

**Li & Fung**

## Case 15

# Li & Fung—The Global Value Chain Configurator

This case was prepared by S.S. George, ICFAI Center for Management Research.

*In an age when the Internet is supposedly going to eliminate the middleman, here's a middleman, an old Asian trading company that has made itself indispensable.<sup>1</sup>*

—An Article in Forbes

*We deliver a new type of value added, truly global product that has never been seen before. We're pulling apart the value chain and optimising each step—and we're doing it globally.<sup>2</sup>*

—Victor Fung, Chairman, Li & Fung, in June 2000

### Strengthening Its Fort

In January 2004, Li & Fung Limited (Li & Fung), a Hong Kong-based global consumer goods trading giant, announced that Li & Fung Trading (Shanghai), its wholly owned subsidiary, had been granted an export company license by the Ministry of Commerce of the People's Republic of China (China). After receiving the license, Li & Fung Trading (Shanghai) became the first wholly owned foreign trading company to be offered direct export rights in China. The company was authorized to export China-sourced goods directly to customers worldwide and import raw materials for manufacturing in China. Li & Fung was until then dependent on its Chinese partners for exporting from China.

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According to William Fung (William), managing director, Li & Fung, the license freed the group companies (see Exhibit 1) from the many trading restrictions in China. It would enhance the company's competitiveness and increase its share in the global market. William said, "With the ability to directly export products from China to our customers worldwide, Li & Fung is now able to offer an even more complete supply chain service."<sup>3</sup>

After China joined the World Trade Organization (WTO) in 2001, it emerged as the world's largest exporter of textile and clothing. The country also consolidated its position as one of the world's largest and fastest growing manufacturing economies. According to the U.S. International Textiles Association, export of textiles and clothing from China to the United States

<sup>1</sup>"Stitches in Time," [www.forbes.com](http://www.forbes.com), June 9, 1999.

<sup>2</sup>"Winning at a Global Game: Part Five of an Eleven Part Series," [www.asiabusinessstoday.org](http://www.asiabusinessstoday.org), June 10, 2000.

<sup>3</sup>"First Hong Kong Trading Firm to Gain China Licence," [www.hktrader.net](http://www.hktrader.net), February 2004.

**EXHIBIT 1**
**Li & Fung's Major Subsidiaries and Associated Companies**

Held Directly	Place of Incorporation and Operation	Issued and Fully Paid Share Capital	Principal Activities
Li & Fung (B.V.I.) Limited	British Virgin Islands	US\$ 400,010	Marketing services and investment holding
Basic & More Fashion Limited	Hong Kong	HK\$ 1,000,000	Export trading
Black Cat Fireworks Limited	England	GBP 1,200,000	Wholesaling
Camberley Enterprises Limited	Hong Kong	HK\$ 250,000	Apparel exporting
Civati Limited	Hong Kong	US\$ 450,000	Export trading
Colby International Limited	Hong Kong	HK\$ 1,500,000	Exporting of garments and sundry goods
Colby Tekstil ve Dis Ticaret Limited Sirketi	Turkey	TL 50,000,000,000	Export trading
CS International Limited	Hong Kong	HK\$ 1,000,000	Provision of export assistance service
Dodwell (Mauritius) Limited	Hong Kong	HK\$ 500,000	Export trading
Golden Gate Fireworks Inc.	U.S.A.	US\$ 600,000	Commission agent and investment holding
GSCM (HK) Limited	Hong Kong	HK\$ 140,000	Export trading
Hillung Enterprises Limited	Hong Kong	HK\$ 300,000	Export trading
International Sourcing Group, LLC	U.S.A.	US\$ 300,000	Trading of apparel
Janco Overseas Limited	Hong Kong	HK\$ 760,000	Buying agent
Kariya Industries Limited	Hong Kong	HK\$ 1,000,000	Manufacturing and trading
LF Maclaine (Thailand) Limited	Thailand	Baht 4,000,000	Export trading
Li & Fung Agencia De Compras em Portugal, Limitada	Portugal	PTE 20,000,000	Export trading
Li & Fung (Exports) Limited	Hong Kong	HK\$ 8,610,000	Export trading
Li & Fung (Fashion Accessories) Limited	Hong Kong	HK\$ 600,000	Export trading
Li & Fung (India)	India	Rupees 64,000,200	Export trading
Li & Fung (Italia) S.r.l.	Italy	Lire 90,000,000	Export trading
Li & Fung (Korea) Limited	Korea	Won 200,000,000	Export trading
Li & Fung (Korea) Limited	Mauritius	Rupees 1,250,000	Export trading
Li & Fung Mumes sillik, Pazarlama Limited	Turkey	TL 25,000,000,000	Export trading
Li & Fung (Phillippines) Inc.	The Philippines	Peso 500,000	Export trading
Li & Fung (Properties) Limited	Hong Kong	HK\$ 1,000,000	Property investment
Li & Fung Taiwan Holdings Limited	Taiwan	NT\$ 287,996,000	Investment holding
Li & Fung Taiwan Investments Limited	British Virgin Islands	US\$ 4,912,180	Investment holding
Li & Fung (Taiwan) Limited	Taiwan	NT\$ 63,000,000	Export trading
Li & Fung (Thailand) Limited	Thailand	Baht 6,000,000	Export trading

**EXHIBIT 1** (continued)

## Li &amp; Fung's Major Subsidiaries and Associated Companies

Held Directly	Place of Incorporation and Operation	Issued and Fully Paid Share Capital	Principal Activities
Li & Fung (Trading) Limited	Hong Kong	HK\$ 10,000,200	Export trading and investment holding
Li & Fung Trading (Shanghai) Limited	The People's Republic of China	RMB 50,000,000	Export trading
Li & Fung (Zhanjiang) Limited	The People's Republic of China	US\$ 1,999,055	Packaging
Livring Limited	Mauritius	Rs 250,000	Export trading
Lloyd Textile Trading Limited	Hong Kong	HK\$ 1,000,000	Export trading
Maclaine Limited	Hong Kong	HK\$ 5,570,150	Export trading
Perfect Trading Inc.	Egypt	LE 2,480,000	Export trading
Shiu Fung Fireworks Company Limited	Hong Kong	HK\$ 1,200,000	Export trading
The Millwork Trading Co., Ltd	U.S.A.	US\$ 1,331,000	Distribution and wholesaling
Toy Island Manufacturing Company Limited	Hong Kong	HK\$ 62,000,000	Design and marketing
Verity Enterprises Limited	Hong Kong	HK\$ 2,000,000	Export trading
W S Trading Limited	Hong Kong	HK\$ 1,000,000	Export trading

*Notes:*

- (1) Li & Fung (B.V.I.) Limited provides the subsidiaries with promotional and marketing services outside Hong Kong.  
 (2) Subsidiaries not audited by PricewaterhouseCoopers, Hong Kong. The aggregate net assets of subsidiaries not audited by PricewaterhouseCoopers, Hong Kong amounted to approximately 5 percent of the Group's total net assets.

Exhibit 1 lists out the principal subsidiaries of the company as of December 31, 2003, which, in the opinion of the directors, principally affected the results for the year or form a substantial portion of the net assets of the Group. To give details of other subsidiaries would, in the opinion of the directors, result in particulars of excessive length.

Source: Li & Fung Annual Report, 2003.

doubled from US\$ 6.5 billion in 2001 to US\$ 11.6 bn in 2003. With export quotas among WTO members proposed to be eliminated from January 2005, China would be free of restrictions on quantity of exports to the United States, enabling further growth.

In this light, analysts felt Li & Fung stood to benefit significantly from its new license as it was one of the world's leading textile export traders, and the largest to the United States. The company was well placed to leverage China's leadership position in textile manufacturing and exports, as that country was the company's largest manufacturing hub, from where it sourced over US\$ 2 bn worth of products annually. Li & Fung had sixteen offices in China, which it planned to take to thirty-six by 2007. The downside was that in early 2004, Li & Fung faced

many challenges such as a slowdown in its overall revenues and net profit growth, overdependence on the U.S. market, declining share of revenues from the European market, and negligible growth in revenues from the rapidly growing Asian markets.

### Background Note

The history of Li & Fung goes back to the early 1900s, making it the oldest trading company in Hong Kong. The company was founded in 1906 by Fung Pak-Liu (Pak-Liu) and Li To-ming (To-ming) in Guangzhou (South China) and was one of the first Chinese-owned export companies. Trade in China at that time was controlled by foreign commercial houses. Li & Fung began operations by exporting porcelain and

silk, mainly to the United States. It later expanded its product portfolio to include bamboo, jade, ivory, rattan ware, fireworks, and handicrafts.

During the early 1900s, since U.S. buyers did not know Chinese and Chinese sellers did not know English, traders who could speak both languages became essential mediators between buyers and sellers. Therefore, Li & Fung prospered, earning commissions as high as 15 percent on each export deal. Li & Fung was formally established in Hong Kong as a limited company in 1937.

World War II disrupted trading in the early 1940s, forcing Li & Fung to cease trading for some years. In 1943, Pak-Liu passed away. Shortly after the end of the war, To-ming, who had been a silent partner, retired and sold his stake to Pak-Liu's family. With this, the Fung family became the sole owners of Li & Fung.

In 1949, Pak-Liu's son, Fung Hon-chu (Hon-chu), restarted trading operations in Hong Kong, which had come under British control. Hon-chu was instrumental in leading Li & Fung into the new era. The trading business picked up momentum in Hong Kong during the mid 1900s, driven by the influx of refugees, which transformed China into a manufacturing economy that exported labor intensive consumer products. Li & Fung began exporting consumer products such as garments, electronics, plastic flowers, and toys and was soon Hong Kong's biggest exporter.

