Investment Manager's Report

February 2014

The fund is up 58% gross of fees since our last newsletter in October of 2013.* As of 28 February 2014, the fund is up, gross of fees, 15% in one month, 28% in three months, and 69% in six months.*

When it comes to the short term, we are reminded of Kipling's poem *IF*..

"If you can meet with Triumph and Disaster, And treat those two impostors just the same."

We do not let short-term ups and downs alter our long-term philosophy of value with a growth catalyst.

I am as non-pulsed about a plus 38% return for a quarter as much as I am about a 20% downdraft. The fund's investment horizon is 3 years, at least. If I were to pay close attention to a quarters' return in this small/mid company space, up or down, I would routinely oscillate between euphoria and depression. Over the long term, a company's valuation will reflect its earning potential. To paraphrase Kipling, treat the stock price, high and low, as the imposter it is and concentrate on the long-term value of the business (a business with a good business model, operating in an attractive industry, led by an ethical management team generating high ROE's).

This quarter's stock price returns have been good. The next quarter's performance may be dismal. Our measurement is over the long run. In the last 3 and 5 year periods we have handily outperformed the BSE Sensex and Small Cap indices. I will be the first to point out in the first year of operations, although we performed in line with the BSE Small Cap benchmark, we lost, and we lost big. The next year the fund was up over 50%, but the indices far outpaced our performance. These past failures stung, but we went to school, and over the last seven years we have become better, succeeding more, failing less, and failing faster. As managers of the fund, we eat our own cooking and rise and fall along with our investors. To our investors who have stuck with us through these times, thank you. I am confident your patience will be rewarded as the fund gathers its stride.

The Economy - We worry from the top down, we invest from the bottom up

Generally, the Indian market is reflecting an insidious malaise from top-down macroeconomic forces of slowing GDP growth, a hog-tied government, higher interest rates and the global investor trepidation. That said, we are seeing good growth in specific sectors, notably IT and Pharma. IT companies, especially mid cap IT companies have done well. We prefer well run, modestly valued, small and midsized IT companies that are catering to global players in niche product areas. Companies developing the next wave of technology known as SMAC (Social, mobility, analytics, and cloud) are poised for growth. We have two portfolio leading

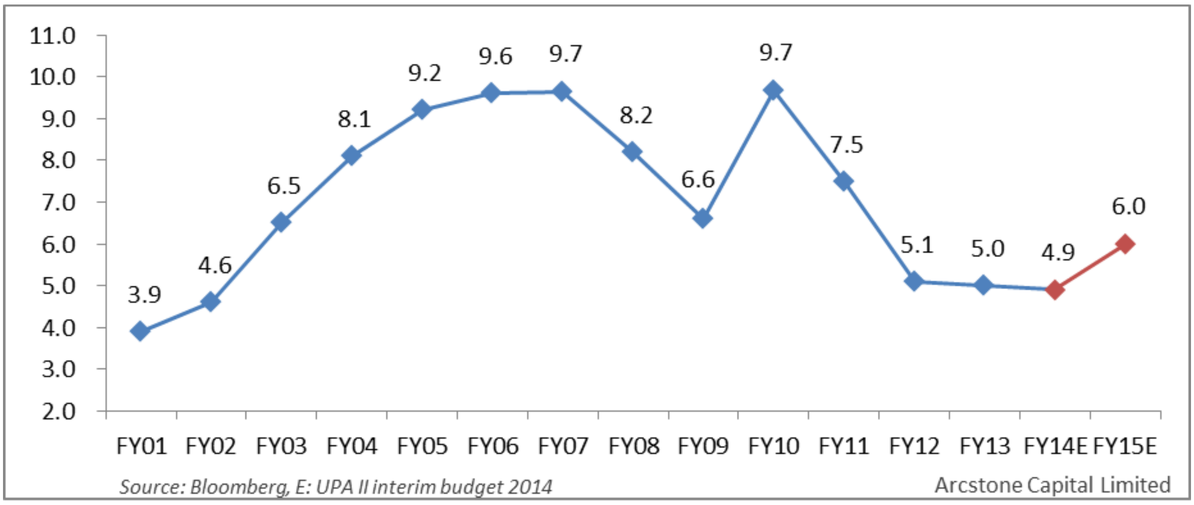
* Based upon preliminary February 2014 NAV

companies in this transformational space. Pharma is also doing well supplying generics and lower cost research and development to the West.

