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Li & Fung 2006

“The company has changed dramatically in terms of scale – but our fundamental philosophy really has not changed. Our three-year planning process is second nature to all Li & Fung companies. The ideas and culture that were developed over a decade ago has – if anything – been totally reinforced with experience. We have not found it necessary to radically change anything but rather we are applying our philosophy with more sophistication and more depth. We are great believers in the “drumbeat theory” of management. This doesn’t mean that we don’t react to crisis – but we follow a steady course.”

—Victor Fung, Chairman, Li & Fung Group

In the fall of 2006, after reminiscing over the financial results of Li & Fung Limited’s (“Li & Fung Trading”) 1997 financial results, Victor Fung, Non-Executive Chairman of Li & Fung Group, expressed both amusement over how “small” the company was at the time as well as a resoluteness that the successes achieved over the course of the past decade were due to the fundamental strategies and three-year planning process he and his brother, William, Group Managing Director, instituted in 1989. As of mid-2006, Li & Fung Trading was on track to reach \$10 billion target on revenue by 2007 as the current 3-year-plan. (**Exhibit 1** provides the consolidated profit & loss accounts for 1993-2002 & 2003-2004. **Exhibits 2 and 3** provide consolidated profit and loss statements for 2005, and the 2005-2006 Interim statements, respectively). Despite being well into its Centennial celebration in 2006, the Li & Fung Group seemed to be just starting to broaden its wings as a truly full service global business in sourcing, retail and distribution.

Li & Fung’s growth spurt in the past decade was generated after intense planning and scrutiny of its core sourcing business. There were two primary plans that helped propel Li & Fung’s growth. First, while remaining committed to its philosophy of not owning any piece of the supply chain, the company instead focused on optimizing the pricing structure of each segment of the global supply chain. After years of gaining efficiencies at the factory level, the business transitioned to focus on how best to “eat into the soft \$3.” Li & Fung was focused on how to squeeze more efficiency in the supply chain between the factory and the consumer. This included efficiencies in logistics, shipping, and customs. Yet, Li & Fung sought not only to gain cost savings from these efficiencies. It also sought to maximize profits by creating more sophisticated value-added services for its customers so

Professors F. Warren McFarlan and William C. Kirby and Research Associate Tracy Yuen Manty prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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that it could also ultimately reap additional profits not pursued in the past. Li & Fung executed on this strategy with the launch of its on-shore presence in the United States. The U.S. on-shore strategy granted the company more control of the supply chain by partnering with its key customers to create customized strategies and services. Its U.S. on-shore strategy allowed Li & Fung to become more versatile in its offerings to customers through the development of proprietary/private label brands and the creation of an import market that it oversaw on behalf of its customers from the vantage point as a U.S. local company.

The second growth strategy was the continued acquisition of competitors. Since 1999, Li & Fung made 22 acquisitions, two of which were of great significance. The late-1999 acquisition of two export trading subsidiaries of Swire Pacific Limited - Swire & Maclaine and Camberley – together with the acquisition of Colby Group Holdings in late 2000 together added 21% in revenue to the 2000 year-end results for Li & Fung Limited. The acquisitions of these key competitors propelled Li & Fung to become the undisputed leader in sourcing and export trading.

In sight of meeting its three-year plan to become a company with \$10 billion in revenues by 2007, Li & Fung was positioning itself for more growth. Its most recent acquisition, in 2006, of the sourcing arm of German retailer, KarstadtQuelle, now allowed Li & Fung to improve the balance of its portfolio by slowly expanding out from its over-reliance on the U.S. market.

Excited by the success of the last decade, Victor remained steadfast that Li & Fung was just beginning to execute on its strategy for the next century. However, at issue for the future was whether the market would be receptive to their on-shore strategies. Furthermore, would opportunities for acquisition in favorable new markets present themselves so that the company could sustain its exponential growth? What were other avenues of future growth available for this trading giant?

Company History¹

The First 100 Years

From Mainland China to Hong Kong The Li & Fung Group was founded in Guangzhou, China in 1906 by Victor and William's grandfather, Fung Pak-liu and partner, Li To-ming. Li & Fung was one of the first companies financed solely by Chinese capital to engage directly in exports from China. It initially traded largely in porcelain and silk before diversifying into bamboo and rattan ware, jade, ivory, handicrafts and fireworks. In 2006, despite garnering little revenue, Victor and William still ensured that fireworks were kept as an export offering for the company because it held a special place in the company history.

On December 28, 1937, Li & Fung was formally established as a limited company in Hong Kong. Trading was halted for several years during World War II and by 1943 Fung Hon-chu took over the company after the passing of his father Fung Pak-liu. It was at this time that silent partner Li To-ming retired and sold his shares to the Fung Family. Despite the absence of the Li family in the company, the name Li & Fung was kept because of the auspicious meaning associated with both of the characters in the company name (Li meaning "profit" and Fung meaning "abundance").

¹ Portions of this company history have been adapted from the Harvard Business School Case No. 9-398-092, "Li & Fung: Beyond 'Filling in the Mosaic,' 1995-1998" prepared by Research Associate Anthony St. George under the supervision of Carin-Isabel Knoop and Professor Michael Y. Yoshino, and from the company history found on the Li & Fung website, <http://www.lifunggroup.com/heritage/heritage01.htm> accessed on November 28, 2006.

