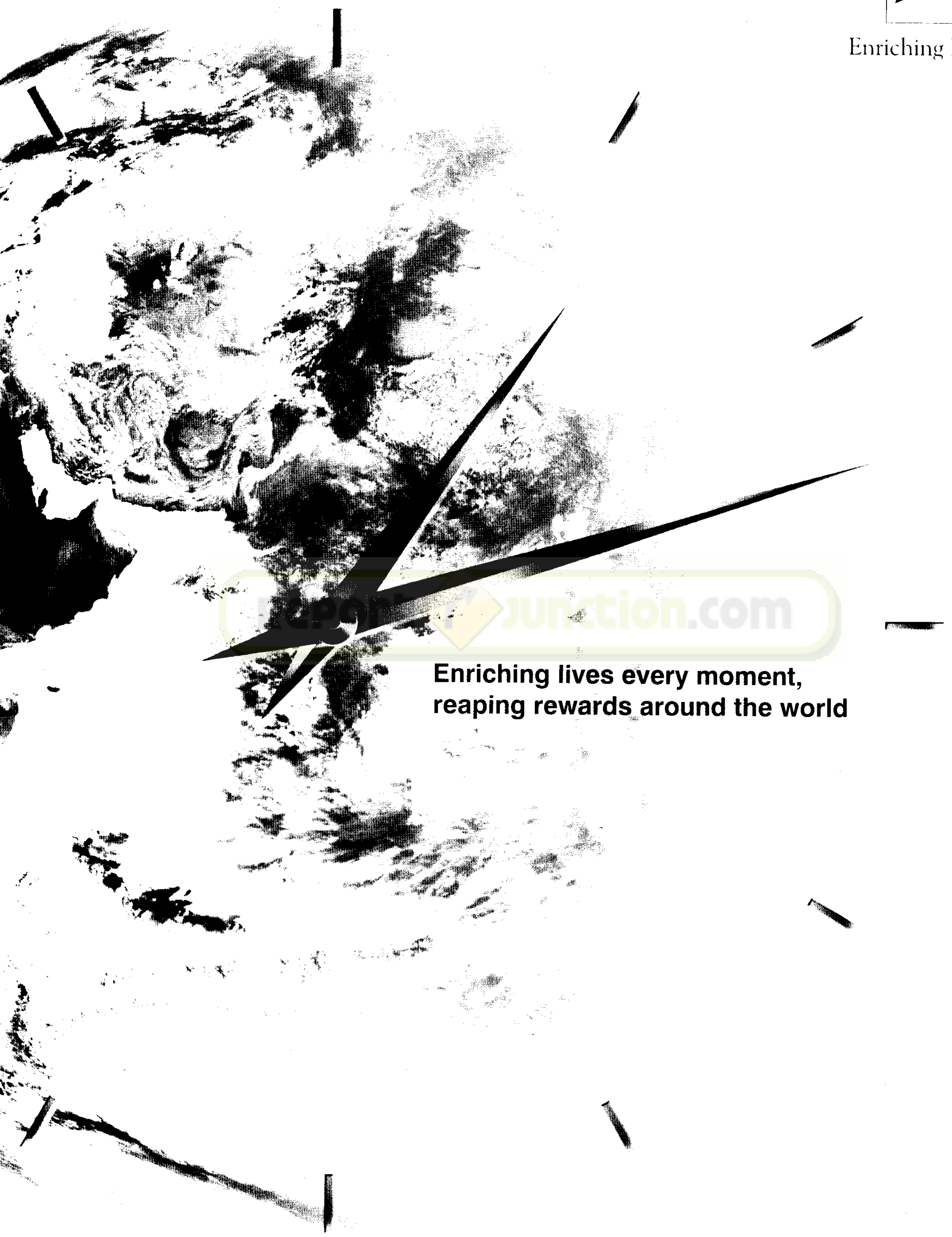
Kirloskar

Enriching Lives



Enriching lives every moment,
reaping rewards around the world

KIRLOSKAR OIL ENGINES LIMITED

Annual Report
2005-06

From India to the world, we are going places.

As one of India's leading engineering conglomerates, Kirloskar has been enriching the lives of millions through world-class engineering solutions. And now, we are making forays in global markets as well. Pillared on the values of true understanding, true effort and true commitment in every endeavour, small or big, our global foothold is getting stronger with every passing moment. So, while we continue to excel in India, our exports will also be contributing significantly to our economic growth in the years to come. And with your continued support and faith, we're sure to make a bigger difference.

