

Li & Fung

2016 three-year targets now "unrealistic"

2014 adjusted recurring earnings declined 21% YoY

Overall 2014 sales increased 1.4% YoY and adjusted recurring earnings (excluding accounting gains, non-cash expenses and one-off reorganization costs for GBG spin-off) were US\$429m, a decline of 21% YoY. A shift in mix between principal and agency has led to a 20bps total margin (trading) contraction to 10.9%, according to management. Core operating profit (COP) for trading dropped 20% YoY to US\$558m (US\$701m in 2013) while COP for logistic increased to US\$46m in 2014 (US\$36m in 2013).

Highly promotional retail environment a new normal

Management noted a highly promotional retail environment which affected operations in 2014 will become the new normal. While orders from core clients remain solid, management warned that uncertainty in currency could impact orders from European operators. We believe a deflationary environment and structural weakness of the agency model could put pressure on sales from trading operations in 2015E and 2016E.

Anticipate a cut to consensus estimate

Management recognized that the 2016 3-year target now seems "unrealistic", though no revision was made. We recall the 2016 target for trading operation was COP larger than the entire group in 2013 (US\$871m). With consensus estimates for 2016 EBIT currently at US\$865m, we anticipate consensus to gravitate towards our 2016 EBIT estimate of US\$650m.

Valuation: Maintain Sell rating

We maintain our Sell rating on L&F and our DCF-based price target of HK\$5.20 (WACC assumption 6.1%). We feel incrementally positive that the new management team is more willing to pursue strategies that could potentially lead to sustained profitability, without overly focused on short-term targets.

Equities

Hong Kong
Industrial Services

12-month rating **Sell ***

12m price target **HK\$5.20**

Price **HK\$8.03**

RIC: 0494.HK BBG: 494 HK

Trading data and key metrics

52-wk range	HK\$12.48-7.13
Market cap.	HK\$67.1bn/US\$8.65bn
Shares o/s	8,360m (ORD)
Free float	62%
Avg. daily volume ('000)	26,171
Avg. daily value (m)	HK\$198.1
Common s/h equity (12/15E)	US\$2.92bn
P/BV (12/15E)	3.0x
Net debt / EBITDA (12/15E)	1.8x

EPS (UBS, diluted) (US\$)

	From	To	% ch	Cons.
12/15E	0.05	0.06	7.64	0.07
12/16E	0.05	0.06	8.23	0.08
12/17E	0.05	0.06	8.48	-

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Highlights (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	20,222	20,745	19,288	20,209	20,009	20,272	20,553	21,299
EBIT (UBS)	435	861	603	653	650	648	668	699
Net earnings (UBS)	262	611	449	485	480	480	498	525
EPS (UBS, diluted) (US\$)	0.03	0.07	0.05	0.06	0.06	0.06	0.06	0.06
DPS (US\$)	0.04	0.06	0.05	0.05	0.05	0.05	0.05	0.05
Net (debt) / cash	(2,596)	(2,601)	(1,479)	(1,478)	(1,468)	(1,430)	(1,386)	(1,339)
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
EBIT margin %	2.2	4.2	3.1	3.2	3.2	3.2	3.3	3.3
ROIC (EBIT) %	6.1	11.3	9.9	15.0	14.7	14.5	14.9	15.5
EV/EBITDA (core) x	25.2	12.1	16.7	12.5	12.3	12.1	11.7	11.2
P/E (UBS, diluted) x	60.3	19.3	24.5	18.0	18.2	18.2	17.6	16.6
Equity FCF (UBS) yield %	2.7	6.9	11.6	8.3	7.5	7.8	8.1	2.9
Net dividend yield %	2.1	4.5	4.0	4.7	4.7	4.7	4.9	5.2

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of HK\$8.03 on 19 Mar 2015 22:27 HKT

www.ubs.com/investmentresearch

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Investment Thesis

Li & Fung

Investment case

L&F's sales rose 1.4% YoY in 2014, with adjusted recurring earnings declining 21% YoY. With the recently-proposed Global Brands Group (GBG) spin-off in place, we believe the rest of L&F will refocus on the low-margin and less volatile traditional sourcing business. Based on the company's track record for meeting its three-year targets, L&F has set a three-year target that we believe is aggressive: 1) core operating profit of the standalone trading business (post spin-off) would be larger than the entire group's was in 2013; 2) GBG's core operating profit would double; and 3) the core operating profit of logistics would double.

