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Shareholders
Aavishkaar International Private Limited

Dear

Status report on Aavishkaar projects as of end-May 2004

I was in Mumbai on March 27-28. On the 28th, there was a full-day discussion on Aavishkaar. Mr. Sanjeev Sanyal, one of the investors in Aavishkaar International and an advisor to Aavishkaar International on fund-raising, joined the undersigned, Arun Diaz, Nilesh Mehta, Krithivasan Ramamritham, Vineet Rai, Maulik Shah, Pradeep Pathiyamveetil and Mr. Pravin Gandhi.

Many of you may not know of Mr. Pravin Gandhi. He is one of the three partners of Infinity Ventures. The other two partners are Mr. Gaurav Dalmia and Mr. Saurabh Srivastava. All three of them are very well known in the Indian Venture Capital space. Mr. Pravin Gandhi has taken a particular liking to Aavishkaar India, its mission and objectives. He is very keenly involving himself in advising Vineet Rai, the Chief Executive Officer of Aavishkaar India. Already, he has participated, along with the two Trustees of Aavishkaar India Mr. Arun Diaz and Mr. Nilesh Mehta and Vineet Rai, in the quarterly review of two of Aavishkaar funded projects, Sri Kamadhenu Electronics and TIDE Technologies. In fact, I should make it three since there was a review on April 6th with Mr. Mukundan, the CEO of Servals Automation. Servals Automation was the first company funded by Aavishkaar India in end-November 2002.

Aavishkaar India completed its first full-year of operations in 2003. The contribution agreement was signed between Aavishkaar India and Aavishkaar International in January 2002 before the application to set up a venture fund in India was filed with SEBI in that month. However, approval to commence business was received from SEBI in August 2002 after Aavishkaar India had received nearly Rs.1.0 crore from Aavishkaar International.¹

¹ One US dollar = INR 45.00 (current exchange rate) and One Crore = Ten Millions.

What is the current state of affairs in each of the three funded projects?

(1) Servals Automation Private Limited (SAPL) makes fuel-efficient kerosene stove burners (under the brand name of 'Venus') and stoves and water conserving sprinkler systems ('Chandraprabha'). Aavishkaar's investment in the firm is Rs.8.0 lakhs. SAPL needs to sell 3500-4000 burners every month to break even financially. It started with sales of 100 burners per month in the middle of 2003. Since then, the company has made steady progress. In the last four months, the monthly sales turnover has reached 1000-1200 burners per month. In the next three months, the company hopes to achieve a turnover of 2000 burners per month.

Initially, the company targeted Original Equipment Manufacturers of kitchen stoves to achieve high volume sale of the burners. However, OEMs did not appreciate the value of the fuel-efficient burner and mandated changes in the burner to bring down the price. That temporarily robbed the burner of its USP – fuel efficiency and enhanced safety. Precious time – six months – was lost.

The company and its management then re-grouped. Marketing the burner to women through self-help groups might be time-consuming but it is yielding steady results as witnessed by the rising graph of sales. Interestingly, OEMs too are coming back, notwithstanding the initially messy approach.

More importantly, since the company's sales have not reached breakeven,,Mr. Mukundan, the entrepreneur, is meeting the cash loss in the form of Director's loans. He had come to Sholapur in Maharashtra to display and market the burner at a huge NGO fair. Thereafter, he visited Mumbai and had a good meeting with the Aavishkaar India team.

Aavishkaar India, were very impressed by his confidence and singular determination to make this business succeed in the fag end of his successful business life. SERVALS has reached a consistent level of sales of 2000 burners per month from April and hope to keep it at that level till June. Aavishkaar management and Servals promoter are set to meet up at the end of June to look at possibility of SERVALS reaching a consistent turnover of 10000 burners by March 2005.

A recent remarkable achievement is that the burner had won a 63%+ thermal efficiency rating from the Regional Testing Centre (RTC). RTC is under the Department of Industries, Govt. of India. The thermal efficiency of the Venus burner was found to be 63.9%. This is as against the 57% specified by the Bureau of Indian Standards (BIS) for burners.

The genesis of this development was a meeting in November 2003 in Chennai of the Sectional Committee of the BIS on Oil Burning Appliances where Servals Automation was invited. At this meeting, the Petroleum Conservation Research Association (PCRA) highlighted the importance of increasing the efficiency of burners as a means of saving kerosene. It had been therein learnt that the Indian Institute of Petroleum (IIP), Dehradun was in the process of developing a burner that offers 60% efficiency. Their effort is still at the drawing board level. Servals had then taken the opportunity and stated that its burners offered comparable efficiencies as attempted by the IIP. The testing by RTC had therefore been recommended.

