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ASIA

Lower Retail Prices Threaten Profits of Middleman Li & Fung

As retailers try to stay competitive, factories and intermediaries feel pressure

Li & Fung Chief Executive Spencer Fung said the company is working more closely with brands. PHOTO: BRENT LEWIN/BLOOMBERG NEWS

By Kathy Chu

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The migration of shoppers online has been squeezing profits throughout the retail industry—including at Li & Fung Ltd. , one of the world's largest factory middlemen.

The more than 100-year-old company, based in Hong Kong, contracts with 15,000 factories globally to make apparel, toys and other goods. Its core business has been connecting Western retailers such as Abercrombie & Fitch Co. and Target Corp. with factories around the world.

But as consumers increasingly shop online for the best deals, retailers have been forced to offer lower prices, putting pressure on factories and intermediaries alike.

Middlemen need to "either figure out ways to create value, or they will be going out of business," said Edwin Keh, chief executive of the Hong Kong Research Institute of Textiles and Apparel. "The bigger question is whether middlemen can still exist in a globalized economy."

On Thursday, Li & Fung reported that net income dropped more than 50% to $72 million for the first half, while revenue dropped 6.4%.

Li & Fung Chief Executive Spencer Fung said weakness in the global economy and heavy discounting by retailers weighed on the earnings.

“The environment is bad,” Mr. Fung said. “It’s probably the toughest we’ve seen.”

Li & Fung reported earnings after trading ended on the Hong Kong stock exchange, where its shares closed at $3.94 Hong Kong dollars (U.S. $0.51). Shares have slipped 23% this year.

Mr. Fung said the company is working closely with brands to win more of their business. Brands often work with multiple intermediaries, and, increasingly, some are sourcing directly from factories to cut costs.

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Li & Fung is also encouraged by demand for the company’s expanded services—including factory inspection as well as logistics and distribution—aimed at helping brands navigate the growing complexity of the supply chain, according to Mr. Fung.

As more shoppers go online, demand is growing for unique private-label products, creating opportunities for factories and middlemen, according to William Connor II, the chief executive of Connor Group, which sources $2 billion annually in products for companies such as TJX Cos. and Crate & Barrel.

This move to private-label products is a “huge opportunity” for Li & Fung, Mr. Fung said.

Founded in 1906 as a porcelain and jade trader, the company began to take its current shape in the 1970s when Mr. Fung’s father and uncle, both educated at Harvard, introduced Western-style management practices and expanded into design, marketing and transportation.

When Mr. Fung took the reins in 2014, the company spun off some money-losing businesses, including ones that owned clothing brands or managed licenses for brands such as Disney and Nintendo, and cut back on acquisitions.

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Two years ago, Li & Fung

also set up a unit called Vendor Support Services to provide factories with consulting services on safety, compliance and efficiency, as well as access to financing and insurance.

The moves came as brands demanded lower prices from factories and middlemen to manufacture goods, while requesting products be made more quickly and closer to the delivery site as online shopping grew.

Online sales are expected to nearly quadruple to $2.4 trillion in China, the world's largest e-commerce market, between 2015 and 2020, and to nearly double in the U.S. to $684 billion, according to eMarketer.

The growth of e-commerce means "prices are constantly under pressure as cost-conscious consumers compare prices and demand the best value," said Stephen Lamar, executive vice president of the American Apparel & Footwear Association.

Brands expect their supply chain partners to respond by "cutting costs or offering more value," he said.

As shoppers switch from brick-and-mortar to online stores, brands are also placing smaller orders with factories and middlemen, weighing on profits.

Sourcing agents "don't have a choice but to adapt" to the demands of the e-commerce world, said Mariana Kou, an analyst at CLSA. "This is a structural trend that's happening globally."

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