By the early 1970s, the trading business in Hong Kong began to struggle owing to stiff competition from other manufacturing economies in Asia such as Taiwan and Singapore. Trading margins also went down significantly to 3 percent, as buyers and sellers became comfortable dealing directly with each other, doing away with intermediaries.

Under these circumstances, Hon-chu called his sons—William and Victor Fung (Victor)—back home from the United States. Victor was teaching at the Harvard Business School, and William had just finished his MBA from the same business school. Despite their friends' warning that trading would die out in a decade, the two brothers returned to Hong Kong to join their family firm.

Victor and William worked hard to modernize and rebuild Li & Fung into a well-structured organization, professionally managed at all levels. In 1973, the company went public and was listed on the Hong Kong Stock Exchange. Li & Fung's initial public offering was oversubscribed 113 times—a record that stood for fourteen years.

With the opening up of the Chinese economy in 1979, many manufacturers in Hong Kong relocated their factories to southern China, which was more cost effective thanks to low labor costs. The rapid industrialization of underdeveloped Asian countries widened the choice of supply sources. Li & Fung realized that there was a huge potential for the trading business. To benefit, the company established a regional network of sourcing offices in Asian countries such as Taiwan, Singapore, and Korea in the 1980s. It emerged as a major regional trading company in Asia.

In 1989, with trading margins decreasing further, Victor and William realized the need for drastic changes to safeguard the company's business. As a result, in that year, Li & Fung was again made a private company, in one of the first management buyouts in Hong Kong. The company was then restructured into a diversified group with export trading and retail as its core businesses. In 1992, the firm's export trading business, Li & Fung (Trading) Pvt. Limited., was relisted on the Hong Kong Stock Exchange.

As Li & Fung expanded its business, it understood that sourcing could no longer be restricted to a few countries but a vast network of sourcing offices to sustain trading business was required. Thus, the company established sourcing offices across the world, mainly around its major markets, the United States and Europe. Li & Fung also went in for acquisitions to strengthen its sourcing and distribution networks and expand its product lines and customer networks. It pursued an active information technology (IT) and Internet strategy to enhance the efficiency and effectiveness of its internal and external communications.

By the turn of the twentieth century, Li & Fung was a premier global trading company, with more than 95 percent of its revenues coming from North America and Europe. East Asia and the South Hemisphere accounted for the rest. In the fiscal year 2002, North America and Europe accounted for 76 percent and 19 percent of the group's total revenues, while East Asia and the South Hemisphere were placed at 3 percent and 2 percent, respectively (see Table 1 for Li & Fung's revenues by geographic segments in percentage terms).

The group's major product segments were both soft and hard goods. While soft goods included garments, hard goods constituted product lines such as fashion accessories, footwear, gifts, and furnishings (see Table 2 for Li & Fung's major product lines). Soft

**TABLE 1**

Revenues by Geographic Segments (1999–2003) (in percentage terms)

Geographic Regions	1999	2000	2001	2002	2003
North America	69%	70%	75%	76%	75%
Europe	27%	26%	21%	19%	19%
East Asia	1%	1%	1%	3%	3%
South Hemisphere	3%	3%	3%	2%	2%
<b>Total (%)</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>Total Revenues (in HK\$ bn)</b>	<b>16.298</b>	<b>24.992</b>	<b>32.941</b>	<b>37.281</b>	<b>42.631</b>

Source: Li & Fung Annual Report 2003.

goods contributed to a majority of the group's revenues. In 2002, this segment accounted for 68 percent of Li & Fung's total revenues, while hard goods generated the remaining 32 percent (see Table 3 for Li & Fung's revenues by product segments in percentage terms).

In 2002, export trading remained Li & Fung's major business, but it also actively operated in the retailing and distribution business through its privately held companies. The retailing business was confined to China and the Asian market, where it operated as a regional license holder for Toys "R" Us, the biggest US toy products chain and was the franchisee for the

Hong Kong-based Circle K convenience store chain. The distribution business, too, was confined to China and the Asian region. Li & Fung was also involved in other businesses such as venture capital, investment holding, and property investment.

In the fiscal 2002, Li & Fung registered revenues of HK\$ 37.3 bn, a 13 percent increase over HK\$ 32.94 bn revenues in 2001. The company recorded a net profit of HK\$ 1.08 bn in 2002, an increase of 38 percent over the figure of HK\$ 782 mn in 2001. The company's largest customer in the United States was Kohl's Department Store Chain, accounting for nearly 13 percent of Li & Fung's total revenues in 2002. Other major clients included Abercrombie & Fitch, Ann Taylor, Disney, American Eagle Outfitters, Guess, Laura Ashley Jeans, Levi Strauss & Company (Levi's), Reebok, The Limited Inc., and Warner Brothers.

By this time, Li & Fung had successfully positioned itself as a cutting edge sourcing company in the world, with a well-established sourcing network of 68 offices across 40 countries and over 4,500 employees. In 2002, Li & Fung was reportedly one of the best professionally run companies in Hong Kong. The company's commitment to excellence and high standards in corporate governance practices earned it many awards and recognitions. Li & Fung was named one of Hong Kong's best companies, by *Euromoney* magazine, in the category "Asia's Best Company 2002." The same year, Li & Fung was named the "Best Managed Company 2002" and "Company Most Committed to Corporate Governance" by *Finance Asia* magazine (see Figure 1 for the corporate governance structure of Li & Fung).

**TABLE 2**

Li &amp; Fung's Product Lines

Soft Goods	Hard Goods
Garments	Fashion Accessories
	Footwear
	Furnishings
	Gifts
	Handicrafts
	Home Products
	Promotional Merchandise
	Toys
	Stationery
	Sporting Goods
	Travel Goods

Source: www.lifung.com.

**TABLE 3**

Revenues by Product Segments (1999–2003) (in percentage terms)

Product Segments	1999	2000	2001	2002	2003
Soft Goods	75%	78%	72%	68%	67%
Hard Goods	25%	22%	28%	32%	33%
<b>Total (%)</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>Total Revenues (in HK\$ bn)</b>	<b>16.298</b>	<b>24.992</b>	<b>32.944</b>	<b>37.281</b>	<b>42.631</b>

Source: Li & Fung Annual Report 2003.

Analysts credited the growth and success of Li & Fung to the visionary leadership and managerial capabilities of Victor and William. Since the early 1970s, the duo had led Li & Fung through a series of transformations in line with changes in the external environment. The major factors that helped Li & Fung evolve into a major global export trading company were the focus on efficiently managing the supply chain of its clients, a unique customer-centric organizational structure, leveraging IT and the Internet and global expansion strategies.

**Managing the Global Supply Chain**

Li & Fung’s evolution into a supply chain manager took place in three stages, driven by significant changes in the global retailing industry, customer and

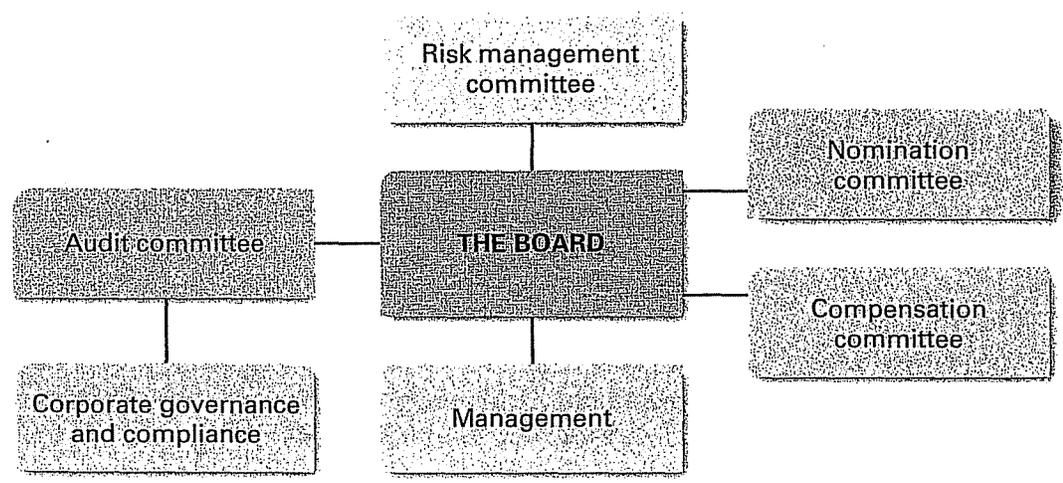
retailer preferences, and economic trends across Asia through the early 1970s.

In the first stage (during the 1970–1978 period), Li & Fung acted as a regional sourcing agent. The company extended its geographic reach by establishing sourcing offices in Singapore, Korea, and Taiwan. Li & Fung’s knowledge and reach in the Asian region held value for customers. This was because many big buyers could manage their own sourcing if they needed to deal only in Hong Kong. Dealing with the whole region was far more complex, and buyers did not have the necessary resources. Commenting on the complexity of sourcing from the region, in an interview to *Harvard Business Review*, Victor said that as quotas governed world trade in the textiles industry, knowledge on which quotas had been used up in Hong Kong and which was the next best place to source textiles from, where quotas had not been

**FIGURE 1**

Li & Fung’s Corporate Governance Structure

Source: Li & Fung Annual Report, 2003.



exhausted, enabled Li & Fung to provide customers with a complete product package.

In the second stage (1979–1982), Li & Fung evolved from a sourcing agent into a manager and deliverer of production programs. When a customer came up with an idea of a product and gave specifications such as look, color, and quality, the company developed a detailed manufacturing program for that product. In other words, the firm created an entire manufacturing program for its customers for a particular fashion season. The program involved all tasks from specifying the product mix to scheduling the manufacturing process and delivery time. Li & Fung worked with factories to plan and monitor the manufacturing process and to ensure quality and on-time delivery.

