

MANAGEMENT DISCUSSION AND ANALYSIS

RESULTS REVIEW

The Group's turnover in the first six months of 2011 increased by 33% to US\$8,798 million (approximately HK\$69 billion), reflecting the continuing expansion of its market share through both organic growth and acquisitions.

- Core operating profit down by 16%; core operating profit margin decreased from 5.1% to 3.2%
- Total margin increased by 40%, increasing as a percentage of turnover from 13.5% to 14.3%
- Profit attributable to shareholders reached US\$236 million, representing a decrease of 15% compared to 2010

Core operating profit was down due to higher operating expenses arising from recent acquisitions and investing in the Group's new Three-Year Plan.

While total margin increased by 40%, they were negatively impacted primarily by LF USA.

Meanwhile, the Group is rationalizing operations and reducing costs, the benefits of which will keep us on track for the year and to meet our targets of this Three-Year Plan by 2013.

Furthermore, the integration of the Group's three business Networks is progressing well and the Group is realizing encouraging results from cross-selling opportunities.

SEGMENTAL ANALYSIS

With the new Three-Year Plan 2011-2013 and new organizational structure, we are also disclosing segmental information based on the three Networks: Trading, Logistics and Distribution.

The **Trading Network** represented 70% of total turnover, up 18% from the same period last year, reflecting strong organic growth from existing customers. Largely due to increased operating costs, core operating profit grew only 4%.

The **Logistics Network** accounted for 2% of total turnover. As the logistics business is a newly acquired business, there is no direct year-on-year comparison regarding growth of turnover and core operating profit.

The **Distribution Network** represented 28% of total turnover, and it grew 85% compared to the same period last year. The growth was mainly due to contributions from acquisitions including Jimlar Corporation, Oxford Apparel and IDS. Core operating profit declined by 48% from last year, reflecting higher operating costs.

In the first half of 2011, softgoods and hardgoods accounted for 64% and 34% of turnover respectively. Logistics represented approximately 2%, which is attributed to the logistics business that we took over from IDS. **Softgoods** turnover grew 16%, which was largely due to the organic growth of some existing customers, together with contributions from acquisitions such as Oxford Apparel, Loyaltex Apparel, HTP Group and Just Jamie & Paulrich.

Turnover from the **hardgoods** business increased by 66%, attributed mainly to acquisitions like IDS, Jimlar Corporation and Jackel Group.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

Geographically, while the **US** continued to be the Group's key export market, representing 58% of total turnover during the period under review, the share came down from 67% of first half of 2010. The change was caused by increased share from other markets, in particular China and rest of Asia, as a result of the acquisition of IDS. Turnover increased by 15%, reflecting growth in both trading and distribution businesses.

Europe accounted for 22% of turnover, compared to 25% in 2010. The overall drop in percentage of total turnover was attributed to the increase in share from the China market after the acquisition of IDS. Turnover increased by 15%, which was caused by the continued progress made in the European distribution business and contributions from acquisitions like Jimlar Europe as well as the logistics business in UK.

China accounted for 6.0% of turnover, compared to 0.6% same period last year. **Rest of Asia** including Japan also accounted for 6.8% of turnover, compared to 0.6% same period last year. Turnover increased by 1,184% for China and 1,430% for rest of Asia including Japan. Both were caused by the flow of business in LF Asia and LF Logistics as a result of the acquisition of IDS at the end of last year. Japan itself represented 0.3% of total turnover in first half of the year.

Turnover in **Canada, Central & Latin America**, and **Australasia** accounted for 4%, 1% and 2% of the Group's total turnover respectively, representing increases of 78%, 42% and 8% over those geographies' previous turnover. **South Africa & Middle East** represented less than 1% of Group's turnover, an increase of 16% in turnover from first half last year.

ACQUISITIONS

During the first half of 2011, the Group signed ten deals which included seven acquisitions for the Group's Trading Network and three acquisitions for its Distribution Network. Turnover and profit before tax of the ten newly acquired companies were approximately US\$800 million and US\$100 million respectively for last year.

TRADING NETWORK

The new additions to Li & Fung's Trading Network include the acquisitions of Modium, Stone Sapphire/Gemstone Printing, Celissa, Techno Source, Loyaltex Apparel, Collection 2000 and Exim Designs.

