



Rating
Hold

Asia
Hong Kong

Consumer
Retail / Wholesale Trade

Company
Li & Fung

Reuters 0494.HK Bloomberg 494 HK Exchange HSI Ticker 0494

Date
15 December 2017

Company Update

Price at 13 Dec 2017 (HKD)	3.95
Price target - 12mth (HKD)	3.80
52-week range (HKD)	4.24 - 2.78
HANG SENG INDEX	28,640

Unwinding the tangles - divestment

LF announced yesterday that it plans to divest its 3 product verticals, subject to shareholders' approval. We view this positively as the structure of the deal would simplify the operation, improve balance sheet structure and minority shareholders will get a special dividend post divestment. Operating outlook for 2018 has improved, according to management, although 2H17 performance will still have some pressure on sales growth. Long term, it needs to roll out its digital supply chain program successfully. Currently, one of the strategies is to improve the adoption rate of its 3D digital printing services which has ~2% adoption rate currently. Maintaining Hold.

Divestment of product verticals:

1) Divestment of three product verticals (namely furniture, beauty and sweaters)

- The cash consideration is US\$1.1bn and will be sold to Hony Capital, FH1937 (Li & Fung's parent co) and FIL (Fung Investment Ltd), based on 14.7x EV/ EBIT vs 8-9x EV/EBIT for some of the previous acquisitions that formed the group, according to management.
- Post transaction, it will pay a special dividend of USD520m (or HK\$0.476/ share).
- It also proposes to enter into a connected transaction on services, leasing and logistics and trading services agreement.
- A one-time non-cash accounting loss of USD610m will be booked in 2017. Another forex loss (non cash) might be booked in 2018.

2) Rationale – simplify the business to concentrate its core competencies and offer capital structure flexibility.

3) It needs shareholders' approval.

The remaining LF – core COP was up by 12% for 1H2017 on a like-for-like basis, which was in line with the 11.9% for the whole group before the divestment.

Valuation & Risks

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Price/price relative



Performance (%)	1m	3m	12m
Absolute	9.4	4.2	13.2
HANG SENG INDEX	0.1	4.8	30.2

Source: Deutsche Bank

Key indicators (FY1)

ROE (%)	7.8
Net debt/equity (%)	14.6
Book value/share (USD)	0.40
Price/book (x)	1.3
Net interest cover (x)	7.6
Operating profit margin (%)	2.6

Source: Deutsche Bank



Forecasts and ratios

Year End Dec 31	2015A	2016A	2017E	2018E	2019E
Sales (USDm)	18,830.8	16,760.6	15,681.4	15,877.8	16,092.8
EBITDA (USDm)	588.6	481.5	509.6	524.6	542.8
Reported NPAT (USDm)	421.0	223.1	259.6	256.5	273.2
Reported EPS FD(USD)	0.05	0.03	0.03	0.03	0.03
DB EPS FD(USD)	0.04	0.03	0.03	0.03	0.03
DB EPS growth (%)	-19.7	-25.0	-1.2	-1.2	6.4
PER (x)	20.3	17.0	16.5	16.7	15.7
EV/EBITDA (x)	14.3	10.3	9.0	8.7	8.3
DPS (net) (USD)	0.04	0.03	0.02	0.02	0.03
Yield (net) (%)	4.3	5.6	4.9	4.8	5.1

Source: Deutsche Bank estimates, company data



Other updates from analyst meeting:

- When asked about the use of the remaining proceeds, management commented that it offers flexibility. **Its goal is to maintain its credit rating as investment grade.**
- In addition to the special dividend, management will **continue to pay ordinary dividend**, which will be a percentage of its NP excluding exceptional items. However, **it did not comment on any payout ratio** - management had mentioned it to be ~80% in the past, when it announced the current 3-year plan.
- **2018 outlook.** While there are store closures still, the overall market experienced some improvement with better channel inventory. That said, there is still some deflationary impact for 2H17. However, its digitization strategy will be expected to help change the whole industry. Currently, it is focusing on 3D virtual design adoption within the whole digital supply chain. Management estimated that the adoption rate of 3D virtual design is ~2%. LF believes that it is the biggest operator in this area.
- As for **the implications of the 3-year plan**, the company maintained its guidance for the remaining business.

