Bonsai Partners

Q1 2023 Investor Letter | *May 24, 2023*

Dear Investor,

For the three months ended March 31, 2023, Bonsai Partners Fund, LP, appreciated 7.7% net of fees and expenses. The S&P 500 Total Return Index appreciated 6.1% during this period.

Bonsai Partners Historical Returns Summary

	YTD 2023	2022	2021	2020	2019	2018	Since Inception	Annualized *Since Inception*
Bonsai Gross Return	7.9%	-26.5%	-13.9%	277.9%	60.3%	-17.6%	240.9%	31.8%
Bonsai Net Return	7.7%	-27.3%	-14.8%	247.9%	56.1%	-17.7%	198.0%	27.9%
S&P 500 Return	6.1%	-18.1%	28.7%	18.4%	31.5%	-8.6%	59.0%	11.0%

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 operating environment in 2023 continues to be dynamic, with no shortage of potential risks and opportunities. The impact of soaring interest rates continues to radiate across the economy, as seen in the banking sector, inflation, asset prices, and consumer demand. While I remain vigilant about how the world is changing, I do not spend significant time trying to predict what will happen next.

In 2022, Jamie Dimon, the CEO of JP Morgan, expressed the futility of such macroeconomic predictions. While he could see storm clouds on the horizon, he had no idea if one was coming. Instead of predicting the future, he focused on preparation. They would be ready, regardless of what came next. This mentality is something I try to emulate within our portfolio: **we can't predict, but we can prepare**. We prepare by investing in companies that will endure difficult operating conditions and by sizing these opportunities appropriately. While I don't know what will happen next, we will be ready.

Objectives for 2023

As outlined last quarter, our objectives for 2023 are:

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.

We continue to progress on each of our objectives. Regarding the first, we are noticeably choosier about which ideas make it into the advanced stages of our idea funnel. Related to our second objective, we deepened our relationship with our outsourced compliance firm, enhancing our compliance capabilities and oversight. Finally, our progress on the third objective is more of a continuous effort, primarily made up of small improvements identified and implemented over time.

Portfolio Review

As mentioned in our last letter, we reduced our cash position during the quarter. We used this cash to buy a new position in **Howden Joinery** and opportunistically add to some of our existing positions. We outline our thesis in **Howden Joinery** below.

New Investment: Howden Joinery Group plc (LSE: HWDN)

Howden Joinery, or Howdens, as it is more commonly known, sells kitchens in the United Kingdom. Put another way, Howdens sells a complete assortment of everything needed to build a new kitchen, from cabinets to drawers, countertops, appliances, sinks, etcetera.

What caught my attention about Howdens was how much their financial performance diverged from my expectations of a kitchen company. I would not have guessed that Howdens' gross margins are consistently above 60%–meaning the items they sell for $100 cost $40 to procure. These are unusually high margins for a company selling physical goods. Similarly, Howdens consistently earned a greater than 20% return on its invested capital (ROIC) over the past decade (excluding 2020), with ROIC approaching 30% over the past couple of years. These data points indicate that something interesting is going on beneath the surface. Howdens might not be a stodgy kitchen company after all.

I was also drawn to Howdens' conservative financial positioning. The company's balance sheet holds hundreds of millions of pounds in cash, no outstanding debt (outside its store leases), and generates significant cash flow. These cash flows are reinvested to fund the company's growth initiatives, and excess cash is returned to shareholders through dividends and share repurchases. Despite its attractive characteristics, Howdens was available for ~10x trailing earnings.

I wanted to know how such an unassuming company could have such appealing business characteristics. Fortunately for us, Howdens shares some of the same attributes present in a few of our other investments: Ferguson and XPEL. This made pattern recognition easier.

How Can Selling Kitchens Be Such Good Business?

