Management Discussion & Analysis

William Fung,
Managing Director

Overview

2006 was a solid year of growth for Li & Fung. The Group has continued to grow organically and gain market share in the markets in which it operates. We made a strategic move to acquire the sourcing arm of one of Germany's largest retailers, KarstadtQuelle, in addition to several other acquisitions during the year that have either served to broaden our overall sourcing capabilities or have further diversified our geographic customer base.

This is the second year of the Group's current Three-Year Plan 2005-2007. The Group has made good progress in line with the Plan's target to achieve a turnover of US$10 billion by 2007. It has also invested heavily in corporate infrastructure during the year to support the anticipated business growth.

The Group's turnover was HK$68,010 million, 22% higher than 2005. Profit attributable to shareholders increased by 23% to HK$2,202 million. Earnings per share were 67.1 HK cents, compared to 55.6 HK cents in 2005 (adjusted for the effect of a 1-for-10 Bonus Issue in May 2006).

We are pleased to report that the Board of Directors has proposed a final dividend of 39.0 HK cents per share. Together with an interim dividend of 16.0 HK cents, total dividend per share for the year 2006 was 55.0 HK cents (2005: 45.5 HK cents, adjusted for effect of the Bonus Issue).

Results Review

Bruce Rockowitz,
President

The strong increase in turnover reflects the Group's success in growing organically and through new acquisitions. In 2006, the Group benefited from a resilient consumer market in the US resulting from stabilized interest rates and lower oil prices. The Group has continued to expand its position amongst existing customers and developed new businesses. The strong results also demonstrated the Group has a very scalable business with an increasing number of retailers worldwide recognizing the strategic value of partnering with Li & Fung in its supply chain.

The Group's total margin increased by 29% and as a percentage of sales, saw an improvement from 10.65% in 2005 to 11.24% in 2006. This is the result of the increasing proportion of higher-margin businesses, particularly in the hardgoods area and the US onshore business. The Group's core operating profit rose by 26% to HK$2,344 million during 2006. The increase in profit was attributed to a continued gain in market share across various markets in which the Group operates. Despite the Group's investment spending in corporate infrastructure, the core operating profit margin improved to 3.45% in 2006 from 3.35% in 2005.

It has always been a Group policy to pursue an asset-light strategy which includes, if possible, not owning factories or properties. However, in years past, because of the growth of the Group, the resultant need for constant expansion and change of office layout and re-decoration, it was necessary for us to control the offices we operate from in some of our major sourcing hubs, especially in Hong Kong. We have also acquired property along with some of our business acquisitions.

Whenever possible, the intention of management is to dispose of the Group's property if suitable "Sale and Lease Back" arrangements can be negotiated with a suitable landlord at favourable rental rates and tenure of occupancy at arm's length and supported by proper independent valuations.

Pursuant to a Connected Transaction announcement on 22 December 2006, the Group disposed of some Hong Kong property holding subsidiaries to LF Investment Properties Limited and recognized a non recurrent profit of HK$69 million.

