Chairman's letter FY 2011-12

Our *reduction* in consolidated net worth during FY12 was `38 million (`20 million ignoring goodwill write-off as explained in my letter last year), which *decreased* the per share book value by 2.9% (1.3%). Over the last ten years (that is, since the present owners took over) per share book value, has grown from `151 to `414 (`498), which, after factoring in dividend paid during this period, works out to a rate of 11.3% (13.1%) compounded annually.

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Many years ago, when I was still in college, I was having a chat with one of my uncles about business prospects in a tough economy. He quite matter-of-factly said a difficult environment hurts almost all businesses. Some more, some less. The experience of the last few years has been a grim reminder of the truth of those words.

It is true that quality of management can make a difference to the fortunes of a business. Which brings me to the next element that has had an important influence on our results. Some of our older shareholders will remember that our previous management team retired in FY10 and we brought in new people to run two of our businesses. Though they are both pedigreed, they produced their best results when the macro economic environment was much more supportive. With all the headwinds in both our businesses, perfectly decent people have been made to look inept. Some of the pain, of course, was self-inflicted. More on that later.

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The Drilling Solutions business saw two important developments during the year.

The older an organization, the greater the chances that a fresh set of eyes will find areas where significant improvement is possible. This is especially true for organisations that have been lulled into complacency due to their success. Success usually leads people to believe they can do no wrong and that is the starting point of things going awry.

Many years ago, we used to initiate action to manufacture a machine after we got an order. In those days, capital was a constraint and necessity led us to postpone procurement action until the last possible moment. Gradually, as the business prospered, enough capital was retained in the business. In company after company I have found that for better or for worse, the Operating team finds good reason to put that capital to work. Our team was no different and in our wisdom, we deemed it fit that we should plan ahead of time and build machines in anticipation of orders. The logic was sound – that having been in the business for long, we should be able to forecast what orders we might get and so plan in advance in order to deliver quickly after we get an order. So far, so good.

However, what happens when the environment changes? For instance, as a result of a major scam in some other industry, there are changes in the overall environment, which lead to a breakdown in the typical procurement program, et al. Initially you assume, this is a temporary blip and we will soon be back to business as usual. But after enduring prolonged pain you realize that the change is systemic and that the old methods need to be reviewed with fresh eyes. This is what led us to appoint an execution consultant to study our order fulfillment process and propose a new approach. They worked with our team for about nine months. Their mandate was to help us implement a reactive order fulfillment process which would help reduce cycle time by sixty per cent, thereby enhancing our production capacity, as well as reducing inventory by about twenty five per cent.

Given that we have lived with a different approach for many years, it will take some time to realize the full benefits but I am confident that gradually we will get there. If any of you face tenuous issues in your own organisations, I would highly recommend you talk to Ganga at Levers for Change. They are one of the nicest people I have interacted with, not to mention highly competent at what they do. The fact that a significant part of their fee is linked to achieving pre-defined targets is the icing on the cake.

The other important development was on the Marketing side. After the arrangement with Bucyrus came to an end, we decided to go directly to target geographies with a view to expanding our customer base beyond India. Last year I had mentioned that we had taken the first steps in this journey. I am happy to note that the hard work put in by the team resulted in us bagging orders for four machines from a geography we had never done business in. Any new market brings with it certain challenges and learning curve. It is no different in this case. However, I am confident that the team will put their heads together and resolve whatever issues come up in these initial years.

We have also started work on a few other markets and hope to share some more positive news next year.

Some additional overhead was built in anticipation of a better market than we had last year. Unfortunately,

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The Concreting Solutions business has remained tough due to a combination of high interest rates and all kinds of policy issues, which have deterred businesses from investing money into new projects. A slowdown in construction activity has led to contraction in total demand for concreting equipment. Slowing demand in a fragmented industry has led to price wars that have led to a diminishing profit pool.

In a tough market, it is survival of the fittest. Either become the lowest cost producer or find a niche strategy. It is times like these that force businesses to become efficient. It is nature's way of forcing people to utilize its scarce resources well. People who become efficient, survive. Nature eliminates the rest. At Revathi, we reviewed our cost structure to optimize it for our current level of operation. Though the short term will remain tough, our expectation is that as mechanization of construction activity increases and as we progress on Bharat nirman, India will need a humongous amount of concreting equipment.

