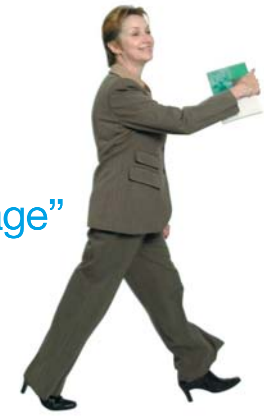
# Operating and financial review



“clear competitive advantage”

**This review includes a description of 3i’s business and strategy and comments on 3i’s performance during the year in the context of the economic and market environment and other influences. The review also discusses 3i’s financial position, including changes to its capital structure, and comments on the main risks inherent in 3i’s business and the framework used to manage them.**


## 3i’s business and strategy

### 3i’s business

3i’s business focus continues to be to invest in buy-outs, growth capital and venture capital. Geographically, most of our investment is in businesses based in western Europe, although 3i does have growing investment operations in the US and in the Asia Pacific region. In the US, 3i currently invests in businesses engaged in technology sectors; while elsewhere 3i invests across a broader range of industry sectors and in each of the investment activities identified above.

### *Buy-outs*

3i invests in European mid-market buy-out transactions with a value between €25 million and €800 million. The vendors of the businesses being sold are typically large corporates disposing of non-core activities or private groups with succession issues.

3i targets the mid-market because that is where we believe we can create the most value. There is less competition for transactions in this market than for larger deals and price is less likely to be the sole or key criterion in “winning the deal” – we believe that, in the mid-market, the relationships we build through our local presence are just as important. Additionally, the nature and size of businesses in this market are such that we are more able to add value through strategic, operational and management input; and, in this market, the underlying businesses will generally have greater growth potential than larger ones and be of such a size as to make them more attractive acquisition targets for a greater number of strategic purchasers.

3i is also active in the smaller buy-out market (below €25 million), both in western Europe and in the Asia Pacific region. This is a more fragmented segment of the market and one in which 3i’s local network provides good access to the private vendors, management teams and local advisers involved.

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## Williams Lea

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|---|---|
| Business description: | Outsourced print management and information management services |
| Country: | UK |
| Investment type: | Growth capital |

In February 2004, 3i invested £33 million in Williams Lea, the UK market leader in the provision of outsourced print management and information management services to major financial institutions and corporates. 3i has been invested in this £200 million revenue company since 1965.

This is a growth capital investment, with 3i’s funding being used both to finance growth by the business and to enable a rationalisation of the shareholder base of approximately 300 individuals.

The growth element of the funding is intended to enable Williams Lea to increase its service offering to its existing blue chip customer base and also to secure new longer-term contracts as the market moves towards a model of full outsourcing of information and document management. This strategy involves a mix of organic growth and growth through acquisition. In addition, the business has plans to strengthen its presence in continental Europe as well as North America and the Indian subcontinent, in line with its customer requirements.

# Refresco

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|---|---|
| Business description: | Fruit juice producer |
| Country: | Netherlands |
| Investment type: | Buy-outs |

In September 2003, 3i led the €312 million buy-out of Refresco Holding BV, investing €60 million (together with Eurofund IV) and taking a substantial stake in the business. Refresco is one of Europe's largest suppliers of fruit juices and soft drinks to food retailers, principally under private label.

This was a secondary buy-out from a Dutch/German/UK syndicate who were selling because they were unable to fund the continuing buy and build strategy.

3i's Benelux team has known the management for over four years and also had strong contacts within the original investor group. The 3i team involved local Dutch investment professionals supported by London-based executives and our food sector specialists.

We introduced a chairman with experience of multi-site, international, low cost manufacturing and of growing businesses through acquisition and supplying to large retailers.

The investment strategy is to grow revenues and increase margins, both organically and by way of acquisition, in a rapidly consolidating European market. 3i has been active in using its network to source potential acquisition candidates.


***Growth capital***

3i makes growth capital investments of between £5 million and £50 million, across a broad range of sectors, business sizes and funding needs. These investments typically involve 3i acquiring minority stakes in established businesses. We therefore seek to ensure a high level of influence and an attractive yield in these situations. 3i's growth capital business is primarily focused on 3i's European and Asia Pacific markets and has historically had a less competitive environment than buy-outs.

Success in this market is determined by the ability to build long-term relationships with local businesses and local intermediaries, as well as demonstrating the capability of helping these businesses to grow. This fits well with 3i's strategy of local presence, sector specialisation, sharing knowledge and offering local businesses access to 3i's international network of relationships.

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# Angel Springs

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|---|---|
| Business description: | Supplier of watercoolers and bottled water |
| Country: | UK |
| Investment type: | Buy-outs |

In December 2003, 3i led the simultaneous acquisition and merger of three UK office watercooler businesses to form Angel Springs, thereby creating one of the largest independent national cooler businesses in the UK.

The watercooler market is growing strongly on the back of the trend to healthier living habits and increased water consumption and is undergoing a phase of consolidation in the UK and continental Europe as a number of larger food and drink groups pursue market share through acquisition strategies.

The investment strategy is to integrate the three businesses, drive organic growth and then sell to one of the industry consolidators or a new strategic entrant to the market.

The managing director of the new group is someone with whom 3i had previously successfully invested within the watercoolers sector and whose operational and other abilities it believes will enable a successful integration of the three businesses. 3i further strengthened the management team by introducing a chairman with relevant experience from its Independent Directors Programme and a finance director with whom it had also successfully worked before.

"a balanced business"

*Venture capital*

3i's venture capital business is targeted at four key sub-sectors – healthcare, communications, software and electronics, semiconductors and advanced technologies ("ESAT"). The main geographic focus is western Europe and the US, though 3i does also invest in the Asia Pacific region.

