Operating and financial review

Contents

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. It 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

The focus of 3i's business continues to be to invest in buyouts, growth capital and venture capital. Buyouts represent 36% of our portfolio by value at 31 March 2005, with Growth Capital at 29% and Venture Capital at 17%. Geographically, most of our investment is in businesses based in Europe, although 3i does have growing investment operations in the US and in Asia.

Buyouts

This business line invests in European mid-market buyout transactions with a value up to €1 billion and targets between 15 and 25 transactions per year. These investments typically involve 3i together with co-investment funds managed by 3i holding the majority of the equity of a portfolio company.

The vendors of businesses acquired through a buyout are typically large corporates disposing of non-core activities, private groups with succession issues or, in the case of a secondary buyout, other private equity investors.

3i targets the mid-market because that is where we believe we can create the most value. There is also 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". 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 segment, the underlying businesses will generally have significant growth potential and be attractive acquisition targets for a number of strategic purchasers. We anticipate growing this business broadly in line with the European mid-market.

Growth Capital

3i's Growth Capital business line targets investments of between €10 million and €100 million, across a broad range of sectors, business sizes and funding needs, investing in 20 to 30 transactions per year. These investments typically involve 3i acquiring minority stakes in substantial privately-owned businesses at key points of change. Growth capital can be invested to accelerate organic growth, to fund acquisitions or to acquire shares from existing shareholders to resolve a succession or other ownership issue. With such minority positions, we seek to ensure a high level of influence to create value for all shareholders.

3i's Growth Capital business is primarily focused on the European and Asian markets where we see excellent opportunities to grow investment by around 15% per annum.

Success in Growth Capital is increasingly driven by sector-focused marketing and the ability to add value to companies expanding internationally through giving them access to 3i's network. These factors, combined with 3i's traditional strength in managing relationships with regional businesses and intermediaries, give 3i significant competitive advantage.

In addition, because 3i's funding, unlike that of most of the private equity industry, is not constrained by being fixed-life or closed-end in nature, we are able to be more flexible regarding the investment holding period.

Our Buyout and Growth Capital business lines delivered strong returns again this year and Venture Capital continues to demonstrate improved performance

During the year, we commenced the recruitment of a team to develop a growth capital business in India, and announced our intention to open an office in Shanghai. In addition, we have also made commitments to invest in a central European growth capital fund and a Chinese growth capital fund. These investments will increase our understanding and capabilities in these developing markets.

3i will continue to target opportunities to invest in infrastructure, a segment of the market where we have historically made a number of successful investments.

Also included within this business line is our investment activity in smaller buyouts in Europe and Asia. These transactions typically have a value of less than €25 million. This activity is managed as part of Growth Capital as it generally involves 3i and its co-investment funds together taking only minority equity stakes.

The financial analyses provided in this review, of returns, amount invested and realisation proceeds by business line, include smaller buyouts within Growth Capital. This represents a change from the basis used in prior years where they were included within Buyouts. For ease of comparison, the 2004 figures have been restated on this new basis.

Venture Capital

3i's Venture Capital business is targeted at four key sub-sectors – healthcare, communications, software and ESAT (Electronics, Semiconductors and Advanced Technologies). The main geographic focus is Europe and the US, though the business also makes venture investments in Asia. As venture businesses compete globally, each investment opportunity is reviewed by reference to the relevant global sub-sector's competitive landscape.

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 typically invests between €2 million and €10 million in each new opportunity and, depending on circumstances and market conditions, we expect to invest between £150 million and £200 million per annum in venture capital.

3i's strategy

Consistent with our vision, we will continue to build our business internationally in markets where we believe we can generate market-beating returns. This will include extending business lines and building the capabilities necessary to deliver our targeted returns.

Integral to 3i's strategy is the ability to use our network to generate market-beating returns at each stage 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.

The main elements of our network are as follows:

Business line teams

Our specialist teams of investment executives in each of our Buyout, Growth Capital and Venture Capital business lines. 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 Initial Public Offerings ("IPOs") of companies from 3i's portfolio.

Sector specialisation

Our sector teams and the relationships that they have around the world provide market access, insight to investment judgment and the capability to add value. These sector teams are drawn from our investment and portfolio management executives and 3i's Sector Group, which comprises around 20 experienced senior industry specialists.

Local presence

The relationships that 3i has across the world with entrepreneurs, business leaders, corporates, universities, research organisations and intermediaries.

