Management Discussion and Analysis

Results Review

2006 is the second year of the Group's Three-Year Plan 2005-2007. The Group is pleased to report strong growth in line with the plan. For the first half of 2006, profit attributable to shareholders reached HK$764 million, an increase of 24% over the same period in 2005.

The Group's turnover increased by 19% to HK$28 billion. This increase is above the targeted annual growth rate outlined in the Three-Year Plan. The strength and resilience of our flexible business model enabled the Group to continue to flourish despite uncertain market conditions. During the period under review, consumer markets were faced with rising interest and energy costs. There were also significant changes in the global trade regulatory environment for textile products in general, with the implications for China having particular significance for the Group's business. Also of concern was the impact of the recently announced movement of the renminbi to the US dollar. These changes proved positive to the Group's business as our wide network enabled our customers to retain global sourcing flexibility in this environment.

The Total Margin rate increased from 10% to 10.6% of turnover during the first half of 2006, a consequence of the Group's strategy to create more added-value for our customers along the supply chain, as well as the development of our onshore US business.

The Group's buying power fueled by its extensive sourcing network led to lower prices to our customers. Both gross and net margins continued to get stronger, in spite of a generally deflationary environment.

Core operating profits increased 35% due to strong organic growth augmented by successful acquisitions. The Group is also continuing to invest in additional staff and systems to strengthen our back office infrastructure to cater for this expected growth in the current Three-Year Plan.

Segmental Analysis

The softgoods business accounted for 69% of turnover in the first half of 2006, with turnover and operating profit increasing by 17% and 38% respectively. The proliferation of bilateral agreements with the United States and Europe continues and the Group is in a good position to capitalize on this trend given our wide sourcing coverage in over 40 countries. Growth in the softgoods business was also boosted by contributions from acquisitions made in 2005.

Turnover from the hardgoods business grew by 26% for the first half of 2006 and accounted for 31% of the Group's turnover. Operating profit increased by 20% over last year. The lower rate of growth of operating profit compared to turnover can be primarily attributed to the seasonal skew of hardgoods towards the second half of the year, making the first half comparison for this segment less important as a measure of profitability for the full year.

Geographically, the United States continued to be the Group's major export market, accounting for 71% of turnover for the first half of 2006. Other important markets were Europe, Canada and Australasia, accounting for 18%, 5% and 3% of turnover respectively. These proportions were relatively unchanged from the same period last year, indicating steady business growth in all its key markets.

Finally, the rest of the world remained at a turnover share of 2%. The Group continues to focus on developing Japan where we have good relationships with several large retailers which could help to grow our business there in due course.

Due to International Sources, a very successful acquisition in 2004, our business in Mexico, Central and Latin America doubled from a small base on the back of this business.

New Business Ventures

The Group continues to look for strategic acquisitions and to seek outsourcing deals with major retails and brands globally.

Acquisitions

A key component of the Group's current Three-Year Plan is our two-pronged approach to acquisitions. Apart from seeking larger acquisitions, which can materially accelerate business growth, the Group has put in place efforts to systematically seek and acquire small-to-medium sized companies as a means to strategically strengthen very specific areas of the Group's business. In a market with a very large proportion of smaller players, this will enable us to make acquisitions a regular part of our growth. This strategy is mainly funded internally by our net cash balance, as well as our strong cash flow from operations. In the arena of large acquisitions, the Group is open to raising funds externally from banking, bond and equity markets to capture large valuable acquisition opportunities and to optimize the Group's capital structure.

In the first half of the year, the Group acquired Oxford Womenswear Group, a design intensive producer of budget and moderately priced, private-label women's apparel collections. This acquisition is in the private label area and is in line with the Group's strategy of accelerating growth through opportunities that complement the Group's core sourcing business including development and marketing in the United States.

The Group completed the formal acquisition procedures for Rosetti Handbag and Accessories Ltd. on 31 July 2006. The total cash consideration for the purchase was approximately US$162 million and was financed by Li & Fung's internal cash reserves and bank borrowings. The Rosetti handbag 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 United States retailers including department stores, mass-merchants and specialty stores.

Finally, the Group completed the integration of five acquisitions made in 2005. PromOcean, a corporate premium and promotional productions supply company based in Europe; Comet Feuerwerk GmbH, a fireworks company in Germany; Briefly Stated, an apparel company in the United States; Young Stuff, a US-based fashion items wholesaler; and Tropicanusa, a furniture sourcing agent based in Indonesia, all enjoyed a smooth and successful integration.

Financial Position and Liquidity

The Group's strong financial position continued during the period under review with cash and cash equivalents amounting to HK$593 million as at 30 June 2006.

Normal trading operations are well supported by over HK$14,653 million in bank trading facilities, out of which only HK$1,452 million had been utilized at end of June 2006. In addition, the Group has available bank loans and overdraft facilities of HK$1,804 million, out of which only HK$692 million was utilized.

The Group has no long-term borrowings; therefore the gearing ratio is not applicable. The current ratio was 1, based on current assets of HK$10,383 million and current liabilities of HK$10,324 million.

Impact of Changes in Accounting Standards

The Group adopted certain new or revised HKAS/HKFRS during the period. However, the adoption did not result in any substantial changes to the Group's balance sheet and profit and loss account.

Foreign Exchange Risk Management

The bulk of the Group's cash balances is 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, 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 non-taxable claims of certain non Hong Kong sourced income and 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 and the results are yet to be announced.

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

As of the end of June 2006, the Group had a total workforce of 8,334, of whom 2,692 were based in our Hong Kong headquarters and 5,642 were located overseas. 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. Emphasis is placed on training and development, as the Group's success is dependent on the efforts of a skilled and motivated work force. Training and development initiatives undertaken by the Group include the Management Trainee Programme and the Merchandising Development Programme. The Management Trainee Programme, first launched in 2003, is a global corporate management programme, with the aim to attract and develop high potential university graduates to become our future leaders through accelerated career development opportunities. 2006 is the fourth year since its launch, and so far, 60 trainees have been recruited around the world. The Merchandising Development Programme, first launched in February this year, is a corporate resourcing programme, with the aim to build up a merchandising frontline resource pool through structured training. A customized Diploma programme for the trainees has been developed in collaboration with the Hong Kong Polytechnic University, to obtain industry recognition of the development programme and to establish industry standards for merchandising skill sets.

The Group invested in sophisticated human resource software during the period under review. Total staff costs for the first half of 2006 were HK$1,217 million, compared with HK$1,019 million for the same period last year.

Prospects and Progress on Three-Year Plan 2005-2007

During the period under review, the Group has achieved strong growth in line with the current Three-Year Plan and anticipates similar momentum for the remainder of 2006.

Our core sourcing business should continue to do well, especially in the context of continuing complexity in the trade arena. In particular, many retailers who had traditionally relied on their in-house buying organizations are rethinking their strategy at this juncture, and the Group's knowledge, expertise and network render it well positioned to capitalize on this trend to gain new customers. Growth will also be aided by our two-pronged acquisition strategy, as well as the development of the licensed brand business. The creation of a Middle Office aims to further increase the efficiency and leveraging in the area of shipping, compliance, and quality assurance. The Group's strategic investment in new information technology, human resource and financial systems will continue to support the growth of our business. Management remains confident in achieving the Plan Target of reaching a turnover of US$10 billion by 2007, of which US$1 billion will be from the United States onshore business.