

Chairman's letter

Our gain in consolidated net worth during FY08 was Rs.142 million, which increased the per share book value by 16.6%. Over the last five years (that is, since the present owners took over) per share book value, has grown from Rs.151 to Rs. 398, which, after factoring in dividend paid during this period, works out to a rate of 18.8% compounded annually.

A clarification is in order. While our consolidated profit for the year was Rs.230 million, we used up Rs.51 million out of it to complete the share buyback program we had initiated last year. As a result of this, while our gain in per share book value got depressed, we were able to permanently extinguish, across two financial years, 142,857 shares outstanding at a per share cost of Rs. 671, using up Rs.96 million. But for the buyback, the gain in per share book value for the year would have been 18.6% and the annually compounded figure would stand at 20.2%.

The American novelist Nathaniel Hawthorne once said, "Easy reading is damn hard writing", but that hasn't stopped me from trying. This year again, the letter runs long, not because I measure substance the way some examiners measure the quality of answer papers submitted in schools. Instead, my endeavor is to lay out the cards before shareholders and potential investors as clearly as I can, so they know where they stand with their investment. There is only one caveat to this: anything that would hurt our competitive advantage will never appear in these pages, even if it may be important for shareholders to know.

The twenty first century did not have to wait very long for its first major financial crisis. It followed a well-trodden path laid down by centuries of financial folly. The combination of esoteric instruments and unaware regulators has so far wiped out over \$,1000,000,000,000 from the balance sheets of global banks. To put that number in perspective, we are talking about the total market value of all the goods and services produced in India in 2007. We are talking about Rs.40 lac crores! Pause for a moment and think. The entire production of a country as large as India, vaporized in quick time, by a combination of high intelligence, low ethics and perverse incentives. It is true. Intelligence by itself does not lead to great, sustainable achievement - unless it is grounded in sound ethics. The great Indian philosopher Bhartrihari in Neeti Shatakam said:

येषाम् न विद्या न तपो न दानम् ,
ज्ञानम् न शीलम् न गुणो न धर्मः।
ते मर्त्यलोके भुविभार भूताः,
मनुष्य रूपेण मृगाश्चरन्ति।।

People who despite taking human birth do not engage in study, do not do penance or charity, do not imbibe knowledge, nor adhere to the code of conduct, nor imbibe virtues like courage, patience, piety, such people are like animals in human form.

Over the past year, after this crisis hit the global economy in the summer of 2007, the mood in the global economy has turned decidedly somber. Crude had already 'soared' to \$70 when the American financial system hit the skids. At the time, the lifeguards had been scanning the horizon for an oil-price shock or a terrorist attack. But when the big wave struck, it surprised them by coming from inside the financial system. Intelligent investors had been asking for years if the frantic innovation in finance, especially the securitisation of just about every form of debt into a tradable asset, was a way to spread risk efficiently, or whether this left the financial system prone to rare, but cataclysmic failures. It appears now that Mr. Buffett's description of derivatives as being financial weapons of mass destruction was a very apt warning – a full six years before calamity struck.

You might say how does a major accident in the USA affect my life? A few decades ago, that observation would have been apt. In today's increasingly connected and boundaryless world however, what happens in one corner of the world will tend to impact the rest of us, in smaller or greater measure. Only a few months ago, we used to read about the decoupling theory. While it made logical sense, we all found out how practically irrelevant it turned out to be. Look, for example, at what happened to the inflation numbers here

in India when China got hungry for commodities. The fact that the world is regularly surprised by some unexpected event, forces me to concur with the Nobel prize winning Danish physicist Niels Bohr who observed, "Prediction is very difficult, especially if it's about the future." This reminds me of the speech Steve Jobs gave at Stanford in 2005. He said, "You can't connect the dots looking forward; you can only connect them looking backwards."

The purpose of writing this brief commentary is to chronicle the state of the global economy in which our dinghy corporation operates. Just as a rising tide raises all boats, so too must all boats bear the consequences of a receding tide. It won't be out of place to put some perspective on how long this environment is likely to last. If we look into the rear view mirror and compute the average length of bear markets over the last five decades, the average comes to thirteen months. We must bear in mind though that averages tend to distort reality when there are wide ranges, as there are in this case. The duration of bear markets has varied between two months in 1987 to a full thirty three months in 2000. If you are smart enough to figure what's the right number this time around, go figure! Enough said about the environment. Let us have a look at the highlights of our businesses.

