Chairman's letter

Our gain in net worth during FY07 was Rs.101 million, which increased the per share book value by 13.7%. Over the last four years (that is, since the present owners took over) per share book value, has grown from Rs.151 to Rs.352, which, after factoring in dividend paid during this period, works out to a rate of 19.9% compounded annually.

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The financial results look terrible, especially in an environment where year-on-year profit growth at something like twenty five percent (or better) seems to have become the norm for the Indian corporate sector. And they are. What's more, this period of pain may continue a while longer than I had originally anticipated. While the reasons are many, there is no hiding the fact that I miscalculated the pace at which some of our initiatives might progress. At these times, it is easy to get philosophical, and quote from books such as Fooled By Randomness or Why Most Things Fail, on what did us in. And while I do believe in the messages contained in those very interesting books, I also believe that some of the errors I made were avoidable. The bad news is that these are, in my view, systemic issues, which may take some time to address satisfactorily. While one gets to read about it, only experience makes the truth sink in, sometimes painfully. Just as earthly objects must attain escape velocity to overcome Earth's gravitational forces and launch into orbit, small organisations I find, need to work on multiple preparatory steps to break the size barrier and go on to the next level. So while the mid-course correction has begun, the results are not likely to be immediately apparent.

Every day, in countless ways, the competitive position of our business grows either weaker or stronger. If we are delighting customers, eliminating unnecessary costs and improving our products, we gain strength. But if we treat customers with indifference or tolerate bloat, our business will wither. On a daily basis, the effects of our actions are imperceptible. Cumulatively though, their consequences are enormous. When our long-term competitive position improves as a result of these unnoticeable actions, we describe the phenomenon as 'widening the moat'. Doing that is essential if we are to have the kind of business we want in a decade or two from now. We always hope to earn more money in the short-term. But when the short-term and long-term conflict, in my book, widening the moat must take precedence. Said more bluntly, this means Revathi continues to be at a stage where it needs to make significant investments of time (but not so significant investments of capital) to build the foundation that can support the growth that lies ahead. More on this a bit later.

After summarizing my thoughts on the state of the core construction and mining business, I now turn to the two strategic investments made by us this year.

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I have stated in the past that we would attempt to use the free cashflow generated by the core mining business to acquire meaningful (even control) positions in, what we believe to be well run businesses with strong market positions and a sustainable competitive advantage. During the go-go years immediately past, when private equity players of all hues were announcing a deal a week, holding cash was uncomfortable, but not as uncomfortable as doing something that might make us look stupid in the long run. I have heard of a syndrome popularly known as the bladder problem: the more cash one holds, the greater the pressure to piss it away. To be honest, it takes a lot of holding yourself back to not fall into the trap of parking money into the first opportunity that comes your way. Or the tenth. Like in test cricket, a few maiden years do not count. What ultimately counts is whether we have the patience to not be bowled out twice over in the space of five days. To finish first, we have to first finish.

I have also been influenced by the writings of Michael Mauboussin, chief investment strategist at Legg Mason Capital Management who, in his book, More Than You Know: Finding Financial Wisdom in Unconventional Places, writes, "The frequency of correctness does not matter; it is the magnitude of correctness that matters". So we bided our time. Until now. Hopefully, these businesses will serve us well in the long run.

This year marked the beginning of that journey, which, if things go as per plan, should metamorphose Revathi from a company manufacturing capital goods for the construction and mining industries to a kind of holding company with meaningful investments in diverse businesses.

We started our journey by taking a twenty six percent stake in Monarch Catalyst. Govind and I were introduced by a common friend over a breakfast meeting at Café Fontana on a cold December morning in 2005. I was initially skeptical about the opportunity, owing to the size of the firm and the age of the promoters. However, as our discussions progressed, I realized the truth behind the age-old wisdom, “looks can be deceptive”. I have judged too soon in the past and was glad that I learnt my lesson well enough to probe deeper into this gem.

