

Business review Financial review

This review provides detailed information on our financial performance for the year and the financial position at the year end.

Investment activity

Table 1: Investment by business line and geography (£m)
for the year to 31 March

	Continental Europe		UK		Asia		US		Rest of World		Total	
	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006
Buyouts	326	248	169	203	–	–	–	–	3	–	498	451
Growth Capital	212	234	11	168	258	91	–	–	1	4	482	497
Venture Capital	15	53	81	31	1	–	92	70	11	2	200	156
Infrastructure	6	–	374	–	–	–	–	–	–	–	380	–
QPE	–	–	14	–	–	–	–	–	–	–	14	–
SMI	1	3	1	3	–	–	–	–	–	–	2	6
Total	560	538	650	405	259	91	92	70	15	6	1,576	1,110

Investment

A total of £1,576 million was invested from our balance sheet during the year in 62 new assets, including the £91 million cash investment in 3i Infrastructure Limited (2006: £1,110 million, 58 new assets). Buyouts accounted for 32% of this total investment; Growth Capital 31%; Infrastructure 24%; and Venture Capital 13%. Investment made on behalf of co-investment funds, principally in Buyouts, was £290 million (2006: £212 million).

This represents a year-on-year increase of 42% in investment and followed an increase in the average size of new investment for the year to £26 million (2006: £15 million).

The two largest new investments for each of Buyouts, Growth Capital and Venture Capital are profiled on pages 14, 18 and 22.

The increase also reflects, in line with our strategy, the significant growth of investment in Asia, which included transactions in China, India and Singapore, totalling £259 million (2006: £91 million). The significant rise in investment in the UK included the £251 million investment in AWG. US Venture Capital investment, principally in later-stage situations, also grew by 31% and accounted for 6% of total Group investment in the year.

The Group invested a further £77 million in private equity funds of which £26 million was in new funds (Ithmar Capital L.L.C., Korea Global Fund L.P., D T Capital Partners, Indiareit Offshore Fund and the SVG Strategic Recovery Fund II). Commitments to these five new funds totalled £81 million.

Table 2: **Realisation proceeds by business line and geography** (£m)
for the year to 31 March

	Continental Europe		UK		Asia		US		Rest of World		Total	
	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006
Buyouts	617	471	724	406	–	–	–	–	–	–	1,341	877
Growth Capital	435	293	203	453	53	66	–	43	–	–	691	855
Venture Capital	61	84	69	89	1	1	56	33	–	–	187	207
Infrastructure	–	–	5	–	–	–	–	–	–	–	5	–
QPE	–	–	–	–	–	–	–	–	–	–	–	–
SMI	46	43	168	225	–	–	–	–	–	–	214	268
Total	1,159	891	1,169	1,173	54	67	56	76	–	–	2,438	2,207

Realisations

The ability to capitalise on continued favourable market conditions throughout this year gave rise to realisation proceeds of £2,438 million (2006: £2,207 million).

Once again, this represented a high level of portfolio activity resulting in some 39% of the total opening portfolio value being realised in the year (2006: 38%). Europe continued to represent the majority of realisations, with the continental European portfolio contributing £1,159 million (2006: £891 million), and the UK £1,169 million (2006: £1,173 million). Realisations from the portfolio in Asia of £54 million came principally from Chinese investments.

The nature of realisations followed a broadly similar pattern to last year with 37% of proceeds arising from trade sales (2006: 31%) and 8% through refinancing portfolio businesses (2006: 8%). Sales to other private equity firms, so-called “secondaries”, amounted to £651 million (2006: £404 million). Ten portfolio companies achieved an IPO during the year and realisations from these and other quoted portfolio companies amounted to £240 million (2006: £372 million).

The SMI portfolio delivered realisations of £214 million from 233 investments (2006: £268 million, 278 investments). Consistent with our strategy, this portfolio, which is now valued at £391 million, has been reduced from 1,079 companies as at 31 March 2004 to 293 at 31 March 2007, realising £916 million in the process.

Returns

Total return

3i achieved a total return for the year ended 31 March 2007 of £1,075 million (2006: £831 million), which equates to a 26.8% return on opening shareholders' funds (2006: 22.5%). This was a very strong result for the year, the most significant component of which was realised profits of £830 million (2006: £576 million).

Gross portfolio return at £1,406 million (2006: £1,053 million) for the year represented 34.0% on opening portfolio value (2006: 24.4%), of which more than 80% was crystallized in the form of realised profits, interest and dividends, and unrealised profits on uplifts to sale in respect of assets sold shortly after the end of the financial year.

After adding carried interest receivable and external fees and deducting carried interest payable and operating expenses, the net portfolio return for the year was £1,127 million (2006: £881 million) representing 27% of opening portfolio value (2006: 20%).

