Corporate Snippet

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Gaining exposure in Europe market — Hong Kong Distribution

Li & Fung (494 HK, HK$19.7) — BUY (unchanged)

Target price: HK$23.0 (+17.1%)

The Acquisition:

Li & Fung (LF) has finalized the deal with German department store and mail order giant, KarstadtQuelle (KAR GR, Euro18.73, Not Rated), for the acquisition of its outsourcing arm KQIS, for an aggregated sum of Euro60m (US$76.5m/ HK$594m) conditional upon the approval of the Federal Cartel Office of Germany. The consideration represents 5.6x P/E for KQIS in FY12/05A, which was inline with the average price LF paid for its previous acquisitions but much lower than market's expectation of US$100-200m. The deal will provide LF a larger exposure to Europe. It is expected to bring in an addition of US$1b (c.10% of total sales) revenue in FY12/07F and an estimated earnings enhancement of 2.6% based on our forecast. Revenue contribution is expected to grow to US$2b in its next 3-year sales plan (FY12/08-10F). The deal will be funded internally with a two-phase payment. The first payment will be paid upon signing the contract with the rest to be paid upon completion.

Market share gain but minimal initial earnings enhancement. LF viewed this an acquisition instead of an outsourcing deal as in the case of Ecko and Mervyn in the past. The acquisition is the largest one in LF's history in terms of scale and it is a vital step to gain market share in Europe. However, KQIS has been baffled by high operating costs with a slim pre-tax margin of c.1% in FY12/05, compared with c.4% for LF in the past. The initial earnings enhancement for LF is minimal. An estimated additional revenue contribution of US$1b is derived based on KQIS's performance in 2005. KQIS's sales and EAT amounted to Euro1.15b (US$1.47b/ HK$11.5b) and Euro10.7m (US$13.6m/ HK$106m). The management indicated that KQIS's Euro1.15b sales contained disposal gain from small department stores, thus LF has conservatively assumed Euro784m (US$1b) in sales contribution. LF expects the revenue contribution to rise to US$2b for the next three years starting from 2008. KQIS total outsourcing amounted to a COGS of c.Euro6b, there is an enormous growth opportunity since LF only took over 17% of KQIS's total outsourcing from this deal. Although the acquisition is margin dilutive initially, we believe LF is able to improve its margins with new product development and enjoy cost savings from the combined sourcing of raw materials for different divisions at a better price.

The acquisition brings further geographical diversification. Upon the acquisition, sales contribution from Europe will increase significantly to 25-28% in FY12/07F from 18% in 1H06A, while the U.S. contribution will fall to 60% from 69%. We view this as a market diversification from U.S. to Europe. Besides, LF can benefit from the robust economic growth in Europe, especially Germany who has experienced the strongest export growth in EU.

Integration time is needed. Currently. KQIS has a sourcing network of 22 offices including several in the Eastern European countries and 1,000 staff. Some of these offices overlap with LF's existing offices. LF has 70

Table 1: Financial summary

Year to Dec	Net profit HK$m	EPS HK$	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
04A	1,530.2	0.526	24.3%	37.5	12.10	31.9	3.4	34.1	35.1	Cash
05A	1,790.9	0.557	6.1%	35.3	13.59	33.5	2.5	38.1	39.1	Cash
06F	2,390.7	0.702	26.0%	28.1	8.83	23.3	2.9	39.0	42.3	Cash
07F	3,019.7	0.887	26.3%	22.2	9.38	19.0	3.6	41.0	42.6	Cash
08F	3,404.7	1.000	12.8%	19.7	9.81	17.0	4.1	48.7	50.4	Cash

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offices over 40 countries at present. Management indicated that they will keep the front-line staff, while adding new staffs to the back-office with a dedicated team to work for this acquisition. We expect time is needed for LF to integrate its overseas offices with KQIS.

Valuation. The KQIS deal has brought LF forward to exceed its 3-year sales plan of US$10b by FY12/07. The acquisition will begin to contribute in 4Q06, thus we have adjusted our earnings forecast by 2-4% for FY12/06F to FY12/08F. The deal will be fully financed by internal resources, since LF has raised HK$2,723m from share placement in early Sept. After financing the acquisition, LF estimates net cash is expected to decrease to HK$2.2b. We are positive over this acquisition because it can achieve 1) market diversification from U.S. to Europe, since the outsourcing market in Europe is relatively under-developed compared to that of the U.S.; 2) huge potential earnings growth once it fully integrates with KQIS and 3) potential acquisitions in the future on the back of strong cash position. We maintain our BUY recommendation with a revised target price of HK$23 (prev. HK$19), based on 1x PEG for FY12/08F.