Benetton Group

3/Underperform

Clothing manufacturing / distribution

18 May 2005

Initiating coverage

It's very early days

- Massive and meaningful changes to make Benetton more market oriented are being rolled out starting in Q1 '05. Potentials in the form of topline turnaround, cost reductions, release of capital and re-rating are substantial.
- However, Benetton's selling space is down this Spring for the first time in its history and it is now spending 5-6% of sales to bolster retailers' mark-ups and cut retail prices.
- Moreover, benefits are subject to execution; progress will at best be slow, with the first real indications of effect unlikely to emerge until 12-18 months from now.
- A quick comparison with its small Danish peer, IC Companys, suggests that 1) it may be a long and bumpy ride before Benetton can hope to turn its fortunes around; and 2) the magnitude of upside potential could be huge in due course.
- 12x EBIT vs. much better quality peers at 13-14x does not fairly reflect the true nature of the dangers facing the company. We set a target of EUR5 or 10x EBIT and will keep Benetton's development under close surveillance.

Price	**EUR7.3**
Target	**-32% EUR5.0**
Market Cap	**EUR1.3bn**
Free float	**33%**
	BNG.MI / BEN IM

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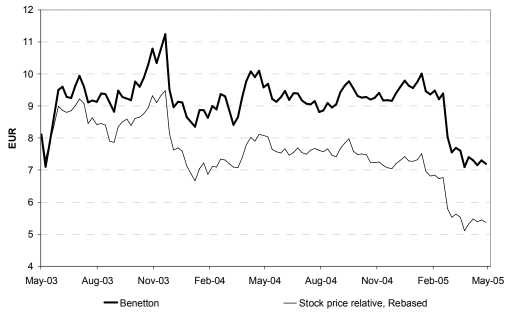
Next event: 12 September Q2 '05 results

Year to Dec	2003	2004	2005E	2006E	2007E
Sales (EURbn)	1.86	1.69	1.65	1.70	1.71
Pre-tax (EURm)	210	195	128	161	152
EPS Adj. (EUR)	.66	.71	.52	.65	.61
P/E (x)	13.8	13.6	14.2	11.3	11.9
P/CE (x)	7.1	7.0	6.9	6.0	6.0
EBITD (x)	6.8	7.1	7.2	6.2	6.3
EBIT (x)	8.8	10.3	12.1	9.9	10.3
ROCE (%)	14.4	12.6	8.5	10.0	9.2
ROE (%)	13.9	13.2	7.7	9.2	8.2
P/BV (x)	1.4	1.4	1.1	1.0	.9
Dividend (EUR)	0.38	0.34	0.21	0.26	0.25
Div yield (%)	4.2	3.5	2.9	3.6	3.4

Stock price and price relative



Shares Outstanding	181m	Perf %	1 Mth	3 Mths	1 Year
Daily Volume	EUR8m	Absolute	+3%	-23%	-24%

Major shareholders: Edizione Holding Group 67%

Proactive Independent Ideas

www.pi-ideas.co.uk

Company profile

Benetton **designs, manufactures and distributes garments** for women, children and men under the main brand UCB (colourful, functional, good quality, price to match) and also the Sisley (more trendy, high quality/price position), Killer Loop (short-cycle, streetwise, teenage) and Playlife (sportswear) brands.

15 of its 21 factories are located in Italy with the rest in Spain, North Africa and Eastern Europe. 69% of production incl. fabrics is outside Italy. 85% of sales are in Europe incl. 50% in Italy, approx. 6-8% in Spain/Portugal and 5% in Germany (see charts on p. 18?).

Selling is done by 67 independent sales representatives earning a commission on sales in their area. **Distribution is mainly through 2,000 external retailers with 4,800 shops** (87% of sales) who also run the stocks. Benetton operates a no-return policy vs. wholesale costumers.

13% of sales are through 204 own stores typically of the flagship variety located in prime sites and functioning mainly as a medium for advertising.

After a foray into, e.g. sports equipment, new management arrived in '03, **shifted Benetton's focus back to UCB**, replaced most managers and initiated a host of changes to cut costs, reduce risk and increase competitiveness.

Valuation

We note that Benetton's earnings from manufacturing and the **lack of integration** between its design/wholesale operation and operations at the retail level weigh on its profitability and **should thus weigh on its earnings multiples relative to peers**.

The comparison with its close but much smaller Danish peer IC Companys is **indicative of the potential upside** once Benetton again sees eye to eye with consumers and retailers and reach the stage where its topline starts to recover organically.

Equally the comparison with IC Companys suggests Benetton has a **long way to go** before it can hope to reach this stage.

At 12x EBITA the shares are rated below Inditex and H&M but at a **premium to our DCF-model** (see p. 3?).

The re-rating potential if/when Benetton emerges successfully from its restructuring **could well be to somewhere in the 15-20x EBIT range and at 15% EBIT margin**.

At our EUR5 target the shares would be rated at 10x EBIT leaving plenty of scope for **further downside should things take a turn for the worse**.

Investment case

With poor sell-through in recent quarters Benetton's distributors' profitability is under increasingly severe pressure. Benetton goes into '05 with **declining selling space for the first time** in its history.

To avoid an exodus from its network of distributors Benetton is in urgent need of a "brain, heart and lung transplant", the success of which is by no means a given.

While doubling collections to 4 p.a., enabling in-season replenishment, and accessing real-time sell-through data **may deliver substantial benefits**, these **will be slow to materialise** and may not emerge in time for consumers to respond, thus easing the pressure on Benetton's distributors.

Meanwhile Benetton now has to bridge the gap by **investing substantially in distributors' margins and funding store leases**.

At 12x '05E EBITA, Benetton **shares do not appear to reflect the severity of the danger** the company is facing.

SWOT analysis

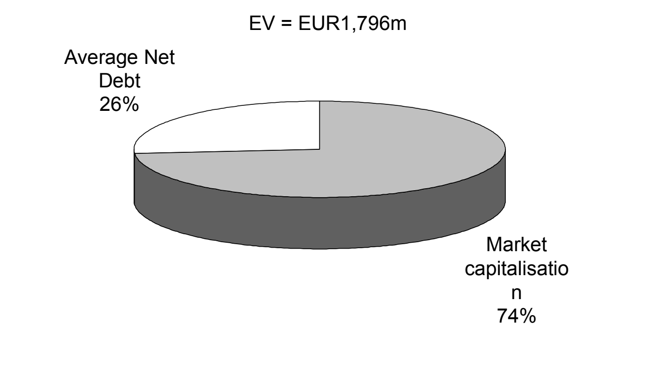
Strengths: It is indicative of the strength of its brands that Benetton's profitability has held up far better than in some other cases we have seen.

Weaknesses: Long lead-times in production which implies lower hit rate in terms of collections. Inflexibility of distribution to wholesale accounts implies lower sales and lower margins.

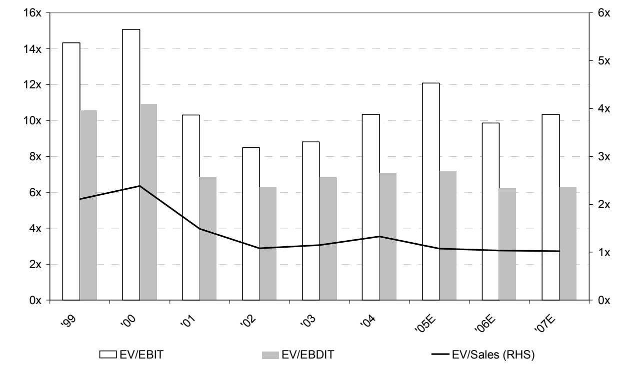
Opportunities: Offset declining distribution in its increasingly competitive core markets by expansion into smaller, less competitive markets. Integration of distribution.

Threats: Exodus by Benetton's distributors to join other brands or chains.

Capitalisation



EV multiples



DCF Summary: Fair value is EUR6

Averages	'97-'01	'02-'04	'05E-'07E	'08E-'14E	Terminal
YoY Growth Revenues	16.5%	-7.0%	0.6%	5.0%	3.0%
EBIT/Sales	14.9%	12.5%	9.8%	10.0%	8.0%
Taxes Paid % of EBIT	34.9%	21.7%	24.1%	27.0%	27.0%
Depreciation/Sales	6.1%	5.1%	6.2%	5.5%	5.5%
Working Capital/Sales	8.2%	-1.9%	-0.5%	2.0%	1.0%
Capital Expenditure/Sa	15.2%	5.7%	9.2%	8.0%	6.0%
WACC	7.8%			DCF value	EUR 6.3

Guidance, consensus and PII forecasts

Official '05 guidance suggests EUR1,635m (1,686) sales at 9.5-10.0% (12.9) EBIT margin incl. EUR7-9m one-off costs corresponding to EUR159m (217) EBIT, and approx. 6% (7.3) Net Margin after 27-29% tax.

According to IBES, consensus looks for EUR170m EBIT on the basis of EUR1,662m sales.

On the basis that Benetton will have left itself some safety margin we are in agreement with consensus as far as topline is concerned, but expect profitability will disappoint. WE look for EUR147m (217) EBIT.

