GORA
GREAT OCEAN ROAD ADVISORS

October 2023

September 2023 letter

Dear Fellow Investors,

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

For the September quarter, the GORA Southern Endeavor Fund advanced +6.2%, net of fees and expenses.

The Retail sector (XRT) retraced -4.2% and the S&P 500 (SPY) retraced -3.6%.

The September quarter was challenging. Markets are extending scant goodwill to the small cap consumer stocks we focus on. Nonetheless, fundamentals drive long-term performance and we are beginning to observe that reality play out.

The largest absolute contributor was negative – Farfetch (FTCH) dragged 6ppt from fund returns in the September quarter. We reduced the position but view this stock as holding among the greatest convexity of return profiles we have observed in our career. We encourage investors to read our FTCH update below.

We had a number of positive contributors, equally split between long and short sides of the portfolio. We have taken profits in TAST, described in our 1Q23 letter and below. MLKN delivered a surprisingly rapid 50% return on two good earnings updates. We described this investment in our 2Q23 letter, but have exited the position given our checks into the space are turning cautious. On the short side, we generated modest positive returns on shorts in the casual dining and furniture space.

Looking forward, we are as enthusiastic as ever about the opportunity set. We strongly encourage readers to parse through our investment case for FirstCash (FCFS) and Torrid Holdings (CURV), both detailed in this letter. We outline a variant view based on our unique knowledge of these businesses. We attempt to articulate where the market is misunderstanding their fundamentals and prove why our base case is more likely to occur and be rewarded.

In non-investment news, GORA Portfolio Manager, James O'Brien, was featured on The Business of Home Podcast, hosted by Dennis Scully, in September. Dennis is an expert within the home furnishings/interior design space and shared interesting takes as an industry insider on companies active within our fund's portfolio. A link to the podcast can be found here.

As always, our letter includes a series of position updates, so investors and readers better understand our process. This letter includes new positions FirstCash (FCFS) and Torrid Holdings (CURV), as well as updates on Farfetch (FTCH), Carrol's Restaurant Group (TAST), and Delta Apparel (DLA).

FirstCash Holdings, Inc. (FCFS) – New position top-5 position

FirstCash (FCFS) is the country's largest pawn broker and third-largest lease-to-own provider.

Its pawnbroking business encompasses 1,100 US stores and 1,700 stores spread across Latin America.

In 2021, FCFS acquired American First Finance (AFF), its lease-to-own business. AFF provides virtual lease-to-own financing to customers at over 10,000 merchant locations throughout the United States.

FCFS became a top-5 position in the quarter because it is a high-quality business trading at a discounted valuation, and we identified two sources of coming upside not captured by the market.

The two sources of upside are:

1. The demand for pawn services continues to grow, driven in part by tightening credit standards at traditional lenders. Furthermore, the recent acquisition of 80 private pawn locations in the United States adds a step change increase to pawn segment earnings.
2. AFF has been over-provisioning its lease losses. These will soon be unwound, boosting earnings.

Regular readers (though I may be flattering myself) may notice parallels with the investment theses of EZCorp (EZPW) from our June 2022 letter and PROG Holdings (PRG) from our December 2022 letter. Our investment in FCFS benefits from both of these forces, namely the acceleration of pawn demand similar to EZPW and an accounting nuance in lease-to-own bringing unexpected earnings upside, as with PRG.

Thesis point 1: Growing pawn loan demand and the powerful earnings flow-through it creates

Few consumer categories are enjoying consistent demand growth currently. Pawn is a clear positive exception. Demand is surging because excess savings accumulated through pandemic government stimulus programs are depleting.

Meanwhile, rising interest rates are causing traditional creditors to tighten lending standards. When they tighten, they don't do so uniformly across the income/wealth spectrum. Instead, they limit access for borrowers perceived as lower quality. Those borrowers are more likely to use pawn lending. Credit tightening is therefore reducing pawn's competition, just as demand is increasing.

