Q4 2022 Investor Letter | *February 14, 2023*

Dear Investor,

For the three months ended December 31, 2022, Bonsai Partners Fund, LP, declined -1.2% net of fees and expenses. The S&P 500 Total Return Index appreciated 7.6% over this same period. Full-year 2022 results are presented in the table below.

Bonsai Partners Historical Returns Summary

	2022	2021	2020	2019	2018	Since Inception	Annualized *Since Inception*
Bonsai Gross Return	-26.5%	-13.9%	277.9%	60.3%	-17.6%	215.8%	31.6%
Bonsai Net Return	-27.3%	-14.8%	247.9%	56.1%	-17.7%	176.8%	27.5%
S&P 500 Return	-18.1%	28.7%	18.4%	31.5%	-8.6%	49.9%	10.1%

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.

Quarterly Update

The past two years have been challenging, and we ended 2022 with our largest annual drawdown since we began four years ago. While I am dissatisfied with these results, I remain cautiously optimistic and continue to focus on the long term.

The fourth quarter was challenging primarily due to the drawdown in Chinese equities in October after the Chinese Communist Party's plenary session. While

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Chinese equities rebounded quickly, we raised new capital in early November, and this investment's timing muted the rebound's impact.

Bear markets make excellent teachers, and we learned many lessons over the past couple years, which will translate into improved long-term performance. I remain enthusiastic and excited about how our portfolio is shaping up. I share some of my learnings in the pages below and how we plan to implement these ideas going forward.

Customer Centric

I used to think that a company’s survival was determined by its ability to beat the competition. I now question this idea. After studying a series of the longest-surviving companies, I was surprised to learn that many of them did not rely on wide "economic moats" (i.e., patents, network effects, high-switching costs) at all. This realization made me wonder if competition really is the primary threat to company survival. Perhaps the real enemy lies within?

Eventually, I realized what many of these long-lasting companies had in common: they shared an ability to keep customers in rather than an ability to keep competitors out. In other words, their long-term survival hinged on customer relationships rather than "economic moats."

Paul Graham, a start-up investor formerly at YCombinator, said that competition was only the cause of failure in a few of the hundreds of companies he invested in. Usually, failure came from self-inflicted wounds, such as overspending, founders giving up, or the company not building what the customer wanted.

Companies survive if their customers want them to. Every dollar of profit, salary paid to employees, or invoice remitted to vendors, ultimately comes from the customer’s wallet in any sustainable business. Without self-sustaining customer relationships, a company must rely on outside funding to survive. The customer, therefore, is the critical link inside any business. If your customers don’t stick around, neither will you.

Customers stick with companies out of self-interest and desire. Does the business provide the best solution for the problems they have? Has the company earned their trust? If these things are true, customers will ensure a business survives, regardless of war, famine, political upheaval, technology transitions, or other challenges the world presents.

Jeff Bezos spoke about the importance of ‘customer obsession’ rather than ‘competitor obsession.’ I argue that leaders also need to be wary of another type of distraction: ‘stakeholder obsession.’ Stakeholders are anyone that relies on a company's business performance. These include shareholders, employees, and supply chain partners. We are stakeholders in the companies we invest in.

When a company puts stakeholders first, it unintentionally makes their business less likely to deliver what customers want. As a result, these companies are less likely to survive over the long term. This trade-off between stakeholders and customers is the root cause of many company failures.

Putting customers first has significant long-term benefits, yet only some companies practice this. Although customer obsession can be profit-maximizing over the long term, it is usually less profitable in the short to medium term. Ironically, an aversion to greed is often the most profitable path forward.

Only a small percentage of companies put customers first because an inherent conflict exists inside every business: the tug-of-war between stakeholders and customers. In any business transaction, offering the customer more means stakeholders get less. And vice versa. Putting customers first means stakeholders must suppress their natural desire to maximize profits right away.