Peer comparison

Company	Share Price	MCap €bn	Rating	P/E 03	P/E 04	P/E 05E	P/E 06E	EPS Growth 03	EPS Growth 04	EPS Growth 05E	EPS Growth 06E
IC Companys	179	0.4	0	-15.8	58.2	37.7	26.3	-144	210	54	44
Hennes & Mauritz	255	21.5	2	33.0	29.0	23.5	20.3	12.3	13.9	23.3	16.1
Benetton	**7.3**	**1.3**	**0**	**13.8**	**13.6**	**14.2**	**11.3**	**196.0**	**0.2**	**-27.9**	**25.7**
Inditex	23.3	14.4	3	22.6	21.4	20.6	18.0	1.4	41.2	11.2	14.6
Lindex	312	0.5	3	12.6	28.6	18.6	15.4	14.9	-49.4	157.0	21.1
Average (excl. Benetton)				13.1	34.3	25.1	20.0	-28.8	54.1	61.5	23.8

Company	EV/EBITA 03	EV/EBITA 04	EV/EBITA 05E	EV/EBITA 06E	RoCE 03	RoCE 04	RoCE 05E	RoCE 06E	EBIT Margin 03	EBIT Margin 04	EBIT Margin 05E	EBIT Margin 06E
IC Companys	neg	22.7	17.4	12.8	-13.1	18.1	23.7	31.6	-7.0	3.9	5.0	6.5
Hennes & Mauritz	14.4	18.4	14.7	12.5	133	148	164	172	19.1	19.9	21.3	20.8
Benetton	**8.8**	**10.3**	**12.1**	**9.9**	**14.4**	**12.6**	**8.5**	**10.0**	**12.5**	**12.9**	**8.9**	**10.5**
Inditex	15.5	14.1	13.8	11.6	34.6	45.1	43.7	43.7	13.6	16.3	15.2	14.7
Lindex	7.1	82.6	12.0	10.3	34.2	7.4	45.3	48.5	5.1	0.5	6.6	7.5
Average (excl. Benetton)	12.3	34.4	14.5	11.8	47.1	54.7	69.1	73.9	7.7	10.2	12.0	12.4

Source: PII forecasts

Investment case

A fading star	Benetton's negative 5-10% p.a. topline performance in recent years is indicative of the fading popularity with consumers of its product relative to its competitors. And the profitability of its customers, the retailers, will inevitably have been negatively affected.
Retailers losing faith	For the first time in Benetton's history the poor performance of its collections meant a contraction in selling space in the wholesale channel this spring by 3% in Q1, by 4% in Q2-Q3 and by 1-2% overall when adjusting for the switching of some stores from the wholesale channel to Benetton's own retail channel.
Targeting potential efficiencies	We see recent actions to get more involved in retailing as important steps to enable closer integration by Benetton's design, wholesale and distribution operations with the retail leg of the value chain. Such integration is typical of Benetton's competitors in fashion retailing and, judging by a simple comparison of profitability, appears to offer very substantial efficiencies.
Right strategy but requiring much patience	It is the right strategy but costly, fraught with risk and requiring much patience. Benefits of keener and simplified pricing structures, of accelerated collections cycles and of in-season replenishment of garments will be discernible only by Spring '06 at best. By '08, changes to Benetton's sourcing are expected to deliver EUR50m cost savings.
First evidence of success in 12 months at the earliest	The question is when Benetton will be able to lift the attractiveness of its collections to a level that delivers topline performance. It is all about increasing the hit rate, i.e. the percentage of winners, of its collections. The most efficient way to achieve this is by cutting lead times, accessing better market intelligence such as real-time sell-through data and by adopting a greater degree of responsiveness to fashion trends as opposed to trying to be trend setters. Gaining access to real-time sell-through data requires consent by Benetton's wholesale customers. Exploiting the data to their full involves major adaptation of Benetton's logistics systems. We believe Benetton is right to go down this path, but factoring in success at this early stage is premature.
Pain before gain	In the meantime, i.e. with P&L effect during Q1 '05 - Q1 '06, Benetton will spend EUR100m, of which half in boosting its retailers' mark-ups thus enabling them to conduct much needed store refurbishment, and the rest in reducing retail prices on some of the most popular garment categories to so-called entry levels, thus enhancing the value proposition of its range.
Risk of fresh turbulence	Our model and EUR5 price target assumes middle-of-the-road performance with the risk of forecast adjustment being more likely on the downside than on the upside.

Success followed by complacency

Benetton was established in 1965 by the brothers and sisters of the Benetton family, a charismatic team of entrepreneurs whose colourful designs brought a freshness and novelty to the market and filled a clear need with consumers.

Distribution model enabled quick expansion

Its distribution model was developed during the 1970s. It still relies on a communal understanding with its customers – the external retailers – of the Benetton way of doing things rather than enveloping retailers in a rigid format. The advantage of this approach was that it enabled expansion of the Benetton brand into new markets and tapped the retail scene for entrepreneurship while avoiding tying up substantial amounts of cash and taking on significant risk at the retail level.

Shock campaigns became UCB's hallmark

Benetton first hit media headlines world-wide when during the 1980s they launched what was to become a long series of controversial advertising campaigns for the United Colours of Benetton brand (UCB), featuring provocative photographs by Oliviero Toscani who went on to win the Lion d'Or at the Cannes Festival.

By the 1990s Benetton was active in 120 countries and sold 110m pieces per annum.

Developments in recent years

Distractions cost dearly

Confident of its continued success, the company diversified through acquisitions into sports equipments. This project never succeeded and in the meantime the core business stagnated. Now 10-15 years later, Benetton still refers to its presence in 120 countries and selling 110m pieces per annum.

The sales trend in Benetton's Casual Wear division, i.e. the core business, has been stagnant for several years reflecting the generally weak market trend in Italy but also the reality of falling behind competitors operationally in the ever more dynamic fashion clothing market. However, management's attention being focused on the Sports equipment venture, as well as weak collections were also negative factors.

Mistakes were made

While competitors scrambled to build in ever greater flexibility, thus increasing the hit rate of their collections and driving industry profit margins down yet boosting their own financial performances, Benetton stuck to its twice-a-year collections cycle, did little to reduce lead-times in production, and maintained minimal operational integration with its customers. The result is that Benetton stores change far less during the season than those of most competitors, thus attracting modest traffic and presumably generating lower turnover and profits than could have been achieved.

Frustrated by the sluggish sales performance, Benetton's designers strayed from the DNA of the UCB brand and changed collections to the extent that they alienated some core costumers while failing to win over sufficient new costumers.

Facing first ever decline in selling space

The loyalty of Benetton's distributors, the 2,000 external retailers with some 4,800 stores, had been built over many years of spectacular performance. Even so there comes a time when the stark reality of financial damage causes loyalties to begin to wear thin. It is only now in '05 that the company faces its first ever decline in selling space in its wholesale channel.

Action commenced in '03

The writing on the wall had been clear for some time: unless Benetton comes up with a better deal for its retailers it risks losing distribution in key locations.

Action in progress since '03

In '03 Benetton's current CEO, Mr. Cassano, arrived from roles with Hertz Car Rental and with Fiat's Consumer Services Business to coincide with the divestment of the Sport Equipment operations. Shortly after, Mr. Cassano replaced most of the top management, and in the Autumn of '04 replaced most of the operational management layer.

De-localization and Dual Supply chain

Mr. Cassano then proceeded to address Benetton's costs. Benetton divides its garments into those that need to be manufactured close to the consumers (we call them short-cycle) even if this involves higher costs, and those that need to be produced very cost efficiently even if this means longer lead-times (we call them long-cycle). The split between short-cycle and long-cycle garments is roughly 50:50 by value.

Less dependence on high-cost production

With a large part of their short-cycle production still located in the high-cost area of Italy the company decided to adopt its "de-localization" and "dual supply chain" programs whereby over the next few years the production of short-cycle garments is moved to countries that are still close to Europe but offer lower costs than Italy, and the production of long-cycle garments is moved to Asia or other low-cost areas.