This strategy worked well for Li & Fung. Yet, the 1980s brought a new challenge. This led to its third stage of evolution (1983 to the present period). Other countries in Asia such as Korea, Taiwan, and Thailand had by then emerged as labor-intensive manufacturing hubs, while Hong Kong had become an expensive and noncompetitive place to manufacture. The Chinese economy was being liberalized, and the company soon took the advantage by moving the labor-intensive portion of production to southern China.

### Dispersed Manufacturing

Li & Fung broke the value chain into parts that it called “dispersed manufacturing.” Under this, the company performed all high-end value-added activities such as design and quality control in Hong Kong and outsourced low-end activities like manufacturing to the best possible locations across the world. For every order, the company aimed at customizing the supply chain to meet the client’s specific requirements. For example, when Li & Fung got an order for transistor radios, it created little kits (plastic bags) filled with all the components necessary to build a radio and shipped the kits to China, where they were assembled. The assembled radios were then shipped back to Hong Kong, where they underwent final testing and inspection.

Similarly, to fulfill an order for baby dolls, Li & Fung designed them in Hong Kong, produced molds for the dolls using sophisticated machinery, and then shipped the molds to China, where plastic was injected into the molds, the dolls were assembled, their fingers were painted, and their clothes were tailored. After the completion of such labor-intensive work in

China, the dolls were shipped back to Hong Kong for final testing, inspection, packaging, transportation and distribution. So, while the front and back ends of the value chain were taken care of in Hong Kong, the middle portion was performed in China.

Once Li & Fung understood the benefits of dispersed manufacturing and gained expertise in it, the company extended its network beyond southern China. It moved into the inner parts of China, where wages were even lower. Li & Fung also began searching for other labor-intensive and potential sources of supply outside China and established a strong global network of suppliers by the late 1990s. Soon, the concept of dispersed manufacturing spread to other industries in Hong Kong, which led to the transformation of Hong Kong from a manufacturing economy into a service economy. By 1997, 84 percent of Hong Kong’s gross domestic product<sup>4</sup> came from services (see Exhibits 2 and 3).

Meanwhile, owing to maturing markets, intense competition and changing consumer trends, many companies in the Western countries were compelled to outsource not only their manufacturing but also the entire supply chain management (SCM) to reap time and cost benefits. Li & Fung, with its extensive sourcing depth and network, grew from a deliverer of production programs into a potential manager of supply chains for companies looking for optimum SCM.

Li & Fung described SCM as “tackling the soft \$3” in the structure—that is, if the price of a consumer product when it leaves a factory in China was \$1, it would end up on retail shelves at \$4. The company felt there was very little companies could do to further reduce production costs, as they had already exhausted all possible ways. It would be easier to cut on costs that were spread across distribution channels—that is, the \$3 (difference between the product price on retail shelves and price when it left the factory).

Li & Fung took its dispersed manufacturing technique further, dissecting the entire value chain and optimizing every step of the chain, from product design and development, raw material sourcing, production planning, conducting quality assurance and factory inspections, managing production and logistics of

<sup>4</sup>GDP is used to measure the growth and health of an economy and is defined as the total market value of all final goods and services produced in a country in a given year, equal to total customer, investment, and government spending, plus the value of the total exports, minus the value of total imports.

**EXHIBIT 2**
**Exports and Imports of Services in Hong Kong (2000–2002)**

Major Service Group	Year	Exports of Services			Imports of Services			Net Exports of Services HK\$ mn
		HK\$ mn	Share (%)	Year-on-Year % Change	HK\$ mn	Share (%)	Year-on-Year % Change	
Transportation	2000	99,513	33.0	11.5	48,628	25.4	23.9	50,885
	2001	93,675	30.4	-5.9	50,916	26.5	4.7	42,759
	2002	103,751	30.9	10.8	48,518	24.3	-4.7	55,233
Travel	2000	46,019	15.2	7.4	97,402	50.9	-4.4	-51,383
	2001	46,362	15.1	0.7	96,057	49.9	-1.4	-49,695
	2002	58,855	17.5	26.9	96,846	48.5	0.8	-37,991
Insurance services	2000	3,452	1.1	12.6	4,111	2.1	-17.4	-659
	2001	3,556	1.2	3.0	4,028	2.1	-2.0	-472
	2002	3,421	1.0	-3.8	4,618	2.3	14.6	-1,197
Financial services	2000	20,859	6.9	8.6	5,536	2.9	-3.4	15,323
	2001	21,823	7.1	4.6	5,242	2.7	-5.3	16,581
	2002	19,564	5.8	-10.4	4,876	2.4	-7.0	14,688
Merchandising and other trade-related services	2000	97,616	32.3	19.7	11,170	5.8	6.3	86,446
	2001	106,447	34.6	9.0	11,802	6.1	5.7	94,645
	2002	115,996	34.6	9.0	14,660	7.3	24.2	101,336
Other services	2000	34,355	11.4	15.8	24,695	12.9	13.7	9,660
	2001	35,794	11.6	4.2	24,408	12.7	-1.2	11,386
	2002	33,826	10.1	-5.5	30,158	15.1	23.6	101,336
All services	2000	301,813	100.0	13.7	191,543	100.0	4.1	110,270
	2001	307,657	100.0	1.9	192,453	100.0	0.5	115,204
	2002	335,412	100.0	9.0	199,676	100.0	3.8	135,736

**Notes:**

(1) Figures for exports of travel services have incorporated the new data released by the Hong Kong Tourism Board in November 2003 on destination consumption expenditure of incoming visitors and travelers. For details, please refer to the feature article "Statistics on Inbound Tourism" in the December 2003 issue of the *Hong Kong Monthly Digest of Statistics*.

(2) The sum of individual items and the corresponding total shown in the table may not tally because of rounding.

Source: [www.info.gov.hk](http://www.info.gov.hk).

exporting, timely delivery, and complying with import and export quota restrictions, imposed by the buyer and seller countries, respectively. The company became a much broader intermediary by connecting and coordinating many links in the supply chain. It made its services more valuable by delivering a better product, which translated into better price and margins for customers (see Exhibit 4).

**Global Supplier Network**

When Li & Fung got an order from a customer, it sifted through its global supplier network (see Exhibit 5) to find the right manufacturer for the specific product and the most attractive combination of cost and quality. The company broke up its supply chain to disperse different production processes to manufacturers in various countries, based on factors

**EXHIBIT 3****Hong Kong's External Trade Performance**

	2003 (HK\$ Mn)	2004 Jan–May (HK\$ Mn)	% Change	
			03/02	J–M 04/03
<b>Overall</b>				
- Domestic Exports	121,687	44,668	-7	1
- Re-exports	1,620,749	713,531	13	16
- Imports	1,805,770	816,918	12	19
- Total Trade	3,548,206	1,575,117	12	17
Balance	-63,334	-58,719	8	99
<b>Total Exports—Major Markets</b>				
All Markets	1,742,436	758,199	12	15
- China	742,544	334,450	21	18
- U.S.A.	324,215	122,950	-3	5
- E.U.	231,033	98,469	12	13
- Japan	94,003	41,241	12	13
- Singapore	35,704	16,866	13	27
- Taiwan	42,269	20,334	22	23
- Rep. of Korea	35,526	18,054	17	29
<b>Total Exports—Major Products</b>				
All Products	1,742,436	758,199	12	15
- Electronics #	732,653	332,023	20	23
- Clothing	180,357	65,408	3	5
- Electrical Products #	192,485	88,524	13	21
- Textile Yarn & Fabrics	101,923	45,067	5	9
- Toys & Games	75,008	22,538	1	-3
- Footwear	44,755	17,874	-1	-3
- Watches and Clocks	41,903	17,237	9	8
- Travel Goods & Handbags	32,070	14,333	*	12
- Plastic Articles	23,872	9,309	-8	-6
- Food	15,404	5,597	-8	-7
- Jewelry	22,231	9,794	17	21
<b>Re-exports—with China</b>				
Total Re-exports	1,620,749	713,531	13	16
- To China	705,787	321,126	23	19
- Of China Origin	967,104	418,816	12	16
<b>Imports—End-use Categories</b>				
Total Imports	1,805,770	816,918	12	19
- Foodstuffs	53,439	22,747	-3	8
- Consumer Goods	573,926	235,109	5	9
- Raw Materials	654,452	319,439	17	27
- Fuels	35,398	18,026	13	28
- Capital Goods	481,081	218,494	12	18

# Overlap with other products

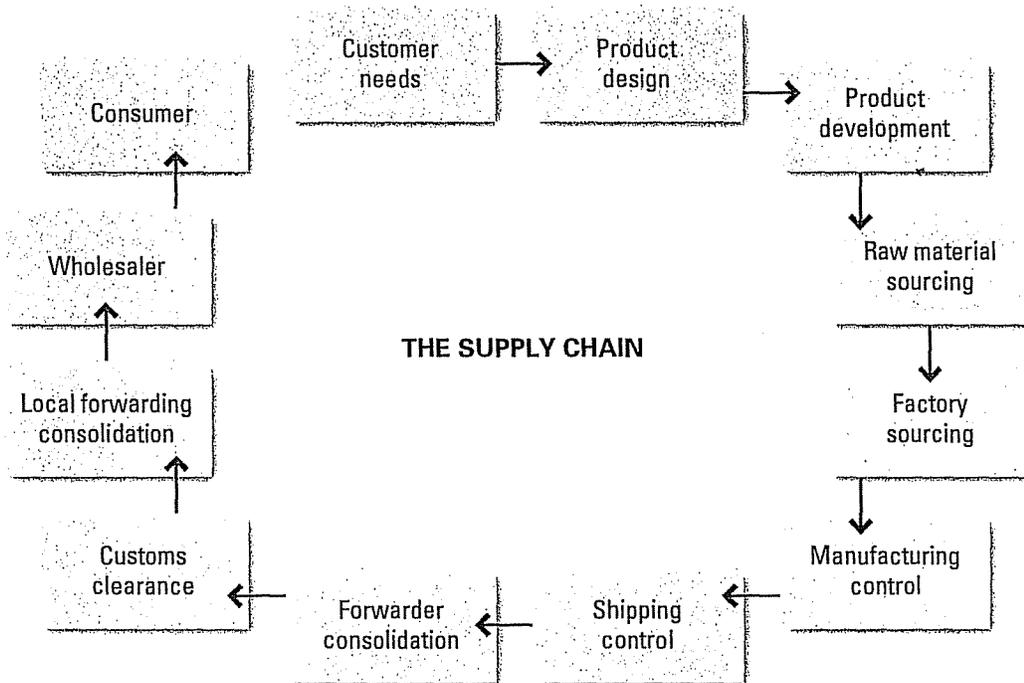
\*Insignificant

Source: <http://stat.tdctrade.com>.

