GORA
GREAT OCEAN ROAD ADVISORS

April 2023

March 2023 letter

Dear Fellow Investors,

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

For the March quarter, the GORA Southern Endeavor Fund advanced +13.8%, net of fees and expenses.

The Retail sector (XRT) advanced +5.3% and the S&P 500 (SPY) advanced +7.5%.

The quarter delivered an aftershock bounce that followed 2022's decent for equities. In our December letter, we laid out how the investor crowd turned bearish by year-end. Our diagnosis is negative positioning in an oversold market left risky assets ripe for rally, which they delivered.

That said, we are skeptical how far the rally can continue. As one data point, almost all of the S&P500's March quarter gain was accounted for by its largest 10 constituents. The other 490 delivered, on average, zero return. Such narrowness in index returns tends to leave them vulnerable to reversal. Meanwhile, the US economic outlook has, on balance, softened due to bank failures amplifying financial tightness beyond central bank prescription. We therefore increased shorts where we have a compelling fundamental view and near-term catalysts.

Our fund returned a healthy quarter thanks to idiosyncratic results from major holdings. Arhaus (ARHS) was the largest single position at the beginning of the year and advanced +50% through late-February, caused by a profit beat in the face of high short interest. We exited the position when our valuation target was realized, and we had exhausted our pipeline of variant future catalysts.

A similar recipe of profit beats against high short interest applied for European Wax Center (EWCZ). It advanced +47%. We are multi-year owners of this business and shared our full thesis in a November investment paper, with an update in our most recent letter. We keep pointing out that an accounting quirk leaves EWCZ simultaneously one of the market's highest quality franchisor businesses, and one of the cheapest.

Drags on performance were created by short positions in bedding manufacturers, primarily Sleep Number (SNBR), which we discuss in this letter. We increased our short position in SNBR with the share price rally.

Looking forward, we remain as focused as ever on bottoms-up fundamentals to identify companies approaching free-cash-flow inflections. Portfolio risk exposures, both to the market and individual companies, are lower than usual.

Finally, the country's largest Furniture trade publication featured us a Guest Editor sharing our outlook for that industry.

Market views – counter-cyclical and contrarian

We are tightly managing risk because the macro outlook has darkened, while indices have rallied. Financial news, which for 18 months centered on inflation, interest rates, and recession risk, was suddenly punctuated in March by four bank failures in quick succession.

Although contagion risk from the failures appears contained, there will be a flow-on effect to even tighter financial conditions as stable banking institutions voluntarily pull back lending to de-risk their own businesses. The IMF delivered the unusual forecast that recent banking stress will impact total US financial credit by 1 to 4% in 2023. It lowered its US GDP expectation on the back of that prediction. And the impact of tighter credit is certainly here. The percentage of US small business owners reporting loan access is becoming more challenging just reached its highest level since 2009.

Meanwhile, the consumer is healthy but has pulled back spending. Healthy because household balance sheets are strong, with low fixed-rate debt and rising variable-rate deposits. Excess savings are within 10% of peak, and disposable income is again outpacing inflation. That said, a type of buyer strike has emerged in pockets of consumer in response to persistently dour economic news, record low consumer confidence. Our concern is the building list of individually surmountable economic risks cumulatively pushes the economy into a downward cycle.

Our most important market thematic is, therefore, owning counter-cyclical businesses that benefit from tightening financial conditions. EZCorp (EZPW) and PROG Holdings (PRG) are large beneficiaries, whom we share updates on in this letter. Both compete with traditional financial institutions to provide consumer credit and are seeing competition weaken. However, both are also insulated from the negative forces causing competitors to pull back: EZPW because its loans are fully collateralized, PRG because tightening conditions pushes high-quality customers into its application funnel. Yet, investors don't appreciate these nuances, so we were able to accumulate shares at trough prices.

Our second market thematic is highly contrarian. We own two currently loss-making consumer-tech companies because an inflection to profitability is imminent and not at all reflected in their share prices. We own Farfetch (FTCH) and Wayfair (W) with cost basis less than 10% of their all-time high share prices, reached in the bull market of 2021. Today, both are universally dismissed (and often derided) by investors as being permanently loss-making businesses that will never reaccelerate growth. Our research shows their histories of losses were voluntary and expense cuts have already been made to accelerate the transition to profitability. Further, the demand outlook for each is improving regardless of the economic outlook. We have treaded water on these investments for some time but with the approaching FCF inflection, are getting more rather than less bullish.

