



Brian Larcombe Chief Executive

Chief Executive's statement

“Our priorities have been to pursue our core strategy, rebalance our investment activity, improve the quality of our processes and investment portfolio, and increase specialisation.”

Overview For the second consecutive year, we are reporting a substantial fall in the value of the portfolio and shareholders' funds.

The market has undoubtedly been difficult and, particularly for early stage technology companies, the operating environment has been the toughest for a very long time.

Our Operating review considers the performance of our product businesses – buy-outs, growth capital and early stage technology – in more detail. In summary, our mid-market buy-out business performed well and achieved a positive return. Our smaller buy-out business and our growth capital business both performed satisfactorily but produced negative returns, partly because of reduced valuations arising from falling stock markets. Our early stage technology business saw a substantial fall in the value of its portfolio and was the principal factor contributing to the Group's negative total return.

The return from our mid-market buy-out business of 5% and the negative return of 12% in our growth capital business compare strongly with the movements for the All-Share Index of minus 29.8% and the SmallCap Index of minus 33.4%. Our early stage technology business saw a decline of 51%, which is very similar to the fall in the techMARK Index of 50.0%.

At the Group level, we generated about £1 billion of realisation proceeds, at good prices, and this has enabled us to retain our balance sheet strength.

We have maintained our long term strategy but have taken significant actions to improve the quality of our processes.

Market conditions The weakness in stock markets in the year clearly recognises the slowing down of world economies and the continuing pressure on corporate profits. This has had a major impact on the private equity industry which has seen falling returns and a difficult fundraising climate.

For calendar year 2002, total investment in private equity and venture capital in the US and Europe is estimated to have increased by approximately 10% to \$91 billion. However, within this total, buy-out investment was up 69% to \$61 billion, whereas early stage investment was down 53% to \$4.1 billion in the US and by 66% to \$2.5 billion in Europe.

We have continued to invest in line with our strategy of building a balanced portfolio.

In our main European markets, we invested in about 10% of completed transactions, thereby maintaining our market leading position.

Liquidity for the private equity and venture market has generally been difficult with significantly lower levels of mergers and acquisitions activity and virtually no IPOs. In this environment, it is very encouraging that we saw such a strong interest in many of our portfolio companies.

Strategy and competitive advantage Our strategy is to:

- develop the business internationally;
- build a balanced investment business;
- use the network as our key competitive advantage; and
- invest primarily in growth companies.

Our network enables us to use our local presence and established relationships to identify opportunities in which to invest. This, combined with our scale, gives us the ability to use specialist resources for winning deals, carrying out extensive referencing and adding value to our portfolio companies.

A key element of our strategy is maintaining a balanced business with about 40% of our assets in buy-outs, 40% in growth capital and 20% of our portfolio in early stage technology based companies. The proportion of our portfolio in technology companies increased during the bubble in

Portfolio value by product (£m) as at 31 March 2003

Buy-outs*	1,927
Growth capital*	1,206
Early stage technology	589
Quoted	217
Total	£3,939m

* Buy-outs and growth capital include a total of £544m in unquoted late stage technology companies. See page 71 for further information.

Portfolio value by geography (£m) as at 31 March 2003

UK	2,494
Continental Europe	1,175
US	180
Asia Pacific	90
Total	£3,939m

Portfolio value by FTSE classification (£m) as at 31 March 2003

Resources	186
Industrials	944
Consumer goods	873
Services and utilities	1,018
Financials	274
Information technology	644
Total	£3,939m

2000 and 2001, which has damaged our short term performance, but we have now broadly restored the shape of the portfolio in line with our long term strategy.

We seek to invest in companies with good growth potential rather than relying on financial engineering as the driver of value growth. Additionally, we look for growth markets, a strong and well-balanced management team and a business strategy that will deliver value to all shareholders.

Strategy and management action We have adjusted our resources and organisation to meet the market challenges. The process of reorganising the business on to a product as well as geographical basis is now largely complete. We have also reduced staff numbers to align resources with market conditions.

Our business is led on a product and sector basis. Jonathan Russell heads up our buy-out business and Rod Perry our technology business. Following the retirements of Peter Williams and Richard Summers, who had respectively run our UK and continental European networks, we were particularly pleased to recruit Chris Rowlands back to 3i. Chris is, in addition to responsibilities for the UK regional network and the northern European countries, driving forward our growth capital business across Europe.

The drivers of change in our product approach have been specialist teams, focused marketing and using our resources on a pan European basis. This model, which we adopted in our buy-out business two years ago, is working well and delivering strong investment opportunities.

Key elements of this approach include a refined investment process and a new performance management system for our staff.

We closed our office in Tokyo and subsequently our office in Dublin, but made no other changes to our country network. In Japan, we had hoped to develop a mid-market buy-out business, but after three years it became clear that this market was not developing at a rate to support a local presence. Our decision to close our Dublin office reflected the slower than expected development of the Irish private equity market.

In Germany, market conditions have been very tough, particularly for early stage companies, and we have carried through a major restructuring resulting in the closure of our offices in Hamburg and Berlin.

Outlook In the short term, the outlook for corporate profits growth remains weak. Against this background, we are actively managing the portfolio and focusing investment on those companies that can thrive in this more difficult environment.

Market weaknesses and imperfections also create great opportunities and we are mindful that the recession years of 1992-93 were excellent vintages in terms of investment returns.

Although cautious about the short term outlook, I have every confidence in 3i's business.



Brian Larcombe
Chief Executive
14 May 2003