GORA
GREAT OCEAN ROAD ADVISORS

July 2023

June 2023 letter

Dear Fellow Investors,

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

For the June quarter, the GORA Southern Endeavor Fund advanced +12.7%, net of fees and expenses.

The Retail sector (XRT) advanced +1.0% and the S&P 500 (SPY) advanced +8.5%.

The June quarter was choppy. Markets oscillated between advancements then retracements, caused by the friction of an uncertain macro picture. That picture is mostly improving simply because inflation is moderating while economic activity holds up. We continue to hope for a new dawn where bottoms-up fundamentals matter more than macro news in setting share prices.

The S&P 500's quarterly return is deceptive, again. Stripping out the largest handful of tech stocks – about whom we know nothing – the S&P's June quarter return was just +2.1%. 490 stocks within the S&P500 have delivered, as a group, practically no return so far in 2023. The market picture therefore isn't as rosy as it might seem.

Our fund delivered a healthy June quarter with positive returns from long and short investments. The largest contributors were investments we wrote about in prior letters: TAST (1Q23), PRG (4Q22), and FTCH/W (4Q21). The fund exited PRG following a 90% move in less than six months. We share a recap below, but in short, our variant view became the consensus view after management delivered better than expected forward guidance, causing the valuation to improve. The fund remains invested in TAST, FTCH, and W where we believe we still hold a variant view and fundamental data points are inflecting in our favor.

There were surprisingly few drags on portfolio performance this quarter. That will certainly be a temporary phenomenon. The largest drag was our short position in SHAK, which appreciated following an activist shareholder winning Board representation. We are persisting with the short because we believe the root cause of SHAK's troubles are excessive menu price increases diminishing its value proposition, which an activist can't fix. We also expect the operating environment to become more difficult for SHAK over the balance of 2023.

In non-investment news during the quarter, GORA Portfolio Manager, James O'Brien, was named to the Furniture industry's 40 under 40 list of up-and-coming leaders. The acknowledgement came thanks to nomination by a number of public company management teams in recognition for James' investment work in the Furniture sector.

Below we share details on two new fund positions, Delta Apparel (DLA) and Miller Knoll (MLKN), as well as a recap on our now-exited position in PROG Holdings (PRG).

Delta Apparel, Inc. (DLA) – New position

Delta Apparel (DLA) is a vertically integrated apparel company. It owns three businesses; each are worth more than its current market value. In fact, we measure DLA's intrinsic value at more than 4x its market cap and its breakup value more than 5x market cap.

DLA's three businesses are:

1. Delta Direct – supplier of blank apparel garments to mass retailers, such as Walmart and Target.
2. DTG2Go – Digital printer of unique on-demand apparel lines. Its largest customer is Fanatics.
3. Salt Life – A premium lifestyle retail brand centered on ocean/water activities. (Website)

We have been watching DLA for more than a year and believe now is the time to aggressively acquire shares. For each of its business, headwinds now abating have been priced into shares as though permanent. Their removal will create 150% earnings upside to consensus forecasts and show each business is more valuable than DLA's share price.

Why Delta Direct is more valuable than DLA's current market cap

Delta Direct is DLA's original business. It manufactures basic t-shirts for sale in mass retailers, such as Walmart and Target. This is normally a predictable business with high volumes but low margins.

In 2022, the two things that can go wrong for Delta Direct did. First, its mass retailer customers overbought inventories just as inflation caused consumer demand to soften. Second, prices for cotton – its major input – spiked due to supply chain snags. The result for Delta Direct was depressed volumes to allow retailers to shed inventories with depressed margins due to higher cotton on the products that were sold.