It is never smooth sailing and there are always challenges in our portfolio companies, the Indian economy, the global economy and the global political landscape. There will always be a restless sea in which we fish.

"We must free ourselves of the hope that the sea will ever rest. We must learn to sail in high winds."
Aristotle Onassis

Indian Current Events



Coming Elections: I feel a sense of urgency. I believe the coming elections will usher in a new government and create an economic tailwind. In my opinion, once the election results are out, the move, especially in small companies, will be abrupt. But here's the problem, everyone is thinking the same thing, and that gives me reason to pause. When I start having thoughts like everyone else, I start to worry.

A recent research paper from Dolat Capital expresses the same concerns. **"**Our concern remains the whole hearted market consensus that the NDA led coalition will be voted to power, and that is partially priced in. Ironically, history offers enough precedents to prove that too much of a consensus usually turns out to be a dampener. And even a swing of 15-20 seats is all it could take to make or break the end result for the elections. We maintain that the NDA seems better placed verses our last analysis (Celebrating too Early, Nov 28, 2013), having gained momentum in battleground states of Maharashtra and UP. Yet it needs to keep this momentum going to get to at least 210 plus seats to be in a position to attract couple of allies to achieve a home run."

Prabhudas Lilladher, another broker dealer research arm, says "As we come closer to the Lok Sabha polls, any indications of a fractured mandate is likely to result in an increase in negative sentiment, sending the market lower."

We'll see from charts below that the market is not over nor undervalued by historical metrics. And the expectations of a new government is priced into the market, but not excessively. Therefore, any move in either direction will not be unusually severe.

India (is not) on the investors' radar

India remains somewhat of an investment backwater because of political and economic uncertainties.

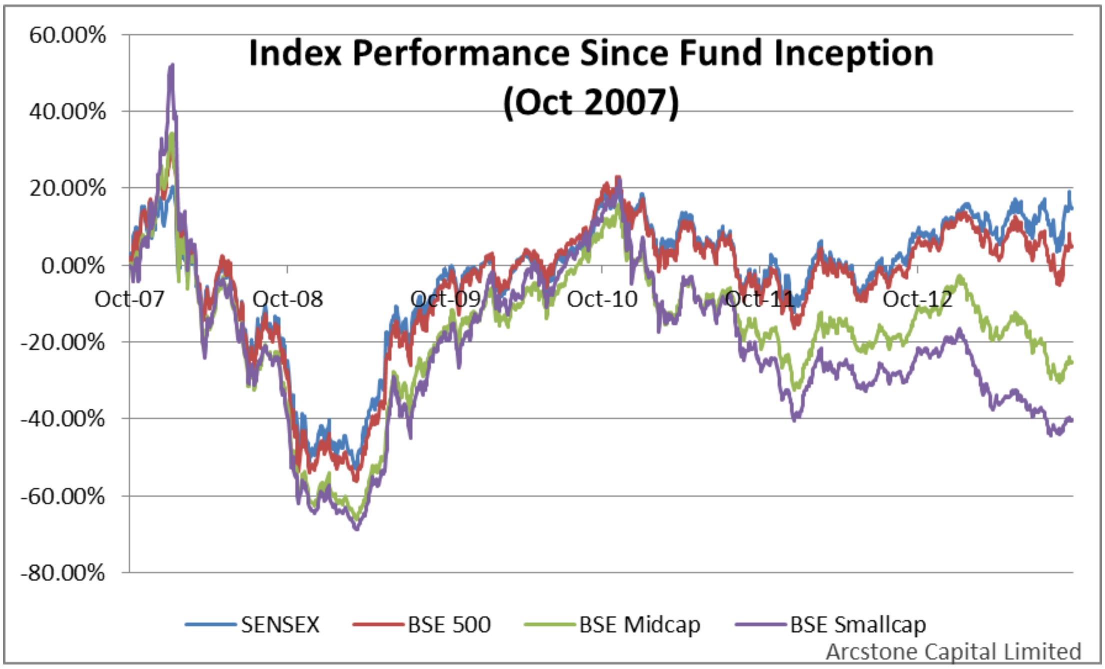
In a recent Financial Times article by Mohamed El-Erian, he believes India is unnoticed because (i) there is a lot else going on globally, (ii) India is hard to analyze, (iii) there is malaise hidden behind the global success of a few Indian MNC's, and (iv) India's disruptive impact is limited to IT, compared to China's broader global manufacturing disruption. El-Erian states these are all specific reasons, but not good reasons, to ignore a huge and growing consumer middle class in a market driven democracy with 1.2 billion citizens. He goes on to say sooner or later, the growth of India's middle class will be felt.

