. The menu included burritos, tacos, taco salads, three-cheese nachos, grilled quesadillas, loaded tortilla soup, chips and dips, kids meals, and, at most locations, a variety of breakfast burritos and breakfast quesadillas. Burritos and tacos could be customized with choices of meats or just vegetarian ingredients and by adding three-cheese queso, guacamole, and a variety of sauces and salsas. Salads were served in a crunchy flour tortilla bowl with a choice of two meats, or vegetarian, and included black bean corn salsa and fat free picante ranch dressing.

Orders were prepared in full view, with customers telling line servers how they wished to customize their dishes. Restaurants offered a variety of catering options that could be tailored to feed groups of five to several hundred. While some Qdoba locations served breakfast, most locations operated from 10:30 a.m. to 10:00 p.m. Seating capacity ranged from 60 to 80 persons, and many restaurants had outdoor patio seating.

Site Selection and New Restaurant Development Site selections for all new company-operated Qdoba restaurants were made after an economic analysis and a review of demographic data and other information relating to population density, traffic, competition, restaurant visibility and access, available parking, surrounding businesses, and opportunities for market penetration. Most Qdoba restaurants were located in leased spaces in conventional large-scale retail projects and food courts in malls, smaller neighborhood retail strip centers, on or near college campuses, and in airports. There were multiple restaurant designs with varying seating capacities to enable flexibility in selecting locations for new restaurants. Development costs for new Qdoba restaurants generally ranged from \$800,000 million to \$1.1 million, depending on the geographic region and specific location. In 2017, management began using new designs for remodels systemwide.

Restaurant Management and Operations At Qdoba's company-owned restaurants, emphasis was placed on attracting, selecting, engaging, and retaining people who were committed to creating long-lasting, positive impacts on operating results. The company's core development tool was a "Career Map" that provided employees with detailed education requirements, skill sets, and performance expectations by position, from entry level to area manager. High-performing

general managers and hourly team members were certified to train and develop employees through a series of on-the-job and classroom training programs that focused on knowledge, skills, and behaviors. The Team Member Progression program within the Qdoba Career Map tool recognized and rewarded three levels of achievement for cooks and line servers who displayed excellence in their positions. Team members had to possess, or acquire, specific technical and behavioral skill sets to reach an achievement level. All restaurant personnel were expected to contribute to delivering a great guest experience in the company's restaurants.

There was a three-tier management structure for company-owned Qdoba restaurants. Restaurant managers were supervised by district managers, who were overseen by directors of operations, who reported to vice presidents of operations. Under Qdoba's performance system, vice presidents and directors were eligible for an annual incentive based on achievement of goals related to region level sales, profit, and companywide performance. District managers and restaurant managers were eligible for quarterly incentives based on growth in restaurant sales and profit and/or certain other operational performance standards.

Food Safety and Quality Qdoba's "farm-to-fork" food safety and quality assurance programs were designed to maintain high standards for the food products and food preparation procedures used by vendors and restaurants. It maintained product specifications for ingredients and the company's Food Safety and Regulatory Compliance Department had to approve all suppliers of food products to Qdoba restaurants. Third-party and internal audits were used to review the food safety management programs of vendors. Food

safety in Qdoba restaurants was managed through a comprehensive food safety management program based on Food and Drug Administration food code requirements. The program included employee training, ingredient testing, and documented restaurant practices and attention to product safety at each stage of the food preparation cycle. In addition, the program used American National Standards Institute certified food safety training programs to train company and franchise restaurant management employees on food safety practices.

Purchasing and Distribution Beginning in March 2017, all Qdoba company-operated and franchise-operated restaurants entered into a five-year distribution services agreement with a consortium of four Qdoba regional distributors comprising 18 distribution centers in the United States and two distribution centers in Canada.

Advertising and Promotion The goals of Qdoba's advertising and marketing activities were to build brand awareness and increase customer traffic. All company-owned and franchised restaurants contributed a percentage of gross sales to fund the production and development of advertising assets suitable for national and regional radio, print, and digital and social media. System operators could utilize these assets, or tap into the parent company's in-house creative services group to create custom advertising that met their particular communication objectives while adhering to brand standards. Additionally, Qdoba had launched a mobile app for placing orders and a rewards program designed to inspire, motivate, and reward increased dining frequency at Qdoba locations.

ENDNOTES

¹ Company press release, November 29, 2017.

² Company press release, February 6, 2018.

³ David A. Kaplan, "Chipotle's Growth Machine," *Fortune*, September 26, 2011, p. 138.

⁴ According to information posted in the careers section at www.chipotle.com, accessed February 18, 2012, May 13, 2013, February 19, 2016, and February 12, 2018.

⁵ Information posted in the careers section at www.chipotle.com, accessed February 12, 2018.

⁶ *Ibid.*

⁷ *Ibid.*

⁸ Company press release, April 25, 2018.

⁹ Company press release, May 23, 2018.

¹⁰ National Restaurant Association, 2017

Restaurant Industry Pocket Factbook, www.restaurant.org, accessed February 15, 2018.

¹¹ *Ibid.*

¹² National Restaurant Association, "Technomic

State of the Fast Casual Industry," May 2017,

www.restaurant.org, accessed February 15, 2018.

¹³ *Ibid.*

¹⁴ Leslie Patton, "Taco Bell Sees Market Share Recouped with Chipotle Menu," *Bloomberg News*, January 11, 2012, www.bloomberg.com, accessed February 20, 2012.

¹⁵ The statistics in this section are drawn from parent company Jack in the Box's 2017 10-K Report.