It Only Takes Five Minutes to Ruin Your Reputation

Have you ever won a really cool or valuable raffle prize? Or maybe you're one of the lucky few of us who has hit a big score with a lottery ticket? If so, then you know the joy of being on the receiving end of an asymmetric payout, which is just a fancy way of saying that the good that you received was much larger than the cost of participation.

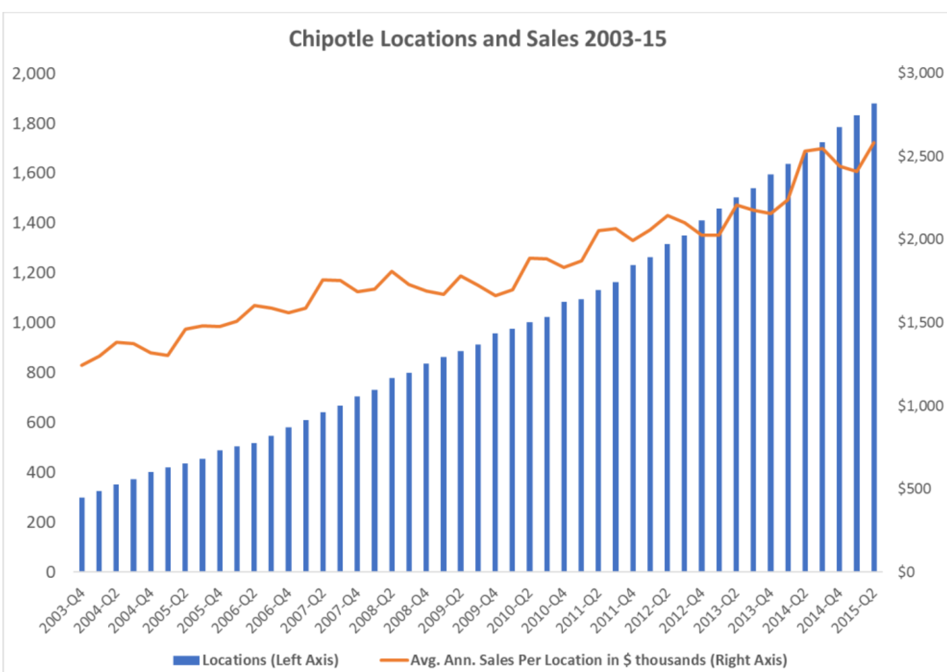
There can also be asymmetry in the other direction, though. Warren Buffett summed that up best when he said, "It takes twenty years to build a reputation and five minutes to ruin it." Which is always the first quote that springs to our mind when we think of the travails that Chipotle Mexican Grill (CMG) has been through over the past couple of years.

Building a Reputation

From the time it was founded in 1993 through 2015, Chipotle enjoyed a meteoric rise in so many things: its number of restaurants, its revenues, its stock price, and its reputation as a good corporate citizen that delivered a delicious product to its customers while treating its employees well.

At the end of 2003 there were just under 300 Chipotles in the world, and these locations averaged about $1.2 million in annual sales. By the middle of 2015, not only had they more than sextupled the number of locations to around 1,900, but they were also able to grow their average revenue per location to more than $2.5 million per year.

This powerful growth produced an increase of more than 1,200% in revenues for the company, which works out to a staggering 25% compound annual rate.



