Tapasya

FEBRUARY 9, 2024

TAPASYA INVESTMENT FUND I

GLOBAL INVESTMENT REVIEW - VII

INTRODUCTION

Welcome to the **7th edition** of the "**Global Investment Review**". The intent of this document is to detail the thesis of companies we have made investments in.

The focus of this document will be

1) Chipotle (CMG)

2) Timeless Lessons of Decision Making and Investing - Charlie Munger

3) Capital Allocation

This edition I will talk about **Chipotle (CMG),** an investment that we have held for over a year now. I expect this company to be a long-term compounder and will be held as such in our portfolio.

Since listing, the company has compounded at ~25% CAGR. In other words every $1 invested is over $59 at the time of writing this document.

I also use this document to communicate to my investors how I think on various aspects of investing. This edition, I am writing about the process of '**Capital Allocation**'.

I firmly believe capital allocation is one of the most important activities for the CEO and senior management within a company.

CHIPOTLE (CMG)

Chipotle Mexican Grill, Inc., owns and operates Chipotle Mexican Grill restaurants. It offers burritos, burrito bowls, quesadillas, tacos, and salads. The company was founded in 1993 and is headquartered in Newport Beach, California.

CMG has restaurants in the US, UK, Canada, Germany and France.

Chipotle's IPO was on Jan'26th 2006 at $22. The stock price doubled on the first day of listing and since then has grown about ~5900%.

Let's start with the financials, understand how it makes money, did we buy it at a fair price , etc. **A company is worth the present value of its future cash flows**.

Financials

Income Statement | TIKR.com	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	12/31/22	LTM
Revenues	3,904.38	4,476.41	4,864.99	5,586.37	5,984.63	7,547.06	8,634.65	9,535.93
Total Revenues	**3,904.38**	**4,476.41**	**4,864.99**	**5,586.37**	**5,984.63**	**7,547.06**	**8,634.65**	**9,535.93**
% Change YoY	***(13.3%)***	***14.7%***	***8.7%***	***14.8%***	***7.1%***	***26.1%***	***14.4%***	
Cost of Goods Sold	(2,764.22)	(3,068.55)	(3,273.96)	(3,683.05)	(3,913.54)	(4,643.00)	(5,260.63)	(5,665.67)
Gross Profit	**1,140.17**	**1,407.86**	**1,591.02**	**1,903.32**	**2,071.09**	**2,904.06**	**3,374.02**	**3,870.26**
% Change YoY	***(32.5%)***	***23.5%***	***13.0%***	***19.6%***	***8.8%***	***40.2%***	***16.2%***	
% Gross Margins	***29.2%***	***31.5%***	***32.7%***	***34.1%***	***34.6%***	***38.5%***	***39.1%***	***40.6%***

As you see here, the company has had a significant growth in its revenues, from ~$3.9Bn in 2016 to ~$9.5Bn in 2023. As this growth occurred it also improved its gross margin rate from about 29% to ~40% (over 1000 bps +).

Few things I look for are companies that can grow its revenues and maintain or in some cases improve its gross margins. CMG fits that bill well. In fact to me, CMG is like Costco where even at a lower gross margin this is a great company.

One of the ways to find out whether the company has a moat is its ability to increase prices without losing customers. During the inflationary period (2022) we have recently experienced Chipotle was able to raise its prices helping its topline and bottomline. Margins and revenues grew during this time approximately in the same range, suggesting customers are able to absorb the price increases with marginal negative impact to the business.

Chipotle's growth in revenues is driven by New Store openings as well as organic growth i.e. comparable store sales growth. Hence it is important to look at both, return on capital employed as well as store economics. This will help us understand whether the company has a long runway ahead or not.

Lets start with some financial metrics related to return on capital.

Ratios | TIKR.com	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	12/31/22	LTM
Return Ratios:								
Return on Assets %	1.5%	8.7%	10.2%	8.1%	3.6%	8.2%	10.9%	13.0%
Return on Capital %	4.1%	20.8%	24.2%	10.5%	6.0%	13.8%	19.1%	21.8%
Return On Equity %	1.3%	12.7%	12.6%	22.4%	19.2%	30.2%	38.5%	44.9%
Return on Common Equity %	1.3%	12.7%	12.6%	22.4%	19.2%	30.2%	38.5%	44.9%

CMG has over 20% Return on Capital and has improved in recent years. Over the long term the share price returns tend to reflect the Return on Capital.

Lets looks at its store economics

CMG's comparable store sales have been growing mid to high single digits. I expect that to continue in the foreseeable future driven by price increases, Chipotle Lane (drive thru) and improved online ordering capabilities.