Total return by year (%)

for the year to 31 March

Year	Total return (%)
05*	15.2
06	22.5
07	26.8

*As restated for last year's adoption of IFRS.

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

Table 3: **Total return**
for the year to 31 March

	2007 £m	2006 £m
Realised profits on disposal of investments	830	576
Unrealised profits on revaluation of investments	323	245
Portfolio income	253	232
Gross portfolio return	1,406	1,053
Fees receivable from external funds	37	24
Net carried interest	(61)	15
Operating expenses	(255)	(211)
Net portfolio return	1,127	881
Net interest payable	(9)	(17)
Movements in the fair value of derivatives	(29)	(78)
Exchange movements	(31)	47
Other	(2)	19
Profit after tax	1,056	852
Reserve movements (pension, property and currency translation)	19	(21)
Total recognised income and expense ("Total return")	1,075	831

Table 4: **Unrealised profits/(losses) on revaluation of investments**
for the year to 31 March

	2007 £m	2006 £m
Earnings multiples*	5	41
Earnings growth	142	95
First-time uplifts	142	70
Provisions	(29)	(62)
Up rounds	15	3
Uplift to imminent sale	139	97
Other movements on unquoted investments	(54)	(29)
Quoted portfolio	(37)	30
Total	323	245

*The weighted average earnings multiple applied to investments valued on an earnings basis for 2007 was 11.6 (2006: 12.2).

Realised profits

The high level of realisations was also accompanied by a significant increase in the level of uplift achieved on sale of 52% (2006: 35%), resulting in realised profits of £830 million (2006: £576 million). This exceptional rate of uplift is in part attributable to a small number of high-value realisations being sold, some still valued at original investment cost. The most significant of which was the partial disposal of NCP, described in more detail on page 15.

Realised profits are stated net of write-offs of £27 million (2006: £66 million).

Unrealised value movement

The unrealised profit on revaluation of investments was £323 million (2006: £245 million). £139 million of this movement arises from revaluations due to imminent sales (2006: £97 million), including Smart & Cook and Clínica Baviera.

A further £142 million (2006: £70 million) is attributable to first time uplifts from cost, particularly in relation to the Buyouts portfolio. Assets valued on an earnings basis at the beginning and end of the financial year also showed an increase of £147 million (2006: £136 million). Offset against these positive movements was a net decrease in the value of the quoted portfolio of £(37) million, principally due to share price movements in the Venture Capital investments Vonage and CSR plc.

Portfolio income

Portfolio income of £253 million (2006: £232 million) includes £158 million (2006: £133 million) of interest and £81 million (2006: £75 million) of dividends, as well as £14 million (2006: £24 million) of net deal-related fees.

The increase in interest income results from a number of high-yielding Buyout investments made in the year together with some early redemption premiums related to the strong realisations in the year. Dividends benefited from some significant distributions from our investments in unquoted funds. Lower levels of negotiation fee income together with increasing deal-related fee costs, underlie the reduction in net fee income.

Gross portfolio return

In aggregate, realised profits, unrealised value growth and portfolio income gave rise to a total gross portfolio return for 2007 of £1,406 million (2006: £1,053 million). From a business line perspective, Buyouts and Growth Capital were the main contributors, delivering gross portfolio returns of 54% (2006: 29%) and 48% (2006: 26%) respectively. For both business lines, these returns were above our across-the-cycle expectations, and reflect favourable market conditions for realisations, good portfolio health and earnings growth. In contrast, despite a stronger second half of the year, the Venture Capital business line generated a negative gross portfolio return of (6)% (2006: 17% positive). This was largely a consequence of adverse movements in the value of its quoted portfolio, but also due to a less advantageous realisations market.

The new Infrastructure business line contributed £15 million to gross portfolio return as a result of income yield on the portfolio, profit on the transfer of assets to 3i Infrastructure Limited and a subsequent rise in the share price of 3i Infrastructure Limited (and its associated warrants) since flotation.

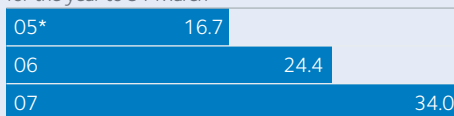
The SMI portfolio generated a positive gross portfolio return of £74 million (2006: £137 million) representing 13% (2006: 18%) of opening portfolio value.

