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Stock Valuation Report
July 6th, 2016

Chipotle Mexican Grill Inc.

Summary

Stock Valuation Report: **Chipotle Mexican Grill Inc.,** July 6th, 2016

Summary: Chipotle has been on the forefront of quick-casual restaurant segment in the US for the last two decades. It is among the few companies in the industry that recorded same-store sales growth every quarter since inception. The management has been conservative in maintaining sound capital structure and carefully driving growth to leverage market opportunity. Stock performance over the last two decades have been a testimony to the good performance and the stock has delivered attractive returns in the long run. However, hygiene concerns have recently emerged and that could substantially dilute brand equity that is built upon healthy food. Coupled with high penetration rate of the company in its target segment, increasing competition, and input cost pressure could have adverse impact on long term operating margins and same-store sales growth. In my view, the current valuations don't provide margin of safety for conservative investors, and therefore I assign SELL rating on the stock with a downside target of $234.7 over the next 12-months. It implies a correction of 40.4% from the current stock price of $393.91.

Investment Thesis: I assign a sell rating on Chipotle due to the following reasons. First, recent regulatory issues about E-Coli and Norovirus contamination in the food offered by Chipotle have caused significant dilution in the brand equity that is built upon offering quality food. Second, increasing competition in the fast food service restaurant segment is likely to result in more moderate same-store sales growth than the historical rates for Chipotle. Third, increasing food, beverages, and packaging costs in an environment of higher competition and fragile real GDP recovery are likely to limit company's ability to pass input cost pressure to final consumers and therefore would put pressure on operating margins. Finally, increasing costs of labor due to recent regulatory changes could cause contraction in operating margins

Risks: Risks include resolution of E-Coli and Norovirus incidents earlier than expected, lower agriculture and crude oil prices, successful international expansion earlier than anticipated, more successful and quicker scalability of diversification in other food segments, quicker break-even period for newly opened stores.

Recommendation: SELL

Ticker	**CMG**
Sector	**Consumer Discretionary**
Industry	**Restaurants**
Current Price (USD) as of (07/01/2016)	**$393.91**
Price Target (USD)	**$234.7**
Total Projected Return	**$111,447**
Dividend Yield	**(N/A)**
Downside	**40.4%**

Market Data

Market Capitalization (USD)	**$11.57 Bn.**
Shares Outstanding	**29.20 Mn.**
52-week Price Range	**$384.77 - $758.61**
Beta	**0.33**

Financial Data (FY2015)

Revenue (USD)	**$4.50**
Revenue Growth (Y/Y)	**10%**
Operating Income (USD)	**$764 Mn.**

Analyst/Fund Information

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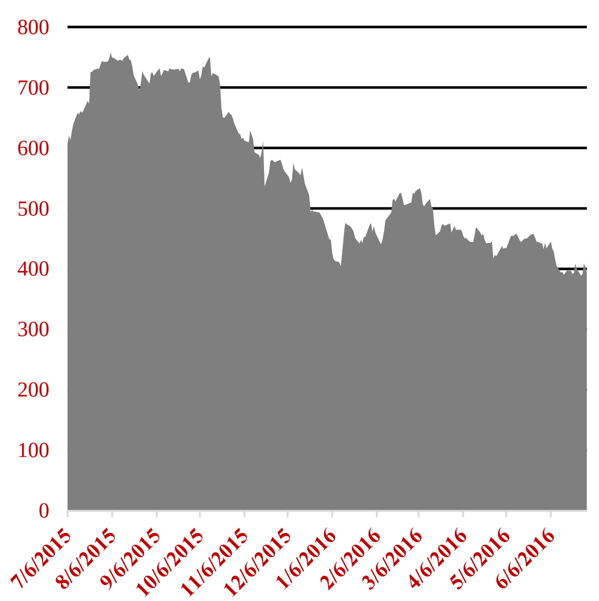
CMG 12-Month Stock Price Chart



Source: NASDAQ

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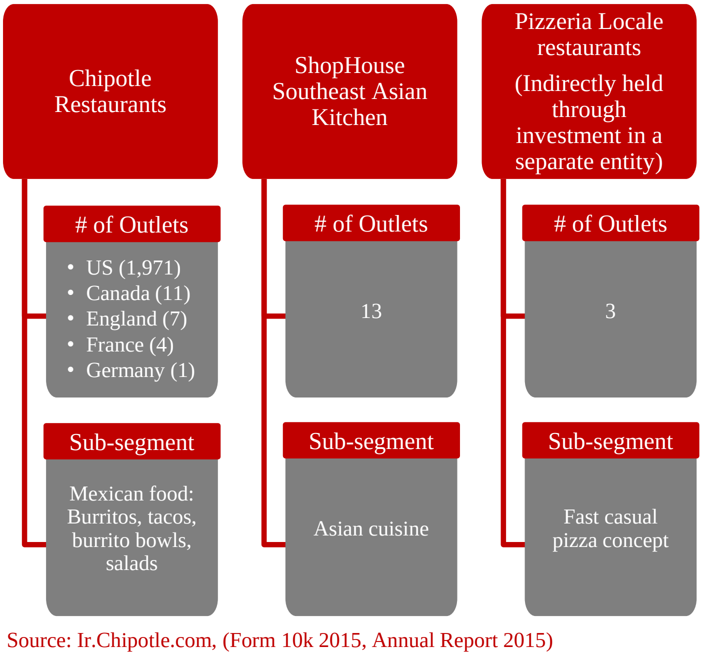
Company Overview

Chipotle Mexican Grill, Inc. operates Chipotle Mexican Grill restaurants. The company was founded by Steve Ells, a classically trained chef in 1993. Most of these restaurants operate on fast-casual Mexican food concept and are located in the US. In order to diversify the risk, the company has gradually been expanding into international markets and other food segments, See (**Figure 1**: Business Segments).

Figure 1: Business Segments



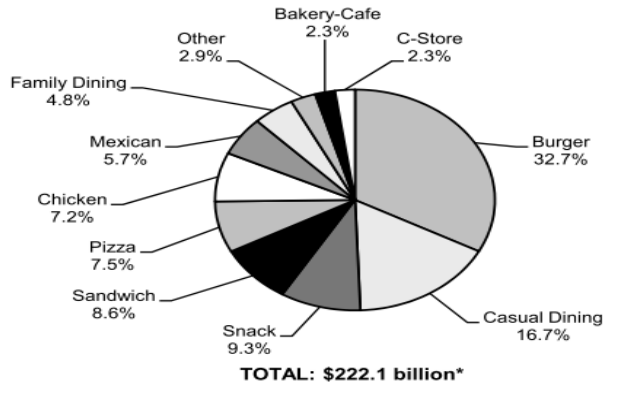
Source: Ir.Chipotle.com, (Form 10k 2015, Annual Report 2015)

Market Share, Addressable Market, Growth Drivers

Restaurants industry is driven by changing consumer preferences and population shift. The size of the industry in 2015 was $683.4 billion. Eating places (operating segment of Chipotle) is the largest segment accounting for $455.9 billion.

