

Dynamics And Risk

Industry Review

The global financial crisis hit most economies hard, especially in the earlier part of the year. Businesses worldwide suffered setbacks, both from shrinking demand as well as the tightening of credit. After a few recessionary quarters, global economies are showing signs of stabilising and gradual recovery. However, growth is expected to be subdued and may not reach pre-crisis levels soon.

ST Engineering's well-diversified portfolio – core businesses in four different segments, and a global customer base in both the commercial and defence sectors – has provided it with some level of resilience through the crisis. In particular, it benefited from governments' stimulus spending in defence, infrastructure and other projects.

However, the Group is subject to its operating and economic environment, and changes to external factors not within its control could impact its performance. Some of these key factors are discussed below.

World Economy

According to the IMF, major economies have stabilised and modest growth is expected in 2010. However, the rebound is mainly due to government stimulus plans. There is a risk that when the spending stops, economies may slow down again.

Not unlike other MNCs, ST Engineering's performance could be impacted by the effects of any resulting slowdown.

Currency Fluctuations

As the Group has substantive business operations in the US and international sales, a weaker USD would have an unfavourable revenue and earnings impact on the Group's results. This negative impact would be partially cushioned by the lower cost of materials and parts imports in USD.

The Group's diversified business portfolio provides some room for offsets. With operating units located in different countries, the currency risk is partially mitigated. ST Engineering also hedges its foreign exchange risks to mitigate anticipated impact.

Oil Prices

Oil prices have been on the uptrend since the beginning of the year and was around US\$70 at year's close. High oil prices would have a negative impact on the

Group's customers in the Aerospace sector, and this may in turn impact the Group's performance. However, such an environment of high costs could present opportunities for third-party MRO providers like ST Aerospace, as airlines outsource more MRO work in an effort to contain costs.

Interest Rates

Changes in interest rates affect the cost of business for the Group. Financial markets were volatile in the earlier part of the year, and credit and borrowing terms were tightened. The markets are now stabilising. As a triple-A rated corporate, ST Engineering's access to funding was relatively unaffected.

As an added precautionary measure to ensure available funding, the Group established a multi-currency Medium-Term Note (MTN) programme, under which it issued a US\$500m 10-year note during the year. This provides the Group the ability to pursue opportunities quickly when the need arises.

Labour Supply

The Group continues to harness the global talent pool for its workforce. There remains a shortage of skilled labour globally. ST Engineering continues to work with local authorities in markets where it operates, and leverages training, retention schemes, scholarships as well as alternative sources for hire to sustain its growth.

Defence Spending and Government Budgets

A substantial portion of the Group's business comes from government agencies, including the military.

While several countries have cut their defence budgets, some, such as Singapore and the US, have maintained theirs. Singapore's defence spending, typically about a quarter of the total government spending budget, corresponds to GDP growth. It is expected that the Singapore government will continue to invest in defence solutions and systems that will give its armed forces technological superiority as it continues developing its 3rd Generation SAF. Locally, homeland security remains a key focus. ST Engineering looks forward to continue its partnering role in national security.

In the US, the proposed defence budget for 2010 is higher than that enacted for 2009, to support the US' ongoing fight against global terrorism, and the need for enhanced homeland security. The Group's operations in both the US and Singapore continue to look for

partnership opportunities with the respective authorities. During the financial crisis, governments in many countries increased spending to stimulate their respective economies, and the Group has benefited from such spending through project wins.

The Singapore, China, Taiwan and Gulf States Governments are placing increasing priority on enhancing Information Communications Technologies (ICT) applications and infrastructure development, boding well for ST Electronics in areas relating to e-Government, education, transport and subway systems.

Emerging markets

Diversification into new emerging markets such as Africa, Central Asia and the Gulf States region will help the Group expand revenue streams, strengthen its market standing, and manage costs.

The Group conscientiously monitors market conditions and will take advantage of new market opportunities wherever possible.

Disasters

Some of the Group's operations are in regions subject to natural occurrences such as hurricanes which could affect the Group's operations. A pandemic outbreak such as H1N1 may have a negative impact on global economies and ST Engineering would not be insulated. The Group has in place disaster preparedness and business continuity plans and these are continually reviewed.