El-Erian suggests India needs the next leg of structural reforms to move to the next phase of growth. Market-based microeconomic behavior, reduction of corruption, and reforms to the budget weaknesses will help move the Indian economy to the next level.

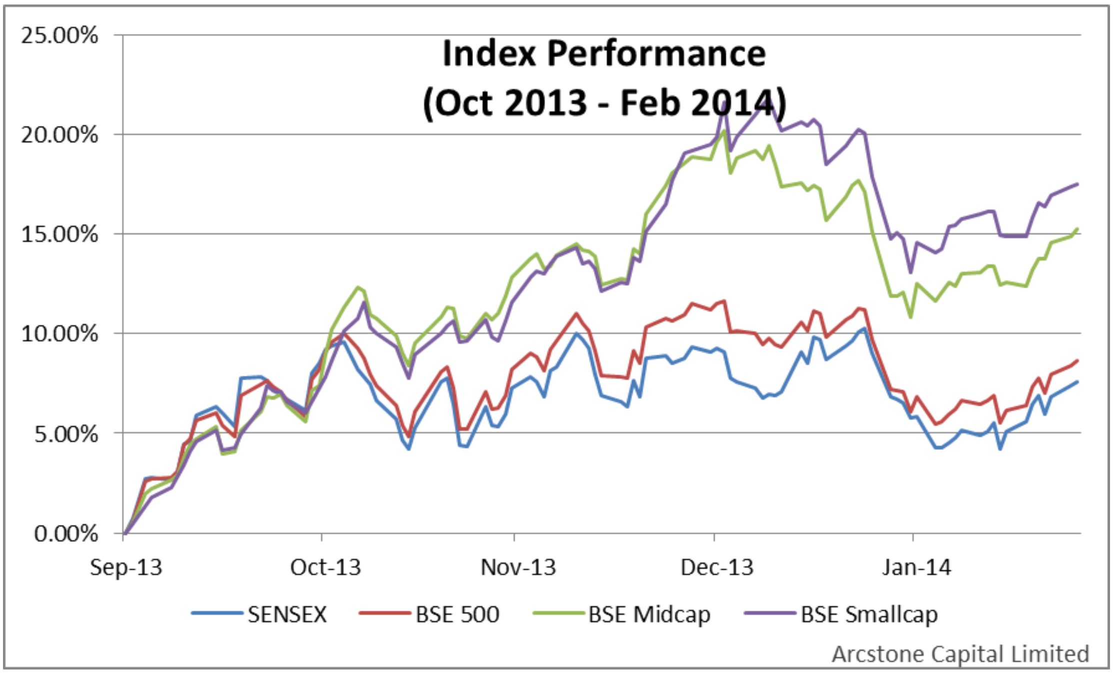
Independent of the challenges faced by India, it is clear to the managers of The Passage to India Fund that India, as the world's largest democracy holstering a nuclear arsenal, in a strategic geographic location, and home to 1.2 billion future consumers, is an independent investment destination that deserves a detailed, dedicated and long-term investment strategy.

