

Business review Venture Capital

“A challenging year for Venture Capital returns but a year in which we strengthened our team and achieved the necessary changes to become more focused on late-stage investing.”

Gross portfolio return on opening value

(6)%

Gross portfolio return

£(46)m

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	123	4	115	(2)%	n/a
2006	80	3	81	5%	–
2005	81	–	80	(1)%	–
2004	137	67	120	14%	36%
2003	116	26	41	(19)%	(19)%

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

Financial performance (£m)

year to/as at 31 March	2007	2006
Investment ²	200	156
Realisation proceeds	187	207
Realised profits	12	72
Unrealised value movement	(61)	51
Portfolio income	3	5
Gross portfolio return	(46)	128

Assets under management

Own balance sheet	741	826
Third-party funds	15	30
	756	856

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

Gross portfolio return by year (%)

for the year to 31 March	
04	10
05	11
06	17
07	(6)

Business model

The Venture Capital business targets cash-to-cash IRR returns of 25% through the cycle.

With an early and late-stage technology focus, our Venture Capital team of 47 investment professionals works as a global team across six offices in Europe and the US. Returns, which are achieved principally through realisations, have a higher volatility than the Group's other business lines.

The purpose of the investment is usually to move a technology business from an early or development stage through to revenue and profit.

A highly-selective approach is taken with around 20 new investments made each year of between €2 million and €50 million in companies new to the portfolio.

Our value proposition is based on the scale of 3i's network of relationships within and outside the venture industry, the proactive involvement of 3i's investment team, the ability to provide multiple investments and our deep knowledge of core technology sectors.

As can be seen from the Financial performance table, the majority of Venture Capital investment is made directly from 3i's balance sheet. We also manage third-party funds of £15 million in Asia.

Strategy

By operating as a single team, 3i's international reach, which is fundamental to our value proposition to entrepreneurs and syndicate investors, is delivered to highly-specialised segments of the technology industry.



For an explanation of IRRs please go to **pages 108 and 109**



Activity has been focused on early (30%) and late (70%) stage investment in healthcare, IT and cleantech. Our preference is to lead or co-lead investments, and invest in companies with significant growth potential, disruptive technologies and strong management. We select opportunities where we can create and realise significant value, take board seats and achieve exits via trade sale or IPO.

This strategy is now working well in the US where our scale and international offering appeals to more mature venture businesses.

Reflecting the increased focus on later-stage investing, we changed our resourcing mix during the year. In the US we recruited Jim McLean, who has almost two decades of venture capital experience, to run our business there. We also consolidated our US team in Silicon Valley and made plans to close our Waltham office.

Marketplace

According to reports from Ernst & Young and Dow Jones VentureOne, European venture capital investment at €4.1 billion and the number of venture IPOs (90) in 2006 were at their highest since 2002 and 2000 respectively.

In the US, the equivalent report stated that US venture capital investment in 2006 increased by 8% to \$26 billion. Fifty six venture IPOs were completed raising \$3.7 billion, an increase of 33% and 64% on 2005 respectively.

Despite the increased amount of investment in both the US and Europe, the actual number of deals dropped 27% in Europe and was only slightly ahead in the US, when compared with 2005.

Corporate acquisitions of venture-backed companies in Europe decreased by 12% with 185 acquisitions made, and in the US the number and value of acquisitions were flat.

The competitive landscape is changing with fewer but larger funds being raised in both Europe and the US. This more selective environment is reflected in the US as the number of active venture capital firms there continues to shrink with many firms not raising new funds.

The main quoted technology indices, NASDAQ and techMARK, rose 3.5% and 7.9% respectively during the year.

Gross portfolio return

Due to a weaker market for realisations and reduced share prices of several quoted assets in the Venture Capital portfolio, both realised and unrealised profits were lower than last year. As a consequence we delivered a negative return of £(46) million, which represented (6)% on the opening portfolio. The unrealised loss on the quoted part of the Venture Capital portfolio was £(64) million in total and, although spread over a number of assets, the fall in the share price of Vonage was most significant. Vonage, a US asset in which 3i first invested in 2004, accounted for £49 million of the unrealised value loss in the year.

Net realised profits of £12 million (2006: £72 million) resulted from a number of smaller disposals as we continued to focus the portfolio.

Our performance for the year at the gross portfolio return level was therefore disappointing despite the modest recovery in the second six months of the year.

Investment and realisations

In line with our strategy, the increase in later-stage investments resulted in total investment of £200 million (2006: £156 million) during the year of which 46% was in the US and 40% was in the UK.

A total of £123 million (2006: £64 million) was invested in 20 companies which were new to the portfolio. Late-stage investment accounted for 65% (2006: 44%) of total investment. The average size of a late-stage investment during the year was £13 million.

This investment included £1 million of a £5 million total commitment in DT Capital Partners fund in China to provide a window on this rapidly-growing venture market.

There were a total of 35 realisations during the year delivering proceeds of £187 million and realised profits of £12 million. Five companies from the portfolio achieved IPOs: Vonage; Eleksen; Newron; Santhera; and Omniture.

The case studies on pages 22 and 23 include the most valuable exit of the year, Domantis, from the 2004 vintage.

Portfolio health

Portfolio health is more volatile in Venture Capital than 3i's other business lines but at 31 March 2007, 69% of the portfolio companies were classified as healthy, against a three year rolling average of 67% (2006: 67% and 65%).

Long-term IRRs

The significant changes that we have made to the venture business in the last two years are having a positive influence on earlier vintages but the main effects will be seen from the 2006 vintage and in subsequent years. Currently the 2007 vintage is showing a small negative IRR of (2)%, in line with expectation at this stage in the vintage's life cycle.

Jo Taylor Manager Partner