- Increase in Sales by 21% to INR 13,953 M.
- PBT increased by 22% to INR 2,460 M inclusive of INR 975 M on sale of investments.
- PBT before Extra Ordinary Items increased by 46% to INR 1,485 M.
- Engine Sales cross INR 10 Billion for first time by registering 30% increase to INR 11,479 M.
- Exports cross INR 1 Billion for first time by registering 42% increase to INR 1,321 M.
- International OEM Customer development continues, and few have started buying.
- Increase in Auto Component Sales to OEMs by 22%.
- INR 683 M CAPEX completed in FY06, 60% is for Capacity increase.

Annual report for the financial year ended on 31 March 2006

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. R. Srinivasan	
Mr. A. N. Alawani	Director (Finance) (upto 31 August 2005)
Mr. D. R. Swar	Director (Large Engines, Auto Components Business Groups and HR)
Mr. R. R. Deshpande	Director (Medium and Small Engines)

Chief Financial Officer
Mr. Sanjay D. Parande

Company Secretary
Ms. Aditi Chirmule

Auditors
M/s. Dalal & Shah, Chartered Accountants

Bankers
State Bank of India
Bank of Maharashtra
HDFC Bank Ltd.
The Cosmos Co-operative Bank Ltd.
ICICI 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
Bhagirathi Building,
1202/3/11, Shivajinagar, Off Ghole Road,
Opp. Hotel Surya, 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	:	Saturday, 22 July 2006
Time	:	11.00 A.M.
Venue	:	Hotel Le Meridien Raja Bahadur Mill Road, Pune - 411 001.
Proposed Dividend	:	100% (Rs. 2 per share of Rs. 2 each) [This is in addition to 100% (Rs. 2 per share of Rs. 2 each) paid as Interim Dividend]
Dates of Book Closure	:	15 July 2006 to 22 July 2006 (both days inclusive)

Contents

DECADE AT A GLANCE

(Rupees in Millions)

Sr. No.	Particulars	2005-06	2004-05	2003-04	2002-03	2001-02	2000-01	1999-00	1998-99	1997-98	1996-97
1.	Net Sales	13,953	11,486	10,025	8,639	7,430	7,908	7,284	7,031	6,143	6,001
2.	Profit Before Tax	2,460	2,013	1,056	383	274	417	891	159	1,717	577
3.	Profit After Tax	2,006	1,739	708	415	186	413	820	158	1,496	480
4.	Dividend Amount	388	243	194	97	67	67	67	67	61	43
5.	Dividend (%)	200	125	100	50	35	35	35	35	35	25
6.	Earning Per Share (Rs)*	21	18	7	4	2	4	9	2	16	6
7.	Book Value Per Share (Rs)*	74	58	43	38	38	37	38	31	37	23
8.	Share Capital	194	194	194	194	192	192	192	192	190	172
9.	Reserves and Surplus	6,990	5,427	3,963	3,476	3,445	3,316	3,473	2,728	3,286	1,828
10.	Shareholders' Funds	7,184	5,621	4,157	3,670	3,637	3,508	3,665	2,920	3,476	2,000
11.	Loan Funds	670	517	297	370	1,082	1,154	1,651	2,539	3,083	3,147
12.	Total Capital Employed	7,854	6,138	4,454	4,040	4,719	4,662	5,316	5,459	6,559	5,147
13.	Gross Block	4,834	4,215	3,864	3,902	3,716	3,610	3,503	3,291	2,557	2,367
14.	Net Block	1,922	1,447	1,295	1,414	1,392	1,538	1,655	1,731	1,519	1,584
15.	Net Current Assets	1,030	974	1,195	914	1,281	1,236	2,023	1,995	3,614	2,635

* The equity share of Rs. 10 each was sub-divided into 5 equity shares of Rs. 2 each w.e.f. 18 August 2005. Previous years' figures have been reworked to make them comparable.

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 2006.

Financial Performance:

	(Rupees in 000's) 2005-2006	*2004-2005*
Total Income	14,712,073	*12,060,157*
Total Expenditure	13,227,319	*11,043,806*
Profit before exceptional items & Taxation	1,484,754	*1,016,351*
Profit / (Loss) on sale of investments	974,941	*996,427*
Profit before taxation	2,459,695	*2,012,778*
Provision for tax (including Deferred Tax)	453,821	*273,832*
Net Profit	2,005,874	*1,738,946*
Surplus (After other adjustments)	3,607,437	*2,127,465*

Appropriations

Your Directors propose to appropriate the available surplus as follows:

	(Rupees in 000's)
Proposed Dividend	194,173
Interim Dividend	194,173
Corporate Tax on dividend	54,466
Transfer to Contingency Reserve	–
Transfer to General Reserve	2,000,000
Balance carried to Balance Sheet	1,164,625

Dividend :

In addition to the interim dividend of 100% (Rs. 2 per share) paid in February 2006, the Directors recommend a final dividend of 100% (Rs. 2 per share) for the year, totalling to yearly dividend of 200% (Rs. 4 per share) *(previous year dividend was 125%).*

Management Discussion and Analysis:

The operations of your Company comprise of Engines and Auto Components. This business segmentation forms the basis for review of operational performance.