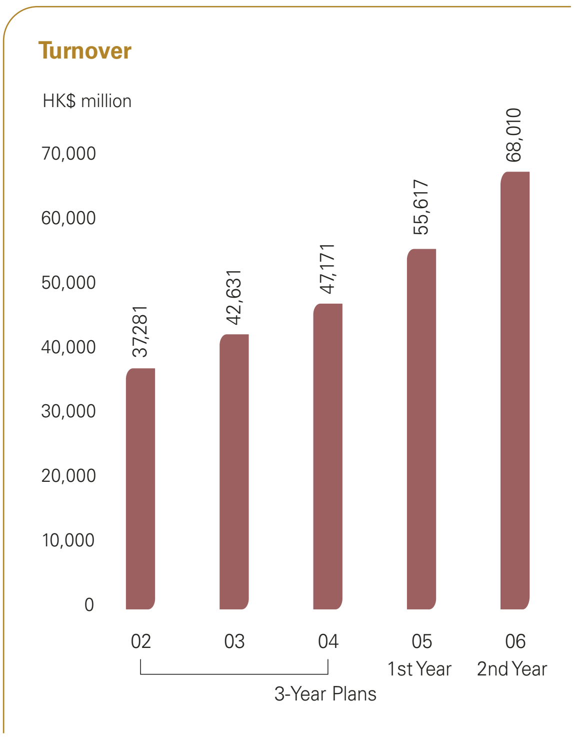
Segmental Analysis

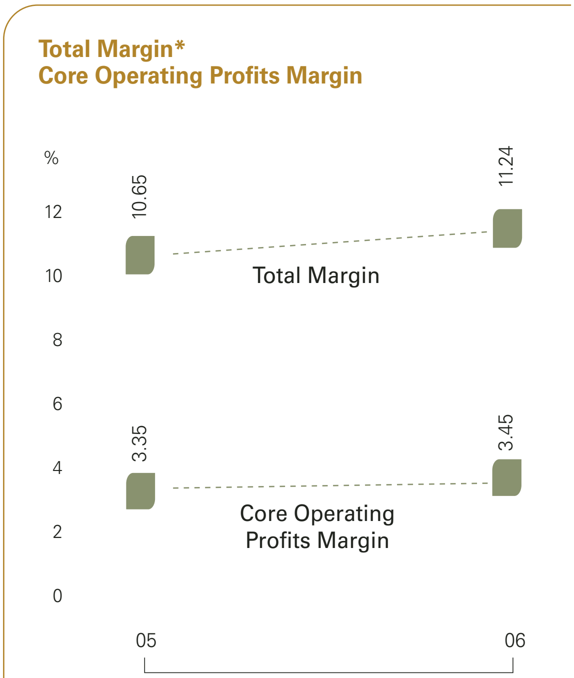
Soft and hardgoods accounted for 68% and 32% of turnover respectively in 2006. **Softgoods** turnover and operating profit increased by 21% and 22% respectively. The increase reflected expansion among the Group's existing and new customers, demand for more value-added services along the supply chain, particularly in design and product development services division of the core sourcing business as well as our increasing involvement in replenishment orders. We are also benefiting from the growth and success of some of our key customers who have consolidated their buying and are outsourcing more to the Group.

Hardgoods enjoyed a year of strong growth. Turnover and operating profit increased by 24% and 43% respectively in 2006. The significant improvement in hardgoods resulted from strong organic growth in the home product area including the home textile and furniture businesses, as well as synergies realized through recent acquisitions of, for example, the Indonesian furniture business Tropicanusa. In addition, the business also benefited from cost synergies resulting from economies of scale.

From a geographical perspective, the **US** market remains a key export market, representing 72% of the Group's turnover. In 2006 the Group operated in a resilient consumer market in the US and achieved turnover and operating profit growth of 28% and 35% respectively. The solid increase in turnover and operating profit was driven by better business growth within the existing customer base in the US including the expansion of business lines as well as business growth through new customers.

In addition, the steady progress of the US onshore business strategy followed a restructuring of the branded and wholesale business into one business unit that resulted in a more cohesive management and gave the Group operating leverage. During 2006, the Group acquired Oxford Womenswear Group, the Rosetti handbag business, and Homestead, which complemented and enhanced the existing range of brands and products in the US onshore business. Smooth integration of these newly acquired companies began during the year and has resulted in significant business synergies.





* Gross Profit plus other revenues, as percentage of turnover

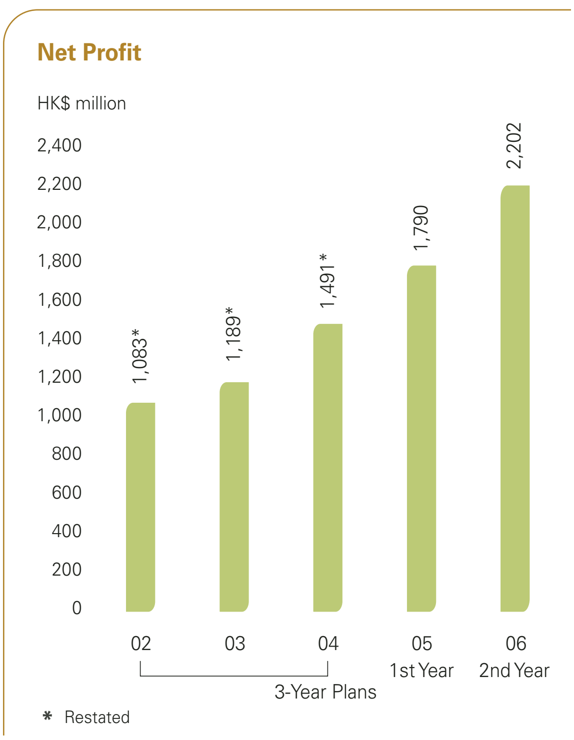
Europe accounted for 18% of the Group's turnover in 2006, with turnover and operating profit growing by 15% and 8% respectively. Growth was primarily in the hardgoods business with significant contribution from previous acquisitions such as PromOcean. We expect that the acquisition of the sourcing arm of German department store and mail order business KarstadtQuelle to significantly bolster Europe's share of the Group's total business in 2007.

