

## Li &amp; Fung Limited

## 2014 was dim; 2015 should be better

**Numbers far lower than consensus:** While our core operating profit (COP) and net income forecasts were well below consensus, the actual numbers came in even lower. This was largely due to the higher than expected increase in overhead costs as the firm looks to invest in new initiatives. But it was also partly to do with slightly lower gross margins from a shift in business from Principal to Agency. We have cut our COP for 2015/16 by 7% and our target price by 3% to HK\$8.5.

**Revenue growth from here on can still help drive growth:** Despite working with the lower 2014 level commission rates, we note that a 6% revenue growth can drive an additional cUS\$150m in gross profits, which could well convert into a c100m increase in core operating profit with overhead costs increasing far more gradually. And this could translate into a much higher delta on the net income line. The business is now highly leveraged to top-line growth, but this also means there is little room now to not fall short of delivering mid single-digit revenue growth.

**e-Commerce shift is a structural headwind but could be an opportunity:** While the e-commerce threat has traditional retailers worldwide in disarray, it also offers the opportunity to work directly with Brands and to convert the e-retailers into customers. Hopefully, stronger consumer sentiment in the US will help too.

**Valuation and risks:** We have trimmed our COP forecasts by c7% for 2015/16 and our target price by 3% to HK\$8.5. We believe the c5% trailing yield offers some cushion and note that the stock is on an undemanding 14x 2015 and 12x 2016 cash earnings, given the large non-cash expenses on the P&L. Today's numbers will likely disappoint the Street but a short-term decline may offer good yield exposure if not a growth story.

## 0494.HK: Financial and Valuation Metrics EPS USD

FY Dec	2012	2013	2014	2015	2016
EPS	0.07A	0.08A	0.06E	0.06E	0.07E
Previous EPS	0.07A	0.06A	0.06E	0.06E	0.07E
P/E	14.5	12.5	16.0	18.1	15.3

Source: Barclays Research.

Stock Rating **EQUAL WEIGHT**  
Unchanged

Industry View **NEUTRAL**  
Unchanged

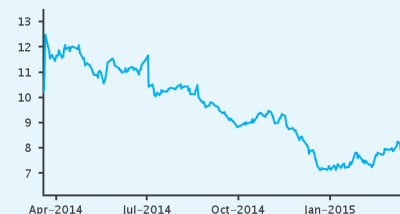
Price Target **HKD 8.50**  
lowered -2% from HKD 8.70

Price (19-Mar-2015) HKD 8.03  
Potential Upside/Downside +6%  
Tickers 494 HK / 0494.HK

Market Cap (USD mn) 8653  
Shares Outstanding (mn) 8360.40  
Free Float (%) 65.80  
52 Wk Avg Daily Volume (mn) 22.5  
52 Wk Avg Daily Value (USD mn) 25.86  
Dividend Yield (%) 5.9  
Return on Equity TTM (%) 16.28  
Current BVPS (USD) 0.63

Source: Thomson Reuters

Price Performance Exchange-HKG  
52 Week range HKD 10.70-7.06



[Link to Barclays Live for interactive charting](#)

## Asia ex-Japan General Retail

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PLEASE SEE ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 6.

## Asia ex-Japan General Retail

Industry View: NEUTRAL

## Li &amp; Fung Limited (0494.HK)

Stock Rating: EQUAL WEIGHT

Income statement (\$mn)	2013A	2014E	2015E	2016E	CAGR
Revenue	19,026	19,288	20,451	21,685	4.5%
EBITDA	772	621	727	817	1.9%
EBIT	737	604	711	804	2.9%
Pre-tax income	682	628	583	682	0.0%
Net income	694	541	479	566	-6.6%
EPS (reported) (\$)	0.08	0.06	0.06	0.07	-6.6%
Diluted shares (mn)	8,356.2	8,356.3	8,356.2	8,356.2	0.0%
DPS (\$)	0.08	0.06	0.06	0.07	-6.6%

Price (19-Mar-2015) HKD 8.03  
Price Target HKD 8.50

**Why Equal Weight?** We think the company still needs to get through at least a set of tough results before any evidence of an earnings pick-up. We therefore maintain our EW rating as we do not see any catalyst for a re-rating near term.

