Investment Manager's Report

January 2017

This year, India's GDP surpassed England's.

Our objective of this letter is to give investors an insight into our thoughts about India and the specific companies we have invested in, plus to explain why we will continue to hold them for the long term, in spite of our expectations of a few rough quarters ahead.

Why would we not sell our positions now, wait for the two rough quarters to push prices down, and then buy back our companies at a lower price? To be sure, regarding the portfolio construction, we do not have our feet stuck in concrete and we do trim and rebalance the portfolio periodically over the year(s) either because the valuation has become stretched, or in the case of an outright sale, something has changed, or we made a mistake. However, in regard to selling in the short term with the idea of buying back in six months, in our opinion, it is not a way to wealth.

First and foremost, we are investors, not short term market timers. In fact, we consider ourselves owners of these businesses. As you know owners of businesses don't make it a habit of selling and buying their company in the short term. Even if we do expect a rough two quarters ahead, we doubt the market would cooperate. If we could predict short term market movements, well, then we'd be in a very different position. Timing the market may be alluring, but it isn't easy, and it's rarely successful. To be successful selling and then buying back a long term investment, one has to make two correctly timed decisions. The first is when to sell, and the second is when to buy back. Do we know when our company's stock price is high? Do we know when the share price has hit bottom? In a nut shell, no we don't.

Secondly, liquidity can be an issue in some of our holdings. The fund may own 1% or 2% of our smaller companies. It takes a certain patient, long term temperament to meter in our buys and sells to accumulate and liquidate these relatively large positions. Short term selling and buying is the antithesis to our patient buying and selling.

Lastly are taxes. Long term gains in India are not taxed. Yup, zero tax rates on long term holds. Short term capital gains are taxed at 15%, low but still a drag in performance if one is a trader. Regardless of timing, liquidity, or taxes, short term trading is not the way to build long term wealth.

So we will continue to hold our companies over the next two quarters and see through the softness in share prices, if indeed there is such softness. And we will continue to keep our eyes on the three-year horizon where we firmly believe our companies' earnings will be higher than they are today.

What are we concerned about in the next two quarters?

The demonetization in the Indian economy will adversely affect some or most of our companies in the short term, while providing for a better economic future in the long term. How much pain in the short term? We don't know. Some of our company's earnings may be off materially while some of our other holdings, such as our digital payment companies, may benefit. We are simply giving you a heads up on what may happen in the short term as well as expressing our confidence in the long term future of our holdings.

Over the longer period, demonetization is moving the Indian economy into the digital world, reducing corruption, increasing tax revenues, and fundamentally changing it for the better. Additionally, the passing of the GST (Goods and Service Tax) Bill on 8th September 2016 will bring more of the smaller, previously non-tax paying businesses, into the formal economy. In the past this unorganized sector has always been an unfair, non-taxpaying, competitor to our listed companies. Now demonetization, digitalization, and the GST implementation will make it more difficult for these unorganized companies to operate in the dark, ultimately benefiting the entire economy, Indian workers, and importantly, our listed companies. Demonetization and GST are but two headline grabbers in a long line of beneficial governance changes since 2014. There has been a host of bad press regarding both. Any change is hard, the bigger the change the more resistance generated. Demonetization has been a large change indeed, generating its fair share of negative news.

As long term investors we know negative news is always out there. Besides, no one reads good news anyway, and the media's business is to sell news. It is important to remember in the face of a torrent of negative news and events, a global financial crisis, increased political and economic risk in Europe and the US, seemingly unending and expanding conflicts, a slowing China, the Indian economy grew from USD 1.0 trillion in 2007 to USD 2.2 trillion today. That's a double plus. Over the last 9 years the economy expanded on the urgency of a young (average age is 25) and aspiring population working hard for a better life. Seven years from now the Indian GDP has a decent shot at being a USD 4.4 trillion economy…….. in spite of all the current and future bad news. So goes the economy, so goes our companies.

The objective of this letter is to share our confidence and optimism by giving you insights into our holdings. It is also an attempt to ally your possible concerns of last year's performance and give you the confidence to look past what could be two bad quarters ahead, and to give you the opportunity to invest in Passage.