Investment in venture capital takes the form of participation in a series of "funding rounds" and we therefore separate out "first investments" (those in businesses where 3i is not already invested) and "further investments". 3i aims to invest between £1 million and £10 million in each new opportunity and, depending on circumstances and market conditions, we would generally expect 3i's venture capital investment to be split broadly 50:50 between first investments and further investments in any year.

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## Cambridge Silicon Radio

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|---|---|
| Business description: | Designer and manufacturer of single-chip Bluetooth wireless devices |
| Country: | UK |
| Investment type: | Venture capital |

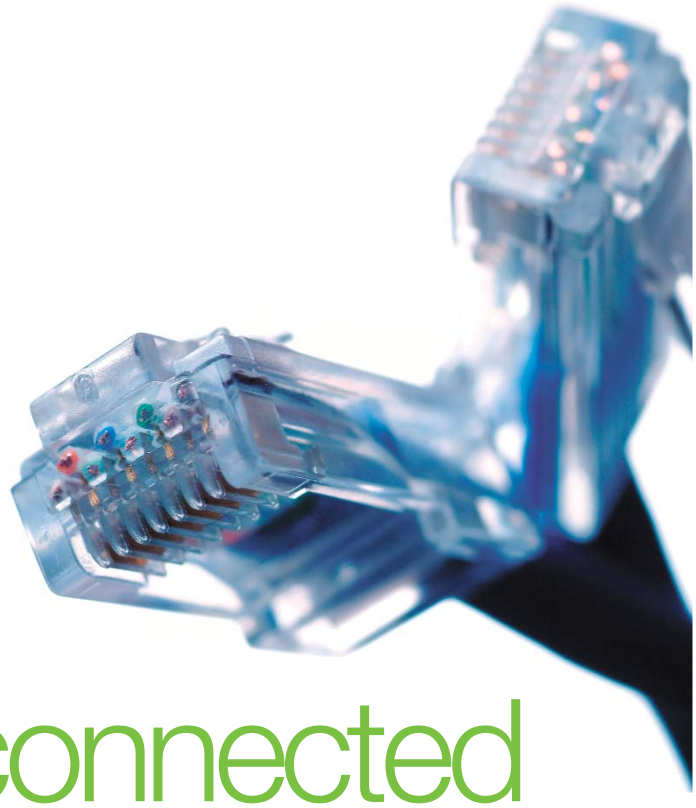
In February 2004, Cambridge Silicon Radio ("CSR"), a leading manufacturer of single-chip Bluetooth wireless devices in which 3i had invested a total of £7 million, achieved a successful IPO on the Official List of the London Stock Exchange. This represented an important milestone for CSR and provided 3i with a partial realisation of its investment in the business. At the IPO price of 200p, CSR was valued at £240 million and 3i's holding was worth £30 million. 3i sold about one-third of its holding in the IPO.

3i supported the spin out of CSR from Cambridge Consultants Ltd in 1999. 3i recognised that the Bluetooth market was expanding and was impressed by the quality of CSR's technology, which supports short-range wireless data and voice communications between different devices.

Since 1999, 3i has backed CSR through three subsequent funding rounds and negotiated a shareholder agreement with a major corporate.

CSR decided to partner with 3i because of its local presence, its global network of corporate and other contacts and its track record of backing successful semiconductor-related businesses.

3i brought together the current management team, assisting with the recruitment of a chairman, chief executive officer, chief financial officer and financial controller and introducing a non-executive director from its Independent Directors Programme. 3i also introduced CSR to a number of business partners and advisers and supported the company through its IPO process.



connected

## Vonage

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|---|---|
| Business description: | Telecoms |
| Country: | US |
| Investment type: | Venture capital |

In February 2004, 3i co-led a $40 million late-stage technology venture funding round in Vonage, a leading provider of broadband "voice-over internet protocol" (VoIP) telephony services, based in New Jersey. The funding, of which 3i contributed $12 million, will be used to accelerate the expansion of Vonage's service in North America and Europe and to support development of new innovative offerings.

The broadband telephony market is projected to expand rapidly over the next decade, due to its significant price advantages and superior functionality over the use of traditional circuit-switched telephone lines.

3i's knowledge of the global communications market and ability to help accelerate the company's international expansion through its network of offices were critical to 3i's ability to secure the opportunity. Since making the investment, 3i has introduced the company to a number of potential customers and partners in the US, Europe and Asia.

Vonage has seen a significant acceleration of its business in recent months and, by May 2004, had surpassed 150,000 subscribers in the US.

**3i's strategy**

The key elements of 3i's strategy are as follows:

– to develop the business internationally;
– to build a balanced investment business;
– to use the network as our key competitive advantage; and
– to invest in companies where there is potential to grow profits significantly.

Globally, private equity and venture capital investment is concentrated in the US and Europe, with the Asia Pacific region showing strong growth. We currently have a strong European presence and aim to grow our activities in the US and Asia. 3i targets investment across a broad range of industrial sectors and also invests at all stages of the corporate lifecycle, from start-ups to buy-outs. We continue to target businesses where we believe we can help to grow profits significantly.

Integral to our strategy is the ability to use 3i's network to generate returns that are greater than those of our competitors. As business becomes increasingly international and complex, we believe that the network provides 3i with real competitive advantage through each phase of the investment lifecycle – origination of the investment opportunity, developing and validating the business case, structuring and making the investment, implementing the operational plan for the business, and exit.

"we invest in businesses with the potential to grow profits significantly"


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# TeknikMagasinet

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|---|---|
| Business description: | Retailer of home electronics and hobby products |
| Country: | Sweden |
| Investment type: | Growth capital |

In January 2004, 3i completed a £6 million investment in TeknikMagasinet, a Swedish retailer of home electronics and hobby products with a current turnover of approximately £20 million per annum. This growth capital investment comprises a mixture of equity shares and loans, with 3i taking a substantial minority stake in the business.

