Business review

Introduction

This Business review provides an overview of our:

- Group strategy;
- main business activities;
- principal markets;
- our Group and business line performance; and
- principal risks.

It also describes our key financial measures and our performance against them.

The key financial performance measures are:

Group measures
- Total return
- Gross portfolio return
- Gearing
- Net asset value growth

Business line measures
- Gross portfolio return
- Portfolio health
- Long-term IRRs by vintage

Non-financial performance measures are considered in the Corporate responsibility segment of this Report and accounts. They include measures of employee engagement and environmental performance.

Group strategy

Our strategy is to grow our assets and those the Group manages on behalf of third parties by using our relationships and knowledge to identify and invest in opportunities that can deliver high returns. Change provides opportunity, and as 3i operates across Europe, Asia and the US, the rapid rate of change in the global economy provides a significant number of investment opportunities where our knowledge and relationships, when combined with active management, can deliver real financial value.

We are constantly reviewing developments in the private equity markets, the competitiveness of our existing business lines and the potential to expand our access to good opportunities. Where appropriate, we use our capital to fund additional resources, to seed new proprietary business lines and to build relations with other investment managers who can give us exposure to an attractive market.

Our people are organised in self-standing teams whose structure is market-adapted, whose compensation is results-oriented, and which have as their principal objective the selection of the very best opportunities within our chosen asset classes. We seek to maximise our performance by the delivery of our collective knowledge and relationships to each investment opportunity. Our teams are both the contributors to, and the beneficiaries of, this culture of knowledge sharing.

Key to our strategy is attracting and developing people who can combine the requisite investment and professional experience with our cultural fit. Part of this culture is an active approach to managing development.

Our financial and risk management processes are focused on delivering targeted returns on asset specific pools of capital, whilst optimising the mix between returns on proprietary invested capital, income received from fees on third-party funds and setting appropriate leverage ratios.

Our business

Group

The Group's investment focus is on buyouts, growth capital and venture capital. At 31 March 2006: Buyouts represented 35% of our portfolio; Growth Capital 31%; and Venture Capital 20%.

Additionally, we have a portfolio of Smaller Minority Investments, which accounts for 14% of the portfolio. It is our objective to realise this portfolio progressively in the near term.

We are a knowledge-based company providing market access, insight for investment decision making and the ability to add significant value to the companies in which we invest.

We use our international network to identify and assess a wide range of investment opportunities, selecting only those that meet our return and quality criteria. Having made an investment, we then work in active partnership with the boards of our portfolio companies to create value through to the ultimate realisation of our investment.

We operate through a network of teams located in Europe, Asia and the US. Europe is our principal region with some 90% of the investment portfolio by value based in this market. We continue to increase our presence in new markets. During the year, teams were formed in Shanghai and Mumbai and, most recently, in New York to extend our Growth Capital business.

Consistent with our strategy of investing in third-party private equity funds to gain market access and additional opportunities to add value to our portfolio, we made investments in Israel and Russia during the year. These accompany existing investments in funds in China, eastern Europe and Japan.

The benefits of having access to permanent capital from our own balance sheet also enable us to take a more flexible and longer-term approach to the structuring of individual investments.

Buyouts

This business line invests in European mid-market buyout transactions with a value of up to €1billion and targets around 15 investments per year. These investments typically involve 3i investing with co-investment funds managed by 3i. Investments are in businesses with development potential where we can work with an incentivised management team to grow value through operational improvements and by exploiting market opportunities. These businesses are generally sold by large corporates disposing of non-core activities, private groups with succession issues or, in the case of a secondary buyout, other private equity investors.

A key to our success is our international network, which enables us to access markets as a "local" participant and to apply to each opportunity the knowledge, skills and sector experience of our much larger pan-European resource. An intimate understanding of the economic model that drives the companies that we invest in is critical, as is the value creation plan that supports each investment decision.

Competition in the European buyout market is intense and the high level of historic returns achieved has continued to attract new entrants, including some non-traditional competitors, such as hedge funds.

Despite the strong competition, we are confident that through a combination of our scale, local knowledge and sector insight, we can build on our position as the leading European mid-market buyout house.

We will also actively review the opportunities to expand our Buyout business beyond Europe, particularly as we build Group-wide experience in Asia.

