Metis Opportunity Fund

Estimates continue to drift lower; material room for operating leverage to kick in

October 2015 Newsletter

October 22, 2015

As *S&P BSE 500* posted its fifth-worst quarter (since our inception in early 2011), we gained material ground on broader benchmarks – In relative terms, 3Q15 was our third best quarter since inception (+7% vs. *BSE 500*), as continued downside estimate revisions and capital flows took the steam off the broader benchmarks, with pain once again concentrated within the widely owned large-caps.

In 3Q15, *Metis Opportunity* was up **+3.2%** (net of all fees; in INR terms), vs. **-5.0%**, **-3.7%**, **-1.0%**, and **-0.5%** declines in *Nifty, BSE 500, Eurekahedge India,* and *BSE Smallcap* respectively, and **+1.1%** increase in *BSE Midcap*. Our net exposure at the end of 3Q was 93%, increasing largely on account of appreciation. Just as in 2Q, we didn't add any new position. Instead, we further consolidated in certain names once we identified a material disconnect between near-term earnings upside vs. underlying stock prices during August's selloff.

Over the last year, *Metis Opportunity* was up **+9.8%** (net of all fees; in INR terms). That compares with **+3.2%**, **+13.3%**, **+3.2%**, and **+9.0%** increases in *BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively, and **-0.2%** decline in *Nifty*. Over this period, our volatility was **198 bps**, **138 bps**, and **126 bps** below that of *Nifty*, *BSE 500*, and *BSE Smallcap* respectively, and **95 bps** ahead of *BSE Midcap*.

Over the past 3 years, *Metis Opportunity* is up **+82.6%** (net of all fees; in INR terms) vs. **+39.4%**, **+45.7%**, **+63.4%**, **+57.0%**, and **+38.3%** increases in *Nifty*, *BSE 500*, *BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively.

Since inception in April 2011, *Metis Opportunity* is up **+107.0%** (net of fees; in INR) vs. **+36.1%**, **+39.3%**, **+50.2%**, **+25.1%**, and **+20.3%** increases in *Nifty*, *BSE 500*, *BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively.

Global earnings estimates continue to drift lower, driven by Base metals and Energy. In 3Q, about 2/3rd of Indian earnings estimates were revised downwards, which was in line with cuts seen globally. Despite the revisions, earnings growth for the broader Indian listed universe is still being pegged, quite optimistically, at around 20%.

Despite Energy and Metals comprising about 16% of *Nifty*, benchmark earnings growth is still being projected to be in the high-teens for F2016E (Mar), with mid and small-cap earnings factoring even steeper growth (see **Exhibit 1a**). That's largely attributable to *Tata Steel*'s growth off of a low F2015 base, which more than offsets sharp expected declines in names such as *Vedanta* and *Hindalco*. Adjusted for outliers though, earnings growth remains muted while our checks suggest that a broader turnaround isn't as close as earnings expectations would have you believe. Nonetheless, between a stable currency and an established easing cycle, India clearly stands out. While clearly not as sustainable as India, Japanese story nonetheless appears solid with majority of estimates rising – continued weakness in the yen and Abe's plan on lowering corporate taxes has established a floor on Japanese earnings expectations. That said hugely cyclical and external market composition, partially offset by lower weight of commodities, brings substantially more exogenous risk into play than is the case with India.

Exhibit 1a – FY1E earnings vs. weight of commodities

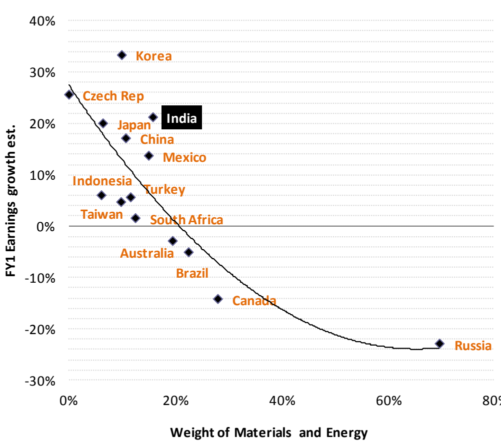
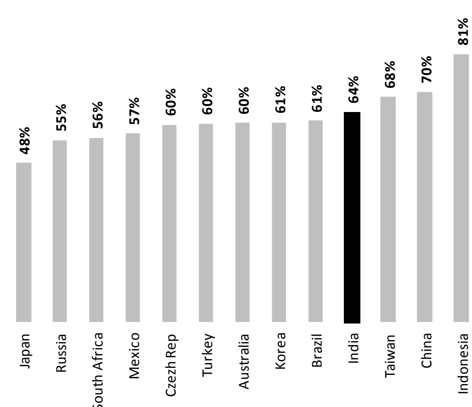


