Management Discussion & Analysis

Chairman's Statement

Victor FUNG Kwok King

Introduction

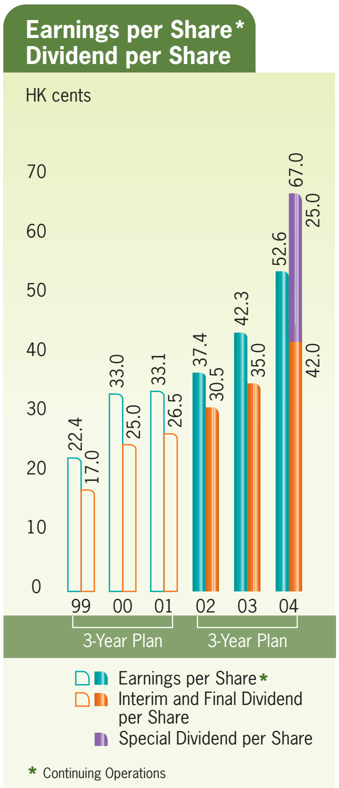
I am pleased to report that Li & Fung Limited (the "Group") made good progress in 2004 despite fairly challenging market conditions. The Group achieved double-digit growth in the face of higher interest rates, a sharp decline in the value of the US dollar and significantly higher oil prices.

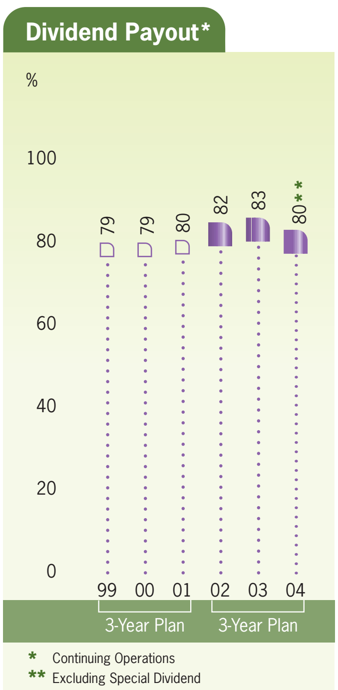
Improvement in the Group's profitability in the first half of the year was sustained in the second half because of continuing demand for the Group's value-added services, a growing client list, its proven licensing strategy and smaller but strategic acquisitions.

By the end of 2004, the Group had moved successfully into a higher-margin business model that will allow for further growth.

Performance

In 2004, Group turnover increased by 11% to HK$47 billion. Profit attributable to shareholders was HK$1.53 billion, representing a 25% increase over the HK$1.22 billion of 2003. Earnings per share were 52.6 HK cents, compared with 42.3 HK cents in 2003.





The Board of Directors has proposed a final dividend of 30 HK cents per share, and also a special dividend of 25 HK cents per share, to be paid as a return of excess cash to shareholders. The Group is keen to ensure efficient capital utilisation and feels that its existing businesses will be able to generate a healthy cashflow. Should additional funds be required to support Group operations and acquisition programme they can be well covered from remaining cash reserves plus the judicious use of additional gearing, if necessary. Together with an interim dividend of 12 HK cents per share, the total dividend for the whole year would amount to 67 HK cents per share (2003 total: 35 HK cents per share).

Market and Business

Although the global economic environment was strong in 2004, the US consumer market was marked by hesitation and uncertainty because of rising oil prices and interest rates. This had an impact on the Group's growth momentum, especially in terms of turnover in the first half of 2004.

2004 was the final year in the Group's Three-Year Plan 2002-2004, and although the Group did not meet its target of doubling its profit for the period, its turnover grew by 43% and profit grew by 61% over the three years.

Margin improvement also provided a positive note for 2004, as did the Group's licensing strategy (with premium brand names such as Levi Strauss Signature™), as well as value-added agency services that include product design and development. By the end of the Three-Year Plan 2002-2004, a 14% increase in higher-margin businesses had helped drive profitability, while the Group's expanded range of add-on services also contributed to profit growth. The Group now has a strong foundation for the next three-year plan. Its enhanced business model will strengthen its core sourcing business and facilitate further growth.

Other developments within the Group are also noteworthy. The successful integration of the Group's Colby and Janco businesses helped to cement Li & Fung's leadership position. The acquisition of International Sources in December 2003, and further smaller-scale acquisitions, including Ralsey Group and an European apparel company in 2004, provided complementarity to the Group's existing businesses.

The Group has also reviewed its capital structure. To facilitate this, it has obtained international credit ratings of A3 and A– from Moody's and Standard & Poor's respectively. These ratings reflect well on the Group's prudent management and strong financial position.

The phasing out of the Multifibre Agreement and the dismantling of the global quota system at the beginning of 2005 has created more opportunities for the Group. It now has more factories it can work with, while the opening up of the China market brings in untapped sourcing opportunities, and now, more than ever, as retailers need help in identifying appropriate factories and vendors. In short, there are now more new customers in search of outsourcing solutions.

Strategies for Sustainable Growth

2005 will see a redoubling of effort by the Group to ensure sustainable growth:

A deepening of the Group's Adjacency Strategy should help accelerate growth from opportunities that sit adjacent to the Group's core business. These new streams of business include on-shore business development and marketing opportunities, design and branding through licensing agreements and a broader extension of the Group's agency role.

Value extraction from the Group's brand business should be another important growth driver. The groundwork has been laid, and the returns should be forthcoming over the next three years and beyond. Brands to watch include Levi's Red Tab, Cannon, Royal Velvet, Disney plush toys and possibly the Ralsey Group's knitwear/sportswear brands.

Value enhancement from the Group's presence and heritage in a market such as China should yield returns over the longer term. The Group has begun to utilize its direct export licence in China, and the removal of the US quota system opens up new sourcing opportunities for the Group.

Selective acquisitions will also remain a priority for the Group, especially given the Group's track record of successes in past acquisitions, such as sourcing company International Sources in Mexico and higher-margin businesses including a European apparel firm, to complement different areas of the Group's business. This approach remains a cornerstone of the Group's strategy of diversification and building more high-margin businesses. Going forward, priority acquisition targets include specialists in hardgoods and in the European market.

The bottom-line is that the future looks encouraging. The Group's Three-Year Plan 2005-2007 sets a bold target of US$10 billion in turnover with further improvements in margin and a cementing of the Group's brand licensing business.

Although global economic performance in 2005 is likely to moderate as a result of high oil prices and increasingly tighter monetary conditions, the Group takes encouragement from a robust global outsourcing trend, its tested business model and a strengthened management team that now includes a president for its principal trading subsidiary Li & Fung (Trading) Limited and a chief operating officer, a newly-created position.

From a long term growth perspective, the Group's key strengths look well-placed: its well-defined global presence and flexibility, its sourcing track record and relationships, its ability to move rapidly and effectively into new markets, and the creation of value from synergistic opportunities as well as new streams of business are all positive factors.

Corporate Governance

The Group's commitment to good corporate governance standards and practices has remained unwavering and has served the Group well. For example, the number of Independent Non-Executive Directors now comprises the majority for three of the Group's committees: the Nomination, Audit and Compensation Committees.

With regard to The Stock Exchange of Hong Kong Limited's recent amendments to its listing rules relating to the code on corporate governance practices and rules on the corporate governance report, the Group will conform with the new requirements as quickly as possible.

In conclusion, I would like to once again, and with great pleasure, thank the members of the Board for their constant and valuable support and guidance. I am also very appreciative and grateful to the Group's management team and staff for their commitment and hard work.

Victor FUNG Kwok King
Chairman

Hong Kong, 22 March 2005