We can safely claim that no other burner in India offers such high efficiency. This is corroborated by the fact that IIP is trying to develop a burner with 60% efficiency and the 'Venus' burner has already demonstrated 63.9%.

Clearly, through SAPL, Aavishkaar India has bagged a product whose technical efficiency and appeal is unquestionable. Its social relevance is beyond doubt and Aavishkaar has backed an entrepreneur whose integrity and commitment are unassailable.

Importantly, Aavishkaar India has and is contributing considerably towards the firm achieving its marketing targets. We are confident thus that the first investment of Aavishkaar would turn out to be a winner. It is expected that, based on the present assumptions, that the company would make cash profits in the financial year 2005-06 and possibly distribute its first cash dividend to Aavishkaar India by the end of that year.

(2) Sri Kamdhenu Electronics Private Limited (SKEPL) is Aavishkaar's second investment. This company has won quite a few awards in the International arena - from the World Bank and from the ICT (Information and Computer Technology) Stories Competition jointly hosted by the Dutch Government and the World Bank. Professor Subash Bhatnagar of the Indian Institute of Management Ahmedabad (IIM-A) has written a case study on this company and so have MBA students of Professor C.K. Prahalad of the University of Michigan, Ann Arbor. The company had achieved an annual turnover of Rs.1.0 crore+ for the previous three years before Aavishkaar India gave money for its expansion plans. Thus, it came with a strong background and reputation.

Just to recall, the product portfolio of SKEPL includes Micro Processor based Milk Collection System, Computer based Milk Collection System, Milk Analyser, Dock Automation System and Truck Route Monitoring System with particular focus on Milk Collection system and Milk analyser. The company markets its product under "Akashganga" brand name. The company also offers Financial Accounting Software and MIS report for Raw Milk Procurement. All the products offered by the company are in regional languages, which make it easier for the rural people to use the systems.

It is expected that the company would have achieved a turnover of Rs.98-99 lakhs in the financial year ending March 2004 (please update this figure). It might come as a surprise that, post-VC funding, the company had achieved a lower annual turnover than it achieved in the previous three years. It is attributable to lacklustre performance in the October-December quarter when sales turnover was just Rs.7.0 lakhs.

Why? The company lost precious time in trying to develop a 30-second milk analyser since there was not much demand for its existing 45-second milk analyser. Its working capital management had considerable scope for improvement and senior management members of the company did not engage in sufficient questioning of each other. It was left to Aavishkaar India, in their quarterly review held in February, to advise them to get back to basics.

The company has a hugely popular automatic milk collection system (AMCS) and they were told to build up the sale of this product brick by brick as they were doing, before Aavishkaar funding. The product is sold to milk co-operatives. After Aavishkaar intervention, working capital management has improved.

The only competitor for SKEPL was the public sector Rajasthan Electronics and Instruments Limited (REIL). Whereas SKEPL's 'Akash Ganga' was well recognised in the market for its quality and after-sales service, REIL's milk collection systems were unpopular due to poor after-sales service and lack of customer care. However, the company has a Rs.25.0 crore annual turnover and has deep pockets.

Aavishkaar advised SKEPL to seek a meeting with REIL to explore how the two companies could work together. The initial meeting with REIL's CMD was very fruitful and further talks are in progress. REIL could use SKEPL as its exclusive franchisee in markets that it does not serve at present. If the business tie-up with REIL is concluded, then the potential for the company to grow the turnover by a significant multiple does exist. If it does not, then the firm would concentrate on its automatic milk collection system and aim at a sales turnover of Rs.1.5 to Rs.1.6 crores for the new financial year, 2004-05.

(3) Tide Technocrats Private Limited (TTPL), the third project that Aavishkaar India financed is based out of Bangalore. Young technocrats with degrees from the Indian Institute of Science and INSEAD France set this company up to translate their experience gained from consulting assignments carried out for the Department of Renewable Energy in installing micro-hydel systems.

TTPL was established in January 1995 and is located in Bangalore, Karnataka. TTPL intended to operate in the niche area of renewable energy based power generation technologies such as micro hydel projects for electricity generation, bio-methanation digesters and Gasifier technologies for Industrial Boilers using biomass waste.

