Kirloskar

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KIRLOSKAR OIL ENGINES LIMITED | Annual Report 2004-05

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True progress is nothing but a result of true understanding, true effort and true commitment in every endeavour, small or big. It is the seamless integration of these attributes that enables us overcome challenges and consistently achieve milestones. Today, we are not just growing, but progressing from strength to strength. Something which is reflected in our comprehensive financial performance.

- Increase in Sales by 15% to INR 11,486 M.
- Auto Component Sales go up by 7% through increased supply to OEMs.
- Net Current Assets reduced by 18% in spite of increased sales.
- Exports shoot up by 47% to INR 899 M, and International OEM Customer development initiative continues.
- R&D CAPEX increased five folds to INR 41 M.
- Profit of INR 1,133 M on sale of investments.
- Executed Gas Turbine packaging agreement with Zorya of Ukraine to extend product range for Distributed Power Generation.

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Annual report for the financial year ended on 31st March 2005

Board of Directors

Mr. Atul C. Kirloskar	Chairman and Managing Director
Mr. Sanjay C. Kirloskar	Vice Chairman
Mr. Gautam A. Kulkarni	Joint Managing Director
Mr. Rahul C. Kirloskar	Director (Exports)
Mr. V. K. Bajhal	
Dr. N. A. Kalyani	
Mr. H. M. Kothari	
Air Marshal Y. V. Malse (Retd.)	
Mr. P. G. Pawar	
Mr. U. V. Rao	
Mr. Vikram S. Kirloskar	
Mr. A. N. Alawani	Director (Finance)
Mr. D. R. Swar	Director (Large Engines, Auto Components Business Groups and HR)
Mr. R. Srinivasan	with effect from 20 January 2005
Mr. R. R. Deshpande	Director (Medium and Small Engines) with effect from 29 April 2005

Assistant Company Secretary
Ms. Aditi Chirmule

Auditors
M/s. Dalal & Shah, Chartered Accountants

Bankers
State Bank of India
Bank of Baroda
Bank of Maharashtra
HDFC Bank Ltd.
The Cosmos Co-operative Bank Ltd.

Registrar & Transfer Agent
Intime Spectrum Registry Limited
Mumbai Office
C-13, Pannalal Silk Mills Compound,
Lal Bahadur Shastri Marg,
Bhandup (West), Mumbai - 400 078

Pune Office
102, Vidyanand, Dr. Ketkar Path,
Erandwane, Near Old Karnataka High School, Pune - 411 004

Registered Office
Laxmanrao Kirloskar Road, Khadki, Pune - 411 003

Location of Factories
Pune, Ahmednagar, Nasik, Solapur, Hospet

Information for shareholders

Annual General Meeting

Date	:	Friday, 15 July 2005
Time	:	10.30 A.M.
Venue	:	Registered Office of the Company
Proposed Dividend	:	75% (Rs. 7.50 per share of Rs. 10 each) [This is in addition to 50% (Rs. 5 per share of Rs. 10 each) paid as Interim Dividend]
Dates of Book Closure	:	5 July 2005 to 15 July 2005 (both days inclusive)

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DECADE AT A GLANCE

(Rupees in Millions)

	31st March									
Particulars	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Gross Fixed Assets	2112.42	2366.66	2556.98	3291.16	3503.44	3609.95	3715.83	3902.39	3863.98	4215.08
Net Fixed Assets	1469.01	1583.59	1518.80	1731.41	1654.92	1537.63	1391.69	1414.25	1295.07	1446.87
Net Current Assets	1304.72	2635.31	3614.32	1995.19	2022.57	1236.49	1280.68	914.38	1194.87	973.65
Total Capital Employed	3714.05	5147.94	6558.38	5458.11	5315.51	4661.83	4795.31	4063.32	4504.26	6204.67
Shareholders' Funds	1566.89	2000.63	3475.73	2919.46	3665.01	3508.06	3637.05	3670.65	4157.57	5620.76
Sales	6138.96	6158.42	6313.52	7133.76	7447.95	7941.59	7444.60	8812.60	10412.82	11825.87
Profit Before Tax	213.38	576.93	1716.87	159.19	890.93	417.03	274.00	383.01	1056.01	2012.78
Retained Earnings	157.20	429.67	1421.30	72.41	745.22	210.97	118.76	301.20	486.92	1463.18
Amount of Equity & Preference Dividend	41.80	42.71	60.65	66.55	67.07	67.07	67.07	97.09	194.16*	242.71**
Equity Dividend%	25	25	35	35	35	35	35	50	100*	125**
FOB Value of Exports	193.56	150.80	169.14	293.43	306.99	443.31	353.07	378.39	610.10	898.88

