GORA
GREAT OCEAN ROAD ADVISORS

January 2024

December 2023 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 +8.1%, net of fees and expenses.

The Retail sector (XRT) advanced +19.5% and the S&P 500 (SPY) advanced +11.7%.

The portfolio lagged indices in the December quarter due to its lower net exposure to markets, which delivered a strong year-end rally. While pleased to return +48% net to our investors in 2023, the most vivid year-end reflection is on investment errors, without which returns would have been higher.

Farfetch Limited (FTCH) we described in past letters (3Q22, 2Q23). The company had among the greatest value creation potential in our coverage entering the year, but poor execution squandered its opportunity. Inexplicably, the company entered administration in December despite having more than $500m cash and no near-term debt maturities.

The reverse error was made in investments such as TAST, CURV and MLKN. All names for whom in past letters we outlined a researched thesis that formed a contrarian view. These names would all more than double in share price within 12 months, but we sized them too small and exited too early.

A silver lining was that 2023 delivered another year of healthy alpha on earnings events. The fund experienced a more than 60% hit rate in all four quarterly earnings seasons. Earnings day events contributed more than 15ppts to returns this year.

Looking forward, we continue to work on our investment process. Our approach to portfolio risk management is improving and our network of industry contacts within our coverage verticals continues to grow. The recent return of high equities correlations is creating alpha opportunities for the months ahead, we believe. Our aim is to sustain the current mid-teens % annualized outperformance of our sector.

In broader business news, we are pleased to share that GORA has begun managing assets on behalf of two large institutional clients through structures separate to the Southern Endeavor fund. These client additions represent a milestone in our journey as an asset manager and a business. There will be no impact to the Southern Endeavor fund as a result of these engagements. Nonetheless, LPs with questions are welcome to reach out.

As always, our quarterly letter includes a series of position updates, so investors and readers better understand our process. This letter includes new positions The Joint Corp. (JYNT) and First Watch Restaurant Group, Inc. (FWRG), as well as updates on our investments in the pawnbrokers (FCFS and EZPW). We also share brief summaries of our closed positions in Carrol’s Restaurant Group (TAST) and Torrid Holdings Inc. (CURV).

The Joint Corp. (JYNT) – New long position

The Joint Corp. (JYNT) is the country's largest network of chiropractic clinics. Its 935 clinics are predominately franchised and use a private pay, non-insurance model.

We initiated a long position in JYNT during the December quarter. We believe this will be a muti-year position due to the coming series of value creating catalysts for shareholders.

The chiropractic industry and The Joint

Almost 40m U.S adults seek chiropractic care each year, supporting annual industry revenue of $20bn across 37,000 chiropractic locations. Industry revenue growth is supported by population growth, an aging population, and mid-single-digit price growth, consistent with the medical services sector broadly.

JYNT stands alone as the only chiropractic brand with scale. It was a first mover – quickly building a national footprint operated by motivated franchisees. Its brand communicates a welcoming environment that is professional and affordable. Average revenue per clinic at JYNT is higher than at all peers for whom data is available.

Chiropractor brand	The Joint (JYNT)	HealthSource	ChiroOne	<20 location brands
Locations	935	130	60	~36,000

$10 to $100 and back again

The share price chart for JYNT looks like Matterhorn mountain. Beginning at just under $10 five years ago, it rapidly ascended to $100 by mid-2021, before a perilous descent to below $10 again in late 2023.

The fact that JYNT's share price hit $100 when its business was smaller than today illustrates the latent potential in this investment. Its rise was driven by accelerating clinic development, healthy same store sales growth, and investor expectations for outsized earnings growth created by the natural operating leverage of a franchise business model. When these metrics are working, investors pay handsome valuation multiples for franchised brands such as JYNT. At its peak, shares traded at an EV/EBITDA multiple of more than 40x.

Unfortunately, strategic blunders by management caused its downfall. A decision to open large numbers of corporate locations bloated the expense base, eliminating the earnings growth that should have flowed from higher franchise royalty revenues. Ineffective marketing then slowed new patient inquiries across the network, eventually weakening same store sales growth. Disappointing earnings and slowing same store sales quickly deflated investor enthusiasm. JYNT's valuation dropped to less than 8x EV/EBITDA.

