

Big burritos, big problems

Growing pains and abdominal pains combined to make 2015 a rough year for Chipotle

by Bill Giebler

“Brown rice or white?” the server asks amidst a flurried assembly line of latex gloves and steel spoons. “Black or pinto? Salsa, sour cream, cheese, lettuce?” The familiar battery of questions keeps me alert, while one of the most efficient machines of modern dining churns out my burrito on a Thursday evening in Longmont, Colorado.

Ahead of me, a woman has just ordered a burrito bowl, a salad and three kid’s meals served up in compostable sectioned trays. Behind me, a line of customers stretches forty-some feet to the door. From where I’m standing, \$8.00 burrito in hand, business seems strong after what *anyone* would call a rough year for the burrito giant. I bite into my burrito just over a week after the **Centers for Disease Control** and Prevention (CDC) declared an end to the multi-state E. coli outbreak that shook the company in the final quarter of 2015.

Chipotle acknowledges that Q4 2015, “was the most challenging period in Chi-

potle’s history,” highlighting, in their Feb. 2, 2016 press release, that—even with 79 new restaurants in the quarter—their:

- Revenue decreased 6.8 percent to \$997.5 million
- Comparable restaurant sales decreased 14.6 percent
- Restaurant level operating margin was 19.6 percent, a decrease of 700 basis points
- Net income was \$67.9 million, a decrease of 44.0 percent
- Diluted earnings per share was \$2.17, a decrease of 43.5 percent

At close of market on Feb. 18th, 2016, the chain’s stock was valued at \$516.69 per share, down 31.1 percent from their Oct. 13, 2015 high of \$750.42—but up from the January 12th low of \$404.26. Analysts believe it will be 2017 before Chipotle returns to where it was before—if it ever does.

Already awkward

Chipotle was already having a challenging year, even before reportedly sickening over 500 diners in six inci-

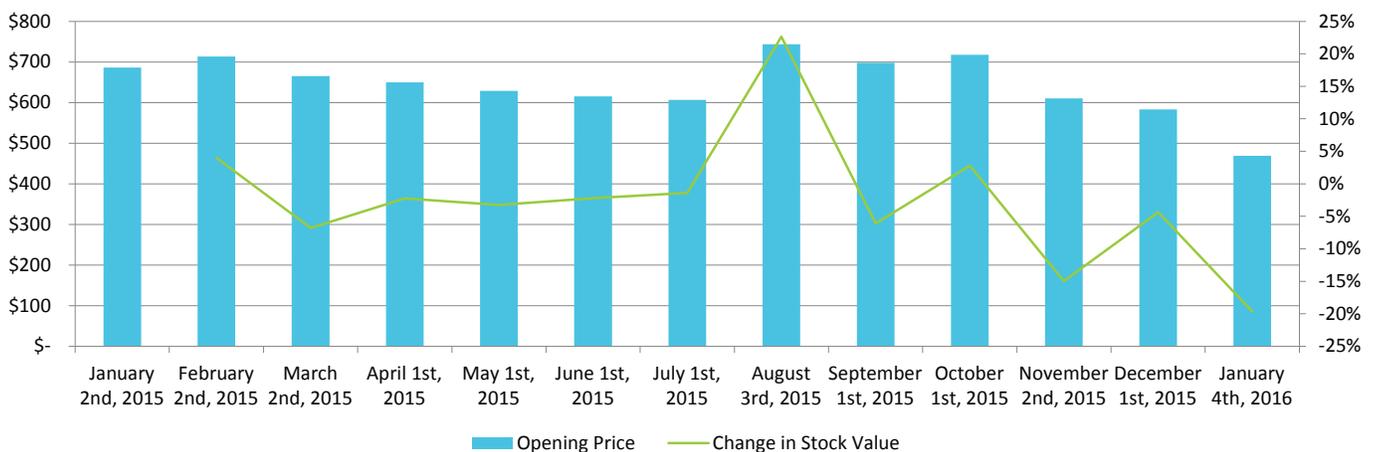
NBJ Takeaways

- On-site food preparation may increase risk of food-borne illness
- Regional food sourcing poses challenges for chains
- Chipotle stock took a big hit, but it’s showing signs of a comeback

dents across 15 states. An Oct. 19th *Wall Street Journal* analysis, titled “Chipotle Reaches Awkward Age,” characterizes a former “renegade” as now “settling into middle age.” The article identifies four key challenges for the company, including, “slower sales growth, difficulty attracting workers, problems securing ingredients, and attacks from critics.”

