Bonsai Partners

Q3 2021 Investor Letter | *November 10, 2021*

Dear Investor,

For the three months ended September 30, 2021, the Bonsai Partners portfolio declined -13.0% gross and -13.3% net of fees and expenses. The S&P 500 Total Return Index increased 0.6% over this same period.

Investors in the Bonsai Partners Fund should note that their performance reports will display different year-to-date figures than those outlined in the table below. This difference is due to the fund's launch mid-year rather than at the calendar year's start. *Fund investors should refer to their statements from South Watch for the most accurate year-to-date performance reporting.*

Bonsai Partners Historical Returns Summary

	YTD 2021	2020	2019	2018	Since Inception	Annualized *Since Inception*
Bonsai Gross Return	-17.4%	275.3%	60.6%	-17.9%	299.9%	60.2%
Bonsai Net Return	-18.1%	247.0%	56.4%	-18.1%	263.9%	55.1%
S&P 500 Return	15.9%	18.4%	31.5%	-8.6%	64.9%	18.5%

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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Choppy Waters

By nature, I am what most people call: "a planner." That is, I take particular glee in mapping out my calendar ahead of time, when possible. This certainly was the case around a month ago when my wife and I visited the Hawaiian Islands for our honeymoon; a jam-packed itinerary awaited us. But, of all the activities I lined up, none excited me as much as our snorkeling trip in Lanai.

While we were all smiles stepping onto the boat that fateful day, the enjoyable cruise I planned ended up being the ride from hell. Within an hour of leaving Maui, our boat began to face intense swells, and this turned our ship into a moving seesaw.

Our captain, facing adversity so early in our trip, decided to take a courageous stance. He told us that: “if we’re going to ride through choppy waters anyway, we might as well go through it as fast as possible!” How bold.

To settle in for the inevitable bumps, my wife and I found a quiet space near the stern of the boat, but our solitude was soon interrupted by other passengers congregating around us. Their pallid hue should have given it away, but I couldn’t understand why everyone needed to stand so close. It all came together when the first person started vomiting over the rear of the ship. Now, I don’t usually get seasick, but seeing others nauseated started to make me queasy as well, and I realized that unless I found a way to firm up my stomach, I, too, would be curled up over the railing.

Fortunately, one of the simplest remedies for seasickness is also one of the most effective. If you ever find yourself in such a predicament, try to fix your gaze on a point far off in the distance, as it can help settle your nerves. This approach works because a point far on the horizon moves up and down far less than a point immediately in front of you. A simple change in your perspective can make all the difference in how you feel.

Just like sailing in uncharted waters, our investment performance will also rise and fall, and while I know where we are going, I can’t know what the conditions will be each step of the way (much like our ship's captain). But, whether on an unpleasant boat ride or investing in a volatile environment, the remedy for these moments remains the same: maintaining a firm gaze on the horizon allows us to keep our composure and reach the other side.

2021 has been quite unpleasant from a performance standpoint, but this too shall pass. Most important is our ability to stay the course and remain true to what we set out to do from the outset: buy shares in great companies, at great prices, run by great people. The rest will take care of itself.

Is China Investible?

The most significant driver of performance this quarter was a wave of Chinese political changes that impacted the financial market. While I tend to avoid macro-economic topics like this, I believe it is worth discussing this one because the changes we observed this past quarter might impact the long-term value of the companies we own in this geography.

While past decades of Chinese progress relied on a steady march toward opening up and adopting elements of free-market economics, more recently, an interventionist wave emerged to curb certain business practices and clamp down on industries deemed not in the broader interests of society. These heavy-handed political actions led to a sell-off in Chinese equities as this new element of uncertainty emerged.

It is in this context that I've heard the question: "is China investable at all?" While this is an interesting question, it represents a false dichotomy that unnecessarily restricts the range of potential outcomes. I'm most interested in ***how investable China is, not whether it is investible at all***. Although the changes in the political landscape impacted our Chinese investments this year, it is crucial to work from first principles to understand what changed, reevaluate what we own, and decide whether it makes sense to stay the course.

In our Chinese investments, I used the past 20 to 30 years of economic progress as a guide for thinking about the future state of the political economy that surrounds our investments. Unfortunately, this turned out to be a miscalculation as the pendulum swung back toward authoritarian, state-planned means for deciding economic outcomes rather than market forces. I honestly don't see this dynamic changing any time soon, but again, I am not trying to make macroeconomic predictions either. I'm more focused on understanding what is in the rear view mirror.

