Investment Manager's Report

April 2014

The Long View, The Only View, One Day at a Time

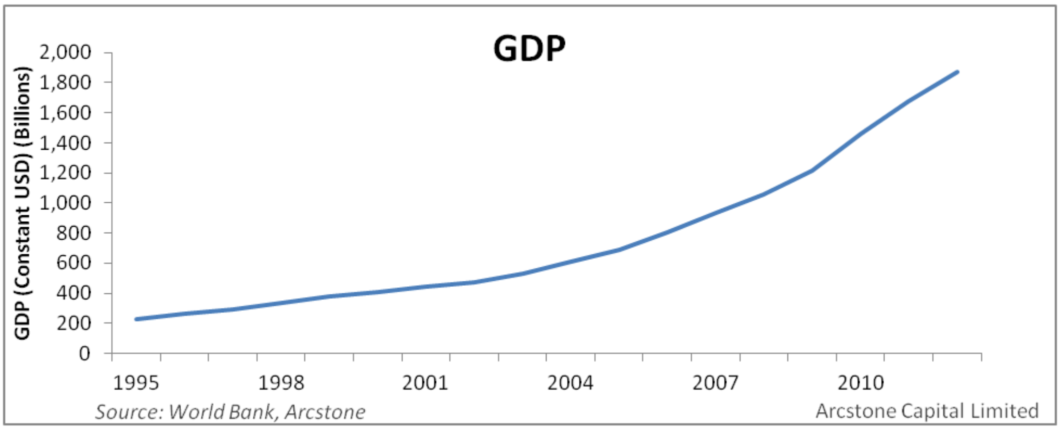
Volatility, uncertainty, risk, I'll invest, not today, but when things get better. Well folks, things are getting better right before our eyes and most of us are still waiting for the right moment to invest in India. There's no right moment to invest in one of the fastest growing and most populated countries on earth. Take the long view, and take it now, for time's a wastin'.

Passage to India's monthly gain, gross of fees, in February was 15%, and in March we saw similar returns of 18%. Sentiment in the India market has slowly turned positive as India's 825 million voters go to the polls to elect a new government for its five year term.

Over the past twelve months, Passage to India's gross of fees return through 31 March was 58%, compared to the USD-adjusted S&P Small Cap and SENSEX indices' returns of 10% and 8%. Previously, the depreciation of the Indian Rupee has been a large headwind for the fund, down 11% over the past year. in spite of the recent run up the valuation of the Fund's specific investments continue to be attractive with high growth rates, excellent ROCE and RONW's, and low debt. We have trimmed some very good performers as valuations moved to the higher side of our comfort level. The fund's dividend yield is 2.3%.

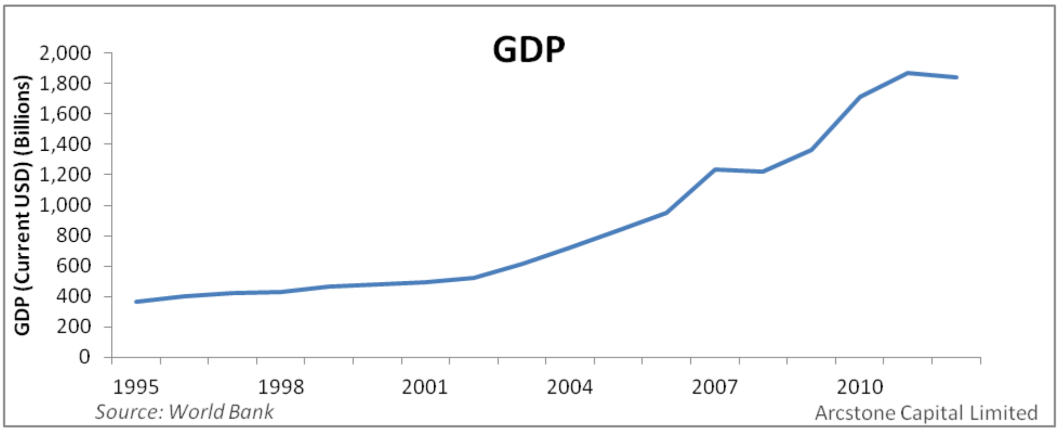
In 2008 we launched the fund in the teeth of the financial crisis. The world's GDP growth had faltered, first in the US, and then the EU struggled, drawing a dark shadow over the hope of a better future. Emerging market growth stalled and China's investment-led growth initially helped global growth but has since turned suspect. During the last 3 years, inflation and interest rates had been increasing in India dampening auto and home sales, which in turn put pressure on auto ancillaries and household goods manufacturers. Finally, the government was largely MIA – bedridden by scandals and ineffective leadership resulting in stalled infrastructure projects, mining projects and oil and gas exploration. Downright terrible conditions.

