Investment Managers Report

April 2020

I will spare you another Coronavirus update. If your inbox has been anything like mine, the last thing you need is another virus update so I will keep it short.

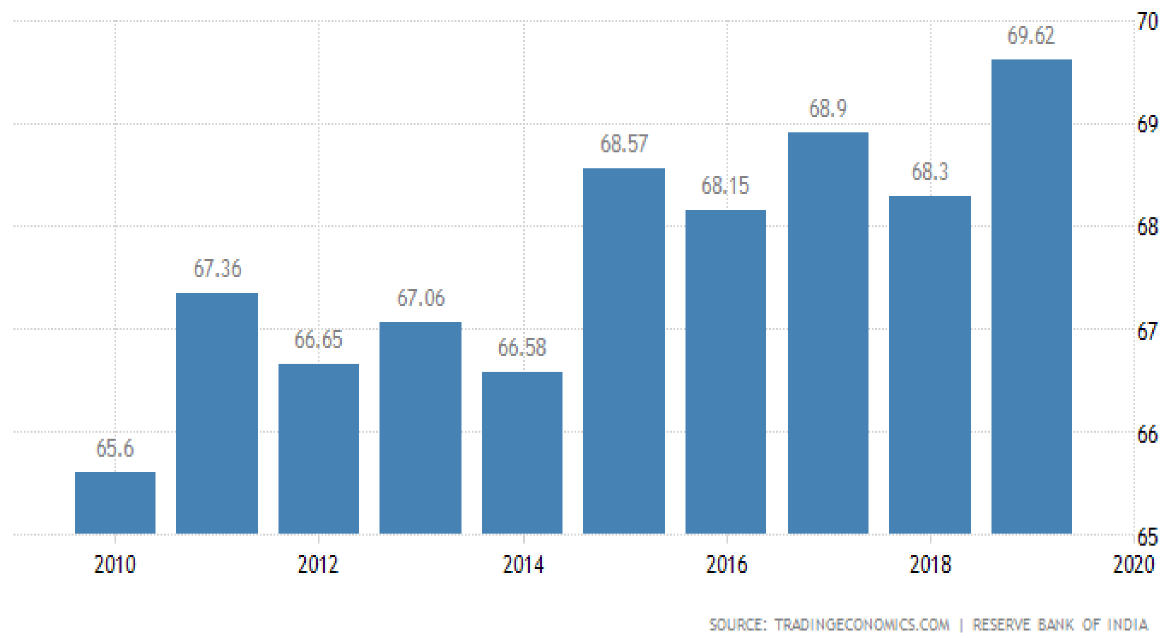
India has not been spared and its lockdown and subsequent stop, started later, as did the virus ramp up which is now in full swing. . The country is about a month behind the US and now major hot spots like Mumbai and Delhi are erupting. While the lockdown only hit in the last few weeks of the latest quarter, GDP for the fiscal year ending 31 March 2020 was 4.2%, its weakest in 11 years, highlighting India's already slowing growth. GDP growth from January 2020 to March 2020, India's fourth quarter of the 2020 fiscal year, was just above 3.0%. Over the last 18 months the economy has had slower growth as a result large defaults of IL&FS, a large infrastructure loan business, and the subsequent contraction of credit with increasing difficulty obtaining loans for autos, commercial vehicles, small businesses. The constriction of credit, increased risk aversion of the banking system, near stop of commercial paper, effected the overall economic credit cycle, investor sentiment, and as a result, the market. The recent robust growth of NBFC's (non-banking financing companies) serving many of the poorly documented workers in the informal economy came to an abrupt halt. Automobile sales was soft coming into the new year only to be further hammered with the lock down. Most manufacturers report for the last quarter sales reductions of over 80%. Consumer durable goods also are down hard. Credit had starting to slowly return, only to be hit again with Covid 19.

Lockdown

India imposed one of the most draconian lockdowns in the world. By all indications the economic numbers will reflect a severe contraction in the second quarter of the Indian 2021 fiscal year, March 31 – June 30th 2020. Crisil, the rating agency, expects the Indian economy to contract 5% in 2020 despite the current lifting of restrictions in some less infected areas. A negative 5% GDP growth would be the worst performance since independence from Britain in 1947 and the first negative growth in the economy since 1980. In the short-term unemployment could rise to 25% from today's 10%. The data will be delayed but it is reasonable to think 25% unemployment rates are with us now.

RBI Response

To combat this swift and steep decline, India's central bank reduced interest rates from 4.4% to 4.0% when the Monetary Policy Committee (MPC) met two weeks early in May, totaling 250 bps since 2019. In other moves the RBI, the Reserve Bank of India, extended the moratorium in asset classification downgrades till 31 August 2020. Plus there is a long list of other banking/government initiatives softening the economic blow. These initiatives will push the budget deficit to 10% of GDP, a far pace from the last years of hard work to get the budget down to 3.2% of GDP. In the short term this will increase debt requirements for the government.

