

IT'S COOL AT THE TOP

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 **BLUE STAR**
A N N U A L
R E P O R T
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**BLUE STAR**

August 11, 1998

Dear Shareholder:

The notice and explanatory statement for the Annual General Meeting to be held next week includes business pertaining to your Company's plans to spin off its software business. Some of the details and benefits of this proposal may not be evident to you. I am, therefore, writing this letter to give you a more complete picture and also to clarify how this is in the interests of all shareholders of Blue Star.

Your Board of Directors is recommending, for your approval, a scheme which involves the Company's fast growing and highly profitable software exports business carried out by its International Software Division (ISD). It is intended that this business be transferred to a separate, listed company to be called BLUE STAR INFOTECH LIMITED (BSIL). This move will provide a sharp focus to our software exports and will also give you a personal stake in a well-established business with enormous potential.

ISD was started fourteen years ago and has delivered over 1000 person years of software development work to overseas clients, 75% of it to customers based in the U.S.A. Its other customers are equally divided between Europe and the Asia Pacific Region. ISD has established a reputation as a provider of high-technology, cost-effective solutions.

ISD presently offers software services for turnkey offshore projects for design and development of new applications on open systems; maintenance and reengineering of legacy systems; onsite consulting, and related activities. It has recently entered specialised, hi-tech areas such as medical imaging software and Baan ERP implementation services. ISD presently has 20,000 sq. ft. of software development facilities in SEEPZ (Mumbai) and Bangalore, and is in the process of acquiring additional premises to meet the growing demand. A U.K. office is being opened shortly.

Our software services are marketed in the U.S.A. by a fully-owned subsidiary of the Company, USIN International Inc., which is located in Silicon Valley in the U.S.A. It will shortly open an office in the State of Indiana. Your Company has received approval from the Reserve Bank of India to increase USIN's equity to \$ 100,000 and to open a line of credit upto \$ 900,000. It is also proposed that USIN be hived off by Blue Star Limited and become a wholly owned subsidiary of BSIL.

As you can see in the table below, revenues were Rs 14.58 crores in 1996-97 and grew to Rs 20.62 crores in 1997-98. Profit before interest and tax last year jumped by 88% from Rs 2.40 crores to Rs 4.50 crores.

(Rs. Crores)

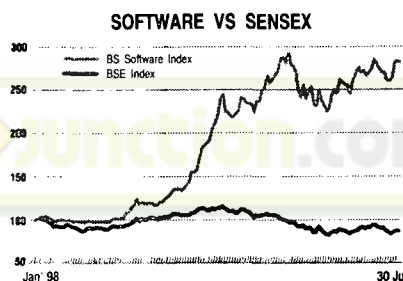
	1996-97	1997-98	Apr-Sep '98
	Audited	Audited	Estimated
Total Income	14.58	20.62	15.35
Cost of Sales	10.50	13.82	9.25
Operating and General Expenditure	1.40	1.87	1.47
Depreciation	0.29	0.43	0.28
Total Expenditure	12.19	16.12	11.00
Profit before Interest and Tax	2.39	4.50	4.35

**BLUE STAR**

BSIL will have a share capital of Rs 10 crores. To ensure liquidity, listing will initially be sought on the Bombay Stock Exchange and later on the National Stock Exchange. 3% of the share capital will be retained in an Employee Stock Option Plan designed to attract and retain talent in an industry where the attrition rate is very high. In order to demonstrate continuing commitment and support, your Company will subscribe to 29% of the equity.

The remaining 68% of the equity will be offered to the shareholders of Blue Star Limited in the ratio of one equity share for every four shares held. This move is calculated to add value to your shares, as the present market price of shares of Blue Star Limited does not appear to recognise fully the true value of ISD because it is a comparatively small division within Blue Star and not very visible. Additionally, as it is a division of Blue Star, the Company has been unable to benefit fully from the exemptions offered for export income under section 80 HHE of the Income Tax Act.

Software services have been doing well in the stock market and have out performed other scrips. The graph of the Business Standards' Software Index compares the movement of software shares versus the BSE Index.



Source : Article "Software scrips logging impressive gain in price"

- Business Standard, Mumbai, dated 3/8/98

In view of the trends in the international software business, the proliferation and use of information technology, and the encouragement given by the government to software exports, the growth potential of the new company is very attractive. Revenues will grow rapidly by about 50% per annum and will exceed Rs 200 crores by 2002-03. Net profit will grow even faster and reach Rs 33 crores. We estimate conservatively that the earnings per share of BSIL will quadruple in three years from an expected Rs 8 per share in 1999-2000 to Rs 33 in 2002-03. The future financial projections are also shown graphically.

