

Thursday, July 19, 2007

Chairman's Speech at Annual General Meeting on July 19, 2007

Welcome

Dear Shareholders and Shareholders representative, Ladies and gentlemen,

It gives me great pleasure to speak to you on behalf of my colleagues on the board and the management of the Kirloskar Oil Engines Ltd.

I am delighted that you have joined today's AGM demonstrating your interest in KOEL.

Last year was a milestone year for the company. The business we know as KOEL, completed 60 years on June 26, 2006. At this milestone, I would like to speak about the changes in the Indian economy through such a long journey, and how KOEL is responding to the changes in recent times.

Economy: Self accelerating growth and sustainability

The economy of independent India was built after 2nd World war by absorbing the trauma of partition and integration of over 500 princely states.

From average growth rate of 3.5% during 1950 to 1980, the growth accelerated to around 6% in 1980s and 1990s. In recent years the economy grew by 8.6%, and in fiscal 06 and fiscal 07, economy has grown at higher rate of 9% and 9.4% respectively. I see this trend as a self-accelerating and sustainable growth.

Another characteristic of the growth in last 25 years is economy's resilience to shocks and considerable amount of stability.

In 1990s, we were impacted with serious balance of payment crisis. Credible macroeconomic initiatives by the government stabilised the situation. In the later years, the economy could avoid impact of East Asian crisis, sanctions due

to the nuclear explosion at Pokhran, and border conflict in 1999. Thereafter, the economic performance in face of the recent oil as well as food shocks, demonstrates the vibrancy and resilience of the Indian economy.

The average saving rate in India was 10% in 1950s, which rose to 17.5% in 1970s and further to 23.4% in 1990s. And, the saving rate was 32.4% in fiscal 06. The strengthening economic activity has been supported by persistent increase in gross domestic investment rates from 22.9% of GDP in fiscal 02 to 33.8% in fiscal 06. It is noteworthy that 95% of the investment in the economy is financed by domestic savings.

On price stability front, performance of the economy has been fair. Since independence, Wholesale Price Index (WPI) crossed 15% for five out of fifty years. In 36 years out to 50, inflation was single digit, and most of the peaks were due to shocks – food and oil. Being a democracy, tolerance level to inflation is low. Inflation averaged 5% during 2003 to 2007, and after few peaks that lasted for a short while in 2007 the inflation rate as on June 16 was 4%.

The Government's fiscal discipline has also improved. The revenue deficit is targeted to 1.5% of GDP in fiscal 08 and revenue deficit is targeted to be zero in fiscal 09. This is commendable, and means that government's borrowings are now mostly for capital expenses.

On foreign exchange front, we have trade deficit of 7% of GDP. But, the current account deficit is only 1.5% of GDP due to the receipts from services and the steady remittances from Indians working abroad.

On the strength of the rupee, India is now one of the 12 countries with more than a Trillion Dollar economy.

Prospects of Economy:

In fiscal 08 real GDP growth is estimated as 8.5% in spite of infrastructure constraints. Some economists say that the economy can grow even at 12% per year as the infrastructure improves. Thus, there is rightful attention to overcome infrastructure constraints. The inflation also appears to be settling down in the range of 5% per year.

In the 10th Five Year Plan, the growth was targeted at 8%, and in the 11th Five Year Plan, which started in current fiscal; growth is targeted at 9%. This growth aspiration requires significant increase in investments from 28% of GDP in the 10th Plan to 35% in the 11th Plan, which is an increase of 26%.

The 11th Plan also targets to double the agricultural GDP to 4%. On May 29, Honourable Prime Minister has announced that government will provide to states Rs. 25,000 crores for new farm initiatives.

The stock markets are demonstrating the confidence of domestic and foreign investors in the India economy.