## EXHIBIT 4

## Li &amp; Fung's Supply Chain

Source: Li & Fung Annual Report, 2003.



such as labor costs, quality, trade barriers, transportation costs, and so on. The company coordinated all processes in the value chain, managing the logistics and arranging the shipment of the finished order to the client. Li & Fung also ensured that suppliers complied with rules and regulations pertaining to environmental standards, child labor, and so on in the importing countries (see Exhibit 6).

For instance, when Li & Fung got an order from Levi's, a leading retail clothes chain in the United States, with garment designs for the next fashion season, the company took the basic product concepts and researched the market to find the right kind of raw materials such as yarn, dye, and buttons. The company then assembled the raw materials to create a prototype, which was sent to Levi's for inspection. Once the prototype was approved, Levi's placed an order for the garments with Li & Fung, asking for delivery within six weeks.

Li & Fung immediately went to work; it distributed various tasks of the overall manufacturing process to different producers based on their capabilities and costs. It decided to purchase yarn from a Korean supplier but have it woven and dyed in Taiwan. The yarn was picked up from Korea and

shipped to Taiwan. As the Japanese offered best quality zippers and buttons, which they got manufactured in China, Li & Fung approached the leading zipper manufacturer in Japan to order the right zippers from Chinese factories. Li & Fung decided to manufacture the final garments in Thailand, based on factors like quota availability and favorable labor conditions. It moved all the materials to Thailand. Since the order had to be fulfilled within six weeks, the order was divided across five factories in Thailand. Li & Fung ensured that within the scheduled date of delivery, the finished products, all looking as if they came from one factory, arrived at Levi's retail stores.

Efficient SCM also addressed the problem of obsolete inventory, a major area of concern for fast-moving consumer goods (FMCG) companies, which were consumer driven. FMCG companies preferred buying closer to the market as it shortened the buying cycle and gave them more time to get a better sense of the changing needs and preferences of consumers. Such quick changes led to shorter product cycles, and the problem of obsolete inventories went up significantly. This was where Li & Fung's global SCM expertise was useful, as it aimed at buying the right things at the right place, at the right cost and quality.

**EXHIBIT 5**

## Li &amp; Fung's Global Sourcing Network

**EUROPE & THE MEDITERRANEAN**

Amsterdam  
 Bucharest  
 Cairo  
 Denizli  
 Florence  
 Huddersfield  
 Istanbul  
 Izmir  
 London  
 Oporto  
 Tunis  
 Turin

**SOUTH ASIA**

Amman  
 Bahrain  
 Bangalore  
 Chennai  
 Colombo  
 Delhi  
 Dhaka  
 Karachi  
 Lahore  
 Mumbai  
 Sharjah

**THE AMERICAS**

Boston  
 Guadalajara  
 Guatemala City  
 Managua  
 Mexico City  
 New York City  
 San Francisco  
 San Pedro Sula  
 Santo Domingo

**SOUTHEAST ASIA**

Bangkok  
 Hanoi  
 Ho Chi Minh City  
 Jakarta  
 Makati  
 Phnom Penh  
 Saipan  
 Shan Alam  
 Singapore

**SOUTH AFRICA**

Durban  
 Madagascar  
 Mauritius

**NORTH ASIA**

Beijing  
 Dalian  
 Dongguan  
 Guangzhou  
 Hepu  
 Hong Kong  
 Huizhu  
 Liuyang  
 Longhua  
 Macau  
 Nanjing  
 Ningbo  
 Qingdao  
 Seoul  
 Shanghai  
 Shantou  
 Shenzhen  
 Taipei  
 Tokyo  
 Zhanjiang  
 Zhongshan

Source: Li & Fung Annual Report, 2003.

**The SCM Strategy**

To ensure shorter product delivery cycles, Li & Fung managed the whole supply chain of its customers. To shrink the delivery cycle, the company reached upstream to organize production and ensure small production runs, which resulted in improved response time for retailers, enabling them to alter production in tandem with market trends. For instance, Li & Fung got to know that Levi's would order 1 million pieces of garments, but did not have specific details of style or colors. This would be disclosed only four weeks before delivery was due. Under these circumstances, based on trust and its strong relationship

with suppliers, Li & Fung reserved undyed yarn and locked up capacity at mills for weaving and dying. It told suppliers that they would receive an order for a specific size and colors six days before delivery. Then the company contacted the factory owners, stating that it did not know product specifications yet, but it had organized the colors, fabric, and trim for them, and they should deliver the order on a specific date, say two weeks from the arrival of raw materials at their factories.

Having a vast network of suppliers enabled Li & Fung to configure activities as if they were modules in a process. For instance, a South Korean yarn

SECTION A Business Level Cases, Domestic and Global

## EXHIBIT 6

### Li & Fung's Code of Conduct for Suppliers

Li & Fung (Trading) Limited Code of Conduct ("Code of Conduct") outlines the basic requirements on working conditions that must be satisfied by all vendors ("Vendors") to principals of Li & Fung (Trading) Limited ("Li & Fung"). Li & Fung and its principals can supplement these requirements at any time.

**Child Labour:** Vendors shall not use child labour. A "Child" is defined as a person who is not older than the local age for completing compulsory education, but in no event is less than 15 years old. Vendors must verify the age of their workers and maintain copies of proof of age. Vendors must follow all applicable laws and regulations regarding working hours and conditions for minors.

**Involuntary Labour:** Vendor shall not use involuntary labour. "Involuntary Labour" is defined as work or service extracted from any person under threat or penalty for its non-performance, and for which the worker does not offer himself or herself voluntarily. It includes prison, bonded, indentured and forced labour.

**Disciplinary Practices:** Vendors shall not use corporal punishment, any form of physical or psychological coercion or intimidation against workers.

**Non-discrimination:** Vendors shall employ workers solely on the basis of their ability to do the job. They shall not discriminate on the basis of age, gender, racial characteristics, maternity or marital status, nationality or cultural, religious or personal beliefs in relation to hiring, wages, benefits, termination or retirement.

**Health and Safety:** Vendors shall maintain a clean, safe and healthy workplace in compliance with applicable laws and regulations. They shall ensure that workers have access to clean drinking water, sanitary washing facilities and adequate number of toilets, fire-extinguishers and fire exits. Workplaces should provide adequate lighting and ventilation. Vendors shall ensure that these standards are also met in any canteen and/or dormitory provided for workers.

**Environmental Protection:** Vendors shall comply with all applicable laws and regulations to protect the environment and maintain procedures for notifying the local authorities in the event of an environmental accident resulting from the vendors' operations.

**Wages and Benefits:** Vendors shall provide wages and benefits that comply with all applicable laws and regulations or match prevailing local manufacturing or industry rates, whichever is higher. Overtime pay shall be calculated at the legally required rate, regardless of whether workers are compensated hourly or by piece rate.

**Working Hours:** Vendors shall not require workers to work, including overtime, more than 60 hours per week or more than the maximum number of hours per week set by applicable laws and regulations, whichever is less. Vendors shall guarantee that workers receive at least one day off during each seven-day period.

**Freedom of Association:** Vendors shall respect the right of workers to associate, organize and bargain collectively in a legal and peaceful manner.

**Familiarization and Display of this Code of Conduct:** Vendors shall familiarize workers with this Code of Conduct and display it, translated in the local language, at each of their facilities in a place readily visible and accessible to workers.

**Legal Requirements:** Vendors shall comply with all legal requirements applicable to the conduct of their businesses, including those set out above.

**Contractors and Suppliers:** Vendors shall ensure that their contractors and suppliers adhere to this Code of Conduct.

**Monitoring of Compliance:** Vendors authorize Li & Fung and its principals to conduct scheduled and unscheduled inspections of vendors' facilities for ensuring compliance with the Code of Conduct. During these inspections, Li & Fung and its principals have the right to review all employee-related books and records maintained by vendors and to interview workers.

**Corrective Action:** When violations are found, Li & Fung and the vendor concerned will agree on a corrective action plan that eliminates the problem in a timely manner. If it is determined that a vendor is knowingly and/or repeatedly in violation of this Code of Conduct, Li & Fung and its principals shall take appropriate corrective action. This may include cancellation of orders and/or termination of business with that vendor.

provider might be appropriate for a product line, but an Indonesian supplier who used different raw materials and production technology might be a better choice for the needs and preferences of a specific customer. Li & Fung assembled the right modules for each job, customizing value chain solutions for its clients. Such flexible modules also meant that the company could quickly change its plans if there were unforeseen problems at the manufacturing site. The company could tap its worldwide network and send the order to another company to avoid delays in order fulfillment. For example, Li & Fung quickly shifted production from high-risk countries to lower risk countries following the September 11, 2001, terrorist attacks in the United States.