Upside case HKD 10.20

The company could fare better on any rebound in US consumption on the back of further acquisitions. Upside case is based on earnings 20% above our base case forecasts.

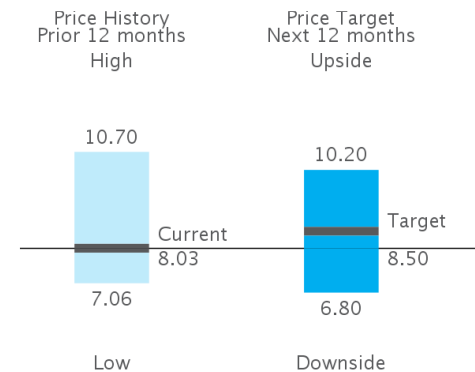
Downside case HKD 6.80

Continued deterioration in US/global consumer sentiment, margin squeeze from acquisitions, and an inability to scale recent acquisitions and cost cuts could lead to earnings 20% below our base case forecasts.

Margin and return data	Average				
EBITDA margin (%)	4.1	3.2	3.6	3.8	3.7
EBIT margin (%)	3.5	2.8	3.2	3.4	3.2
Pre-tax margin (%)	3.6	3.3	2.8	3.1	3.2
Net margin (%)	3.6	2.8	2.3	2.6	2.9
ROIC (%)	10.7	15.8	10.3	11.3	12.0
ROA (%)	5.6	6.4	3.9	4.5	5.1
ROE (%)	12.5	17.4	8.4	9.6	12.0

Balance sheet and cash flow (\$mn)	CAGR				
Tangible fixed assets	440	245	618	730	18.4%
Intangible fixed assets	7,609	4,349	7,300	7,223	-1.7%
Cash and equivalents	460	539	313	366	-7.3%
Total assets	12,465	8,477	12,386	12,715	0.7%
Short and long-term debt	1,293	1,288	1,182	1,080	-5.8%
Net debt/(funds)	834	750	870	713	-5.1%
Other long-term liabilities	1,554	512	1,460	1,460	-2.1%
Total liabilities	6,916	5,367	6,913	7,028	0.5%
Shareholders' equity	5,550	3,110	5,678	5,891	2.0%
Change in working capital	97	28	-25	-22	N/A
Cash flow from operations	-278	-358	-147	-146	N/A
Capital expenditure	-59	-75	-154	-154	N/A
Free cash flow	-337	-433	-301	-300	N/A

## Upside/Downside scenarios



Valuation and leverage metrics	Average				
P/E (reported) (x)	12.5	16.0	18.1	15.3	15.5
EV/EBITDA (x)	14.8	16.5	15.8	14.0	15.3
FCF yield (%)	-3.9	-5.0	-3.5	-3.5	-4.0
EV/sales (x)	0.6	0.5	0.6	0.5	0.6
P/BV (x)	1.6	2.8	1.5	1.5	1.8
Dividend yield (%)	8.0	6.3	5.5	6.5	6.6
Total debt/capital (%)	18.9	29.3	17.2	15.5	20.2
Net debt/EBITDA (x)	-1.1	-1.2	-1.2	-0.9	-1.1

## Selected operating metrics

Effective tax rate (%)	10.6	9.4	12.7	12.6
Payout ratio (%)	75.7	81.4	80.5	79.6

Source: Company data, Barclays Research

Note: FY End Dec

## Changes in estimates

As we expect to see accelerated investment to build new teams and headcount as well as infrastructure to support new business initiatives, we have cut 2015 and 2016 core operating profit by 7% in each year, and 2015 and 2016 net profit by 10% and 9% respectively.

