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F. WARREN MCFARLAN
FRED YOUNG

Li & Fung (A): Internet Issues

"I'm not an Internet guy, I'm a business guy," quipped William Fung, managing director of Li & Fung Trading Co. Clad in his chinos and black American Eagle T-shirt, Fung looked much more like a new economy entrepreneur than the self-described offline, old economy relic: "I'm 51, I'm more than a grey hair in Internet terms, I'm a fossil."[1] Nor did lifung.com, his elder brother Victor's new online company, resemble a typical Internet start-up, particularly with a 96-year parent born at the end of the Qing Dynasty. In August 2000, the day before beta launch of the new business-to-business (B2B) e-commerce portal, William described the challenges facing Li & Fung:

> About three or four years ago, Victor and I discussed the Internet and how it impacts us. Our starting point was a defensive posture: Would the Internet disintermediate us? Would we get Amazoned[2] by someone who will put together all of the information about buyers and factories online? After a lot of research we realized that the Internet facilitates supply chain management and we weren't going to be disintermediated. The key is to have the old economy know-how and yet be open to new economy ideas.

With a press conference the following day, William was confident of the Group's performance and lifung.com's prospects. But he knew that important issues remained unresolved: Was there any chance of channel conflict or cannibalization between the offline business and the startup? How would the market react to the start-up once it was launched the following year? And how specifically would e-commerce ultimately transform his family's century-old company?

Company Background[3]

Li & Fung was founded in 1906 by William's grandfather, Fung Pak-Liu and his partner, Li To-Ming in Guangzhou, China as an export trading company in Southern selling to overseas merchants. In the 1920s and 1930s the company diversified into warehousing and the manufacture of handicrafts.

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[1] Rahul Jacob, "Inside Track: Traditional Values at the Click of a Mouse," *Financial Times*, August 1, 2000, p. 14.

[2] Online bookseller Amazon.com had decimated the ranks of independent booksellers by aggregating services and offering a broader selection of stock at lower prices than the small bookstores could.

[3] Some information in this section comes from previous Harvard Business School Case Studies: "Li & Fung: Beyond "Filling in the Mosaic"—1995-98," Michael Y. Yoshino, Carin-Isabel Knoop, Anthony St. George; January 1, 1998; and "Li & Fung (Trading) Ltd.," Gary Loveman, Jamie O'Connell, October 26, 1995.

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Shortly after Fung Pak-liu passed away in 1943, his son Fung Hon-Chu assumed charge of the company. Two years later, silent partner Li To-Ming retired and sold his shares to the company. The company retained Li's surname, a homophone for "profit" in Chinese, which, along with "Fung," a homophone for "abundance," had an auspicious ring when combined.

Li & Fung relocated permanently to Hong Kong at the end of World War II, expanding its operations to include toys, garments, plastic flowers, and electronics. In the early 1970s, both Fung brothers had just returned from the United States: William had earned his MBA from Harvard Business School and returned to the business in 1972. Victor had recently completed his Ph.D. in economics at Harvard University and, following a two-year stint teaching at Harvard Business School, rejoined the business in 1974. Their return heralded Li & Fung's transition from a family-owned business to a professionally managed firm, with a planning and budgeting system in place for the first time. William and Victor, the third generation to run the company, felt that the next logical step in growing the company was to go public. In 1973, Li & Fung became the holding company for the Group and was listed on the Hong Kong Stock Exchange. Throughout the 1980s, Li & Fung expanded its regional network of offices throughout the Asia-Pacific region as more sources of supply emerged in the rapidly industrializing Asian economies. In 1988 the Group was privatized and streamlined, incorporated in Bermuda in 1991, and its trading activities were listed on the HKSE in July 1992. With the 1995 acquisition of Inchcape Buying Services (formerly Dodwell), Li & Fung expanded its customer base in Europe while simultaneously shifting its sourcing network beyond East Asia to include the Indian sub-continent, the Mediterranean, and Caribbean basins.

By 2000, Li & Fung was a $2 billion global export trading company with 3,600 staff worldwide, sourcing and managing the global supply chain for high-volume, time-sensitive consumer goods. (**Exhibit 1** shows recent Li & Fung financial data.) By 2000, 69% of Li & Fung's sales were in the United States and 27% in Europe. Key customers included The Limited, Gymboree, American Eagle, Warner Brothers, Abercrombie & Fitch, and Bed, Bath, & Beyond. Tesco, Avon Products, Levi-Strauss, and Reebok had become customers within the last two years; Royal Ahold, Guess Jeans, and Bebe had signed on in 2000.

Li & Fung's product mix included hard and soft goods. Soft goods referred to apparel, including woven and knit garments for men, women, and children. Hard goods included fashion accessories, festive or holiday products, furnishings, giftware, handicrafts, home products, fireworks, sporting goods, toys, and travel goods. Hard goods provided higher margins than soft goods because, despite a generally lower item value per unit, they required higher value-added services for orders that were also usually much smaller than soft goods orders. Hard goods items such as watches, shoes, suitcases, kitchenware, or teddy bears required an inspector for quality control evaluation for even the smallest batch order, thereby greatly increasing what Li & Fung could charge. Margins for soft goods were roughly 6% to 8%, while margins on hard goods ranged anywhere from 10% to 30%, depending on the degree of complexity involved in sourcing raw materials. Li & Fung attempted to expand its sale of hard goods. In 1998 soft and hard goods contributed 77.5% and 22.5% of total sales, respectively, while the proportion of hard goods sales grew to 25% in 1999 and was projected to increase to 27% in 2001 and 29% in 2002.

Holistic Supply Chain Management

Although Li & Fung described itself as a trading company, by 2000 it was far more sophisticated than a typical Hong Kong import-export trading company and had come a long way from its roots in matching Chinese manufacturers with Western buyers:

> We have been changing. Now we're orchestrating a whole production process that starts from raw materials all the way through to finished product. If you look at the old days, language skills could guarantee you margins better than we have now. My grandfather used to charge 15% or more, basically to be an interpreter. Those days are over.[4]

With 48 offices in 32 countries, the company provided value-added services across the entire supply chain in a so-called "borderless" manufacturing environment (see **Exhibit 2**). A down jacket's filling, for example, might come from China, the outer shell fabric from Korea, the zippers from Japan, the inner lining from Taiwan, and the elastics, label, Velcro, and other trim from Hong Kong. The garment might be dyed in South Asia, stitched in China, then sent back to Hong Kong for quality control and finally packaged for delivery to The Limited or Abercrombie & Fitch. Victor explained:

> Say we get an order from a European retailer to produce 10,000 garments. We determine that, because of quotas and labor conditions, the best place to make the garments is Thailand. So we ship everything from there. And because the customer needs quick delivery, we may divide the order across five factories in Thailand. Effectively we are customizing the value chain to best meet the customer's needs. Five weeks after we received the order, 10,000 garments arrive on the shelves in Europe, all looking like they came from one factory.[5]

Li & Fung clients benefited in several ways: supply chain customization could shorten order fulfillment from three months to five weeks, and this faster turnaround allowed clients to reduce inventory costs. Moreover, in its role as a middleman, Li & Fung reduced matching and credit risks, and also offered quality assurance to its customers. Furthermore, with a global sourcing network and economies of scale, Li & Fung could offer lower cost and more flexible sourcing than its competitors. In addition, through acquisitions and global expansion, Li & Fung was extending this knowledge base to sub-Saharan Africa, Eastern Europe, and the Caribbean. Finally, Li & Fung provided up-to-date fashion and market trend information to clients. As a result of its Camberley acquisition in 1999 it started offering clients virtual manufacturing, or product design services.

