Bonsai Partners

Q4 2021 Investor Letter | *February 8, 2022*

Dear Investor,

For the three months ended December 31, 2021, Bonsai Partners Fund, LP, appreciated 4.8% gross and 4.5% net of fees and expenses. The S&P 500 Total Return Index increased 11.0% over this same period. Full-year 2021 results are shown in the table below.

Investors in Bonsai Partners Fund should note that their performance reports will display different results in 2021 than those in the table below due to the fund's launch on May 1 rather than at the beginning of the calendar year. In the future, this discrepancy will not repeat. Fund investors should refer to their statements from South Watch for the most accurate 2021 performance reports.

Bonsai Partners Historical Returns Summary

	2021	2020	2019	2018	Since Inception	Annualized *Since Inception*
Bonsai Gross Return	**-13.5%**	**275.3%**	**60.6%**	**-17.9%**	**319.0%**	**56.6%**
Bonsai Net Return	**-13.7%**	**247.0%**	**56.4%**	**-18.1%**	**280.4%**	**51.9%**
S&P 500 Return	28.7%	18.4%	31.5%	-8.6%	83.0%	20.8%

Performance data shown represents past performance. Past performance is not indicative of future results. The period October 22, 2018, to April 30, 2021, presents time-weighted returns of a representative Bonsai Partners, LLC ("Bonsai") managed account with the same strategy and risk profile as Bonsai Partners Fund, LP, (the "Fund") which launched on May 1, 2021. Results from May 1, 2021, reflect the time-weighted returns of Class A shares of the Fund.

Gross returns from October 2018 to April 2021 include transaction and commission fees. Gross returns from May 2021 to the present include transaction and commission fees and fund operating expenses, such as administrative and audit fees but do not include management or performance fees. Net returns reflect the gross returns (as described) reduced by a 1.0% management fee and a 10.0% performance fee above a 6.0% cumulative compounding hurdle.

All performance figures are calculated internally by Bonsai Partners and are therefore estimated, unaudited, and subject to adjustment. The investment return and principal value of an investment with the Fund will fluctuate so that an investment, when redeemed, may be worth more or less than its original cost. Actual performance for a particular investor may be lower or higher than quoted performance due to different fee structures, share classes, beginning periods, capital additions or withdrawals, or individual compliance related mandates. Please refer to important additional disclosures at the end of this letter.

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Our Letters Moving Forward

With each passing quarter I have grown increasingly fond of writing these letters and built an appreciation for what they mean to our partners. However, I've also begun to realize that I need to strike a better balance between time spent conveying our work in these letters and physically executing our strategy. With this trade-off in mind, I intend to employ a new format within our letters that maintains a spirit of deep communication while also allowing me to allocate more time to the tasks that drive our performance.

Each quarter I will continue to provide a complete overview of the portfolio and the same position-specific updates as before. Most importantly, we will continue to write up new ideas that enter the portfolio in the same detailed manner.

However, what will change are the narrative-driven and conceptual sections I have written in the past. These I intend to share with you when I feel I have something worth saying, rather than out of obligation each quarter. Some quarters I will have ideas and concepts worth sharing, and I will write about them when I do. When I don't, I won't.

The guiding principle here is that these letters exist to "open source" our thinking so you can gain conviction in what we own since every concentrated portfolio will experience periods of volatility. Building conviction is the tool that allows us to manage through challenging times. By being more thoughtful about what and when I write, you will continue to stay informed, and our daily work will drive strong results.

Review of 2021

We accomplished a great deal in 2021, even though our returns might tell a different story. In concentrated investing, volatility is the cost we pay to earn long-term outsized results, and I expect our returns will remain predictably unpredictable.

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While I continue to present our returns against a benchmark index, note that we play a different game entirely. Our objective isn't to beat an arbitrary benchmark in each reporting period, and not only is this impossible to do, but it's also the perfect formula for underperformance over the long term. Outperformance ironically isn't the result of trying to outperform.

In 2021, we made multiple investments that set us up favorably for years to come. During the year, as mentioned in our Q3 letter, we invested in many of Bonsai's operational pillars, including the launch of the Bonsai Partners Fund in May. Our focus on improving and simplifying the operation will continue throughout 2022, and I expect these efforts will pay dividends over the coming years. Simplicity allows us to focus on the few areas that deeply matter, allowing us to drive the best performance we are capable of.

From an investment perspective, we added a variety of high-quality businesses to the portfolio at attractive prices. At the start of 2021, Redbubble represented an eye-watering 65% of our equity capital, but, by year-end, the position sat below 15% of our equity, meaning it was no longer our largest position (although still sizable). It's not easy to reallocate nearly 50% of a long-term investment portfolio in a single year; however, it was an endeavor worth taking on since we were able to identify multiple attractive new opportunities throughout the year. I expect in 2022 we will continue to improve the quality of the portfolio and get closer to steady-state positioning whereby new ideas won't act as much to diversify but rather replace ideas that have the lowest risk-adjusted return potential.