FIGURE 1

### Li & Fung – revisions to the Barclays Research estimates for 2015 and 2016

US\$m	2015E new	2015E old	Change	2016E new	2016E old	Change
Revenue	20,451	19,099	7.1%	21,685	20,221	7.2%
Core operating profit	711	762	-6.8%	804	866	-7.2%
Core operating margin	3.5%	4.0%	-0.5 ppts	3.7%	4.3%	-0.6 ppts
Net profit	479	530	-9.7%	566	621	-8.8%
Net margin	2.3%	2.8%	-0.5 ppts	2.6%	3.1%	-0.5 ppts

Source: Barclays Research estimates

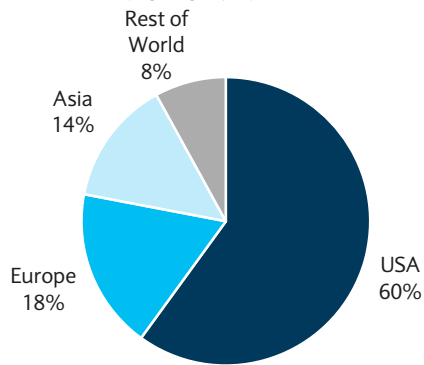
## Results overview

Li & Fung reported that its 2014 recurring net profit (excluding discontinued operations) declined by 12% y/y to US\$539mn (EPS: US\$ 6.46 cents or HK\$50 cents). The company proposed a final dividend of HK\$21 cents per share, in addition to an interim dividend of HK\$13 cents and special dividend of HK\$7 cents per share; 2014 payout ratio stood at 82%.

Revenue was up by 1.4% y/y to US\$19,288mn.

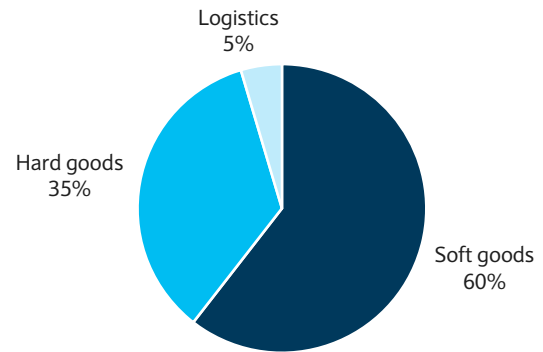
- **By geography**, revenue from the U.S. was up by 0.1% y/y to US\$11.6bn; revenue from Europe was down by 1.2% y/y to US\$3.5bn; revenue from Asia was up by 14.3% y/y to US\$2.7bn and revenue from rest of world was down by 3.4% y/y to US\$1.5bn.
- **By division**, the trading network's revenue was down slightly by 0.5% y/y to US\$18.4bn; and logistics network's revenue was up by 66% y/y to US\$874mn. There was a small elimination of US\$16mn.
- **By product**, revenue from soft goods was up by 0.9% y/y to US\$11.7bn; revenue from hard goods was down by 2.6% y/y to US\$6.7bn and revenue from logistics rose by 63% y/y to US\$886mn.

FIGURE 2  
Li & Fung – Revenue by geography



Source: Company filings, Barclays Research.

FIGURE 3  
Li & Fung – Revenue by product



Source: Company filings, Barclays Research.

The **gross margin** contracted by 0.4 ppts y/y to 11.3% and the **core EBIT** margin shrank by 0.8 ppts y/y to 3.1% on a combination of declining gross margin and increasing operating costs.

In terms of **core EBIT** by division, the trading network's EBIT was down by 20% y/y to US\$558mn with the EBIT margin contracting by 0.8 ppts y/y to 3.0%; and logistics network's EBIT was up by 28% y/y to US\$46mn while the EBIT margin contracting by 1.6 ppts y/y to 5.2%.

