October 2021

September 2021 letter

Dear Fellow Investors,

Thank you for being a part of Great Ocean Road Advisors.

Before discussing our portfolio and market views, as will be the mainstay of quarterly letters, I'd like to use our inaugural letter to discuss a few points about GORA.

A fair question to ask is why start GORA? The conventional narrative is that everything works best at scale and therefore the best choice for you is to invest in a large fund and me to work at one.

I believe this narrative is misplaced. For you, the incentive structure between large funds and their investors is broken. Large funds reap significant profits from management fees and therefore prioritize retention of assets at all costs. This is done quite easily through building highly diversified portfolios that will never outperform nor underperform in any meaningful way. Investors are left with year after year of underwhelming performance but never experience the prick of a bad update that is inevitably necessary on the path to long-term outperformance.

For myself starting a fund, I believe the narrative of scale is more rarely applicable than is conventionally believed. Put simply, despite our small size GORA is already at scale. We have a profitable business with all the resources needed to outperform. In fact, if GORA never added another investor and continued to manage my wealth and a portion of yours for many years to come, we would be just fine. Our small size also leaves us far better equipped to find pockets of market inefficiency large funds cannot explore and with the investment duration needed to profit from them, which is so rarely granted to those working at them.

Finally, I'm proud to share that GORA's initial raising was stronger than we'd hoped for thanks to your support. We have a group of investors much larger than is normal for a fund launch and all are long-term focused partners we look forward to serving over many years.

Portfolio performance and market views

We launched GORA into the third most difficult quarter for our sector in the past decade.

As a result, The GORA Southern Endeavor Fund declined -8.4%, net of fees. The Retail sector (XRT) declined -7.8% and the S&P500 advanced +0.5%.

The market narrative that dominated throughout the quarter was that the US consumer is tired, cost pressures for our companies will grow unbated and that there's safety in large-cap technology. We disagree with the first two points, explaining why throughout this letter, and do not have a view on the third, being outside our investment domain. Although disappointing to be swept up in a sector sell-off so early in our fund's life, we recognize that market sentiment moves fast and unpredictably but ultimately nets to zero.

Our focus will always be on finding excellent investments that will outperform on a long-term horizon and we have those today. Although not reflected in our first quarter performance due to the wholesale selling of the sector, customer demand at our companies is strong, cost pressures are contained, balance sheets are healthy, and earnings set to inflect higher. There will be months and quarters like this but the opportunity for a concentrated, fundamentally researched portfolio of high-quality ideas to outperform is significant and frankly, we believe worth the volatility that inevitably comes along the way.

It may seem fair to ask: why not wait until the sell off in your sector is complete before investing? Unfortunately, we can't time the market. Our understanding is that no human or computer can yet either. It is difficult to find good investments, very difficult to time your purchase of them well and frankly impossible to time the market overall. Attempts to do so inevitably lead to underinvestment and greater missed profits than losses incurred from holding good investments through periods of negative market sentiment.

As will be the focus of future letters, please find below excerpts sampling our largest portfolio investments. We welcome your dialogue.