Upside scenario

In our upside scenario, we assume: 1) double-digit growth from its top 30 customers (10% YoY top-line growth for 2015E); and 2) its operating margin for trading—its major business segment—remains stable at 3.3% in 2015 and onwards. All else being equal, we estimate an upside valuation of HK\$7.00 per share.

Downside scenario

In our downside scenario, we assume L&F's operations will continue to deteriorate and our downside valuation could decline to HK\$4.60 per share (roughly based on 20% of its peak valuation of HK\$25.93 per share before the spin-off). Our 2015E/16E earnings estimates would be 26%/36% below consensus, though faster-than-expected deterioration in the operations could lead to materially lower earnings and dividend.

Upcoming catalysts

US retailer's quarterly updates could be catalysts for the stock.

12-month rating

Sell *

12m price target

HK\$5.20

Business description

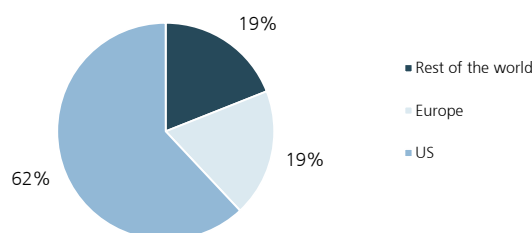
Li & Fung (L&F) sources soft and hard consumer goods for global retailers from suppliers in developing economies. In 2010, L&F acquired Integrated Distribution Services Group (IDS) for approximately HK\$8.0bn to increase its exposure to Asia. On 21 May 2014, L&F released the listing document for the proposed spin-off of the Global Brands Group (the brand business). After the spin-off, L&F will focus on two business segments: trading and logistics. The US is L&F's key export market, representing 62% of total turnover in 2013 and 63% in 2012.

Industry outlook

We believe investors should focus on the sustainability of L&F's middleman model in an increasingly transparent and connected world. Some retailers, buyers and suppliers have recently said that L&F's biggest advantage in the past—its virtual manufacturing strategy with no capacity commitments made to factories—has turned into its biggest weakness. We do not expect L&F to deliver on its 2016 target.

2014 revenues by region (%)

Source: Company data



EBIT by product segment

(US\$ m)	2013 (Restated)	2014 (excl. GBG)	2015E	2016E	2017E
Trading	701	558	627	607	601
Logistics	36	46	56	73	77
Total	737	604	683	680	678

Source: Company data, UBSe

* Exception to core rating bands; See page 7.

Figure 1: Operation metrics of trading network

(US\$ m)	2013	2014	YoY
Turnover	18,514	18,431	-0.5%
Total margin	2,100	2,004	-4.6%
% of turnover	11.3%	10.9%	
Operating cost	1,398	1,446	3.4%
Core operating profit	701	558	-20.4%
% of turnover	3.8%	3.0%	

Source: Company data

Figure 2: Operation metrics of logistic network

(US\$ m)	2013	2014	YoY
Turnover	526	874	66.2%
Total margin	194	240	23.7%
% of turnover	36.9%	27.5%	
Operating cost	159	194	22.0%
Core operating profit	36	46	28.1%
% of turnover	6.8%	5.2%	

Source: Company data

Figure 3: UBS estimates vs consensus

Revenue (US\$ m)	2015E	2016E	2017E
UBS	20,209	20,009	20,272
Consensus	20,545	21,772	
%	-2%	-8%	