Deutsche Bank's view

Improving the balance sheet structure. Since 2014, management has been divesting non-core operations (Global Brands Group, LF Asia and now the three verticals). The proceeds have helped in paying down its outstanding bond (including perpetual bonds, which are regarded as equity sometimes) amounts. With a USD500m perp. bond requiring to reset its rate in 2018, we believe it might retire the bond with the proceeds, saving USD30m. The outstanding bond will be USD1.4bn.

The divested business will remain its client for sourcing and logistic businesses. Based on the financial data for 12 months ending September 2017, and comparing this with our 2017 estimates, the divested business was ~ 12% of the overall sales and ~20%/18% of COP/EBIT respectively. Should most of the sourcing and logistics services be performed by the remaining LF, its sales will not be eliminated by inter company transaction. For 1H17, the COP margin for the principal business was 2.2% and for the agency business 2%. There is no breakdown on an annual basis as it was not disclosed previously.

Minority shareholders can share roughly half of the proceeds from divestment. The special dividend represents about 11.7% yield, based on the current price of HK\$4.08.



Figure 1: Divested business : P&L

YE Dec USDm	2015	2016	12 months ended Sept 2017
Sales	2,154	1,939	1,874
COP	103	92	89
EBIT	89	78	75
PBT	88	77	NA
PAT	70	61	NA
% change			
Sales		-10.0%	-3.4%
COP		-10.7%	-3.3%
EBIT		-12.4%	-3.8%
PBT		-12.5%	
PAT		-12.9%	
Margin			
COP	4.78%	4.74%	4.75%
EBIT	4.13%	4.02%	4.00%
Assets		1920	
Goodwill		1600	
Debt		0	

Of which Sweater JV (62% owned)

YE Dec USDm	12 months ended Mar 2017
Sales	700

Source: Company data

Figure 2: Proposed connected transactions

YE Dec USDm	2015	2016	2018F	2019F	2020F	Remarks
Annual cap						
Service fee			35	45	na	back office function, charged as unit price per transaction
Master property agreement			15	20	25	sub-lease and license office, showroom and warehouse
Ancillary, sourcing, logistic and trading services agreement			40	45	50	services and commission paid
Actual transactions						
Sourcing Services	0.1	0.3				
Logistic Services	4.3	3.6				
Sales to LF	23.3	23.4				

Source: Company data

Figure 3: Deutsche Bank estimates (before divestment)

YE Dec USDm	2015	1H16	2H16	2016	1H17	2H17E	2017E
Sales	17667	7,418	8,777	16,195	7,264	8,417	15,681
COP	496	152	256	408	170	268	438
EBIT					153	255	408
NP					100	160	260
% change							
Sales				-8.3%	-2.1%	-4.1%	-3.2%
COP				-6.0%	11.8%	4.6%	7.3%
Margin							
COP		2.05%	2.92%	2.52%	2.34%	3.18%	2.79%

Source: Company data , Deutsche Bank estimates



Model updated: 02 November 2017

Running the numbers

Asia

Hong Kong

Retail / Wholesale Trade

Li & Fung

Reuters: 0494.HK

Bloomberg: 494 HK

Hold

Price (13 Dec 17) HKD 3.95

Target Price HKD 3.80

52 Week range HKD 2.78 - 4.24

Market cap (m) HKDm 32,011
USDm 4,101.0

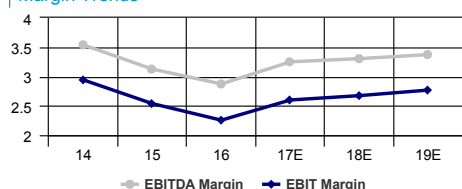
Company Profile

Li & Fung Limited, through its subsidiaries, operates an export trading business. The Company exports consumer products such as garments, fashion, accessories, toys, games, sporting goods, home furnishings, handicrafts, shoes, travel goods, and tableware. In addition, Li & Fung invests in properties.