source: SEC filings, Inkwell analysis

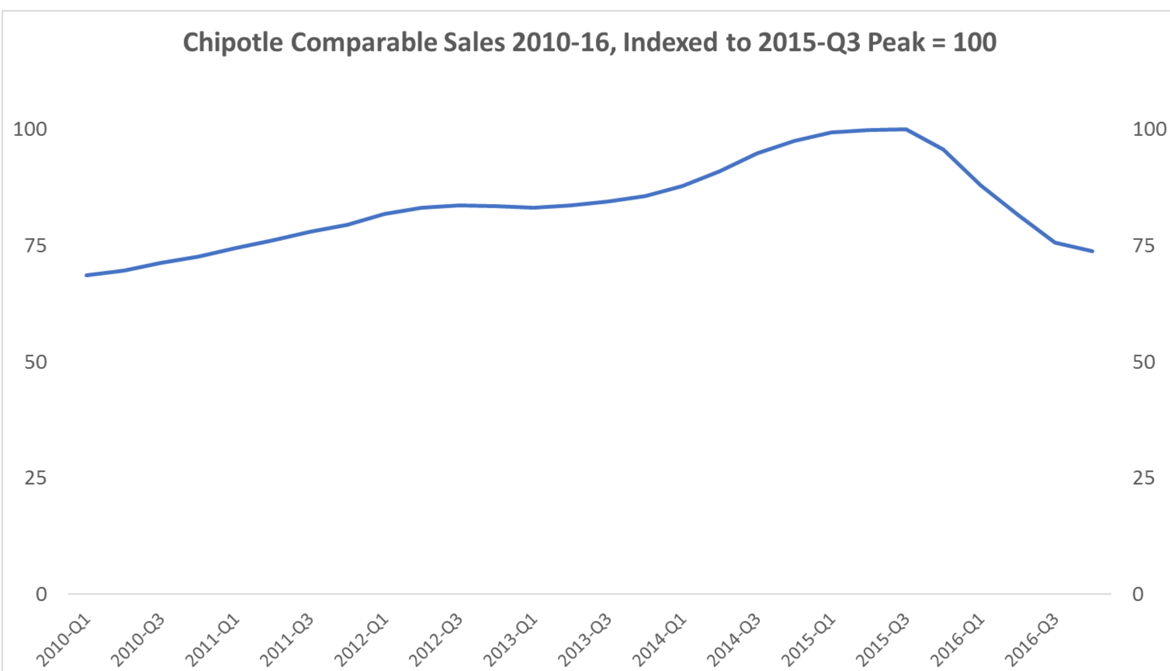
Chipotle's operating costs also expanded as its store base grew, but they grew much more slowly than sales, resulting in a substantial increase in CMG's operating profit margins. From a starting level of around 7%, CMG's margin reached as high as 19% by mid-2015. In other words, Chipotle originally spent 93% of its sales on food, labor, occupancy, etc., but by 2015 it was spending just 81%.

As you can imagine, Wall Street cheered the results. From its IPO price of $22 in early 2006, CMG stock closed above $750 in August 2015, which represents a stunning average annual return of 45%. An initial $1,000 invested at the IPO price would have been worth over $34,000 at CMG's peak.

But Then Came the Bacteria

Starting in the summer of 2015, Chipotles around the country starting sickening their customers. Over 200 customers in Simi Valley, California, followed by over 60 customers in Minnesota, then more than 100 in Boston. Sometimes the culprit was salmonella, sometimes norovirus, and sometimes E. coli, but in each case the common denominator was the lax food safety culture and the sign above the front door: Chipotle.

Nightly news reports spread the word, and customers stayed away for the sake of their own health. Sales began to plummet. As of the end of 2016, the average Chipotle location was doing a full 25% less business than it was at the peak in mid-2015, and about the same level of business as it was doing near the end of 2010 and beginning of 2011. In other words, Chipotle's food contamination crisis set the company back six years in terms of lost revenue.



source: SEC filings, Inkwell analysis

More Than One Way to Lose Your Reputation

But lost revenue is just one way to measure Chipotle's lost reputation. Profit margins have also declined, going from that peak level of 19% we mentioned earlier to a last recorded measurement of just 3%. So while Chipotle's average sales per location has been set back about six years, profitability has been set back more than a decade.

The stock price, too, has taken quite a hit. From that peak of about $750, CMG stock now sits just above $400 per share. This decline of 45% puts the stock back where it was almost exactly five years ago, which is bad enough on its own, but when you compare it to the S&P 500 index which has returned +14% over the same time frame, the comparison becomes even more stark.

Another way to quantify CMG's loss of reputation is to look at its P/E ratio. At the time CMG reached its peak level of around $750 per share, analysts in aggregate expected the company to earn profits over the ensuing twelve months of around $18 per share. Taking that Price of $750 and dividing by those Earnings of $18 means that CMG stock was trading at a P/E of roughly 42 in mid-2015.