EBIT (US\$ m)			
UBS	653	650	648
Consensus	769	865	
%	-15%	-25%	

Net profit (US\$ m)			
UBS	455	450	450
Consensus	574	637	
%	-21%	-29%	

Source: Bloomberg, UBS estimates

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	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Income statement (US\$m)										
Revenues	20,222	20,745	19,288	20,209	4.8	20,009	-1.0	20,272	20,553	21,299
Gross profit	2,868	3,214	2,182	2,129	-2.4	2,111	-0.9	2,129	2,170	2,258
EBITDA (UBS)	721	1,180	777	809	4.1	821	1.5	833	859	895
Depreciation & amortisation	(285)	(319)	(175)	(156)	-10.5	(172)	9.9	(184)	(191)	(196)
EBIT (UBS)	435	861	603	653	8.4	650	-0.6	648	668	699
Associates & investment income	1	1	1	5	264.2	5	0.0	5	5	5
Other non-operating income	0	0	0	0	-	0	-	0	0	0
Net interest	(115)	(123)	(98)	(87)	11.8	(89)	-2.8	(88)	(87)	(85)
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	321	739	506	572	13.0	566	-1.1	565	586	619
Tax	(54)	(98)	(59)	(86)	-45.2	(85)	1.1	(85)	(88)	(93)
Profit after tax	267	641	447	486	8.7	481	-1.1	480	498	526
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	(5)	(30)	2	(1)	-	(1)	0.0	(1)	(1)	(1)
Extraordinary items	355	187	176	0	-	0	-	0	0	0
Net earnings (local GAAP)	617	798	625	485	-22.3	480	-1.1	480	498	525
Net earnings (UBS)	262	611	449	485	8.2	480	-1.1	480	498	525
Tax rate (%)	16.8	13.3	11.7	15.0	28.6	15.0	0.0	15.0	15.0	15.0
Per share (US\$)										
EPS (UBS, diluted)	0.03	0.07	0.05	0.06	7.6	0.06	-1.1	0.06	0.06	0.06
EPS (local GAAP, diluted)	0.07	0.10	0.07	0.06	-22.7	0.06	-1.1	0.06	0.06	0.06
EPS (UBS, basic)	0.03	0.07	0.05	0.06	8.2	0.06	-1.1	0.06	0.06	0.06
Net DPS (US\$)	0.04	0.06	0.05	0.05	-6.9	0.05	-1.1	0.05	0.05	0.05
Cash EPS (UBS, diluted)*	0.07	0.11	0.07	0.08	2.4	0.08	1.6	0.08	0.08	0.09
Book value per share	0.60	0.63	0.34	0.35	2.5	0.36	2.4	0.37	0.37	0.38
Average shares (diluted)	8,285.80	8,356.27	8,399.46	8,442.60	0.5	8,442.60	0.0	8,442.60	8,442.60	8,442.60
Balance sheet (US\$m)										
Cash and equivalents	680	460	539	456	-15.3	481	5.5	535	593	655
Other current assets	3,700	3,838	3,286	3,028	-7.9	3,003	-0.8	3,036	3,070	3,163
Total current assets	4,380	4,298	3,825	3,484	-8.9	3,484	0.0	3,571	3,663	3,818
Net tangible fixed assets	419	440	245	327	33.3	393	20.3	427	455	477
Net intangible fixed assets	7,058	7,609	4,349	4,432	1.9	4,421	-0.2	4,412	4,404	4,397
Investments / other assets	158	120	58	63	8.6	68	7.9	73	78	83
Total assets	12,015	12,465	8,477	8,306	-2.0	8,367	0.7	8,483	8,600	8,775
Trade payables & other ST liabilities	3,756	3,988	3,539	3,382	-4.4	3,358	-0.7	3,390	3,422	3,508
Short term debt	118	94	163	80	-50.88	80	0.00	80	80	80
Total current liabilities	3,874	4,082	3,702	3,462	-6.5	3,438	-0.7	3,470	3,502	3,588
Long term debt	3,159	2,967	1,855	1,854	0.0	1,869	0.8	1,884	1,899	1,914
Other long term liabilities	89	118	62	62	0.0	62	0.0	62	62	62
Preferred shares	0	0	0	0	-	0	-	0	0	0
Total liabilities (incl pref shares)	7,122	7,167	5,618	5,378	-4.3	5,369	-0.2	5,416	5,463	5,565
Common s/h equity	4,882	5,288	2,850	2,920	2.4	2,989	2.4	3,058	3,129	3,202
Minority interests	11	10	9	9	0.0	9	0.0	9	9	9
Total liabilities & equity	12,015	12,465	8,477	8,306	-2.0	8,367	0.7	8,483	8,600	8,775
Cash flow (US\$m)										
Net income (before pref divs)	617	798	625	485	-22.3	480	-1.1	480	498	525
Depreciation & amortisation	285	319	175	156	-10.5	172	9.9	184	191	196
Net change in working capital	(60)	(101)	395	86	-78.2	1	-98.8	(1)	(3)	0
Other operating	(257)	(74)	188	121	-35.9	123	2.0	122	121	(358)
Operating cash flow	586	943	1,382	848	-38.6	776	-8.5	786	806	363
Tangible capital expenditure	(172)	(115)	(119)	(128)	-8.1	(128)	0.0	(109)	(109)	(109)
Intangible capital expenditure	0	(30)	0	0	-	0	-	0	0	0
Net (acquisitions) / disposals	(651)	(587)	(240)	(192)	20.1	(97)	49.2	(99)	(100)	(102)
Other investing	60	46	6	15	-	12	-	13	15	17
Investing cash flow	(763)	(685)	(353)	(305)	13.5	(213)	30.1	(195)	(195)	(194)
Equity dividends paid	(525)	(364)	(440)	(410)	6.9	(405)	1.1	(405)	(421)	(446)
Share issues / (buybacks)	568	2	0	0	-	0	-	0	0	0
Other financing	0	0	0	0	-	0	-	0	0	0
Change in debt & pref shares	385	(119)	(484)	(216)	55.49	(133)	38.43	(133)	(133)	(133)
Financing cash flow	428	(481)	(925)	(625)	32.4	(538)	14.0	(537)	(554)	(578)
Cash flow inc/(dec) in cash	251	(223)	105	(82)	-	25	-	53	58	(410)
FX / non cash items	3	3	(26)	0	-	0	-	0	0	472
Balance sheet inc/(dec) in cash	254	(221)	79	(82)	-	25	-	53	58	62

