GORA
GREAT OCEAN ROAD ADVISORS

April 2022

March 2022 letter

Dear Fellow Investors,

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

For the March quarter, the GORA Southern Endeavor Fund retraced -8.3%, net of fees and expenses.

The Retail sector (XRT) retraced -16.2% and the S&P500 retraced -4.6%.

As can be seen by the performance of the sector overall, the market became especially frightened of cyclical assets during the March quarter. Consumer, where we invest, is front and center here. While our longs showed some resiliency relative to sector peers and our shorts continued to fall, our long bias meant losses were unavoidable.

We foreshadowed potential market weakness in our December letter but expressed a view that highly valued tech stocks were more vulnerable. Our medium-term view here is unchanged. The S&P500 is perilously expensive in light of tightening monetary policy. However, the largest one-third of companies by market capitalization account for all of this over-extension. Our bottoms-up focus on companies off the beaten path of large fund managers means our portfolio is dominated by companies with discounted valuations and earnings upside.

We had a busy quarter. We shared an open letter to the Board of Bassett Furniture (BSET) calling for a large share repurchase given the significant disconnect between share price and intrinsic value. Pleasingly, the company announced a buyback that covers 25% of shares outstanding. We were also published twice on Livewire covering the effects of US fiscal stimulus and the benefits of investing in franchised business models with low debt during tumultuous market.

Market views – growing our way into recession…

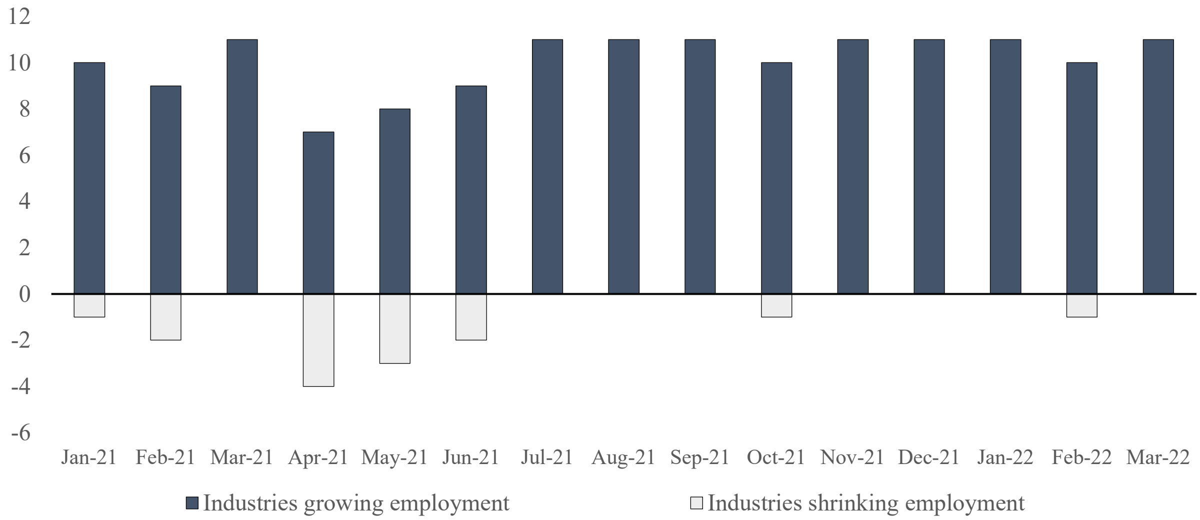
We do not see a damaging recession coming for the US economy.

Howard Marks famously characterized financial markets by the natural oscillation between fear and greed. The pendulum today has swung into Camp Fear. Once in Camp Fear, any data point serves as evidence of looming trouble – usually with calls for imminent recession.

Market fears of recession arrive far more frequently than the real thing occurs. The fears have different creative sources. Today, recession is perceived as inevitable due to inflation. Many equity prices are reflecting this outcome.