> **John Neff:** "Buy stocks that look bad to less careful investors and hang on until their real value is recognized."

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

Carrols Restaurant Group, Inc. (TAST) – Increased position

TAST is the largest operator of Burger King restaurants in the United States. It owns more than 1,000 of the brand's 7,000 locations. Our fund has owned a small position in TAST for more than a year, which we doubled in January.

We are invested in TAST because the market is overlooking that its free-cash-flow (FCF) is significantly greater than earnings, and likely to inflect higher.

A passing glance at TAST looks ugly. From its pre-pandemic peak, EBITDA margins have fallen from 10% to 4%, owing to poor brand marketing by its franchisor, Restaurant Brands International (QSR), and once-in-a-generation inflationary cost pressures created by the pandemic. Net income is a small loss. Add to those that the business is highly indebted, and the result is a market capitalization today of just $140m for a company generating almost $2bn in annual sales.

The business is far healthier than its initial look. First, without any changes to current conditions, annual FCF is $30m higher than accrual profits due to outsized depreciation relative to capital spend. That tailwind accounts for 20% of the current market cap, annually. It also underwrites TAST's solvency – a fact not reflected in the current price.

Next, consider where the quick-service industry has been and where it's going:

1. **Sales:** Quick-service was competing fiercely with more premium restaurant alternatives under the stimulus-infused pandemic-reopening but is now benefiting from the trade down effect that accompanies recession fears. We described this effect for our note on Wendy's (WEN) in a past letter.
2. **Commodity costs:** An unusual supply-demand imbalance in 2022 caused beef costs to spike almost 50%. That has now corrected - beef is deflationary and driving gross margin improvement.
3. **Labor costs:** Reopening worker shortages economy-wide were most acute in the hospitality sector. Its effect was unsustainably high wage growth for restaurant workers. That is now correcting too. TAST recently shared its incoming job applications are back above pre-pandemic levels.

All contribute to a favorable outlook. However, there is much more to TAST than just improving industry currents. We increased the investment because its franchisor is embarking on a multi-faceted brand rejuvenation for Burger King that will tangibly benefit TAST shareholders in multiple ways. In fact, the metric by which QSR is measuring the program's success is franchisee profitability improvement: what could be better aligned with TAST shareholders?

QSR announced its 'Reclaim The Flame' program for Burger King late last year in response to weakening franchisee profitability. The program is a series of contributions that ladder up to $400m of total investments, all funded by QSR, to benefit Burger King franchisees. Representing almost 20% of brand sales, TAST stands front-and-center to collect these benefits.

We doubled our TAST investment during the March quarter because these benefits are beginning now. In April, QSR will begin a $120m special advertising campaign to drive customers into Burger King restaurants. The brand's share of voice will increase 30%. Estimating precisely how this will flow through into traffic gains is a foolish endeavor. However, it will certainly have some benefit. To frame its potential, every 1ppt traffic improvement lifts TAST EBITDA by 10%. Our internal earnings forecasts began the year ahead of consensus forecasts due to the aforementioned industry-wide benefits. Gains delivered through the advertising campaign represent incremental upside.

There are also longer-dated benefits to QSR's 'Reclaim The Flame' investment program. QSR has set aside a further $280m to fund restaurant remodels. TAST's scale within the Burger King system means its pro-rata share of this budget is $45m, more than a full year of capex paid by the franchisor. Said another way, this contribution is equivalent to TAST reaping a FCF tailwind equal to 30% of its entire equity value today.

On the heels of this support, QSR added one more unusual investment to aid franchisee success. It appointed Patrick Doyle Executive Chairman. Mr. Doyle, former CEO of Domino's Pizza (DPZ) is widely considered today's most successful restaurant industry executive. He oversaw a 25x shareholder return at DPZ through a strategy focused on franchisee excellence and profitability. Attracting Mr. Doyle's talents isn't cheap: his starting compensation package is worth more than $100m. Again, all borne by the franchisor, but will significantly benefit franchisees. Investment managers use the term 'Jockey bet' to describe investing with a company because its leadership is so exceptional. Through TAST, shareholders now benefit from the restaurant world's best, without having to pay him.

What was Doyle's first message upon arrival at QSR?

