

Headed into August 2015, Chipotle (pronounced chi-POAT-lay) Mexican Grill's future looked rosy. Sales and profits in the first six months of 2015 were at record-setting levels, and expectations were that 2015 would be the company's best year ever, given the opening of over 200 new restaurants, ongoing enthusiasm for its menu offerings containing health-conscious and freshly prepared ingredients, and growing customer traffic at Chipotle's existing restaurant locations. But over the next five months, a series of events occurred that caught customers and Chipotle top executives by surprise.

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- In August, a salmonella outbreak in Minnesota sickened 64 people who had eaten at a Chipotle Mexican Grill. The state's Department of Health later linked the illness to contaminated tomatoes served at the restaurant.
- In August, 80 customers and 18 employees at a Chipotle Mexican Grill in Southern California reported gastrointestinal symptoms of nausea, vomiting, and diarrhea that medical authorities and county health officials attributed to "norovirus." Norovirus is a highly contagious bug spread by contaminated food, improper hygiene, and contact with contaminated surfaces; the virus causes inflammation of the stomach or intestines, leading to stomach pain, nausea, diarrhea, and vomiting. After the reported food poisoning, the restaurant voluntarily closed, threw out all remaining food products, and sent home the affected employees. Employees who tested positive for norovirus remained off duty until they were cleared to return to work. County health officials also inspected the facility on two occasions and rendered passing grades, despite finding several minor violations. The restaurant reopened the following day, and no further food poisoning incidents occurred.
- In October, 55 people became ill from food poisoning after eating at 11 Chipotle locations in the Portland, Oregon, and Seattle, Washington, areas. Medical authorities attributed the illnesses to a strain of *E. coli* bacteria typically associated with contaminated food. Most ill people had eaten many of the same food items, but subsequent testing of the ingredients at the 11 Chipotle restaurants did not reveal any *E. coli* contamination. (When a restaurant serves foods with several ingredients that are mixed or cooked together and then used in multiple menu items, it is difficult for medical studies to pinpoint the specific ingredient or ingredients that might be contaminated.) A review of Chipotle's distribution records by state and federal regulatory officials was unable to identify a single food item or ingredient that could explain the outbreak. Nonetheless, out of an abundance of caution, Chipotle management voluntarily closed all 43 Chipotle locations in the Portland and Seattle markets, pending a comprehensive review of the causes underlying the food contamination and a check of whether any of Chipotle's food suppliers were at fault. Chipotle management worked in close consultation and collaboration with state and federal health and food safety officials (including personnel from the Centers for Disease Control and Prevention

whether any of Chipotle's food suppliers were at fault. Chipotle management worked in close consultation and collaboration with state and federal health and food safety officials (including personnel from the Centers for Disease Control and Prevention (CDC), the U.S. Department of Agriculture's Food Safety and Inspection Service, and the U.S. Food and Drug Administration) throughout their investigation of the incident and also launched a massive internal effort review of the company's food preparation and food safety procedures. These internal actions included:

1. Confirming that more than 2,500 tests of Chipotle's food, restaurant surfaces, and equipment all showed no *E. coli*.
2. Confirming that no employees in the affected restaurants were sickened from the incident.
3. Expanding the testing of fresh produce, raw meat, and dairy items prior to restocking restaurants.
4. Implementing additional safety procedures, and audits, in all of its 2,000 restaurants to ensure that robust food safety standards were in place.
5. Working closely with federal, state, and local government agencies to further ensure that robust food safety standards were in place.
6. Replacing all ingredients in the closed restaurants.
7. Conducting additional deep cleaning and sanitization in all of its closed restaurants (and confirmed that the company would be conducting deep cleaning and sanitization additionally in all restaurants nationwide).

Meanwhile, the Federal Drug Administration sought to discover the sources of multiple widely distributed ingredients in an effort to identify a cause for the outbreak. The distribution path did not lead to an ingredient of interest. The FDA also conducted investigations of some suppliers, but did not find any evidence that those suppliers were the source of the outbreak. Ultimately, no food item was identified as causing the outbreak and no food item was ruled out as a cause, although fresh produce was suspected as the likely cause.

After health officials concluded it was safe to do so, all 43 restaurants in the Portland and Seattle markets reopened in late November 2015, roughly six weeks after the incident occurred.

- In early December 2015, five people in three states—Kansas (1), North Dakota (1), and Oklahoma (3)—became ill after eating at Chipotle Mexican Grill restaurants. Studies conducted by the CDC determined that all five people were infected with a rare strain of *E. coli* different from the infections in Oregon and Washington. However, investigators used sophisticated laboratory

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- In mid-December 2015, about 120 Boston College students became ill after eating at a Chipotle Mexican Grill near the campus, an outbreak that local health officials attributed to a norovirus. Health officials also tested students for *E. coli* infections but the tests were negative.

