Management Discussion & Analysis

"2005 was an encouraging start to the Three-Year Plan (2005-2007)."

William Fung, Managing Director

Overview

2005 was the first year of the Group's current Three-Year Plan 2005-2007, and we are pleased to report satisfactory performance for the year in line with the Plan's targets. The Group's turnover was HK$55,617 million, 18% higher than 2004. Profit attributable to shareholders increased by 20% to HK$1,790 million. Earnings per share were 61.2 HK cents, compared to 51.2 HK cents in 2004.

The Board of Directors has proposed a final dividend of 35.5 HK cents per share. Together with an interim dividend of 14.5 HK cents, total dividend per share for the year 2005 was 50 HK cents (2004: 42 HK cents, plus a special dividend 25 HK cents making a total of 67 HK cents).

A 1-for-10 bonus issue has also been proposed to commemorate the 100th year anniversary of the Li & Fung Group.

Results Review

The strong increase in turnover for 2005 indicates that the Group has continued to gain market share in the markets where it operates. During this year, consumer markets faced a chaotic environment of rising interest rates and energy costs. The international textile trade also faced great changes as the textile quota system, which had been in place for more than 40 years, was removed. Despite these issues, the Group was able to expand its position amongst existing customers and develop new businesses. Retailers increasingly realize that by finding strong strategic partners in the supply chain such as Li & Fung, they are able to focus on their customers and their unique core competencies.

The current Three-Year Plan's acquisition strategy is also on track with five acquisitions made during the year, adding to the strength of the results.

> "One of the key strategies is to carry out a series of smaller acquisitions to augment capabilities in certain sectors."
>
> Bruce Rockowitz, President

The Group's total margin surged by 30% and as a percentage of sales, saw an improvement from 9.64% to 10.65% in 2005. This reflects a continued shift in more businesses being conducted with a higher-value-added supply chain model. In particular, because of the evolution of the fashion market towards more differentiated designs, the Group saw accelerated demand for our product design and development services.

The Group's operating profit rose 21% to HK$1,885 million during 2005. The margin rate has improved from 3.30% to 3.39%, despite the Group's investments in building up the corporate infrastructure to position for aggressive future growth.

In accordance with the new Hong Kong Financial Reporting Standard ("HKFRS") 2 "Share-based Payments", the operating profit above reflected a change to include an employee share option expense of HK$47 million for 2005.

The operating profit for 2004 has also been restated at HK$1,556 million from HK$1,595 million, reflecting share option expenses of HK$41 million as well as a reversal of depreciation on land revaluation surplus of HK$2 million.

In terms of major non-recurrent items, the Group has recognized a profit of HK$27.8 million related to sale of office premises in Citicorp Centre, Hong Kong. These premises belonged to Colby Group Holdings Limited, which was acquired by the Group in 2000. Since then the business has been fully integrated with the rest of the Company on the Kowloon side, and hence the premises were no longer necessary for self-use.

A small net investment loss was also incurred in a prior venture capital investment the Group has made earlier on.

