

Risk factors of the Benetton business

In carrying out its business activities, Benetton is subject to the following risks:

The Benetton business is subject to competitive pressure. The Group operates in an industry, the apparel sector, which is highly competitive as far as production, sales and distribution are concerned. The number of competitors has grown considerably in the last few years, and companies manufacturing out of countries with a low cost base now play an important role.

To contain this risk, the Group maintains a strategic focus on production and organizational efficiency policies related to the process of production decentralization, completion of production cycles in overseas units, and organizational cost reduction. Increased competition could lead to price pressure, which would have a significantly negative impact on the Group's financial standing and performance.

As far as distribution is concerned, competition could increase given that there are few barriers to entry. Benetton competes against local, national and global department stores, specialized retailers, independent retailers and manufacturing companies, as well as against mail order companies which use catalogues to target customers.

Benetton focuses mainly on quality, breadth of product range and merchandising, customer service, store ambience, and sales and marketing programs. The Group also competes to secure prime retail sites and the best lease and purchase conditions.

The success of Benetton's strategies is influenced by the sales network's buy-in. The substantial incentive scheme in place for the network of commercial partners, in line with the business model, seeks to enable partners to increase their investment capacity in order to open new stores, renew existing ones, and increase competitiveness in terms of price to the final consumer. The success of this strategy depends on the ability to motivate and manage the network by setting specific objectives and monitoring progress on a regular basis.

It is to be noted that the Group's business model is linked to a risk of late payment from customers and, generally speaking, payment collection risk.

Benetton's future performance depends on its ability to develop the business in emerging markets. The Group is strengthening its new commercial strategies. Special emphasis is being placed on certain emerging markets, such as China and India, including through agreements with large-scale retailers for the opening of "stores in stores" in large department stores in the largest cities. The Group's initiatives include the creation of new partnerships to manage and develop commercial activities.

Benetton's business is sensitive to changes in customer spending habits and can be influenced, amongst other things, by business outlook, interest rates, taxation, local economic conditions, uncertainty over future economic prospects and a shift of spending habits towards other goods or services. Consumer preferences and economic conditions may change from time to time in each and every market in which the Group operates.

Benetton's success depends on its ability to anticipate and respond to changing trends. Sales and profitability levels also depend on the ability to anticipate and react immediately to changes in fashion trends and consumer tastes. If Benetton's collections were not to meet with the customers' approval, the result would be lower than expected sales, a higher level of discounts, and reduced margins.

The Group's growth and expansion strategy has led to an increase in fixed and operating costs. To strengthen Benetton's image and market share, investments have been made in recent years to sell products through directly-owned retail stores, even if the Group has traditionally distributed its products through a capillary network of franchise stores. To date, the Benetton Group manages 280 wholly-owned shops, which are strategic as far as the demographic and commercial profile of their locations is concerned. These retail stores have, however, led to an increase in fixed and operating costs. These investments expose the Group to the additional risk that some of the chosen locations may turn out to be inadequate because of changes in the area's demographic profile or the location of shopping districts.

Benetton is exposed to risks linked with its strategies. The Group strives to develop the existing commercial network and to strengthen its brand. However, this growth could be compromised were Benetton not able to:

1. identify adequate markets and adequate locations for new stores;
2. maintain the service levels expected by customers;
3. avoid sales and profit margin erosion for stores selling Benetton-branded goods when directly managed megastores are opened in the same areas or shopping districts;
4. manage inventories on the basis of effective needs;
5. deliver goods on time.

The Group's systems, procedures, controls, and resources need to be aligned to support its expansion plans. Should this not be the case, the success of the strategies proposed would not be ensured.

The protection of Benetton's intellectual property rights is subject to risks. To safeguard the rights on those core product values which are crucial to the Group's success and market competitiveness - i.e. design, proprietary technologies and manufacturing processes, product and concept research, acknowledged trademarks - Benetton relies on the laws on business secrecy, unfair competition, trade dress, trademarks, patents, and copyrights.

Nonetheless, trademark registration requests may not result in effective registrations, and in the same way even registrations granted may be ineffective to fend off competitors and could be subsequently invalidated. Above all, the actions undertaken to protect intellectual property rights may turn out to be ineffective against counterfeiting. The Group's know-how may become known to competitors, and Benetton may not be able to fully protect its intellectual property rights. Other companies may also develop products independently which are substantially similar or better to Benetton's, without infringing the Group's intellectual property rights. In addition, it is to be noted that legislation in some countries does not protect proprietary rights.

The already substantial amount of resources allocated to the protection of proprietary rights could be significantly increased should the level of infringement by third parties

also increase. Furthermore, judgments against us in disputes relating to the Group's proprietary rights may:

1. impose the granting of licenses to third parties or the requesting for licenses from third parties;
2. prevent the production or sale of the Group's products;
3. lead to substantial losses.

United Colors of Benetton, Undercolors, Sisley, Playlife, Killer Loop, and other commercial and service trademarks have been registered or are subject to registration requests with the trademarks and patent offices of many foreign countries and are protected by ordinary legislation.

The real estate market for commercial sites is very competitive. The ability of Benetton and its partners to find locations for new stores depends on the availability of adequate buildings and the ability to negotiate terms that are in line with established financial targets. Moreover, the Group must ensure that existing rental contracts can be renegotiated effectively.

The Group is implementing a number of changes to its information technology systems which, by their very nature, entail the risk of temporary downtime. In synergy with its strategic development plans, Benetton has begun changing and replacing its IT systems. The changes primarily involve the upgrading of current business systems, the development of system modifications, or the purchase of systems with new features. Benetton is aware of the risks linked to substitution, including the accurate transfer of data and possible system downtime, but we feel we have taken all the necessary steps to contain these risks by means of testing, training and project planning, as well as by entering into related commercial agreements with suppliers of the replacement technologies.

The launch of the new versions will be implemented in phases over a three-year timeframe.

Benetton's sales and operating income may be influenced by foreign exchange rate and interest rate fluctuations. The Group's sales and operating income will continue to be influenced by foreign exchange rate fluctuations in the sale currencies, which in turn impact on the prices of products sold, the cost of sales, and operating income. Foreign currency exchange rate variations against the euro may have a negative effect on sales, operating results, and the international competitiveness of the production facilities of the various business units. Even an appreciation of the euro could have an adverse effect on the Group's sales and operating income. Given that Benetton makes use of hedging in order to manage currency exposure, the strategies adopted may not be sufficient to protect income from the negative effects of future fluctuations. Benetton also holds assets and liabilities which are sensitive to interest rate variations and are necessary in managing liquidity and financial needs. These assets and liabilities are exposed to interest rate risk, which is, at times, managed through the use of derivative financial instruments.

Benetton is exposed to risks associated with the internationalization of its business activities, including risks relating to late payments in some countries or, in general, to credit collection difficulties. The business is also exposed to political and economic instability in some of the countries in which we operate, as well as to changes in legislation, to linguistic and cultural barriers, tariffs or trade barriers, and price or exchange rate controls.