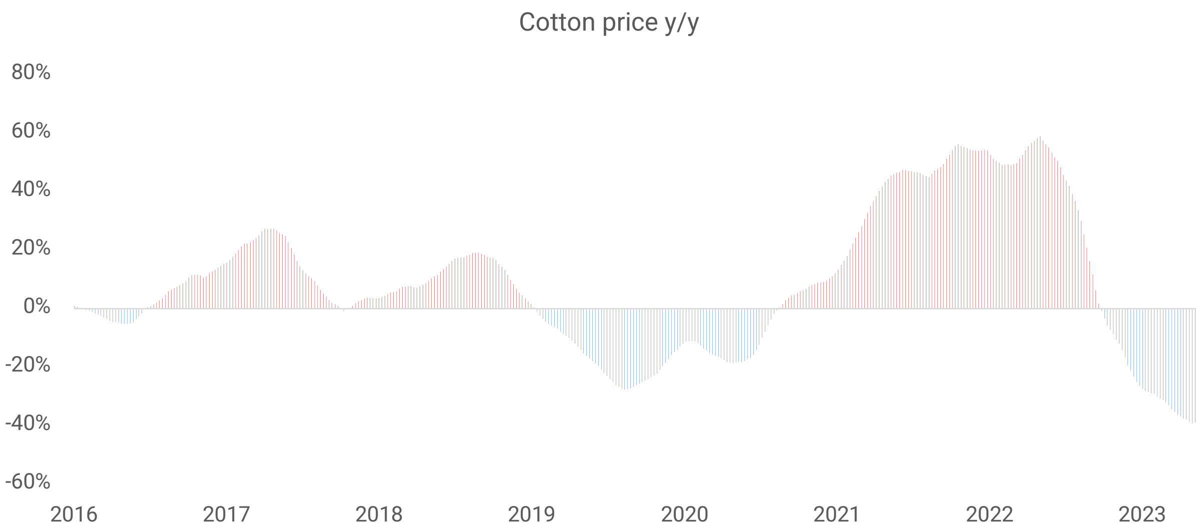
Looking forward, both issues are now repaired. Inventory is right sized, aided by improving demand. A message clearly delivered by DLA's largest customer (Walmart) and largest competitor (Gildan):

> *"In terms of inventory, we're in good shape. In stock is improving and excess inventory keeps coming down. We see it in the numbers, and I see it on store visits."* - **Doug McMillon, CEO Walmart Inc., May 2023**

> *"Most of the destocking has occurred and the inventory is in good position."* - **Chuck Ward, President of Sales Gildan Activewear Inc., May 2023**

Alleviation of excess inventories in retailer warehouses will allow a return to normal sales volumes for Delta Direct.

Cotton prices, the second issue, have come back to earth. Cotton prices affect Delta Direct's profit margins with roughly a nine month lag due to its need to hold large inventories. Beginning next quarter, the price of cotton attached to the items Delta Direct sells will be low enough for it recover full margins, owing to now 40% cotton price deflation.



In a normal operating environment, Delta Direct generates \$360m in annual sales at a 7% operating margin. Using a conservative 5x EBIT multiple, this business is worth ~\$125m – 79% higher than DLA's current market cap.

Delta Direct valuation	
Delta Direct sales \$m	360
EBIT margin	7.0%
EBIT \$m	25
Multiple	5.0x
Delta Direct value \$m	**125**
DLA market cap \$m	70
Delta Direct value premium	**79%**

Why DTG2Go is more valuable than DLA's current market cap

DTG2Go is among the world's foremost digital print garment manufacturers. It is still nascent but could become the most valuable asset in DLA's portfolio.

Digital garment printing is an innovative substitute for traditional Screen printing. Today, almost every artistic image or logo featured on a garment is placed via Screen printing. Screen is cost-effective in large volumes but inefficient for orders of less than 200 items. Screen also leaves environmental waste. The technology behind Digital printing of garment images is young but enjoying rapid growth due to cost advantages in small batch orders and environmental benefits. Digital printing is perfectly suited to serving the growing influencer-economy and corporate-branded attire.

DTG2Go is DLA's Digital print business. DTG2Go is among the largest in this space and has two competitive advantages:

1. It has 14 manufacturing facilities across the United States, allowing it to provide 1–2-day delivery to 90% of the US population. The major Chinese competitor offers delivery windows measured in weeks.
2. Delta Direct supplies DTG2Go with the blank garments it prints images onto. This synergy gives DTG2Go a cost advantage over peers forced to purchase blank garments from third-party suppliers.

The way to win in digital printing is to be the supplier of choice to large enterprises offering repeat business. DTG2Go recently won the business of Fanatics, one of the best customers in the market. Fanatics is valuable because its merchandise offering spans dozens of sporting leagues and thousands of individuals garments, all suited to Digital, rather than Screen printing. Fanatics brings large, consistent demand year-round.

