

CEO's Management Discussion & Analysis

INDUSTRY OVERVIEW

The global economy continued to be characterised by challenging operating environments and volatility caused by trade tensions between the East and the West, as well as strained emerging market economy performances across the world. Global commodity prices also remained erratic making it especially difficult for manufacturers around the world to manage costs and strategise efficiently.

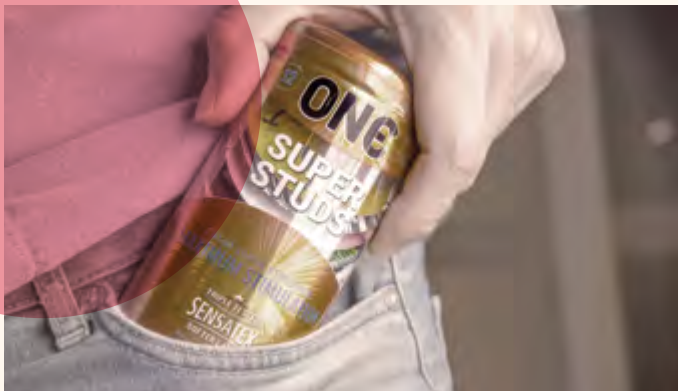
In the Sexual Wellness industry, consumer tastes, preferences and expectations continued to evolve at unprecedented rates. Trends towards digital and online shopping, environmentally conscious packaging, as well as customisable options, are redefining the pace at which we need to innovate. We have focused on embracing the opportunities offered by the digital transformation across marketing, social media and e-commerce. In doing so, as an organisation today, we are delivering more personalised products, messages and services directly to our consumers.

Despite the advancement in consumer platforms, in much of the world, many traditional barriers and inequities hindering the use of condoms continue to exist. These include poor access,



age restrictions, gender norms, religious stigmas, insufficient supply and, in some places, laws that make it an offence to carry condoms. International funding for condom procurement has also noticeably decreased in recent years, with the hope that domestic funding would increase to make up for the deficit yet to materialise. This stark contrast is reflective of the disparity between sexual health education standards in different parts of the world.

Finally, one of the most prominent economic trends noticeable this year pertains to sustainability. From our frequent conversations, we realise that our consumers do not just care about what type of products they use, but also about how products are made and the resultant impact on the environment and society. We have undertaken measures to improve our consciousness surrounding the usage of materials in our packaging, energy conservation in all of our facilities, as well as broader policies governing our operations. Further details on our sustainability efforts can be found in the Sustainability Statement on pages 15 to 25 of this Report.





OPERATIONS REVIEW

The challenging industry climate has continued to emphasise the importance of reducing inefficiencies to ensure that we safeguard our position as one of the leading low-cost manufacturers in the world. To fuel our growth and improve returns, we have intensified our drive to find operational efficiencies and reduce structural costs. These initiatives have made good progress to reducing operational costs across the areas of administration, procurement and manufacturing.

The commissioning of our dedicated latex compounding facility has enabled us to maintain better controls over the quality and costs of our latex formulations. Although still in its infancy, this project has already begun to bear fruits in enabling us to produce thinner condoms more consistently, as well as reduce our rejection rates in our manufacturing facilities. Improvements will continue to be made to equip us with the tools to better insulate ourselves from the volatility in the latex market.

As minimum wages and the costs of social compliance continue to escalate, we recognise that the ability to manage our headcount will also be critical to maintaining our cost advantages in the industry. We have during the year continued to incorporate more automation into our manufacturing processes that have not only improved reliability and productivity especially with regards to condom testing, but have also provided us with a platform to further reduce our dependency on labour moving forward.



We understand that continuing to remain well-informed about our customers' needs from the ground will be critical to future success. A lot of effort has been spent during the year to collaborate with new brand owners and private label customers to develop packaging and product solutions that are customised to the needs of their markets. In doing so, we continued to expand our expertise in working with a wider range of packaging materials, finishing processes as well as condom variants. New product innovation will continue to be critical to our success especially in the Commercial segment moving forward.

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FINANCIAL REVIEW

During the financial year ended 30 June 2019 ("FY 2019"), our Group recorded a revenue of RM378.5 million, representing a decrease of 7.6% in comparison to the previous financial year. This has been due to a challenging operating environment specifically within the Tender segment as well as a disruption of orders experienced during the second half of the FY 2019 resulting in lower condom sales for the year.