Drill Business sales grew 19% over last year, buoyed mainly by a significant growth in export sales to a robust Rs.177 million. While we are still not at a point where the future would be a linear curve sloping steeply upwards, our performance this year leads me to believe that we have moved up to the next level in developing export markets and in diversifying out of a single customer. While sales grew 19%, the material cost, given what happened to steel prices rocketed 27% over last year. It was a combination of operating leverage and exchange rate gains that saved me the blushes somewhat as, despite this huge jump in material cost, our pre-tax profit grew 21%.

While out of place, it is useful to highlight two things here. One, while like many other companies, a few years ago, a few banks approached us to peddle forex derivatives (and make some commission on the sale). We declined politely. Two, during the year, we outsourced our forex management to a specialist firm. The result of the two actions, in combination led to us registering gains, while many large Indian companies struggled on these counts.

The Construction Equipment sales grew significantly over last year's low base to Rs.193 million. To give ourselves a strong product portfolio with which to serve the market, this year we enhanced our basket by adding boom pumps and high capacity batching plants to our stable. We intend to keep developing more variants with a view to offering a fuller product range to our customers.

Given our growth expectations in the Drill business and in the Construction Equipment business, it was becoming difficult to operate both businesses from the same plant. I had also written last year about how the DNA needed for the success of the two businesses is vastly different. Due to these factors, we had taken a decision to physically separate the two businesses. During the year we set in motion our plan to acquire land around Chennai. While we were able to identify the land quickly, it took surprisingly long to close the acquisition and subsequent clearances. We expect to start regular manufacturing from this plant during FY09. This transition out of Coimbatore would mean that we would have to build a new team and develop new vendors for the Construction Equipment business. That, combined with the overall slowdown in construction activity, would mean that this business will not accelerate at the pace that I would have liked. However, these are short-term concerns and I remain quite excited about the prospects of this business over the medium term. We intend to invest about Rs.250 million on the Chennai facility to prepare ourselves for the time when the market gets hot again.

Let us have a look now at Power segment. A brief history for our recent shareholders who may not have read the past reports is in order. With a view to enhancing the return profile of our free cash, which was historically parked in money market mutual funds, and to diversify our earnings source away from Coal India, we had made certain investments in Power assets. While these were not meant to be short-term investments, I did not see them as long-term investments either. They were a bit like place-holders, which gave us significantly better returns while we looked for permanent homes for our free cash.

These investments included Rs.50 million in a natural gas-based merchant power plant over FY04 and FY05 and Rs.523 million in wind energy assets over the period FY04 to FY06. Of these investments, we liquidated

our investments in the merchant power plant last year. The rest of the Power division was disposed off this year. Now that this Division has been wound up, an evaluation of its investment quality is in order.

Despite the terrible plant load factors achieved in Rajasthan (15% as opposed to the guaranteed 25%), we still achieved an IRR of 23.6% after we concluded the sale. The IRR achieved on the turbines located in Tamil Nadu, which is widely regarded as the best site for wind energy, was only a touch better at 23.9%. In cashflow terms, we made a pre-tax profit of Rs.98 million on the sale of all our wind turbines. Overall, for the whole Power division, we made a post-tax IRR of 20.2%. This IRR, I might add, is before factoring in the compensation we are to receive under the guarantees given to us by the equipment manufacturers. Assuming there is no inordinate delay in obtaining the same, the IRR for our Power division would rise to 23.6%. In the context of the tidal wave of economic prosperity that swept market returns up to 23.3% over the comparable period, I would not be terribly dissatisfied with our results from our Power division.

A question arises as to why we sold out our Power assets. Most decisions, barring the simplest ones, are guided by a combination of several factors. Here too, there were many factors at play. We were not and never expected to become energy hungry, and so would never reap the real upside from our wind assets. Despite our best efforts the power generation numbers were way below our original expectations at both locations. The capital deployed into this operation was needed for expanding our core operation. We found, what I believe, would be a permanent home for our capital.

Given that he has brought us two worthwhile investment ideas in two years, I am compelled to feel that my old friend Jacob wanted to make up for the dry spell he had with us between 2001 and 2006. After introducing us to Potential Service Consultants last year, he introduced us to Semac this year. Here's the low down on how this investment happened.

Right after investing into Potential, we had expressed a desire to Jacob to find us more companies in the same space. We even put him onto some of the companies that we found of interest. Semac Pvt. Ltd. was one of them. Semac opened its doors for business in 1969 and does the exact same things that Potential does. However, while Potential is strong in the residential and commercial buildings space, Semac is the gold standard for industrial buildings. While Potential is predominantly a Bangalore-centric company, Semac has a presence in the Bangalore, Hyderabad and Delhi markets, in addition to three offices in the Middle East. Semac also has an architectural and interior design practice, which makes it an integrated player.

