



ANNUAL REPORT 2001-02

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CORPORATE

INFORMATION

BOARD OF DIRECTORS

Shri L. Rajagopal

Chairman

Shri Gowrishankar Tekriwal

Managing Director

Shri G. Bhaskara Rao

Shri Haigreve Khaitan

Shri L. Madhusudhan Rao

Shri G. Maruthi Rao

Shri S. Y. Rajagopalan

Shri P. S. Raman

Shri Shiv Shankar Poddar

Shri Shravan Kumar, IAS (Rtd)

Shri Suresh Chukkapalli

COMPANY SECRETARY

Shri C. Krishnakumar

AUDITORS

M/s K. R. Bapuji & Co., Hyderabad.

BANKERS

Bank of Baroda

M. G. Road, Secunderabad - 500 003.

IndusInd Bank Limited

S. P. Road, Secunderabad - 500 003.

REGISTERED OFFICE

"Lanco House", 141, Avenue # 8,
L. V. Prasad Marg, Banjara Hills,
Hyderabad - 500 034.

FACTORY

Rachagunneri Village,
Shrikalahasti Mandal, Chittoor District,
Andhra Pradesh.

**SHARE TRANSFER AGENTS
& REGISTRARS**

M/s Karvy Consultants Limited
Karvy House, 46, Avenue # 4, Street # 1,
Banjara Hills, Hyderabad - 500 034.

ELECTRONIC REGISTRARS

M/s Aarthi Consultants Pvt. Ltd.,
1-2-285, Domalguda, Hyderabad - 500 029.

MANAG

DISCUSSION AND ANALYSIS

THE BUSINESS

Lanco Industries Limited (Lanco) is located in the Chittoor district in Andhra Pradesh. The company was promoted by the Lanco Group in 1992. Lanco had set up a Mini-Blast Furnace (MBF) with an installed capacity to produce 90,000 tpa of pig iron and molten metal in 1994. The objective for setting up the MBF was two-fold: to supply the slag for the production of portland slag cement and to sell pig iron to the casting and foundry units across India.

PRODUCTS

The company manufactures the following products:

- Pig iron with an installed capacity of 90,000 tpa.
- Cement with an installed capacity of 90,000 tpa.

RATIONALE OF PRESENCE

Pig iron is being increasingly used in the manufacture of iron castings which are used in the automobile, white goods and engineering industries.

Portland slag is a cement variety with a high proportion of slag, used as a binder in the construction industry all over the

world. The product is non-substitutable and its growth is linked with the growth of the economy and the construction sector.

Each of these products is integral to the economic progress of a nation. It has been observed that a stronger industrialisation accelerates the offtake of cement and iron castings.

VALUE-PROPOSITION

The price of pig iron started softening since 1998 on account of an over supply and intra- segment rivalry. To protect itself from competition, Lanco entered into an arrangement for the supply of molten metal to Lanco Kalahasti Castings Limited (LKCL), for the manufacture of iron castings and spun pipes. Lanco protected its value proposition through the supply of the metal in its liquid state for pipe-making, the next tier of operations. This reduced the company's direct exposure in the pig iron market and relatively protected it from competition.

SEGMENT WISE PERFORMANCE

The following table reflects the performance of the company during 2001-02 across the different segments of its business.

EMENT

(Figures in Rs/Cr)

Segment	Revenue	Profit/(Loss)
Pig iron	70.90	(12.25)
Cement	15.83	(0.90)
Construction	0.07	(0.91)

INDUSTRY OVERVIEW - PIG IRON

The following table clearly indicates the oversupply of pig iron in the Indian market leading to slide in prices.

(Figures in '000 tpa)

Year	1996-97	1997-98	1998-99	1999-00	2000-01
Production	3346	3416	3060	3193	3398
Demand	2910	2637	2782	2910	3177

Since demand remained sluggish pig iron prices continued to drop in 2001-02. Fresh capacity creation and the resumption of pig iron supplies from prime producers of steel aggravated the surplus with an incremental annual output of one lac tonnes.