Today's economic environment in China is undoubtedly different from nine months ago and likely not for the better due to a less certain business operating environment. Historically, policy decisions in China embraced a more consensus-driven approach, which served as a check against individual party members acting unilaterally to suit their political interests. However, with the increased consolidation of power into the hands of a single leader today, the Chinese political environment is now more volatile than it was before. When a political leader can use economic policies to drive their agenda, it can lead to less optimal business conditions, as we've observed this year.

I believe that investing in China today involves accepting more volatility than in the past due to the current political structure. As a result, the return threshold for any investment we make in this geography should be higher to justify this. So, in my eyes, China is not "uninvestable"; it's just harder to meet the threshold required to invest. On the other hand, asset prices are now lower in China to reflect this reality.

As it relates to Bonsai, I am not abandoning the Chinese market. Instead, I'm taking a more careful approach to our participation and exposure levels. Through careful reflection on a company-by-company basis, I continue to reassess what we own and make relevant changes as necessary. We will navigate these choppy waters as rationally as possible.

To be clear, the Bonsai thesis remains the same: I will continue to go where the best opportunities are, and all that's changed is the relative attractiveness of this particular geography. In this context, it could mean better opportunities exist elsewhere, or they may be in China. In either case, I will allocate our capital into those pockets of opportunity wherever they present themselves. China isn't "uninvestable," the calculus has just changed, and we will adapt accordingly.

Operational Updates

2021 has been a year of meaningful investment in Bonsai's operation. To recap, this year, we: 1) launched the Bonsai Partners Fund, 2) are transitioning (still painfully in progress) most of our managed accounts into the fund structure, 3) added several value-added service providers in both operations and research, and 4) made the first addition to the Bonsai team: Zi Hao Tan. Bonsai is getting a little better each day.

On this last item, I want to take a moment to introduce Zi Hao to you and discuss his role going forward. Zi Hao interned with me earlier this year, and he played a significant role in researching Greentown Management. From this experience, I came away impressed by Zi Hao's work ethic, tenacity, integrity, and love for investing.

Before joining Bonsai, Zi Hao interned with two other fund managers I deeply respect, and I believe that Zi Hao will add value quickly, especially considering his Mandarin-speaking skills. Zi Hao lives in Singapore, and his work will focus on investment research and specific operational tasks as needed.

I was lucky to have someone bet on me early on in my career, and it's wonderful to be able to bet on someone else early on as well. Welcome, Zi Hao!

As mentioned previously, over the coming years, Bonsai remains focused on:

1) Continuous improvement of the research process

2) Upgrading the quality and positioning of our portfolio, and

3) Increasing the robustness of Bonsai's operation

Portfolio Review

In the quarter, Bonsai purchased a new position in Boozt which I outline in the pages below. We also exited our small Illumina position.

Our cash balance remains elevated due to this year's dynamic conditions and the portfolio changes it required. While I expected our portfolio to reach a point of stasis earlier this year, a few portfolio updates remain ongoing. While our cash position is still too high, I am confident I will rectify this soon. Such a process takes time as it relies on the cadence and maturation of new and existing ideas that remain somewhat out of my control.

Quarterly Position Update

Greentown Management:

If changes in the Chinese political environment were not enough, Greentown Management faced additional pressure this quarter due to the potential default of one of China's largest property developers: Evergrande Group, as well as some other smaller, highly indebted developers. This announcement sparked a panic in the Chinese housing sector that led to contagion concerns throughout the industry.

However, if you recall the Greentown Management thesis from our last letter, Greentown Management's business model is, at least in theory, counter-cyclical. This means that if a period of stress occurs in the property sector, demand for Greentown Management's services should (theoretically) increase, countering weak industry conditions. Who knew that market conditions would test this part of the thesis so soon?

On October 12, Greentown Management released its voluntary third quarter 2021 business update, sharing recent revenue trends and key performance indicators. Despite the property sector's fragile conditions, Greentown Management reported that newly contracted gross floor area (it's leading indicator of future revenue) and estimated new project management fees grew 91.4% and 98.5%, respectively. For context, this represents a significant acceleration from their historical growth trend of roughly 20% to 30% per year. Despite this, investors remain focused on the poor macroeconomic conditions.