Extensive reports of the last three incidents in the national media took a toll on customer traffic at most all Chipotle locations. Revenues at Chipotle restaurants dropped about 6.8 percent in the fourth quarter of 2015 compared to the fourth quarter of 2014; net income in the fourth quarter declined 44 percent compared to the same period a year earlier. The average decline in sales at Chipotle locations open at least twelve months was a stunning 14.6 percent in Q4 2015, after rising in the previous three quarters of 2015. The company's stock price crashed from an all-time high of \$758 in early August 2015 to a low of \$399 in early January 2016, although the stock price recovered to the \$525 range in late February 2016 following a January announcement by the CDC that the prior food contamination and food safety issues at Chipotle were "over."

In announcing Chipotle's financial results for the fourth quarter of 2015 and full-year 2015 in February 2016, Steve Ells, founder, chair, and co-CEO of Chipotle Mexican Grill, laid out the measures Chipotle was taking to regain the confidence of customers and restore the appeal of dining at one of Chipotle's 2,000+ locations. Ells said:¹

The fourth quarter of 2015 was the most challenging period in Chipotle's history, but the Centers for Disease Control and Prevention has now concluded its investigation into the recent *E. coli* incidents associated with Chipotle. We are pleased to have this behind us and can place our full energies to implementing our enhanced food safety plan that will establish Chipotle as an industry leader in food safety. We are extremely focused on executing this program, which designs layers of redundancy and enhanced safety measures to reduce the food safety risk to a level as near to zero as is possible. By adding these programs to an already strong and proven food culture, we strongly believe that we can establish Chipotle as a leader in food safety just as we have become a leader in our quest for the very best ingredients we can find.

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2016 will be a very difficult year relative to our past performance. But, by staying true to our food culture and unique people culture, and layering on our rigorous food safety program, we are confident that we are now in a position to aggressively welcome customers into our restaurants and restore customer confidence in the things that make Chipotle great. With our full commitment to becoming an industry leader in food safety, and our continued focus on delivering an exceptional customer experience, we are confident that Chipotle will emerge as an even stronger company.

In February 2016, Chipotle shut all of its restaurants for a period of four hours to conduct food safety training for all store employees. That same day, in an effort to get customers back into its stores, Chipotle offered a free burrito to anyone who signed up on its website during certain hours. In mid-March 2016, Chipotle reported that January 2016 sales at Chipotle restaurants open at least 12 months fell by an average of 36.4 percent as compared to January 2015 and that February 2016 sales at these stores were 26.1 percent below the February 2015 level.² The company said it expected to report a \$1 loss per share at best in the first quarter of 2016 (the company's first ever loss since becoming a public company in January 2006), compared to a net profit of \$3.95 per share in the first quarter of 2015. To draw customers back into its stores, Chipotle further said it would be conducting mass mail-outs of coupons offering a free burrito, burrito, salad, or order of tacos as part of its marketing program for the first half of 2016.

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Also in its mid-March 2016 announcement, Chipotle said it was considering stepping back from a couple of its earlier food safety changes.³ One of these changes related to precooking beef before it arrived at restaurants in vacuum-sealed bags, where store employees would add spices to the bag without touching the meat, marinate it in refrigerators, and reheat it on a grill before putting it in containers for use on the serving line; furthermore, the spices were added to meat bags after stores closed to avoid any possible contamination with ingredients prepared in stores during the day. Previously, workers at Chipotle restaurants, wearing plastic gloves, transferred arriving raw beef and chicken to bowls, hand-rubbed the beef/chicken with adobo spices, and placed the bowls in refrigerators to let the meats marinate until they were cooked as needed for dishes being prepared on the serving line. The unspoken reason for abandoning the precooking of beef and reverting to the former procedures was thought to be complaints from customers that the precooked beef did not taste as good as when it came off the grill freshly cooked. Chipotle's principle points of differentiation from other restaurant chains had been its much-publicized use of fresh, natural ingredients and antibiotic-free, sustainably raised meats, coupled with in-store preparation and cooking of all dish ingredients—features that had spawned customer enthusiasm for eating at Chipotle restaurants. Management recognized that if customers were disappointed with the

sustainably raised meats, coupled with in-store preparation and cooking of all dish ingredients—features that had spawned customer enthusiasm for eating at Chipotle restaurants. Management recognized that if customers were disappointed with the different taste of the beef dishes being prepared with the new techniques it would compound the problem of rejuvenating customer traffic to former levels.