According to Victor, "Li & Fung does not own any of the boxes in the supply chain, rather we manage and orchestrate it from above. The creation of value is based on a holistic conception of the value chain." In recent years, however, Li & Fung had begun to improve operations by controlling or owning strategic links in the chain. In some cases, Li & Fung offered raw material sourcing. In the past when clients placed an order, Li & Fung would determine the manufacturer best suited to supply the goods, and that factory would source its own raw materials. But Li & Fung understood its clients' needs better than its manufacturing plants did, so by offering raw materials to its suppliers, the company both ensured greater quality control and bought larger and thus more cost effective amounts of raw materials, thereby producing cost savings for each manufacturer. In such cases, Li & Fung also earned revenue by charging its factories a commission on each raw material purchase they made. By mid-2000, nearly 15% of Group sales involved Li & Fung's raw material sourcing service.

Corporate Culture and Compensation

From the 1992 privatization on, the division of labor between the Fung brothers was clear-cut: as Group chairman, Victor was primarily concerned with the Group's strategic issues and long-term

[4] Gren Manuel, "Technology Journal: Historic Trader Keeps Its Cool—Li & Fung Says It's Found a Place in the Internet Economy," *The Asian Wall Street Journal*, March 27, 2000, p. 15.

[5] Joan Magretta, "Fast, Global, and Entrepreneurial: Supply Chain Management, Hong Kong Style, An Interview with Victor Fung," *Harvard Business Review*, September-October 1998, p. 106.

planning. As Group managing director, William attended to everyday operations of the publicly listed trading arm, or as he joked in a recent interview, "Victor is the deep thinker, and I just make the money."[6] In another interview, Victor joked that "William calls me the visionary, meaning that I don't really know what's going on."[7] But both brothers lived in the same apartment building as their mother and sisters and conversed every day to keep abreast of developments at Li & Fung. The duo created a strong synergy that was described by the CEO of the Group's e-commerce venture as

> a combination of both thought leadership and execution, with the unique relationship between Victor and William cementing the entire organization. They create a very particular kind of culture that blends pragmatism and, at the same time, a recognition of and openness to innovation.

According to Victor, once the business was successful, it was essential to keep an open mind and rather than resting on their laurels, that the challenge was to move past success and look forward. Furthermore, Victor held that it was imperative to cultivate a corporate culture that not only tolerated but encouraged diversity, or in his words, "keep the culture so that it remains humble, agile, and responsive all the time and keep the people externally focused." Bi-annual retreats were held in Hong Kong, senior management meetings attended by division-level managers in order to foster communication across the group.

Li & Fung's 3,600 employees were spread around the globe in offices ranging in size from 6 staff in Saipan to 1,100 in the Hong Kong head office. Five of the 48 offices were hubs—Hong Kong, Taiwan, Korea, Thailand, and Turkey. Each (except the Hong Kong office) had 200 to 300 employees. Li & Fung was entrepreneurial, allowing senior managers to run 90 small, worldwide management teams as separate and individual companies. These dedicated teams of product specialists focused on the needs of specific customers and were grouped under a Li & Fung corporate umbrella that provided centralized IT, financial, and administrative support from Hong Kong. This decentralized corporate structure allowed for adaptability and rapid reaction to seasonal fashion shifts.

As a meritocracy, performance-based promotion and compensation were cardinal principles. Each of Li & Fung's top executives negotiated individual compensation packages. In contrast to companies that restricted executive bonuses to a fixed percentage of salary, Li & Fung bonuses were based on profits with no ceiling.

> It's not every company that calls its executives "little John Waynes." But for Li & Fung, the image captures perfectly the drive, dedication, and independence of the company's far-flung managers. As Li & Fung extended its geographic reach, it also expanded its mix of cultures. And to manage the mix it uses a simple formula: give managers the freedom to work as they see fit, so long as they get the job done.[8]

Tripartite Growth Strategy

In 2000 Li & Fung saw its future growth coming from a combination of organic growth, expansion through acquisition, and extension of its supply chain to new markets via the Internet.

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[6] Louis Kraar, "The New Net Tigers," *Fortune Magazine*, May 15, 2000, p. 310.

[7] Joanna Slater, "Masters of the Trade," *Far Eastern Economic Review*, July 22, 2000, p. 10.

[8] Joanna Slater, "Corporate Culture," *Far Eastern Economic Review*, July 22, 1999, p. 12.

Organic Growth

Since 1995, the Group had grown organically by receiving more orders from existing clients and by securing new mandates from strategic clients. Li & Fung further extended its network and diversified its sourcing around the globe with new offices in places as diverse as Bangladesh, Sub-Saharan Africa, and Manchester, England (see **Exhibits 3** and **4**).

In 1996 Li & Fung adopted a "three-year plan" system, one which William described as having been adopted directly from the economic planning system of the Chinese Communist Party, one that "allows the company to look ahead, but not too far ahead." William elaborated:

> We thought that the Chinese had a neat system. They have five-year plans, fixed; we have three-year plans, fixed. We don't want moving goalposts, we want set goals. At the beginning of every three-year plan we sit down and look at the business from its fundamentals. We use backwards planning, we recognize where we want to be in three years time, identify the gaps between that and where we are now, and see what we have to do to get there.

During its first three-year plan (FY1993-1995), entitled "Filling in the Mosaic," Li & Fung focused on filling in the gaps in its network of offices to cover new sourcing markets. The second three-year plan (1996-1998), "Margin Expansion," was launched immediately after the Inchcape acquisition to increase its profitability. A third three-year plan "Doubling Profits" (FY1999-2001), established the goals of doubling profits every three years and achieving $3 billion in annual sales.

Investors liked the results: Li & Fung outperformed the Hang Seng Index by over 75% in 2000. The reward was inclusion in the Morgan Stanley Country Index for Hong Kong in May 2000, subsequent inclusion in the HSI in August 2000 and on the FTSE World Index Hong Kong Section in September 2000. With a market capitalization of $6.6 billion, by mid-2000 Li & Fung was the nineteenth largest Hong Kong stock trading with a company record price to earnings (P/E) ratio of nearly 60x. A local newspaper declared:

> It is difficult to find a bad word [about Li & Fung]. It could be a poster-child for shareholder value, with a return-on-equity of 60.2% at the end of last year. The firm is well positioned to benefit from the opening of the mainland market and Beijing's accession to the World Trade Organization, with 40% of sourcing on the mainland and Hong Kong.[9]

Acquisitions

Li & Fung's acquisition strategy was based on buying rival sourcing companies, thereby gaining new client accounts, integrating their operations, and eventually bringing the operating margins of these acquired units up to Li & Fung levels. In 1995 Li & Fung acquired Inchcape Buying Services, a 100 year-old company roughly the same size as Li & Fung and its closest competitor. The Dodwell acquisition brought access to sourcing markets on the Indian subcontinent and European export markets. This acquisition took nearly three years to be fully absorbed into Li & Fung's operations. Within three years, Dodwell's operating margins increased from 0.8% to 3%, primarily through the provision of Li & Fung value-added services to Dodwell customers.

In December 1999, Li & Fung acquired the export trading operations of the Swire Group, Swire & Maclaine and Camberley, which were Li & Fung's next two largest Hong Kong-based competitors, and in the process became the only listed supply chain management company in Hong Kong. Like Li

[9] David Wilder, "Internet Key to More Gains for Li & Fung," *South China Morning Post*, September 4, 2000, Business Post, p. 1.

