

IS FRANCE PROVIDING INNOVATIVE SMEs WITH SUFFICIENT FINANCE?

¶# *Very small enterprises represent a high proportion of SMEs in France. As French SMEs are less profitable and productive, they are not developing as fast as their counterparts, notably in Germany and the US. To compound matters, structural problems are holding back job creations in this sector.*

¶# *The situation is being blamed on insufficient financing. It would appear that financing is not an obstacle to growth for SMEs in traditional and mature sectors. However, this is not the case for innovative SMEs which find it harder to obtain bank loans because of the high-risk and low-visibility nature of their activities. These SMEs have recourse largely to venture capital for their financing needs.*

¶# *Europe is starting to catch up with the United States in terms of venture capital. This form of financing developed strongly in France in 2005, but has two particularities with respect to investment patterns: i) in contrast to the United States and, albeit to a lesser extent, Germany, the funds invested are mainly channelled into later stage and LBO operations, downstream of the start-up and expansion stages of innovative SMEs; ii) investment is heavily geared to traditional industrial sectors - the most innovative sectors receive considerably less finance than they do in the United States.*

¶# *France therefore has major shortcomings in terms of financing innovative SMEs. That said, the low level of investment capital ploughed into innovative SMEs might be attributable to the limited scope for such projects in France. Innovation is the exception, rather than the rule, in French industry and, to make matters worse, small entities are disadvantaged by sparse production outlets. On this basis, government action to support innovation needs to be strongly focused on stimulating demand.*

French SMEs are not sufficiently dynamic

SMEs represent a staggeringly high percentage of businesses in developed economies. According to the OECD, 99.8% of European businesses had less than 250 employees in 2003. In the United States, 99.7% of companies had less than 500 employees in 2003. In both cases, manufacturing industry is largely made up of small businesses (i.e. those with less than 50 employees): the figure ranges from 90% in Italy to some 80% in the United States.

SME: WHAT EXACTLY DOES THE TERM MEAN?		
Type of enterprise	Germany and France (European definition)	United States
Micro-enterprises	Up to 9 employees	Up to 9 employees
Small enterprises	10 to 49 employees	10 to 99 employees
Medium-sized enterprises	50 to 250 employees	100 to 500 employees
Large companies	Over 250 employees	Over 500 employees

Business creation rates in the three groups of countries under consideration vary sharply. The Global Entrepreneurship Monitor's¹ TEA (Total Entrepreneurship Activity) index measures the number of businesses in the process, or on the point, of being created relative to the working-age population (18 - 64 years). The index covers 34 countries including leading OECD Member States and highlights the stark contrast between France/Germany and the United States. Europe in general is lagging far behind the United States.

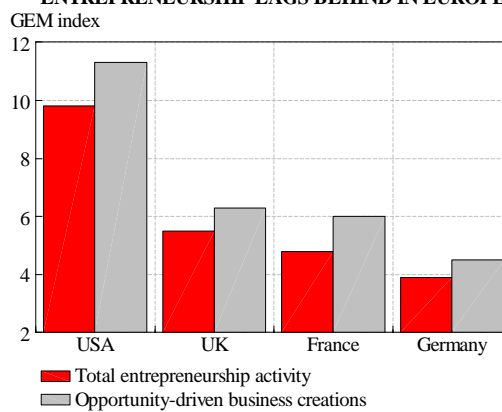
The GEM draws a distinction between two forms of business creation: i) necessity-driven: i.e. the entrepreneur has no other way of finding a professional activity; ii) opportunity-driven: the entrepreneur develops an activity to meet a specific need. Once again, there is a glaring contrast between the United States and Europe. France nonetheless ranks above the European average and higher than Germany.

In 2003, the number of businesses as a percentage of the working-age population was 25% higher in France than in the United States. However, France stands out by its extremely high level of small businesses, mainly micro-enterprises and single-person

¹ <http://www.gemconsortium.org>

enterprises. Small entities account for a lower proportion of businesses in the United States and Germany.