	SALES (BIL. $)
Commercial food service, total	624.3
Eating places	455.9
Bars and taverns	20.0
Managed services	47.1
Loding place restaurants	34.8
Retail, vending, recreation, mobile	66.4
other food service	56.6
TOTAL US FOOD SERVICE SALES	683.4

Restaurants Segments



* Total sales are the combined domestic sales of the top 100 chains.

Source: Nation's Restaurant News

Based on the type of food served, the share of Mexican cuisine is 5.7%. It is considered as a niche though rapidly growing segment. Chipotle is the market leader in the segment and has recorded substantial market share gains over the last two decades.

Fast-food segment is further divided into fast-casual in which Chipotle operates. It refers to a growing group of restaurant operators that provide higher quality food than the traditional fast-food restaurants do but at a lower price-point of full-service restaurants. Historically, Chipotle has grown at a higher growth rate than the industry's growth in fast-food segment.

Following factors are the growth drivers for consumers' preference for fast-casual segment:

- Limited service or self-service format
- Average check generally between $8 and $12
- Food prepared to order
- Fresh (or perceived as fresh) ingredients
- Innovative food suited to sophisticated taste
- Upscale or highly developed interior design
- Alcohol may be served

Technomic (a reputed restaurant market research firm based in the US) expects the market share of fast casual segment to increase to 10% in the long run from the current 7.3%. Quality food, fast service, and reasonable price are expected to be the main driver for this shift. Market leaders such as Chipotle are likely to gain from the shift due to their strong brand equity, robust vendor base, and vast reach.

Sustained Competitive Advantage

Founder, Chairman, and co-CEO Steve Ells is a trained chef. His approach has led to establishing unique approach to cook and focus on quality. In my opinion, the company has strongly conveyed its desired message of "Food with Integrity" in its business practices. Based on my primary research by visiting the outlets of competitors, analyzing advertising campaigns, and by giving attention to small details, I have identified the following unique attributes in the business practices of Chipotle. Over the last 2 decades, the company has been able to gain market share, record robust same-store sales growth, and command pricing power due to these competitive advantages.

Scope of Operations	Unique Attributes	Competitive Advantage For Chipotle
Ownership	All restaurants are company owned and no franchise arrangement	Better control over the quality of food and services
Quality of food	• Year 2000: Starting serving naturally raised pork • Year 2002: started serving naturally raised chicken • Year 2004: started using zero-trans fat frying oil • Year 2007: Made all sour cream and cheese products rBGH free • Year 2009: starting using naturally raised beef • Year 2010: starting using certified organic black beans • Stated policy of not using unnatural hormones or anti-biotic usage for raising meat and additives	• Better customer loyalty • Increased pricing power compared to competitors • Better ability to raise prices due to cost increases. In the past it has not impacted same-store sales growth
Supply chain	• Stated preference to buy from local farms (within 300 miles from a restaurant) • Preference to buy from family farms	• Increased feeling of community ownership within the location of the restaurants • Better longevity of the robust supply chain, acquisition of local knowledge and loyal customers base from the community • High consistency in the quality of ingredients
Architecture of the restaurants	• Most of the restaurants are designed by sculptor Bruce Gueswel • Each restaurant aims for hip and urban feel • Each location has industrial, but little decor, which consists of halogen lighting, metal tabletops, wooden benches and seats, concrete floors, arched metal ceilings, exposed ductwork with artwork • Use of open kitchen	• Consistency in customer experience • Casual yet modern look • Design supports the ability to deliver fast • High quality architecture compliments high quality food to ensure premium positioning • Creating atmosphere of trust between store employees and customers
Focus on sustainability	• Substantial focus on sustainable construction such as solar panels and wind turbines	• Enhances brand equity due to increased customer focus on sustainability
Advertising	• During early years, the advertising was entirely by word-of-mouth • Now it advertises on billboards and on radio • Advertising theme: witty, edgy campaigns poking fun • Giving out burritos on Halloween	• Cost optimization • Better match with the desired ambience of restaurants as casual outlets • Positioning restaurants as a place to relax while having food • Enhancing the image as socially responsible organization
Human resource practices	• Despite having 59,330 employees (as on December 31, 2015), none of the employee is unionized or covered by a collective bargaining agreement	• Reflects trust of employees in management's ability to devise employee friendly policies

Source: www.sec.gov

Recent Important News and Events

During November and December 2015, illness caused by E-Coli bacteria were connected to a number of restaurants operated by Chipotle. The incidence was reported in restaurants located in 12 states. This led to significant decline in company-wide sales.

Source: Form 10k 2015, Annual Report 2015

During the week of December 7, 2015, an unrelated incidence involving norovirus was reported at a Chipotle restaurant located in Brighton, Massachusetts, which worsened the adverse impacted experienced from the earlier E-Coli incidence.

Source: Form 10k 2015, Annual Report 2015

These incidents led to criminal investigation as reported by the company in contingent liabilities section of the annual report of year 2015.

In order to overcome and restore market share, the company has started numerous marketing and advertising activities that included distributing free or discounted food in the first quarter of Year 2016. These activities have substantial cost and are expected to adversely impact operating margins for the year.

Recently the State of California, New York City, and a number of jurisdictions around the US have adopted a regulation requiring chain restaurants to include calories and other nutrition information on their menu. This national health care reform law would go into effect on Dec 1, 2016. This disclosure requirement could adversely impact same-store sales growth and increase expenses of compliance for Chipotle.

Source: Form 10k 2015, Annual Report 2015

Investment Thesis

Economic Analysis: Demand Drivers

A key aspect for the expansion of Chipotle is same store sales growth. Same store sales growth is driven by consumer spending, which in-turn is impacted by the economic conditions. Assessment of the following indicators assists in anticipating demand growth for the company.

Real growth in the GDP: Inflation adjusted GDP measures the health of the economy and in-turn impacts the level of economic activity. Higher real growth rates lead to better labor force participation rate and higher disposable income, which in turn leads to higher growth in same-store sales and higher pricing power. Historically, Chipotle has demonstrated its sensitivity to real GDP growth. During 2008-10 period of post Lehman crisis, revenue growth of the company was substantially below the historical average. I expect real GDP growth to remain at the mid-cycle range 2% and 2.4% between 2016 and 2010. This is in line with the forecasts made by IMF.

