

Chairman's letter

Our gain in net worth during FY06 was Rs.131 million, which increased the per share book value by 18.1%. Over the last three years (that is, since the present owners took over) per share book value, has grown from Rs.151 to Rs.313, which, after factoring in dividend paid during this period, works out to a rate of 21.8% compounded annually.

I would liken the effort being put into building tomorrow's Revathi as striking blows on a rock. While the results of each blow are not immediately discernible to the naked eye, there is no doubt that each successive blow takes us one step closer to the desired end-result. As we are using a new, untested hammer (business segments) to split the rock (achieve earnings growth), we are unable to comment on how many strikes will achieve our end goal. For the moment, what is clear though is that we are beginning to see cracks (sales growth) on the surface of that rock.

According to a study spanning over a century, stocks and commodities have alternated leadership in regular cycles averaging about eighteen years. During the bull phase of the commodity cycle, commodity producing companies and those that support and serve them tend to do well. Given the recent record of global commodity prices, it seems that a new commodity bull phase is under way, and if the rear view mirror is any good, could last at least another decade or more.

It is probably this development that prompted one of the oldest and largest global mining equipment companies to open a dialog with us. They had perhaps started getting feelers from their customers about the possibility of supplying smaller size drilling rigs. However, the overall size of the market for such drills was probably too small for a \$600 million company to go after, especially given their costs of designing a new range of drills.

This company has been servicing the needs of Coal India for many years and has known us all along. During one of the trade fairs, we got talking about the growing global mining market and about the possibility of collaborating to address this opportunity. The trade-off that we faced was building our own brand in international markets, a decidedly expensive and time consuming process, versus gaining a quick market entry in the presently hot mining market. In my view, there are no right answers to such questions and we opted for the latter option.

After long deliberations and multiple visits to each others' facilities, Revathi signed a principal-to-principal agreement with this company. Under the agreement, which was signed in October 2005, the 125-year old Bucyrus International Inc. would use their global presence to solicit business for smaller size mining equipment from their customers. Revathi would design and manufacture these for eventual sale to Bucyrus customers. Additionally, there would arise a need for us to offer spares and after sales service in due course.

However, all good things in life have some counterbalancing factors attached to them. That is not such a bad thing, as often it is these counterbalancing forces are responsible for maintaining an equilibrium state in the world around us. We like participating in opportunities where the upside: downside ratio is far and away in our favor. As is well known, product liability on products sold in the US market could be quite harsh. In our experience this is a risk worth taking. Hopefully, this is a liability that will never convert from being contingent to becoming real.

Revathi has three business segments, construction and mining, power and treasury. Within these, the primacy of the construction and mining segment is likely to remain unchallenged in the foreseeable future. I will now outline the key features of each of these segments.

Net sales from the primary segment grew 32.8% over the previous year on the back of an 84% jump in sales of drilling equipment. However, this growth was offset by a combination of rising input costs, which we have not passed on to our customers and a comparatively unexciting product mix. Though we may have some control over improving operating margins, we have little control over creating a favorable product mix. This is one important reason why sometimes year-to-year comparisons of operating margins throw up intriguing results.

While we now have a wider range of drills, the newer drills have not contributed in any meaningful way to our performance this year. After trying out marketing arrangements with external players, we realized that the margins in smaller drills are not big enough to meet the expectations of two players. Accordingly, we would be looking to address these markets directly. Towards this end, this year we sold some of our smaller drills for construction-related applications.

Last year I had written about some initial work having been done to open up export markets for our drilling rigs. While we did execute the orders we had procured during FY05, our marketing arrangement with Bucyrus meant that we could not follow-up on the orders we supplied to customers in Australia and South Africa. It is hard to say at this point if Bucyrus will bring in more business through our door faster or would our interests have been better served by developing global markets ourselves. What is clear though is that the Bucyrus deal did cause us to lose some traction in the export markets during FY06. At present, we have some orders from Bucyrus which are to be executed during FY07. The performance of these machines will determine the degree of success our Bucyrus partnership achieves. The other variable that will affect our margins is the degree of localization that would be acceptable to global customers.