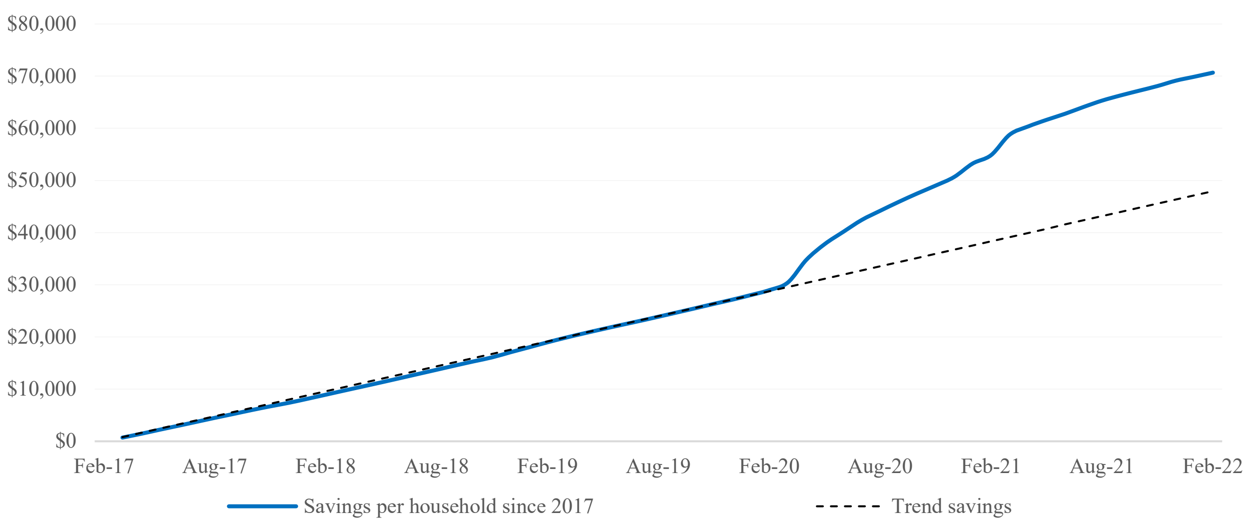
While inflation is high and we expect it to remain so, we do not see inflation leading us off a cliff in economic activity. The most recent inflation level of just under 8%, eye-popping indeed, still falls short of the 11% growth in wages US households are taking home each week. The relative spending power of American families, although in jeopardy, continues to grow. An extraordinary recovery in jobs since the pandemic, paired with rising underlying wages is supporting the largest growth in spending capacity in a generation. The breadth of job gains across industries and the fact that job openings remain 2x their prior all-time record means we expect gains to continue.

Number of industries growing vs. shrinking employment, by month



Savings created by two years with limited spending choices represents a further safety net to future consumption. Because of its difficulty in measuring, we believe this savings pool is an underappreciated tailwind for our businesses.