> "*Franchisee profitability. That is the measure of success ultimately in this business*." – **Patrick Doyle, Executive Chairman Restaurant Brands International February 2023**

A pushback against our investment case can be easily understood. It runs that Burger King's problems are terminal, 'Reclaim The Flame' will have negligible impact, and that recent franchisee bankruptcies (link, link) foretell TAST's future. We disagree. Leaving aside TAST's healthy free cash flow and improving operating environment described above, TAST operates a superior fleet of locations within the Burger King brand. It's average unit volumes (AUV) are 10% higher than the BK system at large. TAST has delivered eight consecutive years of same store sales outperformance at its restaurants vs. the wider brand.

Finally, time may show TAST to actually be an unexpected beneficiary from troubles among peer BK franchisees. TAST has long been a preferred acquirer of BK restaurants. Since 2011, it has steadily acquired more than 800 BK restaurants, or just over 10% of the total system. It previously held a Right of First Refusal (ROFR) to acquire any BK restaurants for sale across 16 states. There are likely few better owners of future BK restaurants coming up for sales, distressed or otherwise, than TAST. None would be more welcomed as restaurant acquirers by the franchisor than TAST. Although not in our base case, we believe it's possible the current environment may create exceptional buying opportunities for TAST if more of its smaller peers fall into insolvency.

We believe TAST could quadruple in value to $10 per share in two years. Our base case does not assume a material sales recovery for the BK brand, but still yields $1.00 in TAST FCF per share by 2026. At a conservative 10% FCF yield, that would be worth $10, per share – a 400% return from today's levels. More bullish scenarios deliver valuation outcomes that look silly.

It's worth noting however, that the risks here are more two-sided than we typically seek. Part of what generates so much upside in that valuation is that profit margins are so thin against such a large sales base – that cuts both ways. If 'Reclaim The Flame' fizzles, then operating costs reaccelerate, TAST will face further margin compression. Because of this, we will never raise TAST's cost basis within the portfolio to more than 5% of assets.

PROG Holdings, Inc. (PRG)

PRG is the foremost lease-to-own company, providing point-of-sale lease financing to customers of its retail brand partners. We invested in PRG late last year and shared our investment case in our December 2022 letter. Our thesis had three points:

1. PRG has a strong financial model being undervalued by the market
2. PRG's over-provisioning for lease losses in 2022 would cause an earnings rebound in 2023
3. In a slowing economy, retail brands will become more amenable to partnering with PRG to drive their sales.

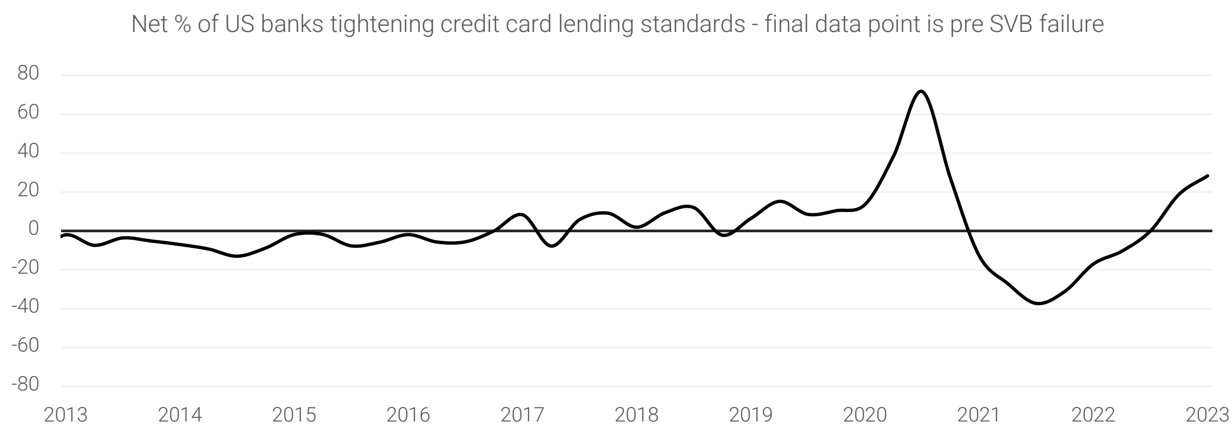
Since then, a fourth has emerged. Traditional credit providers are pulling back lending due to the lagged effect of rising interest rates, and now bank failures. Traditional credit, such as credit card and consumer lending firms, compete with PRG as customer financing options. Traditional credit also, frankly, attracts higher quality customers than PRG. Their decision to tighten lending standards pushes high quality customers into PRG's application funnel. The benefit to PRG is two-fold: PRG writes more leases, and these leases experience fewer losses than occur among its typical applicants.

