U.S.News & WORLD REPORT

CMG Stock: Chipotle Earnings Soar 167 Percent. Is it Enough?

Chipotle earnings may halt CMG's plunge, but the latest norovirus outbreak remains a major concern.

By John Divine, Staff Writer | July 25, 2017

Chipotle Mexican Grill Inc. (ticker: CMG) reported second-quarter earnings after the bell on Tuesday, days after another health scare rocked a location in Virginia. The burrito chain easily beat expectations on earnings, missing slightly on revenue. Shares gained 2 percent in after-hours trading.

Here's a closer look at how Chipotle performed in the quarter ended June 30, 2017.

CMG stock: Q2 by the numbers. Chipotle stock closed at $339.98 on Monday, its lowest closing price in over four years. That, combined with Chipotle already being a rebound play, put a lot of pressure on the company to deliver a good quarter.

And Chipotle did report a solid quarter, logging adjusted earnings per share of $2.32 , up 167 percent from a year ago, on revenue of $1.17 billion, which was up 17.1 percent. Wall Street analysts were expecting EPS of $2.18 on revenue of $1.19 billion.

"Chipotle posted a second-quarter earnings figure that was apparently more than enough for investors to overcome any negative sentiment," related to the outbreak, says Todd Milbourn, professor of finance at Washington University in St. Louis's Olin Business School.

Comparable restaurant sales, a widely used metric in the restaurant industry for year-over-year sales growth in locations open for at least 13 months, grew 8.1 percent.

Margins, which absolutely must increase for CMG stock to be a successful turnaround story, grew from 15.5 percent to 18.8 percent. The company opened a net total of 48 new restaurants in the quarter.

That, however, is likely to be a temporary phenomenon, as Chipotle will have to do a lot of buy-one-get-one-free deals to keep foot traffic up in the third and perhaps fourth quarter.

Food scare: the elephant in the room. Numbers weren't the only thing on investors' minds Tuesday.

On July 17, news broke that multiple customers who dined at a Chipotle in Sterling, Virginia, had gotten sick, suffering symptoms like nausea, vomiting and diarrhea. One customer tested positive for norovirus. The restaurant reopened July 19, and Chipotle said it was safe to eat there again.

But a week later, a second customer tested positive for norovirus, with "more than 135 individuals who reported becoming ill" after visiting the Chipotle in question between July 13 and July 16, according to the Loudoun County Health Department.

Clearly, this did no favors for Chipotle stock, and CMG shares fell more than 13 percent in the week following the news.

No restaurant wants to see an outbreak like this, but the health scare is even more troublesome for Chipotle, which in 2015 had a series of similar outbreaks at different restaurant locations throughout the country.

CMG stock, which in 2015 was in the midst of a monster rally that saw prices reach $750 per share, plunged after those initial outbreaks two years ago. The stock had been climbing back up in 2017, as shareholders regained hope that the restaurant chain was turning things around. You can see why shareholders might think that, with EPS growing 167 percent in the quarter and margins rebounding.

So how does Chipotle move past this and keep up its positive momentum?

Jack Payne is an expert in food safety and vice president of product management and solution consulting at Aptean, a provider of enterprise software solutions.

"Chipotle must quickly find the root cause of the food safety problems and put plans in place in all stores to minimize this risk," he says. "These plans should include improved training for all employees, increased inspections and audits, as well as improved food safety plans and audits at the growers."

Payne also recommends Chipotle expand ingredient preparation to central kitchens, which have better food safety controls.

Valuation implies Chipotle shares could fall further. Despite the CMG stock price recently plunging to its lowest levels since 2013, there's no assurance shares have found a bottom, even after a solid Q2. Going into Tuesday's earnings report, shares traded for 107 times earnings and 30 times forward earnings, which is already quite lofty.

Sprinkle in another norovirus scare, a damaged brand, and the pressing need to do more promotions and compress margins if the company wants to prevent a total top-line meltdown, and one could argue CMG is quite dramatically overvalued.

It seems the famed activist investor Bill Ackman, whose hedge fund Pershing Square Capital Management disclosed a 9.9 percent stake in Chipotle in September 2016, has made another farcically bad bet. At that time, CMG stock was trading around $408 per share.

Ackman's last major investment, Valeant Pharmaceuticals (VRX), lost billions for his investors, as he rode it from $161 up to over $250 – and then all the way down to $11. Before that, he made similarly ill-timed bets on Borders, JC Penney (JCP) and Target (TGT).

"It's a bit disconcerting that Bill Ackman's influence on the board has not come to fruition," says K C Ma, professor of finance at Stetson University.

Chipotle will have to chart its own course from here, and the path looks like a long and unpleasant one. Perhaps the moral of the story is to bet against Ackman when he's on a losing streak.