Source: IMF, World Economic Outlook (WEO) Update, and Author's Analysis

Economic Analysis: Consumer Confidence

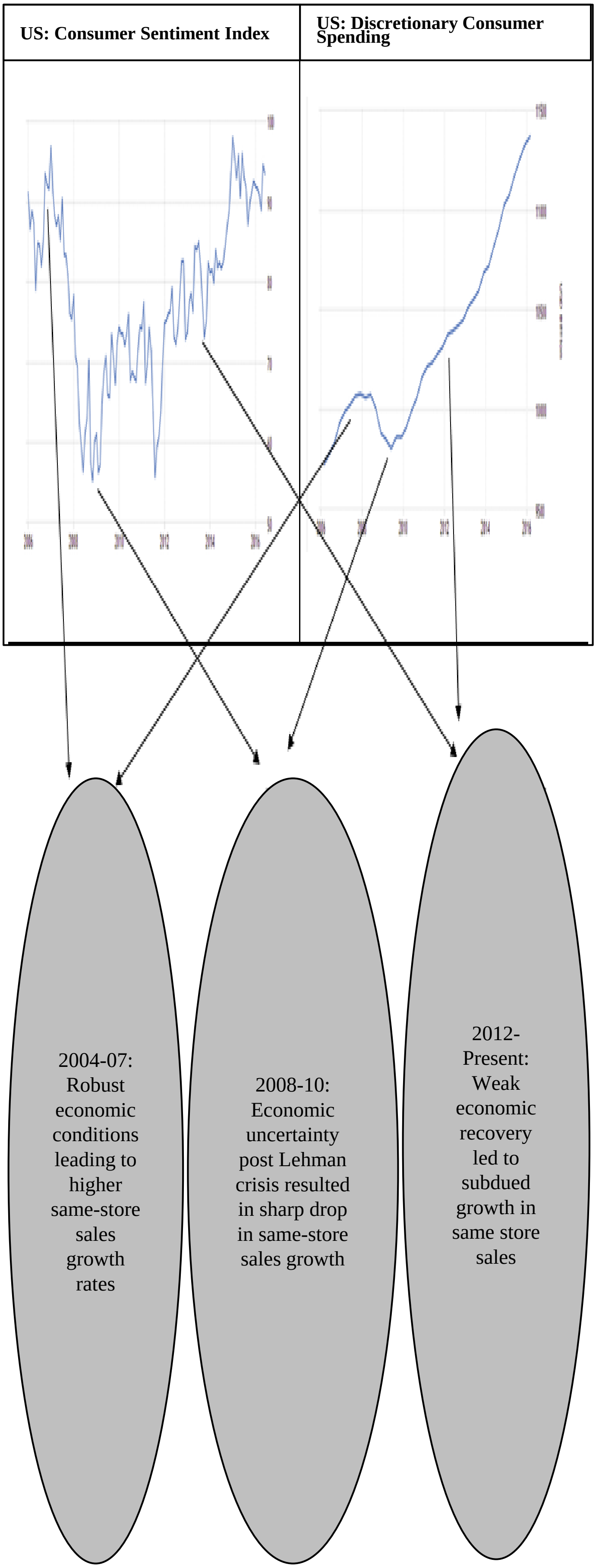
Historically, higher consumer confidence has led to higher same-store sales growth and better pricing power for Chipotle. Consumers' perception of employment availability and current and future projected income levels did impact same-store sales growth rates. When consumer confidence is low or falling, it has usually been accompanied by consumers postponing expenditure.

Economic Analysis: Consumer Spending

Being in the consumer sector, Chipotle has been impacted by consumer spending. During high growth phase of consumer spending, the same store sales growth has been above average. Conversely, during the periods of weaker growth, consumers have preferred to eat at less expensive restaurants or to cook at home.

The following **Figure 2** demonstrates that between years 2004 and 2007, there was high real GDP growth rates, better consumer confidence and higher consumer discretionary spending rates. These resulted in higher same store sales growth rates. Post Lehman crisis between years 2008 and 2010, these economic indicators moved lower therefore resulting in lower same-store sales growth rates. Post 2012 since the real economic recovery has been weaker, higher penetration level of Chipotle's stores, and base effect, same-store sales growth has been moderating.

Figure 2



Chipotle: Same store sales growth rates since inception:

	Q1	Q2	Q3	Q4	FY
2014	2.0%	2.0%	2.0%	2.0%	2.0%
2013	1.0%	5.5%	5.8%	6.6%	4.7%
2012	12.7%	8.0%	4.8%	3.8%	7.3%
2011	12.4%	10.0%	11.3%	11.1%	11.2%
2010	4.3%	8.7%	11.4%	12.6%	9.4%
2009	2.2%	1.7%	2.7%	2.0%	2.2%
2008	10.2%	7.1%	3.1%	3.5%	5.8%
2007	8.3%	11.6%	12.4%	10.6%	10.8%
2006	19.7%	14.5%	11.6%	10.1%	13.7%
2005	4.1%	9.6%	11.5%	14.3%	10.2%
2004	23.2%	13.2%	8.9%	10.4%	13.3%
2003	25.3%	24.6%	24.7%	23.4%	24.4%
2002	16.8%	18.8%	15.5%	17.0%	17.0%
2001					22.5%
2000					16.4%
1999					27.1%
1998					14.9%

Fundamental Drivers of Profitability: Food Commodity Prices

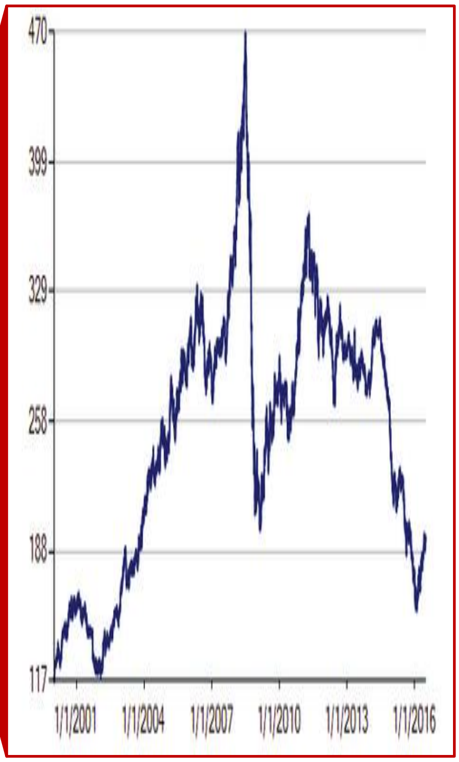
Food and packaging costs are the largest component of the cost structure for Chipotle. Over the last 10-years, these have ranged between 30.6% and 34.6%. Corn, meat, vegetables, edible oils are major ingredients of food items. Most of the packaging material is petroleum based, therefore fluctuation in crude oil prices impact the cost of packaging material. As exhibited in the figure below, between 2009 and 2010, the CRB Index touched the low of 190 and that resulted in food, packaging and beverage cost to decline to 30.6%. Since all stores are owned by Chipotle, the sensitivity to commodity prices are higher for the company compared to franchise operated business models by other competitors. This is because for franchise owned stores, food costs are incurred by the franchisee and not the franchisor. For Chipotle, all food and packaging costs are incurred by the company. During the current cycle of low commodity prices, these costs have not come down because customers have been trading down (buying low priced items) reflecting weaker real economic recovery post Lehman crisis. Consumers' tendency to trade-down coupled with moderate same-store sales growth have limited Chipotle’s pricing power, and a large proportion of the commodity cost increases have been absorbed by the company in the recent years.