Modium was acquired in January and is a virtual manufacturer of ladies' and men's woven apparel based in Istanbul, Turkey. Key competencies are its strong product development skills and short leadtimes.

Celissa was acquired in March and is a trading company based in Istanbul, Turkey, supplying wovens and knits to customers in Europe. Key competencies are short leadtimes and access to key customers.

In March, Li & Fung also acquired Techno Source USA, Inc., one of the fastest-growing toy companies and a toy innovator with a track record of successfully introducing electronic and non-electronic games. This acquisition provides a platform for Li & Fung to continue to build and expand its toy business globally.

In the same month, Li & Fung acquired Stone Sapphire, a company specializing in the supply of printed paper products and technical packaging. The acquisition provides Li & Fung with a platform to source specialty paper products and complex packaging solutions for our customers, and it further complements our expertise in the "Stationery and Supplies" category.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

In May, Li & Fung acquired Loyaltex Apparel Ltd. Loyaltex is a sourcing and development company specialized in knits, woven/denim and sweater. This acquisition will add a new portfolio of customers including Aeropostale, which sells casual clothing to 14-to-17-year-olds through over 900 stores in the United States, Canada and Puerto Rico; Sanmar, a major supplier of apparel to screen printers, embroiderers and promotional product distributors; and Alfred Dunner, the leading manufacturer of moderately priced ladies coordinated sportswear in the United States and Canada. This will further strengthen the Group's capabilities in global sourcing, as well as create significant synergies with its existing business.

During the same month, Li & Fung acquired Collection 2000. It specializes in fashion color cosmetics products for the beauty industry in the UK, with a range of products available in the majority of the country's leading mass color cosmetics retailers. This acquisition is expected to further category and customer base expansion in Li & Fung's Health, Beauty, and Cosmetics (HBC) business in the UK.

In June, Li & Fung acquired Exim Designs Co., Ltd., a Thai-based furniture trading company that specializes in ready-to-assemble, flat-pack furniture. This acquisition will help strengthen Li & Fung's capabilities in the furniture business with mass-market and traditional furniture retailers and the Group expects additional synergies to be created with its existing customers in this product category.

DISTRIBUTION NETWORK

In addition, the Group has acquired Beyond Productions, TVMania and Hampshire Designers for its Distribution Network.

In January, Li & Fung acquired Beyond Productions, LLC, a leading designer and licensor of women's fashion apparel and accessories. The deal broadens the Group's range of offerings for the retail channel and further strengthens its position as an innovative, design-driven company.

In May, Li & Fung acquired TVMania, the leading Pan-European supplier of character licensed and branded merchandise with the most comprehensive set of licenses across Europe. Its portfolio of character licenses include Hello Kitty, Mickey Mouse, Cars, Batman, Ben 10, Bakugan, Star Wars, Barbie, Pokémon, Bob the Builder, Sponge Bob, Spiderman Movies, Smurf, Dora the Explorer as well as the surf brand Gotcha. Major licensors include Sanrio, Disney, Marvel, MTV/Nickelodeon, Hit, Cartoon Network, Lucas Films and Mattel. The company's main product categories are casual, nightwear and underwear. This acquisition will help to further expand the Group's licensed apparel business alongside its private label apparel business across Europe. The acquisition of TVMania underlines the Group's strategy of creating synergies between its US and European distribution businesses. Together with Kids Headquarters, a US deal which was acquired in 2009, this acquisition will allow the Group to become the largest global player in licensed apparel trading, and hence a stronger and even more valuable partner to licensors and retailers.

In May, Li & Fung acquired Hampshire Designers, Inc., the women's division of Hampshire Group Limited in the US. The acquisition includes Designers Originals, Mercer Street Studio and Hampshire Studio, and it is expected to further expand the Group's women's knitwear and woven product offerings and capabilities.

The above acquisitions will further expand our customer base and strengthen our product offerings, creating growth potential across our Networks.

The focus on both acquisitions and organic growth has demonstrated the resilience of Li and Fung's model throughout the years. The Group has relied on sustained organic growth in the business over the last 20 years and has complemented that with an acquisition strategy which could be especially relevant during times of uncertain economic conditions when excellent deals are available at attractive prices.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

The Group will continue to pursue acquisitions to complement our organic business growth during this new Three-Year Plan 2011-2013.