<u>The Market – Still a small and mid cap disconnect</u>

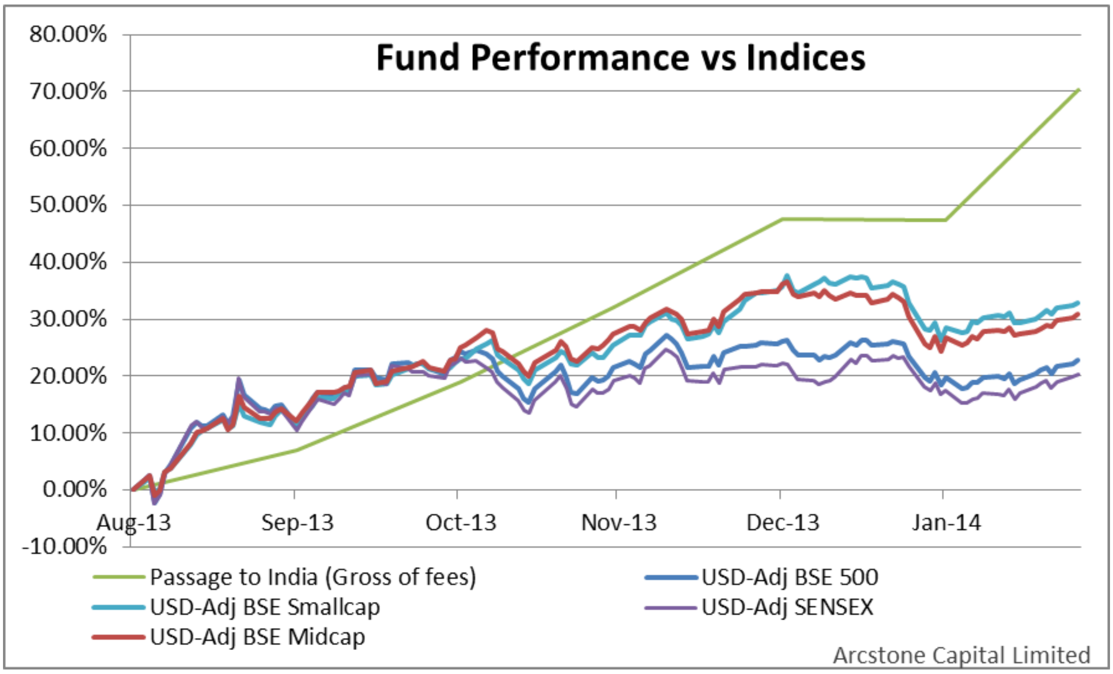
In our previous newsletter we graphically illustrated in the below chart the stark disconnect between the small and mid cap stocks and the front line Sensex.



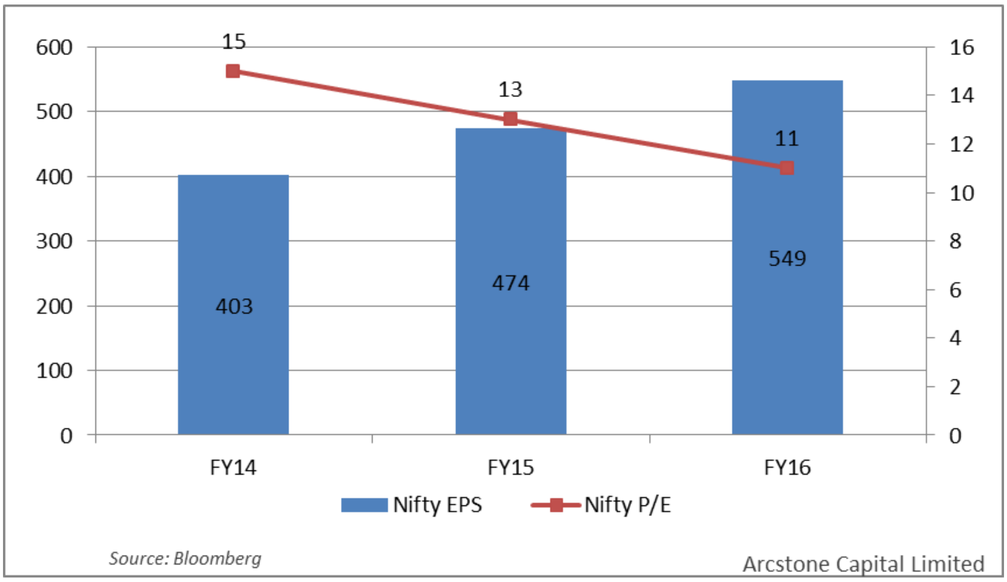
Beginning in November 2010, small and mid cap stocks have been under extreme pressure versus the large caps, producing a 48% difference in performance for the period from November 2010 until October 2013. Since September 2013 the small and mid caps have started a recovery advancing 17% versus the Sensex move up of 8%.