***Includes SLK Birth Centenary Special Interim Dividend of 50% (Rs. 5 per share) paid in December 2003.**

****Includes Interim Dividend of 50% (Rs. 5 per share) paid in November 2004.**

NOTE :
Preference shares were redeemed during the Financial Year 1996-97.

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Directors' Report

To the Members,

The Directors have pleasure in presenting this Report with audited annual accounts of the Company for the year ending 31 March 2005.

Financial Performance:

(Rupees in 000's)

	2004-2005	2003-2004
Total Income	12,060,157	10,639,382
Total Expenditure	11,043,806	9,582,253
Profit before exceptional items and taxation	1,016,351	1,057,129
Exceptional Income / (expenses)	996,427	(1,116)
Profit before taxation	2,012,778	1,056,013
Provision for tax (including Deferred Tax)	273,832	348,354
Net Profit	1,738,947	707,659
Surplus (After other adjustments)	2,127,465	857,498

Appropriations

Your Directors propose to appropriate the available surplus as follows:

	(Rupees in 000's)
Proposed Dividend	145,630
Interim Dividend	97,087
Corporate Tax on dividend	33,113
Transfer to Contingency Reserve	NIL
Transfer to General Reserve	250,000
Balance carried to Balance Sheet	1,601,635

Dividend:

In addition to the Interim Dividend of 50% (Rs. 5 per share) paid in November 2004, the Directors recommend a final dividend of 75% (Rs. 7.50 per share) for the year (previous year dividend was 100%), totalling to yearly dividend of 125% (Rs. 12.50 per share).

Management Discussion and Analysis:

The operations of your Company comprise of Engine and Engine Bearings and Valves. This business segmentation forms the basis for review of operational performance.

A. Industry Overview:

The Industry had to face the following impacts in the year under review.

- Raw Material (Steel and non-ferrous metals) cost increase of 60% to 70%. Competitive markets and unwillingness of customers to accept unprecedented price change resulted in pressures on margins.
- Emission and Noise Regulation change impacted sales of gensets due to uncertainty and unwillingness of customers to accept significantly higher price.

During the year under review, the Indian economy and particularly the manufacturing sector has grown robustly. The automobile sector has also registered strong growth over previous year. The tractor market also

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recovered, and tractor exports are increasing year by year. The resultant growth is also seen in capital goods sector. The services sector of the economy also continues to grow robustly.

It is heartening to note that the central government has declared that agriculture, road construction, and housing will continue to be their priorities and has announced various schemes. We are sure that effects of the public expenditure will be soon felt on the economy.

This vibrant economic scenario generated good demand for power generating sets, construction and material handling machinery and automobile components. However, in the irrigation pumpset sector, the demand for diesel pumping units dropped by 35% due to announcements by the States of free supply of electricity to farmers, rising diesel fuel costs, and increased prices of diesel pumpsets due to steep increase in iron, steel and non-ferrous metal prices. Moreover, the input cost increases could not be fully passed on to the consumers resulting in pressure on margins.

For last couple of years, the generating set industry below 19 kW output has been under threat from alternate source of standby power for homes, shops, and offices – the Inverters. Over time, the performance of the inverters has improved and the prices have reduced. Thus, in lower ratings of upto 6 kW, the genset market is steadily shrinking.

In addition the emission and noise regulation by Ministry of Environment and Forest concerning generating sets came in effect during the year. The industry was immediately impacted by lower sales and deferment of purchases by customers. The increase in the price of generating sets to comply with the regulations is very high in case of output ratings upto 19 kW. This has aggravated the drop in market for lower outputs in range upto 19 kW.

While there is also an increase in price of generating sets of outputs over 19 kW, the consumers have reconciled to the increased price levels to meet the regulation and market for this class of generating sets continues to increase in double digits.