Some of the cost cutting is behind us

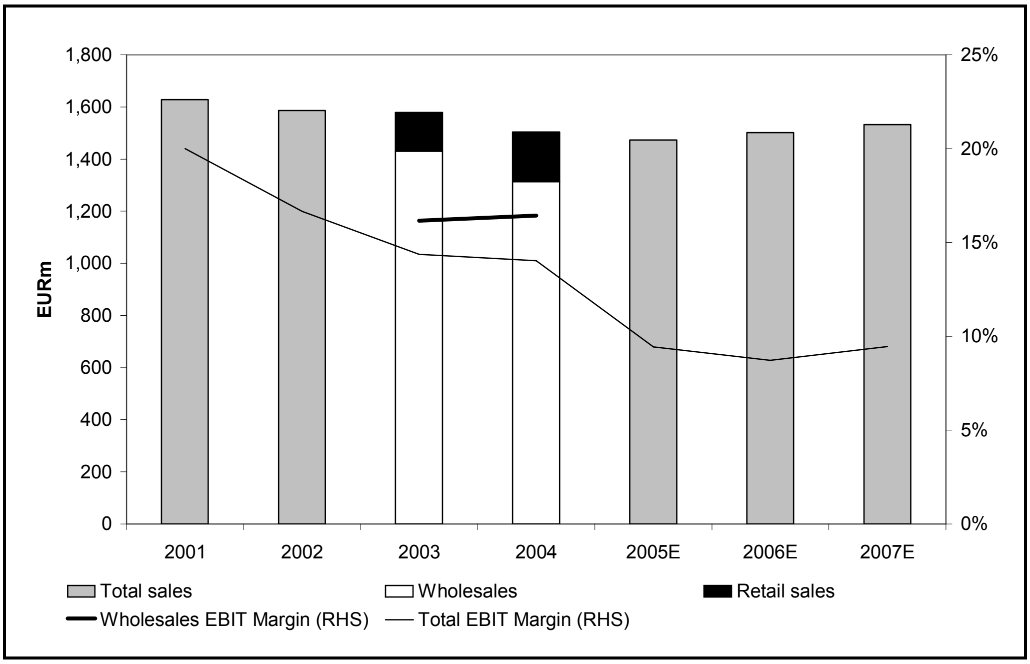
Current planning involves the increase of production of short-cycle garments in low-cost countries to 80% by '07 vs. 69% in '04 while sourcing of long-cycle garments from low-cost areas is expected to reach 30% by '08 vs. currently 5%. Having already realised in '04 some EUR15m savings from such changes, the company aims to reduce its production costs by a further EUR50m or 3% of sales by '08.

Becoming more involved in retailing

First few steps into retailing

Since '00, Benetton has increased the number of retail stores which it operates for its own account from 3 to 204 incl. the 45 stores in Germany which are 51% owned. Initially these were located typically in prime locations, the idea being to support the general brand building process locally and to some extent supporting efforts to sign up external retailers in the local area or region. But it now also operates many smaller stores for the sake of "learning the ropes" of running smaller formats, which make up the majority of its wholesale customers' outlets.

Sales and EBIT margin of Casual Wear



Source: Company data, PII calculations and estimates

Savings offset by loss of leverage

The chart above shows the evolution of Benetton's Casual Wear sales and EBIT margin. Adjusting for the increased importance of own retailing operations at negative EBIT margins it suggests that whatever benefits the company derived from cost cutting so far, they have been offset by increased other costs and/or declining cost absorption as revenues declined.

Given that the spring of '05 is the first time in the history of Benetton that its selling space with retailers has diminished, we can conclude that the sales per Sqm generated by Benetton collection to its customers must have been in decline. With rents generally going up, it seems inevitable that Benetton's retailers' profitability has been in general decline in recent years.

Getting to grips with distribution

By far the easiest way to improve the hit rate of collections seems to be to reduce lead-times in production and to enhance the precision in its allocation of garments to stores such that surpluses and sold-outs are avoided. This is very difficult to achieve without much closer coordination of design, sourcing, distribution and retailing.

In our view Benetton's response must be to try and get control of distribution, which would be either very costly if it were to acquire leases from its distributors, or very slow and risky if it were to open own stores in areas already served by its distributors.

Retailers' profitability too under pressure

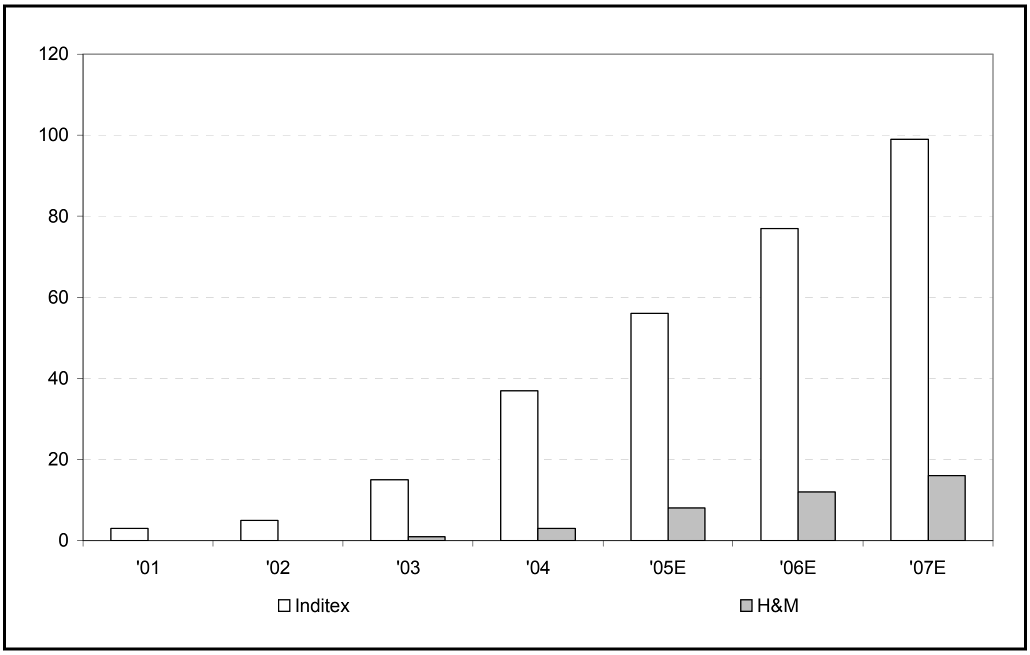
Last year Benetton acquired 51% stakes in three wholesale customers with 45 stores in Germany. A few weeks ago Benetton acquired 50% of its distributor in Turkey with 7 own stores and distribution to 97 wholesale accounts. The company is adamant that these actions should be seen as investments in retailing in their own right with plans to expand the stores network in both Germany and Turkey in the next few years.

Given the modest profitability achieved by Benetton's own stores so far, we feel the more important initial benefit to Benetton is that it gets control of distribution thus enabling it to start integrating operations more closely with the retail leg of the value chain and access the operations efficiencies and financial benefits inherent in this approach. It also provides Benetton with a sales and EBIT margin uplift.

Mounting competitive pressures in Italy

Meanwhile, 50% of Benetton's sales derive from Italy. Both Inditex and H&M started expanding into the Italian market recently. In the case of Inditex the Italian market is earmarked as a core expansion market for the foreseeable future. The market is notorious for its high per capita spend on clothing and high prices, and is seen as very attractive by new entrants. It seem competitive pressures in Benetton's home market will inevitably increase.

Stores network expansion in Italy by Inditex and H&M



Source: Company data, PII estimates

Boosting retailers' cash flows

In their guidance for '05 Benetton announced that it will be investing EUR100m to boost retail margins of which EUR70m in Q2-Q4 '05 and EUR30m in Q1 '06. 50% of this investment will go towards lowering its wholesale prices but maintaining the recommended retail prices, which are printed on the price tags. In this way Benetton aims to boost the cash flows of its retailers thus enabling them to conduct overdue store refurbishment.

The remaining 50% of the EUR100m investment will go towards lowering prices on certain items to so-called entry levels. As an example Benetton will now offer shirts at EUR19.90 and jeans at EUR29.90 vs. Benetton's normal price ranges of EUR25-35 and EUR40-50 for these categories. The negative effect on Benetton's Gross Margin can be dampened by adapting product specifications and by deliberately targeting these garments for traffic generation rather than actual sales generation.

Further initiatives are overdue

Benefits unlikely to last

In the longer run, however, it is difficult to tell whether boosting its retailers' profitability and lowering selected retail prices will enhance the competitiveness of its offer to consumers sufficiently to solve the topline stagnation issue. Substantial improvement in the fundamental competitiveness of Benetton's offer to consumers and retailers alike is essential.

Actions that are in progress or fully implemented include:

Cost savings

1. Cutting costs by moving the sourcing of long-cycle products to low cost areas. Some EUR15m cost savings were already achieved in '04.

Filling the "value" gap

2. Enhancing consumer perceptions of Benetton's value proposition by adding selected garment categories at fighting price levels.

De-cluttering the price palette

3. Reducing consumer perceptions of complexity in pricing by cutting the number of prices per garment category.

Re-discover the magic of the UCB brand

4. Returning UCB collection designs to their roots. The S/S '05 collection is the first of the new design team's collections to reach the market and reflects the DNA of the UCB more clearly than has been the case in recent years. The company suggests the weak order intake for this collection is not at all a fair reflection of its consumer appeal but represents a spill-over effect from Benetton's weaker recent collections.

Adopting mainstream selling tricks

5. Working more actively with Point-of-Sales communication and with editorial coverage. Using posters inside Benetton shops has not been done before. Efforts to assist fashion editors of magazines and newspapers have been strengthened and media coverage of Benetton collections has increased.

All of the above are effective as per early '05 while those below will take effect only later in '06.

6. Between '04 and '08 additional EUR50m cost savings are expected from moving short-cycle garments outside Italy and from moving long-cycle garments to Asia. These savings correspond to as much as 3% of sales.

In-season replenishment of winners

7. Enabling in-season replenishment of winner garments. This is likely to involve higher cost production runs generating lower margins to Benetton but benefits to Benetton nonetheless since its retailers' sales and profitability will be strengthened.