But a funny thing happened on the way to financial ruin. Aside from how badly we felt, the Indian economy continued to grow, doubling since 2008. Huh! Doubling? Really? The economy doubled and earnings of the S&P BSE 500 increased 70%. So much for the world ending. Successful investing is not a Usain Bolt's 19.59 200M dash, it is a coast-to-coast road trip, complete with pot holes, engine trouble, and tire replacements.



As you can see from the below chart, foreign exchange had been a short- to mid-term consideration as our denomination is in US dollars and the falling Rupee decreased the USD returns. Over the long term it may have some impact, either positive or negative. That said, we remain focused on the fund's investments not the exchange rate. In the last 6 years FX has worked against us; over the next 6 years FX may be a negative, neutral, or positive influence. However, we believe most, if not all, of the Rupee depreciation is behind us.

The last 6 years certainly didn't feel all that good. Yet the above and below charts look quite good. So why the sad face, with such a smiley chart? In a word...we don't get out much. While most developed world investors were diving for cover from their own blow ups, much of the world continued to grow. There will always be problems and issues and scandals, but over the long term, people need to eat, buy clothing, go to school, see movies. (Bollywood made 1,000 movies in 2012 compared to 677 Hollywood movies. The Indian movie industry revenues have increased 10% annually since 2004.[1]) As it happens, most of the people who need these items are outside the US/EU population centers.

