GORA
GREAT OCEAN ROAD ADVISORS

April 2024

# March 2024 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 +4.8%, net of fees and expenses.

The Retail sector (XRT) advanced +9.4% and the S&P 500 (SPY) advanced +10.4%.

The portfolio lagged indices in the  March quarter due to its lower net exposure to markets, which continued to rally. We remain broadly skeptical of the rally as it relates to small-cap consumer equities given the breadth of companies reporting ongoing business weakness.

The largest contributors to March performance were long positions in pawnbrokers FirstCash Holdings, Inc. (FCFS) and EZCorp, Inc. (EZPW). Both businesses enjoyed positive earnings revisions and multiple expansion in response to quarterly earnings beats. However, as we share in this letter, the fund exited its pawnbroker positions in early April in response to their sharp share price appreciation and rising crowding among peer investors, which diminished the risk-reward.

Detractors included short positions in furniture and restaurant companies. Both subsectors enjoyed healthy rallies in the March quarter despite negative earnings revisions due to growing investor anticipation for coming interest rate cuts. We remain concerned for these subsectors because consumer demand continues to weaken further in early 2024. We describe two new short positions in this letter; Leggett & Platt, Incorporated (LEG), and Sleep Number Corporation (SNBR) - which both carry dangerously over-levered balance sheets. Our thesis is that time is running out for demand to improve while investors focused on the broadest macro signals are missing the micro of just how bad business has become.

Looking forward, we hold a large number of portfolio positions where we see a realistic case for their equity doubling by year-end. This is unusual given the performance of major indices. However, the recent increase in share price dispersion paired with material underperformance by small caps has created a number of diamonds in the rough. Investors typically don't need to own these businesses, nor do they care to. Hence, opportunities are created. The best example here is J. Jill, Inc. (JILL), whose thesis we outline in this letter.

As always, our quarterly letter includes a series of position updates, so investors and readers better understand our process. This letter includes new positions J. Jill, Inc. (JILL), Leggett & Platt, Incorporated (LEG), and Sleep Number Corporation (SNBR), as well as the closing of our position in the pawnbrokers (FCFS and EZPW).

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## J. Jill, Inc. (JILL) – New long position

J. Jill, Inc. (JILL) is an apparel brand serving affluent, middle-aged women through 240 physical store locations and an e-commerce website.

JILL became a top-5 long position for the fund in the March quarter because we believe its sales are accelerating, which will drive large positive operating leverage, and because the pending paydown of its expensive debt can boost EPS by 25%. These two forces mean if the current share price holds, JILL will be trading at just under 5x EPS within 12 months – the cheapest valuation in our coverage. This for a business consistently delivering high-teens EBITDA margins and 30% ROIC.

JILL is unloved as a public company. It was IPO'd by private equity in 2017 as a high-growth retailer and promptly experienced a disappointing growth slowdown, followed by a near-death experience during the pandemic. Its management team has since improved, the brand has sustained a 30% increase in sales per store vs. pre-pandemic, profit margins have expanded, and it is back to growing its store footprint. As proof of its turnaround, JILL has beaten the consensus earnings forecast every quarter since sellside coverage resumed in 2021.

