Chipotle Mexican Grill: A sustainability champion going global with China

*By Fred DeMicco, H.G. Parsa, Jing Gao and Vijaya 'Vi' Naraparedd*y

Introduction

A Motley Fool's article[1] sparked rumors that Chipotle Mexican Grill (Chipotle, hereafter) was contemplating expansion into China. Chipotle was no stranger to overseas expansion. Under the leadership of founder-CEO-Chairman, Steve Ells, and his co-CEO, Montgomery Moran, the Chipotle brand grew into a highly desired brand in the quick service food service industry. Its enviable position in the home market was the result of its unique strategy known as Food with Integrity, which reflected Ells' passion for sustainable sourcing of quality food supplies locally. At a time when the term sustainability was little known in the industry, positioning the restaurant using this distinctive strategy gave Chipotle significant fist-mover advantages. Sales reached the $5 billion mark in 2015, from $820 million since its Initial Public Offering (IPO) in 2006. The overwhelming demand for the company's shares on the first day of its 2006 IPO resulted in the doubling of the stock's value that day, making it the most lucrative IPO since 2000.

Brief History and Development of Chipotle

Steven Ells, a graduate of the University of Colorado, Boulder, and the Culinary Institute of America in Hyde Park, N.Y., founded Chipotle in 1993 after working at a San Francisco restaurant. As a line cook earning $12 an hour, Ells found himself regularly "dining giant burritos at Taquerias in the Mission District."2 During his lunch hours, the long line of customers waiting for Mexican food day-in day-out sparked the idea of starting his own Mexican-themed restaurant.

It was not until July 13, 1993 that Ells could open his first restaurant. Armed with a loan of $75,000 from his father, Ells leased a space previously occupied by the Dolly Madison ice cream shop near the University of Denver campus in Denver, Colorado, made the renovations himself to the property, and opened his first restaurant. The restaurant was an instant success generating $450 on opening day, $800 the next day, and $1000 a day shortly thereafter. Within six months, sales per day grew to $3,000[3]. This high growth fueled by Ells' novel concept attracted the attention of McDonald's which took a minority stake in Chipotle in 1998, followed by a majority stake in 2001. This capital infusion allowed Ells to expand from sixteen restaurants in 1998 to over 500 by October 2006, when McDonald's liquidated its equity in the company. McDonald's was rumored to have reaped over 416% return on its $360 million investment in Chipotle

Business Strategy:

Ells entered the highly competitive and fragmented quick service dining industry with a socially responsible strategy that he called Food with Integrity. He was the first in the industry to commit to serving only meats from animals that were not raised using non-therapeutic antibiotics and growth hormones. Dairy products like cheese and sour cream were obtained from milk produced by pasture-raised cows. Obtaining ingredients from responsibly raised farms reflected Ells' love for promoting animal welfare and environmental sustainability. Similar high standards were enforced when Chipotle purchased mostly organically grown produce from farmers using sustainable farming practices within a radius of 350 miles from the restaurant where the produce was served. This combination of serving traditionally cooked food with high quality locally grown ingredients in a quick service environment while providing an interactive dining experience blazed the path to Chipotle's success. The restaurant chain, which expanded through the strategy of company-owned stores, attracted celebrities and dignitaries, including President Obama. Using the same quick service concept, Chipotle opened thirteen Chop House Southeast Asian Kitchen restaurants serving Asian cuisine, as well as three Pizzeria Locale restaurants, specializing in pizza and Italian foods

Products

A key competitive advantage that Chipotle had over its rivals was its fresh ingredients, local sourcing, healthy cooking practices, and ease of ordering. Chipotle offered menu choices that customers could pick and choose from. When ordering food, patrons could create their own burrito with their choice of meats, vegetables, beans, rice, salsa, guacamole, cheese or sour cream wrapped inside a Mexican-style whole wheat tortilla (a flat bread), rich in fiber. Alternatively, customers who preferred a gluten-free diet could order a bowl without the tortilla and still receive ingredients of their choice. Other menu choices included