With the rise of the Communist party in Mainland China in 1949, Hong Kong saw an influx of refugees who helped transition Hong Kong's economy into an important manufacturing center for labor-intensive consumer products. During this time, Li & Fung expanded its range of goods for export to include garments, toys, electronics and plastic flowers. The company became one of Hong Kong's largest exporters.

Expansion Beyond Hong Kong In the early 1970s Victor and William were studying in the United States. Victor was completing his Ph.D. in Business Economics at Harvard University and William was getting his MBA at the Harvard Business School. During this time, they observed changes in the sourcing industry and decided that they needed to redefine the way the company was conducting its business. In 1972, William returned to Hong Kong to enter the family firm. Victor, at that time a professor at the Harvard Business School, helped his brother from Boston. Victor eventually returned to Hong Kong in 1974 and together with his brother and father worked to modernize and rebuild Li & Fung into a structured business run by professional management at all levels.

In April 1973, the brothers took the company public and listed it on the Hong Kong Stock Exchange. The new issue was oversubscribed 113 times, a record that remained uncontested for 14 years.

With the opening up of China in 1979 and the rapid industrialization of less developed Asian countries, Li & Fung took advantage and adjusted to these changes by investing in and sourcing supplies from relocated factories in Southern China and other parts of Asia. The company soon established its foundation as a regional network of offices beyond Hong Kong to focus on servicing its various customers.

In 1985, the company expanded its range of business and formed Li & Fung (Retailing) Limited as a company wholly-owned by Li & Fung (1937) Limited (**Exhibit 4** provides a structure of the companies). Circle K convenience stores and Toys "R" Us comprised this retailing group. The retailing business gave Li & Fung the rights to establish stores from Hong Kong to Taiwan, Singapore, Malaysia, the Chinese Mainland and other South East Asian countries.

In 1989 Victor and William bought out the rest of the family and the company was taken private to facilitate restructuring the business into two core areas: export trading and retail. In 1992 the export trading business was re-listed in Hong Stock Exchange while the retail operations remained private.

Mergers and Acquisitions Spur Growth The 1995 acquisition of Inchcape Buying Services (also known as Dodwell), a Hong Kong-based export trading company, began Li & Fung's march toward greater expansion. The HK\$450million (US\$58.1 million)² purchase almost doubled the company and established a strong European customer base to complement its existing strength in the U.S. and also expanded its sourcing network to include South Asia, the Mediterranean and the Caribbean.

Fueled by success of the Dodwell integration, Li & Fung sought to increase its market share by acquiring additional competitors in rapid succession. At the end of 1999, Li & Fung acquired two Swire subsidiaries: Swire & Maclaine Limited and Camberley Enterprises Limited. The Swire acquisitions provided Li & Fung an expertise in the design process. In early 2000 Li & Fung bought Colby Group Holdings Limited, and in 2002 Janco Overseas Limited was taken over. Each acquisition broadened the company's customer base, strengthened its management team, enhanced

² The exchange rate at this time was US\$1=HK\$7.74.

its product offerings, and expanded its geographic reach. Li & Fung was positioning itself into a truly multinational company.

Broadening the Business Model In parallel, Li & Fung continued to expand on the sourcing side by growing a greater presence in the Indian sub-continent as well as the Caribbean and Mediterranean basins - which were important given their geographic closeness to the key North American and European markets, respectively.

In 1999, Li & Fung also diversified into the distribution business through the formation of a privately held business, Li & Fung (Distribution) Limited ("Li & Fung Distribution"). Li & Fung Distribution then acquired the Marketing Services businesses of Inchcape in the Asia Pacific region and continued to provide services in three core businesses across Asia: Manufacturing, Logistics and Marketing. Subsequently, Li & Fung Distribution was reorganized to form the IDS (Integrated Distribution Services) Group and listed on the Hong Kong Stock Exchange in December 2004.

In its first 100 years, Li & Fung made great strides in export trading. The business was on record to reach its three-year plan goal of US\$10 billion by 2007.

The Export Trading Business

Traditional Supply Chain Services

The Ultimate Middleman Li & Fung's core export trading business encompassed a wide array of services that spanned the supply chain. At the most basic level, over 100 years ago, the initial company function was to introduce a buyer to a seller and then provide translation services between Chinese and English. Li & Fung has taken its middleman role and maximized its potential through the application of the most sophisticated technologies, networks, knowledge, staff, and information.

In 2006, Li & Fung supplied its over 1,000 customers in both hard and soft goods from a coordinated network of 8,000-10,000 suppliers through a sourcing network of over 70 offices in over 40 countries and territories. The trading business was divided into seven operating groups – the primary six were broken down by soft goods and hard goods across the U.S., Europe and rest of world, while the newest operating group focused on the U.S. on-shore business. Soft goods were defined as garments and apparel while the hard goods category included fashion accessories, toys, travel goods, gift items, fireworks, stationery, furniture, shoes, etc. The soft goods business comprised two-thirds of the total trading business and the U.S. was responsible for over 69% of customer orders in 2005. Because the scale of the soft goods business in the U.S. was so large, Li & Fung dedicated three distinct operating groups to focus specifically on the soft goods market in the U.S. Customer or channel type distinguished each of these three operating streams. One team focused on the Big Box or "Superstore" retailers; another team focused on Specialty Stores - stores which specialize in a specific range of merchandise and related items, for example, baby clothing, casual, juniors, etc.; and the third team focused on Brands. **Exhibit 5** lists the operating groups of the trading business.