Micro-hydel systems, it was well anticipated, would be slow to turn into a positive cash-flow business given that the end-customers (initially, coffee plantation owners in the upper reaches of Karnataka) were suffering from stagnant coffee sales and difficult financing conditions. Until today, banks are reluctant to finance the installation of micro-hydel systems. The company then took up the procurement of coconut fronds and distribution of dried and chipped fronds as (bio-mass) fuel for sugar and paper mills or whichever plant that uses industrial boilers.

The company seems presently hamstrung by the more than anticipated level of moisture content in the fronds procured. Reality has shown that the conservative assumptions made in estimating the final weight of frond-fuel assumed in the calculations were not conservative enough. Every four kilos of fronds procured was expected to lead to 1.5 kilos of dried frond-fuel. Reality is that it yields 1.1-1.2 kilos of fuel, effectively wiping out the expected margins.

The company is working on revising its strategy and has come up with four possible revenue lines. Biomass supply continues to be a revenue line albeit the contribution is substantially reduced. TTPL intends to move into Rural Electrification and Aavishkaar is helping TTPL to develop a business strategy in this area.

(4) Craftsbridge India Private Limited (CBPL) was Aavishkaar's fourth investment. CBPL is a Pune based cross channel design, manufacturing and marketing organization dedicated to the handicrafts industry in India. It is working with a mission to be a bridge between customers worldwide and crafts persons, designers, bulk buyers, researchers and others that form this community in India.

CBPL offers premium, contemporary designer Handicrafts products in various categories. It is also providing 'made to order' customized products and designer services for the corporate gift market. In addition, CBPL sells a wide range of crafts and designer ware sourced directly from artisans, bulk suppliers and NGOs from different regions across India.

Although the terms of the investment were concluded in January, the audit due diligence threw up issues on the financial accounting and reporting of the company. Aavishkaar India held back its first investment until the company satisfactorily addressed the issues raised in the audit due diligence. The cheque for the first instalment of Rs.20.0 lakhs at a pre-money valuation of Rs.1.0 crore was actually handed over only on April 9, 2004.

The company has likely achieved a turnover of Rs.2.0 crores in the financial year ending March 2004 – more than doubling its turnover from the previous financial year.

A second tranche of funding of INR 15 lacs through a convertible bond issue is scheduled to be entered into shortly.

Concluding remarks on Aavishkaar India portfolio of investments

Although Aavishkaar India's first three investments made up to end-2003 have their fair share of problems, they are on the right track. Management in every case is keen to prove their ventures successful. The sincerity of the entrepreneurs is evident in the example of Mr. Mukundan of Servals who promised to return the full Aavishkaar investment any time Aavishkaar demanded. The reason was that he did not want Aavishkaar India's first investment to be a failure!

So, Aavishkaar India had chosen well. Challenges exist but they are being overcome. While they may not be blockbusters yet, there is basis for reasonable optimism. It was reassuring to hear this from a prospective investor.

Mr. Sushant Gupta became a shareholder recently with a subscription of GBP20,000 (he invested the equivalent amount in INR in Aavishkaar India) did his own due diligence on the four projects that Aavishkaar India had funded and concluded that their progress was reasonable and potential was promising, before he decided to invest in Aavishkaar.

As was clearly stated in the investment memorandums, Aavishkaar India is breaking new ground. Hence, issues that are not only peculiar to venture capital industry but also those that pertain to micro and small businesses crop up – reluctance of promoters to part with equity, opening books to total strangers, resentment at probing questions and issues pertaining to exit.

Aavishkaar India and Aavishkaar International have been clear that returns from the underlying investments would not come through a single bullet exit but from regular cash flows in the form of dividends. Obviously, Aavishkaar India cannot build in a compulsory dividend clause in its subscription agreements. It has, however, a PUT option clause in its subscription agreements with the entrepreneurs.

However, we would like to reassure investors that Aavishkaar is in a position to insist on and receive dividends from all the four firms funded so far, due to our strong hands-on involvement and guidance for the firms. Going forward, we would be paying extra attention towards defining exit clauses more precise than they are now.

Additional remarks

(1) We are considering the introduction of quantitative scoring for evaluating project proposals submitted by entrepreneurs.

(2) Another decision that was made in the Mumbai meet was to have a quarterly (or appropriate) review of the funded projects by the Trustees of Aavishkaar India together with Mr. Pravin Gandhi, adviser to Aavishkaar India and Mr. Vineet Rai, the CEO of Aavishkaar India. Such reviews had already taken place with SKEPL and TTPL in the last few months. A review of Servals took place on April 6th.