1 http://www.fool.com/investing/general/2014/04/26/1-thing-that-worries-me-about-chipotle.aspx

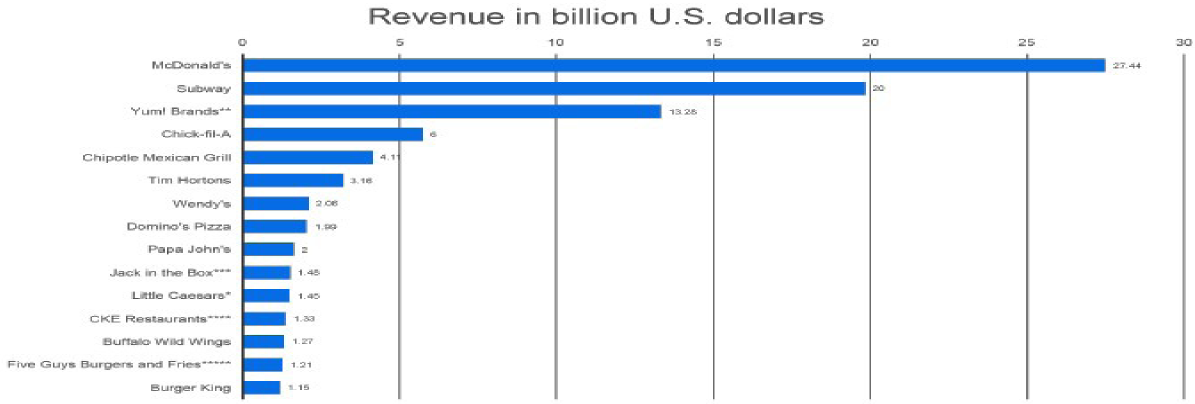
2 https://web.archive.org/web/20080403013733/http://rockymountainnews.com/news/2006/dec/23/chipotlefounder-had-big-dreams/; retrieved on March 17, 2016.

3 Ibid

Fred DeMicco *is affiliated with University of Delaware.* **H.G. Parsa** *is affiliated with University of Denver.* **Jing Gao** *is affiliated with University of Delaware.* **Vijaya 'Vi' Naraparedd**y *is affiliated with University of Denver.*

Exhibit 1

Quick Service Restaurant Chains ranked by Worldwide Sales in 2014



(Source: Statista)

crispy corn tacos, soft corn tacos, soft flour tacos or salads. All ingredients were openly displayed. Several staff members standing on the other (opposite) side of the display counter filled the orders in real time as customers chose the main and side items while moving down the line towards the cash register. This ordering process not only shortened the wait time, but also gave customers the chance to feast on the attractive display of the fresh ingredients while their taste buds received stimulation from the exciting flavors that drifted from the freshly made menu items. Compared to other American quick service chains, such as KFC and McDonald's, the food Chipotle offered was freshly prepared in the restaurant, nutritious, wholesome, and obtained from sustainable sources. This fixed menu concept became Chipotle's source of competitive advantage as busy young professionals, millennials, and students were drawn to the convenience of home-style, high quality food, which offered a range of choices at competitive prices without long wait times.

Employees

By the end of 2015, Chipotle had a total 59,330 non-unionized employees, 5,100 of which were salaried employees. The remaining 54,230 were hourly workers. The company hired only high-performance employees and promoted general managers from within the organization to ensure that they embraced the corporate culture, passion, and vision while working in a high-performance work environment. Consistent with Ells' passion for sustainability and social responsibility, Chipotle entered into partnership with Loomsdale, a sustainable clothing company that also engaged in socially responsible production methods. Chipotle's employees wore organic cotton tee-shirts and hats made by Loomsdale, who also made Chipotle merchandise (graphic tees, polos, and woven shirts) sold online and in the store.