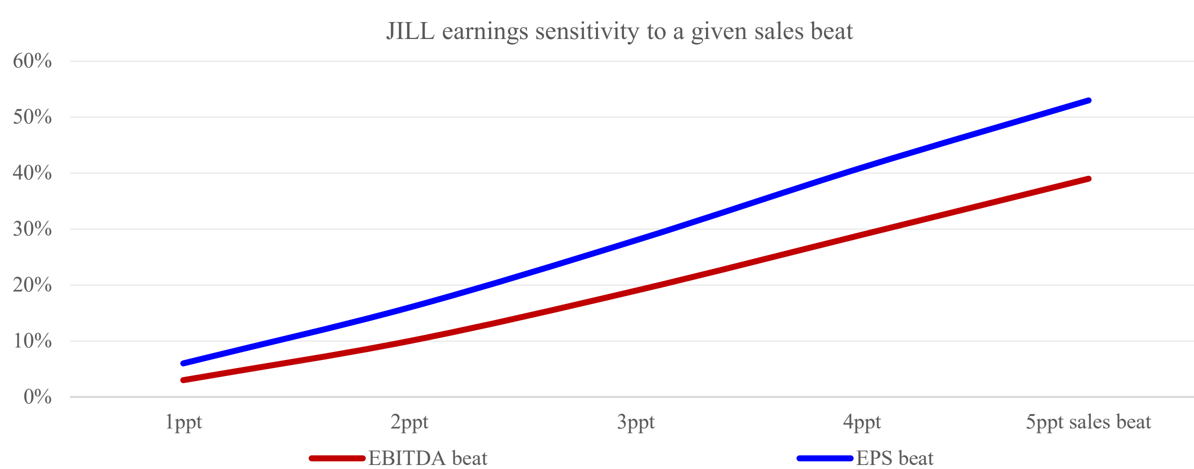
Despite this, the market hasn't taken notice. Shares trade at 4x EV/EBITDA and a 20% FCF yield. Two 2024 catalysts may cause investors to value JILL shares appropriately.

**Catalyst 1: Accelerating sales disproportionately boost EBITDA**

We believe sales growth at JILL is accelerating. A combination of store calls and four independent alternative data sources we track all indicate improving customer spend. Our work reading demand at JILL has a strong historical record of accuracy, and allowed the fund to earn returns in JILL in 2023.

We are particularly interested in detecting a sales inflection at JILL because the incremental profit margins on mono-branded apparel are higher than for any other consumer category we cover. The reason is that the core product margins on mono-branded apparel often exceed 75%, while much of the remaining cost structure is fixed in nature. Incremental purchases therefore deliver a high profit contribution because so much of the cost base doesn't flex with sales.

For example, we forecast JILL sales are tracking 3% ahead of the consensus estimate, which flows through to an EBITDA forecast 20% ahead, and EPS 30% ahead of consensus, respectively. No small beat for a shorted retailer trading at 7x EPS.



**Catalyst 2: Expensive debt can now be repaid**

JILL's awkward credit agreement will soon be available for principle paydown, unlocking significant interest savings. JILL currently carries gross leverage of 1.5x (gross debt/EBITDA) and is charged an effective interest rate of 15% on this debt. For the past three years, just shy of 30% of JILL's operating income went to interest payments. The missteps and misfortunes that explain why JILL carries such expensive debt are not necessary to explain. What's important is that the window in which JILL can repay this debt finally opened in April 2024.

We expect a steady paydown of JILL's entire facility over the next 24 months, saving the company ~$25m in annual interest expense. These savings drop right through to equity investors. $25m of savings is an extremely helpful tailwind for shareholders in a company's whose adjusted operating income averaged $75m over the past three years. In fact, of our 50% upside variance to the consensus EPS forecast for 2025, more than half of this variance is driven by lower interest costs the street is not seeing.

**$60 target price 12 months out –140% upside**

Accelerating sales at a mono-branded apparel retailer paired with interest savings from debt repayments leaves current consensus forecasts for JILL looking very stale.

We expect JILL can deliver $5.50 of EPS in 2025 vs. the current consensus of $3.60.

This variance is incredible given we model sales only 3% ahead of the street - simply capturing the recent business acceleration our brand signals have detected.

Our target price for JILL 12 months out is $60, more than 140% above the current share price of $25. This scenario sees JILL trading at a PE multiple of 11x our EPS estimate, consistent with its historical average and below the peer average.

We display below alternative scenarios for JILL. The stock's high short interest and modest starting valuation leaves scope for an overshoot outcome, in which shares trade above $70.

