

Li & Fung: Banking on economies of scale

Recommendation: BUY (upgraded from HOLD)

Hong Kong Distribution

Price	HK\$16.54	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$19.0 (+14.9%)	Dec	HK\$m	HK\$	Δ %	x	x	X	%	%	%	%
12 mth range	HK\$9.2-17.35	04A	1,530.2	0.526	24.3	32.1	10.35	27.1	4.0	34.1	35.1	Cash
Market cap.	US\$7,005.9m	05A	1,790.9	*0.557	6.1	30.3	11.63	27.3	3.0	38.1	39.1	Cash
Daily t/o, 3 mth	US\$16.99m	06F	2,341.9	0.723	29.6	23.3	10.84	20.4	3.4	48.3	53.2	0.23
Free float %	58.5%	07F	2,886.4	0.891	23.2	18.9	11.22	16.7	4.2	58.2	63.5	0.26
Ticker	0494.HK/494 HK	08F	3,262.9	1.007	13.0	16.7	11.34	14.9	4.8	67.3	73.3	0.33

* Adjusted for the effect of 1-for-10 bonus share issued during the period.

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -9.9%, -2.1%, -5.5%

Actual price changes (1 mth, 3 mth, 12 mth): -6.6%, -1.3%, 6.1%

Consensus EPS (06F-08F): HK\$0.709, HK\$0.896, HK\$1.067

Previous forecasts (06F-07F): HK\$2,255m (\$0.697), HK\$2,828m (\$0.875)

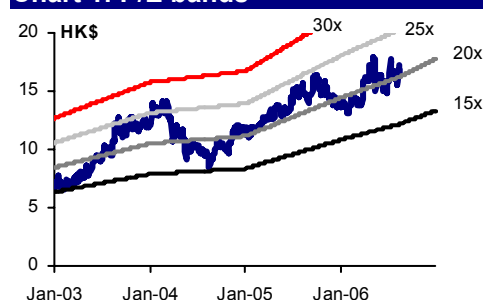
Key points:

- Result beat market expectation by 8%, as well as our estimates by 4%.
- Robust organic sales and volume growth.
- Remarkable margin improvement.
- The KarstadtQuelle outsourcing deal is expected to be completed by the end of 2006.
- Continue to look for more outsourcing deals.
- Interim dividend payout at 67.8%.
- We upgrade it from HOLD to BUY, our target price has been adjusted to HK\$19.0, representing 21.3x P/E and 0.92x PEG in FY12/07F.

Interim result review. 1H FY12/06 net profit reached HK\$764m, up 24% on the back of a 19% increase in turnover to HK\$28b. An interim dividend of HK\$0.16 per share was declared, bringing the payout ratio to 68%. The result beat market expectations by 8%, as well as our estimates of HK\$751m.

- ❑ **Strong sales growth despite a “deflation” on sourcing price.** Sales in 1H06 grew 19%, which was fuelled by strong organic growth and the acquisition of the buying functions for Ecco and Mervyn’s in FY12/05. Due to a wider sourcing choice from South & South East Asia, such as Bangladesh, India, Cambodia and Vietnam, Li & Fung (LF) has brought prices down for some of its customers. As a result, it experienced a slight deflation of 2-3% on sourcing price, despite a global inflationary environment in 1H06. Sales might have grown by another few percentage points without the deflation. LF will be on track to achieve its 3-year sales plan of US\$10b by FY12/07 with a 3-year CAGR of 18%.
- ❑ **Increase in total margin despite heavy investment in back-office infrastructure.** Total margin rose 26% and total margin as a percentage of sales, saw an appealing growth of 5.5% YoY to 10.55% in 1H06. Operating profit rose 35% YoY to HK\$836m on the back of 0.4% improvement in operating margin to 3% in 1H06, despite heavy infrastructure investment in maintaining its global offices. The increase in total margin was mainly attributed to: 1) Keener competition and growing popularity of fast-retailing in the fashion industry has increased the demand for higher-value-added services, such as design and shorter product turnaround time; 2) Faster sales growth from higher-margin hardgoods. Sales for hardgoods saw 31% YoY increase to HK\$8,599m compared to a 17% YoY rise for softgoods to HK\$19,371m in 1H06 and 3) Continual growth in U.S. onshore business.