For any Restaurant or brick and mortar Retailer for that matter, store economics are key to success. Store operating leverage kicks in when there is sales growth at the store level. Costs such as Operational and Occupancy costs will be lower as a "% of Revenues" thus allowing more money to flow to the bottomline. For CMG just in 2023, they have been able to improve the store operational income by 200 bps+.

For context, store costs as "% of Revenues" are

1) Food, beverage and packaging: ~30%

2) Labor Costs: ~25%

3) Occupancy Costs: ~5%

4) Other Operating Costs: ~15%

5) General & Administrative: ~7%

6) Others: ~4%

All this does not and should not add up to 100% (or more) as the remaining amount is store level profit. In retail we also called it 4-wall profit.

Now coming to store level leverage, the more sales the store has, the lower the operating and occupancy costs as a percentage of sales. They could be partially offset by labor costs and food price increases though in most cases these price increases tend to be passed to the customer. Hence increased sales bring in a significant improvement to the profitability.

At 50+ PE is this stock expensive, did we buy it at a fair price?

Since we bought it at a much lower price than the current prevailing price, I will use the current price to explain whether this company is expensive or not. This will also help explain why PE (Price to Earnings ratio) is not the best metric to gauge whether a company is cheap or expensive, at least not in all scenarios.

Historically CMG has had a very high PE since listing. Anyone who used PE as the only metric to determine whether it was a good investment would have missed companies like CMG, Amazon and many others.

CMG PE has averaged a PE of 66 over the last 3 years, 81 over the last 5 years and 83 since IPO. Like most companies, as the growth rates come down so do the PE's typically. At the same time having rules around this metric such as PE below 12 , etc., does not necessarily always result in investing success. Let's dissect this further.

CMG is a cashflow positive company. It has been growing its cashflow from $251M in 2017 to $1.3Bn in Q3'2023-LTM (Last 12 months). What it has been doing with its money is re-investing in growth i.e. opening new stores.

This is in my view the best form of use of capital assuming that the returns on invested capital is higher than other avenues available to deploy that capital. We were in a very low interest rate environment before 2022, and even now compared to CMG's Return on Capital, it is better they continue to re-invest money into the business rather than deploying it in T-Bills or for that matter or as dividends to their investors.

The other avenue to deploy some of this capital is towards buybacks which is another good way of returning capital to its investors/shareholders. They have always done buybacks in most quarters outside of 2020.

Given their store economics that we saw above, their ability to continue to drive these store economics as an aggregate while opening new stores reminds me of Costco. CMG has a long runway. The question is what is the upper limit of stores they could have in the US or elsewhere in other countries.

For this I used Starbucks and McDonalds as a gauge to compare what could be its upper bounds for the number of stores in the US.

# of Stores in the US

Company	# of stores (as of Jan'24) In US	State w/highest stores	Corporate or Franchise Owned
Chipotle (CMG)	3381	California	Corporate
McDonalds (MCD)	13540	California	90% Franchise
Starbucks (SBUX)	16387	California	Corporate

As you see here, even if we assume that CMG won't grow to the level of MCD and SBUX, we could safely assume it would be 2x it stores across the US. Given the stores are corporate owned, the growth rates would be slower than what one could expect in a franchise model. But along with that comes control over operations and improved profitability over time.

Given all this, I believe CMG is a good buy for the long term. Please do your own research should you buy for your own portfolio. I am not a big fan of disclaimers but have to put these in for CYA purposes.

Risks

1. Food Safety Concerns

In the finance industry we see financial disasters and frauds, in the oil & gas industry we see oil spills and in the food industry we see an outbreak or spread of disease/infection. This generally gets traced to food products and CMG is more susceptible to this given its fresh food. Since the 2015 outbreak, CMG has put stringent processes in place to avoid it. Historically in most cases, companies recover within a year unless the impact is very severe.

2. Competition

The fast and casual dining space is an intensely competitive space. There are several other chains that sell Mexican food, though CMG has a great lead over them.

3. Others

There are always risks such as Supply Chain, escalating food prices, economic downturns , etc. CMG has dealt with all of this quite well in the past and though there would be short term impacts that we should be aware of, not something I would be particularly concerned with.

TIMELESS LESSONS FROM CHARLIE MUNGER ON INVESTING AND DECISION MAKING

As some of you may know, I consider Charlie Munger the best teacher I have ever had. He passed away in Dec' 2023 about a month before his 100th birthday.

