Leader Environmental Technologies Limited
利德环保技术有限公司
(Incorporated in the Republic of Singapore on 15 August 2006)
(Company Registration Number: 200611799H)

RESPONSE TO SIAS' QUESTIONS ON LEADER ENVIRONMENTAL TECHNOLOGIES LIMITED'S ANNUAL REPORT

The Board of Directors ("Board") of Leader Environmental Technologies Limited (the "Company", together with its subsidiaries, the "Group") refers to the questions raised by the Securities Investors Association (Singapore) ("SIAS") on the Group's FY2018 Annual Report, and wishes to respond to the questions as follows:

Q1. **Revenue for the group decreased by 55% from RMB119.8 million to RMB53.8 million for the financial year ended 31 December 2018. The group ended the year with a loss of RMB(10.3) million, slipping from a profit of RMB13.4 million a year ago.**

The group disclosed that it has an order book of approximately RMB89.4 million and it intends to target larger scale industrial wastegas and wastewater contracts. The group recognised that a key priority is to improve its cash flow and to strengthen its overall cash position.

(i) **Would the board/management elaborate further on the reasons for the difficulty in securing new projects and the drop in revenue? With the stricter enforcement and further tightening of environmental laws by the PRC government, were there not more projects available to be tendered for?**

Answer:

The securing of the projects was delayed due to, among other factors, monetary tightening by the central bank in China in the early part of 2018. This mainly contributed to the huge drop in revenue as these projects could not be completed in time for delivery in FY2018. Had we been able to perform substantial work on the order book of RMB89.4 million before the harsh winter condition set in, the revenue generated in FY2018 would be comparable to FY2017.

There were indeed more projects available for tender arising from the stricter enforcement of the environmental laws. However, given our working capital constraints, the Group has to be selective and take on projects that offer better gross profit margins and payment terms.

(ii) What are the specific opportunities in the large scale industrial wastegas and wastewater segment that the group is looking to tender for in the next 12-18 months?

Answer:

The Group is exploring public-private partnership projects with third parties, financial institutions and government agencies in the next 12-18 months as the gross profit margins generated for the wastewater related projects can be reasonably higher. Moreover, its operation and maintenance segments will provide regular, stable and long-term cash flows to the Group. The financial institutions are keen to participate and provide substantial part of the funding to finance the construction of these plants and facilities as the assets can be used as collaterals. This will help to relieve the financial burden on the Group. Management is reviewing and evaluating the financial and operational requirements before reaching a decision whether to venture into such partnerships.

As for industrial wastegas, the Group has identified a potential contract from a repeat customer of more than RMB50.0 million and is currently working on the tender submission.

(iii) Can the company explain the group's technological edge and its value proposition to the potential clients?

Answer:

Our projects are characterised by the following attributes:

- simple and compact;
- lower energy consumption;
- longer shelf life of fabric dust bags; and
- higher treatment efficiency rates and lower emission rates.

Given the simplicity and compactness of our dust elimination and desulphurization technological systems, they help our customers to save space when these systems are to be constructed with new power plants or industrial boilers and can also be easily fitted into old or existing power plants and industrial boilers which typically have limited space. They also provide cost savings because the systems in operations consume less energy and for dust elimination systems, our fabric dust bag is not easily damaged and can be used for a longer period of time. Cost of maintenance for both systems is also low. Most importantly, our dust elimination and desulphurization systems have wastegas treatment efficiency rates of up to 99.9% and more than 90% respectively. In addition, both systems have the capabilities of achieving emissions of 10 mg/Nm^3 and 35 mg/Nm^3 respectively that are significantly lower than the stipulated national emission standards of 30 mg/Nm^3 and 200 mg/Nm^3 respectively.

(iv) How does the group ensure that projects tendered for provide the group with sufficient and fair margin for the group?

Answer:

A detailed cost budget is prepared for each potential tender project, taking into account equitable profit allowance according to the nature and complexity of the work to be performed, and also taking into account prevailing market factors. If budget costing is not able to achieve the expected rate of return, then the Group will not participate in the tender. The Group has been adopting this approach in the past and has been able to achieve positive and reasonable returns for its projects.

(v) Does the group have sufficient working capital to fund its projects? Cash and cash equivalents amounted to RMB10.5 million as at 31 December 2018 and the group already has a high gearing ratio of 79.9% (page 119).

Answer:

Management is mindful that the Group has working capital constraints. Over the past two months, the Group has seen better collections from trade receivables, coupled with partial refund of a prepayment made to a supplier of RMB26.0 million. In addition, the Group is also working closely with several of our government related customers to expedite the final settlement amounts for the completed projects. With these recent and pending receipts, management believes the Group will have sufficient working capital to fund its continuing operations.

