

RUSSELL WALKER AND GREG MERKLEY

Chipotle Mexican Grill: Food with Integrity?

By any measure, Chipotle Mexican Grill was a success story in the restaurant business. It grew from one location in 1993 to over 2,000 locations by 2016 and essentially created the fast-casual dining category. One analyst called it “probably the best restaurant brand created in 10 or 15 years.”¹ Its stock appreciated more than 1,000% in the ten years following its 2006 IPO.

In January 2015 the company was lauded for delivering on its promise of “food with integrity” when it took pork off its menu for six months until it could ensure a supply of humanely raised meat. Then, in the second half of the year, after more than 20 years without a major reported food safety incident, Chipotle was revealed as the source of multiple outbreaks of illness from norovirus, salmonella, and *E. coli* that sickened nearly 600 people in 13 states. The company closed stores, spent several months under investigation by the U.S. Centers for Disease Control and Prevention (CDC) and other health organizations, and faced a criminal investigation in connection with the incidents.²

After a much-publicized closing of all of its stores on February 8, 2016, and numerous changes to its food sourcing and preparation practices, Chipotle tried to win back customers with dramatically increased advertising and free food promotions.

However, on April 26 the chain announced its first-ever quarterly loss as a public company. Same-store sales for the first quarter were 29.7% lower than in the previous year. Operating margins fell from 27.5% to 6.8% over the same period, and the company’s share price was down 41% from its summer 2015 high.

What happened to Chipotle, and more importantly, could it be fixed?

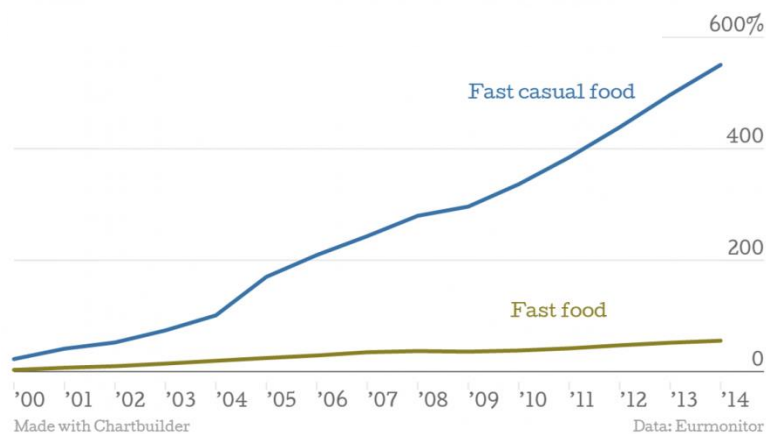
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Fast Casual Dining

Chipotle was considered a fast casual restaurant. The definition of fast casual dining was fluid, but one essential ingredient was price—fast casual restaurants averaged \$9 to \$13 per receipt, versus \$5 for fast food. In addition, a fast casual restaurant did not offer full table service and generally prepared food in full view of customers. It offered higher-quality food than at a fast food restaurant, with fewer frozen or processed ingredients. This profile meant fast casual restaurants competed against both fast food and full-service restaurants.

The popularity of fast casual dining in the United States had soared over the past decade; its sales had grown by 550% from 1999 to 2014, a growth rate ten times that of fast food restaurants (see **Figure 1**).

Figure 1: Fast Casual and Fast Food Sales Growth



Source: Roberto A. Ferdman, “The Chipotle Effect: Why America Is Obsessed with Fast Casual Food,” *Washington Post*, February 2, 2015, <https://www.washingtonpost.com/news/wonk/wp/2015/02/02/the-chipotle-effect-why-america-is-obsessed-with-fast-casual-food>.

The fast casual dining segment was fragmented and highly competitive. Panera Bread Co. was the segment leader, and Chipotle was number two in 2014 with a 17% value share.³ Price competition was not a major factor for Chipotle: customers perceived value in its atmosphere, quick service, and high-quality ingredients. During the post-2008 recession, Chipotle gained business from consumers trading down from more costly dining options and retained many of those customers even after the market began to rebound.⁴

Chipotle Background

Steve Ells, a classically trained chef, opened the first Chipotle restaurant in 1993 in Denver, Colorado. Within one month, the store was selling more than 1,000 burritos per day. Ells added five more locations in the Denver area in the next three years. In 1998 McDonald’s Corporation purchased a minority stake in what was then a 14-store chain, and the next year purchased majority control of the company. By this time, Chipotle had 37 stores, and McDonald’s continued to invest

in the concept to grow its store base. In 2006 McDonald's spun off Chipotle in an IPO on the New York Stock Exchange. As of March 31, 2016, there were 2,066 Chipotle stores worldwide, the vast majority of which were in the United States.

