Management CV

Research Note:

# Chipotle Mexican Grill (CMG)

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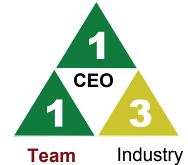
## Unique Corporate Culture Drives Results




Since going public in January 2006, Chipotle's founder and CEO, Steve Ells (43) has articulated a clear and consistent strategy to rapidly expand the unit base and maintain strong same-store sales. Management has delivered consistent growth and profitability by differentiating the brand among fast food restaurants as one that procures its food from a growing proportion of sustainable sources (naturally-raised meats and often locally-grown, sometimes organic produce). The Company's innovative staffing structure, implemented in 2006, gives hourly crew members a clear path into managerial roles - not the norm in the fast food industry and a major differentiator for attracting retaining dedicated staff. This promote-from-within approach to staffing motivates CMG employees and provides a sustainable competitive edge that causes all levels of staff to strive for excellence. We see this corporate culture delivering tangible operating results, with consistently lower employee turnover and higher revenue per employee than average. This meritocracy system also provides Chipotle with a steady pipeline of new managers to support rapid and profitable unit growth. Last week's announcement that the Company intends to abolish its two class share structure and convert all B shares into regular Class A common pending a shareholder vote in December is also positive news. We see a disciplined corporate culture that can provide sustained growth for many more years and rank CEO Ells and his management team as top quintile among their restaurant industry peers.

Chipotle's executive management have been stable and have unusual backgrounds. The team is led by founder and Co-CEO Steve Ells, who has a BA in art history and is a 1990 graduate of the Culinary Institute of America. Ells founded CMG in 1993 with a $2 million investment from his father which paid off nicely when McDonald's acquired the business in 1998. Ells also gleaned many of CMG's most successful operating methods from the MCD relationship before Chipotle became an IPO spin-off in 2006. Ells' culinary background explains Chipotle's unique "food with integrity" focus on fresher, non-hormone treated ingredients and the unique up-front preparation format of the restaurants. Earlier this year Monty Moran was promoted Co-CEO after serving as the firm's COO for the previous four years. For the decade prior to joining CMG Moran was a trial lawyer, which appears a bit incongruous, although part of his legal career (involved in real estate) may provide useful experience as CMG rapidly adds units and leases. Moran joined CMG in 2005 and he is credited with instituting the innovative promote-from-within policy, which has been so successful. CFO Jack Hartung has been with the firm since 2002 and was well prepared for the CFO slot he assumed, having worked previously at McDonald's Corp. for 18 years, most recently as CFO of Partner Brands group. In addition to Co-CEO Moran's appointment, there have been two other management changes this year that should serve to strengthen the team and support CMG's growth strategy. Mark Crumpacker, who developed CMG's original logo and identity package and ran his own creative design firm prior to joining CMG in January, was promoted to CMG's first-ever Chief Marketing Officer. CMG also hired Bill Niman, the founder of the ranch that provides much of CMG's naturally raised pork and beef, in a consulting capacity as a Sustainable Agriculture Advisor.

We think CMG's executive compensation structure is well aligned with investors and yet provides significant incentives for retention and continued operating out performance. There are no formal employment agreements with executives. The team's total cash compensation comprised 3.3% of EBIT in 2008, which we think is very reasonable relative to the Company's superior growth rates and ROIC since going public in 2006. CEO Ells is paid a salary of $1.1 million, and his total 2008 compensation was $5.6 million. Co-CEO Moran receives an $850k salary, and his total compensation in '08 was $3.4 million. CFO Hartung is paid a salary of $470k, and had total compensation of $2.3 million. CMO Crumpacker's salary is $300k. Base salaries represent a modest 20% of senior management's total compensation, with specific incentive cash bonuses contributing another 12%.

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Total annual cash bonuses can range from zero to 204% of salary and are formulated based on Company, individual and team performance. CMG's structure also does a good job of tying management's fortunes to those of outside shareholders although the Co-CEO's are required to hold only a modest minimum of 50k beneficial shares of CMG stock. In 2008 management fell short of all of the various targeted performance measures except new restaurant weeks (unit development) but the firm still significantly out performed the industry. We think the Board prudently rewarded this relative performance and adjusted upward its previously set annual cash bonuses. The four metrics on which incentive payments are based are key value drivers and, with the exception of operating income, would be hard for management to manipulate: 1) pre-bonus operating income, 2) new restaurant average daily sales, 3) same-store sales, 4) new restaurant weeks. Importantly, the targets represent stretch goals that exceed the base level forecasts on which the company computes its full year investor guidance, thus tying bonuses to out performance. In 2008 Ells received a cash bonus of $777k, Moran received just over $1 million, and CFO Hartung received $861k.

Chipolte's top management has strong incentives to make decisions that drive longer-term operating income growth and stock price appreciation. Nearly 30% of management's compensation comes in the form of stock appreciation rights (SOSARs), the dollar value of which, like annual bonuses, is awarded to executives based on their progress relative to Company and individual performance targets. The SOSARs are set at the market price at the time of the award and they cliff vest in three years, providing both retention and performance incentives. Another 40% of management's compensation comes from additional performance shares, which CMG used to replace its time-vesting restricted stock beginning in 2008. Performance shares represent a right to be issued CMG Class A common stock, provided a specified (but non-disclosed) level of cumulative operating income is earned during the four years from the beginning of 2008 through 2011. We like these strong performance based incentives.

With a compensation structure heavily weighted towards stock-based payments, it is not surprising that Chipotle's executive team and directors have a healthy amount of equity "skin" in the game, further aligning their interests with those of shareholders. CEO Ells owns a combined 625,000 class A and B shares or 1.9% of the Company's total shares outstanding (recall that CMG plans to merge A & B shares into a single Class A share this December) and the directors and officers beneficially own a combined 4.0% of the Company – quite significant given its current market cap of nearly $3 billion. We note, however, that insider selling at Chipotle has been heavy in past years and especially since stock options vested that were issued during CMG's January 2006 IPO. In April this year, as the stock climbed 65% in just one month, seven insiders sold more than $18 million in stock and many of those sales were of options that still had long terms remaining before they expired. Since April, however, insider sales have dropped dramatically to immaterial levels and –according to FactSet as of this writing—net insider selling of Class A shares over the last six months has been only 5,737 shares on a volume of just under 100k shares.

Finally, capital allocation by CMG's management has been remarkably prudent. They have studiously maintained a clearly articulated capital allocation policy of self-funding growth, avoiding franchising, and using excess cash to opportunistically repurchase shares without incurring incremental debt. Having completed a $100 million repurchase program at an average price near $54 well below its 52-week high of $98, management has indicated it will not seek additional buyback approvals now. This is prudent, in our opinion, ahead of the company's plans to use cash to reaccelerate new unit growth from the current 911 restaurants to pre-recession levels of 20% annually and to expand into the London metro area in 2010. We note that Chipotle is one of the few restaurant chains that has not been forced by recession-induced cash constraints to shift its capital allocation priorities and slow unit growth. Management's decision to slow unit growth in 2009 was actually driven by its real estate developers funding constraints. We are impressed with this management team and rank both the CEO and team as among our best.

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