Risk Management

The Group's enterprise risk management framework aims to provide reasonable assurance to the Board of Directors that risks are understood and being actively managed within the Group. The framework seeks to achieve downside protection against negative surprises, while at the same time maximising its upside potential when faced with opportunities.

The Group's Risk Review Committee (RRC) maintains oversight of the framework and works with the management to ensure that the Group has adequately prioritised and addressed risk management issues within the Group.

The Group's risk appetite and strategies are regularly reviewed to ensure alignment with its objectives.

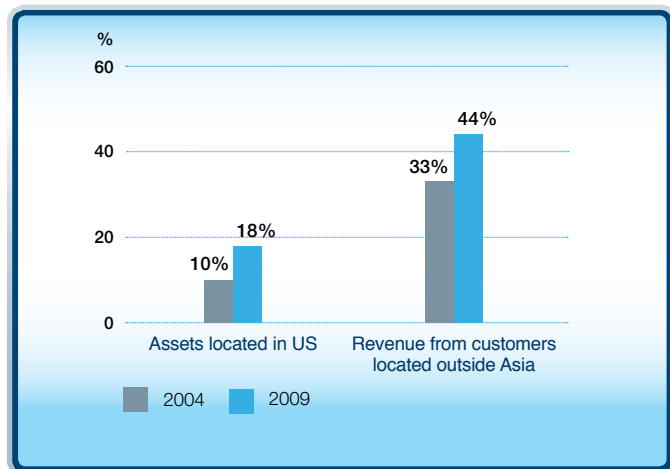
Management reviews and discusses key business risks, and the potential impact brought on by business trends, major events and emerging issues with the RRC at regular intervals.

To promote a strong culture in risk management, risk management discipline is integrated into the main business lines and devolved to the operating level so that risks are managed by all managers. Through a system of Dashboard Reporting that has been developed and cascaded down to the business units, risks and opportunities are periodically reviewed, to respond to the constantly changing business landscape, both locally and globally.

To support the risk management practices within the Group, policies, guidelines and methodologies are constantly being developed and improved upon. Investments are made in our people, to enhance their risk management competencies, as well as in information technology to better facilitate the risk management process.

(a) Strategic and Operational Risk

The Group operates in 24 countries across the globe. As part of the Group's plan to grow its business internationally, it will continue to focus on increasing its operating activities and presence in Europe, Greater China and the US. In 2009, 18% of the Group's assets were in the US (2004: 10%). Revenue from customers located outside Asia increased from 33% of the Group's revenue in 2004 to 44% in 2009.



As part of its business strategy, the Group seeks to increase the proportion of its international business and customers, thereby achieving greater geographical diversification. Likewise, the Group takes the initiative to raise the proportion of its commercial business while maintaining strong support towards the local defence business. The commercial business helps to bring commercially available technology and practices into the defence business, thereby allowing for more cost effective systems and solutions. A more diversified base of commercial and military customers will reduce the risk of customer concentration.

(b) Investment Risk

The Group seeks to grow its businesses on three fronts, through: organic growth of its existing capabilities and capacities; development of new capabilities; and acquisitions of business entities and operating assets or joint ventures.

Investment activities, ranging from the identification of targets to conducting due diligence, are supported by a dedicated team of investment professionals and augmented by external professionals for specialised services. The business proposals are guided by a given set of internal investment criteria, evaluated by senior management and endorsed by a Business Investment and Divestment Committee before seeking final Board of Directors' approval.

(c) Financial Risks and Derivative Financial Instrument Risk

The Group is exposed to financial risks arising from its operations and the use of financial instruments. The Group's principal financial instruments, other than foreign exchange (FX) contracts and derivatives, comprise bankers' guarantees, performance bonds, bank loans and overdrafts, finance leases and hire purchase contracts, investments, cash and short term deposits. All financial transactions with the banks are governed by banking facilities duly accepted with Board of Directors' resolutions, with banking mandates, which define the permitted financial instruments and facilities limits. All financial transactions require dual signatories. The Group

has various other financial assets and liabilities such as trade receivables and trade payables, which arise directly from its operations.