We believe both missteps are now being corrected and their benefit is not yet reflected in the share price.

A new Board appointment and a mandate for change

In November 2023, JYNT appointed Jeff Gramm to its Board of Directors. Gramm leads Bandera Partners, an activist value fund that is by far the largest shareholder in JYNT. Jeff has extensive Board experience and is the author of Dear Chairman, which covers a short history of activist struggles. He is well equipped to advocate for shareholder-friendly outcomes.

The day after Gramm's appointment, JYNT announced that it would be refranchising the majority of corporate-owned clinics. This shift in strategy offers major potential improvement to profitability, cash flow, and returns on capital.

Refranchising to unlock earnings upside, cash proceeds

Selling back to franchisees the corporate locations that contributed to the company's shortcomings over the past three years offers many benefits. A more focused and lean organization can better execute its core responsibility as franchisor – driving new patient inquiries to franchisee clinics. The volatile profit contributions of corporate-run clinics will be replaced by highly predictable royalty revenue streams. The company will also enjoy cash proceeds from selling the locations. Finally, refranchising brings the opportunity for G&A expense savings that will flow through to earnings. We believe this is the best source of upside unappreciated by the market.

Determining appropriate G&A expense for JYNT is difficult, but it is clear today's level is too high. In 2018, early in its life as a public company and with a system of 450 clinics, annual G&A expense was $20m. Today, with just over 900 clinics, annual G&A has inexplicably ballooned to $80m. Inflation and the pivot into corporate clinics explain some of the growth, but this outcome belies the inherent scale opportunities that come with franchised growth.

A comparison to JYNT's closest public peer, European Wax Center (EWCZ), is also unflattering to JYNT management. The two are similar in that they are both the dominant franchise brand in their space of health/beauty services (chiropractor vs. waxing), and both have a network of approximately 1,000 centers. Differences between the two all suggest EWCZ should have a higher annual G&A budget:

- EWCZ system sales are 2x larger than JYNT
- EWCZ operates an ancillary wholesale business supplying wax to its franchisees
- EWCZ's branding and marketing operations are larger and more complex due to waxing's discretionary nature
- EWCZ's technology is superior with a well-reviewed app that seamlessly coordinates client bookings

Despite EWCZ's more expansive G&A functions, its $50m annual G&A budget is nearly 40% lower than JYNT's current $80m budget.

Our thesis is that the process of refranchising and slimming down JYNT's business will reveal far greater savings opportunities than currently appreciated. The comparison to EWCZ and JYNT's own recent history suggests there may exist as much as $30m in annual G&A savings potential. A $30m G&A reduction opportunity dwarfs current JYNT total EBITDA of just over $10m. A $30m annual G&A savings opportunity even looks large compared JYNT's current enterprise value of $120m.

Accelerating same store sales

Same store sales growth drives valuation multiples for franchised companies and JYNT's same store sales have been slowing. The cause is a downtrend in new patient inquiries. The solution is a revamped marketing push. JYNT began this process in August 2023 through the hiring of Lori Abou Habib as its new Chief Marketing Officer. Her expertise is digital marketing where JYNT had been misfiring.

Over the past several months, we've built relationships with a number of JYNT franchisees. They lament the poor marketing of their franchisor, causing fewer new patient entering their clinics. That tone shifted noticeably in November. A new marketing campaign run through TikTok was apparently delivering improved new patient CACs. One franchisee offered that new patient inquiries, jumped from 80 per month over the past two years to 100 during a seasonally slow time of year.