Another procedural change being contemplated by Chipotle related to eliminating pathogen testing on certain ingredients, particularly beef sourced from Australia; such testing was costly and was thought by some Chipotle personnel to be an unnecessary food safety precaution. While Chipotle personnel investigating the fall 2015 food contamination problem suspected that the source of the *E. coli* was beef imported from Australia which somehow spread to other ingredients through cross-contamination.⁴ Federal authorities had disagreed, saying that cross-contamination was unlikely because Chipotle's distribution records did not confirm Australian beef had been shipped to those restaurants where people reported becoming ill. Because Chipotle decided not to drop the Australian beef supplier, Chipotle had instituted pathogen testing for the imported beef as a precautionary measure.

Then in April 2016, Steve Ells's announcement of Chipotle's Q1 2016 performance contained some alarming numbers. Revenues of \$834.5 million were 23.4 percent lower than the \$1.09 billion reported in the first quarter of 2015. The company had a net loss of \$26.4 million versus a net profit of \$122.6 million in the prior year's first quarter. Sales at Chipotle restaurants open at least 12 months were down 29.7 percent; the average number of sales transactions at these restaurants was down 21.1 percent. He provided no guidance as to management's expectations what Chipotle's performance might be in the remaining three quarters of 2016.

CHIPOTLE MEXICAN GRILL'S EARLY YEARS

Steve Ells graduated from the Culinary Institute of America and then worked for two years at Stars Restaurant in San Francisco. Soon after moving to Denver, he began working on plans to open his own restaurant. Guided by a conviction that food served fast did not have to be low quality and that delicious food did not have to be expensive, he came up with the concept of Chipotle Mexican Grill. When the first Chipotle restaurant opened in Denver in 1993, it became an instant hit. Patrons were attracted by the experience of getting better-quality food served fast and dining in a restaurant setting that was more upscale and appealing than those of traditional fast-food enterprises. Over the next several years, Ells opened more Chipotle restaurants in Denver and other Colorado locations.

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MacBook Air

Ells's vision was "to change the way people think about and eat fast food." Taking his inspiration from features commonly found in many fine-dining restaurants, Ells's strategy for Chipotle Mexican Grill was predicated on six elements:

- Serving a focused menu of burritos, tacos, burrito bowls (a burrito without the tortilla) and salads.
- Using high-quality fresh ingredients and classic cooking methods to create great tasting, reasonably priced dishes prepared to order and ready to be served 1–2 minutes after they were ordered.
- Enabling customers to select the ingredients they wanted in each dish by speaking directly to the employees assembling the dish on the serving line.
- Creating an operationally efficient restaurant with an aesthetically pleasing interior.
- Building a special people culture comprised of friendly, high-performing people motivated to take good care of each customer and empowered to achieve high standards.
- Doing all of this with increasing awareness and respect for the environment and by using organically grown fresh produce and meats raised in a humane manner without hormones and antibiotics.

In 1998, intrigued by what it saw happening at Chipotle, McDonald's first acquired an initial ownership stake in the fledgling company, then acquired a controlling interest in early 2000. But McDonald's recognized the value of Ells's visionary leadership and kept him in the role of Chipotle's chief executive after it gained majority ownership. Drawing upon the investment capital provided by McDonald's and its decades of expertise in supply chain logistics, expanding a restaurant chain, and operating restaurants efficiently, Chipotle—under Ells's watchful and passionate guidance—embarked on a long-term strategy to open new restaurants and expand its market coverage. By year-end 2005, Chipotle had 489 locations in 24 states. As 2005 drew to a close, in somewhat of a surprise move, McDonald's top management determined that instead of continuing to parent Chipotle's growth, it would take the company public and give Chipotle management a free rein in charting the company's future growth and strategy. An initial public offering of shares was held in January 2006, and Steve Ells was designated as Chipotle's CEO and board chairman. During 2006, through the January IPO, a secondary offering in May 2006, and a tax-free exchange offer in October 2006, McDonald's disposed of its entire ownership interest in Chipotle Mexican Grill.

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When Chipotle became an independent enterprise, Steve Ells and the company's other top executives kept the company squarely on a path of rapid expansion and continued to employ the same basic strategy elements that were the foundation of the company's success. Steve Ells functioned as the company's principal driving force for ongoing innovation and constant improvement. He pushed especially hard for new ways to boost "throughput"—the number of customers whose orders could be taken, prepared, and served per hour.⁵ By 2012, Ells's mantra of "slow food, fast" had resulted in throughputs of 300 customers per hour at Chipotle's best restaurants.