Based on the information shared with you, barring unforeseen circumstances, I am confident that Indian economy will continue to grow robustly in this fiscal and beyond. This view is shared globally. Growth will be in sectors such as services, infrastructure, manufacturing, agriculture, power, urban areas and public services like water, sewage, health and education. This growth will result in growth in demand for capital goods. The capital goods sector has grown by 16% in fiscal 06 and growth estimate for fiscal 07 is 18%. I believe that growth in capital goods in coming years will be stronger due to reasons shared with you. Your company will be a natural beneficiary.

Industry Structure:

The sales of your company have grown by 35% per year for last two years. This rate of growth is higher than Industry average.

The brand Kirloskar is most preferred brand of engines in Agriculture and Industrial and Construction machinery market. The Kirloskar Green brand of diesel gensets is the world's largest selling in the range the company operates – 3 to 6600 kVA.

The sales and service network of company is widely spread in India and is effective. We are in the process of developing one in the export market. Thus, from perspective of being able to take advantage of the growing economy, I am optimistic. Though, there will be challenges, and the company will have to effectively overcome these.

As the rupee is becoming stronger and customs duty is reducing, foreign made goods are becoming attractive in price. To combat this situation, Indian industry has to become more competitive to face the competition of foreign goods at a lower price to the Indian consumers.

Another challenge to industry due to rising rupee is to retain margins on export sales. To battle both situations while retaining margins, our Industry has to cut costs aggressively.

Challenges Ahead:

The Indian economy is growing and so are company's exports. The challenge is to take advantage of situation and increase profits in sustainable manner.

Towards this objective the Company has taken the following major initiatives :

1. Investment in Plant and Machinery has been stepped upto Rs. 450 crores in FY08 as compared to Rs. 123 crores in FY07.
2. Order Fulfilment and New Product Development Processes are being redesigned to improve customer delivery in full and in shorter lead times.
3. Sourcing function is being strengthened to meet increasing demand and develop quality suppliers at competitive costs.

4. Leadership Development Programme has been started to develop future leaders at all levels of management.

I will now dwell on each of these initiatives:

Plant and Machinery Investment:

Our sales in FY07 could have been higher but for the demand outstripping capacity of our Medium Engine plant and the material flow from the suppliers. Some of you may be aware from our press release on March 26, 2007 that we have embarked on setting up a green field plant in MIDC's D Plus Zone at Kagal near Kolhapur. The capacity of the plant is 100,000 engines per year and we expect to start manufacture in this plant in next fiscal and utilize full capacity in 3 to 4 years. The progress on erecting the plant is satisfactory.

As the potential to export generating sets is high and company's products have been accepted in many countries, we are setting up an Export Oriented Unit at Kagal to manufacture 12,000 generating sets per year. We expect to fully utilise this capacity in 3 years.

We are investing Rs. 550 crores in Kagal. The investment is funded by long-term debt of Rs. 350 crores, and the rest by accumulated internal accruals. At full capacity, our plants at Kagal will employ about 1,000 people.

Order Fulfilment Process:

With the scaling up of company's operations, it is imperative that we have in place robust and scalable processes. Efficient order fulfilment process achieves timely deliveries to customers in shorter lead times, and also reduces costs, and inventories in the supply chain. The process has been carefully redesigned with help of reputed external consultant and the redesigned processes will be implemented in our plants, as well as at our suppliers.

New Product Development Process:

To remain attractive to domestic and foreign customers, new products have to be developed quickly and in given budget. Additionally, our customers require

application engineered, or customised products and expect us to achieve the customisation very quickly and at minimal cost. As a first step, the company has invested in a world class Product Lifecycle Management (PLM) software. Our engineers have been trained to use this tool efficiently. Now, we are implementing the new efficient process to develop new products and customise present products.

Improved Sourcing:

While demand is growing, we need participation and support of our suppliers to increase capacities and also join us in setting up an efficient supply chain. In addition, we need to search for cost effective and high quality suppliers in India and abroad. Thus, we have created a sourcing department and are strengthening it with appropriately skilled and experienced managers.