The company has a market-leading position in this sector, with 37 retail outlets across Sweden. The strategy that 3i's investment is supporting includes a rapid extension of the chain of outlets in Sweden, as well as expansion of the network into the other Nordic countries.

3i's local presence in Stockholm, as well as in Helsinki and Copenhagen, together with its experience and expertise in the retail sector and in growing retail businesses, enabled it to secure the opportunity. 3i has introduced a chairman and two additional non-executive directors with relevant capabilities and experience to help the business achieve its growth strategy.

# Gant

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|---|---|
| Business description: | Marketing and design of premium branded apparel |
| Country: | Sweden |
| Investment type: | Buy-outs |

In June 2003, 3i co-led the €109 million buy-out of Gant Company AB, an international marketer and designer of premium branded apparel. 3i, together with 3i Eurofund III, invested €13 million, taking a significant minority stake.

3i was introduced to Gant in late 2002 by a member of 3i's Independent Directors Programme who was a deputy non-executive director on the board of Gant. The approach followed the abandonment of IPO plans due to adverse market conditions.

Insights gained from previous investments in this sector helped 3i to understand, contribute to and validate the value growth strategy for the business and gain exclusivity almost from the start of the process. 3i used its local presence in Stockholm, supported by colleagues from its Spanish, Italian and UK offices with sector specific knowledge, to ensure that it had the best "angles" for the opportunity. The transaction was complicated by the diverse vendor group which consisted of the three founders, a multi-national business and a private equity firm.

Exit plans are currently focused on achieving an IPO on the Stockholm Stock Exchange in two to four years' time.

"3i's network is integral to all that we do"

The main elements of what we refer to as "our network" are as follows:

– local presence – this enables 3i to build strong relationships with entrepreneurs, corporates, universities, research organisations and intermediaries, and is particularly important in the deal origination phase of the investment lifecycle;
– sector specialisation – underpinning 3i's ability to build meaningful business relationships, sector specialisation is critical in the phases of developing and validating the investment case and subsequently implementing the growth strategy. Our sector teams are drawn from 3i's Industry Group, which comprises around 20 experienced senior industry specialists, and 3i's investment and portfolio management executives;
– "product" specialisation – each of buy-outs, growth capital and venture capital has teams of specialist investment executives skilled in project management and financial structuring specific to the product. 3i's scale and structure also allow us to utilise specialist skills in a number of other areas, including portfolio management, restructuring and turnarounds, and exits and IPOs of companies from 3i's portfolio;
– sharing knowledge and contacts – the importance of knowledge and strong relationships in each phase of the investment lifecycle is difficult to overstate in the private equity and venture capital investment business and, for 3i, the benefits of sharing these across the organisation represent a substantial source of competitive advantage. We believe we have in place the systems, processes and structures and, as importantly, the corporate culture to help 3i maximise the potential benefits;
– relationships with corporates – another benefit of 3i's scale and organisation is that we have meaningful relationships with a large number of corporates in each of the geographies in which we operate. These relationships are particularly useful at the origination, investigation and exit phases of an investment. Furthermore, 3i's ability to make effective business introductions across a range of geographies is increasingly a critical factor in our ability to "win deals" and provides 3i with a distinctive source of value creation; and
– strengthening boards and management teams – the "People Programmes" 3i runs for chairmen, chief executives, chief financial officers and independent directors provide an excellent resource for building and strengthening boards and operational management; and are also a strong source of both investment opportunities and due diligence capability.


## Senoble

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|---|---|
| Business description: | Manufacturer of dairy products and chilled desserts |
| Country: | France |
| Investment type: | Growth capital |

In March 2004, 3i made a substantial growth capital investment in Senoble, a €600 million turnover French manufacturer of dairy products and chilled desserts, taking a 25% equity stake in the business. The investment was made to support capital expenditure.

Senoble, which has operations in France and Spain, is the leading manufacturer of private label milk-based products, but also produces a range of desserts under its own Senoble brand and a number of low-calorie products under the Weight Watchers brand through an exclusive licence for France.

The investment opportunity was originated through some direct marketing by one of 3i's French food sector specialists. The depth of 3i's network in the food industry in Europe (demonstrated through the pan European Food & Drink Sector conference at the IESE Business School in Barcelona in November) and the breadth of its sector experience and expertise were key differentiators in 3i's ability to secure the opportunity. 3i has introduced a non-executive director with strong dairy sector and private label experience.

The investment strategy is premised upon strong growth of sales, mainly through increasing exports, and improvement in margins.

## Organisation and office network

There have been no changes since March 2003 in the leadership of our three investment businesses. Jonathan Russell continues to lead the pan European mid-market buy-out business; Chris Rowlands leads the growth capital and smaller buy-out business; and Rod Perry leads the venture capital business.

Within each of these activities, a panel of our most experienced investors ensures rigorous application of our investment processes and provides guidance to help ensure we maximise value across each phase of the investment lifecycle. These panels also seek to ensure, on a case-by-case basis, that we assemble "the best team for the job" from the regional, sector and product specialists.

The investment and divestment approval functions for larger transactions are carried out by two Investment Committees, addressing technology and non-technology investments respectively. The membership of these Investment Committees is drawn from 3i's Executive Committee.

3i's Smi (small and medium-sized investments) initiative, which was established in 2001 and which reports to Chris Rowlands, continues to be successful in generating returns from some of the older and lower-growth investments and, importantly, in enabling non-Smi investment professionals to focus on identifying investment opportunities and managing larger investments. At 31 March 2004, £698 million of value (16% of 3i's total portfolio) and 849 investments (45% by number of 3i's total portfolio) were managed by the Smi team.

