Corporate Snippet

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Strong growth will continue — Hong Kong Distribution

Li & Fung (494 HK, HK$27.15) — BUY (unchanged)

Target price: HK$35.0 (+28.9%)

Results review. Sales rose 22% YoY to HK$68b and net profit 23% YoY to HK$2.2b in FY12/06A. The results were lower than expected mainly due to a notional interest charge of HK$49m (against net interest income of HK$48m in FY12/05A) for outstanding payments related to acquisitions, as a result of a change in accounting treatment. Excluding the above, core operating profit actually rose 26% YoY, pretty much in line with market expectation. EPS amounted to HK$0.671 and a final DPS of HK$0.39 was declared. Together with an interim DPS of HK$0.160, the total DPS amounted to HK$0.550 (FY12/05A: HK$0.455). The payout ratio was similar to last year.

Results highlights.

Sales ahead of three-year target of US$10b. Sales grew 22% YoY in FY12/06A, ahead of the annual rate of 18% required to achieve the company's three-year sales target of US$10b by the end of 2007. Out of the 22% sales growth, 15% came from organic growth and the remainder from Oxford WomensWear Group and Rosetti handbag acquisitions completed in 2006.

Margin improvement. The total margin as a percentage of sales and operating margin increased to 11.2% (FY12/05A: 10.7%) and 3.45% (FY12/05A: 3.35%) respectively, as high-margin hardgoods sales grew 24.3% YoY and their operating profit 43% YoY, compared with a 21.4% YoY increase in sales and 22% YoY in operating profit growth by softgoods. Soft and hardgoods accounted for 68% and 32% of sales, respectively, in FY12/06A.

No price deflation. Li & Fung (LF) did not experience any price deflation as a result of sourcing changes and since its revenue is denominated mostly in the USD, the appreciation of RMB and higher raw material prices have led to firmer prices.

Outlook

Integration of KarstadtQuelle (KQIS). The integration of KQIS's 1,000 employees and 22 offices is well on track and the company will start contributing to the group in FY12/07F.

More balanced geographical sales mix. In FY12/06A, the U.S. market accounted for c.72% of total sales and Europe for c.18%. With contributions from KQIS and Tommy Hilfiger, Europe's sales contribution is expected to increase to c.25% in FY12/07F, giving the company a more balanced market exposure.

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 %
05A	1,790.9	0.556*	5.8	62.9	24.20	59.8	1.3	38.1	39.1	Cash
06A	2,201.5	0.671	20.6	52.2	13.84	47.7	1.6	34.0	29.6	Cash
07F	2,939.0	0.862	28.5	40.6	16.13	34.1	2.0	37.4	30.9	Cash
08F	3,685.6	1.081	25.4	32.4	16.06	27.5	2.5	49.7	39.7	Cash
09F	4,550.6	1.334	23.5	26.2	15.62	22.4	3.0	60.4	47.6	Cash

**Adjusted for 1-for-10 bonus share issue*

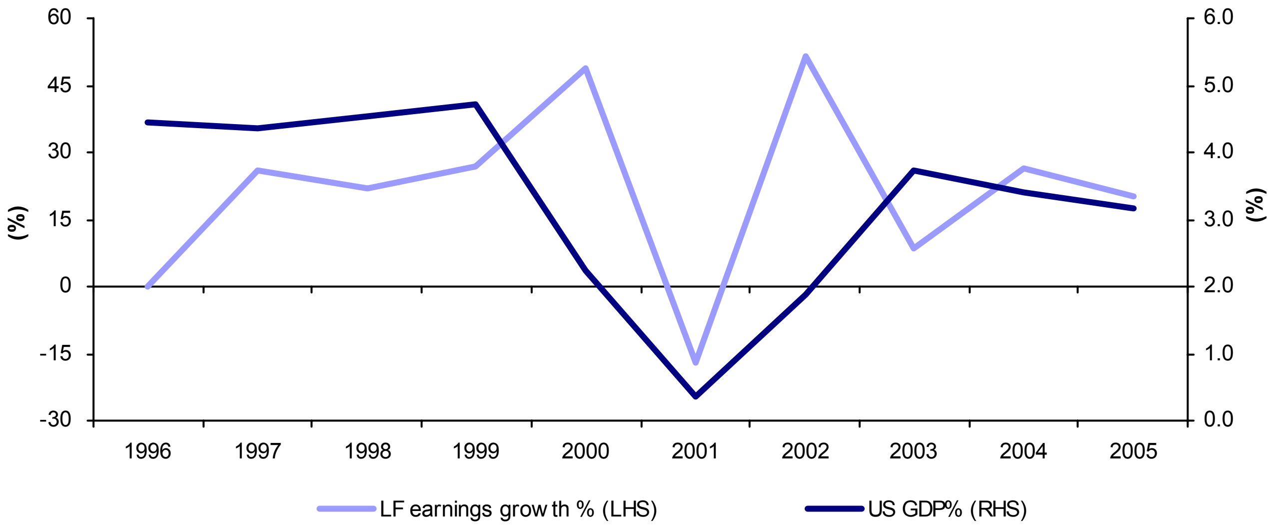
Strong order book in hand. LF has a strong order book in hand with visibility into the middle of 2007, despite market worries over a possible economic slowdown in the US. The management expects growth in FY12/07F to exceed that of FY12/06A.

Attracting new outsourcing partners. With the KQIS deal, LF has attracted the attention of many other reputable European names interested in outsourcing partnerships.

The fallacy of US economic slowdown on LF's profitability.

Market concerns over a possible adverse impact from an economic slowdown in the US are overdone and unsupported by historical data. According to our historical analysis, the correlation between US GDP and LF's earnings (1996-2005) is weak at 0.23, while the correlation between US retail sales and LF's earnings is even lower at 0.02. (Refer to chart 1)

Chart 1: Relationship between U.S. GDP and LF earnings



The drop in 2001 was due to the 9-11 terrorist attack

Source: SBI E2-Capital

Valuation

Despite the expected strong top-line growth, we have trimmed down our earnings forecast for FY12/07F and FY12/08F by c.2-8% due to higher infrastructure expenses in preparation for the next three-year plan as guided by the management. Although this move might lead to margin pressure in FY12/07F, we believe it is necessary to beef up the infrastructure. We continue to favor LF as we believe the benefits from KQIS and Tommy Hilfiger acquisitions will come into fruition from FY12/07F onwards. We maintain our BUY rating with a target price of HK$35.0, equivalent to 26.2x P/E in FY12/09F compared with a three-year average trading P/B range of 30x.