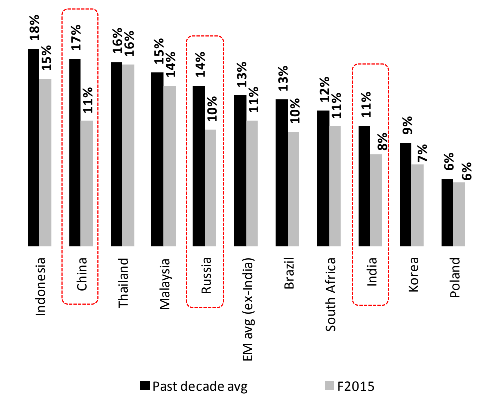
Exhibit 1b - % of estimates lowered in 3Q15



Source: MSCI; Thomson Reuters

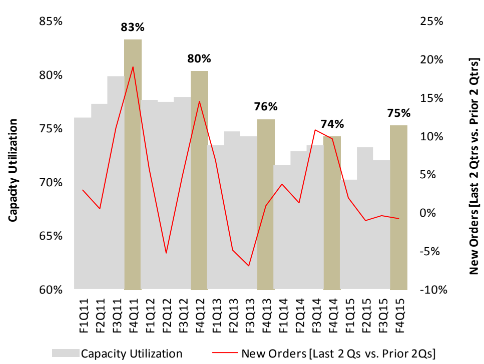
Capex cycle is quarters away from revival; solid room for operating leverage to kick-in. With the exception of China and Russia, no major emerging market has seen as sharp a contraction in capex cycle as India has (see **Exhibit 2**). Headline contraction would be even sharper if we were to exclude *ONGC*, which is on a renewed exploration drive. Despite the sharp capex contraction in F2015 (Mar), utilization levels have remained poor as demand continues to remain anemic (see **Exhibit 3**).

Exhibit 2 – Avg. capex/sales for EM benchmarks



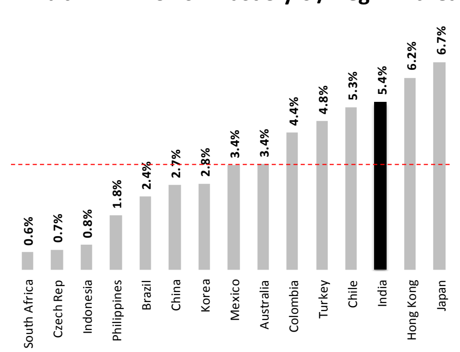
Note: Outliers were excluded
Source: Thomson Reuters; Company reports

Exhibit 3 – Cap Utilization vs. chg. in new orders



Source: RBI

Exhibit 4 – FII flows in last 3 yrs / Beg. Mkt. Cap



Source: IIF

With capacity utilization hovering in the low-mid 70s and demand showing little signs of a broad turnaround, we don't see capex cycle reviving for at least the next few quarters. Consensus estimates however are factoring in a material turnaround in F2016E (Mar), with *Sensex*' average capex/sales estimated at 10%, highest in 6 years. This is to some extent 'padded' by budgetary allocations outside India – *Bharti Airtel* is a case in point, where a material portion of F2016E INR 300 Bil+ consensus capex is attributed to its African and Asia (ex-India) spends. Nonetheless, even adjusting for such select situations, street expectations cannot be reconciled with underlying realities.

Given our expectations of a tepid capex cycle, we anticipate materially improved free cash flows (outside base metals and energy), further improving balance sheets. Our checks continue to confirm India Inc's renewed and broad focus on cost control and we can expect material inbuilt operating leverage in the system to drive earnings growth at some point later next year.