A. Industry Overview:

During the year under review, the growth in the Indian economy continued and some sectors have shown an accelerated growth. The services sector of the economy also continues to grow robustly. The resultant growth is seen in capital goods sector.

The central and state governments continued to give priority to agriculture, road construction, housing, and other infrastructure development and have announced various schemes. The effect of such investments was noticeable in the economy.

This vibrant economic scenario generated good demand for power, construction and material handling machinery and automobile components. The Telecom industry's need for power increased remarkably. The demand for irrigation pumpsets has stabilised and economically priced pumpsets are now driving the growth of the sector. New product development targeted at this growing segment is nearly complete and launch of these new products is scheduled in near future.

The emission and noise regulation by Ministry of Environment and Forest concerning generating sets came into effect in the year ending March 2005. The consumers in urban areas have reconciled to the increased cost of complying with the regulations and have accepted the sleek, canopied, and silent Kirloskar Green Power Ideas generating sets.

However, the regulation on emission and noise has also resulted in reduction in the number of competitors up to 19 kW output generating sets, as those who cannot meet the regulation cannot sell in the regulated market.

The OEM demand in Auto Component Industry for your Company's products increased by 15% in the year under review.

The overall demand from all sectors of economy in which the Company operates, continue to grow robustly.

B. Company Performance:

During the year under review your Company achieved sales of Rs. 13,953 million *(Rs.11,486 million)* resulting in increase in sales by 21.5% over the previous year.

The profit before tax is at Rs. 2,528 million *(Rs.2,013 million)* after providing for depreciation of Rs. 280 million *(Rs.266 million).*

Analysis for both segments – Engines and Auto Components is presented below.

C. Segment-wise Operational Performance:

Engines:

The sales of engines registered an increase of 27% at Rs. 11,412 million in the year under review *(Rs. 8,969 million),* crossing the Rs. 10 billion mark for the first time.

In the agricultural sector, the engines are used in the farm machinery and farm tractors. In the lower end of the range, there is competition from several domestic players, and few imports from China while few domestic competitors vie for market share in the upper range. We continue to expand our market share by in-depth and effective marketing activities in the potential villages, and offer products for each user segment while improving distribution network in depth, quality and service. Affordable pumpsets and engines drive the growth in this market. Thus, a year ago the Company had started the design of less material intensive products to meet the price levels desired by farmers. These products are now being prepared for launch in near future.

The Farm Tractor market grew by 9% in the year under review and the Company has also started supply to two more tractor manufacturers. Thus, sales to this segment are expected to grow in coming years.

The Company is the leading player in the Power Generation segment with the widest range in the industry. The Power Generation market experienced high growth in the year under review mainly due to demand from manufacturing, telecommunication and services sector, resulting in an increase in sales to the power generation segment by over 30% as compared to the previous year.

The "Kirloskar Green Power Ideas" brand under which gensets are marketed has become the most preferred brand in India, and is also introduced in selected countries. The exports of generating sets also grew significantly in the year under review. In sheer numbers, we, the Board believes that "Kirloskar Green Power Ideas" is now the largest selling brand in the world in the range 15 to 250 kVA.

We introduced generating sets in 250 to 600 kVA range three years ago. These products now command a market share of about 25% in the Indian market.

The changed fuel price scenario has resulted in customers mainly looking for standby power solutions in larger power output generating sets using high-speed diesel as compared to the Company's designs in this class that are predominantly competitive when heavy fuels are used. This situation is putting pressure on sales of the Company's larger generating sets.

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. Your Company expects to book initial orders for these in the current year.

Another important application of engines is for industrial and construction machinery. The Directors assess that the manufacture of the Construction and Material Handling Equipment has good growth prospects in the country. The exports of these equipments by OEM customers have also started. In the year under review, your Company's sales to this sector grew by 50 %.

The Company is an established supplier to the Indian Armed Forces for decades and the sales to the Armed Forces have increased in the year under review resulting in a healthy order board.

The engines in the output range 2400 to 11000 hp are also sold for marine applications. The Company has healthy order board from marine sector and further orders from the Indian Navy are expected shortly.