B. Company Performance:

Highlights of your Company's performance are as under.

- Increase in Engine Sales Value though engine volumes up to 20 hp dropped.
- Exports increased by 47% to INR 899 M.
- International OEM Customer development continues.
- Executed Gas Turbine packaging agreement with Zorya of Ukraine to extend product range.
- Income from sale of shares INR 1,133 M.

During the year under review your Company achieved sales of Rs. 11,486 Million (previous year Rs.10,025 million) in spite of sharply reduced farm machinery market resulting in increase in sales by 14.6% over previous year.

The profit before tax and exceptional items is Rs. 1016.35 million (previous year Rs. 1057.13 million), profit before tax after exceptional items is Rs.2012.77 million (previous year Rs. 1056.01 million) and profit after tax is Rs. 1738.95 million (previous year Rs. 707.66 million).

Analysis for both segments – Engines and Engine Bearings and Valves is presented below.

C. Segment-wise Operational Performance:

Engines:

The sales of engines registered 15% increase at Rs. 8,954 million (previous year Rs. 7,807 million) in the year under review.

The engines up to 20 hp are used in the farm machinery, generating sets and construction machinery. In this range, your Company faces competition from several domestic players, and imports from China. The Company's strategy is to expand market share by in-depth effective marketing activities in the potential villages, and

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offer products for each use while improving distribution network in depth, quality and service. However, the irrigation diesel pumpset market dropped by 35% in the year under review. Company's sale of this range of engines dropped to 84,770 units as compared to 124,361 units in the previous year. A drop of 32%. However, the drop in sales in rupee terms was arrested to 14% at Rs. 1,690 million by improved product mix and higher sales of products with better unit price.

These engines upto 20 hp use Iron and Steel in much larger proportion as compared to higher output engines. Thus, the Company has started design of less material intensive products to meet the price levels desired by farmers.

The engine in the output range 20 hp to 720 hp is predominantly sold for power generation, tractors and industrial and construction machinery.

The tractor market grew by 22 %. The resultant growth in Company's sales was in-line with market growth.

The Power Generation market experienced dramatic growth in the year under review mainly due to demand from manufacturing, telecommunication and services sector. Company's sales to power generation segment increased by about 35%.

"Kirloskar Green Power Ideas" brand under which gensets are marketed in India has become the preferred brand, and is now also introduced in selected countries.

We assess that Construction and Material Handling Equipment has good prospects in the country. In the year under review, Company's sales to this sector grew by 16%.

The Company is an established supplier for decades to the Indian Armed Forces of engines and engine based systems. In the year under review, Company has expanded range of its supplies to the Armed Forces, and sales have increased.

The Company introduced generating sets in 250 to 600 kVA range two years ago. These products now command a share of about 15% in Indian market.

In range 1600 to 11000 hp Company delivered two marine engines and nine generating sets. The doubling of sales of generating sets in 2.5 MW class and strong order board for these affirms the customers confidence in the Company to deliver quality products at competitive prices.

To expand product range and also offer gas fuelled power generation products to large consumers of power, your Company has entered into an agreement with Zorya of Ukraine, a reputed manufacturer of gas turbines. Under this agreement, the Company will package turbines and offer distributed power generation solutions in 2.5 to 40 MW class.

In the year under review Company has enhanced its customer centricity by implementing world class Customer Relationship Management (CRM) solution that runs on Internet. The use of the CRM solution by Service Dealers and field service personnel has started. This will increase satisfaction of customers with Company's products and service, which in turn will lead to sustainable market leadership.

Engine Bearings and Valves:

The buoyant automobile market, especially commercial vehicle and car markets grew robustly in the year under review. However, the "after-market" dipped in the year because the number of engines overhauled went down. This is result of improved life of automotive engines, better roads and improved oils, fuels and maintenance. Thus, your Company's sales to OEM market increased by 15% and sales to "after-market" reduced by 7%. Overall growth was limited to 5% mainly due to capacity constraints. The Company initiated investments in plant and machinery during the year and increased capacity will start coming on stream in current fiscal. The resultant growth in your Company's sales was about 8% over previous year at Rs. 1,043 million (previous year Rs. 968 million).