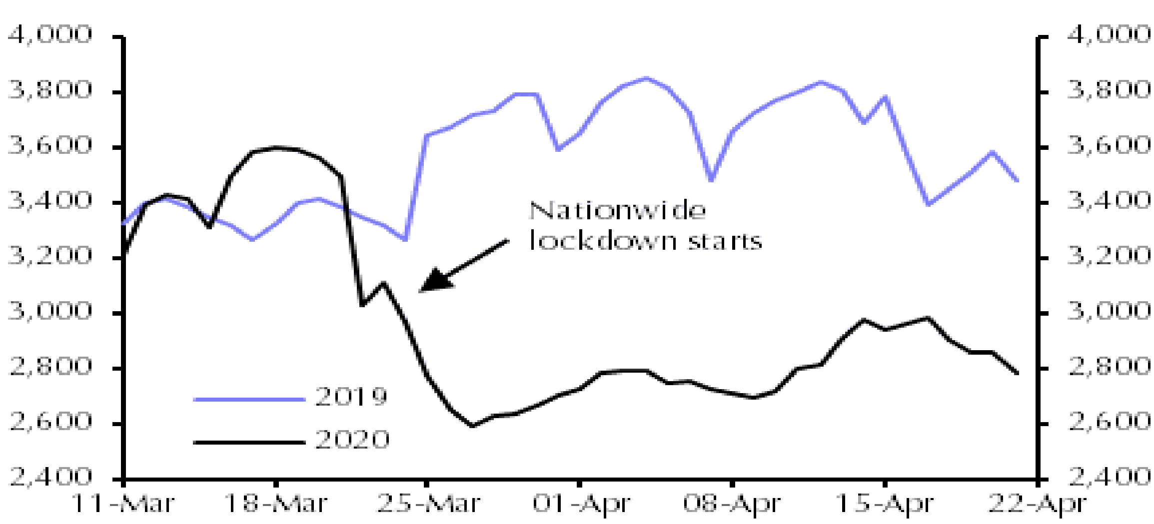


At 70%, of GDP, India's sovereign debt is below many developed and emerging countries. While we are always debt adverse in all forms, government, state and local, and of course corporate this increase is unfortunate, but necessary in the short term. Keep in mind government expenditures in India are roughly 13% of GDP. And in symmetry, India's tax collection is also low. As a result the government's impact will be naturally less.

Although recent moves will increase government debt, it is still mostly in domestic hands. Less than 2%% of India's national sovereign debt is held in foreign hands avoiding the classic pain point of foreign investors withdrawing support. In spite of a small holding, there has been recent outflows causing some pain but resulting in foreigners holding Indian debt is at the lowest in 5 years on fears of a higher deficit and a recent downgrade. India's debt is denominated in Indian Rupees and not tied to any foreign currency. Plus, India's foreign currency reserves are reasonable and at their historic highest levels of 493 B USD. This hasn't stopped the Rupee from declining to 76.90 Rs/USD in April, an all-time low.

Easing of the lockdown is a step forward but the top 6 industrial producing states are still in red/orange areas with limited industrial production. Most other indicators, IIP, core sector, PMI, import/export trade, indicate a serve, negative impact for this upcoming quarter. Electricity usage, a good independent real time indicator of activity, is down. While manufacturing has indeed restarted, they will need to clear the hurdles of availability of labor (many workers have returned to their villages), disruption of supply chains (our portfolio companies have felt this disruption less), delays in port clearances (our portfolio's revenue is 65% domestic, export revenue mostly is in the form of software), and the availability of trucks and truckers. This will take some time, exactly how much is unknown.

<u>Electricity Usage</u>



All is Not Lost

Record food-grain production for this growing season called the *Rabi* will support farm income and farm sector trade. The next growing season called the *Kharif* is in the process of being sowed now. Expectations of a normal monsoon season will usher in a good *Kharif* harvest as well.

The government is now opening up sections, notably manufacturing of the economy slowly, with the appropriate safety measures although new virus cases have not tempered. Most companies are reporting a slow uptick in their manufacturing capacity utilization. Most companies are actively reducing costs, laying off workers, and conserving cash. The good news is our companies have not had to go to the credit market, if indeed it was available to them, for short term loans to weather the pandemic storm. A consistent theme, little to no debt.

Looking Ahead

Long Term: Looking well past this pandemic, 3 years, 5 years or even 2 years out, the virus will, sooner or later, be dealt with. There will be a vaccine developed, people will return to work, eat, play, and socialize. Humans have suffered extreme hardships for millenniums and they have survived and flourished. This time will be no different. India's economy will recover and its 1.3 billion young people will go to work, be productive, and individually add to India's GDP.