DISPOSAL OF PROPERTIES AND MEDICAL EQUIPMENT BUSINESSES (CONNECTED TRANSACTIONS)

In June, the Group announced the disposal of IDS Group's medical equipment businesses to Li & Fung Distribution Limited, a wholly owned subsidiary of Li & Fung (1937) Limited, which is a substantial shareholder of the Group. The reason for disposal was that the medical equipment businesses, which involved the distribution of durable medical equipment and required provision of long-term maintenance services, were not consistent with the Group's overall on-shore distribution business strategy. This disposal generated a gain of approximately US\$47 million for the Group.

At the same time, the Group also announced the sale of two properties in Turkey and Taiwan as well as a property company in China, and a lease back of the property in Turkey. The Group believes the disposal and leaseback allow the Group to achieve its asset light strategy while obtaining a long lease for the Group's use. The disposal resulted in a gain of approximately US\$14 million.

THE NEW THREE-YEAR PLAN 2011-2013

This is the first year of the current Three Year-Plan. The targets of this new Three-Year Plan 2011-2013 are to achieve core operating profit of US\$1.5 billion by 2013, with Trading, Logistics and Distribution expected to contribute US\$0.7 billion, US\$0.1 billion and US\$0.7 billion respectively.

We have grown from one global network to three – Trading, Logistics and Distribution – but the whole is much greater than the sum of its parts. While the Three-Year Plan targets are once again ambitious, we are confident about achieving them because the Group now covers the entire supply chain end to end and is well positioned to grow across these three distinct yet interconnected Networks.

Li & Fung will also continue to monitor market conditions to ensure the continuing strength of its franchise, and to meet its responsibilities to all its stakeholders, including customers, employees, vendors and shareholders.

Li & Fung has maintained strong credit ratings from Moody's and Standard & Poor's, at A3 (stable) and A– (stable) respectively. The Group continues to enjoy healthy cash flow and has strong credit ratios. For details, please refer to the following "Financial Position and Liquidity" section.

PEOPLE

The Group aims to attract, develop and promote the best talent. The strategy is to offer innovative, practical opportunities to learn allowing each employee develop the right capabilities that support the mission and goals of the Company.

As of 30 June 2011, the Group had a total workforce of 27,542, of whom 4,506 were based in Hong Kong and 23,036 were located overseas. With the increase in size, ensuring that our people – regardless of where they are located – have the resources they need to learn and grow is critical. Besides formal classroom learning, the Group enables merchandising e-learning across the enterprise through our internally developed knowledge platform inaugurated in February this year. This e-learning platform includes a spectrum of core and discretionary online courses that are specific to job-role learning. It also contains a deep mine of searchable knowledge related to sourcing, business trends and management practices that employees can access at their fingertips. In the last six months, over 3,000 employees have participated in these learning activities.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

Other than core functional skills, the Group continues to invest in building leading capabilities. The Leadership Development Program is running for its second year in conjunction with the MIT Sloan School of Management and The University of Hong Kong. A group of 53 senior executives participated in the two learning weeks in March and June respectively. The Group is planning on the next-level Leadership Program to be launched in the second half of the year.

In 2010, Li & Fung also launched our corporate Program for Management Development (PMD) focusing on attracting and developing talent for future business leadership positions. A total of 43 Management Associates will graduate from this Program in the second half of 2011.

The investments we make in learning help our people for the future. When we invest in our people, we are creating a sustainable competitive advantage.

Total manpower costs for the Group for the six months ending 30 June 2011 were US\$556 million, compared with US\$320 million for the same period in 2010.

CHANGE IN FUNCTIONAL AND PRESENTATION CURRENCIES

In prior years, the Company regarded HK dollars as its functional currency. However, as a result of the Group's continuous acquisitions in recent years, the Company and most of its major operating subsidiaries' business transactions in terms of operating, investing and financing activities have increasingly placed greater reliance on US dollars. As such, effective from 1 January 2011, the Company and certain of its subsidiaries have changed their functional currency from Hong Kong dollars to US dollars. US dollars have also been adopted as the presentation currency of the Group's interim financial report. The Group's businesses as well as interests of its stakeholders are becoming more globalized and the change in presentation currency to US dollars will result in a more appropriate presentation of the Group's financial position and performance. The comparative figures in this interim report are translated accordingly. The changes in functional and presentation currencies have no significant impact on the financial positions of the Group as at 31 December 2010 and 30 June 2011, or the results and cash flows of the Group for periods ended 30 June 2010 and 2011.

