

Business review Buyouts

“An excellent year for 3i Buyouts in a very competitive market. Our performance and market position, combined with our new €5 billion Eurofund V, position the business well for future growth.”

Gross portfolio return on opening value

54%

Gross portfolio return

£788m

Long-term IRRs (£m)

years to 31 March	Total ¹ investment	Return flow	Value remaining	IRR to 31 March 2007	IRR to 31 March 2006
2007	396	4	401	9%	n/a
2006	439	351	352	47%	3%
2005	335	482	267	54%	38%
2004	297	387	109	30%	32%
2003	261	620	58	50%	49%

¹ Total investment relating to each vintage, including subsequent investments.

Financial performance (£m)

year to/as at 31 March	2007	2006
Investment ²	498	451
Realisation proceeds	1,341	877
Realised profits	538	208
Unrealised value movement	123	124
Portfolio income	127	115
Gross portfolio return	788	447

Assets under management

Own balance sheet	1,281	1,465
Third-party funds	2,129	1,090
	3,410	2,555

² First and further investment made in the year in all vintages.

Gross portfolio return by year (%)

for the year to 31 March	(%)
04	27
05	20
06	29
07	54

Business model

The Buyouts business line targets cash-to-cash IRR returns of 20% through the cycle and is focused on leading or co-leading mid-market transactions across Europe of typically up to around €1 billion in value. Investments are made through a Limited Partnership private equity fund vehicle (currently Eurofund V), which is managed by 3i (see Fund management section opposite). Returns from individual investments are achieved through a mix of income, returns of capital and capital realisation upon exit. Returns to 3i Group are enhanced through fees and carried interest from these funds.

A core element of the business model is that our team of over 100 investment professionals operates as one pan-European team with full economic alignment. This enables resources to be matched to opportunities across Europe on a “best team for the job” basis, allowing 3i to pursue larger and more complex transactions than smaller funds.

Strategy

The core elements of strategy relate to origination and value creation. As part of 3i Group, an extensive origination network is combined with pan-European decision making, sector expertise and access to high-quality operational expertise. This provides the opportunity to be able to choose the best 12 to 15 investments to make in each year.

Working with management, we create a bespoke value creation plan for each investment, focused on growing earnings and using 3i’s network, knowledge and expertise to maximum effect. These value creation plans are benchmarked and reviewed by a team of experienced partners on a pan-European basis. An illustration of the range of business transformation possible through this approach can be seen from the case studies on pages 14 and 15.

Extending our international reach has also been a component of our strategy. During the year a team was established to focus on central and eastern European investments.



For an explanation of IRRs please go to [pages 108 and 109](#)



This team made its first investment shortly after the 31 March year end. Our latest fund, the €5 billion Eurofund V, also has the capacity to invest up to 10% of its capital in companies outside Europe.

Marketplace

The mid-market buyout market in Europe remains buoyant. In calendar year 2006 this segment, defined as deals between €25 million and €1 billion deal size, according to *unquote*, represented some 470 transactions with an aggregate deal value of €67 billion (2005: 402 transactions, €69 billion).

It is a highly fragmented and competitive marketplace with 283 different firms completing transactions in 2006 (2005: 227).

Increased market activity has been driven by an increase in the capital allocated by institutions to buyout funds attracted by the recent track record of returns on buyouts generally and a benign economic environment which presents favourable investment conditions and low corporate default rates. There has also been a plentiful source of debt from traditional lenders and, increasingly, from institutional investors such as collateral debt and loan obligation funds.

Increased competition continues to put upward pressure on deal entry pricing multiples. Therefore, in this environment, we have remained highly-selective buyers and active sellers.

Investment and realisations

We invested £383 million (2006: £360 million) in 12 new transactions in the year (2006: 14). Investment including co-investment funds was £615 million (2006: £525 million). Although the amount of investment was ahead of the previous year, the number of transactions was marginally lower as we remained highly selective.

In addition to new investments, £115 million of further investments were made into the existing portfolio, which included sizeable acquisitions made by portfolio companies such as Carema.

Realisation activity was also very strong with total proceeds of £1,341 million (2006: £877 million) or £2,089 million including co-invested funds (2006: £1,477 million). Significant realisations during the year included SR Technics, NCP Off Street and Vetco Gray, all businesses which had been significantly developed, where employment had grown and which attracted good prices due to their future growth prospects.

Gross portfolio return

The Buyouts business line generated a gross portfolio return of £788 million in the year to 31 March 2007 (2006: £447 million). As can be seen from the chart opposite, this represented some 54% (2006: 29%) of opening portfolio value, demonstrating the continuing effectiveness of our business model.

Realised profits up 159% to £538 million were responsible for 68% of gross portfolio return. The unrealised value movement was £123 million (2006: £124 million).

Portfolio health

The health of the Buyouts portfolio remains robust. The realised loss rate on total investments since the new business model was introduced in 2001 was 1% as at 31 March 2007, and the level of provisions taken for the same period was 4% of total investment at cost as at 31 March 2007 (2006: realised loss rate 1%, provision rate 2%).

Fund management

During the year we successfully closed Eurofund V with €5 billion of commitments, exceeding our initial target of €3.5 billion. The fund attracted 62 Limited Partners, approximately half of whom are based in Europe, a third in North America and the balance in the Middle East and Asia Pacific.

This year saw the final investment made by the predecessor €3 billion fund, Eurofund IV. By 31 March 2007, four new investments had been completed by Eurofund V, which started investing in January 2007.

The performance of Eurofund IV continues to remain strong in comparison to market benchmarks for funds of a similar vintage. At 31 March 2007, Eurofund IV had already returned 76% of its drawn commitments, with a significant portfolio value still remaining.

Fund management fees and carried interest receivable by 3i amounted to £118 million (2006: £103 million).

A list of current funds, together with details relating to their size and the size of 3i's commitment, can be found on page 38.

Long-term IRRs

We have a target "through the cycle" IRR of 20% on each vintage and look to achieve aggregate money multiples in excess of two times the original cost we invest.

Our 2003 vintage has delivered a strong performance with an IRR of 50% at 31 March 2007, a large proportion of which is driven by realised profit. The 2004 and 2005 vintages continue to perform well (30% and 54% IRRs respectively), with the strong performance of the 2005 vintage being driven by exits in the year of Keolis, Vetco Gray, Damcos, Interflora, Jung Pumpen, and KBBI.

The 2006 vintage, although still relatively immature, is already showing strong performance assisted by the early positive realisations of NCP Off Street and Nordic Modular.

Jonathan Russell Managing Partner