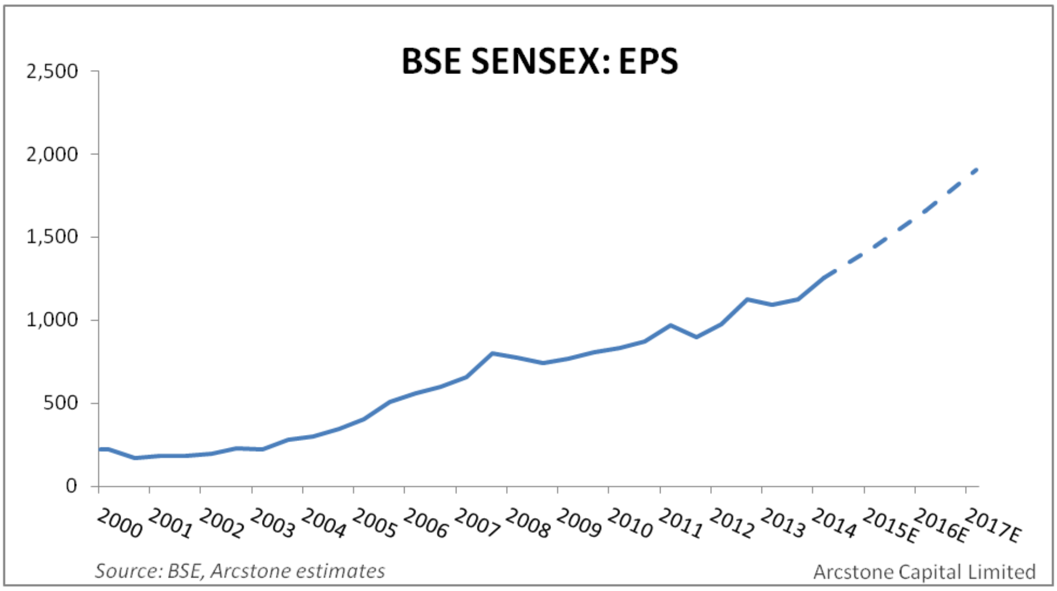


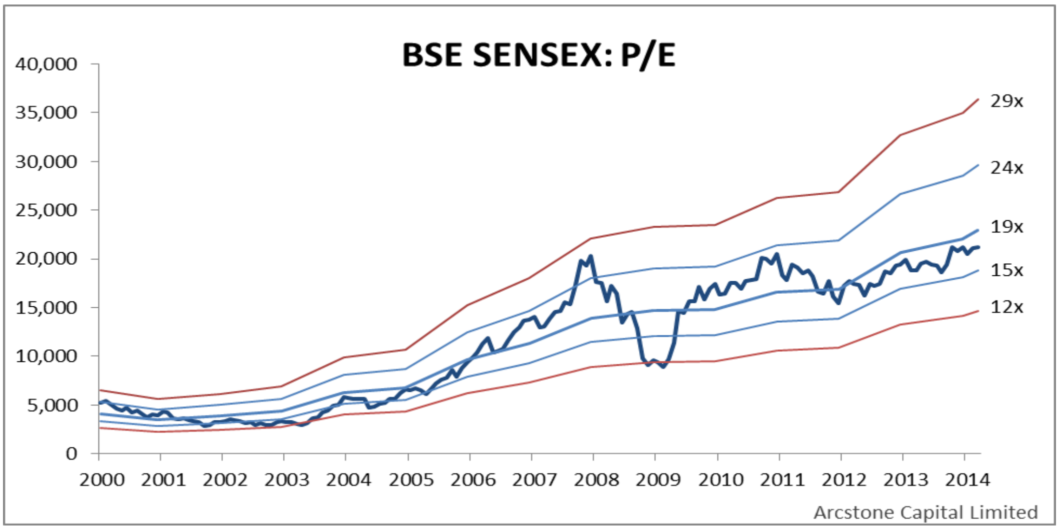
As Western investors we intuitively understand that democracies, over the long term, have a tendency create growth and a rise in the standard of living. I argue India is no different. Over the last ten years roughly 100 million people moved to the middle class. In the next 10 years, predictions have another 300 million more citizens moving to an economic level where they can buy more food, clothing and maybe a motorcycle.

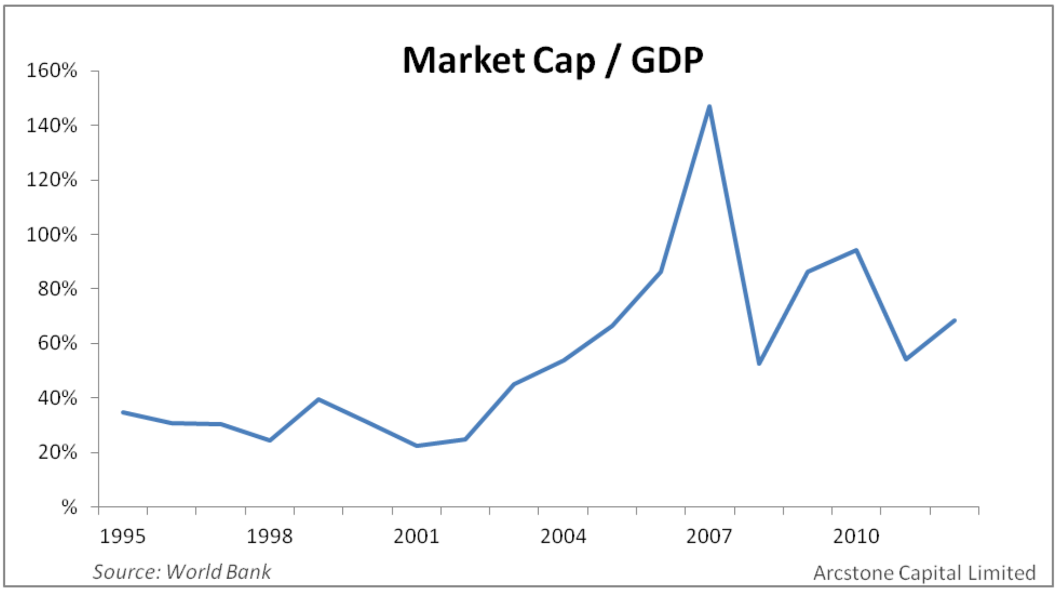
In 2001 India had 220 million citizens defined as aspirers. In 2010, 400 million, an addition of 180 million people, or more than half the population of the US, was <u>added</u> to this group. Are these people going out and buying Mercedes? No, of course not. But they will buy more food, more 2 wheelers, more shoes, and more shirts, more everything. That is why the fund has invested in manufacturers of pesticides which increase agricultural productivity, auto ancillaries that address the 14M 2 wheelers and serve India's growth as a regional auto production hub, synthetic leathers for everything from shoes to car and motorcycle seats, ceramics for the millions of homes needed, and plastic furniture for the home and business owner.