Speeding up the collections cycle

8. Accelerating from 2 to 4+1 collections per annum (the "+1" refers to the collection of long-cycle items such as T-shirts which Benetton will stock for retailers to order on an ad-hoc basis). Although some competitors are already several steps further down this road, the partial catch-up by Benetton ought to deliver a discernible increase in the attractiveness of Benetton stores as perceived by consumers. The first collections under this new regime to hit the market will be Spring '06 and with full effect only by Autumn/Winter '06.

Early identification of winners

9. Accessing real-time sell-through data from 500 stores (incl. the 204 operated by Benetton for its own account) to enable early identification of winner trends. This may be a problem in a set-up such as Benetton's because the retailers may resist sharing these, their innermost secrets with Benetton. The company aims to get retailers on its side by offering them a software package that will not only generate the real-time sell-through data, but also provide retailers with various valuable management systems.

It is not clear how Benetton plans to avoid the disadvantages inherent in allocating all ordered garments to stores as opposed to delaying delivery of a portion until such time that sell-through data can be retrieved and interpreted.

While supplying 5,000 outlets with 110m garments p.a. is no easy task and Benetton points out that its logistics facilities represent state-of-the-art technology the complexity would increase manifold if it were to make the transition to supplying stores on a call-off basis.

The devil is in the detail

If successful the benefits to Benetton's retailers of the above actions will include increased sales per Sqm, reduced mark-downs and much improved profitability. The benefits to Benetton itself would include increased sales through existing retailers and increased leverage of its cost base.

Q1 '05 review

Q1 sales numbers largely flat

Benetton reported Q1 '05 results on 16 May. Sales were largely flat with -9% volumes and -3% effect of investment in retailers' mark-ups offset by improved product mix and channel mix. The product mix improvement (equivalent of 9% sales growth) reflects the return to normal levels after last year's exceptional deterioration. The sales growth effect of channel mix improvement was approximately 3% with the importance of sales through Benetton's stores increasing to 13% (10) of sales thanks to the number of own stores increasing by 79 units to 204 (125).

P&L— Q1 '05

	Q1		Year	
EURm	*'05*	*chg (prev)*	*'05E*	*chg (prev)*
Net sales	378	*-0.8%*	1,649	*-2.2%*
Profit before depr	61	*-11.6%*	247	*-22.2%*
Depreciations	-25	*4.2%*	-100	
EBIT	36	*-20.0%*	147	*-32.5%*
Pretax Income	30	*-22.3%*	128	*-22.3%*
Gross Margin	*43.4%*	*(44.9%)*	*44.0%*	*(44.9%)*
Oper margin	*9.5%*	*(11.8%)*	*8.9%*	*(12.9%)*
Pretax margin	*7.9%*	*(10.1%)*	*7.8%*	*(9.8%)*

Sales breakdown — Q1 '05

	Q1		Year	
EURm	*'05*	*chg*	*'05E*	*chg*
Casual	339		393	*-2.0%*
Sportswear	16	*-2.0%*	16	*-2.0%*
Manufacturing	23	*-2.0%*	27	*-2.0%*
Group	378	*-0.8%*	436	*-2.0%*

EBITA breakdown — Q1 '05

	Q1		Year	
EURm	*'05*	*chg*	*'05E*	*chg*
Casual	34	*-21%*	35	*-38%*
Sportswear	2		-3	*1%*
Manufacturing			3	*4%*
Group	36	*-20%*	35	*-38%*

EBITA margin breakdown — Q1 '05

	Q1		Year	
EURm	*'05*	*(prev)*	*'05E*	*(prev)*
Casual	10.0%	12.7%	9.4%	14.0%
Sportswear	12.5%	10.0%	1.1%	1.3%
Manufacturing			6.4%	4.7%
Group	9.5%	11.8%	8.1%	12.8%

Source: Company data, PII estimates

The LFL trend in own stores was negative 6% in Q1. However, this reflected merely the decline in sales of surplus garments from the Autumn/Winter season, which were lower this year and generate little by way of profits anyway. In March, which reflect sales of Spring/Summer garments, the LFL trend in own stores was flat.

Gross profit in decline

Benetton's Gross Profit declined to EUR164m (171) or 43.4% (44.9) of sales with negative EUR11m or 2.9% of sales coming from its investment in retailer mark-ups, the launch of garments at entry level prices, and positive EUR5m or 1.3% of sales coming from product/channel/brand mix.

SG&A costs increased to EUR129m (126) with increased own retailing being a significant adverse factor and sourcing-in of selling efforts favourably affecting costs by EUR3m. Underlying this, SGA costs were down EUR6m (see table on p. 11).

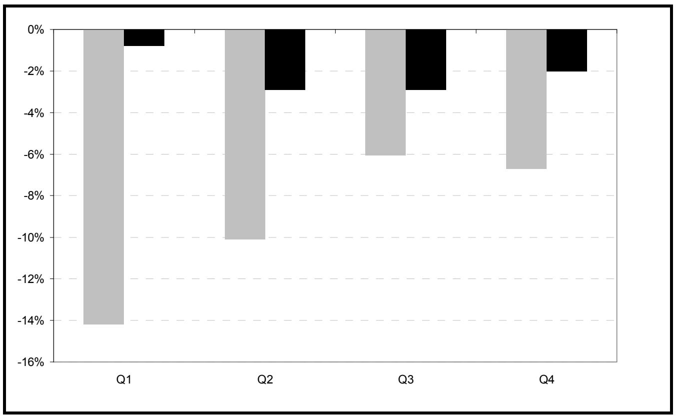
Implications for Q2 '05

FY guidance remains

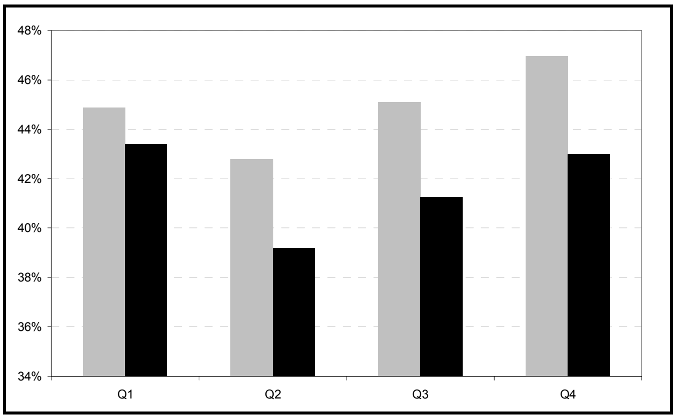
Benetton has the advantage of knowing exactly how much in terms of sales their pre-order intake amounts to and so they ought not to be far wrong when they maintain their EUR1,620-1,650m (1,686) sales forecast for the year, which amounts to EUR1,242-12,72m for the remaining quarters.

However, some uncertainty remains, mainly regarding the level of re-ordering by the wholesale accounts and the sell-out performance by its own stores. Management said sell-out was flat for own stores as well as for wholesale customers in March, April and May, but added that it was too early to draw any conclusions from this.

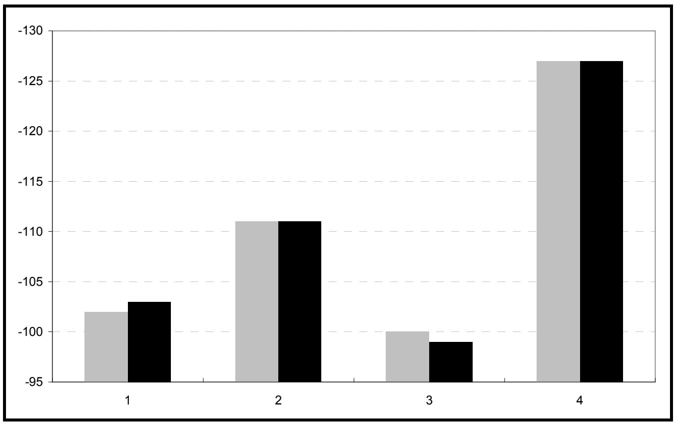
Sales growth — Q1 '04–Q4 '05E



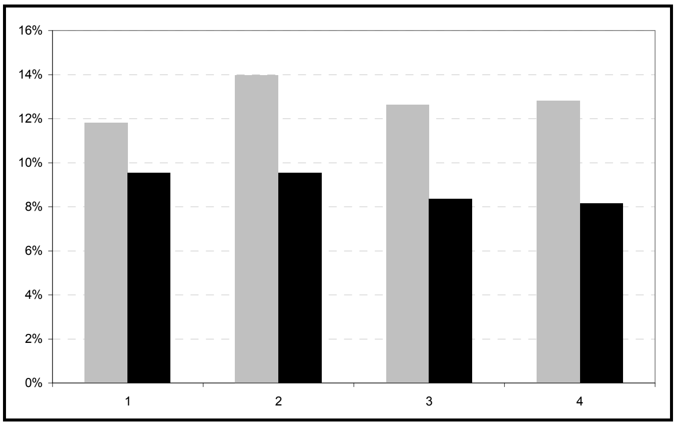
Gross Margin — Q1 '04–Q4 '05E



SG&A costs — Q1 '04–Q4 '05E



EBIT Margin — Q1 '04–Q4 '05E



Source: Company data, PII estimates

Medium-term prospects

It will be well into '06 before we should expect to see reliable evidence of consumer reactions to Benetton's efforts. In the meantime we face sluggish volume trends and margin pressure.

