KHONG GUAN LIMITED
(Company Regn. No. 196000096G)

RESPONSE TO EMAIL FROM SECURITIES INVESTORS ASSOCIATION (SINGAPORE) ON THE ANNUAL REPORT FOR THE FINANCIAL YEAR ENDED 31 JULY 2018

QUESTION 1

1. As noted in the Chairman's statement (pages 6 and 7 of the annual report), the group's net profit after tax slipped from $1.488 million to $1.242 million "*due to the increase in cost of wheat grains and challenging market conditions for wheat flour*". In particular, the developments in the year included:

- (Trading) Tong Guan Food Products Sdn Bhd ("TGF"): Revenue was fairly stable even though it experienced a reduction in the quota of subsidized cooking oil and the loss of a major agency. Going forward, sales at TGF would likely improve after securing several new agencies
- (Trading) Swee Hin Chan Co Sdn Bhd ("SHC"): Revenue increased by almost 30%, driven by the increase in the sale of starches and animal feed, but profit margin experienced a squeeze due to challenging market conditions. SHC will be exploring new overseas export markets
- (Manufacturing) United Malayan Flour (1996) Sdn Bhd ("UMF"): Revenue was fairly stable at $80-81 million for the past two years although the group's share of results of associates dropped from $1.84 million to $0.89 million in the financial year. The reasons given were the increase in the cost of raw materials and market competition
- (Investment property) 2 MacTaggart Road: With the redevelopment of the heritage building completed, the temporary occupation permit has been obtained and it was disclosed that two tenants have been secured.

(i) **Would management help shareholders understand the key value drivers of the trading operations (for each of the two trading subsidiaries) and of the associate (which is carrying out manufacturing)?**

(ii) **Please also elaborate further on the main products/brands/agencies and the profiles of its key customers.**

ANSWERS 1 (i) and (ii) :

a) Tong Guan Food Products Sdn Bhd ('TGF')

The key value drivers of TGF are its strong network of distribution hubs in all the major towns in Sabah and its wide range of products from basic food essentials such as flour & cooking oils, edible consumer goods such as biscuits, canned food, drinks, coffee & tea, dried noodles, to non-edible consumer goods such as personal care products and household cleaning agents.

The main products are divided into 4 main categories, namely, flour, biscuits, edible consumer products and non-edible consumer products. Prominent brands that the TGF carries include Ayam brand, Saji, Mentos, Boh, Interflour, Captain Oats, Khong Guan,3M, UIC, Fumakilla, etc.

TGF's strong network of distribution hubs in all the major towns in Sabah helps to bring its principal partners' brands to all corners of Sabah. Its customers range from coffee shops, convenient stores and local "mom & pop" shops to modern F&B outlets and hypermarket chains such as Giant.

b) Swee Hin Chan Co Sdn Bhd ('SHC')

The key value drivers of SHC are its commitment to product quality, competitive pricing, reliable delivery and services. SHC has a wide network of distributors for its flour products in northern peninsular Malaysia.

It main products are divided into 3 main categories; flour products, starches (corn, wheat, potato, tapioca and sago) and animal feeds.

SHC supplies its starches, animal feeds and some of the premium flour directly to the user industries such as the food manufacturing industry and food services industry. It also distributes general-purpose flours through its network of distributors all over peninsular Malaysia.

SHC has started supplying starches to Indonesia and is exploring the markets for starches in Vietnam, Cambodia and Philippines. The strong network of starch suppliers will provide SHC with a competitive edge in the new markets.

c) United Malayan Flour (1996) Sdn Bhd ('UMF')

The key value drivers of UMF are its commitment to the milling of high quality flour and supplying such flour to bakery, biscuit and noodles manufacturers. It has established its distribution network by appointing agents and wholesalers to sell its products under several brands; each flour brand serves the needs of specific food segment. Its oats milling subsidiary manufactures oats products and markets them under the popular 'Captain' brand which is well known in oversea markets especially markets of the Middle Eastern countries.

(iii) Specifically for UMF, what is the impact of the new oat mill on the group's capacity and on the cost structure? What is UMF's overall strategy to capture more value for shareholders given that margins are being squeezed by rising raw material costs and intense market competition?

<u>ANSWER</u> :

The new oat mill is being built by the subsidiary of UMF to meet the growing demand of oats products presently produced by its own mill in Butterworth. The oats milling subsidiary will utilize part of its internal financial resources and bank borrowings to fund the construction of the new oat mill. To offset the rising raw material costs and market competition, UMF will seek opportunities to grow businesses with higher margin and better market potential than its core wheat milling business.

(iv) What are the key overseas markets that are being explored by SHC? What is the market entry strategy? How would the group be able to compete against the incumbents as it expands to new markets?

ANSWER :

Please refer to Answer 1 (b) above.

(v) Given that the development at 2 MacTaggart Road has been completed and the group will be progressively leasing out the available space, has management estimated the return on investment achieved with the redevelopment? Has the board considered if the company would be in a position to increase its dividends as the group generates steady cash flow from the asset?

ANSWER :

The Company has projected the rental income for the lease of the extra space in the newly developed industrial building based on prevailing market conditions. The Company will decide the payment of dividend after having reviewed its current year's operations together with the financial and cash flow position.

QUESTION 2 :

2. The "Recoverability of receivables and reasonableness of allowance for impairment" is a key audit matter (KAM) highlighted by the Independent Auditor in their Report on the Audit of the Financial Statements (page 30). Key audit matters are those matters that, in the professional judgement of the Independent Auditor, were of most significance in the audit of the financial statements of the current period.

As noted in the KAM, as at 31 July 2018, the group has trade receivables (before impairment) and allowance on impairment amounting to $11.72 million and $0.511 million respectively.