Relationships with corporates

Another benefit of 3i's scale, international reach and membership of the FTSE 100, is that we have developed valuable relationships with many of the leading corporates in each of the geographies and sectors in which we operate. Furthermore, 3i's ability to make effective business introductions across a range of geographies and sectors is increasingly a critical factor in our ability to "win deals" and provides 3i with a distinctive source of value creation.

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.

Sharing knowledge and relationships
Having invested in building such a significant network, it is imperative that 3i maximises its value through having the systems, processes and, most importantly, culture to enable this to happen. An important tool is the 3i portal. This web-based knowledge system provides everyone at 3i with instant access to the combined knowledge and relationships of the Group.

Organisation and office network
A number of changes to the management and organisation of our investment business were announced during the year. Chris Rowlands was appointed as Head of Group Markets, with responsibility for further developing the benefits of 3i's geographic network and our sector and business relationships. Michael Queen was appointed to succeed Chris Rowlands as Head of Growth Capital. These changes took effect from 1 April 2005. In addition, we announced that Rod Perry would be retiring as Head of Venture Capital in July 2005 and would be succeeded by Jo Taylor, who has run 3i's UK Venture Capital team since 1999. Jonathan Russell continues to lead our Buyouts business line.

Within each business line, a panel of 3i's most experienced investors ensures rigorous application of our investment processes. These panels also seek to ensure, on a case-by-case basis, that we assemble "the best team for the job" from our regional, sector and business line 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 initiative, which was established in 2001, continues to be successful in generating returns from some of the older and lower-growth investments. At 31 March 2005, £762 million of value (18% of 3i's total portfolio) and 807 investments (54% by number of 3i's total portfolio) were managed by the SMI team. It is our objective to continue to realise the SMI portfolio over the medium term.

As noted above, we have started the recruitment of a team for India and intend to open an office in Shanghai to complement our team based in Hong Kong. During the year, we closed a number of our smaller offices, in Padua, Nantes and Vienna. At 31 March 2005, we had a total of 28 offices (24 across Europe and two each in the US and Asia).

Since 31 March 2005, with a view to focusing our new business activity in the UK and Germany in fewer locations, we have communicated the decision to close our offices in central Birmingham, Reading and Düsseldorf. Following these closures, we will have eight offices in the UK, of which four (Aberdeen, Cambridge, London and Manchester) will focus on new business, with the other four (Birmingham – Trinity Park, Bristol, Glasgow and Leeds) being solely focused on portfolio management.

Operating review

Macroeconomic and market conditions
Overall, the macroeconomic environment in the geographies where 3i operates remained supportive during the year, though conditions within the different regions and sectors in which our portfolio companies operate were variable. Broadly, the year was one of economic growth with low levels of inflation and interest rates, which helped to keep business sentiment and consumer confidence positive throughout.
In currency terms, sterling strengthened slightly against the US dollar and a number of Asian currencies, and weakened slightly against the euro, giving rise to a modest negative impact on the competitive positions of some of our European and UK portfolio companies.

Stock market indices rose over the year as a whole, after a relatively subdued first half, though technology indices and markets did less well, experiencing either flat or moderately negative performances. The strong overall increase reflects improving confidence in underlying economic growth and prospects for corporate earnings. Mergers and acquisitions ("M&A") volumes, a key driver of activity in our Buyout business, remained relatively subdued, both in Europe and globally, as corporates remained cautious despite improved balance sheets.

The private equity markets in which 3i operates experienced increased levels of activity. Market statistics for calendar year 2004 show that total private equity investment in Europe increased by 18% compared with 2003, with buyout investment up by 15%, growth capital up by 61% (from a particularly low level in 2003) and venture capital up by 16%. The level of investment in 2004 represented the second highest year on record after 2000 (the height of the "technology bubble").

Market statistics for the venture capital market in the US show that investment in 2004 was up 11% on 2003; and statistics for the same period for Asia show overall private equity investment also up 11% on 2003.

Conditions for realisations improved, with the return of corporate buyers to the market and the IPO window reopening to some extent. Market statistics for Europe show a 53% rise in the number of divestments in 2004 compared with 2003. Secondary buyouts (sales of private equity-backed businesses to other private equity-backed teams or businesses) have become an increasing feature of the market place, providing a significant alternative realisation route. In 2004 they accounted for 28% of total buyout investment in Europe. In addition, 2004 saw increasing amounts of debt available, which led to an increase in refinancing activity across the industry.