Monarch is India’s largest producer (third largest globally), of catalysts for hydrogenating oils and fatty acids for the edible oil, personal care and cosmetics industries. They also produce process catalysts that reduce the time it takes for a chemical reaction to take place in industries such as pharmaceuticals and fine chemicals. The company was set up by two technocrats including Shanti bhai Vadalia, in 1973, who were joined by K. Ganesh shortly after. These four built a strong base, which was inherited by the next generation of the founding families. Since 1998, these two young and dynamic professionals, Hitesh Vadalia and Govind Krishnan Muthukumar have put Monarch on a different platform. Together, they have the energy and vision to put Monarch on the global map.

The biggest problem for catalyst users is disposing the chemical waste that arises at the end of the process. In classic entrepreneurial fashion, the boys converted this problem into an opportunity, wherein they offered to buy back the waste from their customers, thereby making catalyst waste a key raw material source. This is a typical example of a win-win mindset, which when applied to the right business, can create significant shareholder value. Another example of a customer first attitude is reflected in Monarch leveraging its significant technical strength and integrated manufacturing facilities to offer customised solutions to global customers. A reasonably consolidated industry structure ensures that a typical contract provides for passing on price risk arising out of fluctuations in raw material prices on to customers. This business model, combined with ever-increasing economies of scale, has yielded a return on equity exceeding thirty percent in all but three years since the boys took charge.

A confluence of all things positive led to a dream performance in our very first year of courtship. Monarch more than doubled its sales over the previous year and profits grew at a blistering 257%. All this was achieved, while simultaneously achieving a return on equity unmatched since FY00. While the company’s business has been built on strong foundations, I would regard such a performance as a black swan event, unlikely to be matched in its magnitude.

Before I move on, a word of appreciation for Hitesh and Govind. Despite the fact that I have known them for just under eighteen months, I get a good feeling about having chosen them as business partners. They have the personal and professional qualities that one admires in a business associate and cherishes in a close friend.

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Our second investment was a forty percent stake in Potential Service Consultants, with an obligation to buy at a pre-agreed valuation, an additional eleven percent, thirty months after the date of the initial purchase. The connection here was to be made by the same common friend, who introduced us to Monarch, but after discussing a possible meeting for almost twelve months through this friend, we finally got introduced through another investment banking friend. We had last worked together almost five years ago. Over time, they spoke to us about multiple opportunities, but unfortunately we never found one that got us really excited. As a result of these misadventures, they perhaps concluded that we are too finicky an investor to waste time on. Gradually I stopped getting their calls, though we kept in touch socially. Then, in August last year, I got a call from Jacob about investing in an engineering design firm. I had been looking to invest in that space and had had a look at a few other opportunities, without success. When I heard his story, my interest was piqued.

Potential is one of the largest integrated engineering design firms in India servicing the construction industry. The company had been set up over two decades ago by three professionals, TS Gururaj, BRV Murthy and BSA Narayan, each a recognised authority in his field of specialisation. At the first meeting itself, the partners laid down their preconditions for selecting a new partner. It was a short list, which included that the firm name be preserved and that the people be looked after just as they had before the sale. After the deal was done, I learnt that they had chosen us over stronger contenders, for fear of having their pre-conditions diluted. For us though, it was a no-brainer. For in a people-intensive business, what matters most are the people. And for a company, which has attained a special status in the eyes of its customers, through painstaking hard work over twenty long years, the brand certainly is not inconsequential. Now Infosys today, by any other name may sound as sweet, but I am not sure if that would be the case when they were 1/300th their present size!

Here is what Potential does. It is typically recruited by an architectural firm to prepare detailed engineering drawings for a project. The combined specialisations of the three promoters cover engineering designs for civil, structures, electrical, public health and engineering, air-conditioning, fire-fighting and IT systems, among others. What distinguishes Potential from most of its competitors is that very few offer a comprehensive solution under one roof. Using these skills, Potential receives conceptual architectural drawings from architects and produces 'ready for construction' drawings which are handed over to a construction management company for translating into the actual building. Over the years, their work has spanned designing buildings for use as residential complexes, offices, malls, hotels and hospitals.

Potential is a live example of the tipping point principle. It took them eleven years to reach the Rs. Ten million billing and seventeen years to reach the strength of a hundred people. They were still south of Rs. thirty million in FY03, but since then, sales have grown at a compounded annual rate of eighty percent. The interesting part is that this has been achieved by increasing team size at a compounded rate of about thirty four percent. In effect, the revenue per employee has gone from Rs. 350,000 to Rs.1.4 million during this time period. This clearly is quite a significant change in such a short time period, especially for a company of this size.