The result is robust pawn loan growth for FCFS. And their growth affects earnings in a magnified way because pawn loans are essentially assets returning 10%+ per month, with no associated variable costs. For FCFS, its US pawn loan book is growing +9% on an organic basis. Add to that the Sept. 2023 acquisition of 80 private pawn locations from Fortress Capital, and we can reliably underwrite mid-teens EBITDA growth for its pawn segment over at least the next 12 months.

FCFS Pawn business	2018	2019	2020	2021	2022	2023	2024
Pawn loan income	525	565	458	476	561	651	750
Growth %		*8%*	*-19%*	*4%*	*18%*	*16%*	*15%*
Other pawn revenue	1,199	1,279	1,172	1,191	1,369	1,565	1,664
Growth %		*7%*	*-8%*	*2%*	*15%*	*14%*	*6%*
Pawn EBITDA	403	423	349	395	475	551	625
Growth %		*5%*	*-17%*	*13%*	*20%*	*16%*	*14%*

Thesis point 2: Lease provision reserve release – among the least interesting topics in the world

But valuable to understand. We highlighted this dynamic for PRG less than 12 months ago and the stock has appreciated more than 100% since then. A few things went right, but PRG's lease provisioning dynamics had a material effect.

FCFS is where PRG was 12 months ago.

A full explanation of this lease accounting quirk can be found in our Dec 2022 PRG note. However, here's a quick summary:

Lease-to-own providers, such as FCFS and PRG, record expected losses on their leases at the moment the transaction occurs. For example, if a customer purchases a $1,000 television through an LTO payment plan, the LTO provider might record a $100 anticipated loss for future missed payments, even before the customer has taken the TV home. Since no actual economic loss has occurred, this accounting loss is offset by an asset known as a lease provision reserve, which remains on the balance sheet until, and if, the customer ceases making payments.

Because LTO providers don't know how many customers will eventually miss payments, there is subjectivity in how big a provision they should record. If they over-provision, short-term profits are hurt because of the high lease provision expense hitting their income statement, but long-term profits are boosted because they can eventually under-provision on future leases due to the large reserve asset already on their balance sheets.

Since FCFS acquired American First Finance in 2021, it has adopted a conservatism-squared approach to its lease provisioning. This has made sense to do. For three decades as a public company, FCFS has been a pure-play pawnbroker whose loans never lose money because they are fully collateralized. By acquiring AFF, it was introducing risk of losses on its LTO leases. To mitigate the risk of surprising investors with a toxic lease book, FCFS have been over-provisioning. Over-provisioning causes a consistent dampening on profits, but never a shock loss.

Meanwhile, the leases themselves are performing quite well. During the past 12 months, for every $1.00 of loss provision reserved, realized losses have only been about 70c. The result is a steadily building lease provision reserve asset.

The lease provision reserve is now too high. Starting with its 3Q23 earnings, we expect the lease provision reserve asset will be 'worked down', by recording relatively less in provision expense than is being charged-off as a realized loss. Profits will benefit. The market will be surprised because this dynamic is not understood by analysts who set "consensus" expectations.

Further, this will be material. Over-provisioning has dragged on FCFS EBITDA by $37m over the past five quarters, a 6% drag on profits. That should now flip to a $17m EBITDA boost over the next six quarters, on our estimates... A 6% profit drag becoming a 2% boost is a nice ace to hold.

	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24
	Historic results						*Forecasts*					
Reserve as % of leased portfolio	20.9%	27.0%	26.5%	23.6%	26.6%	30.0%	29.2%	28.0%	27.6%	27.2%	26.6%	25.9%
EBITDA impact from (build) / release	0.0	-17.9	-3.5	6.3	-12.0	-10.5	4.1	5.3	1.4	1.5	2.2	2.8
	Period of reserve build, hurts profits						Period of reserve release, benefits profits					

Catalysts and valuation

The two sources of fundamental upside above should cause FCFS to beat current consensus EBITDA estimates by ~20% through 2024. That is large variance for a high-quality company like FCFS.