I hope that Greentown Management's growth remains robust, and potential weakness in the housing sector may bolster Greentown Management's value proposition and ultimate market opportunity as more real estate projects require the services of a company like Greentown Management. While its share price continues to be weak, I wonder if this moment provides an opportunity rather than just a threat. Time will tell.

New Investment: Boozt (STO: BOOZT)

Idea Overview:

Boozt is an e-commerce platform for fashion apparel within the Nordic region. The company was founded in 2007 and was "re-founded" again in 2011 under its current leadership team and business model.

Selling Apparel On the Internet:

Over the past twenty-plus years, e-commerce's combination of convenience, low prices, and wide selection allowed it to continuously capture additional market share from traditional "in-person" retail each year. By 2020, and partly due to the pandemic, e-commerce's wallet-share reached over 25% of total retail sales.

The reach of e-commerce continues to radiate further outward as its underlying value proposition remains strong and new entrepreneurs continue to break down the remaining barriers of e-commerce adoption. Although core categories like electronics and books quickly reached high levels of online penetration, the 'frontiers of e-commerce,' such as furniture, apparel, automobiles, art, etc., have only so far obtained limited acceptance. Obviously, many of these frontier categories didn't achieve much e-commerce penetration because these purchase occasions were better served in-person. However, I now believe many of these frontiers of e-commerce are rapidly gaining adoption in a post-COVID world.

This section focuses on the nuances of one particular frontier e-commerce market: fashion apparel, which represents one of the largest consumer markets that is now scaling the e-commerce adoption curve. I also explore the barriers to adoption in this space and how companies such as Boozt break down those barriers to build a loyal customer base.

10x Better and Cheaper:

As a rule, getting people to try something new is tricky because inertia is a formidable force to overcome. While it is easy to think of entrepreneurial success stories, the reality is most new companies never gain meaningful traction with consumers, even if they offer a better product. To achieve significant adoption of a new product or service, it's just not good enough to be marginally better; it has to be dramatically so.

Sarah Tavel, a General Partner at Benchmark Capital, coined the term: "10x Better **and** Cheaper" as a simple way to describe what a new product must offer to achieve mass behavioral change. Just think back to your first Uber ride or Airbnb booking; how much did it take to push you over the edge to try one of these unfamiliar and uncomfortable services?

Let's now use this framework as a lens to think about what it takes to convince people to buy clothes online. In the apparel market, the variability of 'clothing fit' is the most significant barrier to e-commerce adoption. The potential of poor fitting clothing creates uncertainty and headaches (due to the returns process). Unless this barrier was broken down, the status quo of in-person apparel shopping would have remained intact.

I believe that footwear retailer Zappos.com was the first to break through this e-commerce barrier by making it easy and free for customers to return shoes if they do not fit. By creating a culture of loving the customer and loving returns, Zappos convinced consumers to try buying their next pair of shoes online. This was a watershed moment, and Zappos made an implicit bet that once customers tried this new way of buying shoes, there would be no turning back; lower prices, better selection, and more convenience would take care of the rest.

Ultimately, the few companies that learned from Zappos's model of loving the customer and loving returns are the new ones who lead the charge today in the under-penetrated apparel e-commerce market. For example, Zalando, a European company, more or less copied the Zappos model in Europe, making them the largest e-commerce fashion retailer in Europe. Boozt, on the other hand, brought the Zappos model into the Nordics.

Boozt’s Company History

Boozt was founded in 2007 with the mission to offer a turn-key platform to fashion brands who wanted to sell their apparel online. Rather than provide a singular storefront, as it exists today, Boozt originally developed custom websites for local fashion brands, all run through Boozt's unified order fulfillment backend. However, after roughly four years of offering this white-labeled service to brands, Boozt decided to pivot and convert these independent websites into a unified storefront that today represents over one thousand brands. Boozt's current CEO, Hermann Haraldsson, joined the company in 2011 to ‘re-found’ the company around this new vision, and he has remained the CEO since.

Nordic customers use Boozt due to its unique combination of low prices, selection, convenience, and trust. I discuss the latter three points below.

Selection

Boozt aggregated a collection of over 1,000 local and international brands due to their ability to offer a trusted space for brands to sell their products in a non-brand damaging environment.