As Fanatics scales with DTG2Go, the profit potential is immense. DTG2Go can improve from breakeven operating margins now to double-digit over the next two years. We spoke with two peers earning double-digit operating margins today.

> *"Margins on digitally printed clothing are incredible: you buy a blank t-shirt for $2, spend $1 adding the digitally printed art, then sell the t-shirt for $20."* – **Employee at Printful (largest competitor), July 2023**

Valuing DTG2Go is challenging because nobody knows how large the industry shift into Digital printing will be. Some analysts believe Digital will triple in size over the next decade. We value DTG2Go using today's $100m sales level, apply a 10% operating margin to reflect coming fixed cost leverage, and a 12x EBIT multiple for a $120m valuation. The implied 1.2x revenue multiple looks conservative relative to a peer of similar scale who raised capital at a 5x revenue multiple.

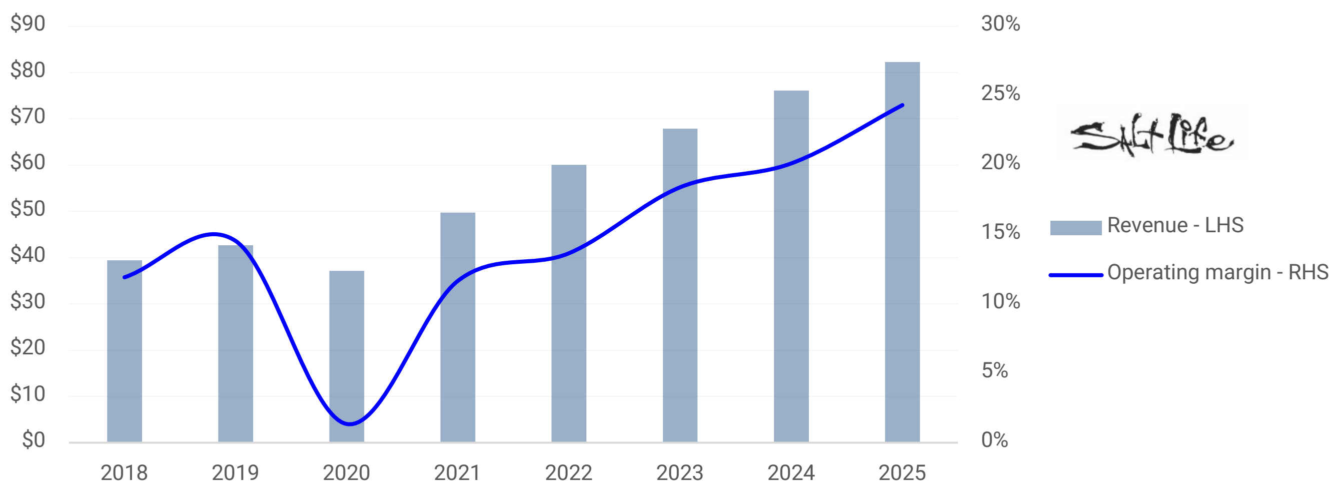
DTG2Go valuation	
DTG2Go sales $m	100
EBIT margin	10.0%
EBIT $m	10
Multiple	12.0x
DTG2Go value $m	**120**
DLA market cap $m	70
DTG2Go value premium	**71%**

Why Salt Life is more valuable than DLA's current market cap

Salt Life is an apparel/lifestyle brand, focused on the water, and has a lot of momentum. Sales have grown DD % CAGR since DLA acquired Salt Life ten years ago. Today, it is a $70m brand with mid-teens operating margins.

That this brand carries cache has a number of proofs. Salt Life has 2m followers across social media, millions of its distinctive stickers adorn car windshields, and there are brand licensing deals in beer and furniture. Perhaps most telling is a May 2023 New York Times article that seems to be explaining this ever-present brand to city people who don't spend time at the beach.

For DLA, Salt Life remains in growth mode. Retail store count doubled to 24 in the past two years. Its wholesale business is up 50% over that time due to more independent retailers stocking the brand. For FY24, Salt Life is on track to deliver another year of DD revenue growth and high-teens operating margins.