The European mid-market for buyouts saw increased levels of competition during the year, driven by a combination of the high availability of debt at aggressive prices and the large amounts of cash in the hands of private equity investors. Rising leverage ratios often enabled private equity buyers to outbid trade buyers.

Within growth capital, the level of competition remained at much lower levels than for buyouts, with relatively few private equity players pursuing these transactions. The market itself is much less well-defined and understood than buyouts, but we have noted a growing acceptance in some of the less mature private equity markets in Europe of the role of external equity funding in enabling businesses to grow. We continue to believe that the use of private equity to facilitate cross-border expansion within the European market is a key driver of investment opportunity.

For venture capital, 2004 saw a number of positives, including signs of increasing technology expenditure by corporates, greater willingness on the part of the stock markets to absorb venture-backed companies, especially within the biotechnology sector, and the return of trade buyers in greater numbers, particularly from the US.
The fundraising environment in Europe remained slow and difficult throughout 2004, influencing the choice of syndicate partners for 3i.

56% of the amount invested in the year was made outside the UK

Table 1: **Total return**

	2005 £m	2004 (as restated) £m
Realised profits on disposal of investments	**260**	228
Unrealised profits on revaluation of investments	**270**	336
Portfolio income	**232**	199
Gross portfolio return	**762**	763
Fund management fee income	**30**	35
Total income	**792**	798
Carried interest and investment performance plans	**(66)**	(40)
Administrative expenses	**(172)**	(163)
Net portfolio return	**554**	595
Net interest payable	**(36)**	(60)
Other	**(6)**	(11)
Total return	**512**	524

Table 2: **Return by business line** (£m)

	Buyouts		Growth Capital		Venture Capital		SMI		Total	
	2005	2004	2005	2004	2005	2004	2005	2004	2005	2004 (as restated)
Gross portfolio return	**332**	291	**286**	258	**74**	32	**70**	182	**762**	763
Return as % of opening portfolio	**22%**	25%	**24%**	23%	**11%**	5%	**7%**	17%	**18%**	19%
Net portfolio return									**554**	595
Return as % of opening portfolio									**13%**	15%
Total return									**512**	524
Total return as % of opening shareholders' funds									**15.9%**	18.8%

Total return

3i achieved a total return of £512 million for the financial year, which equates to 15.9% on restated opening shareholders' funds. This compares with returns on the FTSE All-Share, FTSE 100 and FTSE SmallCap (ex investment companies) total return indices of 15.6%, 15.4% and 11.4% respectively. The components of the total return are shown in table 1.

The main drivers of the total return were a good level of profitable realisations, strong levels of income and steady growth in the value of the portfolio.

Our Buyouts and Growth Capital business lines delivered strong returns for the second successive year, and Venture Capital continues to demonstrate improved performance. Table 2 contains an analysis of returns by business line, at the gross portfolio return level (ie before deduction of remuneration and other expenses).

We have decided this year to disclose separately the returns, amount invested and realisation proceeds of the SMI portfolio, in order to provide greater visibility on trends in our three ongoing business lines. In prior years, the SMI figures were included within those of the business line to which individual assets previously related. For ease of comparison, we have adjusted the 2004 figures to show them on the same basis as those for 2005.

For Buyouts, the gross return of 22% was underpinned by a high level of profitable realisations and the continuing strong performance of the portfolio. The Growth Capital business line achieved a 24% gross return, mainly as a result of strong realisation profits and good "first-time uplifts" on a number of recent investments. Venture Capital made a gross return of 11%, reflecting a good level of realised profits and a number of valuation increases arising as a result of portfolio companies raising funds from new investors at increased values. Across each of the business lines, we have seen the portfolio's health improving and the level of provisions falling.

The gross portfolio return from the SMI portfolio was £70 million (7%), which comprises £86 million of income receipts, realised profits of £2 million and a net unrealised valuation reduction of £18 million.

Investment

3i invested a total of £755 million (£962 million including investment on behalf of co-investment funds), which is marginally lower than the prior year and lower than our expected run-rate over the cycle. This reflects two main factors. First, within Buyouts, as noted previously, competition has been intense and price levels high, and we have sought to remain selective and disciplined in our approach. Second, in Growth Capital, as we have moved to a larger average deal size, investment levels are less evenly spread.