The allowance for doubtful receivables (recognised)/written back in the past 5 years were $5,764 in 2014, $(19,239) in 2015, $(8,453) in 2016, $(440,732) in 2017 and $(53,477) in 2018.

The large increase in doubtful receivables in 2017 was due to the allowance made by SHC with regard to the receivables due from the subsidiaries of Eka Noodles Berhad ("EKA Group"). As disclosed in the key audit matter in the 2017 annual report, EKA Group is a listed company on Bursa Malaysia and it had, on 30 August 2016, been designated as a PN17 company and the High Courts of Malaysia had also granted an order to EKA Group to hold a meeting with its creditors and members of EKA Group.

(i) **Can management provide an update on the status of EKA and on the collectability of the outstanding receivables from EKA? What are the subsidiary's efforts in collecting these outstanding debt given that the EKA is going through a restructuring where the unsecured creditors will get a haircut of up to 82.5% and the balance settled in new shares?**

ANSWER :

The modified Scheme of Arrangement and Compromise proposed by EKA has obtained the order from the High Court in Penang on 28th August 2018 after being approved at the Creditor Meeting of EKA held on 18th August 2018. EKA owed an amount of over RM69.227 million to secured creditors and SHC was one of the unsecured trade creditors.

As at 31 July 2018, out of the total trade receivables, aging of trade receivables that are past due but not impaired amounted to $3,107,898 (2017: $2,059,121), of which $550,563 (2017: $126,414) has aged over 90 days. The aging analysis is shown on page 73 of the annual report and reproduced below:

Ageing of receivables which are past due but not impaired:

	GROUP		COMPANY	
	2018 $	2017 $	2018 $	2017 $
Less than 30 days	1,891,240	792,667	96,024	82,567
31 to 60 days	499,802	368,604	—	116,616
61 to 90 days	166,293	771,436	—	52,604
More than 90 days	550,563	126,414	—	2,928
	3,107,898	2,059,121	96,024	254,715

(Source: Company annual report)

While the group's consolidated revenue increased by 7% in 2018, trade receivables past due but not impaired increased from $2.06 million as at 31 July 2017 to $3.11 million at the end of the current financial year. More importantly, trade receivables past due by more than 90 days but not impaired has jumped from $126,414 to $550,563.

(ii) Can management show a more meaningful analysis by providing an upper limit to the aging (with the appropriate breakdown)?

ANSWER :

	2018	2017
	$	$
91 to 120 days	113,733	72,146
121 to 150 days	4,760	2,929
151 to 180 days	1,455	0
181 to 365 days	67,748	0
More than 365 days	362,867	51,339
Total	550,563	126,414

(iii) What are the specific reason(s) for the sharp increase in trade receivables past due by more than 90 days but not impaired?

ANSWER :

The sharp increase in trade receivables past due by more than 90 days but not impaired in current year were due to the slow-down in the economy and it was further exacerbated by the change in the indirect tax regime from GST regime back to SST regime in Malaysia that cause confusion in the market and it affects the payments.

(iv) What is the process by management to evaluate the collectability of these long outstanding debts?

ANSWER :

The Management has taken pro-active steps to visit the customers to settle its discrepancies and the confusion caused by the change in the indirect tax regime in Malaysia and to collect its debts. The Group has subsequently collected 39% of the debts over 365 days and 81% of the debts between 180 and 365 days.

(v) As the group is looking to expand to new overseas markets, would it be timely for the audit committee to review the robustness of the group's credit evaluation policies and framework, especially for customers new to the group?

ANSWER :

The Group already has robust credit evaluation policies and framework in place. However, the audit committee has taken note of the recommendation and will continue to review the robustness of the group's credit evaluation policies and framework, especially for new customers, and will adjust them as needed.

QUESTION 3 :

3. Currently, the board comprises 3 executive directors and 3 independent directors. Mr Chew Soo Lin is the executive chairman while Mr Chew Soo Eng is an executive director and Managing director. Mr Daniel Chew is the third executive director, whose present assignment includes procurement of raw materials, shipping freights and logistics for production planning.

The profiles of the directors could be found on pages 24 and 25 of the annual report.

In the Corporate Governance report, under Principle 3 (Role of chairman and managing director), the company has stated the following (page 13):

> *The roles and responsibilities of the Chairman and the Managing Director are distinct and separate. This is to ensure appropriate balance of power and accountability in decision making. The Managing Director is the most senior executive in the Company and bears responsibility for the Company's business, while the Chairman is responsible for the leadership of the Board. The Chairman schedules Board meetings and sets Board agenda in consultation with the Managing Director. The Chairman ensures that all Board members are provided with complete, adequate and timely information.*

(i) Would the board further clarify if Mr Chew Soo Lin, as executive chairman, has roles and responsibilities in the day-to-day operations of the group?

ANSWER :

Apart from his duties as Chairman of the Company, Mr Chew Soo Lin also supervises the financial management of the Company.

(ii) For the benefit of new and old shareholders, would the nominating committee provide shareholders with better clarity on the division of responsibilities (as executive directors) between the executive chairman and the managing director?

ANSWER :

The Managing Director takes charge of all the Group operations and makes decisions related to managing the Group business activities.

(iii) In addition, what is the division of responsibilities between the Managing director and the third executive director, Mr Daniel Chew?

ANSWER :

The responsibilities of Mr Daniel Chew are quite distinct from those of Mr Chew Soo Eng. Mr Daniel Chew focuses on raw materials sourcing, shipping freight, vessel chartering and other logistics functions pertaining to production planning.

By Order of the Board
Koe Eng Chuan
Company Secretary
12th December 2018