We value Salt Life using FY24 EBIT of $12m then apply a 10x multiple to reach a valuation of $120m. This valuation is conservative given Salt Life's brand awareness and strong earnings growth outlook. Within a timeframe of 2-3 years, we believe the business could be sold or even IPO at a valuation double or triple our current value.

Salt Life valuation	
Salt Life sales $m	75
EBIT margin	16.0%
EBIT $m	12
Multiple	10.0x
Salt Life value $m	**120**
DLA market cap $m	70
Sale Life value premium	**71%**

DLA is a stock with 150% consensus EPS upside, 4x intrinsic value upside, and 5x breakup value upside

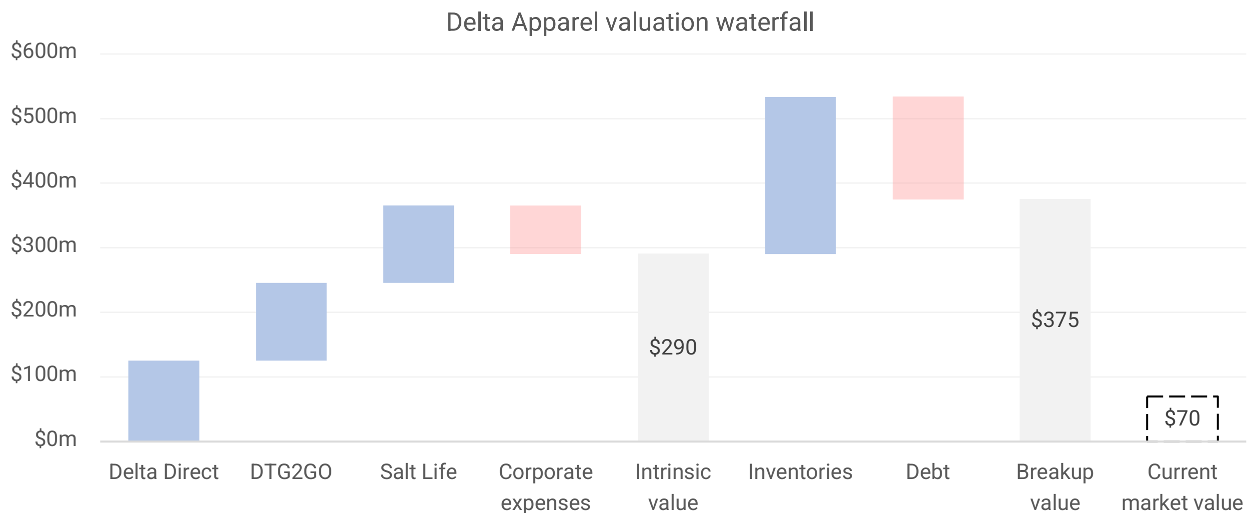
DLA's event path heats up immediately following its August earnings release. This should be the 'last bad print'.

All transient headwinds then dissipate in unison: lower volumes with higher priced cotton for Delta Direct, scaling Fanatics for DTG2Go, continued compounding of high growth rates at Salt Life.

This opportunity exists now because sellside and buyside analysts have predictably capitalized DLA's headwinds permanently into forecasts. We expect DLA can deliver FY24 EPS of $2.00 on just partial recovery from FY22-23 headwinds. This puts DLA at 5x EPS today. Consensus forecasts FY24 EPS of just $0.84, offering 150% upside between our forecast and consensus.

Summing our valuations for its three businesses, less corporate expenses, reaches an intrinsic value of $290m. This is more than 4x the current market value.

DLA does carry debt. However, its $150m facility is securitized against $235m of inventories, comprised of blank t-shirts that don't age or go obsolete. Adding inventories less their debt gives a breakup valuation of $375m – more than 5x the current market cap.



Miller Knoll, Inc. (MLKN) – New position

Miller Knoll (MLKN) is a collective of furniture and design brands that primarily furnish office workspaces for corporates.

This may sound like a terrible place to start. We don't believe it is, but the security is priced that way.