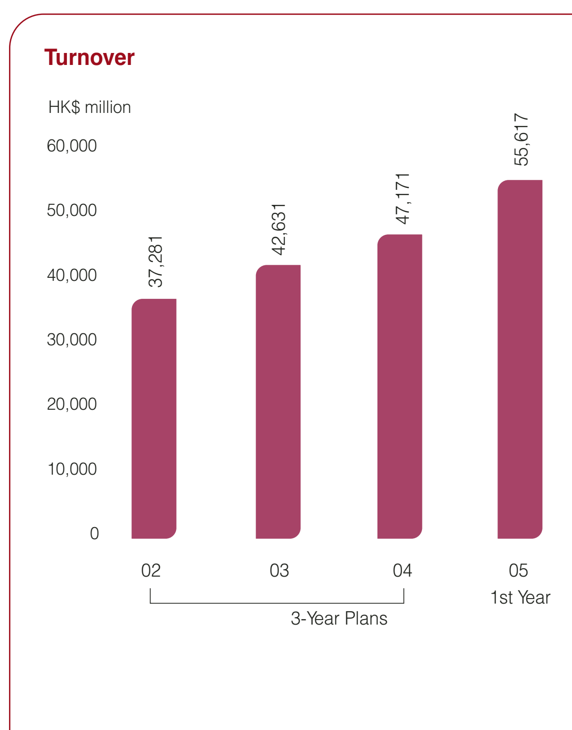
Segmental Analysis

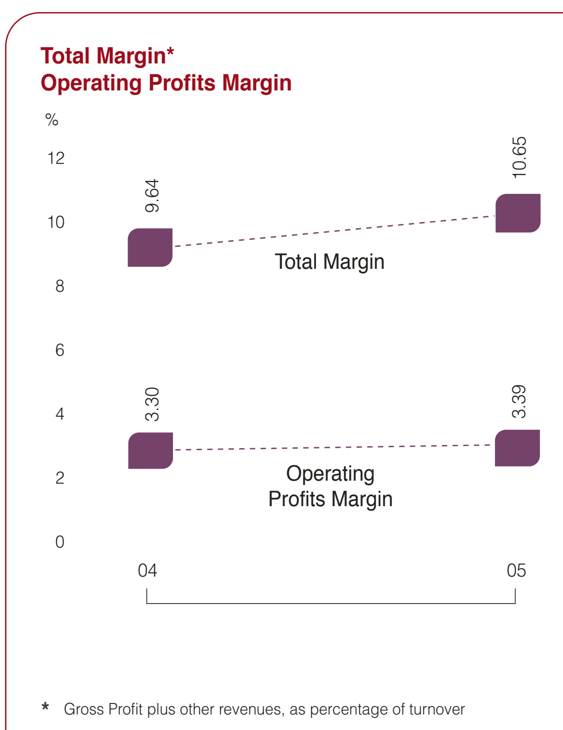
The softgoods business accounted for 68% of the Group's turnover. Turnover and core operating profit increased by 21% and 27% respectively. The strong increase was mainly driven by organic growth as well as from new customer additions. In particular, the Group's size and leadership position has enabled us to gain new customers by providing complete outsourcing solutions to retailers who previously had in-house buying offices. During 2005, the Group took on the buying functions for two major new accounts, Ecko and Mervyn's.

The removal of the textile quota system during the year created great changes in the sourcing markets, particularly with the subsequent textile safeguards placed on China by the US and the EU. The Group was well-prepared for these developments, and during this time our geographically diversified and flexible sourcing network proved invaluable to our customers. The Group will continue to strengthen our presence in markets that are expected to benefit from the new trade regime, particularly from South Asia and South East Asia.

In terms of the hardgoods business, turnover increased by 12% but core operating profit saw a drop of 3%. The slight drop in core operating profit from this area mainly reflects start-up losses incurred in developing the two home textile brands under the Group's brand strategy and is not likely to be incurred again in 2006.

Geographically, the US is the Group's major export market, accounting for 69% of the Group's turnover. The consumer market has demonstrated resilience to a rising interest rate and energy cost environment, and market sentiment has remained generally healthy. A return to focus on fashion and differentiated products, instead of lower prices, has created extra demand for quick-response sourcing, as well as value-added services such as product development. Turnover and core operating profit saw





* Gross Profit plus other revenues, as percentage of turnover

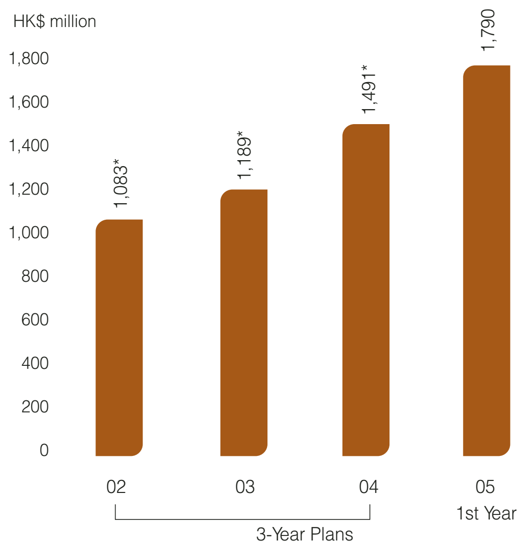
healthy increases of 20% and 16% despite some small start-up losses in the brand business.

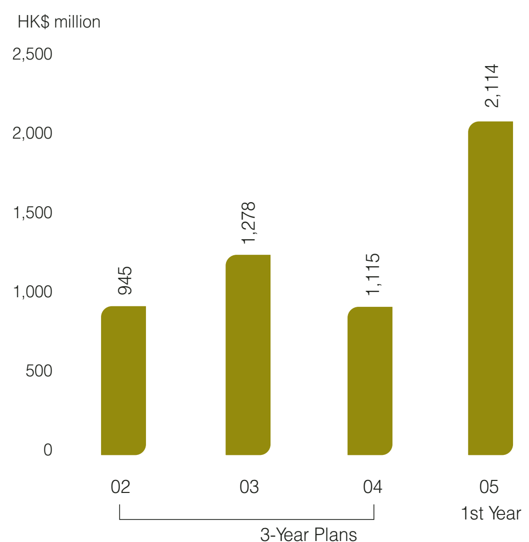
The Group's turnover and core operating profit in Europe grew by 11% and 13% respectively in 2005. Although the general market saw slow growth during this year, the Group saw good progress with the acquisitions it has made in the past two years and has since continued to build up these new capabilities. Europe accounted for 19% of total turnover during the year.

