# MANAGEMENT DISCUSSION & ANALYSIS

William Fung
*Managing Director*

## RESULTS REVIEW

Notwithstanding a challenging business environment, the Group is pleased to report that we have continued to expand market share and have experienced strong turnover growth in a gloomy market.

Turnover increased by 20% to US$14,195 million (approximately HK$111 billion), despite many of our customers having reduced inventory in 2008, reflecting Li & Fung's solid organic growth, growth through acquisitions and an accelerated flow of outsourcing deals in recent years.

Core operating profits decreased by 3% from the previous year. Core operating profit margin decreased to 2.79% from 3.45% which is attributed to the higher operating costs committed in 2007 which impacted on 2008. This also reflects the time lag in incorporating the benefits of new outsourcing deals. For example, the Group immediately incurs additional operating costs when a new outsourcing deal results in incorporating new staff but faces a delay in realizing revenue benefits.

Profit attributable to shareholders reached HK$2,422 million for 2008, a decrease of 21% over 2007. Apart from the overall weak market sentiment, the bottom line was also affected by a number of one-time events including restructuring costs in many of the high cost cities, in particular the US onshore business as this was rationalized after three years of numerous acquisitions, start-up costs incurred for the European onshore business, certain provisions made due to a small number of customers' bankruptcies in 2008, and a one-time gain from disposal of property holding subsidiaries in 2007 which was not present in the 2008 accounts.

Total margins increased by 17% but as a percentage of turnover, declined slightly from 11.12% to 10.86% in 2008, due to change in customer mix.

The Group saw an increased flow of outsourcing deals in 2008. Many of our customers opted to focus on their core competencies such as retailing and marketing, and elected to outsource their non-core operations such as their sourcing operation to Li & Fung. In 2008, we executed a number of significant outsourcing deals, including Toys'R'Us' private label business, Sanrio, Timberland's apparel business, and Mexx.

In addition, we continued with our two-pronged acquisition strategy with the Group undertaking seven acquisitions in 2008: Imagine, RT Sourcing, Silvereed, Wilson & Wong, Giant Merchandising, Van Zeeland and Miles Fashion. Undoubtedly, these acquisitions will have had a significant impact on the Group's product platforms and geographic reach.

In 2008, the Group entered into a Subscription Agreement through which a wholly-owned subsidiary of Temasek Holdings (Private) Limited agreed to subscribe to 168,000,000 new shares at a price of HK$23.09 per subscription share. The proceeds provided funds for the Group to take advantage of acquisition opportunities that may arise in this economic environment.