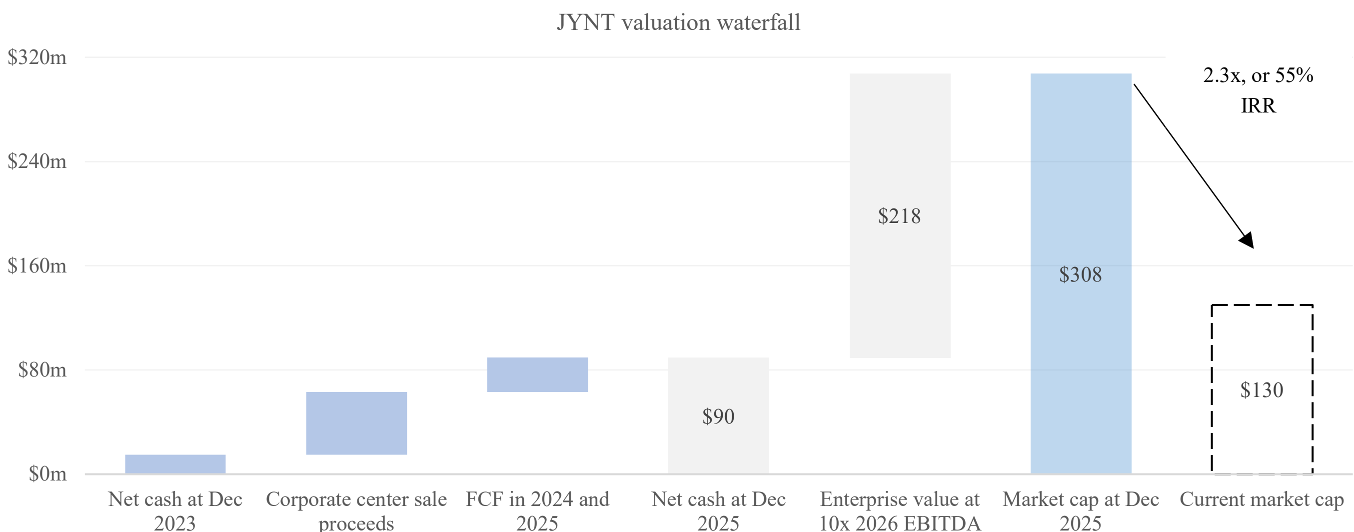
We expect this new marketing push will gradually translate those new patient inquiries into recurring patient bookings that drive same store sales.

The other two sales metrics besides new patient inquiries - conversion and retention – are both trending at record levels. This suggests that if the new brand marketing approach can reignite new patient inquiries, as we believe it is, there is potential for a strong positive inflection in same store sales.

Higher earnings and multiple drives 55% expected IRR

We conservatively expect that post-refranchising and G&A cuts, JYNT can generate EBITDA of $22m in 2026. A modest franchise multiple of 10x, implies an enterprise value of ~$220m. Current cash, future sale proceeds and coming FCF increases expected market cap above $300m by Dec 2025, a 55% two-year IRR.

Zooming out, our December investment was made at a share price of $8, the same share price as in mid-2019. Today, JYNT's clinic network is 2x larger, its balance sheet stronger, and the recent Board appointment of Jeff Gramm is encouraging for sound governance and capital allocation.



First Watch Restaurant Group, Inc. (FWRG) – New short position

First Watch Restaurant Group, Inc. (FWRG) is a made-to-order breakfast/brunch/lunch concept with 500 restaurants. Its first were in Florida, and it is now accelerating a nationwide expansion.

The fund initiated a short position in FWRG during December because we believe customer traffic will deteriorate, restaurant builds in new markets will underperform, and because the company earns an insufficient return on invested capital (ROIC) to justify restaurant development, even in its home markets.

We cover each of these short thesis points below:

Our first thesis point is that after four years of outsized menu price increases, customer traffic is weakening. FWRG has historically increased menu prices 2-3% per annum. However, in response to elevated cost pressures experienced since the pandemic, the company raised menu prices more than 30% since 2020. The natural customer pushback didn't initially occur because of brisk industry-wide business in response to post-pandemic reopening. That tailwind has ended and FWRG's traffic growth has turned negative. Our early January reads show further softening. We expect 2024 to be a year of traffic declines paired with a return to modest 2-3% menu price increases. This tepid sales outlook makes margin expansion challenging. A situation exacerbated by anniversarying unusually high deflation in 2023 for its core commodities of eggs, avocados and dairy. At today's market prices, FWRG should deleverage its cost of sales line in 2024 and deliver modest total earnings growth at best. The company's long-term guidance for mid-teens EBTIDA growth looks unrealistic.

Our second thesis point is that FWRG needs to expand into new geographies where restaurant performance is likely to be softer than in its home markets. The brand today is a regional concept. More than half its restaurants are in five states and more than one-third in just two (FL and TX). In order to meet ambitious growth targets set during the IPO, FWRG is opening more units in less desirable trade areas where the brand lacks recognition. This dynamic elevates risk of declining new restaurant performance dragging on profitability.