Investors tend to concentrate on today and next week and maybe next month, but much of the time the investors' gaze is firmly fixed on the cracks in the sidewalk. Meanwhile the cityscape surrounding us goes through a slow metamorphous, changing, building roads, metros, and in a word - growing. Companies grow larger, increase earnings, expand product offerings right in front of us while we worry about the world ending. As time marches on, earnings increase, and the economy grows, doubling in this case. Over the long term, the market will ultimately track earnings and it too will double. The BSE500 earnings are expected to grow at a 15% CAGR for the next 5 years, doubling over that period of time. All things being equal, the market will double as well. India's GDP just doubled in the last 6 years, and sure enough, we believe it will double again in the next 5 to 6 years.

[1] The Wall Street Journal, 12 April 2014





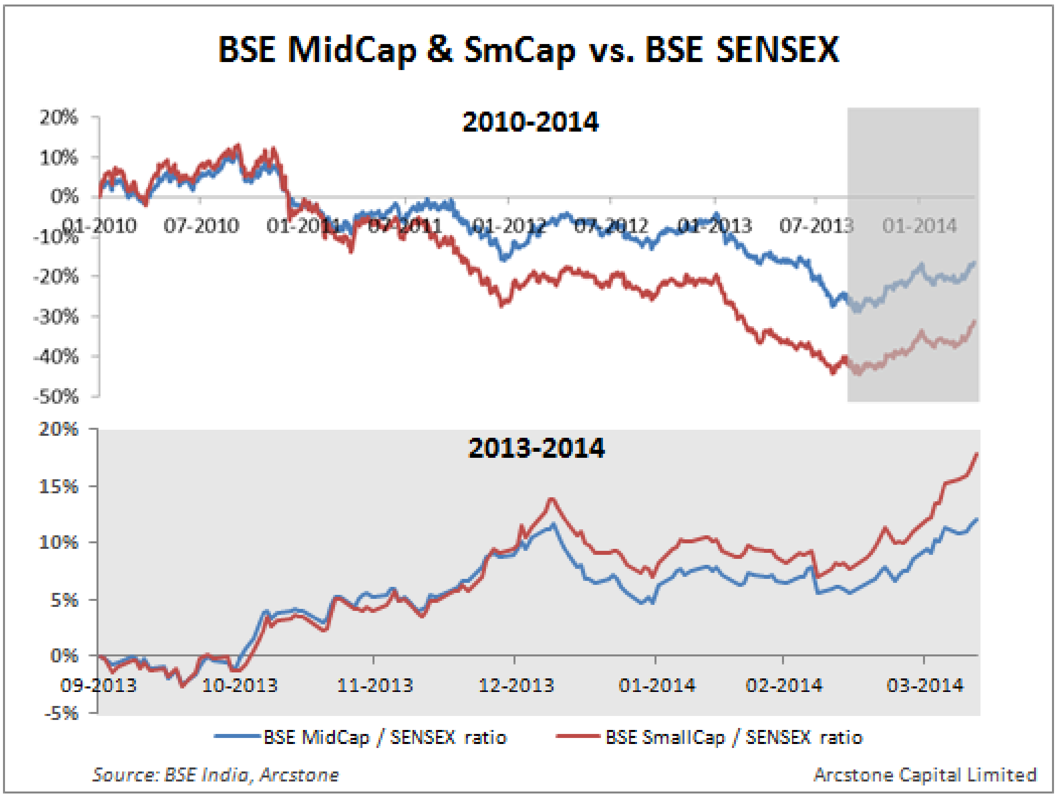


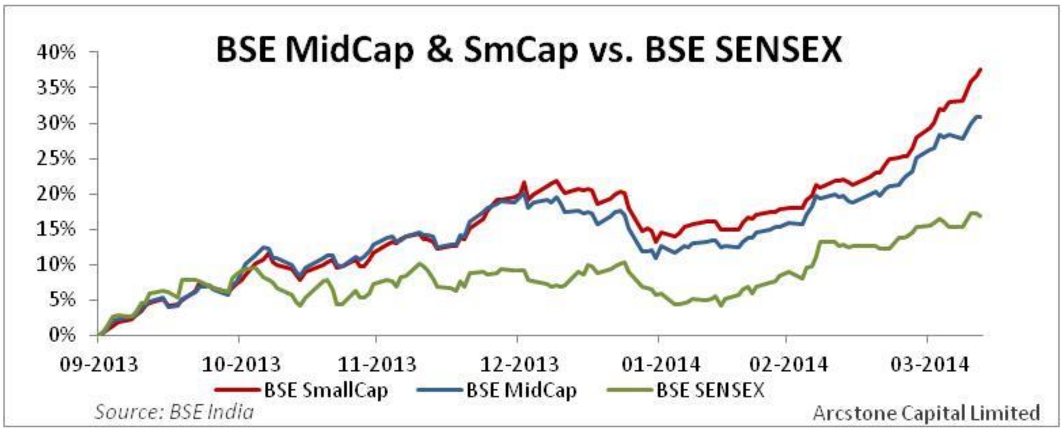
At 65% market cap to GDP, the overall market valuation is very reasonable.

The Moving Parts of a Fair Value

In January 2008 India's GDP was USD 800 billion, the SENSEX was 22,287, and its PE was 29. The market had a capitalization of 150% of GDP. Today, the SENSEX is still near 22,000, it earnings have increased by 70%, and the PE is now a comfortable 18. The economy has doubled in constant dollars and the market cap to GDP has been reduced to 65%. Earnings continue to grow at 15% annually. If the market simply maintains its reasonable valuation, it too will grow at 15% annually, doubling over the next 5 years.

The macro metrics are fairly valued, there is growth in the system, and as we pointed out six months ago, there is a disconnect between the small/mid and larger indices. This gap is closing and over the next few quarters we predict the gap will completely close and the smaller and midsized companies will again start to