An analysis of the amount invested, by business line and geography, is given in table 5. Buyouts represented 45% of total investment, Growth Capital 35% and Venture Capital 19%. Of the amount invested in Venture Capital, 59% was further investment into existing portfolio companies.

Continental European investment represented 45% of the total invested, the US 7% and Asia 4%. The share of investment represented by continental Europe reflects our focus on the relatively less mature private equity markets there compared with those in the UK.
3i's ability to access and execute deals across Europe through our regional presence and ability to resource transactions on a pan-European basis has also driven investment growth.

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

	2005 £m	2004 £m
Opening portfolio	**4,326**	3,939
Investment	**755**	784
Realisation proceeds	**(1,302)**	(923)
Realised profits on disposal of investments	**260**	228
Unrealised profits on revaluation of investments	**270**	336
Other	**(8)**	(38)
Closing portfolio	**4,301**	4,326

Table 4: **First and subsequent investment**

	2005 £m	2004 £m
First investment in new investee companies	**491**	535
Drawdown on existing arrangements for first investments	**23**	18
Newly arranged further investment in existing portfolio companies	**173**	176
Other – including capitalised interest	**68**	55
Total	**755**	784

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

	UK		Continental Europe		US		Asia		Total	
	2005	2004	2005	2004	2005	2004	2005	2004	2005	2004
Buyouts	**193**	61	**145**	221	**–**	–	**–**	–	**338**	282
Growth Capital	**83**	184	**149**	123	**3**	3	**28**	9	**263**	319
Venture Capital	**50**	55	**44**	39	**48**	58	**1**	4	**143**	156
SMI	**8**	9	**3**	18	**–**	–	**–**	–	**11**	27
Total	**334**	309	**341**	401	**51**	61	**29**	13	**755**	784

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

	UK		Continental Europe		US		Asia		Total	
	2005	2004	**2005**	2004	**2005**	2004	**2005**	2004	**2005**	2004
Buyouts	**354**	94	**148**	58	**3**	–	**–**	53	**505**	205
Growth Capital	**327**	233	**103**	152	**7**	–	**6**	6	**443**	391
Venture Capital	**82**	58	**51**	22	**23**	10	**–**	1	**156**	91
SMI	**134**	223	**63**	13	**1**	–	**–**	–	**198**	236
Total	**897**	608	**365**	245	**34**	10	**6**	60	**1,302**	923

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

	2005 £m	2004 £m
Earnings multiples	**40**	287
Earnings	**20**	(37)
First-time valuation uplift from cost	**149**	238
Provisions	**(66)**	(143)
Up/(down) rounds	**36**	(70)
Other movements on unquoted investments	**79**	1
Quoted portfolio	**12**	60
Total	**270**	336

Realisations

3i generated realisation proceeds of £1,302 million (2004: £923 million) during the financial year, reflecting a profit over 31 March 2004 values of £260 million (25%), compared with £228 million (33%) in the prior year. The uplift over 31 March 2004 values on realisations of equity investments was 40% (2004: 58%). The reduced uplift percentage relative to last year is largely due to the high level of realisations achieved in the earlier months of the year. These assets were realised for amounts similar to their carrying value at 31 March 2004 as they were then valued on an imminent sale basis.

Realised profits are stated net of write-offs, which amounted to £37 million (2004: £50 million). Overall, 24% of the opening portfolio (by value) was realised during the year (2004: 18%), including sales and redemptions of loans and fixed income shares.

Table 6 shows an analysis of realisation proceeds by business line and geography. Realisations were strong across all business lines, but most significantly within Buyouts, where advantage was taken of the high level of secondary buyout activity. Geographically, the UK was particularly active, generating 69% of total proceeds.

Although most of our realisation proceeds continue to come from sales of portfolio businesses to trade and financial purchasers, 12 portfolio companies achieved IPOs during the year on six different markets. The IPOs of Pinewood Shepperton, the film and TV studios business, in May 2004 and E2V Holdings, a supplier of switching, sensing and imaging components, in June 2004, were notable in providing 3i with a 100% cash realisation on IPO.

Significant individual contributions to our realisation proceeds for the year were Yellow Brick Road, the telephone directories group, where we achieved interim realisation proceeds of £61 million through a merger and refinancing completed in April 2004;

and the sale in October 2004 of Westminster Health Care, the care homes operator, which generated realisation proceeds of £155 million at an uplift of £97 million over its 31 March 2004 valuation.