And the fund has performed better than the indices during the same recovery period due portfolio concentration, sector allocation and lower valuations.



The larger market is fairly valued as the economy continues to grow, albeit at a slower 5.5% pace.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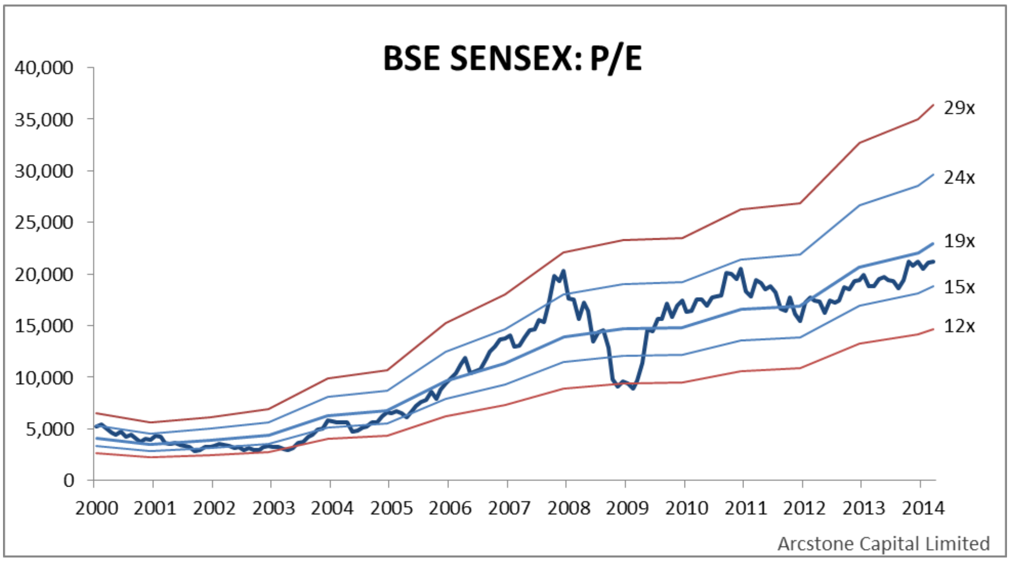
Nifty EPS
Nifty P/E
Source: Bloomberg
Arcstone Capital Limited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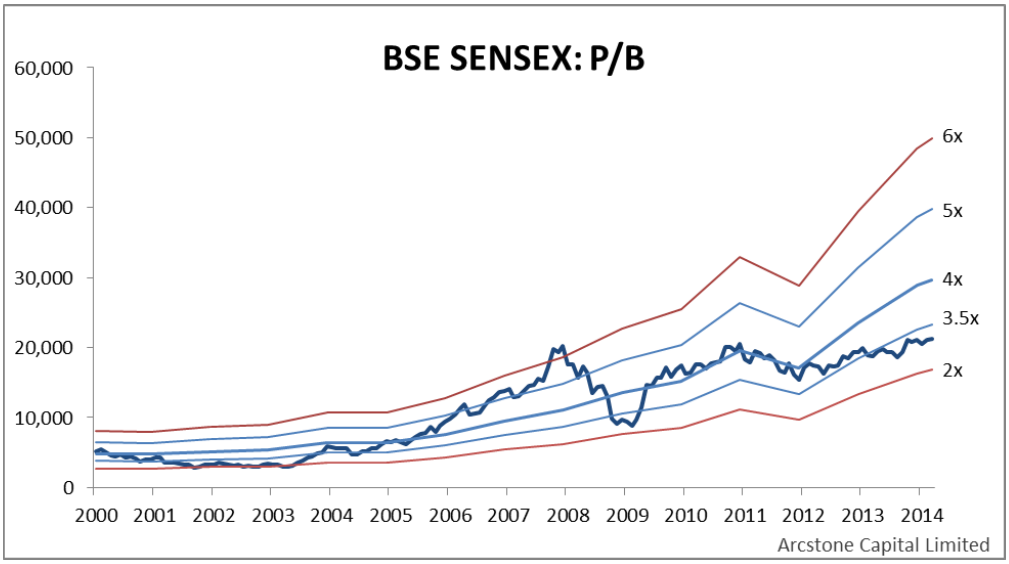
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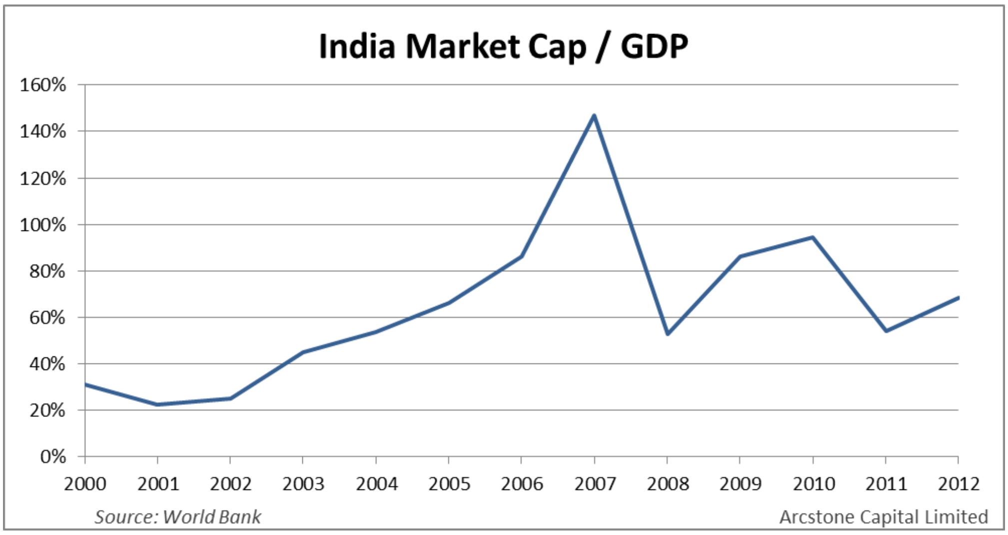