& Fung, Camberley did not own its own factories. Instead, it provided "virtual manufacturing" in the form of in-house design, pattern and sample making, and raw material sourcing. Manufacturing was subcontracted to factories in China. Through Camberley, Li & Fung gained access to the design process—another link in the value chain—as well as access to new clients such as the Asia buying offices of Laura Ashley and Anne Taylor. As it had with Inchcape, Li & Fung expected to bolster its own bottom line by raising the operating margins of these two companies. With a robust cash flow and the solid financial performance of past acquisitions, Li & Fung was in position to continue growing its business by further acquisitions.

By August 2000, Li & Fung was nearly five times the size of its two closest local competitors, William E. Connor and Associates and Colby International, which had twice postponed the IPO of its B2B portal in 2000.

E-Commerce

A core element of Li & Fung's three-year planning system included an introspective look at "whether we are still relevant, including whether or not we are going to be disintermediated." Part of its response was an internet initiative of its own. In 1995 Li & Fung launched an Intranet to link the Group's offices and manufacturing sites around the world, thereby expediting and simplifying internal communications. The progress of orders and shipments could be tracked in real time and digital imagery allowed for online inspection and troubleshooting. For example, past quality problems with Bangladeshi production would require an on-site Li & Fung inspector to send physical samples to Hong Kong by express mail, whereas the Intranet now allowed a high resolution digital photo to be sent via the Intranet for real-time response and remedy.

In 1997, Li & Fung launched secure Extranet sites. Each site linked the company directly to a key customer and was customized to that customer's individual needs. By 2000, 10 such Extranets were in place, each taking nearly 6-9 months to fully implement, from design to testing of the user interface. Through each Internet site, Li & Fung could carry out online product development as well as order tracking, obviating much of the cost and time necessary to send hard copies of documents back and forth. Furthermore, with Li & Fung as the key link between manufacturers and retailers, the Extranet provided a platform for the two to interface, thus streamlining communications as the order moved through the supply chain. Customers could track an order online just as it was possible to track a UPS delivery. This monitoring of production also promoted quick response manufacturing. Until the fabric was dyed, the customer could change the color; until the fabric was cut, the customer could change the styles or sizes offered, whether a pocket or a cuff would be added, and a number of other product specifications. According to William, some customers went as far as connecting their entire ERP (enterprise resource planning) system to Li & Fung's Extranet system.

Li & Fung's IT division had 60 people, all based in Hong Kong, but software development of both the Intranet in 1995 and its Extranets in 1997 was outsourced.[10] Successful implementation of these systems provided the initial building blocks of Li & Fung's e-commerce solution and with them in place, the Fungs became further aware of the extent to which integration of Internet technology enhanced internal efficiency and improved communication between Li & Fung divisions and customers and began to consider extending the organization's online presence.

[10] See **Appendix A** for more details on the Intranet and Extranet.

Competitive Threats

The Fung brothers said that they decided to go online to avoid being disintermediated. But a closer examination of local B2B portals and online exchanges led Victor to conclude that the online threat to their offline business was far less than first imagined. "People from the first wave were so far out and garbled in their thinking that we felt that there was no immediate threat," he noted, "Therefore, we needed to think through e-commerce properly, to formulate a proper response."

In Victor's words, B2B exchanges were "a molecule thick and a mile wide, " based on many depthless relationships. Li & Fung preferred "narrow and deep" relationships nurtured with fewer customers and including value-added services. As William professed, "The same reason why we were not disintermediated by the offline guys is going to be the reason why we're not going to be disintermediated by the online guys."

However, William discovered on a 1999 visit to the United States that Li & Fung's old economy retail customers felt seriously threatened by Internet pure plays. At first this hype did not make much sense:

> I asked my friend at Toys 'R' Us, "Why are you concerned about eToys? It does about $28-$30 million in sales whereas you do $11 billion, and it loses as much as its entire turnover? How can you worry about them?" And the first lesson I learned was that it's not their size that is the threat but the fact that investors are throwing money at them.

William discovered that Internet companies could use the money that was pouring in to them to damage offline competitors, either by acquiring them or their key people. "They can hire away all of the talent that you have. The biggest weapon is the money they have. At one point, they could have hired away my entire management."

Other possible threats came from online companies acquiring an old economy trading company, or from offline companies like Japanese trading companies or local sourcing firms that could partner with a dotcom and become a competitor overnight. William hinted that the Swire & Maclaine acquisition was a defensive move to preempt acquisitions by new economy companies.

William gave his view of the Internet revolution:

> I started off saying that the Internet is just another technology that affects the way information is transferred and people communicate with each other. It has a very dramatic impact, more dramatic than the fax. But for me it's yet another in a series of technological changes that affects our business that we have to be keenly aware of. It may be the most important change until now, but it is probably not the last.

According to Victor,

> The Internet is a revolutionary technology, but new technology is nevertheless still technology. Li & Fung always has been aggressive in adopting new technologies. When the telephone came along, my grandfather was shocked. When the fax came around, the technology changed our turnaround time into just days. With Internet technology, now we get answers within hours. When broadband and WAP comes online, there will be even less lag.

"Bubble In"

Once the Fungs determined that Li & Fung needed an e-commerce strategy, the remaining question was how and in what shape it would emerge, how specifically e-commerce would eventually add value to Li & Fung, and whether it would use the existing IT department of 60 or absorb a new team of "netrepreneurs." Victor felt strongly that their e-commerce strategy should come from within the company, not outsourced as the intra- and extranets were, or as he phrased it, "bubble in, *not* bubble out." According to Victor, only if the solution was an internal one could he be certain that "the technology would pervade the entire Li & Fung organization." Nor did Victor care to start a brand-new entity separate from the parent:

> I'm not interested in starting a dotcom division, getting a high valuation with, a $13 million cash flow, and then spinning it off. I want Li & Fung to be around for another 100 years, not just 5 or 15. To start a pure Internet division is as equally absurd as starting a fax division, a division that exclusively uses faxes.

To better grasp the fundamentals of embarking on a new IT venture, Li & Fung added two new technical directors to its board, one a technology company CEO, the other an academic. According to William,

> The one thing certain about our business is that it will be constantly changing, so we need to install a mechanism for monitoring external environmental changes that impact our business. We decided a long time ago that we were an information and knowledge-based services company, so anything to do with information technology is crucial to us. We keep up with what's happening with board-members who can help us scan the horizon.

Enter Castling

In 1997, Michael Hsieh (HBS '84), president of LF International Inc., Li & Fung's venture capital arm and 15-year Li & Fung veteran, received a telephone call from John Suh (HBS '97), CEO of Castling Group, an Internet start-up company that, like the chess move "that allows you to defend your king and simultaneously position your rook for attack," used the Internet to both defend the offline, old economy companies against online companies' threat to their markets while simultaneously extending their own online presence. The two met in San Francisco to discuss how a focused combination of technology and supply chain reform could transform retail.."

Hsieh, well aware that Li & Fung was working on its own e-commerce strategy, noted:

> As a VC, I see numerous business plans that say that with Li & Fung behind an online exchange, we create significant value and therefore offer you 5% if you join us. However most of the plans do not make sense. They offer very little value and the founders lack either industry or technology expertise. John had the right blend of technology and business sense, the right mix of right and left brain.

