GORA
GREAT OCEAN ROAD ADVISORS

October 2022

September 2022 letter

Dear Fellow Investors,

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

For the September quarter, the GORA Southern Endeavor Fund retraced -7.0%, net of fees and expenses.

The Retail sector (XRT) retraced -3.4% and the S&P500 retraced -5.9%.

The specter of an inflationary recession continues to loom over financial markets, amplifying short-term volatility and asset price correlations. It can feel like our focus area of the investment universe is, in the eyes of the market, nothing more than a bag of potatoes traded back-and-forth depending on the mood of the day while being afforded no more consideration than a one-word descriptor, such as 'cyclical' or 'discretionary.' As we continue to emphasize, this environment reveals high quality opportunities to those who understand these assets in more depth than just a single word. Attempting to pick the bottom of the market is a fool's errand, but the rewards are always material for those who can select the correct assets and persist with conviction.

Highlights and lowlights were experienced during the September quarter. Company earnings events were a source of profit for the fifth consecutive quarter. The fund's largest investment, ARHS, delivered one of the best beats across consumer so far this year. In the teeth of slowing activity, the company doubled the consensus EBITDA estimate. In contrast, FXLV, which by the beginning of the quarter was outside the fund's top-10 investments, told the market past representations to investors were false and fired its CEO. We had never seen such a disclosure from a public company before and have learnt much. We discuss both ARHS and FLXV in more detail in this letter.

Looking forward, we continue to feel luckier than might be expected following a third quarter of retracement. Our live tracking of the 40 largest fundamental equities hedge funds again signals widespread pain. Our fund's performance YTD likely sits within the top third, with the bottom third of funds now showing YTD losses beyond -40%. A number have retraced greater than -50%. Our sharing of these insights is no victory lap. As we discuss below, stock correlations have become unusually high. Everything is macro. Therefore, relative outperformance/(underperformance) in 2022 feels as much down to chance and portfolio concentration as it does stock-picking. We make the point of active manager performance because it is another driver behind our conviction that the opportunity set emerging is special. The managers in our sample set are extremely successful investors. A byproduct of their experience in 2022 is that our funnel of potential new investment ideas includes several quality businesses trading at a small fraction of their recent market values. These potential investments need to clear high hurdles, including resiliency against a recession, but we much prefer a wide funnel of potential ideas to a narrow one where everything feels too expensive.

Market views – a market of one

What has made 2022 YTD so challenging is that bottoms-up, fundamental research has barely mattered. Swings in broad market sentiment are driving short-term share price returns. Correlations rising during macro scares is no surprise. What is surprising is just how much this has been the case.

As we show below, the degree to which consumer equity returns this year have been determined at the macro level, as opposed to the individual company level, is unprecedented:

Consumer equities	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022 YTD**
Median stock return	17%	-24%	-47%	36%	40%	7%	25%	44%	6%	-3%	18%	8%	-8%	14%	17%	16%	**-36%**
Sector co-movement	32%	50%	48%	47%	50%	42%	48%	39%	64%	52%	65%	34%	58%	54%	58%	40%	**75%**

To give a real-world example, we are long ARHS and have a small short in SNBR, a bedding company, as a hedge.

- ARHS has enjoyed a *positive* +35% EBITDA revision YTD while,
- SNBR has seen a *negative* -40% EBITDA revision.

Their share price performance YTD? ARHS -45%, SNBR -56%.

This story repeats throughout our portfolio. Four of the fund's five largest investments have enjoyed material positive earnings revisions in 2022 vs. one out of five for the S&P500. However, these positive earnings revisions have not yet materialized in share price gains because the market remains so focused on the macro without regard for the micro.

GORA top-5 and total market	**ARHS**	**BSET**	**ETD**	**EZPW**	**WEN**	**S&P500**
Consensus EPS on Jan 1st	0.53	1.83	2.96	0.60	0.89	227
Consensus EPS today	0.73	2.46	3.74	0.69	0.85	224
Revision YTD	+38%	+34%	+26%	+15%	-4%	-1%

Perhaps the market is ahead of GORA. Is it already discounting a coming deterioration for our top-5 investments which simply hasn't arrived yet? It's possible but that risk belies the significant work we have done to build a top-5, from a consumer universe of more than 100 companies, that is insulated from a downturn. Our top-5 includes companies who see demand grow in an economic downturn, or sell to customers wealthy enough to be impervious to the economy, or have large order backlogs that can sustain earnings through a downturn. We believe the reason these companies have been sold YTD is because they are simply 'consumer'. To sell these investments would be against our better judgement because there is no evidence they are bad ones. The evidence, as indicated by their revision track record, is they are good ones!

