Investment Manager's Report

December 2014

As Diwali, Hindu's festival of lights, passes and the holiday season approaches in the West, we at Arcstone Capital wish good will to all the men and women of the world. We are thankful for being alive and strive to live each day like it is our last. The very best wishes to you.

I am sure you have noticed the strong, albeit unsustainable performance over the last year. Over the last 18 months we have highlighted this once-in-a-decade "catch up" in the small companies verses larger companies. Looking ahead, we believe the growth story in India's small and midsized companies remains intact. Over the long term, performance is driven a company's earnings. Small or large, companies are ultimately valued by what they can earn.

Independent of our portfolio company's sterling performance, we expect our portfolio companies will grow revenues by 20% annually and earnings by 25%. Valuations have increased to be sure, but we believe over the next five years, the earnings of our companies will continue to rise in excess of India's GDP.

We are optimistic India will return to a higher growth trajectory for the following reasons. Modi's election stampede and the recent election of BJP representatives to the state assemblies, argue a favorable trend for project execution in infrastructure. Secondly, the new government eliminated the planned economy vestige, the Planning Commission and its Five-Year Plans – a needless and extra layer impeding execution – exhibiting real reform. Thirdly, there is effort to push through a countrywide uniform tax code, streamlining interstate commerce's inefficient multi state edifice tax regime. In spite of recent setbacks, we believe this important reform will be ultimately implemented. The RBI's steadfast inflation vigilance has kept interest rates high, and they have resisted the temptation to prematurely lower rates until inflation's back is truly broken. Inflation has fallen from over 11% to a current 5.5%. Also, lower oil prices and the reduction/elimination of oil and gas subsidies will improve India's balance of trade and current account deficit, already coming down from 4.8% a year ago to 1.7%.

Of course all is not roses and the end of QE3 in the US will undoubtedly put some pressure on the Rupee. However we believe this will have less of an impact given India's debt is still largely domestic and its foreign reserves are USD 300B, muting the downward exchange rate pressures.

All in all, we think there is more to like in the long pull than not.

Regarding our portfolio, I find it intensely interesting to hear investors' responses to the recent performance through the spectrum of investing in India over the last 7 years. Previously investors were concerned by their perceived risk in the Indian market place. Now investors are concerned about the strong fund performance with the thought that what goes up....fast...must come down...faster. Please let me offer one thought. Rather than suffering the ups and downs of the stock prices, a habit that can make one seasick before lunch time, let's concentrate on the earning power of our portfolio companies over the long term. In our process, we re-evaluate the portfolio constantly, confirming our long-term investment thesis for each of our holdings. And the future looks bright indeed. We keep a vigilant eye on the following:

I. ***Sales***

Can the company we have invested in continue to grow their sales by 20% to 30% annually? We think about this every day in a common sense way.

For example, the fund owns a leading rigid plastic container manufacturer catering to the largest Indian manufacturers of Paints, Lubes, and FMGC (fast moving consumer goods). Are people in India going to buy more paint for their new homes, apartment buildings and offices? We think yes.

As the population's income increases they may treat themselves to a small pack of Cadbury's chocolate that is packaged in a world class IML (In Mold Labeled) plastic container. With 1.2 billion people it doesn't take much of a change in a daily habit to have a large sales impact. Our company's sales to Cadbury and Mother Dairy are increasing nicely from zero when we invested four years ago. Four years ago, IML, with higher margins, was 5% of sales; now IML is 20% of sales and rising, increasing margins.

A major pipe manufacturer. When big MNC's explore for gas and oil, domestic infrastructure companies build roads, airports, and other public works, they will need more pipes. The portfolio has one of the best pipe manufacturers in India.

This well-managed company sports an operating margin of 20%, net margin of 11%, ROCE of28%, and RONW of 20%. Sales and profits have nearly doubled over the last five years during an arguable very dismal time. In 2003-2008, the largest pipe manufacturers increased manufacturing through debt. During the ensuing slowdown, unable to sell their product, the 6 other largest players either suffered losses or experienced significant reductions in profitability. Our company, Ratnamani Metals & Tubes Ltd, posted solid earnings and continued its 11-year uninterrupted dividend payment stream. Consistent with our emphasis on management and debt, Ratnamani's superior management has kept net debt to zero.