FIGURE 4  
Li & Fung – financial summary

US\$m	2014	2013	Y/y change
Turnover	19,288	19,026	1.4%
Total Margin	2,244	2,294	-2.2%
<i>As % of turnover</i>	11.6%	12.1%	-0.5 ppts
Operating Costs	1,640	1,557	+5.3%
<i>As % of turnover</i>	8.5%	8.2%	+0.3 ppts
<b>Core Operating Profit</b>	<b>604</b>	<b>737</b>	<b>-18.0%</b>
<i>As % of turnover</i>	3.1%	3.9%	-0.8 ppts
<b>Profit Attributable to Shareholders (ex-Loss from Discontinued Operations)</b>	<b>539</b>	<b>612</b>	<b>-11.8%</b>

Source: Company filings, Barclays Research.

## Divisional details

### Trading Network

Total revenue was down mildly by 0.5% y/y to US\$18,431mn, comprising of 63% soft goods and 37% hard goods. By geography, the US represented 62% of the division's total revenue with Europe, Asia and the rest of world accounting for 19%, 11% and 8%, respectively. Notably, company signed a number of new sourcing deals with major customers in the U.S. and continued to grow business via cross-selling. In Asia, the company secured a China distribution business for Coty (beauty brands).

The core operating profit declined by 20% y/y to US\$558mn with the EBIT margin down by 0.8 ppts y/y to 3.0%, mainly from investment in infrastructure, new product categories as well as new markets and services. In particular, the company built up its Vendor Support Services team to improve supply chain sustainability. Besides, the company also mentioned heavier-than-usual promotions launched in the U.S. as well as Europe which also adversely impacted margins.

The company maintains a global trading network covering more than 40 economies, which allows for flexibility in moving orders. The top three sourcing countries for the company remained China (49% soft goods and 51% hard goods), Vietnam (91% soft goods and 9% hard goods) and Bangladesh (99% soft goods and 1% hard goods).

FIGURE 5

**Li & Fung – Trading network's financial summary**

US\$mn	2014	2013	Y/y change
Turnover	18,431	18,514	-0.5%
Total Margin	2,004	2,100	-4.6%
<i>As % of turnover</i>	10.9%	11.3%	-0.4 ppts
Operating Costs	1,446	1,398	3.4%
<i>As % of turnover</i>	7.8%	7.6%	+0.2 ppts
<b>Core Operating Profit</b>	<b>558</b>	<b>701</b>	<b>-20.4%</b>
<i>As % of turnover</i>	3.0%	3.8%	-0.8 ppts

Source: Company filings, Barclays Research.

**Logistics Network**

In 2014, the logistics network, which accounted for 4.5% of total revenue, displayed robust revenue growth of 66%, mainly organic growth via new business wins, geographic expansion and growing market share. For in-country logistics, China, Malaysia, and the Philippines registered strong performance. While for global freight management, the company's acquisition of CCL (China Container Line) significantly added scale to its freight forwarding business. In terms of revenue by geography, 56% of revenue was from China, 30% was from the rest of Asia and 14% was from the rest of the world.

The division's core operating profit saw a 28% y/y increase to US\$46mn although the core EBIT margin contracted by 1.6 ppts y/y to 5.2% as a result of the China Container Line acquisition as the freight forwarding business had a lower operating margin than in-country logistics (which was in-line with the industry standard).

FIGURE 6

**Li & Fung – Logistics network's financial summary**

US\$mn	2014	2013	Y/y change
Turnover	874	526	+66.0%
Total Margin	240	194	+23.6%
<i>As % of turnover</i>	27.5%	36.9%	-9.4 ppts
Operating Costs	194	159	+22.5%
<i>As % of turnover</i>	22.2%	30.2%	-8.0 ppts
<b>Core Operating Profit</b>	<b>46</b>	<b>36</b>	<b>+28.1%</b>
<i>As % of turnover</i>	5.2%	6.8%	-1.6 ppts

Source: Company filings, Barclays Research.