It is noteworthy that three leading Automotive OEM customers have increased purchases from your Company significantly due to superior service, near zero defects, and quicker product development.

Bearing plants at three locations were certified to TS 16949 standard. This certification is necessary to

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develop OEM supply relationships with global OEMs.

The sales of engines valves grew by about 20% in the year under review.

Other Businesses:

The oil trading business grew by 73% over previous year and sales of castings grew by 30% over previous year.

As mentioned in the previous year, business of power was de-emphasised, as it is not remunerative.

Research and Engineering:

Company keeps its technology up to the mark by continuously enhancing the learning and knowledge of employees and investing in leading software and hardware. The Company also maintains relationships with leading global consultants for external validation.

In last couple of years, your Company has invested in the Emission Centre, and analysis and simulation software like BRICKS, BOOST, GLIDE and EXCITE from AVL, Austria and ANSYS for finite element analysis. Employees have been trained to use these modern tools effectively.

Corporate Social Responsibility:

In the year under review, Company has contributed to the following social causes.

- Contribution of Rs. 16,00,000 to Prime Minister's Tsunami Relief Fund. This is matching contribution to the contribution by employees out of their salaries.
- Sponsored education and health of under privileged children through social organisation – Akanksha.
- Encouraged tree plantation by distributing saplings.
- Organised free pollution check of two wheelers for students.
- Periodic spraying of insecticides in surrounding residential areas to improve health of community.
- Encouragement to school children to visit company's plants.
- Free health check to poor sections of surrounding community.
- Community perception survey has been carried out and specific initiatives are taken to improve perception.

Cost Control:

Your Company believes that costs have to be continuously brought down while improving product performance. Towards this objective, several initiatives started in previous years have delivered results in the year under review. Significant initiatives resulting in permanent cost saving are mentioned below.

- Energy conservation to the extent of 60,000 kWh per year in addition to savings in LPG and HSD.
- Improvement in manufacturing processes to cut conversion costs and process rejection.
- Improvements in business processes to cut Sales and Administration costs.

In the year under review, the Company reduced scrap, improved plant ambience and house keeping. Through workshops and small group activities Company has inculcated feeling of ownership and sense of belonging amongst all levels of employees. This has brought about significant change in productivity and accountability.

The implementation of the Total Quality Management's (TQM's) '5S' principles was initiated during the year and several areas and departments have now qualified to levels of 2S. Progress continues to achieve 5S status at the earliest.

To reduce defects and also improve productivity, concept of Pokayoke (no fault forward) has been pursued in the plants and initial success is spurring employees to make this integral part of your Company's working.

In the year under review, economy experienced steep increase in Iron and Steel and Copper prices. The impact of increase was also felt by your Company and efforts were made to pass on the increase to the market. Due to inability of the markets to fully absorb price increase, the Raw Material consumption increased as a

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percentage to sales during the year under review.

D. Exports:

In the year under review, the exports of the Company grew by 47% to Rs. 899 million (previous year Rs.610 million).

Your Company traditionally exports engines, diesel pumpsets and generating sets mainly to Africa, Middle East, and Asian Region. In order to increase exports, Company has upgraded products to meet international market expectations in the previous years. The results of specific efforts to increase exports are now showing as geographic and customer class portfolio is being expanded. Though OEM business takes time to develop momentum.

Company has started seeing initial successes in securing OEM customers in overseas markets, and exports of generating sets. Simultaneously, the essential and time-consuming activity of creating after sales service network in chosen overseas markets continues.

The efforts to increase exports of engine bearings, bushes and valves have resulted in a significant rise in sales. The focus for this product group is to develop new products targeted at precise needs of the foreign markets. Thus, this business is now leveraging Company's capability to design and develop bearings and valves on the strength of Company's engine design capability.

With continued efforts, Company is expected to soon cross Rs.1,500 million mark in export sales.

E. Concerns and Threats:

Rising prices of Steel, Iron and non-ferrous metals impact Company's material costs significantly. While efforts are made to convince the customers to accept the corresponding rise in prices, it is rarely possible to recover full impact of the cost rise in the prices due to competitive pressures. To protect the margins to the extent possible, balance has to be stuck between rising material costs, savings in costs by the Company by various initiatives and the price increase.