Ells said: "When I created Chipotle in 1993, I had a very simple idea: Offer a simple menu of great food prepared fresh each day, using many of the same cooking techniques as gourmet restaurants. Then serve the food quickly, in a cool atmosphere. It was food that I wanted and thought others would like too. We've never strayed from that original idea. The critics raved and customers began lining up at my tiny burrito joint. Since then, we've opened a few more."⁵

Chipotle's business model was defined by five elements: a simple menu; high-quality fresh ingredients; fast, personalized food; no franchises; and committed employees.

Simple Menu

Chipotle offered only burritos, bowls (essentially a burrito served in a bowl rather than wrapped in a tortilla), tacos, and salads. The price of each item was based on the choice of meat (or vegetarian option). There was no extra charge for additional elements, which included rice, beans, four types of salsa, sour cream, cheese, and lettuce. In total, each store used 64 main ingredients.⁶

High-Quality Fresh Ingredients

In 2001 the company adopted the slogan "food with integrity" to describe its approach to sourcing and preparing ingredients. Chipotle prepared all food on-site from raw ingredients, which were responsibly sourced from producers that used sustainable, humane practices. It screened potential suppliers for compliance with the company's standards for animal care and sustainable farming.

Chipotle had about 100 suppliers, most of them small- to mid-sized regional companies, not large national firms. It also sourced ingredients from local farms (within 350 miles of a given restaurant), but these supplied no more than 12% of its fresh produce in 2015.⁷

In most cases the company did not purchase products directly from suppliers. Once suppliers were approved, they sold to third-party distributors purchasing on behalf of Chipotle. Purchased goods were taken to 24 independently owned and operated regional distribution centers and then delivered to Chipotle stores for preparation.

In 2013 Chipotle became the first major American chain to identify genetically modified ingredients on its menu. In 2015 it went one step further and announced it would use only non-GMO foods.

Sourcing meat became a problem as the company grew. In 2013 Chipotle began serving "conventionally raised" beef because there was not enough antibiotic- and hormone-free beef available. Then, in January 2015, it removed pork carnitas from the menu in 600 stores when one of its suppliers violated Chipotle's standards. Replacing the supplier proved challenging – it took more than six months to find a supplier that raised pigs to Chipotle's standards – but the company was lauded for its commitment to humanely raised pork.

Despite its high-quality ingredients, Chipotle was criticized for offering food high in calories and fat. For example, its chicken burrito (with black beans, rice, cheese, and salsa) contained nearly 1,000 calories and 12 grams of saturated fat,⁸ equivalent to two Big Macs from McDonald's.⁹

Fast, Personalized Food

Chipotle offered a personalized service model. Customers chose a base for their meal (burrito, burrito bowl, tacos, or salad) and then selected their choice of meat, rice, beans, salsa, and other toppings as their meal was prepared in an assembly-line style in front of them.

No Franchises

All Chipotle restaurants were company-owned. During the period of McDonald's ownership, the company experimented with franchising in eight locations, but all were later repurchased. Ownership gave Chipotle total control over how the business was executed in each store.

Committed Employees

In 2016 nearly 60,000 people worked in Chipotle restaurants, most of them relatively inexperienced and low-paid hourly workers. Employees were paid above-market rates and offered incentives for performance. They also received two days of paid sick leave each year, a generous benefit by industry standards. As a result, Chipotle employee turnover was lower than the industry average.¹⁰

Food Safety in the United States

In the United States, numerous safety protocols had been designed to prevent food-borne illnesses. For example, the U.S. Department of Agriculture developed Hazard Analysis and Critical Control Point (HACCP), "a management system in which food safety is addressed through the analysis and control of biological, chemical, and physical hazards from raw material production, procurement, and handling, to manufacturing, distribution, and consumption of the finished product."¹¹ The system was voluntary, but McDonald's and other large-scale food producers incorporated the principles and practices into their operations (and their suppliers' operations) in order to reduce the risk of food poisoning by *E. coli*, salmonella, norovirus, and other pathogens.