Objectives for 2022

In 2022 our key objectives are as follows:

1) Hunt for and add attractive new ideas to the portfolio that offer differentiated exposures than those presently expressed

2) Simplify our operation and improve our operational infrastructure

3) Invest in our processes and people to improve the work we repeatedly do, both from an operational and investment perspective

I look forward to updating you on our progress over the year

Portfolio Review

During the fourth quarter, Bonsai purchased a new position in 1stDibs, a business that we outline in the pages below. Similarly, we trimmed our Redbubble position meaningfully to accommodate 1stDibs and add to other existing ideas. Our portfolio continues to improve with each passing quarter for two reasons: 1) we are achieving a better balance of good ideas, and 2) the quality of the companies we own continues to increase. I expect these trends to continue in 2022.

As promised in last quarter's letter, our cash balance declined materially.

New Investment: 1stDibs (Nasdaq:DIBS)

Idea Overview:

1stDibs is the world's leading online marketplace for extraordinary design. The company connects design lovers to over 4,300 high-quality dealers and makers of vintage, antique, and contemporary furniture, home décor, fine art, jewelry, watches, and fashion. In 2021, ~$450 million of gross merchandise value transacted through 1stDibs, thereby connecting over 72,000 buyers to, as 1stDibs puts it, *the most beautiful things on Earth*.

Company History

1stDibs began in the year 2000 by its founder Michael Bruno who had a vision for bringing the dynamism of the Paris Flea Market onto the internet. As his idea grew, dealers worldwide began listing their goods onto 1stDibs, thereby creating an ecosystem for sellers of unique high-end products. Over time, the site's growing popularity allowed 1stDibs to gain acceptance with many leading furniture and art dealers, cementing its position as a starting point for high-end design purchases.

By late 2011, 1stDibs experienced a "re-founding" moment when a leading venture capital firm, Benchmark Capital, provided an injection of capital and installed new leadership to take the company on its next phase of growth. This was when David Rosenblatt, current CEO of 1stDibs, joined the company. Over the subsequent ten years under Rosenblatt, 1stDibs evolved as a business in three key ways:

First, 1stDibs transformed its business model from operating as a "classifieds" company (e.g., Craigslist) into an e-commerce marketplace where the transaction ultimately takes place (e.g., eBay).

This transition started in 2012 when the platform initially adopted a hybrid e-commerce/listing model. By 2016, the listing-only model was discontinued for dealers; thereby, only on-platform transactions were allowed.

The business as it exists today is a prototypical asset-light, zero-inventory, two-sided marketplace where 1stDibs connects buyers and sellers globally in exchange for 15% (on average) of the value of each transaction (their "take-rate"). In addition, 1stDibs also charges dealers a monthly access fee for the right to sell their goods on the marketplace.

Second, 1stDibs widened its collection of products from a historically USA-heavy dealer base into one that captures the diversity of selection that international markets have to offer. In 2011, less than 5% of 1stDibs sellers were based outside of the USA, and today that figure stands at nearly 50%. By building out a global dealer base, 1stDibs further enhanced its lead as the singular place people go to find the most beautiful things on Earth.

Third and finally, the company set to expand into new category verticals. In 2012, 1stDibs' business predominantly focused on a single product category: vintage & antique furniture. However, over the past ten years, the company expanded outward into four new categories: fine art, jewelry & watches, new & custom furniture, and fashion apparel. These new categories have each scaled quickly, comprising nearly 50% of gross merchandise value at present.

History of the High-End Interior Design Market

Antiques, vintage furniture, jewelry, and fine art are markets characterized by high prices and rare/unique goods. Considering how virtually every item is different throughout these industries, transactions in these markets heavily rely on interpersonal relationships between buyer and seller. Put differently, trust matters when you're buying a $10,000 Victorian-era table.

Over time, ecosystems of dealers emerged in these markets, which in turn created global hotspots such as in New York City, Paris, Los Angeles, London, Milan, etc. These clusters of dealers made it easier for prospective buyers to locate items by reducing how much they needed to travel to see a wide selection of product. While these physical clusters made it easier for buyers to find what they were looking for, the industry's Achilles heel was that buyers physically had to be in close contact with many potential sellers. Unless someone were willing to travel to multiple locations, it would be difficult even to know what's available for sale, let alone make an informed purchase decision from what is available.

The Power of the 1stDibs Marketplace

1stDibs, in essence, created its own dealer "cluster," but instead of a physical location, they formed a digital gathering place. Rather than rely on retail foot traffic or their Rolodexes to find potential customers, Dealers gained exposure to a global audience seemingly overnight through 1stDibs.

