GORA
GREAT OCEAN ROAD ADVISORS

January 2022

December 2021 letter

Dear Fellow Investors,

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

For the December quarter, the GORA Southern Endeavor Fund advanced +0.6%, net of fees and expenses. Performance in the quarter matched the broader consumer sector we invest in but lagged the S&P500 index, which advanced almost 10% driven by continued investor enthusiasm for a small handful of names in the technology sector.

Our research at GORA is detailed, narrowly applied, and our portfolio very much off the beaten path of the crowd. For example, our largest exposure is to the Furniture sector, representing roughly 25% of our assets spread across six companies. Not one of these six companies is in the S&P500. Some do not have a single sellside research analyst covering them. Combined, their market valuation is less than 0.1% of Apple's (AAPL). However, our research supporting this idea draws upon hundreds of hours of analysis and financial modeling, more than 100 industry calls, more a dozen independent data sources, and regular meetings with the management teams at each company.

Being long-term investors, our portfolio swings with market sentiment because we do not change tack with short-term currents. Our furniture investment exemplifies this. In 2021, fundamentals were strong and are getting stronger, but this microscopic segment of the stock market was not in 'vogue' with the crowd during the year and so offered excellent entry prices. We have a favorable catalyst path across our entire portfolio. Expect few changes in the year ahead.

Market views entering 2022 – investor exuberance and the monopolization of mindshare

We expect 2022 will be a year stock-picking pays off. Entering the year, we see exuberance in pockets of the market. Investors are showing indifference for the disconnect between market and intrinsic valuations. Fiscal and monetary stimulus paired with the 'democratization' of finance has driven excessive bidding for a limited number of well-known assets monopolizing mindshare of everyday investors.

The beneficiaries will be familiar: Apple, Bitcoin, Ethereum, GameStop, Microsoft, Tesla. The effect has been to deeply inflate their valuations due to the concentration of focus upon them by a new generation of investors agnostic to fundamentals. Examples highlighting what market valuations have embedded in these names include:

- Apple (AAPL), the most valuable technology company, has a market capitalization ($3tn) greater than all 750 companies belonging to the consumer sector combined.
- Tesla's (TSLA) *change* in market capitalization in the past six months was $411bn, more than the entire market capitalization of Walmart (WMT), the most valuable consumer company in the world at $404bn. For every dollar of revenue TSLA generated in 2021, WMT made approximately $12.

- In fact, just 5 technology companies drove the majority of the S&P500's appreciation in the second half of 2021, while the other 495 companies in the index experienced stagnant appreciation as a group.

We see a fragility in the prices of these high-profile assets belied by the strength of major market indices. Less well-known assets with immaterial index weightings have been left behind, and therefore opportunities for stock picking have been created.

In reading about past cycles that echo today's 'narrative over numbers' mentality, we appreciated the words of two investors who have seen many:

> **Seth Klarman (15 years ago):** "The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions. Success in the market leads to excess, as bystanders are lured in… Then, eventually, and perhaps after more time than contrarians would like, the worm turns. Things quickly reverse, as leveraged investors receive margin calls and panicked investors dump their holdings."

> **Warren Buffett (64 years ago):** "During the past year almost any reason has been seized upon to justify 'investing' in the market. There are undoubtedly more mercurially-tempered people in the market now than for a good many years and the duration of their stay will be limited to how long they think profits can be made quickly and effortlessly."

We do not pretend to share the prescience of Buffet or Klarman. However, we note cracks forming for tech-at-any-price investors. Namely, this approach has until-now been backstopped by supportive fiscal and monetary policy. The removal of extremely accommodative policy coupled with high inflation for the first time in a generation necessitates a return to investment considerations such as earnings, cash flow and valuation.

More pressingly, a new generation of investors without a disciplined process has been taught to always "buy the dip". This new generation may become panicked when they discover that for the first time in their investing careers the Fed is not there by their side buying the dip with them. The absence of quick profits from aggressive investing might test the mettle of these participants. Markets and technology evolve, but human psychology does not.

GORA is, and will always be, invested in a portfolio of high-quality companies generating strong cash-flows whose intrinsic value both grows over time and is currently being underestimated by the market. As usual, we use these letters to share examples of our investment process. We welcome your questions or feedback on any.

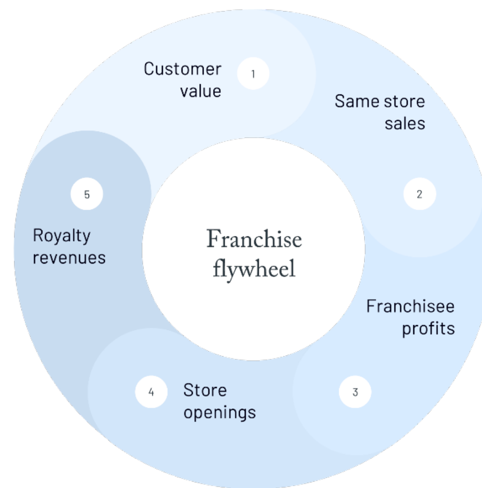
Franchised businesses and customer value

DRVN, EWCZ, FXLV, MCD, WEN, YUM

As regular readers know, we like franchise business models. Franchisors own the brands and collect royalties on sales made by franchises. Franchisees run the stores, retain sales ex royalties, and bear business operating costs. The franchisor (where GORA is invested) enjoys predictable revenue streams with strong profit margins – they are high quality businesses.