There were no changes to the office network during the year, though we have just announced that 3i's offices in Padua and Nantes will close in the summer of 2004. 3i will then have a total of 29 offices (25 across Europe and two each in the US and the Asia Pacific region). We continue to recognise the need to deploy resources through critical mass teams based in locations of greatest opportunity. To this end, 3i's Glasgow, Bristol and Leeds offices were, in February, directed to focus on portfolio management, with the executives responsible for new investment in these offices being redeployed. We do not anticipate any substantial changes to the current network of offices.

During the year, headcount was reduced from 858 to 750, reflecting a continued application of the cost reduction measures and changes in investment processes and resource alignment initiated over recent years.

"net investors in the second half"

## Operating review

### Macroeconomic and market conditions

The macroeconomic environment in the regions where 3i has operations improved substantially during the financial year under review. Looking at the period as a whole, perhaps the key defining features of the economic environment were as follows: gradually improving consumer and business confidence from the lows experienced during the extended build-up to hostilities in Iraq, though ongoing geo-political uncertainty appears to be a fact of life; the significant strengthening during the period of sterling and the euro compared with the US dollar and a number of Asian currencies, which has impacted the competitive position of a number of our portfolio businesses; improving economic growth outlook for the US and, to a lesser degree, for Europe, though across most of Europe levels of government spending remain high; and the strength of the Chinese economy and the implications of this for western economies and businesses.

Stock market conditions and mergers and acquisitions ("M&A") activity levels also showed improvement through the financial year. Most stock market indices rose substantially, reflecting improving confidence in underlying economic growth and the prospects for corporate earnings. The increased business confidence, improving stock market conditions and continuing low interest rates are all enabling and encouraging businesses to recommence their disposal and acquisition strategies, though the number of completed M&A transactions remains subdued, both in Europe and globally.

The private equity and venture capital markets are also showing increased activity after a slow first half of 2003. Market statistics for 2003 show that total private equity and venture capital investment in Europe fell by 16.5% compared with 2002, with "high technology" investment down 25%, "growth" investment down by 29.4% and buy-out investment down by 9.5%. The second quarter experienced the lowest levels of investment (as expected, given the prevailing uncertainty and consequent deferment of business decisions), with strong increases in the third and fourth quarters.

Elsewhere, the "high technology" segment of the market in North America showed a 5% increase in total investment over 2002; and investment levels in Asia Pacific rose very substantially in 2003 to a new "all-time high".

Conditions for realisations were difficult for most of 2003, with relatively few active trade buyers and continuing low levels of IPOs by historical standards. Market statistics for Europe show a 25% fall in the number of divestments in 2003 compared with 2002. However, we are seeing encouraging levels of renewed interest by trade buyers for strategic assets and the IPO markets are showing signs of re-opening, at least for strongly performing and profitable businesses.

There were also a number of features specific to the markets of each of our three investment businesses. Activity in the pan European mid-market for buy-outs was driven largely by strategic reorganisation and restructuring initiatives within conglomerates under continuing pressure to sell off non-core assets and manage their balance sheets. In addition, secondary buy-outs (where a private equity investor buys a business from another private equity investor) were a significant feature during the period, accounting for 31.3% of investment (by transaction value) in 2003. This is a reflection of the amount of buy-out funds raised and seeking investment opportunities and also, on the sell side, of the pressure on some funds to sell investments and return cash to investors.

Within the European growth capital market, investment in 2003 was down sharply on 2002, largely as a result of growth and acquisition plans being deferred in an environment of business uncertainty during the first half of the year. Since then, these strategies have increasingly been recommenced and we believe that the use of private equity to facilitate cross-border expansion within the European market is a key driver of investment opportunity.

The venture capital markets are seeing increased levels of IT spending by businesses as well as improved conditions for realisations as the appetite of corporates for buying venture-backed businesses improves and stock markets re-open to some extent to technology companies. Reduced levels of competition following the fallout from the "technology bubble" are also a feature of the marketplace in Europe, though competition for particularly good opportunities is still significant.

"the strategy is delivering"

## Total return

3i achieved a total return of £531 million for the financial year, which equates to 18.1% on opening shareholders' funds. While this compares with returns on the FTSE 100 and FTSE All-Share total return indices of 25.7% and 31.0% respectively, it is normal that 3i's returns lag an upturn in quoted markets. This is because our valuations of unquoted investments are generally based on historical earnings and our venture capital investments are not marked up in line with a rise in quoted markets.

The components of the total return are shown in table 1; and table 2 contains an analysis of total return by business and geography.

Chart A: **Comparison of 3i's compound annual return with the FTSE All-Share total return index**
for the years to 31 March 2004

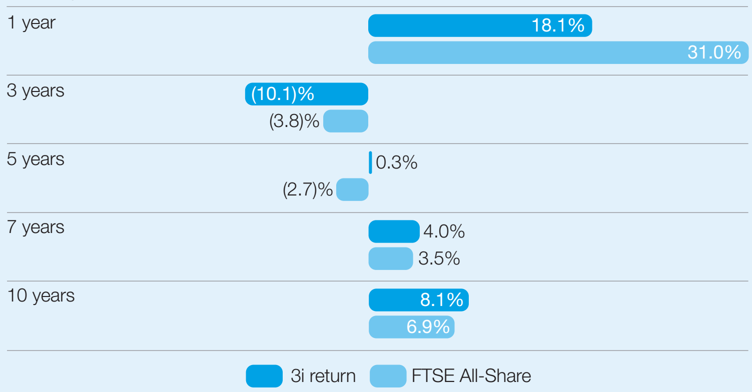



Table 1: **Total return**

| | 2004 £m | 2003 £m |
|---|---|---|
| Total operating income before interest payable | 267 | 308 |
| Interest payable | (93) | (110) |
| Management expenses | (163) | (163) |
| Realised profits on disposal of investments | 228 | 190 |
| Unrealised profits/(losses) on revaluation of investments | 336 | (1,159) |
| Carried interest and investment performance plans | (40) | (12) |
| Other | (4) | 11 |
| – Revenue return | 134 | 146 |
| – Capital return | 397 | (1,081) |
| **Total return** | 531 | (935) |

Table 2: **Total return by business and geography** (£m)
year to 31 March 2004

| | UK | Continental Europe | US | Asia Pacific | Total |
|---|---|---|---|---|---|
| Buy-outs | 123 | 185 | (4) | 31 | 335 |
| Growth capital | 238 | (16) | 1 | 8 | 231 |
| Venture capital | 25 | (28) | (24) | (8) | (35) |
| **Total** | 386 | 141 | (27) | 31 | 531 |

Returns are stated after currency translation losses.