OPPORTUNITIES AND THREATS

Unless the demand picks up to absorb the additional supply, the pig iron market is

expected to remain sluggish (threat).

However, companies with downstream capabilities are likely to be better protected from the drop in realisations (opportunities).

OBJECTIVES, 2001-02

When the company embarked on 2001-02, its objectives were to:

- ▀ Maximise the production of hot metal and maximise the hot metal transfer to LKCL (implying a reduction in pig iron sales in the open market) for an increased production of castings and pipes.
- ▀ Rationalise the debt on the company's books through timely repayment, timely service of the company's debt on schedule and fund the operations with adequate working capital at a reasonable cost.
- ▀ Negotiate better with vendors to reduce raw material costs and negotiate better with customers to accelerate receivables.

ACHIEVEMENTS, 2001-02

These objectives could not be achieved for various reasons. (discussed in detail under the following sections)

RAW MATERIALS

The principal raw materials used in the

IN 2001-02, THE PIG IRON MARKET CRASHED FURTHER. DEMAND REMAINED SLUGGISH. SIGNIFICANT INCREASE TOOK PLACE IN THE SUPPLY SIDE WITH FRESH COMMISSIONING OF CAPACITIES AND THE RESUMPTION OF SUPPLIES OF PIG IRON FROM PRIME PRODUCERS OF STEEL. ALL THESE CAPACITIES TOGETHER SUPPLIED (APPROXIMATELY) ONE LAC TONNE OF ADDITIONAL VOLUME.

manufacture of hot metal are iron ore, metallurgical coke and additives (dolomite, quartzite and limestone). Ore with 65-66 per cent iron content was sourced from the Bellary region, almost 400 kms from the plant. Coke was imported from China and Japan. The other additives were sourced from the proximate mines. Limestone, the main raw material in the manufacture of cement and an additive in the MBF, was sourced from a captive mine.

The company worked with a stable base of raw material vendors. However, there was considerable delay in payments. As a result, the company had to purchase raw material at higher cost which accounted for 86 per cent of the company's manufacturing costs in 2001-02. This was considerably higher than the prevailing industry benchmark for companies with acceptable economies of scale.

The company incurred losses due to high cost of production and was unable to pay the vendors for raw material purchases. These vendors, in turn, reduced the supply of raw material, compelling the company to taper production targets.

MBF OPERATIONS

The MBF of Lanco possessed an installed capacity of 90,000 tpa in 2001-02. However, the utilisation was only 92 per cent due to the non-payment of dues from LKCL to the extent of Rs 30 cr which accounted for six months working capital for the MBF. LKCL could not raise the resources to pay Lanco due to continued losses. Consequently, Lanco was not able to fund the working capital requirement. To generate revenues and sustain operations, Lanco sold pig iron (non molten) in Punjab and Haryana at low realisations. Due to these reasons, the MBF operated at less than its capacity during the second quarter of 2001-02 and the potential

of the anticipated synergy could not be achieved.

DEBT

Due to poor inflow of revenues, the interest and instalment on term loans were not paid, which compelled the company to pay liquidated damages and penalty, resulting in increased interest outflow. As a result, interest was higher by Rs 3.17 cr to Rs 10.23 cr for the financial period under review.

STRATEGIC ALLIANCE

The most significant transformation in the company's fortunes arose by way of Electrosteel's participation in the company's management. In March 2002, the management of Electrosteel Castings Limited entered into a strategic alliance with the promoters of the Lanco Group and acquired a 46.43 per cent stake in Lanco and a 48.89 per cent stake in LKCL.

Electrosteel's participation in LKCL was crucial for the survival of Lanco. Electrosteel possessed longstanding expertise in the manufacture of Ductile Iron (DI) pipes and was competently placed to solve LKCL's technical and financial problems.

