

COMPANY UPDATE

Benetton Group (BNG.MI)

Sell

Raising EPS forecasts

What's changed

We are increasing our EPS forecasts for Benetton by 6.5% for 2007E and by 7% for 2008E owing to strong forward wholesale orders and a better outlook for gross margin. We now expect a flat gross margin for 2007 compared to our previous expectation of a 30 bp decline owing to:

- 1) Lower price cuts to franchisees – these were 5% this year which is falling to 3% for spring/summer 2007 and nil for autumn/Winter 2007.
- 2) More accessories in the product mix – these represent 7% of product sold now, up from 3% in 2003 and the medium-term target is 10%.
- 3) A higher number of directly-owned stores – these should contribute c.10% of EBIT in 2007.
- 4) Stronger LFL sales leading to higher profit retention. We now forecast 10% revenue growth for 2007E compared to our previous estimate of 8%, split one-third space contribution and two-thirds LFL sales growth.

Implications

We have raised our 12-month price target on the stock from €10.2 to €12.4 based on cash returns analysis. A DCF gets us to €12.6 using a 7.4% WACC and 0% terminal growth rate. Our preferred European apparel stock remains Inditex.

Valuation

On our new forecasts, Benetton still looks fully valued, trading on a 2007E calendar P/E of over 17x, for c.10% long-term EPS growth. Benetton's valuation is mid range historically on EV/GCI, forward P/E and lease-adjusted EV/EBITDAR.

Key risks

Benetton could continue to surprise on the upside in terms of volume growth, particularly in the fragmented Italian market, where both Benetton and Zara have been taking share from independents.

INVESTMENT LIST MEMBERSHIP

Pan-Europe Sell List

Coverage view: Cautious

Italy:
Retail

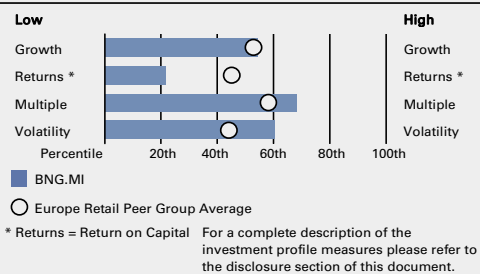
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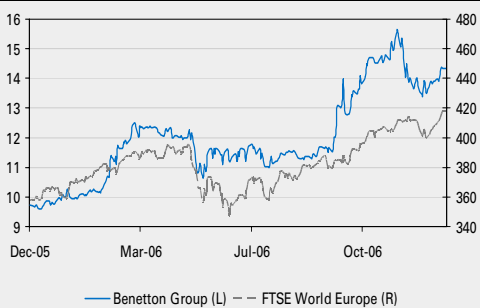
Investment Profile: Benetton Group



Key data	Current
Price (€)	14.33
12 month price target (€)	12.40
Upside/(downside) (%)	(13)
Market cap (€ mn)	2,601.7
Enterprise value (€ mn)	3,013.9

	12/05	12/06E	12/07E	12/08E
Revenue (€ mn) New	1,765.0	1,906.5	2,091.9	2,243.6
Revenue revision (%)	0.0	0.0	1.6	1.8
EBIT (€ mn) New	205.0	189.7	213.3	236.7
EBIT revision (%)	0.0	(1.0)	6.8	13.1
EPS (€) New	0.62	0.73	0.82	0.89
EPS (€) Old	0.62	0.71	0.77	0.83
EV/EBITDA (X)	6.5	10.9	10.4	10.0
P/E (X)	13.6	19.6	17.5	16.0
FCF yield (%)	16.5	3.3	1.3	1.9
CROCI (%)	11.0	8.9	9.0	9.0

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	10.2	26.3	55.0
Rel. to FTSE World Europe	0.8	5.0	29.8

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 12/18/2006 close.

