CHAIRMAN'S LETTER 2018-19

Our increase in consolidated net worth at the end of FY19 was ₹103 million, which increased the per share book value by 7.0%. Over the last seventeen years (that is, since the present owners took over) per share book value, has grown from ₹151 to ₹525 (₹602 after ignoring the effect of goodwill write-offs), which, after factoring in dividend paid during this period, works out to a rate of 8.9% (9.9%) compounded annually.

It has been an eventful year at Revathi. A year marked by some new initiatives that would impact the balance sheet and both sides of the profit and loss account.

Balance sheet first. Shortly after we acquired the company, I had taken a view that using internal accruals in the business leads to inefficiencies in working capital management. As such, I decided to build a treasury with the surplus cash and started managing it actively. It was invested in a variety of asset classes, including public market equities, power assets including wind and a group captive gas-powered project, a joint development real estate project and minority as well as majority stakes in operating businesses.

Excluding the capital employed for acquiring majority stakes in operating businesses, about which I have been sharing my thoughts over the years, our average capital employed in Treasury operations has been about ₹28 crores (currently at ₹17 crores, invested in the real estate project). On this, we earned pre-tax profits of approximately ₹2 crores annually. This excludes the unrealized gains on the real estate investment. If we include that, the figure would more than double to about ₹4.5 crores. This works out to an average return of c.16% annualized.

The real estate market in general and specifically the real estate market in Mumbai has been unusually tough for unusually long. Over the years, I have been updating you about the challenges we have faced in liquidating this investment. The latest challenge arises out of the drying up of liquidity for developers from lenders of last resort, i.e., NBFCs. Our partner acquired several joint development projects but is being able to work on only about twenty per cent of these. The rest are in a state of limbo due to tight liquidity in the market.

Our attempt to sell our stake in this project was very near conclusion last year, but unfortunately fell through as the acquirer could not arrange the finances to acquire it. Now that Revathi's balance sheet is debt free, the pressure to sell the project has eased. We are no longer in a hurry to exit this project. Having said that, we continue to be sellers and if we find an interested buyer at a fair price, we will seriously consider an exit.

I had shared in my letter for FY16, how an event led to the acquisition of Semac. It also led to significant build-up of debt, which almost trebled from the pre-acquisition level of ₹30 crores. As soon as that deal fell through in FY10, we knew it would be an uphill task to clean up the balance sheet. Due to losses in the Construction Equipment business, debt stayed at an uncom-

fortably high level for eight long years. It started winding down meaningfully only in FY17 and I am happy to report that by the end of FY19, we were debt free again.

The lesson in all of this is only one – avoid debt or at the very least, have very conservative levels of debt. The external environment has plenty of uncertainties which contribute to the risks a business faces. Why add a new and potentially lethal source of risk by way of debt? Having debt also crimps on the ability to invest in the core business to strengthen it. Thankfully, the bad dream is finally over!

Now turning to the Income statement. The Drilling Solutions business has had fairly stable Revenues. While that means, there has not been much growth, it has also meant that there has not been much volatility in the Revenues. In this sort of a business, keeping costs under control becomes an important lever to maintain profitability. Due to inflation, keeping costs under check requires a cost control mindset. When a business is consistently profitable, as the Drilling Solutions business has been, the cost control culture is not automatic. Over the years, we have had periods when the costs raged out of control (FY11 to FY14) and there have been years we pulled things back. Our total overheads peaked at ₹22 crores at EBIT level (FY17) and at ₹27 crores at pre-tax level (FY13). In FY13, we had almost ₹10 crores of costs relating to interest (that four-letter word again - debt) and warranty costs on a poorly structured annual maintenance contract with a large customer. Taking those extraordinary costs out, our normalized overheads have been in the ₹17-18 crore range. Over the past two years, we have scaled the overheads down from ₹25 crores in FY17 to the ₹18-19 crore range at present. Until we find a sustainable way to grow the business, we will continue to stay mindful of our cost structure.

The Income statement also has, well, the Income side. Early this year, we split the business into three verticals to bring greater focus on each. These are Equipment, Spares & Service and Exports. Each vertical is headed by a seasoned hand. By doing this, we intend to have greater focus on each segment, including demonstrating greater intent on growing our exports. In the past, we have exported equipment to several parts of the world including some of the biggest mining markets such as the US, Australia, Indonesia and Brazil. We have also exported to markets closer home like Jordan, Tunisia, Serbia, Zimbabwe, etc. All these export efforts were sporadic. As a result, we got limited success.

By making this organizational change, we intend to invest consistently in building our exports business, such as visiting potential customers in target markets, participating in exhibitions, building distribution channels and perhaps even enter into joint ventures with local partners. We are exploring all these options and we hope that over the next few years, we will have a meaningful and repeat exports business.

