

# CHAIRMAN'S LETTER 2019-20







Our increase in consolidated net worth at the end of FY20 was Rs.141 million, which increased the per share book value by 9.5%. Over the last eighteen years (that is, since the present owners took over) per share book value, has grown from Rs.151 to Rs.570 (Rs.648 after ignoring the effect of goodwill write-offs), which, after factoring in dividend paid during this period, works out to a rate of 9.5% (10.4%) compounded annually.

We continued to make progress in our Drilling Solutions business. Historically, the Drilling Solutions business has been a cash cow, with very little growth. In the early years (between 2003 and 2010), we tried multiple things to grow the business, without much success. Then we unfortunately got hit by the Construction Equipment distraction, about which I have written in some detail in the FY16 letter. It took a whole decade to repair the balance sheet from that accident. As I mentioned in last year's letter, we were finally debt free again in FY19. While we have remained largely debt free through FY20, we drew down on our overdraft facility for a few months towards the end of the year.

Just like we cleaned up our balance sheet, over the past couple of years, we have also been working to clean up our profit and loss account. I am quite pleased with the way the team has supported our effort to become more vigilant while spending money.

As a consequence of a clean balance sheet and a tighter control on costs, we were able to deliver a seventy-five per cent growth in pre-tax profits, despite no growth in Revenues. To be sure the margins were a bit depressed in FY19 due to fairly meaningful write-offs of inventory and receivables, which totaled to Rs.3.5 crores. Adjusted for these write-offs, our pre-tax profits grew by twenty-nine per cent year-on-year. Due to the effect of deferred tax credit, our effective tax rate in FY19 was only 4.5 per cent. This went up to the maximum marginal rate of 29.12% in FY20. As a result, our year-on-year profit after tax grew by thirty one percent.

This year, we also took some initiatives to consistently grow our Revenues, going forward. Here are some specifics about the steps we took.

Historically we have been offering annual maintenance contracts to some customers. Such contracts typically guarantee a certain up time on our equipment to our customer to give them confidence that our equipment will support their production plans. Such contracts normally cover the cost of service engineers as well as the cost of spare parts consumed to keep the machine working as per agreed criteria.

This year, in addition to spares and service, we started offering consumables also. This takes the relationship with our customers deeper by a notch. So far, we were guaranteeing machine availability. With the addition of consumables to our offering, we are now able to guarantee a certain operating cost per meter drilled. In essence, wherever possible, we are trying to convert the business model from one of supplying equipment to offering a full stack service. Of course, we are not taking up drilling contracts but as we gain more experience with offering such terms, we could potentially enter that space in the future.

For the first time ever, we put in a lot of energy into pushing exports. We participated in some important trade shows on the African continent, hired some key people and also appointed distributors for various parts of Africa. Based on feedback received at these trade shows, we developed some new machines for target customers. As a result of these initiatives, we won orders for three machines, including two from the largest cement manufacturer in Africa. Unfortunately, due to the lockdown in March, the shipment got stuck en route the port and the sale could not be booked during the year.

In anticipation of building our exports business, our Finance Team secured packing credit facilities at 4.6 per cent. For the moment, we do not need to draw down on this facility. That said, as exports grow, we will be able to finance our working capital for exports at a fairly modest cost of capital.

Compared with the Drilling Solutions business, Semac had a soft year with a two percent growth in profit after tax. The good news is that we achieved this despite a thirty-eight per cent fall in Revenues over FY19. Some highlights follow.

My job #1 at Semac has been to find and groom new leadership for running the business after the Founding Principals gradually moved on between 2010 and 2016. As you know, we tried hired guns with very little success. On the other hand, giving opportunities to our own people has worked out quite well. Just that, developing people to take on higher responsibilities is a time-consuming process. Like for most other things in life, there are no short-cuts. I am quite pleased with how our people are rising to take on higher responsibilities.

The other big task we have been working on is building organization culture. It sounds very fuzzy and it is. It was Peter Drucker who said, "culture eats strategy for breakfast". The easiest way to explain this is a winning sports team. 1983 Cricket World Cup. India had no star players. But our players were playing as a team – singular focus to go all the way. And they did. The principles are the same in organisations. Getting everyone pulling in one direction is not easy. But when people get aligned, magic happens. That is why culture eats strategy for breakfast. One indication that we are on the right track is that we have won several projects from large clients like PepsiCo, Hindalco, Mars Wrigley Confectionery, etc. competing with large global competitors. As a result, our total wins for Design jobs was the highest in five years, though only just.