India's pipeline density, 3 km per 1,000 square km (50km per 1,000 square km in the US), is the lowest in the world. Global demand and India's renewed infrastructure projects for oil and municipal water and gas infrastructure, along with applications in food processing, dairy production, paper, pharmaceuticals, automobiles, and aeronautics, bodes well for capacity utilization (and margin expansion) of this low-cost producer of high-quality pipes.

At 9X FY15-16 earnings, we think the best is yet to come for this well managed, net debt free, critical infrastructure business.

An instant coffee manufacturer. Are Indian's as well as other Asian citizens are drinking more coffee, with a preference to instant coffee? Yes they are. The fund owns a rapidly growing instant coffee manufacture that just opened a plant in Vietnam, reducing DOS, inventory requirements, tariffs, and taxes, and increasing sales and margins.

India's largest artificial leather manufacturer. India is fast becoming an Asian auto hub, augmenting its own domestic car and motorcycle sales. International as well as domestic auto producers will need more artificial leather. The India population has fewer shoes per capita than most Emerging Markets. Will Indians buy more new shoes? The expectation of constantly increasing sales is why we own the largest and, we think, the best-managed artificial leather manufacturer in the country. Our company has contracts with Indian, German, and US auto manufacturers. World-class quality at one of the lowest-cost plants in the world. We believe our portfolio company will continue to grow relentlessly for a decade, at least.

II. ***Durable and sustainable margins***

We find companies that have a competitive moat around their product which will preserve margins. Most of our companies are small and growing. Top-line growth does not mean margin shrinkage. Of course sometimes it does, but we strive to find companies where margins can be realistically preserved over the next 5 to 10 years. For example, Nestle – a USD 90 billion in revenue company with 48% gross margins. Our companies are much smaller than Nestle, but growth does not mean margin deterioration.

"Warren Buffett believes that firms with excellent long term economics tend to have consistently higher margins.

Durable competitive advantage creates a high Gross Margin because of the freedom to price in excess of cost. Companies can be categorized by their Gross Margin

1. Greater than 40% = Durable competitive advantage
2. Less than 40% = Competition eroding margins
3. Less than 20% = no sustainable competitive advantage

Consistency of Gross Margin is key."[1]

If sales increase over the years and there are durable margins, low debt, and high reinvestment returns, then everything else falls into place. This is what we concentrate on, not the yearly share prices running up or down because of a market tailwind or headwind. Sales and margins. (We are also debt adverse with nearly half of our holdings have zero debt.) Low debt, superior management, in a profitable industry.

We take a long-term viewpoint. The last year's return was a catch up from years of headwinds in share prices while the sales and earnings of our portfolio were growing. The market simply did not give credit where due. After Modi's landslide victory the market sentiment turned on a dime and share prices caught up, fast. Now, we look to the future and to our portfolio's sales and earnings growth in a country heading in the right direction.

Over the past 18 months we have been touting our companies in spite of a challenging stock market. Below is a recap of our thought process regarding the drubbing small to medium companies received from 2011 to 2013. We now argue the 24 businesses in the Passage portfolio will continue to grow and lend strength to our already strong group of managers.

[1] http://www.gurufocus.com

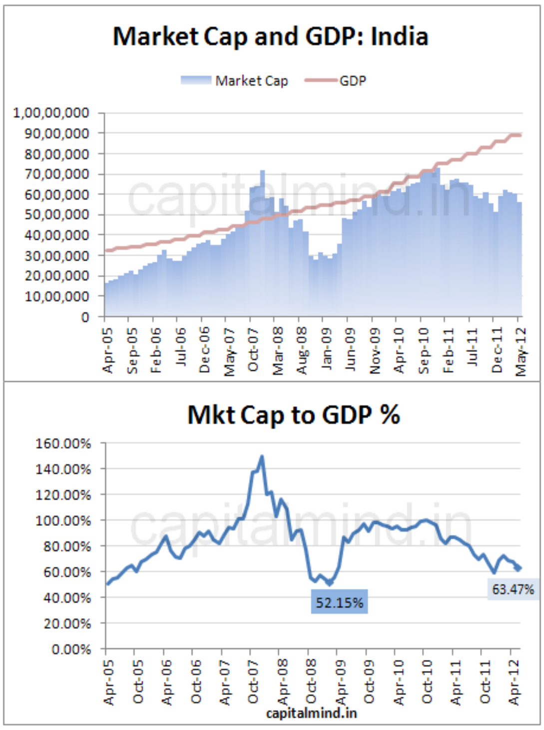
From our August 2013 newsletter:

There are good small to mid sixed companies whose share price has suffered unnecessarily simply because of market sentiment.

