Annual General Meeting to be held on 20 April 2023
Responses to SIAS

Singapore Technologies Engineering Ltd (ST Engineering) would like to thank the Securities Investors Association (Singapore) (SIAS) for its list of questions in advance of our 26th Annual General Meeting (AGM) to be held on Thursday, 20 April 2023 at 2:30 p.m. (GMT +8).

Please refer to the Appendix for our responses to the questions raised by SIAS.

By Order of the Board

Tan Wan Hoon
Joint Company Secretary
Singapore, 14 April 2023

Appendix

Q1. In 2022, Group revenue was $9.0 billion while EBIT and net profit were $735 million and $535 million respectively. Between 2020 (the start of the pandemic) and 2022, Group revenue grew 26%, while the underlying operating performance (excluding government support) at Group EBIT and Group net profit levels was three times as strong.

However, if one were to compare to 2019, the higher revenue in 2022 has not translated into a stronger bottom line. 2019 EBIT was 0.4% lower while 2019 PBT was 16% higher and 2019 net profit was 8% higher.

Accordingly, 2019 EPS was higher. Return on sales, equity and capital employed were all higher in 2019 even though the Group operated at a smaller scale in 2019.

(i) Can management explain in greater detail how the Group's growth strategy (mainly by acquisitions) can generate greater shareholder value in the long term?
(ii) Specifically, can management address the reasons for the drop in return on sales, return on equity (despite the higher leverage (see Q2)) and return on capital employed?
(iii) What are the plans by management to raise its financial performance?

- The Group strategy was formulated which informs our core competencies and domain areas with attractive growth, and hence our target areas of growth in commercial aerospace, smart city and defence.

- Successful growth confers value for our stakeholders, including shareholders, customers, employees, suppliers, and lenders.

- The Group sought focused growth in the target areas both organically and through acquisitions. In so doing, we worked the balance sheet harder to achieve a better mix of debt and equity to achieve a lower weighted average cost of capital (WACC), while maintaining a strong balance sheet.

- Post the acquisition of TransCore, and as at end December 2022, the Group's credit ratings remained strong at Aaa (Moody's) and AA+ (S&P).

- As with any corporate growth, especially through acquisitions, there will be upfront capital outlay and costs. However, given our highly focused approach to growth, we are confident that these new additions to the Group will over time contribute to our EPS, ROCE and ROE.

- The Group has at Investor Day 2021 articulated a clear set of mid-term financial goals through 2026. The Group is confident that our strategy for achieving sustainable growth is on track given achievements in the last two years, especially the Group's resilience in managing the COVID-19 pandemic.

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- By 2026 (using 2020 as the base year), we expect to grow our revenue at a CAGR of two to three times global GDP growth rate, which will translate to a Group revenue of more than $11b by the end of the five-year plan, with net profits expected to grow in tandem.

- Additionally, Commercial Aerospace segment which accounts for 40% of the Group's business pre-COVID has not fully recovered in 2022. We expect better performance going forward as the aviation industry recovers. Moreover, new conversion sites for our Passenger-to-Freighter (P2F) conversion business are still at the early stage of their learning curve. As the programme continues to mature across our conversion sites, so will the programme profitability at the EBIT level. Conversion slots for our A320/321P2F and A330P2F are fully booked through 2026.

- The TransCore acquisition, while achieving the target of being cash flow positive to the Group in 2022, was not yet earnings accretive in the first year; it was planned to be earnings accretive from the second year post-acquisition. Meanwhile, we continue to drive synergies and focus on cross-selling opportunities to bring TransCore's toll solutions into Southeast Asia and tap on its extensive and established market channels in the U.S. to export our Smart Mobility solutions. TransCore will also leverage the Group's R&D and product development capabilities.

- Throughout the years from 2020 to 2022, the Group achieved cost savings from procurement and continuous improvement efforts, which together with business growth, more than offset reduction in government support as well as mitigated the challenges of macroeconomic headwinds post-COVID. Savings from our initiatives also provided capacity for us to invest in new growth areas.

- Lastly, we ended 2022 with a strong order book of $23 billion. We see our robust order book as a leading indicator of growth in the years ahead. The revenue pipeline it provides, and the results we delivered in 2022 put us on track towards achieving our five-year plan targets.

(iv) With regard to the recent and major acquisitions, when will the "transitioning" of TransCore into the Group be completed and has MRA Systems met management's expectations since the Group acquired it in 2019?

<u>TransCore</u>

- TransCore's transition into the Group covering business operations, policies and processes is nearing completion.

- Meanwhile, TransCore continues to win notable contracts in the U.S. We continue to drive synergies and focus on cross-selling opportunities to bring TransCore's toll solutions into Southeast Asia and tap on its extensive and established market channels in the U.S. to export our Smart Mobility solutions. TransCore will also leverage the Group's R&D and product development capabilities.

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- Our target for TransCore to be earnings accretive in the second year post-acquisition remains unchanged.

MRA Systems (MRAS)

- The driver for nacelle systems growth is aircraft order and production, which in turn is driven by air traffic. As the sole source nacelle provider for A320neo (LEAP 1A), MRAS has benefitted from the popularity and growth of the A320neo fleet. Our investment in MRAS was immediately accretive in the first year of acquisition.

- MRAS' orders for nacelles are closely tied to the production rates of the A320neo aircraft. We are confident that MRAS' profitable performance will continue to improve as Airbus increases its A320neo production to meet market demands.

(v) Lastly, can management help shareholders better understand its competitive advantage in digital business, especially cloud and AI analytics?

- ST Engineering has the capabilities, proven expertise and track record to capture the growth in Cyber, AI analytics and Cloud. Our core capabilities include large scale system development, including mission critical and high availability software systems. Our Cloud capabilities include the design, building and management of secure on-premise and hybrid cloud infrastructures, as well as professional and managed services for cloud migration and management.