This investment is particularly attractive because even if our signal of accelerating sales proves wrong, there is a full $1 of EPS not captured in street numbers from the pending debt repayments. This backstops our downside case even in a scenario where sales decelerate.

| | | P/E multiple | | | | |
|---|---|---|---|---|---|---|
| | | **9.0x** | **10.0x** | **11.0x** | **12.0x** | **13.0x** |
| **2025 EPS** | **4.50** | $40.5 | $45.0 | $49.5 | $54.0 | $58.5 |
| | **5.00** | $45.0 | $50.0 | $55.0 | $60.0 | $65.0 |
| | **5.50** | $49.5 | $55.0 | $60.5 | $66.0 | $71.5 |
| | **6.00** | $54.0 | $60.0 | $66.0 | $72.0 | $78.0 |
| | **6.50** | $58.5 | $65.0 | $71.5 | $78.0 | $84.5 |

| 1 year upside to current share price | | | | |
|---|---|---|---|---|
| 62% | 80% | 98% | 116% | 134% |
| 80% | 100% | 120% | 140% | 160% |
| 98% | 120% | 142% | 164% | 186% |
| 116% | 140% | 164% | 188% | 212% |
| 134% | 160% | 186% | 212% | 238% |

## Leggett & Platt, Incorporated (LEG) – New short position

Leggett & Platt, Incorporated (LEG) is a manufacturer specializing in furniture, mattress and automotive components. Its customers are the major global manufacturers of these products as finished goods.

The fund is short LEG shares because the company's stubborn adherence to growing its dividend in the face of declining business performance has jeopardized its financial stability. Further, now that the company will have to cut its dividend, we expect outsized selling as a result of unusually large holdings by dividend ETFs.

**Weak end market demand**

LEG's problems began with persistently weak end market demand. Its largest exposure is to the US mattress industry where demand volumes have declined for consecutive years to a level of demand per capita below the troughs of the financial crisis of 2007-08. Through the first four months of 2024, mattress demand is declining further still. Exacerbating the issue of industry weaknesses, low-cost Asian competitors are winning share from LEG. Its largest mattress customer, Tempur Sealy International, Inc. (TPX), is in-housing elements of its components production. Finally, an ill-timed acquisition of a bed-in-a-box foam producer at the peak of excitement for that product in 2019 has been a significant drain on capital, profits and management energies. The result of these headwinds is LEG has lost ~30% of its mattress volumes since 2019 and is expected to lose at least a further 5% in 2024. The realities of fixed cost deleverage on manufacturing means EBIT margins for LEG's mattress products have shrunk from +DD% in 2019 to barely +5% today.

This story repeats across LEG's other product segments. The residential furniture industry remains in a slump and LEG's largest customer within that space, Miller Knoll, Inc. (MLKN), is attempting to course-correct its own strategic blunders. Demand for their home furniture products has fallen 25% over the past two years. Automotive production globally has also been slowing, driven by economic weakness in China and Europe. LEG's contracts for automotive components work in lockstep with total unit production by the major OEMs. Therefore, its automotive business is highly sensitive to softening global output.

Said another way, nothing is working for LEG.

**Creating a significant dividend problem**

Which makes its dividend a large problem. LEG has famously grown its dividend every year for more than fifty years. It has perhaps the best track record of dividend growth of any company in the S&P500.

During the recent two-year period in which EPS halved, DPS grew 10%. The result is LEG's payout ratio has ballooned from 60% in 2021 to 130% in 2023, and would become 180% in 2024 using GORA earnings estimates, if it is not cut.

LEG's creditors don't like what they see. Its leverage ratio (net debt/EBITDA), which for more than ten years was stable around 1.5x, has been stuck at 2.5x for the past three years, and is now moving through 3.0x due to the declining EBITDA profile of its business. Sustaining the current dividend requires diverting all free cash flow to dividend payments, instead of prudently paying down its now bloated debt balance.

The March 2024 amendment to LEG's credit agreement, designed to accommodate it breaching prior covenants, makes clear something has to give. The amendment temporarily lifts the allowable leverage ratio to 4.0x – a limit implying EBITDA could fall a further 20%. At that level of EBITDA erosion, LEG could only sustain its current dividend through a payout ratio as high as 180%. Given how reckless that outcome would be for a company in breach of covenants, it seems certain the LEG dividend will finally be cut.