FCFS EBITDA $m	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24
GORA forecast	148.5	180.6	153.5	155.0	174.3	197.8
Consensus forecast	124.2	148.3	139.0	130.2	142.5	162.6
Variance	*20%*	*22%*	*10%*	*19%*	*22%*	*22%*

We have sized this investment up to be top-5 because we have very high visibility into this outcome. Pawn loan revenue is sticky. Its recent growth is also understandable within the context of an economy experiencing financial tightening, inflation, and a depletion of savings. Our thesis of lease provision reserve release is something we can quantify and test. We've also, frankly, been right on this thesis point for peer companies in the past.

FCFS shares are trading at an all-time historic low valuation on our forecasts. We acquired our position at a valuation of 8x forward EV/EBITDA. Shares have never traded below10x consensus EBITDA. That valuation may sound rich but is deserved for a company whose underlying ROIC has never fallen below 25%.

Our forecasts simply being right leads to a 30% return in the next nine months to the current valuation, and closer to 50% return on a normalized multiple.

Finally, management are well regarded by the investors. They have proven themselves capable capital allocators. They have a track record of successful acquisition as well as returning capital to shareholders through dividends and share repurchases at prices below current levels.

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Torrid Holdings (CURV) – New 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 are invested in CURV because its business is inflecting positively, shares are unsustainably cheap, and highly shorted. Finally, there is a reasonable case that CURV becomes a takeover target.

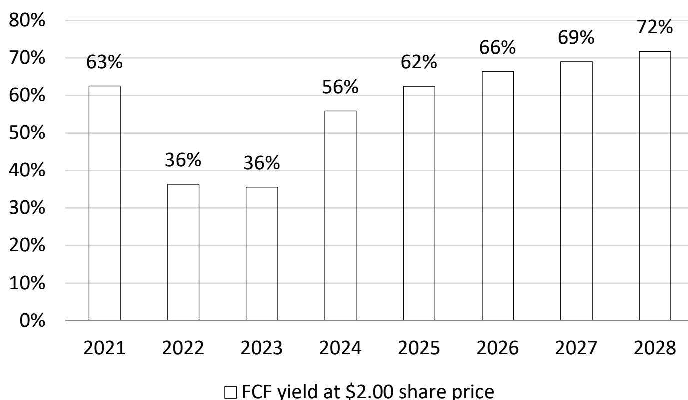
CURV has a strong brand and a good business, but IPO'd at the wrong time. It is among the 2021 class of IPOs - the last round before capital markets closed. There remains deep skepticism towards this group of companies by equity investors. For CURV, its IPO coincided with peak retail spending for women's apparel. It has reported progressively softer results each quarter since. A CURV share price chart tells this story well. From its IPO price of $21 two years ago, we have been able to purchase shares for just $1.50.

We believe business has bottomed and is improving. We can observe this through a number of sources: high-frequency data sets show inflection, at store visits we hear of improvement, and we have heard from peer retailers that their business picked up after summer travel. We are convicted that for the first time since its IPO, there is upside to consensus estimates.

There is a behavioral element to our higher-than-consensus forecasts too. CURV management, like many consumer management teams, have become wary of forecasting their business through formal guidance only to disappoint expectations due to the volatile ebbs and flows of the current environment. As far as we can tell, management have given up on forecasting their business in any calculated manner when setting guidance and have arbitrarily selected the worst recent month of sales then presumed that level persists for the balance of the year.

Investors being investors have taken CURV's guidance seriously. Believing management has some greater visibility into future sales, consensus estimates have homed in on this new excessively conservative guidance level. The valuation multiple has contracted too. As luck would have it, business now appears to have gotten better – much better than what is embedded in guidance. We therefore acquired shares at an EV/EBITDA valuation of just 3.0x, and FCF yield above 50%.

Finally, CURV's shareholder registry makes it an interesting investment. Major PE firm Sycamore Partners IPO'd the company and retains 79% ownership. Management insiders account for the majority of the rest. The value of CURV shares not owned by Sycamore or insiders is less than $20m. Said another way, Sycamore could take CURV private again, then reintroduce it to public markets during better times for a check size of just tens of millions. Not bad for a business with $1.2bn in annual sales and EBITDA around $150m. Also, very doable for a PE group with more than $10bn in committed capital. Sycamore took private Chico's (CHS) in September at a 65% premium, suggesting they have appetite.