The main drivers of the total return were a good level of profitable realisations and strong growth in the value of the portfolio. The latter was due to two main factors: the use of higher earnings multiples, as a result of rising stock markets; and a good level of "first-time uplifts" on a number of recent investments in the mid-market buy-out portfolio as they moved from being valued at cost to being valued on the earnings basis. The total return also reflects an unrealised loss on foreign currency translation of £64 million, arising on 3i's euro- and US dollar-denominated portfolios net of currency borrowings, as sterling appreciated over the year relative to the euro (up 3%) and the US dollar (up 16%).

Improved results in each of 3i's business areas underpinned the overall return. The mid-market buy-out return of 22.6% (on opening shareholders' funds attributed to this activity) was largely driven by growth in the value of the portfolio, with strong first-time uplifts on a number of recent investments and a minimal level of provisions. Returns in the smaller buy-out and growth capital businesses, of 22.1% and 26.8% respectively, were driven by strong realisations, while the portfolios increased in value mainly as a result of using higher earnings multiples. Both businesses continued to generate a good income yield. The venture capital business produced a total return of (6.0)%, though its return was broadly break-even before the impact of foreign currency translation losses. There were a small number of funding rounds at higher company valuations, allowing us to increase the carrying value of these investments, but we have not sought to reflect in the valuations of unquoted venture capital investments the significant rise in quoted technology indices over the year.

Geographically, 3i's returns in the UK, continental Europe and Asia Pacific were strong. The return in the UK of 22.2% was driven mainly by a high level of profitable realisations and healthy value growth in the portfolio. Whilst the buy-out and growth capital businesses were the main contributors to the UK's return, the venture capital business also achieved a positive return.

In continental Europe, 3i's return of 14.5% (17.5% before the impact of unrealised foreign currency translation losses of £29 million) was largely due to the high level of first-time uplifts.

In Asia Pacific, the sale of our investment in Vantec Corporation, the logistics business acquired from Nissan in 2001, was the main contributor to our 34.3% return.

The US business made a loss of (7.4)% before taking account of the £17 million translation difference arising on the dollar-denominated portfolio (net of dollar borrowings).

## Investment

3i invested a total of £784 million (£979 million including investment on behalf of co-investment funds), which is a 9.5% increase over the prior year.

During the first half of the year, 3i invested £211 million, with the balance of £573 million being invested in the second half. The substantial increase in the second half was largely due to 3i's ability to complete new investment opportunities that had built up in the new investment pipeline up to 30 September – in contrast to the low pipeline coming in to the financial year, reflecting the deferral of many strategic decisions by businesses and investors in an environment of business uncertainty during the extended build-up to the hostilities in Iraq.

An analysis of the amount invested by business and geography is given in table 5. Buy-out transactions represented 42% of total investment, growth capital 37% and venture capital 21%. Of the amount invested in venture capital, 55% was further investment into existing portfolio companies.

Continental European investment represented 51% of investment, up from 42% in the prior year, and is a reflection of our ability, through the network, to source and complete larger deals across Europe. The UK represented 39% (down from 44%), with the US and Asia Pacific investing 8% and 2% respectively.

Table 3: **Summary of changes to investment portfolio**

| | 2004 £m | 2003 £m |
|---|---|---|
| Opening portfolio | **3,939** | 5,109 |
| Investment | **784** | 716 |
| Realisation proceeds | **(923)** | (976) |
| Realised profits on disposal of investments | **228** | 190 |
| Unrealised profits/(losses) on revaluation of investments | **336** | (1,159) |
| Other | **(38)** | 59 |
| **Closing portfolio** | **4,326** | 3,939 |

Table 4: **First and subsequent investment**

| | 2004 £m | 2003 £m |
|---|---|---|
| New first investments | **535** | 432 |
| Further funding or drawdown on existing arrangements | **249** | 284 |
| **Total** | **784** | 716 |

Table 5: **Investment by business and geography** (£m)

| | UK | | Continental Europe | | US | | Asia Pacific | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 |
| Buy-outs | **86** | 163 | **240** | 149 | **–** | – | **–** | – | **326** | 312 |
| Growth capital | **166** | 112 | **111** | 75 | **3** | 32 | **9** | 15 | **289** | 234 |
| Venture capital | **57** | 43 | **50** | 80 | **58** | 42 | **4** | 5 | **169** | 170 |
| **Total** | **309** | 318 | **401** | 304 | **61** | 74 | **13** | 20 | **784** | 716 |

Table 6: **Realisation proceeds by business and geography** (£m)

| | UK | | Continental Europe | | US | | Asia Pacific | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 |
| Buy-outs | **229** | 467 | **178** | 142 | **–** | – | **57** | 4 | **464** | 613 |
| Growth capital | **303** | 199 | **34** | 66 | **–** | – | **2** | 5 | **339** | 270 |
| Venture capital | **76** | 61 | **33** | 30 | **10** | 2 | **1** | – | **120** | 93 |
| **Total** | **608** | 727 | **245** | 238 | **10** | 2 | **60** | 9 | **923** | 976 |

## Realisations

Despite a relatively poor environment for realisations, 3i generated good realisation proceeds of £923 million (2003: £976 million) and strong realised profits of £228 million (2003: £190 million). Realised profits are stated net of write-offs, which amounted to £50 million (2003: £79 million).