One small advantage of long lead-times is that Benetton has better visibility of its near-term operations than most companies. Right now it is about to close the pre-order book for Autumn/Winter '05. Normally pre-orders account for 75% of total orders with the remaining 25% being ordered very close to or even in season.

S/S '05 orders down 9%, space down 3%

Benetton's pre-orders for the Spring/Summer '05 collection were down 9% YoY by volume with 3% due to reduced selling space and 6% due to poor sell-through in recent quarters. Sell-through was negative again in January and February, but this was related to the fact that the surplus of Autumn/Winter items was less in early '05 than '04.

Keeping close eye on sell-through this Spring

The S/S '05 collection is the first by Benetton's new team of designers to hit the market. Management said sell-through was positive in March thus reflecting favourably on this first collection by the new design team. Judging by the performance of most retailers in March, however, it may still be too soon to draw a positive conclusion from this. Monitoring sell-through of S/S '05 as well as orders for A/W '05 is more crucial.

Quarterly assumptions: Casual

	Q1 04	Q2 04	Q3 04	Q4 04	Q1 05	Q2 05E	Q3 05E	Q4 05E
Sales growth analysis								
Mark-up investment/ entry prices					-3.2%	-5.2%	-5.2%	-5.2%
Own retailing					3.0%	3.0%	0.5%	0.5%
Product mix					9.0%	2.5%	2.5%	2.5%
Volume					-8.7%	-3.0%	-1.0%	0.0%
Forex					-0.3%	-0.1%	0.0%	0.0%
Other					0.2%	-0.2%	0.2%	0.2%
Sales change YoY					0.0%	-3.0%	-3.0%	-2.0%
EBIT margin analysis								
Price cuts					-3.2%	-5.2%	-5.2%	-5.2%
Mix								
Channel					1.5%	1.2%	0.5%	0.5%
Product					-0.9%	0.0%	0.0%	0.0%
Brand					0.9%	0.3%	0.3%	0.3%
Delocalisation					1.2%	0.4%	0.7%	0.7%
In-sourced selling					0.9%	0.7%	0.9%	0.8%
Depreciation					-0.6%	-0.5%	-0.6%	-0.5%
Provisions					-0.9%	-0.5%	-0.6%	-0.5%
Forex					-0.3%	-0.2%	-0.1%	0.0%
Other					-1.2%	-1.2%	-1.2%	-1.2%
Operating margin change YoY					-2.7%	-5.0%	-5.3%	-5.2%
De-localisation	56%	66%	67%	69%	67%	70%	73%	76%

Source: Company data, PII estimates

A/W '05 orders down 4%, space down 4%

For April, sell-through was very slightly positive. Re-ordering of SS '05 is slightly positive vs. budget. For Autumn/Winter '05 pre-orders are down 4% by volume with selling space at wholesale customers down 4%. Reduced selling prices amount to 5% of sales while the mix of products and brands should add 2-3% to sales.

Severe margin pressure in Q2 '05 – Q1 '06

Starting in Q2 '05, Benetton's investments in retailer mark-ups and in garments at entry price levels, which together amount to about 5-6% of sales, will gain importance and put greater pressure on Sales and Gross Margin.

Recovery to normal brand and product mix with the Sisley brand and hanging garments and men's garments gaining importance will remain a positive factor albeit less so than in Q1 '05 (see table above). The uplift in sales, Gross Margin and EBIT margin inherent in taking control of retailing will remain in Q2, but diminish in Q3-Q4. All this is reflected in Benetton's 9.5-10% EBIT margin guidance for '05, which also includes EUR7-9m one-off charges in accordance with IFRS.

The benefit of delocalisation will be less in Q2-Q4 than in Q1.

Benetton will also engage in vendor financing on an opportunistic basis. What this means is that Benetton may decide to step in and run the stores of that retailer for its own account. The cost of this is included in Benetton's EUR120-150m Capex guidance for '05.

Benetton will present an update of its strategy in late '05.

Where sits the value?

Dividing EBIT in rating groups

We make a notional division of Benetton's EBITA into three categories: (1) manufacturing, (2) design/wholesale and (3) retail. We argue the case for applying very different multiples to these categories and apply the same approach to other operators, such as Danish Peer IC Company's which we examine as a means of comparison in the following section.

Low rated production

1. **Production services** are relatively capital intensive, meaning that the cost of growing them is high. Moreover they form an increasingly commoditized global market offering only slim returns, especially if based in a relatively high cost area. We would apply a low multiple to the 10% of Benetton's EBIT which represents manufacturing.

Higher rated design/ purchasing/wholesale

2. Of the entire Value Added chain in the fashion clothing business it is the **design and sourcing** processes which are the least capital intensive, has the most leverage on the upside and the most flexibility on the downside. Until a few years ago one would ideally restrict ones involvement in the trade to these particular parts of the Value Added chain.

Highest rated is integrated design/ purchasing/ wholesale/retail

3. The **retail** leg of the chain is also very capital intensive and costly to grow. On a stand-alone basis we would not apply a high rating to retailing earnings. However, because of the huge efficiencies inherent in coordinating design/purchasing with retailing (thanks not least to exploitation of ever cheaper IT capabilities) such outfits earn very generous premium returns and can grow rapidly and at high profitability. For earnings of this variety the market appears to pay very high multiples indeed.

Benetton is involved in Production in high-cost areas, it has a high portion of its earnings from design/wholesale and a small portion from retailing. The high rated part of its operations, the design/wholesale part, is losing customers. Moreover, the level of integration between its design/purchasing and retailing is very modest.

All this is abundantly evident in Benetton's pedestrian RoCE as compared to peers (see table at the bottom of p. 3). With major restructuring work still ahead of it we feel a rating of 12x EBIT prematurely anticipates a smooth path to recovery. We feel the discount to far better positioned peers is very modest.

Our DCF-model (also on p. 3) suggests EUR6 is fair value. Since we rarely see even the most brightly shining stars trade at their DCF value but at a discount of 10-30% we feel a target of EUR5 is not at all ungenerous. It could in fact slip further if Benetton sees further deterioration.

It is still very early days

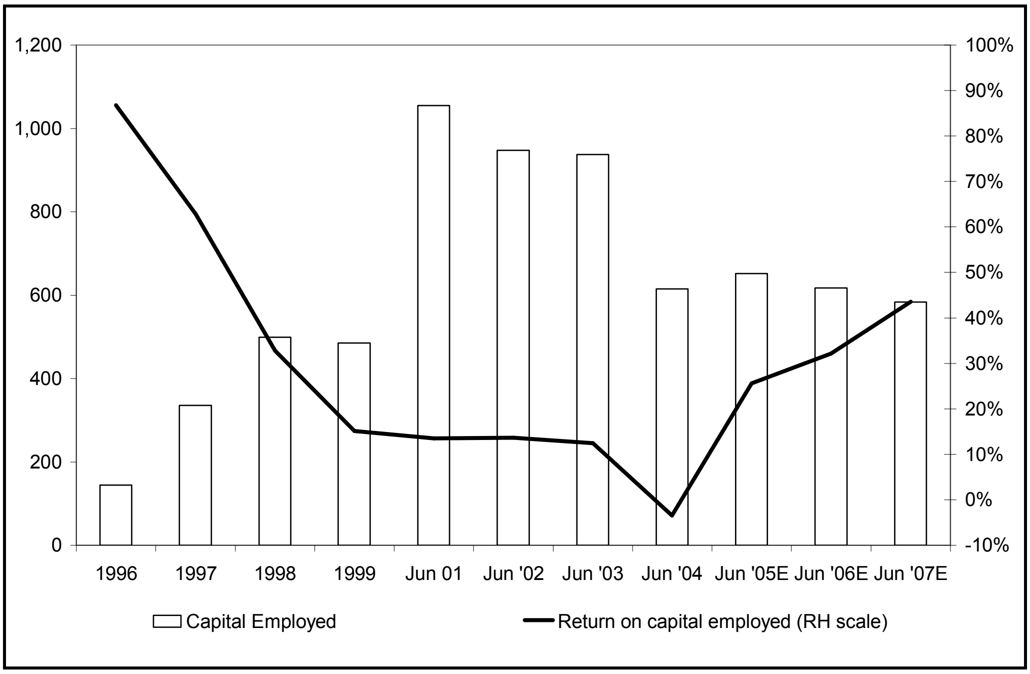
Comparison with IC Companys

IC Companys is a Danish designer/purchaser/wholesaler which emerged from the merger in '01 of InWear and Carli Gry. Both companies were already in decline 3-4 years ahead of the merger.

Unlike Benetton, this company outsources all production. In addition it got much more involved in retailing than Benetton with some 33% of sales vs. Benetton's 13% deriving from own retailing. This proved highly challenging initially but thanks to intensive efforts and substantial format changes (including the addition of assortment from external suppliers) it now looks like some improvement is materialising.