Our construction equipment division (within the primary segment) consists of a range of three equipments, batching plants, transit mixers and concrete pumps. In combination, they mix various aggregates with cement to produce concrete, transport such ready-mix concrete (RMC) from a central batching location to the construction site and pump the RMC to the exact location where the concrete is to be poured. While no official data is available on the size of the construction equipment market, we estimate the same at around Rs.4 billion, growing at about 25 per cent annually. We believe rate of growth of cement consumption and the project pipelines of construction companies are good proxies to estimate the potential of this sector.

While we expect this business to contribute fairly significantly to our future sales, there are a few factors that will weigh on its short-term profitability. The first, obvious factor is competitive intensity. There are two significant and established players in the market. Typically, the entry of a new player into such a market causes the incumbents to act in ways that makes the entry of a challenger difficult. Eventhough this hurts the profitability of the entire industry; the incumbents expect that the challenger, with lower volumes, would suffer greater damage than themselves.

Over time, as the seriousness of the challenger becomes obvious, rationality tends to return to the industry. In the meanwhile, we will focus on building scale during the irrational phase in the evolution of the industry. To create greater focus in this business, we have created a new strategic business unit for construction equipment. We are in the process of building new infrastructure to increase the volumes, which is expected to cost about Rs.60 million.

I will now comment on our second segment, which is Power. Our major investments in the Power segment have happened in wind energy. We started with 2.4 MW of installed capacity in Rajasthan and later added 8.75 MW in Tamil Nadu. This 11.15 MW of capacity has been set up at a total cost of Rs.523 million or a per MW cost of Rs.47 million. The rationale behind investing in wind energy was twofold - diversify our earnings stream away from fossil fuels and use the fiscal concessions to conserve cash to grow the size of our balance sheet. While a small balance sheet may not be a hindrance for a stable business, it does affect the plans of a company that has a growth agenda. For, amongst other things, the strength of the balance sheet is an indicator of the staying power of the company to its competitors.

Though these broad objectives have been achieved, this investment has not lived up to our expectations from a cashflow perspective. Here, the outcome in Rajasthan is significantly below expectations Though the news from Tamil Nadu is better, even this has been below guaranteed levels of output. Overall, the impact on our pre-tax cashflow is approximately Rs.23 million this year.

We have also invested Rs. 50 million in a 25 MW gas-based power project also in Tamil Nadu. However, due to legal requirements, we classify this under Investments. Accordingly, the income earned on that investment is accounted for under Other Income. This plant became operational on schedule in November 2004 and has consistently exceeded its power generation and financial targets. So far we have received tax-free dividends of Rs.16.5 million in the seventeen months we have been invested. Once the accounts of the power generation company get finalized for FY06, we expect a final dividend, which would further enhance the above figure.

The third segment is Treasury. Our Treasury at the beginning of FY04 was Rs.366 million. Over the last three years, the business has produced Rs.839 million in cashflows (including Other Income of Rs.112 million and extraordinary income of Rs.150 million) and we have contracted net debt worth Rs.308 million.

As is to be expected for a business in growth mode, and which started with a low base, a significant amount of cashflow generated has been soaked up in incremental working capital (Rs.327 million). Another noteworthy reason that has caused this surge is the long lead times being quoted by component vendors (as evidenced by *their* burgeoning order books). Owing to this, we have had to order components much in advance to ensure timely deliveries to our customers and until our suppliers do not add capacities, we do not expect any significant changes on this front.

As mentioned a bit earlier, Rs.523 million has been invested in wind energy and Rs.50 million in the gas-based power project, thus taking the total investment in the Power segment to Rs.573 million. Rs.78 million has been used up in servicing equity and debt capital and Rs.77 million has been paid as taxes.