The aggregate uplift over 31 March 2003 valuations on equity realisations was 58% and, including sales and redemptions of loans and fixed income shares, 18% of the opening portfolio was realised.

Table 6 shows an analysis of realisation proceeds by business and geography. The growth capital and smaller buy-out businesses were particularly active in generating realisations, mainly through a focus on selling investments that have been in the portfolio for several years.

Sales of quoted equity benefited from the general rise in equity markets, with £40 million of profits generated over 31 March 2003 valuations (an uplift of 51%). Four investee companies achieved IPOs during the year, with the most high profile probably being that achieved by Cambridge Silicon Radio ("CSR") in February (see panel on page 11). The successful IPO of CSR, a leading manufacturer of single-chip Bluetooth wireless devices, at a market capitalisation of £240 million was seen as a key test of the stock market's appetite in Europe.

### Unrealised value movement

The unrealised value movement on the revaluation of investments was a positive £336 million, representing a significant improvement on the £1,159 million value reduction in the prior year. An analysis of the different components of the value movement is given in table 7.

The weighted average earnings multiple applied to investments valued on an earnings basis rose from 8.1 to 12.0 over the period. The impact of increased earnings multiples on investments valued on an earnings basis at the start and end of the year generated value growth of £287 million (2003: £244 million value reduction).

There was a fall of 4% over the year in the aggregate attributable earnings of investments valued on an earnings basis at the start and end of the year, giving rise to a value reduction of £37 million (2003: £48 million value increase). Two larger investments whose profits fell significantly during 2003 were the main components of this value reduction, but the fall in earnings is also due to the use of historical audited accounts (therefore not reflecting the more recent upturn in the economic environment) in valuing most of this component of the portfolio.

Table 7: **Unrealised profits/(losses) on revaluation of investments**

| | **2004 £m** | 2003 £m |
|---|---|---|
| Earnings multiples | **287** | (244) |
| Earnings | **(37)** | 48 |
| First-time valuation uplift from cost | **238** | 31 |
| Provisions | **(143)** | (379) |
| Down rounds and restructuring | **(70)** | (361) |
| Other movements on unquoted investments | **1** | (45) |
| Quoted portfolio | **60** | (209) |
| **Total** | **336** | (1,159) |

“strong first-time uplifts”

It should be noted (by reference to table 7) that the value movement relating to first-time uplifts includes £71 million which is due to earnings growth and that the “other movements on unquoted investments” item includes £7 million in respect of companies that recovered from making losses to being profitable. The net value movement due to earnings growth is therefore a £41 million increase.

First-time uplifts totalled £238 million (2003: £31 million). This is a reflection of the quality of investments made in recent years and the results beginning to come through as value growth strategies in investee businesses are implemented.

Provisions for investments in businesses which may fail totalled £143 million (2003: £379 million) and valuation reductions relating to the application of our downround methodology and restructuring provisions fell significantly to £70 million (2003: £361 million). The latter figure is stated net of valuation increases of £65 million, arising as a result of investee companies raising funds from new investors at increased values.

The quoted investments held at the end of the year increased in value by an aggregate £60 million over the year.

### Carried interest and investment performance plans

Market practice in the private equity and venture capital industry is to offer investment staff the opportunity to participate in returns from successful investments. Amounts payable on the successful realisation of investments in the year to 31 March 2004 totalled £8 million. A further £32 million has been accrued in respect of amounts potentially payable if assets are ultimately realised at the values they were held at in the accounts at 31 March 2004.

### Income and costs

The main elements of income and costs are shown in table 1.

Total operating income before interest payable was £267 million (2003: £308 million). The decrease when compared with the prior year reflects a lower level of special interest and dividend receipts during the year and the realisation of a small number of higher yielding investments. Fee income is marginally lower than in the prior year, although there was a substantial increase in the second half of the year, with arrangement and negotiation fees contributing strongly.