The Portfolio

Overall market valuation is reasonable, and the portfolio is squarely positioned in the smaller company space where we believe the greatest informational inefficiencies, higher growth rates, and discounted value reside.

Market Cap		
	USD	**% of Holdings**
Mega	5.0+ B	0%
Large	1.0-5.0 B	11%
Mid	200M-1.0 B	10%
Small	100-200 M	8%
Mico	20-100 M	46%
Nano	0-20 M	25%
Total		**100%**

Top 5 Holdings	
Small specialty chemical	>15%
Small plastic manufacturer	>10%
Large pharma	>10%
Small software testing company (buy out)	>8%
Electrical lamination manufacturer	>5%
Concentration	**60%**

GICS Sectors	
Consumer Discretionary	5%
Consumer Staples	2%
Energy	0%
Financials	1%
Pharma	12%
Industrials	17%
Information Technology	19%
Materials	43%
Telecommunication Services	0%
Utilities	0%
Other	1%
Total	**100%**

Last quarter's good performance is the result of (i) the portfolio's infrastructure and manufacturing companies' prices stabilizing after pressure on these companies ran its course, (ii) good results in our IT and Pharma holdings, and (iii) a specialty chemical manufacturer which tripled in value for the quarter on good revenue growth, earnings growth, and domestic mutual funds moving into the company (i.e., discovery of the company by the market).

Holdings – We invest for the long term

The fund turnover has been 35% for the last 7 years, meaning our average holding period is roughly 3 years. Overtime, we are aiming to increase this holding period to 5 years. Our three best absolute return performers have been in the portfolio for over 3 years, one for over 6 years. We think the next growth and recovery sector will be the current beaten down manufacturing and materials companies and we have positioned the portfolio for this 3 to 5 year cycle.