And therein lies the rub. While the company is sitting on a two-year plus order book, every incremental improvement from here on will need important management inputs. There is no question that the team is technically robust, but the business is going to need strong management systems and processes to leverage those innate skills to reach its full promise. For contrast, it is instructive to note that world-beating tier I Indian IT companies, with all their scale and management competence have been able to attain a per employee revenue of about Rupees Twenty lacs. While Potential would aspire to reach those standards, it is clear that in the immediate term, any growth would have to come out of adding more people to the team. While hiring people in an intensely competitive market brings its own challenges, as the team grows, the complexity of managing it will increase in geometric progression. The good news is that the team is very alive to these challenges and is taking suitable steps to address these issues.

Before I end this section, a brief look at the financial side of this business is in order. On many of the critical metrics, such as return on equity, employee cost to sales, capital turnover ratio, net margins, etc., this business approximates numbers achieved in the IT/ITES business. I would like to add one caveat however. Potential has so far been run much like Revathi had been – on maintenance mode. The investments needed in people and systems to manage growing complexity have not been made in the past. As these investments get committed, they will temporarily depress the financial performance. But if the factors driving the real estate industry remain stable, over a three year timescale, then I think this business should be able to achieve robust growth mirroring growth rates in the real estate industry.

Both these businesses are fairly small at the time of our investment, but small doors sometimes open up into large rooms. However, there is one crucial distinction between the two businesses. Whereas Potential is in a high growth industry, Monarch's growth will have to necessarily come out of winning market share over global competitors. The good news is the global players increasingly seem to find this sub-segment of catalysts as too small, with mediocre growth prospects. They seem to prefer focusing on environment catalysts (including catalytic converters used in automobiles) and it is not inconceivable that over time they may gradually vacate spaces in the market place for a player like Monarch to enter.

A question is bound to arise in the investors' mind - Why make passive investments when we can never get our hands on that money? Here is my thinking on the subject. Until these businesses are in a position to utilize their free cashflow to grow their core business, they would continue to invest internal accruals to fund such growth. This could be organic or inorganic. When they transform from being growth businesses to being cash cows, we would dividend out all the spare cash, which we then find new homes for. In essence, as long as we can ensure that the capital allocation is done by these businesses in a way that focuses on maximizing long-term shareholder value, we would be served well.

Before I move on, here is a statistic that should give us shareholders that warm fuzzy feeling. With these investments, Revathi, with its associate companies reaches out to a shade north of eight hundred families.

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Including the two segments described above, Revathi now has five business segments including construction and mining, power and treasury. Let us now look at the state of each.

Construction and Mining first. Despite what we all read about how commodities are booming and how mining must necessarily follow, the facts that we observe on the ground seem closer to "business as usual". There are no major inquiries, nor any impressive capital expenditure that we have so far come across while talking to mine owners. When we compare our results to competition, we find that while Atlas Copco's sales from its Construction and Mining segment grew sixteen percent, Ingersoll Rand's sales from its Drilling Solutions business fell eleven percent. Since Atlas' numbers include consumables, other equipment and trading activity, we see Ingersoll as a more direct comparison to our business. In contrast, our sales fell four percent. Intriguing as it is, the mining equipment business in the country seems to stick out as a sore thumb in an ocean of opportunity that has flooded the country.

We had started the process of diversifying our revenue base away from Coal India, indeed from India itself, back in March 2004. But so far we have, quite apparently, had limited success. If I were to put a finger on one single reason to explain this, it is that to create credibility with new customers in new markets for high value capital equipment takes time. It is an arduous process, the fruits of which, when they materialize, would be worth the time and effort being put in by the team. Until then, our financial results will remain exposed to the capriciousness that comes with putting (almost) all our eggs in one basket.

So we are all on the same page, it would be useful to briefly chronicle our efforts towards opening up new markets. We first initiated a dialog with Bucyrus in 2004, which got formalized into a five-year agreement in 2005. We got our first order for three machines towards the end of 2005, which was to be executed during calendar year 2006. After shipping the first machine in 2006 we got a repeat order for six more machines in 2007, for shipment during calendar 2007. If one were to look at the soft indicators or progress, ever since we signed the agreement, we have been getting a constant stream of visitors from Bucyrus offices all over the world. Just last week, we had visitors from Latin America, who felt very excited about the prospects of placing more orders after seeing the machine we had built for that market.

