Investment Managers Report

August 2019

The Globe

This feels bad. Not only in India, not only in Passage, but around the world. People and investors alike are, in my opinion, concerned and worried. And that's just the political side of the equation. Throw in a global economic slowdown to 2.5%, including India's GDP slowing for 3 consecutive quarters, and one gets the markets we have today. Jittery, on edge, and volatile. This latest quarter, April-June, we are looking at 5.0% GDP growth for India. And, we are not out of the woods yet. What's an investor to do? Well, we carry on.

On the backs of uncertainty, global unrest, and slowing earnings, a laundry list of local events in India has moved the Indian market down from its all-time high after Modi's reelection, to a five-month low. All this said, we feel confident the Indian economy, with its young population, aspiring workers, and growing consumption, will continue its upward trajectory. If the economy grows and prosperity increases, the market, being mostly rational, will reflect this.

During this down period, investing in a concentrated small company portfolio which is getting a trashing, certainly feels bad. But this frantic, unstable, rumor prone market in the short term turns out to be a reasonable and rational market in the long term.

Broadly, over the last year, India's average company revenue and growth have slowed. As a result, there have been a number of government initiatives to stimulate growth. In our view the most important one was the very recently announced roll back in an increase in corporate taxes. Finance Minister Nirmal Sitharaman (FM) announced a corporate tax rate cut to ~25% from the recently raised 35%, after having taken a series of steps in recent past in order to stimulate overall growth. While democratic governance is not perfect, it does allow for a quick and solid response if its citizens push back enough.

In another response to slowing growth, the government pledged to significantly shorten its schedule to pay back tax receipts generated by the recent GST. This has been a pain point for India Inc, especially smaller companies. With car sales off, contracting for the last four months and declining 31% in July YOY, the government has lifted a prohibition of government offices buying cars in a hope to stimulate the auto industry. When citizens are concerned, they will postpone purchases. Car sales is just one indication. Once again negative sentiment, like euphoria, ebbs and flows.

India

In India the sentiment is decidedly negative and many investors, especially global investors, have exited the Indian market in part or in whole. As value buyers and contrarians, that's the first piece of good news we have seen in more than a year. In this sea of negative thoughts, we do read some positive comments. For example, DR. RAJENDRA KUMAR SOMANY, Chairman and Managing Director of Hindware, a large kitchen and bath hardware company, writes in his Management Discussion in Hindware's Annual Report.

"India continues to be one of the world's fastest growing major economies; and is poised to touch US$ 5 trillion in five years and US$ 10 trillion in eight years (Source: Budget 2019). It is also one of the most diverse nations, with many regional and cultural nuances. Our country is powered by a huge, aspirational young population with growing disposable income and greater integration with the world, thanks to the digital-first economy that it is building. This interesting confluence of robust economic growth, a vibrant consumption landscape, greater connectedness and key socio-economic reforms creates favorable opportunities for all future-focused businesses like ours. Consumption expenditure contributes over 57% of the country's GDP, which augurs well for businesses. For close to six decades, we have grown by leveraging consumption growth in an economy, which is becoming increasingly inclusive. The government has rolled out multiple measures to bolster the rural economy and also drive consumption in Tier II and Tier III cities. Some of these measures include 'Ujjwala' scheme, which provides free cooking gas connections to poor rural families, the 'National Rural Health Mission' (NRHM) that offers accessible, affordable and quality healthcare to the rural population and 'Housing for All', which provides affordable housing to the urban poor, India is now the world's fifth largest economy and has seen a major transformation in recent years. The most important among them is the successful rollout of the Goods and Services Tax (GST), in addition to the Make in India initiative, the Insolvency and Bankruptcy Code (IBC) and the Real Estate Regulatory Authority (RERA). These reforms address some of the intrinsic challenges that the country was facing even five years ago. The reform measures and other initiatives by the Government of India and state governments have helped India improve its rank considerably, from 100 to 77 in the World Bank's Ease of Doing Business, 2019 report. The ranking provides a useful input to influence investment decisions among global and domestic investors."

Passage

As you may expect in the general carnage we have made some mistakes in the smaller percentage holdings in the portfolio which we are exiting, albeit at a painful pace. In a nutshell I paid up for some of our smaller holdings, buying at an elevated PE. That said, overall the portfolio is in good shape, operating margins and net margins are 18% and 10% respectively, down some but still respectful. Revenues are rising and over the longer term we can expect the portfolio to get back on track.

We look to increased sales and earnings with sustainable margins in higher growth areas of the economy. This isn't rocket science but in the last 24 months index beating returns have completely eluded us pulling down many years of good performance.

On an annual basis: Our portfolio companies have averaged 10.7% revenue increases YOY with nearly half of our companies reporting higher YOY earnings. 10% growth falls short of our targeted 15%-20% annual increases, but considering the broad slowdown, we are good with this result. This is not the complete story however. Earnings growth has declined in 9 of the 16 companies but our companies have still increased their earnings on an average of 3.2%. To be clear, all but 2 of our portfolio companies have registered solid, sustainable earnings with good margins this year. But, our goal of a 10-15% increase in earnings has not been realized for during the last 12 months.

As you know, we shoot for the same 15% earnings growth. For the year, revenue growth has slowed from a historical 15% on a quarterly basis to 10.7% this quarter. The rate of earnings growth has slowed more, increasing across the portfolio by 3% when we look for an increase of 15%. This company performance is well below our targets. Our portfolio companies remain leaders in their industries with excellent long-term focused management operating in higher growth sectors of the economy but the last two years of stock performance have been uninspired.