The press release announcing the amendment effectively confirmed the cut is coming – M. Dolloff (CEO – March 2024):

*"As a Board and management team, we are carefully evaluating capital allocation priorities, including the amount of cash allocated to our dividend program."*

**Earnings cut; dividend cut**

The event path from here is likely to be a cut to LEG's earnings outlook during 2024, paired with a dividend cut.

Our checks show no improvement in end markets. Frustratingly for LEG, its customers also appear to be running leaner on inventories and therefore ordering lower volumes than they are selling through. Perhaps more worryingly, many of LEG's customers have their own struggles caused by the demand downturn and are seeing their access to credit tighten. LEG may face the unenviable decision between increasing its risk of bad debt by supplying these customers, or missing sales due to an unwillingness to extend payment terms during a time of customer stress.

The result is LEG is likely to earn below $1 in EPS, which makes its current share price of around $20 look expensive.

More importantly for us, a dividend cut could be damaging for the stock. 11% of its shares are owned by passive ETFs whose mandates are in some way tied to dividends. Not all of these shares would need to be sold with a dividend cut, but we believe many would. We identified numerous shareholders whose mandates specifically call for the issuer to be growing its dividend.

A fair question to ask is whether these passive ETFs can detect a dividend cut may be coming and reduce their exposure ahead of it? We think this is unlikely. There has been no material selling of LEG shares by dividend ETFs, and in fact on balance they have been *net buyers of LEG shares over the past six months*. The warning signs appear to have been missed.

| ETF provider | LEG shares owned within dividend ETFs | Dec 31st filing |
|---|---|---|
| State Street | 3,630,047 | No trades |
| Charles Schwab | 3,046,787 | Bought |
| Blackrock | 2,831,648 | Bought |
| Invesco | 2,012,612 | No trades |
| Proshares Advisors | 1,268,579 | Bought |
| WisdomTree | 738,342 | Bought |
| Vanguard | 588,496 | Sold |
| UBS | 211,175 | No trades |
| Goldman Sachs | 175,900 | No trades |
| Credit Suisse | 150,220 | Sold |
| **Total** | **14,653,806** | |
| Percentage of total shares outstanding | 11% | |
| Trading days to sell at 10% of volume | 80 | |

## Sleep Number Corporation (SNBR) – New short position

Sleep Number Corporation (SNBR) is a manufacturer and retailer of Sleep Number branded smart beds.

The fund has previously been short SNBR shares, and re-engaged the short position following SNBR's earnings in April. We are short SNBR shares because we believe time is running out for demand for its mattresses to improve. We view SNBR as having now entered a window where in any given month a supplier or creditor could set off a downward spiral for its business. We see a real likelihood the equity in SNBR will be wiped out by year-end.

