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## Foreword

The private equity industry experienced an exceptional growth on a global scale until the great credit turmoil that unfolded in September of last year. The current environment raises particular challenges but also offers opportunities.

It is now a great pleasure to send you this first KPMG Luxembourg Private Equity Newsletter which is intended to provide a discussion forum about macro issues and also inform on tax, legal and regulatory developments in Luxembourg relevant to private equity.

The first article written by Yves Courtois, our Head of Private Equity and also Head of Corporate Finance and Valuation, covers the issues impacting the buyout industry. The article concludes with a personal view on the application of fair value in a private equity context. The following two articles, authored by Ilka Hesebeck and Julien Bieber from our Tax practice, provide insights on investment opportunities and tax considerations for distressed debt investing and new double tax treaties with Hong Kong offering private equity opportunities for cross border investments in Asia.

If you are interested in discussing any of these issues, please feel free to contact our dedicated Private Equity Group.

With best regards,

John Li  
*Chairman of the Supervisory Board*

## State of the Buyout Industry in the Great Credit Crisis

By Yves Courtois

The great credit crisis that started in mid 2007 in the US subprime residential housing sector, a rather benign part of the global credit markets, has spread to other credit sectors and culminated with the collapse of the investment bank Lehman Brothers. These events led to dire consequences for a number of credit institutions, many of them having at least been partly nationalized. Some of these banks were also large providers of senior debt financing to the leveraged buyout industry. And considering that at the peak of the market, roughly three quarters of fund raising in private equity flocked to leveraged buyout funds, the credit crisis will have profound influences on the shape of the private equity industry.

This article will discuss some of the recent key trends observed in the buyout segment of the private equity industry and the application of fair value in private equity.

### Refinancing of leveraged buyouts and governments' stance as de facto holders of leveraged buyout debt raise near term concerns

Statistics from Dealogic indicate that about \$ 1 Trillion of leveraged buyout debt at portfolio companies is due for refinancing in the coming years. The bulk of the debt that will become due for refinancing was originally negotiated on very favourable terms with low credit spreads relative to risk free rates. Frequently, banks were competing among themselves to provide debt financing to leveraged buyouts sponsored by the most established names in the industry. There were regional differences in lending patterns between the US markets where "covenant-lite" loans offering lower protection to the lender were more prevalent relative to the lending practices observed in Europe. Since the collapse of Lehman Brothers however, the traditional providers of debt financing to leveraged buyouts have been destabilized and some have landed in government hands. Credit availability for large leveraged buyouts has evaporated. The severity of the global recession is also eroding the debt service capacity of a number of large leveraged buyout portfolio companies, particularly those operating in cyclical industries such as automotive suppliers or semiconductors. Headroom, the cash flow available for debt service, has been generally contracting, exposing some portfolio companies to a growing risk of technical breaches of their debt covenants and sometimes to default. As a result, senior debt of a number of large leveraged buyouts is trading at deep discount to reflect both a lack of liquidity and significant credit concerns.

The rescue of some banks in the form of full or partial nationalization implies that governments have become de facto direct stakeholders in many large leveraged buyouts. Although many governments generally recognize the importance of private equity to their economy, political influence and public scrutiny implies that private equity will be more under the spotlight of the media and of politicians. The demand for greater transparency of the industry will inevitably increase. The attitude of governments when refinancing becomes due is however uncertain.

## Regulation of private equity is hotly debated

In response to the financial crisis and to the G20 consensus, the European Commission has drafted a new Directive targeting alternative investment funds. The recently proposed Directive on Alternative Investment Fund Managers (AIFM) is aiming to provide an integrated regulatory framework for the supervision of hedge funds, private equity funds, commodities funds, infrastructure funds and other alternative investment funds established in the European Union. This draft regulation is targeting fund managers exceeding certain size criteria which are deemed to potentially pose systemic risks. It is anticipated that the Directive will only apply to those AIFM managing a portfolio exceeding € 100 million. A higher threshold of € 500 million will apply to AIFM not using leverage and having at least a five year lock-up for their investors. The regulation is intended to impose certain regulatory authorization and ongoing regulation procedures to AIFM and require their service providers (mainly administrators and depositaries) to specific standards. It is also foreseen that the level of information transparency, including valuation, and governance standards will be enhanced. The flip side of the coin will be that regulated AIFM will be authorized to market their funds to professional investors throughout the European Union. Note however that the AIFM Directive is merely a proposal at this stage and is well over a year from any final resolution.