Escherichia coli, also known as *E. coli*, commonly was found in the lower intestine of animals. It could be transmitted by water used to irrigate crops, or by manure that was not properly treated. Produce that was hard to clean and eaten raw, such as lettuce, tomatoes, and cilantro, was at high risk for *E. coli* contamination. Cooking and properly sanitizing killed *E. coli*, but restaurants and food producers combined multiple approaches, including washing hands, preventing cross-contamination between food items, storing food at proper temperatures, and maintaining adequate cooking temperatures.

There were many different kinds of salmonella bacteria, which caused food poisoning in over one million Americans each year. Food—most commonly poultry, beef, eggs, and milk—

could be contaminated with the bacteria during food processing or handling. A common cause of contamination was food handlers who did not wash their hands with soap after using the toilet. Preventive measures included refrigeration; cleaning food preparation surfaces; avoiding cross-contamination of cooked and raw food; fully cooking ground beef, eggs, and poultry; and pasteurizing milk.

The highly contagious—and common—norovirus sickened millions of people in the United States every year and was the leading cause of illness from contaminated foods.¹² It was transmitted by an infected person or contaminated food, water, or surfaces, so the best way to prevent it was by washing hands properly and frequently and keeping sick workers away from food-processing areas. Chipotle established protocols to prevent norovirus incidents in its stores after an outbreak sickened 500 of its customers in Ohio in 2008.

Chipotle's Food Safety Problems in 2015–16

Chipotle's public food safety problems began in August 2015 when salmonella from tomatoes sickened more than 60 people at 28 Chipotle restaurants in Minnesota and Wisconsin. That same month, 82 customers and 17 employees fell ill with norovirus infections at a Chipotle restaurant in Simi Valley, California.

The big blow came in October when 22 customers became sick from *E. coli* at eight of its locations in Oregon and Washington. All 43 of the region's stores were closed voluntarily on October 30 due to what co-CEO Ells called "an abundance of caution."¹³ Shares of Chipotle fell 2.5% on the first trading day after the store closings.

Chipotle cooperated with state and federal health officials as they tried to identify the origins of the *E. coli* strain that caused the outbreak. The Oregon Public Health Division suspected vegetables rather than meat. "We've looked at every food item there, including meat, and it seems like the common denominator is produce."¹⁴

Some experts said companies, such as Chipotle, that source fresh produce from small farmers may be more vulnerable to foodborne illnesses. "A company like McDonald's tends to work with large-scale suppliers that have resources of their own to do the types of assessments [that can detect dangerous pathogens]. . . . But if you're working with small, independent farmers, it requires a lot of effort to validate them."¹⁵ However, other experts pointed out that because some of Chipotle's produce was sourced within 350 miles of its stores, outbreaks would tend to be regional, rather than national, in scope, and thus be smaller and more contained.¹⁶

Chipotle's CFO said: "We like the local program, we think it's important, but with what's just happened we have to make sure food safety is absolutely our highest priority. If it's testing and safety versus taking a step backward on local, we would do that and hope it would be temporary."¹⁷ An independent expert said, "They were paying attention to [selling food that is unprocessed, antibiotic- and GMO-free, and local], but they weren't paying attention to microbial safety."¹⁸

In response to the outbreak, the company worked with health officials to improve its food handling procedures. It deep-cleaned and sanitized not only the closed stores but all of its restaurants nationwide. It tested food, preparation surfaces, and equipment in all of its stores and found no evidence of *E. coli*. It replaced all ingredients in the closed stores and tested all fresh

produce, raw meat, cheese, and sour cream prior to restocking the stores. It hired two food safety consulting firms to “assess and improve upon” its “already high standards for food safety.”¹⁹ On November 10 the company reopened all of its stores in Oregon and Washington.