An Inflection Point

We have always been optimistic about India's long term growth, but now we believe the timing is especially fortunate. The recent economic body blow of demonetization has served up an excellent investment opportunity. We think the next two quarters will be tough simply because consumers didn't have the cash to go about their normal consumption habits. Short term sales in many businesses could take a hit and profitability may decline. Share prices will most likely react negatively. But over the long term the economy will be better and stronger as a result of this short term pain. In our view, this is an opportunity to invest more in Passage to take advantage of these lower prices. If stock prices do not falter and an investment is made at current prices, the future is still bright.

One positive result of demonetization is digital payments options have been jump started. From small mom and pop stores to large retail stores, plus many other businesses, have transitioned to digital payments. For example, moving workers' salaries and other business payments to digital payments will also bring these smaller enterprises and individuals into the formal economy. From workers' salaries to petrol payments, the economy will see a significant increase in digital inclusion. The result will be more economic information and a better operation, not to mention increased tax receipts.

We are more optimistic than ever. These recent government initiatives, plus the changes in basic government functions like online application for passports and drivers licenses to granting large infrastructure projects has put the Indian economy squarely at an inflection point.

Infrastructure: (77 railroad projects were announced in 2015 and today 69 have all approvals, in one year. It is an unprecedented acceleration of the approval process. 1750 miles of large gage track were added last year, 200 more than projected. 1700 miles are slated to be added this year, plus an additional 1200 miles of electrification of existing tracks. In the next three years USD 130B will be spent on improving and expanding railroads, more than double India spent in the last 10 years. As a matter of scale, contrast this expenditure to the US's 1.3B annual budget for its railroad system.)

Because of these changes we believe the next decade will be very rewarding for investors who can stay the course. In an effort to help you understand our optimism, we are talking about our specific holdings. As you know, normally we do not offer a clear view of our portfolio complexion. Why? Because it takes an inordinate amount of work finding these gems and we are reluctant to simply hand out our hard labored for information. However, we now believe that if we can convince our current shareholders that our portfolio owns excellent companies with excellent futures, you may share our enthusiasm and be motivated to increase your investments in the fund. Current investors are the only recipients of this letter.

Although we are confident, we normally don't sound the klaxon. If you look back at our newsletters (late 2013 especially and 2009), there were two periods when we started jumping on the table and shouting now is a good time to invest in Passage. Well, we are climbing back up on the table; shouting now is another good time to increase your holdings in the fund.

We are optimistic about India's growth, and we are optimistic about our companies because our managers have grown revenues and earnings apace for many years in the past. They have chosen to operate in good, profitable industries, they have executed well thought out product selection, plus they have deployed capital judiciously. In addition, our portfolio's holding's profitability has increased over the long term as a direct result of superior management.

The Numbers

Note: the below numbers illustrates concepts only. They are from 22 Dec 2016, percentage change is in Rupees aside from the fund performance which is in dollars, and these are simple averages, meaning each company is calculated as equally weighted in the portfolio and present in the *portfolio for all five years, again equally weighted. This is different than the actual holdings in the fund but we think it illustrates the points we are trying to make. Over the 1, 3, and 5 year time periods companies were sold, bought, trimmed and over-weighted in the portfolio. And of course, they are all not equally weighted over any time period. Furthermore, the exchange rate would play a part in the returns and portfolio performance. The data we use is from ACE.*

Over the past 5 years, revenues in the portfolio (assuming our holdings have an equal weight and are held for the duration) have grown at an average of 18.14%, roughly in line with our expectations of 20% growth. Over that same period, earnings have increased 27.36% as a result of management driving more productivity, efficiency, and/or moving up the value chain. The annualized average stock performance during this period was 51.51% in Rupees. PTIOF's annualized return over the same 5-year period was 25.3% in USD. During this period the Rupee depreciated at an annual rate of 4.41% to the dollar, making the portfolio's return 29.71% in the Rupees.

Over the last 3 years, revenues and earnings have grown 16.59% and 35.80% respectively (in Rupees). The average stock price assuming an equal weighting and held in the portfolio for the time period, was up 60.22% in Rupees, PTIOF returned 44.84% (in USD). The Rupee declined at an annualized rate of 3.16% over the past 3 years.

