Chairman's letter

Our *loss* in consolidated net worth during FY09, after a goodwill write-off of Rs. 66 million, was Rs.30 million, which *decreased* the per share book value by 2.5%. Over the last six years (that is, since the present owners took over) per share book value, has grown from Rs.151 to Rs. 388, which, after factoring in dividend paid during this period, works out to a rate of 15.6% compounded annually.

This goodwill write-off is a mandatory charge due to the applicability of Accounting Standard 26. According to this Standard, any difference between acquisition cost and book value is goodwill and must be written off over a period of ten years. So whereas the value of the underlying business may be growing, due to accounting rules currently in force in our country, its carrying cost on our books will keep going down. So far, we have written off Rs. 97 million due to this Standard. According to the new International Financial Reporting Standard 3, which will become mandatory with effect from April 1, 2011, the acquiring company must only test for impairment in the value of the asset annually. Only if there is a permanent impairment must a charge be recorded.

Before you read further, here is a cautionary statement: This year's letter is not going to give you the usual mood lift. With the ferocity and speed of the global meltdown, which is widely recognized as the worst since 1929, everyone was caught completely unawares.

This year, it was though a blanket of fog had dropped over commerce. Visibility was near zero. The year ended with the world economy stopping to shrink. Rarely, if ever, those words have been used to describe a positive emotion. However, in the context of the current state of the global economy, that is the most positive way in which I can describe the state of affairs of global business. The reason I am not as exuberant as the Sensex, is that the world economy has been kept alive by a huge and continuing shot of mojo, injected deep into its veins. The consumer in the countries that have been the cause of the dramatic rise of China have spent all their pocket money, and then some. Also, when you are not sure if you will be welcome at office tomorrow, you are in no mood to buy a new car or invest in a new house.

What we have seen in recent months is perhaps a government-funded parachute rather than a more robust green shoot. Over the past five years, almost everyone was running downhill. When government and central bank bailouts cease globally, as they must, the terrain will now turn uphill. As a consequence, over the next few years, we will find out who the real athletes are.

India however, has been different. Mr. YV Reddy never allowed the kind of asset bubbles, which have since become the nemesis of the world economy, to build in the first place. That said, the mood upto September 2008 can be likened to the adventurous couple on their first date – no one thought that anything could go wrong. Those are the kind of times when greed is all pervasive and everyone is tripping over each other to make the next killing. Never mind that that behavior may get *you* killed. We ourselves ventured out further than I would deem as prudent, but then such things become clearer after the hangover is over. Thankfully, that adventure has not been life threatening and is unlikely to cause serious damage to our long-term health. Let us see how each of our businesses fared in this global storm.

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Drill sales, apart from a fifty per cent drop in exports, was also hurt by delay in placement of a major order. These factors caused sales to fall to a touch below the level achieved two years ago. While sales dropped twenty per cent over last year, operating profits dropped twenty five per cent, due to the same factor, operating leverage, which caused a bump up last year.

On the back of the real estate industry meltdown that started in October, our Construction Equipment business shrank thirty per cent. This does not tell the whole story. I wrote about our new facility outside Chennai for the Construction business. By the time we got ready to get started, we were all dressed up and nowhere to go. As real estate projects went into suspended animation, so did our equipment sales. The freeze started to thaw only twelve months later. South, which is a major market for us, was particularly hard hit due to its dependence on the IT industry. All in all, the core engine of our business sputtered during the year and left tell tale marks on our financial results.

The good news is studies by the housing finance industry, the real estate industry, government and international agencies, confirm the gap between demand and supply in both, dwelling units as well as infrastructure. As the recessionary headlights dim, the real estate industry deer will start to sprint again. We have started seeing the first signs of that. To be sure, the industry had raced so far ahead of underlying demand that it will take a while for the unsold inventory to wind down. However, infrastructure projects and affordable housing are likely to be two exceptions to this and we hope these engines will be strong enough to make up for the lack of demand in other verticals of the real estate industry.

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Potential, which focuses on non-industrial buildings (Commercial buildings in industry parlance) bore the full brunt of an economy where cash absolutely dried up. With end user demand evaporating overnight, developers stopped projects mid-stream. The buildings that shone bright under night-lights, cranes towering over them, suddenly looked like ghost towns. This phenomena was not limited to any city or region, it was global. When developers were unable to sell their projects the entire value chain went dry. During the year, RBI put top guns in the real estate industry under the scanner to ascertain if they would stay solvent or whether a possible default would pose a risk to the banking system. Things got really dire and the real estate industry stocks fell on an average by about ninety per cent. Even at the time of writing this letter, the BSE Realty index is only a third of its peak, scaled almost two years ago. This tells as much, the story of excess, as of the subsequent crisis. In this kind of ruthless environment, the business that has hardly ever written off bad debts, took a write off of almost ten per cent of Billings! Despite this, I am not sure if we have seen the last of bad debts.