- Our core customer base comprises public and security, critical infrastructure and enterprise segments.

Q2. As at 31 December 2022, the Group's gross debt and net debt are $6.5 billion and $5.9 billion respectively. The Group has equity of $2.65 billion.

The Group is funding its business growth mainly with commercial papers and medium-term notes. In 2022, net finance costs increased by over $101 million from $36.0 million to $137.6 million.

The gross and net debt/equity ratios are 2.5 and 2.3 times respectively, as at 31 December 2022. Just recently in 2016, the Group had just $59 million in net debt and the net debt/equity ratio was negligible.

(i) What is the board's view on interest rate trends?
(ii) Can the board outline the guidance given to management concerning leverage and the capital structure? Is there a limit on the Group's gearing? How is management refining its acquisition strategy in the current high interest rate environment?

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(iii) With interest rates trending high and staying elevated, how does management optimise borrowing costs?

(iv) With the recent turmoil in the U.S. financial system, how does management perceive the commercial paper market, particularly regarding liquidity and pricing, and what impact does it have on the Group's borrowing costs? Are commercial papers viable as a long-term source of capital?

(v) The Group has banking facilities of $21.2 billion, utilising $7.2 billion of the facilities. What are the costs associated with maintaining the $21.2 billion in banking facilities? Would the company benefit from an equity fund raising (i.e., a rights issue) to reduce its gearing?

(vi) Are the dividends sustainable, considering that the dividend cover has hovered between 1.1 and 1.2? Would it be challenging to increase dividends?

- The Fed funds rate is currently at 4.75% - 5.00% range. Markets are expecting another 0.25% of rate hike at the upcoming FOMC meeting in May 2023. With easing inflation and recessionary fears, markets are pricing in rate cuts from the second half of 2023 onwards, while some pundits are suggesting rate cuts in 2024.

- The Group's credit ratings remain very strong post the acquisition of TransCore. Moody's and S&P have rated us Aaa and AA+ respectively, with the most recent credit opinion report dated 21 February 2023 (from Moody's).

- We want to remain as a highly rated company.

- We expect our borrowings to come down as we pay down debt with stronger operating cash flows and with cash freed up from our capital employed optimisation efforts.

- The Group is monitoring the bond market for the next bond issuance. Post this next bond issuance, the Group expects its weighted average borrowing cost to be in the low 3% for FY2023 based on various interest rate scenarios, comprising a balanced mix of fixed and floating interest rates.

- The U.S. commercial paper (USCP) market remains very liquid with over US$1.1 trillion outstanding as at 31 March 2023. The Group's USCP programme is rated by Moody's and S&P at their respective 'highest' tier for short-term ratings of P-1 and A-1+ respectively and commands a competitive interest rate with the investors.

- The Group's outstanding USCP is fully backstopped by a committed revolving credit facility (RCF) of US$2.2b (around S$2.9b equivalent). This committed RCF allows ST Engineering to execute a same day loan drawdown in the highly remote liquidity crisis event.

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- The $21.2 billion of banking facilities are put in place for trade financing, forex and interest rate hedging, and short-term loans. Of the $7.2 billion utilised as at 31 December 2022, $0.9 billion are short-term loans and the remaining are mainly trade finance and hedging transactions outstanding as at year-end. Given the Group's strong credit ratings, most of these facilities are offered by various banks on an advised basis with no commitment fee.

- Our balance sheet remains strong, and we continue to have good access to diverse sources of funding. There is no plan for an equity issue.

- The Group continues to generate good net profit. Additionally, we have sufficient retained earnings to sustain dividend payment. The Group maintained 15 cents per share in total dividends even in the trough of the COVID-19 pandemic. We announced the increase to 16 cents per share in total dividends, with four cents per share to be paid out quarterly, subject to shareholders' approval of the final dividend at the upcoming AGM.

- The Group's retained earnings was $1.5 billion or 47 cents per share as at year-end 2022, compared to current dividend payment of 16 cents per year.

Q3. As noted in the corporate governance report, the Group has an in-house internal audit function – ST Engineering's Group Internal Audit (IA) which comprises a team of professionals and the Group Head, IA with relevant experience in corporate governance, internal controls, IT security and other relevant disciplines.

As a corporate member of the Singapore Chapter of the Institute of Internal Auditors (IIA), the IA adopts the International Standards for the Professional Practice of Internal Auditing (the IIA Standards) laid down in the International Professional Practices Framework issued by the IIA. A quality assurance and improvement programme on the IA function is in place which evaluates its conformance with the IIA Standards and assesses the efficiency and effectiveness of the IA activities and any improvements.

(i) What is the size of the in-house IA team? Is the IA team based in Singapore?
(ii) Can the company provide details on the scope, key findings, and recommendations made by the IA for FY2022?
(iii) Can the audit committee (AC) confirm that the foreign operating subsidiaries/entities in U.S, Europe, China and other foreign countries were included in the IA? How was the IA carried out for these foreign subsidiaries?
(iv) What is the level of oversight by the AC on the actions taken by management to follow up on the recommendations?

- ST Engineering's IA team is based in Singapore and consists of 21 members. We occasionally also outsource some IA work to the Big 4 accounting firms, excluding our auditors.

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- The audit scope for FY2022 was determined in conjunction with an assessment of our key business risks, precedent audit results and various other factors. There were no audit findings which would warrant shareholders' attention.

- The overseas operations are essentially covered by our in-house IA.

- The AC provides direct oversight on the remedial actions recommended by IA following the audits. The status of these remedial actions is presented to the AC as a matter of routine.

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