Chart 1: P/E bands

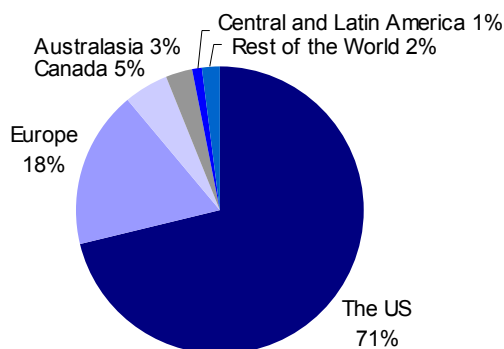


Source: SBI E2-Capital

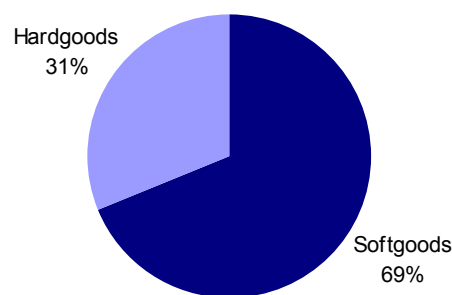
Table 1: Interim results

Six months to Jun	Turnover (HK\$m)	Total margin (HK\$m)	Total margin/ Turnover (%)	Operating profit (HK\$m)	Operating profit margin (%)	Net profit (HK\$m)	EPS (HK\$)	DPS (HK\$)
1H FY05	27,970.0	2,952.0	10.6	836.0	3.0	764.0	0.236	0.160
1H FY04	23,466.4	2,343.3	10.0	619.1	2.6	617.4	0.192	0.132
YoY (%)	19.2	26.0		35.0		23.8	23.0	20.9

Source: Company data

Chart 2: 1H FY12/06 geographical breakdown

Source: Company data & SBI E2-Capital

Chart 3: 1H FY12/06 turnover breakdown

Source: Company data & SBI E2-Capital

Outlook

- ❑ **LF targets 15-16% top-line organic growth in the coming few years**, based on a strong performance for its major customers and accelerating hardlines growth.
- ❑ **Gaining sizeable exposure in the top-ten US retailers.** LF has insofar made two acquisitions in 2006, namely the Oxford Collections and Rosetti Group. After these acquisitions, LF has gained a more sizeable business with Wal-Mart and Target, which is the top-ten retailer in US. This is the area LF found it difficult to penetrate into except Kohl's, which it already secured a foothold in the past. Going forward, large acquisitions are more opportunistic in nature.
- ❑ **Looking for more outsourcing deals.** LF has signed a Letter of Intent in July with KarstadtQuelle AG, the largest trading company in Europe to take over KarstadtQuelle International Services AG ("KQIS"), which is the buying arm of the Group. Negotiations are still underway and the deal is expected to complete before the year end in Dec. LF would take over 1,100 employees worldwide in 19 countries. The expected revenue from KQIS is c.US\$1b and LF targets revenue to grow to US\$2b. KQIS will give LF diversification from the US consumer, which accounted for 71% of total sales in 1H06. LF will continue to look for more outsourcing deals.
- ❑ **Further margins enhancement ahead.** 1) Proprietary brands, private label and brand licensing business will be the next area of focus, given higher margins and huge growth potential on the back of a fragmented market. 2) Increase the contribution from US onshore business. The US-onshore business is expected to account for US\$1b out of the US\$10b 3-year sales target. 3) The acquisition of Rosetti has opened up the higher-margin handbags market, which is new for LF.

Earnings revisions & valuation.

Our earnings forecast for FY12/06-08F has been revised up by 2-4%, factoring a higher total margin/sales and stronger sales growth. The strong result proved that LF will continue to benefit from organic growth on the back of higher economies of scale achieved, as well as ongoing acquisitions and outsourcing deals over the next few years. We upgrade it from HOLD to BUY with a target price of HK\$19.0 from HK\$17.0, representing 21.3x P/E and 0.92x PEG in FY12/07F.

