Short seller on Chipotle: Great company, dangerous stock

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The sign of a Chipotle Mexican Grill restaurant is seen in Redlands, California, in this file photo taken February 9, 2011. Chipotle Mexican Grill Inc on February 3, 2015, reported fourth-quarter sales at established restaurants that decelerated from prior periods and slightly missed Wall Street's estimate, sending shares down more than 6 percent in after-hours trade. REUTERS/Lucy Nicholson/Files

When Brad Lamensdorf talks about Chipotle (CMG), the company, he'll discuss how management has gotten much right. When he talks about Chipotle, the stock, that's another matter.

On the stock, he's not at all positive, not at its current levels. As a result, an ETF he manages, the AdvisorShares Ranger Equity Bear, (HDGE) has a short position in the Denver-based burrito maker. Doing so worked out previously for the fund back in the spring of 2012, when the stock was around $365. Shares of Chipotle stumbled on earnings worries, and Lamensdorf covered with the stock at about $300.

Since then, betting against Chipotle has been a money-loser for the most part. The shares did fall 11.9% that year, but in 2013 rose 79.1% and in 2014 another

28.5%, according to FactSet. Lately, Lamensdorf grew interested again, shorting the stock at $672.

"There's no question that [Chipotle] did a fantastic job" operating since its setback of a couple of years ago, he says. "They did a lot of very good management-oriented things to solve problems and to continue to bring in revenue. Our feeling has been that, while they've done a great job, the stock is completely priced for perfection."

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Chipotle, at about $665, trades at 47 times last year's earnings. Lamensdorf believes a multiple of 25 to 30 times earnings would be more appropriate -- at 30 times, the stock would trade for $424, or a 37% drop from today. His view is that the prices momentum traders have been paying on the way up has created a massive gulf from where investors with the "growth at a reasonable price" philosophy would buy. Because of what he sees as the size of this difference, if the outstanding sales and earnings growth Chipotle has seen slows even modestly, he believes it could be quite a fall before buyers appear in large numbers.

"Management is doing a very good job, and they definitely plugged a lot of holes that we saw," he says. "Expectations are just running way ahead of where we think the stock should be. It's an example of a great company and a dangerous stock."

For the majority of its history, Chipotle has been an indisputable smash with diners and investors. It has developed into the restaurant many restaurants want to be -- Wall Street and the business media regularly research potential "next Chipotles." With each quarterly financial report since late 2010, Chipotle has averaged year-over-year revenue and earnings growth well above 20%. Same-store sales have had three consecutive double-digit quarterly increases, including a 16.1% gain in the fourth quarter. It's making progress toward changing how we view fast food and how its competitors operate. Earlier this month, McDonald's (MCD), which used to own a controlling interest in Chipotle, said it would begin selling chicken without certain antibiotics.

Major worries?

Yet Chipotle's shares are down this year by 2.6%. Since the $726.63 close on Feb. 3, the day of Chipotle's last earnings report and near the all-time high set in January, the stock has fallen 8.3%. What happened? Even at their incredible level, same-store sales were slightly below analysts' estimates. And the company forecast "low- to mid-single-digit comparable restaurant sales increases" for 2015. Though that was the same outlook Chipotle offered for 2014 and better than what it saw for 2013, traders had grander hopes.

It lends at least some credence to Lamensdorf's position on the momentum buyers. Still, if the concerns were truly outsized, the stock may have been even worse -- most of the decline took place right after the report. Additionally, short interest actually has decreased, now at about 2.7% of the float. In other words, it's not gotten especially popular to short this stock.

Aside from the valuation, Lamensdorf worries about Chipotle's ability to continue finding premium real estate locations and premium sourcing for its menu; Chipotle mainly buys food from suppliers with only particular specifications around farming practices and feeds. When it can't do this, it tells diners as much or takes the item off the menu, as it did recently with carnitas in some stores. Can the company continue to meet its own goals?

"The more they expand, the more they create kind of a problem for themselves," Lamensdorf says.

Chipotle is aware of this, as detailed in its regulatory disclosures on business risks. Chris Arnold, Chipotle's communications director, said in an email the company's view is that, with around 1,800 U.S. restaurants now, Chipotle isn't overly stressed about having ample room to build out.

"We continue to be a very desirable tenant in the eyes of developers, and we maintain solid financials," he said. "This all bodes well for our growth, and, in fact, we plan to open more restaurants this year than we did last year [up to 205]."

He added that although "we do see periodic challenges finding some ingredients that meet our high standards, we continue to find ways to meet these challenges and this has never before been an impediment to our growth."

Shorting has been far from ideal amid the years-long market rally. The Ranger Equity Bear ETF itself has lost more than 50% since it started trading in early 2011 and 11.5% in the past year, Yahoo Finance data show. (Ranger Capital as a firm has a variety of strategies, including those involving long equity positions.)

Clearly, shorting does remain an approach, and many market commentators have long said that when Federal Reserve policy decisions stop keeping interest rates down, as it indicated on Wednesday, stocks will drop back. But even if they do, whether Chipotle will be among them is far from certain.

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