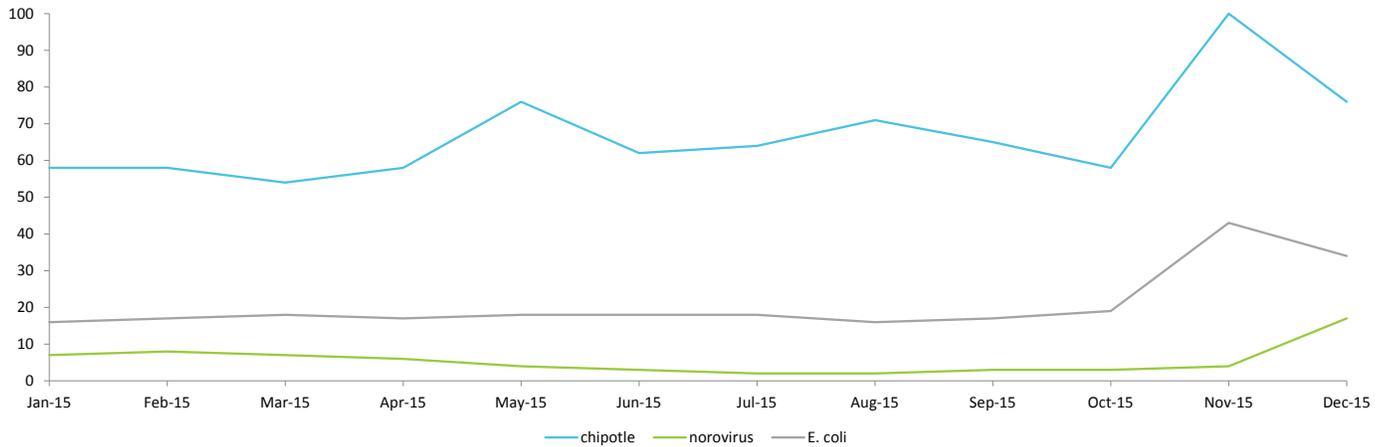
The fifth and largest challenge was, rath-

CHIPOTLE STOCK PRICE AND MONTHLY VALUE CHANGE, JANUARY 2ND 2015 THROUGH JANUARY 4TH, 2016



Source: Yahoo Finance

SEARCH VOLUME ON CHIPOTLE, NOROVIRUS AND E. COLI



Source: Google Trends

er prophetically, identified a full year ago by Chipotle itself. Their Feb. 4, 2015 annual report stated that, “Instances of food-borne or localized illnesses could cause the temporary closure of some restaurants or result in negative publicity.”

On Oct. 19—the same day the *WSJ* published its analysis—it came true: a Chipotle customer fell ill with an E. coli related infection. That illness, the first of 60 chipotle-related E. coli victims across 14 states (registered by the CDC as two outbreaks over three months), was uncomfortably straddled by a different E. coli strain sickening five in Washington in July, bi-coastal norovirus outbreaks sickening 385 people in August and December, and a salmonella outbreak affecting 64 in Minnesota in September.

All of this came on the heels of a months-long *carnitas* shortage. But the missing meat—when chipotle found that their supplier was not adhering to the company’s animal welfare standards—can be seen as a minor inconvenience at worst, and a “*where’s the pork?*” credibility-building marketing scheme at best. In either case, it’s now paled by the food safety crisis.

What happened?

Amid the crisis, reports began to identify the chain’s localized sourcing as part of the problem. More likely, the multi-state outbreaks point to a less localized supply chain than Chipotle would have consumers believe. Even so, it does appear that the company’s commitment to fresh ingredients prepared in store put them at a higher risk than the fast food chains more dependent on frozen goods and food prepped offsite.

A common criticism in the media aftermath of the crisis is that Chipotle focused too much on their sustainable sourcing campaign (marketed as “food with integrity”) and took their eyes off the *food with safety* ball.

“You’ve got to be thinking of food safety from day one, across your supply chain in your facilities... doing everything you can,” says Bob Gravina, professor of food science at Cornell University College of Agriculture and Life Sciences. “The organism doesn’t know whether the product is locally sourced or globally sourced ... whether the farm is large or small, or whether it’s organic or conventional.” It’s important to back up and make sure everybody in the supply chain is playing their part in preventing contamination, he says. That includes processing steps that destroy pathogens, and

the handling of products at proper transport temperatures across the entire distribution system.

Chipotle did not respond to several requests for comment—nor did competitor **Qdoba** when asked what impact the situation has had on their food safety practices. [Curiously, Qdoba’s owner, **Jack in the Box Inc.**, is responsible for the single largest recorded E. coli outbreak, sickening 700 and killing 4 children in 1992-93.]

It’s safe to assume anyone in that sector is taking note, says Gravina. “When a situation like this occurs,” he says, “the first thing that should happen is everyone should ... totally reevaluate their food safety management system—what they’re doing, how they’re doing it—and go back and double check all their suppliers.”

This is exactly what Chipotle has done, beginning with hiring a top consultancy, IEH Laboratories & Consulting Group, to tighten up protocols—everything from adding cilantro to rice still at a cooking temperature to boiling avocados before cutting. They’ve also implemented changes throughout their supply chain, increasing the volume of food prepared at processing facilities—and decreasing what’s prepared fresh in store—undermining a key brand differentiator.

No smoking gun

The entire campaign to step up food safety standards in the stores, however, is built on “lots of speculation,” says Gravina, “since the FDA found, in my words, no smoking gun.”