It is this anticipation that has brought some of the largest global players to India. We have the Germans: Schwing Stetter, Putzmeister, Liebherr; the Chinese: Sany and XCMG and of course the Indians: Greaves, Aquarius, etc. The good news is that the consolidation process has started with first Sany acquiring Putzmeister globally and then XCMG acquiring Schwing Stetter. As a result, we now have six major players vying for the ` 14 billion market.

At the moment, net margins are low single digits, after you reach critical mass. Neither the industry size is such nor are the capital turns so high that such margins become worthwhile. Clearly this is not sustainable. Something's got to give. Sooner or later, there will have to be an improvement in price realisations to make this business worthwhile. It could happen through more industry consolidation or it could happen as a result of improved demand and resulting higher capacity utilization of the industry.

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Potential Semac continues to be in the growth mode and the published results mask the underlying story. While the market is down, we continue to invest in the future. As part of our growth plans, we invested in new offices in Navi Mumbai and Chennai, which are still young an therefore need investment before they start producing a return. We also started project management consultancy (PMC) services, and Engineering Procurement Construction management (EPCm) contracts. Finally, we brought in senior leadership at some of our Middle East offices.

The new verticals we launched (PMC and EPCm) are in effect, forward integration of what we already do. These services will help us capture a bigger part of the value chain and also help us build deeper relationships with our clients. Since the job sizes are completely different as is the risk profile, these activities have been started in a hundred per cent subsidiary of Revathi, Renaissance Construction Technologies.

PMC provides owners with the management tools for a project. The project manager acts as the interface between the client and the main contractor. We were fortunate to win the prestigious Ford plant project in our very first year. We also won a project from IIM, Bangalore.

In EPC, the company provides engineering, procurement and construction services. Here the Owner has to manage the contractor to get the project executed on schedule. EPCm is an integrated approach that delivers design and construction services under one contract with a single point of responsibility. Owners select design-build to achieve best value while meeting schedule, cost and quality goals. The service provider acts as the Owner's in-house project team and takes on the responsibility for executing the project on time and on budget. The difference between PMC and EPCm is that PMC is more akin to consulting and EPCM is getting your hands dirty during project execution. We won a few EPCm jobs during the year.

After the FIFA World Cup 2022 was awarded to Qatar, there has been a flurry of activity in that country for building infrastructure, housing complexes, etc. To capitalize on that opportunity, we brought in a senior leader. Opening up Navi Mumbai and Chennai offices are aimed at winning business in those micro-markets. One might ask as to why open so many offices. Why not have an "offshore delivery model" like they have in IT. Based on my experience, offshoring is possible when the industry reaches a certain maturity. Until then, clients want to deal with a local service provider. That way, they feel more in control of their project. These are some examples of how we are investing in the business today in the expectation that when the economy turns, we will be ready to capitalize on it.

The other important reason why the results have dropped significantly from last year is that the economy got worse and project execution slowed to a crawl. As a result billing on existing projects got delayed. To add to our misery, new project wins also slowed down. In a people's business, a big part of your cost structure is people's cost. While it is completely variable in some sense, it is totally fixed if you want to send the right signals to your time. Fire them and the best talent figures that the company does not really care about them. Keep them and you have fixed costs, which are not necessarily linked to Revenues.

After years of hurtling from crisis to crisis, we believe the pressure on government to address the real issues in the economy are growing to a point where, like 1991, some action will need to be taken.

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People familiar with Mumbai's real estate market would be aware that until 2011, the prevailing rules allowed the authorities a lot of leeway in sanctioning how much space could be built on a parcel of land. Though some rules existed, enough areas were left to the discretion of the sanctioning officer. Mr. Subodh Kumar, erstwhile Municipal Commissioner of Brihanmumbai Municipal Corporation was brought in January last year to clean up the rules and give the players in the Mumbai real estate industry a level playing field. The process of studying the issues involved and coming up with the new Development Control Rules took almost a year, during which time, no approvals were granted for any project. As a result, according to data compiled by Knight Frank, in 2011, a mere 19,470 residential units were launched in Mumbai, a drop of 65% compared to 2010.

We had acquired the slum land neighboring the land we had originally acquired. As a result, it had become a slum rehabilitation project, requiring fresh set of approvals. As a result, there was almost no progress to our project during the year. That's the bad news. The good news is that in real estate, if the location is decent, time delays are usually compensated by higher land values. So to some extent, delays affect cash flows but not profitability.

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While we are all hopeful that the macro environment will get better, it is unlikely to happen in a hurry. Until then, we have to work hard and hope for the best.