In order to sustain profitability, the company has undertaken various cost cutting initiatives. These include reducing wastage and optimizing logistics costs for sourcing raw material. Due to these initiatives, I expect food, beverage, and packaging cost to decline to 33% and 27% respectively in FY2017 and FY2018.

Chipotle: Food, packaging, and beverage cost as a percentage of sales

2015	33.4%
2014	34.6
2013	33.4%
2012	32.6%
2011	32.5%
2010	30.6%
2009	30.7%
2008	32.4%
2007	31.9%
2006	31.4%
2005	32.2%
2004	32.7%
2003	33.3%
2002	33.1%
2001	34.4%
2000	35.3%

Total Return: Core Commodity CRB Index:



Fundamental Drivers of Profitability: Labor Costs

Labor costs are the second major component of the cost structure of Chipotle. Over the last decade, these costs have been range bound between 22% and 24%. However unemployment rates have been falling even though the quality of employment has been lower than the pre-Lehman crisis levels. Chipotle relies heavily on the availability of a dependable work force at the low end of the national pay scale. In such an environment coupled with robust national employment outlook, the company has to raise pay levels to attract and retain workers. Minimum wage legislation, regional labor shortages, and higher healthcare costs could increase the labor costs. I have projected labor costs to be in the range of 25% to 26% in my financial model.

Fundamental Drivers of Profitability: Unemployment Rate

Source: US Bureau of Labor Statistics, from Tradingeconomics.com

Financial Analysis and DCF Model

As shown in the appendix, my estimates for both revenue growth and operating margins are more conservative than consensus estimates. The difference is on the following account:

Operating Margin

	2015 (Actual)	2016 (Estimated)	2017 (Estimated)	2018 (Estimated)
My Projection	**17.0**	**5.1%**	**13.1%**	**19.1%**
Analysts' Consensus	**-**	**6.2%**	**14.4%**	**19.6%**

Source: Author's Analysis

My projections are more conservative than analysts' consensus. It can be attributed to the following discrepancies:

- Food, Beverage, and Packaging Costs: As per consensus opinion, food costs would continue to remain moderate over the next two years. In my view, due to severe drought in major agriculture producing countries such as Brazil (recorded among the worst drought in the last 80 years) during 2014 and 2015, the agriculture production has decreased. The impact of El-nino has also affected agricultural crops in the other parts of the world. Consequently, the prices of products such as milk, coffee, corn and spices would remain at an elevated levels. Adverse agriculture crops lead to higher prices for meat products such as beef, pork, and poultry. All these are key ingredients of the menu of Chipotle. These trends have already reflected in the higher levels in CRB index in which agricultural commodities and meat products account for a major part.

Since Chipotle's brand positioning is based on high quality food ingredients, it is unlikely to compromise on the quality of inputs, and therefore these costs would remain high.

While analysts expect same-sales growth rates to return to the historical trend resulting in increased ability of Chipotle to pass the cost pressure to consumers by raising prices, I believe that such cost inflation would largely be absorbed by the company due to fragile real economic recovery and increased competition in the sector.

- Crude Oil Prices: Most of the packaging material is based on crude oil derivatives. Analysts expect crude prices to remain benign below $50 per barrel. In my opinion, due to persistence of supply side constraints, crude prices (WTI) could move to higher levels. This would cause packaging costs to move higher.

- Labor Costs: Analysts project labor cost to remain at a long term average of 22-23.5% of sales. In my opinion, robust employment outlook, minimum wage regulation, and higher healthcare costs would result in labor costs moving above the long term average to 25% over the next 3-years.

- Break-Even Period: Chipotle expects to continue expansion at 220-235 restaurants per year. Historically, the break-even period of these restaurants has been 12-months. Break-even period is defined as the duration in which the restaurant stops incurring operating losses and expects to become profit neutral. Analysts expect the break-even period to remain at the historical level. In my opinion, increased competition, down trading by customers for lower value products, and fragile real economic recovery could cause break-even period to increase from 12 months to 15-18 months. It would result in delayed contribution of new restaurants in operating profits.

Revenue Growth

My estimates for revenue growth are more conservative than analysts' consensus. Analysts are more bullish on the prospects of international expansion of the company. They also expect that Chipotle would continue to find attractive niche within the food segment (such as Asian Cuisine and pizza) to record robust growth.

Revenue Growth	2016-2018 (CAGR %)
My projection	1.0
Analysts' consensus	10.0

Source: Author's Analysis

In my view, international expansion is a long-term strategy for Chipotle. Based on historical evidence, the management is conservative in expansion strategies. It patiently tests its business model in new location. Acquiring local knowledge and build local vendor base to ensure food quality are of immense importance for the company. However this requires time. I believe that the company plans to expand into newer niche but without diluting its corporate image, therefore it would be more conservative on such aspect as well. There has been increasing competition in the US markets and newer players are as nimble and technology savvy as has been Chipotle. In view of these, I have projected 1% revenue CAGR for the company between 2016 and 2018.

Earning Per Share (Diluted EPS)

My EPS estimates are more conservative than the consensus. This is due to:

- Muted revenue growth projections than the consensus
- Relatively lower operating margins than the consensus

Due to relatively conservative estimates, my view on the projected stock price is more moderate than the consensus.

Valuation

Since restaurant industry has steady and stable cash flows, and Chipotle is a major player with the focus on profitable growth, DCF is an appropriate model to assess the stock value. I have assigned 60% weight to the DCF based valuation.