My intent here is to document some of the investing principles he has articulated in 'Poor Charlie's Almanac' by Peter Kaufman. It's my favorite book and would highly recommend it to everyone here.

The book draws on his encyclopedic knowledge of business, finance, history, philosophy, physics, and ethics to introduce the latticework of mental models that underpin Charlie's rational and rigorous approach to life, learning, and decision-making.

It's not a book just on investing, after all as Charlie said,

"If all you succeed doing in life is getting rich by buying little pieces of paper, it's a failed life. Life is more than being shrewd in wealth accumulation."

The lessons in the book are documented in a Checklist format that Charlie always loved, but was not executed as one-by-one or one-time fashion. Rather should be considered as a part of a complex whole like a tile in a larger mosaic that it appears.

✦ **Risk** - All investment evaluations should begin with measuring risk, especially reputational

- Incorporate appropriate margin of safety
- Avoid dealing with people of questionable character
- Insist upon proper compensation for risk assumed
- Always beware of inflation and interest rate exposures
- Avoid big mistakes; shun permanent capital loss

✦ **Independence** - "Only in fairy tales are emperors told that they are naked"

- Objectivity and Rationality require independence of thought
- Remember just because people agree or disagree with you doesn't make your right or wrong - the only thing that matters is the correctness of your analysis and judgment
- Mimicking the herd invites regression to the mean (merely average performance)

✦ **Preparation** - "The only way to win is to work, work, work, work and hope to have a few insights"

- Develop into a lifelong self-learner through voracious reading; cultivate curiosity and strive to become a little wiser everyday
- More important than the will to win is the will to prepare
- Develop fluency in mental models from the major academic disciplines
- If you want to get smart the question you have to keep asking is "why, why, why"?

✦ **Intellectual Humility** - Acknowledging what you don't know is the dawning of wisdom

- Stay within a well defined circle of competence
- Identify and reconcile disconfirming evidence
- Resist the craving for false precision, false certainties, etc.
- Above all, never fool yourself and remember you are the easiest person to fool

✦ **Analytical Rigor** - Use of the scientific method and effective checklists minimizes errors and omissions

- Determine value apart from price; progress apart from activity; wealth apart from size
- It is better to remember the obvious than to grasp the esoteric

- Be a business analyst, not a market, macroeconomic, or security analyst
- Consider totality of risk and effect; look always at potential second order and higher level impacts
- Think forwards and backwards - Invert, always invert

✦ **Allocation** - Proper allocation of capital is an investor's number one job

- Remember the highest and the best use of capital is always measured by the next best use (opportunity cost)
- Good ideas are rare - when the odds are greatly in your favor, bet heavily
- Don't "fall in love" with an investment - be situation dependent and opportunity-driven

✦ **Patience** - Resist the natural human bias to act

- Compound interest is the 8th wonder in the world (Einstein); never interrupt unnecessarily
- Avoid unnecessary transactional taxes and frictional costs; never take action for its own sake
- Be alert on the arrival of luck
- Enjoy the process along with the proceeds, because the process is where you live

✦ **Decisiveness** - When the proper circumstances present itself act with decisiveness and conviction

- Be fearful when others are greedy, and greedy when others are fearful
- Opportunity doesn't come often, so seize it when it does
- Opportunity meeting the prepared mind, that's the game