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Li & Fung Limited (0494.HK, 19-Mar-2015, HKD 8.03), Equal Weight/Neutral, J/K/N

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**Overweight** - The stock is expected to outperform the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

**Equal Weight** - The stock is expected to perform in line with the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

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BGF Retail (027410.KS)	Cheil Industries (028260.KS)	Chow Tai Fook Jewellery Group Ltd. (1929.HK)
CJ O Shopping (035760.KQ)	E-Mart (139480.KS)	Esprit Holdings Limited (0330.HK)
Golden Eagle Retail Group Ltd. (3308.HK)	Gome Electrical Appliances (0493.HK)	Gourmet Master (2723.TW)
GS Home Shopping (028150.KQ)	GS Retail (007070.KS)	Hyundai Department Store (069960.KS)
Hyundai Home Shopping (057050.KS)	Jubilant Foodworks (JUBI.NS)	L'Occitane International (0973.HK)
Li & Fung Limited (0494.HK)	Li Ning Co., Ltd. (2331.HK)	Lifestyle International Holdings Ltd. (1212.HK)
Lotte Shopping (023530.KS)	Luk Fook Holdings (International) Limited (0590.HK)	Page Industries (PAGE.NS)
Parkson Retail Group Ltd. (3368.HK)	PRADA S.p.A. (1913.HK)	President Chain Store (2912.TW)
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target over the same 12-month period.

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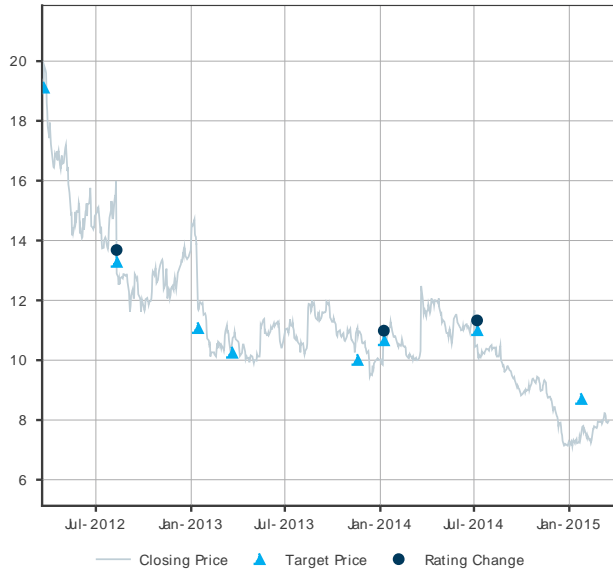
**Li & Fung Limited (494 HK / 0494.HK)**  
**HKD 8.03 (19-Mar-2015)**

Stock Rating  
**EQUAL WEIGHT**

Industry View  
**NEUTRAL**

**Rating and Price Target Chart - HKD (as of 19-Mar-2015)**

Currency=HKD



Date	Closing Price	Rating	Adjusted Price Target
24-Jan-2015	7.42		8.70
07-Jul-2014	10.50	Equal Weight	11.00
08-Jan-2014	9.01	Overweight	10.66
18-Nov-2013	9.09		10.01
21-Mar-2013	8.66		10.25
14-Jan-2013	9.63		11.07
10-Aug-2012	10.58	Equal Weight	13.29
22-Mar-2012	15.63		19.11

Source: Thomson Reuters, Barclays Research

Historical stock prices and price targets may have been adjusted for stock splits and dividends.

Source: IDC, Barclays Research

[Link to Barclays Live for interactive charting](#)

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N: Li & Fung Limited is, or during the past 12 months has been, a non-investment banking client (non-securities related services) of Barclays Bank PLC and/or an affiliate.

**Valuation Methodology:** Our 12-month price target of HK\$8.5 on Li & Fung is based on a target P/E of 19x applied to our 2015E EPS.

**Risks which May Impede the Achievement of the Barclays Research Price Target:** Key downside risks include the company's ability of management to achieve its stated Three-Year Plan targets; while upside risks include better-than-expected revenue growth and margins improvement. Key lag to immediate performance is that one will have to wait until 2H15 to see if Plan progression is on course.

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