Astral Poly Technik Ltd – A six year hold

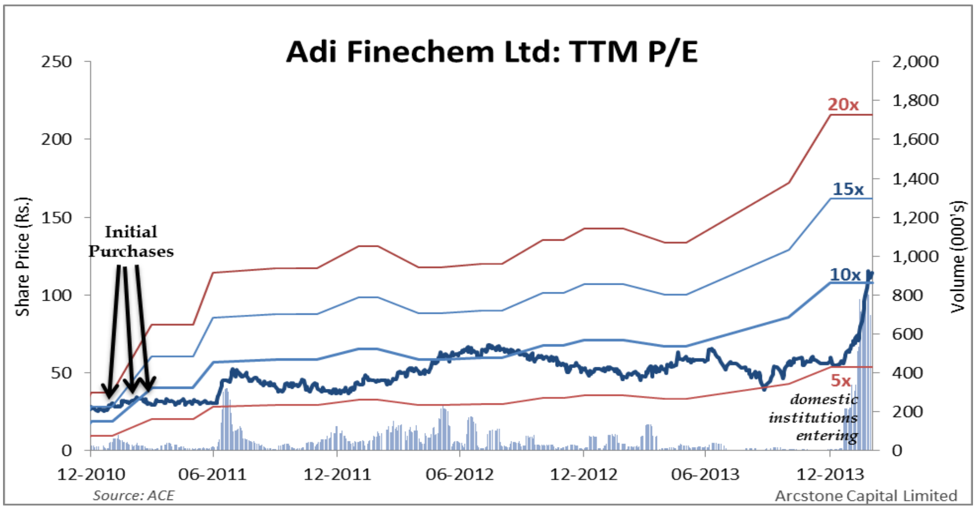
Lead by a solid and tenured management group, this PVC pipe manufacturer's revenues increased from USD 21M in 2008 when we invested to last quarter's run rate of USD 170M. Year over year, last quarter's revenue increased 38%, EBITDA increased 126%, and profitability was up 97%. Management continues to deploy Astral's capital efficiently and profitably. ROCE and RONW are 32% and 28%, respectively.

Astral Poly is one of India's largest PVC pipe manufacturers. Its pipe product lines have expanded into fire suppression and bendable pipes and its distribution network has deepened and broadened. India is a country still short 10 million homes providing amble room to grow. We bought the company at a valuation of USD 40M (45 Rs/USD). This year Astral will generate a net profit of USD 14M (62 Rs/USD), in the face of a 37% decline in the Rupee. On a constant currency basis, the net profit this year would be roughly half the company's valuation when we invested.

Adi Finechem Ltd – Specialty Chemical Manufacturer

A small specialty chemical manufacturer, a 3 year hold, took time to debottleneck its factory, expand its product offerings, and fully utilize its increased capacity. Today it is a USD 25M revenue company, up from USD 10M in revenue when we purchased the company in 2011. Previously, Passage was the only institutional investor in this small well-run, niche, yet unknown company. Recently the company retained an outside IR firm and has attracted domestic institutions, increasing its trading volumes dramatically and pushing up the share price. The value of the company remains very favorable: a P/S of <1.0, trailing P/E of 10 (still a 40% discount to the industry average of 17), and top-line growth rates of 20+%.

The company is now poised to enter its next leg of growth as it secures a green field expansion, further increasing its capacity.



Aurobindo Pharma Ltd

The pharma industry is another sector that we believe has good growth ahead of it. Currently, India is the second largest provider of finished drugs and the eighth largest exporter of food products to the US. In the US, demand for generics is rising as the Obama administration is trying to reduce healthcare costs. Also, according to IMS Health, India's USD 14 billion-a-year drugs market is expected to be worth USD 22-32 billion by 2017. Furthermore, USD 70 billion is going off-patent in the US over the next 3 years and we believe APL is well placed to tap this opportunity. Western multinationals such as Pfizer Inc, Novartis AG, Roche Holding AG and Sanofi SA are eyeing a larger share of the growing drugs market in India plus partnering with low-cost suppliers for their global sales. Aurobindo has entered into long-term supply agreements with Pfizer (March 2009) and AstraZeneca (September 2010), which provides significant revenue visibility going ahead.