FINANCIAL POSITION AND LIQUIDITY

The Group continued to be in a strong financial position for the period under review with cash and cash equivalents amounting to US\$573 million as of the end of June 2011.

Normal trading operations were well supported by more than US\$2 billion in bank trading facilities. In addition, the Group had available bank loans and overdraft facilities of US\$1,108 million, out of which US\$496 million were committed facilities. As of 30 June 2011, only US\$340 million of the Group's bank loan and overdraft facilities was drawn down, out of which utilization of committed facilities was US\$145 million.

At balance sheet date, the Group's gearing ratio was 22%, calculated as net debt divided by total capital. Net debt of US\$1,022 million was calculated as total borrowings (i.e. the aggregate of long-term bonds and bank loans of US\$1,595 million) less cash and cash equivalents of US\$573 million. Total capital was calculated as total equity of US\$3,697 million plus net debt. The current ratio was 1.1, based on current assets of US\$4,040 million and current liabilities of US\$3,610 million.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

CREDIT RISK MANAGEMENT

Credit risk mainly arises from trade and other receivables.

The Group has stringent policies in place to manage its credit risk with trade and other receivables, which include but are not limited to the measures set out below:

- (i) A significant portion of business is secured by back-to-back payment arrangement with vendor or covered by letters of credit, customers' standby letters of credit, bank guarantees or credit insurance;
- (ii) Certain trade receivable balances on open account term are factored to external financial institutions without recourse;
- (iii) The Group's credit control team makes an ongoing assessment of each counter party and determines the credit limits based on, among other factors, their trading and settlement history as well as their respective financial background.

FOREIGN EXCHANGE RISK MANAGEMENT

Most of the Group's cash balances were deposits in HK\$ and US\$ with major global financial institutions, and most of the Group's assets, liabilities, revenues and payments were held in either HK\$ or US\$. Therefore, we consider that the risk exposure to foreign exchange rate fluctuations is minimal.

Foreign exchange risks arising from sales and purchases transacted in different currencies are managed by the Group treasury through the use of foreign exchange forward contracts. Pursuant to the Group policy in place, foreign exchange forward contracts, or any other financial derivatives, are entered into by the Group for hedging purposes. The Group has not entered into any financial derivatives for speculation.

CAPITAL COMMITMENTS AND CONTINGENT LIABILITIES

As of the date of this interim report, the Group has disputes with Hong Kong Inland Revenue ("HKIR") involving additional tax assessments amounting to approximately US\$247 million on both the non-taxable claim of certain non-Hong Kong sourced income ("Offshore Claim") and the deduction claim of marketing expenses ("Deduction Claim") for the years of assessment from 1992/1993 to 2009/2010.

The Commissioner of the HKIR issued a determination on 14 June 2004 to one of our subsidiaries, Li & Fung (Trading) Limited ("LFT"), confirming additional tax assessments totaling US\$43 million relating to the years of assessment from 1992/93 to 2001/02. Under further legal advice from the Group's counsel, the directors believed that the Group had meritorious defense to appeal against the Commissioner's determination. Accordingly, LFT served a notice of appeal to the Board of Review on 13 July 2004. The appeal was heard before the Board of Review in January 2006.

The Board of Review issued its decision on 12 June 2009 ("the Board of Review Decision") and held partially in favour of LFT. It agreed that the Offshore Claim for the years of assessment from 1992/93 to 2001/02 is valid. In other words, the relevant assessments in respect of such Offshore Claim shall be annulled. On the other hand, the Board of Review disagreed with the Deduction Claim for the years of assessment from 1992/93 to 2001/02. Therefore, the relevant assessments in respect of such Deduction Claim should be confirmed.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

The Group considered the reasoning of the Board of Review Decision and, having obtained professional advice, decided to lodge an appeal against the Board of Review Decision in respect of the Deduction Claim. An application requiring the Board of Review to state a case on questions of law for the opinion of the High Court was made by LFT on 10 July 2009.