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Benetton Group: Summary financials

Profit model (€ mn)	12/05	12/06E	12/07E	12/08E	Balance sheet (€ mn)	12/05	12/06E	12/07E	12/08E
Total revenue	1,765.0	1,906.5	2,091.9	2,243.6	Cash & equivalents	196.3	145.8	38.3	0.0
Operating costs	(1,225.8)	(1,353.6)	(1,490.5)	(1,597.7)	Accounts receivable	655.4	625.4	675.4	729.5
R&D	0.0	0.0	0.0	0.0	Stocks	287.2	327.2	353.4	378.2
Lease payments	(92.2)	(102.0)	(112.0)	(122.0)	Other current assets	96.0	69.6	48.6	23.6
Other operating profit/(expense)	(157.0)	(175.4)	(188.3)	(197.4)	Current assets	1,235.0	1,168.1	1,115.8	1,131.3
EBITDA	290.0	275.5	301.1	326.4	Accounts payable	(315.0)	(365.0)	(415.0)	(465.0)
Depreciation & amortisation	(85.0)	(85.8)	(87.9)	(89.7)	Other current liabilities	(133.8)	(133.8)	(133.8)	(133.8)
EBIT	205.0	189.7	213.3	236.7	Current liabilities	(448.7)	(498.7)	(548.7)	(598.7)
Net interest income/(expense)	(23.0)	(17.0)	(20.4)	(26.0)	Gross PP&E and intangibles	1,610.8	1,810.8	2,010.8	2,210.8
Associates	0.0	0.0	0.0	0.0	Net PP&E	743.0	857.2	969.3	1,079.6
Profit/(loss) on disposals	0.0	0.0	0.0	0.0	Net intangibles	151.7	151.7	151.7	151.7
Others (recurring)	(48.0)	0.0	0.0	0.0	Total investments	277.6	277.6	277.6	277.6
Pretax profits	134.0	172.7	192.9	210.7	Other long-term assets	0.0	0.0	0.0	0.0
Income tax	(20.0)	(38.0)	(42.4)	(46.4)	Long-term assets	1,172.3	1,286.5	1,398.7	1,508.9
Tax rate (%)	15.0	22.0	22.0	22.0	Total assets	2,407.3	2,454.7	2,514.5	2,640.2
Minorities	(2.0)	(2.0)	(2.0)	(2.0)	Unfunded pensions & other provs	(41.6)	(41.6)	(41.6)	(41.6)
Preferred dividends	0.0	0.0	0.0	0.0	Deferred taxes & other liabilities	(84.0)	(84.0)	(84.0)	(84.0)
Net income (pre-exceptionals)	112.0	132.7	148.5	162.4	Long-term liabilities	(125.6)	(125.6)	(125.6)	(125.6)
Other non-recurring items post tax	0.0	0.0	0.0	0.0	Total shareholders' equity	1,261.9	1,266.3	1,276.1	1,250.9
Net income	112.0	132.7	148.5	162.4	Minority interest	13.1	6.0	6.0	5.0
EPS (underlying) (€)	0.62	0.73	0.82	0.89	Short-term debt	54.9	54.9	54.9	156.8
EPS (basic, reported) (€)	0.62	0.73	0.82	0.89	Long-term debt	503.2	503.2	503.2	503.2
Weighted shares outstanding (mn)	181.6	181.6	181.6	181.6	Capitalised leases	737.6	816.0	896.0	976.0
Common dividends declared	61.7	73.0	81.6	89.3	Capital employed	2,570.6	2,646.3	2,736.1	2,891.9
DPS (€)	0.34	0.40	0.45	0.49	Adj for unfunded pensions & GW	(193.4)	(193.4)	(193.4)	(193.4)
Dividend payout ratio (%)	55.1	55.0	55.0	55.0	Adj capital employed	2,377.3	2,453.0	2,542.8	2,698.5
Dividend cover (X)	1.8	1.8	1.8	1.8	Gross cash invested	3,215.9	3,427.9	3,713.1	3,996.9
					Ratios	12/05	12/06E	12/07E	12/08E
Growth & margins (%)	12/05	12/06E	12/07E	12/08E	CROCI (%)	11.0	8.9	9.0	9.0
Revenue growth	3.6	8.0	9.7	7.2	CROCI/WACC (X)	1.8	1.4	1.5	1.6
EBITDA growth	(3.0)	(5.0)	9.3	8.4	ROIC (%)	9.4	9.5	10.2	10.7
EBIT growth	(8.9)	(7.5)	12.4	11.0	ROIC/WACC (X)	1.5	1.5	1.7	1.8
Net income growth	2.7	18.5	11.9	9.4	ROA (%)	4.5	5.5	6.0	6.3
EPS growth	2.7	18.5	11.9	9.4	WACC (%)	6.2	6.2	6.0	5.8
DPS growth	--	18.2	11.9	9.4	Inventory days	59.4	62.7	61.7	61.5
EBITDA margin	16.4	14.5	14.4	14.6	Asset turnover (X)	2.4	2.2	2.2	2.1
EBIT margin	11.6	10.0	10.2	10.6	Net debt/equity (%)	28.4	32.4	40.5	52.6
					EBITDA interest cover (X)	12.6	16.2	14.8	12.6
Cash flow statement (€ mn)	12/05	12/06E	12/07E	12/08E	Valuation	12/05	12/06E	12/07E	12/08E
Net income	112.0	132.7	148.5	162.4	EV/sales (X)	0.9	1.5	1.4	1.4
D&A	85.0	85.8	87.9	89.7	EV/EBITDAR (X)	6.3	9.5	9.2	8.9
Minority interest	2.0	2.0	2.0	2.0	EV/EBITDA (X)	5.7	10.1	9.6	9.3
Other recurring items	75.0	0.0	0.0	0.0	EV/EBIT (X)	8.1	12.3	11.6	11.2
Post tax cash flow from operations	274.0	220.5	238.3	254.1	P/E (X)	13.6	19.6	17.5	16.0
Net inc/(dec) working capital	217.8	66.4	(5.2)	(3.8)	Dividend yield (%)	4.0	2.8	3.1	3.4
Capital expenditures	14.0	(200.0)	(200.0)	(200.0)	FCF yield (%)	16.5	3.3	1.3	1.9
Acquisitions	0.0	0.0	0.0	0.0	EV/GCI (X)	0.8	1.1	1.1	1.1
Divestitures	0.0	0.0	0.0	0.0	EV/adj. capital employed (X)	1.2	1.7	1.6	1.6
Dividends paid (common & pref)	(62.4)	(73.0)	(81.6)	(89.3)	Price/book (X)	1.4	2.1	2.0	2.1
Other non-recurring items	(350.1)	(64.4)	(59.0)	(101.3)					
Surplus/(deficit)	93.3	(50.5)	(107.5)	(140.3)					
Capex/D&A (%)	(16.5)	233.1	227.6	222.9					
Reinvestment rate (%)	(5.1)	90.7	83.9	78.7					
Cash flow cover of dividends (X)	4.4	3.0	2.9	2.8					
Free cash flow cover of dividends (X)	4.1	1.2	0.4	0.6					