US households have amassed the largest pool of savings in their history

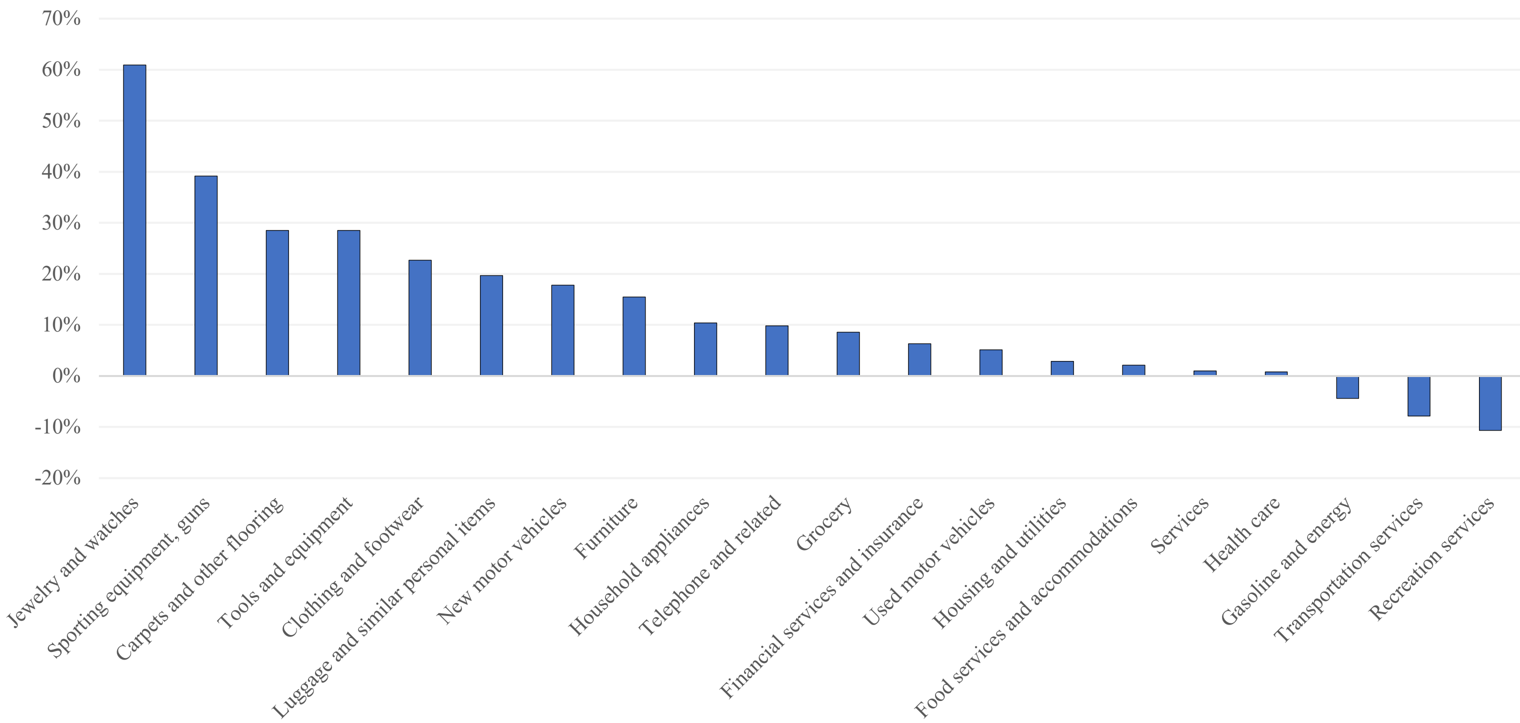


Any consumer-facing company will agree with our equation below:

job gains + wage growth + savings = healthy consumer spending

The below chart is a reminder of where the consumer stands today vs. pre-pandemic. By showing volume of consumption, we eliminate inflationary effects on spending. This true apples-to-apples analysis reveals consumer demand remains very healthy. We expect it will remain so, driven by the forces in our equation above.

Volume of Consumption in Feb 2022 vs. 2019 avg



These are shaky times. Inflation is high, geopolitical risks are rising and monetary policy is tightening. The S&P500 overall is expensive, and we continue to see index-level risk skewed to the downside.

However, it's during these times that the very best opportunities are born. Market participants who bought in when the pendulum was in Camp Greed become unnerved by their sudden arrival in Camp Fear. Selling begets panicked selling, which distorts prices. Depressed market prices are then viewed as definitive evidence of coming economic doom.

We remain wholly invested in our long positions. Demand for the products our companies sell is healthy and growing, almost all carry large cash balances with no debt, and their valuations are at the reasonable end of reasonable. Trimming into market fear would ultimately be to the disadvantage of our limited partners and our portfolio is well-lined with shorts to cushion an ongoing correction.

Howard Marks: "Most of the time, the end of the world doesn't happen."