Although BSIL will be closely linked with your Company, it will, as a separate body, have far greater flexibility and focus and the opportunity to grow faster and more aggressively.

With its low debt/equity ratio and not being capital-intensive, Blue Star Limited does not need such a large equity base without the software division. We would be overcapitalised. Your Directors, therefore, recommend for your approval a reduction of the issued share capital of Blue Star Limited by 25%, which is in line with the Company's level of activity following the separation of ISD. Thus, for every four shares of Blue Star Limited, you will continue to hold three shares of Blue Star Limited and will get one share of BSIL. Your proportional holding in Blue Star Limited will not be diluted in the process. As a percentage of the total equity of Blue Star Limited, your ownership will remain unchanged.



The proposed effective date of transfer of the software business to BSIL will be October 1, 1998. However, the lengthy legal and statutory procedures including an Extraordinary General Meeting convened by the High Court and ending with listing on the Bombay Stock Exchange may extend till March '99. The book closure date for the scheme should be around January '99. These are approximate dates because much depends on when we receive clearance from the court and your approval. In any case, we would make the transfer of the business retrospective to October 1, 1998.

As a consequence of the spin-off, you may receive odd lots of shares in one or both of the companies. Since marketability is often a problem with odd lots, we intend to provide you with avenues to trade the shares by setting up two odd lot trusts, one for Blue Star Limited's shares and one for BSIL's shares. The details are being worked out and will be communicated to you in due course.

The spin-off will obviously reduce Blue Star's profit. But in view of the simultaneous reduction in equity, the impact on earnings per share and dividend is not likely to be significant. On the whole, Blue Star is financially stable and has a strong balance sheet, so there should not be any serious cause for concern of the impact on Blue Star.

To summarise, the spin-off of the International Software Division as a separate entity will:

- o Give you a direct stake in a fast growing sunrise industry at no additional cost to you.
- o Offer the potential of significant capital appreciation because the price earnings ratios of software companies are markedly higher than those of engineering companies. I am confident that this will also be true of BSIL.
- o Enable the new company to avail of the substantial concessions available under the Income Tax Act. The anticipated tax savings for six months of 1998-99 will be in the region of Rs 0.7 crores projected to grow to Rs 8.5 crores by 2002-03.
- o Allow BSIL to offer its key employees a lucrative stock option plan in order to attract and retain them.

This new initiative reaffirms your Company's commitment to all shareholders. Your Directors recommend your support for and approval of these initiatives.

Yours sincerely,

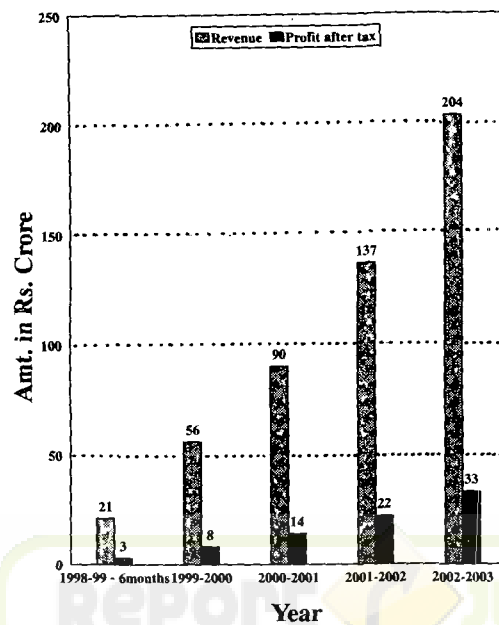
ASHOK M. ADVANI
Chairman & Chief Executive

Blue Star Limited, Kasturi Buildings, Mohan T Advani Chowk, J Tata Road, Mumbai 400 020.

