CHAIRMAN'S LETTER

Our gain in consolidated net worth during FY11 was ₹75 million, which increased the per share book value by 6.1%. Over the last nine years (that is, since the present owners took over) per share book value, has grown from ₹151 to ₹427, which, after factoring in dividend paid during this period, works out to a rate of 13.0% compounded annually.

The above numbers are after providing for goodwill write-offs occasioned by the application of Accounting Standard 26. This Accounting Standard provides that if a company acquires a stake in another, at a price that is higher than the tangible net assets of the acquired business, then the balance would be deemed as goodwill, which must be written off over a specified period. The rationale perhaps is that in case of a sale, a business will at least realize a value based on its tangible assets, conservatively speaking. Therefore if the books have recorded the cost of acquisition as something higher than the book value, the balance ought to be written off, so that the books, after a specified period of time, will reflect the book value of the business.

Of course the fallacy with this reasoning is that businesses do have intangibles, which are not recorded on its books. Further, if the business is run well, the value of the intangibles will likely grow over time. Last but not the least, if the business is being run profitably, the book value will itself grow over time. However, the Accounting Standard recognizes goodwill only on the date of the acquisition and mandates a write down to the then prevailing book value over a specified number of years.

As a result of the application of this Standard, our per share book value has been understated by ₹78. In other words, had we not written off a part of this goodwill year after year, our gain in consolidated net worth during FY11 would be ₹155 million, which increased the per share book value by 10.2%. But for this charge, over the nine years, our per share book value has compounded annually at a rate of 15.0%.

****

The macro economic environment for our business remained challenging. Less than healthy state of public finances, uncertainty in the minds of private players that create demand for our goods and services, a political environment not conducive to decision making and continuing concerns over the health of the global economy led to slow decision-making across industries that we serve.

When demand is slow, competitive intensity tends to increase as market participants try to maximize their volumes to cover their fixed costs and stay profitable. We observed the same phenomenon in our businesses where sales stayed flat, but our margins shrank.

****

It has been almost a decade since we acquired control of Revathi. I think this is as good a time as any to reflect on our journey so far.

When we acquired Revathi from Atlas Copco, it was a one trick pony. The trick was admittedly quite profitable, and that created all sorts of side effects ranging from over-confidence to complacency to fossilization in the status quo. Over the next few years, we tried many things including developing new products, opening up new markets, starting a new business unit, etc. The intent was to try to diversify out of the single customer who contributed predominantly to our fortunes.

Due to a combination of factors though, none of these initiatives has so far done enough to redefine the complexion of the business. These factors include a couple of lost years due to market meltdown but if I were to really boil it down to one single factor, it is quality of execution. When you become wildly successful doing one thing, you get delusional about your capability to repeat your success doing other things.

While our track record on the operating business has been uninspiring, thankfully our experience with our investment operations has been fairly satisfactory. Whether it was our investment into public equities or wind energy assets or picking up a minority stake in an unrelated business or participating in a real estate venture, we have had very satisfactory outcomes.

Over the last nine years, the company, on standalone basis, earned a gross pre-tax profit of ₹1.6 billion. Of this, ₹537 million came out of investment operations. This excludes our investment in the real estate project, which will take another eighteen or so months to mature. Based on current market prices, my current estimate of pre-tax profit on that investment is ₹300 million. Including this unrealized gain, almost forty per cent of our money has been made outside of the business that we acquired.

Not included above, are the results from the fairly substantial ₹862 million investment we made to acquire a controlling stake in two engineering design companies, Potential and Semac (P+S). We now hold seventy per cent in the company that was merged through a court order during the current financial year. After we invested, P+S has, in aggregate, made a pre-tax profit of ₹160 million, excluding minority interests. This is despite the fact that out of the total investment period of about forty-two months, we lost about eighteen months to the global recession. During those dark days, we had to write-off about ₹100 million in bad debts, in a business with almost no bad debt history.