Business Strategy - Disciplined Entrepreneurship In 2006, Li & Fung was divided into over 170 entrepreneurial profit centers that maintained a customer centric focus. To further reinforce this customer culture, Li & Fung offered its staff competitive compensation, incentive bonus plans, and stock option grants based on individual and group performance. Since 1989, when Victor and William instituted a culture of three-year business planning, the process has been institutionalized

and created a core culture of disciplined entrepreneurship. Once the goals of a three-year plan were defined, they were cast in concrete. This process allowed the management team to instill new thoughts and new strategies into the company and to create a process that held managers accountable for their goals. If goals were unmet, the process provided the means to measure and analyze why they failed. As a result, Li & Fung could test management and business theories and if something worked well – it could choose to sustain it in the next three-year plan or it could start from scratch after the three year cycle was over.

William recognized that the fashion industry was cyclical and not all managers would succeed in making his goals. William stated, “If managers don’t succeed, however, we don’t necessarily get rid of them right away. We understand the nature of the business and sometimes during a downturn a manager can do poorly for a few years. Our father taught us the value of loyalty, however, and we will keep a manager on or move them around if poor results are a consequence of something other than their efforts.”³

Transforming the Customer Experience The tradition of retail stores was to rotate their inventory through the four primary seasons, which meant goods were shipped only four times a year. However, the trend moved to getting fashions in and out more quickly in order to keep stores “fresh” and to drive customers in the stores on a more regular basis. In an effort to keep up with these demands, retailers have had to compress the process between planning, designing, sourcing and manufacturing. Li & Fung offered its customers its deep experience and expertise through the sheer scale of its operations. Li & Fung’s expertise was its ability to collect the most up-to-date information on how to best manufacture a product for a customer.

When a customer placed an order with Li & Fung, a dedicated team would take the order and work with the customer to clarify all needs and specifications. The Li & Fung manager would next take the order instructions and feed it into its intranet to find the right supplier of raw materials and the right factory to assemble the clothes. The goal was to get top-notch quality at the best price in the timeliest manner. What this meant was that orders could be woven in China, sent to Korea to apply fastenings and then sent to Guatemala for sewing. Before each production step, the customer was able to make changes to its orders, i.e. before the fabric is dyed, the customer could change the color; before the garment was cut the client could change design.⁴ Li & Fung virtually offered “just-in-time” coordination that allowed the customer more lead time to garner more accurate information on trends. The outcome of this level of efficiency was less product markdowns and increased sales. This process reinforced a core Li & Fung philosophy that the company was organized around the customer in a “flat world.” The transfer of information in a timely manner was fundamental to the success of its services.

Information Technology as a Core Strength One of the primary strengths of Li & Fung was its investment in information technology that helped it manage the logistics of the supply chain process. Staunchly against owning any of the production facilities from which it sourced, Li & Fung instead focused on connecting and sharing information across its headquarters, customers, sourcing offices and factories. In addition, to further embody the importance of getting closer to the customer, Li & Fung’s operating groups would adopt each specific customer’s in-house system software systems from logistics to billing, if required. Victor stated, “We adopt the customer’s processes and organize for the customer - using their software if we need to; we operate the way they operate, that’s

³ Li & Fung: Beyond ‘Filling in the Mosaic,’ 1995-1998 the Harvard Business School Case No. 9-398-092, prepared by Research Associate Anthony St. George under the supervision of Carin-Isabel Knoop and Professor Michael Y. Yoshino, June 23, 1998, p. 3.

⁴ “Furiously Fast Fashions,” by Joanne Lee-Young, The Industry Standard, June 22, 2001.

the only way we can really be customer-centric.” Li & Fung’s IT competency was so strong that in May 2005, the company was recognized by Wired Magazine as one of “The Wired 40,” a distinguished title that underscored its mastery in technology and innovation. Li & Fung shared a place on this list with such firms as Apple Computer, Google, Samsung Electronics and Yahoo!⁵

As a result of its sophisticated IT and centralized back-office systems, Li & Fung found acquisition integrations highly turn-key and from where most efficiencies were gained. Immediate first steps involved a “plug and play” model where it centralized back-end operations including administration, finance, human resources, and most importantly, IT. Li & Fung invested in systems that could be installed into any warehouse that would link them immediately into headquarters. The first step in most acquisitions was to immediately replace the support groups by “plugging” in Li & Fung resources, which provided immediate efficiencies. As a result, the company could then concentrate on the true value of the acquisition - front-end customer relations. Victor underscored, “We are very careful not to change the front-end piece of an acquisition. We do not want to change the talent that has the relationship with the customer.”