Over the last year; the holdings in our portfolio on an equally weighted basis had revenues, earnings, and stock returns of 19.53%, 21.39%, and 0.91% respectively. PTIOF has performed -13% to date.

The 5-year annualized index performance has been; SENSEX, 10.44%, BSE 500, 12.82%, BSE Mid Cap, 17.91% and BSE Small Cap, 16.26%, all in Rupees. Comparing the five year return of the BSE Small Cap index to the fund in dollars, the index grew 11.85% in USD and Passage returned 28.26%.

Over the past 3 years, the annualized performance for the SENSEX, 7.18%, BSE 500, 11.52%, BSE Mid Cap, 21.5%, and BSE Small Cap, 22.84% in Rupees. Passage compares favorably with a return of 44.84% in dollars over that same 3-year period.

Finally, over the past year, for the SENSEX, BSE 500, BSE Mid Cap, and BSE Small Cap in Rupees: 1.52%, 3.37%, 7.8%, and 1.54% respectively and again, Passage is down 13% for the most recent 12 months.

So what are these numbers telling us?

1. Generally, it is clear to us that the Indian economy is growing. The revenues and the profitability of India's broad stock market reflect this economic growth. Plus, smaller compares are growing revenues and profitability at a more rapid rate than large companies and the indices are reflecting this as well. This should come as no surprise. In all developed markets from the US to Europe, to Japan to India, smaller companies have outperformed larger companies over longer periods. And yes, I did include India in the developed market description.

2. We believe India is a developed economy and market, that just happens to be smaller than the US or EU. India is very similar to the US and EU, which is very different than China or Russia. Indian laws are based on English common law. The stock market and its structures would be easily recognized by a western investor. Most Emerging Market countries (we say none!) do not offer this Full Monty of solid growth, a broad and deep stock market, with a diversified domestic economy and political stability. India has a fully developed stock market (market capitalization of USD 1.9 Trillion) which reflects the country's economic growth as well as any developed country's stock market. India is a 2.2 trillion USD economy and its over 5000 listed companies represent most every facet of this domestically oriented, consumer economy.

   The stock market has a long history, beginning in 1875. Indian regulations require GAAP accounting, annual and quarterly reports, plus reporting of major and minor events including analyst meetings, insider purchases and sales, product offerings, etc. India, like the western world, has an independent Reserve Bank. India's democracy has had peaceful transfers of civilian power for nearly 70 years. Like we said, India is similar to the West, different than Russia or China.

Change is a Com'in

The world is changing. In the past political risk may have been greater in Asia and in India. Today we no longer believe this is true and the political risk of the US and Europe, with its high debt, low growth, and the inability of governments to fulfill long term future promises to its citizens, is arguably higher in than in India with its lower debt, higher growth, and younger population. Change is a com'in.

Before we go too far down that road and lose our heads, is the Indian market place as highly efficient as the US market where quant shops move a few miles closer to Manhattan to get a few nanoseconds faster execution times? No. Are there institutions, program trading, black pools, and quant shops running most to the market volume? No. Is the market as deep and wide as the US's 18 trillion-dollar market place, no it isn't. However, is the Indian market more inefficient, offering excess returns to those investors willing to do the hard work of finding less followed, excellent companies, selling at discounted prices? Yes sir! Yes, we believe India is a developed market, but it is clearly less mature than the US or Europe. As investors we much prefer the Indian market today than the highly complex, efficient, institutional, ETF, and robot driven markets of the US and Europe.

The Companies

The numbers also tell us we are picking good companies whose earnings have grown faster than growing revenues. In a less flattering light we are not perfect in our weighting. If we were able to place all these companies we have in the portfolio today into the portfolio 5 years ago, and keep an equal weighting, then our performance would have been somewhat better. Hindsight is 20/20.