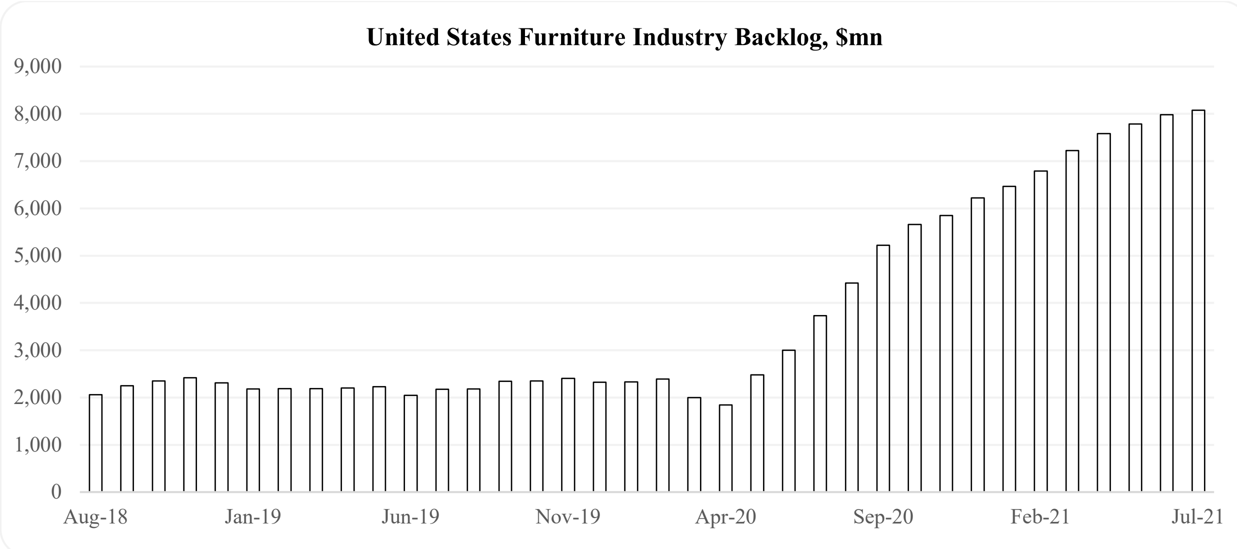
Furniture

The furniture sector offers one of the most interesting and asymmetric risk-rewards we've ever seen. Like many of the opportunities staring at us today, it is a product of the pandemic. The market believes these companies missed the boom in home spending created by the pandemic when in fact they did not, and the benefit is just getting started. We are in the early stages of investing here and it will be represented at varying sizes through six companies.

When the pandemic arrived and work-from-home became the normal, consumer demand for home furnishings boomed. Demand was in such abundance that domestic furniture companies couldn't satisfy the incoming orders at normal production levels and were soon constrained in what they could produce.

A series of temporary bottlenecks throughout the production supply-chain was created by the pandemic. Carpentry workshops had to enforce social distancing between employees that halved staff counts and therefore halved production. Once staffing levels returned, access to steel and wood became tight. Those shortages were resolved just in time for a winter storm in Houston shutting down the country's polyurethane production - the foam that goes into cushions. Finally, Vietnam, among the world's largest furniture producers, ordered the temporary shutdown of its factories to curb the Delta variant. All represent discrete and transient issues that netted to a prolonged period of limited production.

However, unlike a pizza parlor out of dough, a furniture company that cannot produce a sofa today does not lose the sale. The purchase goes onto the company's order backlog and is delivered at a later date once produced. Throughout the past 18 months, furniture design centers have been enthusiastically taking new orders. Production limitations have simply extended delivery windows for customers beyond the usual 4-6 weeks but have not halted incoming demand. Below we show a survey of private furniture company order backlogs - its growth captures this dynamic of abundant demand under constrained production.



Source: Smith Leonard Furniture Insights Survey

Recognizing the scale of furniture order backlogs is important for understanding the market's mispricing of these companies. Accounting 101 teaches that a sale is recognized only when the goods are delivered, not when an order is placed or customer payment made. A sofa paid for by a customer today but delivered in six months will benefit the company's income statement two quarters from now, not this quarter.

Investors are trained to focus on the income statement to measure financial performance and sales to measure demand. These investors see the underwhelming sales furniture companies have reported over the past 18 months and are ill-equipped to appreciate the giant backlog of orders awaiting a normal production environment that underwrite large sales and profit improvements in future periods. These investors go further by hypothesizing that if furniture company sales have been underwhelming during a known boom in home spending, sales are likely to deteriorate further in future periods when the tailwind of stay-at-home diminishes. This negative narrative now dominates furniture company share prices, pushing valuations to unprecedented low levels.

So what drives our conviction in this contrarian idea? Our focus on only one sector gives us stronger, experience-driven insights than generalist investors anchored to a thematic narrative. In fact, of the six companies we will be invested in this idea through, we have spoken with senior leadership at four of them in the past two weeks alone. This helps equip us with an informational advantage over other investors less familiar with these businesses.

In this case, the informational advantage leads to two important data points:

1. Although absent from the income statement, we can see for ourselves the backlog of furniture orders that will underwrite future sales and profits. It's on these companies' balance sheets. Customer deposits represent prepayments for future deliveries and are recorded as liabilities. For every company in the sector this balance has grown 400% since February 2020 driven by the steady inflow of orders that outstrip production. These customer deposits underwrite our conviction in the coming profit inflection.

2. Furniture companies have traditionally operated with extremely conservative balance sheets. Capital preservation throughout COVID has only amplified this favorable position. None of the furniture companies we are invested in

carry debt and most hold cash equivalent to ~30% of their market cap. High property ownership and excess inventory positions to protect against future supply shortages means in most cases the implied market value of future profits amount to less than half of their total valuations. This part gives asymmetry to the investment: our downside is mitigated by the net asset value of non-operating assets held.

As above, we are in the early stages of this investment and will represent it through the companies below. They each have their own idiosyncratic drivers but the thematic described above is true for all. Our conviction in this industry investment is high but we do not want one industry to dominate our portfolio. As such, one or two will be large positions, and the remaining will be small.