1stDibs' supply-side advantage originated from its time operating as a listing site in its early years, which lowered the barriers to adoption and ultimately helped migrate hesitant dealers into the marketplace model. As is usually the case for marketplaces, the platform with the best supply attracts the most demand, thereby further attracting and retaining sellers in a self-reinforcing cycle. The net result is over 4,300 trusted, vetted dealers on the site that offer access to nearly $11 billion of inventory, all from the convenience of a buyer's couch.

Joining 1stDibs is valuable to a dealer because their products are of such high value and uniqueness that inventory cycles are incredibly long due to low sales frequency. By joining 1stDibs, dealers significantly increase the odds of matching their unique supply to an interested buyer, thus increasing conversion of their expensive inventory into cash flow. Unfortunately for most dealers, 1stDibs is quite selective on who they accept onto the platform, as less than 10% of seller applicants are invited to join.

Ultimately for 1stDibs to become a long-term success, it needed to conquer the trust of buyers. To address this issue, 1stDibs implemented a handful of hard-to-replicate marketplace practices, which are collectively referred to as *The 1stDibs Promise*. These practices exist to give a hesitant buyer enough confidence to make their first high-value purchase on the site.

These practices include:

1. All sellers on the 1stDibs platform are vetted and only include gallerists, furniture & jewelry creators, artisans, artists, craftspeople, and professional dealers. There are no amateur "consumer sellers."

2. 1stDibs offers a buyer protection program on all purchases in case an item does not arrive as described.

3. If a product is listed by the same seller elsewhere at a lower price, 1stDibs will match it.

4. Delivery fulfilled by 1stDibs is fully insured anywhere in the world.

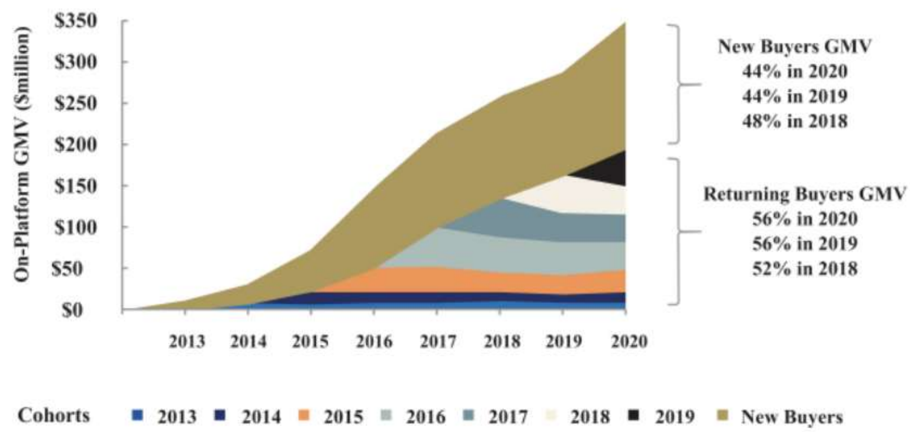
These marketplace policies remove buyer friction and engender enough trust such that 1stDibs' average order value today sits at over $2,000, with new buyers typically spending over $5,000 in the first year on the site.

Few websites can sell such high-value items, and when asked at a recent conference what makes 1stDibs' different, CEO David Rosenblatt replied: *"I've always felt that the answer to that is trust. We have the consumer's trust, in particular, that is required to sell high average order value items."*

Customer economics[1]

Trust, selection, and convenience, together with a lack of direct competition and high average order values, offer attractive economics to 1stDibs. By the company's metrics, every $1 spent on acquiring new customers generates over $3 of gross profit over their first three years, with a complete payback of the acquisition cost achieved on the first order.

Once a customer cohort is brought onto the platform and it matures, a reasonable segment remains sticky and loyal for many years. These returning customers today represent nearly 60% of GMV. Over the past six years, 1stDibs' grew its gross merchandise value at an approximately 30% compounded annual growth rate.



[1] 1stDibs services two main customer types: "trade buyers" (e.g Interior designers) and everyday consumers. Trade buyers are more limited in number but purchase consistently and buys significantly more products while consumers are more plentiful. Both customer types are highly valuable to 1stDibs, with unit level profitability at the first purchase.

The company chooses to remain slightly loss-making by investing through the income statement to continue to capture market share. In 2021, the company 'accidentally' achieved EBITDA profitability in one month, which illustrates their ability to turn to profitability when the right time comes. However, due to their attractive end markets and customer economics, it is prudent for management to continue investing in the business to capture market share, as marketplaces enjoy meaningful benefits of scale.

By my estimates, 1stDibs' customer lifetime value is conservatively greater than 5x the cost of acquiring a customer, which is on par with many leading software companies that trade for dramatically higher valuations.