Table 5: **Gross portfolio return by business line** for the year to 31 March

	Gross portfolio return		Return as a % of opening portfolio	
	2007 £m	2006 £m	2007 %	2006 %
Buyouts	788	447	54%	29%
Growth Capital	569	341	48%	26%
Venture Capital	(46)	128	(6)%	17%
SMI	74	137	13%	18%
Infrastructure	15	n/a	16%	n/a
QPE	6	n/a	n/a	n/a
Gross portfolio return	1,406	1,053	34%	24%

Gross portfolio return by year (%)

for the year to 31 March



*As restated for last year's adoption of IFRS.

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.

Fees receivable from external funds

Following the successful launch of Eurofund V, fees receivable from our managed funds have increased substantially in the year to £37 million (2006: £24 million).

Net carried interest

Carried interest aligns the incentivisation of 3i's investment staff and the management teams in 3i's portfolio with the interests of 3i's shareholders and fund investors. 3i receives carried interest from the co-investment funds managed by 3i Investments plc, and pays carried interest to investment staff based on the performance of its assets under management. An explanation of carried interest is provided on pages 110 to 111, together with a description of our accounting methodology.

Carried interest receivable of £81 million (2006: £79 million) relates primarily to two managed funds, Eurofund III and Eurofund IV, which account for 80% of the accrued income. Investments in these funds have performed particularly strongly in the period and the Group has accrued its entitlement to carried interest based on the realised profits generated in the funds and the fair value of unrealised assets at 31 March 2007.



A commentary on gross portfolio return for each business line is contained on pages 13, 17, 21 and 24

In the prior year, most of the carry receivable related to Eurofund III, which achieved its performance hurdle in that year.

There has been a substantial increase in carried interest payable to investment staff in the year. The Group has accrued £142 million of carried interest payable across all its business lines, based on the realised profits generated by assets in carry schemes and the closing value of assets that remain unrealised (2006: £64 million). The increase is due to the strong gross portfolio return in Buyouts and Growth Capital in the financial year, and the high proportion of realisations being made from the most recent vintages, all of which are in market-aligned carried interest schemes with typically higher carry rates than earlier vintages. Of the £142 million charge in the year, 63% relates to Buyouts and 35% to Growth Capital.

Costs

Operating expenses totalled £255 million (2006: £211 million). Approximately one-third of the £44 million increase in costs relates to expenses associated with implementing new strategic initiatives such as the establishment of the two new business lines (Infrastructure and QPE), continued development in Asia and the US, as well as the move of our office in London. In addition, the exceptional level of total return has generated correspondingly higher levels of performance payment to employees.

We have continued to reshape our regional network with new offices added in Beijing and New York, the closure of four smaller regional offices in Europe and the decision to focus our US venture activity in Silicon Valley and to close our office in Waltham, Massachusetts. Restructuring costs in the year for these changes totalled £8 million.

Net operating expenses for the year (after offsetting fee income from external funds) are 5.3% of opening portfolio value.

With effect from 1 April 2007 we are adopting a further key performance measure to monitor cost efficiency. We expect this measure to reduce to around 4.5% in the next two to three years, with a long-term target of 3%.

Net interest payable for the year was £9 million (2006: £17 million), reflecting the low level of net borrowings maintained throughout the year.

Other movements

The two largest "other" movements in the year relate to Exchange movements and the movements in the fair value of derivatives.

The movements in the fair value of derivatives relate largely to the valuation of the equity derivative embedded in the €550 million 2008 Convertible Bond. This unrealised value movement accounted for a gross charge of £(62) million in this category. It is the product of a number of factors, the most significant of which was the Company's share price which rose 21% during the year to 1136p (2006: 941p). Offsetting this movement were net movements on interest-rate swaps used to hedge the portfolio. A number of these swaps were closed out profitably during the period to reflect changes in the proportion of the sterling portfolio.

Exchange movements of £(31) million (2006: £47 million) arose as a result of the weakening of both the US dollar and the Euro during the year.

Portfolio and assets under management

Assets under management

At 31 March 2007 assets under management totalled £7,134 million (2006: £5,712 million). This comprised £4,362 million of portfolio assets owned directly (2006: £4,139 million), co-investment funds of £2,387 million (2006: £1,573 million) and external quoted investment companies of £385 million (2006: nil).

The main contributors to this 25% growth in assets under management were the closing of 3i's latest mid-market buyout fund, Eurofund V, in November 2006 at €5 billion and the £700 million launch of 3i Infrastructure Limited on the London Stock Exchange in March 2007. 3i Group's commitment to Eurofund V is €2,780 million and the Group's investment in 3i Infrastructure Limited was valued at £334 million at 31 March 2007.

Portfolio assets directly owned by the Group

The value of the portfolio at 31 March 2007 was £4,362 million (2006: £4,139 million).