> **Howard Marks:** "Reducing market exposure through ill-conceived selling – and thus failing to participate fully in the markets' positive long-term trend – is a cardinal sin in investing."

As always, we share below updates on key fund positions, so investors and well-wishers know not just what GORA is invested in, but why.

Farfetch Limited (FTCH)

FTCH is the world's foremost luxury retail e-commerce platform. We previously wrote about FTCH in our 2021-4Q letter.

The company was founded to act as an online marketplace (Farfetch.com) by aggregating the inventory of hundreds of luxury apparel brands and independent boutique stores, for purchase by millions of customers, all around the world. Farfetch.com developed the world's best back-end infrastructure, front-end user experience, and transport/logistics network to efficiently process the millions of cross-border luxury apparel purchases made through its site each year. It's enjoyed the fruits of its labor: Farfetch.com process 4x the transaction volume, carries 8x the SKUs, and has 10x the brands featured as its largest competitor. The website is ubiquitous in the luxury industry.

However, FTCH the company is a two-stage rocket: Farfetch.com igniting the first, blasting through the worst gravity and grittiest friction inherent with building a world-class e-commerce tech stack, logistics, and brand relationships with notoriously intractable fashion Maisons. The second rocket is Farfetch Platform Solutions (FPS), our focus this letter.

FPS white labels the expertise developed at Farfetch.com and licenses it directly to luxury fashion brands, department stores to power their own websites and e-commerce. It is solving numerous, near-identical problems faced by hundreds of brands and retailers seeking an e-commerce revenue stream. FPS earns income by receiving a % of all sales generated through the sites it is powering - its 'take-rate'. More than 20 luxury websites are currently operated by FPS. Visit Ami Paris. You won't see it displayed, but you're scrolling a site built and maintained by FPS. Purchase an Ami product through its web store and FTCH takes a cut.

FPS is an excellent business because it is so value additive to clients and so profitable to FTCH. Revenue received by FPS is devoid of variable costs because these are borne by the client: the physical goods, transaction processing, transportation, advertising – all are costs paid by the client. Instead, FPS experiences a period of cost investment without revenue while its engineering team build the new client site and capabilities before going live. Then, one day in the middle of the night, a switch is flicked, and the FPS site replaces the outdated version. From that day forwards, FPS enjoys a cut of the site's transactions with its expenses being the fixed wages of the FTCH tech team operating the site. It is one of the highest flow-through business models we have discovered.

Our enthusiasm for FTCH as an investment has increased because FPS has been announcing new, large client mandates with brio. Prior to 2022, only Harrods among FPS' existing 20+ brand clients was considered a very large player. This year, FPS has announced four game-changing client wins. Richemont, announced in August, is likely to generate more revenue than all other FPS accounts combined.