This new proposed regulatory framework has received a prompt cold response from the European Venture Capital Association (EVCA) which believes that it may be detrimental to the mid market private equity buyout industry. According to the EVCA, the new regulation may impose costly transparency requirements to an estimated 5,000 private equity sponsored mid market companies across the European Union. The EVCA also claimed that both the "de Larozière" Report and the G20 did not identify private equity as posing systemic risk.

This rift illustrates a change in attitude from governments towards the investment funds industry. In the past, governments considered that alternative investment funds did not need to be subject to comprehensive regulations on the grounds that they were targeting groups of well informed investors. These same funds are now becoming under scrutiny on the grounds that these activities may pose systemic risk to the entire economic and financial system.

### The activity of secondaries funds provides indications on liquidity constrained Limited Partners and also provides indications as to the health of some players

Secondaries fund managers used to have much less visibility in the industry relative to the most publicized names of the buyout, venture capital, mezzanine industry. It may be explained by their secretive nature. Typically transactions between secondaries funds and institutional investors selling their private equity holdings are negotiated between four walls and details are not released, not even to the Limited Partners invested in these funds.

Since the collapse of Lehman Brothers, the activity of secondaries funds has picked up considerably. Conferences on secondaries funds have mushroomed like never before. Three factors may explain this trend. First, a number of institutional investors, including banks, have been weakened in the credit crisis and some have been exploring ways to free up cash including conducting a secondary sale of their private equity funds investments. Second, other institutional investors such as pension funds and insurance companies frequently need to comply with a maximum

allocation to private equity and to other alternative investments by regulation. With the public equity markets falling dramatically in the fall and winter of 2008, some of these institutional investors have been constrained to reduce their allocation to private equity to comply with allocation requirements. Finally, the secondaries fund industry has matured considerably and target returns have moved from the low teens to the region of 20%, attracting a growing investor base. Secondaries funds have been able to obtain discounts sometimes in the region of 70% for transactions with distressed sellers. Secondaries funds have also been pickier in terms of placing their bids. Some have expressed doubts as to the viability of some leveraged buyout firms in the long run and been reluctant to even bid at low levels for some funds.

### Balance of power in the General Partner – Limited Partners relationship may swing back in favour of the latter

At the peak of the market, gaining access to the top funds in the industry for a Limited Partner was a leitmotiv. To gain access, Limited Partners had to have long established relationships or be big ticket investors. Terms were increasingly in favour of General Partners in that context.

Performance of buyout funds for the fourth quarter of 2008 has generally been sharply negative, ranging from -15% to -40%. The volume of European buyout deals as monitored by the Candover barometer has plunged to € 2.5 billion for the first quarter of this year, down 90% from the same period last year and with the lowest quarterly level since 1995. Less than 50 transactions were conducted, the lowest amount of transactions since 1992. No deals above € 1 billion took place signaling that large transactions may remain history for a long time. Considering the drop in transaction volumes, the markdowns in funds primarily reflect the unrealized losses on investments required by the accounting rule FASB 157 in the US and by the valuation guidelines of the EVCA in Europe which both require private equity funds to mark their investment to fair value. A lot more downside in the performance of buyout funds may be expected if there is a prolonged recession. Capital may be lost in significant proportions at some funds. Maintaining confidence with Limited Partners will be an essential task for General Partners if they want to successfully raise funds for the upcoming funds. Some buyout firms with experience investing in distressed debt have announced their intentions to reallocate a substantial part of the Limited Partners' undrawn commitments in existing buyout funds to invest in distressed debt trading at deep discount. The private equity arm of investment bank Goldman Sachs and Apollo Management have been reported to pursue such an investment strategy. But some institutional investors have also been vocal at other funds warning that they would object additional draw downs unless General Partners have a deal to make. They will also likely request more transparency on portfolio companies and making independent valuations of investments by third party valuers may be instrumental in ensuring that there are no biases in the approach.

### Application of fair value in private equity raises specific challenges

Unlike shares of public companies that are regularly traded on a regulated market, buyers and sellers of private equity shares generally deploy more efforts to "discover" the value. The value of private equity stakes is determined either on the basis of an appraisal or by means of an arm's length transaction taking place at some point in time for a specific purpose.



Private equity valuation is thus time bound, dependent on the motives as to why a valuation is needed. Therefore, valuation is primarily based on appraisals conducted by professionals, preferably independent from the parties interested in the valuation, but more frequently part of the investment teams.

Frequently, there is a belief among investors and managers of privately held firms that there is a unique true value for the firm at one point in time. This is not the case. Private equity value is a relative concept depending on the perspective of the interested parties and also magnified by the nature of the price discovery process, as no reference to publicly available market prices exists.