True value to be revealed

IC Companys: Capital Employed and RoCE

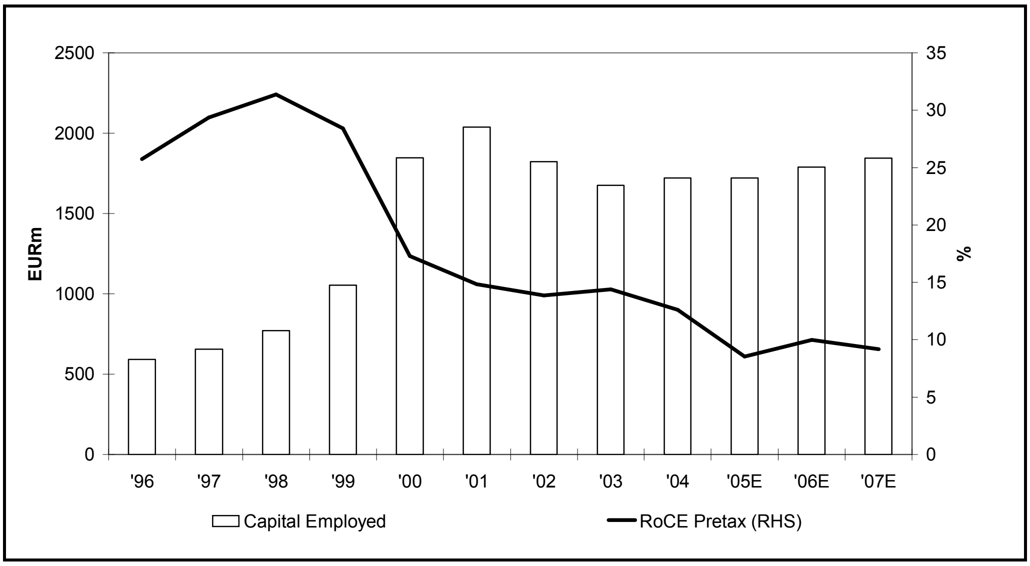


Source: Company data, PII estimates

IC C's restructuring period lasted a full 6-7 years…

A simplistic visual comparison of the two charts showing Capital Employed and RoCE suggests IC Company's restructuring period lasted 6-7 years. It spent 3 years running at what was thought to be rock-bottom 10% EBIT margin but then disappointed yet again with another step down in '04.

Benetton: Capital Employed and RoCE



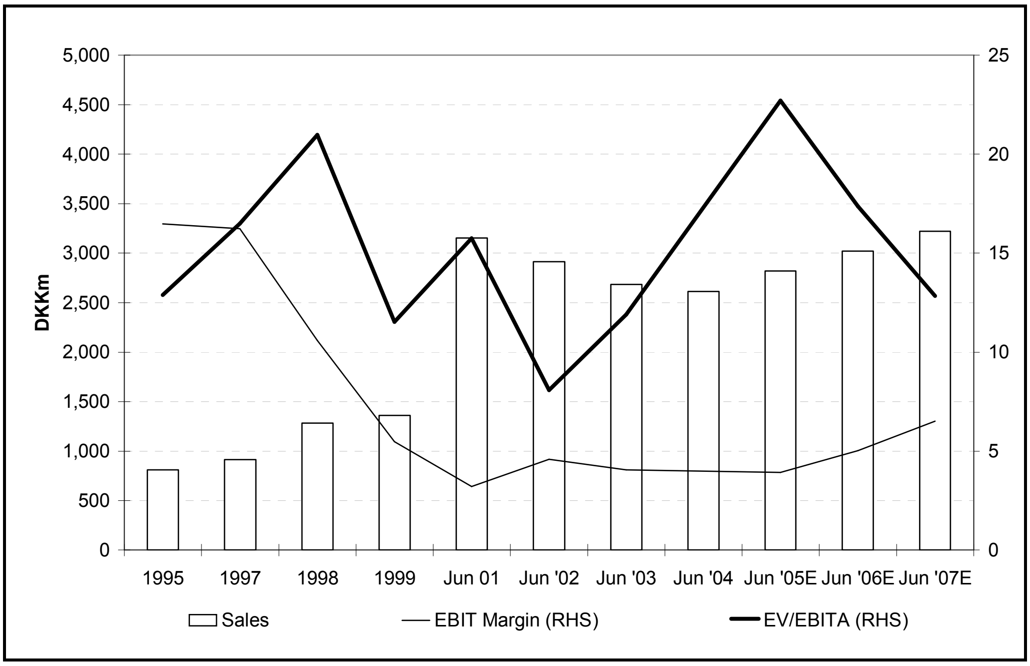
Source: Company data, PII estimates

... Benetton may not escape the same indignity...

Compared to IC Companys we see Benetton lagging at least 1-2 years on the one hand, while on the other hand benefiting from greater logistics competency and a stronger brand, which may enable it to progress more rapidly than IC Companys.

The charts below show the evolution of sales, profitability and valuation of IC Companys since 1995. At the depth of IC Company's development in '02 the share traded at 8x EBIT but it has since recovered and stands currently at approx. 20x EBIT.

Sales, EBIT margin and EV/EBIT: IC Companys

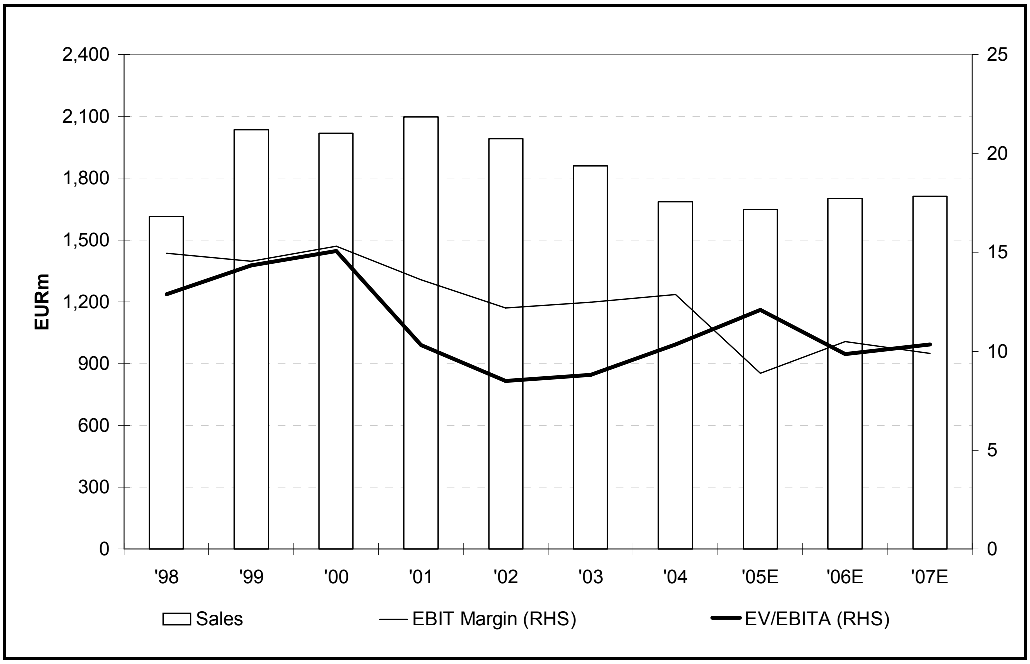


Source: Company data, PII calculations and estimates

... with little room for excitement in the meantime

Benetton shares also troughed in '02 at 8-9x EBIT and have since recovered to 12x EBIT. We would argue that the market in IC Companys shares discounts upward revision of guidance/consensus, which is likely to materialise in our view, while Benetton does not appear to be in a position to put forward more ambitious guidance with much conviction.

Sales, EBIT margin and EV/EBIT: Benetton



Source: Company data, PII calculations and estimates

Key model assumptions

Group performance and key assumptions: Annually

	'01	'02	'03	04	05E	06E	07E
Sales growth							
Casual	9.5%	-2.6%	-0.4%	-4.7%	-2.1%	2.0%	2.0%
Sportswear	-17.8%	-13.4%	-43.8%	-52.8%	-6.8%	2.0%	2.0%
Manufacturing	7.0%	-13.9%	-1.6%	-11.6%	-0.7%	2.0%	2.0%
Group	3.9%	-5.0%	-6.7%	-9.3%	-2.2%	3.2%	0.6%
Gross Margin							
Casual	46.6%	47.2%	46.7%	47.9%	44.9%	43.0%	43.0%
Sportswear	32.2%	34.3%	30.2%	25.3%	24.9%	25.5%	25.5%
Manufacturing	34.1%	18.7%	19.8%	15.9%	14.4%	15.0%	15.0%
Group	43.5%	43.6%	43.6%	44.9%	42.1%	40.0%	40.5%
SG&A							
Casual	(433)	(484)	(511)	(510)	(512)	(515)	(514)
Sportswear	0	(125)	(50)	(18)	(19)	(21)	(21)
Manufacturing	0	(16)	(17)	(12)	(8)	(8)	(8)
Group	(623)	(625)	(578)	(540)	(539)	(544)	(543)
EBIT Margin							
Casual	20.0%	16.6%	14.4%	14.0%	9.4%	8.7%	9.5%
Sportswear	0.0%	-9.9%	-1.3%	1.3%	1.1%	-3.3%	-3.4%
Manufacturing	0.0%	5.7%	5.8%	4.7%	6.4%	7.6%	7.8%
Group	13.6%	12.2%	12.5%	12.9%	8.9%	10.5%	9.9%