Three elements of Howdens make it an unusually high-performing business:

1. **Friendly intermediaries**: Howdens does not have to pay for an expensive sales force or distributor network to get its products into the end customer's home. Instead, the contractors who install Howden kitchens promote its products on their behalf. Howdens' business model involves selling its products indirectly through hundreds of thousands of independent kitchen installers throughout the U.K., which we refer to as 'tradespeople.' These tradespeople act as a massive unpaid sales force since they evangelize the Howden product line for free.

   Tradespeople are typically considered trusted experts by homeowners, and this gives them considerable influence over where the kitchen is ultimately purchased. Kitchen installers recommend Howdens frequently because Howdens makes the tradesperson's life significantly easier, its products rank at the top of the price-to-quality spectrum, and the tradesperson earns more installing a Howdens kitchen—more on these factors below.

   As a result, Howdens does not have to waste money on distribution or marketing to attract end customers, resulting in a very efficient sales cycle.

2. **Vertical integration**: Howdens carefully absorbs high-value segments of the kitchen value chain through vertical integration. This allows Howdens to have better control over its supply of products while also retaining more of the profits within each kitchen they sell.

3. **De-centralized decision making, combined with aligned incentives**: each of Howdens' ~850 store managers run autonomous local businesses. This structure allows for local decision-making and re-calibration as conditions on-the-ground change. Such a strategy is more resilient and adaptive than relying on headquarters executives anticipating the needs of their stores.

   Further, Howdens' store managers and employees earn a fixed percentage of their store's profits, incentivizing employees to maximize store-level profitability. This compensation structure ensures that natural alignment exists between on-the-ground employees and shareholders.

Some Of Howdens' Kitchen Lines:

Source: Howden Joinery 2022 Full Year Results Presentation

Howdens, an Overview

Howdens may not be a revolutionary idea, but it is unique. Howden Joinery was founded in 1995 by Matthew Ingle, a descendant of "U.K. kitchen royalty," if you can imagine such a thing. Matthew's grandfather Tom Duxbury founded the leading U.K. kitchen maker at the time: Magnet, where Matthew worked up the corporate ladder to become the managing director of its trade business. Matthew was later pushed out of the company when Magnet fell into self-inflicted financial distress due to a combination of excessive debt and a U.K. recession. After leaving the company, Matthew wanted to re-create a stand-alone version of the trade business he built inside Magnet. The central premise of what would eventually become Howdens was that a company focused exclusively on tradespeople would best serve these customers and win their repeated stream of business.

Howdens is valuable to tradespeople because they offer the following:

1. **Superior service**: Howdens' network of >800 small depots across the U.K. means that ~85% of their trade customers are within five miles of their local store. They can quickly get whatever they need from someone they know and trust. Howdens offers white glove service and delayed payment terms so tradespeople can pay for a kitchen after the installation is complete. This saves tradespeople from worrying about their cash flow.

2. **Product availability**: Howdens' "in-stock" model means that kitchen installers can get what they need quickly and replace parts without hassle if something goes wrong or a change is necessary. Such rapid product availability saves time and allows a tradesperson to complete more jobs each year.

3. **Aligned interests**: Tradespeople earn more working with Howdens. Howdens' confidential pricing model allows tradespeople to mark up the products they install, allowing them to earn from the Howden products they sell in addition to charging for their labor. Retail customers cannot go around the tradesperson to buy directly from Howdens, and this gives the tradesperson a proprietary product offering. These elements create alignment between Howdens and the tradesperson.
4. **Great Kitchen Value**: Most importantly, Howden kitchens are top quality for the money. An installer knows that if they choose Howdens, their customer will be happy with the result; the kitchen looks nice, it was provided at a fair price, the installation went smoothly, and it will last a long time. Howdens offers competitive pricing due to scale advantages and vertical integration.

Assuming ~80% of Howdens' revenue is kitchen-related (the remainder is joinery, doors, and other trade-related accessories), the company has approximately 25% kitchen revenue share in the U.K. According to the research firm JKMR, Howdens sells roughly ~40% of all U.K. kitchens by volume due to its high exposure to low to mid-range kitchens.