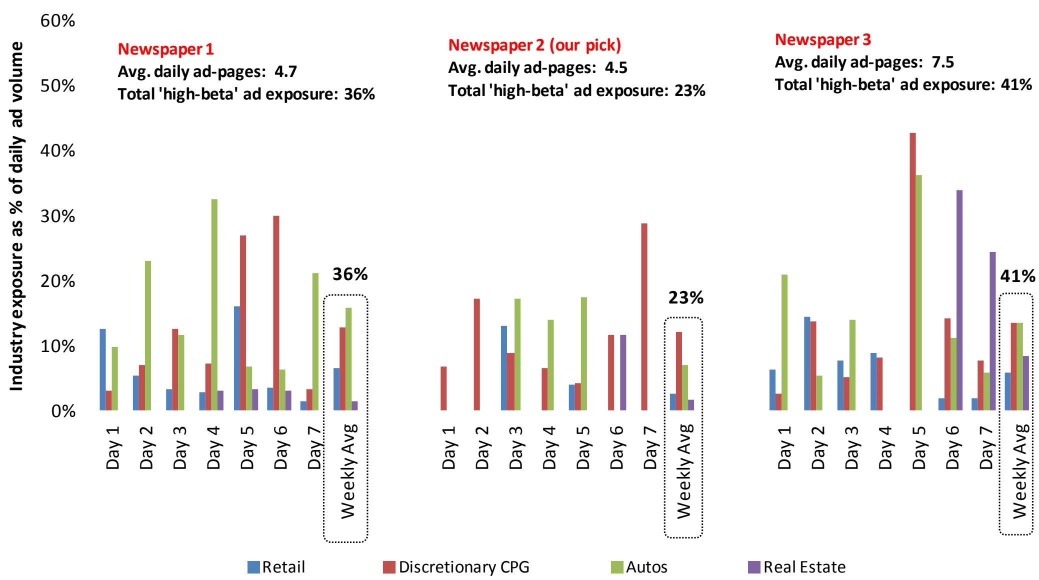
3Q saw the biggest flight of equity capital from India since after the Lehman collapse……. With foreign portfolio equity flows registering the maximum outflows of any quarter since 4Q08, large-caps bore the brunt of the 3Q sell-off. Nonetheless, despite an overwhelming capital flight in public equities during the quarter, India's capital account looks solid as the economy solidified its #1 ranking among FDI recipients, more than offsetting the portfolio equity outflows in 3Q. Consequently, rupee remains one of the least affected currencies among emerging markets, and with import cover likely to remain north of 10 months in F2016E (est. at ~55/bbl for crude), we expect rupee to remain stable in the near term. Accordingly, while RBI is clearly not dovish, there is almost nothing to suggest that the broader trend of reduction in real rates wouldn't continue.

……and benchmark constituents can still move lower. While there has been quite a bit of chatter around magnitude of 3Q outflows, its less than surprising given that allocation towards India (adjusted for size) over the past 3 years had trumped just about all major emerging markets (see **Exhibit 4**). Given current foreign ownership within *Nifty* constituents, current valuations (of these constituents), and lack of visible near-term catalysts, it isn't inconceivable to expect these names to bleed further, should there be a global risk-off trade as easing cycle reverses, especially since nearly all of these flows are 'passive' in nature. Ask yourself how often you see *Nifty*'s annual volatility running 300 bps ahead of midcaps!. Outside the benchmark though, it's easy to argue that these overseas inflows largely fail to appreciate India's broader underlying sustainable earnings expansion potential.

We initiated a new exposure in a news daily (soon after end of 3Q). In 3Q15, we didn't initiate any new exposure. However, soon after the quarter ended, we allocated about 3% of our book to a North Indian news daily. In an industry where circulation and readership numbers aren't always credible, it took us longer than usual to build comfort and establish conviction in the name. Incidentally, this was our first exposure in a print name, even as we do maintain exposures elsewhere within Media & Entertainment.

Local influence remains an attraction; immaterial exposure to real-estate advertising. Before we briefly explain our thesis on this new position, it might be worth noting how local advertising is driving profitability across several non-English dailies. This not only comes at a mid-teens premium over national adverts but is also far less susceptible to general contractions in media budgets. We note that, in volume terms, our pick would likely achieve equal share of local advertising (vs. national) by F2017E (Mar). It's not only the local flavor which makes Hindi print establish a more stable revenue base, but also the favorable industry exposure within local adverts. Take real estate, for instance, whose print exposure is now largely limited to national dailies – With most Indian households having been priced out of reasonable home ownership, it makes little sense for the cash-crunched industry to allocate precious dollars towards the Hindi print space. Hindi print allocation is therefore skewed towards the weekend with nearly entire budget focused on the readership leader. That takes one highly volatile part of the ad-inventory out of our evaluated situation.