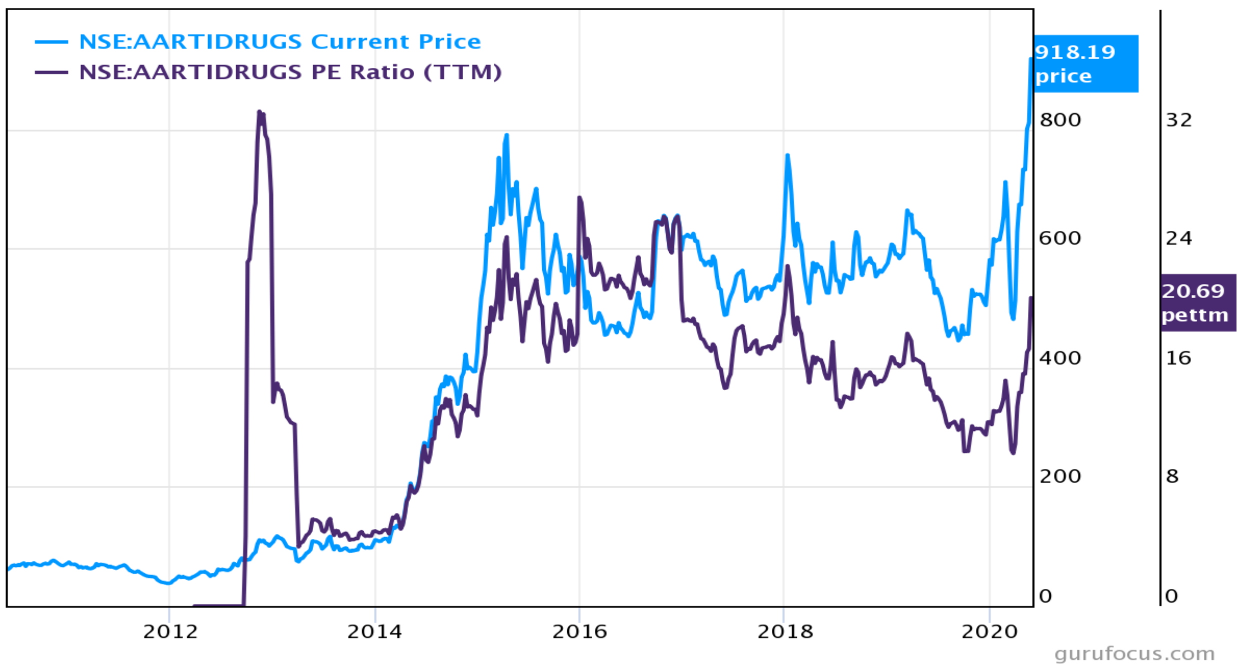
Mid Term: In the mid-term the question is when will economic activity recover to previous levels, or at least to a level that will provide consistent profitability, however small? I think government support in India (and globally) will mitigate a drastic, prolonged decline, avoiding the worst-case depression scenario. Nonetheless the extraordinary cessation of economic activity, the high levels of deficit spending by the government taken on fighting the economic shutdown, will have consequences over the next decade. If this short term fix does not become a habit and the government can get back on track to 3.2% or 3.5% deficits we can avoid a major risk to India's economic expansion.

Short Term: In the shorter term, the next two to three quarters look daunting. No question the next quarter, 1 April to 1 July 2020 will be, well, horrible. Regarding our portfolio, looking out from here we have a couple things going for us. First, our companies have little to no debt. During a downturn or slowdown, debt is the most damning of all vices. It compromises the fundamental strengths of the business and backs management into places where choices are limited. Not only do our companies have little debt, but many have healthy cash balances protecting them from needed short term financing. Can they run on empty for the long run? Of course not. But so far, we have heard of no pressure to secure loans to stay in business. While most of our portfolio is being hit hard, as you know too well, all of our holdings are hanging in there as necessary products and services for a growing India. We are in no business that is existentially threated by this short-term event.

Portfolio

Aarti Drugs

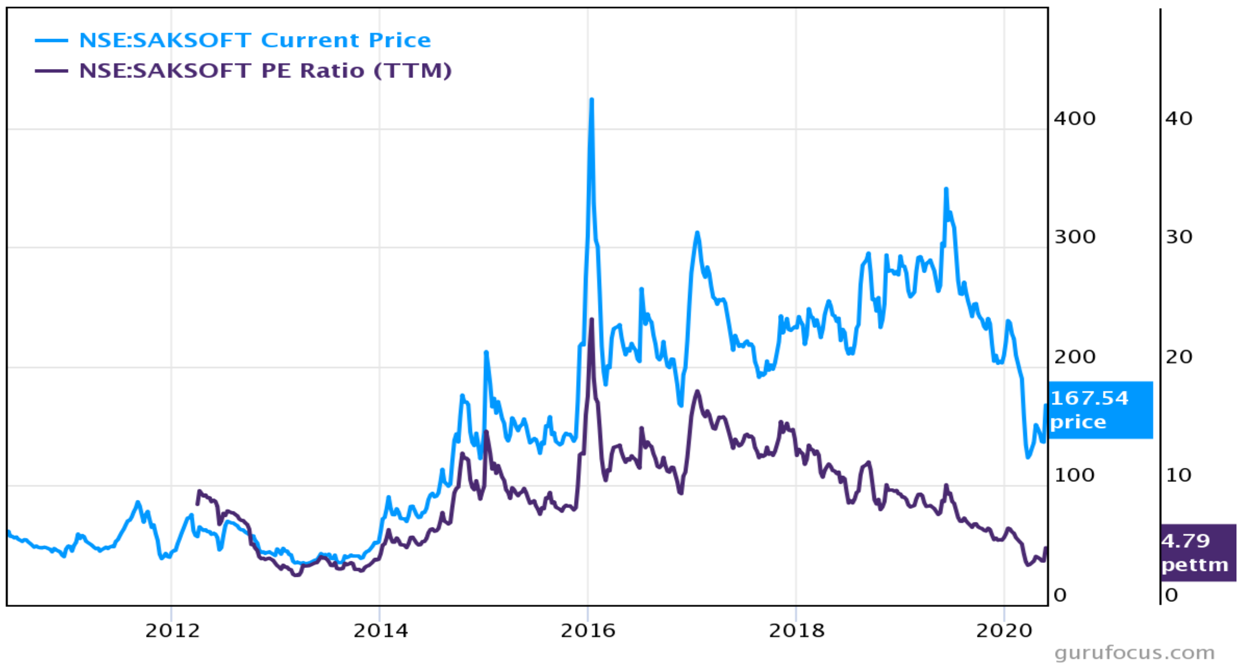
Aarti Drugs is a 300 M USD drug company catering to common diseases like inflammation, diabetes, and diarrhea that has held up well in 2020 returning 64% YTD and over 100% since its March 2020 lows. We have held Aarti for over 6 years in the portfolio and we have trimmed the position recently during is strong up move this year.