Growth Capital

Our Growth Capital business targets investments of between €10 million and €150 million, across a broad range of sectors, business sizes and funding needs. We aim to invest in between 20 and 30 such transactions per year and it is our strategy to continue to grow the average size of investment.

Growth capital investments typically involve 3i acquiring substantial minority stakes in 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 shareholders.

Success in growth capital is increasingly driven by deep sector knowledge 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.

To date, our Growth Capital business has focused on the European and Asian markets where we have strong networks and relationships and see good opportunities to invest. During the year, we extended our reach by entering the US market.

The competitive environment in the growth capital market is more attractive than in the buyout market. Additionally, not all private equity funds' mandates provide the freedom to make minority investments. Our permanent capital differentiates us from other private equity investors, enabling us to make not only minority investments, but provide more flexible longer-term funding.

A dedicated infrastructure team has also been created within this business line with the goal of building a high-quality portfolio in this asset class. Our investment strategy here is threefold: direct investment in infrastructure projects; investment in infrastructure funds; and creating portfolios of infrastructure assets to bring to the market.

Venture Capital

Our Venture Capital business is focused on early and late-stage technology investing and targets investments in the range of €2 million to €50 million. The four main sub-sectors are: healthcare, communications, software and ESAT (Electronics, Semiconductors and Advanced Technologies).

The main geographic focus continues to be Europe and the US, though we have made venture investments in Asia. As venture businesses typically compete globally, each investment opportunity is reviewed by reference to the relevant global sub-sector's competitive landscape.

We work closely with each company we invest in to create a route map to becoming a scalable, successful business. We are a selective, active investor and we sit on the boards of the majority of companies in which we invest. We work in partnership with our investee management teams to add value by utilising 3i's global network of relationships. Through these relationships, we will often introduce new partners, customers and suppliers, and because our network is international, we can help young businesses to bridge the gap to new markets.

Our Venture Capital business has a prominent position in Europe with a strong track record of investment and divestment. Competition is strong in markets such as the UK, where many US firms are active. However, we continue to be well placed here and in other European venture markets. The US market is highly competitive but our global network, sector focus and international offering position 3i well alongside local firms.

Our markets

Europe

Europe is our principal geographic market, with the majority of our assets and investment activity being conducted in this region. Our business strategy is focused on harnessing our strong regional presence and deep sector experience.

2005 was a record year for the market, with the level of fundraising being twice that of the previous year and total investment increasing by 39%. A number of substantial buyout deals in the UK and across continental Europe were a major contributor to this record level of activity.

European buyout investment increased by 44%, driven by increased M&A and secondary market activity, the return of trade buyers and improved IPO markets.

Activity levels in the growth capital market in 2005 were similar to 2004, although this market presents an excellent opportunity as the economy continues to restructure, sectors consolidate and companies seek to expand internationally.

The venture market is showing increased levels of investment and capital market activity.

The year also saw divestments in Europe at record highs as favourable exit conditions were prevalent. The return of trade buyers, improved IPO markets, secondary sales and increased M&A activity were all strong sources of exits.

Asia

This region comprises a number of stand-alone markets and each market has very different characteristics. Asian markets are in the growth phase and forecast macroeconomic growth rates make this a particularly attractive region for private equity investment.

At the present time, Asia is predominantly a growth capital market for 3i. However, we expect to develop Buyout and Venture Capital teams in the longer term.

Currently, India and China represent the highest potential private equity markets, although we will seek opportunities to develop our business in Japan, South Korea, and South East Asia.

In 2005 the Asian private equity industry saw a very significant increase in incoming funds compared to 2004, with India leading the way. Investment increased 29%, with growth capital returning to prominence. Japan accounted for the largest proportion of capital returned to investors, followed by India and China. IPOs were the most preferred exit route, making up 50% of divestments, although trade sales remained the dominant exit route in Japan.

The US

Venture capital has been our focus in the US, where we have invested in both early and late-stage technology companies. During the year, we recruited a Growth Capital team to take advantage of the opportunities in this market and complement our investment teams in Europe and Asia.

The US continues to be the largest and most attractive venture capital market in the world. The market is characterised by a high level of competitiveness, access to technology and clusters of innovation, combined with significant numbers of serial entrepreneurs. Our leading competitors are typically niche partnerships operating domestically.

US venture capital investing in 2005 rose to its highest level since 2001. Market activity was based on the strong fundraising environment of 2004 and 2005, which contributed to increased investment levels. Improved exit markets, particularly for venture-backed companies, was another important contributor.