Two potential strategic acquirers of a privately held target company may for example assign a different value to the same target depending on their own assessment of specific factors that they may benefit from combining their operations, including the amount of synergies, diverging assessment of market potential for the target's product, different strategic motives, ect ... Although these two values assigned to the target business may be significantly different, they are both correct at the same time.

In contrast, fair market value refers to any potential buyers and sellers, not to any specific ones. There are many definitions of fair market value. A classic one is derived from the US Supreme Court in the Cartwright case: "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts". The concept of fair market value is generally the cornerstone of broadly accepted private equity industry standards, such as the International Private Equity and Venture Capital Valuation Guidelines issued by the European Venture Capital Association (EVCA).

Robert T. Slee<sup>1</sup> proposed an interesting valuation framework for privately held companies. His suggested framework is founded on the assertion that privately held companies may be valued at different values at a certain point in time depending on the intention as to why a valuation is required (the purpose) and on the specific use of the appraisal leading to the selection of the appropriate valuation methods (the function). The purpose of the valuation in turn guides the selection of what the author calls "Value Worlds", which represent mutually exclusive contexts for the valuation. The table hereafter is an excerpt highlighting how this framework may be articulated:

Purpose	Value World	Functions (examples)
Identify the highest price in the market	Market value	Sale of a controlling or minority block of shares in a disposal or a merger
Finding an appropriate value for tax, regulatory or legal purpose	Fair market value	Intra group restructuring, issuance of an employee stock option plan (ESOP), ...
Supporting a value in relation with some shareholder actions	Fair value	Negotiation led by a dissenting minority shareholder
Finding the value from an acquirer perspective	Investment value	Support buy side negotiations in the specific context of an investor (synergies, value of control, ...)
Finding the value from a controlling shareholder perspective	Owner value	Support sell side negotiations

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<sup>1</sup> Private Business Appraisals as Viewed through Value Worlds, Rob Slee, In Business Appraisal Practice, The Institute of Business Appraisers, Summer 2003

The above selected examples may also extend to other value worlds such as value impairment for IFRS, economic value, collateral value...

In the context of an independent periodic valuation of investment portfolios to Limited Partners, reports should provide sufficient information on the value for Limited Partners to decide on what value corresponds best for the intended "Purpose" and "Value World". Typically, relative valuation methods by reference to a peer group of comparable quoted companies or comparable transactions provide insight into the recent valuation trends observed on the market. By contrast, the income approach or discounted cash flows valuation methodology, provides a longer view on value as the explicit forecast period is intended to give management's views over a three to five year horizon. In times of stress in the markets, relative value approaches generally provide a lower bound on value relative to discounted cash flows approach which provides an upper bound. Forecast used for discounted cash flows should be stress tested for any single key value driver and prior forecast accuracy assessed with actual performance.



## Distressed Debt Investment opportunities and tax considerations

By Ilka Hesebeck

### Introduction

As a general principle distressed debt opportunities are counter-cyclical, i.e. opportunities arise when the economy slows. An economic downturn such as the current global financial crisis can impact a company's financial health by decreasing revenues, profitability and debt-service ability. Distressed debt arises when a company is in financial difficulties and cannot meet or has difficulty paying off its financial obligations.

Distressed debt investors purchase the distressed debt at a deep discount to face value hoping to enjoy strong returns after a turnaround.

These days not only distressed debt is traded at discount, but commercial banks are selling both performing and non-performing assets at deep discounts to face value with a view to adjusting their balance sheets and raising liquidity.

Distressed debt investing strategies can take several forms, e.g. purchasing debt obligations at a discounted level and reselling those securities within a relatively short term period at a higher level (trading) or by taking control over a company by acquiring a controlling position of a company's debt obligations and/or by converting existing debt into the company's equity.

Distressed debt investors include wealthy individuals, pension funds, private equity funds and hedge funds.

According to the "Telegraph" industry sources say private equity and distressed debt specialists have raised about \$ 26 billion since the beginning of October 2008, with some 80% coming from hedge funds. The report adds that amongst the biggest distressed debt fund raisings since October have been Oaktree, which

has secured \$ 10.5 billion, Towerbrook with \$ 2.75 billion, Intermediate Capital with \$ 1.5 billion and Alchemy with \$ 1 billion.

According to a Wall Street Journal Article of March this year, the Nordic buyout firm EQT Partners has become the latest buyout firm to target the distressed debt sector with plans to raise a € 500 million credit opportunity fund. Based on the same Article other firms that raised credit funds last year include U.S. bank Goldman Sachs Group Inc., which raised \$ 10.5 billion, and CVC Cordatus, the debt affiliate of UK buyout firm CVC Capital Partners, which raised € 480 million.