Exhibit 5 – Ad page volume and 'high-beta' breakdown over a typical week for top-3 Hindi newspapers in Delhi NCR



Source: Internal research

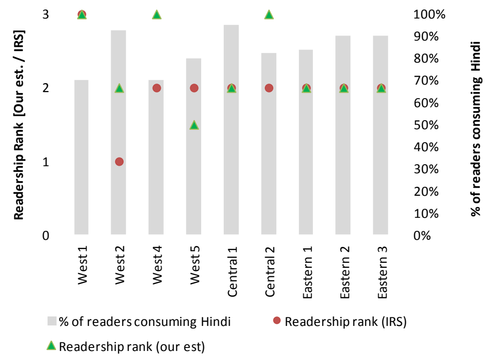
The cornerstone of our thesis on this name is our expectation on how the underlying business continues to ramp up in Uttar Pradesh, India's biggest Hindi print market. There are 3 key reasons that helped us establish conviction in how this business was gaining traction in UP.

1. **Solidly 2nd in Eastern UP; about there in West too; Gaining readership across UP**. IRS surveys on readership remain highly contested and for good reason. In order to create an objective framework to evaluate this situation, we conducted elaborate checks across media buyers, agencies, distributors, and last-mile vendors – While our readership estimates for Western UP for this publication trail published IRS numbers (see **Exhibit 6**), they don't trail by much and we have gathered enough evidence to suggest that it continues to gain readership in the region, where it is now, arguably so, the second highest read publication. In Eastern UP, where our readership estimates are in line with IRS estimates, this publication is also the second highest read newspaper.

2. **A relatively stable readership base**. In several university towns in UP, which happens to be one of the youngest states in India, this publication has built impressive affinity within the student community. Students widely cite the publication when it comes to their awareness of jobs, education, student politics, or general university relations.

   Within Western UP in particular, several last-mile vendors confirmed how this publication picked up readership share by focusing on issues most relevant to youngsters. Overall, their readership base continues to grow steadily within UP even as in its mature markets such as Bihar it seems to have reached a saturation.

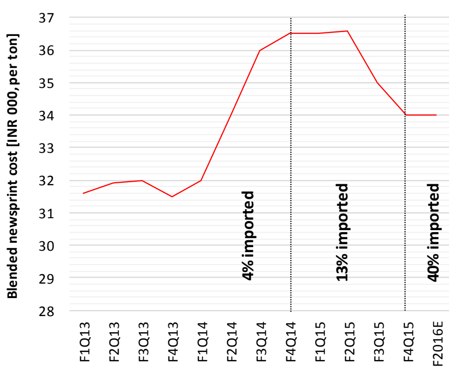
Exhibit 6 – Readership rank in key cities in UP



Source: IRS and Internal surveys

3. **We expect pricing in UP to continue to rise; sharp decline in newsprint costs provides ample buffer**. We note that our pick's effective ad-rate across UP, India's biggest market for Hindi print, is about a third of the #1 peer. Overall however (including the 2 other markets where the publication is sold), its average pricing is about half that of its #1 peer in UP. Our work on readership trends across its 3 key markets confirms how its now maintaining its readership (and pricing) in its leadership markets, while gaining in UP, where by our estimate, it has averaged high teen pricing growth (ex mix-shift) over the past two years. In the other two markets, pricing gains have averaged around 5% (ex mix-shift) over the same period. We have every reason to believe that its ongoing readership gains in the state would further translate into better pricing, which has already shown high-teens growth over the past 2 years.

Exhibit 7 – Blended newsprint cost



Source: Company reports; IISI

We note that the decline in newsprint costs in F1Q (Jun) alone contributed 2-3% to margin expansion. This is despite the fact that the imported newsprint (42 gsm) is likely to contribute 30-40% of the requirements in F2016E (Mar) vs. just about 13% in F2015 and under 5% in the prior two years (see **Exhibit 7**). While global newsprint production is facing a structural decline, continued capacity cuts in Europe might put a floor on newsprint prices, with rupee depreciation potentially putting pressure. That said, with nearly 40% of current requirements being imported, the company seems confident to shift back to locally sourced newsprint (comes at 10-15% discount) to offset any potential price rise in imported 42 gsm paper.

We also note that this publication's margin in UP is about half of its margins elsewhere, leaving solid room for expansion as pricing ramps up. With UP currently accounting for under 40% of this business' advertising revenues, we expect substantial margin upside as the mix shifts.

Assuming zero volume expansion, we anticipate about 70%+ upside within the next 18-24 months. By our estimate, if pricing in UP rises 30% over the next 8-10 quarters (through a combination of mix-shift towards local, and effective rates), that by itself can raise UP's margins from mid-high teens into mid-20s, still well behind 30%+ margins in this business' other markets. Note that we aren't baking in volume expansion despite fairly clear indications of increasing readership and ample room to raise ad-pages (see avg. daily ad page differential for Delhi NCR in **Exhibit 5**; differential in UP vs. market leader is higher).