It is the Group's policy not to engage in FX and/or derivatives speculation. The purpose of engaging in treasury transactions is solely for hedging. The Group's treasury mandates allow only FX spot, forward or non-deliverable forward, FX swap, cross currency swap, purchase of FX call, put or collar option, forward rate agreement, interest rate swap, purchase of interest rate cap, floor or collar option ("Permitted Transactions"). These instruments are generic in nature with no embedded or leverage features. Any deviation from these instruments and any other derivative transactions would require specific approval from the Board of Directors.

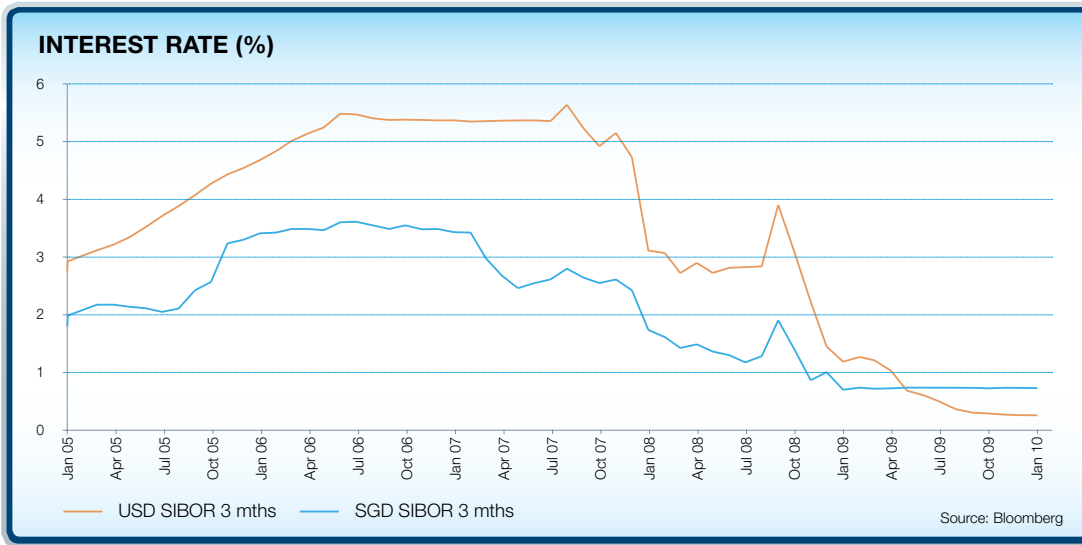
The main financial risks arising from the Group's operations and the use of financial instruments are interest rate, FX, market, liquidity and credit risks. The policies for managing each of these risks are broadly summarised below:

(i) Interest Rate Risk

The Group has cash balances placed with reputable banks and financial institutions. The Group manages its interest rate risks on its interest income by placing the cash balances in varying maturities and interest rate terms with due consideration to operating cash flow requirements and optimising yield.

The Group's debts includes 10-year bonds issued, long and short term bank borrowings and lease commitments. The Group seeks to minimise its interest expense exposure through tapping different sources of funds to refinance the debt instruments in different tenors and/or enter into interest rate swaps, where appropriate.

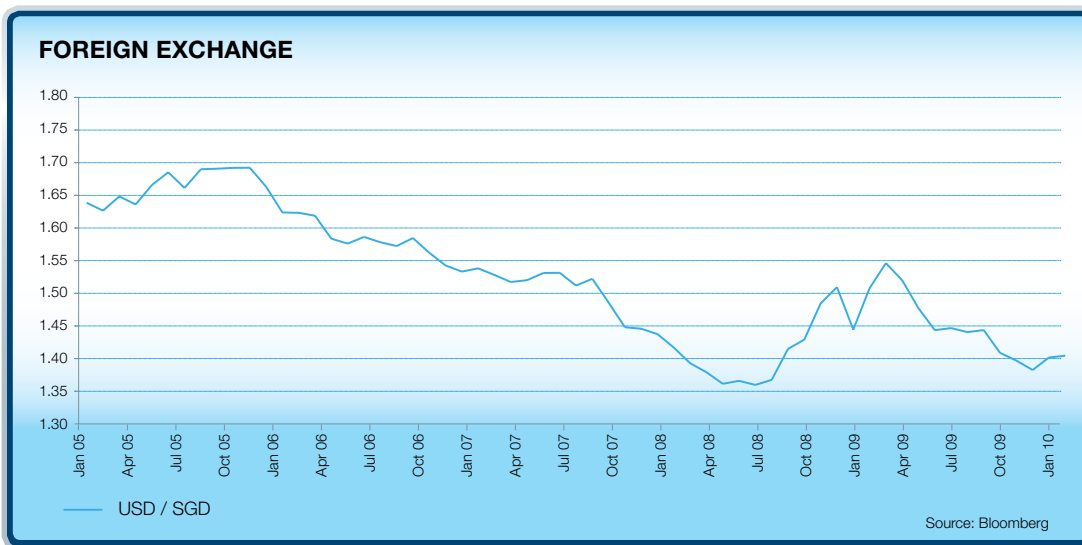
The impact on the Group's annual interest income and interest expense based on a one percentage point movement in the effective fixed deposit rate and borrowing rate are estimated at \$15m and \$2m respectively.