Group financial review

Total return

3i achieved a total return for the year to 31 March 2006 of £831 million, which equates to a 22.5% return on restated opening shareholders' funds (2005: 15.2%). A key feature of this return is the very strong level of realised profits on disposal of investments where, throughout the year, we have benefited from good market conditions for sales.

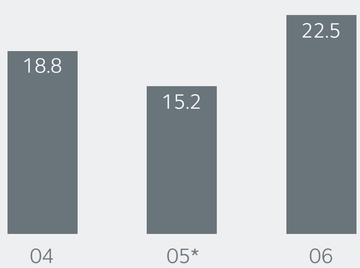
Table 1:
Total return

	2006 £m	2005 (as restated)* £m
Realised profits on disposal of investments	**576**	250
Unrealised profits on revaluation of investments	**245**	245
Portfolio income	**232**	232
Gross portfolio return	**1,053**	727
Net carried interest	**15**	(64)
Fund management fees	**24**	30
Operating expenses	**(211)**	(177)
Net portfolio return	**881**	516
Net interest payable	**(17)**	(42)
Exchange movements	**47**	13
Movements in the fair value of derivatives	**(78)**	13
Other	**19**	(2)
Profit after tax	**852**	498
Reserve movements (pension, property and currency translation)	**(21)**	3
Total recognised income and expense ("Total return")	**831**	501

*As restated for the adoption of IFRS.

Total return comprises the total recognised income and expense as stated as a percentage of opening shareholders' funds.

Total return by year (%)
to 31 March



*As restated for the adoption of IFRS.

As indicated in table 2, we have generated a very good level of gross portfolio return of £1,053 million (2005: £727 million), representing 24.4% on opening portfolio value (2005: 16.7%). Each of our core business lines has generated higher returns, with Venture Capital showing the most improved result over last year. Buyouts and Growth Capital are operating at the top end of their long-term target ranges, with returns of 29% and 26% respectively.

Table 2:
Return by business line (£m)

	Buyouts		Growth Capital		Venture Capital		SMI		Total	
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005 (as restated)*
Gross portfolio return	**447**	301	**341**	285	**128**	76	**137**	65	**1,053**	727
Return as % of opening portfolio	**29%**	20%	**26%**	23%	**17%**	11%	**18%**	7%	**24%**	17%
Net portfolio return									**881**	516
Return as % of opening portfolio									**20%**	12%
Total return									**831**	501
Total return as % on opening shareholders' funds									**22%**	15%

*As restated for the adoption of IFRS.

The Group's gross portfolio return of 24% compares with 17% in 2005. After costs and carried interest, the net portfolio return is 20% (2005: 12%). The reduction of 4% from the gross level is below our anticipated range of 5% to 6%, as net carried interest benefited from significant carry receivable in the year.

Through gearing the balance sheet to an appropriate level, we would expect to enhance total return on opening shareholders' funds by some 4% from the net level. However, given the low level of gearing in our opening balance sheet, the benefit from leverage was below our long-term expectation.

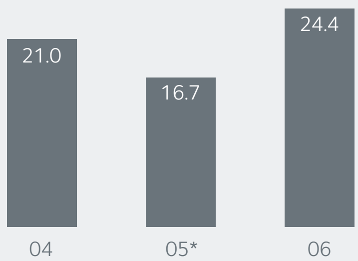
Gross portfolio return

The chart below sets out the gross portfolio return for the Group for the past three financial years. This continued good performance reflects both the focus and discipline of our investment teams and favourable market conditions through the year.

Gross portfolio return comprises the income and capital return (both realised and unrealised value movement) generated from the portfolio and is expressed as a percentage of opening portfolio value.

2004 has been restated as unrealised currency movements are no longer included within gross portfolio return.

Gross portfolio return by year (%)
to 31 March



*As restated for the adoption of IFRS.

Investment

3i invested a total of £1,110 million in the year, significantly up on the £755 million invested in 2005. Having entered the year with a very strong pipeline of new opportunities, some significant individual investments were made in the first half, including NCP (£96 million) and Giochi Preziosi (£61 million). The split of investment across our regions reflected our increasingly international focus, with 63% invested outside the UK. Investment, including co-investment funds, totalled £1,322 million. Consistent with our strategy, the most notable increase by business line was within Growth Capital.