Moving Up the Value Chain Although Li & Fung found success in its traditional sourcing business it sought to offer more services so it could increase its profit margin. William Fung stated, “Nobody is going to pay you more unless you do more.”⁶ For its soft goods customers the company provided product planning, design services and development in addition to its traditional raw material and factory sourcing. Li & Fung’s customer facing teams were in the position to provide more creative suggestions based on their expertise in areas such as what new colors and fabrics were available in any given season. These services helped merchandisers make better buying and designing decisions. Further upstream, Li & Fung supplied quality control, testing, export documentation, and logistics services.

In 2002, by moving up the value chain and before it had launched its U.S. on-shore strategy, Li & Fung had grown to sales of almost US\$5 billion.

Eating Into The Soft \$3

“Global sourcing has changed dramatically. There is no where in the world that you can produce from that we are not sourcing from. So when we are working with our own businesses and with our customer’s businesses, we bring that all to the table and therefore pricing on the front-end is lower while customer price is getting higher resulting in not just the soft \$3, perhaps even a soft \$4, \$5, or even \$6.”

—Bruce Rockowitz, President of Li & Fung (Trading) Ltd.

By 2003, Li & Fung knew that in order to continue growing, it had to expand its services not only to find value for the customer at multiple links throughout the supply chain but also to do so by getting closer to the customer. As a result, one of the key strategies that it launched in the most recent three-year plan was its U.S. on-shore strategy. The goal of this strategy was to gain even more margin. It was clear that the company could no longer just squeeze cost savings and improve the factory price. Instead, Li & Fung focused on providing more value through new services in the area of the supply chain between the factory and selling floor. New services ranged from orders analysis

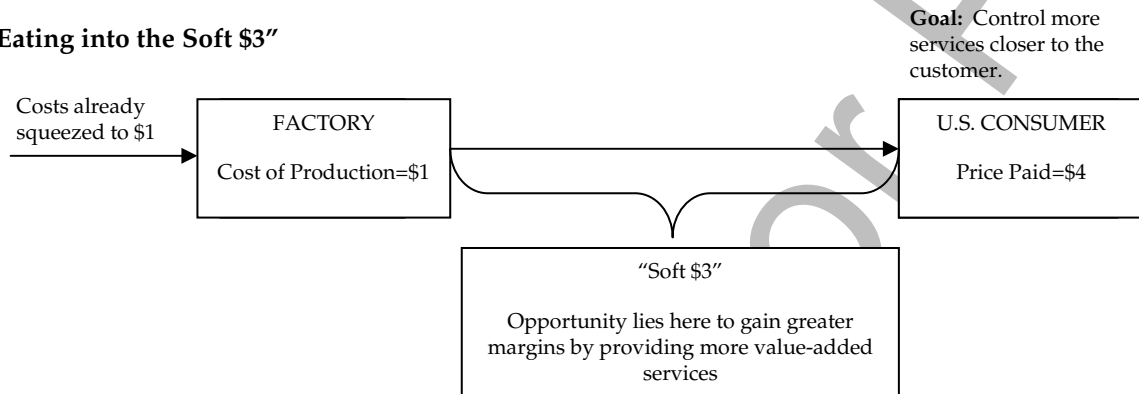
⁵ “The Wired 40,” by Duff McDonald, Wired Magazine, May 2005, accessed on the Wired Magazine website, <http://www.wired.com/wired/archive/13.05/wired40.html> on December 1, 2006.

⁶ “Li & Fung Takes Its Middleman Role to Extremes,” by Jason Booth, The Asian Wall Street Journal, December 14, 2001.

that aimed to reduce markdowns, decrease the inefficiencies of the reorder cycle, and minimize the risk of inventory to logistics including contract shipping, customs clearing, and store delivery. The diagram below displays where Li & Fung sought new business opportunities within the supply chain.

Diagram 1

“Eating into the Soft \$3”



On-Shore Supply Chain Strategy

Focus on the U.S. Market Over 70% of Li & Fung’s customer base was located in the U.S. Li & Fung felt that an on-shore strategy would benefit their business and key customers because it would be better able to participate in all levels of their customer’s decision-making.

There were four primary benefits in pursuing an on-shore strategy in their largest market. First, a closer relationship would improve margins because Li & Fung would be able to create more services within the value chain and charge for these services. Second, an on-shore strategy would create more “stickiness” between Li & Fung and their best customers. Li & Fung wanted to ensure that the company was top of mind for their customers at the very start of their customer’s business planning. Third, an on-shore strategy would benefit Li & Fung because the company would be closer to information. Instead of a 10,000 mile geographic separation, being on-shore allowed Li & Fung to react faster and better to any announcements or changes its customers made that could affect its relationship.

The final reason to go on-shore in the U.S. was to penetrate the import market. Li & Fung saw a huge opportunity in the U.S. to develop the robust, yet fragmented “middleman” import market. There were still many, many companies based in the U.S. that managed the design, logistics and sourcing of products on behalf of other companies – in both hard and soft goods. These middlemen often sourced products through Li & Fung on behalf of their U.S. customers. Over the years, Li & Fung created services to compete with these importers, that is, it provided design and logistics but what it could not do was compete fully with them unless it entered the U.S. and made a local commitment.