✦ **Change** - Live the change and accept unremovable complexity

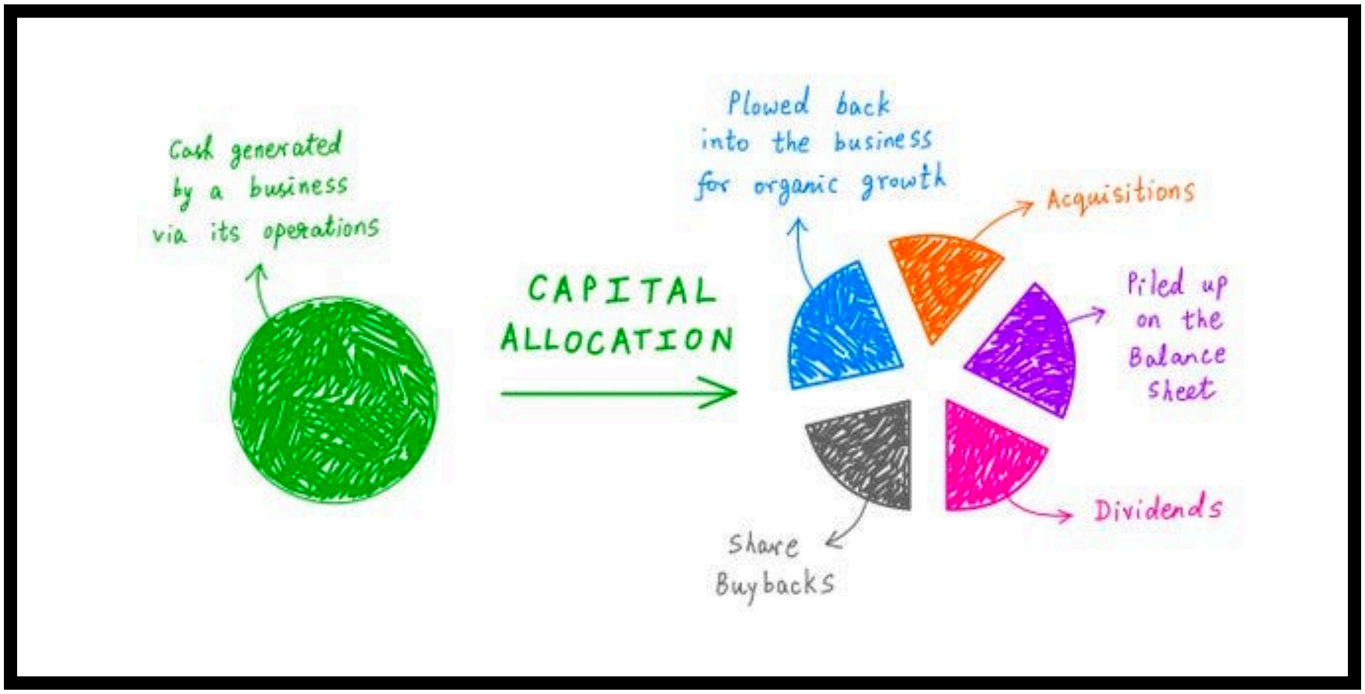
- Recognize and adapt to the true nature of the world around you; don't expect it to adapt to you
- Continually challenge and willingly amend your "best-loved ideas"
- Recognize reality even when you don't like it - especially when you don't like it

✦ **Focus** - Keep things simple and remember what you set out to do

- Remember reputation and integrity are your most valuable assets - and can be lost in a heartbeat
- Guard against the effects of hubris and boredom
- Don't overlook the obvious by drowning in minutiae
- Be careful to exclude unneeded information or slop: "A small leak can sink a great ship"
- Face your big troubles; don't sweep them under the rug

CAPITAL ALLOCATION

Over the long term stock returns will be determined largely by which capital allocation decisions a CEO makes. Two companies with identical operating results and different approaches to allocating capital with derive two very different long-term outcomes for shareholders - Mark Leonard



Source: Compounding Quality

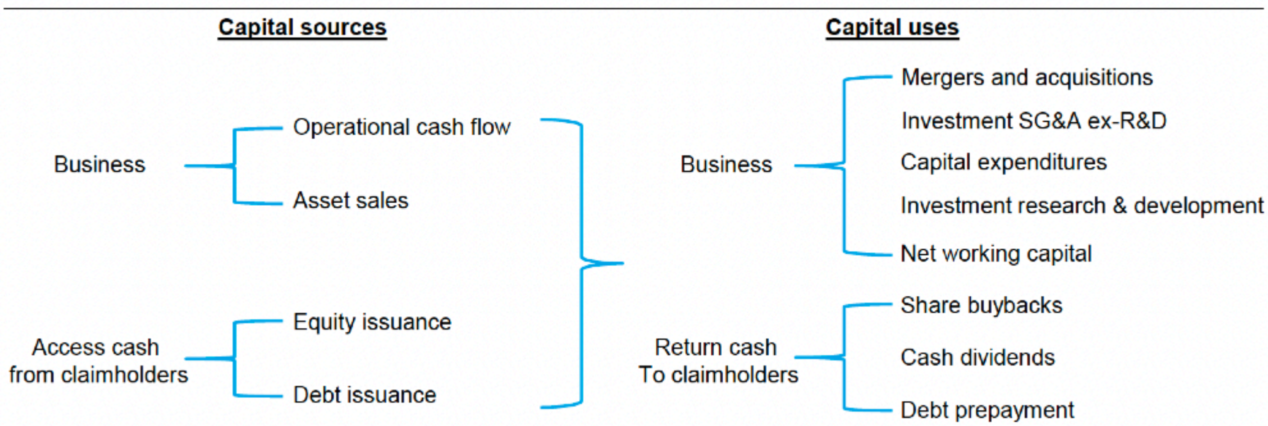
Let's start with understanding **what is capital allocation**?