During 2011–2015, Chipotle's revenues grew at a robust compound average rate of 18.7 percent. Net income grew at a compound rate of 19.4 percent, due not only to sales increases but also to improved operating efficiency that boosted profit margins. Growing customer visits and higher expenditures per customer visit drove average annual sales for Chipotle restaurants open at least 12 full calendar months from \$1,085,000 in 2007 to \$2,424,000 in 2015. The average check per customer ran \$8 to \$10 in 2011–2015.

Exhibit 1  presents recent financial and operating data for Chipotle Mexican Grill.

EXHIBIT 1

Financial and Operating Highlights for Chipotle Mexican Grill, 2011–2015 (in 000s of dollars, except for per share items)

Income Statement Data	2015	2014	2013	2012	2011
Total 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
As a % of total revenue	33.4%	34.6%	33.4%	32.6%	32.5%
Labor costs	1,045,726	904,407	739,800	641,836	543,119

CHIPOTLE MEXICAN GRILL IN 2016

Going into 2016, Chipotle operated 1,971 Chipotle restaurants in 46 states and the District of Columbia, as well as 11 in Canada, 7 in England, 4 in France, and 1 in Germany. Additionally, the company's restaurants included 13 ShopHouse Southeast Asian Kitchen restaurants, serving Asian-inspired cuisine, and Chipotle co-owned and operated 3 Pizzeria Locale restaurants, a fast-casual pizza concept, giving it a total of 2,010 restaurants. Chipotle management expected to open between 220 and 235 additional restaurants in 2016, including a small number of Chipotle restaurants outside the United States and ShopHouse and Pizzeria Locale restaurants within the United States.

Menu and Food Preparation

The menu at Chipotle Mexican Grill restaurants was quite limited—burritos, burrito bowls, tacos, and salads, plus soft drinks, fruit drinks, and milk. Except in restaurants where there were restrictions on serving alcoholic beverages, the drink options also included a selection of beers and margaritas. However, customers could customize their burritos, burrito bowls, tacos, and salads in hundreds of different ways. Options included four different meats or tofu, pinto beans or vegetarian black beans, brown or white rice tossed with lime juice and fresh-chopped cilantro, and a variety of such extras as sautéed peppers and onions, salsas, guacamole, sour cream, shredded cheese, lettuce, and tortilla chips seasoned with fresh lime and salt. In addition, it was restaurant policy to make special dishes for customers if the requested dish could be made from the ingredients on hand. **Exhibit 2**  shows some of the dishes served at Chipotle Mexican grill restaurants.

EXHIBIT 2

Representative Dishes Served at Chipotle Mexican Grill Restaurants

From the outset, Chipotle's menu strategy had been to keep it simple, do a few things exceptionally well, and not include menu selections (like coffee and desserts) that complicated store operations and impaired efficiency. While it was management's practice to consider menu additions, the menu offerings had remained fundamentally the same since the addition of burrito bowls in 2005 and tofu Sofritas (shredded organic tofu braised with chipotle chilis, roasted poblanos, and a blend of aromatic spices) as a meat alternative in 2013–2014. So far, Steve Ells had rejected the idea of adding a breakfast menu and opening earlier in the day.

The food preparation area of each restaurant was equipped with stoves and grills, pots and pans, and an assortment of cutting knives, wire whisks, and other kitchen utensils. There was a walk-in refrigerator stocked with ingredients, and supplies of herbs, spices, and dry goods such as rice. The work space more closely resembled the layout of the kitchen in a fine dining restaurant than the cooking area of typical fast food restaurant that made extensive use of automated cooking equipment and microwaves. Until the food contamination and food safety incidents in Q4 of 2015, all of the menu selections and optional extras were prepared from scratch in each Chipotle location—hours went into preparing food on-site, although some items were prepared from fresh ingredients in area commissaries. Kitchen crews used classic cooking methods: they marinated and grilled the chicken and steak, hand-cut produce and herbs, made fresh salsa and guacamole, and cooked rice in small batches throughout the day. While the food preparation methods were labor-intensive, the limited menu created efficiencies that helped keep costs down.