This pressure will abate, and it has already begun to show hints of a modest reprieve. I would argue the smaller companies will close the gap and begin to again outperform the overall market. Smaller company valuations are in fact very cheap now with the BSE Small Cap Index's P/B of 0.96 compared to the historical average of 1.96.

<u>Improvements Are Afoot</u>

It can get worse, but we believe the news, market sentiment, and the economy are more likely to improve than further deteriorate. We see some fresh legs after years of running on empty. The government is rousting out of its paralysis as the national elections in the spring of 2014 starts to exert its influence. Interest rates have not fallen and actually were raised last month by the new RBI Governor, Raghuram Rajan, but we are near the end of the interest rate cycle. The global economy is stabilizing and in many Indian export destinations high growth is still the norm, notably in Africa. International investor sentiment is warming up to the higher growth markets as investors pull themselves out of the bunker mentality and begin to realize mature economies, with aging populations, over burdened entitlements and in some cases, severely dysfunctional governments, will face slower growth in the coming years and decades. This will positively affect the Indian market and its smaller cap segment.



We believe this will push the small and mid caps back to their historical correlation to the larger indices. Before October 2010, the BSE Small Cap's correlation to the SENSEX was 0.97, while over the past 3 years it has been 0.40. This correlation can stay unusually low longer than we would like, but it will not remain outside its historical norm indefinitely.

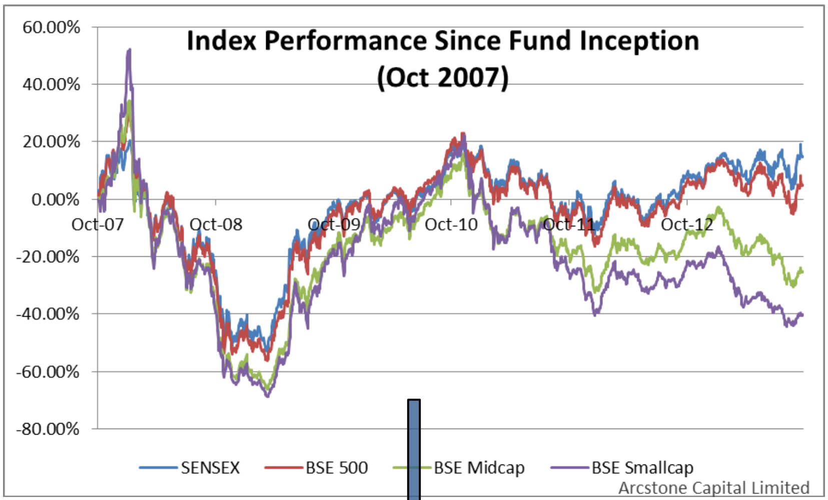
While GDP has tripled, the 750 companies (500 in the small cap index and 250 in the mid cap index) representing the bottom 20% of the investable market are down nearly 30% over the same time period. Our portfolio experience points to the same dynamic of growing businesses and shrinking share prices. Over the last four years, the companies in the portfolio have increased sales by an average of 230%. Yet, in our part of the court, the valuations have been hammered. A sip of Red Bull anyone?

From our February 2014 newsletter:

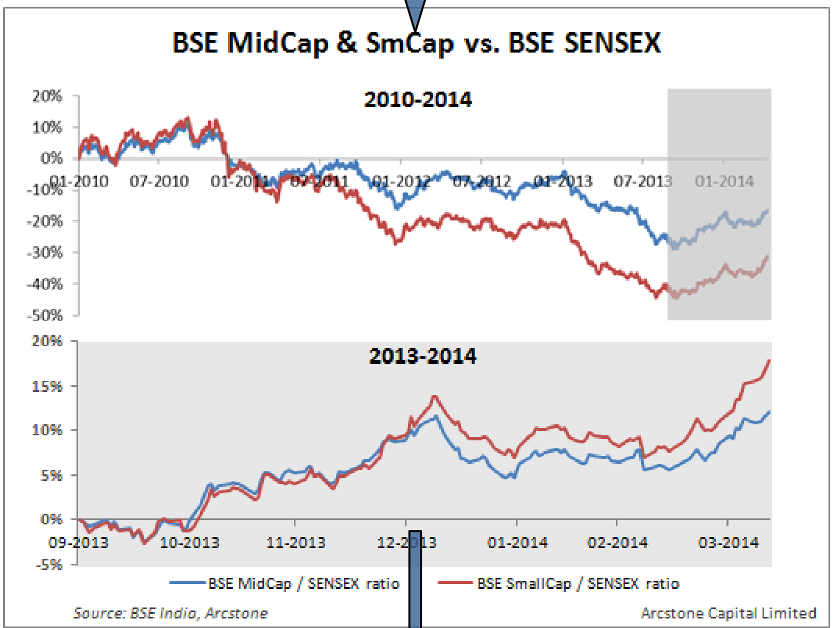
Coming Elections: I feel a sense of urgency. I believe the coming elections will usher in a new government and create an economic tailwind. In my opinion, once the election results are out, the move, especially in small companies, will be abrupt. But here's the problem, everyone is thinking the same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

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.

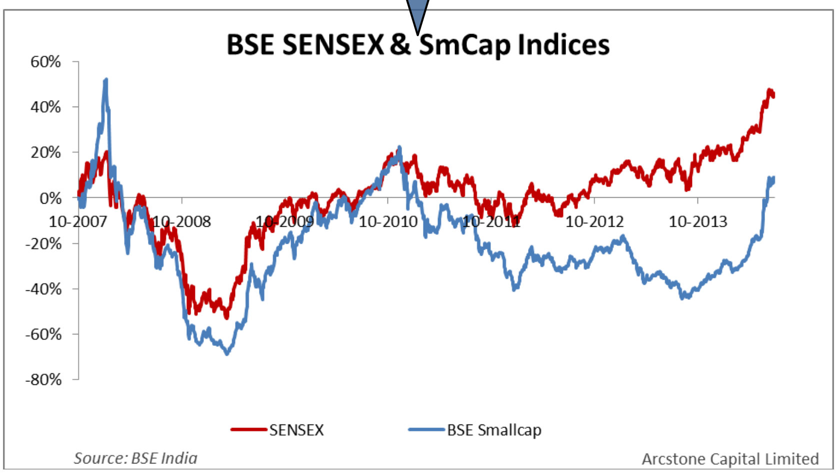
Independent of the challenges faced by India, it is clear to the managers of The Passage to India Fund that India, as the world's largest democracy holstering a nuclear arsenal, in a strategic geographic location, and home to 1.2 billion future consumers, is an independent investment destination that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