ENTREPRENEURSHIP LAGS BEHIND IN EUROPE



Source: GEM consortium

BREAKDOWN OF BUSINESSES BY CATEGORY OF SIZE

Size of business	Germany (2003)	France (2003)	United States (2003)	EU-15 (2001)
micro-enterprises	Number: 80.9	93	78.5	89.1
	Employees: 19.1	29.2	11.0	27.8
	Turnover: 15.4	16.2	9.5	20.8
small enterprises	Number: 15.2	5.9	19.7	9.1
	Employees: 22.4	19.2	25.1	21.9
	Turnover: 12.0	15.9	21.8	19.9
medium-sized enterprises	Number: 3.3	1.0	1.5	1.5
	Employees: 26.1	14.7	14.5	17.1
	Turnover: 13.9	12.6	13.6	19.0
Total SMEs	Number: 99.4	99.8	99.7	99.7
	Employees: 69.4	62.3	50.6	66.9
	Turnover: 41.3	44.9	45.0	59.7
Large companies	Number: 0.6	0.2	0.3	0.3
	Employees: 30.6	36.9	49.3	33.1
	Turnover: 58.7	55.1	55.0	40.3

Sources: Eurostat, US census

SME sector financial profitability is being undermined by the preponderance of micro-enterprises. According to the findings of the Observatory of European SMEs², profitability rates³ of small to large European companies range between 40% and 52%, but fall

² The European Commission Enterprise Directorate-General "SMEs in Europe in 2003" report 2004.

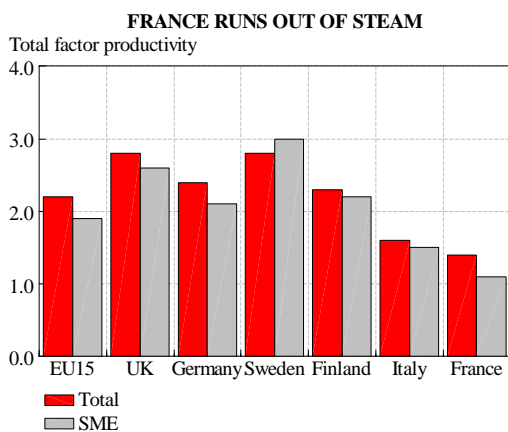
³ Gross operating profits, less amounts paid to subcontractors, as a percentage of value added.

SME FINANCING: AN OVERVIEW OF PUBLIC POLICY

United States	France	Germany
<p>€# The Small Business Investment Companies (SBIC) programme is a public-private sector joint venture to raise private sector capital guaranteed by the Small Business Administration (SBA). The objective is to broaden the capital base of entrepreneurs at the start-up or expansion stage. The programme serves as a linchpin between entrepreneurs and venture capitalists and helps fill the gap between business capital requirements and traditional sources of finance.</p> <p>€# The SBA is also responsible for a large number of loan and loan guarantee programmes aimed at helping small enterprises to obtain finance. Loan Guarantee programme 7A facilitates small business access to credit. In 2001, commercial lending organisations taking advantage of the SBA guarantee granted almost 43,000 loans to SMEs, representing a total of nearly USD 10bn.</p> <p>€# The objective of the Microloan programme is to offer a larger number of very small loans to owners of small enterprises. Certified Development Company (CDC) programme 504 puts long-term fixed rate funds to finance the acquisition of essential fixed assets, such as land and buildings, at the disposal of growing businesses.</p>	<p>€# Via its SOFARIS subsidiary, OSEO-BDPME (the French SME development bank) is responsible for guaranteeing loans and, in some cases, capital provided by various financial institutions. To this end, SOFARIS manages largely government-backed guarantee funds to shoulder part of the risk related to the granting of loans or capital contributions (25% of the annual funding requirement) to SMEs.</p> <p>€# The business creation loan, launched in October 2000, is aimed at helping new entrepreneurs to establish their businesses. High priority is given to small-scale projects (less than EUR 45,000) and to the financing of intangible assets. These loans range between EUR 2,000 and EUR 7,000 over a period of 5 years and are combined with medium to long-term bank loans for double or triple the amount. Since the BCL was launched, 52,712 new businesses have received financial support worth EUR 326m in total, together with associated bank loans amounting to EUR 572m.</p>	<p>€# The Federal Authorities have taken a number of important decisions to step up efforts to finance SMEs via the new KfW Mittelstandsbank (the German SME development bank), created by the merger of Kreditanstalt für Wiederaufbau (reconstruction loan corporation) and Deutsche Ausgleichsbank (German Equalization Bank) in September 2003.</p> <p>€# In order to facilitate SME access to loans, all loans aimed at young entrepreneurs and SMEs have been grouped into a single product called "The Entrepreneur Loan". Loans amounting to nearly EUR 4.3bn were approved in the first three quarters of 2004.</p> <p>€# Since March 2004, SMEs have been able to apply for "Entrepreneurship Capital". The three forms of finance offered under the scheme (ERP* capital for start-ups, ERP capital for expansion and ERP capital for employment and investment) are an important step forward as they represent a source of high-quality mezzanine finance. In 2004, the ERP fund distributed loans worth approximately EUR 1.3bn.</p>