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.*Cash EPS (UBS, diluted) is calculated using UBS net income adding back depreciation and amortization.

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Valuation (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
P/E (local GAAP, diluted)	25.6	14.7	17.6	18.0	18.2	18.2	17.6	16.6
P/E (UBS, diluted)	60.3	19.3	24.5	18.0	18.2	18.2	17.6	16.6
P/CEPS	28.8	12.7	17.5	13.5	13.3	13.0	12.6	12.0
Equity FCF (UBS) yield %	2.7	6.9	11.6	8.3	7.5	7.8	8.1	2.9
Net dividend yield (%)	2.1	4.5	4.0	4.7	4.7	4.7	4.9	5.2
P/BV x	3.2	2.2	3.8	3.0	2.9	2.8	2.8	2.7
EV/revenues (core)	0.9	0.7	0.7	0.5	0.5	0.5	0.5	0.5
EV/EBITDA (core)	25.2	12.1	16.7	12.5	12.3	12.1	11.7	11.2
EV/EBIT (core)	NM	16.5	21.6	15.5	15.6	15.6	15.1	14.4
EV/OpFCF (core)	NM	16.5	21.6	15.5	15.6	15.6	15.1	14.4
EV/op. invested capital	2.6	1.9	2.1	2.3	2.3	2.3	2.2	2.2
Enterprise value (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap.	15,436	11,595	10,918	8,653	8,653	8,653	8,653	8,653
Net debt (cash)	2,767	2,599	2,040	1,479	1,473	1,449	1,408	1,408
Buy out of minorities	8	10	9	9	9	9	9	9
Pension provisions/other	62	83	67	40	40	40	40	40
Total enterprise value	18,272	14,287	13,034	10,180	10,174	10,150	10,109	10,109
Non core assets	(88)	(41)	(23)	(29)	(36)	(42)	(48)	(55)
Core enterprise value	18,184	14,245	13,011	10,150	10,138	10,108	10,061	10,054
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	1.0	2.6	-7.0	4.8	-1.0	1.3	1.4	3.6
EBITDA (UBS)	-30.8	63.7	-34.1	4.1	1.5	1.4	3.1	4.2
EBIT (UBS)	-46.6	97.8	-30.0	8.4	-0.6	-0.2	3.0	4.6
EPS (UBS, diluted)	-58.4	131.0	-26.9	7.6	-1.1	-0.1	3.8	5.5
Net DPS	-41.2	56.6	-16.2	-6.9	-1.1	-0.1	4.0	5.9
Margins & Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Gross profit margin	14.2	15.5	11.3	10.5	10.5	10.5	10.6	10.6
EBITDA margin	3.6	5.7	4.0	4.0	4.1	4.1	4.2	4.2
EBIT margin	2.2	4.2	3.1	3.2	3.2	3.2	3.3	3.3
Net earnings (UBS) margin	1.3	2.9	2.3	2.4	2.4	2.4	2.4	2.5
ROIC (EBIT)	6.1	11.3	9.9	15.0	14.7	14.5	14.9	15.5
ROIC post tax	5.1	9.8	8.7	12.7	12.5	12.3	12.6	13.2
ROE (UBS)	5.9	12.0	11.0	16.8	16.3	15.9	16.1	16.6
Capital structure & Coverage (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net debt / EBITDA	3.6	2.2	1.9	1.8	1.8	1.7	1.6	1.5
Net debt / total equity %	53.1	49.1	51.7	50.5	49.0	46.6	44.2	41.7
Net debt / (net debt + total equity) %	34.7	32.9	34.1	33.5	32.9	31.8	30.6	29.4
Net debt/EV %	14.3	18.3	11.4	14.6	14.5	14.1	13.8	13.3
Capex / depreciation %	60.4	36.0	68.0	82.1	74.7	59.1	57.1	55.6
Capex / revenue %	0.9	0.6	0.6	0.6	0.6	0.5	0.5	0.5
EBIT / net interest	3.8	7.0	6.1	7.5	7.3	7.3	7.7	8.2
Dividend cover (UBS)	0.8	1.2	1.0	1.2	1.2	1.2	1.2	1.2
Div. payout ratio (UBS) %	126.7	86.0	98.1	84.4	84.4	84.4	84.6	84.9
Revenues by division (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Others	20,222	20,745	19,288	20,209	20,009	20,272	20,553	21,299
Total	20,222	20,745	19,288	20,209	20,009	20,272	20,553	21,299
EBIT (UBS) by division (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Others	435	861	603	653	650	648	668	699
Total	435	861	603	653	650	648	668	699