That said, our performance over the long run has been good and the financial results are telling us we have invested in superior, long term focused, experienced management, running very good companies. Our manager/owners drive higher returns on capital invested than the industry average and our companies experience higher earnings growth. As a result, our companies are better equipped to provide growth capital from internal accruals. In other words, the reinvestment of earnings and the reinvestment returns (ROCE, RONW) are sufficiently high to provide (most of) the necessary capital to grow the business without going back to the market (as much as competitors) to issue more equity or debt. (The Indian corporate debt market is underdeveloped and corporate debt opportunities, especially for smaller companies are less available. Interest rates can be as high as 12%) Therefore, our companies avoid increases of shares outstanding (which is often the dearth of emerging market equities), and increases in high cost debt to fund their growth.

This is our thought process when we look for companies with low debt and higher reinvestment rates. Our companies are growing revenues and preserving, or increasing margins, without taking on additional debt or increasing the number of outstanding shares. This virtuous cycle of increasing cash flow, providing funds to invest back into the business, increasing the size of the business, resulting in long term increases in EPS, should ultimately result in an increase in the share price.

Management and Debt Are Key

Management in smaller companies is a critical component of success and is the number one driver that will enhance (or diminish) shareholder's wealth. The number two driver, in our opinion, is debt. If we can look through the short term ups and downs and concentrate on the long term increases in our specific company's earnings power as a result of low debt (over 30% of our companies have zero debt, and the overall D/E in the portfolio is 0.35), high growth, fundamental value companies, then we can have the confidence and the patience required for long term successful investing.

Portfolio Details

First; the short term bad news:

Our six capital goods companies (16.5% of the portfolio) were down 15% as a group (if equally weighted and held through the time period). Also, there has been downward pressure on the portfolio from pharma (6.5% of portfolio, 2 holdings) which are down 30%. The recent US accusation of price fixing has ensnared a few large Indian companies and has pushed down the stock prices in the entire Indian pharma segment. It is important to note that our pharma companies have zero direct exposure to the US drug market.

Furthermore, negative US rhetoric during and after the US Presidential election regarding off shoring and H1B Visas, plus disparaging international trade remarks, has put pressure on the Indian IT industry (5 companies, 28% of portfolio). Our IT companies are off a cumulative of 19%. Information Technology is one area where the portfolio does have a significant exposure to the US market with over 60% of our IT Company's revenue generated from the US.

Some bright spots:

Specialty Chemicals

The fund owns four specialty chemical companies which make up 8% of the portfolio. Adi Fine Chemical, Paushak Limited, Vinati Organics, and a fourth company which we are building a position in now.

We are currently buying our new company at a PE of less than 10, a price to sale of less than 1, and annual sales growth above 15%. This particular company is 33 years old and is the only global manufacturer in 50% of its products. Over the next year, this company plans to separate its two distinct businesses of specialty chemicals and veterinarian API into two separately listed companies, which we believe will result in an increased valuation.

A few common characteristics are present in our four specialty chemical companies. They are all niche players who generally enjoy either a large market share or monopolistic power in many of their chemical products. Our chemicals companies are also the largest producers in the world for many of their products. In two of our companies, 50% of their products enjoy a monopoly. The fund's chemical companies produce hundreds of different products and export to well over 30 countries. All of our companies have had their customers for decades. And none of the companies have a dependence on any one chemical, one customer, or one geography. Furthermore, the applications for the chemicals produced vary widely from drugs, to paints, to shampoos, to detergents and cleaners, to water treatment, to oil and mining applications.

As a group, our niche chemical businesses have returned 58% for the year. The investment thesis for specialty chemical companies in India is that India has a large and growing domestic demand for chemicals, and in addition, the country is a global low cost producer. Today, India makes up roughly 3% of the global volume of chemical production which ranks India as the 3rd largest producer in Asia and the 6th largest producer of chemicals in the world. They have been in business from 27 to 43 years. The portfolio's holding period for these companies ranges from as long as 6 years to as recently as last quarter.

Pharma

Our two pharma companies, Suven Life Sciences and Aarti Drugs (6.5% of the portfolio) produce API (active pharmaceutical ingredients), intermediaries, formulations, and are also engaged in drug discovery. The fund has owned Suven for just over a year and Aarti for nearly 3 years. They are 6.5% of the fund.