outperform their larger brethren. As you can see from the charts below, the return to the historical correlation of large and small/mid caps has begun. In the last 6 months as from the end of March, the Small Cap Index moved up 29% and the Mid Cap Index improved 26%, compared to the larger cap SENSEX's 16% return. The Fund returned 87% gross-of-fees during the same 6 month period.





Current Events

In the short run the election is all the rage. The country, as a whole, is looking for a change and will most likely vote that way. In this year's election there are 100 million first time voters who will exert some impact. The National Council of Applied Economic Research reports 66% of 18 to 29 year olds support pro-business Modi and the BJP. 67% think the BJP should lead the next government.

There are two questions for me: one short term, the other long term. In the very short term, how many of the 544 Lok Sohba seats Modi will get as the leader of the BJP (and it is an election to elect Modi, not necessarily to elect the BJP). Currently, the market is expecting 220-230 seats. If the BJP and its allies tally 250 seats, which most international investors are expecting, then you may see a solid and crisp rally on May 17th. Secondly, in the long term, can Modi govern effectively on a national scale? I am not looking for a slam dunk here, but a measurable improvement. Country governance, like corporate governance, will either improve or impede economic and financial performance. In the recent past it has been an impediment. If a good government starts to rule India, earnings and share prices will reflect this change, and to some degree the market has already anticipated an improving government. If a good government can continue reforms, the small to midsized Indian company could grow at 20% annually. And, even in the face of adversity over the last few years, many of our existing companies in the portfolio have done exactly that.