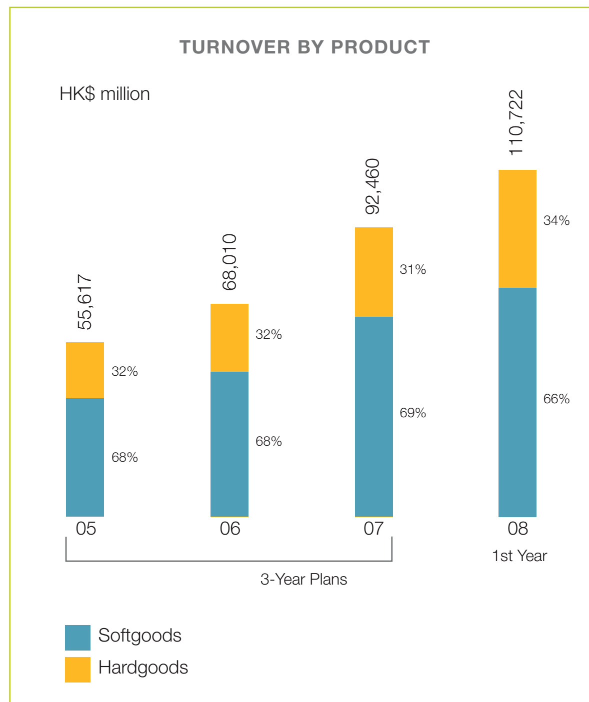
Bruce Rockowitz
*President*

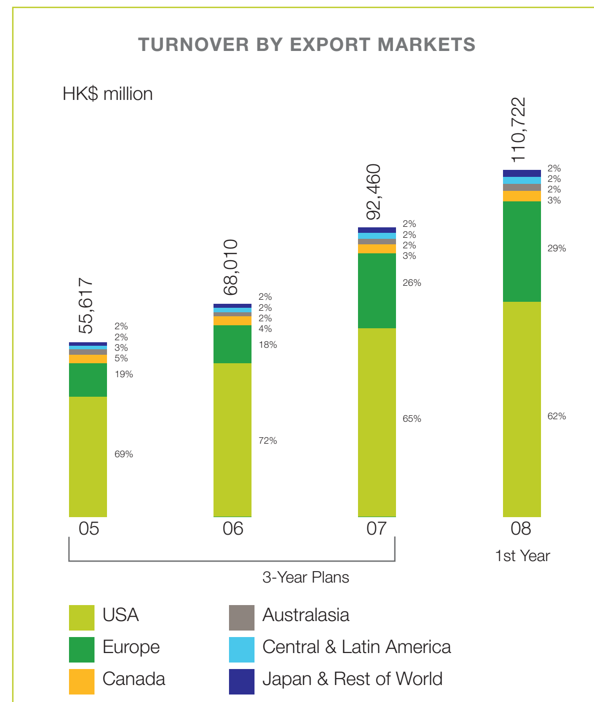
## SEGMENTAL ANALYSIS

In 2008, softgoods and hardgoods accounted for 66% and 34% of turnover respectively. **Softgoods** turnover increased by 14% while operating profit increased by 11%. The improvement reflects the positive contributions from previous acquisitions such as Tommy Hilfiger's sourcing operations, American Marketing Enterprises (AME) and Regatta.

Turnover from the **hardgoods** business grew by 31% but operating profit decreased by 45%. This turnover growth reflects solid organic growth from some existing customers and contributions from previous acquisitions in the Health, Beauty and Cosmetics (HBC) business as well as the shoe business. The decline in operating profit reflects the drop in margins in the hardgoods business and in particular, the European onshore business.

Geographically, the **US** continues to be the Group's key export market, representing 62% of total turnover during the period under review. However, this represents a fall from 65% in 2007 and reflects our continued success in diversifying geographically. Turnover and operating profit grew by 14% and 2% respectively, which resulted from contributions from acquisitions such as AME and Giant Merchandising, and our active involvement in the proprietary brand business through Regatta, in addition to our core sourcing business. As well, our US onshore business continued to grow at healthy levels in 2008. On the other hand, the operating profit of the overall US business was adversely affected by hardgoods business which saw decline in operating profit in 2008.