Chart B: **Portfolio value by investment type** (£m)
as at 31 March 2004

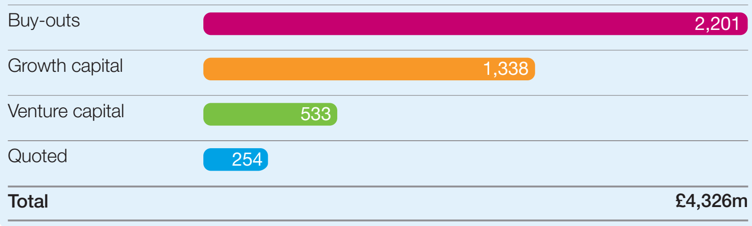



Chart C: **Portfolio value by geography** (£m)
as at 31 March 2004

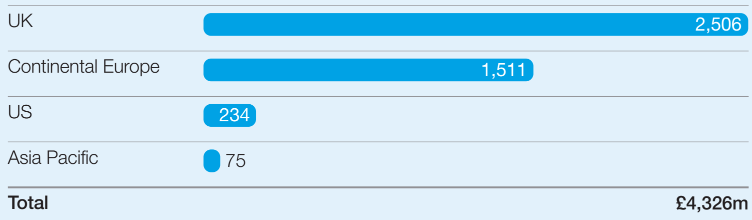



Chart D: **Portfolio value by FTSE classification** (£m)
as at 31 March 2004

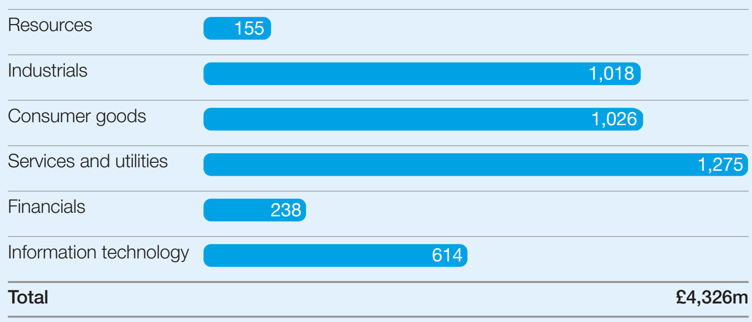
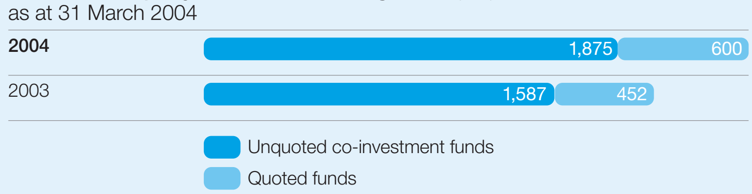



Chart E: **Third party funds under management** (£m)
as at 31 March 2004




Net interest payable decreased, reflecting the reduction in net borrowings and also the lower average rate of interest on long-term borrowings following the €550 million convertible bond issue in August 2003.

Management expenses of £163 million (2003: £163 million) include fundraising costs of £6 million incurred in connection with the Eurofund IV fundraising and a higher level of staff bonuses than in the prior year.

## The portfolio

At 31 March 2004, the portfolio comprised 1,878 investments, a reduction from 2,162 a year earlier and a reflection of the strategy of seeking exits from investments where we believe the value growth potential is not sufficiently attractive. We would expect this number to continue to decrease over the medium term.

Charts B, C and D show the portfolio analysed by investment type, geography and sector respectively and demonstrate the balance we seek in the business. At the year end, 53% of the portfolio is represented by buy-outs, 35% by growth capital investments and 12% by venture capital investments. Geographically, 58% is in the UK, 35% in continental Europe, 5% in the US and 2% in Asia Pacific.

3i's portfolio, in contrast to many others in the private equity and venture capital industry, has relatively low exposure to individual company risk, with the top 10 investments representing 13% by value at the year end and the top 50 investments 35%.

## Fund management activities

Fund management activities comprise the management of both private equity funds and quoted funds.

The private equity funds are primarily co-invested alongside 3i's own capital when financing buy-outs, enabling an investment to be made without 3i holding a majority interest. During the year, 3i earned fee income of £31 million (2003: £34 million) from the management of private equity funds. In addition, 3i receives carried interest in respect of third-party funds under management. During the year, 3i received £1.7 million in respect of realised investments and accrued an additional £1.7 million in respect of unrealised investments. At 31 March 2004, the invested portfolio managed on behalf of private equity fund investors was valued at £1,324 million (2003: £1,158 million), excluding undrawn commitments.

During the year, we announced that the final closing of Eurofund IV, the latest fund targeted at pan European mid-market buy-outs, would take place by 30 June 2004. It is expected that third party commitments will amount to at least €800 million over the life of the fund, enabling 3i (together with the fund) to invest up to €3 billion in buy-outs over the next three years.

3i Asset Management manages 3i's portfolio of quoted investments (comprising principally our holdings in investments that have achieved an IPO) as well as the portfolios of the 3i Group Pension Plan and of three quoted specialist investment companies (3i Smaller Quoted Companies Trust plc, 3i Bioscience Investment Trust plc and 3i European Technology Trust plc). At 31 March 2004, total third party quoted funds under management were £600 million. Fees earned from quoted fund management amounted to £4 million (2003: £4 million).

## Accounting policies and valuation

### *New valuation methodology*

In August 2003, the British Venture Capital Association ("BVCA") issued new valuation guidelines for private equity and venture capital investments, which resulted in changes being made to 3i's portfolio valuation methodology (summarised on page 69). The new methodology has been approved by the Board and was applied in carrying out the 31 March 2004 portfolio valuation. The net impact of these changes on the overall valuation of the portfolio was immaterial.

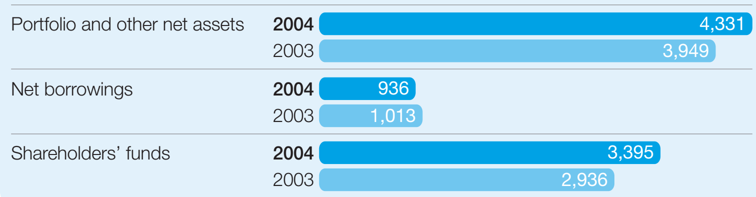
### *Changes to accounting policies*

There have been no changes to accounting policies during the year.

### *Introduction of international financial reporting standards*

In June 2002, the European Union adopted a regulation that requires, from 1 January 2005, European listed companies to prepare their consolidated financial statements in accordance with international accounting standards. 3i's 31 March 2006 financial statements will therefore be prepared in accordance with International Financial Reporting Standards ("IFRS"). These comprise not only IFRS but also International Accounting Standards ("IAS"). Details of 3i's implementation programme are discussed on page 53.

Chart F: **Balance sheet summary** (£m)
as at 31 March 2004




## Financial review

### Cash flows

The key cash flows during the year were the aggregate cash outflow of £756 million in respect of investment and cash inflows totalling £913 million in respect of proceeds received on realising investments. Net cash inflow for the year was £45 million (2003: £170 million), reducing net borrowings at the year end to £936 million (2003: £1,013 million). With the significant growth in the value of the portfolio during the year, gearing fell to 28% at 31 March 2004 compared with 35% a year earlier.