A short commentary on the financial results now follows. Ever since the old management (which we inherited with the business) retired in FY10, we have had only two good years (FY16 and FY17), in comparison with our history up until FY10. Our average pre-tax margin in the second period (FY11 onwards) has been half the average margins we used to make in the period leading upto FY10. The good news is we got back to those historical levels in FY19, after adjusting for a couple of big write-offs, that do not pertain to actions taken in the current year. We wrote-off unusable inventory worth ₹1.5 crores and bad debts worth almost ₹2 crores during the year. Without these write-offs, our margins climbed fifty percent over the average margins during the second period. To be sure, some of these write-offs are unavoidable and will happen in the future also. But not of this magnitude and not in a single year.

Another metric to focus on is the return on capital employed. In the

Drilling Solutions business, in three of the last four years, our return on capital has ranged in the early to mid-twenties. This is in line with the historical average of the period upto FY10.

The underperformance of Semac, relative to the ₹90 crores of capital deployed, has been a drag our overall performance. A quick recap of our journey with Semac so far is in order. Management transitions, especially of founders who have built the business over several decades, in a service-oriented business (as opposed to manufacturing), are disruptive. At the time of purchase of the two businesses, we had put in suitable covenants to align their interests to ours as well as some non-compete covenants. Unfortunately, neither of those covenants led to a smooth transition from the old leadership to new leadership.

We delayed the inevitable, buying time to prepare for the eventual disruption. The upside of this was that we had only one loss year in the eight years post acquisition, despite the Lehman blow up, which led to a serious disruption in the global (and Indian) economy for several years right after our acquisition and despite the prolonged slowdown in the Indian economy, which led to a significant slowdown in industrial capex, which continues to this day. The profits were not outstanding (in relation to the investment made), but fairly consistent at c. ₹8 crores pre-tax. The downside was these Principals ran the business on such a hands-on basis that it was very tough to build the next line of leadership under them. As a result, we were able to postpone the inevitable but not avoid it altogether.

That inevitable finally hit us in FY17, which was the first year post the exit of Principals. While we had been developing new leadership at some of our offices, we were not able to groom anyone for taking on the role of a CEO. This forced us to hire two CEOs in quick succession, neither of whom was able to fill the large shoes of the Founders.

After two years of trying out hired guns, at the end of the first quarter of FY19, I did what I should have done sooner - promoting people from within to take up the role. By that time, our order pipeline had significantly depleted as the new CEOs failed to bring in enough work to replenish our order book. Inheriting a weak order book means at least a few quarters of pain, since the sales cycles in this business is three to six months. This is when the economy and capex cycle are normal. When the capex cycle is slow, as it has been, the pain gets prolonged. To make up for lost time, we bid for projects worth about ₹10,000 crores, in a short span of three quarters. However, we saw decision making for new capex get delayed even at bellweather companies like Tata Consultancy Services. Given our focused strategy, the quality of clients we are working with and the kind of competitors we are winning against, I am quite hopeful that these dark days will end sooner than later.

There is of course a silver lining to our underperformance in the Design business. That is the Design Build business, which has gone from a startup with no team and no Revenues at the beginning of FY16 to ₹80 crores in Revenues this year. This business has consistently earned low teens pre-tax margins with very little capital employed. So far, the business model seems to be holding up and therefore we should be able to continue to grow the business with similar financial characteristics.

In the FY14 letter, I had written about a company that was wholly owned by Revathi – Renaissance Construction Technologies. That company was into the business of providing project management services. Post our exit, it also got into construction of projects, as distinct from Design Build described above. At the time, the business was quite new and there were a lot of risks involved in the business, including the liability of torts. Besides, Revathi's balance sheet was under a lot of stress due to underperformance in the Construction Equipment business, soft Drill business and a leveraged balance sheet. Keeping the overall circumstances in mind, the Board decided that being a startup in a non-core business, it was adding extra risk to Revathi, which was not advisable. Hence, Revathi sold the business to Revathi's promoters in FY14.

Semac's performance in recent years has been quite soft. As a result, banks were uncomfortable in extending non-fund based facilities to the Design Build business. Given the success of the business, we were getting more business than Semac could handle due to the limitation imposed by banks. Therefore, we decided to take on the spillover work in Semac Construction Technologies (SCTIL) (erstwhile Renaissance Construction Technologies). FY19 was the first year in which SCTIL took on its one and only Design Build project.

Now that the business is stable and proven and given that Revathi's balance sheet is now healthy, it makes sense to grow this business under the direct ownership of Revathi, so that there are no conflicts of interest between Semac and SCTIL, going forward. Given this would be a related party transaction, shareholders will be asked to vote on this proposed corporate action.

I would like to thank each and every member of Revathi and Semac and their families for batting for the company, during tough times. It takes belief in the management, when there are no results to show for all the talk. I want to express gratitude to everyone for standing behind me like a rock and working twice as hard to row our boat away from the stormy seas towards calmer waters. I am quite confident that there is pot of gold at the end of the rainbow.

I would also like to thank our shareholders for being patient in these difficult times. All of you have suffered due to my mistakes and I am committed to come good and make your journey with us worthwhile.