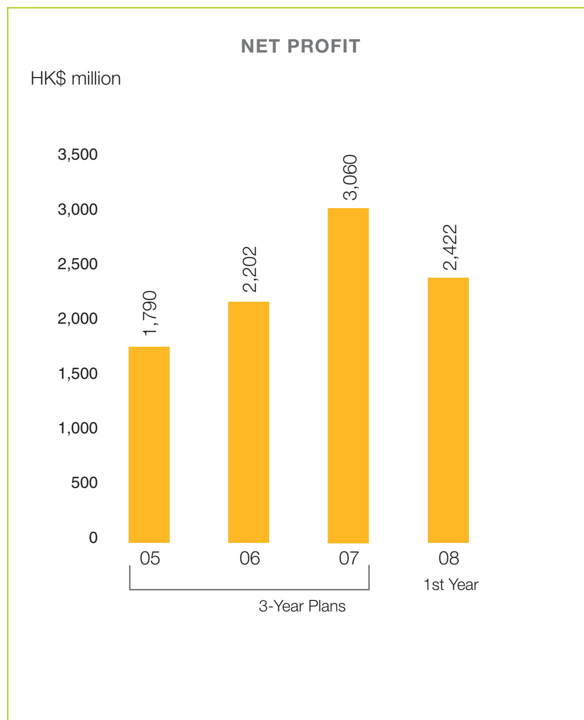


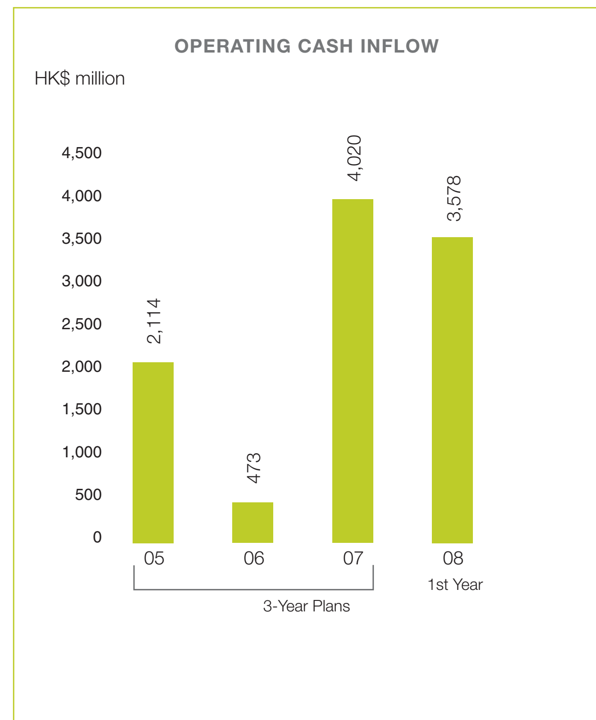



**Europe** accounted for 29% of turnover, reflecting growth of 36%. This growth reflects the contribution from Peter Black and outsourcing deals as well as solid organic growth from existing customers. Operating profits dropped by 18% attributed to factors including to start-up costs incurred at European onshore business and that Peter Black's margins have also decreased from previous year.

In 2008, Li & Fung began to develop the European onshore business. Similar to the US onshore business, the first year was a start-up period with associated costs and we expect the European onshore business to reach its Three-Year Plan targets in 2010.

Turnover in other markets such as **Canada, Central and Latin America,** and **Australasia** accounted for 3%, 2% and 2% respectively. Turnover growth for these markets stood at 6%, 21%, and 23%. Operating profit declined in Canada and Australasia was down 7% and 1% respectively but Central and Latin America recorded operating profit growth of 7%. **Japan** and the rest of the world representing turnover share of 2%, experienced growth of 18% in turnover and 16% in operating profit.



## ACQUISITIONS

We continued to pursue a two-pronged acquisition strategy in 2008, marked by a total of five roll-up acquisitions (Imagine, RT Sourcing, Silvereed Group, Wilson & Wong, and Giant Merchandising) and two large acquisitions (Van Zeeland and Miles Fashion).

Key acquisitions include:

### • HEALTH, BEAUTY AND COSMETICS (HBC)

The Group continued to strengthen its capabilities in the HBC sector by acquiring Imagine in January 2008 and RT Sourcing in July 2008. Imagine is one of the leading companies in Asia designing and developing point-of-sale displays for retailers and manufacturers globally.

RT Sourcing is a sourcing and development company that specializes in primary packaging and components for beauty brands and full service beauty products for retailers.

The Group sees tremendous growth opportunities in the area of HBC to leverage potential synergies with existing customers.

### • FASHION

The Group increased its presence in the better priced fashion label arena by acquiring the Silvereed Group in February 2008 and Wilson & Wong Trading Company Limited in July 2008. Both are based in Hong Kong and are "virtual manufacturers" with the focus on design and product development of ladies' fashion garments. These deals added a new portfolio of the fashion customer.

### ONSHORE BUSINESS

*(i) Van Zeeland*

In August, the Group announced that it had entered into an agreement to acquire Van Zeeland for HK$2,574 million with additional incentives based on performance. Van Zeeland is a leading New York-based importer of mid-tier and department store handbag brands, including flagship labels Kathy Van Zeeland Handbags, B. Makowsky & Tignanello. The deal helps to establish the Group as the leading handbag supplier in the US across all distribution channels.