Canada accounted for 5% of the Group's turnover, up from 4% in 2004, with improved operating margins. Through increased penetration of more anchor customers in this market, the Group was able to generate higher sales and profitability.

Turnover and core operating profit in Central and Latin America surged by 52% and 76% respectively. First entering this market through a small acquisition in 2003, the business has generated strong momentum as well as great potential for further growth. Though not a very big market in terms of total size, there are a number of large retailers with large market share with which the Group has already developed relationships.

Business in Australasia accounted for 3% of the Group's turnover. Turnover and core operating profit grew by 10% and 46%. After a few years of strong growth, this business is now focusing on consolidating our position amongst customers there, which has led to an improvement in margins.

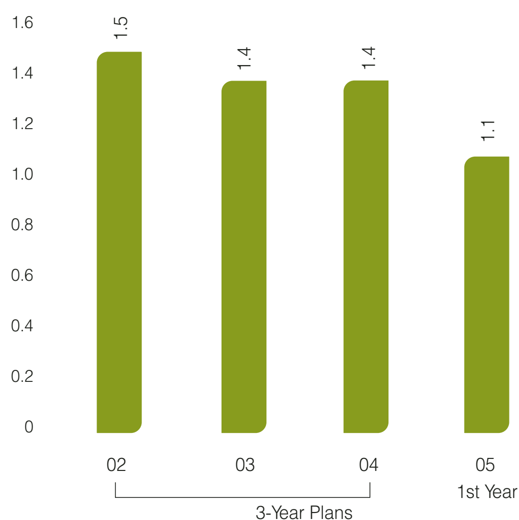




The rest of the world, mainly comprising business in Japan, saw a drop from 3% to 2% of total turnover. The Group has yet to find a successful strategy to build a meaningful presence in this market despite the good relationships already forged with leading players. Japan will continue to be viewed as an initiative for the longer term.

New Business Ventures

During 2005, the Group launched two more labels under the brand strategy, namely Levis RedTab tops and Royal Velvet. Despite some start-up teething problems during the initial phase, the brands enjoyed positive response from retailers and consumers. The acquisition of Briefly Stated Holdings, Inc. in the latter part of the year also greatly strengthened our capabilities and portfolio of brand licenses. Though the operations still incurred small losses for the year 2005, the Group feels that this business is now firmly on the growth track.



Acquisitions

One of the key strategies of the Group's Three-Year Plan 2005-2007 is to carry out a series of smaller acquisitions to augment capabilities in certain sectors. We believe by integrating these smaller companies into Li & Fung, we can tap into great synergies from their strong customer relationships as well as niche capabilities.

During 2005, the Group completed five acquisitions. The Group has acquired the remaining 55% of equity interest of Comet Feuerwerk GmbH. This is a fireworks company in Germany in which the Group already held 45%. The second acquisition was PromOcean The Netherlands BV, a corporate premium and promotional products supply company based in Europe. In August we announced the acquisition of Briefly Stated Holdings, Inc., an apparel company in the US with a portfolio of more than 40 character brand licenses.

The fourth acquisition conducted in 2005 was Young Stuff Apparel, Inc, an apparel company focused on supplying private label products to mass-market retailers such as Wal-Mart and Target.

Finally, the Group also acquired a hardgoods agency business sourcing primarily furniture based in Indonesia. This acquisition greatly improves the Group's sourcing in this market and also brings in a number of major new customers to the Group.

Financial Position and Liquidity

The Group continues to be in a strong financial position for the year under review with cash and cash equivalents amounting to HK$1,044 million at the end of 2005.

Normal trading operations are well supported by over HK$14,507 million in bank trading facilities, out of which only HK$1,554 million has been utilized at year end. In addition, the Group has available bank loans and overdraft facilities of HK$1,577 million, out of which only HK$204 million has been utilized.

The Group has no long-term borrowings; therefore the gearing ratio is not applicable. The current ratio was 1.1, based on current assets of HK$10,528 million and current liabilities of HK$9,862 million.