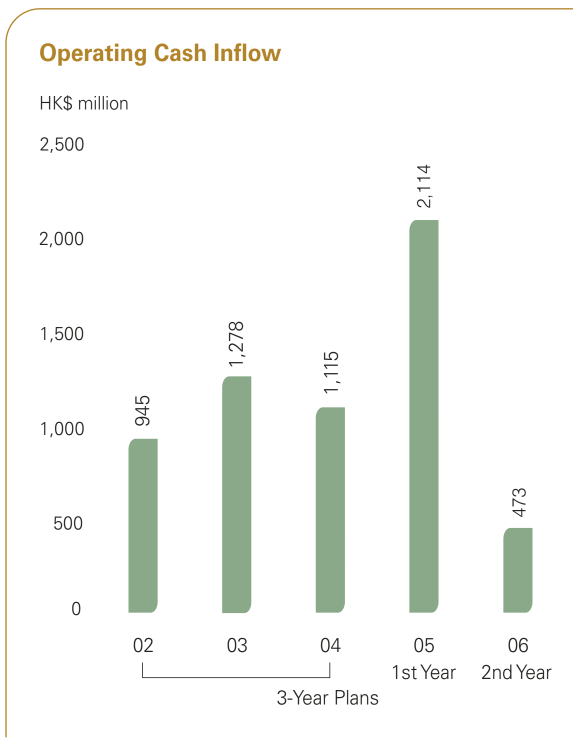
Turnover in **Canada** accounted for 4% of the Group's turnover. Turnover and operating profit experienced growth of 10% and 33% in 2006. The Group was encouraged to see solid business penetration of some existing key accounts in Canada and will continue to further enhance these relationships.

The Group's turnover and operating profit in **Central and Latin America** grew by 10% and 4.8% respectively. This business represented about 2% of the Group's total turnover. While this business was relatively small, the Group was very pleased to see significant growth in its business in Mexico, and momentum is expected to continue.

Business in **Australasia** accounted for 2% of the Group's turnover. Both turnover and operating profit declined by 13%. We expect our business to improve after the finalization of the outsourcing deal with large department retailer Myer in 2007.

The remaining 2% of Group turnover is primarily generated in **Japan**. Although small, the Group is committed to continuing to explore ways to develop a meaningful presence in the Japanese market.





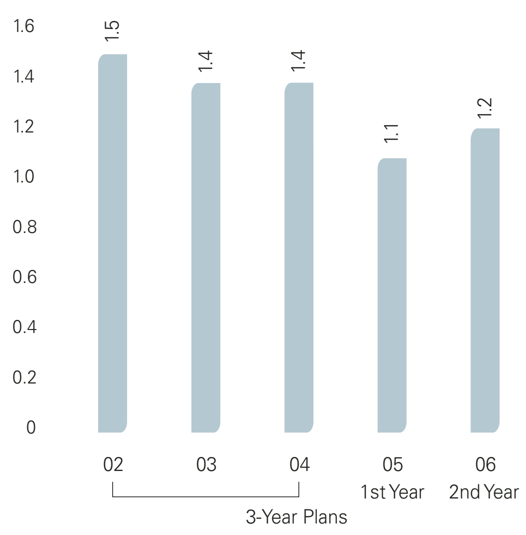
New Business Ventures

The acquisition of Homestead significantly enhances our product design, merchandising and marketing capabilities in the home textile area. As a leading innovator in the market, Homestead's micro branding strategy has resonated across distribution channels and it has placed brands in many of the leading home textile retailers in the U.S. and Canada. These micro brands form the foundation for a new approach to private labeling and augment the positioning of Royal Velvet and Cannon as the leading national consumer brands in the market.