Investor	Role	% Outstanding
Sycamore Partners	***Financial sponsor***	***79.1%***
Lisa Harper	***Insider - Management***	***5.4%***
Mark Mizicko	***Insider - Management***	***2.2%***
Elizabeth Munoz	***Insider - Management***	***2.0%***
George Wehlitz	***Insider - Management***	***1.6%***
Gilder Gagnon Howe	Active investor	0.9%
BlackRock	Passive investor	0.8%
Timothy Martin	***Insider - Management***	***0.4%***
Vanguard	Passive investor	0.4%
Michael Salmon	***Insider - Management***	***0.3%***

Farfetch Limited (FTCH) – Reduced position, looking to add back

Farfetch (FTCH) is the world's foremost luxury e-commerce platform. It operates its own marketplace (Farfetch.com) as well as powering the e-commerce of brands and department stores globally (Farfetch Platform Solutions, FPS).

FTCH was the fund's largest detractor in the September quarter, dragging 6ppts from returns. During the quarter, FTCH delivered an earnings update that included pushing out the launch dates of major new partners joining FPS and tempering sales forecasts for its own Farfetch.com website. In theory, these should have an immaterial impact on FTCH's intrinsic value. In practice, the market's faith in FTCH was badly shaken. The reason is FTCH is currently a breakeven business, and linear extrapolation of the earnings update suggested future losses.

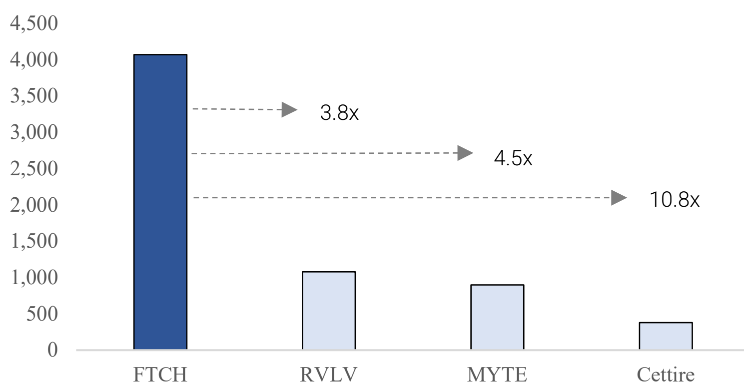
Linear extrapolation is not appropriate for FTCH. It has large FPS partnerships coming down the pike that are currently pre-revenue, but not pre-expense. Their effect is to suppress FTCH profitability in the short-term. However, there will be step-change in revenue and earnings when these partnerships come online over the next 12 months: Reebok (3Q23), Neiman Marcus (4Q23), Richemont (2024).

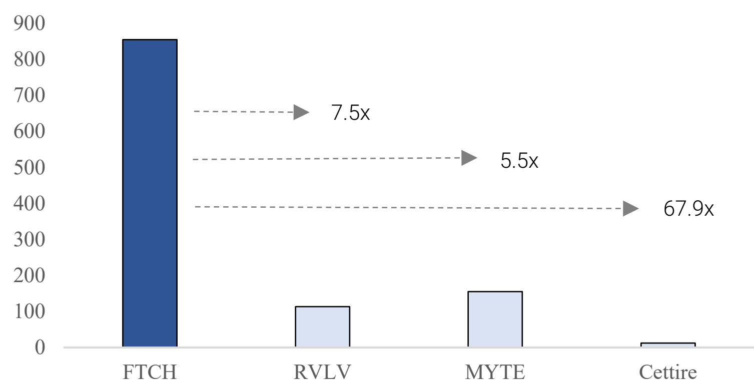
Despite our continued positive view, we reduced the position as a risk management measure. The negative earnings update highlighted FTCH's cost structure is simply too big. FTCH is the industry's market leader with 4x the transaction volume of its nearest peer. However, FTCH spends multiples more operating its platform. That fact flies in the face of the notion that e-commerce should enjoy economies of scale.