Several years ago we recognized that our older product lines wouldn't generate the kind of growth that would be required to grow our per share earnings at rates that create wealth. Accordingly, we developed a series of new products to try and fuel future growth. While we have built a lot of new products, so far, we have underestimated how long it would take to get prosperity out of them.

These are by no means the only arrow we have on our bow, aimed at the target of diversification of our revenue base. That brings me to our next arrow, construction equipment. We continue to build this sub-segment, which in my view can outgrow the mining equipment business in times to come. The initiatives taken this year included hiring a business unit head and a head of marketing. By and large, we now have an independent organisation, with a different DNA, for this business. Whereas the construction equipment business is high volume – low margin, the mining equipment business is low volume – relatively better margin. While an independent organisation adds costs initially, without it, the stresses to the existing organisation would prove counter-productive. Owing to the ground situation, we decided to defer the capital expenditure that I mentioned in last year's letter. We will now be using that money to expand capacity during FY08. To get a sense of the potential in this business, Greaves Cotton, which is the only listed player in the space, grew its Infrastructure Equipments segment by twenty eight percent and almost trebled their pre-interest and tax profit. It must be said though that they have been in the business for quite some time and only now are beginning to see such traction.

The segmental financials, while look sordid, hide the real story. Are things really as bad as they seem? At the topline level, things could surely be better, and hopefully will be better in FY08. On the costs side however, we need to factor in these realities. When bringing new products to market, many costs are incurred upfront, such as R&D, initial high-cost production (due to lack of economies of scale and learning curve issues), building credibility through participation in trade fairs, etc. The fact these new products have been bunched together has resulted in continued to depress earnings. When compared with the olden days, when the company was not making any fresh investments to seed future growth, the present set of numbers do not appear as terrible. In that sense, I think we are today on a stronger wicket than we might have been five years ago.

A quick word about material costs before I move on. Material costs have climbed across the board for all industries. Some have passed on these cost increases to their customers and some have not. In our case, we have passed on only a part. However, that does not fully explain the material cost numbers, which have also got impacted by the product mix. The industry structure of the construction equipment business will ensure that the margins would be leaner when compared with mining equipment. So as the contribution of this sub-segment will go up, so will the material cost to sales ratio.

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Let me now shine the light on our next segment, Power. While we were quite enthusiastic about this investment when we started out four years ago, some of that has waned in light of our actual experience since. Despite locating our wind assets on supposedly proven sites, the wind patterns, post investment, have flattered to deceive. Equally importantly, State Governments, who are responsible for creating evacuation capacity, probably have a much less demanding audience to address as compared with producers of wind turbines who have anxious (and demanding) shareholders. Given this treacherous landscape, we decided to take some money off the table. Towards this objective, we have signed an agreement with one of our vendors to buy back our turbines at our original cost. With this, our exposure would come down from Rs.523 million to Rs.409 million. As an aside, gain on sale of depreciable assets will be liable to income tax. Thus, the taxes we saved in FY04, when we made this investment, will now be paid back to the exchequer when the turbines are sold.

We had also invested in a gas-based power project, which was captive to India Cements. One of the terms of the agreement was that India Cements or their nominee would have a right to buy us out at any time. Perhaps owing to the stupendous run being witnessed by the cement industry, they decided to exercise that option sooner rather than later. As a result, right after the close of the year, that investment was also converted back to cash.

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Finally, we come to the last segment, Treasury. A significant part (Rs.363 million) of our free cash got deployed into two strategic investments, about which I wrote towards the beginning of this letter. Another significant portion (Rs.96 million) got used up in completing a share buyback program, whereunder we bought back 4.5% of the pre-buyback shares outstanding at an average price of Rs.671. Of this, only Rs.45 million was used up by year-end.

The equity portfolio continued to do well (there *are* some bright spots in our armory!) At year-end, we had Rs.141 million in secondary market equities, with an unrealized gain of Rs.13 million.