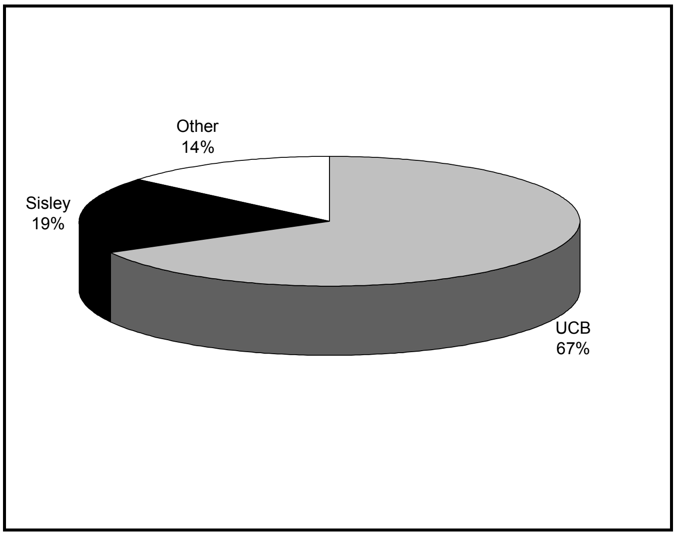
Source: Company data, PII estimates

Group performance and key assumptions: Quarterly

	Q1 04	Q2 04	Q3 04	Q4 04	Q1 05	Q2 05E	Q3 05E	Q4 05E
Sales growth								
Casual	-0.3%	-5.2%	-5.2%	-7.4%	0.0%	-3.0%	-3.0%	-2.0%
Sportswear	-74.0%	-65.1%	-4.0%	14.3%	-2.0%	-2.0%	-2.0%	-2.0%
Manufacturing	-18.5%	-5.1%	-20.0%	-6.7%	-2.0%	-2.0%	-2.0%	-2.0%
Group	-14.2%	-10.1%	-6.1%	-6.7%	-0.8%	-2.9%	-2.9%	-2.0%
Gross margin								
Casual	47.2%	46.2%	48.0%	50.4%	48.0%	42.4%	43.7%	45.9%
Sportswear	35.0%	20.0%	25.0%	18.8%	35.0%	20.0%	25.0%	19.0%
Manufacturing	18.2%	13.5%	20.0%	14.3%	15.0%	11.0%	19.0%	15.0%
Group	44.9%	42.8%	45.1%	47.0%	43.4%	39.2%	41.2%	43.0%
SG&A								
Casual	(117)	(130)	(118)	(145)	(118)	(131)	(118)	(145)
Sportswear	(5)	(3)	(4)	(6)	(6)	(3)	(4)	(6)
Manufacturing	(4)	(3)	(4)	(1)	(3)	(2)	(2)	(1)
Group	(126)	(136)	(126)	(152)	(127)	(136)	(124)	(152)
EBIT margin								
Casual	12.7%	15.2%	13.7%	14.2%	10.0%	10.2%	8.3%	9.0%
Sportswear	10.0%	0.0%	8.3%	-18.8%	12.5%	-0.4%	8.0%	-19.3%
Manufacturing	0.0%	5.4%	0.0%	10.7%	0.0%	5.5%	8.8%	11.4%
Group	11.8%	14.0%	12.6%	12.8%	9.5%	9.5%	8.3%	8.1%

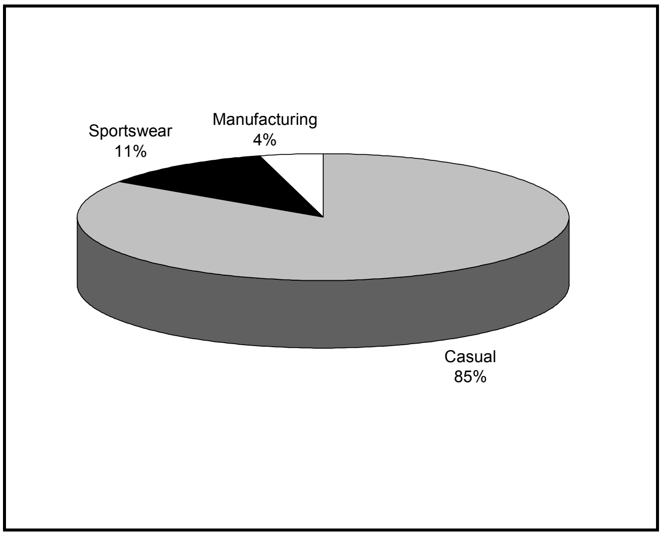
Source: Company data, PII estimates

Casual sales by brand



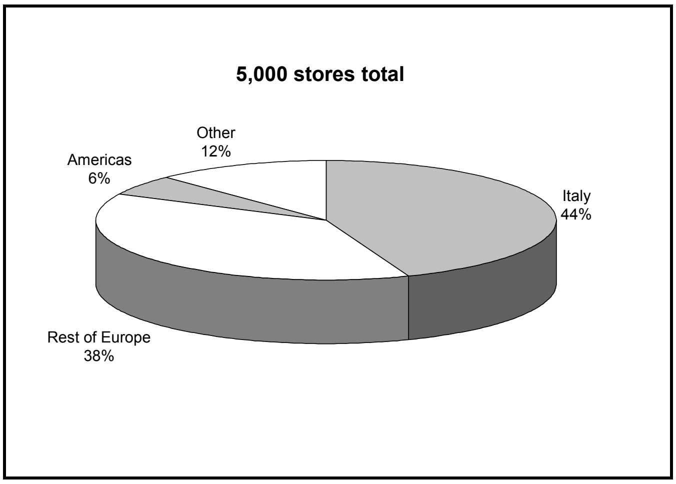
Source: Company data

EBIT by division



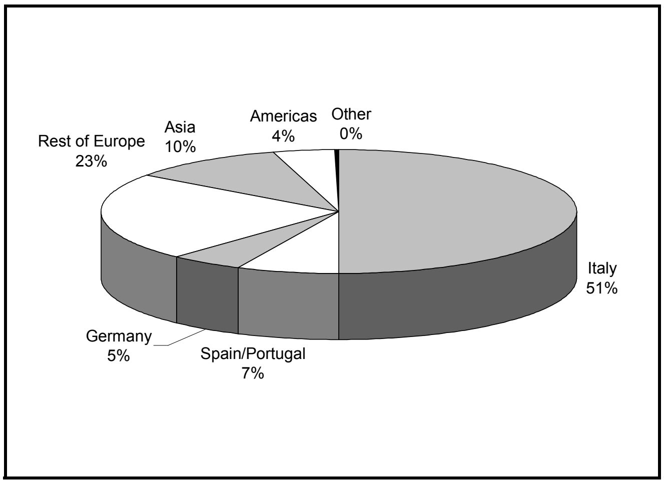
Source: Company data

Stores network, Geographical breakdown



Source:: Company data

Sales by region



Source: Company data and PII estimates

P&L summary: historic and forecast

	'96	'97	'98	'99	'00	'01	'02	'03	'04	chg%	'05E	chg%	'06E	chg%	'07E	chg%
Net sales	1,008	1,217	1,615	2,035	2,018	2,098	1,992	1,859	1,686	*-9*	1,649	*-2*	1,702	*3*	1,713	*1*
Costs of goods sold	-808	-963	-1,290	-1,628	-1,578	-1,642	-1,649	-1,548	-1,369	*-12*	-1,403	*2*	-1,418	*1*	-1,433	*1*
PROFIT BEF DEPR	200	255	325	407	440	455	343	311	317	*2*	247	*-22*	284	*15*	280	*-1*
margin %	19.9	20.9	20.1	20.0	21.8	21.7	17.2	16.7	18.8		14.9		16.7		16.3	
Depreciations	-50	-62	-84	-111	-131	-170	-100	-79	-100	*26*	-100		-105	*5*	-110	*5*
OPERATING PROFIT	150	193	242	296	309	286	243	232	217	*-6*	147	*-32*	179	*22*	170	*-5*
margin %	14.9	15.8	15.0	14.6	15.3	13.6	12.2	12.5	12.9		8.9		10.5		9.9	
Interest net	-11	-4	-6	-6	-14	-21	-32	-22	-23		-18		-18		-17	
PROFIT AFT FINANCE	140	188	236	291	295	264	211	210	195	*-7*	128	*-34*	161	*26*	152	*-5*
margin %	13.8	15.5	14.6	14.3	14.6	12.6	10.6	11.3	11.5		7.8		9.5		8.9	
PRETAX PROFIT	139	188	236	289	293	260	209	209	195	*-7*	128	*-34*	161	*26*	152	*-5*
Taxes	-39	-60	-76	-86	-107	-150	-57	-56	-42	*-25*	-35	*-18*	-44	*26*	-41	*-5*
% of pretax profit	28	32	32	30	37	58	27	27	22		27		27		27	