Tightening approval rates by competitor credit providers is a material enough catalyst that management have been speaking to it regularly in public forums:

> "*We have not seen to date a material change in the application funnel above us. But as inflation continues, we do expect that, the next marginal group of customers above us in the FICO stack will --less of them will be offered credit by traditional providers, and they'll flow into our market. We're not seeing it right now, but we expect, as the year goes on, that phenomenon will happen*." **- Steven Michaels, CEO PROG Holdings, Inc. February 2023**

We believe this catalyst has now arrived. Data from the Federal Reserve shows a strong uptrend in domestic banks tightening credit card loan standards (below). The latest survey was collected prior to recent high profile bank failures and these bank failures will reinforce the trend. Regional US banks shed $200bn in deposits during March. They will become understandably reticent to issue fresh credit. Another data point indicating lessening credit from traditional lenders comes from public companies. Synchrony Financial (SYN) and Ally Financial (ALLY) are the two most consumer-focused lenders directly above PRG in the FICO funnel. Both have experienced rising loss rates for six consecutive quarters through December 2022. Rising losses are a clear harbinger that fewer credit applications will be approved going forward.

Importantly, tightening credit and increased losses above PRG in the lending funnel does not foreshadow its own increased losses. PRG's leases are far shorter duration than traditional loans and it can therefore control loss rates more easily. As above, it will also benefit from higher quality applicants than normal entering its funnel.



EZCorp, Inc. (EZPW) – Increased position

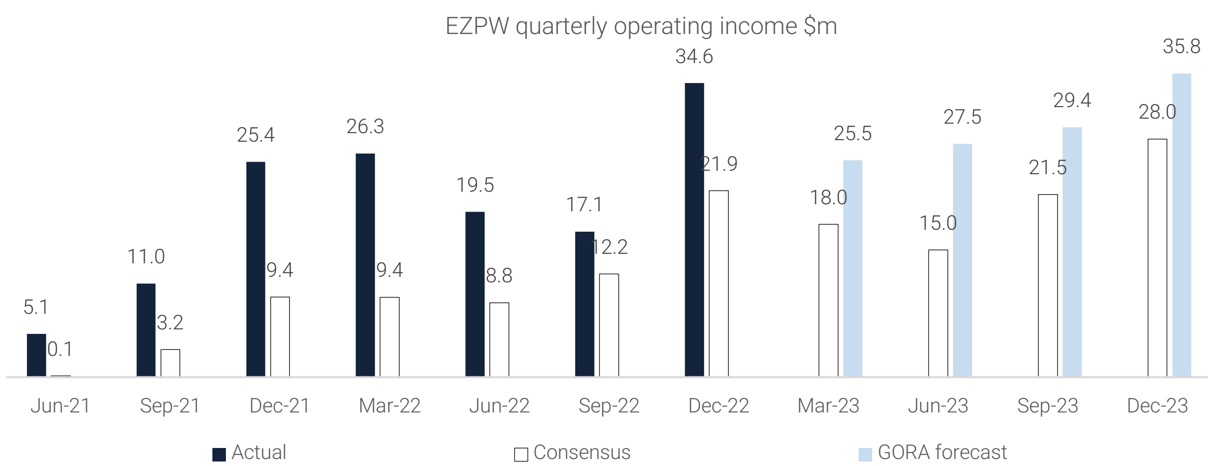
EZPW is the second-largest owner of pawn shops in the United States, with a burgeoning Latin America presence. We have been invested in EZPW for almost a year and first shared our thesis in a prior quarterly letter. We used the March quarter to increase the fund's position size.

Our reason for owning EZPW is that it is counter-cyclical - benefiting from inflation and financial tightening. Yet, the market values the stock like a small cap cyclical, which is to say cheaply. It's progress since our investment paired with a recent share price pullback gave us the confidence to add to the position. We have a pipeline of earnings beats ahead, and the company is repurchasing shares in the open market.