Unlike selling kitchens to consumers in a retail setting, selling to tradespeople through small local depots is a far more attractive business model. Homeowners are fickle and only buy kitchens infrequently, which makes acquiring them as customers less attractive. On the other hand, tradespeople are sticky, repeat customers that will return to Howdens as long as they continue offering the best place to buy kitchens.

As mentioned earlier, Howdens maintains hundreds of thousands of accounts with tradespeople across the U.K. and its brand is well-known among installers. Howdens strong market position is evidenced by the struggles of its closest competitor: Benchmarx Kitchens (a subsidiary of Travis Perkins plc). Benchmarx tried to copy Howdens' trade-only business model while also undercutting their pricing, but failed to gain any meaningful market share. Howdens trade customers are loyal and sticky.

Howdens stocks and sells its ~90 different kitchen ranges via its network of ~800 small format depots across the United Kingdom and ~60 continental European locations concentrated in France. Howdens' depot model is powerful because each depot manager runs the branch in the way they think is best for their local economy. Managers stock the products they think their customers want, price them based on local supply and demand trends, offer discounts as they see fit, and service customers in a high-touch way that keeps them coming back. This autonomy works because managers are incentivized simply: they earn 5% of the net store-level profit (assuming they meet their basic margin requirements). Pushing decision-making authority out to the depots removes the need for headquarters to make brilliant decisions and see around every corner consistently. Instead, depots can naturally adapt and respond to conditions as they see them, resulting in better operating performance.

Behind each depot is a strong manufacturing footprint based at their Runcorn and Howden sites, as well as two sites dedicated to manufacturing quartz countertops. Howdens' manufacturing strategy emphasizes only making products in-house that are simple, high-volume, and represent an outsized portion of a kitchen's profitability. As a result, Howdens today manufactures roughly one-third of the products it sells, with the rest outsourced to specialists who can do it better. From these manufacturing criteria, Howdens today makes its wood cabinets, kitchen frontals (drawers, facias), solid work surfaces, and a small variety of other wood-based products such as skirting and architrave.

Put together, the above factors allowed Howdens to become the largest kitchen supplier in the U.K. while earning industry-leading gross margins and returns on invested capital. In 2022, Howdens generated nearly £400m of operating cash flows and, after subtracting depreciation (a proxy for maintenance capex), approximately £350m of look-through "free cash flow." This compares with the company's current enterprise value of approximately £3.6b, which represents a ~10% free cash flow yield despite the attractive nature of the business. Howdens has no debt, pays an attractive dividend, and aggressively repurchases its shares.

Opportunities for Growth

While Howdens does not have an infinite growth runway, there are many logical places it can invest in to increase future profitability meaningfully. Regarding its depot base, Howdens has ~800 depots in the U.K. today, with aspirations to reach ~1,000 depots over time. Further, outside of the U.K., Howdens started to see signs of success in its store clusters in France. Howdens expects 60 operational depots in France by the end of 2023. While I was initially quite skeptical of their French expansion–British companies don't typically succeed there–my research indicates they are gaining momentum. I was encouraged to learn that they assembled a high-performing local French management team, which, combined with their autonomous depots, allows them to be nimble and adapt to the nuances of the French market. Over time, France could provide an opportunity for hundreds of additional new depot locations and serve as the prototype for expanding into other continental European markets.

In addition to new store growth, there are multiple opportunities for Howdens to make its existing depots more profitable. First, Howdens is refreshing its store base to its updated depot format. This investment makes existing locations more appealing to visit (driving increased store traffic) and more efficient to operate.

Next, Howdens is making significant investments in its digital capabilities due to its historical underinvestment in this area. To illustrate this point, Matthew Ingle, who was Howdens' founder and CEO until 2018, **did not have a computer or**

smartphone during his 23 years running the company. Virtually all customer interactions today happen over the phone or in person, with only basic IT systems behind each order. By creating a digital offering designed for customers, a tradesperson can see what's in stock locally, place orders online, and get notified when their products arrive. This will save depot managers significant amounts of time, which they can reinvest in offering better service and generating new business.

