Returns and IRRs – an explanation

Our aim is to achieve market-beating returns by generating cash to cash vintage year IRRs of 20% for Buyouts and Growth Capital and 35% for Venture Capital

How does 3i's total return equate to the IRR measures?

Table 1 on page 20, shows how 3i's total return is made up.

Total return is calculated as a gross portfolio return plus other fee income, less costs and net interest payable. Total return can be expressed as a quantum (ie £512 million for the year to 31 March 2005) or as a percentage of opening shareholders' funds (ie 15.9% for the year to 31 March 2005).

Gross portfolio return is made up of the income and value movement (both realised and unrealised) generated from our portfolio.

Costs include expenses and carried interest payable.

The elements that make up the gross portfolio return are the same constituents used in an IRR calculation.

Gross portfolio return (stated as a percentage of opening portfolio value) will equate to an IRR measure over time. So, if 3i achieves 20% gross portfolio returns each year, the long-term IRR will also move to 20%.

What is total shareholder return?

Total shareholder return is the change in share price over a period plus dividends reinvested.

What is an IRR measure?

The Internal Rate of Return ("IRR") is the interim return earned by 3i investing in an asset from the date of initial investment up until a particular point in time. It is calculated as the annualised effective compound rate of return, using monthly cash flows, generated from the asset. For assets that have yet to be sold, and therefore have not generated a final cash inflow from sale proceeds, the asset value at the date of calculation of the IRR is used as the terminal cash flow. An IRR can apply to a single asset or a pool of assets (eg all new investments made in financial year 2003 can be pooled to calculate an IRR for vintage year 2003).

An IRR calculated using the current value of the asset as the terminal cash flow is called a Fund IRR. A Cash to Cash IRR does not include any terminal value for unsold assets and is a pure, more simple measure of cash invested compared to cash returned as it does not include any judgmental asset valuation for the unsold assets.

What is a vintage and a vintage year?

A vintage is a collection of assets in which 3i makes its first investment during a defined period of time. The most common time period measured in the Private Equity industry is a year. A vintage year at 3i includes all new investments made within our financial year, ie vintage year 2005 covers new investments made from 1 April 2004 to 31 March 2005.

Why does 3i track the performance of vintage years?

Looking at the performance of a vintage enables us to asses the returns we are making on pools of assets invested during a vintage year. It gives a measure of the performance of each year's investment activity in isolation.

It also allows us to assess the return generated from assets over the length of time we hold them, rather than just looking at the performance between the beginning and end of a financial year, which is shown in our yearly total return statement. The annual total return analysis has limitations as a measure of longer-term performance as it is only a representation of how the assets have performed in one financial year and is heavily influenced by the valuation of the asset at the beginning of the year and the end. It does not show the evolution of how a vintage year is performing over time.

To achieve this longer-term measure of performance over time, the IRR is the standard measure used across the Private Equity industry.

What IRR measures do 3i use to assess the performance of a vintage?

3i has published target Cash to Cash IRRs for each business line. These targets are 20% for Buyouts and Growth Capital and 35% for Venture Capital.

A Cash to Cash IRR cannot be meaningfully used to measure the performance of a vintage until the majority of assets in that vintage are realised. Therefore, 3i monitors the progress of each vintage and the evolution of the IRR using a combination of the Fund IRRs and the extent to which a vintage is realised, to assess the interim performance. Case A, depicted in Chart 1, is an example to show the interim Cash to Cash IRR of an asset and clearly indicates why, during the holding period of an asset, the Fund IRR gives a more appropriate measure of performance.

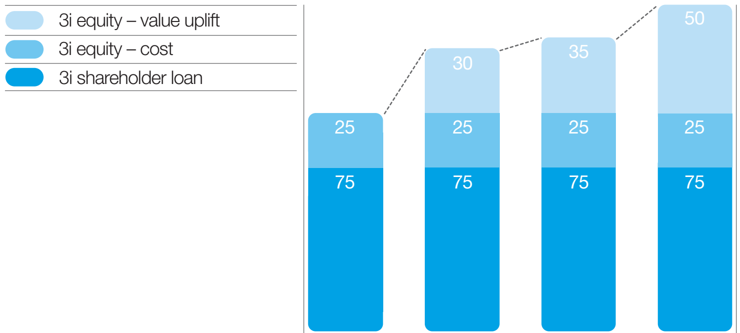
Volatility, the portfolio effect and the holding period

The published target IRRs are for each business line in aggregate. It does not mean that the IRR for each asset in those business lines will achieve the target IRRs individually. There will always be a range of IRRs achieved on each of the individual assets in each vintage year. However, when assets are pooled together, the portfolio effect will reduce this overall volatility in each vintage year. The range of volatility we expect in any one given vintage year is +/-10% for Buyouts, +/-7% for Growth Capital and +/-20% for Venture Capital.

Taking a longer period (say five years), we expect the volatility to average out at +/- 5% for Buyouts, +/- 3% for Growth Capital and +/- 10% for Venture Capital.

A 3i vintage year is made up of many assets. All will have their own individual cash flows and different timings of when value uplift occurs and holding periods. We believe that after three years the maturity of a vintage will have developed enough for the Fund IRR to give a good indication of the final outcome. By seven years most vintage years will be largely realised.

Chart 1 IRR evolution



Case A	Year 0	Year 1	Year 2	Year 3
Investment	(100)			
Yield		6.5	6.5	6.5
Value at year end	–	130	135	–
Sale proceeds				150
Fund IRR	0%	36%	22%	20%
Cash to Cash IRR	(100%)	(94%)	(71%)	20%

Tracking our progress

To monitor a vintage year we use a combination of Fund IRRs and money multiples. The Fund IRR to give a measure of performance and the money multiple to show how much cash has been returned compared to cost (eg Case A = 1.7x) so that we can assess the extent to which that performance is "locked-in".