*(ii) Miles Fashion Group*

In November, the Group announced that it had entered into an agreement to acquire all of the shares of Miles Fashion Group, a leading German supplier to some of the largest discounters and retail chains in Europe. Miles Fashion sells a wide range of ladies and menswear, kidswear, outdoor and footwear products. This acquisition helps to give the Group the platform to accelerate growth of LF Europe in the current Three-Year Plan.

*(iii) Licensed Brands*

In April 2008, the Group continued to further our US onshore business by acquiring the trademark and assets relating to the T-Shirt licensed business of Giant Merchandising. The transaction helps to provide further category and brand expansion in our licensed product business.

## OUTSOURCING DEALS

2008 marked a year which saw the acceleration of outsourcing deals. These included Toys'R'Us' private label business, Sanrio, Timberland's apparel business and Mexx. Undoubtedly, these outsourcing deals, together with our acquisitions, will further solidify our market share in these respective business areas and will contribute positively to our bottom line in the years ahead. These deals have also added strong expertise and capabilities to our product design and development function in our hardgoods, softgoods as well as health, beauty and cosmetics businesses.

## PROGRESS ON THREE-YEAR PLAN 2008–2010

While our new Three-Year Plan 2008–2010 began against the backdrop of uncertain global economic conditions, we remain committed to the targets it outlined, that is, a turnover target of US$20 billion, a core operating profit target of US$1 billion, and an operating leverage target of doubling income percentage growth over turnover percentage growth (i.e. 2x). We anticipate that outsourcing deals and selective acquisitions will be a key plank of our Three-Year Plan 2008-2010 as the Group pursues this growth strategy in view of the uncertain economic environment.

Li & Fung will continue to expand our network relentlessly to meet the needs of customers. We opened four offices in 2008, namely Xiamen (China), Druillat (France), Hamburg (Germany), and Kahramanmaras (Turkey). At year-end, we had a network of more than 80 offices in over 40 economies.

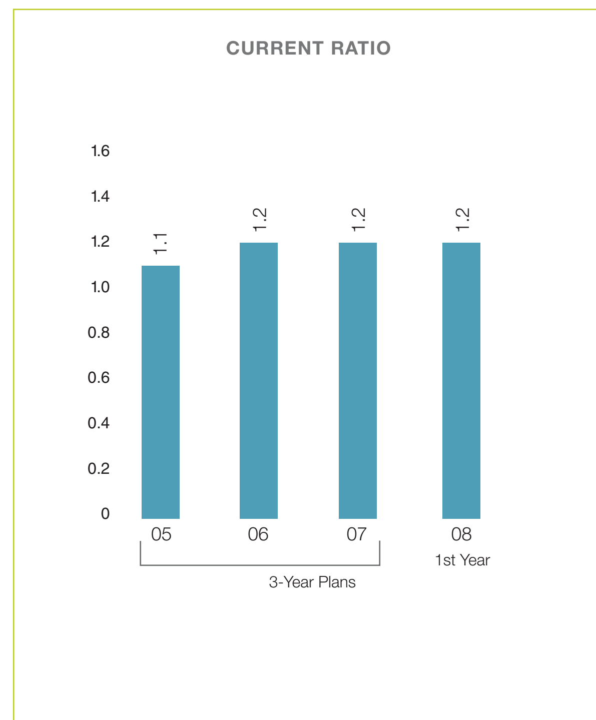
We are also very pleased to report that the Group's financial strength is highly resilient despite uncertainty in the external financial market. We have maintained our strong credit ratings from Moody's and Standard & Poor's at A3 (stable) and A- (stable) respectively. Li & Fung continues to enjoy healthy cashflows and has strong credit ratios. For details, please refer to the following "Financial Position and Liquidity" section.

The Group recognizes the challenging times faced by companies worldwide. We will continue to monitor market conditions to ensure the continuing strength of our franchise and to meet our responsibilities to all our stakeholders including customers, employees, vendors and shareholders.

## FINANCIAL POSITION AND LIQUIDITY

The Group continued to be in a strong financial position for the year under review with cash and cash equivalents amounting to HK$2,182 million at the end of December 2008.