Saksoft

Saksoft, a 24 M USD software company with a PE of 5 is down 13% YTD. Down, but down less than the market. We recently added to our position when its PE dropped to below 4. That said, overall, the portfolio has had a very modest 12% increase in share price over the last 6 years since our first purchase. Like so many lessons learned we bought Saksoft at a higher level, with a PE of 15 and P/S of 1.78 and hence the lack of a robust return in share price. Now Saksoft has a PE of less than 5, a P/S of 0.52. The lesson, buying a good company is fine, but buying a good company at a good price is much better. We did not a very good job on the former, and corrected the mistake recently. We have done this recently buying Saksoft at a PE of 4,with a healthy net cash position, and P/S less than 0.6. This recent buying has complemented the tactical purchases over the years positioning the portfolio to realize value from these lower levels. Saksoft is now roughly 10% of the portfolio with very low valuations and we are looking past the pandemic.

In the below chart the steady declining PE value for Saksoft, annual revenue growth of 9%, EPS growth of 15%, and Free Cash Flow growth of 17% will lead to higher valuations. Saksoft's operating margins are 21% and net margins 11%. With a healthy net cash position and a dividend yield of 4.2%, plus a meaningful position in the portfolio, Saksoft is but one reason I am optimistic regarding the future of Passage.



Mayur Uniquoters

Mayur Uniquoters carters to the footwear and the automobile market with its artificial leather products. Mayur faces headwinds as you would expect. Indian auto sales which are roughly 50% of revenue have declined sharply in the last few months following a general softness in auto sales for the last two years beginning with credit contraction. This 6-year hold, while underperforming because of the above, nonetheless is an excellent company. It is the largest artificial leather producer in India with international marque clients along with nearly every domestic auto OEM. Mayur will over the longer-term, return to its historical growth and profitability. The other half of its revenue comes from mainly footwear. While many Indians may put off buying a pair of shoes for some time, sooner or later they will need a pair of shoes and a large market share of those shoes will have Mayur's artificial leather. Meanwhile, we hold the shares in spite of being underwater.

Permanent loss of capital - avoided

In my judgement none of our companies is in an industry that will not recover once the pandemic has passed. And all of our companies are in products that are needed in the economy. Furthermore, nearly all of our companies are the market leader or have a significant market share.

We have human ingenuity for the long run, an unknown shorter period of time to recover, and a most certainly a bad March-June quarter and an equally bad CY20, to look forward to. Our portfolio, while being hurt has had some positive movers and now, after a lot of pain, is positioned with very attractive valuations. As you know by now, we have not sold our holdings in the face of this onslaught. Bloodied and bruised we have not locked in a permanent loss of capital of these well-run companies and the portfolio is still standing to fight another day.

Today the PE's look very attractive, but will undoubtable increase after next quarter.

Keep in mind that these current low PE's will likely change, moving higher without a corresponding increase in stock price. If the E in the P/E comes in lower, PE's will naturally climb. In the next two quarters lower earnings are a given. Looking out to the end of 2020 and into 2021, in India, I see no reason why the E should not revert, albeit slowly, back to the mean.

While hope is not an investment strategy, it does spring eternal, and our view on India is this extreme negative impact too will pass.

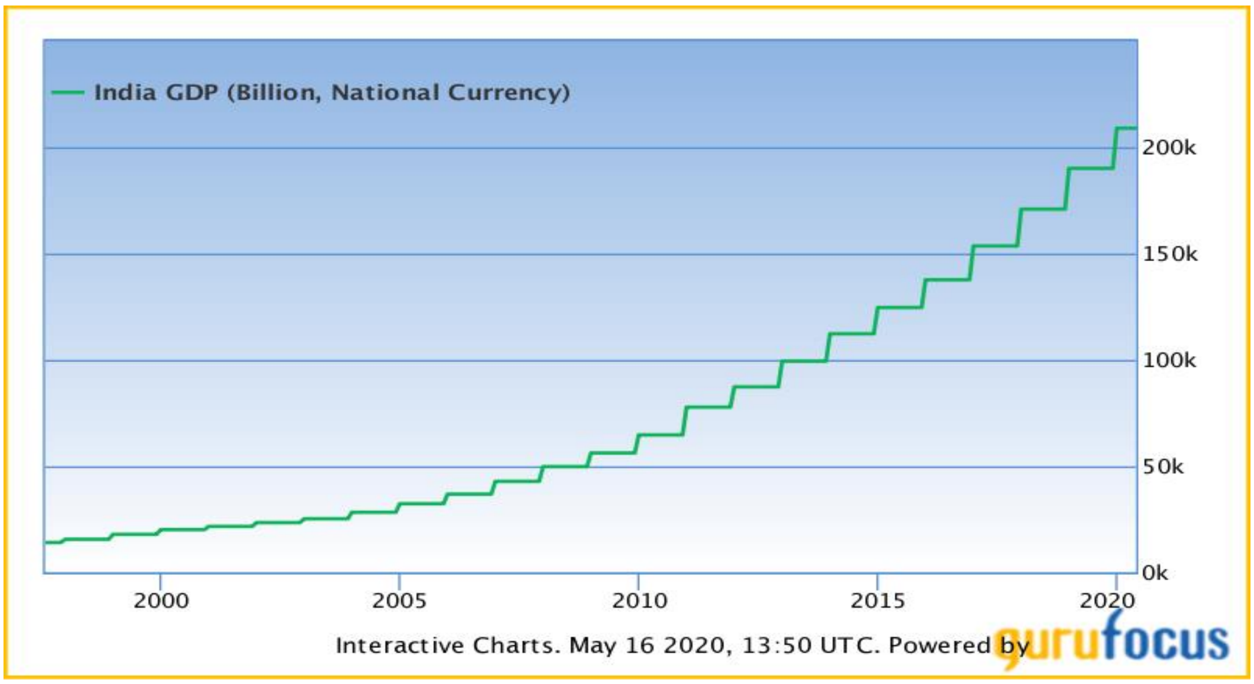
Our companies look reasonable, what about the Indian economic outlook. Looking at the expected return of the market. A simple equation gives a reasonably probable scenario.