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

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Stock looks fully valued

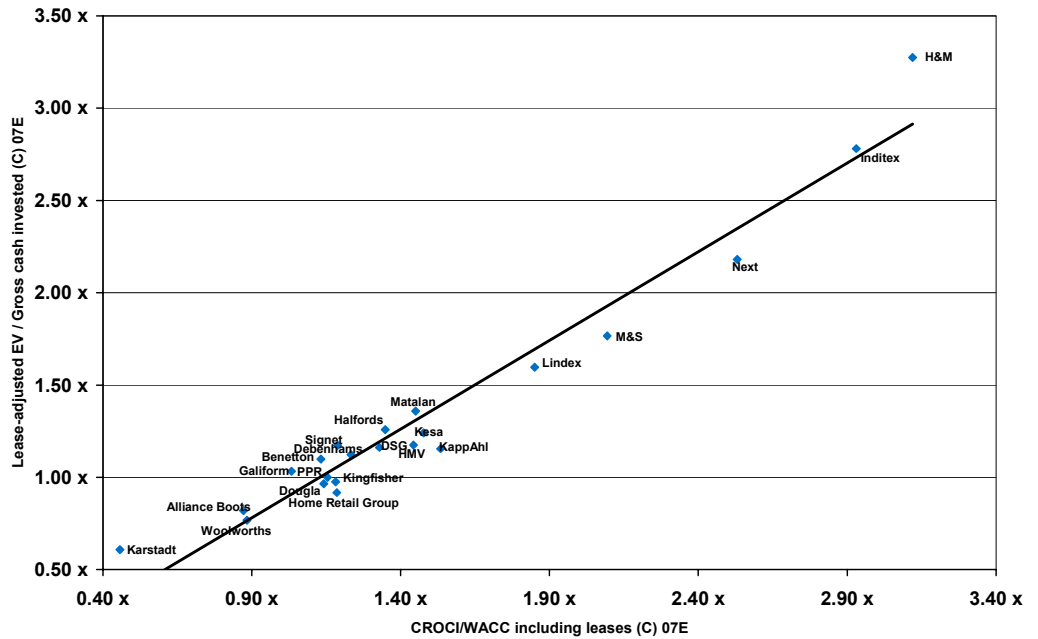
Benetton has staged a strong recovery over the past two years as a result of stronger collections, more competitive pricing and as it has increased its sourcing flexibility. Recently we have seen a polarization in apparel between fashion and price, and Benetton should benefit if consumers now gravitate towards retailers positioned more in the middle. We are now more positive on the sales and gross margin outlook, but we believe that the stock is fully valued at current levels.