Problems remain as growth continues. Issues of Intellectual Property Rights (IPR) are bedeviling the drugs trade. A recent report by the US Chamber of Commerce ranked India at the bottom of 25 countries in protection of IPR, which has been questioned in India. The seas are never smooth.

We purchased Aurobindo Pharma 3 years ago at a valuation of less than USD 600M. (This company materially skews the portfolio's average market cap. Without Aurobindo Pharma the average market cap of the portfolio is approximately USD 100M, our historical average.) This company has the largest Abbreviated New Drug Application (ANDA) filed with the US FDA and it has increased its filings (ANDAs and dossiers) in the US dramatically from 313 in FY2008 to 1,647 in FY2013. Amongst peers, APL has emerged as one of the top ANDA filers. Aurobindo is one of the largest generic suppliers under ARV contracts, with a 35% market share.

We estimate net sales to log a 40% CAGR over FY2013–15 on the back of supply agreements in the US and ARV formulation contracts, which will be supplemented through the recent acquisition of the Western European formulation business of Activas. This has also brought the company to become a ~USD 2 billion in sales company, with more than 85% of sales being accounted for by formulations.

Manufacturing & Infrastructure Companies

Of the eight manufacturing and infrastructure companies in the portfolio, all have experienced either a bottoming out or a slight recovery. In spite of averaging down, the fund's average purchase price in most cases is still underwater by 10% to 20%, but our downdraft it is not near the decline of 40% and 50% if we had not averaged down.

The fund has held for 2 years a small USD 20M infrastructure construction company with revenues of USD 330M. Earnings are down 50%, the stock is off 40%, and now the P/E is now less than 2.5. Battered by high interest rates, slow contract execution due to a stalled government process, and a lower order book, the company's NPM has declined from near 10% to 3%. Yet, this 17 year old company is still profitable, which is saying something in this space today. When the government gets straightened out, payments speed up, and execution of projects are normalized, the profitability will return, and we anticipate at a normalized P/E of 7. If a new government is elected, this turn around could occur in 6 to 9 months. If Congress maintains its hold, or the BJP does not command a significant number of seats, then we wait patiently.

Information Technology Companies

We had two companies being bought out, one company the portfolio had just purchased making the return rather lucky timing, the other a longer-term hold of nearly 4 years. Both of these companies were up over 3X for the quarter and each had become greater than 10% of the portfolio. I have sold the entire stake in one company, a logistical software company, because the company is now embarking in a new business. The other company, a software testing company I have pared back to 8% of the portfolio. These two companies attributed significantly to the overall performance.

The portfolio has been positively impacted by all 5 smaller to mid IT companies that have benefited from the Rupee depreciation plus low financial valuations. Two are still low at 0.5 P/S. Four of these companies have a P/E below 6, and three of those a P/E of 4. They have high ROE's and are growing fast.

<u>"Patience while the revenues grow, the company becomes larger, profitability expands, the market discovers and the small company discount shrinks."</u>

In the remaining portfolio, we have manufacturing companies which have been in the same boat as infrastructure: down, down, down. We have been averaging down on most of these as well. With four companies the fall has been so steep that even with averaging down, the positions are still in negative territory from -51% to -29%. These dogs will hopefully be the outperformers of the second half of CY14 to the end of CY16. The short-term stock price does not worry me in the least. This perspective allows the long view riding out even multiyear disappointments.

We have sold a small plastic manufacturer because of lack of communication with management after repeated attempts to schedule meetings. We have doubled down on a hard hit high value steel pipe manufacturer which, along with another electrical manufacturer is down today, but most likely a very good performer in the future.

We stick with good management even in challenging times. There are two things that can sink a good small company: management and debt. It is hard enough to find stellar smaller companies in India, to dump overboard in a down cycle is the equivalent of selling fertile farmland to pay short-term bills.

We steadfastly believe value is in the long term and we do not let short-term rough waters alter our sailing course. While we navigate these seas we always keep a weather eye on the horizon and keep sailing true.

I would like to thank our long term holders for their continued trust in our course knowing my personal wealth is inextricably tied to the same vessel.

Kind regards, Ralph

Ralph Kruger
Managing Director
Arcstone Capital