Delays in public spending as announced in the budget can impact Company's growth in sales.

We notice signs of competitive pressure from foreign manufacturers in the range up to 20 hp engines. Your Company is addressing the threat by developing new cost effective products precisely targeted at meeting customers' needs, and also to attend to cost increase in Iron and Steel that could not be fully passed on to the market.

F. Prospects for Current Year:

The domestic farm machinery market in engine range up to 20 hp is expected to remain weak due to inability of market to absorb price increase necessitated due to increase in Iron and Steel prices. The Company's efforts are to design products that meet customers' expectations while lowering costs. However, such products will be introduced only in subsequent years.

The tractor market is growing. Moreover, tractor manufacturers are increasing exports of tractors with our Company's emission compliant engines. We believe that these factors will result in healthy increase in sales in the current year.

The genset market is expected to continue its growth driven by demand from manufacturing and services sector in the vibrant economy. Barring unforeseen developments, the genset market, and your Company's sales to this market will grow in the current year.

Growth in sales is also expected in Construction and Material Handing market.

As the growth of automobile sector continues and increased capacity for bearings and valves comes on stream, your Company expects to increase sales of Engine Bearings and Valves.

With the healthy growth in domestic sales and exports expected in coming years, and also to meet product up-gradation needs, the Company continues to invest adequately in plant and machinery. The capital expenditure is targeted to expand capacity, develop new products, improve quality, and reduce costs.

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Value Added Tax:

The Value Added Tax (VAT) regime brought in effect from 1 April 2005 will reduce the costs of manufacture and is certainly a welcome step. Your Company's systems and procedures have been attended to comply with the new regulations.

We look forward to VAT regime being implemented in all states and quick resolution of remaining anomalies.

Company looks forward to the current fiscal with optimism and expects overall results to be better than the year under review.

Cautionary Statement:

Statements in this Report, particularly those which relate to Management Discussion and Analysis, describing the Company's objectives, projections, estimates and expectations may constitute "forward looking statements" within the meaning of applicable laws and regulations. Actual results might differ materially from those either expressed or implied.

G. Internal Controls Systems and their adequacy:

Your Company's operations are IT enabled for the last few years by use of the world-renowned Enterprise Resource Planning (ERP) system. In the year 2000, the entire Supply Chain from dealers to factories, to suppliers was Internet enabled for on-line eCommerce transactions. In the year under review, the Company is using these proven solutions to cover all its operations including sales offices and logistic service providers.

The selected auditing firms continue to conduct Internal Audit of the Strategic Business Units, Corporate Services, and Area Offices of your Company. The system weaknesses noticed during the audits have been attended to the satisfaction of the Audit Committee of the Board of Directors.

H. Personnel and Human Resource:

With the objective to prepare the Company to expand its scale of operations, develop new markets, compete with global players in global markets, company has taken various initiatives to identify the required skill and competency sets. Specific training programmes and workshops were conducted to enhance competency and skill to meet the challenges of the future.

The Company follows the philosophy of Business Excellence as devised by CII EXIM Business Excellence model. The Company is preparing to excel by paying increased attention to enablers and processes to ensure results.

In the year under review,

- 736 Kiazens were implemented, and this movement continues to gain momentum.
- 42 Quality Circles operated successfully and 3 Quality Circles were selected for QCFI International Conventions at Bangkok and Singapore

To encourage employees to learn higher skills and enhance capability, the Company sponsors employees to post graduate education. Employees are benefiting from these schemes.

In the year under review, Company conducted assessment of Employee Satisfaction by engaging reputed research organisation – Gallup. The results of the assessment are being used to formulate specific initiatives.

As exceeding attention is necessary to Research and Engineering and Quality Assurance, these functions have been strengthened and made reportable directly to Directors.

Company continues to enjoy healthy and productive relationship with employees. The Wage Agreement with the employee Union for the next period of three years came in effect at Pune plant from 1 April 2005. Thus, the employee expenses increased by 22.7 % in the year. With increased sales and improved productivity, we expect the employee related expenses to reduce as a ratio of sales in coming years.

I. Environment:

Your Company has to deal with the environmental issues on two fronts. One, the Company's products (that is,

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