One might guess that the P/E of today is significantly lower than that. However, current expectations among Wall Street analysts are for Chipotle to earn about $8 in per-share profits this year, improving to about $12 per share next year. At the time of this writing, shares of CMG stock are trading hands at close to $420 each, which—if you compare it to the average for the next couple of years of $10 per share—is just about exactly equal to that same 42 level from before the food contamination crisis.

So even though Chipotle has lost a lot of its reputation in terms of customer traffic, revenue, and profitability, the stock market is already giving it credit for recovering from these setbacks.

Can Chipotle Right the Ship?

Is Wall Street right to give them that credit? Will Chipotle be able to come back from these depths?

The first way we would think about that problem is to look at similar issues in the past and how those companies were able to weather the storms. Jack In the Box (JACK) was the cause of several customer deaths in the early 1990s, due to pathogens in under-cooked meat. This was a much more serious loss of reputation and consumer trust, and JACK endured three long years of large negative sales trends before picking back up again. It seems like CMG will not suffer a similar fate, as its problems did not cause any deaths, and its comparable sales in December 2016 were already higher than they were a year earlier.

Another similar case would be McDonald's (MCD) in the first part of this century. Though it never caused any deaths or widespread sickness, MCD was suffering from a glut of poor press. From the documentary film Supersize Me, which lampooned the basic unhealthiness of the

McDonald's menu, to the general backlash from a more-informed consumer base that was turning its attention to taking control of its health through improved nutrition and exercise, MCD stock suffered mightily. From a peak of around $50 per share in late 1999, the stock sank all the way to $12 in early 2003, a loss of 75%. And yes the S&P 500 index was also down over that same time frame, but only about half as much.

McDonald's was able to get past its problems with menu reconfigurations, including many healthier options such as salads, and the stock recovered to its previous peak of $50 by 2007. It now stands at about $125.

Viewed through the first lens, if CMG is able to get through its problems as successfully as JACK or MCD did, that could bode well for current shareholders.

The second, and more relevant way, to think about the problem is to ask yourself what might Chipotle look like five or ten years from now? How many stores will it have? How many burritos will it sell? How much profit will it retain after paying its operating expenses? And what should the stock then be worth, assuming all that?

There are literally thousands of ways those questions will be answered in the due course of time, but here is just one of those possible scenarios:

Category	**2025 Estimate**	**Notes**
Restaurants	4,000	~200 new locations per year (similar to current pace) Taco Bell has ~6,000 now
Sales/Location	$3.5M	pre-crisis level $2.5M + ~4% average annual growth
Revenue	$14.0B	4,000 locations x $3.5M per location
Net Income	$1.3B	9.3% of revenue, vs 11.6% pre-crisis
# of Shares	29.3B	same as 12/31/2016
EPS	$44	net income divided by # of shares
P/E	25	dependent on prevailing interest rates, market sentiment
Stock Price	$1,100	P/E of 25 x EPS of $44

source: SEC filings, Inkwell analysis

There are a lot of implicit and explicit variables in that table, and the actual numbers for each one will surely turn out to be different than the estimate presented here. If, for instance, Chipotle is only able to grow their store count to 3,500 instead of 4,000, then the stock would only be worth about $960 in the year 2025. Or if they can get to 4,000 stores but are able to achieve a net profit margin of 11.0% instead of 9.3%, then the stock would be worth $1,300.

Each investor must come to his or her own conclusions about the probable values for each of the variables, then decide whether to buy the stock today for around $420. If $1,100 does indeed turn out to be the correct value for CMG stock in 2025, then a buyer today would realize an average annual return of 12%. Or if the “right answer” turns out to be $960 or $1,300, today’s buyer would earn 10% or 14%, respectively.

These differences of opinions and estimates are what put the “market” in the “stock market.” There are thousands of other companies out there, each with its own set of variables, and our job as investors is to pick the ones we believe have the highest chance of success.

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