Impact of Changes in Accounting Standards

The Group adopted certain new or revised HKFRSs during the year. The impact of these HKFRSs are set out as below. Pursuant to Hong Kong Accounting Standard ("HKAS") 17 "Leases", up-front payments made for leasehold land with a carrying value of approximately HK$766 million as of 31 December 2005 (2004: HK$765 million) are re-classified as prepaid premium for land leases payments instead of fixed assets.

According to HKAS 21 "The Effects of Changes in Foreign Exchange Rates", goodwill arising from acquisitions of foreign operations is being treated as assets of the foreign operations and expressed in their respective currencies. As of balance sheet date, this goodwill has been translated at closing exchange rates, and a difference of HK$15 million so arising has been charged to the exchange reserve.

In accordance with HKAS 39 "Financial Instruments: Recognition and Measurement", investments previously stated at costs of approximately HK$110 million as at the beginning of 2005 have been reclassified as available-for-sale financial assets and stated in the balance sheet at 31 December 2005 at fair value of approximately HK$92 million, with the difference of HK$14 million charged to the reserves and HK$4 million charged to the consolidated profit and loss account in the current year.

In addition, the Group's discounted bills with recourse of approximately HK$1,554 million, which were previously not recognized but treated as contingent liabilities, have been recognized as bills receivable of the Group, and the corresponding proceeds received have been accounted for as collateralized bank advances.

Following the adoption of HKFRS 2 "Share-based Payments", the fair value of share options at grant date of HK$47 million (2004: HK$41 million) is charged to the consolidated profit and loss account in the current year.

Foreign Exchange Risk Management

Most of the Group's cash balances are deposited in HK$ or US$ with major banks in Hong Kong, and most of the Group's assets, liabilities, revenues and payments are either in HK$ or US$. Therefore, we consider our risk exposure to foreign exchange rate fluctuations is minimal.

Foreign exchange risks arising from sales and purchases transacted in different currencies are managed by the Group treasury with the use of foreign exchange forward contracts.

Capital Commitments and Contingent Liabilities

At the date of this announcement, the Group has a long-running dispute with the Hong Kong Inland Revenue Department related to the non-taxable claims of certain non Hong Kong sourced income and the deduction of certain marketing expenses of approximately HK$757 million for the years of assessment from 1992/1993 to 2004/2005. The disputes were initiated in 1999 and have been disclosed in our annual reports since that year. The Group has been working with its accounting and legal advisors in respect of its dealings with the Hong Kong Inland Revenue Department in relation to these matters. A hearing of the disputes was held before the Board of Review in January 2006 but as at the date of this announcement, the result is not yet known.

The structure of the Group's offshore sourcing and marketing activities was established at the time of the Group's re-listing on the Hong Kong Stock Exchange in 1992, at which time the Group had sought advice from its external professional advisors. The directors consider that sufficient tax provision has been made in the accounts in this regard and no additional material tax liabilities are expected to finally crystallize.

Other than the above, there are no material contingent liabilities or off-balance-sheet obligations.

Human Resources

At the end of 2005, the Group had a total workforce of 7,629, of whom 2,565 were based in our Hong Kong headquarters and 5,064 were located overseas throughout our sourcing network of over 70 offices in 40 countries and territories. The Group offers its staff competitive remuneration schemes. In addition, discretionary bonuses and share options are also granted to eligible staff based on individual and Group performance. The Group is committed to nurturing a learning culture in the organization. Heavy emphasis is placed on training and development, as the Group's success is dependent on the efforts of a skilled, motivated work force. Total staff costs for the current year amounted to HK$2,211 million, compared to HK$1,726 million in 2004.

Outlook and Progress on Three-Year Plan 2005-2007

The Group is pleased with its good start to the Plan, and we were able to see an accelerated growth rate compared to 2004 in the face of uncertainties brought by the economic environment as well as the dismantling of the textile quota system. We feel that this strong momentum is set to continue into 2006.

2006 is a special year for the Group as we celebrate the trading business' 100th year in history. It is increasingly apparent that the Group's size and leadership position are creating new business opportunities that did not exist before, as we now have the capability to offer complete outsourcing solution to even very larger customers. The trend towards retailers outsourcing their in-house buying functions will continue.

As the Group progresses towards its US$10 billion turnover target, management is also focusing on developing the organization to further capture the economies of scale resulting from our growth, and major process and organization reviews are underway. Whilst in the short term this will lead to increased infrastructure costs, management believes that these investments will lead to increased profitability in the longer term.

All in all, 2005 was an encouraging start to the Plan, and management remains committed to pursuing the Plan targets.