Source: Company data, PII estimates

Balance sheet summary: historic and forecast

	'96	'97	'98	'99	'00	'01	'02	'03	'04	chg%	'05E	chg%	'06E	chg%	'07E	chg%
Cash & Liquid assets	82	142	152	164	243	176	297	369	394	*7*	425	*8*	436	*3*	445	*2*
Inventories	82	102	158	188	329	305	284	234	255	*9*	214	*-16*	221	*3*	223	*1*
Receivables	58	62	101	153	1,001	1,010	1,055	1,074	928	*-14*	908	*-2*	937	*3*	943	*1*
CURRENT ASSETS	223	306	410	506	1,573	1,491	1,637	1,677	1,577	*-6*	1,547	*-2*	1,594	*3*	1,610	*1*
FIXED ASSETS	598	671	916	1,267	1,302	1,330	1,007	1,020	1,046		1,100		1,145		1,195	
TOTAL ASSETS	820	977	1,326	1,773	2,875	2,821	2,643	2,697	2,623	*-3*	2,647	*1*	2,739	*3*	2,805	*2*
Accounts payable	105	131	356	435	416	387	340	332	284	*-14*	278	*-2*	287	*3*	289	*1*
Debt	672	684	631	116	230	456	93	37	326	*786*	326		326		326	
Other liabilities	-373	-375	-342	314	1,043	721	1,055	1,142	776		774		777		778	
Share holders equity	415	530	673	893	1,175	1,241	1,141	1,174	1,230	*5*	1,262	*3*	1,342	*6*	1,406	*5*
LIABILITIES & EQUITY	820	977	1,326	1,773	2,875	2,820	2,643	2,697	2,623	*-3*	2,647	*1*	2,739	*3*	2,805	*2*
Working capital/sales (%)	*4*	*3*	*-6*	*-5*	*43*	*43*	*44*	*41*	*47*		*44*		*44*		*44*	
Net gearing (%)	*48*	*27*	*15*	*18*	*70*	*64*	*52*	*40*	*38*		*35*		*32*		*30*	
Equity ratio (%)	*51*	*55*	*51*	*51*	*41*	*45*	*44*	*44*	*47*		*48*		*49*		*50*	
Net debt/(cash) (EURm)	*202*	*146*	*105*	*160*	*831*	*810*	*602*	*473*	*474*		*444*		*433*		*424*	

Source: Company data, PII estimates

Cash flow summary: historic and forecast

	'96	'97	'98	'99	'00	'01	'02	'03	'04	chg%	'05E	chg%	'06E	chg%	'07E	chg%
CASH EARNINGS	123	180	236	317	322	283	92	188	224	*19*	194	*-13*	223	*15*	221	*-1*
Change in working capital		-2	-131	4	971	18	-8	-133	33	*-125*	-53	*-260*	23	*-145*	5	*-79*
Investments		-43	-46	-603	-412	-278	-152	-10	-156	*1439*	-154	*-1*	-150	*-3*	-160	*7*
NET CASH FLOW		139	322	-290	-1,061	-13	-52	311	35	*-89*	92	*166*	49	*-47*	56	*15*
Dividend paid				2	187	84	74	64	69	*9*	62	*-11*	38	*-39*	48	*26*
CHANGE IN NET DEBT		-139	-322	292	1,248	96	126	-248	34	*n.m.*	-30	*n.m.*	-11	*n.m.*	-9	*n.m.*

Source: Company data, PII estimates

Summary financial and valuation ratios

P&L	*'96*	*'97*	*'98*	*'99*	*'00*	*'01*	*'02*	*'03*	*'04*	*'05E*	*'06E*	*'07E*
Revenues	1,008	1,217	1,615	2,035	2,018	2,098	1,992	1,859	1,686	1,649	1,702	1,713
growth %	*-39*	*21*	*33*	*26*	*-1*	*4*	*-5*	*-7*	*-9*	*-2.2*	*3.2*	*0.6*
EBITD	200	255	325	407	440	455	343	311	317	247	284	280
margin %	*19.9*	*20.9*	*20.1*	*20.0*	*21.8*	*21.7*	*17.2*	*16.7*	*18.8*	*14.9*	*16.7*	*16.3*
EBIT	150	193	242	296	309	286	243	232	217	147	179	170
margin %	*14.9*	*15.8*	*15.0*	*14.6*	*15.3*	*13.6*	*12.2*	*12.5*	*12.9*	*8.9*	*10.5*	*9.9*
Pretax profit	140	188	236	291	295	264	211	210	195	128	161	152
margin %	*13.8*	*15.5*	*14.6*	*14.3*	*14.6*	*12.6*	*10.6*	*11.3*	*11.5*	*7.8*	*9.5*	*8.9*
Adjusted pretax	142	188	237	294	306	276	57	173	166	128	161	152
Tax rate %	*28*	*32*	*32*	*30*	*37*	*58*	*27*	*27*	*22*	*27*	*27*	*27*
Financial risk												
Net gearing (%)	48.4	27.2	15.5	17.6	70.0	64.5	52.1	39.9	38.3	35.0	32.1	30.0
Equity ratio (%)	50.8	54.9	51.3	51.2	41.3	44.5	43.7	44.0	47.2	47.9	49.2	50.4
Debt/Equity (x)	.7	.5	.4	.4	.9	.8	.8	.7	.7	.7	.6	.6
Interest cover (x)	13.5	26.4	38.3	33.7	25.8	20.4	6.1	7.3	9.6	8.0	10.2	9.9
Interest rate (%)	5.3	2.6	4.5	4.2	2.8	2.6	4.5	4.1	4.8	4.0	4.0	4.0
Efficiency & Returns												
Inventory/sales (%)	8.1	8.4	9.8	9.3	16.3	14.5	14.3	12.6	15.1	13.0	13.0	13.0
Work cap/sales (%)	3.5	2.8	-6.1	-4.6	43.4	42.7	44.5	40.5	46.6	44.5	44.5	44.5
Turnover ratio (x)	1.2	1.2	1.2	1.1	.7	.7	.8	.7	.6	.6	.6	.6
Capex/sales (%)		10.8	19.3	15.2	17.4	13.2	7.9	5.9	9.0	8.5	8.8	9.3
Capex/depr (x)		2.1	3.7	2.8	2.7	1.6	1.6	1.4	1.5	1.4	1.4	1.5
R&D/sales (%)		.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
RoE (%)	27.4	27.4	27.0	25.6	17.2	9.2	14.3	13.9	13.2	7.7	9.2	8.2
RoA (%)	18.3	20.0	18.3	16.8	10.6	9.7	9.4	8.9	8.3	5.5	6.5	6.0
ROCE (%)	25.7	29.4	31.4	28.4	17.3	14.8	13.9	14.4	12.6	8.5	10.0	9.2
Per share data	***'96***	***'97***	***'98***	***'99***	***'00***	***'01***	***'02***	***'03***	***'04***	***'05E***	***'06E***	***'07E***
Price			17	23	22	13	9	9	10	7.3	7.3	7.3
abs performance							-33	7	7	-25	0	0
EPS (adjusted)	.55	.70	.88	1.13	1.04	.60	.19	.66	.71	.52	.65	.61
growth %		*28*	*25*	*28*	*-8*	*-42*	*-69*	*251*	*8*	*-28*	*26*	*-5*
EPS (adj. Incl. goodwill)	.56	.70	.88	1.14	1.10	.70	.24	.71	.7	.5	.6	.6
growth %		*25*	*26*	*29*	*-4*	*-36*	*-66*	*196*	*0*	*-28*	*26*	*-5*
P/E H						38.9	130.0	34.8	30.9	0.0	0.0	0.0
P/E L						25.3	97.6	23.6	21.8	0.0	0.0	0.0
P/E Y/E			18.8	20.2	21.1	21.1	45.1	13.8	13.6	14.2	11.3	11.9
CEPS	.8	1.0	1.3	1.7	1.8	1.6	1.4	1.3	1.4	1.1	1.2	1.2
P/CE			12.4	13.1	12.4	8.1	6.1	7.1	7.0	6.9	6.0	6.0
P/Sales (%)			1.87	2.03	1.96	1.10	0.77	0.89	1.05	0.81	0.78	0.78
EV/Sales (%)			1.93	2.11	2.39	1.49	1.08	1.14	1.33	1.07	1.04	1.02
EBDIT (x)			9.6	10.5	10.9	6.8	6.3	6.8	7.1	7.2	6.2	6.3
EBIT (x)			12.9	14.3	15.1	10.3	8.5	8.8	10.3	12.1	9.9	10.3
BV	2	3	4	5	6	7	6	6	7	7	7	8
P/BV			4.5	4.6	3.4	1.9	1.4	1.4	1.4	1.1	1.0	.9
Dividend				1.03	0.46	0.41	0.35	0.38	0.34	0.21	0.26	0.25
Div yield (%)				4.5	2.1	3.2	4.1	4.2	3.5	2.9	3.6	3.4
Div/EPS (%)	.0	.0	1.1	91.5	44.3	67.9	185.7	57.5	47.6	40.5	40.5	40.5
No of shares (m)	181	181	181	181	181	181	181	182	182	182	182	182

Source: Company data and PII forecasts