Suven's main business is in Contract Research and Manufacturing Services (C-R-A-M-S), serving as many as 22 global Life Science and Fine Chemical Companies by developing and supplying cost effective Pharmaceutical and Agro Chemical Intermediates for New Chemical Entities (NCE's). Suven's CRAMS business provides ample cash flow to fund new drug discovery plus has sufficient earnings to reinvest in its bread and butter CRAMS business. The company has been in business since 1989.

For the first half of the year, Suven's revenues grew 14% and profitability increased 29%. Suven has a PATM of 19% and a PBDIT of 25%. Sales have increased from 38M USD in 2013 to 73M USD in 2016. However, in the short term, contrary to the financial results, Suven Life Science's share price has had a negative 38% return for the 2016 calendar year, down 34% in the fund. Over the past 3 and 5 years, Suven's stock has returned 113% and 1100% respectively. Over the next 10 years we do not see Suven's growth or profitability profile changing significantly. Suven has zero direct exposure to the US market. Furthermore, Suven's drug discovery could be a game changer if any one of their drugs makes it through Phase II.

The second company, Aarti Drugs is a pharma investment with 60% of its revenues generated within India, unlike most of the Indian pharma companies who are exporters. Of Aarti's exports, none go to the US. For the September quarter, YOY sales rose 15.58% and net profit increased 40.48%. Aarti Drugs has announced a small buyback of shares at a price of Rs. 750 CMP is currently Rs. 603. Since 2010 sales have increased from 63M USD to over 180M USD in FY ending March 2016. During that time, profitability increased 110%. Aarti Drugs currently trades at a 25% discount to the industry PE.

Information Technology

The fund owns 5 information technology companies; Infinite Computer Solutions, Mold Teck Technology, R.S. Software, Saksoft Ltd, and SQS India BFSI Ltd. These companies include a building management software company, a credit card and digital payment systems software company, a large pure play software testing company, a communications software company, and a value-added software company levered to the banking and financial industry. IT is 28% of the portfolio and has a combined return of 3.25% for the fund over the last year.

E-Commerce

The fund also owns one E-Commerce company: Palred Technologies which is 5.0% of the portfolio, and owns Hyderabad-based LatestOne.com. LatestOne.com is India's largest e-tailer specializing in tech and mobile accessories such as Bluetooth devices, mobile covers, tablet accessories, cables, power banks, Android TVs, headsets, smart watches, CCTV's etc. LatestOne.com stocks over 10,000 different products in its inventory and operates through its own fulfillment centers in Delhi and Mumbai.

Palred is our one speculative investment in the fund. Palred was spawned from a previous 5 year hold, Four Soft Logistics. Four Soft was sold to a multinational for cash nearly 3 years ago giving the fund a handsome return. After returning most of the proceeds from the sale, the founder Srikanth held back 8.0M USD to create an e-commerce company. This e-commerce company will be Srikanth's third business built from scratch. After 2 years of operations, Palred Technologies now is India's largest pure play electronic accessories company which has recently become a direct cost profitable e-commerce company. This accomplishment shouldn't be dismissed lightly; it is a very important aspect of this company's DNA and how management is guiding the company's well thought out growth.

Palred has a number of shots on goal in addition to being a B2C electronics accessory e-commerce company that sells its own branded products (PTron). Palred operates in the B2B space. It also has built a managed market place for small retail shops, and offers technology solutions. Importantly, Palred has used its capital intelligently resulting in a vastly superior bang for the investment buck compared to other e-commerce companies who are burning tens of millions of dollars in customer acquisitions. We believe Palred could be a moon shot, or at the very least be acquired by another e-commerce company. We have great confidence in the management team and believe they will be able to build a great deal of value for the fund over the medium term. In the long term, the sky's the limit.