A franchise flywheel can be created with customer value at its core that drives compounding investor returns. The flywheel starts with customer value because customer value ensures franchisees see customers walking into their stores (same store sales). Healthy same store sales make their enterprises profitable. Profitable franchisees will choose to reinvest into the brand

by opening new stores because their returns on investment are attractive. More stores means more sales, means more royalties coming back to the franchisor – the franchisor is profitable. The last stop in our flywheel is the franchisor re-investing into the brand through marketing, product, technology to further enhance customer value.



This flywheel effect favors large brands with scale. There are many franchised brands we can invest in, but we only invest in the largest because their scale enables them to present customers with the greatest value and so spin the flywheel.

Examples of scale's benefit to customer value can be seen through a brand such as McDonald's:

1. All quick-service brands have a digital ordering app, but the McDonald's app is the best. It was also the lowest cost per customer to develop because it is downloaded by vastly more users than competitor apps.
2. McDonald's franchisees can simultaneously offer the best price-point meals while retaining the highest gross margins, because MCD's buying co-ops dwarf the co-ops of competitors.

Below are six franchised business models we are invested in:

- **Driven Brands (DRVN) 4% position –** Owner of a portfolio of automotive service brands. It is the largest provider in a fragmented market with very reliable customer demand; unfortunately, car accidents occur with surprising reliability. DRVN has the added advantage of acquiring independent stores at low multiples .

- **European Wax Center (EWCZ) 2% position –** The largest provider of waxing services. The very low cost of operations for franchisees make their stores highly profitable. Significant white space for future store growth underwrites long-term royalty revenue growth for the franchisor.

- **F45 Training (FXLV) 4% position –** Fitness studio franchisor with franchisee commitments in place to more than triple the number of studios currently open.

- **McDonald's (MCD) 3% position –** Largest QSR chain in the world while also enjoying the highest same-store sales growth in the industry thanks to its continuous reinvestments in improving customer value.

- **Wendy's (WEN) 5% position –** Second largest burger chain in the world enjoying accelerating development in Europe.

- **YUM Brands (YUM) 2% position –** Portfolio owner of four quick service brands and largest restaurant company in the world. Growth is accelerating due to unprecedented franchisee profitability.

All companies featured above are high-quality businesses with predictable growth and stable cash-flows. They form an important role within our portfolio construction by dampening the unavoidable volatility inherent with other investments we make offering greater potential payoffs.

Two new growth investments in 2022

W and FTCH

W and FTCH are internet consumer companies that have disrupted their respective categories of retail. Each have reached a tipping-point in their scale which make them highly attractive long-term investments.

W sells furniture and home goods. Its structural advantages are:

1. Its vast assortment. 22m products are available to customers vs. 3m at the largest competitor.
2. The user experience, defined by search, filtering and image rendering of its website is world-class.
3. An owned large parcel distribution network enabling one- or two-day delivery of heavy bulky items, providing an unprecedented service level in the category.

FTCH sells luxury apparel through its website marketplace. Its structural advantages are:

1. Preferred partner of luxury brands. More brands, brings more customers, which brings more brands.
2. The amalgamation of all inventory belonging to more than 500 independent boutiques around the world, giving FTCH unmatched breadth of assortment and speed of delivery.
3. Farfetch Platform Solutions (FPS), a B2B service directly powering the online retailing of more than 20 fashion brands and department stores who don't share FTCH's expertise of internet. FPS is a high-margin product for FTCH and a high-value service to these corporate clients.

Being an internet disruptor of a consumer category is extremely difficult. Aspirants are often much hyped within the investment community but very few ultimately succeed. Most discover that after initial success with easy early customer adopters, growth soon slows because the aspiring disruptor does not offer compelling value to a wide enough group of customers. They fail to reach critical scale and never build successful moats. For internet disruptors of retail, it is more than 10x harder to attain 10% market share than 1%. Reaching the tipping point of critical scale requires relentless focus on superior customer experience from an outstanding management team.

W and FTCH have hit their tipping points. In 2020, each saw increases in revenue and customer counts equivalent to their entire businesses as they were in 2017. In 2020, each saw increases in revenue and customer counts equivalent to their

nearest competitors' entire businesses as they were that same year. Both are now indispensable players in their respective value-chains with scale and market power. And critically, both use their power to reinvest back into further elevating their customers' experience and so deepen the competitive moats.

In 2021, W and FTCH's share prices declined 16% and 48%, respectively. The post-pandemic recovery, and a flaw in the conventional approach of financial analysts explain their retracements last year.