Performance and Attribution summary

3Q15 was our 17th quarter since inception, and we have outpaced *BSE 500* in 14 of those quarters. This incidentally followed a surprising underperformance in 2Q when we had underpaced in a declining market for the first time. Overall, we outpaced the broad index by 7% during the quarter, which in relative terms was our third best quarter, two of which saw broad-market drawdowns. With capital flows unlikely to materially drive sentiment, and earnings expectations almost certain to drift lower, we expect to expand our differential in 4Q.

In 3Q, just under half of our names finished higher, with financial holdings in particular dragging our performance. Our two best performing positions in the quarter were a *Packaging* name (**+75%**) and a *Paper* name (**+31%**), neither of which are among our top-5 holdings. Our two worst performing positions in 3Q were a *Business Services* name (down **-21%**) and an Infrastructure name (down **-23%**), neither of which feature among our top-5 positions. For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 8d**.

In 3Q15, *Metis Opportunity* was up **+3.2%** (net of all fees; in INR terms), vs. **-5.0%**, **-3.7%**, **-1.0%**, and **-0.5%** declines in *Nifty, BSE 500, Eurekahedge India,* and *BSE Smallcap* respectively, and **+1.1%** increase in *BSE Midcap*. Since inception in April 2011, *Metis Opportunity* is up **+107.0%** (net of fees; in INR) vs. **+36.1%**, **+39.3%**, **+50.2%**, **+25.1%**, and **+20.3%** increases in *Nifty*, *BSE 500*, *BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively (see **Exhibit 8a** and **8c**). Over trailing 12 months, our volatility was **198 bps**, **138 bps**, and **126 bps** below that of *Nifty*, *BSE 500*, and *BSE Smallcap* respectively, and **95 bps** ahead of *BSE Midcap* (see **Exhibit 8b**).

Exhibit 8a – Perf. since inception

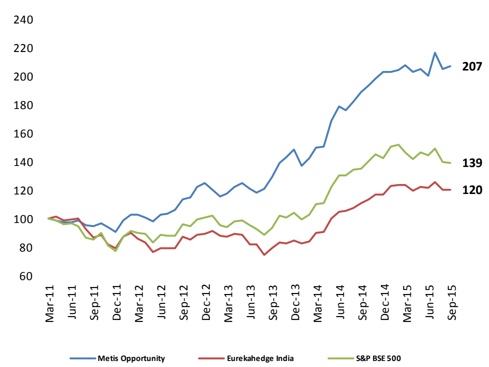


Exhibit 8b – TTM volatility

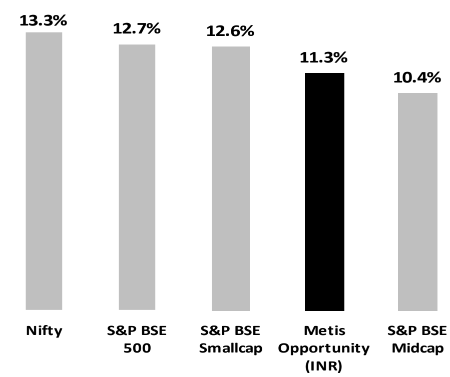


Exhibit 8c – Annuals and average –ve month returns

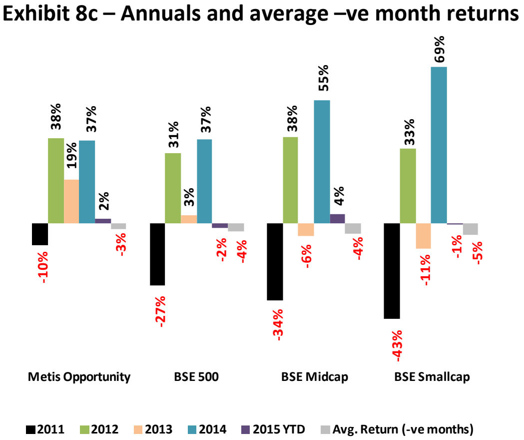
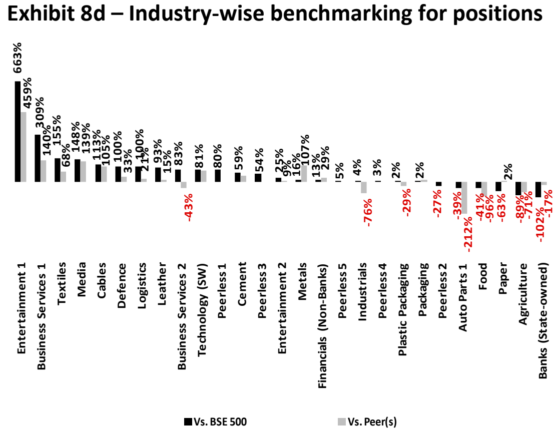