As noted in the market commentary above, sales of businesses to financial purchasers, through secondary buyouts, were a feature of the market during the year. Realisation proceeds of £182 million arose through such sales of portfolio businesses. In addition, conditions were favourable for refinancing businesses and we were able to generate realisation proceeds of over £100 million through refinancings, with the merger and refinancing of Yellow Brick Road being the prime example.

Sales of quoted equity benefited from the general rise in equity markets and a more active realisation strategy by 3i, with proceeds of £134 million and a profit of £28 million (26%) over 31 March 2004 valuations.

Unrealised value movement

The unrealised profit on the revaluation of investments was £270 million (2004: £336 million). 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 was 12.0 at both the end and the start of the year. However, for those investments valued on an earnings basis at both dates, the weighted average earnings multiple rose from 11.7 to 12.3 over the year, giving rise to a value increase of £40 million (2004: £287 million). In the prior year, largely because of the general rise in equity markets, the weighted average earnings multiple increased from 8.1 to 12.0 over the year.

The aggregate attributable earnings of investments valued on an earnings basis at both the start and the end of the year increased by approximately 3%, giving rise to a £20 million value increase. A number of strongly-performing Buyouts and Growth Capital assets contributed significantly to this increase. It should be noted (by reference to table 7) that the value movement relating to first-time uplifts includes £74 million which is due to earnings growth and that the "other movements on unquoted investments" item includes a net £3 million valuation increase in respect of investments that moved between a net assets and an earnings basis of valuation. The net value movement due to earnings growth is therefore a £97 million increase.

The net valuation impact arising on investments being valued on a basis other than cost for the first time ("first-time uplifts") was £149 million (2004: £238 million). This is a reflection of the quality of investments made in recent years and also of the general increase in price levels over the period.

Provisions against the carrying value of investments in businesses which may fail totalled £66 million (2004: £143 million), representing 1.5% of the opening portfolio value and a significant improvement over levels in recent periods.

There was a net £36 million valuation increase (2004: £70 million decrease) as a result of investee companies raising funds from new investors at increased values (£56 million), net of value reductions (£20 million) relating to the application of 3i's downround valuation methodology and fair value adjustments to our Venture Capital portfolio.

Other movements on unquoted investments include valuation increases totalling £101 million on investments being revalued on an imminent sale basis. This includes £52 million in respect of the announced sale of Travelex, the foreign currency services business, which is due to complete in the summer.

The quoted investments held at the end of the year increased in value by an aggregate £12 million over the year, largely reflecting the rise in equity markets.

Carried interest and investment performance plans

Market practice in the private equity industry is to offer investment staff the opportunity to participate in returns from successful investments through "carried interest" or similar arrangements. The charge in the year of £66 million (2004: £40 million) reflects both profitable realisations and strong value growth on a number of recent investments.

Amounts payable under such arrangements on the successful realisation of investments in the year totalled £30 million (2004: £8 million). A further £36 million (2004: £32 million) has been accrued in respect of amounts that would be payable under such arrangements if assets were ultimately realised at their 31 March 2005 carrying values.

Income and costs

The main elements of income and costs are shown in table 1 on page 20.

Total portfolio income was £232 million (2004: £199 million). The increase when compared with the prior year is due mainly to the receipt of several large special dividends arising on the sale of investments, an increase in the level of interest income and a rise in deal-related fees (net of abort costs).

Management expenses of £172 million (2004: £163 million) were 6% higher than in the prior year, during a period in which our staff headcount fell slightly, from 771 at the start of the year to 740 at the end. The increase reflects the costs associated with "upskilling" our investment teams and the costs associated with changes in senior management.

Net interest payable decreased relative to last year, reflecting both the reduced level of net borrowings and the lower average rate of interest following the €550 million convertible bond issue in August 2003.