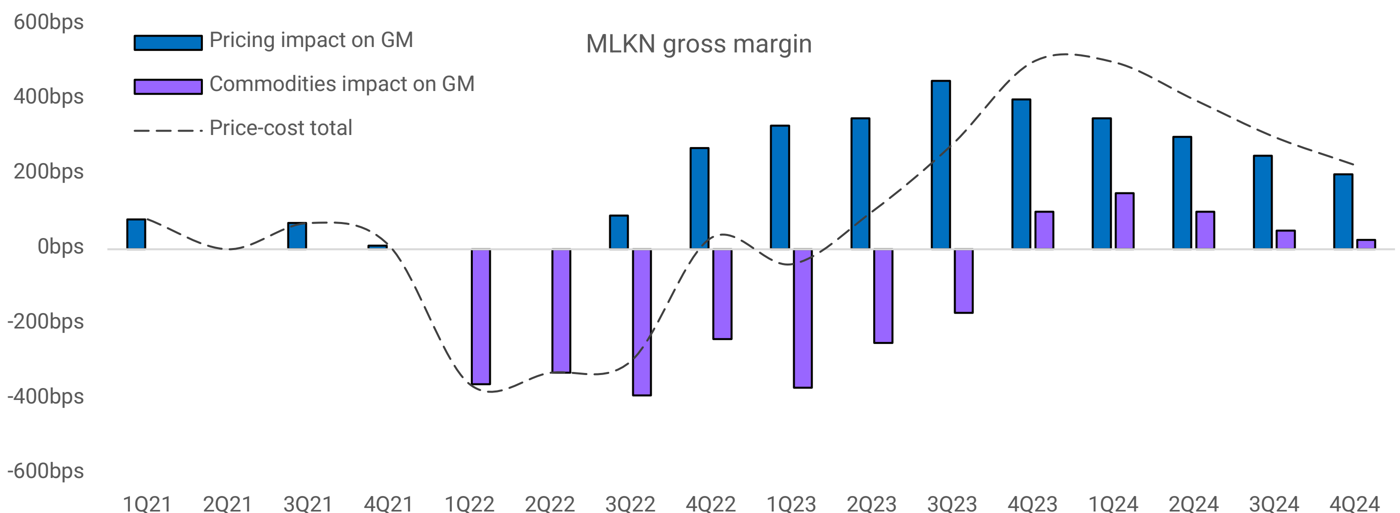
Our view is that MLKN's shares have been caught up in the well-publicized demise of major office REITs. The thesis is that offices will never again be fully utilized and therefore any business with office exposure is permanently impaired. The share price performance of major office REITs shows this thesis in action. MLKN shares have underperformed all of them.

Major office REITs		Share price since Jan 2022
Alexandria Real Estate Equities	ARE	-44.4%
Boston Properties	BXP	-42.6%
Cousins Properties	CUZ	-36.2%
Kilroy Realty Corp	KRC	-46.9%
SL Green	SLG	-51.3%
Office REIT average		**-44.3%**
Miller Knoll	MLKN	-54.0%

Our first point is MLKN can succeed without a full return to office. Changing of office spaces for that outcome benefits MLKN because it is literally the architect of the change A detailed McKinsey report published last week articulates that employers will have to adapt office spaces to "earn the commute" from employees. Office space adaptation is what MLKN does. In contrast, a 10% reduction in office space leased could be fatal for a highly levered office REIT.

Second, demand has picked up. Underwhelming orders in 2022 was a symptom of corporate nervousness around recession and rising interest rates rather than a long-term rejection of office. Corporates have now grown tired of being scared and are executing previously delayed remodels. We are also seeing more major corporates calling staff back to office on acceptance that productivity is greater there. All office furnishing peers have seen the lift in demand, suggesting a trend emerging.

Finally, MLKN has a strong idiosyncratic profit driver. Its office projects are commodity intensive (steel, lumber, oil) and take nine months from signing to completion, on average. MLKN sets project prices based on commodity prices at the time of signing then bears commodity price risk through completion. In a persistently inflationary environment, this is awful - it is constantly earning lower profit margins on projects because commodity prices keep inflating. Such a window has finally lapsed. Major commodities are now deflationary, while project pricing keeps going up. A double benefit to margins.



PROG Holdings, Inc. (PRG) – Exited position

PROG Holdings (PRG) is the country's largest lease-to-own provider. We shared our thesis on PRG in our December letter and updated it in our March letter.