Like the Fungs, Hsieh favored a "bubble in" approach. He compared outsourcing e-commerce implementation to a third-party consultant for a $10 million fee as "putting the fox in the chicken coop." It created a risky dependency on outsiders, particularly if future design changes were required, and also provided outsiders with proprietary information, strategy, and the entire business model. Finally, Hsieh remarked: "As a venture capitalist, I always have to think about the strength of the management team and what could go wrong with the venture. Can they deliver? Do they know the industry? Is this a credible business proposition? What if there is a negative reaction?" By late

1999, the time was right to act on their initial meeting. Hsieh commented that "both the evolution of Castling from B2C to B2B and Li & Fung's needs complemented each other nicely; John had a real appreciation for the supply chain and a record for building successful e-commerce models." In December 1999 Hsieh joined Castling's board and LF International invested in Castling. They subsequently co-invested in an initial round of financing for lifung.com, and Castling committed key managerial staff to lifung.com. Suh described Li & Fung as "the perfect strategic partner. They have an entrepreneurial philosophy rooted at the core of their system. They've got an aggressive and visionary leadership team at the forefront of supply chain management. And they're ready to operate according to the rules of the new economy."

In one fell swoop, San Francisco-based lifung.com's management team was immediately staffed with Castling's professionals, serving as vice president of Business Development, vice president of Operations, director of Marketing, and CTO. Suh stepped down as CEO of Castling, retaining the position of Non-Executive Chairman, and signed on as CEO of lifung.com. Apart from Suh and CTO Derek Chen, 20% of lifung.com's initial staff came from Castling, amounting to an in-house e-commerce incubation team that represented a slight twist on Victor's "bubble in" strategy. Suh and Chen, the latter formerly of Andersen Consulting's Advanced Network Solutions Group, brought along their experience from Castling e-commerce strategy projects for jcrew.com, hifi.com, giftcertificate.com, and ferragamo.com. The rest of the team came from either within Li & Fung (e.g., the senior vice president of Merchandising) or from outside the Li & Fung organization (e.g., the vice presidents of Sales and of Marketing). To facilitate the integration of the new online entity into the Li & Fung fold, a senior manager was tasked to provide an interface between the two groups. By Q3 2000, lifung.com had 40 full-time professionals and 25 consultants, with 80 full-time staff expected by year's end. For B2B ventures, moving first and fast was often a prerequisite for dominance. Scarcely a year had passed since the initial meeting with Castling and its first round of financing. According to Suh, there were three stages of launching an online venture: the business strategy, the design-build-test phase, and then actual execution. "Moving quickly," Suh remarked,

> requires a fundamental trust in an organization that best arises from the experience of a team that has built things together, with members who know each other's strengths and weaknesses. We do a lot of team building, because without trust you cannot move at the speed required. There are certain elements critical to the success of a dotcom . . . openness and constant communication are essential because there are so many skills and inter-functional dependencies that must be navigated for a successful launch. At lifung.com, we have a great mix of people, individuals with 30 years of merchandising experience, a deep operations staff, seasoned technologists and wonderkids, rounded out by newly minted MBAs. It's truly a mix of old and new, but what's united through this mix is the culture and that's what makes me most proud of our team.

However, before Li & Fung fully embarked on its e-commerce venture, William reminded analysts at a press conference that, "although the Group is developing along the lines of the new economy, we're still using an old economy mindset." At this juncture, William felt that it was essential to complete some traditional market research, something that most dotcoms simply did not do: "We cannot assume," he said, paraphrasing Kevin Costner in *Field of Dreams*, "that if you build it they will come. In building lifung.com we have to have a balance of the two mentalities, both old and new, there needs to be a happy medium. So let's do some top-down old economy market research first to find out how big the target market is, some bottom-up focus group research to identify retailers' real needs, and then we'll see whether or not they will come."

SME Target Market: "B to small b"

Market research was well received by industry analysts, who unanimously endorsed Li & Fung's preliminary research of its target SME (small and medium-sized enterprise) market. Given the proliferation of B2B portals in early 2000, it was important to foster initial investor confidence in the lifung.com business model. Li & Fung defined its target SMEs in the United States as primarily retailers with annual sales under $100 million and wholesalers with turnover of less than $50 million. According to William, 15 to 20 SME focus groups told him that the Li & Fung brand was well known as "the guys who work with the Gap and The Limited." More importantly, the market research pinpointed SME needs and determined the extent of demand for a "B2b" portal like lifung.com. According to William, "One of the beauties of B2B is the finite number of customers. You don't have to take out Super Bowl advertising time or plaster the New York subway system with ads. By and large, we knew just whom to target, we know the names and addresses of these retailers, we know how to reach them since they all read the same trade publications and go to the same trade shows."

Li & Fung's research determined that 20,000 retailers and 2,800 wholesalers in the United States with a total market size of $54 billion were potential customers, not including the more fragmented markets of Europe and Japan. Because SME orders were small and lacked economies of scale, SMEs traditionally had to pay importers high margins, ranging anywhere from 25% to 30% of the total order, compared with the 6%-8% commission Li & Fung charged its key clients for apparel and 10%-12% average commission for hard goods. Not only did the SMEs pay the most, but they were also served the least: these smaller firms were typically only offered a limited range of options in product specifications and were frequently overlooked by suppliers more concerned with serving larger clients. Furthermore, SMEs often lacked current information and lagged far behind large retailers in identifying fashion trends (see **Table A**). William summarized: "Not surprisingly, the small guys want what the big guys want, a differentiated product line at good prices. However, the SMEs do not have many options and have been poorly serviced in the past."

Table A Needs and Realities for SMEs

	Needs	Realities
Product	Differentiation of product at competitive price	No purchasing power
Service	Reliable procurement	No supplier leverage, no logistics for direct sourcing
Information	Up-to-date news, information	Starved for information

Source: Li & Fung analyst presentation.

Historically it had not been cost effective for Li & Fung to trade with SMEs since orders were small and often below factory minimums. But by aggregating their smaller orders via its B2B portal, the Fungs projected that they could profitably offer SMEs an array of products with the option of limited mass customization. In other words, Li & Fung could offer a differentiated product to SMEs despite the small order size, providing them with the limited amount of customization that they required. Explained William, "The idea is to capture economies of scale by concurrently manufacturing the aggregated orders while giving SMEs enough differentiation of embellishment choice (i.e. color, pockets, label) to enable them to each have a different product."

Lifung.com planned to charge SMEs a 10%-15% commission, far less than what these small retailers were used to paying. Limited mass customization represented a further extension of Li & Fung's supply chain customization and innovation, critical in the Internet age in which customers expected even greater speed and reliability of order fulfillment. With lifung.com's limited customization, a given China-sourced item might be available in one shape but with 10 different patterns and 15 different colors. The possible permutations were infinitely greater than what other online and offline competitors could efficiently offer. (See **Table B**.)

In addition, by not requiring a minimum order, Li & Fung added further value by allowing SMEs to reduce their inventory levels and use the system for replenishment buying. This made it easier for them to respond to changing market conditions and fashion trends. If, for example, orange polo shirts were fashionable one season and light blue the next, orders could be placed in small quantities each month to avoid being stuck with a surplus inventory of orange polo shirts.

Table B SMEs' Sourcing Possibilities

	Product Differentiation	Competitive Price	Reliable Procurement	Information Flow
Importer	Poor	Poor	Strong	Poor
Small agent	Fair	Fair	Poor	Poor
Small buying office	Fair	Fair	Poor	Fair
Internet exchange	Poor	Fair	Poor	Fair
lifung.com	Strong	Strong	Strong	Strong

Source: Li & Fung analyst presentation

"B2B[3]" Parameters

On March 27, 2000, Li & Fung announced 1999 final results and the creation of B2B portal lifung.com, as well as the start-up's management team. Li & Fung also acknowledged that it was committing $200 million to build the online business and proceeded to outline how the start-up would achieve $2 billion in sales by 2004 by targeting SME clients. The next day Li & Fung raised $250 million by placement of 60 million shares through underwriter Goldman Sachs to fund the new online venture, fortuitously timed just before the mid-April 2000 dotcom crash in the U.S. stock market. According to Li & Fung management, $200 million of these funds were slated for lifung.com with the remaining $50 million devoted to acquisitions in the core business start-up.