This leaves us with an investible surplus of Rs.499 million. On a net of debt basis, this figure contracts to Rs.191 million. Historically, the company's treasury has predominantly been deployed in debt funds of varying maturities (depending on our view on interest rates). After we took control, we had stated our intent to invest the free cashflow generated by the business into other free-standing businesses. These could be minority stakes or outright acquisitions. While we have made two such investments on a Group basis, none of these have been made through Revathi so far. At some level, this might prove to be a good thing, given the historical growth in the core business and prospects of further growth in the foreseeable future.

Since we did not make strategic investments through Revathi, we had to find other ways to improve the return profile on the Treasury to ensure that the cash hoard does not start weighing down on the return on net worth. Towards this goal, last year we decided to invest upto Rs.100 million (revised upwards to Rs.200 million during this year) into equities through the secondary markets. The reason we preferred equity investing is that such investments can be converted back to cash (without too much risk of a loss in the bull market of the year past, I might add) should a business need arise. At year-end, we had Rs.124 million worth of equity investments, on which the unrealized gain was Rs.44 million. Overall, our pre-tax realized return on average Treasury deployed during the year, including in debt funds, was 7.1%. If we include the unrealized gains, the figure goes up to 20.5%.

I would like to spend some black ink on the red flags facing us. In the short- to medium-term, there are the usual red flags of growing competition and costs pressures from many directions, which I have elaborated earlier in this letter. I do not see these cost pressures abating in the near-term.

In the long-term, there is an even more serious issue that faces every manufacturer of capital goods for the coal mining industry. That factor is global warming. So far, most of the talk about global warming has merely been, in scientific parlance, 'noise'. However, as the supposed effects of global warming begin to stare humanity in the face, in the form of a growing frequency of natural calamities of increasing intensity, people are beginning to sit up and take notice. Insurance companies are beginning to tweak the premia they charge to cover risks from natural calamities. Thought leaders such as General Electric are beginning to use environment consciousness as a metric to measure employee performance. And GE's CEO, Jeff Immelt, is betting the company's future on green technologies. That to me signifies a serious change in people's attitudes about environment protection. And while that is a good thing for humanity, it is not so good for a company as dependent on coal as us!

Some of the technologies GE is trying to develop are collectively referred to as clean coal technologies. More specifically, they are classified as underground coal gasification (UCG) and surface coal gasification (SCG). While the former is in advanced stages of development and also has some test sites in Australia, the latter is still under development. What these technologies aim at doing is to extract the carbon trapped inside the coal without having to mine it. This technology solves multiple problems such as gaining economic access to difficult to retrieve coal reserves (such as those lying underneath cities or forests), cleaner residues on burning the gases (instead of coal) and elimination of residues such as fly ash that is generated upon burning coal.

What is unclear at this point is how quickly will these technologies become widespread and more specifically, how quickly will they get adopted in our own country. There are many reasons why their adoption in our

country should be gradual. For starters, almost eighty percent of the coal produced in India is used by for generating power and producing steel and cement. For a nation which is staring at a huge infrastructure deficit, an investment of this magnitude cannot be de-commissioned overnight. Perhaps equally importantly, the political incentives of feeding the families of over half a million employees that directly depend on Coal India for their livelihood are not small in a democratic nation.

However, it is clear that globally, coal mining will see a disruptive technology in the form of UCG and SCG. And as and when it gets adopted widely, which is now visible on the horizon, there could be important consequences for the mining equipment industry.

Enough heavy stuff! One of the most interesting books I read in the past year was Freakonomics, written jointly by Steven Levitt and Steve Dubner. The book questions conventional wisdom, which on many occasions enters the public consciousness without much thought or debate. The capital markets have had their own share of conventional wisdom, which, upon deeper thought, seem irrational. As Eddie Lampert said, "conventional wisdom many times turns out to be only conventional and not at all wisdom." Here then are some thoughts on the conventional wisdom of markets...

Stock liquidity is essential for efficient price discovery

Keynes made an acute observation on this subject. "...of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of "liquid" securities. It forgets that there is no such thing as liquidity of the investment for the community as a whole."