February 2014 Newsletter



April 2014 Newsletter

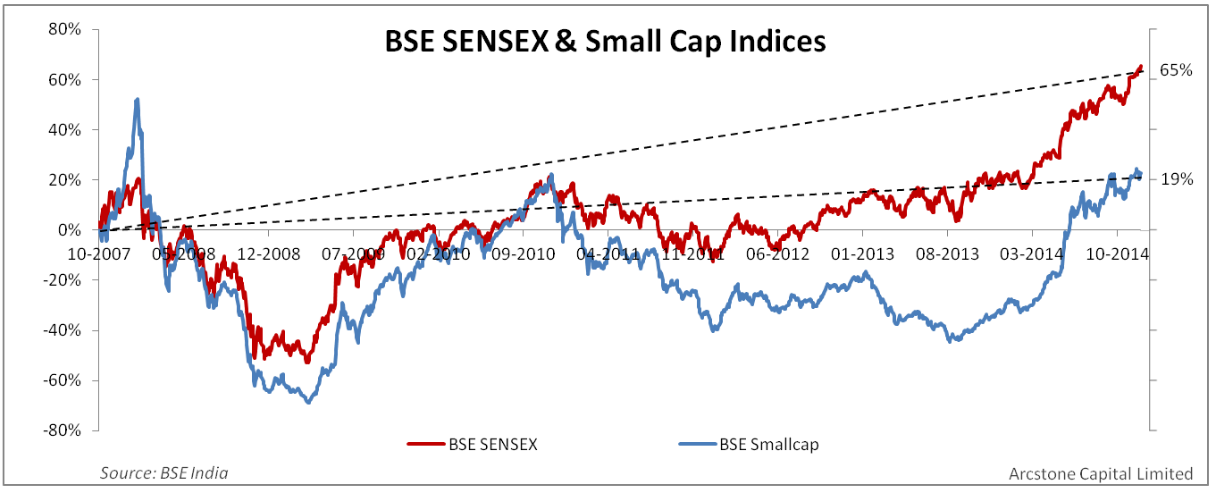


July 2014 Newsletter

The great disconnect between the small and the large indices has now largely closed, resulting in quite a sharp recovery of share prices in the SME's. Going forward, we look to these same companies to grow their top-line at least 20% annually with overall 20% operating margins and 10% net profit margins. To wit, the portfolio's average top-line growth has indeed increased at a CAGR of over 20%, but as these companies have gathered heft and operating efficiencies, the profitability has increased at a 30% CAGR over the last 2 years.

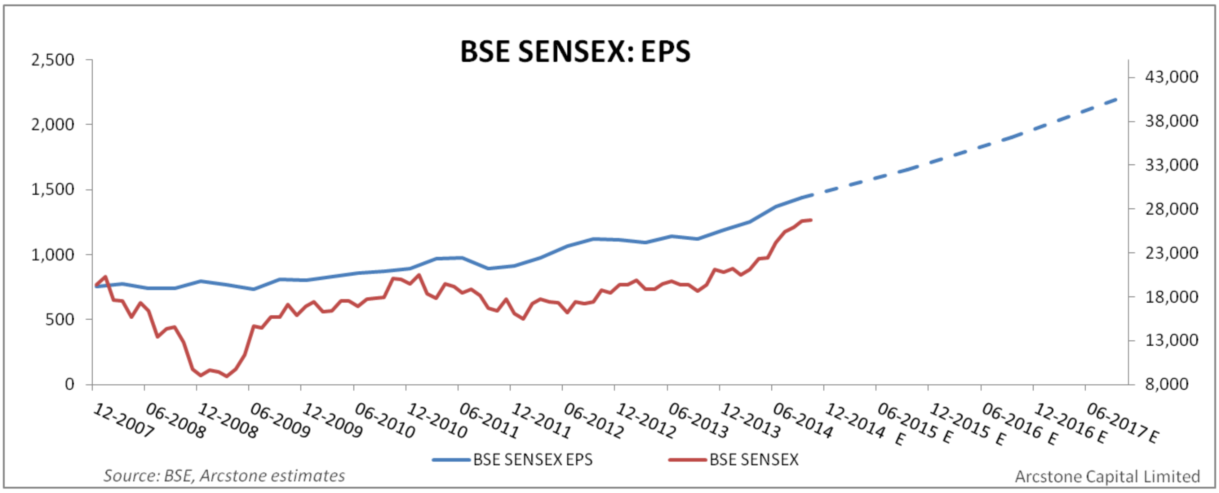
If a company maintains its margins and grows sales an average of 20% annually, in a little less than 4 years, given a fairly-valued company today, its value will double. Notice I did not say share price. Share price, given the short-term horizon of most investors, may be up or down, who knows. But the companies' value, in our opinion, will double. Therefore, over the long term, we would expect the value of the portfolio to double as well.

After a strong up move, after years of getting pounded by short-term market forces, we believe the valuations of the companies will continue to rise for at least the next 5 years.