A major supplier management strategy of Li & Fung was to utilize anywhere from 30 percent to 70 percent of factory capacity of suppliers, ensuring that at such a capacity, the company would be one of their important customers. Most times, Li & Fung would be their largest customer. Li & Fung also ensured that it did not use up the entire capacity of any manufacturer to give itself flexibility. It did not want manufacturers to be completely dependent on the company. This strategy also enabled the company to gain exposure to new suppliers.

To improve suppliers' performance, Li & Fung managers, based on their interactions with them, provided a detailed performance feedback to each supplier, mentioning strengths and weaknesses. Faltering suppliers were dropped from a project or from the company's network if they failed to improve. According to analysts, as Li & Fung offered many economic incentives to suppliers, they willingly customized their own operations to fit Li & Fung's supply chain strategy. The major benefits to suppliers were substantial and steady business from Li & Fung and the opportunity to improve their performance, as the company set detailed benchmarks across its entire process network and gave all partners valuable insights into their specific strengths and weaknesses. It also helped them address performance gaps.

To further strengthen its supplier network, Li & Fung constantly looked out for new suppliers. The company evaluated the experience and skills of each prospect to determine whether its operational standards could be met. By the early 2000s, Li & Fung had an extensive network of over seventy-five hundred regular suppliers; each on an average had about two hundred employees. Li & Fung described itself as

a smokeless factory. Though it did not own any manufacturing concern, it was involved in various functions that qualified it as a manufacturer.

### Customer-Centric Organizational Structure

Li & Fung had an organizational structure that masked its size. In line with the transformation of the company's business strategy during the 1980s, Li & Fung revamped its organizational structure to manage its global sourcing network better and meet customer needs. The company discarded its traditional structure of geographic division as it found inefficiencies in this. During this period, all large trading companies in the world with vast supplier networks were organized geographically with country units as profit centers. Such a structure made it tough for the companies to optimize the value chains for their customers, as the country units competed against each other for business. The lack of cooperation and coordination among country units also resulted in loss of customers, affecting a company's business.

To eliminate this, Li & Fung adopted a new customer-centric structure, where it organized itself into various small customer-centric divisions.<sup>5</sup> Under the new structure, an entire division focused on serving a big customer such as The Limited, Levi's, Kohl's, and Abercrombie & Fitch. A single division aimed at fulfilling the needs of a group of smaller customers, with similar needs. For example, the company's theme-store division served a group of customers like Warner Brothers stores chain and Rainforest Café. According to company sources, this new model assisted them in creating a customized value chain for each customer order.

As part of its customer-centric strategy, Li & Fung created small divisions dedicated to serving one customer, and a person managing the unit as if it was his/her own company. Li & Fung hired people who were entrepreneurial in nature and whose ultimate aim was to run their own business. Thus, each division was run by a lead entrepreneur, designated as division manager, who was responsible for understanding customers' needs and fulfilling them by mobilizing resources from the group's sourcing and process network. For instance, the Gymboree division, which served

<sup>5</sup>In 2002, Li & Fung had about 120 business divisions across forty countries.

Gymboree, a leading U.S.-based clothing store, was headquartered in a separate office within the Li & Fung building in Hong Kong. It had forty plus employees focused on meeting Gymboree's needs. The division was further broken up into specialized teams in areas such as technical support, raw material purchase, quality assurance, merchandising, and shipping. Apart from the employees at its head office, the division also had dedicated sourcing teams across the branch offices of Li & Fung in China, Indonesia, and Philippines, the countries from where the division purchased in high volumes.

These divisions also promoted knowledge sharing during their interactions with customers, which benefited customers. Commenting on this, Frank Leong (Leong), CFO and head of the Operation Support Group (OSG), Li & Fung, said, "Our people sit down to share with them the latest information from the production side—what sort of material is hot, what new colours are available, where a product can be produced."<sup>6</sup> Such discussions not only expanded the fashion retailers' knowledge, but also gave them scope for more creativity and financial liberty in designing garments for a season. If required, the divisions also offered trade financing services to customers, through Letters of Credit (L/C).<sup>7</sup>

To preserve the entrepreneurial spirit, Li & Fung kept each division relatively small, with average revenues ranging between HK\$ 30 million and HK\$ 50 million. The company allowed each division to act as an independent unit with its own customers and profit and loss accounts. Li & Fung gave considerable freedom to division managers to run their divisions, as it believed that autonomy would encourage a free spirit. To further ensure the commitment of division managers, Li & Fung tied up their compensation to their division's bottom line. To motivate them to achieve their division's targets, the company gave out substantial financial incentives. Reportedly, Li & Fung did not fix any ceilings on bonuses. The company followed the same policy of performance

based compensation and incentives for other employees, too.

Li & Fung provided the divisions with all necessary financial resources and administrative support, mainly through the OSG, which provided back-end support to the entire group operations. The OSG supplied all divisions with personal computers and network connections, at a charge per PC, which covered the entire network, including order processing, production tracking, and e-mail communication. These charges were paid from the division's revenues.

The OSG also acted as an in-house HR provider, as it supplied recruitment services by internally matching staff from across various divisions, to meet some specific requirements of clients, and training them. It also acted as the divisions' chief banker as all divisional revenues finally went to the OSG. According to company sources, the divisions could take loans from the OSG at an interest rate cheaper than the market rate.

The OSG's performance was measured against its profit and loss account as was the case of any other division in the group. According to Leong, such a performance measurement strategy ensured that the OSG provided advanced high-quality services to its customers (other divisions) and at the same time optimized its costs.

The logic behind such an organizational structure was to allow each division to function like an independent company without worrying about back-end needs. Such a model provided the group with the flexibility of a small company, while having the strengths of a large, global company. As Leong said, "We're marrying the strength of being small and big together. Big companies tend to get bureaucratic, while small companies can do specialized products. Our small business units act extremely fast, but at the back-end, they get the level of service of a huge company."<sup>8</sup>

However, while Li & Fung believed in flexibility in some things, the company was highly conservative when it came to financial control and operating procedures. These were centralized and tightly managed. Li & Fung also maintained tight control over its working capital. All cash flows were centrally managed through headquarters in Hong Kong. For instance, L/Cs from all divisions came to headquarters for approval and were then reissued. The company

<sup>6</sup>"Asset Lite," [www.cfoasia.com](http://www.cfoasia.com), April 2002.

<sup>7</sup>A document, consisting of specific instructions by the buyer of goods, that is issued by a bank to the seller who is authorized to draw a specified sum of money under certain conditions, that is, the receipt by the bank of certain documents within a given time. A confirmed L/C is one issued by a foreign bank, which is validated or guaranteed by a Hong Kong bank for a Hong Kong exporter in the case of default by the foreign buyer or bank.

<sup>8</sup>"Asset Lite," [www.cfoasia.com](http://www.cfoasia.com), April 2002.

also had a standardized and fully computerized order executing and tracking system used by all divisions.

## Leveraging IT and the Internet

To leverage the potential of IT, Li & Fung took many initiatives through the mid 1990s. It tied up its global network of offices with intranet<sup>9</sup> since 1995, to enable free information flow. In 1998, the company began creating dedicated extranet<sup>10</sup> sites for major customers. These sites enabled the company to interact with customers, track their orders, help in product development, and perform many other tasks in a cost-efficient manner. The extranet also enabled customers to track their orders and gain access to related information through Li & Fung's Electronic Trading System, known as XTS, which was linked to Li & Fung's global network of offices.

The major benefits of a dedicated extranet site can be understood from the following example. In the late 1990s, Coca-Cola, the leading soft drinks company, and many of its independent bottlers worldwide, largely relied on merchandize tied to sporting events to promote the company's core brand, Coca-Cola. As Coca-Cola was mainly a beverage company, with no exposure to manufacturing, the company found managing the manufacturing activity (for its merchandise) expensive and outside its area of core expertise. The company also feared that its manufacturing process might be too slow to respond to sporting and entertainment events. As a result, in March 2001, the company turned to Li & Fung for managing its manufacturing activities. Li & Fung designed and built an extranet site, called Kodimsum.com (KO for Coke's stock symbol, and dimsum for a Hong Kong food delicacy), enabling Coca-Cola's executives and bottlers to place online orders. The extranet also allowed bottlers to check orders placed by other bottlers of the company, enabling them to place a similar order if they found that the product would be useful in their own markets.

<sup>9</sup>An intranet is a restricted-access network that works like the Internet. Usually owned and managed by a corporation, an intranet enables an organization to provide content and services to its employees across its various divisions, without allowing external people to view it.

<sup>10</sup>An extranet is an Internet site that is offered to a select group of people such as customers, suppliers, and business partners, usually to provide or share nonpublic information.

With the emergence of the Internet as a major communication medium, industry observers felt it would make trading companies like Li & Fung redundant. Li & Fung opposed this view, stating that the key to its business was not hardware but information and its application to the management of client supply chains. The company believed that instead of being a threat, the Internet and e-commerce would offer more opportunities by helping it drive supply chain costs down and integrating management of supply chain via IT. Analysts, too, felt that this was true. They said that the real value of Li & Fung's business model lay not just in its ability to link suppliers and buyers, but in its power to influence suppliers and manufacturers, with whom the company had a strong relationship of trust.