1. Ratio of total market cap over GDP: India MC/GDP since 1997: Maximum - 158%; Minimum - 40%; LT Ave - 76%, Current – 51%
2. Current dividend yield: 1.34%
3. Market Index used: BSE SENSEX
4. Current Annual GDP: 2.754 Billion USD
5. India's Annual Growth Rate of 11.52% including inflation in local currency

The SENSEX's expected future annual return is 17.9%, assuming India returns to its long-term growth rate and the MC/GDP reverts to its long-term average of 76%, including dividends in local currency.

<u>India Historical GDP Growth</u>

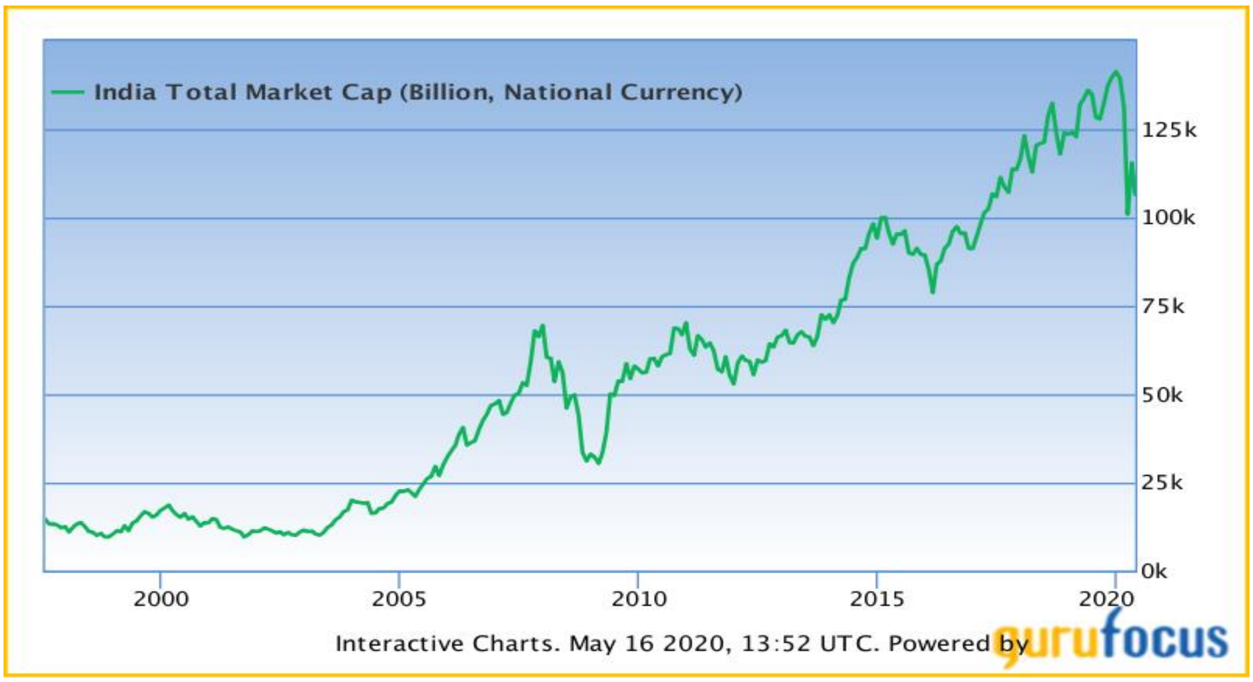
The GDP in local current prices has grown at the annual rate of 11.52% over the past 8 years. Please note this growth rate includes the effect of price inflation and it is NOT the real GDP growth rate. Current Annual GDP: 2,754 Billion USD



Historical Stock Market Cap

This value is normalized using the data published by World Bank. BSE SENSEX is used for the normalization. The Bombay Stock Exchange SENSEX also referred to as BSE 30 is a free-float market capitalization-weighted stock market index of 30 well-established and financially sound companies.