Major risks: 1) **Turning from a net-cash to net-gearing position.** LF's cash on hand at the end of 2005 amounted to c.HK\$1.5b, while the two acquisitions LF made insofar in 2006 required c.HK\$1.5b. We expect LF to turn into a net gearing of 0.23% in FY12/06. While there is no guidance on the cash level in 1H06, the management suggest a debt level of c.US\$200-300m is manageable. It might seek financing in the priority of bank borrowing, followed by bond and equity issuance. The net debt position might lead to a more conservative payout in the future. 2) **An unexpected slowdown in the U.S. and Europe economy.** 3) **Infrastructure**

spending is higher in 2H06. LF will upgrade its accounting system, sourcing IT system and maintaining its 8 to 9 hub management. **4) Deflation will persist in 2H06.**

P & L (HK\$m)	04A	05A	06F	07F	08F	Cash Flow (HK\$m)	04A	05A	06F	07F	08F
Year to Dec						Year to Dec					
Turnover	47,170.6	55,617.4	66,094.5	76,666.3	86,683.8	EBIT	1,595.0	1,856.8	2,607.7	3,193.4	3,610.7
% chg	10.6	17.9	18.8	16.0	13.1	Depre./amort.	147.5	129.5	133.5	152.8	172.0
Gross profit	4,322.6	5,660.9	6,543.4	7,567.0	8,555.7	Net int. paid	(31.7)	(48.2)	33.3	17.7	19.7
						Tax paid	(105.5)	(114.5)	(145.6)	(188.6)	(263.4)
EBITDA	1,742.6	1,986.2	2,741.2	3,346.2	3,782.7	Gross cashflow	1,605.4	1,823.5	2,628.9	3,175.4	3,539.0
Depre./amort.	(147.5)	(129.5)	(133.5)	(152.8)	(172.0)	Chgs. in working cap.	(523.5)	(131.3)	(254.1)	110.5	(230.3)
EBIT	1,595.0	1,856.8	2,607.7	3,193.4	3,610.7	Operating cashflow	1,081.8	1,692.2	2,374.8	3,285.9	3,308.7
Net int. income/(exp.)	31.7	48.2	(33.3)	(17.7)	(19.7)	Capex	(416.8)	(1,010.7)	(1,821.8)	(1,064.2)	(1,016.1)
Exceptionals	-	27.8	0.0	0.0	0.0	Free cashflow	665.1	681.6	553.0	2,221.7	2,292.6
Associates	35.5	9.1	12.7	13.4	14.1	Dividends paid	(1,061.4)	(2,020.3)	(1,873.6)	(2,309.1)	(2,610.4)
Jointly-controlled entit.	-	-	-	-	-	Net distribution to MI	0.0	0.0	0.0	0.0	0.0
Pre-tax profit	1,662.3	1,941.8	2,587.0	3,189.1	3,605.1	Investments	(10.5)	0.0	0.0	0.0	0.0
Tax	(133.0)	(151.2)	(245.8)	(303.0)	(342.5)	Disposals	10.4	128.0	0.0	0.0	0.0
Minority interests	0.9	0.3	0.7	0.3	0.3	New shares	122.1	175.0	0.0	0.0	0.0
Net profit	1,530.2	1,790.9	2,341.9	2,886.4	3,262.9	Others	33.8	(25.7)	(319.9)	(21.7)	(23.8)
% chg	25.1	17.0	30.8	23.2	13.0	Net cashflow	(240.7)	(1,061.5)	(1,640.4)	(109.1)	(341.5)
Dividend	(1,951.0)	(1,468.4)	(1,873.6)	(2,309.1)	(2,610.4)	Net (debt)/cash - Beg.	2,550.1	2,309.4	1,247.9	(392.5)	(501.6)
Retained earnings	(420.8)	322.4	468.4	577.3	652.6	Net (debt)/cash - End.	2,309.4	1,247.9	(392.5)	(501.6)	(843.2)
						Interim Results (HK\$m)					
EPS (HK\$) - Basic	0.526	0.557	0.723	0.891	1.007		05A	06A			
EPS (HK\$) - F.D.	-	-	-	-	-	Six months to June					
DPS (HK\$)	0.670	0.500	0.578	0.712	0.805	Turnover	23,466.4	27,970.0			
No. sh.s o/s (m) - W.A.	2,911.9	3,213.3	3,241.2	3,241.2	3,241.2	% chg	19.3	19.2			
No. sh.s o/s (m) - Y.E.	2,917.1	3,241.2	3,241.2	3,241.2	3,241.2	Profit from operations	619.1	836.0			
No. sh.s o/s (m) - F.D.	-	-	-	-	-	Net int. income/(exp.)	30.3	0.0			
						Exceptionals	27.3	0.0			
Margins (%)						Associates	8.4	11.5			
Gross	9.2	10.2	9.9	9.9	9.9	Jointly-controlled entit.	-	-			
EBITDA	3.7	3.6	4.1	4.4	4.4	Pre-tax profit	685.1	830.7			