As a CEO, you must choose which side comes first: stakeholders or customers. Of these options, it is far easier to put stakeholders first. Shareholders select the board of directors, and the board will replace a CEO if shareholder interests are not satisfied. Customer centricity, therefore, can create stakeholder misalignment if a leader is not careful.

Putting customers first requires a CEO with unique abilities and perspectives. This person must be willing to swim against the tide to do what they believe is right, regardless of external pressures. These leaders must also control their own destiny through either voting control or shareholder support from long-term-minded owners. Without control, their customer-facing objectives are at risk of being cut short. It's rare to find companies with all the right elements in place to nurture a customer-centric culture.

Since the natural state of a company isn't to put customers first, there needs to be a driving force that tips the scales and overrides conventional thinking. While there are multiple methods to overcome 'stakeholder obsession,' founder leadership is the most common.

Founders tend to put customers at the heart of their mission because they often started their company out of frustration that the product they wanted to buy didn't exist. This frustration is why I started Bonsai–I couldn't find the fund I wanted to invest in, so I needed to create it. Founders break through the impasse between stakeholders and customers because they can see through the eyes of both parties and therefore view the trade-offs more clearly. Founders are sympathetic to customers because they used to be one, yet they also recognize–as business owners–that stakeholders stand to earn more over the long term by serving the customer and earning their trust.

A common mistake I've noticed companies make is building products that are attractive to stakeholders rather than to their customers. Similarly, it's just as common for investors to seek out investments that deliver the most value for themselves rather than the end user. For example, I was trained to hunt for companies with high margins, high returns on invested capital, recurring revenue, low capital intensity, and any other metric that might amplify shareholder returns. While an attractive financial profile is vital to shareholders, this is a losing game when great financial metrics come at the customer's expense. I've made this mistake multiple times, and it usually ends in the permanent impairment of capital.

I now wonder if a more logical starting point for a long-term investor is to ask: which companies are increasingly earning the trust of their customers? Unlike high margins, customer centricity is not something you can easily input into a stock screener. Identifying customer-centric companies is a much more difficult starting point.

If customer trust is a leading indicator of company survival, I need to increase its emphasis within our investment evaluation process. Similarly, if I want to increase the longevity of the ideas in our portfolio, I need to embrace a deeper appreciation of the customer in each investment case. While this is not new work for us, we need to pay closer attention to it.

I believe the five most dangerous words in business are: “what's in it for me?” This way of thinking tends to create situations where someone wins at another’s expense. These behaviors introduce fragility by introducing unstable relationships and damaging trust. These actions pull forward rewards today for a price that must be repaid tomorrow. Such actions include raising prices as a strategy, customer experiences designed for shareholder outcomes, unnecessarily adding debt, and strong-arming suppliers.

An unbalanced company is unlikely to stand the test of time. The most enduring businesses are those whose everyday transactions strengthen their foundations rather than weaken them. As our time horizon lengthens, this consideration becomes more important. Customer obsession is just another form of long-term thinking.

Objectives for 2023

We continue to evolve and improve. Our objectives for 2023 include the following:

1. **Seal the leaky bucket**: reduce our unforced error rate.
2. **Reinforce our operations**: refine the processes behind repeated tasks and add expertise.
3. **Promote longevity**: implement systems that increase the odds of capturing long-term compounding.

Seal the leaky bucket: reduce our unforced error rate.

If you’re filling up a bucket of water, it will fill up faster if the bucket has no leaks. Investment mistakes are like holes drilled into the bottom of a bucket: they reduce the rate of return. In addition to dragging down portfolio-level results, they also force us to divert attention toward identifying new ideas to replace those that didn't work. While we will continue to make unavoidable mistakes, I can do more to minimize the avoidable ones.

If we look back at our history of investment decisions, we've committed some headscratchers. Although these mistakes are painful to review, I am energized by their existence because it means there are plenty of opportunities to eliminate avoidable errors and improve our results.

