

Revathi's corporate performance vs. the Nifty

Year	Annual percentage change in		Relative results (1)-(2)
	Per share book value of Revathi (1)	Nifty 50 with dividend included (2)	
2002-3	15.6%	-11.7%	27.3%
2003-4	21.8%	86.3%	-64.5%
Average annual gain (FY03-FY04)	18.1%	28.2%	-10.1%
Overall gain (FY03-FY04)	39.4%	64.4%	-46.3%

Notes:

1. All data is for financial years and includes dividends paid, if any.
2. The Nifty-50 numbers are pre-tax and assume that dividends were reinvested, whereas the numbers for Revathi are after tax.
3. We think our investors should measure our performance against their general experience in the equity markets. While the Nifty-50 is not perfect (nor is anything else) as a measure of performance, it has the advantage of being widely known and reflects with reasonable accuracy the experience of investors generally with the market.
4. The reason we have used the "growth in book value" as against stock price is, that over time, we intend measuring our performance by checking if a rupee retained has created a rupee worth of market value.
5. If you expect, as we do, that owning a representative stock index would produce reasonably satisfactory results over a period of time, it follows that, for long-term investors, gaining small advantages over that index must prove rewarding.

Chairman's report

Our gain in net worth during FY04 was Rs.116 million, which increased the per share book value by 22%. Over the last two years (that is, since the present owners took over) per share book value, has grown from Rs.151 to Rs.202, which, after factoring in dividend paid during FY03, works out to a rate of 18.1% compounded annually. Despite its shortcomings, I think the book value calculation is useful as a slightly understated gauge for measuring the long-term rate of increase in our intrinsic value.

On a comparative basis, though it might appear that this year we were taken to the cleaners, I fully expected this result. For such large gains in the equity markets over the course of one financial year are about as rare as the *Mahakumbh* – its occurrence during the average human life span is in the low single digits. Further, as noted in last year's report, we do expect to achieve "... average or perhaps poorer-than-average performance in rising markets".

We continue to measure our performance in comparison to the performance of the broader markets and unless we achieve gains in per share intrinsic value that outdo the Nifty's performance, we would be adding nothing to what you can accomplish on your own by purchasing an index fund. Even though historically, many Indian fund managers have been able to outperform the broader indices, I think as patient money coming into the equity markets increases, this statistic would start moving towards the developed world averages of one in seven. Therefore, if we are able to do better than the broad markets over the long term, we would have served our shareholders well.

This is the first full year under the new ownership and at this juncture, I would like to share with you some of the principles we follow at Revathi and of which I think you should be aware. Although our form is corporate, our attitude is partnership. I think of our shareholders as owner-partners and of myself as the managing partner. Just as an investor would not check the market value of his house often, we believe intelligent stock investors should do likewise. Indeed, if we have good long-term expectations, short-term price changes are meaningless except to the extent they offer us an opportunity to increase our ownership at an attractive price.

As the managing partner, I think it is appropriate that I be as candid in my reporting to you as I would expect you to be, if our positions were reversed. Accordingly, through this letter to our shareholders, I will try to give as much value-defining information as can be conveyed in a document kept to reasonable length. The objective would be to tell you how the business is doing, with both positive and negative developments, so that you can make an informed assessment of what the business should be worth.

To more fully understand our overall guiding philosophy, I would urge all shareholders to read the Owners Manual which was written in 1996 by the Chairman of Berkshire Hathaway, Mr. Warren Buffett for his shareholders. It is available at <http://www.berkshirehathaway.com>.

We have just completed another year in the history of Revathi. To the untrained eye, it might appear to be just another year, when sales dropped but mysteriously, the bottom-line grew. Observers, who examine the numbers a bit more closely, might realize that had it not been for the non-compete fee paid last year, the bottom-line would have stayed at last year's level. Therefore, they might conclude that another lackluster year comes to an end at a boring company.