The implementation of the world class Customer Relationship Management (CRM) solution continues at the Company's Service Dealers and field service personnel. The CRM will further increase satisfaction of customers with the Company's products and service which in turn will lead to sustainable long term market leadership.

Auto Components:

The buoyant automobile market, especially commercial vehicle and car markets, grew robustly in the year under review. However, the "after-market" continues to stagnate. Thus, the Company's sales to OEM market increased by 22% as compared to industry growth of 15% and sales to "after-market" reduced due to reduced overhauling activity of heavy and light commercial vehicles. The overall growth was limited to 6% mainly due to capacity constraints though the Company's plants operated at over 100% capacity. The Company has invested in plant and machinery during the year under review and the increased capacity has now started coming on stream.

The resultant growth in the Company's sales was 6% over the previous year at Rs. 1,103 million *(Rs. 1,044 million)*.

it is noteworthy that leading Automotive OEM customers have increased purchases from your Company due to superior service, near zero defects, and quicker product development. The Company has received orders for engine valves for Maruti Udyog Ltd.'s diesel engine project.

A critical requirement of the OEM customers for engine bearings is 'lead free' materials. The Company has developed and obtained approval to its first 'lead free' material for a large OEM Customer.

Sundaram Clayton Ltd, is one OEM customer of the Company for many years and has awarded us its 'Best Quality Supplier' award for the third year in a row.

The manufacturing facility of the Company was re-certified with the ISO-TS 16949 Certification in the year under review.

The sales of engines valves did not register a growth in the year under review.

Other Businesses:

Your Company is also in the business of manufacturing grey iron castings and trading in oil and power generation and power sales.

In the year under review the casting business registered only a marginal growth and is in need of infusion of new technology & investment.

The oil trading business caters to engine and furnace users who require fuel oil and also lubricants. This business registered increase of 26% in the year under review while expanding its area of operations and customer base.

The Power business is being de-emphasised for last few years as it is not viable. Thus, in the year under review, the sales income of this business dropped by 80% as compared to previous year.

Research and Engineering:

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

The investments made by the Company in last couple of years in the Emission Centre, and analysis and simulation software and hardware has been put to productive use to design new products and improve the present products.

New products are under development and their launches are scheduled from the current year.

Corporate Social Responsibility:

In the year under review, your Company has contributed to social causes to the extent of approximately Rs. 4.6 million. Some of the main social causes towards which the Company contributed are as follows:

- Rs. 700,000 to CII Kashmir Earthquake Relief Fund.
- Rs. 500,000 to INTACH for River Cleaning Project.
- Rs. 500,000 to Society of Friends of the Sassoon Hospitals (SOFOSH) for Challenged Children.

The Company continues the following initiatives:

- Tree plantation encouraged by distributing saplings.
- Free pollution check of two wheelers for students organised.
- Periodic spraying of insecticides in surrounding residential areas to improve health of community organised.
- Free health check for poor sections of surrounding community organised.
- Maintenance of roads adjoining Company's plants.
- Sponsored education and health of under privileged children through social organisation – Akanksha. In the year under review, the Company commenced the sponsorship of the second Akanksha Centre.
- Community perception survey was carried out last year and in the year under review, specific initiatives were taken in the areas of health and education.

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. However, due to competitive pressures the full impact of increased cost was not passed on the market. Thus, the raw material consumption increased as a percentage to sales during the year under review.

D. Exports:

In the year under review, the exports of the Company grew by 43% to Rs. 1,284 million *(Rs.899 million)* maintaining a substantial year on year growth for three consecutive years. It is heartening to note that milestone of Rs.1 billion exports in a year was achieved in about 9 months of the year. The Board is confident that growth in exports will continue in the coming years.

The Company has started seeing initial successes in securing OEM customers in overseas markets, and sales to OEMs have nearly doubled in the year under review as compared to previous year. Parallelly, the essential and time-consuming activity of creating after sales service network in chosen overseas markets continues.

The efforts to increase exports of auto components have resulted in a rise in sales by 7%. In the year under review, two European OEMs have agreed to purchase bearings and bushes in significant volumes. Additionally, one American OEM has agreed to purchase significant volume of engine valves. To meet the demand for valves, the Company is setting up Export Oriented Unit (EOU). 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 the Company's capability to design and develop bearings and valves on the strength of Company's engine design capability.

E. Concerns and Threats:

The signs of competitive pressure from foreign manufacturers in the range up to 20 hp engines are noticed. The Company is addressing the threat by developing new cost effective products precisely targeted at meeting customers' needs. These products will be launched in market in few months.