Exhibit 8d – Industry-wise benchmarking for positions



Note: Metis Opportunity went live on Mar 11th 2014; Industry-wise benchmarking compares performance from initial cost basis to present/exit.
Source: Internal Sources; NSE, BSE, Eurekahedge

Exhibit 9a – Relative rolling 12-mth returns

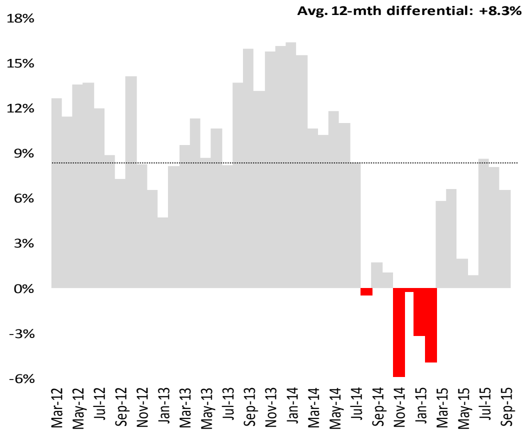
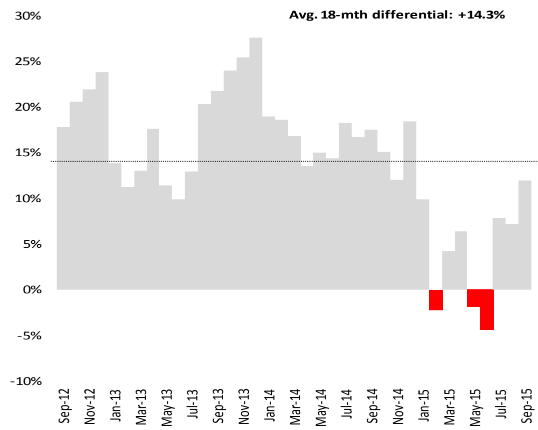


Exhibit 9b – Relative rolling 18-mth returns



Note: Relative strategy return differentials are calculated vs. BSE 500
Source: Internal Sources

Exhibit 10 – Time window analysis for our sub-strategies

	India Underserved		*India Undervalued*	
	3 Month	*12 Month*	*3 Month*	*12 Month*
Number of periods	52	43	57	48
Average period return	**5.0%**	**25.2%**	**4.2%**	**23.4%**
Number of profitable periods	37	41	35	45
% profitable periods	**71%**	**95%**	**61%**	**94%**
Best period	24%	55%	26%	66%
Gain Standard Deviation	6.5%	14.3%	6.6%	18.4%
Sharpe Ratio @10%	0.34	1.00	0.22	0.67
Sharpe Ratio @5%	0.49	1.33	0.36	0.92
Sharpe Ratio @0%	0.65	1.66	0.51	1.17
Loss Standard Deviation	2.0%	0.4%	3.2%	0.9%
Downside Deviation @10%	3.2%	3.1%	4.2%	5.5%
Downside Deviation @5%	2.6%	1.5%	3.6%	4.0%
Downside Deviation @0%	2.0%	0.2%	3.0%	2.7%
Sortino Ratio @10%	0.80	4.94	0.43	2.42
Sortino Ratio @5%	1.45	13.71	0.83	4.62
Sortino Ratio @0%	2.49	130.83	1.42	8.61
Average Gain/Loss	2.6	30.9	2.5	2.4
Profit/Loss Ratio	6.4	633.5	4.0	35.5

Note: Metis Opportunity is a direct blend of above two sub-strategies
Source: CogentHedge

Exhibit 11 – Long-book snapshot

Top position as % of book	11%
Smallest position as % of book	0.3%
Top 5 positions as % of book	46%
Avg. weighted market cap of book (mil)	$561
Avg. weighted free float of book	44%
Net Exposure	93%
# of positions	24