Leadership development:

There is increased manufacturing activity in the country and fresh investments in manufacturing are taking place. Thus, there is increasing demand for trained and experienced managers. We have aligned the compensation to industry standards and have also implemented other measures to retain experienced manpower. However, we are experiencing attrition rate which can be a potential hurdle to our growth. To address this challenge, we have identified potential leaders at all levels of management. The identified managers are being trained formally, and are also being groomed to take leadership positions in the company. While technology and machines can be bought, we believe that the leaders have to be home grown and have to imbibe company's ethos and culture. Amongst, other initiatives, this one is very important to achieve ambitious growth.

Company has also increased intake of fresh engineers to secure critical resource of potential managers.

Alternate and sustainable energy:

The awareness about climate change has now spread globally. Thus, all are looking at energy solutions that avoid environmental degradation or minimise degradation, and the solutions have to be sustainable. At the same time, the energy solutions have to be economically viable.

Our approach is two pronged. One, we will continuously keep minimising use of energy in our operations. Two, we will develop economically viable green products. Towards these objectives, the company's Green Technology Cell has been set up this year and it has started functioning. In June 2007, we have already launched engines to run on bio-diesels. The emissions from these are 20% to 50% lower as compared to engines running on high-speed diesel. The added benefit is that bio-diesel run engines do not emit any sulphur.

We now plan to run all our standby generating sets in the Plants on bio-diesel. As a tribute to our commitment to Green Technology, the Annual Report cover shows germinating seedlings with caption "growth in harmony with the environment."

In the years to come, I will keep sharing with you the development of products and processes out of this initiative. The processes we are looking at encompass the production of bio-fuels in economically sustainable manner.

Company Performance:

Having shared with you my views on the economy and how company is addressing the challenges; let me highlight achievements of the year.

The Annual Report has been with you for sometime and I am certain you have studied it with interest. Thus, permit me not to repeat all the figures from the Annual Report.

The financial highlights are:

Sales have increased by 35% for second year in succession.

Engine revenue has crossed Rs. 1,500 crores mark for the first time to reach Rs. 1,650 crores.

Profit before exceptional items has increased by 46% to Rs. 217 crores.

Cash Profit (EBDIT) before Tax has increased by 41% to Rs. 263 crores.

Shareholders funds have increased by 19 % to Rs. 851 crores.

Order Board of Large Engines as on April 01, 2007 stood at Rs. 360 crores.

This illustrates potentially reduced cyclical performance of this business.

The major non-financial highlights in the year are:

We have informed you that company is developing compact diesel pumpset to target compact pumpset market, which is now sizeable. The field testing of the newly developed compact pumpset named “Varsha” by us has given positive results. Thus, product is being prepared for commercial launch.

In the higher power output range, company achieved two significant milestones in the year under review. First, the company successfully manufactured and delivered two numbers 20 cylinder 11,000 hp engines for Offshore Vessels on Indian Coast Guard. Second, 12 cylinder newly developed engine with power output of 5,270 hp passed stringent tests of Navy. The tests included meeting stringent noise emission standard. These are examples of our being able to meet rising standards of customers for large engines.

The company secured orders for highly specialized standby generating sets for Nuclear Power Plants. Few companies in the world are able to provide products for this demanding use in Nuclear Power Plant. We believe that this market will grow substantially in the coming years.

Our engine bearings business is a cause of concern. In this business, we face pressures of rising costs of material and persistent demand for price reduction from customers. Margins have reduced over recent years. We are working

towards development of global alignments for this business, and I will share the progress with you at appropriate time.

The engine valve business is poised to grow from its present small base as our EOU commences production. In a year or two, we expect to utilise full capacity of the EOU plant to achieve invoicing of about Rs. 60 crores per year.

Exports:

The company's strategy to develop overseas institutional sales and foreign OEM businesses in addition to the sales to our foreign distribution network continues.

In fiscal 07, the sales of generating sets to institutional customers were lower as compared to fiscal 06 while sales to OEM customers increased dramatically to about 4 times the previous year. The sales to distributors in Africa also increased significantly. Thus, the overall increase in exports in fiscal 07 was 8% as compared to the previous year.