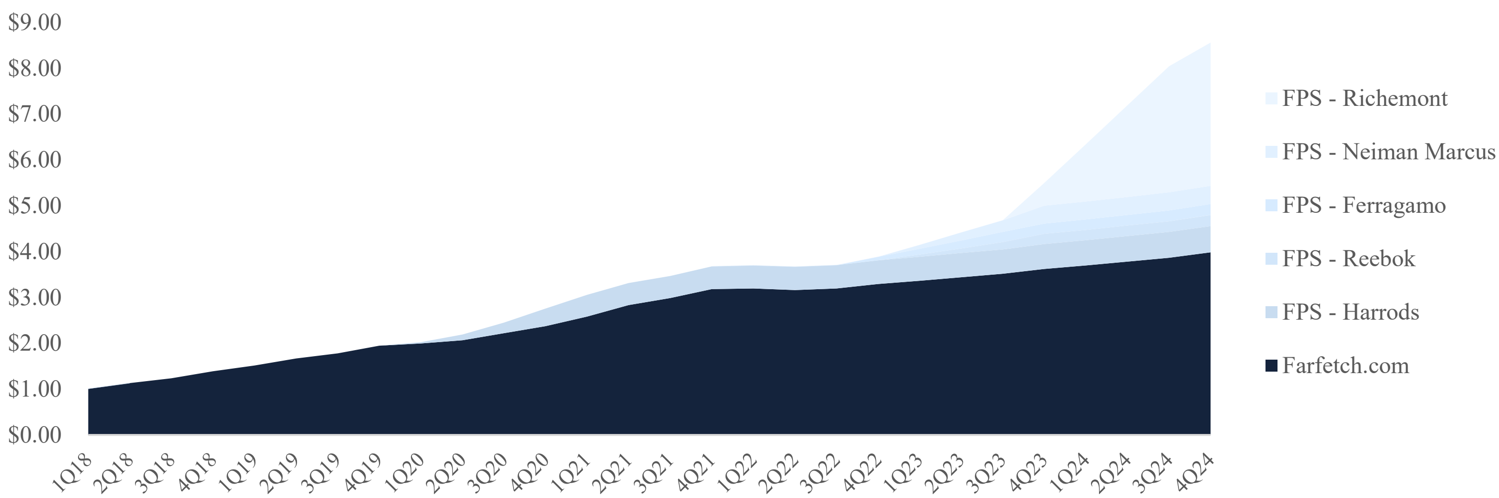
FPS major client wins	*Announcement of engagement*	*Anticipated start date*	*GORA est. of GMV $mn*
Harrods	February 2019	February 2021	$475
Salvatore Ferragamo	August 2022	December 2022	$225
Reebok	April 2022	January 2023	$250
Neiman Marcus	April 2022	March 2023	$385
Richemont	August 2022	January 2024	$3,000

The 2022 mandate wins for FPS will transform FTCH. Salvatore Ferragamo, Reebok and Nieman Marcus all go live over the next 12 months. That will bring almost $1bn of annual Gross Merchandise Volume (GMV) flowing through the FPS tech-stack – netting for FTCH north of $100m annually for its efforts. None of this revenue is being earned today, only the costs of the engineers replatforming these websites are presently visible in FTCH financials. However, the inflection is coming.

The big one here though is Richemont. Richemont is a luxury empire spanning 26 well-known brands generating combined sales second-only to the LVMH empire. FPS will soon be driving the e-commerce arm of all Richemont brands following the announcement of a multi-faceted agreement that sees equity exchanges between the two companies as well as Richemont's brands being added to the Farfetch.com marketplace. Richemont's FPS adoption will conservatively funnel $3bn in annual GMV through the FPS pipes.

To illustrate how material these signings are, consider our chart below. FPS, the little-known subsidiary within the business owning Farfetch.com, will soon be processing more GMV than the namesake site. We believe FPS is becoming a more valuable business than Farfetch.com.