Beginning in 2005, the start of Li & Fung’s fifth three-year plan, the company deepened its commitment in the U.S. with the goal to build business scale in the U.S. Li & Fung sought areas of consolidation to build its on-shore operations from an “adjacency” business to a core competency. Although Li & Fung had some U.S. on-shore presence in the past, it fulfilled on its pledge through acquisitions. From 2003 through 2006, Li & Fung acquired seven on-shore U.S. businesses (**Exhibit 6** lists these acquisitions) and signed a lease for a 70,000 square foot space in Manhattan’s fashion district to house its global brands business, design studios, logistics operations and to provide

showroom space for its licensed brands. From 2005 to 2006, the company grew its U.S. on-shore business from almost nothing into an almost US \$1 billion business.

Three-Pronged U.S. Strategy

Li & Fung's U.S. on-shore strategy focused on providing additional services in three primary areas of the supply chain that had remained unexploited by Li & Fung in the past.

Licensing Recognized Brands This strategy was not new to Li & Fung. By the time it was fully on-shore in the U.S., Li & Fung already had experience in managing licenses for some popular brands in the U.S. The focus of this service was to build up an already well-known brand by controlling product design, branding, sourcing, product delivery, quality control, pricing and warehousing. Some of the licensed brands that Li & Fung already managed from start to finish included Cannon, Royal Velvet, Disney, and Levi's. Licensing and managing the production of products for these brands garnered twice the margin when compared to only sourcing materials to produce the same products.

Li & Fung sold these products into a variety of major retailers. The products it produced under the brand license most often were not high fashion but rather were targeted to the middle market.

In 2005, Li & Fung acquired Briefly Stated, a portfolio company with over 60 brands in its stable, to expand its licensing business. Most of the brands that Briefly Stated designed for were well-known entertainment companies. Briefly Stated focused on producing loungewear and undergarments for children and adults.

Private label The focus of this strategy was to acquire companies that specialize in producing finished products with a specialty in design. Companies that specialized in private labels designed products for retailers who would give the product a private label/in-house brand to differentiate its offerings from its competitors. Over the last decade, private label brands have proliferated and transformed the retail industry and Li & Fung saw an opportunity to claim a piece of this market. Private label applied to hard and soft goods and even food.

Proprietary Brands This strategy was a combination of first two services. The major differentiator was that this strategy focused on making an already recognized brand exclusive to a retailer. Establishing proprietary brands was a tremendously successful strategy for retailers such as Target and J.C. Penney and proliferated across many retailers as a key approach in less than a decade.⁷ Target was one of the first retailers to enter this business when it hired architect Michael Graves in 1999 to create a whimsical line of house wares. Other examples of proprietary brands included Martha Stewart's exclusive relationship with K-Mart, Karl Lagerfeld, Stella McCartney, and Viktor & Rolf at H&M, Nicole Miller at J.C. Penney, and in 2007, Vera Wang planned to roll out a collection of lingerie and bedding at Kohl's.

Li & Fung's plan was to use the companies it acquired in the U.S. to produce the designs on behalf of the designer or retailer to create proprietary branded soft or hard goods or to gain a license to produce these proprietary brands directly from the designer. Li & Fung had already had some success with proprietary brands with its Oxford acquisition.

⁷ "Cheap Chic: Who Gets it Right" by Rachel Dodes and Ann Zimmerman, The Wall Street Journal Online, November 25, 2006.

A Foot in the Door Rockowitz's mindset for this business model was to think, "How do we sell to additional major retailers?" He knew that Li & Fung could not bring sourcing to retailers who historically sourced the production of their products in-house because this approach assumed that their model was not working. However, Li & Fung's senior management wanted a way to reach out to those blue chip retailers that were not yet its customers. Li & Fung saw the on-shore business strategy as narrow but deep and believed that if it worked well it could be a successful business model that it could apply to other markets. The strategy allowed the company a means to sell services: licensed brands, proprietary brands, private label goods to the Top 10 major U.S. retailers who had their own sourcing arms. It gave Li & Fung the opportunity to get a foot-in-the-door to those customers that Li & Fung would not or could not otherwise do business with. If the company could provide one area of service to a major U.S. retailer that it did not have any sourcing business with, it was still a significant customer acquisition strategy because it was a first step in building ongoing organic growth.

Only one-year into the launch of its U.S. on-shore approach, Li & Fung was staunchly committed to this business model.

The Next Wave of Acquisition

Although the tremendous U.S. market continued to be strong and its growth encouraging given the broad range of retailers, products, and customer demands, Li & Fung was cognizant of its over-reliance on the U.S. market. As a result, the company sought to address this issue through a series of mergers and acquisitions to rebalance its portfolio.

Rebalancing the Portfolio

Major Sourcing Acquisitions Historically, many of the major U.S. and European retailers had established their own buying offices in Hong Kong long before Li & Fung reached a size large enough to support them. A decade ago, most of these companies had sourcing arms bigger than Li & Fung. However, given Li & Fung's recent growth, the company was now at a size where it knew it could take on a larger outsourcing deal. In 2006, Li & Fung executed against this strategy by acquiring KarstadtQuelle's sourcing arm. KarstadtQuelle was a major German catalog and retail business and Europe's largest department store operator. The deal brought to Li & Fung over US\$1 billion in additional revenues and a stronger base in Europe, including additional sourcing customers that had outsourced to KarstadtQuelle.