Our third thesis point is that FWRG restaurants generate insufficient returns on invested capital to justify its growth. We measure its restaurants earning just a HSD % return on invested capital. This is because FWRG restaurants deliver only industry-average sales and profit margins but require above-average capital spend to build and maintain. Its returns today barely exceed its cost of debt, leaving the equity return on a new restaurant near-zero. These underwhelming returns risk falling further given our two thesis points above. How this will manifest at the company level is a business that grows revenue but never generates meaningful net income or free cash flow.

FWRG's valuation appears vulnerable to correction if our thesis points play out. Shares trade at 45x 2024 EPS – a year in which we believe EPS is unlikely to grow. High capital expenditure plans mean FWRG is unlikely to generate any FCF over the coming 24 months and only modest FCF thereafter.

Finally, FWRG's financial sponsor, Advent International, continues to hold more than 50% of shares outstanding and will need to sell those shares into the market. Advent is seven years into its FWRG investment– the typical maturity window for private equity. It has already undertaken three secondary share sales since the IPO. All three were at prices at least 10% below the current share price. We expect Advent to expedite its investment liquidation in 2024 and therefore be a persistent source of selling pressure on shares.

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Pawn operators (FCFS and EZPW) – Position update

FirstCash Holdings, Inc. (FCFS) and EZCorp, Inc. (EZPW) are the two largest pawn shop operators in North America. Both are top-5 positions for the fund.

We wrote about each in prior letters: EZPW in June 2022, and FCFS in September 2023. Both have appreciated approximately 20% since purchase. However, we believe their intrinsic value increases have been greater and therefore, the market price discount to intrinsic value has widened. While we originally bought $1 of value for 70c, today we believe the market price reflects closer to 60c for each $1 of value.

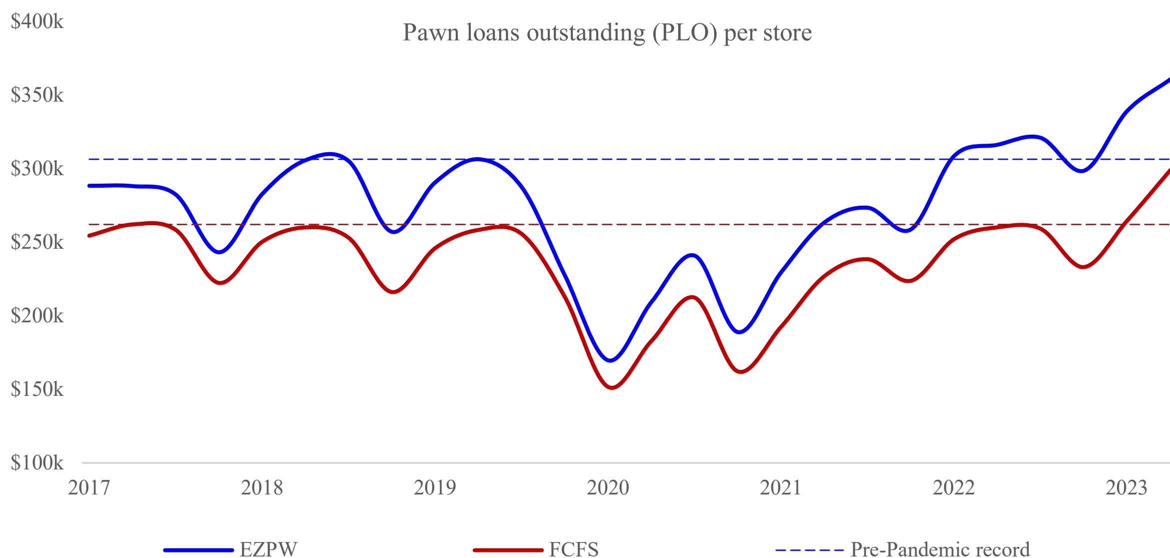
Recent earnings results show why. Since our investment, each has delivered operating profit beats to consensus averaging more than 20%. Importantly, each have grown their book of pawn loans outstanding (PLO) by mid-teens % y/y. PLO growth is valuable because these assets return 10%+ interest per month and have no associated variable costs. Operating leverage to PLO growth is substantial.