Increasing competition and disruption in the traditional business models of restaurants has made the industry more dynamic. In such as

Scenario, multiples based valuation gains importance as competitive landscape in the marketplace could have impact on the performance of Chipotle. I have done valuation based multiples at 3 levels:

- 1: Chipotle vs S&P 500
- 2: Chipotle vs Consumer Discretionary Sector
- 3: Chipotle vs Peers

DCF Model

The appendix contains Discounted Cash Flow (DCF) Model. I have taken discount rate of 10%, and terminal growth rate of 4%. The model implies a final target price of $226 per share.

The S&P 500 is currently trading at a forward P/E of 16.6. Based on the P/E of consumer discretionary sector, the implied growth rate is 5.8%. However over the long run, I expect P/E of Chipotle to be at a discount with consumer discretionary sector and have used 4% terminal growth rate in my DCF model. This is on account of relatively high penetration level of the stores in the US, increasing competition, and Mexican cuisine accounting for a larger proportion in the revenue stream compared to bigger competitors who are well diversified across different food categories. Even though the company has provided indication of adding 220-235 stores per year for the next few years, in my view focus on profitable growth and increasing competition might lead the company to reconsider its expansion plans. While other analysts are optimistic about international expansion plans, I believe that due to conservative nature, the management might build international base more gradually than the expectations of the analysts, Source: Author's Analysis and Annual Report 2015.

I have used the discount rate of 10% on account of increasing food safety regulations resulting in higher potential risk for companies operating in food segment. Recent cases of E-Coli incident indicate the potential dilution in brand equity and potential adverse impact on long term revenue growth.

Figure 3 below illustrates the target stock prices given adjustments to both discount rate and terminal growth rates.

Figure 3: Sensitivity analysis of target price to growth rate (row) and discount rate (column)

	10.75%	11.00%	11.25%	11.50%	11.75%
2.00%	$196.89	$191.42	$186.25	$181.35	$176.70
2.25%	$203.18	$197.37	$191.89	$186.70	$181.79
2.50%	$209.85	$203.67	$197.85	$192.36	$187.16
2.75%	$216.93	$210.36	$204.17	$198.34	$192.83
3.00%	$224.47	$217.46	$210.87	$204.67	$198.82
3.25%	$232.52	$225.02	$218.0	$211.38	$205.16
3.50%	$241.12	$233.08	$225.56	$218.51	$211.89
3.75%	$250.33	$241.70	$233.65	$226.11	$219.04
4.00%	$260.23	$250.94	$242.28	$234.21	$226.65
4.25%	$270.89	$260.86	$251.54	$242.87	$234.77

Source: Author's Analysis

The DCF model also accounts for the value of Chipotle's cash acquisition. In December 2015, the company reported cash and liquid investments of $0.67 million. Since the company is debt free, I have provided $0.22 million for expansion initiatives to achieve projected revenues and to maintain liquidity for operating purposes. Then, I added $0.43 million (or $7.6 per outstanding share) to the valuation model to arrive at a DCF implied price of $226.0 per share. The DCF implied price implies a discount of 42.6% from the current stock price of $393.91.

I expect Chipotle to maintain the large cash balance due to its conservative management, requirement of growth plans, and policy to maintain relatively conservative capital structure.

Relative Valuation

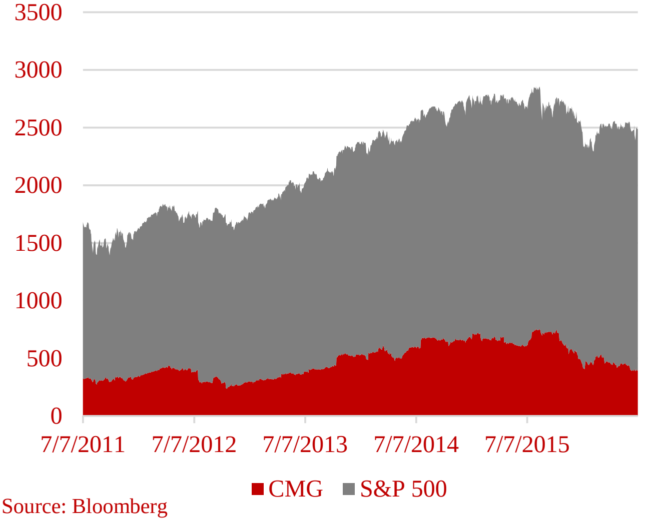
As a sector, consumer discretionary sector is considered a stable cash flow business with moderate growth rates due to relatively saturated market opportunity, steady population growth, and low working capital intensive business model. Although the sector has been trading at a moderate premium to S&P 500 valuation, the valuations of the sector have been range bound over the 10-years. This is contrary to the period before 2003-04 when the sector used to command higher valuation multiples compared to S&P 500 valuations. In my opinion, this is due to increasing competitive intensity leading to more moderate growth opportunities and lower operating margins than before.

Table: Sector's Historical Multiples' Range (10Y CMG Absolute Valuation)

	High	Low	Median	Current
P/E	64.79	21.66	36.86	25.92
P/S	5.17	1.52	3.43	2.75
P/B	10.75	3.20	7.42	5.73
P/CH	32.70	10.23	22.32	18.13
P/EBITDA	30.42	10.57	18.23	13.86

Source: Author's Analysis

Sector's Stock Price Performance Chart Compared to S&P 500



Source: Bloomberg

Table: Stock Relative Valuations Compared to S&P 500. (10Y CMG Relative to S&P 500)

	High	Low	Median	Current
P/E	4.12	1.54	2.74	1.95
P/S	4.32	1.19	2.51	1.52
P/B	5.78	1.23	3.15	2.67
P/CH	4.82	0.92	2.48	2.19
P/EBITDA	5.05	1.33	2.70	1.71

Source: Author's Analysis

While the company is currently trading at a premium to the valuations of consumer discretionary sector, in my view the earnings are lower than the long term average. This is partly due to expenses on rebuilding the brand post E-Coli incident in Year 2015. The incident has also brought down the revenue growth rate due to aversion of some consumers to visit company's outlets until the inquiry is complete and the issue to satisfactory resolved. Lower than historical operating margins and revenue growth have caused valuation multiples including P/E, P/B, P/CH, P/EBITDA to be on the higher side as earnings are lower than the normalized scenario.

Figure 4 below shows Chipotle's price and enterprise value based multiples relative to its peers. As indicated by the wide range of these results within each multiple, the companies are at a different growth phases, management strategies, and market presence. Due to dominant proportion of Mexican cuisine in the capital structure, Chipotle's performance is largely driven by dynamics in this niche than more diversified competitors. Within these limitations, I believe that Chipotle is strongly positioned within the consumer discretionary sector and management has done commendable job in ensuring consistent growth, debt free balance sheet, and strong brand equity.