On the other hand, the HKIR also lodged an appeal against the Board of Review Decision in respect of the Offshore Claim. An application requiring the Board of Review to state a case on questions of law for the opinion of the High Court was made by the HKIR on 10 July 2009.

On 19 March 2010, the Board of Review stated a case on questions of law in respect of both LFT's appeal in respect of the Deduction Claim, and the HKIR's appeal in respect of the Offshore Claim. On 1 April 2010, both LFT and the HKIR transmitted the stated case to the High Court for determination. On 15 July 2010, the HKIR applied to the High Court to remit the stated case to the Board of Review for amendment so as to include certain evidence and additional questions of law in the stated case. On 11 February 2011, the HKIR amended its application to remit the case stated to the Board of Review to include a further request that further findings of fact be made by the Board of Review and be set out in the case stated.

The HKIR's application to amend the stated case was heard by the Court on 17 February 2011. The Court did not allow the Commissioner's application to remit the case stated to the Board in respect of the Offshore Claim. The Court also disallowed the Commissioner's application to set out the requested evidence and pose the requested additional questions of law on the Offshore Claim in the case stated. Nevertheless, the Court directed the parties to try to agree some neutral facts in respect of the Offshore Claim on which the Court can rely in determining the appeal. As regards the requested additional questions of law on the Deduction Claim, the Court directed the parties to try to agree on the reformulation of those questions, and on directions for the case stated to be remitted to the Board for amendment.

As LFT and the HKIR were not able to reach agreement on all the facts propounded by the HKIR in respect of the Offshore Claim, the Court fixed another hearing on 28 March 2011 to give further directions. At that hearing, the Court dismissed the HKIR's application to remit the stated case to the Board of Review in respect of the Offshore Claim.

Accordingly, the appeal by the HKIR in respect of the Board of Review Decision on the Offshore Claim was heard before the Court of First Instance on 6 April 2011 as scheduled.

On 18 April 2011, the Court of First Instance delivered its judgment. It upheld the Board of Review Decision in respect of the Offshore Claim and dismissed the HKIR's appeal. LFT was also awarded costs of the appeal. On 16 May 2011, the HKIR has lodged an appeal against the judgment of the Court of First Instance to the Court of Appeal, which appeal is fixed to be heard on 14 and 15 February 2012 before the Court of Appeal.

As regards LFT's appeal on the Deduction Claim, upon the consent of the parties, the Court of First Instance has remitted the case stated to the Board of Review and directed it to make further findings of fact and to determine certain issues. As of the date of this interim report, further directions/decisions from the Board of Review are awaited.

MANAGEMENT DISCUSSION AND ANALYSIS (CONTINUED)

The Group has also filed objections with the HKIR against the remaining additional tax assessments of US\$204 million. The case before the Board of Review and now the Court of Appeal only applies to the additional tax assessments in respect of LFT for the years of assessment from 1992/93 to 2001/02. The Group's dispute with the HKIR regarding the remaining additional tax assessments in respect of certain other subsidiaries for the years of assessment from 1992/93 to 2001/02, and in respect of the Group for the period after the 2001/02 assessment years, is ongoing and has not yet been determined. It is therefore not yet before the Board of Review, and no hearing is currently scheduled.

Based on the assessment of the Group's legal counsel on the merits of LFT's further appeal in respect of the Deduction Claim and the HKIR's further appeal in respect of the Offshore Claim, and having taken into account the impact and ramification that the Board of Review Decision has on the tax affairs of LFT, the directors consider that no material tax liabilities will finally crystallize and sufficient tax provision has been made in the accounts in this regard.

On 11 June 2010, the Group also applied for a judicial review of the HKIR Commissioner's decision rejecting LFT's application for an unconditional holdover of tax for the year of assessment 2008/09 pending the determination of the objection lodged with the HKIR. The Group has purchased tax reserve certificates in respect of LFT for the year of assessment 2008/09 as directed by the Commissioner of the HKIR pending the decision of the judicial review application. As of the date of this interim report, the hearing date for the judicial review application is yet to be fixed.

Other than the above, there are no material capital commitments, contingent liabilities or off-balance sheet obligations.