Upon reflection, our unforced errors largely came from accidentally identifying bad companies as good companies. In other words, false positives. False positives are a natural byproduct of something we often do: hunting for 'diamonds in the rough.' We've been willing to jump through intellectual hoops to uncover hidden greatness, but sometimes this led me to fool myself into thinking that something bad was good.

We will continue to hunt for overlooked opportunities and go off the beaten path, but such behavior requires a refined set of guide rails to keep us on course. We have made significant progress on these criteria. Going forward, we will strike a better balance between reducing unforced errors while retaining a willingness to identify unusual opportunities that offer meaningful upside.

Inevitably, minimizing false positives will have undesirable consequences. By avoiding false positives, we will unintentionally introduce false negatives. This issue occurs when we mistakenly categorize good ideas as bad ones. This trade-off will ultimately be a net positive for us if we can significantly reduce our false positive rate while only marginally increasing the false negative rate. I believe this is achievable.

False positives occur when you invest in something you shouldn't have, while false negatives occur when you don't invest in something you should have. Depending on the maturity of an investment portfolio, false positives can become more dangerous than false negatives, and vice versa. As our portfolio improves, we can accept more false negatives if it means we can significantly reduce avoidable mistakes. Said differently, it is more acceptable to miss out on good ideas when you already have them.

It is difficult to distill into a succinct sound bite what we will do differently from past years since it is an incremental improvement process. However, some examples of the guardrails we plan to further ratchet up include improved criteria for selecting management teams, reduced interest in companies enacting uncertain transformative change, fewer investment cases that rely on precise forecasting, weeding out companies that don't care about the customer, and avoiding ideas that have convoluted investment theses.

To summarize, we are demanding significantly more from prospective new ideas and will say "no" more often. These actions will lead to a higher hit rate and should unlock the latent potential within our portfolio.

Reinforce our operations: refine the processes behind repeated tasks and add expertise.

This goal continues our objective from last year: "invest in our processes to improve the work we repeatedly do, both from an operational and investment perspective."

In 2023 we will continue to invest in our processes and operational relationships. In doing so, we will free up time to re-invest in our highest return areas while improving institutional knowledge around our work.

Promote longevity: implement systems that increase the odds of capturing long-term compounding.

It is challenging to deliver compounded long-term returns within a fund structure because most funds do not survive over the long term.

Although we started Bonsai with this issue in mind, we are taking additional steps to ensure thoughtful long-term decision-making. These actions will improve our odds of long-term survival and, hopefully, allow us to improve our results.

Such changes will come in the form of how we fundraise, when we accept new capital and how much, relationship management, the types of companies we're willing to invest in, the activities required to underwrite and maintain those investments, and the degree of operational burden we are willing to accept.

If our day-to-day activities aren't second nature for us and our clients, it is hard to expect us to maintain them over long periods. Without a low-friction state of being, our investment horizon is at risk. We aim to future-proof as much as possible and this allows us to retain control over our investment time horizon. By improving our longevity, we increase the odds that the compounding process will go uninterrupted for as long as possible.

New Investment: Ferguson plc (NYSE: FERG)

Idea Generation

We often receive questions about idea generation. Although I'd prefer to share that we have a repeatable process for coming up with attractive investment ideas, great ideas are rare and usually difficult to identify in the first place. Our best ideas come from keeping an open mind and accepting that inspiration can come from anywhere.

Our investment in Ferguson emerged from a conversation Zi Hao shared with his uncle, who runs a plumbing business in Singapore. I paraphrase their discussion below:

> **Zi Hao**: "How's your plumbing business doing? I heard the cost of some of your materials rose 100% - 200% this year."
> **Uncle**: "That's right."
> **Zi Hao**: "That's tough. Is the business losing money on those products?"
> **Uncle**: "No, not at all. We pass on those cost increases to the client."
> **Zi Hao**: "Ok... So, what happens if those material costs come back down? Do you adjust prices again?"
> **Uncle**: "I've never seen material costs go down. It either stays the same or increases."
> **Zi Hao**: "Hm...ok. What about supply chain issues? Has it been more difficult to source parts?"
> **Uncle**: "It is certainly more challenging than in the past, but our parts supplier knows what we need. We've been buying from them for over 30 years."