India Total Market Cap (Billion, National Currency)



Historical Ratio of Total Market Cap over GDP (%)

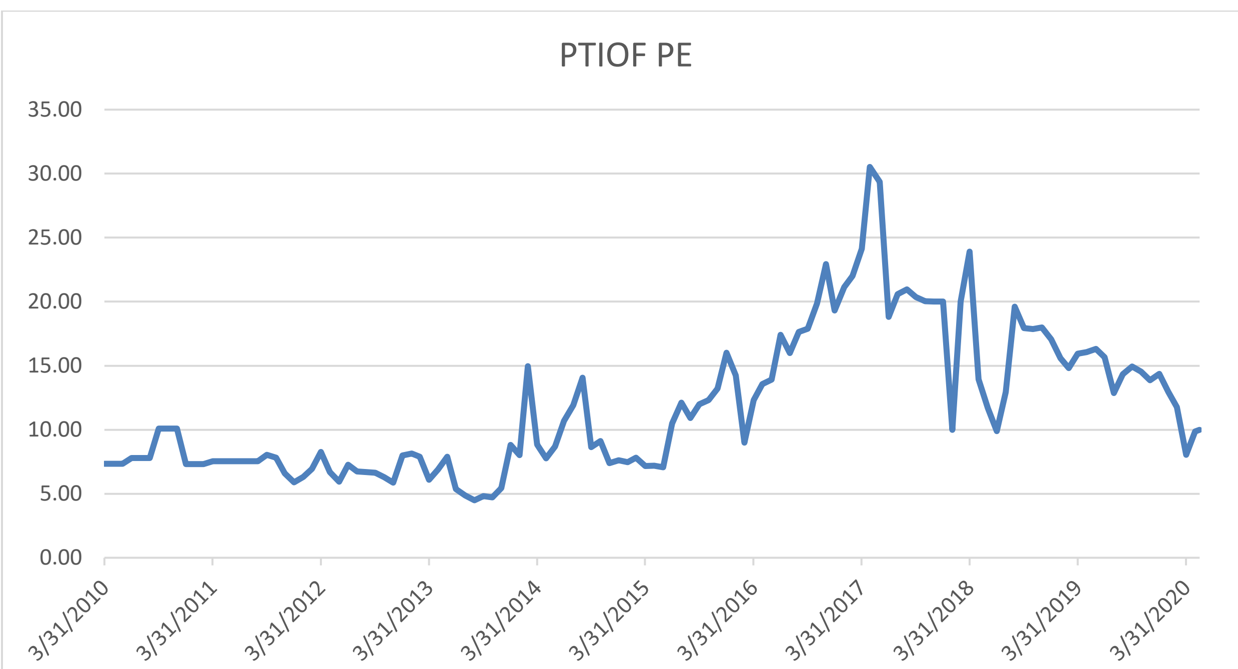
The current ratio of total market cap over GDP for India is 51%. The historical high was 158%; the historical low was 40%. If we assume that the ratio will reverse to the historical mean of 76% over the next 8 years, the contribution to expected annual return is 5.07%. Below is the detailed historical chart of the ratio.

From the above it is reasonable to expect the stock market of India is expected to return 17.9% a year for the coming years. This is from the contribution of economic growth in local current prices: 11.52%, Dividend Yield: 1.34% and valuation reverse to the mean 5.07%. Guru

We expect this return to be a base line for our companies. Integral to our India's thesis, over the longer run, smaller companies will outperform the overall market. Since 20218 this has not been the case and sooner or later, smaller companies are due for a reversal.

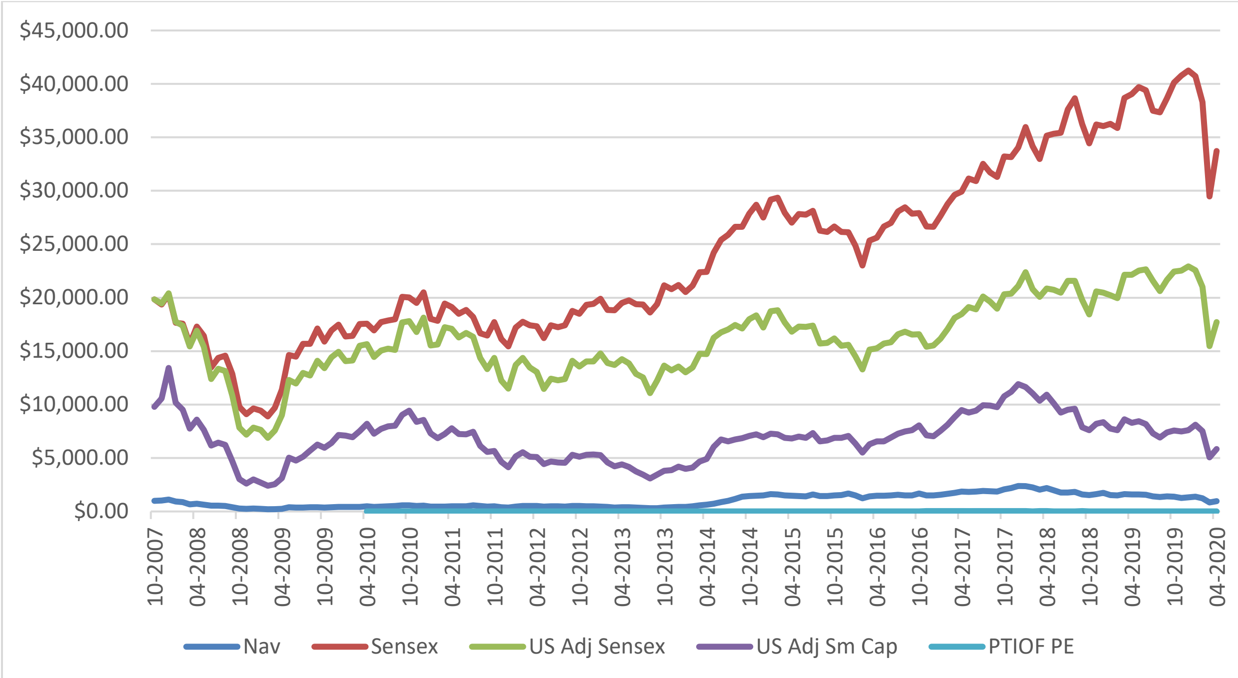
The below chart (please excuse the hard to read colors) indicate at the start of 2020 India's SENSEX's PE was reaching new highs while the smaller cap indices were held to a lower trading range. Passages PE has declined materially to a value we have not seen since 2014 and earlier. (Celicdata.com)

Along with the overall Small Cap's stock underperformance combined with rising revenues and profitability of our companies has pushed the portfolio's PE to levels we haven't seen since at least 2015 and 2013.