On a quarterly basis: For the quarter ending June 19, India Inc's top line growth grew YOY 7.8% and bottom line suffered a negative 2.3%. As a favorable comparison and not to beat a dead horse, our portfolio revenue increased over 10% and earnings increased 3%. While most of the market has reported substandard results, with more than 2400 companies having reported, a low 655 companies (27%) reported Net Profit growth in both QOQ and YOY, our portfolio has had an average increase in revenues and earnings across the board, save two companies. One company was and is a real mistake, the other, a works in progress.

That's the bad news. The good news is because of increasing earnings and lower share prices the portfolio's trailing twelve-month PE has fallen to today's single digit level from last year's low teens. On a quarterly YOY weighted basis, our portfolio's revenues have increased 14.6%. However, in this tough quarter our portfolio profitability has increased less than 1% due to higher tax rates and employee expenses. It may take a couple quarters for management to adjust and the businesses to sort themselves out, but eventually margins will regress to the historical mean. The portfolio's market cap to sales is a heathy 1.11X (TTM). Furthermore, we believe today's portfolio is well priced and well positioned.

Portfolio Companies

Our largest and longest hold (a plus 7 years hold), Moldtek Packaging Limited, is continuing to deliver on our original thesis of expanding its paint/lube packaging business while increasing its fast-moving consumer goods (FMGC) packaging from 0% in 2010 to 24% this quarter. FMCG packing commands higher margins and has had the desired effect of slowly and inextricably increasing margins. With new plants coming on line and Moldtek Packaging cracking into the edible oil market, plus continuing its marque customer additions, Moldtek Packaging's management is guiding to 15-20% revenue growth and margin expansion for the next 3 years at least. With a price of high 200's Rs and the portfolio's cost basis in Moldtek Packaging is less than 18 Rs, I am comfortable in Moldtek Packaging's future outlook.

Our second largest holding, Freshtrop Fruits Limited, a nearly 5 years hold, has increased its quarterly revenue on a YOY bias by 20%, but its profitability <16%> has suffered as management roles out its fresh fruit drinks. The stock price had increased in the last year on the expectation of increased growth and profitability from the new fresh drink segment but the stock price has recently slid back on the news of a slower roll out. The market has reacted accordingly by selling off the company to a point that Freshtrop Fruits's PE on the latest quarter's run rate is less than 7 and its valuation is 0.71 market cap to sales. Over the years, Freshtrop Fruits's core grape export business has been a steady Freddie, 10% grower. While the grape business is a slow growth business (if you can call a 10% long term growth slow) it has provided Freshtrop Fruits with steadily increased sales and profitability. The fresh fruit drink is some extra juice (pun intended) but like all things, this takes a lot more time, energy, and investments than expected. So we wait, we carry on.

Our third largest holding, Saksoft Limited, has increased revenues YOY this quarter by 10.5%, profit by 23%, and is trading at a PE of 7. Last year revenue increased 25% and profitability increased 56%. Operating margins and net margins are 20% and 10% respectively. Saksoft is a 38 Million USD digital transformation company founded in 1999. Its current market cap is 38 Million USD and with over 50 Million USD in sales. Saksoft has been in the portfolio for 5 years, returning 55% while being down 10% this last year.

Ion Exchange Limited is our fourth largest position and a 2.5 year hold. YOY revenue increased 48% and profitability a plus 41%. Currently its PE is 9.20. Ion Exchange is one of the two listed water companies in India. Ion Exchange builds water filtration and desalination plants, sells to commercial customers resins for water purification, and sells in home and small water purifiers.

India is water stressed and this is getting worse at an alarming rate. Over the last two years the company was under investor pressure because of a large infra project in Sri Lanka that was seriously delayed. Ion Exchange also has somewhat lower, but increasing, margins and the Sir Lanka project had pulled down its profitability. Now the delay is behind the company and its revenues and margins have improved. This 138 Million USD company with revenues of 172 Million USD is a premier international water company founded in India in 1964. While last year was a good year for profits and share price, I believe in 10 years we will see better metrics from a company in the heart of the future, water stress.

Control Print Limited is an ink jet printer manufacture. The company manufactures machines that time stamp products at the end of the assembly line. As consumer-packaged goods become more and more prevalent in the Indian economy and government requirements for time stamping become more strident and enforced, Control Print stands to benefit. With about 18% share in this four-player market, Control Print is the only indigenous manufacture giving it a cost advantage whilst still maintaining international standards.

This quarter's revenue for Control Print increased 12% YOY to 7.34 Million USD while profit was flat at 1.24 Million USD. Margins held up reasonably well, 22% operating margins, 17% net margins. Because of the consumer packaging growth expectations, our small niche time date stamp manufacturer has a somewhat high PE of 12.5. Control Print has been in the portfolio for 3.8 years with no share price appreciation for our 4 years hold after this year's 36% decline. That said, it is a solid profitable company, increasing its revenues by 20% annually with very good and sustainable margins, and we expect good things from the company and the sector over the long term. Carry on.
These four companies represent nearly 60% of the portfolio. Yes, it is concentrated. While it may take time, and we do get it wrong at times, over the long term if we buy good solid companies with sustainable margins, in growing areas of the economy, we will be rewarded.

As you ponder the cause of the decline in value of Passage shares you will find the culprits in our more numerous and smaller percentage holdings. Believe me I am working on righting that part of the ship taking on water. We have exited 3 of these sub business performers and expect the ship will be squared up over the next two quarters.

While this period is painful to say the least, we own solid companies that have increasing revenues and earnings, plus sustainable margins, low to no debt, in higher growth areas of the economy.
Thank you for your continued steadfastness in these trying times.

Kindest regards, Ralph