Figure 4: Sector's Historical Multiples' Range vs Peers (9Y)

	P/E	P/S	P/B	P/CH	P/EBITDA
Average	23.53	1.48	3.06	11.55	9.92
CHIPOTLE	41.92	2.22	3.91	17.63	18.23
LUBY'S INC	13.71	0.78	1.64	9.92	7.52
MCDONALD'S CORP	18.71	2.53	3.45	12.60	9.38
BOB EVANS FARMS	23.49	0.81	1.85	8.85	7.76
PANERA BREAD	29.66	2.10	4.43	16.56	12.87

Source: Author's Analysis

However, the company suffers from long term structural limitations:

- Relatively concentrated presence in Mexican Cuisine segment therefore increasing the sub-segment concentration risk
- Limited international presence
- Recent lawsuits diluting the brand equity of the company since the brand is built on high food quality

Compared to Chipotle, other similar sized competitors like McDonalds and Panera Bread score higher therefore have less risky and more mature business model.

Final Price Target

For the final price target, I undertook a weighted average of the target prices from the implied prices from DCF valuation and valuation multiples. I assigned 60% weight to the DCF implied valuation as the sector is characterized by low working capital requirement and steady cash flows. In my opinion, the certainty of the cash flow for Chipotle is high considering the strong brand equity and conservative management approach, the conditions suitable to apply DCF model.

Given the disparities among different players, I have assigned 40% weight on valuation of multiples. Since Chipotle is impacted by market and competitive dynamics, the weight is appropriate in my view. In order to further normalize the impact of Chipotle's lower than normalized earnings due to the recent E-Coli incident, I have assigned equal weight to different multiples based on earnings, sales, book value, cash flow, and EBITDA

Table: Final Price Target For Chipotle's Stock Based on Valuation of Multiples

	P/E	P/S	P/B	P/CH	P/EBITDA
Implied value (Chipotle)	397.3	234.6	176.9	204.2	226.5
Equal Weight valuation multiple based price	$247.9				

Source: Author's Analysis

Table: Final Target Price as The Weighted Average of DCF and Multiple Based Approaches

	Weight	Implied value by using the model
DCF	60%	226.0
Valuation multiples based	40%	247.9
Final target price		234.7
Discount to the current market price (%)	40.4	

Source: Author's Analysis

The table above implies a price target of $234.7, which is at 40.4% discount to the current stock price of $393.91. The target price represents 40.4% downside from the current stock price over the next 12-months.

Since the sensitivity analysis indicates high sensitivity of Chipotle on potentially adverse scenarios, in my opinion the current stock price does not provide adequate margin of safety for conservative investors. Due to these reasons, I assign sell rating on the stock with a price-target of $234.7 over the next 12-months.

Risks

Resolution of E-Coli and Norovirus incidents earlier than expected:

I have assumed historical revenue growth to resume 12-18 months from now after satisfactory resolution of these incidents. Earlier resolution would be a key upside risk to the target price.

Lower agriculture and crude oil prices:

A key component of cost structure are Food, beverage, and packaging costs. These have accounted for between 30.6% and 34.6% over the last 5-years. In my view, increasing competition and fragile real economic recovery would limit Chipotle's ability to pass the input cost pressure to consumers. I expect large part of such input cost increases to be absorbed by Chipotle and therefore operating margins would be adversely impacted. However, in the event of food, beverage, and packaging costs moving to lower levels would negate this assumption and lead to upturn in the stock price.

Successful international expansion earlier than anticipated:

Due to conservative management and focus on profitability, I expect Chipotle to adopt gradual approach to expand in international markets. Intense competition in these markets, and lack of familiarity with the newer markets could cause further challenges. However, in the event of such international expansion becoming more successful than my expectation, there would be upside risk to my target price.

More successful and quicker scalability of diversification in other food segments:

In order to diversify from Mexican food segment, Chipotle is gradually expanding to Asian cuisine and Pizza segments. As of now the contribution of these segments in the total revenue is negligible. Due to lack of experience of Chipotle's management and intense competition in these segments, I expect gradual scalability of these businesses. However in case these businesses become more scalable earlier than my expectation, then that would cause stock price to move higher.

Quicker break-even period for newly opened stores:

Chipotle expects to continue expansion at 220-235 restaurants per year. Historically the break-even period of these restaurants has been 12-months. In my opinion, increased competition, down trading by customers for lower value products, and fragile real economic recovery could cause break-even period to increase from 12 months to 15-18 months. It would result in delayed contribution of new restaurants in operating profits. In case the break-even period remains at the historical level, then they would start contributing in profit pool earlier than my expectation and lead to upside in the stock price.

Conclusion

Over the last two decades, Chipotle has emerged as a key player in Mexican food segment in the US. It is among the few companies that have recorded same-store sales growth in each quarter since inception. This has resulted in the stock price commanding premium relative to the sector. However, recent regulatory issues, increasing competition, and input cost pressures have caused uncertainty about the sustainability of such premium. Chipotle's sensitivity to these issues are higher than peers causing significant downside risk to the current stock price. After incorporating these factors in the DCF and valuation based multiples approaches, I arrived at a target price of $234.7 over the next 12-months. The target price represents 40.4% potential downside to the current stock price and accordingly I assign SELL rating to the stock.

References & Appendix

- All prices are taken from Bloomberg and most updated as on date
- Stock price: Closing price as on July 1, 2016
- Main sources of prices:
    - Yahoo Finance: http://finance.yahoo.com/q?s=CMG&ql=1
    - Bloomberg Terminal
- 12-month stock chart, NASDAQ, from: http://www.nasdaq.com/symbol/cmg/stock-chart
- Business segment: Ir.Chipotle.com and Form 10k 2015, Annual Report 2015
- Technomic, from: https://www.technomic.com/Pressroom/Releases/dynRelease_Detail.php?rUID=402
- Sustained competitive advantage: All data has been taken from Form 10k for years from year 2005 to 2015, Annual Reports: From 2005-2015; Before 2005, the data has been taken from SEC filings, US Securities and Exchange commission, www.sec.gov
- Recent restaurant news/events: http://ir.chipotle.com/phoenix.zhtml?c=194775&p=irol-sec and Form 10k 2015, Annual Report 2015
- Investment thesis: IMF: http://www.imf.org/external/pubs/ft/weo/2016/update/01/, World Economic Outlook (WEO) Update, Subdued Demand, Diminished Prospects
- Brazil Drought: http://www.bbc.com/news/world-latin-america-30962813
- US Consumer sentiment index: http://www.tradingeconomics.com/united-states/consumer-confidence
- Chipotle: Same store sales growth: All data has been taken from Form 10k for years from year 2005 to 2015, Annual Reports: From 2005-2015; Before 2005, the data has been taken from SEC filings, US Securities and Exchange commission, www.sec.gov
- Food, beverages, and packaging costs: All data has been taken from Form 10k for years from year 2005 to 2015, Annual Reports: From 2005-2015; Before 2005, the data has been taken from SEC filings, US Securities and Exchange commission, www.sec.gov
- Unemployment rate: www.tradingeconomics.com
- Other: Author's analysis, Annual report; 2015