Source: OECD "Outlook for SMEs and entrepreneurship 2005" 2005.

to nearly 25% in the case of businesses with less than 10 employees. Worse still, Observatory statistics show that productivity gains achieved by French SMEs are below the European average whilst SME total factor productivity growth averaged 1.9% between 1988 and 2003 in the EU15, it was only 1.1% in France – which is significantly lower than in Germany (+2.1%) and in the United Kingdom (+2.2 %).



The fact that SMEs lack vitality has two major consequences for the French economy:

€# Job creations are lower. According to a Commissariat au Plan (French governmental think tank, now replaced by the Centre d'analyse stratégique - Centre for Strategic Analysis)⁴ report, France is not creating enough jobs because of its shortcomings in terms of the development of existing businesses via organic growth. The high proportion of job creations accounted for by SMEs is largely due to growth of existing companies as the impact of business creations is minor in comparison;

€# Failure to react to technological changes. The government would like banks and insurance companies to do more to support SMEs, notably via investment capital and bank loans. The aim is to provide SMEs, innovative enterprises in particular, with capital. However, it remains to be seen whether lack of SME vitality is due to the scarcity of capital or rather to the failure to match supply and demand with respect to the financing of innovative businesses.

SME financing: exploding the myth that capital is scarce

According to the OECD report presented as an introduction to the world conference on SME financing and entrepreneurship, held in Brazil in March 2006, SME access to capital in industrialised countries is not an obstacle to project development in the case of traditional industries or mature technologies. In leading OECD countries, SMEs have sufficient access to credit as a result of competitive pressure between financial institutions. In the same vein, the Commissariat au Plan has exploded the myth that capital is scarce in France. The Plan concludes that the French production system is not being handicapped by a lack of capital apparently caused by the rationing of financial resources available to enterprises. However, it is suffering from excessive tangible fixed assets, which are undermining returns on capital, and, to an even greater extent, from the insufficient amounts of capital channelled into activities likely to pump fresh vitality into the economy.

The conclusions drawn by the Plan are corroborated by a report of the European Commission⁵ which points out that the capital per hour worked ratio for the economy as a whole remained higher in France and Germany than in the United States during the 1980s and the 1990s. However, ratios were significantly higher in mature technology sectors (i.e. those deemed to be low ICT producers or users) in both countries and ratios in ICT development-related

⁴ Commissariat au Plan "to promote a financial environment favourable for business development" 2005.

⁵ Mary O'Mahony and Bart van Ark, "EU productivity and competitiveness: An industry perspective. Can Europe resume the catching-up process?" Enterprise Publications, 2003.