When I first considered Boozt as an investment, I couldn’t understand why Amazon wouldn’t capture this market as well over time. Of all of the product categories that Amazon dominates, oddly, they have not had much success in fashion apparel because most fashion brands are unwilling to sell their products alongside brand-damaging items like toilet paper or toothpaste. This consideration makes brands picky about where they are willing to sell their goods online.

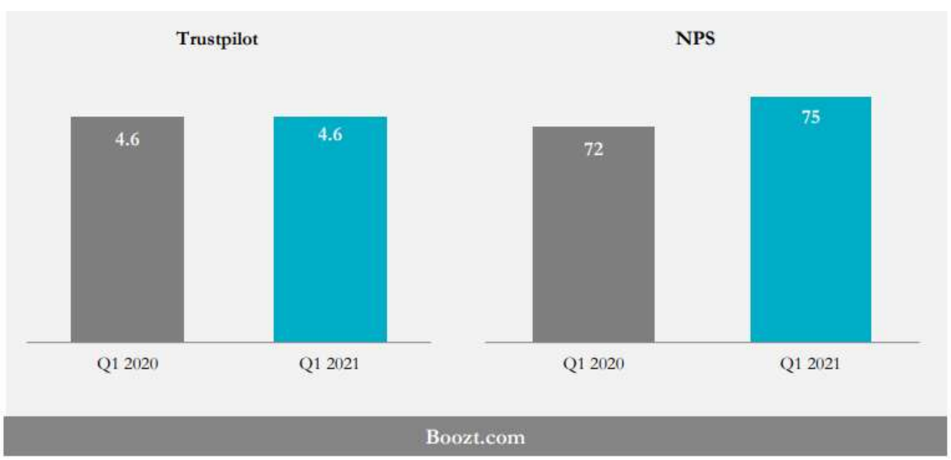
Boozt purpose-built its platform for its brand counterparts, and as a result, they are now one of the few online spaces a fashion consumer can find the widest selection of Nordic and international brands in one place.

Convenience (Fast Shipping)

In addition to their leading selection, Boozt purpose-built its logistics footprint to provide the Nordic consumer an unmatched speed of delivery. Due to their highly efficient automated fulfillment warehouse and partnership deals with local logistics partners, up to 90% of the Nordic population can receive a Boozt order either on the same or the next day. Impressively, these service levels are available across 100% of their product assortment. While Zalando is Boozt's largest competitor in the Nordics, they cannot fulfill orders as quickly as Boozt since most of their inventory exists in fulfillment centers outside of the Nordics.

Trust

At the start of each earnings call, Boozt's management reviews its customer satisfaction metrics, and they usually describe this data as "likely our most important slide."



Boozt built a culture focused on customer satisfaction because, without it, the customer wouldn't be willing to take the leap and try buying apparel online. Boozt builds trust with consumers by making their website easy to use, shipping fast, and returns easy and free.

Below is an excerpt from an interview with Boozt's CEO describing how they think about returns.