Unfortunately, the wins on Design Build have been slowing and we need to find a way to turn that around as well. The slowing wins has a direct impact on Revenues, with a lag of a quarter or two. So, while we ended the year fairly strongly on profitability, slowing wins means we will have a tough situation next year.

From a capital efficiency point of view, here is how things have panned out over the years. The Drill business has typically soaked up about Rs.50-60 crores of capital. The investment into Semac has been around Rs.90 crores on original cost basis (Rs.66 crores after considering the goodwill write-offs of Rs.24 crores since acquisition till date). And we have Rs.17 crores invested in the Real Estate project at Chembur.

Due to the reasons elaborated in earlier years, either Revathi or Semac made losses in eight out of the ten years between FY09 and FY18, depressing the consolidated return on equity for many years. After a lot of work at both companies over the past few years, we have had two consecutive years of profits at both companies. Going forward, things should only get better.

Barring a few exceptional years, the Drill business has typically made Rs.15-20 crores of EBITDA ever since we acquired the business in FY03. This translates to a post-tax profit of approximately Rs.10-15 crores, which implies a return on equity of roughly 20-25%.

Compared with the Drilling Solutions business, Semac has had a bit of a bumpy ride with profit after tax fluctuating between Rs.(-)5 crores to Rs.9 crores, with the average clocking at around Rs.5 crores. However, these numbers are quite misleading since barring the last five years of Semac's five-decade history, we have been a pure design consultancy firm. In FY15, we pivoted the business from a pure consulting firm to a differentiated EPC play. The economics of the EPC business, which we call Design Build, are dramatically different from the core consulting business, for the better.

However, the results have not been visible in the overall results since the core consulting business has been under a fair bit of stress due to internal and external factors. The external factors are mostly to do with industrial capex being in a state of secular decline for the past 5-7 years. I have shared the internal factors in the previous letters. By way of a quick recap, practically all of the Founding Principals of both Potential and Semac (the two companies we acquired in 2007 and 2008 respectively) left the company to set up their own competing practices, taking away key staff and customers. There was a non-compete in force, but the legal opinion we got was that such clauses are really not enforceable. This forced us to reimagine the way we do business, including identifying new leaders, setting up new business processes and even a new business model. All that strife served us well when we got hit by SARS Cov-2 towards the end of the year, when we shifting to working from home almost overnight without missing a heartbeat.

Going forward, the Design Build business is going to be a strong growth engine for Semac, with good return on capital ratios. That said, it will take us a few more years for the return on overall capital employed in Semac to become healthy. With the core consulting having stabilized and growth coming from the Design Build business, I believe better times are ahead for Semac. As such, we concluded, with your approval, a fresh investment of Rs.25 crores for acquiring a controlling interest in Semac Construction Technologies, about which I had written in some detail in last year's letter. That takes the total capital employed in Semac's business to Rs.115 crores (Rs.91 crores after considering goodwill write-offs).

At Revathi, we have had net debt (total debt less cash in hand) on our balance sheet since FY07. The situation changed in FY19 after twelve long years. Semac had no treasury up until FY12. We gradually started building our cash reserves in FY13, which peaked out at Rs.25 crores in FY17. Post that, we have had some serious losses in the Consulting business, which were offset by profits in the Design Build business. Also, our focus on working capital also helped in funding some of the losses through converting some of the working capital into cash. As a result, our treasury contracted only by about Rs.5 crores over the next few years to stand at Rs.21 crores at the end of FY20.

At a consolidated level, our group treasury stood at Rs.30 crores at year-end. A part of this was used to fund the growth of the Design Build business and some was invested to earn treasury income. Going forward, I am hopeful that our Group treasury will expand, thereby allowing us to add a new source of income.

Of course, the role of treasury is not just to be productive. It is also a war chest for any possible strategic move. It is also savings for a rainy day.

I would like to thank our people for putting their heads down and making sure we don't concede defeat over the past few years. We have had periods where we were not able to pay salaries on time. And yet, our people soldiered on. That was an incredible act of faith on their part. I am humbled and touched by their commitment to the cause. Thankfully, we are out of that predicament. And I have our people to thank for it. But for their dedication and commitment, we would not have been able to climb out of the deep hole we found ourselves in a few years ago.

After a long time, we are in a strong position and I am sure we now have a solid foundation on which we will build the Revathi and Semac of tomorrow. Stay tuned.