Overall, the business in which we acquired a majority stake at an equity value of ₹770 million in 2003 has produced gross pre-tax profits of ₹1.6 billion so far excluding an unrealized gain on the real estate investment and without counting gains on the above strategic investment.

****

Our Drilling business has been overly dependent on the domestic coal sector. That has been the equivalent of riding on a bicycle in the jet age. The industry in which we have participated historically has moved at glacial speed and once you are at a certain market share, growing faster than market is impossible. My original plan was to let the management team decide the plan for the business they had become masters at while I would focus my attention on capital allocation. To be fair to the team they did try many new things but I realized that being a great dental surgeon does not mean those skills will translate into heart surgery. Given the fact that in this business it takes several years to develop and commercially exploit a new product, my reaction time on making mid-course corrections to the above approach was slower than I would have liked it to be. By the time I realized that the model needed tweaking, we were on the cusp of the recession, which placed severe constraints on making the much needed changes. For all changes require upfront investment and a few years of incubation before you start seeing some results. After the dust settled, we have commenced our ‘new’ journey and I am quite hopeful that future results will be better.

As mentioned in last year’s letter, our agreement with Bucyrus to tap international markets drew to a close in October 2010. Over the five years that our arrangement was active, we learnt a lot about global markets. We also learnt a basic lesson – howsoever good intentions might be, it is the size of the win that determines resource allocation. For us, this relationship was important and we gained a lot along multiple dimensions, though not the financial one. But, for Bucyrus, it was too small to get senior management attention. So while there was a lot of collaborative effort, the financial results did not measure up to our expectations.

There were some other extraneous factors that affected the success of the partnership. After signing up with Bucyrus in 2005, we spent a couple of years in market research and product development. We did export a few machines to places as diverse as Serbia and Brazil. However, before we got warmed up, we were in the middle of the global downturn and by the time we came out of it, Bucyrus was preparing to sell itself to Caterpillar. So effectively, out of the five years, we were in aggressive mode only for about thirty months.

Knowing that continuing with the relationship would not serve our goals, we started preparing for life independent of Caterpillar (Bucyrus). In high value capital goods, the cycle time to reach inflexion point is at least five years. Some of the export markets we have opened up look quite promising. But, being new to these markets, it will take some time before we have a good understanding of the local competitive landscape and get a good handle on what kind of results we can expect to achieve.

During the year, Press Note 1, which imposed some limitations on the entry of foreign players into the Indian market was abolished. As a result, international companies that historically had Indian partners no longer need to get an approval from their erstwhile partners to come into India on their own. This will mean that global mining equipment companies will likely to set up their own manufacturing bases in the country, though we cannot be sure about the timing.

The financials for the year under review were pretty pedestrian owing in part to the slowdown in decision-making at our key customers’ end. Substantial orders have remained live but have not been awarded for about three years now. There are other factors which are within our control and which we are gradually addressing.

****

Our concreting business recorded its best ever year, with Revenues climbing almost 5x the previous year. This is just the beginning and, if the economy holds up, I am confident of posting strong Revenues in the coming years. Many factors contributed to these results, but at the core, it boils down to the quality of the team that was put in place late last year. We now have a decent team that is ably supported by a national dealer network that was set up during the year. While sales grew strongly, we will take another few years to reach critical mass. However, the direction is right and in a couple of years, the financial results for this business should start looking healthy.

This year was the year of undoing the past, when we had a sub-optimal team leading to a weak offering overall. Product quality issues were exacerbated by less than stellar after sales support. Most of these issues have been rectified, though the resurrection of the brand will require consistent quality, good technical support and good spare part availability over several years. The journey has started well and we will capitalize on this foundation in the years ahead.

In addition to the existing product line-up of batching plants, transit mixers and concrete pumps, during the year we also added vibrating hammers and piling rigs to our product basket.

Vibrating hammers are used for driving steel piles into the ground. Sheet Piles are steel sections (sheets) that are pushed into the ground in series for side consolidation/retention of earth prior to any deep excavation. The steel segments are typically interlocked to form a sort of continuous barrier. Common applications are marine piles (for construction of berths

for jettys), metro rail projects with underground sections where the soil conditions are unstable, bridges (coffer dam to block water flow to facilitate construction of the main structure), large construction sites of housing/commercial projects. A new application that is emerging is solar farms.