(ii) Foreign Exchange Risk

The Group's FX risk arises both from its subsidiaries operating in foreign countries, generating revenue and incurring cost denominated in foreign currencies, and from operations of its local subsidiaries which are transacted in foreign currencies. The Group's FX exposures are primarily from USD and Euro, and the

Group enters mainly into forward currency contracts to hedge against its FX risk resulting from anticipated sale and purchase transactions denominated in foreign currencies in accordance with the Group's hedging policy. The Group also enters into cross currency swap to hedge the FX risk of its loans denominated in foreign currencies.



(iii) Market Risk

The Group has strategic investments in quoted equity shares. The market value of these investments will fluctuate with market conditions. Management reviews the market value of these investments regularly.

(iv) Liquidity Risk

To manage liquidity risk, the Group monitors its net operating cash flows closely, maintains an adequate level of cash and cash equivalents, secured additional funding facilities from more financial institutions, and diversified the source of funding with a US\$1.2b MTN programme ready to tap the debt capital market when needs arise.

(v) Credit Risk

Credit risk, or the risk of counterparties defaulting, is managed through the application of credit approvals, credit limits and monitoring procedures. Where appropriate, the Company or its subsidiaries obtain collateral from customers or arrange master netting agreements. Cash terms, advance payments and letters of credit or bankers' guarantees are required for customers of lower credit standing.

(d) Acts of God and/or War Risk

The Group recognises that quick recovery and resumption of business operations after a disruption are critical to minimising financial, operational and reputation impact.

Accordingly, it has in place a Business Continuity Management Framework ("BCM Framework"), which embodies enterprise-wide planning and arrangements of key resources and procedures that enable the Group to respond and continue to operate critical business functions across a broad spectrum of interruptions to the business, arising from internal or external events.

The BCM Framework sets out the business continuity methodology which requires business units within the Group to identify and assess the impact of potential threats that could severely interrupt business operations, develop and continuously maintain business continuity strategies and plans to manage the risks of major disruptions.

The key threats identified by the Group include severe weather (such as hurricanes and storms), loss of properties resulting from fire and/or acts of terror, and pandemic flu outbreak.

Business continuity plans have been developed for scenarios arising from these threats, and the plans are tested and updated at periodic intervals.

Besides incorporating force majeure clauses in all contracts to mitigate risk from Acts of God, the Group also has in place a comprehensive insurance programme aimed at mitigating financial losses that might arise from such risks.

(e) Legal and/or Political Risk

Due to the nature of the Group's business, legal risk can arise from the non-enforceability of material contracts, and the violation of rules, regulations, laws and business practices.

As part of the enterprise risk management framework, legal and compliance risks are identified and reviewed periodically.

Policies and practices to manage contract risks include requiring all contracts of material values to be reviewed by legal counsels, and adhering to pre-approved standard contract terms and conditions. Significant deviations from these standard terms are explained and highlighted, and the rationale reviewed and approved by higher levels of management.

Compliance risk may arise from the violation of laws and regulations by which the Group is bound. Significant laws and regulations include the FAA rules and regulations in the Group's Aerospace business, the Strategic Export Control Act, and relevant Security laws and regulations in the Group's defence business.

Practices to manage compliance risks are integrated into the core business processes, to enable these risks to be managed holistically.