William remarked on the old economy-style financing of lifung.com:

> Besides market research, the second atypical thing for Internet companies that we did was the way we approached financing: The typical way of financing Internet startups is that first you have some entrepreneurs who decide on a great idea. They have a lot of sweat equity in the beginning and don't want that diluted unless the value increases a lot. Consequently they finance themselves very short, up until the next stage where they have something new to

show. However, they don't think about how much financing required to make this a viable business.

Our approach has been completely different: We come from a traditional background and don't want to think about that kind of financing at all, particularly since we are building this as part of our total business. Therefore we want to know what it's going to cost us to take it all the way to the end. And that's why we went out into the market for $200 million and got $250 million.

Furthermore, according to the Fungs, two of the three guiding principles behind lifung.com referred to as "B2B[3]" were old economy standards: the online company would adopt a "business-to-business" model that which took a "back-to-basics" approach by implementing Li & Fung's supply chain management know-how to SMEs on a "back-to-back" order basis, in other words, with no inventory risk for Li & Fung.

While its initial contribution to Group earnings were likely to be minimal for the first two years, lifung.com was expected to bolster earnings by an operating margin of roughly 6%, or 14% of total revenue. Li & Fung expected that by 2004 the online division would contribute as much as $2 billion in sales, or nearly up to one-third of the group's total revenues, with 1,000 new SME clients in the United States targeted for sales of $2 million each. As lifung.com gained credibility over time and its value proposition became known among SMEs, Li & Fung expected its operating margins to increase to 7%-8%.

Located near Silicon Valley, lifung.com would not only be close to the heart of Internet culture, but also close to its SME clients in the United States. Nor was lifung.com a prodigal start-up that would be allowed to run at a loss for long; like the parent company, there was an unspoken mandate from the top which decreed that it would follow the three-year planning system with attention focused clearly on the bottom line. According to Suh, lifung.com was steeped in the pragmatic culture of Li & Fung Trading, which was "How does it affect my bottom line? What are the commission rates? "William dismissed the risk of channel conflict between the SMEs and key client business :

The biggest conflict that our existing customers fear is us working in an old fashioned way with their direct competitors. In other words, if I am Abercrombie & Fitch and you also work with American Eagle, which is a direct competitor, I normally should have a problem. But if you are big enough, like Li & Fung is, you can compartmentalize these customers, you put walls between them, which is also how banks work with clients who are competitors. We have a system of dedicated accounts and management to segregate the two. Our large customers' first concern will not be the SME competitors but large direct competitors.

E-commerce Execution

Lifung.com[11] offered a wide array of customization options to its clients. For example, with polo shirts, users could choose on screen from a limited variety of specifications such as pockets, collars, and buttons including that customers' own logo. The website would display a high-definition, rotating image of a polo shirt (see **Exhibit 5**) which the user can customize. When satisfied with its appearance, the user could then place an order online, 24 hours a day. Lifung.com used Sun Microsystems for its hardware platform, Selectica for online configuration of products; Oracle for its database software; Broadvision for its transaction system, an interface to CIT, the U.S.'s largest factor,

[11] On August 17, 2000, lifung.com was rebranded as StudioDirect.com (http://studiodirect.com/).

to evaluate credit risk; an interface to Danzas AEI, a bulk freight specialist, that would allow door-to-door tracking; and Andersen Consulting, a leading systems integrator, to "wrap" the entire package for a seamless experience.

Moreover, lifung.com was developed and operated independently of Li & Fung's IT department, particularly since the two were based on separate continents. From time to time, four or five programmers from Li & Fung's IT department traveled to lifung.com in San Francisco in order to map the connection between the two units and to ensure that the order placement and fulfillment processes functioned seamlessly. In practice, lifung.com was designed to interact with Li & Fung in the same way as one of the Group's key customers, with orders placed through an Extranet. However, as part of Li & Fung Trading, lifung.com would enjoy a far closer interaction with its parent.

If there was any concern that it would be difficult to integrate an online venture into the corporate culture of a 96-year-old trading company, Victor was determined to "demystify" the technology among the offline staff with internal training courses and daily exposure to the new technology. Victor noted:

> The Internet is not black magic, there is no need to be afraid of it. Yes, it is a disruptive technology, but so what? I want to ensure that the technology pervades the entire organization, mainly because it is a technology that will be adopted sooner or later, and the sooner we do, everyone will be the wiser. Disruption comes from the real world, not cyberspace. For example, if the whole world goes into a trade war, or China doesn't gain entry into the WTO, now those are real world issues I worry about. Li & Fung has always been at the forefront of adopting new technology and that's why we are ahead of the game.

Just as Castling's e-commerce solution prescribed, lifung.com was not only a defensive move, protecting the traditional markets of Li & Fung from local online sourcing companies such as GlobalSources.com and Alibaba.com, but also offered an offensive thrust at new markets that these B2B pure plays were aiming for (see **Exhibit 6**). The Fungs believed that B2B exchanges did not constitute a tangible threat since they only offered a trading platform matching buyers and sellers. They could not add value in the same way that Li & Fung could through back-end logistics infrastructure, reliable procurement, market knowledge, and brand reputation, nor could they provide product differentiation. Referring to Li & Fung's historical relationships with suppliers, William believed that it would be difficult for any B2B portal to effectively compete with lifung.com: "You couldn't just have four recent MBAs put this all together."

Future Ventures

William indicated that Li & Fung was exploring ways in which the Internet could draw on the company's traditional strengths to enhance Li & Fung's existing business. Lifung.com was only the beginning. By 2001 Li & Fung planned to expand its online B2B penetration with a new platform known as "Electronic Stock Offer." Whereas lifung.com aspired to aggregate the orders of retailers, Electronic Stock Offer, code-named "eSO," would target the other side of the butterfly model (see **Exhibit 7**) and attempt to aggregate suppliers to post surplus inventory for sale on the Internet. According to William,

> What we've done on the buyer side, we're now doing on the supply side. We thought about what business we should be in with the suppliers that we haven't been in before that would actually help our business. Because we're in the quick response fashion business, a business

where there is very little machinery, we generate a lot of stock and this creates seconds for orders that are cancelled because of untimely delivery. What can the Internet do more efficiently than what we do now? We view these stock problems as a nuisance and have a handful of buyers such as Value City, Ross Stores, and TJ Maxx and who do nothing but specialize in buying these goods.

In particular, eSO was aimed at creating an efficient system for reaching out into Li & Fung's supplier base and posting surplus stocks on the Internet. This, in turn, would provide a more efficient and cost-effective platform from which Li & Fung could sell to buyers primarily interested in purchasing seconds. Li & Fung maintained close contact with its suppliers, inspecting and certifying each on an annual basis to ensure quality. Buyers trusted Li & Fung quality and price, and would readily join this online trading platform.

As William pointed out:

Because of our old economy history and our network, we can inspect suppliers' goods much easier. Buyers don't have confidence to buy from anonymous suppliers that they don't know. We think we can bring the two together within the Li & Fung network, we can build a business using the Internet to aggregate suppliers on their stock positions. You go back to the butterfly shape: We feel it's far too ambitious to create a virtual exchange inside this middle space that tries to be a clearinghouse for both sides. All I need to do is interpose Li & Fung and we can intermediate the whole process. This is the mirror position of what we are doing at lifung.com, using the Internet to aggregate thousands of small suppliers around the world and then have them post whatever stock they have available.