References & Appendix

CMG

(000$)	FY 2018E	FY 2017E	FY 2016E	FY 2015	FY 2014	FY 2013	FY 2012	FY 2011
Consensus	*5,940,000*	*4,980,000*	*4,200,000*					
Net Sales	4,625,097	4,447,208	4,276,162	$ 4,501,223	$ 4,108,269	$ 3,214,591	$ 2,731,224	$ 2,269,548
	1.32	1.03						
Restaurant operating costs:			1.33	1.03				
Food, beverage and packaging	1,248,776	1,467,579	1,710,465	1,503,835	1,420,994	1,073,514	891,003	738,720
Labor	1,156,274	1,111,802	1,111,802	1,045,726	904,407	739,800	641,836	543,119
Occupancy	323,757	311,305	299,331	262,412	230,868	199,107	171,435	147,274
Other operating costs	508,761	489,193	470,378	514,963	434,244	347,401	286,610	251,208
General and administrative expenses	323,757	311,305	299,331	250,214	273,897	203,733	183,409	149,426
Depreciation and amortization	138,753	133,416	128,285	130,368	110,474	96,054	84,130	74,938
Pre-opening costs	23,125	22,236	21,381	16,922	15,609	15,511	11,909	8,495
Loss on disposal of assets	18,500	17,789	17,105	13,194	6,976	6,751	5,027	5,806
Total operating expenses	3,741,703	3,864,624	4,058,078	3,737,634	3,397,469	2,681,871	2,275,359	1,918,986
Income from operations	883,393	582,584	218,084	763,589	710,800	532,720	455,865	350,562
Interest and other income (expense), net	4,625	4,447	4,276	6,278	3,503	1,751	1,820	(857)
Income before income taxes	878,768	578,137	213,808	769,867	714,303	534,471	457,685	349,705
Provision for income taxes	(338,326)	(222,582.8)	(82,316.1)	(294,265)	(268,929)	(207,033)	(179,685)	(134,760)
Net Income	540,443	355,554	131,492	$ 475,602	$ 445,374	$ 327,438	$ 278,000	$ 214,945
Other comprehensive income (loss), net of income taxes:								
Foreign currency translation adjustments	(1,471)	(1,471)	(1,471)	(6,322)	(2,049)	596	827	(409)
Unrealized loss on investments	-	-	-	(1,522)	-	-	-	-
Other comprehensive income (loss)	(1,471)	(1,471)	(1,471)	(7,844)	(2,049)	596	827	(409)
Comprehensive income	538,971	354,083	130,021	$ 467,758	$ 443,325	$ 328,034	$ 278,827	$ 214,536
EPS:								
Basic	17.43	11.47	4.53	$ 15.30	$ 14.35	$ 10.58	$ 8.82	$ 6.89
Diluted	16.89	11.11	4.50	$ 15.10	$ 14.13	$ 10.47	$ 8.75	$ 6.76
Consensus - GAAP	*17.66*	*11.80*	*4.72*					
Guidance			*15.10-4.72*					
Weighted Average Common Shares Outstanding:								
Basic	31,000	31,000	29,000	31,092	31,038	30,957	31,513	31,217
Diluted	32,000	32,000	29,200	31,494	31,512	31,281	31,783	31,775
Tax Rate	38.5%	38.5%	38.5%	38.2%	37.6%	38.7%	39.3%	38.5%
D&A	138,753	133,416	128,285	130,368	110,474	96,054	84,130	74,938
% of Sales	3.0%	3.0%	3.0%	2.9%	2.7%	3.0%	3.1%	3.3%
CapEx	265,199	262,574	259,974	257,400	252,600	199,900	197,000	151,100
% of Sales	5.7%	5.9%	6.1%	5.7%	6.1%	6.2%	7.2%	6.7%
Receivables	39,326	38,975	38,628	38,283	34,839	24,016	16,800	8,389
% of Sales	0.9%	0.9%	0.9%	0.9%	0.8%	0.7%	0.6%	0.4%
Inventory	15,194	15,148	15,088	15,043	15,332	13,044	11,096	8,913
% of Sales	0.3%	0.3%	0.4%	0.3%	0.4%	0.4%	0.4%	0.4%
Payables	90,866	89,084	87,337	85,709	69,613	59,022	58,700	46,382
% of Sales	2.0%	2.0%	2.0%	1.9%	1.7%	1.8%	2.1%	2.0%
Change in WC	1,385	1,339	1,239	12,941	(2,520)	(8,842)	1,724	8,131
Sales	4.00%	4.00%	-5.00%	9.56%	27.80%	17.70%	20.34%	23.62%
Expenses as % of Sales:								
Restaurant operating costs:								
Food, beverage and packaging	27.0%	33.0%	40.0%	33.4%	34.6%	33.4%	32.6%	32.5%
Labor	25.0%	25.0%	26.0%	23.2%	22.0%	23.0%	23.5%	23.9%
Occupancy	7.0%	7.0%	7.0%	5.8%	5.6%	6.2%	6.3%	6.5%
Other operating costs	11.0%	11.0%	11.0%	11.4%	10.6%	10.8%	10.5%	11.1%
General and administrative expenses	7.0%	7.0%	7.0%	5.6%	6.7%	6.3%	6.7%	6.6%
Depreciation and amortization	3.0%	3.0%	3.0%	2.9%	2.7%	3.0%	3.1%	3.3%
Pre-opening costs	0.5%	0.5%	0.5%	0.4%	0.4%	0.5%	0.4%	0.4%
Loss on disposal of assets	0.4%	0.4%	0.4%	0.3%	0.2%	0.2%	0.2%	0.3%
Interest and other income (expense), net	0.1%	0.1%	0.1%	0.14%	0.09%	0.05%	0.07%	-0.04%
Operating Margin	19.1%	13.1%	5.1%	17.0%	17.3%	16.6%	16.7%	15.4%

	2008	2009	2010
Food, beverage and packaging	431947	466027	549211
Sales	1331968	1518417	1798084
% of Sales	0.324292325	0.306916348	0.305442349
Sales per share	158.3937211		

References & Appendix

Chipotle Mexican Grill, Inc. (CMG)