EBIT	3.4	3.3	3.9	4.2	4.2	Tax	(67.2)	(67.0)			
Pre-tax	3.5	3.5	3.9	4.2	4.2	Minority interests	(0.5)	0.3			
Net	3.2	3.2	3.5	3.8	3.8	Net profit	617.4	764.0			
						% chg	23.0	23.8			
						Dividend	425.1	517.4			
						EPS (US\$) - W.A.	0.192	0.236			
						EPS (US\$) - F.D.	-	-			
						DPS (US\$)	0.132	0.160			
Year to Dec						Shareholding Structure					
Fixed assets	1,583.0	1,242.6	1,409.1	1,556.3	1,684.3		Shares o/s (m)		%		
Intangible assets	1,304.3	2,776.0	2,776.0	2,776.0	2,776.0	King Lun Holdings Ltd.		1,150.6		35.5	
Other LT assets	239.3	248.4	261.0	274.4	288.5	The Capital Group Co.		194.5		6.0	
Cash	2,350.0	1,247.9	(348.5)	(455.5)	(794.7)	Public shareholders		1,896.1		58.5	
Accounts receivable	5,408.9	8,623.2	9,167.0	9,843.3	11,055.3	Total		3,241.2		100	
Other receivables	-	-	-	-	-						
Inventories	458.5	628.1	793.1	920.0	1,040.2	Background					
Due from related co.s	29.1	25.0	25.0	25.0	25.0	Founded in Guangdong, China in 1906, Li & Fung is mainly engaged in export trading business. Leveraging on its global networks in 38 countries and territories, the company exports consumer products (both hardgoods and softgoods) such as garments, fashion accessories, toys, sporting goods, footwear and home products. It has transformed from a sole sourcing agent into supply-chain manager with the virtual manufacturing across countries. About 68% of sales generated from the US market. Its customers are international renowned specialty retailers, toy retailers and food retailers and value retailers.					
Other current assets	-	-	-	-	-						
Total assets	11,373.2	14,791.2	14,082.6	14,939.5	16,074.6						
Accounts payable	(5,366.6)	(7,064.9)	(7,519.6)	(8,433.3)	(9,535.2)	Key Ratios (%)					
Other payable	-	-	-	-	-		04A	05A	06F	07F	08F
Tax payable	(290.9)	(391.4)	(491.5)	(605.9)	(685.0)	Net gearing	Cash	Cash	0.23	0.26	0.33
Proposed dividend	-	-	-	-	-	Net ROE	34.1	38.1	48.3	58.2	67.3
Due to related co.s	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	EBIT ROCE	29.8	33.0	45.3	56.6	64.2
ST debts	(243.5)	(204.0)	(248.0)	(250.2)	(252.5)	Dividend payout (%)	127.5	82.0	80.0	80.0	80.0
Other current liab.	-	-	-	-	-	Effective tax rate (%)	8.0	7.8	9.5	9.5	9.5
LT debts	(509.5)	(753.2)	(753.2)	(753.2)	(753.2)	Net interest cover. (x)	na	na	78.2	180.0	183.1
Other LT liabilities	(25.2)	(27.7)	(27.7)	(27.7)	(27.7)	A/R turnover (days)	36.9	46.0	49.1	45.3	44.0
Total liabilities	(6,435.7)	(8,441.4)	(9,040.1)	(10,070.4)	(11,253.7)	A/P turnover (days)	38.2	40.8	40.3	38.0	37.8
Share capital	72.9	73.4	73.2	73.2	73.2	Stock turnover (days)	2.9	4.0	4.4	4.5	4.6
Reserves	4,668.9	4,583.4	7,436.1	8,449.0	9,402.8						
Shareholders' funds	4,741.8	4,656.9	7,509.3	8,522.2	9,476.0						
Minority interest	32.4	32.1	31.4	31.1	30.7						
Total	4,774.2	4,688.9	7,540.7	8,553.2	9,506.7						
Capital employed	4,814.9	4,688.9	5,117.8	4,946.3	4,900.1						
Net (debt)/cash	2,309.4	1,247.9	(392.5)	(501.6)	(843.2)						

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BUY : absolute upside of >10% over the next six months

HOLD : absolute return of -10% to +10% over the next six months

SELL : absolute downside of >10% over the next six months

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