In contrast with vertical B2B portals, exchanges that proposed to match suppliers with buyers, Li & Fung aimed to add value to the e-commerce transaction by virtue of its old economy network, brand, and reputation. Through online ventures such as Electronic Stock Offer and lifung.com, the Group intended to exploit e-commerce as an integral constituent of its strategy of expanding and diversifying its traditional, offline business.

Outlook and Prospects

Thanks to robust macroeconomic conditions in the United States and Europe, the trend towards casual wear in the American workplace, and the rapid growth of private label in United States and Europe, the Group was expected to enjoy strong top-line growth for at least the next few years. A survey by Levi-Strauss indicated that over half of the American white collar workforce now wore casual apparel to work every day.[12] The trend towards casual wear in the American workplace offered considerable upside for retailers of polo shirts and khakis and thus for sourcing agents such as Li & Fung. Even a downturn in the U.S. economy promised potential upside, as retailers would consolidate and turn to outsourcing to minimize costs and remain competitive. An increasing number of Li & Fung's key clients as well as SMEs had already begun outsourcing in order to minimize costs, which along with the rapid growth of private label in United States and Europe provided lifung.com with a fertile market for limited mass customization.

"What if we do build it and no one comes?," William wondered. In other words, what if the 1,000 SMEs projected to procure customized goods through lifung.com and provide $2 billion in sales over the next four years did not flock to the B2B portal? If the online venture had a negative impact on

[12] "Retailing: General Industry Survey," *Standard & Poors*, May 25, 2000, p. 13.

share performance, at what point would Li & Fung cut its losses and shut it down? Suh had remarked in his presentation that "Beta means never having to say you're sorry." The soft beta launch was intended to highlight bugs in the system. The company was on the verge of beta-testing with a select few American clients, but if the beta launch was a failure, would that undermine investor and SME confidence in the model?

When asked about competition, Suh pledged that "We're going to run like we don't know who is chasing us."[13] But was there in fact, a risk Li & Fung would not be able to see who was chasing them, such as a copycat old economy sourcing company that would see the success of lifung.com and mimic its well-publicized model?

Finally, what was the chance that Li & Fung's offline operations would eventually migrate online after lifung.com had proven itself as a reliable and established model? This could potentially reduce many of the offline costs and enhance operating margins, but what of possible channel conflict? Although the online venture was based in San Francisco, how would its integration into the group be perceived by old economy Li & Fung veterans? What would be the future of the in-house e-commerce team once lifung.com was on-line? Would Li & Fung eventually spin off the clicks-and–mortar hybrid and take it public, or would it remain within the group?

[13] L. R. Scott, "Chess and the Wired Age," *Global Partnerships*, vol. 5, no. 2, p. 1.

Exhibit 1 Li & Fung Consolidated Income Statement (December 31, 1999), in HK$[a]

	2000 (HK $'000 (June 30)	1999 HK$'000 (December 31)	1999 (HK $'000 (June 30)	1998 HK$'000 (December 31)
Turnover	10,267,606	16,297,501	6,583,730	14,312,618
Cost of Sales	(9,262,171)	(14,585,881)	(5,895,432)	(12,891,709)
Selling expenses	(191,616)	(354,124)	(143,136)	(287,524)
Administrative expenses	(87,741)	(867,842)	(56,436)	(747,725)
Profits before taxation	328,943	613,861	208,936	471,098
Taxation	(29,805)	(36,638)	(14,536)	(16,425)
Profit after taxation	299,338	577,223	194,400	454,673

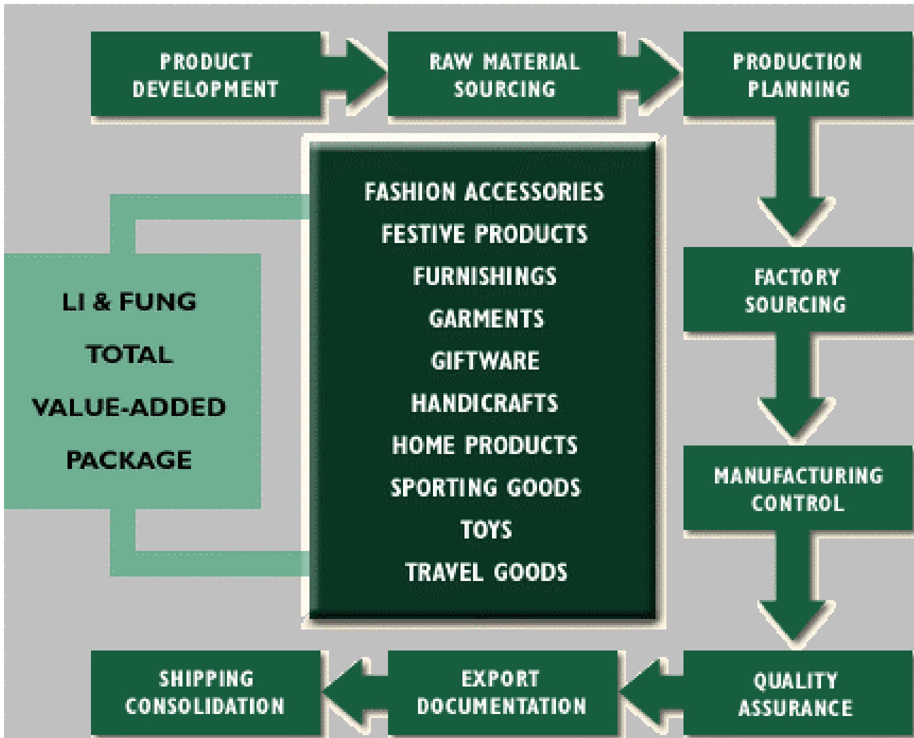
[a]In August 2000, $1 = HK$7.78.

Exhibit 1 (continued) Li & Fung Consolidated Balance Sheet (December 31, 1999), HK$

	1999 HK$'000	1998 HK$'000
Fixed assets	**1,161,808**	1,145,056
Investment securities	**86,484**	51,389
Current assets		
Inventories	**110,014**	72,267
Trade and bills receivable	**1,488,780**	1,089,011
Cash and bank balances	**1,029,373**	904,581
	2,961,634	2,234,490
Current liabilities		
	2,976,829	1,976,958
Net current (liabilities)/assets	**(15,195)**	257,532
	1,234,339	1,466,767
Financed by:		
Share capital	**64,765**	63,761
Reserves	**749,346**	1,030,295
Shareholders' funds	**814,11**	1,094,056
Minority interests	**4,460**	(24,595)
Long-term liabilities	**414,868**	397,058
Deferred taxation	**900**	248
	1,234,339	1,446,767