Chart A: **Portfolio value by business line** (£m)
as at 31 March 2005

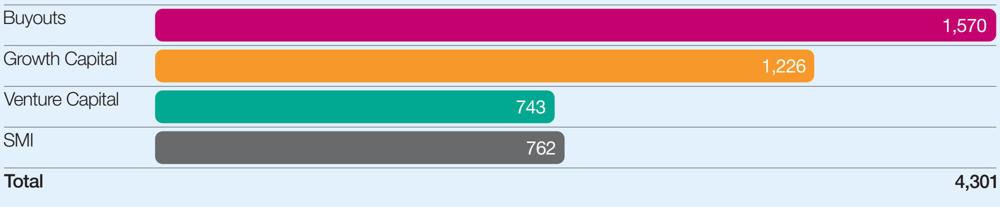


Chart B: **Portfolio value by geography** (£m)
as at 31 March 2005

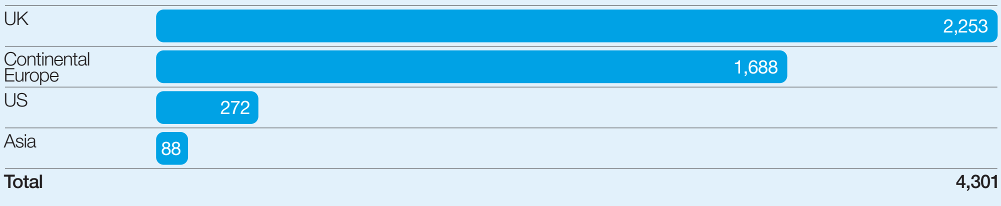


Chart C: **Portfolio value by FTSE classification** (£m)
as at 31 March 2005

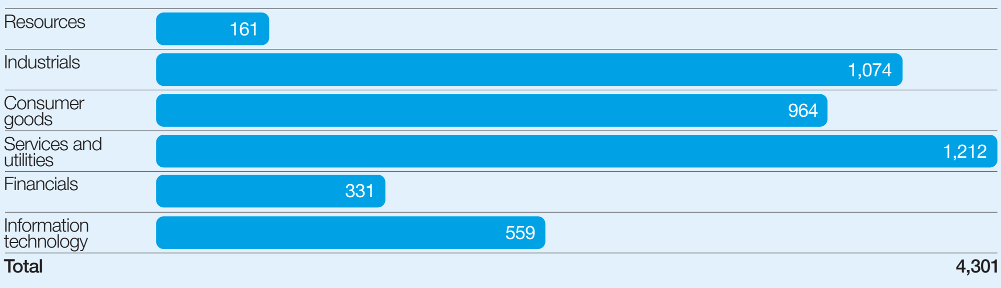
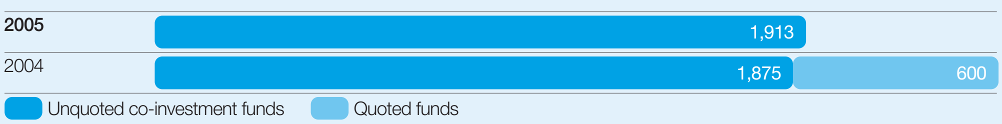


Chart D: **Third party funds under management** (£m)
as at 31 March



3i closed its quoted fund management business during the year.

The portfolio

The number of investments in the portfolio fell from 1,878 (of which SMI was 1,079) at the start of the year to 1,502 (of which SMI was 807) at the end, reflecting the high level of realisations. We would expect this trend to continue over the medium term, as a result of our SMI initiative and partly also of our strategy of making a smaller number of higher value investments than in the past.

Charts A, B and C show the portfolio analysed by business line, geography and industry sector respectively. At the year end, 36% of the portfolio was represented by Buyouts, 29% by Growth Capital investments and 17% by Venture Capital investments. Geographically, 52% was in the UK, 39% in continental Europe, 7% in the US and 2% in Asia.

Although the number of investments in 3i's portfolio has reduced, 3i still has, in contrast to many others in the private equity industry, relatively low exposure to individual company risk. The top 10 investments represented 15% of portfolio value at the year end and the top 50 investments 40%.

Fund management activities

Consistent with our announcement last July, we have ceased managing quoted funds and our fund management activities now comprise solely the management of private equity funds.

These funds are primarily co-invested alongside 3i's own capital when financing buyouts, enabling an investment to be made without 3i holding a majority interest. During the year, 3i earned fee income of £27 million (2004: £31 million) from the management of private equity funds. In addition, 3i receives carried interest in respect of third-party funds under management. At 31 March 2005, the invested portfolio managed on behalf of private equity fund investors was valued at £1,260 million (2004: £1,324 million), excluding undrawn commitments. The final closing of Eurofund IV, our latest fund targeted at pan-European mid-market buyouts, took place in June 2004 with 25 investors. We subsequently placed further commitments with an additional 15 investors, taking total third party commitments to €1.1 billion. At 31 March 2005, Eurofund IV was 44% committed, with investments in 30 companies.