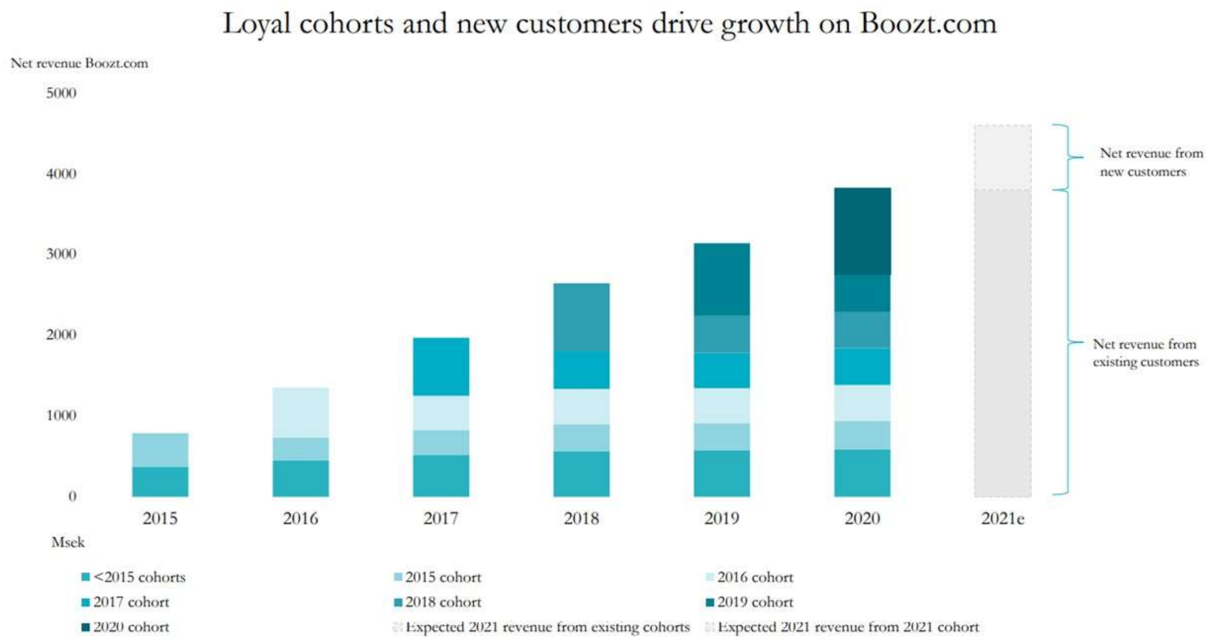
> ***Interviewer****: You've invested a lot of time and money into your return process to make it simpler and easier for customers to return any items... why are you focusing so much on your return policy, and what do you what kind of results are you expecting*
>
> ***Hermann Haraldsson (Boozt CEO)****: Returns [are] probably the biggest issue for many that are [sic] hesitant on buying fashion online because they say 'what if it doesn't fit me, right?'*
>
> *You have to say you either hate returns or love returns. Returns are expensive.*
>
> *But if you hate returns, the customers will get the same feeling...and they won't come back. If you love returns, they think, "okay, yes, it's fair for me to try it, and I can return it and have a good experience and come back.*

In short, customer trust is a crucial ingredient for new trial and adoption of fashion e-commerce, and Boozt built its culture around this concept.

Selection + Convenience + Trust = Recurring Predictable Growth

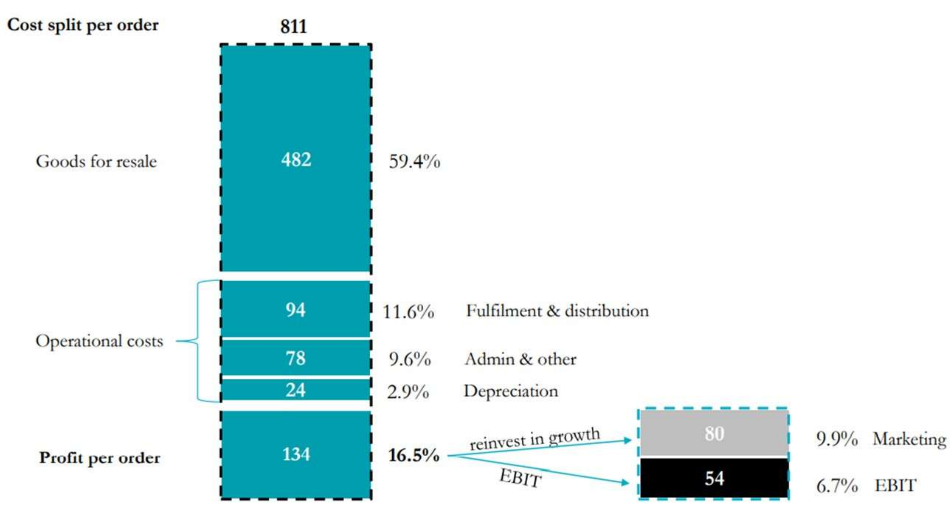
I mention selection, convenience, and trust in detail above because these are the key ingredients behind

"cheaper and **10x better**." In addition, I believe these elements are what drives Boozt's rapid growth and retention of the customers they acquire. As a result, Boozt grew revenues by +40% on average per year over the past six years, and its total sales increased by 10x over the past seven years.



While fashion purchases are generally unpredictable, Boozt's customer cohorts are almost recurring in nature due to their unique value proposition that has customers coming back consistently on average. As a result, Boozt can acquire new customers at attractive multiples of their acquisition cost due to these predictable purchase rates and long purchase lifetimes.

Attractive Underlying Economics



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While growth is important, it doesn't mean much if the "unit economics" underneath these revenue streams are poor. Fortunately, Boozt isn't selling dollars for fifty cents, and their business is quite profitable on an underlying basis. Moreover, these "unit economics" allow Boozt to self-fund its growth by reinvesting the profitability embedded in each order into marketing to bring in new customers and fund incremental operational investments. From this, we can conclude that at scale, Boozt should be able to achieve strong profitability, all things equal.

