Chipotle Faces a New Risk: Commodity-Food Inflation

Chipotle Mexican Grill serves customers fresh, tasty Mexican dishes at its "fast-casual" outlets. Rising commodity costs, however, could do something the U.S.-based operator's competition has been unable to do for years — eat away its profits.

Federal statistics showed that in September of this year, the consumer price index rose year-on-year 0.8 percent — the lowest since March 1961. The core index, however, excludes price changes of food and energy costs (viewed as too volatile by most economists to give an accurate reading of inflationary trends).

Rising prices of agricultural products continue trending higher than the core index, with the meat and eggs index up 5.8 percent year-over-year, among the biggest of increases for any food category, according to recent U.S. Bureau of Labor Statistics data.

Though **Baja Fresh**, **Qdoba**, **Moe' Southwest Grill**, and others aggressively promote a "food fresh" philosophy, Chipotle (CMG) has emerged the market leader in the $4 billion Mexican-themed, fast-casual, dining segment, with 1,023 units opened in 33 states and Toronto, Canada (2) as of September 30.

Instead of catering to customer whims by expanding meal choices, the company outperforms the competition by sticking with a limited-service menu, consisting primarily of burritos, tacos, and salads.

Distinctive to Chipotle's business model is an obsessive and resolute commitment to its "Food Integrity" branding concept: whenever possible Chipotle pledges use of locally grown, fresh produce and meats from "naturally raised" livestock (no antibiotics or added hormones). Almost one-third of fresh produce is grown in fields located within 50 miles of the designated eatery.

This dependence on local food suppliers can leave Chipotle vulnerable to the vagaries like the weather in key states. Fresh produce procurer **Danaco Solutions** warned food buyers on December 21 to expect supply shortages through late winter on green beans, sweet corn and tomatoes due to multiple nights of freezing temperatures throughout central and southwest Florida. A doubling in corn prices to $24 a crate and spot price increases of up to two-dollars per carton of central Florida tomatoes — to $9.95 for cartons (5×6). Chipotle operates more than 50 eatery locations in the "Sunshine State."

Unfortunately, pricing risk hasn't been a local event. On December 23, the **U.S. Department of Agriculture** (USDA) forecasted overall food inflation for 2011 of two percent to three percent. **Michael Swanson**, a senior economist at **Wells Fargo & Co** (WFC) opined in an interview last month he expected food inflation in 2011, on average, to increase by as much as six percent, according to a Bloomberg wire story.

Chipotle has locked in most of its corn, rice, and bean inventories for 2011. At what prices, however, is unknown. In 2010, U.S. corn prices surged more than 50 percent.

Talks with farmers in the Midwest raising livestock (and advocates of "Food Integrity" dogma), such as **Richard Oswald**, president of **Missouri Farmers Union**, and Iowan **Galen Bontrager**, lead me to conclude that Chipotle could face additional commodity pricing pressures for its key protein products — beef, chicken and pork — due to a real risk of supply scarcity:

- Livestock farmers — especially those adhering to "naturally raised" food philosophy — are facing increasing financial difficulties due to higher feed costs. In general (excluding grass-fed cattle), corn and soybean meal represented between 40 percent - 45 percent of total production costs for all three key protein groups in 2010: beef, pork, and chicken.

Farmers have responded to higher feed costs by cutting feeder cattle, poultry and hog output, curbing production.

More problematic for the company this year and next could be securing *sustainable* supplies of locally-sourced beef, chicken, and pork at reasonable costs. As suggested by a commodities inflation outlook report published by the **U.S. Department of Agriculture** (USDA) , rising prices could be more than just a short-term phenomenon, and Chipotle will need adjust its growth plans accordingly:

- http://www.ers.usda.gov/briefing/baseline"Prices for corn, oilseeds, and many other crops will remain at historically high levels over the next decade." Further, the livestock sector is still making adjustments to herd size in response to high grain and soybean meal prices in 2007 and 2008, followed by weak meat demand caused by the global economic recession. The end result is lower production at higher prices.

It's worth noting, too, that the USDA published this forecast before commodities renewed their aggressive move higher in the second-half 2010.

Protein inflation could be even higher than even economist Swanson's prediction. **Dan Faulkner**, professor of Animal Sciences at the University of Illinois, pointed out in a recent interview with me that accelerated reductions in breeder herds served only to exacerbate supply shortages, leading to higher retail beef prices. As noted by Faulkner, beef production is related to cattle cycles, a series of peaks and troughs in herd size and production that typically lasts from 8 to 12 years. Given recent events, he believes that cycle could almost double to 10-20 years — and we are currently at cycle lows.

Faulkner just might be right. In December, a document published by the USDA, "Cow Herd Liquidation Continues," said more heifers than steers were still being slaughtered, confirming Faulkner's concern that inventory imbalances were unlikely to be resolved anytime soon.

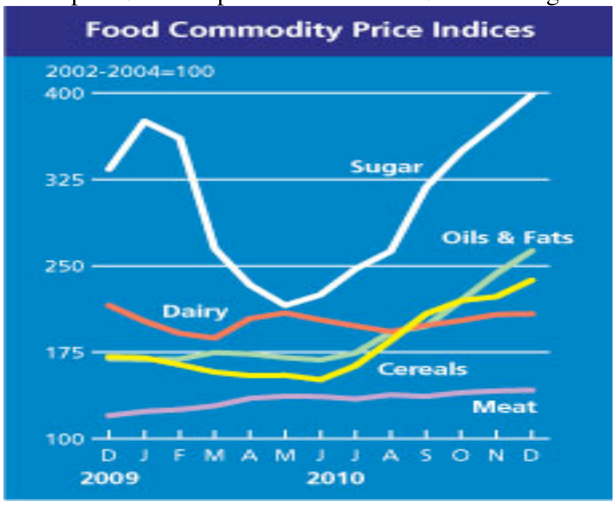
How does this hurt Chipotle? A shortage in protein supplies and a hostile inflation outlook could spoil company sales-growth expectations.

Despite evidence presented to the contrary, Chief financial officer **Jack Hartung** told analysts on the third-quarter 2010 earnings call that the company is planning operations this year with "overall food-cost inflation in the low-to- mid-single digit range." Additionally, the company planned to be patient with pricing strategy, and would monitor competitor traffic patterns in response to their menu price hikes.

Food and beverage costs are the largest input to operating costs: 30.4 percent for the nine-months ended September 30, 2010.

Hartung remained resolute in his belief that Chipotle had more "pricing power" than some of its competitors; all stores are company-owned, and it could more readily absorb higher food costs than franchise-operated chains (which pay royalties to the parent companies).

Management's "wait and see" strategy is likely rooted in a decision back in 2008 to raise menu prices in response to soaring commodity costs — store traffic fell for four consecutive quarters before recovering. However, food costs as a percent of sales dropped back in 2009 by 170 basis points to 30.7 percent — as the impact of menu price increases did offset falling traffic.



Chipotle opened its first overseas restaurant in London, England last May, and has talked about opening additional locations in other European markets, such as Paris and Munich. In my opinion, surging commodity prices worldwide — from cereals to oilseeds and sugar — will curb the burrito chain's appetite for additional European expansion, at least for now.

Today, a three percent increase in food costs would compress margins by roughly 100 basis points (one-percent), according to Hartung.

If Chipotle cannot get an accurate handle on how customer transactions and traffic will respond to price hikes, its strategy of patience could gobble up operating profits quicker than an an uneaten burrito goes stale.