I believe, when the election is over on May 17th more foreign inflows will come in, the rupee will strengthen, and the market will respond to the expectations of government reform. Then we wait. We wait to see if the new government can improve and create new initiatives generating economic growth. Meanwhile we continue our search for growing industries, superior companies, and excellent management.

The portfolio is positioned to grow faster than GDP. We search for companies addressing large and growing markets, typically growing much faster than GDP. We look for superior, honest, and transparent management (not as easy in India) that have proven themselves and which have a product moat protecting margins over the longer term. This could be from a large and leading market share, patents, or a piece of the consumers' hearts and minds. Most of our companies, even manufacturing, have low debt, many with zero long-term debt. Integral to our strategy is the ability to buy the company at a good valuation. We also pay close attention to the management's ability to redeploy profits from the existing business. This shows up in ROCE and RONW and increasing book value.

Good industry, good management, and a good company, bought at fair to low valuations is our strategy. It is certainly not rocket science, and we don't have to get it right all the time. But over the long term we expect to outperform the market indices and our peers while growing the book value of our portfolio.

Two Portfolio Companies

The Fund owns a <u>small niche chemical company</u> – the only company in India to manufacture over 50% of its products. Its raw materials are the by-product fractions of natural oils and fats generated during refining of sunflower and soya bean oils. It is also one of the few companies in the world to manufacture its products using byproducts, cutting its expenses significantly and making it one of the lowest cost producers in the world. Its products have applications in paints, inks, and adhesives along with the nutritional market.

Over the last three years, revenue has grown at a CAGR of 46%, EBITDA has grown at 26% and Net Profit has grown at a CAGR of 29%. Management is preparing a new plant to increase capacity as well as add new products. Management's reinvestment expertise is excellent: ROCE 33%, RONW 31%.

The company is the sole player in the Oleo chemical market, and it is the sole manufacturer in India for more than 50% of its revenue. The company can sell all that it produces, even though capacity expansion has outpaced industry growth. And it has the ability to pass increases of raw material cost to its customers.

It has well entrenched customer relationships in high growth industries like paint, inks, and FMCG. The company has greater than 10 year relationships with key raw material suppliers.

The portfolio also holds one of the largest synthetic leather manufacturers in India. The company has the dominate market position in India's addressable market of USD 1.0B. Its products and much of its revenue are derived from footwear (there are a lot of feet in India) and autos. Per capita, footwear has increased from 1.4 shoes in 2004 to 2.5 shoes in 2012. Average per capita footwear in developed countries is 5.0.

Over the past few years there has been a dramatic shift in sales from the unorganized to the organized market. Unorganized players are greater than 50% of the market and decreasing. The company has the lion's share of the organized segment in both shoes and auto.

Management expects 20% annual revenue growth over next three years and the company has consistently registered higher than industry growth. The company's margins are improving as management backward integrates production by making the fabric the artificial leather is placed on. A new coating line will increase efficiencies allowing the company to effectively compete with cheaper Chinese imports in the handbag market.

There have been great improvements in the quality of artificial leather prompting both midrange and high-end auto OEMs to purchase from the company. They have a pedigree client list including GM, Chrysler, Ford and soon, we hope Mercedes Benz. The company expects to increase its exports from 20% of its revenue to 35% of its revenue over the next three to five years leading to improved margins. Capital reinvestment is top notch with a 57% ROCE and a 42% RONW. Profitability, a strong balance sheet, free cash flows, and dominant completive position make this company an excellent addition to the portfolio.

I hope by looking through the short term and fixing your gaze solidly on the longer term horizon, you can see the real and quite amazing potential of India, the world's largest democracy. And don't wait, its growing before our eyes.

Kind regards, Ralph

Ralph Kruger
Managing Director
Arcstone Capital