Early in December, the CDC updated its original count of Chipotle-linked *E. coli* victims to 52. It also began investigating five new cases of *E. coli* potentially linked to Chipotle. On December 4, Chipotle warned investors that the *E. coli* outbreak could cause fourth quarter same-store sales to decrease 11% and profits 26%.²⁰

Separately, illnesses linked to Chipotle were reported in seven more states across the United States.²¹ That same month at least 80 students (later increased to 140) were sickened by norovirus linked to a Chipotle restaurant in Boston. The Boston Public Health Commission said the norovirus incidents did not appear to be related to *E. coli* incidents in Oregon and Washington. One food expert said, “I can’t think of a situation with five separate incidents involving one restaurant chain in a six-month period.”²²

Chipotle hired IEH Laboratories and Consulting Group, a food safety research firm, to improve food safety procedures at Chipotle’s suppliers and restaurants. The company said the new procedures would put it 10 to 15 years ahead of industry standards. “They’re trying to be local and serve food with integrity, but as you grow it becomes incredibly complex and difficult and challenging. When you look at what’s going on, how they’re expanding, the outbreak was almost bound to happen,” said one observer.²³

Finally, on February 1, 2016, the CDC announced that the *E. coli* outbreak officially was over. According to the CDC, evidence suggested the outbreak arose from a “common meal item or ingredient” served at Chipotle, but it was unable to identify the specific ingredient. Chipotle suspected the cause likely was cross-contamination from beef imported from Australia, a conclusion the CDC said was unlikely.²⁴

Impact on Chipotle

On April 26, Chipotle announced its first-ever quarterly loss as a public company. For the first three months of 2016, same-store sales were down 29.7% from the previous year and operating margins fell from 27.5% to 6.8%. Chipotle’s share price was 41% lower than its high in summer 2015. The company’s CFO admitted that 5% to 7% of its customers had said they would never return.²⁵

Chipotle did not provide a public estimate of the cost of its new safety programs. Ells called them “very, very expensive.” The CFO added, “Right now we’re not trying to make this cost-effective.”²⁶ He acknowledged, however, that Chipotle might need to raise prices in order to repair its margins, noting that “instead of investing [those profits] in food integrity, we might have to invest that in food safety.”²⁷

Rebuilding Confidence and Traffic

About the challenge of getting customers to return, the company's chief creative and development officer said, "There's nothing worse from a trust perspective. This is not the kind of problem that you market your way out of."²⁸

Chipotle's other co-CEO, Monty Moran, told investors in early February that the company had improved its traceability program to identify the specific farm at which each ingredient was produced in real time through its distribution system and in its individual restaurants via bar codes on each package.²⁹ The company also hired food safety expert James Marsden, a meat science professor at Kansas State University, to oversee food safety for the entire company.

On February 8, Chipotle closed all of its stores for several hours to train employees on new food safety measures. Among the changes it implemented were the following:

- Cheese will arrive at restaurants already shredded. Tomatoes and cilantro, which are particularly vulnerable to bacteria, will be washed, chopped, and tested in a central kitchen. Similar processes will be used for beef, romaine lettuce, and bell peppers.
- In the restaurant, lemons, limes, jalapeños, onions, and avocados will be blanched (plunged into boiling water before being submerged in ice water to stop cooking) for five to ten seconds before serving to reduce germs on their skins. Chipotle claimed this would not affect flavor.
- Employees who are sick or have vomited will be asked to stay home for five days after their symptoms have disappeared. Employees will be paid for those days.
- Suppliers will run "DNA-based tests" on small batches of ingredients before shipping them to restaurants.
- A \$10 million Local Grower initiative will be initiated to help small suppliers meet the new standards.

While the stores were closed on February 8, patrons who showed up were able to request a "rain check" free burrito. There were 5.3 million requests, twice as many as expected, and two-thirds of the coupons were redeemed. The company increased its promotional efforts, sending 21 million offers for free food via direct mailings and launching its largest-ever ad campaign in 31 of its top markets.³⁰ To improve the in-store experience for customers, Chipotle increased staff hours to reduce waiting times.³¹

Future Outlook

By April 2016, there were positive signs for the brand. Analysts reported that Google searches for Chipotle and food safety had decreased sharply since the beginning of the year.³² Troublingly, however, an analysis of traffic data from Chipotle restaurants by Foursquare Inc. showed that its most loyal customers had been 50% more likely than infrequent customers to stay away from the restaurant during the outbreaks, and some had stopped eating at Chipotle altogether.³³

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