> **Zi Hao**: “30 years? Why would you only work with the same supplier for so long? Don’t you compare prices across different suppliers?"
> **Uncle**: “Well, materials are a small part of the total cost of a job. I’d rather work with one person who consistently delivers on time and always has the parts we need.”

Zi Hao’s idea generation antenna received the signal loud and clear. After this conversation, he needed to learn more about plumbing parts distribution. Not only could it act as an inflation hedge, but it also might not be affected by deflation.

Ferguson – The Inflation Hedge

Ferguson is a leading distributor of plumbing, heating, ventilation & air-conditioning (HVAC), and waterworks in North America. The company was founded in 1953, with a rich history dating back to its predecessor, Wolseley plc, which was established in 1887. Wolseley plc, through many iterations, became a leading heating and plumbing distributor in the United Kingdom by 1976.

In pursuit of its goal to establish a global distribution business, the company embarked on an acquisition spree, targeting a variety of distributors across Europe and North America. In 1982, Wolseley acquired Ferguson Enterprises to enter the U.S. market, followed by the acquisition of Brossette, a leading supplier of plumbing products in France, in 1992. Additional acquisitions in Austria, Hungary, Germany, the Czech Republic, Italy, Luxembourg, Ireland, Canada, the Netherlands, Belgium, and the Nordic region further solidified Wolseley’s position as a global distribution leader in its end markets.

While the company’s acquisition strategy was ambitious, it led to several missteps. They overpaid on some acquisitions, such as in the Nordics, and mismanaged others, such as in France. They also acquired businesses outside of distribution, which resulted in a loss of focus.

Despite these issues, Wolseley’s U.S. subsidiary: Ferguson Enterprises, continued to thrive in the background, growing organically and through targeted acquisitions. By the fiscal year 2008, their U.S. plumbing and heating business accounted for one-third of revenue and over half of Wolseley’s profits.

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The Turning Point

The 2008 financial crisis presented a significant challenge for Wolseley, which forced the company to restructure its operations. This process involved bringing in a new set of executives and the sale of Stock Building Supply, a commodity supplies business in the United States.

Wolseley's new management team pivoted away from empire-building and focused instead on building its U.S. business: Ferguson Enterprises.

Since the restructuring began, the company disposed of all its businesses outside North America, culminating in the sale of the original Wolseley U.K. business in 2021. Now renamed Ferguson plc, the company is a North America-centric business with +95% of its revenues originating within the United States with the remainder in Canada.

Business Description

Ferguson is a leading plumbing, infrastructure, and appliance distributor in the United States, with over 75% of revenues derived from segments with either the #1 or #2 market position. Ferguson operates under the credo that "if water flows through it, Ferguson wants to distribute it."

A distributor like Ferguson exists to bridge the gap between a highly diversified supplier base and a highly diversified customer base. The more fragmented a supply chain, the greater the value the distribution layer earns to connect these disparate parties. Plumbing, for example, is a valuable niche for distributors.