Agritech

The fund owns India's third largest agrochemical company, Dhanuka Agritech who owns 8,600 distributors across the country. This leading company has launched 16 new products in the last 3 years, and has 7 new launches in the first half of this FY year. Dhanuka Agritech is the partner of choice for global innovators such as Dupont, Nissan Chemicals, and Chemtura who chose Dhanuka for its extensive distribution network across India who also has a reputation for creating a brand and handling intellectual property. Over the past 5 years, Dhanuka has grown its revenues in excess of 20% annually and we do not expect this rate to abate. YOY sales rose 14.36% and profits rose 30.46% in the latest quarter. Dhanuka's board approved a share buyback at a maximum price of Rs. 850 per share (CMP Rs. 750). "The company intends to buyback one million equity shares representing 2% of the total equity share for an amount not exceeding Rs 80 crore," Dhanuka Agritech said in a statement.

Textile

We own one high value added textile manufacturer, Nitin Spinners. Our niche, high quality cotton yard and fabric manufacturer sells higher value products to major garment manufacturers. Nitin Spinners is increasing its capacity 50% by February of 2017 and moving up the value chain. This small, high quality, cotton manufacturer has no difficulty selling its product and we expect the increased capacity to quickly increase sales. The company is trading at a PE less than 7 and is selling for less than 0.5 market cap to sales. Over the past 4 years, sales have nearly doubled, book value has more than doubled, and earnings per share have more than tripled. With its new capacity, we expect EPS to increase roughly 50% over the next 2 years. India has the second largest textile industry in the world and is also the world's largest cotton producer (35 million bales). India's share of the global textile market is 4.5% - 5.0%.

Artificial Leather

The fund owns the largest artificial leather producer in India, Mayur Uniquoters, with an installed capacity of 3.05 million metric meters per month. Mayur has been a public company for more than 23 years. Artificial leather's raw material is petroleum based and lower oil prices has significantly reduced raw material costs which are then passed on to the customer resulting in a somewhat flattish top line recently. Volume growth remains on track. Mayur Uniquoters is levered to two specific industries, automobiles and footwear.

First, there are a lot of feet in India that need shoes. Second, India is one of the largest auto makers in the world and has designs on being an Asian/African export hub. In the last calendar year, India produced over 19M vehicles. M&M, Ford, GM, Chrysler, and BMW are Mayur's automobile OEM customers. Currently, 26% of revenues are exports and this number is expected to grow as the company provides more products to US auto OEMs. Half of the company's revenues are generated by providing high quality artificial leather to India's footwear industry's major players including Liberty, Relaxo, VKC, and Paragon. The footwear industry in India is 65-70% unorganized and is becoming more organized benefiting Mayur. Mayur's profitability grew 25% in the last fiscal year. We expect revenue growth and profitability to continue its 5-year average growth of 16% and 23% respectively. This year the company had sales of 80M USD. The company is trading at one half of the industry's PE and sports a ROCE and RONW of 36% and 30% respectively which is considerably higher than the industry. Mayur has been in the portfolio for over 3 years.

Others

Other portfolio holdings includes defense contractor, Astra Microwave, the largest instant coffee producer in India, CCL, one shrimp and shrimp feed producer who has a JV with the largest shrimp/feed producer in the world, Avanti Feeds. Also in the portfolio; one plastic furniture maker, Wim Plast, India's largest grape exporter, Freshtrop Fruits, one of India's largest NBFC (non-banking finance company), Cholamandalam Investment and Finance Company Limited, plus one energy services player which we recently bought.

Long Term, Long Term.

When we say we are long term investors, we talk the talk and walk the walk. The fund's turnover in 2016 was 22%, up from 12% in 2015. The average turnover over the past two years was 17%. A 17% turnover indicates a 5.8 year holding period for the average company in the portfolio. We believe we have one of the longest holding periods in the business. In a time when buy and hold strategies are out of favor and the average fund turnover is near 100%, we believe India's current high growth and basic market make-up is a place where the buy and hold investor can significantly increase their wealth. Furthermore, I put my money where my mouth is and I have 95% of my investable assets in Passage………. right alongside you.

I think now is a great time to invest in India and this is a way of expressing to you the opportunity I see in our Indian portfolio. We are looking forward to a solid 5 years ahead of us and sincerely hope you agree.

Thank you for your continuing support in this endeavor.

Kind regards,
Ralph

Ralph Kruger
Managing Director
Arcstone Capital

Arcstone Capital
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