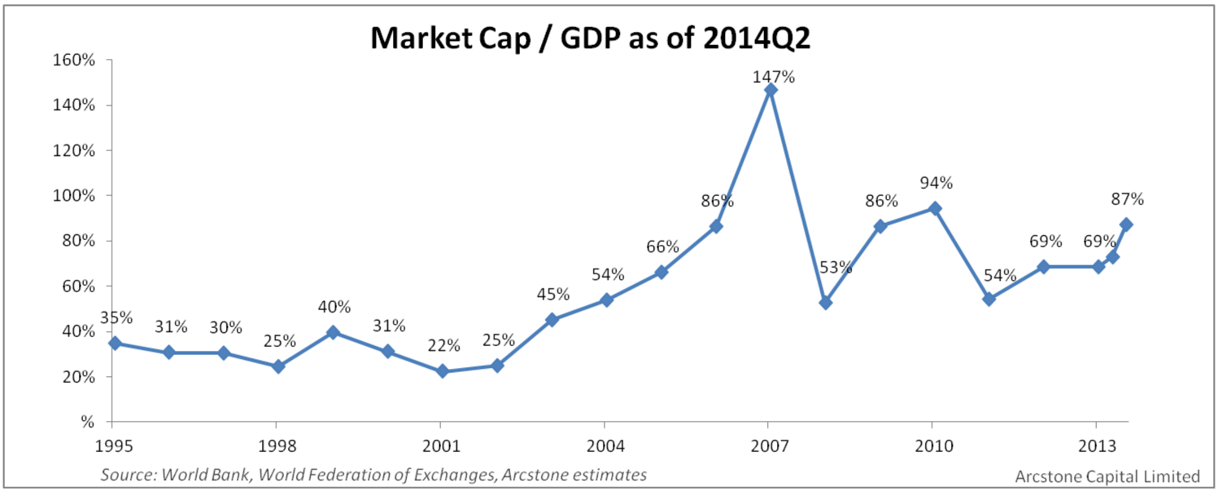
The divergence between the large and small caps has diminished, but not completely.

The overall economy will also follow a similar trajectory. During the financial crisis in the West, from 2008 to 2013, the economy nominally doubled. We believe the economy will again double in the years 2013 to 2018. India will grow for some time to come, we think at least five years, more like eight. We are in a bull market cycle, where India is all the rage. For us we are reminded of a fashion article a few years ago saying the new black, is black. For us, the new investment darling is our old India, with a new sentiment.



Share prices ebb and flow depending on the flavor of the month or year. Investors time this market and that market trying to get in before a rise and out before a fall.

Pundits now are saying India is looking good. We are independent and chart our own course, not following the crowd. We will stick to our knitting, always trying to become better investors, reducing our mistakes, and concentrating on finding superior management in solid, growing businesses with sustainable margins.



Overall GDP to market cap valuations are still reasonable.

We buy companies, not stocks

Yes, we do keep an eye on valuations and trim or sell when overvalued, add when undervalued, and backup the truck when extremely undervalued. Our time horizon is at least 3 years, usually much longer.

Over the last 6 years our portfolio of roughly 20 companies have grown their revenues and earnings at an average of 20% and 30% respectively. Average operating margins are 20% and net margins, 10%. High reinvestment rates and low debt are very important to our portfolio construction. Nearly half of our companies have zero net debt, and the portfolio has an average of debt-to-equity ratio of 0.60.

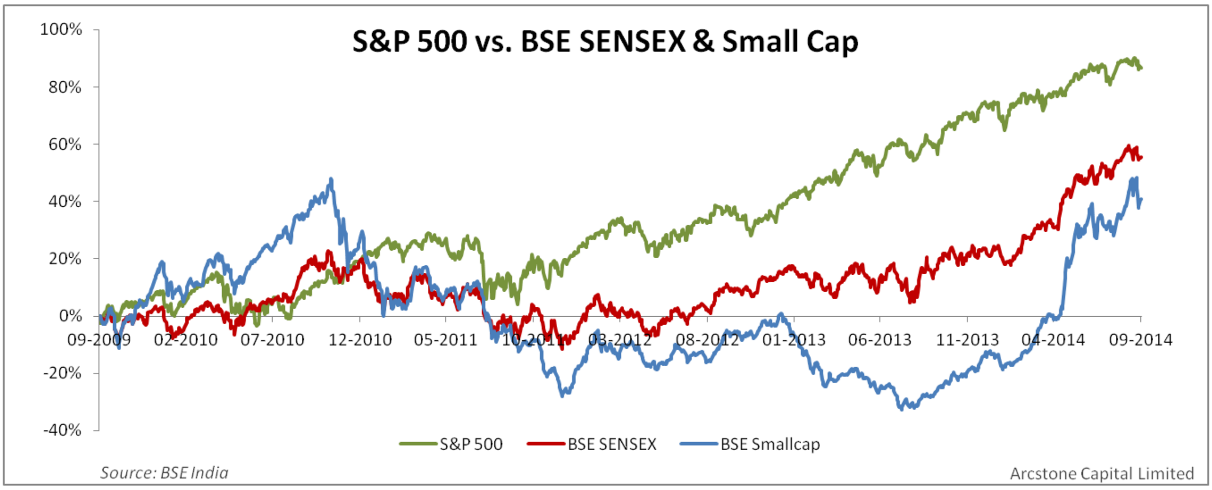
A very important time to lend a critical eye to stock price is at our initial purchase, and only in regard to determining company valuation. There are many great companies for sale in the market but that does not mean they are a good value. We enter a company at what we believe are very good valuations and look to the long-term growth potential of a company. It is key to buy a company at low valuations, and hold on while they grow.