Thus, Li & Fung used the Internet as a tool to make supply chains more transparent. When Li & Fung received an order from a customer, it used extranet sites and the Internet to fine-tune specifications. It then took instructions from the customer and fed the information on to its intranet to find the right raw material suppliers and right factory or factories to assemble the product. The Web also aided customers in quickly assessing shifting consumer demands. Thus, as an order moved through different phases of production, customers could make last-minute changes through Li and Fung's website, which hosted real-time information on the entire production process.

This real-time tracking by customers was not possible until the mid-1990s, when Li & Fung began using phone and fax. For instance, when a customer ordered 50,000 khaki cargo pants, the company delivered the pants five months later, leaving the customer with little chance of altering their orders in line with changing market trends. By the early 2000s, once the Web-based communication system was established, customers could cancel their order until the time the material was woven, change the color until the fabric was dyed, and alter design or size until the fabric was cut.

In March 2000, Li & Fung announced its Internet strategy to enter the e-commerce market, through its Business-to-Business (B2B) initiatives. Li & Fung aimed at creating economies of scale and scope for small- and medium-sized enterprises by bundling their orders for the same products and then customizing the mass-produced product to meet the requirements of each customer.

Commenting on this, William said

Li & Fung has done private-label manufacturing for a long time. We can only do this if the customers are very large and they have the scale, since you need intensive interaction when you do private-label work. To capture economies of scale, we need large customers, not small ones.... What the Internet does is allow us to reach the small and midsize guys we could never reach before. What do they want? What the big guys have—a private label, their own differentiated line, and at the same price as the big guys.... The Internet allows us to reach those people—without intensive interaction—and to aggregate their orders. We can allow you different styles, limited customisation using American yarn, knitted in China, assembled in Bangladesh. And we can allow you to put in your own label, embroidery, colours, packages, boxes. We can reap the economics of mass production, but with enough customisation.<sup>11</sup>

As part of Li & Fung's Internet strategy, StudioDirect Inc. was formed in April 2000 as an e-commerce subsidiary of the company (57 percent controlling stake) with an investment of US\$19 million. StudioDirect's website, [www.studiodirect.com](http://www.studiodirect.com), launched in March 2001, allowed placement of highly individualized orders from small- and medium-sized retailers, enabling them to choose from a wide variety of fabrics, colors, and accessories such as cuffs, pockets, buttons, and embroidery. According to Li & Fung sources, StudioDirect had customization options that could satisfy 90 percent of the smaller retailers.

StudioDirect aggregated all orders placed on its website and put them on to Li & Fung's manufacturers, resulting in a series of private-label lines ready for delivery. To handle the logistics needed to deliver finished goods to retailers across the world, StudioDirect tied up with Danzas AEI Intercontinental, a business division of the Danzas Group, which specialized in logistics services and had already worked with Li & Fung.

StudioDirect was reportedly capable of beginning production within six hours of receiving an order from a client over the Internet. For marketing its B2B initiative, the company chose the strategy of direct mailing. Through this, the company aimed at reaching about one thousand small- and medium-sized retailers in the first year and expected to do business

of \$2 million with each of them, in the next five years. The initiative was launched in the United States in early 2001.

Analysts felt that Li & Fung, with its sound global sourcing network and strong financials (US\$ 270 million in cash reserves) was poised to establish itself as a strong player in the B2B market place. Commenting on what Li & Fung could provide small- and medium-sized customers with, Barnett, a Goldman Sachs's analyst, said, "A large company that uses Li & Fung typically pays 4% to 12% of the value of the order [because of economies of scale]. It's about 30% for a small company. Those costs come down to 4% to 12% if clients use the [studiodirect.com](http://studiodirect.com) Internet site."<sup>12</sup>

In the early 2000s, Li & Fung maintained Internet-based communication with all its major customers worldwide. About 75 percent of them were large retailers in the United States, who reaped significant benefits from the transparent SCM attained due to the use of IT and the Internet.<sup>13</sup> Laurence H. Alberts, managing partner, Mercer Management Consulting (Asia), said, "They [Li and Fung] are the leaders in Asia in providing this full solution of sourcing and supply-chain management. They've built up a very considerable barrier to anyone else trying to replicate it."<sup>14</sup>

## Global Expansion

During the late 1990s, with the growing popularity of private label brands, shortening product life cycles, and acute competition in the retailing industry, companies had to focus on their supply chain processes. As many companies did not have expertise in SCM and outsourcing was a cost-efficient alternative, the demand for companies that offered SCM services increased. Li & Fung, which already had an impressive sourcing network and SCM expertise, increased efforts to position itself as a global consumer goods trading company. The company devised an acquisition strategy to strengthen its position in the global trading market. The strategy aimed at expanding the sourcing network, product lines, and customer base.

<sup>12</sup>"Picking Asian Winners in the Internet Age," [www.asiaweek.com](http://www.asiaweek.com), 2000.

<sup>13</sup>However, in countries such as China, Bangladesh, Philippines, Africa, and the Caribbean, where communication systems are still underdeveloped, Li & Fung relied on personal visits, phones, faxes, and couriers to communicate information and manage operations.

<sup>14</sup>"Middleman Becomes Master," [www.chiefexecutive.net](http://www.chiefexecutive.net), October 2002.

<sup>11</sup>"A Different Kind of B2B Play in China?" [www.businessweek.com](http://www.businessweek.com), May 8, 2000.

In 1995, Li & Fung acquired Inchcape Buying Services (also known as Dodwell) from Inchcape Pacific, a leading British trading conglomerate. That company had an established network of offices in South Asia, the Mediterranean, and Caribbean regions, where Li & Fung had little or no presence. The acquisition nearly doubled the size and geographic reach of Li & Fung and brought with it a vast European customer base that complemented Li & Fung's strength in North America. The acquisition also contributed significantly to the company's success in achieving its three-year plan (1995–1998) target of doubling its profits from HK\$ 225 million in 1995 to HK\$ 455 million in 1998.

As a part of its proximity strategy, which aimed at producing products closer to the customer market (North America and Europe), Li & Fung began establishing and expanding its sourcing networks in regions such as the Mediterranean, Eastern Europe, North Africa, South Africa, and Central America in the late 1990s.

In December 1999, Li & Fung acquired Swire & Maclaine and Camberley Enterprises, the trading businesses of the Hong Kong-based group, Swire Pacific, for HK\$ 450 million. While Swire & Maclaine was a major provider of product sourcing and quality assurance services in Hong Kong, Camberley Enterprises made high-quality ladies sportswear, ready-to-wear garments, and home accessories. These acquisitions offered Li & Fung design process expertise and helped it further strengthen its customer base in the United States and Europe, by adding some major customers such as Laura Ashley and Ann Taylor. As Swire & Maclaine had been a major competitor of Li & Fung in Hong Kong, its acquisition helped Li & Fung further consolidate its business in Hong Kong and strengthened its position as one of the world's leading sourcing and supply chain management companies.

In November 2000, Li & Fung announced the acquisition of Colby Group Holdings Limited; a Hong Kong-based leading consumer goods trading company, for HK\$ 2.2 billion to consolidate its global competitive position further and helped it emerge as the largest consumer goods export trading groups in Hong Kong. Commenting on the rationale behind the acquisition, William said, "Colby has strong brand recognition, especially among US department stores. Its seasoned staff and diversified sourcing capabilities will complement our existing business. With this acquisition, we will be able to expand our

customer base and further penetrate what is an important new market segment."<sup>15</sup> Even after the acquisition, Colby continued to operate under its own company name as a subsidiary of Li & Fung.

In the early 2000s, Li & Fung focused its acquisition strategy on hard goods companies. In mid 2002, Li & Fung acquired Janco Overseas, a Hong Kong-based buying agent, specializing in hard goods, for HK\$ 249.6 million. According to company sources, the acquisition was expected to increase Li & Fung's turnover by HK\$ 1.4 billion. Reportedly, Janco's strengths in the hard goods segment and focus on large food retailers, who were rapidly expanding their nonfood offerings, was expected to strengthen Li & Fung's position in the hard goods segment. It was also expected to open up new customer segments and opportunities on account of expansion in its hard goods product portfolio.

In the fiscal year 2002, the hard goods segment accounted for 32 percent of Li & Fung's revenues compared with 28 percent in 2001. The segment registered a 29 percent increase in revenues and 70 percent in operating profits over 2001. Li & Fung sources said the acquisition of Janco was a major factor that contributed to such a significant growth in its hard goods business.

In August 2003, Li & Fung announced plans to purchase the remaining one-third stake in the group's New York-based garment importer unit, International Sourcing Group (ISG), for US\$ 5.22 million, from ISG's chief executive, Alan Chartash, who owned that stake. The acquisition was expected to increase Li & Fung's profitability. Victor said, "By further leveraging the group's financial resources, management strength and entrepreneurial corporate culture, it is envisaged that a more comprehensive service will be provided to ISG's customers."<sup>16</sup>

During the early 2000s, Li & Fung focused on expanding its customer base in non-U.S. markets to balance the group's overall revenue portfolio, which was highly skewed toward the United States. It concentrated on the fast developing economies in Asia and the Southern Hemisphere, where more and more companies were outsourcing manufacturing and SCM on account of increasing globalization and resulting competitive pressures that were forcing companies to optimize resources.