Investors remain fearful. FTCH has been flagged as the consumer company most likely to file for bankruptcy in 2024. We see that outcome as highly unlikely. Besides our knowledge of the forthcoming revenue inflection from FPS new partners, there are cash flow nuances such as the imminent receipt of $200m in tax receipts owed to FTCH, which underwrite its liquidity. Nonetheless, that article helps explain why the share price has fallen as low as it has.

The way forward for FTCH is demonstrating profitability and cost discipline. Here enters Tim Stone.

FTCH in August appointed Tim Stone its new CFO. Stone's resume includes 20 years at Amazon, a company known for getting a lot done on modest budgets. His tenure included CFO of Amazon Web Services, whose business model parallels FPS, and which has achieved more than modest success. Stone is apparently energized by the opportunity at FTCH, so much so he reneged on an agreement to become CFO of a company with a market cap 20x larger. Our hope is Stone introduces cost discipline, which in tandem with FTCH's burgeoning revenue streams, creates an enterprise whose profitability reflects its reach within the industry.





Carrols Restaurant Group, Inc. (TAST) – Position update – reduced 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.

Our fund's investment in TAST is off to a good start. The share price has doubled since we wrote about the investment in our March 2023 letter and tripled since we first acquired shares.

What's gone right? Not much, actually. The share price performance reflects the significant operating and financial leverage inherent in TAST's business. Over the past six months, traffic to its restaurants has improved modestly caused by customer trade-down to lower-priced QSR chains. Additionally, inflationary pressures on TAST's operating costs have abated.

TAST's very modest 2% EBITDA margins have therefore bounced to 5% as a result. Still modest, but a 250% earnings improvement from their starting point, which has driven a comparable share price return.

However, we are not satisfied. The core tenant of our TAST thesis was that Burger King franchisor, Restaurant Brands International (QSR), had unveiled a $400m investment program supporting franchisees, such as TAST. The program includes a $120m special advertising boost, which curiously has not yet played out. It will come, but the traffic-boosting effect of this advertising blitz is not yet benefiting TAST's business.

We remain invested in TAST but have reduced the position following its share price surge as we await the coming Burger King advertising program. Shares still trade at a more than 20% FCF yield, which is attractive, but our catalyst is improving traffic trends. If those arrive, and traffic is boosted by say 2.5%, shares will be closer to a 30% FCF yield and have scope to double again.

Delta Apparel, Inc. (DLA) – Position update

Delta Apparel (DLA) is a vertically integrated apparel company. It owns three distinct business: Delta Direct – supplier of blank garments to mass retailers, DTG2Go – digital printer of unique on-demand apparel lines, and Salt Life – a premium lifestyle retail brand centered on water activities.

Our thesis for DLA is that each of its three businesses are independently more valuable than the current market valuation of the entire company. We highlighted transitory headwinds affecting each business that was challenging near-term profitability.

Unfortunately, the challenges constraining profitability have persisted longer than anticipated. Namely, mass merchant apparel inventory destocking and start-up frictions with new clients and machinery at DTG2Go.

Fortunately, others in the market appear to have identified the anomaly of DLA's current share price. Just this week, DLA announced it had received an unsolicited offer to purchase its Salt Life business. A financial advisor has been appointed and its Board of Directors is conducting a strategic review. We estimate a sale of Salt Life could yield $80-120m in gross proceeds, representing 2-3x DLA's current market capitalization.

We also believe the sale of Salt Life could have a corollary benefit of making the remaining DLA more digestible to a separate acquirer given the natural synergies between the two remaining businesses, described in our June 2023 letter, not shared with Salt Life.

Outlook

Macro news continues to dominate markets more than in decades. It is driving outsized market volatility, as well as index underperformance by our sector and the small caps we concentrate in.

This continues to make for extremely challenging investing in the short-term but is opening large opportunity sets we have been able to monetize even with persistent macro-overhangs. An example is TAST, where our investment tripled despite no improvement to the consumer environment. Looking forward, we detailed in this letter how we have been able to acquire CURV shares at a FCF yield above 50%. Our view is these opportunities simply don't exist in bull markets, but we have to accept large volatility along the road to capturing these usually high returns.

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