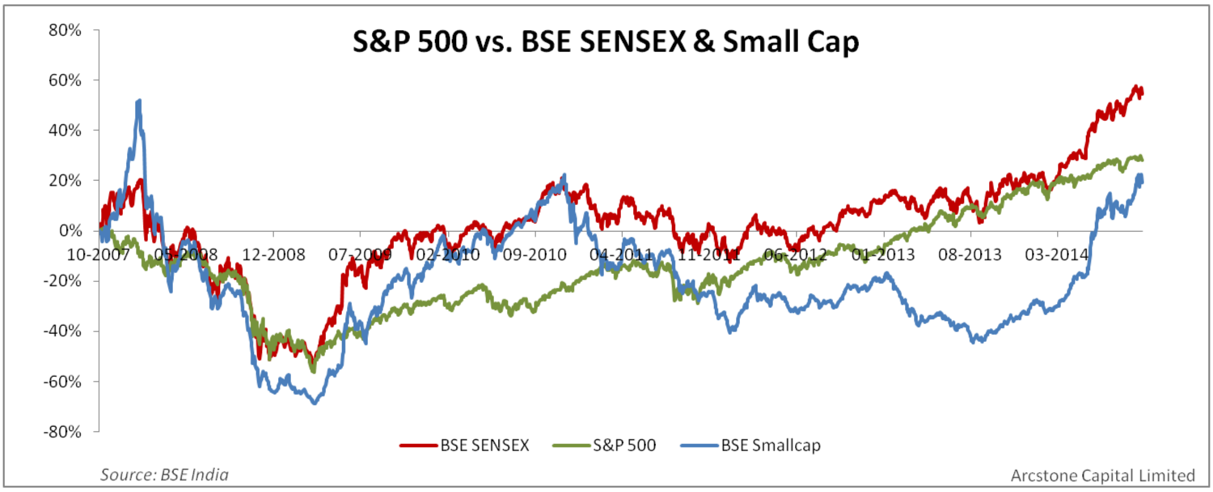
In this regard our philosophy and our investments have not changed over the last 6 years. What has changed of course are the stock prices and subsequent company valuations. We consider short-term (less than a couple of years) fluctuations in stock prices as total impostures driven by an investor beauty contest.

	Jan 2008 High	Current Value	
S&P BSE Small Cap Index	14,239	11,271	***Off 21% from all-time highs***
S&P BSE Mid Cap Index	10,246	9,835	***Off 4%***
S&P BSE 500 Index	8,991	10,595	***Up 18%***
S&P BSE SENSEX Index	21,207	27,865	***Up 31%***