Normal trading operations were well supported by more than HK$19,656 million in bank trading facilities. In addition, the Group had available bank loans and overdraft facilities of HK$4,029 million, out of which HK$1,080 million was committed facilities. At 31 December 2008, only HK$606 million of the Group's bank loans and overdraft facilities was utilized, in which HK$234 million was a drawdown of the committed facilities.



At balance sheet date, the Group's gearing ratio was about 14%, calculated as net debt divided by total capital. The Group's gearing ratio decreased from last year of 24% as the Group's total equity was further strengthened by the share subscription of a wholly-owned subsidiary of Temasek Holdings (Private) Limited of approximately HK$3,879 million. Net debt of HK$2,199 million is calculated as total borrowings (including long-term bank loans of HK$234 million, short-term bank loans of HK$278 million and long term notes of HK$3,869 million) less cash and cash equivalents of HK$2,182 million. Total capital is calculated as total equity of HK$13,382 million plus net debt. The current ratio was 1.2, based on current assets of HK$21,466 million and current liabilities of HK$17,848 million.

## IMPACT OF CHANGES IN ACCOUNTING STANDARDS

The following amendments to standards and interpretations are relevant to the Group and are mandatory for the financial year ended 31 December 2008.

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|---|---|
| HKAS 39 | Financial instruments: Recognition and measurement |
| HK(IFRIC) – Int 11 | HKFRS 2 – Group and treasury share transactions |
| HK(IFRIC) – Int 14 | HKAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction |

These amendments to standards and interpretations do not have any significant impact on the Group's account.

## CREDIT RISK MANAGEMENT

Credit risk mainly arises from trade and other receivables and cash and bank balances of the Group.

Most of the Group's cash and cash equivalents are held in major global financial institutions.

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 arrangements 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 ongoing assessments of each individual customer and vendor and determines the credit limits based on, among other factors, their trading and settlement history and 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 is managed by the Group treasury, with 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

At the date of this announcement, the Group has a long-running dispute with the Hong Kong Inland Revenue Department related to the non-taxable claims of certain non-Hong Kong sourced income and the deduction of certain marketing expenses of approximately HK$1,599 million for the years of assessment from 1992/1993 to 2007/2008. The disputes were initiated in 1999 and have been disclosed in our annual reports since that year. The Group has been working with its accounting and legal advisors in respect of its dealings with the Hong Kong Inland Revenue Department in relation to these matters. A hearing of the disputes was held before the Board of Review in January 2006 but as at the date of this announcement, the result is not yet known.

The structure of the Group's offshore sourcing and marketing activities was established at the time of the Group's re-listing on the Hong Kong Stock Exchange in 1992, when the Group sought advice from its external professional advisors. The directors consider that sufficient tax provision has been made in the accounts in this regard and no additional material tax liabilities are expected to eventuate.

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

## HUMAN RESOURCES

As of the end of 2008, the Group had a total workforce of 14,438 of whom 3,599 were based in Hong Kong and 10,839 were located overseas. The Group offers its staff competitive remuneration schemes. In addition, bonuses and share options are also granted to eligible staff based on individual and Group performance. The Group is committed to nurturing a learning culture in the organization. Emphasis is placed on training and development, as the Group's success is dependent upon the efforts of a skilled and motivated work force. Training programs have been developed to align with the profiles of different job levels and functions. There are different series of training programs in place including: the Management Development Series, Professional Development Series and Supervisory Skills Series focusing on the management skills training for managerial and frontline staff; the Functional Competency Training Series focusing on the technical skills training for merchandising and quality assurance functions; and Language Training for all staff. For new employees, we have also put in place a Global Induction Program across the whole group. Through this program, we aim to better integrate new staff and facilitate their development within the Company.

In addition, there are two key talent resourcing programs: the Management Trainee Program and the Merchandising Development Program. These two programs are more described in Corporate Governance section of this Report on page 35.

To further uphold the corporate philosophy of talent building, the Group has recently launched a key business initiative called "Building Skills for Growth" which focuses on the Group's investment in building new skills or upgrading existing skills of employees in order to sustain personal and organizational growth.

The Group invested in sophisticated human resource software during the period under review. Total staff costs for 2008 were HK$4,683 million, compared with HK$3,952 million for 2007.