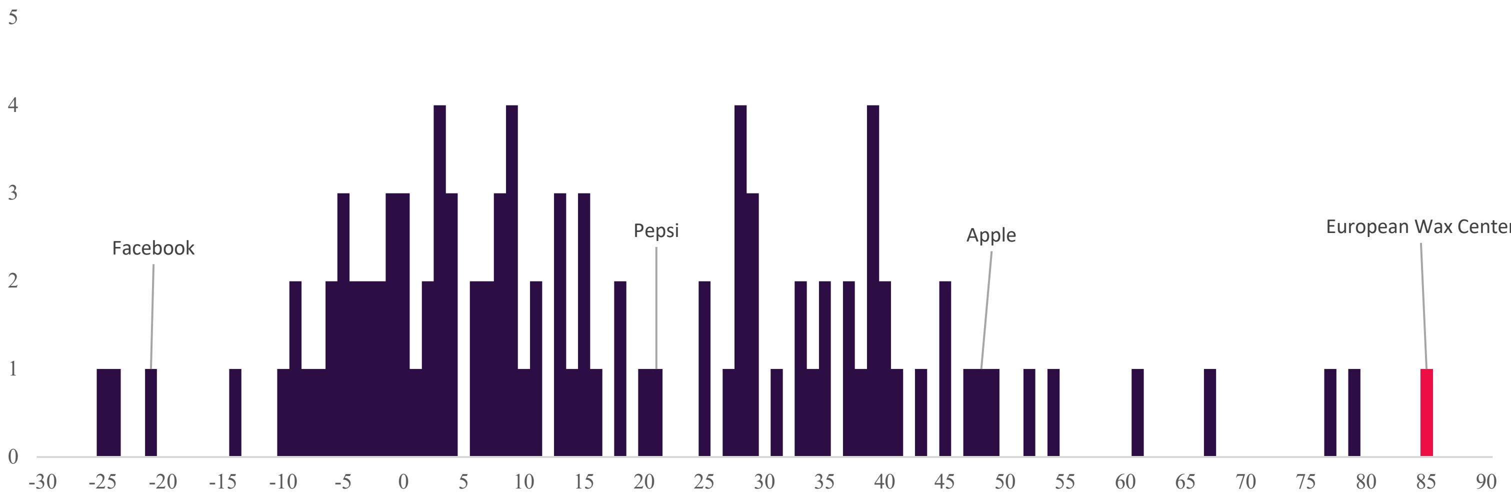
European Wax Center (EWCZ)

EWCZ has gradually become a large position for our fund following ongoing research revealing a greater opportunity and risk-reward than we first appreciated.

EWCZ is the franchisor of the European Wax Center brand of waxing salons. The brand currently has 853 locations, 99% of which are owned and operated by franchisees.

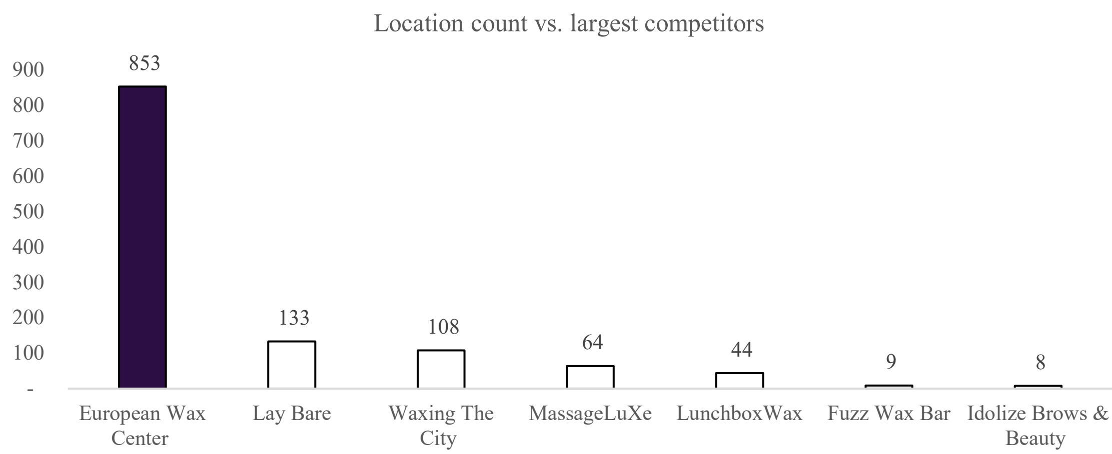
In our December quarterly letter, we described the merits of investing in franchised business models. We emphasized that a flywheel effect can be created by franchised brands, proivded they meet three criteria: excellent customer value, high franchisee profitability, and scale. EWCZ posses all three in abundance.