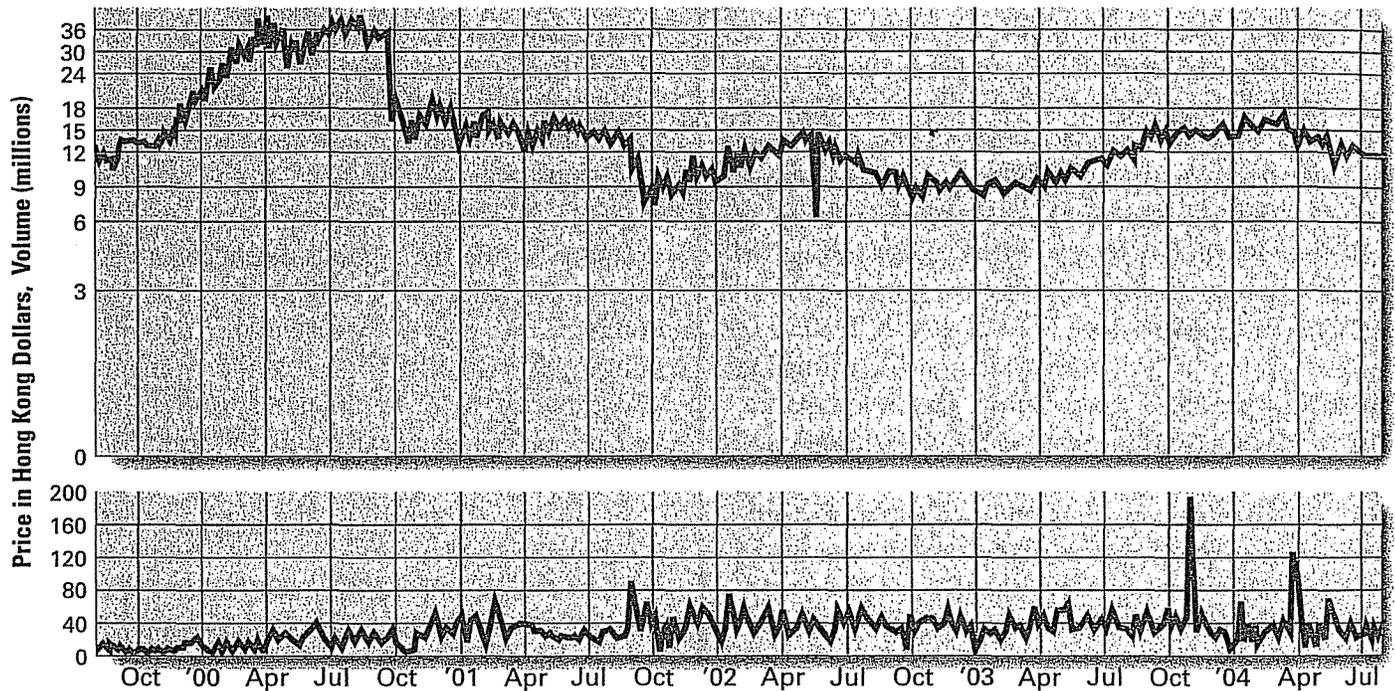
<sup>15</sup>"Li & Fung to Acquire Colby," [www.irasia.com](http://www.irasia.com), November 9, 2000.

<sup>16</sup>"Li & Fung to Buy Out Last Stake of US Unit," Hong Kong iMail (China), August 20, 2003.

## EXHIBIT 7

Li & Fung's Five-Year Stock Price Chart (August 1999–July 2004)  
(Price in HK\$, Volume in mns)

Source: [www.prophet.net](http://www.prophet.net).



Li & Fung identified Japan as a potential market, where the fashion retailing business was booming. In October 2003, Li & Fung entered into an alliance with Nichimen Corporation (Nichimen), a leading general trading firm in Japan, to offer higher value for Japanese retailers. This was possible due to the integration of Li & Fung's global sourcing network with Nichimen's customer servicing capabilities.

In December 2003, Li & Fung acquired the sourcing business of the Hong Kong-based Firstworld Garments Limited and the U.S.-based International Porcelain Inc. for US\$ 27 million. These two companies would together operate under the name "International Sources." They were expected to strengthen Li & Fung's presence in the hard goods business and enable it to reach out to Mexico.

### The Challenges

By the end of 2003, Li & Fung emerged as one of the few global consumer goods trading companies with geographic flexibility and depth of expertise required for success in the fiercely competitive business environment of the early twenty-first century. In the fiscal year ending December 31, 2003, the group's revenues amounted to HK\$ 42.6 billion, a 14.3 percent

rise over HK\$ 37.3 billion in 2002. Net profits amounted to HK\$ 1.22 billion in fiscal 2003, a 13.2 percent increase over the HK\$ 1.08 billion in fiscal 2002. In December 2003, the share price of Li & Fung was quoting around HK\$ 13 (see Exhibit 7).

However, according to company sources, revenues and profits were below expectations. The Iraq War,<sup>17</sup> the SARS epidemic,<sup>18</sup> and poor business

<sup>17</sup>The U.S. government believed that the Osama Bin Laden led terrorist organization, Al-Qaida, which was responsible for the September 11, 2001, terrorist attacks on the World Trade Center in the United States, may obtain weapons of mass destruction (WMD) from Iraq. As Iraq was ruled by Saddam Hussein (Hussein), who was openly hostile to the United States, the U.S. officials considered it a severe threat to the country's security, and felt the need for preemptive war against Iraq to prevent further damage from occurring in the United States. In March 2003, the United States declared war against Iraq (the second war, the first being in January 1991), called "Operation Iraqi Freedom." In May 2003, the U.S. Army captured Tikrit, the birthplace of Saddam Hussein. Saddam himself was captured in December 2003.

<sup>18</sup>According to [www.cdc.gov](http://www.cdc.gov), Severe Acute Respiratory Syndrome (SARS) is a viral respiratory illness caused by a corona virus called the SARS associated corona virus (SARS-CoV). The first case of SARS was reported in Asia in February 2003. Within a few months, the illness spread to more than twenty-four countries throughout the world. The outbreak of SARS in the Asian region severely damaged its economic performance—the hardest-hit business was the region's tourism industry.

performance in the holiday season of some major customers were cited as reasons. The drop in the group's nontrading income also had an unfavorable effect on overall financial results. Reportedly, the net loss from Li & Fung's venture capital business amounted to HK\$ 8 million in the fiscal 2003.

That year, the soft goods segment accounted for 67 percent of Li & Fung's total revenues, while hard goods accounted for the remaining 33 percent. Geographically, North America continued to be the company's largest export market, accounting for 75 percent of its total revenues. It was followed by Europe (19 percent), East Asia (3 percent), and the Southern Hemisphere (3 percent). As part of achieving its three-year plan (2001–2004) goal of doubling profits by the fiscal 2004, Li & Fung announced that it would continue its aggressive acquisition drive, focused at non-U.S. companies, and new product lines that could open up more revenue opportunities.

In August 2003, Li & Fung finalized a licensing agreement with Levi's, under which the former would design, manufacture, and market clothing under the latter's Levi Strauss Signature label. According to company sources, these products would be marketed in the United States by late 2004. In early 2004, Li & Fung also signed similar licensing deals with Official Pillowtex LLC, a U.S.-based company that owned the Royal Velvet linen brand. Commenting on these deals, William said, "Leveraging our strong position in the supply chain, we are building a higher-margin business model of licensing well-known brand names. This new business model will augment our core sourcing business and will be an important growth driver for the group in our next three-year plan for 2005–2007."<sup>19</sup>

By mid-2004, Li & Fung had an extensive network of over 65 offices in 40 countries worldwide, managed by a dedicated employee base of over 6,000. Reportedly, the company faced very little competition, which analysts attributed to its unique positioning as a supply chain manager for its clients and its focused acquisition strategy. William E. Connor & Associates (WEC&A), an American-owned, Hong Kong-based trading company, was the closest competitor to Li & Fung in Hong Kong as textiles was WEC&A's major product line. But, as WEC&A focused on large department store customers and

Li & Fung concentrated on specialty store chains, analysts felt that competition between them was not intense (see Exhibit 8).

While Li & Fung's business model might seem error free and its future bright, analysts were quick to point out that every business had its negative side, and Li & Fung also had made miscalculations. They said the company's much hyped B2B initiative "StudioDirect," had failed to get the expected response, forcing Li & Fung to restructure its operations. In 2002, Li & Fung converted StudioDirect from a full-service e-commerce company into a private label golf-wear specialist, offering services to customers through the Internet. The company also reduced its stake in StudioDirect from 57 percent to 15 percent. Li & Fung attributed this restructuring to changes in market conditions in the United States, which were not conducive to the growth of StudioDirect's business. It stated that it was still committed to e-commerce, and its aim was to reach smaller and midsized retailers. However, even by early 2004, StudioDirect had failed to make major progress on this front.

The continuous fall in the annual growth of revenues and profitability through the early 2000s was also perceived as an area of concern by many analysts (see Exhibit 9). While Li & Fung registered a high growth in revenues and profit after taxation of 53.35 percent and 49 percent, respectively, for the fiscal year ending December 31, 2000, the growth in revenues and profit after taxation came down to 14.35 percent and 12.06 percent, respectively, by the fiscal 2003. Analysts felt that the sharp decline in the share of overall revenues derived from European markets, during the early 2000s, was not a good sign for the company. They felt the company had failed to come up with effective strategies to increase revenue share from the European market, which, next to the United States, had immense potential for fashion goods, especially garments, Li & Fung's major business. They criticized Li & Fung for failing to build on the opportunities provided by its acquisition of Inchcape Buying Services, which had a strong presence in Europe.

Analysts also felt that Li & Fung's high dependence on large retailers, especially in the United States and Europe, might prove a threat for the company in the long run, given the uncertainties in the retailing industry. They pointed out that a major consolidation in the North American retailing industry, Li & Fung's largest export market, might severely affect the company's business. For instance, if a retailing giant such as Wal-Mart,

<sup>19</sup>"Hong Kong Li & Fung Posts 13% Net Profit Rise on Sales Growth," [www.prophet.net](http://www.prophet.net), March 24, 2004.