The macro backdrop is highly supportive for EZPW's business and becoming more so. Inflation and the depletion of low-income household excess savings has elevated the need for short-term consumer financing (demand). Meanwhile, competitors are restricting loan access (supply). We described last year how VC capital was flowing out of once hot alternative financing concepts, such as Buy-Now-Pay-Later. Now, as described above, traditional banks are tightening too, particularly for the customer profile EZPW serves. The effect is diminishing access to credit when their need is stronger. EZPW is benefiting immensely.

This situation is manifesting in large earnings beats for EZPW. Over the past two years, the company has earned 3x the operating profits sellside analysts had forecast. We expect the trend of material earnings beats to continue. Here, we have a forecasting advantage through our modeling. EZPW's financial model is sensitive to its value of Pawn Loans Outstanding (PLO), which represents the value of pawn loans from which it will derive fee revenue in coming periods. This metric is unique to its business and overlooked as a forecasting input by sellside analysts anchored to 'typical' retail financial models whose inputs are more straightforward. We believe our approach of utilizing PLO as an input gives us a forecasting advantage over the market that reinforces our conviction of healthy profits ahead.

This conviction is then further reinforced through our on-the-ground checks. Conversations with operators of small private pawn shop brands emphasize robust loan demand. Business concerns for these individuals are centered on accessing capital to fund incoming loan demand, a good problem to have. Also, as in the past, our web scrapping checks of local news stories highlight pawn as pocket of local community economies enjoying strong activity in the face of a broadly slowing economic landscape: story, story.



Sleep Number Corporation (SNBR) – Short position

SNBR is a manufacturer and retailer of Sleep Number branded smart beds. The fund shorted SNBR shares during the quarter.

We have a negative view on SNBR's equity because customer demand is insufficient to cover its fixed operating costs, the company is highly indebted, its CFO who orchestrated taking on debt has abruptly resigned, and the share price experienced a 'short squeeze rally' to begin the year despite providing an earnings outlook below market expectations.

The Sleep Number brand has carved out an interesting niche in the highly competitive mattress/bedding industry. It sells expensive mattresses, averaging well over $5,000, which it contends are worth the cost thanks to their ability to share data on how well you slept the previous night. A sleek brand helps too.

We've always been wary. SNBR earns unusually high gross margins, aided by those high selling prices. It achieves these through very large sales & marketing spend. The company actually spends more dollars convincing you to buy its products than it does making them. Half its customers use the in-housing financing program. Finally, a typical store sells only one bed on a slow day, two on a busy one - they can feel like ghost towns. All these traits make the company more susceptible to economic cycles than most consumer brands.

We expect SNBR has now become a victim of the cycle. Demand for its beds boomed in 2021. The company responded by raising prices nearly 20%, opening 125 new stores, and taking on $400m in debt to fund share repurchases. Then demand turned. Its customer is more aspirational than usual for high-end mattress customers, evidenced by the financed sales mix. This customer is sensitive to economic pressures and pulled back demand when 2021's government stimulus payments were replaced by 2022's inflation in everyday goods. We calculate its original stores are today selling 40% fewer mattresses than at peak, and its newer stores only half that again.

This leaves SNBR in a bind. The company has remained profitable since the recent downturn thanks to servicing an outsized backlog of orders. That backlog is now depleted. Without demand improvement, the company could quickly become loss-making.

Our concern was amplified when SNBR's long-time CFO, David Callan, suddenly resigned in January. Callan was the architect of SNBR's strategy to debt-fund share repurchases. Servicing this debt is now a challenge – SNBR has already amended its covenants to avoid breach. The debt is variable-rate debt and therefore becomes more onerous with rising interest rates. Callan's exit was presented to investors as a natural step to the next opportunity in his career. We are skeptical and believe he fell on the sword. His LinkedIn profile reads more like a job-seeker than an executive on gardening leave.

Finally, where to for SNBR from here? Despite the warning signs above, its share price has rallied nicely with the bounce in cyclical assets to start the year. The company issued its own explicit warning in February by setting 2023 earnings guidance below market expectations. We model further negative earnings updates ahead and note the company lowered its 2022 earnings expectations four times over the course of last year. The valuation is full at almost 20x P/E and therefore, even if our bear case does not play out, we like the risk-reward.

Outlook

A decent start to the year for the fund has not made us complacent. Macro shocks damaged our portfolio last year and we are as attuned as ever to their risks going forward. An emphasis on variant views with catalysts now defines the portfolio over simply owning high quality businesses. Market exposure has been reduced.

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