CREDO WEALTH

Holy Guacamole

Chipotle Mexican Grill (CMG) is a fast-casual, Mexican restaurant chain in the United States, United Kingdom, Canada, Germany and France. McDonalds (MCD) was an investor from 1993 to 2006. During that time, CMG went from 16 locations to around 500. Today it has over 2,000. Sometimes making money is about “thinking inside the box”. Taking something that works well and doing it again in a similar market. Good management is largely on the edges, tweaking something that already works (the menu, the prices, the store layout). CMG has proven itself over an extended period.

CMG promotes itself as a brand of fresh organic ingredients that supports local producers. In contrast, MCD uses a consolidated, frozen inputs model that is more scalable and allows a greater control over food safety. CMG’s customers like this difference. It does however add an element of risk.

In 2015, CMG faced two “systemic” outbreaks of norovirus which resulted in sales per store dropping approximately 20%. With the advent of online social media sites like iwaspoisoned.com, this was fodder for viral negative headlines. CMG is devoting significantly more resources to containing such outbreaks in the future by adopting various food safety protocols. Despite this, in 2017 CMG suffered two more isolated incidents. One outbreak in Virginia was caused by a sick employee breaking protocol (working while ill). Another suspicious incident occurred when mice fell from the roof in a Dallas store, which was captured in an online video that went viral.

Investors looking for short-term consistency were scared off. The share price fell from a high of almost $750 in August 2015, to a low of almost $250 in February 2018. Despite great long-term numbers, more than two years of pain makes investors skittish.

However, at Credo we believed the impact of the health scare would be temporary. In time, we felt that CMG stores would return to growth and profitability. Indeed, this has been our experience with one-off problems of this sort with other chains like Yum! (KFC, Pizza Hut etc.) and Wendy’s. CMG has previously operated for many years, without any issues, and we were comfortable with the additional safety protocols. The fall in the share price and resultant valuation, represented an attractive margin of safety, should things not turn out as we hoped.

On top of this, there were new digital initiatives which could drive further footfall. The chairman resigned his executive responsibility, opening the way for Brian Nichol to be recruited as CEO. Nichol had previously overseen a turnaround at Taco Bell and we believed that many of his successful initiatives could be repeated at CMG. The health scare meant that these positives were underappreciated. Again, we had seen these models drive sales growth in similar companies like Yum! and Domino’s Pizza. CMG already had spare capacity in restaurants which had to date only been used to fill catering orders. The new digital offering could make better use of these resources. The plan was to make digital ordering, pickup, and payment seamless. This could drive sales density with insignificant incremental investment.

Taken together, the negativity and unappreciated growth opportunities were what got us interested originally in CMG. However, after some strong performance, as a result of the new CEO’s initiatives starting to bear fruit and with renewed investor enthusiasm for the share, we have now sold the shares. This is not because we believe the business is broken. On the contrary, unlike those who sold when things went wrong, this is a genuine case of “it’s me, not you”. Contrarian opportunities present themselves through excessive negativity. We believe the valuation now reflects significant investor optimism about the potential opportunities from the outlined revenue growth initiatives. Given the less attractive risk-reward, we sold and put the capital to work elsewhere.

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