Acquisitions

While the Group remains committed to growing its business organically, Li & Fung has also continued to pursue its two-pronged acquisition strategy which has yielded fruitful results. On one hand, the Group acquired smaller companies like Homestead in the US to further enhance the existing product range within the home textiles businesses. On the other, the Group continued to pursue larger acquisitions including Oxford Womenswear Group and the Rosetti handbag business to further augment the onshore business in the US. In the last quarter of 2006, the Group completed its acquisition of the sourcing arm of KarstadtQuelle in Germany. This acquisition will help to rebalance the Group's geographical mix of business and provide us with further access to production capabilities in the Eastern bloc and Italy. We expect that the European share of our Group's turnover will increase considerably in 2007.

Current Ratio



In early 2007, the Group acquired the global sourcing operations of Tommy Hilfiger. The Group is excited to embark on this partnership with Tommy Hilfiger as it sees excellent global growth potential for the brand. The acquisition will bring to the Group substantial additional sourcing volume and reinforce diversification into branded apparel in the Group's sourcing portfolio.

All in all, we see acquisitions as complementary to the Group's organic business growth as they broaden our sourcing power on a global scale, provide the means to expand the customer base and further enhance our geographical diversification.

Integration of these newly acquired companies is well underway and they have already started to contribute to our bottom line.

The Group has funded these acquisitions through a combination of internal cash flow and funds raised through a share placement last year. The Group raised HK$2,723 million through a share placement in September 2006.

Outlook and Progress on Three-Year Plan 2005-2007

We are very pleased to report that the Group is well on track to meet its US$10 billion turnover target by the end of 2007. The Group made a good start to realizing the Plan's objectives in 2005, and 2006 proved to be another solid year. We expect the good momentum to continue in 2007 with strong orders placed to date.

Our consistently strong growth and the scale of our operations have provided us with the capability to provide such large businesses such as KarstadtQuelle and Tommy Hilfiger with outsourcing solutions. We expect this outsourcing business growth to continue and together with our organic business growth will continue to further strengthen our leadership position in the market.

In 2006 the Group also reinvested in its infrastructure, including investment in information technology, human resources and financial systems. The review of our major processes led to the creation of a middle office by centralizing various business streams' shipping and vendor compliance operations in order to create economies of scale and to enhance further cost savings.

The growth of the sourcing network of the Group to over 70 offices in more than 40 economies necessitates the creation of a hub corporate office structure to better manage and operate this large network. We expect the hub structure will help to further facilitate coordination amongst offices within various regions. The Group expects that such investments will provide sufficient support for our longer term growth.

Financial Position and Liquidity

The Group continued to be in a strong financial position for the year under review with cash and cash equivalents amounting to HK$3,302 million at the end of 2006.

Normal trading operations were well supported by more than HK$14,611 million in bank trading facilities. In addition, the Group had available bank loans and overdraft facilities of HK$4,287 million, out of which only HK$2,869 million was utilized.

The Group had no long-term borrowings; therefore the gearing ratio is not applicable. The current ratio was 1.2, based on current assets of HK$15,335 million and current liabilities of HK$12,937 million.

Impact of Changes in Accounting Standards

Hong Kong Accounting Standard 19 (Amendment) Employee Benefits, introduced the option of an alternative recognition approach for actuarial gains and losses. It imposed additional recognition requirements for multi-employer plans where insufficient information was available to apply defined benefit accounting. It also added new disclosure requirements. As the Group does not intend to change the accounting policy adopted for recognition of actuarial gains and losses and does not participate in any multi-employer plans, adoption of this amendment only impacted the format and extent of disclosures presented in the accounts.

Foreign Exchange Risk Management

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

Foreign exchange risks arising from sales and purchases transacted in different currencies is 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$1,015 million for the years of assessment from 1992/1993 to 2005/2006. 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, when the Group 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 eventuate.

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

Human Resources

At the end of 2006, the Group had a total workforce of 9,705, of whom 2,961 were based in our Hong Kong headquarters and 6,744 were located overseas throughout our sourcing network of over 70 offices in over 40 economies. 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 workforce. Total staff costs for the current year amounted to HK$2,964 million, compared to HK$2,258 million in 2005.