Source: Internal Sources

Exhibit 12 – Historical Monthly Performance

	Metis Opportunity (INR)	*Nifty*	*S&P BSE 500*	*S&P BSE Midcap*	*S&P BSE Smallcap*	*Eurekahedge India*	*India-focused CE Funds**
Apr-11	-1.3%	-1.6%	-1.5%	-1.3%	-1.0%	1.4%	-3.3%
May-11	-1.3%	-3.3%	-2.6%	-2.6%	-5.5%	-2.6%	-2.2%
Jun-11	-0.3%	1.6%	0.4%	-0.8%	-1.0%	0.2%	-0.6%
Jul-11	1.6%	-2.9%	-2.1%	0.9%	1.8%	0.7%	-2.8%
Aug-11	-3.7%	-8.8%	-8.8%	-9.3%	-14.1%	-7.4%	-7.1%
Sep-11	-0.7%	-1.2%	-1.6%	-2.3%	-3.5%	-6.3%	-4.5%
Oct-11	2.0%	7.8%	5.9%	2.7%	1.4%	2.1%	4.8%
Nov-11	-2.8%	-9.3%	-9.6%	-10.6%	-12.6%	-7.9%	-5.7%
Dec-11	-3.4%	-4.3%	-5.5%	-8.8%	-9.0%	-2.7%	-8.6%
Jan-12	9.2%	12.4%	13.3%	14.3%	16.5%	9.5%	10.2%
Feb-12	4.0%	3.6%	4.7%	8.8%	6.1%	3.3%	4.1%
Mar-12	-0.3%	-1.7%	-1.4%	-0.6%	-3.4%	-4.1%	-0.1%
Apr-12	-1.9%	-0.9%	-0.9%	-0.5%	2.0%	-3.4%	-0.6%
May-12	-2.5%	-6.2%	-6.2%	-6.8%	-7.3%	-7.9%	-5.2%
Jun-12	4.9%	7.2%	6.4%	4.5%	4.3%	2.8%	6.8%
Jul-12	0.9%	-0.9%	-1.1%	-2.3%	-1.5%	0.0%	-0.8%
Aug-12	2.0%	0.6%	0.4%	-0.2%	-0.8%	0.4%	1.9%
Sep-12	7.4%	8.5%	8.7%	10.1%	9.7%	10.2%	7.5%
Oct-12	1.4%	-1.5%	-1.2%	-0.6%	-0.4%	-2.1%	-0.4%
Nov-12	6.1%	4.6%	5.0%	5.1%	4.1%	4.0%	3.3%
Dec-12	2.0%	0.4%	1.5%	3.1%	1.4%	0.6%	-0.9%
Jan-13	-3.5%	2.2%	1.1%	-2.0%	-4.1%	2.2%	0.6%
Feb-13	-3.8%	-5.7%	-6.5%	-9.6%	-12.3%	-3.9%	-3.2%
Mar-13	1.3%	-0.2%	-1.1%	-2.6%	-6.5%	-0.9%	0.0%
Apr-13	4.2%	3.9%	4.2%	3.3%	3.7%	3.0%	2.3%
May-13	2.0%	1.4%	0.8%	0.7%	-1.3%	-1.0%	1.1%
Jun-13	-2.8%	-2.4%	-3.7%	-6.7%	-5.0%	-7.4%	-4.2%
Jul-13	-2.5%	-1.7%	-2.5%	-7.1%	-5.9%	-0.6%	0.9%
Aug-13	2.3%	-4.7%	-4.5%	-4.4%	-2.3%	-9.1%	-5.9%
Sep-13	6.5%	4.8%	5.2%	5.8%	5.3%	7.1%	5.6%
Oct-13	7.9%	9.8%	9.1%	8.9%	7.9%	5.1%	9.0%
Nov-13	3.3%	-2.0%	-0.8%	3.6%	3.4%	-0.9%	-0.7%
Dec-13	3.7%	2.1%	3.0%	6.0%	7.4%	2.0%	1.2%
Jan-14	-7.7%	-3.4%	-4.2%	-5.9%	-4.4%	-2.4%	-3.7%
Feb-14	3.8%	3.1%	2.8%	3.1%	2.9%	2.1%	5.2%
Mar-14	5.0%	6.8%	7.6%	9.0%	9.7%	7.1%	8.2%
Apr-14	0.5%	-0.1%	0.6%	3.4%	5.9%	0.6%	-0.6%
May-14	12.2%	8.0%	10.4%	15.6%	20.4%	10.5%	9.1%
Jun-14	5.9%	5.3%	6.4%	10.8%	13.2%	4.6%	7.1%
Jul-14	-1.5%	1.4%	0.4%	-2.0%	-2.1%	0.4%	1.7%
Aug-14	3.5%	3.0%	2.7%	1.2%	2.8%	2.4%	4.2%
Sep-14	3.5%	0.1%	0.8%	2.5%	4.1%	2.8%	4.3%
Oct-14	2.6%	4.5%	4.1%	3.2%	2.3%	2.5%	2.9%
Nov-14	2.5%	1.9%	3.4%	4.4%	3.1%	2.9%	5.8%
Dec-14	2.5%	-2.3%	-2.1%	1.0%	-1.6%	0.2%	-2.8%
Jan-15	0.0%	6.4%	5.8%	3.5%	2.2%	5.2%	6.9%
Feb-15	0.6%	1.1%	1.0%	0.7%	-0.6%	0.5%	1.7%
Mar-15	1.6%	-4.6%	-3.5%	-2.0%	-3.3%	0.1%	-2.8%
Apr-15	-2.5%	-3.6%	-3.2%	-1.7%	0.5%	-3.2%	-4.7%
May-15	1.3%	3.1%	3.1%	2.9%	3.1%	2.0%	4.4%
Jun-15	-2.3%	-0.8%	-1.1%	-0.3%	-1.8%	-0.3%	-0.6%
Jul-15	7.8%	2.0%	3.0%	5.6%	6.8%	3.1%	3.5%
Aug-15	-5.3%	-6.6%	-6.2%	-4.8%	-7.3%	-4.3%	-6.6%
Sep-15	1.1%	-0.3%	-0.4%	0.6%	0.5%	0.3%	0.8%
Trailing 12 months	10%	0%	3%	13%	3%	9%	8%
Trailing 24 months	61%	39%	50%	93%	102%	52%	66%
Trailing 36 months	83%	39%	46%	63%	57%	38%	64%
Since inception	**107%**	**36%**	**39%**	**50%**	**25%**	**20%**	**50%**
2015 YTD	2%	-4%	-2%	4%	-1%	3%	2%
2014	37%	31%	37%	55%	69%	39%	49%
2013	19%	7%	3%	-6%	-11%	-6%	6%
2012	38%	28%	31%	38%	33%	14%	28%
2011	-10%	-25%	-27%	-34%	-43%	-25%	-31%
Annualized Volatility (TTM)	11%	13%	13%	10%	13%	9%	15%
Sharpe Ratio	1.05	0.32	0.34	0.40	0.20	0.15	0.46
Calmar Ratio (3-yr/3%)	2.50	0.81	0.80	0.58	0.45	0.45	1.62