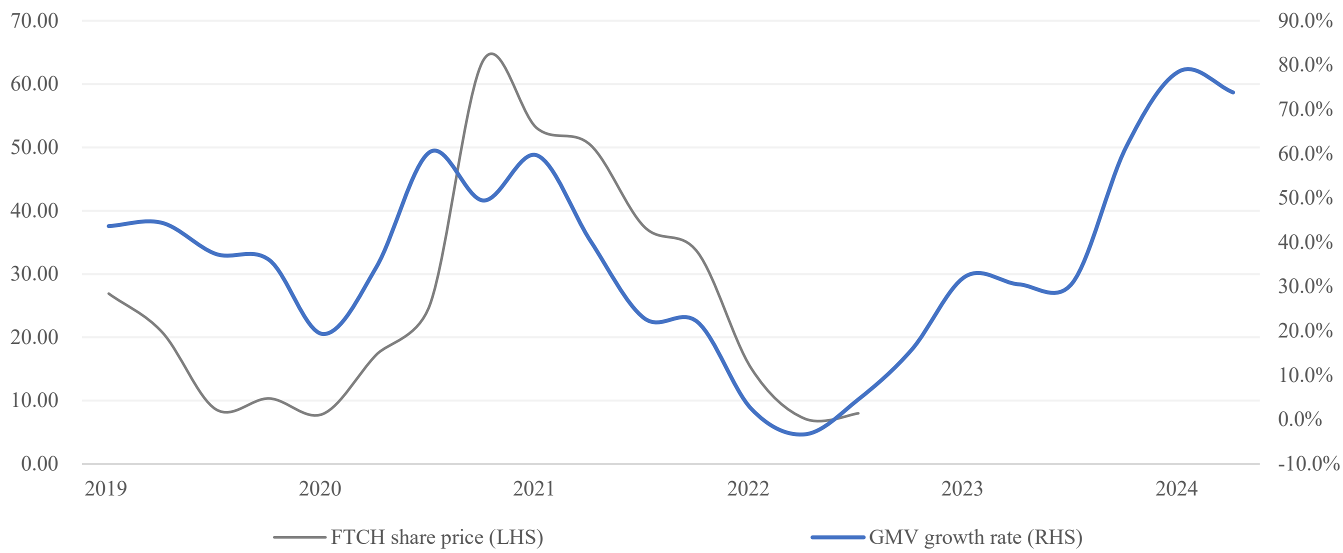
Farfetch GMV by source - trailing 12 months, $bn



Why does this matter? Why display a chart of GMV from FTCH's various sources?

Because FTCH GMV growth is the single most important KPI for the share price.

We show below the share price since its IPO in 2019 with its GMV growth rate. The correlation is uncanny. Notice the unusual share price spike in early 2021 that occurred concurrent with Harrods joining FPS as a client. The Harrods activation helped drive FTCH GMV growth above 50%. We believe that level of acceleration is coming again with these new, large corporate clients layered into the FPS ecosystem.



Finally, on profitability. A common criticism of FTCH by investors, and why the share price has fallen as low as it is, is that FTCH is unprofitable. Its breakeven position is further discouraging because its largest competitor (Mytheresa, MYTE), is a profitable business. FTCH is 4x bigger than MYTE and therefore MYTE's profitability in the face of losses at FTCH undermines the notion that scale supports expanding profitability. This fear is misplaced. We show below a side-by-side comparison of FTCH and MYTE to illustrate.

FTCH is more profitable at sourcing the product, winning the customer then getting the product to their doorstep. This is what it counts. These metrics are all likely being helped by the current mix of highly profitable FPS clients in the FTCH business. This benefit will grow through the aforementioned FPS client wins.

Corporate and technology spend is where MYTE is far leaner than FTCH. This is where the costs of building the world's best luxury e-commerce platform lie. It is also where the start-up costs for the coming FPS clients sit. We have no problem being invested in a company spending almost 10x its competitor's dollars on technology development when this spend is driving future, highly profitable revenue streams.

Profit comparison	FTCH	MYTE
Sales – trailing 12 months	$2,340m	$690m
Expenses:		
Cost of sales, transport	55%	63%
Marketing	13%	14%
Corporate & Technology	34%	14%
Adjusted EBITDA	**-2%**	**9%**

The Wendy's Company (WEN)

WEN is the fund's preferred quick service investment and is a position we added to during the quarter.

This investment might sound boring: WEN steadily grows its global restaurant count 3-4% each year. As a franchisor, it has few variable costs and can therefore grow EBITDA 5-10% consistently year after year. WEN generates lots of free-cash-flow which it prudently returns to shareholders through dividends and repurchases. In short, things are going well at WEN. It's winning share from competitors, its franchisees are highly profitable, and its international expansion is delivering impressive results. However, a more interesting development has piqued our interest.

WEN's largest shareholder, Trian, filed a 13-D in May because its conversations with management regarding a possible acquisition of the entire company by Trian had progressed to a level both parties felt legally necessitated disclosure of the conversations to shareholders. There is no guarantee of a deal, but a 13-D filing confirming advanced conversations to that end is more than just financial press speculation. Talks have advanced far enough that WEN canceled its investor day previously scheduled for this month and has suspended its buyback program. These are serious steps the company is taking.

We do not know if an acquisition by Trian will occur and like the investment regardless. However, we appreciate that this additional source of upside now exists. But what if a takeover doesn't occur?