Looking to the future

1stDibs currently only has 72k active buyers but over 3.5 million users in their catalog, translating to roughly $450 million of GMV in 2021. As a reference, Christie's and Sotheby's processed over $15 billion in the same period. There is a long runway for buyer growth as the gap between active buyers and users is meaningful, and there remains a large number of potential buyers who have never heard of the website. With a median item value of $1,100 and correspondingly half available below this price, the items on 1stDibs remain in reach for the mass affluent consumer.

In November 2021, 1stDibs released a new auction format for buyers and sellers. This effort aims to drive increased conversion by addressing two key areas of friction for buyers: 1) they do not have a good sense of what items are intrinsically worth since most are one-of-a-kind pieces, and 2) dealer list prices are often high, requiring negotiation. An auction format solves both of these issues as a market-clearing price offers a price discovery engine, thereby giving buyers the confidence to bid the price they're comfortable with.

Auctions completed on 1stDibs offer an improved customer proposition over the traditional auction houses because 1stDibs offers increased liquidity due to their scale of buyers, sellers, and inventory already available on the site. In addition, 1stDibs does not charge a buyer's premium, allows for messaging between bidders and sellers, shipping costs are known in advance, and The 1stDibs Promise stands behind each auction.

International expansion is another core driver of growth for the company. In the first half of the calendar year 2022, 1stDibs will begin releasing local language services in Europe to improve international conversion rates since the 1stDibs website is only available in English today. International buyers represent ~19% of GMV, although nearly 50% of sellers, 40% of items, and 33% of site traffic come from outside the US. In other words, conversion rates are significantly lower for non-U.S. buyers, and localization offers a solution to narrow this gap.

Lastly, as an area of potential optionality, 1stDibs launched an NFT platform in August 2021 (led by a VP of engineering who is a passionate digital artist). This effort started in response to the rapidly growing market for digital art, and 1stDibs designed its NFT platform to make the buying process as simple as possible via an auction site built on the Ethereum network. While I don't count on this business line driving our investment case, the upside it presents if it gains some traction is appealing, considering they incubated the concept at a minimal cost.

Management

One of the evolutions in my investment philosophy has been better defining the characteristics of people that I want to work with. Rather than focus solely on answering: "Is this a good management team?" I've also begun to ask: "Is this the right team for the problem they are trying to solve?"

Since two-sided marketplaces tend to optimize for efficient customer acquisition to drive scale advantages, I believe 1stDibs' CEO David Rosenblatt is an outstanding person to lead this company.

As background, David joined the advertising network DoubleClick in 1997 and worked up the ranks to become the company's President and CEO. In 2008 DoubleClick was acquired by Google, whereby this business became the foundation for Google's advertising business. David was the President of Google's Global Display Advertising business before leaving the company in 2009.

From these experiences, I believe David gained a nuanced understanding of how websites can scale an audience in a digital world. Further, David currently sits on the board of directors of multiple industry-leading companies such as Twitter, the luxury clothing marketplace: Farfetch, and internet & marketplace investment holding company: IAC/InterActiveCorp.

Surrounding David is a capable executive team that brings a diverse set of backgrounds. These include Xiaodi Zhang (CPO), Ross Paul (CTO), Tu Nguyen (CFO), and Sarah Liebel (CRO). 1stDibs built a deep bench of talent and strong company culture, and together these pieces give me confidence in their ability to solve difficult problems and endure over the long term.

Conclusion

While Amazon already won the fight for the $50 item, the $2,000 order is not yet dominated by any single player. This is the opportunity 1stDibs has in its sights for premium design and décor. At present, 1stDibs is the leading design marketplace with a critical mass of supply and demand, a strong team, and a thoughtful approach to scaling this business over time. We are excited about what the future holds for 1stDibs.

1stDibs presently trades at a roughly $360 million market capitalization with $160 million of net cash on the balance sheet, translating into a $200 million enterprise value. I expect gross profit less customer acquisition costs in 2021 will equal roughly $45 million, which results in an enterprise value to "contribution profit" of 4.5x for 2021, one of the lowest marketplace valuations I've seen since I started Bonsai.

This valuation does not make sense since 1stDibs is in a strong position due to a lack of a true competitive threat, a long runway for growth, strong unit economics, and a world-class management team leading the effort.

Investors today are likely concerned about possible slowing growth rates due to difficult comparable periods from last year. However, I believe the company will reaccelerate growth over the medium term and compound capital at high rates over a multi-year time horizon.

Closing Thoughts

As always, thank you for trusting me with your precious savings. If you have questions or comments, don't hesitate to reach out to me directly.

Fondly,

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Disclaimer:

Bonsai Partners, LLC ("Bonsai") is the investment manager of Bonsai Partners Fund, LP (the "Fund").

This letter has been updated from its original version. Disclaimers were revised to reflect current standards and clarifications for the intended audience. Certain visual elements, formatting and brand identifiers have been refreshed to align with our current branding. These changes do not alter the core message of the original letter.

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