SPECIFIC MEASURES TO PROMOTE VENTURE CAPITAL

	United States: Small Business Investment Companies	France: FCPI innovation funds
Principle	This programme was launched in 1958 and partially re-worked in 1995. The objective is to help SMEs to obtain venture capital finance, regardless of the particular sector in which they operate. SBICs are privately-owned dedicated entities which can offer refinancing facilities via the Small Business Administration (SBA), the supervisory authority which grants operating licences. Financing takes the form of debt (debt leverage effect).	FCPI innovation funds were created by the legislator in 1997 with a view to encouraging the funnelling of public savings into investment in young innovative enterprises. The funds offer two tax incentives: a tax reduction upon entry and capital gains tax exemption.
Characteristics	The minimum capital requirement is USD 5m (USD 10m in the case of the SBIC participating securities programme) at least 30% of which must be derived from a source bearing no relation with the management team. A SBIC can have recourse to public and private finance alike. The SBA can provide the SBIC with finance equivalent to up to 300% of the leveraged capital, with an upper limit of USD 108.8m. In order to obtain financing, the SBIC must issue fixed-interest or participatory securities guaranteed by the SBA. The maturity of the securities issued is 10 years and interest is payable twice a year. SBICs must be managed by professionals qualified for this type of operation and have a business plan detailing the sectors and operations targeted. Constraints, in terms of financial reporting, are severe and SBICs are inspected every 2 years.	In return for the tax incentives, the FCPI innovation funds have to respect an investment quota of 60%, excluding fund-raising exercises and the launch of FCPR high-risk funds and FCPI innovation funds or those based on their "innovative securities" assets classed as securities issued by companies subject to company tax, and which must fill one of the following conditions: - have invested an accumulated amount on R&D over the last three years at least equivalent to one third of the highest turnover figure reports during the three-year period; - prove the creation of products, processes or techniques the innovative nature and financial growth prospects of which are recognised, together with the corresponding financing requirements. This assessment procedure is carried out on the basis of a three-year period by ANVAR, the French Agency for Innovation.
Scale of programme	Financing, provided by some 450 SBICs, amounted to USD 2.36bn in 2003 (USD 27bn between 1995 and 2003). In 2003, 4,361 SMEs were financed by this system. SBICs accounted for 58% of venture capital finance (in terms of number of operations) in 2002. Investment is proportionately higher in early stage projects and in traditional sectors.	The total number of subscriptions to FCPI innovation funds consequently represented EUR 330m in 2004, vs. EUR 393m in 2003, split between 144 FCPI innovation funds managed by 27 entities. Funds invested are equivalent to more than 50% of funds raised after 2 years.
Performance	The average 30-year return is 14.11%. Between 1995 and 2004, the average return was in the region of 19%.	Although the average return between 1997 and 2003 was negative (-4%), the maturity of these funds is 10 years. Management fees are high: 4% in 2002, according to the COB (the French stock market watchdog).

Sources: SBA, OECD, AMF, OSEO

sectors declined in the 1990s

CAPITAL PER HOUR WORKED, US=100

	1980	1990	1995	2000
France				
Activities producing ICT	144	118	102	72
Activities using ICT	123	123	120	96
No recourse to ICT	77	128	134	123
Total economy	99	126	125	103
Germany				
Activities producing ICT	84	78	93	81
Activities using ICT	110	116	128	113
No recourse to ICT	131	154	157	143
Total economy	113	129	141	131
United Kingdom				
Activities producing ICT	60	73	73	73
Activities using ICT	38	52	53	45
No recourse to ICT	76	84	86	76
Total economy	66	71	73	65

Source: Mary O'Mahony and Bart van Ark (2003)

Europe is catching up in terms of venture capital ...

The OECD stresses the need to facilitate innovative SME access to venture capital as this type of funding is still underdeveloped in Continental Europe. The problem is that it would appear no easy undertaking to reconcile funding via traditional banking channels with the high-risk and low-visibility nature of the activities developed by innovative SMEs. The OECD explains that it is particularly hard for financial institutions and investors to evaluate the level of risk and the probability of business failures in this sector. The financial worth of SMEs is also difficult to estimate, as innovative activities are generally focussed on intangible assets that cannot easily be proposed as collateral for loans or capital injections. Innovative SMEs consequently have substantial recourse to venture capital.