A corollary of current share repurchase restrictions is that WEN's cash balance is swelling. The company began 2022 with just under $250m cash in its corporate account and is on track to end the year with $800m. Enough cash for a company WEN's size that it would necessitate an Accelerated Share Repurchase program (ASR). If no Trian deal eventuates, we calculate WEN would announce a $600m ASR in early 2023 - enough to repurchase 15% of shares outstanding, accelerating EPS growth above 20% for the next two years. Not a bad backup catalyst for a stock on its lowest EPS multiple ever.

A caution against this investment may be that the share price is depressed to reflect recession risk. We disagree with that risk. Quick service is one of the best places to be in a recession because families trade down to QSR in hard times. This is especially true in an inflationary recession such as the one we face today. The QSR industry has historically delivered its best outperformance of other industries during a downturn. Further, WEN's position as franchisor adds natural insulation from the operating leverage effects created by a downturn.

Industry sales growth	Quick service	Full-service	Total retail
2005	7%	6%	6%
2006	5%	8%	5%
2007	4%	6%	4%
2008	4%	1%	1%
2009	0%	-2%	-3%
2010	4%	3%	3%
2011	5%	7%	5%
2012	5%	6%	4%
2013	4%	4%	3%
2014	5%	7%	4%
2015	9%	8%	4%
2016	6%	5%	3%
2017	6%	5%	4%
2018	6%	5%	5%
2019	6%	5%	4%
Avg	**5.3%**	**4.8%**	**3.5%**
Std	**1.7%**	**2.5%**	**2.2%**

F45 Training Holdings, Inc. (FXLV)

FXLV is a position we exited during the September quarter. It was a disappointing experience that inflicted the fund's largest single loss in the quarter and for the year.

During July, the company delivered a market update that effectively amounted to an admission that past representations about the business to investors were false and that the CEO's employment had been terminated. The stock fell 60% on the news, bringing a 90% YTD loss of value for investors. The fund's internal risk controls, which limit position sizes, showed value by mitigating damage from the event.

Our diligence was thorough. It included frequent management contact, and more than 40 conversations with the brand's franchisees and competitors. The fact we spent so much time researching FXLV is, with hindsight, a clue – we were never completely comfortable with the investment. We were looking for a silver bullet to address our fears. However, the nature of deliberate deception, which here may be ruled fraud, is there is rarely an all-revealing data point.

Since July when we exited, a number of things have happened: Shareholder lawsuits are underway, the pre-IPO investors have made legally required filings to sell their shares, franchisees are suing the company, and the former CEO has gone missing. Perhaps most surprisingly, one shareholder has made a non-binding offer to take over the company at a price that would be just a small fraction of the IPO value 12 months ago. We regret the investment and have learned much from it.

> **Charlie Munger:** "I never lose sleep over my investments."

Bassett Furniture Industries, Inc. (BSET)

BSET is a top-5 investment for our fund. We've written extensively about BSET through our December 2021 Furniture investment note, our open letter to the BSET Board in March this year, and in our recent June 2022 quarterly letter. In October, CSC Generation Holdings, Inc. (CSC) made public its proposal to take over BSET at a price of $21 per share.

Below we refresh the analysis included in our June quarterly letter. We compare BSET's net realizable value to the offer from CSC. Our analysis demonstrates BSET's appeal by showing its realizable value as higher than the price proposed by CSC. We therefore view this offer as undervaluing the company.

As one of the company's largest shareholders, we are actively engaging in conversations with the BSET board.

BSET assets, value per share	
Cash and investments	$9.24
Inventories	$10.01
Other net working capital and commitments	-$2.95
Real estate	$6.10
Net realizable value of BSET	**$22.40**
CSC offer	$21.00
Premium of realizable value to offer	**7%**

Arhaus, Inc. (ARHS)

ARHS is the fund's largest positions and was in focus this quarter because it delivered a stand-out earnings update.

ARHS possesses traits generalist investors have deeply disliked in 2022: it sells consumer discretionary products tangentially tied to housing, it IPO'd in 2021 (there were many bad companies in the 2021 IPO class), and a private equity firm is a cornerstone shareholder.