Across the Group we invested in 58 new assets in the year (2005: 67). We also increased our investment in established funds to gain exposure to new or emerging markets. We invested a total of £111 million (2005: £26 million), 10% of our total outlay, into these externally managed funds. This included five new funds into which we committed £242 million (of which £97 million was invested during the year), the largest of these being the I² infrastructure fund (£79 million invested).

The average investment size in the other 53 new assets was £15 million (2005: £8 million), in line with our strategy of increasing deal size within the "mid-cap market" segment.

Table 3:
Investment by business line and geography (£m)

	UK		Continental Europe		US		Asia		Total	
	2006	2005	**2006**	2005	**2006**	2005	**2006**	2005	**2006**	2005
Buyouts	**203**	193	**248**	145	**–**	–	**–**	–	**451**	338
Growth Capital	**172**	83	**234**	149	**–**	3	**91**	28	**497**	263
Venture Capital	**31**	50	**55**	44	**70**	48	**–**	1	**156**	143
SMI	**3**	8	**3**	3	**–**	–	**–**	–	**6**	11
Total	**409**	334	**540**	341	**70**	51	**91**	29	**1,110**	755

Realisations and realised profits

Realisation proceeds for the year were £2,207 million, an increase of 70% over 2005. The favourable market conditions experienced in the first six months continued throughout the second half, enabling strong realisations across all business lines (shown in table 4). We also made further progress in selling down the SMI portfolio, realising £268 million from 278 investments. In total, 38% of our opening portfolio value was realised during the year.

In continental Europe realisations totalled £891 million (2005: £365 million), reflecting the maturity of the portfolio which we have built up in this region.

Realisations were made at a profit over opening carrying value of £576 million (2005: £250 million), representing an uplift on sale of 35%, and are stated net of write-offs of £66 million (2005: £37 million).

During the year, 15 of our portfolio companies achieved IPOs across nine different markets and £229 million of realisation proceeds were raised through sales at the time of flotation or subsequently. Sales from other quoted portfolio companies generated proceeds of £143 million.

Cash proceeds have also been generated through refinancing portfolio businesses where we have realised £168 million and through secondary buyouts, where we have sold 10 assets for £404 million.

Table 4:
Realisation proceeds by business line and geography (£m)

	UK		Continental Europe		US		Asia		Total	
	2006	2005	**2006**	2005	**2006**	2005	**2006**	2005	**2006**	2005
Buyouts	**406**	354	**471**	148	**–**	3	**–**	–	**877**	505
Growth Capital	**453**	327	**293**	103	**43**	7	**66**	6	**855**	443
Venture Capital	**89**	82	**84**	51	**33**	23	**1**	–	**207**	156
SMI	**225**	134	**43**	63	**–**	1	**–**	–	**268**	198
Total	**1,173**	897	**891**	365	**76**	34	**67**	6	**2,207**	1,302

Unrealised value movement

The unrealised profit on revaluation of investments was £245 million (2005: £245 million). An analysis of the components of this return is given in table 5.

Table 5:
Unrealised profits/(losses) on revaluation of investments

	2006 £m	2005 (as restated)* £m
Earnings multiples[1]	**41**	40
Earnings	**95**	20
First-time uplifts[2]	**70**	149
Provisions[3]	**(62)**	(66)
Up rounds	**3**	36
Uplift to imminent sale	**97**	101
Other movements on unquoted investments	**(29)**	(45)
Quoted portfolio	**30**	10
Total	**245**	245

*As restated for the adoption of IFRS.

1 The weighted average earnings multiple applied to investments valued on an earnings basis increased from 12.0 to 12.2 over the year.
2 The net valuation impact arising on investments being valued on a basis other than cost for the first time.
3 Provisions against the carrying value of investments in businesses which may fail.

The aggregate attributable earnings of investments valued on an earnings basis at both the start and end of the year increased by 5%, giving rise to a value increase of £95 million (2005: £20 million).

Assets which were revalued on an imminent sale basis generated value uplifts of £97 million, reflecting the good realisations pipeline at the year end.

Portfolio income

Portfolio income of £232 million (2005: £232 million) includes reduced depreciatory dividends (arising on the sale of more mature assets), offset by increased interest income from a number of new higher-yielding investments. Negotiation fees for new investments have risen with increased investment levels.