**EXHIBIT 8****A Note on Hong Kong's Export Trade Industry****The Export Trade Industry:**

Hong Kong has always been one of the world's major export trade centres. Until the 1970s, Hong Kong was a manufacturing economy, supplying the world with textiles, handbags, toys, plastic flowers, watches and footwear. Most of its exports were to the US and Europe. After the Chinese economy was liberalized in 1979 (initially only some coastal regions were opened up for foreign investors) many companies across all the major industrial segments and trading companies in Hong Kong moved the labour-intensive part of manufacturing to China.

The rapid industrialization of Asian countries from the 1980s resulted in expansion of production capabilities in the manufacturing sector and related supporting services especially in other low cost countries like Taiwan and Korea. This in turn led to trading companies expanding their sourcing reach beyond China to optimise sourcing costs for their clients. By the late 1990s, Hong-Kong emerged as a service economy with 84% of GDP derived from services. According to a survey by the Hong Kong Trade Development Council (TDC) in 1998, 64% of international buyers sourced China-made products through trading companies in Hong Kong. The country's strategic location, good physical infrastructure, expertise in international trade and well-established legal framework made trading reliable, simple and convenient. By the turn of the 20th century, Hong Kong became one of the world's largest export trade countries.

In 2001, Hong Kong earned HK\$ 106 bn from exporting trade-related services, accounting for 32.7% of total services exports. In 2002, one in five employed persons in Hong Kong were engaged in the import-export trade. The sector produced a net output of HK\$ 249 bn and accounted for 21% of Hong Kong's GDP. In 2002, there were more than 1,133 companies involved in the wholesale, retail and import and export trade businesses.

In the early 2000s, off shore export trading was increasing rapidly on account of many factors. The use of advanced technology, sophisticated production processes and on-site inspections by trading firms eliminated the need for further processing of products like final assembly, packaging and imposing quality control procedures. At the same time, the increased availability of cost-effective and reliable transport services contributed to the rise in off shore export trade. Some expected changes in the regional trade regimes including the China-ASEAN Free Trade Agreement and the Closer Economic Partnership Arrangement (CEPA) between Hong Kong and mainland China were expected to further boost the trading industry in Hong Kong.

In 2003, Hong Kong was the world's freest and 10th largest trading economy. It was a major trading centre with total merchandise trade amounting to US\$ 457 bn, equivalent to 289% of GDP for that year. Major exports included clothing, electrical machinery, apparatus, textiles, jewelry, insurance services, financial services, transportation and travel services. In 2003, Hong Kong earned US\$ 287.9 bn from exporting goods and services. Major export trading partners included mainland China (39.3%), US (21.3%), Japan (5.4%) and the UK (3.5%). With trading volumes of such magnitude, Hong Kong became a leading sourcing hub in the Asia-Pacific region in the early 21st century.

**Export Trading Firms in Hong Kong:**

Export trading firms in Hong Kong can be divided into three categories:

**Left hand-right hand traders:** Traditional trading firms that matched sellers and buyers but did not add significant value. These firms identified goods produced in Hong Kong or neighbouring countries and shipped them to their customers.

**Traders with some value-added services:** These firms, apart from sourcing raw material for their customers, offered some additional value such as providing trade finance and freight forwarding services.

**Traders with sophisticated value-added services:** These exporting firms went beyond traditional trading services. Additional services included product designing and development, manufacturing prototypes, offering supply chain management services, undertaking distribution and delivery of finished goods.

Hong Kong's export trading firms source garments, toys, electronic items and other manufactured goods. The sourcing activities are of three types:

- Sourcing goods produced in Hong Kong.
- Sourcing goods from the Asian region for re-export from Hong Kong.
- Sourcing goods from one country for direct shipping to another country, without touching Hong Kong. This is called offshore trade.

Trading firms in Hong Kong usually specialize in one product. In most cases, they offer shipping services to customers and manage their own warehousing facilities. Such facilities enable exporters of durable goods to offer better customer service, as a certain quantity of stock is always readily available for shipment. For goods like textiles, trading firms use temporary storage, with emphasis placed on prompt dispatch for shipping.

**EXHIBIT 8** (continued)

## A Note on Hong Kong's Export Trade Industry

Most export trading firms in Hong Kong are closely involved in manufacturing activities, though indirectly, as actual production is usually sub-contracted. Short production cycles, a preference for smaller quantities of more product lines and keeping tight deadlines ensured that companies met customer needs. They provided supplier factories with advanced production techniques and know-how and helped solve production bottlenecks.

**Profile of William E. Conner & Associates (Li & Fung's Major Competitor):**

William E. Conner & Associates (WEC&A) was founded in 1949 in Tokyo and moved to Hong Kong in 1985. It is one of the major export trade companies in Hong Kong in the early 21st century and the closest competitor to the market leader, Li & Fung, in the consumer goods trading market. WEC&A optimised the supply chain for its clients by managing every aspect of sourcing, right from product design & development to distribution and delivery of the finished product. The company's products included apparel, fabrics, fashion accessories, footwear, decorative accessories, textiles, housewares, furniture, lighting, office products, stationery and fashion-related products.

In the early 2000s, WEC&A had a global network of 35 offices in 20 countries. With an employee base of over 1,400, the company fulfilled the requirements of over 70 customers, which included leading department stores, specialty stores, catalogue companies, e-commerce retailers and importers, mainly in North America, Australia, Europe, Latin America and Japan. In 2002, WEC&A's net worth amounted to US\$ 850 mn.

Sources: [www.tdc.trade.com](http://www.tdc.trade.com) and [www.weconnor.com](http://www.weconnor.com).

**EXHIBIT 9**

## Li &amp; Fung—Consolidated Statements of Income (1997–2003)

Year Ending December 31	2003 HK\$'000	2002 HK\$'000	2001 HK\$'000	2000 HK\$'000	1999 HK\$'000	1998 HK\$'000	1997 HK\$'000
Continuing operations	42,630,510	37,281,360	32,941,392	24,992,227	16,297,501	14,312,618	13,345,722
Discontinued operations	—	—	87,183	791	—	—	—
<b>Total Turnover</b>	<b>42,630,510</b>	<b>37,281,360</b>	<b>33,028,575</b>	<b>24,993,018</b>	<b>16,297,501</b>	<b>14,312,618</b>	<b>13,345,772</b>
Counting operations	1,285,952	1,134,605	904,520	830,223	592,885	469,501	361,289
Discontinued operations	—	—	(237,955)	(39,375)	—	—	—
<b>Gross Profit</b>	<b>1,285,952</b>	<b>1,134,605</b>	<b>666,565</b>	<b>790,848</b>	<b>592,885</b>	<b>469,501</b>	<b>361,289</b>
Interest income	38,373	49,581	112,837	140,330	43,830	56,093	37,772
Interest expenses	(9,813)	(8,987)	(12,464)	(20,585)	(32,243)	(61,346)	(6,270)
Share of profit less losses of associated companies	2,015	393	1,443	13,677	9,389	6,850	6,666
Profit before taxation	1,316,527	1,175,592	768,381	924,270	613,861	471,098	399,457
Taxation	(105,513)	(94,896)	(55,637)	(64,178)	(36,638)	(16,425)	(25,326)
Profit after taxation	1,211,014	1,080,696	712,744	860,092	577,223	454,673	374,131
Minority interests	12,104	(228)	69,567	10,296	(2,585)	495	974
Continuing operations	1,223,118	1,080,468	951,307	893,118	574,638	455,168	375,105
Discontinued operations	—	—	(168,996)	(22,730)	—	—	—
<b>Net Profit</b>	<b>1,223,118</b>	<b>1,080,468</b>	<b>782,311</b>	<b>870,388</b>	<b>574,638</b>	<b>455,168</b>	<b>375,105</b>

Source: Li & Fung Annual Report, 2003.

which rarely outsourced its manufacturing activities, acquired other major American retailers, or put them out of business, it could lead to an 8 percent to 10 percent cut in margins for Li & Fung. Such consolidation might also result in only a few large retailing giants surviving (with other companies either having been acquired or forced to quit) in the market, which might also have severe implications on Li & Fung's revenues. This was because the company mainly derived its revenues from a large base of companies in the United States, with revenues of over US\$ 100 million.

Analysts further added that Li & Fung's hopes of benefiting from increased manufacturing activity in China to strengthen its competitive position in the United States, after the removal of the quota system in January 2005, might fail. They were of the view that according to WTO rules, the United States and Europe were entitled to impose "antisurge" quotas until the end of 2008, in case they felt any threat to domestic industry from exports. Antisurge quotas restricted annual growth of imports from a country to

7.5 percent per product category. Analysts also said that it was very likely that the antisurge quotas would come into existence in 2005.

Despite these challenges, industry observers felt that with Li & Fung focusing on expanding its customer base outside the United States, especially in Asia, in the years to come the company could reduce its dependence on the United States, its largest market. Meanwhile, Li & Fung had already achieved considerable success in lessening its dependence on soft goods over the years, reducing some risks in its business.

Media reports expressed optimism for Li & Fung's future. They wrote that the company, powered by its depth of sourcing knowledge and positioning as an efficient manager of global supply chains, was well poised for growth, in the light of increasing globalization. An *Economist* article had quoted in 2001, "Li & Fung appears to have as bright a future as globalisation itself."<sup>20</sup>

<sup>20</sup>"Li & Fung: Optimising Supply Chain for Other Companies," *The Economist*, May 31, 2001.