Boosted by the significance and market reaction of this acquisition, in 2006 Li & Fung ensured that it raised capital through a public offering to fund similar acquisitions in the future. However, such large deals were few and far between and the company managers understood that it had to be patient before another significant opportunity presented itself.

Steady Drumbeat to Fill in the Hard Goods Mosaic Parallel to its major acquisition efforts, Li & Fung also continued to "fill in the mosaic" and sought acquisitions in products and regions in which it was weak. The middleman market was still very fragmented across the world so Li & Fung saw many opportunities to consolidate the industry. The company eyed small and medium-sized sourcing offices with specific specialties in areas such as furniture, home textiles, etc. In particular, Li & Fung was hungry for acquisitions in the hard goods area to further balance its portfolio.

Hard goods were financially less profitable for the company. The production process required longer lead times due to production set-up, was more labor intensive, and the customer price of the products were on average much less than soft goods. However, there was a strong potential for growth in this area as well, especially since the garment industry was getting increasingly crowded and opportunities for sourcing acquisitions were getting more difficult. In 1992, when Li & Fung re-listed on the Hong Kong Stock Exchange, the hard goods business accounted for less than 10% of total trading business. By 2006, the business comprised over 30% of total trading revenues. Key markets for raw materials of hard goods were China, Vietnam and Southeast Asia. Henry Chan, Executive Director of the Hard Goods line for Brands and Specialty Stores, expressed optimism in the further growth of the business. "As the company has grown, the hard goods area has grown faster than soft goods on a percentage basis and we are encouraged by this." The total hard goods revenue for Li & Fung by third quarter 2006 was over US\$3 billion.

The approach to service hard goods customers mirrored that of soft goods. The hard goods staff was divided into dedicated product matrix teams that serviced a particular customer in a specific hard goods product line. The product teams provided additional services such as product design, merchandising ideas in addition to the traditional product sourcing. Some of Li & Fung's most important hard-good customers, such as Bed, Bath & Beyond and Avon also had account facilitators on-shore in the United States, some even at the customer site to manage their businesses. While the hard goods business had many large customers, there remained a strong commitment to small companies. The philosophy of the hard goods team was to provide a dedicated service team on small projects, delight the customer with its results and then build up the relationship so new customer commitments could be secured. Li & Fung wanted to grow with its customers.

Over the next five years, Chan believed that China would continue to be the major supplier for more than 80% of all hard goods produced. Merchandise from China is of good quality and China has the most diversified base of products. Chan viewed China as a country with four sourcing hubs:

1. **Southern China** (primarily Hong Kong and Guangdong Province): This area provided production for goods that had sophisticated design. The factories had the most experience and were usually joint ventures with Hong Kong and Taiwanese business partners. Labor costs in this area were the highest and production in Southern China focused on high value products. Southern China comprised about 55-60% of Li & Fung's hard good sourcing within China.
2. **Central China** (Shanghai): With a population of over 230 million people within the four-hour driving radius of Shanghai, its strength was in the labor. Local Chinese entrepreneurs developed most of the factories in this central coastal area and it was easier to negotiate production rates and smaller quantities with these factories. In addition, cost of labor was approximately 15% cheaper than that of Southern China. Core competencies in this region were focused on home textiles, glass, ceramics, home decoratives and plush toys. The port of Shanghai further made this hub convenient for hard goods sourcing. Central China comprised about 25-30% of Li & Fung's hard good sourcing within China.
3. **Northern China** (Qingdao and neighboring areas of Beijing): JV factories in Northern China were mainly Korean influenced and also a lot of vendors were run by local Chinese entrepreneurs. Labor and infrastructure costs were approximately 25% cheaper than Southern China with a strong expertise in metal, home textiles, ceramics and glasses. Northern China comprised about 10% of Li & Fung's hard good sourcing within China.
4. **Western China** (Chengdu): Li & Fung saw great potential in western China. This area was viewed to be similar to the Shanghai region of 20-25 years ago. Workers from Szechuan

returned to this region and brought back their production expertise to start their own businesses. Western China comprised about less than 5% of Li & Fung's hard good sourcing within China.

In addition, hard goods sourced from China were mostly not subject to quotas of anti-dumping by the U.S. or Europe, so its importance in the production of hard goods was not insignificant. Still, Li & Fung also diversified geographically for its hard goods business. Vietnam was a key supplier for wood, sea glass, shoes and gardening items. Southeast Asia, in particular, Indonesia, was a key market for wood and furniture products. India and Pakistan provided home textiles and some handicraft items made of metal, but were limited by their ability to produce for the mass market for most of the product categories. Turkey, Europe and Mexico rounded out the top sourcing areas for the hard goods business and further helped to "fill in the mosaic" and further strengthen Li & Fung's overall position.

Growing Europe In the past, there were significant difficulties in Europe that affected Li & Fung's success in the market and to date, Europe still only accounted for about 20% of the total trading business for Li & Fung. The goal was to have Europe account for one-third of the trading business. According to Wai Ping Leung, the Executive Director of Soft Goods in Europe, there were several factors for concern in Europe.

