A letter from our Chairman

William Fung
Group Chairman

Dear Shareholders,

As we traversed the first six months of 2016, global economies remained soft and consumer spending generally cautious. We continued to be negatively affected by a persistently deflationary environment, increased geopolitical uncertainties and weak European and Asian currencies. Nevertheless, despite macroeconomic headwinds, we continue to focus on building a sustainable enterprise for long-term growth.

During the first half of the year, we successfully divested our Asia consumer and healthcare distribution business, which is a non-core business for us. This divestment re-aligns our strategic focus on our core trading and logistics businesses and allows us to better focus our resources and management attention.

The Impact of Brexit

Although the full impact is unknown at this point, the recent Brexit referendum is leading to additional global economic uncertainties. As a result, Europe's consumer confidence, employment and foreign investments are expected to be affected. UK brands and retailers face immediate rising overseas input prices due to the weaker British Pound, while soft consumer sentiment makes it difficult to pass on these costs to consumers. In the meantime, European brands and retailers also suffer similar negative impact as a result of Brexit which may weaken the Euro and add to uncertainty across the Eurozone.

A more subdued European economic outlook will exacerbate the already-sluggish demand in Asian exports, which may also be disadvantaged if there is a relative appreciation of the Asian currencies against the British Pound and Euro. Over the longer run, free-trade agreement (FTA) negotiations between China and the EU are likely to be more difficult without the advocacy and involvement of the UK, who has played an instrumental role in promoting deeper China-EU ties. Production countries that are currently benefiting from preferential tariff treatments under the EU's Generalized Scheme of Preferences are set to lose such privileges when exporting to the UK and would need to re-negotiate new FTAs. Separation of the UK from the EU is likely to lessen the bargaining power of a reduced EU in future trade negotiations. All of these potential effects are expected to add uncertainty and extra complexity to the sourcing landscape.

E-commerce Brings about Huge Sourcing and Logistics Opportunities

The advent of e-commerce and the increase in competitive pressure it brings continue to disrupt retail markets. However, the need for supply chains to be digitized to work with the increasingly digitized consumer market will bring a lot of opportunities for Li & Fung.

At the retail level, there is an influx of online retailers entering the market, fighting for market share and competing largely on price. Brick-and-mortar retailers continue to invest in omni-channel capabilities to compete for the online consumer. An increasingly larger proportion of the goods we supply to our brick-and-mortar retail customers is being sold by them online under the omni-channel model. This has greatly intensified price competition which coupled with a generally weak consumption market has resulted in a persistently highly-promotional marketplace. At the same time, many online retailers are also launching their own private label lines. With our deep expertise in developing private labels, we are already helping some online retailers source their private label collections. We feel this move to private label will be a major trend with the pure play online retailers and will present significant opportunities for Li & Fung.

In addition, e-commerce players also compete heavily on their logistics capabilities. With our leadership in e-logistics in Asia, we are becoming the trusted logistics partner for both pure online retailers and traditional retailers' online business. We were early investors in logistics capabilities to pick-and-pack by the piece and expedite in small packages to consumers. This requires a thorough integration of IT systems with those of our customers and last-mile transportation companies. We are now reaping the fruits of these early investments.

China Remains to be an Important Sourcing Base

China has remained an important sourcing hub due to its abundance of highly skilled labor, strong production expertise, efficient infrastructural support and a relatively stable political and social situation. Its labor costs, which rose dramatically in its last Five-Year Plan, have stabilized. Coupled with low raw material prices and a lower RMB exchange rate, China has regained some of its competitiveness. Recent geopolitical unrest and disruptions in other parts of the world have also accentuated the importance of working with an experienced and stable supply country, like China, despite a higher cost.

As a result, there is a slowdown in the decanting of production out of China. Furthermore, China's one-belt-one-road initiative is expected to reinforce China's dominance and importance in the global supply chain, as it continues to explore opportunities with its neighbors to connect production and consumers across the region.

Continual Focus on Value Added Services

Our Vendor Support Services (VSS) business, which serves our vendor base by increasing their sustainability and competitiveness, has continued to make progress in the first half of the year. Following from our efforts in 2015, VSS continued to track ahead of plans and improve profitability and we expect VSS to contribute over 5% of COP in 2016.

Building a Sustainable Enterprise in a Volatile Market

Under the current market conditions, there is little sign of any meaningful turnaround in consumer demand and trade flows for the remainder of 2016. We expect the next six months to continue to be overshadowed by uncertainties. While the US market continues to recover and shows growth, this growth is subdued and muted. The outcome of the upcoming US presidential election will set the tone for the country's economic direction. In Europe, it will take some time to resolve the issues arising from Brexit before it can restart its growth momentum. In the meantime, we expect Asian growth to be lackluster given the slowdown of the Chinese economy and the impact from Europe.

For Li & Fung, the difficult macro and retail environment may lead to volume and margin pressures for our trading business in the near term. Nonetheless, we will focus on productivity and cost efficiency improvements while continuing to execute our strategies for our key product verticals. Our VSS program is growing as expected and is contributing positively to profitability. I remain upbeat on the prospects of our VSS program and I am confident that it will become one of our important profit contributors. In addition, I expect our logistics business will sustain its robust growth through increasing business with existing customers, geographical expansion, new contracts and broader service offerings.

We have commenced the planning of our next Three-Year Plan for the period of 2017 to 2019, which will focus on maintaining our global leadership position in the consumer goods supply chain. We will develop and maintain our excellence by leveraging on our deep product expertise and diverse sourcing base, while helping our customers to stay competitive. In the future, we foresee a proliferation of FTAs, increasingly on a bilateral, rather than a multilateral, basis that will shift the dynamics of global sourcing, increasing the complexity of the sourcing landscape to Li & Fung's advantage. In such a sourcing world, major brands and retailers will increasingly need to rely on reputable supply chain managers who have strong product expertise and a flexible global footprint to minimize supply disruption risks while increasing competitiveness. We believe Li & Fung is in a prime position to fulfill that role in the coming years.

I would like to extend my gratitude to our colleagues for their dedication and hard work, amid challenging market conditions, in driving our resilient performance during the past six months.

Yours sincerely,

William Fung Kwok Lun
Group Chairman

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