A final concluding point on our furniture investment. While the large order backlogs mean we do not require the positive macro environment for furniture to persist, we continue to expect that it will. The combination of accelerating incomes, property values and significant savings accumulated since the pandemic began all support ongoing strong demand. Reflecting this point, August 2021 spend by US households on furniture hit a fresh all-time high – a year and a half after the first work-from-home orders were instated.

GORA Furniture Industry Summary table

All values are $/share

Company	Basset	Ethan Allen	Haverty's	Hooker	Flexsteel	La-Z-Boy
Ticker	BSET	ETD	HVT	HOFT	FLXS	LZB
Share price	$17.61	$24.26	$34.34	$27.49	$29.53	$32.89
Surplus assets:						
Cash and Investments	$5.71	$4.10	$12.77	$5.00	$0.00	$8.56
Property	$6.13	$3.79	$8.88	$11.03	$17.22	$5.01
Excess Inventories	$1.02	$0.00	$0.00	$0.83	$5.56	$1.50
Implied value of operations	$4.79	$16.33	$12.45	$10.56	$6.76	$17.84
Earnings forecast	$2.75	$3.12	$4.80	$4.20	$3.75	$5.00
Implied earnings multiple	**1.7x**	**5.2x**	**2.6x**	**2.5x**	**1.8x**	**3.6x**

Restaurant Brands International (QSR)

QSR is the franchisor of three quick-service restaurant brands: Burger King, Tim Hortons and Popeyes.

We love franchised quick-service restaurant businesses. Operating costs are borne by franchisees who make royalty payments to the franchisor, resulting in high-margin business models containing few variable costs and which grow each year with restaurant openings. These models are highly cash-flow generative which can be deployed into share repurchases. These repurchases, combined with the brand growth, virtually underwrite long-term earnings growth and value creation.

QSR is among the strongest of these businesses thanks to its strategy of growing through Master Franchise Agreements. Deals are inked with institutions such as private equity firms and large restaurant operating companies who receive exclusive rights to build its branded restaurants in a given territory in exchange for a commitment to opening a minimum number of restaurants. QSR has more than 20 Master Franchise Agreements in place around the world and as a result grows its brands faster than almost any other global quick-service chain.

The lack of operating leverage in these business models creates high stability and visibility into earnings and therefore intrinsic value. We have learned to buy these assets when market prices fall below intrinsic value, particularly if driven by a transitory market concern. QSR meets this criterion. The stock trades at 19x forward EPS, which is below its peers at 25-35x and is below any level its traded at in the company's history. The market concern driving the discount is slowing sales at Burger King due to the fading lift created by economic reopening. These waves come and go. This one too shall pass.

In contrast to this transient concern, we have longer duration reasons to be positive on QSR. The Tim Hortons brand is returning to life after a year of harsh lockdowns in its home country of Canada and is positioned to realize long-term benefits from a new digital loyalty program that was completed late last year. Additionally, QSR's debt level has fallen below where quick-service brands are comfortable operating, opening the company up to more aggressive capital return options, such as share repurchases which can accelerate EPS growth and act as a catalyst for share price appreciation.

Bed, Bath and Beyond (BBBY) – Exited position

BBBY was an investment we got wrong and, directly and indirectly, accounted for roughly 5ppts of the quarterly losses incurred during the quarter. It occurred on the last day of the quarter and was the first earnings print that went against us in size.

As a fund manager, we keep track of what is known in the industry as a "hit rate" – the percentage of correct calls on earnings events as measured by generating positive profits. The industry standard for a good hit rate is 60% and this quarter we were at 65%, which until the last day of the month had driven our outperformance of the sector index. There will inevitably be periods of uplift and drag from earnings but ultimately we expect positive outperformance from investing in earnings events.

BBBY is a home furnishings retailer led by Mark Tritton, an Australian who engineered the new version of Target (TGT) via a merchandising strategy that focused on brands developed in house. Our BBBY investment was not predicated on Tritton's ability to make it a leading destination retail chain (good to great) but simply to take it from bad to competent through common-sense retail best practices the team at Tritton's old company are famous for. In many respects, he is the perfect leader for BBBY which depends heavily on commodity goods where BBBY has historically not had brand control nor credibility in the customer's eye. The company had made demonstrable progress towards this aim in recent quarters. We also saw support from the significant tailwinds benefiting the category as consumers continue to prioritize spend on their homes.

On the last day of the September quarter, BBBY delivered an earnings update that was below expectations. Sales per square foot, which had performed consistently within +/- 10% of the broader industry's growth, gapped to underperformance of -20%. Where its peers reported gross margin expansion, BBBY's fell by 200bps. The result was earnings were below expectations and management's own guidance, causing investor skepticism for Tritton's strategy and selling down of the stock. We shared this skepticism and exited our position in full early. The stock has since fallen a further 10% since our sale, suggesting others remain wary.