Having made one investment in the same space, I had a much better understanding of what to look for. Armed with this knowledge, in May this year, we concluded the purchase of a 70% stake for Rs.455 million. From start to finish, the closure took four months, longer than Potential had. But the only reason for that was the geographic dispersion of the founders and their preoccupation with running the business. But as they say, better late than never!

On a consolidated basis across all its offices, and after accounting for minority interests in their Middle East business, Semac closed FY08 with a total income of Rs.376 million and profit after tax of Rs.79 million. Since FY05, they have been growing their revenues at 52% and post tax profits at 120% annualised. Such strong growth rates are likely to moderate because they were achieved on a very low base to start with. Also, with the economy slowing down, companies will take a more measured approach towards making fresh capital commitments towards creation of fresh industrial capacity.

One last statistic before I close this section. Though the two companies continue to function independently, on a combined basis, we closed the year with about 750 people, almost certainly making us amongst the largest companies in the country in our chosen market. On a combined basis, we now cover a much larger served market and our presence in multiple geographies I believe allows us a strong foundation from which to grow further.

Potential Service Consultants had an indifferent year, when measured by growth in profitability and efficiency of usage of capital. While billings growth continued to be robust at 31%, the year saw a big value transfer from shareholders to employees. One of our biggest strengths, our brand, became a drawback when the buoyant market led local and international competitors to our door looking for talent. They believed, rightly, that by hiring people with experience of having worked at Potential would be invaluable in

presenting strong credentials to a prospective customer. This caused pressure on our system, leading to a 29% spurt in per head manpower cost, even as we were entering a slowing economy. In a more benign environment, the 'spurt' would be no more than the 8%-10% rise that the IT industry paid out. This single factor caused the fall in net margins that we witnessed this year.

The strong hiring during the year added 50% to the team we started the year with. While this was key to servicing our customers, such a large addition in a single year also caused our people productivity metric to stay flat over last year. We expect that the productivity of these new hires will climb as they climb up the learning curve of the Potential way of doing things.

Our experience with small businesses has thrown up some common features across industries. I will dwell upon one such in this letter. Upto a certain size, small businesses do well on the back of the extraordinary effort put in by the founders. They take personal responsibility for every aspect of the business, from the smallest thing to the most important. However, as work expands, they can no longer spend more hours every day to address the needs of the business. At that fork in their lives, they need to take a decision to either work longer hours (which is a physical impossibility) or stop growing (which is too limiting for their continuing passion and ambition) or professionalise. By bringing in business processes that allow greater delegation, they are able to unload a lot of the work they did themselves onto ever lower levels in the organisation. This of course releases their time to pursue strategic choices in their personal and professional lives. The successful companies are the ones which are able to make this transition.

Something similar happened with the Founders at Potential when they started talking with us. They felt the pressing need to professionalise and were very keen to bring on board a CEO. Late during the year, we hired a professional, who started his professional career with McKinsey & Co. and worked with some BPOs before joining us, to take charge as CEO of the business. His mandate includes setting up strong internal processes which will then allow Potential to go global. Eventhough change is a slow process, we have taken and continue to take deliberate steps to introduce such processes which will align the organisation to the new environment.

With global architectural firms setting up offices in India, our interacting with them on local projects will help build relationships that could then lead to working with them on their global assignments. Even within India, the opportunity is immense. At a macro level, the overall market for architecture and design is estimated at Rs.17 billion growing at 25% annually. I will share with you another data point, which is indicative of the gaps in every segment, which constitutes Potential's addressable market. According to Knight Frank Consulting, India with a population of 1.1 billion people has only 12% of the hotel rooms available in China, whose population is barely 10% more than ours. Just Shanghai has more hotel rooms than all of India! Similar statistics applies to housing, hospitals, office space, you name it.

While the environment we operate in is likely to throw up significant opportunity for us to capitalise on, we must not lose sight of some of the factors that are likely to materially affect future performance. Global competitors such as Singapore-based RSP, British firm Atkins and Satellier, have set up India offices. This will bring much more professionalism in the industry and will make it imperative for us to upgrade to being a company that is as well respected for its overall approach to business as for its technical competence. In this emerging environment, we will do well to internalize the axiom that the game of business is very much like the game of tennis. Those who fail to master the basics of serving well, usually lose.

Our financials are also likely to be significantly impacted when our current rent agreements come up for renewal. We have been lucky so far to pay an average rent per square foot of only Rs.33 in South Bangalore, where the market rents are closer Rs.60. This is clearly an aberration that won't last much longer. Last but not least, with money becoming harder to come by, some developers have become very tight fisted. This will mean we will need more capital to generate the same Rupee value of Sales. Given where interest rates are, this will obviously mean the Company that has had negligible interest costs for the most part, will now have a fairly meaningful charge under this head.