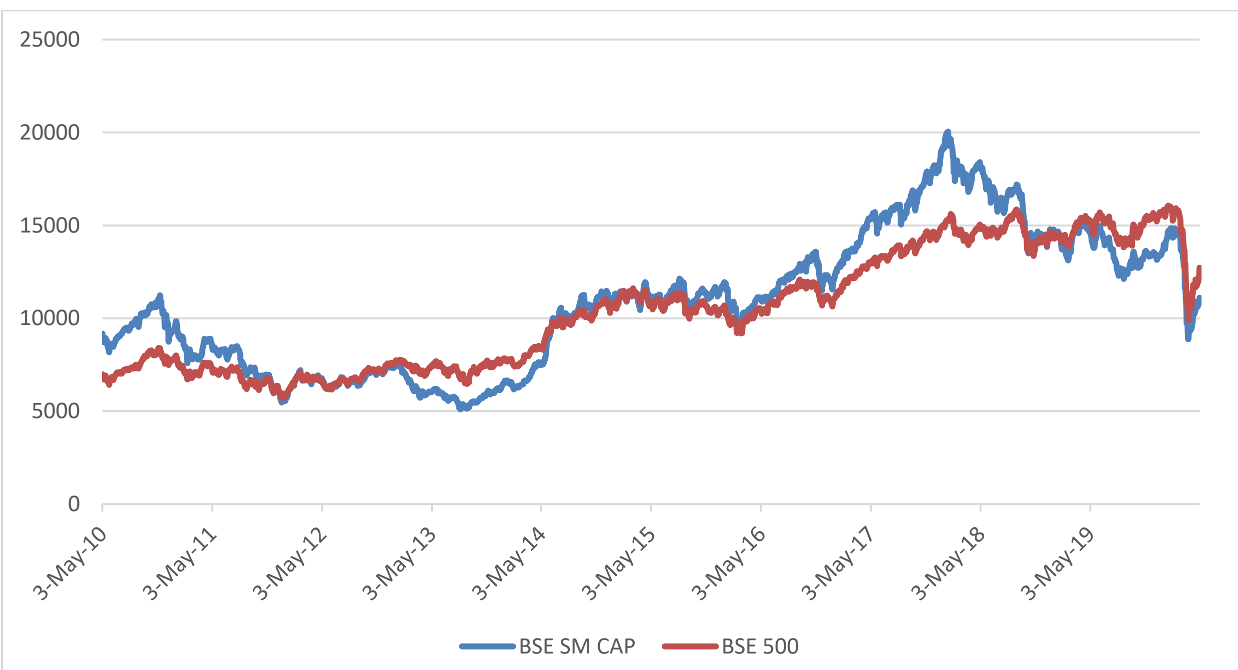


Below you can see that the small cap index performed well in the years after 2009 from its low in February 2009 of 2,407 to its 2018 high of 11,640. However, since the beginning of 2018 the small caps have been under pressure declining to 5,833 in April of 2020, a decline of 50%. Comparably, the SENSEX declined 6% from 35,965 at the beginning of 2018, to 33,717 during the same period.

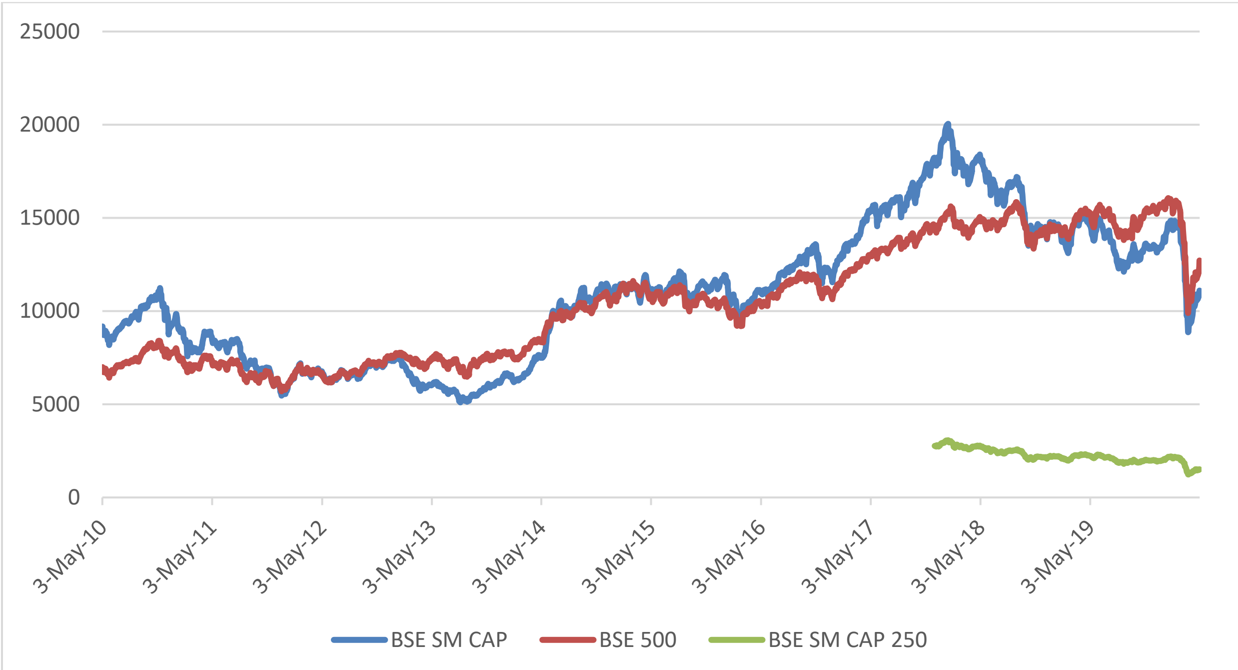
This tells me the small cap's relative underperformance should sooner or later revert to its mean and produce better performance relative to the larger caps.