Net carried interest

Carried interest payable for the year was £64 million, which is offset by carry receivable of £79 million.

Carried interest payable is broadly in line with last year's level, despite the increase in proceeds, as a number of realisations were from early vintages with no associated carry schemes, or from carry schemes which have yet to reach the hurdle at which carry payable is accrued.

Carry receivable of £79 million relates primarily to Eurofund III, 3i's 1999 pan-European fund, whose cumulative performance in the first half passed through the point at which carried interest receivable within 3i's financial statements is triggered. The accrual at 31 March 2006 has been calculated on a fair value basis and includes carry receivable relating to realised and unrealised value increases arising on assets in more recent vintages, including Eurofund IV.

Costs

Operating expenses totalled £211 million (2005: £177 million). The increase over last year reflects higher variable remuneration costs arising on the improvement in total returns and costs associated with implementing new strategic initiatives. Operating expenses include a charge in respect of share-based payments, to reflect the fair value of options and other share-related rewards granted to employees, of £8 million (2005: £6 million).

Net interest payable for the year was £17 million, reflecting the considerable fall in net borrowings resulting from our net realisation proceeds and an increase in the proportion of borrowing in non-sterling currencies for which interest rates were more favourable during the year.

Other movements

Unrealised value movements in the fair value of derivatives of £(78) million were recognised in the income statement for the first time, having adopted IFRS. £(75) million of this movement relates to the valuation of the equity derivative embedded in the €550 million 2008 Convertible Bond. The movement is the product of a number of factors, the most significant of which was the increase in the Company's share price of 40% in the year.

Exchange movements of £47 million arose in respect of the US dollar denominated investment portfolio. As the dollar strengthened relative to sterling, the currency risk relating to this portfolio is now substantially hedged.

Cash flows

Net cash inflow for the year was £550 million, reducing net borrowings, including the Convertible Bond, to £56 million at 31 March 2006 (2005: £545 million).

During the year, capital was returned to shareholders through the payment of £245 million by way of a special dividend of 40.7p per share and a further £222 million of on-market share buy-backs, as approved by shareholders at an Extraordinary General Meeting following the 2005 Annual General Meeting.

Capital structure

3i's capital structure comprises a combination of shareholders' funds, long-term borrowing, short-term borrowing and liquid treasury assets and cash. In managing our capital structure, we seek to balance the current needs of the business with our ability to support new business growth. Total shareholders' funds at 31 March 2006 were £4,006 million (2005: £3,699 million), the main components being capital reserves of £3,110 million, revenue reserves of £263 million and share capital and share premium of £668 million.

Total Group borrowings at 31 March 2006 were £1,474 million, which is repayable as follows: £231 million, less than one year; £643 million, between one and five years; and £600 million, greater than five years. At the year end, 3i had committed and undrawn borrowing facilities of £488 million, and cash and liquid assets totalling £1,955 million. Additionally, as noted above, in 2003, 3i issued a €550 million Convertible Bond due in 2008.

Gearing

3i's listed status and permanent capital structure enables the Group to enhance returns to shareholders through leveraging our equity. The Board's view is that a gearing ratio of debt to shareholders' funds set between 30% and 40% is appropriate across the cycle, given the current investment profile.

Despite growing our investment by 47% and returning £467 million of capital to shareholders, during the year the exceptionally high level of realisations caused gearing at 31 March 2006 to fall to 1% (2005: 15%).

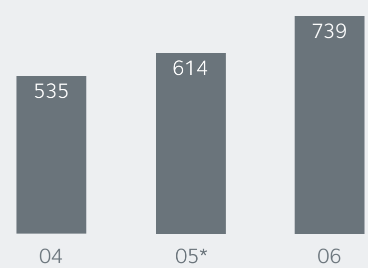
Taking account of future cashflow projections and the development plans of the business, the Board has proposed a further return of £700 million by means of a bonus issue of listed B shares accompanied by a share consolidation designed to maintain comparability of share price and earnings per share. This is currently expected to take place in July 2006.

Growth in diluted net asset value

Diluted net asset value ("NAV") per share was 739p at 31 March 2006, which compares with 614p at 31 March 2005, an increase of 125p, reflecting the strong results for the year.

Diluted NAV shows the net assets attributable to each share in issue after adjusting for the effect of share options and other instruments convertible into shares.

Diluted NAV per share by year (pence) to 31 March



*As restated for the adoption of IFRS.