However, ARHS possesses several traits we look for: strong brand delivering value to customers, capable management team aligned with shareholders, underlying business momentum, idiosyncratic drivers to sustain momentum, and a conservative balance sheet characterized by excess cash and no debt.

The company's first 12 months in public markets have gone well. It delivered sales of $995m vs. consensus expecting $905m, and EBITDA of $150m vs. consensus expecting $99m. Nonetheless, its share price has not performed well. Notwithstanding a +40% move higher on its most recent earnings result, shares have fallen 45% YTD. ARHS therefore trades at a valuation unheard of for healthy companies prior to 2022: 4x EV/EBITDA and 6x EPS ex cash.

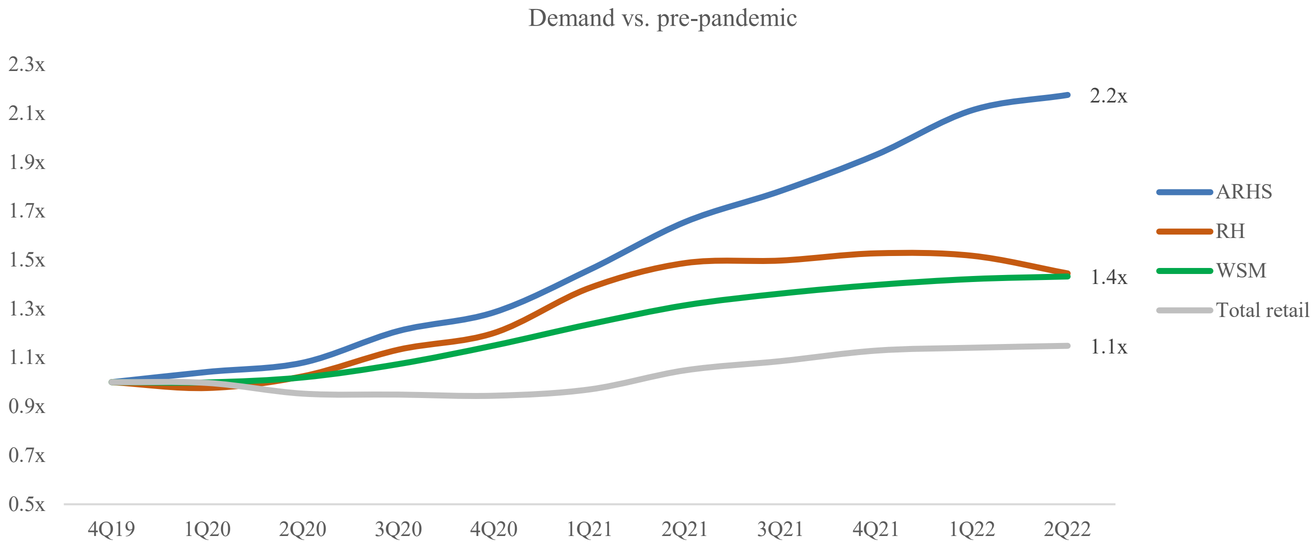
The explanation for this discounted market valuation is the same as for many companies with market caps under $1bn. Investors don't have time to research their fundamentals. Instead, they apply a broad-brush view based on the sector. For ARHS, investors believe a uniquely favorable macro environment buoyed results over the past two years. They further believe this environment should now reverse, and with it ARHS' fortunes.

We do have the time and energy to learn the company-specific details of smaller public businesses. We understand the macro view, and do not dismiss that past tailwinds have aided cyclical companies but see more to the ARHS story than just the macro. Underneath are impressive company-specific initiatives sustaining its results:

1. **Product assortment** – its rate of quality new product introduction is the highest of any furnishing brand we follow.
2. **Website** – a re-platformed e-commerce site has improved reach and conversion, near tripling online revenue.
3. **Production/sourcing** – by owning domestic upholstery production facilities and sourcing from quality manufacturers all around the world, with a focus in Italy, ARHS delivers higher quality product with faster lead times than peers whose souring is concentrated in bottlenecked distribution lines throughout Asia.
4. **Disciplined pricing** – ARHS has raised prices more modestly than premium furnishings peers, most notably its largest competitor RH. We believe ARHS is taking market share vacated by RH which has priced out customers.