Performance

In 2014, Chipotle ranked fifth in worldwide sales, behind McDonald's, Subway, and Yum Brands (see Exhibit 1). With sales of $27.44 billion, McDonald's was the largest player among all quick service restaurant chains. Subway ranked a distinct second with $20 billion whereas Yum Brands and Chick-fil-A ranked third and fourth, respective-

Exhibit 2

Chipotle's Mexican Grill Consolidate Balance Sheet, 2011-2015

(All numbers in thousands; source: MCG's SEC 10K filings)

	December 31,				
	2015	2014 (1)	2013 (1)	2012 (1)	2011 (1)
Balance Sheet Data:					
Total current assets	$ 814,647	$ 859,511	$ 653,095	$ 537,745	$ 494,954
Total assets	$ 2,725,066	$ 2,527,317	$ 1,996,068	$ 1,659,805	$ 1,419,070
Total current liabilities	$ 279,942	$ 245,710	$ 199,228	$ 186,852	$ 157,453
Total liabilities	$ 597,092	$ 514,948	$ 457,780	$ 413,879	$ 374,844
Total shareholders' equity	$ 2,127,974	$ 2,012,369	$ 1,538,288	$ 1,245,926	$ 1,044,226

(1) Data adjusted to conform to the Financial Accounting Standards Board Accounting (FASBA) standards that required deferred tax liabilities and assets to be classified as non-current.

ly. Chipotle, which came in fifth in this competitive segment had sales of $4.11 billion – approximately 15% of McDonald's revenues. Chipotle was also ranked in fifth place among the top ten most valuable quick service brands in 2015. This brand recognition was noteworthy as there were key differences between Chipotle and its key competitors. While Chipotle expanded through company-owned stores, its rivals became global brands through franchising.

Chipotle stood out from its competitors with its strong commitment to environmental sustainability and social responsibility. Founder Ells' culinary background influenced the way food was prepared at the Chipotle restaurants. Despite the high costs of obtaining from local and sustainable farmers as well as using organic ingredients wherever possible, Chipotle achieved strong profit performance. The company's indexed performance shown indicates that it outperformed the S&P 500 Index and the S&P 500 Restaurants Index from 2010 through 2015. This high value created by Chipotle for its shareholders was also evident from the Balance Sheet data presented in Exhibit 2, which showed that Chipotle's shareholders' equity grew 203.7%, from approximately $1.04 billion in 2011 to $2.13 billion in 2015. The company's Profit & Loss statement (see Exhibit 3) indicated that labor costs constituted one of the major expenditures in operations. Yet, Chipotle's profits (i.e., Net Income) more than doubled between 2011 and 2015.

In spite of the highly competitive nature of the industry, a large number of restaurants were opened in the U.S. between 2004 and 2015. The continued and steady growth of revenues in the U.S. quick service sector may have helped Chipotle become a household name, but the company's strategic site selection also contributed to its success. Chipotle restaurants were located in colleges, universities, strip malls, local and regional malls, downtown business centers, free-standing buildings, food courts, train stations, military bases, and airports. The site selection process was managed by an internal team, which sought the help of local real estate brokers. On-site visits were supplemented by a rigorous analysis of trade, business, and demographic data as well as the locations of direct and indirect competitors in the area.

The Chinese Market

As China was home to the largest population in the world, the Chinese government sought to legally control the growth of its population through its one-child policy. However, the population grew from 1.34 billion in 2010 to about 1.37 billion in 2014. With the relaxation of the one-child policy, China's population was expected to exceed 1.4 billion by the year 2020. Even though it was home to the largest population, China enjoyed a rising prosperous economy, as measured by the country's growing GDP (Gross Domestic Product) per capita. China lagged behind the U.S. in GDP. In 2015, while the U.S. had the highest GDP of $17,968 billion, China had the second highest with $11,384.76 billion. However, during the same year (2015), China's share of global GDP based on purchasing power parity (PPP), was the largest at 17.24% as opposed to the U.S. (15.88% of the global GDP), suggesting that Chinese consumers had greater buying power than consumers in the U.S. or any other country.[4]

4 Based on the data presented in the Statista report on China.

Exhibit 3

Chipotle Mexican Grill Consolidated Profit & Loss Statement, 2011-2015

(All numbers in thousands, except per share date; source: Chipotle's SEC 10K filings)