The collaboration has already benefited LKCL in the following ways: transfer of technology into better quality and higher output, repayment of loans, and the adequate funding of working capital requirement, stronger product acceptance among buyers, stronger organisation through managerial expertise and an ongoing benchmarking of various processes to raise efficiencies.

VALUE FROM THE STRATEGIC ALLIANCE:

More specifically, value for Lanco is expected to be derived from the efficient procurement of raw material, stronger control on the production process and ongoing financial and managerial inputs from Electrosteel.

Value from a better raw material procurement efficiency:

Following the strategic participation, vendor confidence in Lanco strengthened. Lanco is now in the process of initiating a supply chain to maximise purchase efficiencies at a higher production level.

Value from the efficient utilisation of pig iron:

Following Electrosteel's participation, the technology and the quality of the DI pipes have substantially improved. From a level of 1100 tpm of DI pipes when the management control was assumed, LKCL had raised its production to 3000 tonnes. Concurrently, realisations also improved, and LKCL began to pay Lanco for the supply of molten metal – in complete settlement and on schedule. As a result, Lanco's cost of production for liquid metal declined substantially. Lanco now caters to the pig iron requirements of Electrosteel's CI pipe unit at Elavur. A higher consumption of Lanco's pig iron for value-added production has ensured a reduced dependence on the open pig iron market, which was in line with the anticipated synergies when LKCL was commissioned. As a result, Electrosteel's financial and technological support helped Lanco achieve its potential.

Value from improved capital structure:

The financial structure of the company was strengthened through the preferential issue of equity shares of Rs 22 cr to Electrosteel. Besides, with Electrosteel's support the company is able to mobilise its working capital requirement at a reasonable cost and repay term loans and other high cost working capital loans.

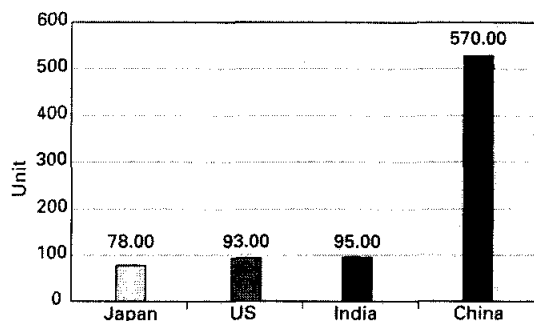
INDUSTRY OVERVIEW - CEMENT

The Indian cement industry was characterised by the following features:

A LARGE AND GROWING MARKET

The Indian cement industry is the second largest producer and the third largest consumer in the world.

LEADING CEMENT PRODUCING COUNTRIES



Source : US Geographical Survey

■ Fast growing market

The demand for cement in India has grown at nine per cent per annum over the last five years, higher than China's growth rate of five per cent during the period. Interestingly, cement demand has been - 14 per cent, 3 per cent and 1 per cent in Japan, USA and China respectively over the last three years while it has been higher in India thanks to the under-penetration and the increasing focus on infrastructure creation.

The Indian cement industry grew by 8.5 per cent in 2001-02 compared to -1 percent in 2000-01. In 2001-02, the Indian cement industry produced 99.9 million tonnes as against 93.52 million tonnes in 2000-01, inspired by a stronger government focus on housing and infrastructure, an excellent monsoon, a positive credit cycle and higher disposable incomes.

■ Slower capacity addition

India has 120 large cement plants owned by 57 companies. In 2001-02, the total installed capacity for cement manufacture stood at 134 million tonnes, 16.52 per cent higher

than in 2000-01. It is expected that a slower capacity addition will transpire over the next three years - not more than 15 million tonnes - in view of weak prices and poor profits. This could lead a deficit of cement in the country at that time.