EWCZ serves its customers well. Its locations are clean, professionally run, backed by a reliable brand and offer price value. As a result, more than 80% of visitors are repeat customers. EWCZ's customer loyalty stands out through its Net Promoter Score (NPS) of 85. That's among the highest NPS scores we've witnessed and eclipses all of the largest 100 consumer brands. For reference, an NPS of 85 means more than 10x as many customers are likely to recommend the brand to a friend as would not recommend it.



Franchisees make a lot of money. Low studio build-out costs, low operating costs, paired with consistent recurring revenue stream dues to EWCZ's very loyal customer base means franchisees earn 60%+ cash-on-cash returns on their mature studios. That level is more than 2x best-practices among quick-service restaurants, the most common franchising category. Profitability for European Wax Center franchisees is so strong some franchisees are even openly petitioning their peers to buy their locations from them – something we've never seen before in franhcised brands. It's clear franchisees of EWCZ want to invest in the brand. As a reminder, when franchisees invest it benefits us (shareholders in EWCZ), but does not come out of our pocket.

Finally, scale. EWCZ is the largest waxing center brand by a factor of five. In fact, its location count eclipses the next ten largest waxing brands combined.



At its most recent earnings update, EWCZ delivered a strong earnings beat and guided to continued healthy growth in the year ahaed. We were particularly impressed by a non-financial metric – the company shares its 'pipeline' of centers that have been signed into opening with franchisees but which are not yet open. The pipeline is a precursor for future openings. On December 31st, EWCZ's pipeline jumped to 330. These are contractural agerements with franchisees to open new centers. The pipeline isn't benefiting financial performance yet, but will in the future. Supported by its strong pipeline of center openings, we believe EWCZ's future is very bright.

Ethan Allen Interiors (ETD)

Ethan Allen Interiors (ETD) is among the fund's largest long investments and featured in our [Furniture Investment paper](#).

We are invested because two seismic shifts have occurred benefitting ETD's business that remain unrecognized by the market. ETD delivered results during the March quarter exemplifying these shifts.

The first is demand for ETD's products has step changed higher. Its customer demographic of high-income, middle-to-older families, in suburban parts of the county are enjoying things. They have outsized income growth, wealth accumulation and a hot housing market as tailwinds. All are driving demand for high-quality furnishings, which ETD happily provides. During its most recent quarter, ETD's customer orders were more than 40% above pre-pandemic.