Management

As many of you know, one of the most significant shifts I've made in my investing process recently was adding emphasis on the quality of management. Of course, everyone knows that you want to have aligned leaders who are capable. However, it took me nearly a decade to identify what I was looking for with a bit more precision.

As someone building a company that is my life's work, I realized that I am also looking for leaders who view their job as their life's work as well. I believe Boozt's CEO is a missionary leader, and despite running the company for the past ten years, it appears he wants to be doing this for as long as possible. Before Boozt, CEO Hermann Haraldsson was the CEO of a large advertising agency and also the CEO of the Danish football club. It's clear that Hermann has a knack for constructing high-performance teams, and he built Boozt to have an ambitious and hard-working culture.

At its core, Boozt management embraced and cultivated a culture of thoughtful risk-taking, which constantly expanded its total addressable market over time. For example, Boozt was overexposed to women's fashion, but they successfully introduced new categories such as kids, beauty, home, and sport to branch outward over the past five years. These new verticals expanded the reach of the company, average basket sizes, and repeat rates, all while diversifying their offering.

Aside from additional horizontal expansion, Boozt has also thoughtfully expanded its reach through vertical integration. For example, an often-repeated word in the Boozt vocabulary is 'control,' which stems from Boozt's early days building independent online fashion brand stores for others. Since the company didn't have control over its destiny back then, this taught them the importance of systematically integrating additional pieces of its value chain to maintain control over its future. For example, Boozt recently insourced its labor contract that provided staffing for its warehouse, acquired a private-label clothing provider, acquired its outsourced development partner in Eastern Europe, and added new initiatives such as Booztpay, etc.

That said, the real shining star of their optionality efforts is a new business that Boozt incubated in 2015-2016 called Booztlet. Booztlet is the company's outlet concept (similar to an online version of TJ Maxx, etc.) that allows the underlying Boozt business to clear slow-selling or older model inventory at a discount, as well as liquidate excess inventory directly from brand partners. Customers love it because they can buy hard-to-find fashion brands at closeout prices they can't find anywhere else.

Booztlet has been a tremendously fast grower, scaling nearly 10x over the past two years, and now contributes around 15% of total Boozt revenue. Further, Booztlet is even more profitable per order than its core Boozt counterpart, and I believe this business segment could eventually become as large as Boozt is today.

While Boozt maintains a culture of continuous innovation and careful risk-taking, this does not appear as an asset on its balance sheet. I believe that even though their current total addressable market is large, management will continuously widen the reach of their business and maintain control over their value chain to ensure that their destiny remains intact. This strategy allows the company to continue to grow quickly and profitably.

As usual, I avoid writing about valuations and price targets, but I will say that I believe Boozt should compound at attractive rates and will likely be worth multiples of its current value over time. Moreover, Boozt is now one of our largest positions since the business has significant growth potential, strong leadership and is available at an attractive price.

Our Three Year Check-In

I honestly find it hard to believe that Bonsai recently passed its third anniversary. While I am proud of what we have accomplished so far, it is worth remembering that there have been multiple ups and downs along the way to reach this point: from a quick stumble out of the gate in 2018, to our largest position declining 40% in a single day in 2019, to a crippling pandemic in early 2020 where this same largest position fell another 50%, to now facing Chinese headwinds in 2021. So, despite what we've achieved so far, our growth trajectory has never been linear.

I've said from the beginning that any investor will need at least three years to get a sense of how we're doing, and even at this point, it does not paint a complete picture either. However, now that we have reached this three-year milestone, I want to take a moment to reflect.

I am encouraged by this initial set of results in what has been, to put it mildly, a very dynamic environment. While it's easy to focus on near-term volatility, this tends to overshadow the multi-year perspective. All the more reason to take a long-term perspective, I suppose? Doing so renders the short-term noise irrelevant.

There will be pain points along the way, and while I'm encouraged by where we've been, I'm more focused than ever on what's next. Bonsai is stronger than it's ever been, and this sets us up nicely for our next three years. I'm excited and ready for the challenges and opportunities that lie ahead.

Thank you for trusting me with your capital. As always, if you have questions or comments, don't hesitate to reach out to me directly.

Fondly,

Andrew

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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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