DEMAND-SUPPLY EQUATION

(mn tonnes)

	2001-02	2002-03	2003-04	2004-05
Domestic demand	90.0	97.2	106.0	115.5
Domestic supply	90.3	97.5	107.7	112.5
Net surplus/(deficit)	0.3	0.3	1.7	(3.0)

(Industry Estimates)

INDUSTRY CHARACTERISTICS

Freight accounts for almost 30 per cent of the delivered cost of cement. As a result, manufacturers attempt to maximise their sales in regions close to the plants. Rail is the preferred mode of transport over reasonable distances. As a result, cement is sold within regions or clusters only. Even though cement is sold within regional markets, a glut in one region adversely affects the price economics in the adjacent markets.

South India, is a favorable market for cement, as the demand outstrips the supply in this region. Not many cement plants are present in this region (except in parts of Andhra Pradesh) due to the non-availability of the key raw material limestone.

OPPORTUNITIES AND THREATS

The real demand for cement comes from the growth of the infrastructure sector, this is closely linked to the economy. With the economy showing signs of recovery and government's thrust on infrastructure this demand is expected to rise. The threats are from incremental capacity addition or the flushing of cement from one cluster to

another in an attempt to dispose the surplus output. The additional supplies of cement might dampen prices.

REVIEW OF OPERATIONS CEMENT DIVISION

The company produced 71,118 tonnes of cement during 2001-02 as compared to 78,800 tonnes in 2000-01. Dispatches dropped by 9.06 per cent to 71,652 tonnes in 2001-02 due to a sudden fall in the demand on account of an irregular monsoon and dumping by the major manufacturers. However, realisation per bag improved by 15 per cent to around Rs 105.

The company expects demand to rise and cement prices to strengthen during 2002-03. The company expects to diversify into value-added cement categories like PPC and High Alumina.

THE REAL DEMAND FOR CEMENT COMES FROM THE GROWTH OF THE INFRASTRUCTURE SECTOR, THIS IS CLOSELY LINKED TO THE ECONOMY. WITH THE ECONOMY SHOWING SIGNS OF RECOVERY AND GOVERNMENT'S THRUST ON INFRASTRUCTURE THIS DEMAND IS EXPECTED TO RISE.

INTERNAL CONTROL SYSTEM AND ADEQUACY

The company has an adequate system of internal control to reasonably safeguard its assets against certain kinds of losses. Internal audits and checks are carried out effectively to ensure that the adequate systems are in place.

HUMAN RESOURCE

The company undertook extensive steps in the optimisation of manpower. Industrial relations were cordial throughout the year. Measures for safety of employees, their training and development received the top priority. As on 31 March, 2002 the total number of salaried employees stood at 381.

RISKS AND CONCERNS

Please refer to the risk management section appearing elsewhere in this annual report.

RISK

MANAGEMENT

VISION RISK

The possible lack of vision on the part of Lanco's management could restrict growth and value enhancement for shareholders.

RISK MITIGATION

Lanco is clearly focused on the enhancement of its operational efficiencies with the objective of emerging as a competitive long-term producer. The company expects to achieve this through organic growth, a more aggressive use of pig iron/molten metal for a higher value-addition, the manufacture of a superior quality of cement and the ability to generate a higher-than-average realisation across its products.

The company expects that the value from these activities will be attractive and sustainable. This vision has been articulated across the various management tiers of the organisation.

INDUSTRY RISK – PIG IRON

The industry may cease to be attractive.

RISK MITIGATION

The drop in international prices and an

oversupply in the domestic market have made the market for pig iron unattractive.

The company is adequately protected against low realisations and competition through its arrangement to captively supply pig iron/molten metal to the spun pipes units of Lanco and Electrosteel (Elavur unit). Nearly 97 per cent of the company's production was sold to these units in the first quarter of 2002-03.

INDUSTRY RISK – CEMENT

The business may cease to be attractive.

RISK MITIGATION

The low penetration of cement in India (97 kgs per capita) compared to the international levels (261 kgs per capita) is an indicator of the potential for growth in the country. The correction is expected to transpire over the medium to long-term. The government's thrust in infrastructure projects is expected to strengthen prospects.

TECHNOLOGY RISK

The company's investment in assets or infrastructure runs the risk of technological obsolescence.