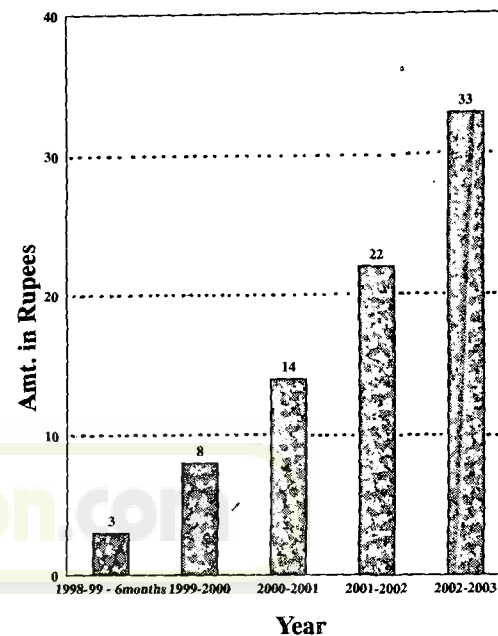


BSIL - The Growth Plan

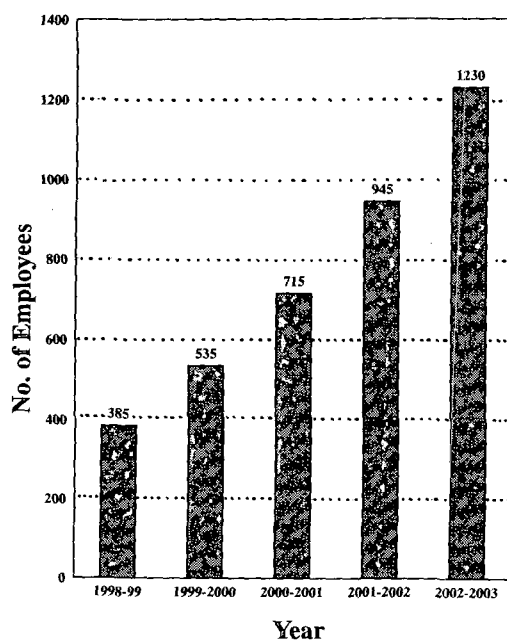
Revenue and Profit after Tax



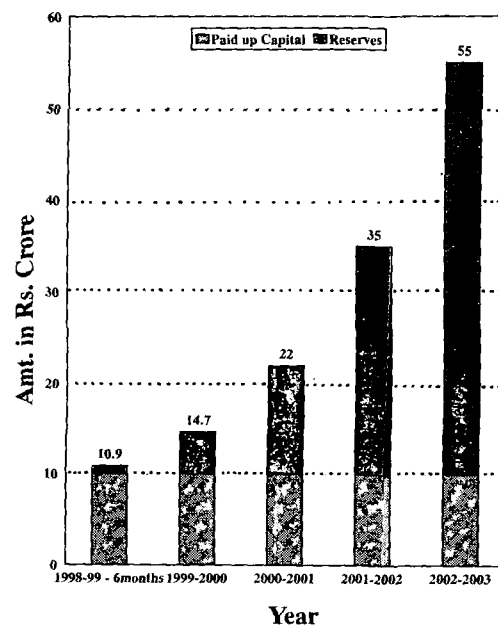
Earnings Per Share



Employees



Networth



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Board of Directors

Ashok M Advani
Chairman & Chief Executive

Suneel M Advani
President & Vice Chairman

Bal K Malhotra
Executive Director

Atul Choksey

Uday Kotak

G Ramchandani

Minoo R Shroff

Suresh N Talwar

Corporate Management

Ashok M Advani
Chairman & Chief Executive

Suneel M Advani
President & Vice Chairman

Bal K Malhotra
Executive Director

MD Mansukhani
Executive Vice President

T G S Babu
Vice President
Packaged Airconditioning Division

R N Bhawe
Vice President
Information Technology & Systems

H N Ganatra
Vice President
International

V V Inamdar
Vice President
Industrial Division

Satish Jamdar
Vice President
Dadra Plant

Arun Khorana
Vice President
Electronics Group

Asit B Mohapatra
Vice President
Human Resources & Quality

A S Prakash Rao
Vice President
Eastern Region

Assar S Sambtani
Vice President
International Software Division

S Sankaran
Vice President
AC&R Projects, Southern Region

M S Sethi
Vice President
Thane & Bharuch Plants

Neeraj Seth
Vice President
Commercial Equipment Division

N Sivasankaran
Vice President
AC&R Projects, Northern Region

Company Secretary

K P T Kutty

Bankers

The Hongkong & Shanghai
Banking Corporation Ltd.
ANZ Grindlays Bank
State Bank of India
Oriental Bank of Commerce
ABN-AMRO Bank
Banque Nationale De Paris
Bank of Baroda
Abu Dhabi Commercial Bank

Auditors

K S Aiyar & Company,
Mumbai

Branch Auditors

R Venkatarama Aiyar & Company,
Calcutta
Fraser & Ross, Chennai
Mohinder Puri & Company,
New Delhi

Registrars & Share Transfer Agents

Consolidated Share Services
Private Limited
Shantinagar, Cross Road A
Near MIDC Bus Depot
Andheri (East)
Mumbai 400 093

Registered Office

Kasturi Buildings
Mohan T Advani Chowk
Jamshedji Tata Road
Mumbai 400 020
Telephone : 2020868
Telex: 011-82156
Fax: 91-22-2025813

The Directors are pleased to present their 50th Annual Report and the Audited Accounts for the year ended March 31, 1998.