As noted above, we have ceased managing quoted funds and have closed our 3i Asset Management operation. Fees earned from quoted fund management amounted to £3 million (2004: £4 million) and total third party quoted funds under management at 31 March 2005 were £nil (2004: £600 million). Net costs incurred in closing the 3i Asset Management operation were not material.

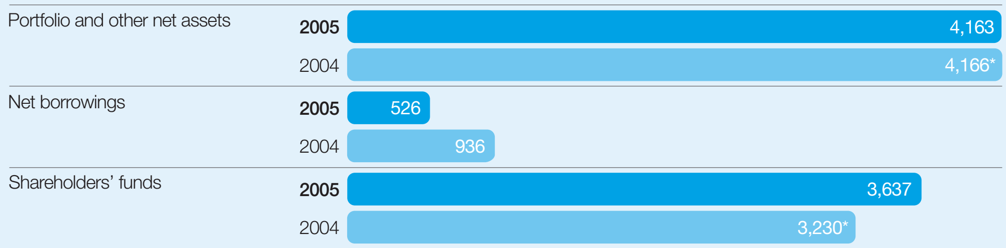
Accounting policies and valuation

Valuation
The valuation guidelines of the British Venture Capital Association were superseded with effect from 1 January 2005 by "International private equity and venture capital valuation guidelines", issued and endorsed by the BVCA, the European Private Equity and Venture Capital Association and the French national association, AFIC. These new guidelines effectively incorporate, without substantial change, the superseded guidelines of the BVCA and have not resulted in any changes to 3i's valuation methodology.

Changes to accounting policies
Financial Reporting Standard 17 "Retirement Benefits" was implemented in full for the first time during the year. Additionally, the recommendations of Urgent Issues Task Force Abstract 38 "Accounting for ESOP Trusts" were implemented and the presentation of comparatives changed accordingly.

Introduction of International Financial Reporting Standards ("IFRS")
Work to comply with the requirements of IFRS in the year to 31 March 2006 is advancing to plan. Differences have been identified, revised accounting policies are being finalised and systems changes have been implemented. We are

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



* The figures at 31 March 2004 have been restated to reflect the adoption of FRS 17 and UITF 38.

confident that 3i will be able to meet requirements for financial reporting during the year to 31 March 2006. The first financial statements prepared on an IFRS basis will be those for the six months to 30 September 2005. Further details are provided on page 55.

Financial review

Cash flows

The key cash flows during the year were the aggregate cash outflow of £719 million (2004: £756 million) in respect of investment and cash inflows totalling £1,287 million (2004: £913 million) in respect of proceeds received on realising investments. Net cash inflow for the year was £433 million (2004: £45 million), reducing net borrowings at the year end to £526 million (2004: £936 million). The level of gearing fell from 29% as restated at 31 March 2004 to 14% at 31 March 2005.

Capital structure

3i's capital structure comprises a combination of shareholders' funds, long-term borrowing, short-term borrowing and liquid treasury assets and cash. There were no significant changes in 3i's capital structure during the year, other than the growth in shareholders' funds and the strong cash inflow.

Long-term borrowing at 31 March 2005 is £1,623 million and is repayable as follows: £154 million between one and two years, £818 million between two and five years and £651 million after five years. In addition, at the year end, 3i had committed and undrawn borrowing facilities amounting to £579 million and cash and other liquid assets totalling £1,199 million. We are confident we have in place adequate funding for foreseeable investment needs.

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

Proposal to return capital to shareholders

As indicated in the Chairman's statement, it is intended that £500 million will be returned to shareholders through a combination of a special dividend and a programme of on-market share buy-backs.

The pro-forma level of gearing at 31 March 2005, based on flowing through into net borrowings the impact of this £500 million proposed return of capital and the proposed final dividend of £56 million, is 34%. This represents a more efficient level of balance sheet leverage for our shareholders, whilst maintaining the funding we require to achieve our medium-term investment plans.

Risk management

Introduction

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. However, the majority of the portfolio by value (52%) 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, which may be subject to 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 2005.

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 is currently in the process of implementing a new policy for foreign exchange risk management. The policy is designed to eliminate, as far as possible, the exposure of assets denominated in foreign currencies to movements in the exchange rates between sterling and the respective currencies. Foreign currency borrowings and swaps will be used to effect the hedges.

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. Other than as noted above, 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.

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 business line and geography. Within this framework, 3i invests in most sectors of the economy. 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 is 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. 39% 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.

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.