Analyst: Turki AlSabbar

6/7/2016

Terminal Discount Rate =	*10.00%*
Terminal FCF Growth =	*4.0%*

(000s)

Year	2016E	2017E	2018E	2019E	2020E	2021E
Revenue	4,276,162	4,447,208	4,625,097	4,810,101	5,002,505	5,202,605
% Growth		4.0%	4.0%	4.0%	4.0%	4.0%
Operating Income	218,084	582,584	883,393	**769,616**	**800,401**	**832,417**
Operating Margin	5.1%	13.1%	19.1%	16.0%	16.0%	16.0%
Interest Income	4,276	4,447	4,625	4,810	5,003	5,203
Interest % of Sales	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Taxes	82,316.12	222,582.78	338,325.82	294,450.3	306,228.3	318,477.4
Tax Rate	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%
Net Income	**131,492**	**355,554**	**540,443**	**470,356**	**489,170**	**508,737**
% Growth		170.4%	52.0%	-13.0%	4.0%	4.0%
Add Depreciation/Amort	128,285	133,416	138,753	144,303	150,075	156,078
% of Sales	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Plus/(minus) Changes WC	1,239	1,339	1,385	1,441	1,499	1,558
% of Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Subtract Cap Ex	259,974	262,574	265,199	275,807	286,840	298,313
Capex % of sales	6.1%	5.9%	5.7%	5.7%	5.7%	5.7%
Free Cash Flow	**1,041.63**	**227,735.56**	**415,381.43**	**340,292.12**	**353,903.80**	**368,059.96**
% Growth		21763.4%	82.4%	-18.1%	4.0%	4.0%

Year	2022E	2023E	2024E	2025E	2026E
Revenue	5,410,709	5,681,244	5,965,307	6,263,572	6,576,751
% Growth	4.0%	5.0%	5.0%	5.0%	5.0%
Operating Income	**865,713**	**908,999**	**954,449**	**1,002,172**	**1,052,280**
Operating Margin	16.0%	16.0%	16.0%	16.0%	16.0%
Interest Income	5,411	5,681	5,965	6,264	6,577
Interest % of Sales	0.1%	0.1%	0.1%	0.1%	0.1%
Taxes	331,216.5	347,777.4	365,166.2	383,424.6	402,595.8
Tax Rate	38.5%	38.5%	38.5%	38.5%	38.5%
Net Income	**529,086**	**555,540**	**583,318**	**612,483**	**643,108**
% Growth	4.0%	5.0%	5.0%	5.0%	5.0%
Add Depreciation/Amort	162,321	170,437	178,959	187,907	197,303
% of Sales	3.0%	3.0%	3.0%	3.0%	3.0%
Plus/(minus) Changes WC	1,621	1,702	1,787	1,876	1,970
% of Sales	0.0%	0.0%	0.0%	0.0%	0.0%
Subtract Cap Ex	216,428	227,250	238,612	250,543	263,070
Capex % of sales	4.0%	4.0%	4.0%	4.0%	4.0%
Free Cash Flow	**476,599.88**	**500,429.87**	**525,451.36**	**551,723.93**	**579,310.13**
% Growth	29.5%	5.0%	5.0%	5.0%	5.0%

NPV of Cash Flows	**2,504,535**	39%
NPV of terminal value	**3,871,385**	61%
Projected Equity Value	**6,375,920**	100%
Free Cash Flow Yield	**0.01%**	
Current P/E	**87.5**	**32.3 21.3**
Projected P/E	*48.5*	*17.9 11.8*
Current EV/EBITDA	**31.3**	**15.1 10.6**
Projected EV/EBITDA	*16.5*	*8.0 5.6*
Shares Outstanding	**29,200**	
Current Price	**$ 393.91**	
Implied equity value/share	**$ 218.35**	
Upside/(Downside) to DCF	**-44.6%**	
Debt	-	
Cash	**667,470**	
Cash/share	**22.86**	

Terminal Value	**10,041,376**
Free Cash Yield	**5.77%**
Terminal P/E	**15.6**
Terminal EV/EBITDA	**7.5**

As on Dec 31, 2015		
Cash	248005	
Investments	415199	
Total	663204	
Cash for regular operations and liquidity	7.619520548	
Implied value from DCF	226.0	Discount
Upside/(Downside) to DCF (after adding cash)	0.573666462	0.426333538

References & Appendix

FY 2018 (Projected)	EPS (FY 2018): Chipotle
EPS	16.89
Sales per share	158.4
Book value per share	57.8592
Cash flow per share	17.6841
EBITDA per share	22.832775

(10Y) CMG Relative to S&P500	High	Low	Median	Current
P/E	4.12	1.54	2.74	1.95
P/S	4.32	1.19	2.51	1.52
P/B	5.78	1.23	3.15	2.67
P/CH	4.82	0.92	2.48	2.19
P/EBITDA	5.05	1.33	2.70	1.71

(10Y) CMG Relative to Con. Disc. Sector	High	Low	Median	Current
P/E	4.04	0.06	2.18	1.90
P/S	6.17	1.95	3.34	1.95
P/B	3.99	1.10	2.29	1.54
P/CH	3.73	0.55	2.14	1.90
P/EBITDA	5.37	1.49	2.65	1.94

(10Y) CMG Absolute Valuation	High	Low	Median	Current
P/E	64.79	21.66	36.86	25.92
P/S	5.17	1.52	3.43	2.75
P/B	10.75	3.20	7.42	5.73
P/CH	32.70	10.23	22.32	18.13
P/EBITDA	30.42	10.57	18.23	13.86

Company: (9Y) P Multiples	P/E	P/S	P/B	P/CH	P/EBITDA
Average	**23.53**	**1.48**	**3.06**	**11.55**	**9.92**
CHIPOTLE MEXICAN GRILL INC	41.92	2.22	3.91	17.63	18.23
LUBY'S INC	13.71	0.78	1.64	9.92	7.52
MCDONALD'S CORP	18.71	2.53	3.45	12.60	9.38
BOB EVANS FARMS	23.49	0.81	1.85	8.85	7.76
PANERA BREAD COMPANY-CLASS A	29.66	2.10	4.43	16.56	12.87
DENNY'S CORP	13.66	0.44	--	3.71	3.74

Implied value (Chipotle)	397.3	234.6	176.9	204.2	226.5
Equal weight: 20%	79.46824979	46.91538201	35.37652435	40.83362661	45.29671999
Implied value (Chipotle: Weighted average)	247.8905027				

References & Appendix

Final target price	Weight	Implied value by using the model	Weighted average value
DCF	0.6	226.0	135.6
Valuation multiples based	0.4	247.9	99.2
Final target price			234.7

Discount to the current market price	40.41%