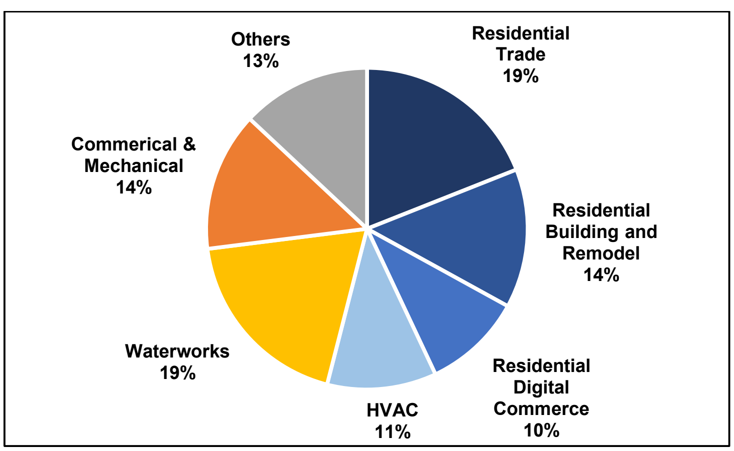
Ferguson exists because it is difficult for plumbing part manufacturers to distribute their products independently. The skills required to produce fault-free products at scale differ from those needed to run a global supply chain that can reach a fragmented customer base.

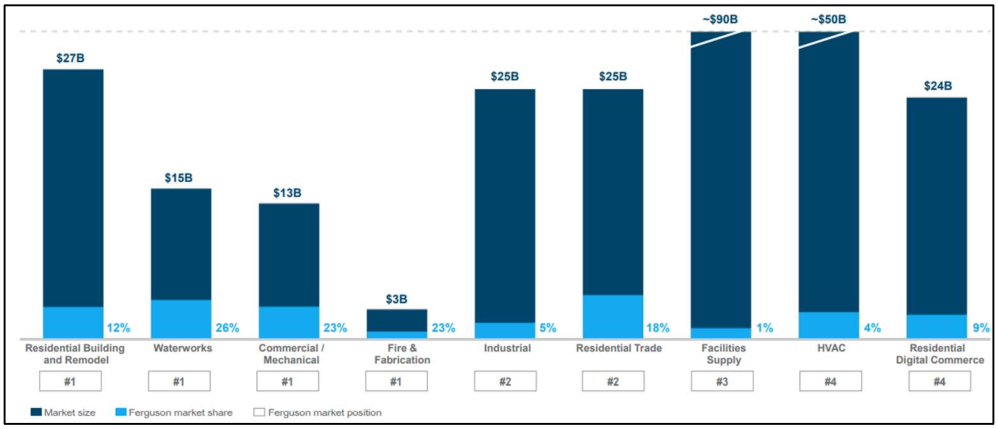
For Ferguson, their abilities and capabilities involve managing and transporting 22,000 shipping containers annually which hold over 3.5 million products from 30 different countries across 34,000 suppliers. Individual suppliers face dizzying logistical complexity and a lack of scale benefits if they try to go to market directly. As a result, suppliers typically rely on companies like Ferguson to facilitate their transactions more efficiently.

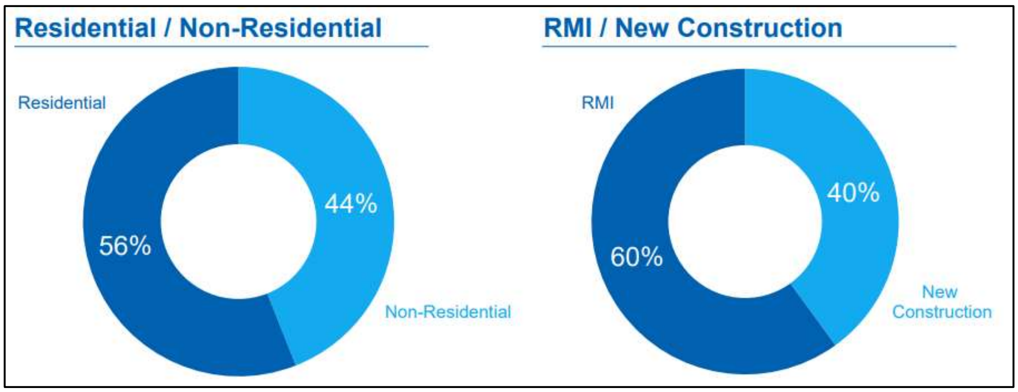
Ferguson's size and scope in consolidating these fragmented product catalogs allow the company to handle extensive inventories and logistics that would be hard for manufacturers to match. For example, Ferguson holds more inventory of Kohler products than Kohler does.