Q2. **On 5 December 2018, the company announced that its key subsidiary successfully renewed its loan facilities from China Merchants Bank in respect of a loan amount of not more than RMB55.0 million for a one year tenure commencing from 21 November 2018. In addition, the group obtained unsecured loans of RMB6.5 million and RMB3.7 million, comprising interest free loan and interest charge of 10.0% per annum respectively from certain third parties.**

(i) Who is the third party that provided the group with interest free loan?

Answer:

The third party is an unrelated business associate of the Group's CEO and Chairman.

(ii) What is the interest rate of the loan from China Merchants Bank?

Answer:

As disclosed in page 103 of the Annual Report, the effective weighted average interest rate is 8.71%.

(iii) Has the board evaluated the group's cost of capital? With the new loans renewed at average interest rate of 9% in 4Q2018, how much profit margin is left?

Answer:

Management has considered and factored in the higher interest costs into the detailed cost budget for each individual project based on the project's funding requirements in 2019. The prevailing cost of borrowing is still reasonably lower than the historical gross profit margins the Group has managed to achieve from its past projects.

(iv) Given that the group has to fund projects with its own working capital, has the group considered alternate ways of funding the projects, including structuring in more milestone payments and upfront payment by the customer? The issue of large repayment is also the subject of a SGX-ST query dated 20 March 2019.

Answer:

The Group had tried exploring long-term financing arrangement and project financing with other financial institutions, but without much success. In addition, the Group is also unable to secure equity investment from strategic investors in view of its current financial performance. Hence, at the moment, the Group can only focus on strengthening its working capital, and will work closely with customers to agree to more upfront payments and milestone payments prior to contract signing. This will apply to new contracts secured after May 2019. Apart from improving its payments terms, the Group will also expedite its trade collections to further improve our cash flows.

(v) As the cycle of the projects tends to be long (i.e more than a year), does the board consider it appropriate to fund its working capital with short term funds from the bank?

Answer:

While there appears to be a funding mismatch prima facie due to the short term nature of our secured bank borrowings, the Group has been able to refinance and roll over these loans yearly without much issue. This may not be an ideal situation for the Group but in the absence of a long term funding option from our financiers, this approach has served our Group adequately. Separately, the Group shall also partake in projects with a shorter duration (3 - 6 month period) to obtain a right mix of projects so that our working capital is not over-stretched.

(vi) Would the board evaluate how it could further strengthen its capital structure so that it could support the group's activities and growth?

Answer:

The existing engineering, procurement and construction ("EPC") business of the Group faces challenges despite the favourable government policies and initiatives. Hence, management is fully aware that the Group cannot solely depend on the cash flows generated from its EPC business to strengthen its capital structure, and has identified the need to venture into other environmental related businesses. Accordingly, the Group has considered the public-private partnership model of projects to be a possible solution. This model is long-term in nature and its operation and maintenance segment can provide a steady stream of long-term recurring income which the Group can tap on to support and expand the Group's EPC business. With the regular cash flows generated, the Group will have more resources at its disposal to execute its growth plans. Management is currently reviewing and evaluating the financial and operational requirements of such public-private partnership projects. Furthermore, it is also in discussions with financial institutions on potential collaborations and funding support. The above still remains in an explorative stage.

Q3. In the Corporate Governance Report, under Principle 13: Internal audit (page 39), the company stated the following regarding the internal audit function:

Internal Audit

Principle 13: ***The Company should establish an effective internal audit function that is adequately resourced and independent of the activities it audits***

The Company currently does not have a separate internal audit function. The Audit Committee will, as and when necessary, make an assessment and then recommend to the Board the appointment of internal audit professionals (with the requisite qualifications and experience) to undertake the internal audit function of the Group for the relevant financial years. The internal audit professionals will report primarily to the Audit Committee. The internal audit plan will be submitted to the Audit Committee for approval prior to the commencement of the internal audit and the Audit Committee will oversee and monitor the implementation of improvements as required. The appointed internal audit professionals shall have unfettered access to all the company's documents, records, properties and personnel, including access to the Audit Committee. The Audit Committee shall, at least annually, review the adequacy and effectiveness of the internal audit function. The Audit Committee reviewed the internal audit function and noted necessary co-operation were provided by the Management to enable the internal auditor to perform its function. After reviewing the internal auditors' reports and actions implemented by Management, the Audit Committee is satisfied that the internal audit functions are adequate and effective.