*Note: Metis Opportunity Fund's INR track record was a live blend of our running onshore strategies till March 31, 2014; Fund went live on March 11, 2014 and reports net of all fees;*Close-ended funds in US, with USD returns converted into INR.*
Source: Internal Sources; NSE; BSE; Bloomberg; Eurekahedge

Investment Managers

Piyush Sharma, is the co-investment manager of Metis Opportunity Fund. Having spent time with Citigroup and Bombay Stock Exchange in India, he moved to United States in 2002, where he covered stocks within Business Services, Autos, Consumer Products and Financials with Sanford Bernstein, Longbow Research, and Avondale Partners, working in teams that received accolades by leading institutional research arbiters , including Institutional Investor (II) and Greenwich Associates. Piyush received an MBA from University of North Carolina at Chapel Hill, MS from MNNIT, and BS in Accounting from University of Allahabad.

piyush@metisopportunity.com
+1-919-360-0359 (Cell-US)
@ps_tarheel

Gaurav Aggarwal, CFA, CPA, CIPM is the co-investment manager of Metis Opportunity Fund. He was a senior analyst with portfolio management duties over $50 million in fund of fund assets at a leading regional investment bank (Global Investment House) in the Middle East. Prior to this, he was with Bay Harbour Management, a $1.2 billion distressed debt and equity hedge fund in New York City. He has also served as an analyst with Polen Capital Management, a $2 billion long-only value money manager in Florida. He received an M.S. in Accounting (specializing in Finance) and B.S. in Business Administration from the University of North Carolina at Chapel Hill. He is a Chartered Financial Analyst and a Certified Public Accountant.

gaurav@metisopportunity.com
+1-919-665-0696 (Cell-US)
@gaurav_metis

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Metis Opportunity Fund
c/o Equinoxe Alternative Investment Services (Mauritius) Ltd.
12th Floor, Raffles Tower
19 Cyber City, Ebene, Republic of Mauritius
T: +230-468-1291
F: +230-468-1219
www.metisopportunity.com

metisopportunityfund