Semac, which is more in the industrial buildings domain was somewhat more resilient, relatively speaking. Ongoing industrial investments were less exposed to the vagaries of end-user demand for, by and large, industry believed that, in the Indian context, the downturn is exaggerated and the market will turn much sooner than the global economy in general. Despite this broader view, new projects slowed down and the same cashflow issues made the business charge off four per cent of its billings to write-offs.

Combined, Potential + Semac had a seriously tough year, where Revenues struggled, but managed to stay flat; where working capital, riding on the back of ballooning receivables rocketed up seventy per cent and profits dropped to less than half the levels achieved in the previous year. These numbers only tell one part of the story. In our Commercial business, which is headquartered at Bangalore, the hardest hit Region owing to its dependence on the IT industry, headcount went from 250 in April 2007 to about 400 in June 2008 and came back down to 300 by year-end, and falling. To a financial analyst, this headcount reduction would probably be too little, but for an operating manager, there can be no other more harrowing experience than telling your colleagues that they need not come to work tomorrow. I personally know people who have had a heart attack after they shut a plant down. There is probably nothing more stressful, and yet to save the business, we had to do it. We found ourselves between a rock and a hard place in October 2008, and in order to save 300 families, we had to ask 100 of our people to go. The storm had not ceased at the end of the year and more pain lies ahead. There is no greater teacher than a crisis. Many hard lessons have been learnt, which will hold us in good stead in the years ahead.

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That Monarch, a business dependent on non-discretionary consumption for the most part, faced an almost total disruption of demand for one whole quarter, tells you how severe the crisis was at its peak. It is neither practical nor wise to fine-tune your cost structure based on quarter-to-quarter vicissitudes of the market. So while our costs stayed at our expected level of operation, demand sank as our customers consumed their inventories while waiting for the windscreen view to get clearer. Given that costs were constant, this factor alone caused a dent of Rs. Four crores on our profits. The bad news does not end there.

As the global economy crashed, it took down with it commodity prices, which also witnessed a free fall. Nickel, one of our key raw materials, fell by a third in the first half of the year and then fell another fifty per cent between August and October. When you are holding inventory bought at higher prices and the demand for your product collapses, it is the seller who has to take the hit by marking his inventory down to market prices. The impact of this was another Rs. Four crores.

When the US economy led the global economy into the abyss, everyone believed that the US Dollar was doomed. After all, how could a rapidly deteriorating economy have a rapidly appreciating currency? However, no one anticipated that the TINA (there is no alternative) factor would cause a huge surge in the demand for dollar. Globally, there was no other currency that had the credentials as a reserve currency that matched the dollar's. The flight to safety that followed, as it usually does in times of crisis, resulted in a huge surge in the value of the dollar vis-à-vis most other currencies. Our Rupee was no exception – it duly fell from about Rs.40 to the dollar in early April 2008 to Rs.50 by the end of March, the following year. As with commodity prices, most of this correction was concentrated between August and October. No prizes for guessing our bill – yes, Rs. Four crores.

Is there any positive side to all this crashing and burning? The core engine remains strong. We have a strong suite of products and an ever-increasing list of international customers is appreciative of our quality and competitive prices. Our core business model is robust and our recent entry into noble metal catalysts reaffirms my belief that we have a good team with a quality production facility and competitive offering.

We got a harsh reminder about operating in the global market. Merely producing a good quality, competitive product is not enough. A significant part of our business risk comes not from our performance in the R&D lab but from the greed-led follies of smart MBAs in the global financial markets. Accordingly, we have evolved a stringent policy for managing risk arising out of both, commodity price and currency movements.

This crisis has also made the team hungrier and keener to undo the damage done to our balance sheet this year. Both, the Marketing and the Operations teams have taken more aggressive targets and I expect FY10 to reverse much, if not all, of the adverse result of this year.

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During the year, we invested Rs. Seventeen crores in acquiring an interest in a land in Mumbai, with the intent of joint development. Given the new infrastructure developments in the vicinity and the general prices in the area, this should prove to be a worthwhile investment. We have no intention of getting into real estate development in a systematic way and this was more of an opportunistic investment. This amount is reflected in the capital work-in-progress number in the Fixed Assets schedule.

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We have had one of the toughest years in living memory. I do not expect the economy to see a 'V' shaped recovery and FY10 is likely to be a sedate year as opposed to a terrific one. Hopefully if regulators continue to do a good job of managing this crisis, we should see a better FY11.

Abhishek Dalmia
Chairman of the Board