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Forecast returns

Forecast price appreciation	-35.2%
Forecast dividend yield	4.8%
Forecast stock return	-30.4%
Market return assumption	6.6%
Forecast excess return	-37.0%

Statement of Risk

Given the lack of visibility on consumer trends, we believe the following are risks to our earnings forecasts and valuation. As 60% of Li & Fung's sales are to US-based retailers, the company's operating performance, and equity risk premium in particular, are shaped by trends in US consumption. Given we view Li & Fung as expensive, we think its share price could be vulnerable to investor disappointment.

Required Disclosures

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UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	47%	37%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 December 2014.

1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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UBS AG Hong Kong Branch: Spencer Leung; Siguo Chen; Erica Poon Werkun, CFA.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Li & Fung ^{16, 20}	0494.HK	Sell (CBE)	N/A	HK\$8.03	19 Mar 2015

Source: UBS. All prices as of local market close.

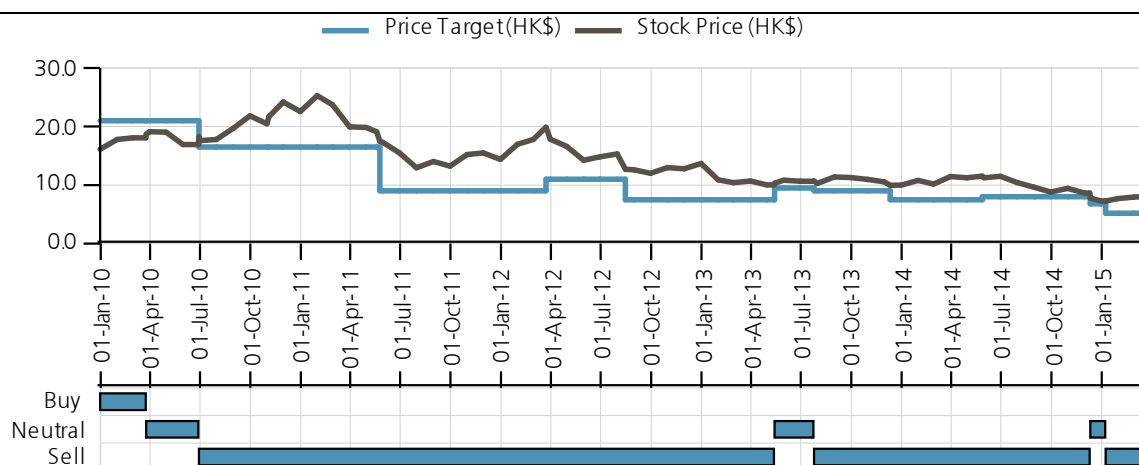
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

16. UBS Securities (Hong Kong) Limited is a market maker in the HK-listed securities of this company.

20. Because this security exhibits higher-than-average volatility, the FSR has been set at 15% above the MRA for a Buy rating, and at -15% below the MRA for a Sell rating (compared with 6/-6% under the normal rating system).

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Li & Fung (HK\$)



Source: UBS, as of 19 Mar 2015

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