F. Prospects for Current Year:

The domestic farm machinery market in engine range up to 20 hp is expected to remain stable after drop in market size in last two years. The Company's new products that meet customers' expectations while lowering costs will be introduced soon.

The tractor market is growing and, in addition to Punjab Tractors Ltd., the Company is now supplying to two other tractor manufacturers. Moreover, tractor manufacturers are increasing exports of tractors with your Company's emission compliant engines. The Board believes 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. 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 Handling market as the Company's long-standing customers have drawn up growth plans.

To meet the increasing demand for auto components, further investments to increase capacity continues. The supplies will start in this year against the agreements reached with domestic and foreign OEMs. Thus, the Company expects to significantly increase sales of Auto Components in the current year.

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

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) and eBusiness solutions. 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, your 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 an objective to compete in the domestic as well as international market and prepare to compete in CII Exim Business Excellence Award, your Company has taken initiatives in the area of people management.

Employee survey was conducted by engaging Gallup in the year 2004 with the objective to understand the satisfaction level. Various HR initiatives were initiated in the year under review to address some of the top concerns that emerged in the survey findings.

Some of these areas are as under:

- Organization Development (OD) initiatives like Succession Planning and Job rotation.
- Forum for interaction between Superior and Subordinates.
- Training programs and workshops to enhance the competencies of the employees.

  To bring in greater business focus, erstwhile Marketing has been separated into Sales and Marketing in each Strategic Business Units. Similarly, erstwhile Materials function has been separated into Materials and Sourcing.

In the year under review:

- 1,732 Kaizens were implemented, as compared to 736 Kaizens the previous year. It is heartening to note that this movement is gaining momentum.

- 56 Quality Circles operated successfully.
- 2,316 Suggestions were received.

The Company continues its heritage of healthy and harmonious Industrial Relations during the year. A unique initiative in this area is the process of institutionalisation of Industrial Relations in order to maintain continuity in the Philosophy of the Workers' Union. The Union is now in the process of articulating its values.

The Company continues to enjoy healthy and productive relationship with employees. With increased sales and improved productivity, we expect the employee related expenses to reduce as a ratio of sales in coming years. The total number of employees stood at 3,445.

I. Environment:

Your Company has to deal with the environmental issues on two fronts. One, the Company's products (that is, engines) are inherently polluting: Thus, research and technology up-gradation is necessary to meet the stringent emission standards. The Company's products already meet the emission standards in target markets in India and abroad. With the investment in the emission centre, and development of in-house capability, the Company is poised to keep developing products to meet future standards.

Two, the Company believes that operations have to exceed the regulatory norms concerning pollution. Towards this objective, your Company has in place TUV certified Environmental Management System to ISO-14001 since November 1999.

SEBI Regulations & Listing Fees:

Since SEBI has stipulated electronic filing of Annual Report, Corporate Governance Report, Financial Results, Share Holding Pattern, etc. on website www.sebiedifar.nic.in, statements of your Company can be accessed at this website.

The annual listing fees for the year under review have been paid to Bombay Stock Exchange Limited and National Stock Exchange of India Limited, where your Company's shares are listed.

Directors:

Mr. A. N. Alawani resigned from the Board with effect from 1 September 2005. The Board places on record its warm appreciation of the contribution made by Mr. A. N. Alawani during his tenure as director.

Mr. Rahul C. Kirloskar, Mr. P G. Pawar, Mr. D R. Swar and Mr. Vikram Kirloskar, retire by rotation at the ensuing Annual General Meeting and being eligible, offer themselves for re-appointment.

The Board of Directors has re-appointed Mr. Rahul C. Kirloskar as Wholetime Director of the Company on 19 April 2006 for a period of 5 (five) years with effect from 5 June 2006. A proposal for his appointment as Wholetime Director and remuneration payable to him is being placed before the Members for approval at the ensuing Annual General Meeting.

The brief resume and other details relating to the directors who are to be reappointed, as required to be disclosed under Clause 49 of the Listing Agreement, form part of the Report on Corporate Governance.

Directors' Responsibility Statement:

Pursuant to Section 217(2AA) of the Companies Act, 1956 the Board of Directors state:

That in the preparation of the annual accounts, the applicable accounting standards have been followed along with the proper explanation relating to material departures;

That the Directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company at the end of the financial year and of the profit of the Company for that period;

That the Directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Companies Act, 1956 for safeguarding the assets of the Company and for preventing and detecting fraud and other irregularities.

The Directors have prepared the annual accounts on a going concern basis.