Historically, Indian construction sites have used a winch or an excavator to drive the steel sheet into the ground. A vibrating hammer does the same job many times faster. For example, at a metro project site, the conventional method would take about four hours to drive an eight-meter long section into the ground, a job that the vibrating hammer can accomplish in ten minutes.

Piling rigs started becoming popular in India during the late 90's with NHAI road and bridges projects and later for the metro rail projects. Piling rigs replaced the conventional tripod since the boring rates were at least four times faster. Piling rigs were also insisted by authorities for projects within urban limits since they work with much lower noise. Piling rigs are commonly used for construction of flyovers, bridges, metro rail, power plant chimneys, structures that needs to withstand heavy loads, construction on soft soil strata, etc.

Traditionally piles were bored with a simple tripod and winch arrangement which cost about ' 10 lacs and achieved a drilling rate of one meter per hour in typical soil conditions. A piling rig costs twenty five times that and has a drilling rate of fifteen meters per hour. In addition to replacing fifteen tripod – winches, a piling rig, being crawler mounted is much more mobile and generates much less noise.

****

During the year, we got the court order for the merger of the Potential Service Consultants Pvt. Ltd. and Semac Ltd. Accordingly Potential Semac Consultants Pvt. Ltd. (P+S) was born on July 8, 2010. P+S is now a seventy per cent subsidiary of Revathi.

The business turned around after a very tough two years. Though we were still shy of the Revenues we achieved in FY08, adjusted for write-offs billed in that year, we got back to almost the same profitability that we had achieved that year. We now have six offices in India and three in the Middle East, making us one of the few truly national, full service engineering design firms in the country.

We are a part of what is known as the AEC industry, AEC being Architecture – Engineering – Construction. Of these, we are offering architecture for industrial projects and engineering design for industrial and commercial projects. During the year, we also took a minority stake in the Noida-based architecture KPO company, Satellier. This company has been working with US and UK architects, on their global projects. Most of their work is architectural detailing.

The Mumbai office, which was the first new office we opened after we took over and which was started just before the meltdown turned profitable this year. This is proof of concept about opening up new markets and gives us confidence to expand further. The opening of Chennai and Navi Mumbai during the year comes out of that confidence. However, these initiatives obviously come at a cost. Every new office requires a significant and prolonged investment before it turns profitable. To that extent, the existing results get depressed. This happens in every business but in a people's business, the big costs are people, rent and travel, which add up to almost two thirds of Revenues. So a new office is a significant drag on current profitability.

****

Monarch Catalysts continued to grow its topline and grew it almost 50% this year. However, profitability stayed at last year's levels. In the fight for market share, margin is the first casualty. That has been the story with Monarch ever since we invested. Back in FY07, when our Revenues were about a fourth of this year's levels, our net margin was approaching seven per cent. Since then, we have been hovering in the four to six per cent range due to a combination of nickel price fluctuations and fight for market share. Despite the fact that there are only three major players in the world market, including Monarch, this has remained a tough business. The lesson learnt is that size does matter. When all your customers are giants, you are unlikely to make supernormal profits, unless you are a monopoly.

The operating gross profit, which to me is a better indicator of performance in this business than Revenues, fell almost six per cent from last year, in large part due to intra-day nickel price fluctuation, which has been as high as five to six percent.

After holding the investment for touch short of five years, we sold it to a Group company on March 29th for ₹171 mn. After factoring in dividends, we achieved an IRR of about twenty four per cent on this investment. The sale was done on the basis of an independent valuation done by a firm with whom we have had no dealings in the past.

****

The new team is earnest and the initiatives being undertaken are likely to bear fruit. A lot of activity is underway at Revathi and it is a matter of time before we convert this work into financial results.

Abhishek Dalmia
Chairman of the Board