Several other companies including UK house GMT Communications Partners and UK buyout firm Advent International, are considering investing in buyout debt.

### Tax planning opportunities

Different terms are used depending on the exact circumstances, ranging from "Distressed debt" to "Impaired debt" to "Debt acquired at a discount".

When the term "distressed debt" is used in the following, it is meant to cover loans that are acquired at a discount in general, irrespective of whether or not the borrowing entity is in financial difficulties.

Investments in distressed debt can be an excellent investment opportunity potentially delivering double-digit returns based on the following considerations:

- Interest is accrued/paid based on the nominal value of the debt rather than the market value;
- Realisation of a capital gain:
  - The debt may not be held until maturity, but may be sold before at a capital gain;
  - The debt is held until maturity and nominal is paid back at maturity (the capital gain can be an important amount depending on the discount applied at acquisition).

Where the borrowing companies are in financial trouble a careful due diligence for the investment is required to avoid potential losses for the investors.

As a general principle interest and capital gains realized on the distressed loans are fully taxable in most jurisdictions. Therefore, the acquisition and holding of distressed loans requires proper legal and tax structuring.

When setting up the acquisition structure for a distressed debt investment the following tax issues – amongst others – need to be taken into account:

- country of residence of the investors and their tax status (taxable/tax-exempt);
- country of residence of the borrowing countries: e.g. potential domestic withholding tax upon payment of interest by the borrowing countries and possible reductions (under domestic law or double tax treaties), potential beneficial ownership requirements, potential substance and residence requirements;
- location for the company acquiring and holding the debt investment: e.g. taxation of interest/capital gains on the receivables, treaty network;
- VAT needs to be considered carefully in order to avoid unexpected VAT charges.



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Luxembourg is one of the most popular jurisdictions for the acquisition and holding of distressed debt investment and has become a preferred location for the following main reasons:

- Flexibility in terms of company law and vehicles;
- "Tried and tested" location for financial investors such as PE houses, the major players already having a presence in Luxembourg;
- Reasonably low effective taxation on margins realized;
- Possibility to secure the tax treatment in advance through Advance Tax Agreements.

Depending on the exact facts and circumstances (incl. amount of bank financing used for the acquisition of the loan portfolio) the acquisition structure for the investment in the debt portfolio can range from a standard acquisition vehicle (a normal fully taxable Luxembourg company that is entitled to treaty benefits and to the European Directives) to more complex structures.

As a general rule the interest/capital gains generated on the loan investment are fully taxable, but in the absence of thin capitalization rules can be substantially reduced by the use of appropriate shareholder debt.

Other important considerations when structuring the acquisition and holding of distressed loan portfolios are the following:

- **Regulatory aspects:** Depending on the facts and circumstances (and potential requirements of the investors) the Luxembourg company holding the debt portfolio can either be set up as a regulated or non-regulated entity;
- **Accounting aspects:** Understanding of the accounting implications is equally important as they may impact on structure and investors.

## Conclusion and outlook

According to the "Telegraph" distressed debt funds have been around for years, but specialists are looking to a "bonanza" year in 2009. Following this forecast market development a number of distressed debt acquisitions are expected to take place within the next couple of months, and Luxembourg will certainly have an important role to play when it comes to the structuring of these acquisitions.

## Connecting gateways

### Luxembourg – Hong Kong double tax treaty creates opportunities for more tax efficient cross-border investments By Julien Bieber

Luxembourg has become an international hub for cross-border investments thanks to its regulatory, legal, political and economic stability, coupled with the flexible approach of its tax authorities. Luxembourg also offers a constant modernization of its business-friendly environment and the access to its extensive network of double tax treaties: 52 double tax treaties signed by Luxembourg are currently in force. These key factors have allowed for many years the emergence and fine-tuning of tried and tested investment structuring solutions for Private Equity houses.

On 2 November 2007, Luxembourg and Hong Kong signed a comprehensive double tax treaty (hereinafter "the Treaty"). The Treaty entered into force on 20 January 2009 and is effective from 1 January 2008 in Luxembourg and from 1 April 2008 in Hong Kong.

The key economic strengths of Luxembourg and Hong Kong are financial services, trading and logistics and professional services. The Treaty provides investors with increased certainty in relation to the tax treatment of cross-border transactions and aims at eliminating double taxation situations. Business relations between Luxembourg and Hong Kong shall therefore intensify.

### Comparison with other treaties signed by Hong Kong

Luxembourg became the fourth jurisdiction to enter into a bilateral tax agreement with Hong Kong after Belgium, the mainland of China (People's Rep.) and Thailand. The Treaty offers the most favourable withholding tax rates in comparison with the other treaties signed by Hong Kong.