Portfolio

The value of the portfolio at 31 March 2006 was £4,139 million (2005: £4,317 million). As shown in table 6, the reduction in portfolio value resulted from the high level of realisations in the year. Other movements include transfers of assets into the portfolio previously held through joint ventures and the currency movement in the year.

Table 6:
Summary of changes to investment portfolio

	2006 £m	2005 (as restated)* £m
Opening portfolio	**4,317**	4,362
Investment	**1,110**	755
Realisation proceeds	**(2,207)**	(1,302)
Realised profits on disposal of investments	**576**	250
Unrealised profits on revaluation of investments	**245**	245
Other movements	**98**	7
Closing portfolio	**4,139**	4,317

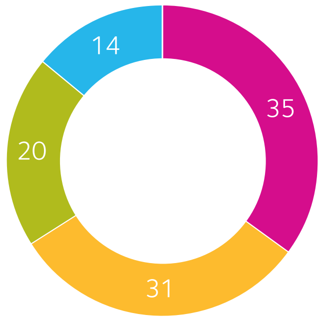
*As restated for the adoption of IFRS.

Charts A and B show the portfolio value analysed by business line and geography. Chart C shows the age profile of the portfolio.

At 31 March 2006, 6% of the portfolio value was held in investments in quoted companies (2005: 5%).

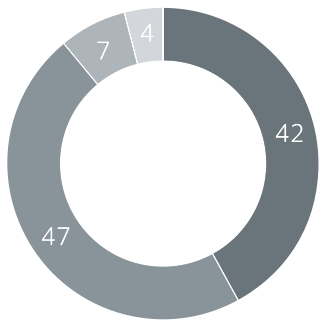
The number of investments in the portfolio continues to fall, reflecting the high number of realisations in the year, our policy to seek investment opportunities in fewer larger deals and our strategy to reduce portfolio numbers within SMI. At 31 March 2006, the number of investments stood at 1,087 (excluding SMI: 561), down from 1,502 (excluding SMI: 695) at the beginning of the year.

Chart A: Portfolio value by business line (%)
as at 31 March 2006



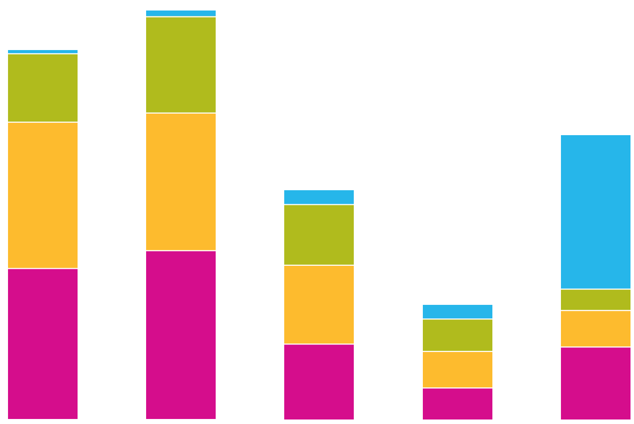
Buyouts	£1,465m
Growth Capital	£1,284m
Venture Capital	£826m
SMI	£564m

Chart B: Portfolio value by geography (%)
as at 31 March 2006



UK	£1,740m
Continental Europe	£1,925m
US	£307m
Asia	£167m

Chart C: Portfolio value by age (£m)
as at 31 March 2006



1,088	1,204	674	336	837	4,139
26%	29%	17%	8%	20%	100%
Up to1 yr	1–3 yrs	3–5 yrs	5–7 yrs	Over 7 yrs	Total

Buyouts Growth Capital Venture Capital SMI

Accounting policies

As a result of the Group's adoption of IFRS, certain accounting policies have been amended. Prior year figures have been restated so as to provide meaningful comparison with the results for the year to 31 March 2006.

The major changes are as follows:

- derivative financial instruments are now held at fair value and any movements in value taken to the income statement;
- a charge is made in the income statement in respect of share-based payments based on the intrinsic value of awards at grant date;
- foreign currency items in the Group's income statement are converted at the actual exchange rate and not the year end rate;
- dividends declared after the balance sheet date are not recognised as a liability at the balance sheet date.

There have been no significant changes to 3i's valuation policy in the year. However, to comply with IFRS, discounts are no longer applied to market prices and quoted investments are valued at bid price rather than mid price.