The development of venture capital⁶ in France and Germany is extremely encouraging. According to an annual survey published by PricewaterhouseCoopers (Global Private Equity report 2005⁷), France and Germany rank 4th and 5th respectively in terms of the amounts invested in 2004. Growth picked up sharply between 2003 and 2004: +23% in France and +52% in Germany. That said, both countries are still lagging far behind the United Kingdom which ploughed USD 22.4bn (+41%) into investment capital in 2004. Growth rates between 1998 and 2004 were broadly similar in these three major European economies (+20% in France, +18% in the UK and +12% in Germany) and well in excess of those witnessed in the United States (+2%). And so, Europe is catching up with the United States, with respect to investment capital. In 2004, the amounts invested were equivalent to 0.39% of GDP in the United States vs. 0.29% in France and 0.19% in Germany.

According to the European Private Equity and Venture capital Association (EVCA), the trend gained momentum in 2005 and funds raised overshot levels recorded for 2001. In 2005, funds collected from French investors⁸ surged by 55.6% (taking in total operations in France and abroad) to slightly over EUR 8bn, vs. EUR 5.2bn in 2004. In Germany, funds raised skyrocketed in the first half of 2005, largely due to capital inflows from other parts of Europe.

⁶ Definitions: - Early stage: start-up + seed stages;

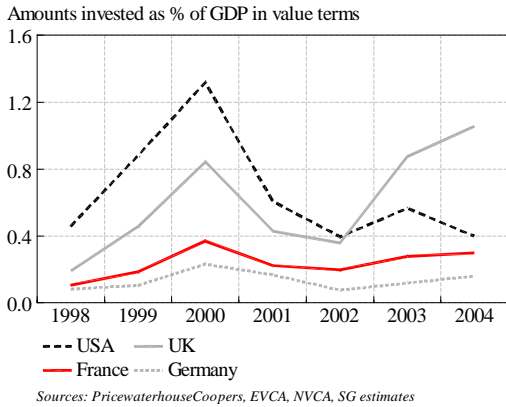
- Development capital: expansion stage;

- Venture capital: early stage + development capital + LBOs and later stage.

⁷ <http://www.pwcglobal.com>

⁸ Source: The French Association of Venture Capital Investors

THE INVESTMENT CAPITAL DIFFERENTIAL NARROWS



Sources: PricewaterhouseCoopers, EVCA, NVCA, SG estimates

... but SME financing is problematic ...

As mentioned earlier, the French economy is not short of capital. However, the redistribution of financial resources would appear to pose more of a problem. ICT investment slowed down sharply in France between 1990 and 2000. Data contained in the European Commission report on trends in the capital per hour worked ratio show that Germany has maintained its lead over the United States, insofar as concerns ICT user sectors, but that France has lost ground. In addition, investment in ICT producer sectors slumped less sharply in Germany than in France: -12 points and -30 points respectively.

In Germany and France alike, the start-up and seed stages, which represent the so-called early stage, only account for a marginal percentage of investment. In France, a meagre 2% of funds were used to finance early stage operations in 2005, vs. 19% in the United States. In contrast, 82% of the sums invested were channelled into later stage or LBOs, vs. 45% in the United States. Germany is nonetheless a case apart: a mere 9.4% of funds were used to finance early stage operations, but 16% of the sums invested were accounted for by expansion stage operations, compared with only 12% in France. This represents an 8-point differential between France and Germany with respect to the start-up/seed and expansion stages. France is nevertheless broadly in line with the European average (7.3% of funds raised in 2005 were accounted for by early stage operations and more than 70% by later stage operations).

These disparities are highlighted by the breakdown of funding by sector. In France, investment capital is heavily focused on three traditional sectors, which accounted for 59% of total investment in 2005. Life sciences accounted for 7% of the total (of which 3% was invested in biotechnology) and IT for 8%. In Germany, these two sectors, life sciences in particular, account for a substantial proportion of investment. That said, Germany is still lagging far behind the United States, where funds are principally invested in high-tech sectors. And so, despite the fact that investment capital is developing rapidly in France and Germany, the amounts invested in strong growth sectors still pale in comparison with venture capital operations in the United States.