	Year ended December 31,				
	2015	2014	2013	2012	2011
Statement of Income:					
Revenue	$ 4,501,223	$ 4,108,269	$ 3,214,591	$ 2,731,224	$ 2,269,548
Food, beverage and packaging costs	1,503,835	1,420,994	1,073,514	891,003	738,720
Labor costs	1,045,726	904,407	739,800	641,836	543,119
Occupancy costs	262,412	230,868	199,107	171,435	147,274
Other operating costs	514,963	434,244	347,401	286,610	251,208
General and administrative expenses	250,214	273,897	203,733	183,409	149,426
Depreciation and amortization	130,368	110,474	96,054	84,130	74,938
Pre-opening costs	16,922	15,609	15,511	11,909	8,495
Loss on disposal of assets	13,194	6,976	6,751	5,027	5,806
Total operating expenses	3,737,634	3,397,469	2,681,871	2,275,359	1,918,986
Income from operations	763,589	710,800	532,720	455,865	350,562
Interest and other income (expense), net	6,278	3,503	1,751	1,820	(857)
Income before income taxes	769,867	714,303	534,471	457,685	349,705
Provision for income taxes	(294,265)	(268,929)	(207,033)	(179,685)	(134,760)
Net income	$ 475,602	$ 445,374	$ 327,438	$ 278,000	$ 214,945
Earnings per share					
Basic	$ 15.30	$ 14.35	$ 10.58	$ 8.82	$ 6.89
Diluted	$ 15.10	$ 14.13	$ 10.47	$ 8.75	$ 6.76
Weighted average common shares outstanding					
Basic	31,092	31,038	30,957	31,513	31,217
Diluted	31,494	31,512	31,281	31,783	31,775

Exhibit 4

China's Growing Trade Surplus

(Source: Statista)

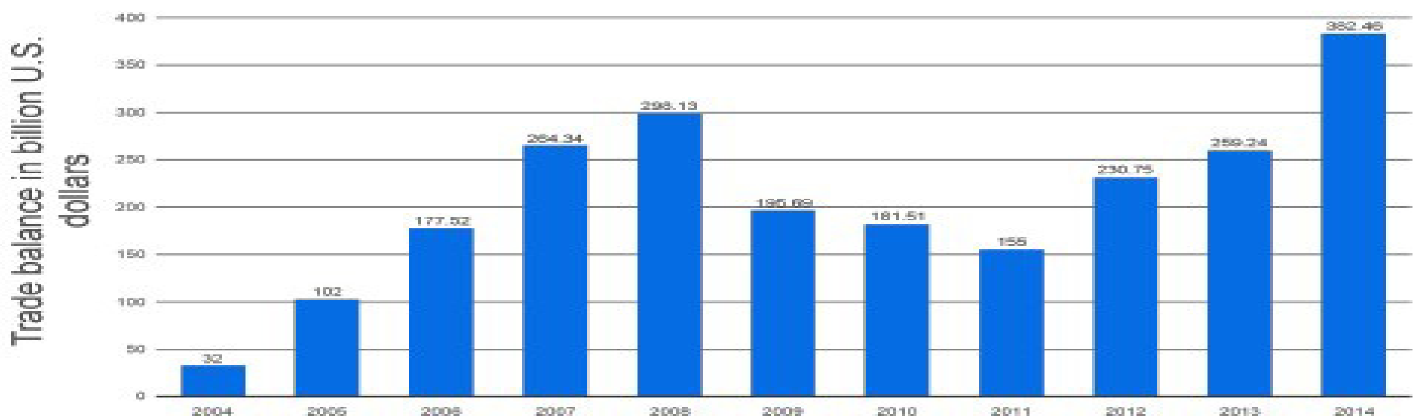
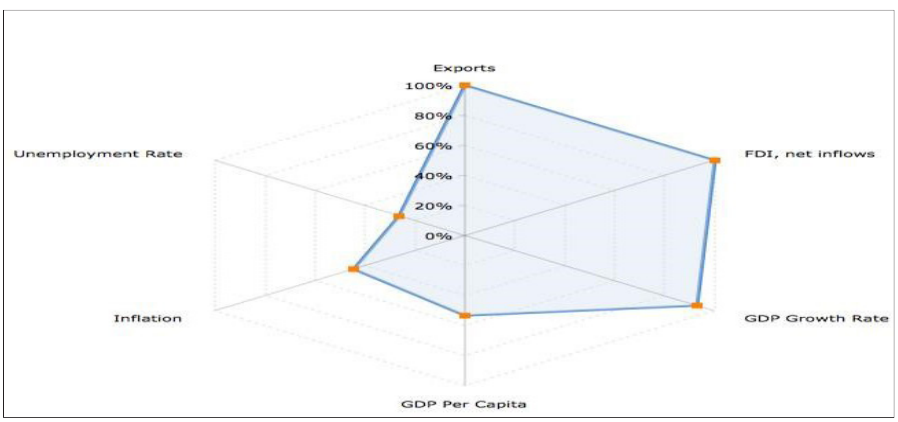