Monarch Catalysts had a mixed year. While the spurt in commodity prices and the slowdown in the global economy did have its effect on our business, it is not immediately discernible from the Sales numbers. Post-tax profit, which fell 43%, behaved as if it was unaware that Sales had grown 48% over last year. This

'reversal of fortune' happened due to two main factors, neither of which were known at the beginning of the year.

The first factor was the adverse wild gyrations in the prices of nickel, our main raw material. It is important to clarify that given how our business works, for us a fall in nickel prices is an adverse movement. Last year, I had written about the business having enough pricing power to allow passing on raw material price movements to our customers. I realised that formula only works in orderly commodity markets, i.e., when the price movements are not sudden and steep. When they are, we can either end up making a lot of money, as we did last year – Rs.18 million, or losing a lot, as we did this year – Rs.20 million. We have taken various steps to get away from the business of commodity trading and get closer to our business of manufacturing catalysts. Hopefully therefore, future volatility on nickel prices should not impact our results as significantly.

The other factor that hurt our results was the combination of deteriorating economic health of the global economy and the significant tightening in the overall money market. This combination resulted in the business needing greater working capital for doing business and having to borrow money at higher rates. In other words, a double whammy, which had the effect of increasing our interest costs by 72%.

After that reality check, here is some positive news. As in the Construction Equipment business, we are quite bullish about our prospects in the medium term and we spent a further Rs.65 million on expanding capacity (while capitalizing last year's capital work-in-progress worth Rs.152 million during the year) and debottlenecking our production so that we would be ready to service the market when it turns. Monarch invested another Rs.35 million in their future headquarters in Chembur. There is a further commitment of Rs.18 million, after spending which Monarch would own 6,500 square feet of office space.

The share buyback program which was initiated on January 22, 2007 was completed on June 28, 2007. Overall, we bought back 142,857 shares at an average price of Rs.671 using up Rs.96 million of cash. In effect, we bought back 4.45% of total shares outstanding at a price that places an implied value of about Rs.2.20 billion on the Company.

US Attorney General and Senator Robert Kennedy once said, "Too often we forgive those who are willing to build their own lives on the shattered dreams of other human beings." In today's world, we see many who would do whatever it takes to climb a notch higher on the 'Rich List'. While we respect raw ambition, hunger and passion, we certainly do not subscribe to the 'do whatever it takes' approach. I would rather compromise on growth than mortgage my soul in our quest to climb higher. I am reminded of how James Baldwin described the predicament of those who do indeed mortgage their souls. He wrote: "People pay for what they do, and still more for what they allow themselves to become. And pay for it simply, by the lives they lead."

The voice of *voluntary* corporate social responsibility, which propagates helping the needy *by design*, is growing ever louder. Until recently, most of this advocacy was being done by NGOs. Now however, I hear the same clarion call from intelligentsia, for good reason. In a democracy, if the gap between the haves and the have nots grows too large, we will have laid the foundations from which revolutions spring.

In the FY06 letter I had written about donating Rs.2 million to build a school for poor children. Here is a lowdown on the background. For many years, I had harbored the thought of building a school for the underprivileged. For many years I looked for the right NGO to partner with, an NGO that brought commitment, passion and integrity to the job. In my quest, I came across many so-called NGOs, which had more socialites than social workers. After hunting high and low, I was finally introduced to Literacy India (www.literacyindia.org) by an organisation called Youth Reach.

It was formed in 1996 by Asia's first woman flight commander, Captain Indraani Singh. While she is a full time pilot with Indian Airlines, her real passion is Literacy India. Having seen her in action for over three years now, I am amazed by her energy for a cause which has no pay-offs for her or her family. Most of us find it hard to do justice to one job. Indraani juggles two with ease. As a direct consequence of that passion, Literacy India with the help of donors such as Dell Foundation, American Express, Coca Cola, Hero Honda,

etc., has so far reached out to over 8,000 beneficiaries. The school we built for them in Gurgaon, within a year of opening, houses over 600 kids. Some of these kids have staged a play for our past President, Dr. APJ Abdul Kalam at Rashtrapati Bhawan, and some have acted in famous movies such as Omkara and Blue Umbrella. If any of you are in the New Delhi area, I would urge you to pay a visit to the school and see for yourself the magic that Indraani brings to the institution.

This year, we spent Rs.1.63 million on various education and infrastructure projects. Included in this is a contribution of Rs.600,000 towards the upgradation project currently on at Shri Ram College of Commerce, my alma mater. We do hope to do more than cheque-book charity as we become larger and command more of society's resources. That time is approaching and I hope to write about it in more detail in a few years' time.

Abhishek Dalmia
Chairman of the Board