(Source: Company annual report)

Elsewhere in Principle 11: Risk management and internal controls (pages 32 and 33), the company has also said the following:

The Audit Committee has also appointed MS Risk Management Pte Ltd in November 2018 to review Jilin Anjie Engineering Co., Ltd's internal controls of the Purchases to Payment Process including Prepayments. These business processes have been identified by the Audit Committee, upon discussion with management as most critical to the operations of the Group's most significant operating subsidiary. The review work has been completed as of the date of this report and the draft internal audit findings highlighted the following three significant internal controls deficiencies which required immediate remedies:

(i) Approval for Use of Official Seals and Custodianship

The use of the Company Seal and Contract Seal is to be approved by the respective heads of departments currently. The internal auditors is of the opinion that the current designated approving personnel are inappropriate as the Company Seal can be used for all legal documents and supplants all the functions of other Official Seals such as Contract Seal, Finance Seal, Legal Seal, except for the Customs Seal and the Invoice Seal….

(ii) Enhancement on the Segregation of Duties within the Finance Team

The internal auditors noted that the Accounts Supervisor was tasked to perform both keying in and approval of journal entries. The lack of proper segregation of duties may lead to weak check and balance that may result in material misstatement of financial statements….

(iii) Enhancement on the process to release payment in bank portal

Our CEO has delegated the authority to release payment in the bank portal to his personal assistant ("PA") single-handedly and without limits. As the releasing of payment request in the bank portal is deemed reviewed and approved, the internal auditors is of the opinion that there may be a lack of accountability over the good corporate governance practices within the Company. Notwithstanding, the internal auditors have not noted any anomaly in the course of their review….

Apart from the above highlighted control weaknesses, there were also other controls improvement recommendations proposed by the internal auditors in their draft internal audit report.

(i) Can the board confirm that while it does not usually have an internal audit function, the audit committee specifically engaged MS Risk Management Pte Ltd in November 2018 (on an ah-doc basis) to review Jilin Anjie Engineering Co., Ltd's internal controls?

Answer:

Yes, the board has specifically appointed MS Risk Management Pte Ltd to review the internal controls of its subsidiary, Jilin Anjie Engineering Co., Ltd. Going forward, the board will continue to assess the business processes of the Group and when appropriate, engage the services of internal auditors to review the internal controls of its operating subsidiary/subsidiaries.

(ii) Would the audit committee help shareholders understand their oversight and monitoring of the group's risk management and internal controls in the past?

Answer:

As part of its oversight and monitoring of the Group's risk management and internal controls in the past, the Audit Committee had performed the following works:

reviewed quarterly results announcements to ensure the numbers presented are consistent with their understandings and also to identify potential risk areas;

discussions with the Group's CFO to understand the nature of certain transactions which were recorded or highlighted;

discussions with the Group's CEO during the quarterly board meetings to obtain a better understanding of the Group's businesses and its developments; and

reviewed audit findings and key audit matters and, to the extent necessary, engaged the external and internal auditors directly to help the Audit Committee better understand certain issues raised in external and internal auditors' respective reports and whether they were adequately addressed.

(iii) Going forward, how closely will the audit committee be working with management to address the issues raised in the internal audit?

Answer:

The Audit Committee has always been actively involved in addressing the issues raised by both external and internal auditors. Going forward, the Audit Committee will continue obtain updates from the CFO regarding the actions taken to address the issues raised in the internal audit. It will also follow up on the issues with the CEO during the quarterly board meetings if certain material weaknesses are not rectified.

(iv) Would the audit committee be shortlisting and selecting an internal auditor on a permanent basis? How soon can an internal auditor be appointed? Would the audit committee be announcing the appointment of an internal auditor on SGXNet and disclosing the scope of work of the internal auditors for FY2019?

Answer:

Yes, the Board intends to shortlist and engage the services of internal auditors to review the internal controls of the Group's subsidiary/subsidiaries on an annual basis. The appointment of internal auditors will usually be made prior to the Group's third-quarter board meeting and the internal audit plans will be presented to the Chairman of the Audit Committee and its members for approval. The Group will not announce such appointment and scope of work on SGXNet as it is not required under the Listing Rules, but will continue to disclose information such as the audit firm rendering the internal audit services, the summarized work scope covered under the engagement, and if there are material weaknesses found, a summary of the audit findings and remedy actions, in the Group's Annual Report.

By Order of the Board

Lin Bai Yin
Executive Chairman and Chief Executive Officer
30 April 2019