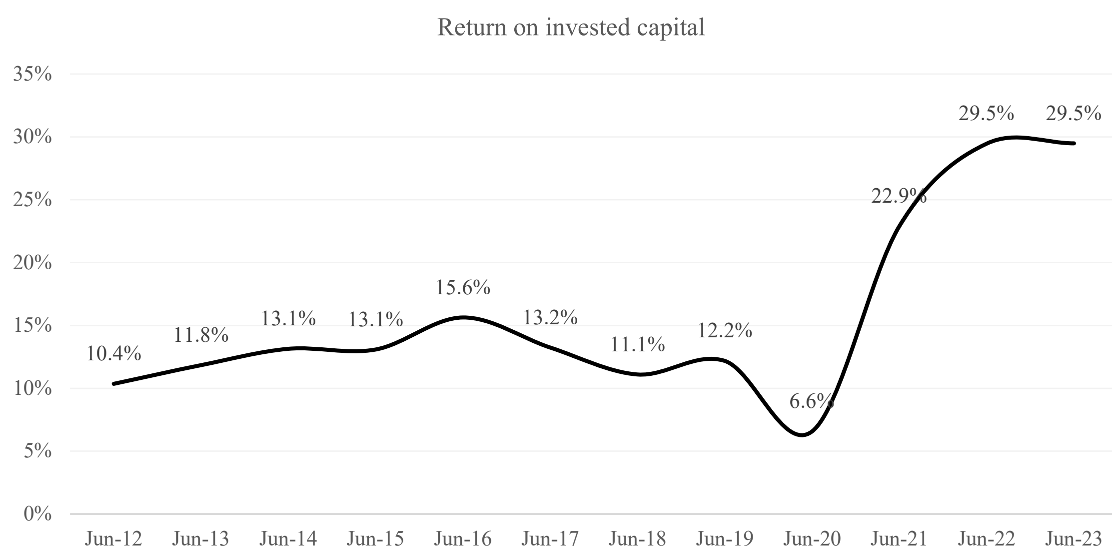
The second shift is that ETD benefits, rather than suffers, from global supply-chain disruptions. In a world where off-shoring became status-quo, ETD stood apart by owning its supply-chain and keeping it in the US. This extends all the way down to the forests supplying the wood in its dining tables!

Competitors gradually shifted to an Asian-import model. Now in a disrupted world, these companies can't get the product they need and face large cost increases on the product they can. Competitor selling prices have jumped ~25% to offset these cost pressures. ETD is largely immune. Its prices to customers are up a relatively modest 10%, while earning record profits due to its insulated position.

CEO Kathwari put it best on a recent earnings call: "our long-term focus on maintaining and growing manufacturing in North America has become a major advantage."

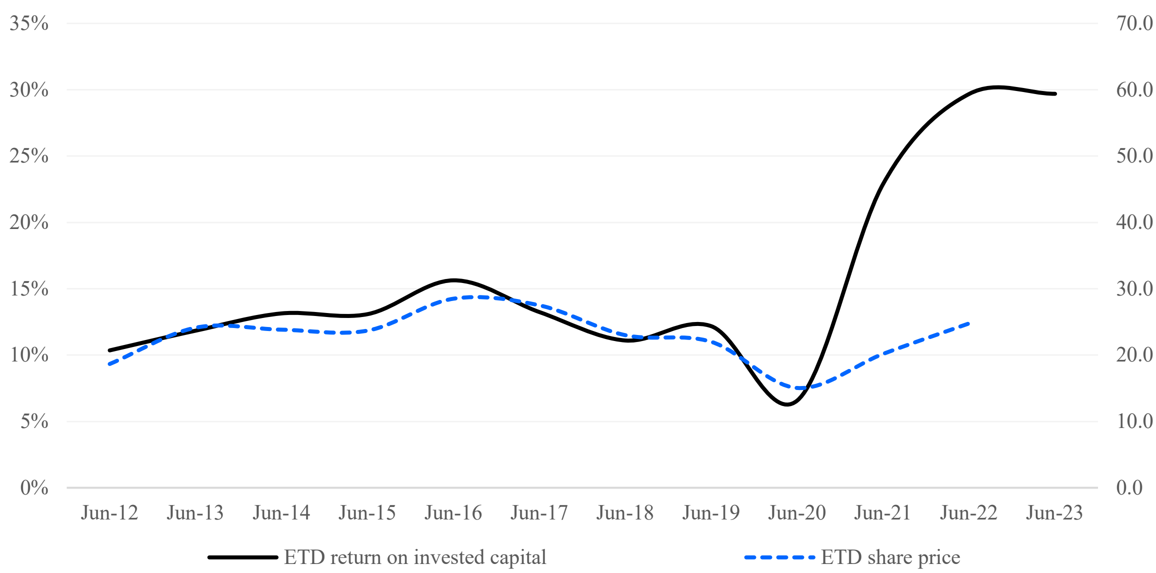
How are these advantages reflected in the numbers? Return on invested capital (ROIC) gives the clearest picture of company performance. ETD's ROIC has improved from an industry-normal of 10-13% to now almost 30%.