Following pandemic-induced restrictions on movement in 2020, 2021 saw a material step-back in consumers shopping online after they regained the freedom to visit physical stores in person. Frequency of online shopping, which has increased steadily for more than 20 years, even dipped below 2018 and 2019 levels in 2021. Given the advantages of online vs. offline retail, we are confident online retail will resume its long-term journey of market share capture in 2022. We are happy buying shares in W and FTCH from sellers who think it will not.

The flawed approach of conventional financial analysis is illustrated through the table below using FTCH as an example. Financial analysts are trained to measure year-on-year growth % in KPIs such as revenue, customers, and earnings. Acceleration in y/y growth is good news, deceleration bad. This approach works well for mature, stable businesses. We believe it falls over for high growth disruptors on a journey of market share accumulation. Our preferred approach for these disruptors is to focus on market share gained, as measured by absolute number of customers or revenue gained.

Farfetch customers
Values are 000'except y/y growth

	2017	2018	2019	2020	**2021**
Farfetch Customers	936	1,382	2,068	3,024	**3,918**
New customers added – GORA's preferred metric	288	446	686	956	**894**
Y/Y growth – market's preferred metric	44%	48%	50%	46%	**30%**

As can be seen, 2021 was another year of successful customer growth for FTCH. It added almost 900,000 loyal customers to its ecosystem, a record year outside of 2020 which had the unusual benefits created by customers being forced to shop online. However, look again through the lens of a conventional financial analyst who applies the same y/y growth-based approach to all companies, shown row 3. 2021 appears a disappointing aberration: 30% growth following a history of growth between 44-50%.

We believe the conventional approach of financial analysts is flawed for W and FTCH in 2021 because they are steady market-share accumulators. Their starting point was 0% market share at founding and their destination is 15, maybe 20% market share. A year in which one moves from 8% market share to 10% (25% y/y growth) looks less impressive than a year in which it moves from 2% share to 3% (50% growth), using the conventional approach applied by financial analysts. In contrast to this conventional wisdom, we are more impressed by the year of greater market share accumulation.

The consequences of FTCH's 2021 year of 'slow' 30% growth was a near halving in its share price. We have therefore been able to accumulate a small position in FTCH at a price of around $30 – the same price it traded at three years ago, despite the business today being 3x bigger and adding 2x as many new customers each day.

2022 will certainly be a year of continued volatility for W and FTCH but we see the risk-reward highly favorable. Both are led by their founders who bootstrapped their businesses from nothing. Each is among our most highly regarded executives and work hard to provide further catalysts for their business' growth. In 2022, W will further its international expansion by launching in Austria and Ireland, begin another significant reinvestment in its industry-leading supply-chain and launch ad-space monetization of its website. FTCH is in talks with Richemont, one of the largest luxury brand owners in the world, to bring their brands onto FTCH's website. FTCH will also be launching Beauty products and bringing more clients into its FPS service through a modulization of its offering. All for the benefit of customers.

Update on Furniture position

BSET, ETD, FLXS, HOFT, HVT, LZB

Furniture is our largest exposure. Spread across six companies, the combined investment value represents roughly 25% of our portfolio.

Furniture is an area we've spoken about in depth in the past. It was the topic of our first investment paper, published last month. Please find a link to our note here. We also had the pleasure of catching up with GORA investor and media personality Daniel Attia for a brief video to discuss the idea. The video can be viewed on our LinkedIn page here.

GORA is invested in Furniture because these are high-quality businesses experiencing an abundance of demand that has been temporarily masked by supply-chain constraints. The market is capitalizing their transitory supply-chain pressures into perpetuity. Instead, those issues are being resolved and profitability is set to inflect higher. Our downside on this investment is protected by rock-solid balance sheets and outsized order backlogs that underwrite revenue growth in 2022 and beyond.

Fundamentally, we have few updates on this investment to share other than that incoming data points continue to affirm our thesis. Since we published our Furniture paper last month, industry checks continue to tell us demand remains robust. Inflation of furniture prices continues to outstrip every other category the Bureau of Labor Statistics measures and is now approaching 20% above pre-pandemic prices. These companies which have been defined by the market as 'Work-from-home stocks' are continuing to enjoy robust demand beyond their ability to supply – further inflating backlogs of future revenue which will come at high profit margins.

In the month since we published our paper, our furniture investments have outperformed the broader retail sector by 10ppts. That said, we view monthly price moves as simply noise. Per our investment note, we are invested in Furniture for years and are playing for 100%+ share price moves. We will be patient and keep you abreast of any updates to this key investment.

Outlook

Above we shared brief insights into 14 companies, spanning three groups of investments that combined represent approximately 50% of total portfolio exposure. We'll close by highlighting how these investments differ and what they share:

- While consumer facing, these businesses span varied customer offerings: quick-service restaurants, auto service centers, luxury online apparel, furniture manufacturing
- Stylistically, these investments are different: quality, growth and value across the three buckets
- Our investments span the gamut of large-cap, mid-cap and small-cap companies.

- All are consumer facing and provide an excellent customer experience
- All have scale and have organically built clear barriers against competitors
- Our investment thesis for all is highly researched and differentiated from consensus market thinking
- All are long-term investments. We will ride through any short-term volatility that comes with them along the way

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