Stock splits create lasting value

Dividing a pizza into more slices does not give us any more pizza. Besides, if splits (or bonuses) created lasting value, companies that adopt this supposed 'easy way out' would get a higher than industry price-earnings multiple (PE_x) on a sustained basis, regardless of future performance. If however, the PE_x falls back to industry levels a few quarters after the split, then all the split created was temporary volatility. And as we all know, volatility is the enemy of the small investor. If splits created lasting value, there should have been calls to split the index when it touched 10,000!

Earnings guidance helps price discovery

On December 1, 2005, The Washington Post carried a story, in which the US Chamber of Commerce president and chief executive called on all publicly traded companies to stop offering quarterly earnings guidance, saying such predictions create a damaging focus on "meaningless short-term performance" and undermine a company's ability to manage for the long term.

The Washington Post Chairman and CEO, Don Graham said in a speech in 2004, "Quarterly earnings are not in the top 100 things you should care about if you want to value the company. If you care about that sort of thing, you shouldn't own our stock."

Our comment: Amen!

Free markets are a good means of achieving economic efficiency, but they are capricious in the extreme when allocating perks. Financial rewards of educators do not reflect the significant value they add to a nation. On the other hand, investors sit in the comfort of their air-cooled offices allocating capital, but get paid much more. In my view, the role of philanthropy is to balance this capriciousness of the free market system.

Last year the Board decided that we must have a formal corporate social responsibility agenda. The prime focus of all our CSR activities has been chosen as education. Imparting primary education to underprivileged children in the communities in which we work and live, imparting hands-on shop-floor training to diploma students and providing concessional education loans to children of our people. On all these initiatives in aggregate, we decided to spend each year upto one per cent of our pre-tax profits of the preceding year.

This year, we spent Rs.2 million on building a school for underprivileged children. We also gave educational loans worth Rs.1.1 million and trained twenty one diploma students, some of whom we might employ in due course.

We would be very likely to pay either large dividends or none at all because our test is whether we think we can use the money in a way that creates more than a rupee of market value for every rupee that we retain. Obviously, if we can keep a dollar and have it become worth more than a rupee on a present value basis, then it would be foolish to pay it out because shareholders can instead get Rs.1.10 or maybe Rs.1.20 - or whatever it may be - by selling the stock.

It's a very simple dividend philosophy and one whose logic we've explained in a past annual report. And I see nothing in terms of the principles of that philosophy that would change. We aren't going to make a decision every week, obviously, based on whether we can employ the earnings that week at a satisfactory rate of return - or every month. We base it on a reasonable expectancy about whether or not we can use our earnings advantageously over a couple of years or more.

Any given decision like that is subjective. But we're fairly objective about trying to figure out whether we are creating value or destroying value by retaining earnings over time. There's an objective test as to whether or not we do create more value - whether with each rupee of retained earnings, we actually do create an extra rupee or more of value.

We've retained earnings to date because we've felt that if we keep a rupee and use it to grow our core business or buy other businesses or whatever else it may be, that it will become worth more than rupee on a present value basis. There's no reason to keep a rupee in the business that will become worth 90p. So far, the news is good. Over the past three years we have earned Rs.546 million after taxes, of which we have retained Rs.473 million. The gain in market value over the same time period has been Rs.2540 million. Obviously this comparison cannot be made on a year-to-year basis, nor might it be appropriate to do it only during bull markets. We intend making this comparison regularly and checking if we are passing this test, failing which, we would be forced to revisit our dividend policy. We might do it via share repurchases or via dividends or some combination thereof.

Again, we'd never have a conventional dividend policy. The idea of paying out 20% of earnings - or 10% or 30% as dividends strikes us as nuts given our characteristics. You may get yourself into a position where you have to do it because you build these expectations in people's minds. However, there's no logic to it whatsoever. If you can create more than a rupee of value for each rupee you retain, why in the world would you pay any of it out? And if you can't, then why wouldn't you pay all of it out?