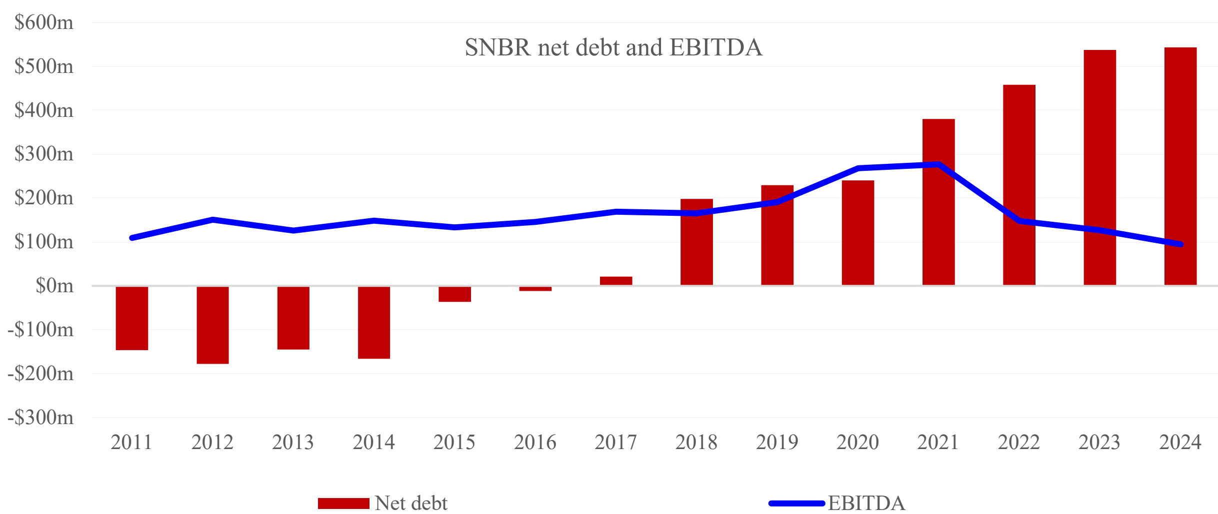
SNBR's first problem is straightforward to understand. Demand for its mattresses is highly cyclical. Demand boomed in 2020-21 when pandemic-induced lockdowns and government stimulus spurred home goods demand. Now, demand has fallen. Also, when demand was strong, SNBR raised its prices by almost 20%. There are fewer shoppers today and they have become more discerning, penalizing SNBR for the perceived poor value in its products. The result is SNBR stores, which at peak sold 16 mattresses per week on average, today sell only 9.

SNBR's second problem is self-inflected. It used the cash windfall when times were good to repurchase its shares, then borrowed a further $500m to keep buying back its stock. Now EBITDA has cratered, and the company is dangerously over-levered. The latest credit amendment reads clearly like it's the last one SNBR will receive. It included both a temporary increase to SNBR's maximum allowable leverage, and a redefining of the leverage ratio to be more accommodating.

Even with these accommodations, SNBR's 2024 guidance to investors only just fits within the new covenant limits. We are skeptical the company can achieve its 2024 outlook and point to three suspect assumptions within it:

1. SNBR's EBITDA guidance is predicated on a meaningful demand improvement in 2H24 relative to 1H24. No such signs of improving demand have been picked up in our industry checks.
2. SNBR's EBITDA guidance assumes cutting major expense lines to levels below 2015, but without any detrimental effects on sales.
3. SNBR's FCF guidance includes a large cash inflow from working capital when suppliers are tightening terms.

In summary, we believe SNBR's financial projections are an example of where management smile and grit their teeth – hoping things will work out. The company's carries negligible cash. Refusal to extend terms from a supplier, or another bad month of sales necessitating a downward revision to its guidance could set off an unwind from which it can't survive.



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## Pawn brokers (FCFS and EZPW) – Exited positions

FirstCash Holdings, Inc. (FCFS) and EZCorp, Inc. (EZPW) are the two largest pawn shop operators in North America. Both were top-5 positions for the fund, which we have written extensively in past letters (4Q23, 3Q23, 1Q23, 2Q22). We sold out of both positions shortly after the close of the March quarter.

The reason we sold was that the risk-reward had become less attractive, in our view. Both positions had appreciated approximately 40% since our first investment. We observed both mentioned as attractive counter-cyclical investments in peer fund letters and discussed at investor conferences, leading us to believe positioning was becoming crowded. Finally, although pawn loan demand remains robust, both companies have begun to demonstrate the inevitable pernicious consequence of sustained tailwinds for an industry – being that cost inflation steadily creeps into their business and blunts the upside benefit of strong demand for shareholders.

We will look to re-enter these positions in the event of a sell down in their share price, or if we observe a further step change inflection in demand.

## Outlook

We are maintaining a balanced portfolio with lower-than-normal net market exposure. The risk of macro shocks to the portfolio remains elevated, even if they are obfuscated by temporary bursts of market excitement.

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**