Benetton has improved its sourcing structure recently but still lacks the stock control and speed to market of Inditex and the sourcing flexibility of H&M. In terms of sourcing, 75% of product comes from Benetton's own factories split between Italy (16%), Tunisia (20%) and Eastern Europe (mainly Hungary) 39%, with a further 25% coming from third-party factories in Asia. Over time this will shift to 10% Italy, with 30% each from Eastern Europe, Tunisia and Asia. Benetton is therefore not such a beneficiary from a weaker dollar as other apparel retailers.

Benetton has recently lost its CEO and CFO but we understand that the company is close to hiring a new CFO. The focus will be on EBITDA growth, with relatively high capex (c.10% of sales) next year as the company steps up its international expansion in areas such as Asia. This is likely to act as something of a drag on returns, although we expect these to improve slightly in 2007 as a result of the stronger sales outlook, together with some operating leverage.

Our main issue with Benetton is the valuation of the stock, following a strong run in the share price (+19% vs. the sector year to date). Our preferred stock in European apparel is Inditex, which although trading on a calendar 2007E P/E of 22x, compared to 17x for Benetton, offers a much higher 2007-2009E EPS growth rate of 20% compared to 10% for Benetton.

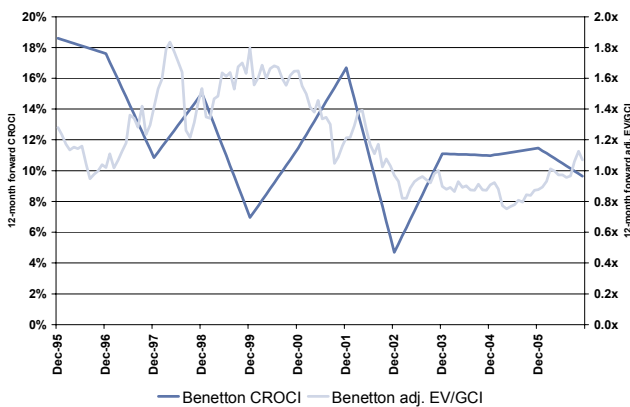
Exhibit 1: Benetton looks fully valued versus the sector relative to cash returns
 CY2007E leveraged EV/GCI versus CROCI/WACC



Source: Goldman Sachs Research estimates.

Exhibit 2: Benetton's EV/Gross Cash Invested and Cash Return on Cash Invested (CROCI) are mid to low of its historic range

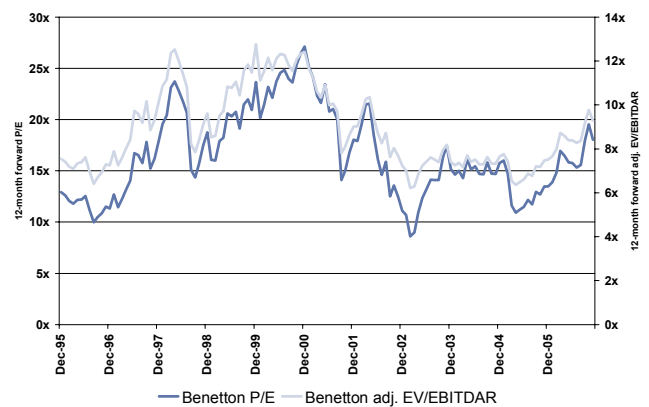
Benetton 12-month forward CROCI vs leveraged EV/GCI



Source: Company Data, Goldman Sachs Research estimates.

Exhibit 3: Benetton is trading in the middle of its historical P/E and leveraged EV/EBITDAR

H&M 12-month forward P/E and leveraged EV/EBITDAR



Source: Company Data, Goldman Sachs Research estimates.

Reg AC

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