1. Geographically, Europe was fragmented and not a homogeneous market such as the United States, therefore, penetration in each country required more work.
2. The buying, sourcing, and logistics business was sophisticated and European retailers were just not used to outsourcing.
3. Many retailers have their own buying offices so it was difficult for Li & Fung to garner business in this core area.
4. European retailers used multiple agents and supply chains so the size of business was smaller.
5. Buyers opted to diversify the number of vendors which provided creative services so they could generate a variety of ideas to make up for the lack of scale and design inherent in-house.

Although, the KarsdadtQuelle acquisition strengthened Li & Fung's base for sourcing and trading in this region, the issues above coupled with the more specific tastes of the European countries still presented a challenge to Li & Fung in its sourcing business for Europe. Leung's immediate focus was to integrate the acquisition and find more customers in fast growing markets such as Eastern Europe and Russia. Leung stated, "We have more room to grow in Europe in the sourcing business. We want to gain more experience on our on-shore business in the U.S. before executing a European onshore strategy."

The Second Hundred Years

With the major centennial celebrations for Li & Fung coming to a close in late 2006, the company was positioned to make the start of its next century of business successful by reaching all the goals of its current three-year plan. Yet, as a US\$10 billion business how far could it surpass itself given the challenges of an unbalanced portfolio: an over-reliance on the U.S. market; a rather diversified European market; a global saturation of demand for soft goods? Should there be new areas of business it could enter or were there other supply chain efficiencies not yet analyzed that it could

hope to find and champion? Perhaps Victor and William would leave these issues up to the fourth generation to ponder.

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Exhibit 2 Consolidated Profit & Loss Account 2005

	2005	
	HK\$ '000	
Turnover	\$	55,617,374
Cost of Sales	\$	(49,956,433)
Gross Profit	\$	5,660,941
Other Revenues	\$	264,384
Total Margin	\$	5,925,325
Selling Expenses	\$	(973,874)
Merchandising Expenses	\$	(2,666,214)
Administrative Expenses	\$	(424,569)
Core Operating Profit	\$	1,860,668
Gain on Disposal of Properties	\$	27,832
Net Investment Loss	\$	(3,900)
Operating Profit	\$	1,884,600
Interest Income	\$	69,539
Share of Profits Less Losses of Associated Companies	\$	(21,376)
Profit Before Taxation	\$	9,062
Taxation	\$	1,941,825
Profit for the Year	\$	(151,248)
Attributable to:	\$	1,790,577
Shareholders of the Company	\$	1,790,279
Minority Interests	\$	298
	\$	1,790,577
Earnings per share for profit attributable to the shareholders of the Company during the year		
--basic (HK cents)		61.2
--diluted (HK cents)		60.7
Dividends		1,468,432