### Capital structure

3i's capital structure comprises a combination of shareholders' funds, long-term borrowing, short-term borrowing and liquid treasury assets and cash.

The major changes in capital structure during the year, other than the growth in shareholders' funds, were the €550 million convertible bond issue completed in August 2003 and the replacement of the £625 million multi-currency facility in January with a new €595 million revolving credit facility. The convertible bonds are due in 2008 and have a conversion price of 842p (a 45% premium to the "reference price" of 580p) and an annual coupon of 1.375%.

Long-term borrowing at 31 March 2004 is £1,595 million and is repayable as follows: £5 million between one and two years, £944 million between two and five years and £646 million after five years. In addition, at the year end, 3i had committed and undrawn borrowing facilities amounting to £583 million and cash and other liquid assets totalling £819 million. We are confident we have in place adequate funding for foreseeable investment needs.

3i Group plc has credit ratings with Moodys and Standard & Poor's of Aa3/stable and A+/stable respectively.

## Regulation and risk management

### Introduction

3i Group plc and relevant subsidiaries continue to be authorised and regulated by the Financial Services Authority.

3i has a comprehensive framework to manage the risks that are inherent in its business. This framework includes a risk committee whose purpose is to monitor the identification, assessment and management of key risks across the business. The main risks comprise economic risk, treasury and funding risk, investment risk and operational risk.

### Economic risk

3i invests mainly in European companies and continues to develop its operations in the US and Asia Pacific. However, the majority of the portfolio (58%) is still in UK companies and there is an element of exposure to the UK economic cycle. To mitigate this, 3i has invested in different sectors of the UK economy with different economic cycles. In addition, an increasing proportion of assets is invested in continental Europe, in the US and in Asia Pacific, which may have different economic cycles.

### Treasury and funding risk

The overall funding objective continues to be that each category of investment asset is broadly matched with liabilities and shareholders' funds, with corresponding characteristics in terms of risk and maturity, and that funding needs are met ahead of planned investment. This objective continued to be met during the year ended 31 March 2004.

All assets and liabilities are held for non-trading purposes and, as a result, 3i does not have a trading book. 3i does not trade in derivatives and does not enter into transactions of either a speculative nature or unrelated to 3i's investment activities. Derivatives are used to manage the risks arising from 3i's investment activities.

The main funding risks faced by 3i are interest rate risk and exchange rate risk. The level of these risks is mitigated by the overall funding objective and the Board regularly reviews and approves policies on the approach to each of these risks.

3i's policy for exchange rate risk management is not generally to hedge its overall portfolio in continental Europe or the US. In line with its funding policy, part of those assets are funded by borrowings in local currency and, as a result, a partial hedge exists. 3i's largest exposure is £0.8 billion in respect of net assets denominated in euros in continental Europe. The level of exposure to exchange rate risk is reviewed on a periodic basis.

Day to day management of treasury activities is delegated to executive Directors and the Group Treasurer. Regular reports on 3i's funding position have been considered during the year by the Board. There has been no change during the year or since the year end to the major funding risks faced by 3i, or to 3i's approach to such risks.

"growth in shareholders' funds"

## Investment risk

This includes investing in companies that may not perform as expected, being over exposed to one sector of the economy and the portfolio valuation being partly based on stock market valuations.

Investment levels are set, allocated and monitored by product area and geography. Within this framework, 3i invests in all sectors of the economy, except those, such as property, where the opportunity to invest in private equity and venture capital backed businesses meeting 3i's investment criteria is limited. Management periodically reviews the portfolio, which is well diversified by industry sector, to ensure that there is no undue exposure to any one sector.

3i's investment criteria focus on management ability and market potential. Investment appraisal and due diligence are undertaken in a rigorous manner by drawing on our international network and experts in individual industry sectors. In general, proposed investments over £5 million are presented to 3i's Investment Committee or Technology Investment Committee, which are committees of senior management including executive Directors.

The valuation of a large proportion of 3i's equity portfolio is based on stock market valuations for the relevant industry sector. Quoted investments are valued using the closing mid-market price at the balance sheet date. 48% of the unquoted portfolio is valued using stock market earnings multiples for the relevant industry sector discounted for non-marketability. Accordingly, stock market valuations for individual sectors are an important factor in determining the valuation of 3i's portfolio and the total return.

There are regular reviews of holdings in quoted companies and exposure to individual sectors in order to monitor the level of risk and mitigate exposure where appropriate. In particular, the level of future funding of technology companies is kept under review. However, it is not possible to protect against the risks of a downturn in stock markets generally or in any specific sector.

Accordingly, the valuation of 3i's portfolio and opportunities for realisation depend on stock market conditions and the buoyancy of the wider mergers and acquisitions market.

"financial capacity and flexibility"

## Operational risk

This includes operational events such as human resources risks, legal and regulatory risks, IT systems problems, business disruption and shortcomings in internal controls.

Line management at all levels is responsible for identifying, assessing, controlling and reporting operational risks. This is supported by a framework of core values, standards and controls, a code of business conduct and delegated authorities.

The ability to recruit, develop and retain capable people is of fundamental importance to achieving 3i's strategic objectives. We operate in a competitive industry and aim to remunerate our staff in line with market practice and to provide superior development opportunities.

A group-wide business continuity strategy is in place. This strategy has been assessed against a detailed business impact analysis and independently benchmarked against best practice.

## Conclusion

The year under review saw a strong return on opening shareholders' funds, driven mainly by healthy realisation profits and good value growth from the portfolio. In addition, 3i took advantage of improving conditions to invest just under £1 billion (including co-investment funds) in good businesses with attractive growth prospects.

3i's balance sheet at the year end is strong, with gearing at a relatively low 28%, providing the financial capacity and flexibility to vary investment and realisation activity in line with market conditions.