Food preparation methods at Chipotle's restaurants were overhauled in late 2015 in response to the food contamination incidents. The goal was to develop an industry-leading food safety program utilizing the assistance and recommendations of highly respected experts. Components of the new program included

- DNA-based testing of many ingredients to evaluate their quality and safety before they were shipped to Chipotle restaurants.
- Changes to food preparation and food handling practices, including washing and cutting some produce items (such as tomatoes and romaine lettuce) in central kitchens.
- Blanching of some produce items (including avocados, onions, jalapenos and citrus) in each restaurants before cutting them.
- New protocols for marinating meats.
- Utilizing the Food and Drug Administration's Hazard Analysis Critical Control Point (HACCP) management system to enhance internal controls relating to food safety.
- Instituting internal training programs to ensure that all employees thoroughly understand the company's newly imposed

Quality Assurance and Food Safety

Chipotle's quality assurance department was charged with establishing and monitoring quality and food safety measures throughout the company's supply chain. There were quality and food safety standards for farms that grew ingredients used by company restaurants, approved suppliers, the regional distribution centers that purchased and delivered products to the restaurants, and frontline employees in the kitchen and on the serving lines at restaurants. The food safety programs for suppliers and restaurants were designed to ensure compliance with applicable federal, state, and local food safety regulations.

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Chipotle's training and risk management departments developed and implemented operating standards for food quality, preparation, cleanliness, and safety in company restaurants.

Chipotle's Commitment to "Food With Integrity"

In 2003–2004, Chipotle began a move to increase its use of organically grown local produce, organic beans, organic dairy products, and meats from animals that were raised in accordance with animal welfare standards and were never given feeds containing non-therapeutic antibiotics and growth hormones to speed weight gain. This shift in ingredient usage was part of a long-term management campaign to use top-quality, nutritious ingredients and improve "the Chipotle experience"—an effort that Chipotle designated as "Food With Integrity" and that top executives deemed critical to the company's vision of changing the way people think about and eat fast food. The thesis was that purchasing fresh ingredients and preparing them daily by hand in each restaurant were not enough.

To implement the Food With Integrity initiative, the company began working with experts in the areas of animal ethics to try to support more humane farming environments, and it started visiting the farms and ranches from which it obtained meats and fresh produce. It also began investigating using more produce supplied by farmers who respected the environment, avoided use of chemical fertilizers and pesticides, followed U.S. Department of Agriculture standards for growing organic products, and used agriculturally sustainable methods like conservation tillage methods that improved soil conditions and reduced erosion. Simultaneously, efforts were made to source a greater portion of products locally (within 350 miles of the restaurants where they were used) while in season. The transition to using organically grown local produce and naturally raised meats occurred gradually because it took time for Chipotle to develop sufficient sources of supply to accommodate the requirements of its growing number of restaurant locations. But substantial progress had been made. By year-end 2011, all of the sour cream and cheese Chipotle purchased was made from milk that came from cows that were not given rBGH (recombinant bovine growth hormone). The milk used to make much of the purchased cheese and a portion of the purchased sour cream was sourced from dairies that provided

Serving Orders Quickly

One of Chipotle's biggest innovations had been creating the ability to have a customer's order ready quickly. As customers moved along the serving line, they selected which ingredients they wanted in their burritos, burrito bowls, tacos, and salads by speaking directly to the employees that prepared the food and were assembling the order behind the counter. Much experimentation and fine-tuning had gone into creating a restaurant layout and serving line design that made the food-ordering and dish-creation process intuitive and time-efficient, thereby enabling a high rate of customer throughput. The throughput target was at least 200 and up to 300 customers per hour, in order to keep the numbers of customers waiting in line at peak hours to a tolerable minimum.

Management was focused on further improving the speed at which customers moved through the service line in all restaurants, so that orders placed by fax, online, or via smartphone ordering apps could be accommodated without slowing service to in-store customers and compromising the interactions between customers and crew members on the service line. The attention to serving orders quickly was motivated by management's belief that while customers returned because of the great-tasting food they also liked their orders served fast without having a "fast-food" experience (even when they were not in a hurry). Delivery service was also offered in many areas through a number of third party services with whom the company had partnered.

Catering

In January 2013, Chipotle introduced an expanded catering program to help spur sales at its restaurants. The rollout began in the company's Colorado restaurants and was available at every Chipotle Mexican Grill, except those in New York City, in 2014. The program involved setting up a portable version of its service line for groups of 20 to 200 people; guests could create tacos and bowls with either two or three meat choices (including vegan Sofritas), fajita veggies, white and brown rice, black and pinto beans, four salsas, cheese, sour cream, guacamole, lettuce, chips, and soft flour and crispy corn tortillas. For customers wanting to accommodate a smaller group of 6 or more people, Chipotle offered a Burritos by the Box option with a choice of meat, Sofritas, or grilled veggies (or an assortment of these) plus white or brown rice, black beans, and cheese; with each two burritos, a bag of chips, tomatillo-green chili salsa, guacamole, and sour cream was included.

SUPPLY CHAIN MANAGEMENT PRACTICES

Top executives were acutely aware that maintaining high levels of food quality in its restaurants depended in part on acquiring