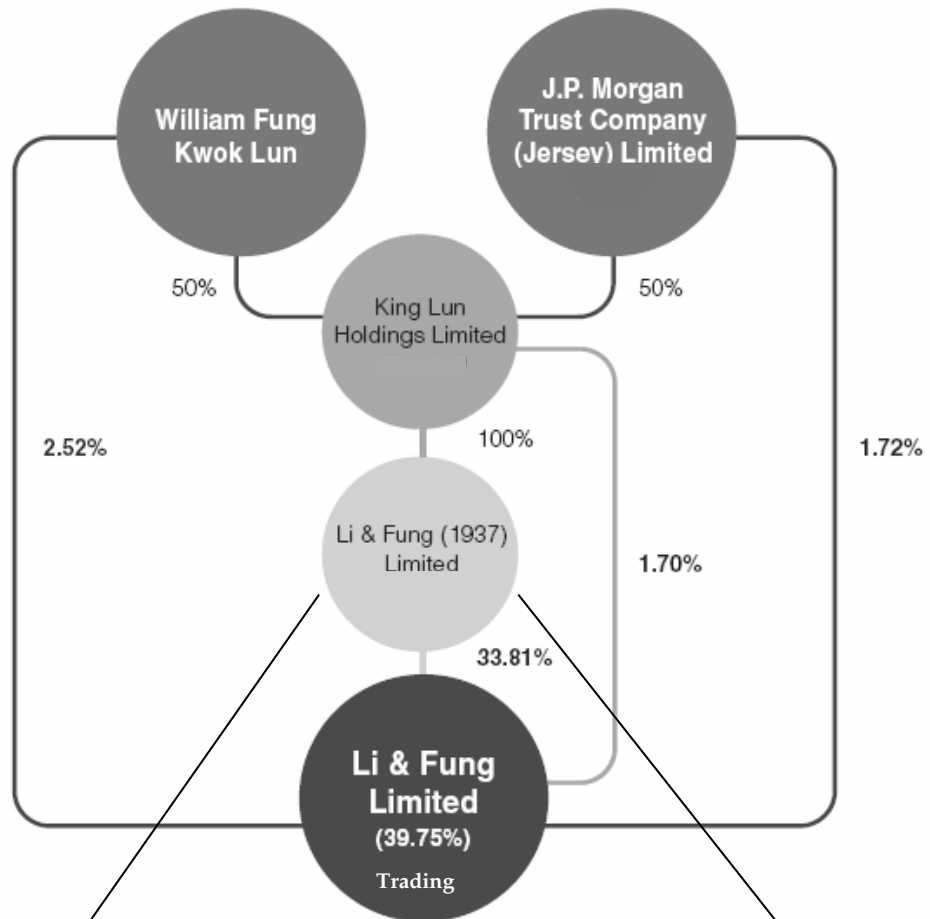
Source: Li & Fung

Exhibit 3 Consolidated Profit & Loss Account – 2005-2006 Interim Year Report

	2006 Six months ended 30 June HK\$'000	2005 Six months ended 30 June HK\$'000
Turnover	\$ 27,970,274	\$ 23,466,448
Cost of Sales	\$ (25,152,988)	\$ (21,238,163)
Gross Profit	\$ 2,817,286	\$ 2,228,285
Other Income	\$ 134,927	\$ 114,969
Total Margin	\$ 2,952,213	\$ 2,343,254
Selling Expenses	\$ (447,287)	\$ (338,979)
Merchandising Expenses	\$ (1,417,384)	\$ (1,194,683)
Administrative Expenses	\$ (251,340)	\$ (190,462)
Core Operating Profit	\$ 836,202	\$ 619,130
Gain on Disposal of Properties	\$ 3,268	\$ 27,332
Operating Profit	\$ 839,470	\$ 646,462
Interest Income	\$ 23,056	\$ 36,753
Interest Expenses	\$ (43,050)	\$ (6,490)
Share of Profits Less Losses of Associated Companies	\$ 11,507	\$ 8,404
Profit Before Taxation	\$ 830,983	\$ 685,129
Taxation	\$ (66,702)	\$ (67,209)
Profit after taxation	\$ 764,281	\$ 617,920
Attributable to:		
Shareholders of the Company	\$ 764,105	\$ 618,468
Minority Interests	\$ 176	\$ (548)
	\$ 764,281	\$ 617,920
Interim Dividend	518,742	425,095
Earning per share for profit attributable to the shareholders of the Company during the period		
--basic (HK cents)	23.6	19.2
--diluted (HK cents)	23.5	19.1

Source: Li & Fung

Exhibit 4 Li & Fung Corporate Structure



Note: the trustee of a trust established for the benefit of the family of Victor Fung Kwok King



Source: Li & Fung

Exhibit 5 Li & Fung Trading Operating Groups

	Operating Group	Region	Scope/Channel
1	Soft goods/Apparel	United States + Non-Europe	Brands
2	Soft goods/Apparel	United States + Non-Europe	Specialty Stores
3	Soft goods/Apparel	United States + Non-Europe	Big Box Stores
4	Soft goods/Apparel	Europe	All Retailers
5	Hard goods Including but not limited to: Automobile accessories Bedding goods Fashion accessories Fireworks Footwear Furnishings Gifts Handicrafts Home Products Kitchenware Promotional Merchandise Toys Stationery/Paper crafts Sporting Goods Travel Goods	All Regions	Brand/Specialty Stores
6	Hard goods Including but not limited to: Automobile accessories Bedding goods Fashion accessories Fireworks Footwear Furnishings Gifts Handicrafts Home Products Kitchenware Promotional Merchandise Toys Stationery/Paper crafts Sporting Goods Travel Goods	All Regions	Big Box Stores
7	U.S. On-Shore Strategy	U.S.	All Retailers

Source: Li & Fung

Exhibit 6 Li & Fung U.S. On-Shore Acquired Companies

Company Name	Type of Company/Products	Date Acquired
International Sourcing Group, LLC	Li & Fung bought the remaining one-third interest in ISG that it did not already own. ISG is a garment importer that sells product to mass market retailers in the U.S. Headquartered in New York	August 2003
Ralsey Group Limited	Private label knitwear/ and sportswear company with a diversified product line of women's, kids' and teens' ready-to-wear apparel. Headquartered in New York	October 2004
Young Stuff Apparel Group	Young Stuff Apparel Group is one of the leading American manufacturers of high quality, high value apparel. The business produces private label clothing and a branded line (YSAG) that is sold in department stores, national chains, mass merchants, specialty retailers, catalogs, and wholesalers. They offer a wide range of design and price options and are known for quality products, innovative styling, competitive pricing, excellent customer service, and integrity in our relations with suppliers and customers. Headquartered in New York	2005
Briefly Stated Holding Group, Inc.	Briefly Stated offers high-quality lines of men's, women's and children's underwear and sleepwear. Collaborates with licensors through strategic partnerships, and provides retail buyers with fashion-forward designs, innovative and diverse product assortments and exceptional quality and service. Headquartered in New York	August 2005
Oxford Womenswear Group	Design intensive producer of budget and moderately priced, private-label women's apparel collections. It is primarily focused on the mass merchants segment of the U.S. Headquartered in Atlanta	May 2006
Rossetti Handbags and Accessories, Ltd.	Leading designers and importers of handbags in America. The business comprises the design, arrangement for the manufacture of, import, marketing, and sale of women's handbags, purses and related accessories for its own brand, as well as licensed and private labels for U.S. retailers including department stores, mass-merchants and specialty stores. The company designed its handbag lines internally & outsourced the production of finished goods to a network of manufacturers. Headquartered in New York	July 2006

Source: Li & Fung press releases found on www.lifung.com