Exhibit 5

China's Economic Snapshot



How to interpret the graph: The purpose of this graph is to take a snapshot of a country's economy in comparison to other economies. For example, China's Exports rank is higher than 100% of the countries in the dataset. For Exports, FDI and GDP measures, a higher rank (closer to 100%) indicates a stronger economy. Conversely, for Unemployment and Inflation, a lower rank (closer to 0%) indicates a stronger economy.

(Source: http://globaledge.msu.edu/countries/china/economy)

Table 1

Blue and Red Ocean Strategy

Blue Ocean Strategy	Red Ocean Strategy
-Create uncontested market space	-Compete in existing market space
-Make the competition irrelevant	-Beat in competition
-Create and capture new demand	-Exploit existing demand
-Break the value-cost trade off	-Make the value-cost trade off
-Align the whole system of a firm's activities in pursuit of differentiation and low cost	-Align the whole system of a firm's activities with its strategic choice of differentiation or low cost

Source: Blue Ocean vs. Red Ocean (W. Chan, 2005)

Society & Culture

China shares geographical boundaries with fourteen Asian countries, including Mongolia, Russia, North Korea, Taiwan, Vietnam, Laos, Burma, Bhutan, Pakistan, Afghanistan, Tajikistan, India, Kazakhstan, and Nepal. So, it was no surprise that ethnic minorities comprised of about 8 % of the population and the Han Chinese made up the rest 92%[5]. In addition to Mandarin and Cantonese, the Chinese spoke a multitude of dialects.

China was well known for its high context culture, where communication rested not only on the spoken words but also the context. Confucianism which dominated the Chinese philosophy and lifestyle promoted duty, sincerity, loyalty, honor, and respect for age and seniority, among others. Maintaining harmonious relationships was at the heart of creating a stable society[6]. This collectivistic focus meant s that individuals acted in the best of interest of the group (family, work, etc.,) rather than their own self-interest.

Blue Ocean in China's Market

In 2015, there were no Mexican quick service restaurant chains in China. The concept of quick service restaurants was not yet popular in China. As a result, if Chipotle were to enter China's market, it would be the first U.S. chain restaurant offering a unique Mexican quick service food experience. Chipotle could explore a large "blue ocean" in China with greater opportunities than its competition. In this blue ocean, several strategies, such as developing distinct competencies, identifying high traffic restaurant locations, and expanding into the urban markets first could be adopted. The table given below describes the differences between Blue Ocean and Red Ocean.

Place

Location selection was the most critical issue for business expansion, especially in international operations. Traditionally most US-based restaurant chains entered the Chinese market by exploring major urban centers such as Beijing and Shanghai. Some of the attractive characteristics of these major urban centers included high per capita income, considerable purchasing power, fast-paced urban life demanding conveniences of quick service restaurants, access to technology, modern cultural food habits, exposure to and acceptance of international foods, large population of international and domestic tourists seeking American food. Typically, urban customers had pervious exposure to international cuisines, making it easier for Chipotle to enter the Chinese market. In Beijing, highly desired locations were the first floor of upscale office buildings in the Zhongguancun area, SOHO, and food courts in large shopping malls. These locations were often characterized by high foot traffic, thus, offering maximum exposure.