(3) State of fund mobilisation

Collectively, Aavishkaar International has mobilised nearly Rs.4.0 crores solely from individual subscriptions. Aavishkaar cannot close its first round of funding before mobilising a sum of Rs.5.0 crores, as it is a regulatory requirement for on-shore venture capital firms such as Aavishkaar India to have a minimum share capital of Rs.5.0 crores. Aavishkaar International aims to close the first fund of Rs.5.0 crores by the middle of this year (sometime in the third quarter). The International Finance Corporation (IFC), India has shown interest in investing in Aavishkaar. Conversation is ongoing. We hope to receive a favourable response from them soon.

Any help from existing investors – either through referrals or through additional contributions to their existing stake – would be gratefully welcomed. Some of you have already done so.

(4) Out of this Aavishkaar I (Rs.5.0 crores) fund-raising, Aavishkaar India would like to be invested in about 9-10 projects for a total disbursement of around Rs.3.0 to Rs.3.5 crores. The balance would be earmarked for funding the expansion plans of some of the funded enterprises and for meeting annual running expenses of Aavishkaar India over the life of the Fund (about seven years).

(5) At present, the contribution agreement between Aavishkaar India and Aavishkaar International (as well as other contribution agreements that Aavishkaar India has made with individual investors who have invested directly into Aavishkaar India) states that the period of subscription agreement is for five years, extendible by two or more years, by mutual agreement. It is unlikely that the ventures would be ready for exit in seven years, let alone in five years. Nine to ten years is a more reasonable assumption.

Hence, at the end of year 5 (that is January 2007, from the date of initial contribution agreement between Aavishkaar International and Aavishkaar India), a decision would be made on the extension of the contribution agreement for a further period to be mutually agreed.

(6) Aavishkaar International has also decided that it would neither be legally permissible nor feasible to differentiate between investors who have subscribed to Aavishkaar I at different points in time. Aavishkaar International would consider some incentives for current investors when Aavishkaar II is launched sometime in the course of 2005, after the annual review of the current portfolio and the pipeline of proposals in February/March 2005.

(7) It must be evident from our plans for Aavishkaar II (and Aavishkaar III, etc.) that the Trustees of Aavishkaar India, the management team of Aavishkaar India and the directors of Aavishkaar International are determined to work for the long-term success of Aavishkaar investors and entrepreneurship in India.

(8) Our initial assumptions about the lack of financing for SMEs continues to prove true (see article next page) and provide further incentive for Aavishkaar to raise new funds and continue on its mission with more determination.

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Getting bank loans difficult: SSIs
(Ankita Sarkar in New Delhi)

Bank financing does not cater to the entire funding requirements of the small scale industry sector and is supplemented by promoters' own contributions and loans from financial corporations, according to survey done by the Federation of Indian Chambers of Commerce and Industry (Ficci).

Of the 229 SSI respondents, 59 per cent said it was moderately difficult to obtain funds from banks, while 20 per cent said it was extremely difficult. Around 21 per cent of the respondents said procuring funds from banks was not difficult.

The survey shows that there has been an improvement in the availability of working capital finance from banks to the SSIs. Forty-two per cent of the respondents said they were obtaining 10-20 per cent of their projected annual turnover as working capital loans. Five years ago, 35 per cent were getting 10-20 per cent of their turnover as loans.

However, despite the improvement, nearly a third of the respondents are getting less than 10 per cent of their annual turnover as working capital loans. On the interest rate front, 51 per cent of the respondents said they were paying interest in the range of 12-14 per cent on working capital loans, while 12 per cent were paying around 14-16 per cent.

About 47 per cent said they were paying 14-16 per cent interest cent and 17 per cent were paying 12-14 per cent interest five years back. However, while the interest rate has come down, some of the banks have increased the frequency of compounding interest from quarterly to monthly, which increases the financial burden and negates the benefits of reduced interest rates.

Also, half of the respondents complained of lack of transparency saying bank authorities did not provide reasons in case they refused loans. Around 70 per cent complained of inadequate publicity of various schemes related to SSIs.

SSIs are plagued with problems like delay in loan sanctions and realisation of cheques, inadequate discretionary power with the bank manager, absence of collateral security norms and low composite loan limit, which is Rs 25 lakh at present. Also, most banks do not have forex facilities, which is a hindrance for SSI exporters.

The survey suggested that decision on loan applications should be taken within four weeks; information of credit appraisal should be discussed with applicants and devolution of greater authority to branch managers.

The raising of composite loan and collateral free loan limits were the other suggestions. The survey also said banks should revert to quarterly compounding of interest rates.