I have been thinking about sharing some thoughts on the issues facing our nation. While these are not directly relevant to the company's performance, by being a part of the national ecosystem, it is obvious that we will be affected by whatever affects our country. Read on!

What is causing ever-increasing parts of the developed world to become uncompetitive vis-à-vis the Asian tiger and dragon economies? I think this question was answered by Alfred Marshall, the 19th century British economist who propounded the theory of demand and supply. Just as the demand and supply of commodities affects their market price, so I think it affects the market price of people. In the developed world, decades of high productivity at the workplace seems to have been offset by low productivity at home, which seems to have caused a worrisome demographic situation. In a decade I hear, the US will have ten million more jobs than applicants, for which they will need to 'import' people. We are all aware of the Japanese miracle during the '70s and '80s. What the world is realizing now is that there has been a price they have paid for staying at the workplace too long. China's one-child policy, kicked off in 1979 also seems to have caused a situation, whereby their population has now (over two decades after the policy was first introduced), started aging at a rapid pace.

This suggests to me a need for balance, especially in these economically exciting times India is witnessing. It is all too easy to focus on work, and forget the family. I am beginning to see Indians falling into that same trap - no time to have kids. Sustained cost competitiveness owing to 'cheap labor' can only be attained if we ensure that supply keeps up with demand. The fact that India is now regarded as amongst the youngest economies in the world, with a forecast of continued youthfulness well into this century, arises out of the Malthusian 'population problem' that was created by us in the previous century. Only now, many decades

later, are we beginning to realize the happy economic consequences of rapid procreation. Just one other statistic: It takes 2.16 births per couple to keep the population *static*.

While on the subject of contrasting the Anglo Saxon society with India, I would also like to briefly comment on some other aspects of these two societies. While the developed countries have given a lot of good things to the world, there have been some spectacular failures as well. Nuclear families (giving rise to a need for publicly funded social security), education system (which we hear is the symbol of mediocrity) credit card culture (borrowing from tomorrow to live it up today leading to rapidly evaporating public finances) and working women (broken marriages and inadequate children) have all led to serious societal problems. Contrast this with the joint family system (where the family takes responsibility for its aged), the gurukul system of education (based on the now widely regarded system of mentoring), saving-for-a-rainy-day attitude and home-makers (who invest their time in bringing up the next generation). Empirical evidence seems to suggest that whereas the 'new' systems have brought their society under severe strain, the Indian system has been tested over many millennia. It is time we start thinking about the consequences of blindly aping the West. It is also time we start respecting our own culture and traditions.

The above narrative would be a culture shock to many readers, appearing as it is in the annual report of a public company. However, given the experience of the developed world, it is quite clear that there are deep and important linkages between the health of society and the health of the economy, within which a business operates. If we as informed citizens are to play a role in building tomorrow's India, it is imperative that we think beyond merely earnings per share. This brief discussion is meant to be a thought starter amongst our thinking shareholders. A word of caution though - the mind tends to reject new ideas, especially those that go against long-held beliefs. We owe it to the idea to think about it rationally, rather than rejecting it outright, merely because it does not fit into our present mental framework.

About a year ago, I read a piece which said that among the toughest challenges for one of the leading global mining companies was finding enough qualified engineers to run their mines. As a result they were looking to recruit mining engineers from China and India! My guess is the citizenry of that country (where the mines are) finds it more lucrative to work in investment banks than to toil in mines. Just as riches tend to blunt the competitive instincts of members of a wealthy family, so too do they affect the hunger to strive of wealthy nations. Once a society gets used to the good life, it becomes progressively more difficult for it to work as hard as it used to when it struggled to make two ends meet. If this is true, the implications for India are obvious. We have the poor man's advantage – and we must not squander it.

When we started the year, we were a national company, but due to the untiring efforts of the team, we ended it with a global footprint. The journey for becoming a significant world player has begun and I, on behalf of all shareholders, congratulate the team for this momentous achievement.

Abhishek Dalmia
Chairman of the Board