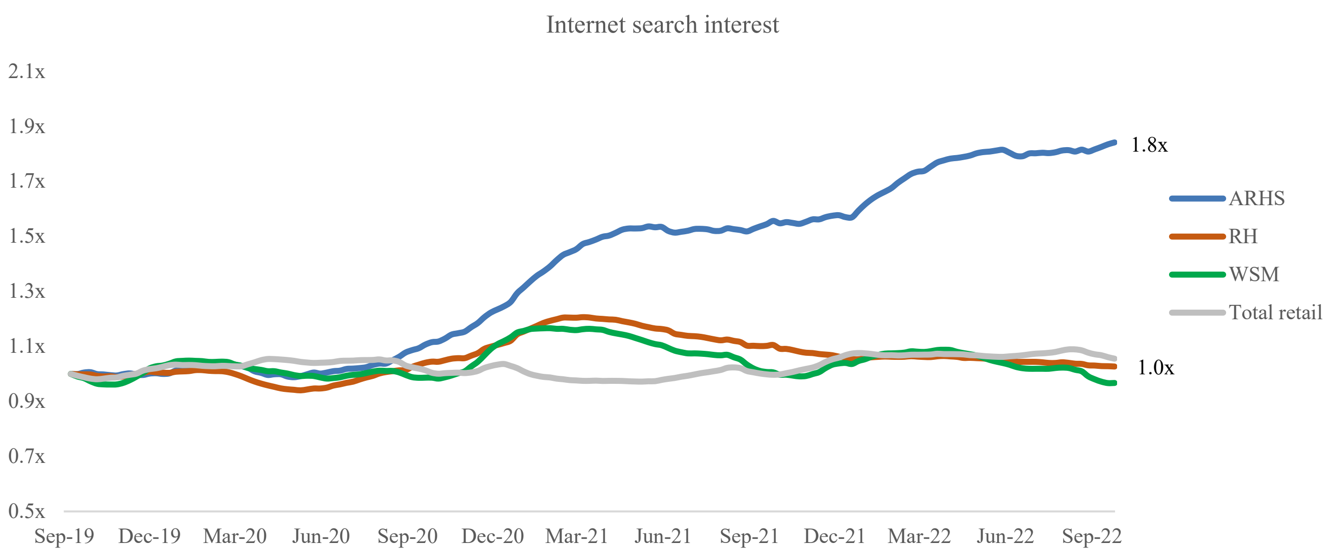
The result is demand for ARHS product is more than twice its level from 2019. But maybe it's all just cyclical?

Consider our chart showing customer product demand at ARHS and its two largest peers, RH and WSM, relative to 2019. We also show demand for the total retail industry for added context. For all except ARHS, demand reached new heights in mid-2021, concurrent with federal stimulus payments and equity markets peaking. Since then, demand has mostly sustained but not grown. For ARHS, demand continues reaching new highs, easily eclipsing the relative demand performance of peers and the wider retail industry.



Demand is an imperfect measurement requiring some subjectivity in calculation when limited to using only publicly-available information. We calculate it based on sales and estimated movements in order backlogs. Nonetheless, evidence ARHS has built sustainable demand improvements is displayed even in something as simple as internet search interest. The ARHS brand has enjoyed a step change in search interest that belies a simple narrative of just benefiting from a cyclical bounce. Hence, our conclusion remains that ARHS has delivered real underlying improvements that are idiosyncratic.

We look for ongoing earnings beats in future quarters to continue challenging the current market view that its strong results are simply the tail end of a good cycle.



Outlook

Stock picking isn't dead. Our fund, along with many peers, are working through a period of heightened uncertainty which is causing outsized volatility and dislocations. These are frustrating in the short-term but have provided the most fertile environment for long-term investors. We believe 2022 will prove this to be the case again.

Beyond the investment portfolio, this month concluded the summer internship of Joseph Dyke. As part of his internship, Joseph was tasked with analyzing The New York Time Company (NYT) and writing a comprehensive investment paper detailing his research and recommendation. He did an excellent job and we encourage readers to download his 120-page investment memo on the company whose news publication everyone is familiar with, but which few have likely considered from a business and investment perspective.

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