Withholding Tax Rates <sup>2</sup>			
	Dividends (%)	Interest (%)	Royalties (%)
<b>1. Domestic rates</b>			
Luxembourg	0/15	0	0
Hong Kong	0	0	4.95/16.5
<b>2. Hong Kong treaties with</b>			
Belgium	0/5/15	0/10	5
China (People's Rep.)	5/10	0/7	7
Luxembourg	0/10	0	3
Thailand	10	0/10/15	5/10/15

<sup>2</sup> The purpose of the chart is solely to present a rough overview. It provides simplified information without any reference to the cases where the rates are applicable.

<sup>3</sup> China (People's Rep.), Indonesia, Japan, Korea (Rep.), Malaysia, Mongolia, Thailand, Uzbekistan, Singapore, Vietnam.

Given 10 other double tax treaties between Luxembourg and Asian jurisdictions<sup>3</sup>, the Treaty enhances the competitive position of Luxembourg with respect to cross-border investments into/from Asia.

## Residents

The Treaty only applies to Luxembourg and Hong Kong resident "persons". The term "person" includes an individual, a company, a partnership, or any other body of persons. It also explicitly applies to Hong Kong trusts.

The Treaty explicitly stipulates that it does not prevent Luxembourg and Hong Kong from applying their respective domestic laws and measures concerning tax avoidance. However, it does not contain a specific limitation on benefits provision.

A company that may consider benefitting from the Treaty must have sufficient economic substance in Luxembourg or Hong Kong to qualify as a resident there, and also from the perspective of third party jurisdictions relevant to Private Equity investors, fund managers and targets. This generally requires that the place of effective management of the company be clearly located either in Luxembourg or in Hong Kong.

## Major benefits

Some major benefits of the Treaty are highlighted below.

### Dividends

The entry into force of the Treaty allows dividend distributions from Luxembourg free from withholding tax, if the Hong Kong receiving company holds directly at least 10% of the capital, or a participation with an acquisition cost of at least EUR 1.2 million in the Luxembourg paying company.

Together with the abolition of the Luxembourg capital duty from 1 January 2009, Private Equity fund managers will find it easier to structure their investments to mitigate taxes on the realisation and repatriation of profits out of Luxembourg.

Hong Kong does not levy withholding tax on dividends, so that profits can be repatriated out of Hong Kong with no further tax leakage.

### Interest

Interest payments from/to Luxembourg to/from Hong Kong are generally not subject to withholding tax in both jurisdictions under their domestic tax laws and the Treaty.

### Royalties

Luxembourg does not levy withholding tax on royalty payments by Luxembourg residents (except for income derived by artists and sportsmen).

Hong Kong levies withholding tax on royalty payments. The Treaty allows reducing the Hong Kong royalty withholding tax to 3% which is currently the lowest rate Hong Kong agreed on in a double tax treaty. This gives an additional advantage to Luxembourg over other jurisdictions.



## Business profits

The Treaty provides that Luxembourg companies doing business through a permanent establishment (e.g. a branch) in Hong Kong are fully tax-exempt in Luxembourg on business profits derived from the activity performed by such a permanent establishment.

Hong Kong operates a territorial system, which provides that profits derived from non-Hong Kong sources are generally not subject to Hong Kong tax.

## Capital gains

Luxembourg domestic tax law provides that capital gains derived by non-Luxembourg resident shareholders in relation to the disposal of shares in a Luxembourg company are taxable in Luxembourg under very specific circumstances. The Treaty provides that such capital gains be tax-exempt in Luxembourg if a Hong Kong investor realises a capital gain upon the disposal of shares in a Luxembourg company, provided that no more than 50% of the asset value of the Luxembourg company comprises directly or indirectly immovable property located in Luxembourg.

Hong Kong domestic tax law provides that a Luxembourg resident carrying out business activity in Hong Kong is subject to tax on gains realised from the disposal of investments in Hong Kong, if the gains are assimilated to Hong Kong sourced income and revenue in nature. Gains on capital in nature are not subject to tax in Hong Kong.

## Tax planning opportunities

The reduced rates of withholding tax, the exemption from withholding tax on dividends and the exemption for capital gains derived from the disposal of shares in a non-real estate company provided under the Treaty, together with Luxembourg's extensive treaty network, participation exemption and IP regimes, and the territorial-based tax system in Hong Kong create many opportunities to set up and operate tax efficient investment structures in both Luxembourg and Hong Kong.

The entry into force of the Treaty will undoubtedly drive many Private Equity houses to consider using the Luxembourg – Hong Kong route for their international investments.



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