(f) Reputation Risk

The damage to the Group's reputation may result from any risk event the Group is confronted with. The damage may also be directly linked to how the Group manages and deals with that risk event. The Group's reputation can be ruined overnight, if the risk event is not managed well, and it results in a crisis.

Hence, the Group recognises that the key to managing reputation risk is not only sound risk management, but also good communication with our stakeholders.

The Group's existing enterprise risk management framework is aimed at building business resilience through sound risk management practices. It also ensures that a structured group-wide corporate communications programme is developed to facilitate effective communication with our stakeholders.

Cash Flow

Operating Activities

In 2009, net cash generated from operating activities amounted to \$932m, \$421m higher than the \$511m in FY2008. This was mainly due to favourable working capital movements with positive variances in trade debtors, advance payments to suppliers, other debtors, deposits and prepayments as well as advance payments from customers, but these were partially offset by the negative variances in progress billings in excess of work-in-progress and trade creditors.

Investing Activities

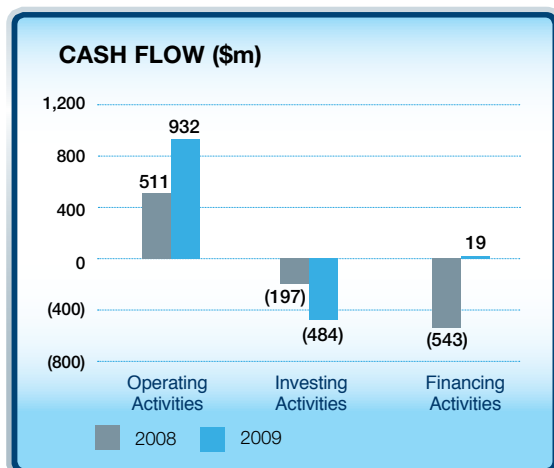
The Group's net cash used in investing activities of \$484m in FY2009 was higher than FY2008 by \$287m, mainly due to increase in purchase of investments and property, plant and equipment, as well as lower proceeds from sale and maturity of investments, but these were partially offset by lower cash outflow for the acquisition of subsidiaries and acquisition of additional interest in subsidiaries.

Financing Activities

The Group had a net cash from financing activities of \$19m in FY2009 compared to a net cash used in financing activities of \$543m in FY2008. The higher cash inflow was attributable to proceeds from the issue of bonds net of repayment of bank loans.

Cash and Cash Equivalents

As at 31 December 2009, the Group's cash and cash equivalents stood at \$1.51b, \$465m higher than that of FY2008. The cash and cash equivalents are managed by the Group's centralised Treasury Unit and the majority of the funds were invested in liquid assets such as fixed deposits. The cash and cash equivalents as at yearend are adequate to fund the committed and planned capital expenditure, as well as to service the Group's borrowings.



Capital Structure And Treasury Management

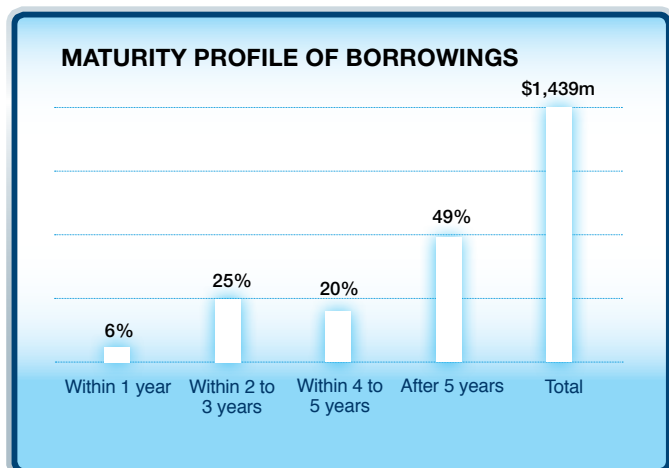
The Group strives to maintain a strong balance sheet and an efficient capital structure to ensure a strong credit rating and healthy capital ratios in order to support its business and maximise shareholder value. To maintain or adjust the capital structure, the Group may adjust the dividend payment to shareholders, return capital to shareholders or issue new shares.