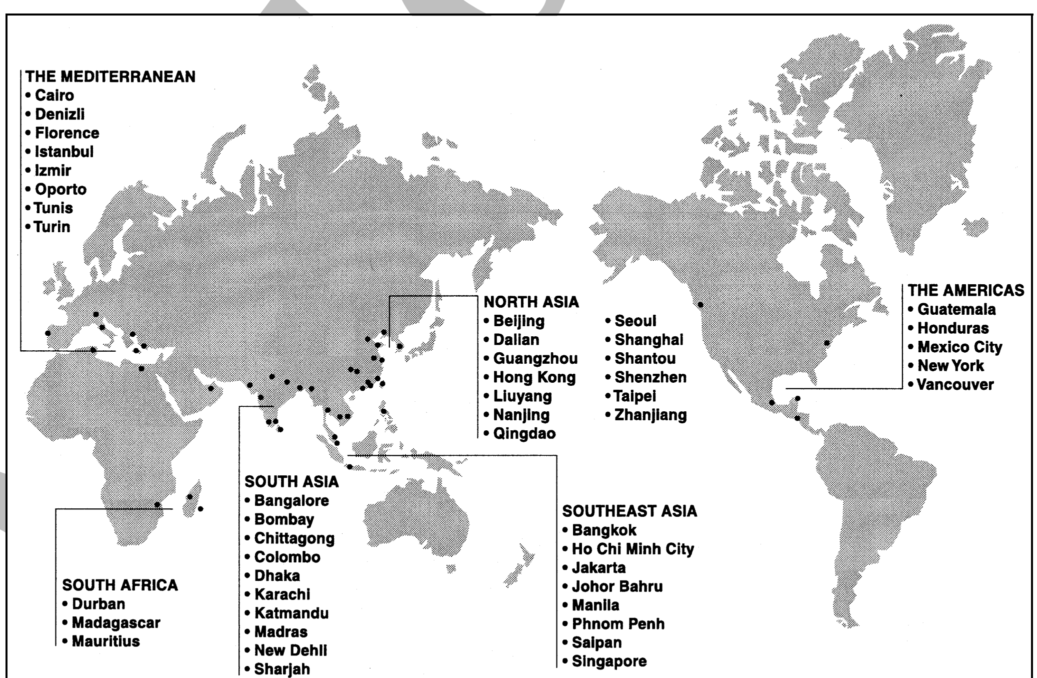
Source: Company documents.

Exhibit 2 Li & Fung Total Value Added Package



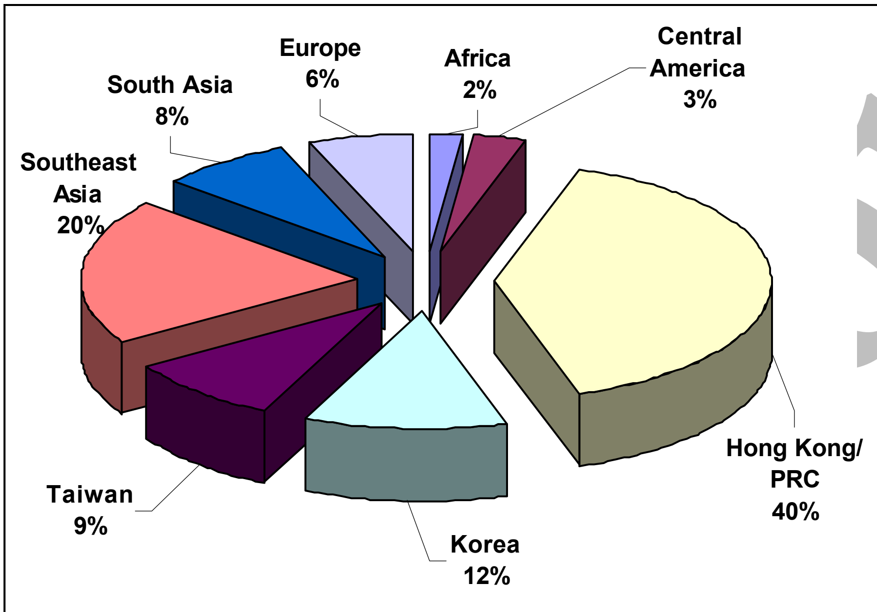
Source: Company documents.

Exhibit 3 Li & Fung's Global Network



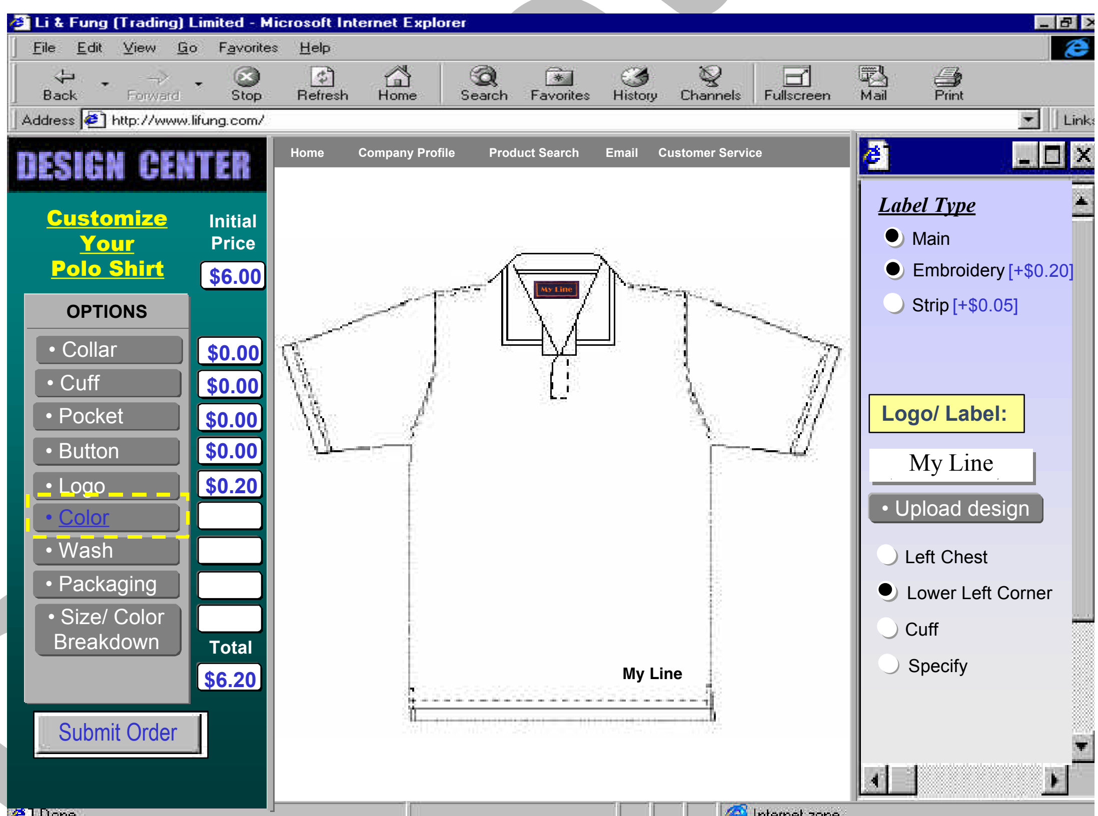
Source: Company documents.