Ferguson Business Mix, Market Sizes, Market Share, and End-Markets:

While Ferguson's business segments may not appear closely related at first glance, they complement the company's core plumbing business. These adjacent markets have three things in common: they share similar customers, use similar products, and can easily be handled by the company's existing distribution infrastructure. This diversification across different verticals also makes the business more resilient, allowing Ferguson to perform better through market cycles.







Leading Customer Proposition

Ferguson’s value proposition to contractors is centered around the tradesperson’s cost structure. For contractors, labor costs are >50% of their total costs, while materials tend to be <25% on average. Since materials are a significantly smaller portion of their total expenses, hunting down the lowest prices on pipes is less important than optimizing a contractor’s time.

Ferguson saves contractors time by offering: 1) the broadest selection of in-stock materials, 2) the fastest logistics network, ensuring high in-stock availability and rapid delivery of new orders, 3) access to the largest network of local branches in case of last-minute needs, and 4) favorable payment terms to contractors.

Ferguson's high availability of stock, reliable delivery, fast logistics, and large footprint of retail distribution points ensure that contractors get more jobs completed in less time.

Since price transparency only exists between the contractor and the distributor, this prevents end customers from negotiating on price and allows contractors to pass through cost inflation as necessary.

Scale & Logistics

Ferguson's scale and logistics capabilities offer a significant competitive advantage. As the largest distributor in its end markets, Ferguson built a best-in-class logistics network, where 99.8% of in-stock products ship the same business day from their distribution centers.

Ferguson's logistics network includes two import centers, 14 distribution centers (with more in the pipeline), nearly 1,700 branch locations, and same-day or next-day delivery for virtually all products to 95% of the U.S. population using a fleet of 5,300 trucks.

Scale advantages allow Ferguson to:

Maintain extensive inventories of products, including those that turn over at a slower rate. This ensures that contractors can access even rare products on short notice. This is especially important if a job requires immediate attention.

Offer flexible payment terms. Contractors are typically paid after a project is completed. Flexible payment terms mean a contractor can pay Ferguson for materials after a project finishes. This otherwise would create cash flow issues or force the contractor to accept fewer jobs.

Have bargaining power with suppliers. This allows Ferguson to buy goods at lower prices, maintain competitive pricing, and invest in its lead in logistics and retail infrastructure.

Ferguson's emphasis on payment terms, convenience, selection, and confidential pricing makes them an attractive option for contractors. Higher inflation surprisingly does not hurt Ferguson since price increases are of little consequence to the contractor.

Ferguson’s scale also allows the company to build out its private-label portfolio. Private label products, such as the company’s ProFlo brand, are specifically designed to appeal to segments where customers are less brand conscious. By manufacturing products in the same factories as branded peers, Ferguson can keep product quality high while offering lower prices by removing the brand premium.

Currently, private label products represent approximately 9% of Ferguson’s revenue; however, they are growing twice as fast as the core Ferguson business, and these products have twice the gross margin of branded products.

Acquisition of Relationships

Sticky customer relationships are often associated with software companies due to their recurring revenue and “calculatable customer lifetime value.” However, software companies operate in an industry where the only constant is change. This makes such lifetime value calculations unreliable.

The concept of customer lifetime value may be more useful in a company like Ferguson since the plumbing industry has remained unchanged for over a century, and contractor relationships can last for decades.

Like Zi Hao's uncle, who worked with the same distributor for thirty years, most contractors work with a single primary distributor for long periods. Branch associates that contractors typically work with act like outsourced employees; they know the contractor’s business exceptionally well, creating stickiness.

Such close relationships tend to cause contractors to continue working with even suboptimal distributors unless significant events–such as the COVID pandemic–prompt them to work with other suppliers like Ferguson.