Below you can see periods of under and over performance by the small cap companies relative to their larger peers. Since 2018 we happen to be in a period of underperformance, similar to 2012-2013. This underperformance ushered in a catch and overshoot cycle in the years 2013-2018.



Below is the introduction of the SP BSE Small Cap 250. Although the chart does not have high granularity, you can see the new Small Cap 250 index is more stable than the BSE Small Cap index.



Passage's Small Cap Index

As you know all portfolios use an index for benchmarking their performance. Typically, the index is a stable measure to compare against.

Reasons to change an index would be:

1. The portfolio has changed and the index is not an accurate reflection of the portfolio. This of course is not desirable because as an investor, building a portfolio you want the manager you picked to manage large cap domestic or small cap European stocks to stay put. Over a period of time some managers do have a tendency to style drift away from their original thesis. Others, myself included are just too stubborn to move, or better, have conviction in the area they invest.
2. The manager is having difficulty outperforming the index and he is searching for one that will show better relative performance. Obviously not good.
3. The index complexion itself may change over time. The same market segment may be reworked by the index sponsor or the index expands to other areas. An example is the MSCI Emerging Market has been steadily adding countries over time, moving it away from the core countries in the index 15 years ago. To have apples to apples comparisons, the manager would have to add at least some, if not most of the countries added to the index. Maybe he or she is unwilling or unable to take on another country.
4. There may simply be an index that more closely matches where the manager is investing.

But, regardless of the reasons, whenever a manager changes his fund's index, you as the investor, should take notice. It would be a real warning flag if a fund has changed its index repeatedly.

So why am I talking about this. Well, let's get one thing out of the way upfront. Passage has underperformed its index since Jan 2018, pulling down its longer-term performance as well. Obviously this is not desirable, but it is hardly the index's fault.

1. Passage's investments have been consistent with an average market cap of its holdings ranging from 60-120 M USD, medium market cap of 30-60M throughout most of its operations. At some points we have had a large company in the mix, but the portfolio has been remarkable consistent.
   Regarding market cap, one aspect of this is as the market grows in size it would be natural for the average and median size of the company to grow commensurately.
2. We have also held between 15 and 25 companies throughout nearly all of its existence. Our style has not waivered.

3. The index methodology/complexion itself has changed. In fact, that is my issue with the BSE Small Cap Index, which is now the S&P BSE Small Cap Index. Before Standard and Poor's was in the picture the BSE, or formally known as the Bombay Stock Exchange, had a number of indices. Now with many more indices some of the older collections have changed in the process. The new SP BSE has a much greater number of indices, or slices at the market which funds and investors can create and measure an ever-increasing market segments or characteristics.
4. The BSE Small Cap index definition has changed. Before 2017 the BSE Small Cap was the bottom 5% of the market capitalization, above a minimum trading, market cap, governance, and reporting threshold. The BSE Mid Cap Index was the next 15% of the market capitalization. Together the small and mid-cap indices represented the bottom 20% of the market above a minimum threshold. Previously the BSE Small Cap index was roughly 250 companies with a market capitalization ranging from 5 M USD to 200 M USD and a PE between 5 and 30.

Today however the new small cap index has expanded to 650 companies with market capitalization range of 1 M USD to 5.5 B USD and sports a PE of 150. After revising this newsletter, two weeks later, the PE has declined to 101 and the min market cap doubled to 2.0M USD. The SP BSE Small Cap index has had a PE of negative 140 as well. Clearly the new Small Cap index is not what it was.

In 2017 the SP BSE also created other indices to include a new SP BSE Small Cap 250. The S&P BSE 250 SmallCap is designed to track the performance of the 250 small-cap companies by total market capitalization within the S&P BSE 500 that are not part of the S&P BSE 100 or S&P BSE 150 Mid Cap.

The new S&P BSE SmallCap 250 index is more similar to the Passage in market cap, especially considering the market cap range of companies in the index, and PE. Today's range is from 23 M USD to 1.0 B USD, with a mean of 373 M USD. We are now including this index along with the S&P BSE Small Cap index on our factsheets. Eventually, we would use the S&P BSE 250 Small Cap as our index. Meanwhile you will see both. Rest assured; we have still underperformed the S&P BSE Small Cap 250 as well.

Kind regards,
Ralph

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