Howdens is also working to build higher brand awareness with homeowners to continue the trend of stealing share from traditional kitchen retailers that represent the majority of the U.K. market. While Howdens maintains significant brand awareness among tradespeople, less than one in four British consumers is familiar with the Howden brand today. Through targeted investments in marketing, Howdens is attempting to entice consumers to seek out their products directly, either via their website or stores, thereby closing the customer loop. In our portfolio, XPEL is an example of a company that built a desirable consumer brand that funnels customer leads back to its network of skilled installers. If Howdens can attract customers and refer those leads back to its tradespeople, it will further reinforce its value proposition while also driving additional market share gains.

As mentioned earlier, Howdens improves its profitability by continuously capturing more of the kitchen value chain through vertical integration. Historically, the company only manufactured cabinets, a limited selection of frontals, and some wood-based laminate countertops. Today, Howdens is investing in additional manufacturing capabilities for a more comprehensive array of drawers, facias, quartz work surfaces, skirting, and architrave.

Through the acquisition of Sheridan Fabrications and the acquisition of the assets of J. Rotherham out of administration, Howdens acquired two of the largest manufacturers of quartz countertops in the U.K. While Howdens only manufactured laminate wood countertops in the past, these acquisitions offer Howdens the ability also to manufacture higher-end work surfaces that resemble natural stone countertops at an attractive price. Unlike traditional stone surfaces that are difficult to manufacture consistently due to the constraints of rock sizes and shapes extracted from the ground, these highly manufacturable man-made stone surfaces cater to Howdens' ethos of high-volume manufacturing at consistent quality levels.

High-end stone countertops can represent 20-40% of the total value of a new kitchen, which means these acquisitions materially increase Howdens' reach of a kitchen's 'bill of materials.' Offering quartz countertops also gives Howdens a more competitive offering in the higher-end kitchen market, where the company is historically underrepresented. Howdens continues moving upmarket through its refreshed premium kitchen offering.

In short, Howdens has multiple pathways to grow its profitability over time, all funded through internal cash flows without relying on the capital markets. After investing in its growth initiatives, the company returns excess cash to shareholders through its nearly 3% dividend, and last year alone repurchased **~6.2% of its total outstanding shares**. When valuations are depressed, these repurchases accelerate value creation for shareholders. Between investments in its core business, accretive M&A, dividends, and repurchasing shares, Howdens has multiple pathways to compound shareholder capital.

Conclusion

Howdens is attractive because of its robust business model, straightforward means to grow its profitability, fortress balance sheet, strong cash flows, and opportunity to return capital to shareholders, all at an undemanding valuation.

Of course, we contend with the obvious question of how much COVID pull-forward the company faces or whether the U.K. faces a recession. Investors hate such uncertainty, which is partly why the shares are so cheap. While it is possible, if not probable, that the company will see declining revenue in the short term, there are many reasons to be optimistic over the medium to longer term. Given the maturity of the housing market in the U.K. and its aging housing stock, 95% of Howdens' business is tied to repair, maintenance, and improvement, which is more resilient to economic cycles. Further, with more time spent at home and accelerated home purchases due to the COVID period, homeowners are likely to continue investing in their homes instead of buying new properties.

Lastly, while inflation continues to be a concern, Howdens has significant pricing power due to its business model, which relies on the goodwill of the tradesperson combined with its confidential pricing practices. There has been limited sensitivity to Howdens' price increases to date. Howdens appears well-suited to handle whatever lies ahead.

Closing Thoughts

Thank you again for your partnership.

Beginning at the end of March, we started providing monthly exposure reports through the investor portal, and these short reports provide some intra-quarter visibility between our quarterly letters.

I'm always open to feedback and strive to serve you better. If there are other ideas you would like me to consider implementing that would add significant value to you, please let me know. I'm considering sending out a survey around the end of the year to hear more about what I can do better from an operational perspective.

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

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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