Exhibit 4 Li & Fung Sourcing Markets (Q1 and Q2, 2000)



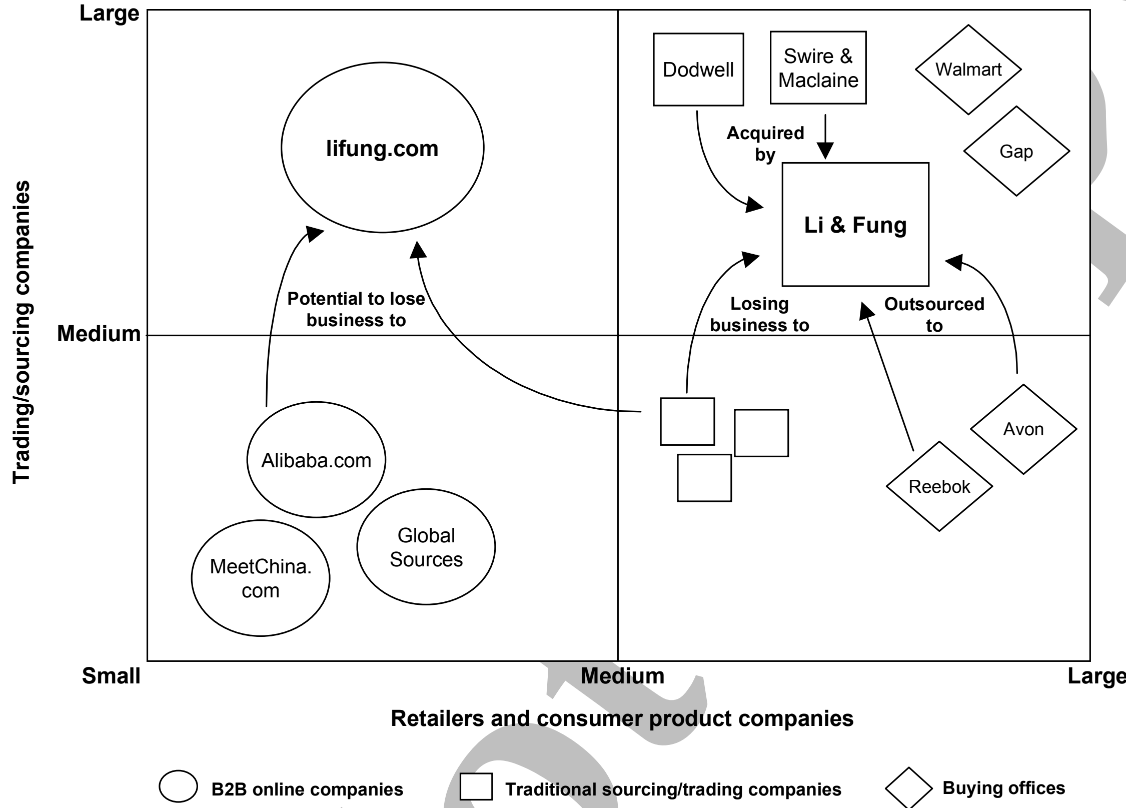
Source: Company documents.

Exhibit 5 Limited Mass Customization (web page sample)



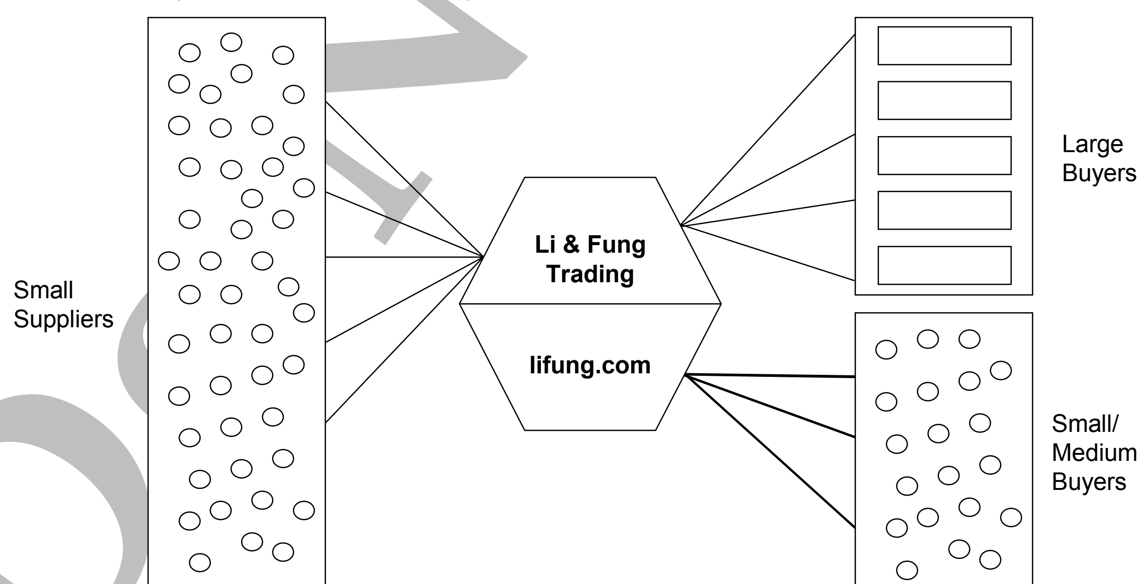
Source: Company documents.

Exhibit 6 Li & Fung Competitive Positioning



Source: Tristan Chua, Wui Kiat Heng, "Li & Fung," *Goldman Sachs Global Equity Research*, June 21, 2000, p. 10.

Exhibit 7 lifung.com Market Positioning



Source: Company documents.

Appendix A

. . . . What the Fungs created is a hybrid system. Today, the company maintains Internet-based communications with its major customers. Almost 75 percent of those are large retailers in the United States including Avon, The Coca-Cola Co. and Disney, all of which rely on Li & Fung for promotional items. Its largest customer in the U.S., Kohl's Department Store chain, accounts for 13 percent of Li & Fung's sales.

For these large customers, Li & Fung has created extranet sites dedicated to them. Information about the products they've ordered comes from Li & Fung's Electronic Trading System, now in its fifth generation of refinement and known as XTS 5.

Li & Fung's XTS is also linked to its own network of offices, where it has 5,000 people supervising the manufacturing of customer items. The nature of its electronic connections varies depending on the sophistication of a country's telecommunications system. In more advanced countries, a Li & Fung local office can be linked immediately to headquarters in Hong Kong. The branch office can tap the company's central databases and send digital photos of fabrics or products back and forth. The geeks at Li & Fung call that a "thick" connection. In cases where telecommunications are more primitive, however, the company depends on emails and email attachments, using Lotus Notes. That's a "thin" connection.

Li & Fung uses Hewlett-Packard and Compaq computers and Oracle database software to manage information and store the data, but has largely designed and written the software that makes up its XTS. "The important part is what we do with the technology," Fung says. Altogether, the system currently holds a very respectable 1.5 terabytes of data, which is equivalent to 1.5 million books.

The company's most important tech initiative is working with Microsoft's Biztalk software to better connect front-end orders from all customers—from the biggest to the smallest—with the back-end order processing system. That will enhance the supply chain's efficiency and make the system more transparent to customers. But Fung points out that the Internet applies only to certain segments of the supply chain. At other points, there is no substitute for human expertise, such as in the designing of products or allocating a single big order to four different factories to get the job done quickly.

The company doesn't connect its system to the thousands of manufacturers who make its products, partly because communications systems aren't advanced enough in China, the Philippines, Bangladesh and other Asian countries, not to mention Africa and the Caribbean. Li & Fung relies on personal visits, phones, faxes and couriers to keep in touch.

The other reason manufacturers aren't linked to Li & Fung's system, however, is that it wants its own employees to make sure that materials have arrived, that production has been scheduled and shipping arrangements have been made. If it depended on manufacturers to directly enter that information, the quality of its data would be "like raw sewage," says Fung. A manager in Pakistan could say, "Sure, we've started production-pay us," even if nothing was happening. Li & Fung personnel also have to be on the ground to make sure manufacturers comply with a customer's standards in terms of how they treat labor.

For all those reasons, it's unlikely the Internet will ever connect the complete supply chain. "Technology is an enabler," says Fung, a 53-year-old marathon runner who needs stamina for the 150 days a year he spends on the road. "You have to be clear on what you want to achieve. . . ."

Source: William J. Holstein, "Middleman becomes master," *Chief Executive*, October 2002 (vol. 182): 53. Also accessed at <http://www.chiefexecutive.net/depts/regionalreport/182b.htm>.