Ethan Allen Interiors ROIC	Jun-2017	Jun-2018	Jun-2019	Jun-2020	Jun-2021	Jun-2022	Jun-2023
Net sales	763.4	766.8	746.7	589.8	685.2	815.1	849.5
Adjusted operating income	65.0	50.1	55.1	17.0	80.3	122.2	136.6
operating income margin %	*8.5%*	*6.5%*	*7.4%*	*2.9%*	*11.7%*	*15.0%*	*16.1%*
Lease expense added back	31.4	32.0	32.0	32.7	33.3	34.0	34.7
Adjusted tax rate	*25.0%*	*25.0%*	*25.0%*	*25.0%*	*25.0%*	*25.0%*	*25.0%*
Net operating profit less adjusted taxes (NOPLAT)	72.2	61.6	65.3	37.3	85.2	117.1	128.5
Shareholder equity	400.7	383.7	363.9	328.1	351.4	378.7	419.9
Debt	14.3	1.7	1.1	50.0	0.0	0.0	0.0
Lease liabilities	188.1	192.1	192.1	261.2	125.3	118.5	118.5
Less: cash and marketable securities	-57.7	-22.4	-20.8	-72.3	-104.6	-99.8	-102.8
Ethan Allen invested capital	545.5	555.1	536.2	567.0	372.1	397.5	435.6
Return on invested capital (ROIC)	**13.2%**	**11.1%**	**12.2%**	**6.6%**	**22.9%**	**29.5%**	**29.5%**



ETD's improved ROIC is sustainable. The customer has absorbed inflation in selling prices without pushback. Competitors are trapped in import models, a disadvantaged position vs. ETD, which necessitates their selling prices being higher than ETD's. Pivoting to domestic production would take peers years to execute, if feasible at all. Therefore, ETD will continue to enjoy large returns on capital.

Why focus on ROIC as a measure of company performance? Because movement in ROIC predicts share price returns over the long-term better than any other metric. This is true for equities in all industries and geographies. And so it is with ETD.



Changes in ROIC have reliably led changes in ETD's long-term share price over the past decade. The present situation stands out as an aberration on the chart - and hence our interest in the investment. The disconnect is between the two lines is actually understated visually because:

- The company today has no debt today compared to a debt burden historically, adding roughly $2/share in value
- The company today carries $3/share in extra cash vs. its normal history
- There are 20% fewer shares outstanding today than when the chart began.

Where do we go from here? A deeply undervalued stock is a good start, but better to have catalysts. A series of earnings beats are coming down the pike for ETD driven by consensus modeling that, we believe, underappreciates the complexities of the business and is therefore prone to error. Consensus also exhibits a natural trend for mean-reversion in earnings and is therefore failing to capture the sustainability of ETD's improved ROIC.

Furthermore, we believe ETD's burgeoning cash balance is becoming so large that the company is likely to announce a fresh share buyback, which we expect would be a boon for the stock.

Lastly on ETD, a thank you is deserved to Ethan Allen management if they are reading this letter. The team were kind enough to send us a copy of CEO Kathwari's biography during the quarter, which we've enjoyed reading. We look forward to continuing to work with you in the future.

Outlook

Tracking forecast revisions is a quantitative and objective measure of a portfolio's strength. What this means in practice is recording whether one's forecasts for a company's free-cash-flow are moving higher or lower through time. For each of our top-5 longs, our internal forecasts moved higher during the March quarter. This means we are not suffering anchor bias, whereby our ideas are not playing out as expected but we cling to them, nonetheless. Instead, when forecasts continue to move higher, you should be, and we are, continuing to add to position sizes. We expect strong portfolio performance on the horizon.

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