As of 31 Oct 2014

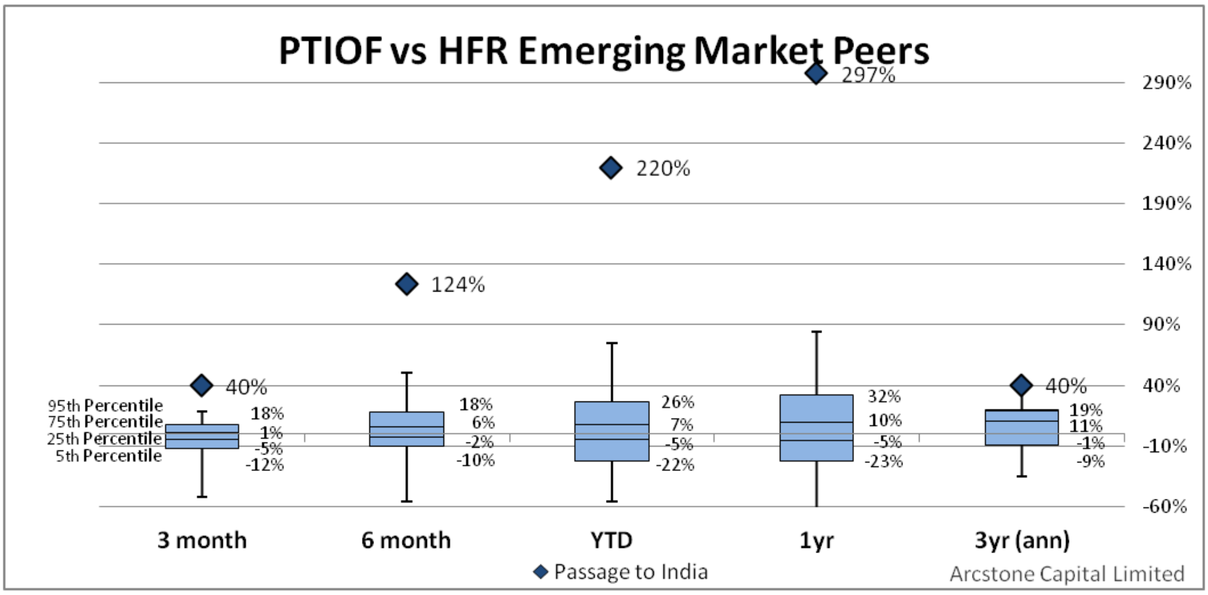
A catch-up, not a melt-up





The plan for the next couple of years

We will rotate down into smaller companies buying a handful of new companies and shedding longer-term holdings that have become overvalued. But we will not jettison a wonderful company because its share price has increased in the year – we concentrate on value through a 5 year lens. I can say with confidence, all of our companies have had a solid 20 years of sales and profitability growth behind them. We believe that same management team will have another 10 years of growth in the Indian economy going forward. In the short term, share prices will move up and down; in the long term, they will reflect the earning power of our companies. And I have great confidence in the ability of our companies' management to continue to increase earnings power for many, many years to come.



Source: HedgeFundResearch, Inc; Passage to India Opportunity Fund (Cayman) Ltd, A Shares net returns as of 31 Oct 2014

Remember the financial crisis of 2008? All hell breaking loose, melt down, governments on the brink, disaster, the world at an end. Well, India's GDP doubled in nominal terms from 2008-2013. I believe the Indian economy will again nominally double from 2013-2018, driving the market to respond accordingly and then yet again double from 2018-2023. To double in 5 years the economy, or in our case the company, needs to grow its earnings by 15% annually. Ladies and gentlemen, with the companies we have in the portfolio, 15% annual growth rates has already been demonstrated and at average sales of USD 200M we have high conviction our companies will continue to grow into the future as they have demonstrated in the past.

One year return - nearly 300%[2]

The grand imposter is back in full regatta. Ah but this transformation is not as the Grim Reaper we have seen over the past 6 years, but it is the Arc Angel – as beautiful as the grim reaper is menacing. But, rubbing our eyes, we know she is an illusion, as was the grim reaper.

We buy companies, not share prices. We look to the long term for our companies to create value via excellent management, good products, sustainable margins and long term growth. There is one critical time when we pay very close attention to share price. And that is when we buy the company.

Entry valuation is critical and we attempt to enter our investments with a steady eye towards valuations. This is exactly the reason we find ourselves in the most inefficient, under followed, under loved part of the market – because we can find excellent companies, cheap. And the fund is small and nimble enough to invest in these small, world class companies.

Kind regards, Ralph

Ralph Kruger
Managing Director
Arcstone Capital

[2] Passage to India Opportunity Fund (Cayman) Ltd, A Shares net return as of 31 Oct 2014 (+297%). The return is net of all fund expenses, management fees and performance fees. Accrued performance fee allocations, if any, are based upon if an investor invested at the fund's inception. Please refer to the Return Disclosures at the end of this document.

Disclaimer