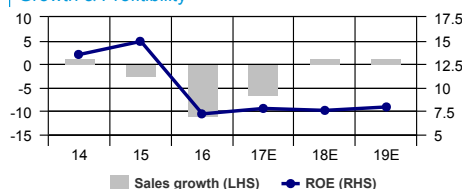
Price Performance



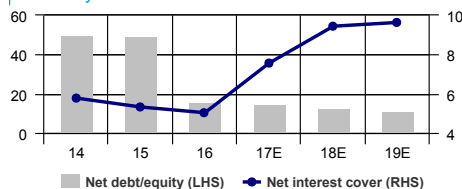
Margin Trends



Growth & Profitability



Solvency



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Fiscal year end 31-Dec

Financial Summary

	2014	2015	2016	2017E	2018E	2019E
DB EPS (USD)	0.05	0.04	0.03	0.03	0.03	0.03
Reported EPS (USD)	0.06	0.05	0.03	0.03	0.03	0.03
DPS (USD)	0.05	0.04	0.03	0.02	0.02	0.03
BVPS (USD)	0.3	0.3	0.4	0.4	0.4	0.4
Weighted average shares (m)	8,360	8,360	8,422	8,455	8,455	8,455
Average market cap (USDm)	10,917	6,996	4,439	4,101	4,101	4,101
Enterprise value (USDm)	12,324	8,413	4,965	4,596	4,554	4,497

Valuation Metrics

P/E (DB) (x)	25.4	20.3	17.0	16.5	16.7	15.7
P/E (Reported) (x)	20.2	16.6	19.9	16.5	16.7	15.7
P/BV (x)	2.79	2.01	1.11	1.26	1.24	1.22
FCF Yield (%)	11.8	6.8	6.8	5.9	7.3	7.7
Dividend Yield (%)	4.0	4.3	5.6	4.9	4.8	5.1
EV/Sales (x)	0.6	0.4	0.3	0.3	0.3	0.3
EV/EBITDA (x)	18.1	14.3	10.3	9.0	8.7	8.3
EV/EBIT (x)	21.7	17.6	13.1	11.3	10.7	10.1

Income Statement (USDm)

Sales revenue	19,288	18,831	16,761	15,681	15,878	16,093
Gross profit	2,244	2,189	1,962	1,796	1,838	1,895
EBITDA	683	589	481	510	525	543
Depreciation	115	111	103	102	100	97
Amortisation	0	0	0	0	0	0
EBIT	567	478	378	408	425	446
Net interest income/(expense)	-98	-90	-75	-54	-45	-46
Associates/affiliates	1	2	2	2	2	2
Exceptionals/extraordinary	156	117	2	30	0	0
Other pre-tax income/(expense)	0	0	0	0	0	0
Profit before tax	627	507	307	385	382	402
Income tax expense	59	58	49	62	61	64
Minorities	-2	-2	-1	0	0	0
Other post-tax income/(expense)	-30	-30	-36	-64	-64	-64
Net profit	539	421	223	260	256	273
DB adjustments (including dilution)	-110	-76	38	3	3	3
DB Net profit	430	345	261	263	260	277

Cash Flow (USDm)

Cash flow from operations	1,368	562	376	363	425	443
Net Capex	-75	-85	-75	-110	-111	-113
Free cash flow	1,293	477	300	253	314	330
Equity raised/(bought back)	0	0	0	0	0	0
Dividends paid	-507	-441	-282	-188	-207	-209
Net inc/(dec) in borrowings	-1,333	-193	-242	-499	0	0
Other investing/financing cash flows	700	18	942	0	0	0
Net cash flow	153	-139	719	-434	107	121
Change in working capital	853	64	17	-37	7	7

Balance Sheet (USDm)