Tritton attributed the soft performance to industry troubles with supply-chain rather than anything specific to his company. We knew of these supply-chain challenges but had observed all peer companies overcome them. We also skewed our portfolio to companies insulated from these challenges. Nonetheless, Tritton's comments precipitated widespread selling of the consumer sector on Sept 30th which impacted GORA's portfolio to a larger degree than exposure to BBBY itself. For example, KIRK (discussed below), had seen the supply-chain challenges coming and bought all of its holiday inventories during the summer. Its inventories are sitting in KIRK's warehouses today. Nonetheless, KIRK sold down more than 6% on the last day of the quarter. Additionally, LZB (within furniture above) owns its entire supply-chain and is therefore immune to third-party cost pressures but still sold down 5% on that day.

While disappointing for this to occur, we change nothing in our process and firmly believe the impact this event had on the portfolio will prove to be noise. Both KIRK and LZB will demonstrate their resilience through their own earnings updates. We believe Tritton will ultimately right the ship but the current risk this update introduced outweighs our upside case and therefore BBBY does not warrant committing our capital at this time.

Kirkland's (KIRK) – Special situation

KIRK is a home décor retailer based in the southern states. It is a special situation investment because it is priced for bankruptcy, but we believe the probability of this occurring is close to zero. In fact, there is likely to be a large short squeeze.

Market skepticism for KIRK is understandable: a big-box retailer without strong brand recognition barely profitable prior to the pandemic, whose business will return to that state once stimulus driven consumer demand fades.

We believe this view is mistaken. KIRK has been ably turned around by new CEO Steven Woodward and especially by new CFO Nicole Strain. We are naturally skeptical of turnaround stories: they take longer than expected, are filled with bumps along the way when they do work, and they often simply don't work. However, we are invested in KIRK because its turnaround is finished, proven, and sustainable.

Under the leadership of Woodward and Strain, EBITDA margins have expanded from 5% to more than 10%. What skeptics believe is a pandemic-driven pop is instead a well-executed turnaround. Below we show the major drivers of KIRK's improved profitability, all are permanent rather than benefiting from the pandemic:

Turnaround Factors	**EBITDA margin impact**
Reduction in corporate overhead expenses	3.0%
Shift to direct sourcing for half of all merchandise	2.5%
Rent reductions of ~20% on average	2.5%
Total	**8.0%**

The three sources of improvement listed above are lasting rather than products of the pandemic. They also add up to more than the total 5% EBITDA margin improvement, with the offset being greater supply-chain pressures that are expected to abate next year.

However, these fundamental reasons are alone are not enough to invest in KIRK, even at a valuation of just 3x EBITDA. We see high potential for a significant short squeeze based on this simple math: KIRK's market capitalization is just under $300m and ~30% of its shares are sold short with a further ~20% owned by insiders/long-term holders. That leaves the market value of shares not short and not permanently owned at just under $150m. KIRK has on its balance sheet ~$50m in net cash, will generate ~$50m in cash this holiday season with a further ~$50m in cash next year. Those numbers add up to $150m - the full value of its free float not sold short.

With the company repurchasing its shares every day, we see increasing potential for a large short squeeze against the 30% of shares outstanding that are sold short in the coming 12 months. Given KIRK's low liquidity, days-to-cover is above 10, which amplifies the risk of a squeeze. I put this scenario to Woodward and Strain during the quarter and received the response that: "We see what you see and are in the market repurchasing our shares aggressively."

While this setup is overwhelmingly skewed positively, there is still ample risk we are wrong. Consumer demand for décor could fade, KIRK's concentrated geographic exposure could work against it, management may eventually stumble. As such, when we discovered a liquid options market in KIRK, we took advantage. Our exposure to KIRK is largely expressed through long-dated out-of-the-money call options whereby if KIRK can execute over the coming 9-12 months and drive a short-squeeze, we stand to benefit handily. However, if things don't work out, our downside exposure is limited.

Outlook

The outlook for GORA is positive. We are invested in a portfolio of high-quality businesses experiencing significant demand growth who are operating conservative balance sheets trading at deeply discounted valuations.

We are, in some respects, unlucky to have launched our fund into one of the most difficult periods of performance for our sector in the past decade but believe it will ultimately prove to be to our benefit because of the opportunity set it has created.

Thank you for your trust and support. We are humbled that you have decided to invest a portion of your assets with Great Ocean Road Advisors.

Sincerely,

James O'Brien
Managing Partner & Portfolio Manager
Great Ocean Road Advisors