BREAKDOWN OF AMOUNTS INVESTED BY STAGE (%)

	United States (2004)	France (2005)	Germany (2004)
Early stage	11	6	10
Expansion stage	22	12	17
Later stages	45	82	73

Sources: AFIC, PricewaterhouseCoopers, BVK (German Private Equity and Venture Capital Association), SG calculations

BREAKDOWN OF AMOUNTS INVESTED BY SECTOR (%)

	United States (2005)	France (2005)	Germany (2004)
Telecommunications	10	12	4
Software	22	3	4
Information technology	10	5	5
Biotechnology	18	3	5
Medical equipment	10	4	14

Sources: AFIC, PricewaterhouseCoopers, BV, SG calculations

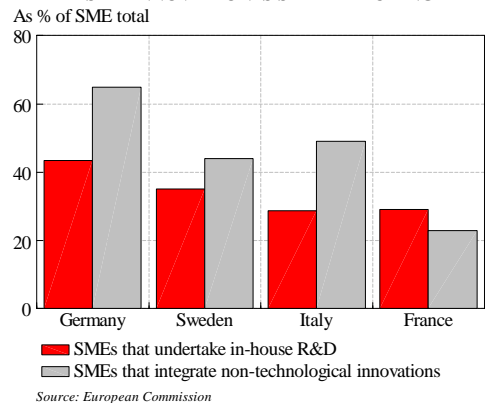
Even though France has an active and sizeable investment capital market, early and expansion stage funding is inadequate. It would nonetheless appear that this situation is the result of a lack of dynamism in innovative sectors in France. A COB⁹ report on FCPI innovation funds, which accounted for approximately half the venture capital market in 2003, highlights the poor performance of these funds. One of the main problems is that FCPIs have difficulty in investing all the capital raised. The report draws attention to the fact that, in the case of some of these funds, the capital raised would appear to dwarf investment. It seems that the lack of innovative projects is acting as a brake on investment. Furthermore, FCPIs invested only 10% of total capital in seed stage operations in 2003. Lastly, business angels are still far too thin on the ground in France, especially in comparison with the United Kingdom. On a brighter note, measures have been taken to step up tax incentives for such investment. This should eventually boost venture capital funding of young innovative enterprises at the seed stage.

... as prospects would appear uninspiring

The scope for innovation is sadly lacking

France has a low ranking in terms of innovation. International and European innovation scoreboards all indicate static, or even declining, scope for innovation in France¹⁰. French SMEs are in line with this French general trend in innovation. Over the period 1998/2000, the number of SMEs that produced innovations was below the EU-15 average. In the same vein, developments related to marketing, design or production methods were far less widespread in France. 66% of SMEs with less than 50 employees stated that they did not undertake any research into innovation. This compares with less than 60% in Sweden and Finland. Only 29% actually implement R&D programmes, vs. 35% in Sweden and 38% in Finland.

SME INNOVATION IS SADLY LACKING



Source: European Commission

⁹ COB (the French stock market watchdog) "Annual Report 2002", 2003.

¹⁰ Cf. February Focus: "What can be expected from the French competitiveness clusters?"

SMEs have to contend with a shortage of market outlets

French SMEs are disadvantaged by weak European economic growth and consumption. US SMEs have the advantage of a large, buoyant domestic market. In addition, US legislation (Small Business Act) strives to ensure that SMEs have fair access to government procurement. Federal procurement represents an average of approximately USD 305bn p.a. and Federal State and local authority procurement some USD 400bn p.a.¹¹. The Small Business Administration plays a role of "facilitator". SMEs consequently account for 23% of government procurement, in terms of direct contracts. The system has provided SMEs, notably the most innovative, with substantial markets via military and public sector research programmes. This means that US SMEs are not handicapped in their domestic market – which might also explain their limited presence in export markets.