This strong pawn performance stands in stark contrast to mainstream goods retailers who have universally experienced challenging business over the past year. Bellwethers of goods retailing such as Best Buy (BBY), Home Depot (HD) and Macy's (M) are all seeing sales decline.

Tightening credit from traditional lenders is pushing some households away from mainstream retailers and into pawn, both for borrowing and shopping second-hand goods. Three data points lead us to believe this will continue:

1. Fed data shows aggregate credit card delinquencies hit their highest level in ten years in September 2023.
2. JP Morgan recently reported a 54% y/y increase in 90+ day credit card delinquencies.
3. Our conversations with private debt collectors called out a larger than usual pick up in holiday case files.

Our view is that worsening consumer credit metrics will cause banks to continue tightening, spurring more households into the pawn channel. The effect will be to further grow PLO at both FCFS and EZPW, underwriting another year of outsized earnings growth in 2024. With both stocks trading at valuation multiples below historic averages, we are looking for a multiple re-rating and earnings upside to bring their current 60c of market value closer to $1.



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

Carrol's Restaurant Group, Inc. (TAST) is the largest franchisee operator of Burger King restaurants, with over 1,000 BK locations in the United States. We first shared our investment case for TAST in our March 2023 letter and updated our view in our September 2023 letter. We exited the position in early January, realizing an approximately 400% return over our one-year investment.

Our initial thesis was that TAST's profitability would inflect higher. This would come from improved traffic to its restaurants driven by customer trade-down into quick service, as well as a temporary boost in marketing efforts funded by its franchisor, Restaurant Brands International (QSR).

While business trends did improve and TAST enjoyed a 3-fold increase in EBITDA profitability, its results were below our expectations. We reduced our position after the share price appreciated 200% in just a few months.

With the benefit of hindsight, that partial sale was a bad sale. In early January, TAST's franchisor, QSR, announced a takeover of all TAST shares for $9.55, almost 5x our initial purchase price one year earlier. We don't fully understand QSR's rationale for acquiring TAST. However, the acquisition is a reminder that mispriced securities can be noticed by strategic partners, even if not by the market.

We have added the capital invested in TAST to our position in The Wendy's Company (WEN). WEN announced in early January that it was replacing its long-serving CEO with a successful executive from PepsiCo, Inc (PEP). This could be a positive catalyst for change. WEN trades at an unsustainably cheap valuation of just 10x FCF per share, has enough cash on balance sheet to repurchase 10% of its shares outstanding, and is itself a takeover target.

Torrid Holdings Inc. (CURV) – Exited position

Torrid (CURV) is the largest direct-to-consumer brand of women's plus-size apparel and intimates in North America. It serves more than 3m repeat customers through its e-commerce site and 640 physical store locations.

We invested in CURV in September at a price of $2 per share and shared our investment case in our September 2023 letter. In the December quarter, we sold out of our position at an average price of $4.80 per share.

This rapid positive return was driven by two factors, only one of which we anticipated. Firstly, sales inflected positively, allowing CURV to deliver a large earnings beat over excessively depressed market expectations. This we anticipated.

Secondly, CURV shares became unavailable for borrow to short sell. While we highlighted in our September letter almost 90% of shares were owned by CURV's financial sponsor and management, we neglected to see that fact's corollary: that the number of shares naturally available to borrow and short sell was tiny. As a result, CURV's positive earnings update set off a short squeeze that manifested in shares tripling in just a few weeks. This we didn't anticipate.

Shares have re-rated from a FCF yield of 50% at the time of our purchase to 15% today. Meanwhile, our checks indicate sales have resumed their slump. We have therefore exited the position but, as with TAST above, regret selling some of the position too soon. We will continue to follow CURV shares closely for future alpha opportunities.

Outlook

In the two years of our fund's life so far, our sector has dropped 30% and the small caps we concentrate our investments in have underperformed the larger S&P500 benchmark with stunning consistency.

Instead of wishing for more favorable environments ahead, we have used this experience to continue refining our process. We are more cognizant of how broad macroeconomic themes can drive the cursory perspective most investors view our universe with. We continue to improve our approach to risk, portfolio correlations and position sizing.

It is highly achievable to deliver positive absolute returns in such a market with a strategy such as ours. Our LPs should continue to demand it.

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