Menu Prices

Setting appropriate menu prices in China's market could be a tough decision to make for most U.S. restaurants for the following reasons. Even with the dramatic increase in the size of the middle class in China, the per capita income still lags behind the U.S. Furthermore, news that China experienced high inflation would result in dramatic in creases in the cost of raw materials, gas, transportation, labor, real estate etc. In addition, Chipotle must be cognizant of the Chinese culture where numbers are associated with distinct meaning. For example, number "4" is associated with death. Therefore, it is imperative that Chipotle avoid "4" in all menu price-ending choices. In contrast, number "8" is considered most lucky, so it is highly advisable to end all prices in digit 8 or other even digits, such as 6, 2 or 0. At the same time, odd digits are considered less desirable in Chinese culture since the times of Confucius (Hu, Parsa & Zhao, 2006). Albeit, one may find some McDonald's using 9 as a price ending digit in certain locations of China following the policies of the US counterparts. It is more an exception than a rule.

In Beijing, the average price of a meal at McDonald's and KFC is ￥30, which is the equivalent of US $5. In other words, this price

5

6

￥30 can buy a meal at McDonald's and KFC in China. Chipotle must consider these facts in choosing its pricing strategies in order to be competitive. Subway tried to buck the trend by charging ￥70 for their 12" subs. It was no surprise that consumers rejected it even though it was a good value for the size of a 12" sub. Culturally Chinese preferred a 6" sub for ￥30 over 12" sub for twice the price. Eating large amounts of bread as is the case with a 12" sub at a Subway is counter to the Chinese culture as they prefer eating rice and noodles more than bread.

Promotion

Carefully developed marketing strategies can considerably increase overall brand image and subsequent revenues. The most commonly practiced restaurant marketing strategies in China include: product bundling (meal specials; multi-course deals; lunch discount bundles); special edition gifts (equivalent to holiday specials in US; weekend specials; slow Monday deals), and coupon strategy (all types of coupons, product discounting to free food/drinks). Bundling can provide customers with a feeling of good value for money since things become cheaper when selling together. Chipotle China may want to consider offering bundled meals or platters to offer high value perception. Unlike some of the other cultures, lunch is the main meal of the day for most Chinese, thus, they prefer to have multiple items for lunch making it a whole meal. Chipotle may want to offer bundled meal deals and include a small dessert cookie etc..

Similarly, free refills on drinks are often perceived as a good deal in China. In China, it is not uncommon to see loyalty program where loyal customers accumulate points towards a meal. It plays on the saving psychology of China. A typical Chinese customer is most likely to participate in loyalty programs if there is a reward attached. To attract the younger generations, Chipotle may consider an application "App", where loyalty points are tracked similar to the Starbucks "App" used in the U.S.

Physical Evidence

The physical evidence of a company is an impressive logo that can make more customers remember its image and maintain positive word-of-mouth advertising. Almost all popular food service chains in China rely on physical appearance, such as logos, to communicate their value propositions. For example, McDonald's visual image is a yellow capital M, so customers associate the big yellow M with McDonald's taste. KFC's physical evidence is an elderly man with glasses (Col. Sanders), which displays KFC as a worldwide popular brand. Chipotle China, in consultation with local experts, could consider developing a catchy logo / figure for promotional purposes similar to Ronald McDonald of McDonald's. To differentiate from the crowded quick service segment from USA, Chipotle may consider a Tex-Mex spokesperson as a champion of Chipotle brand. The hot pepper symbol can also be a