Managing production output against erratic ordering patterns during the year was made even more difficult against the backdrop of volatile raw material prices, most notably latex. Moreover, social compliance audits and remediation measures stemming from the migrant worker allegations caused pressure on overall profitability, resulting in the overall gross profit margin of 23.6% for the year.

Distribution expenses were approximately 19.4% lower than the previous year in line with lower condom sales, however these savings were partially offset by higher administrative expenses exceeding last year's total by RM4.9 million. Ultimately, combined with the impact to our gross profit margins, the corresponding profit before tax and profit after tax decreased to RM3.8 million and RM3.1 million respectively for the financial year.

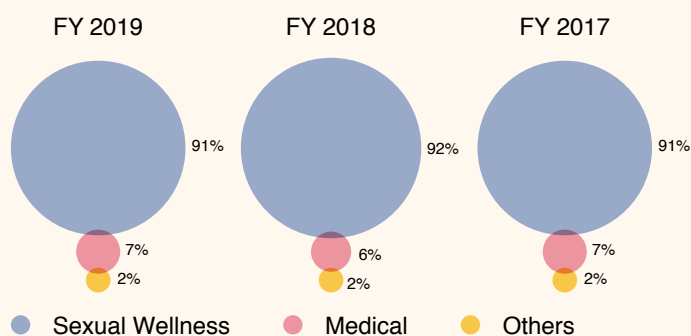
In spite of lower profits during the year, we recorded a drastic improvement in cash flows from operating activities in comparison to the previous financial year. This contributed positively to our total cash and cash equivalents total of RM63.6 million as at the end of FY 2019, representing an increase in excess of 32.0% from the previous year's total. Consequently, we have maintained liquidity on our balance sheet as represented by a healthy current ratio of 3.23x as at the end of FY 2019.

Capital expenditures amounted to RM19.0 million during the year and were primarily directed at the commissioning of our latex compounding facility as well as incorporating more automatic testing machines into our production lines. Although we did increase utilisation of some of our trade facilities during the year, overall debt still remains relatively low as reflected by a gearing ratio of 0.07x for the year. In aggregate, this contributed to non-current assets totalling RM319.2 million and a corresponding total asset base of RM595.1 million.

Product Divisions

The Sexual Wellness division continued to contribute in excess of 90% of Group revenue despite condom and personal lubricant sales being adversely affected by the social compliance allegations during the second half of FY 2019.

The Medical division recorded healthy growth lead primarily by catheter sales that increased by approximately 8% compared to the previous year. This achievement is even more impressive considering the catheter facility had been limited during the year by a lack of capacity. Plans to expand the existing site are already underway and are expected to come online over the course of the next few months.



OBM segment contributed

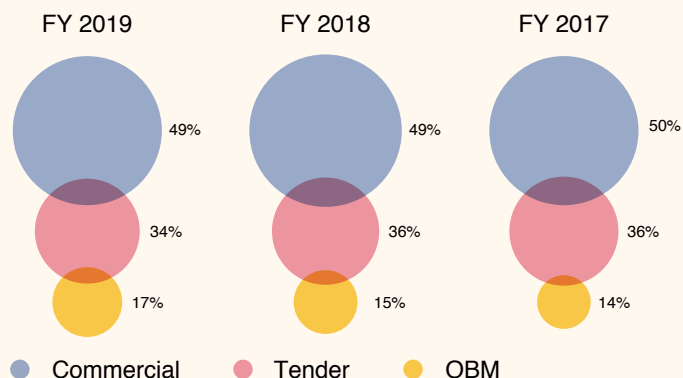
17% of revenue

Market Segments

Global tender markets remained extremely challenging to navigate during the year with the trade war between the United States of America (“USA”) and China intensifying the struggle for NGOs and government bodies to secure budget allocations for humanitarian aid purposes. Market forces continued to perpetuate competitive pricing which affected the Tender segment’s profitability. Sales volumes were also adversely affected by a number of social audits that had to be completed during the second half of the financial year in order to provide assurance to our customers with regards to the allegations regarding our treatment of foreign labour.

The Commercial segment remained the most significant avenue of sales for our Group with increasingly more brands opting to outsource manufacturing as a lack of product variety and costs concerns have become more prominent in developed nations. Unfortunately, sales in this segment was also hindered by social audits during the year.

Our Own Branded Manufacturing (“OBM”) segment contributed a record high sales total during the year underlining its importance to our Group as a segment that not only demonstrates high future growth potential but also provides diversification for our Group’s revenue stream. ONE® Condoms in particular continues to receive very positive feedback as evidenced by the increased range of products available in Walmart stores as well as the new retailers that have commenced listings during the year across the USA.