In Germany, the reverse is true. The domestic market has been stubbornly lifeless since 2001 and SMEs have responded by seeking out international market outlets. In 2004, the proportion of exporting SMEs was broadly equivalent in France and in the United States: 3.7% and 4% respectively. In Germany, however, the figure was in excess of 11%. The trend has since gained momentum and German export growth has been defying gravity since the middle of 2005.

French exports are focussed principally on the European Union. Nearby emerging countries, such as Africa and the Near-East, represent France's next most important export market. Exports to Asia and to the Americas are considerably lower. SMEs are even more highly geared to the first two markets. The reason for this is that trading with far-away countries involves major logistic and financial hurdles for micro-enterprises and small businesses. Medium-sized companies face fewer problems in developing far-away markets. Furthermore, Asia and Latin America are extremely buoyant import markets.

According to the French Directorate-General of the Treasury and Economic Policy (DGTPE), it can be concluded that above a certain critical mass (measured on the basis of employee numbers), export companies' share of French foreign trade with far-away countries is almost equivalent to, or in excess of, their share of French exports to nearby markets. Critical mass (calculated on an empirical basis) is estimated at 20 employees in the case of firms exporting to far-away developed countries and at 100 employees for companies exporting to far-away developing countries. This means that size is a major stumbling block for French businesses seeking major strong-growth markets.

NUMBER AND TURNOVER OF FRENCH EXPORT COMPANIES BY EXPORT MARKET ZONE
(EXCLUDING THE EU-15) IN 2003

	Number of French companies	Export turnover in the zone (€ bn)	Average turnover per French company (€K)
Nearby developing countries	46,505	27.8	878
Far-away developed countries	23,451	18.1	1,197
Far-away developing countries	16,879	16.0	1,383

Source: DGTPE

It should be noted that the non-EU export markets most easily accessible to SMEs are countries with low demand for high-tech products – this is particularly true of Africa. Geographical

¹¹ A measure of this nature is currently impossible in the European Union as, the EU signed the WTO Agreement on Government Procurement (GPA), which prohibits such programmes, in 1996. The Small Business Act can derogate from this agreement as it antedated it.

specialisation is thus consistent with industrial specialisation (heavily geared to medium-technology products) and reduces SME appetite for innovation.

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The matching of supply and demand of finance for innovative businesses in France would seem to leave much to be desired. Firstly, despite the fact that the OECD considers that access to bank loans is not a major obstacle to the financing of so-called traditional projects, the financing of innovative SMEs remains a thorny problem. Venture capital, which is the main source of finance for innovative SME projects, does not invest sufficiently at the crucial start-up and expansion stages. Unlike their US equivalents, FCPIs produce disappointing results. Secondly, the scope for innovation is somewhat limited in France. SMEs are not innovative enough and their horizons are limited by the scarcity of potential market outlets.

On this basis, measures to increase the supply of venture capital finance are likely to encounter two stumbling-blocks. Firstly, due to the relative dearth of projects, capital is likely to be focussed increasingly on LBO operations. As a result, investment capital funds will rise, but little or no progress will be made in terms of Innovative SME start-ups and expansion. Secondly, because of the shortage of projects, FCPIs might be tempted to finance unprofitable ventures (windfall effect). The problem here is that FCPI returns are already poor (tax concessions excluded).

Failure to provide SMEs with priority access to government procurement implies that there are only two viable solutions for stimulating demand: i) improved access to international markets and ii) greater scope for innovation. In 2006, France introduced a new measure aimed at creating SME export partnerships. Calls for projects¹² will be launched to select and support the creation of partnerships. Dedicated development and market research structures will receive financial aid of up to EUR 10,000 p.a. The scope for SME innovation should be enhanced by policies aimed at stimulating innovation (competitiveness clusters and major industrial programmes selected by the Agency for Industrial Innovation); by measures to facilitate co-operation between SMEs and major public sector research institutes, such as CEA and CNRS; and by start-ups initiated by researchers in these centres.

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¹² The first call for projects opens before March 20, 2006 and will close on May 20 2006 (source: www.pme.gouv.fr).



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