Problem 1. Business Strategy Analysis

(i) Chipotle emphasizes 'Food With Integrity' as a key element of its business strategy. Identify two key success factors associated with this aspect of Chipotle's business strategy. **[4 points]**

1. First key success factor

Attract customers who share these values (fresh, natural, organic etc.)

2. Second key success factor

Better tasting food attracts repeat business.

(ii) Identify two key risks associated with Chipotle's emphasis on 'Food With Integrity'. **[4 points]**

1. First key risk

Higher cost of food deters customers or lowers margins

2. Second key risk

Supply shortages force restricted menu or use of compromised food.

 Name:____

Problem 2. Accounting Analysis

(i) Briefly describe how Chipotle currently accounts for its restaurant leases. **[2 points]**

Operating method, with rent expense recorded on a straight line basis over the lease term (see p. 44 of 10-K)

(ii) Assume that instead of using its current accounting practice for restaurant leases, Chipotle instead recognized rent expense equal to rent paid for the period. Estimate the Income from operations that Chipotle would have reported for the fiscal year ended December 31, 2009. **[4 points]**

Resated Income from Operations
= Reported Income from operations + Increase in Deferred Rent*
= 203,705+19,386 = 223,091
* From SoCF or Change in BS (19,386=106,395-87,009)

(iii) Assume that instead of using its current accounting practice for restaurant leases, Chipotle instead used the capital lease method. Provide a brief qualitative explanation of how this would have impacted Chipotle's Income from operations for the fiscal year ended December 31, 2009 (i.e., would income from operations have been higher or lower and which income statement line items would have been impacted?) **[6 points]**

Income from operations would be higher. Eliminate rent expense (from Occupancy) and replace with Depreciation & Amortization expense on leased asset (Chipotle uses straight line method) and Interest Expense on lease liability. Since straight line Depreciation &Amortization expense on leased asset must be less straight-line rental expense (because some of rent expense is allocated to interest expense) and interest expense does not impact Income from operations, Income from operations will be higher under the capital lease method.

(iv) Which of the above methods of accounting for Chipotle's leases do you think best reflects the underlying economics of the lease transactions? Briefly explain your answer. **[4 points]**

This depends on expected flow of benefits (i.e., revenues and gross margins) from the restaurants. A reasonable assumption is that the benefits will be realized uniformly over the life of the leases, in which case the current straight line rental expense best captures the underlying economics.

Note that expensing leases as paid recognizes lower expenses early on, and is appropriate if we expect benefits to increase over time. On the other hand, the capital lease method recognizes higher expenses early on (due to effective interest method for computing interest expense on lease liability), and is appropriate if we expect benefits to decrease over time.

Could also mention that by reflecting leased asset and liability on balance sheet, capital lease method provides a better indication of the benefits and obligations of Chipotle.

(v) This question concerns Chipotle's restaurant pre-opening costs **[8 points]**

1. Briefly explain how Chipotle accounts for its pre-opening costs.

Pre-opening costs are expensed as incurred (p. 43 of 10-K)

2. Assume that instead of using its current accounting practice for pre-opening costs, Chipotle instead capitalized pre-opening costs in the fiscal year incurred and amortized them on a straight line basis over the subsequent two fiscal years. <u>Estimate</u> the <u>Income from operations</u> that Chipotle would have reported for the fiscal year ended December 31, 2009.

Restated Income from operations = Reported income from operations + 2009 Pre-opening costs – ½ 2008 Pre-opening costs-1/2 2007 Pre-opening costs
=203,705 + 8,401 - ½ 11,624 – ½ 9,585 = 201,501.5

Problem 3. Financial Analysis

(i) Compute Net Profit Margin ratios for Chipotle and Brinker for fiscal year 2009. **[4 points]**

Net Profit Margin for Chipotle = 126,845/1,518,417=8.3%

Net Profit Margin for Brinker = 137,704/2,858,498 = 4.8%

(ii) What are the primary explanations for the difference between the Net Profit Margins that you computed above? Please be specific, referring to particular line items in the financial statements where possible. **[6 points]**

Brinker's operating expenses are much higher, driven by Restaurant expenses. This reflects the fact that Brinkers is a full-service restaurant, while Chipotle is a 'fast food' restaurant. Note that gross margins are similar at the two businesses. Brinker's 'full service' strategy should generate higher gross margins to cover the higher operating costs, but Chipotle's strategy looks more effective, generating similar gross margins on lower operating costs to generate superior net margins.

Brinkers also has an interest expense, reflecting its use of some debt financing, while Chipotle is almost all equity financed. This also lowers Brinker's net margin.

Offsetting the above effect, Brinker's has a lower effective tax rate than Chipotle and also some income from discontinued operations.

(iii) Compute the Average Inventory Holding Period (in days) for Chipotle and Brinker for fiscal year 2009. **[6 points]**

Average Inventory Holding Period for Chipotle = 365 days * ½ (5,614+4,789)/466,027 = 4.07 days

Average Inventory Holding Period for Brinker = 365 days * ½ (26,735+33,845)/816,015 = 13.55 days

(iv) Briefly identify the key reason(s) for any difference in the Average Inventory Holding Periods that you computed for Chipotle and Brinker above. **[4 points]**

Chipotle's lower average inventory holding period reflects its more efficient inventory management. In particular:

Limited menu results is less required inventory
Focus on fresh food requires more just-in-time inventory management

Problem 4. Forecasting

(i) The Deutsche Bank research report provided in the financial statement booklet forecasts that Chipotle's EPS will grow from \$5.20 in fiscal year 2010 to \$6.37 in fiscal year 2011. Identify the key forecasting assumptions driving this EPS growth (be as specific as possible). **[5 points]**

Sales Growth of 16.6%
- 13% growth in stores
- 1% pricing growth
- 3% transaction check growth

20bp reduction in occupancy costs
20bp reduction in G&A costs
0.3 million reductions in shares out.

(ii) The Deutsche Bank research report forecasts that Chipotle will generate free cash flow of \$188.8 million in 2011. What does the Deutsche Bank research report forecast that Chipotle will do with this free cash flow in 2011? **[3 points]**

Acquisition of treasury stock = \$150 million
Increase in Cash = \$52.8 million
(Offset by Proceeds from option exercises \$14 million)

(iii) The cash flow model on the final page of the Deutsche Bank research report forecasts an amount of \$19.4 million for **Deferred rent** in fiscal 2011. Briefly evaluate the plausibility of this forecast. **[4 points]**

Analyst report has held constant at 2009 amount through 2010 and 2011. The key driver of this amount is new restaurant openings, and since 119 restaurants were opened in 2009 and the analyst report forecasts that 140 restaurants will be opened in 2011, this amount looks too low.

Problem 5. Valuation Analysis

Use a cost of equity capital of 10% in answering this problem.

(i) Using the information in Chipotle's Form 10-K for fiscal 2009, compute Chipotle's book value of shareholders equity per share at the end of fiscal 2009. **[3 points]**

BV/share = $703,461/33,473 = $21.02

(ii) Using your answer to part(i) above and the EPS forecast from the Deutsche Bank research report, compute Chipotle's residual income per share for fiscal 2010. **[3 points]**

= $5.20 – 0.1*21.02 = $3.10

(iii) Compute the constant annual growth rate in residual income per share beyond 2010 that would be required to justify a $184/share valuation at the end of 2009. **[5 points]**

$184 = $21.02 +$3.10/(0.10-g)
0.10-g = 3.10/(184-21.02) = 0.019
g=0.081 = 8.1%

This is the end of the exam.