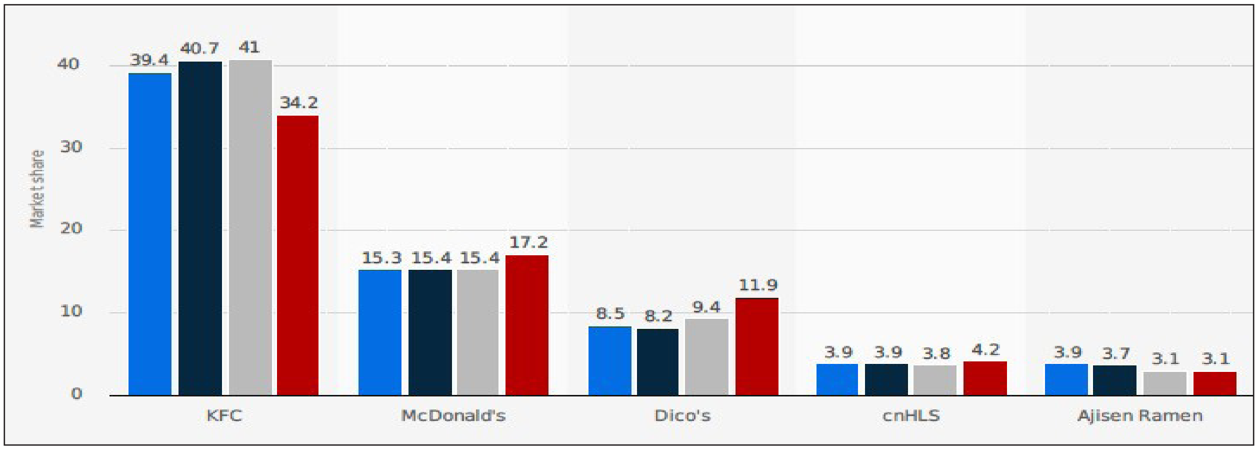
Table 2

Income Statement Projections per Restaurant

Item	Year 1: Quarters Ended (dollars in thousands)				
	31-Mar	30-Jun	30-Sep	31-Dec	Total
Revenue	1003.8	1003.8	1003.8	1003.8	4015.2
Food, beverage and packaging	281	281	281	281	1124
Labor	302	302	302	302	1208
Occupancy cost	70	70	70	70	280
Other operating costs	50	50	50	50	200
General and admin. expenses	100	100	100	100	400
Depreciation and amortization	50	50	50	50	200
Pre-opening costs	100	20	0	0	120
Marketing	90	30	30	30	180
Total operating costs	1043	903	883	883	3712
Income from operation	**-39.2**	**100.8**	**120.8**	**120.8**	**303.2**
Interest and other expenses	30	30	30	30	120
Income before taxes	**-69.2**	**70.8**	**90.8**	**90.8**	**183.2**
Provision for income taxes	5	5	5	5	20
Net income	**-74.2**	**65.8**	**85.8**	**85.8**	**163.2**

Exhibit 6

Market Shares of Leading Quick Service Chains in China



(Source: http://www.statista.com.du.idm.oclc.org/statistics/429950/market-share-of-leading-fast-foodbrands-china/)

good choice as presented below as the colors in the logo are appropriate for the Chinese culture. Color red represents prosperity, and the bright red colors of the logo and interior décor shown below may be well received by Chinese customers

Distribution Strategy

Chipotle China has three options (and may be a hybrid of these three options) with its entry into China: 1) Direct Entry as the Chipotle corporate operated restaurants; 2) Joint partnership with a Chinese restaurant company or an investment company; or 3) franchise solely with local Chinese restaurant investors. All three modes were found to be successful by various companies in China. For example, Starbucks prefers to enter international markets as a Direct Entry. KFC and others prefer joint partnerships or franchising. Some companies prefer exclusive franchising arrangements. The mode of entry depends on the internal resources of the entering firm, socio-political and economic situation of the host country, the competitive nature of the market, and other macro-environmental markets. It is noteworthy that the Chinese Government banned the use of joint ventures between foreign and domestic Chinese companies in 2004, and that over 90% of Yum Brands' restaurants in China were company-owned resulting in profit margins as high as 15% of its sales in China.