The institutional customers and distributors have appreciated the improved quality of our generating sets. To address this demand, as I mentioned earlier, we have commissioned an EOU plant for 12,000 generating sets per year. The first consignment of production from this plant was invoiced in July 2007. The OEM customers from Europe and China are also appreciating the specifications and quality of our products and have placed repeat orders.

The exports in first quarter of current fiscal are 12% higher as compared to the same period in fiscal 07. Though there is moderate growth to exports in the first quarter of the current fiscal, we estimate that growth will catch-up by end of the year to register robust growth for the year.

Quarterly Results, Q1, FY08

The Sales have increased by 15% to Rs. 492 crores over same period last year (Rs. 427 crores). Having exited the castings business, the growth in sales is higher by 18% over last year on like to like basis.

The Profit before tax is at Rs. 41 crores (Rs. 34 crores), which is higher by 20% as compared to the corresponding quarter of previous year.

Announcement:

Now I have few announcements to make:

Waukesha

The first one is concerning alliance with Waukesha Engine, USA. Under this alliance, we have secured exclusive licence to manufacture and sell and service globally 1500 rpm diesel engines in range of 3,250 to 4,900 hp for generating sets from 2.4 MW to 3.6 MW.

This alliance will also provide us gas engines in the same range. These will be packaged by us in India and the packaged generating sets and other aggregates will be sold and serviced by us in India.

In addition to the above, the alliance will provide us the opportunity to manufacture and supply components and assemblies to Waukesha for their manufacture of gas engines in USA.

Shifting of Small Engine Plant to Rajkot

As you are aware, we have been operating the Small Engine Plant at Phursungi near Pune. As a Continued Policy of the Company to improve competitiveness, the Board has approved to shift this plant to Rajkot. Rajkot offers us several advantages including the proximity of large supplier base for our conventional designs of engines.

While the conventional design of Small Engines will be manufactured in Rajkot, we will invest in Kagal for the manufacture of compact engines.

Declaration of Bonus

I am glad to inform you that the Board of Directors in its meeting held just prior to this Annual General Meeting has approved the issue of bonus shares to the shareholders of the Company, in the ratio of one (1) equity share of Rs. 2 each, for every one (1) equity share of Rs. 2 each, held by the shareholders, subject to the approval of the shareholders, in the general meeting to be convened for the same. It is also decided to increase the authorised share capital of the Company from Rs. 27 crores to Rs. 50 crores to accommodate the increase in the paid up capital resulting from the issue of bonus shares.

Management and Employees:

I would like to specifically appreciate the contribution of Mr. D. R. Swar to Company's growth. He was with the Company from 1987 and retired on 19th April 2007. From 26th July 2000 to 19th April 2007 Mr. Swar led the company in the capacity of an Executive Director. Mr. Swar has left behind a strong platform and management team to grow the Company to greater heights.

Mr. R. R. Deshpande has been with the Company since 1977, and he is a Director since 29th April 2005. I am sure Mr. Deshpande duly supported with the management team at KOEL will take the company to greater heights. As shareholders, let us wish them success.

The Company's harmonious relationship with the workers union was supplemented further by executing yet another 3 year wage agreement prior to the expiry of the previous agreement. This has been achieved for the 5th time in succession, thus, covering a span of 15 years. Under the wage agreement the incentive compensation has been done away with. Our workers, who have at all times been very supportive, have agreed to productivity increases as per principles of MOST (Maynard Operating sequence Technique), a well established global standard.

I am sure that combined efforts of management and workers (we call them Team Members) will grow the company to greater heights.

Acknowledgements:

I am happy to inform that the customers in each market have appreciated our products, responsiveness and customer care. As a result company's market shares in domestic markets have gone up in key markets, and exports are increasing. Hence, I would like to thank all our customers with a promise that our customer centricity will keep on becoming sharper with time.

I am grateful for the support given to us by you, the shareholders, our bankers, our suppliers, and our employees.

Thank you!