- For a profitable company it is the decision of how to deploy the money they have earned.

The primary job of senior management and CEO is to create value over the long term. The reason an individual reaches the CEO position typically tends to be their understanding of the business, operations, strategy and leading large teams. Capital allocation is usually not the criteria on which they tend to get promoted to the role especially if it's an internal candidate.

This is where the challenge arises. It's basically like having a musician play in a concert hall which they are adept to do and simultaneously also lead the Fed. The CEO's may not be the most effective in raising, managing and disbursing capital.

Sources and Uses of Financial Capital



Source: Counterpoint Global.

In the US, historically Mergers & Acquisitions (M&A) have taken the lions share of capital allocated. We see an increase particularly when markets are in a euphoric state, hence usually an inopportune time for such acquisitions.

The allocation of capital whether it's a business or household should be determined based on "opportunity cost" i.e. driven by what is the next best use of that capital.

For example, within a household after all expenses are paid for, we are left with savings. How these savings are deployed over long periods of time will ultimately determine the wealth of that household. It could be kept in a checking account, but at a similar risk profile one would get approx. 4%-5% in a short term T-Bill or High Yield savings account.

Hence in this case the difference between these 2 options is the opportunity cost. Every company or household needs to consider this. In the context of a business it gets more complicated and there is no definitive answer because 'it depends' on the market conditions . For example if the stock has been punished and the price is way below what true market value for the company is; a buy back is a great strategy to deploy capital.

On the other hand the company has a long runway for growth e.g. Chipotle, re-investing into the business like opening new stores is a great way to deploy capital.

If I had to state a preference again depending on correct assessment of the situation at hand, this is how I would rank it

1) Re-Investing in the business

2) Share Buy Backs

3) Dividend Payouts

There are several examples where re-investing in the business has yielded great results. One could look at Amazon, Costco, Chipotle , etc.

Share buyback is another great way of returning capital to the shareholders. For example if we own 10% of a company and it decides to buy back 20% of its outstanding shares. At that point should we decide to hold our portion of the equity, then we would move from owning 10% of the company to 12% of the company. This way we own 12% of all the profits the company generates.

Historically though, the CEO's have executed buybacks, at what can be considered as very high valuations usually when the markets are in a euphoric state. One of the other reasons companies execute buyback is to offset the equity given to employees as RSU's (Restricted stock options) to avoid shareholder dilution.

If there is no good way for deploying capital, then companies should give dividends. That said, sometimes given media coverage and retail investors' love for dividends, companies use that to their advantage getting a boost to their stock price.

In some instances they have also raised debt to payout dividend, hence retail (or institutional) investors should closely look at the cashflow statement and balance sheet to understand where the money is coming from and simply not get swayed by media reports and stock price movements when dividends are announced.

Overall, as previously mentioned capital allocation is an essential part of value creation and senior management/CEO need to consider this as one of their prime responsibilities.

Some great capital allocators in the history of US business

1) Berkshire Hathaway - Warren Buffett

2) Capital Cities - Tom Murphy

3) Teledyne - Henry Singleton

“The Outsiders” by William N. Thorndike is a great book to read about some of the best capital allocators in our history.

CONCLUSION

I expect Chipotle to be a multi-bagger and long term compounder and plan to hold it for 10+ years which basically means I am unlikely to sell it. That said, like everything else I will continue to monitor it and should my thesis prove wrong I will not hesitate to wind down our position.

I would welcome any feedback you may have on this document and as always feel free to reach out to me by email or phone if you have any questions.

We are in this journey together, **our biggest advantage is going to be our collective focus on the long term** along with my skills on capital allocation.

If you have managed to read this document in its entirety itself is one measure of success for me, as unless I receive feedback I will assume it was a reasonably good read.

APPENDIX

I want to mention some references that I have used for ideas on writing this document.

Firstly, Nick Sleep and Qais Zakaria (Nomad Investment Partnership), used to provide such documentation to their investors. You would see a common thread across my investment philosophy and how I manage the fund, similar to Nomad's which closed in early 2014 (thankfully, else they would be the best game in town - I would still compete though!!).

Other Tools and websites used-

1) TIKR - Analytical tool to analyze financial metrics

2) Value Investor Club, YouTube Videos, Bard, Google, Investor relation website of PayPal , etc.

3) The book "The Outsiders" by William N. Thorndike

4) Morgan Stanley's write up on Capital Allocation (Link)

Thank you for taking the time to read this and as always, if there are any questions please do not hesitate to reach out to me.

Sincerely,

Pratik Kodial