It may be unsurprising that no source of E. coli was found. The bacteria take several days to incubate into illness, and often several more to be reported and traced to a specific restaurant. Whatever ingredients caused the illness are likely to have moved across the counter days before an investigation—especially in a high volume chain like Chipotle where cases of fresh produce move through each of the more than 1,900 outlets each day.

Gravina is surprised, though. “It’s really a tremendous mystery,” he says. “The FDA took a huge number of samples and nobody could find anything, and that is perplexing. Obviously if the organism is present in a food item, you’re going to find it.” Even with perishability of produce and volumes of product moving through the system, there’s typically a frozen sample or leftover food, he says. “One would think you would find something somewhere.” That lack of evi-

dence—and therefore no substantive indication of safety violations—may undermine another campaign: the dozen or more legal cases filed against the company, including at least one criminal case.

Deborah Denenberg, a partner at **Gallo Vitucci Klar, LLP**, is an attorney typically found on the defense side of such cases. Denenberg says that while the multitude of outbreaks does present sufficient circumstantial evidence of negligence, without direct evidence of a violation, “The plaintiffs will have to demonstrate a pattern of neglect by the restaurant, including a failure to properly vet vendors or other cost cutting measures.” Even with the extensive changes

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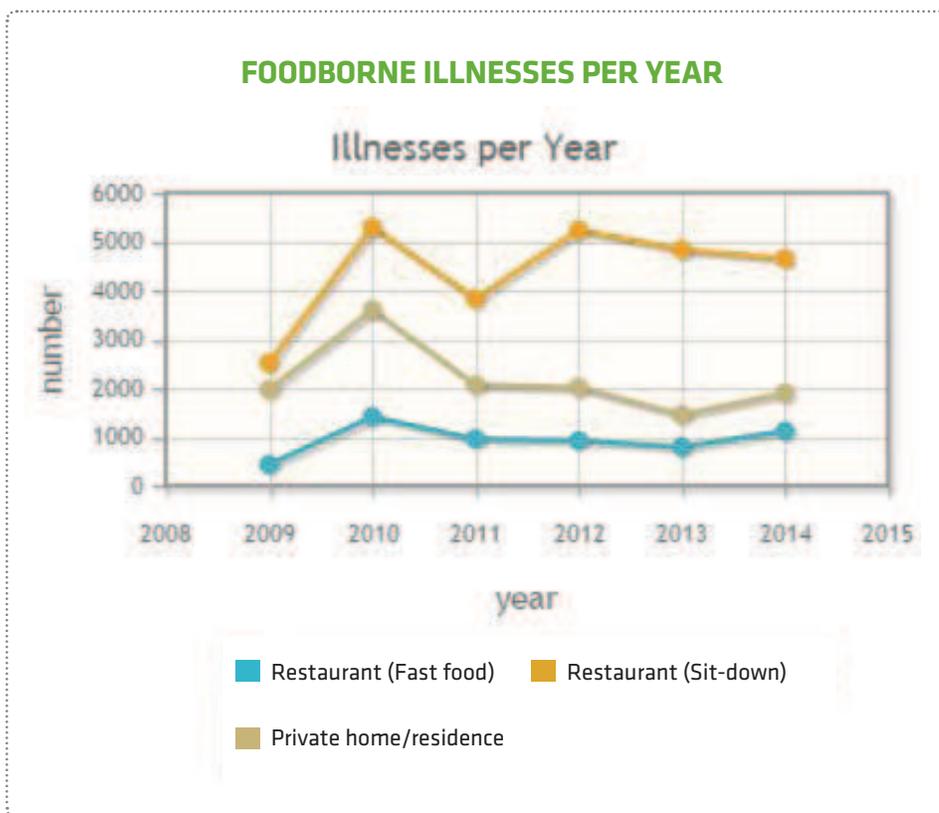
Chipotle has made to their food safety program, in court the company is likely to argue that they already followed strict food safety guidelines.

Staying busy

Chipotle is not going away. They’re already showing signs of recovery—well beyond the busy Longmont shop that made my dinner. (I’m fine, by the way). Their stock valuation is up 27.8 percent from their January low and many believe that the restaurant is likely among the safest places to eat in the near term. Chipotle’s cooperation with the investigation, and their efforts with IEH, are certainly part of the recovery. Jack in the Box—remember, the largest E. coli outbreak ever?—has maintained an excellent safety record since their 1992-93 catastrophe. Chipotle may do the same.

“One would look back so that we can look ahead,” Gravani says. “What lessons did we learn from this situation?” For the E. coli cases, Gravani details constructing very strict supplier requirements, including testing, onsite evaluations and audits, and building strong partnerships with your suppliers so that they understand your stringent requirements, and meet them. In that way, a successful program becomes part of the corporate/supply chain culture.

Greater than any specific protocols, Gravani professes the importance of, “a culture of food safety in operations.” That means involvement throughout the organization—not just the VP of food safety or the VP of quality. “It has to be uppermost in any company’s mind that on any given day a product could be contaminated if food safety procedures are lax or if someone’s asleep at the switch,” he says. “We can’t let that happen given the fact that we’re feeding 317 million Americans.”



Source: Centers for Disease Control