Sustainability

Chipotle's mission included sustainability and local sourcing. It may be a challenge for Chipotle as they seek local supply chains that are similarly committed to sustainability. Obtaining ingredients such as free range pork and free range chicken locally can pose a major challenge in China. Securing a supplier that can reliably supply safe, local produce can be another challenge. Crisis events like the Asian Bird flu virus in 2013 serves to remind the importance of establishing and developing good supply chains. If Chipotle could achieve sound local supply chains, it would be a major economic boost to the rural Chinese economy as well. Chipotle can be a good neighbor who supports local economies. It can set new precedence for other companies to follow the mantra of 'doing good while doing well.' At the same time, Chipotle China may learn from its local suppliers about Chinese taste preferences, regional differences, and cultural taboos.

Advertising Strategies

As a new brand entering a new market, Chipotle can be expected to invest extensively to build brand awareness. In addition, Chipotle may have to educate local consumers about burritos, a product which is not well known in China. Almost all Chinese office workers and college students heavily depend on the internet both for work and entertainment. Thus, online advertisement is one of the preferred means to reach these customers. Alternatively, Chinese youth use the Internet exclusively for entertainment. Thus, it would be best to use local social media to reach them.

Long-term Plan

The urban strategy is highly attractive for Chipotle but should be deployed with caution. Slow growth with highly established supply chain systems would be the best method of operation when entering China. A long term plan may include about fifty Chipotle restaurants in China within the first five years. Most of these fifty outlets could be located in major cities like Beijing or Shanghai, or other major urban markets. To develop new methods and standardize the operational procedures, Chipotle may want to enter the market as a wholly-owned subsidiary of Chipotle USA for the first five years. It can be followed by selected franchising for other markets.

Financial Projections

The following section provides financial projection for Chipotle operating units in Beijing in the first operational year, and is based on the research for this paper. This situation analysis is based on previous experiences of other U.S. restaurant chains and the knowledge of the foodservice industry in China. The following estimations are presented.

Quick service retail sales in China depict the Asian quick service segment was a dominant component in the country. As shown in Exhibit 6, market shares of the top-5 quick service chains in China remained relatively stable. However, quick service sales in China were expected to grow from approximately $85.4 billion in 2013 to about $107.1 billion[7] in the year 2016. Yum Brands announced that its subsidiary, Taco Bell, would reenter China in 2016 –eight years after the latter closed for business in the Chinese market.

The main question facing Chipotle was whether China was the right market for Chipotle to expand. "Do the right things in a right time at a right place," a Chinese adage, properly describes Chipotle's future path in China, which can be explained as exploring a brand new market with huge potential. Chipotle's entry into the profitable Chinese market potentially could return very high returns on investment and could give Chipotle a worldwide reputation. Additionally, it could provide a platform for further expansion into Asian countries and boost them up the learning "curve." Specifically, if Chipotle China performed well in China, its profit from China's market could become another source of financing for further expansions. These profits could be used for further improvement, such as developing new products, setting more outlets up, and optimizing the internal management. Exploring China's market could also bring Chipotle into a regeneration stage within a huge "red ocean" of competition, and similar to McDonald's and KFC in China, Chipotle has the opportunity to become a household name in their new huge "blue ocean".

If Chipotle were to enters the Chinese market, it could create an integrated supply chain with many logistics centers in China, which could, in turn, simplify further restaurant expansion into other Asian countries, such as India, Japan, and the South Korea, some of the largest economies in Asia. From a financial aspect, a successful expansion in China can enhance the company's overall value, such as increasing the value of their stock and attracting more qualified human talent. In light of the 2015 recent foodborne illness reports from multiple states in the USA, the key question was whether it made sense for Chipotle to pursue expansion plans into China at a time when it was mired with food contamination issues in the U.S. Alternatively, Should Chipotle hold off its international expansion plans to China or even alternatively consider expanding into China slowly If Chipotle decides to enter China, what should be the correct mode of entry: totally company owned units; franchising; joint ventures; or some form of hybrid of the three modes of expansion?

As co-CEOs Ells and Moran sought to build their overseas business into a global presence, they faced many questions. Was China the answer to their quest for accelerated growth? Was it the right market for Chipotle? Could Chipotle embrace more sustainable development if it explored this new market properly? Could it gain high customer satisfaction and loyalty in the huge "blue ocean" market of China? Finally, was Chipotle in China a viable strategy for the company?

7