From our perspective, both these observations are improper as FY04 has been the year when Revathi achieved adolescence. It is not yet an adult, but no longer is it a child. During FY04, the first steps were taken towards growing Revathi's hitherto stagnant topline. However, new business development is like pregnancy – you know there is a lot to be happy about, but you have nothing to show for it during the early stages. We are a bit like the superstitious 'mother-to-be', who doesn't want to talk about her condition until she absolutely must. Bear with me a bit longer and I will be ready to share with you more information about developments at your Company.

Meanwhile, I would like to explain another principle that guides our thinking and action at Revathi. I feel that telling outstanding CEOs, how to run their companies would be the height of stupidity. Most of our people wouldn't work for us if they got a lot of backseat driving. Besides, they are the Sachin Tendulkars of the business world and need no advice from us as to how to hold the bat or when to swing.

Nevertheless, Renaissance Group's ownership may make even the best of managers more effective for we eliminate all of the nonproductive activities that normally go with the job of CEO. Our people are totally in charge of their personal schedules. We give them a simple mission: Just run your business as if you own 100% of it; it is the only asset that you and your family will ever have; and you can't sell it during your lifetime. As a corollary, we tell them they should not let any of their decisions be affected even slightly by accounting considerations. We want our managers to think about what counts, not how it will be counted.

I would like to explain how this principle worked for us in FY04. We had been working on a new product for over eighteen months and there was real temptation to ensure that the product be despatched within the financial year. Doing so would have raised the reported profit significantly with consequent impact on the performance bonus payouts. However, it would have meant that the internal testing of the equipment would have to be compromised to meet the deadline. This could have led to defects being discovered by the customer. At this moment of truth, they were guided by a very important principle: Though the objective of business is to earn money, we can afford to lose money – even a lot of money. But we cannot afford to lose reputation – even a shred of reputation. I am happy to report that they decided to not cut corners and defer the despatch from the last quarter of FY04 to the first quarter of FY05. Such attitude is rare and we are lucky to have people with such character, which when combined with competence has only one end-result – creation of sustainable shareholder value.

Very few CEOs of public companies operate under a similar mandate, mainly because they have owners who focus on short-term prospects and reported earnings. We ask our CEO to manage for maximum long-term value, rather than for next quarter's earnings. We

certainly don't ignore the current results of our businesses - in most cases, they are of great importance - but we never want them to be achieved at the expense of our building ever-greater competitive strengths.

I believe the Revathi story demonstrates the benefits of Renaissance Group's approach. We haven't taught our CEO a thing - and never will - but we have created an environment that allows him to apply all of his talents to what's important. He does not have to devote his time or energy to press interviews, presentations by investment bankers or talks with financial analysts. Furthermore, he need never spend a moment thinking about market expectations for earnings per share. In this environment of freedom, both our CEO and the company can convert their almost limitless potential into matching achievements.

We stand at the threshold of a momentous era in the history of India. Everything that was wrong about India could be summarized thus: "lack of self-belief" in our people. But that is changing, slowly but surely. People are beginning to believe in themselves and are realizing that they are second to none in the World. This change in mindset is a huge transformation and its impact will be felt by the World, over the next decade. There are many other things that are going in our favor as a nation, not the least of which is our average age. Commentators have said that India has and will continue to have, over the next few decades, amongst the youngest populations in the World. This is very significant development, since the countries that have a young population will get greater opportunities to service the needs of the aging World.

It is our firm belief that this is going to be India's golden era, one that will firmly place India amongst the most prosperous nations of the World within the next few decades. History will remember India's current generation of working men and women as the generation that was responsible for that stupendous transition. There is a lot of work to be done and very little time. We have to be the people who will be counted as the people who built modern India. It is us who have to lay the foundation of that magnificent country, the fruits of which will be enjoyed by our future generations. As Robert Frost put it, "The woods are lovely dark and deep, but I have promises to keep and miles to go before I sleep, and miles to go before I sleep..." These are promises we have made to our country and promises we have made to our children. The moment is upon us and we must seize the opportunity now.