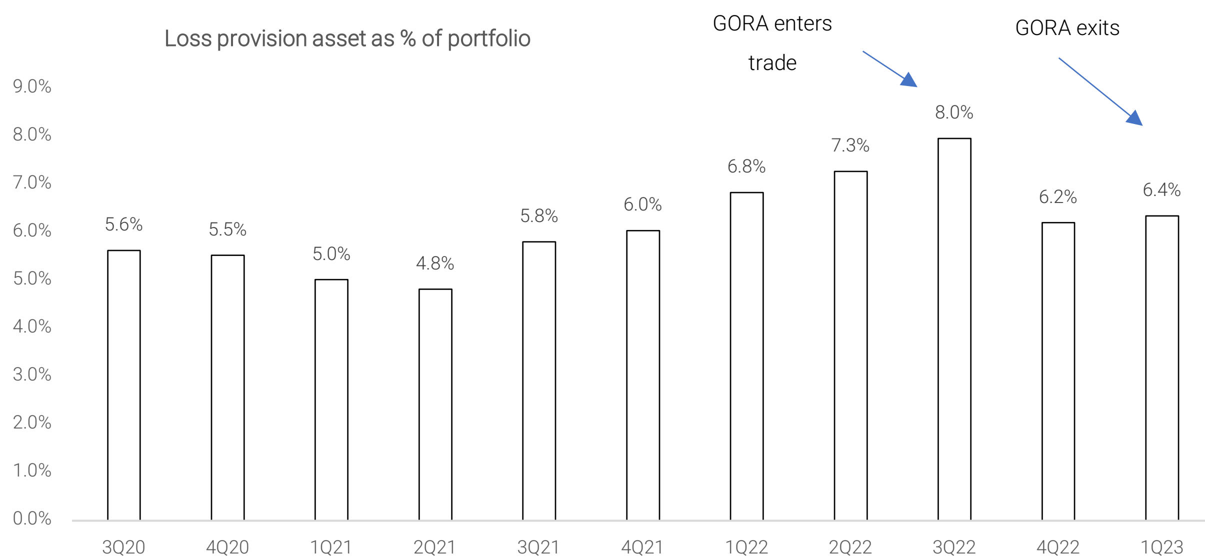
We closed the position in the June quarter, earlier than initially expected. Our key variant view became extinguished and with the share price up more than 90% in six months, its valuation was closer to intrinsic value.

Our key variant view was that PRG had over-provisioned for lease losses in 2022. Over-provisioning is damaging to the income statement in the short term, as it was for PRG in 2022. However, over-provisioning also creates a buffer against future losses. When future lease losses occur, the company can work down its loss provision asset instead of writing off the losses through its income statement - a profit tailwind.

PRG has done exactly this over the past two quarters. Since we entered the trade, PRG delivered quarterly earnings beats of 40% and 30% over the consensus estimate. The share price impact of the beats was magnified by deeply negative investor sentiment following earnings downgrades throughout 2022. As a result, the stock advanced from a P/E multiple of just 7x when we entered to 12x today. There should be no future tailwinds from loss provision releases, which means our near-term forecasts match consensus.

Looking further ahead, we have become concerned about the outlook for 2024. PRG's lease balance is likely to shrink precipitously in the coming months due to previously slow customer repayments returning to a normal cadence. This headwind will make growing earnings next year challenging. The market doesn't see this.

Finally, there continues to be scant progress in delivering new retailer partnerships for its service. This was another tenet to our thesis published at the beginning of the year. We believed the economy's transition from goods-scarcity with abundant consumer demand to over-inventoried store shelves lacking consumer interest would push major national retailers such as Walmart and Home Depot to consider introducing PRG's payment financing at its stores to stoke sales. No partnerships have come. While only six months is a limited window to expect partnerships, its absence is worrying. We think best to take profits and be on the sidelines for now.



Outlook

There has been a noticeable dip in stock correlations. This favors our bottoms-up investment process because it supports outperformance/underperformance of individual securities. It is a welcome reprieve from the macro-dominated markets of the past two years. We hope it continues.

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

James with Furniture Industry 40 under 40 award