As a result of these sticky relationships, the typical “customer lifetime value” for a Ferguson customer or the customer of another plumbing distributor is significant. While Ferguson captures incremental market share each year due to their superior offering, they also acquire competitors to obtain its customer relationships.

In Ferguson's acquisition model, they acquire competitors for high single-digit multiples of operating profit (before synergies). After synergies, the price paid is roughly a mid-single-digit multiple of operating profit. Put another way, Ferguson acquires companies that contribute operating profits equal to ~15-20% of the total acquisition cost each year. These growing businesses are likely to continue delivering value for decades, compared to the implied 5 to 7-year payback period for the acquisition. Ferguson's acquisition strategy remains very attractive.

Looking to the Future

Previously, the sentiment in plumbing distribution was that anyone could open a branch or stock the shelves with inventory. It was the customer relationship that was hard to replicate. As younger contractors enter the industry, they also demand a robust online experience.

To remain competitive, distributors must meet the expectations of this new generation of contractors. Given their logistics expertise, we believe Ferguson is best suited to meet this challenge. Smaller 'mom-and-pop' competitors will likely struggle to deliver what contractors want.

Why does this opportunity exist?

Ferguson was trading close to its all-time low valuation multiple, primarily due to investor concerns around the COVID pull-forward of home building and housing renovation demand, a potential recession, and the impact of possible price deflation.

These points of uncertainty presented an opportunity since the business today is different than it was during the 2008 financial crisis, with lower cyclical risk. In 2008, 69% of Ferguson's revenue was derived from new construction, with only 31% originating from renovations, maintenance, and improvement (RMI). Today, their breakdown reversed, with 60% of revenue coming from RMI, which is far less cyclical.

In addition, investors are concerned that as commodity prices fall for materials such as plastic and copper, the price inflation of 2022 will also reverse. However, it is important to note that 85% of Ferguson's products are not commodity products with direct alternatives; therefore, these products are less likely to drop significantly in price. From our conversations with contractors and former Ferguson employees, they rarely see prices go down in earnest outside of commodity products. While commodity prices may fluctuate, the impact on Ferguson's business should be manageable.

Conclusion

We believe Ferguson is investable today because it is a structurally advantaged business with a leading customer proposition in a slow-changing industry. If you look at the historical financials of Ferguson, they appear messy and inconsistent due to the poor performance of their old international divisions and the timing of divestitures. This history hides the solid financial performance of Ferguson underneath. Ferguson is a high-quality business generating an excellent and consistent return on invested capital (>20%), which we acquired for 10-12x earnings. Contractors love Ferguson's value proposition, and the company continues to gain market share. We see no reason why this will change anytime soon.

While there are short-term headwinds to contend with, the long-term algorithm for growth is straightforward. Ferguson's focus on the contractor, track record of gaining market share, and higher exposure to RMI, accompanied by a reasonable valuation, make it attractive.

Closing Thoughts

Thank you again for your partnership. I will continue to provide updates throughout 2023.

In addition to our quarterly results and monthly statements from our administrator, we will shortly begin providing a monthly exposure report that provides additional portfolio-level visibility in-between our quarterly letters. This is what I would want to receive if I was a client. I hope the added transparency is appreciated.

Please don't hesitate to contact me with questions or comments.

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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The S&P 500 Total Return index is a basket of 500 large U.S. stocks, weighted by market capitalization, and is the most widely followed index representing the U.S. stock market. The S&P Total Return Index includes the reinvestment of dividends. Benchmarks and financial indices are shown for illustrative purposes only. They provide general market data that serves as a point of reference to compare the performance of other securities that make up a particular market. Such benchmarks and indices are not actively managed and do not reflect the expenses associated with managing an actual portfolio, the cost of investing in the instruments that comprise it, or other fees. No representation is made that any benchmark or index is an appropriate measure for comparison.

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