Highlights of 1997-98

- * The pronounced slowdown in the Indian economy for the second year in a row resulted in a modest growth in total income to Rs. 452.77 crores from Rs. 440.85 crores in the previous year.
- * Export earnings showed encouraging growth from Rs. 21.64 crores to Rs. 35.19 crores, an increase of 63%.
- * Profit after Tax improved by 5% to Rs. 15.51 crores.
- * The Company added Rs. 38.93 crores to the Gross Block of fixed assets.
- * Internal generation of funds (Profit after Tax plus Depreciation) grew from Rs. 19.14 crores to Rs. 23.63 crores.
- * Equity dividend is being maintained at 35%.

DIRECTORS' REPORT

Summarised Financial Results

	April '97 March '98 Rs. Lakhs	April '96 March '97 Rs. Lakhs
Total Income	45277.31	44084.88
Profit before depreciation and taxation	2616.19	2757.04
Depreciation	811.83	435.88
Provision of taxation	253.00	843.00
Profit After Taxation	1551.36	1478.16
Add: Balance brought forward	983.46	919.11
Transfer from:		
Investment Allowance Reserve	—	17.73
Debenture Redemption Reserve	—	250.00
Foreign Projects Reserve	—	0.20
Total available for appropriation:	2534.82	2665.20
Less: Foreign Projects Reserve	—	38.50
General Reserve	400.00	600.00
Dividend	948.40	948.40
Corporate Dividend Tax	94.84	94.84
Balance carried forward-	1091.58	983.46

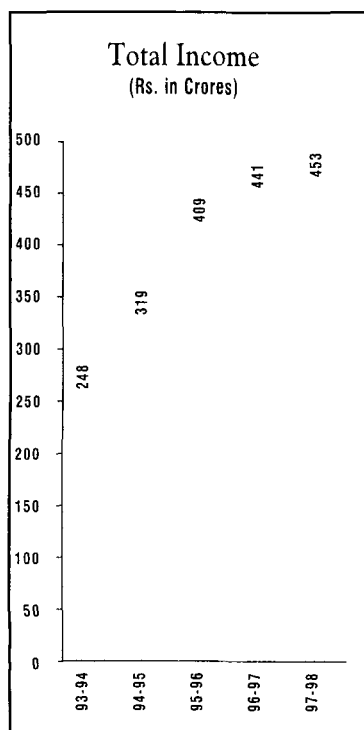
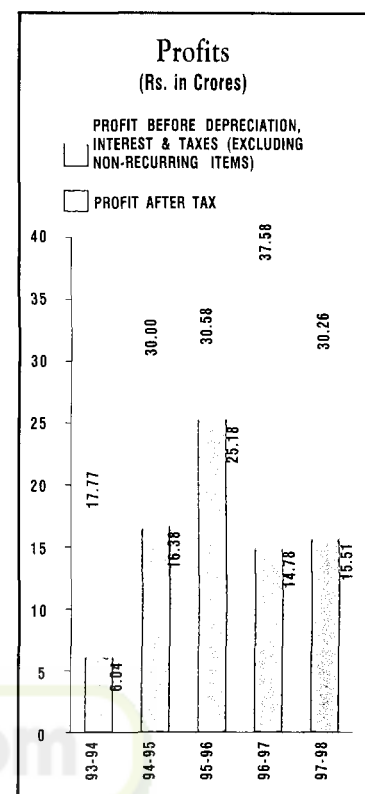
Dividends

The Directors propose maintaining the equity dividend at Rs. 3.50 per share. The dividend will absorb Rs. 1043.24 lakhs including Corporate Dividend Tax.

Operating Results

With the slowing down of new order inflow there was a simultaneous erosion of market prices due to competitive pressures. This required a continuous drive to keep costs under control. Aggressive purchasing and innovative design and engineering and productivity improvement enabled the Company to virtually maintain the average gross margin inspite of lower price realisation in the market.

Substantial investments were made for improving manufacturing processes to improve quality and reduce production cost. The Company entered into technology tie-ups with Kolpak, U.S.A., for coldrooms and Climatrol, Italy for double skin airhandling units. These products are to be manufactured at the Thane and Bharuch plants.



Financial Position

An encouraging development last year was the decline in interest rates. As a result, interest cost increased but moderately, although the capital employed was higher than in the previous year.

Additions to fixed assets during the year amounted to Rs. 38.93 crores which resulted in a significant increase of 86% in depreciation. This enabled the Company to reduce its tax burden by 70%.