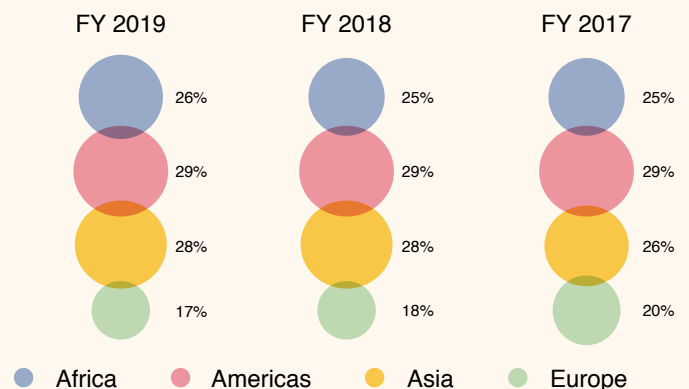


Geographical Regions

Asia remains the region that demonstrates the most prospect following last year’s record sales contribution. Sales in Asia are predominantly commercial in nature, with customers in the region driving demand for our Group’s most imaginative packaging and product concepts over the last few years.

Sales in the European region trended towards the private label business with many government funded health avenues being limited by budget restraints. Helping to offset this is the encouraging growth demonstrated by e-commerce sales in the region that continue to show promising growth via the Commercial as well as OBM segments.

Due to humanitarian budget constraints, sales to African and the South American sub-region were lower in the year. Sales to these regions are generally made via the Tender segment and typically involve specifications with simpler packaging and product varieties.



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OUTLOOK

As we look ahead to 2020, it is clear that uncertainties will continue to persist. Trade disputes and the Brexit outcome, fluctuations in commodity and currency prices as well as expected slower growth in major economies will pose significant headwinds and heightening risks to global economic prospects. The consumer goods market in particular has evolved at a phenomenal pace to integrate the rapidly changing trends in purchasing patterns.

In spite of these changes, condoms remain the most efficient and economical means of contraception and prevention against the spread of sexually transmitted infections. Although widely acknowledged for their importance, humanitarian aid budget constraints and changing consumer trends have resulted in insufficient condoms being made available to those who need them – especially in regions of the world where the burden of HIV is highest.

Recently, UNAIDS published a feature story simply called “Not enough condoms” in which it wrote ‘Condoms, if easily available and used consistently and correctly, are one of the most effective and inexpensive methods available to reduce the sexual transmission of HIV and other sexually transmitted infections and to prevent unintended pregnancy. Whilst considerable progress has been made, there is a risk that we will lose momentum. If the world is to be on track to end AIDS by 2030, there must be adequate and predictable financing for development. But, for the first time since 2000, the resources available for the AIDS response globally have declined.’

Rather than fallback to traditional avenues of education and distribution, the world is primed for new programs that should be aimed at strengthening demand for and supply of condoms and lubricants. Innovative solutions will be required to address the barriers and inequities that hinder access and use of condoms by young people, key populations and other people at higher risk of HIV. These promotion and distribution strategies need to be driven by data and tailored to the needs of different communities.

This shift will clearly advantage manufacturers like ourselves who have prioritised innovation and modernised their processes to incorporate environment, social and governance aspects into traditional core values. Though it has been challenging at times, I see many of the protocols that we have been implementing to be defining traits of our organisation moving forward that will really set us apart from the competition for years to come.

This year in particular has demonstrated that resilience, diversity and an inherent entrepreneurial spirit continue to be the key strengths of our Group. Combined with prudent capital management, a healthy liquidity and debt profile and a sustained focus on our key strategies, I am cautiously optimistic that we will be able to position ourselves at the forefront of a sexual health industry that is on the verge of dramatic transformation.

ACKNOWLEDGEMENTS

I want to thank my colleagues throughout the whole company for their hard work in persevering through these challenging times. Karex is fortunate to have such talented and dedicated people and I am deeply aware of my responsibilities to them – and to our many other stakeholders – in being asked to steer us through these waters.

I also want to thank the Board of Directors for their confidence and invaluable guidance as we aim to continue our transformation into a holistic sexual wellness solution provider. And, finally, to our shareholders, thank you for your ongoing unwavering support and belief in our company especially during these challenging times.

MK Goh

Chief Executive Officer