Funding and Borrowings

The Group funds its investments and operations through a mixture of shareholders' funds, advance payments from customers, and borrowings. On an ongoing basis, the Group reviews its cash flow, debt maturity profile and overall liquidity position. In addition to bilateral borrowing facilities with the banks, the Group established a US\$1.2b MTN programme in July 2009 as part of the Group's financing strategy to diversify its funding sources. The Group issued US\$500m of bonds at a fixed coupon of 4.8% in July 2009 for the purpose of funding new capital expenditures, merger and acquisitions and other general corporate purposes.

As at end of 2009, Group borrowings amounted to \$1,439m, which is about 86% of its shareholders' funds including minority interests. 94% or \$1,353m of total borrowings are long term borrowings and the balance is of a short term nature. The long term borrowings comprised US\$500m bonds (10-year) and other term loans largely denominated in USD and Euro, while short term loans are mainly denominated in USD and Chinese Yuan. 90% of total borrowings is on fixed interest rate basis while the balance is on floating rate basis.

The Group's interest cover stays at a healthy 10 times, with a gross debt-to-equity ratio of 85.8%. The Group is in a net cash position (see details in Note 52 in the Notes to the Financial Statements).



Cash Management

The Group's centralised Treasury Unit seeks to minimise the Group's financial risk, to ensure sufficient liquidity to meet day-to-day operational needs, and to invest the cash and cash equivalents within the guidelines approved by the Board of Directors.

The Group adopts the strategy of centralised cash management, where the excess cash of its business entities are pooled and managed through a cash management system. The aim of the centralised cash management strategy is to maximise the returns of the Group's cash resources and minimise associated risks and costs.

Foreign Exchange Management

The aim of the Group's FX management strategies is to minimise FX exposures and associated costs. The most common financial instruments used to manage the FX exposures are spot, forward FX contracts, as well as cross currency swap.

The Group's centralised Treasury Unit ("Unit") facilitates material intra-group FX transactions within the Group to net-off the FX exposures before proceeding to transact the hedge with banks. The Unit executes the Group's material FX transactions with proper segregation of duties between authorised dealers and back office. Only authorised dealers can transact with the counterparties on behalf of the Group, with back office confirming and settling the trades. The dealers' limits and permitted treasury instruments in the form of an authorisation matrix and mandates are communicated to all counterparties.

In accordance with the Group's counterparties risk management policy, the Group established banking facilities including FX facility with a wide panel of local and foreign banks.

Share Purchase Mandate

The purpose of the Share Purchase Mandate is to give the Company the flexibility to undertake the share purchase exercise expeditiously. The Share Purchase Mandate provides the Company an alternate avenue to reward shareholders apart from the traditional dividend payment route as well as acts as a tool for the Company to manage its capital structure.

In the coming EGM, the Company will again seek shareholders' approval to renew the Share Purchase Mandate for the purchase of up to 10% of the number of ordinary shares in the capital of the Company. The share purchase can be effected either through market purchases or off market purchases. The financial impacts of various share purchase scenarios will be presented in a circular to shareholders.

Insurance

Where appropriate, the Group manages its insurance risks on a group basis to leverage its position with the general insurance market.

The Group reviews its insurable risk profile continually and makes the necessary adjustments on risk retention to optimise the coverage and cost. This is done with advice and support from selected insurance brokers. Major group insurance policies include Industrial Special Risk, Liabilities and Workmen Compensation, designed to protect the Group against properties risk, liabilities for its products and services, and workplace accidents respectively. The aviation and marine businesses have specialised insurance programmes.

The Group adopts a proactive strategy with advice and recommendations from insurance brokers to manage the insurance risk with specific risk management programmes covering the prevention of fire and the adoption of behaviour based safety practices, among others.

Accounting Policies

The Group's significant accounting policies are presented in Notes to the Financial Statements, Note 2 (pages 112 to 133). The Group has applied the same accounting policies and methods of computation in the preparation of the financial statements for the current reporting period compared with the audited financial statements as at 31 December 2008, except for the adoption of all the new and revised Financial Reporting Standards (FRS), that are mandatory for financial years beginning on or after 1 January 2009. The adoption of these FRS has no significant impact on the financial statements, except for FRS 1, FRS 107 and FRS 108 as indicated on pages 129 and 130.