Cash and other liquid assets	550	347	996	527	570	627
Tangible fixed assets	4,596	4,510	4,119	4,127	4,138	4,153
Goodwill/intangible assets	0	0	0	0	0	0
Associates/investments	23	40	43	45	47	50
Other assets	3,308	3,036	2,535	-4,699	2,428	2,454
Total assets	8,477	7,933	7,693	0	7,183	7,284
Interest bearing debt	1,957	1,764	1,522	1,023	1,023	1,023
Other liabilities	3,710	3,321	2,818	2,676	2,704	2,750
Total liabilities	5,667	5,086	4,340	3,699	3,727	3,773
Shareholders' equity	2,810	2,843	3,354	3,406	3,457	3,512
Minorities	9	4	-1	-1	-1	-1
Total shareholders' equity	2,810	2,847	3,353	3,405	3,456	3,511
Net debt	1,407	1,418	526	495	453	396

Key Company Metrics

Sales growth (%)	1.4	-2.4	-11.0	-6.4	1.3	1.4
DB EPS growth (%)	-14.0	-19.7	-25.0	-1.2	-1.2	6.4
EBITDA Margin (%)	3.5	3.1	2.9	3.2	3.3	3.4
EBIT Margin (%)	2.9	2.5	2.3	2.6	2.7	2.8
Payout ratio (%)	81.6	71.8	111.3	80.0	80.0	80.0
ROE (%)	13.5	14.9	7.2	7.8	7.6	7.9
Capex/sales (%)	0.4	0.5	0.4	0.7	0.7	0.7
Capex/depreciation (x)	0.7	0.8	0.7	1.1	1.1	1.2
Net debt/equity (%)	50.1	49.8	15.7	14.6	13.1	11.3
Net interest cover (x)	5.8	5.3	5.0	7.6	9.5	9.6

Source: Company data, Deutsche Securities estimates



Appendix 1

Important Disclosures

*Other information available upon request

Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
Li & Fung	0494.HK	4.08 (HKD) 14 Dec 2017	13

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Historical recommendations and target price. Li & Fung (0494.HK)

(as of 12/13/2017)



Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

** Analyst is no longer at Deutsche Bank

1.	01/07/2016	Sell, Target Price Change HKD 4,07 Anne Ling	5.	03/30/2017	Hold, Target Price Change HKD 3,71 Anne Ling
2.	03/17/2016	Sell, Target Price Change HKD 3,51 Anne Ling	6.	07/16/2017	Hold, Target Price Change HKD 3,40 Anne Ling
3.	08/26/2016	Upgraded to Hold, Target Price Change HKD 4,07 Anne Ling	7.	08/28/2017	Hold, Target Price Change HKD 3,64 Anne Ling
4.	01/18/2017	Hold, Target Price Change HKD 3,85 Anne Ling	8.	11/02/2017	Hold, Target Price Change HKD 3,80 Anne Ling

Equity Rating Key

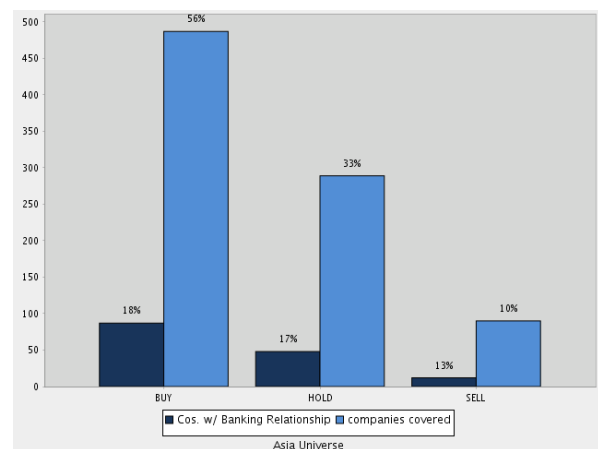
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Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock.

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Newly issued research recommendations and target prices supersede previously published research.

Equity rating dispersion and banking relationships





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