We have not remained unaffected by these strong tailwinds blowing in our macro-economic environment. Over the course of the past year, due to the untiring efforts of our CEO, we have gone from being under-nourished to being a glutton in the matter of growth ideas. We now have our plates full of ideas, which need to be worked upon to convert them to financial results that would create shareholder value. Doubtless, this would take some time, but to my mind, the journey is now firmly underway.

Revathi has been engaged in manufacture and sale of drilling rigs used in open cast mines, for tapping ground water and in the construction industry. The Company's products continue to be sold largely to the Coal industry thereby linking our fortunes with the fortunes of that industry. It is clear that India will continue to rely on coal for over half its energy needs even over the next few decades. The concrete steps taken by the Government to improve the financial condition of the State Electricity Boards are also well known. Yet this lack of diversification has been on our minds for some time now, but I did not act on it until this year.

This thumb-sucking on the part of your Chairman could have cost the Company dear had it not been for some rearguard action on the part of the management team. Our fears of putting all our eggs in one basket came true when Coal India decided to decentralize its capital equipment purchases. Ever since we came to know of this policy change, our team was thinking up ways of compensating for the drop in equipment sales that might occur due to the transition, and the results speak for themselves. Even though sales fell due to the shift in decision-making from the Coal India office to its eight subsidiaries, EBITDA was protected. The demand for our products did not change, it merely got postponed, and we expect to address that need in FY05.

The reduced orders from Coal India caused a change in product mix which also gets reflected in the higher EBITDA margins in the current year. The rest of the financials are more or less comparable with historical performance, except that some of the expense ratios start looking unpleasant due to the lower topline.

While we are quite upbeat about the prospects of the Indian coal and power sectors, nevertheless, we took our first steps towards achieving a more diversified revenue base this year. For we think that growing the topline is amongst the key drivers of shareholder value.

Last year, we had spoken of investing in opportunities that would fuel future revenues. The large jump in fixed assets represents one such investment. Towards the end of the year, we commissioned a small wind farm just outside Jaisalmer. Given our huge exposure to the coal sector, producing some clean energy helps us sleep a bit better. However, we have no intention of buying sleep with shareholder money, unless it is incidental to making them wealthier. This is the second coming of wind energy into India and this time, only the serious investors are getting in. Just recently there was a story about Reliance's plans to set up 500 MW of wind energy. As an aside, due to the fiscal concessions available to power projects, the deferred tax provisions made due to the prevalent Accounting Standards would cause a slight under-reporting of the true earnings per share in the year under consideration as well as a few years following the year in which the investment has been made.

In addition to the wind energy project, we have made another investment in the power sector, by subscribing to 15% participating preference shares in a captive power generation company. This project is based at Ramanathapuram in Tamil Nadu and should get commissioned in the second half of FY05.

Depending on the actual performance of these projects, we expect to make more investments in this sector in the future. Both these investments should significantly improve our returns on capital, when compared with the debt fund returns we were historically making. Though the power sector regulatory framework is only just starting to evolve, we feel that it is a sector which holds promise for the diligent investor.

I believe that these investments coupled with the initiatives taken on the new product development front would cause the company to move from being a play on the slow growing coal industry to being a play on India's infrastructure. This metamorphosis would take some more time, but the first signs would start becoming visible soon.

This report would be incomplete without a standing ovation from my side, on behalf of all shareholders, to the people who 'made it happen'. They are the real heroes, who work conscientiously and tirelessly to produce the results that we see. It is a bit like the role of the coach in the Indian cricket team – without his contribution, the results we see in the field would be missing. We must ensure that we foster an organisation culture that allows them to focus their minds on only one thing – creating shareholder value.

There is a new buzz at the office and this reflects the general mood inside the Company. I wait with baited breath to see another fascinating year unfold at Revathi. Make sure you catch the action as it unfolds over the next four quarters.

Abhishek Dalmia

Chairman of the Board