In line with our strategy, the number of companies in the portfolio was reduced further during the year. At 31 March 2007 there were 762 companies in the portfolio compared with 1,087 at the start of the year and 1,878 just three years ago. The SMI programme again made another significant contribution to this reduction with 233 exits during the year. This reduction, combined with higher realisations in other business lines, means that more than two-thirds of the portfolio is now less than three years old, and 36% is less than one year old.

The portfolio is well diversified by business line. The high level of realisations in the Buyouts business has resulted in the value of the Buyouts portfolio falling by 13% despite increasing investment by 10%. This has increased the proportion of the Buyout portfolio held for less than three years from 64% to 83%.

Excluding Infrastructure investment (£89 million) from the 2006 total, Growth Capital investment grew by 18% in the year, and the proportion of the portfolio represented by Growth Capital increased to 33%. During the year, £234 million of portfolio assets were transferred to 3i Infrastructure Limited, £92 million of which was included in Growth Capital as at 31 March 2006.

Geographically, significant growth in investment in Asia led to an increase in the proportion of the portfolio value in that region, rising from 4% to 9% during the year. The continental European portfolio now represents 43% (2006: 46%) of total value with the UK representing 41% (2006: 42%) and the US portfolio 6% (2006: 7%).

The Group also increased its investment in private equity funds. As a consequence, the value of this portfolio of investments at 31 March 2007 was £64 million (2006: £25 million). These investments are included within the respective business line totals in table 6 and geographies in table 7.

Assets managed and advised by 3i

These assets principally relate to Buyouts, where there are three current funds in operation, and to Infrastructure, where our investment in 3i Infrastructure Limited includes the provision of advisory services to the company on an exclusive basis.

Chart A: **Assets under management** (£m)
as at 31 March

	2007	2006
3i direct portfolio	4,362	4,139
Third-party advised and managed	2,772	1,573
Total	7,134	5,712

Table 6: **Portfolio value by business line and age** (£m)
as at 31 March

	Up to 1yr	1-3yrs	3-5yrs	5-7yrs	Over 7yrs	2007	2006
Buyouts	461	599	148	23	50	1,281	1,465
Growth Capital	449	579	200	159	73	1,460	1,192
Venture Capital	205	233	129	99	75	741	826
Infrastructure	451	–	18	–	–	469	92
QPE	20	–	–	–	–	20	–
SMI	4	10	14	35	328	391	564
Total	1,590	1,421	509	316	526	4,362	4,139
Percentage	36	33	12	7	12		

Table 7: **Portfolio value by geography** (£m)
as at 31 March

	2007	2006
Continental Europe	1,894	1,923
UK	1,792	1,736
Asia	373	167
US	283	307
Rest of World	20	6
Total	4,362	4,139

Table 8: **Managed funds**

Fund	Date closed	Fund size €m	3i commitment €m	Invested at 31 March 2007 %
Eurofund III	1999	1,990	995	90%
Eurofund IV	2004	3,067	1,941	90%
Eurofund V	2006	5,000	2,780	1%

Balance sheet

Capital structure and gearing

3i's capital structure comprises a combination of shareholders' funds, long-term borrowing, short-term borrowing and liquid treasury assets and cash. The Board is committed to achieving capital efficiency for the Group and remains of the view that a gearing ratio of debt to shareholders' funds of between 30% and 40% is appropriate across the cycle given both the current profile of the business and its plans for development.

During the year, £774 million was returned to shareholders by way of the B share arrangements (£700 million) and an on-market share buy-back programme (£74 million), as approved by shareholders at an Extraordinary General Meeting and the Annual General Meeting in July 2006.

Despite a 42% increase in investment, repurchases of B shares amounting to £689 million and the aforementioned buy-backs of ordinary shares, the Group ended the year ungeared (0%), with a net cash balance of £1 million (2006: 1% geared, equating to net borrowings of £56 million). At 31 March 2007 there were B shares outstanding at an issued value of £11 million.

On 29 March 2007, the Board announced its intention to return a further £800 million to shareholders by means of a bonus issue of listed preference shares and approval for this issue will be sought at an Extraordinary General Meeting expected to take place in July 2007. Had this further £800 million return taken place before the year end, it would have resulted in gearing of 23% on a pro forma basis at 31 March 2007.

Growth in diluted net asset value

Diluted net asset value ("NAV") per share was 932p at 31 March 2007, which compares with 739p at 31 March 2006, a net increase of 193p.

This increase comprises 236p attributable to the total return of £1,075 million in the year, offset by the combination of the dilutive impact of the £700 million return of capital (14.5p), share buy-backs (1p), the payment of the interim and final dividends (15.5p) and other adjustments (12p), which together totalled 43p.

Diluted NAV per share by year (pence) as at 31 March

05*	614
06	739
07	932

*As restated for last year's adoption of IFRS.

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.