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While I have written about our unorthodox dividend policy in the past, it might be useful to look at the genesis of the conventional dividend policy that pervades the corporate world globally.

The global investment community has long been prejudiced against companies that retain all their earnings and don't pay dividends. This prejudice is rooted in the early part of the 20th century, when the majority of people bought bonds instead of stocks for investment purposes. People felt more comfortable with bonds because they were secured with the assets of the businesses, which meant that bondholders had first claim on assets of the company if it went bankrupt. Bonds paid interest to investors on a quarterly basis, so investors knew there was trouble with company if the interest check wasn't in the mail.

Common stocks at that time were considered dangerous for the financially naive, because of a lack of accounting regulations; majority owners and managements had enormous leeway to monkey with the books. But the strengthening of the regulatory framework has led to considerable improvement in the quality of accounting and disclosures.

But even though the investment status of common stocks has greatly improved, people retain their prejudice for getting that check in the mail. Be it for bonds or for common stocks, investors shy away from companies that don't pay a dividend. They see it as a sign of weakness. Many shareholder activists even attend Annual

General Meetings to urge management to consider paying higher and higher dividends, often without regard to the propriety of a payout versus retention.

To this day it is not uncommon for some security analysts to assign a higher value to companies that pay a dividend than to those that don't. This is true even when the company that is retaining all its earnings in an infinitely better enterprise.

For intelligent investors, common stocks have always represented ownership in the underlying business, and ownership means the company's earnings belong to you, the investor. The investors/owners of the company, through their elected board of directors, can instruct the company's management either to pay out the earnings as dividends or to retain the earnings for further development and expansion of the company's business.

This arrangement places a great deal of emphasis on the integrity of the company's management to do what is best for the shareholders of the company. Dishonest management can often manipulate a board of directors into fulfilling management's desire to build grandiose empires that enrich the management but do little or nothing for the financial benefit of the shareholders.

Some of the world's most successful investors therefore, place a great amount of weight on the quality of a company's management when they make their investment decisions. One way to determine the quality of management is to see what it does with its earnings. Does it pay out dividends, or retain them? If it retains them, does it profitably employ them, or does it squander them on dreams of grandeur?

Mr. Buffett believes that the test to which management should hold itself in determining whether or not to pay out a dividend is, "Would the investors be better off removing the capital from the business and investing it in other enterprises?" For example, let's say company A has a great business that makes lots of money. Now, if the management can profitably put to work the money that the great business earns, then it would make sense to let management continue its course and improve the fortunes of the company. But if management makes foolish investment decisions with the company's earnings and ends up losing money, then the shareholders would have been better off taking earnings out of the company and investing them on their own.

Indeed, Bill Miller of Legg Mason sees dividends as an unfavorable form of shareholder returns. According to his estimation, they are generally reinvested back into the market and earn, on average, only the market rate of return. While he does look at dividends, Miller says he may not be interested in a firm if it announced a big dividend increase, because that could imply that management is finding it difficult to locate compelling internal growth avenues. Therefore, Miller's approach to investing is more focused on estimating the firm's growth in future cash flows.

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Andrew Carnegie, the Scottish American who founded what became US Steel, and who went on to become the richest man of his times, famously said, "Huge fortunes that flow in large part from society, should in large part, be returned to society. We need to take responsibility of those less fortunate than ourselves." In recent times, this philosophy has been exemplified by no less than the two richest men on the planet, Bill Gates and Warren Buffett. Closer home, we are all familiar with the deep seated ethic of the Tatas.

I too strongly believe in this dictum. At Revathi, this belief translates into building programs that impart education to the underprivileged. For if you give a man a fish, you feed him for a day, but if you teach him fishing, you feed him for a lifetime. This year, we spent Rs.1.3 million on various programs including primary education, scholarships and imparting hands-on training to people in our neighborhood. I feel if each fortunate human being takes responsibility for the underprivileged around him, society would not need the Government to create some of the support structures that though present, are glaring examples of human incompetence. Without this approach, we will have what the celebrated economist JK Galbraith called, "Private opulence and public squalor". Good while it lasts (for the fortunate ones of course), but unsustainable in the long run.

Abhishek Dalmia
Chairman of the Board