Michael Queen Finance Director

"3i has the financial capacity to increase investment when economic and market opportunities improve."

Financial review

Total return Total return for the year was a negative 23.7% on opening shareholders' funds, a return of £(935) million. High levels of investment in early stage technology companies in the three years to 31 March 2002, combined with the current exceptionally difficult conditions, have resulted in a total return of £(671) million for our early stage technology business. The downturn in other sectors and the fall in stock markets have resulted in negative returns for our smaller buy-outs and growth capital businesses, although our mid-market buy-out business produced a positive return. Overall, the effect of falling stock markets on total return was £(453) million.

3i's return of (23.7)% represents an outperformance against our benchmark indices, the FTSE All-Share (29.8)%, the FTSE 100 (29.1)% and the FTSE SmallCap (33.4)%. Over the medium and longer term, 3i has maintained its record of outperformance against stock market indices, except that over a cumulative three year period to 31 March 2003, the FTSE All-Share and FTSE 100 had marginally smaller negative returns by 0.4% and 0.2% respectively. For all longer cumulative periods up to 10 years, 3i has continued to outperform, and overall has maintained its margin of outperformance.

There was a strong performance on realisations, with realised capital profits of £184 million. The negative total return arose from the unrealised valuation movement on the portfolio of £1,165 million, due mainly to reductions in the valuation of the technology portfolio.

Given the difficult economic conditions, the mid-market buy-out business performed well, delivering a positive total return of £61 million, through a strong level of profitable realisations and a good income yield.

The smaller buy-outs and growth capital portfolios have produced negative total returns of £(188) million and £(137) million respectively. This is largely as a result of unrealised losses on the revaluation of the portfolio, caused mainly by a fall in price-earnings ratios used to value a large proportion of the portfolio and provisions for companies that may fail. Realisations were, however, strong, producing a satisfactory level of realised profits and there were also continued good levels of dividend and interest income.

In the early stage technology business, provisions continued at the high levels experienced in the previous year and the impact of the worsening conditions necessitated additional valuation reductions.

Geographically, the return from our UK investments was £(400) million and the return on our continental Europe investments was £(379) million. UK investments have earned a good income yield, mainly in the form of dividends and interest, and also strong realised profits, which partially offset reductions in the valuation of the portfolio. In continental Europe, the portfolio is weighted more towards early stage technology but the valuation reductions were partly offset by a currency gain of £95 million.

Our Asia Pacific business produced a return of £(16) million, and our US business, mainly in early stage technology, a return of £(140) million, which includes a currency loss of £26 million arising from the weakening of the US dollar against sterling.

Total return (£m)	**2003**	2002
Total operating income before interest payable	**308**	355
Interest payable	**(110)**	(120)
Management expenses	**(153)**	(171)
Realised profits/(losses) on disposal of investments	**184**	(39)
Unrealised value movement on revaluation of investments	**(1,165)**	(890)
Other (changes to organisational structure, goodwill, tax and currency)	**1**	(95)
– Revenue return	**146**	102
– Capital return	**(1,081)**	(1,062)
Total return	**(935)**	(960)

Total return by product (£m)		
Mid-market buy-outs	**61**	(48)
Smaller buy-outs	**(188)**	(38)
Growth capital	**(137)**	14
Early stage technology	**(671)**	(815)
Goodwill amortisation	**–**	(73)
Total return	**(935)**	(960)

Total return by geography (£m)		
UK	**(400)**	(298)
Continental Europe	**(379)**	(481)
US	**(140)**	(74)
Asia Pacific	**(16)**	(34)
Goodwill amortisation	**–**	(73)
Total return	**(935)**	(960)

Statement of Recommended Practice: Financial Statements of Investment Trust Companies (SORP) The recommendations of the revised SORP issued by the Association of Investment Trust Companies in February 2003 have been adopted in these accounts. Fee income earned and costs incurred on the acquisition or intended acquisition or disposal of investments are included in the capital return. The revenue account includes a tax charge of £30 million and the capital account a corresponding tax credit in respect of expenses charged to the capital return which are being utilised in reducing taxable revenue profits. Adoption of these recommendations has had no effect on total return and, as a result, as required by the SORP, comparatives for the previous year have not been restated.

In addition to implementing the revised SORP recommendations, the methodology used to identify management expenses and interest costs available for allocation between the revenue and capital accounts has been revised, resulting in a higher level of costs being available for allocation. All finance costs, less interest income on short term funds, are now available for allocation, as borrowings are now considered to finance investment packages, comprising equity shares and loans, rather than primarily loans as previously. The proportion of available management expenses and interest charged to the capital reserve has been reduced from 80% to 70% to reflect the expected future balance of returns from capital and revenue. This proportion had been increased from 70% to 80% in the year to 31 March 2001.

The effect of adopting the revised SORP recommendations and changes in the allocation methodology for management expenses and interest payable has been to increase revenue profits after tax this year by £50 million and to reduce the capital return by a corresponding amount, compared with the previous methodology.

Income, costs and revenue profit Total operating income was £308 million, a reduction from the previous year, £355 million. Interest receivable on loan investments of £96 million (2002: £113 million) has fallen due to lower interest rates (and the prior year benefited from some exceptional high yields on certain investments). Dividend income of £123 million (2002: £130 million) includes £46 million of dividends received on the sale and restructuring of investments (2002: £44 million). Fee income, comprising mainly unquoted fund management fees and investment negotiation fees, amounted to £56 million, the same as last year. Interest receivable on treasury assets has fallen to £34 million from £46 million, mainly due to a fall in interest rates.

Management expenses were £18 million or 11% lower than in the previous year, as the number of staff employed reduced from 943 to 858 at 31 March 2003. The cost of organisational changes in the year was £10 million (March 2002: £18 million). Costs less fee income amount to £97 million compared with £115 million last year.

Interest payable on borrowings, which are mainly fixed rate, has reduced by £10 million but this is offset by the fall of £12 million in interest receivable on treasury assets, included in total operating income.

Revenue profit after tax was £140 million, which is higher than last year (£106 million), because of changes in accounting treatment arising from the SORP and in the allocation of costs.

Realised profits on disposal of investments Realised profits on disposal of investments were £184 million which compares to a loss of £39 million in the previous year.

Proceeds amounted to £976 million, of which £110 million were realised from the quoted portfolio. Despite corporate mergers and acquisitions markets remaining weak throughout the year, realisations from the unquoted portfolio were strong, generating proceeds of £829 million, significantly higher than £514 million in the previous year. Realisations included the sale of Go, the low cost airline, which generated £144 million of proceeds and contributed £86 million to realised profits.

Unquoted equity investments were realised, after taking account of write-offs, at a good uplift of 40% over their March 2002 valuations. Sales of holdings in our quoted portfolio generated an uplift of 6% despite falling stock markets. The uplift achieved on the total equity realisations was 34%.

Overall, 14% of the total equity portfolio at 31 March 2002 was realised and, including loan and fixed income share repayments, 16% of 3i's total portfolio was realised.

Realised profits also include £50 million in respect of the write-off of subordinated borrowings, which are no longer repayable in full. These borrowings, where some of the risk was assumed by the finance provider, funded the acquisition of German technology investments, which have failed or been provided for this year and in previous years.

Realised profits are stated net of write-offs, which amounted to £79 million (2002: £151 million).

Realisations – five year record

Year	Unquoted realisations	Quoted realisations
1999	687	165
2000	781	351
2001	1,015	536
2002	569	370
2003	866	110

Excludes realisations of non-venture capital investments in FTSE 350 companies of £156m in 2002 and £49m in 2001.

Realisation proceeds (£m)	**2003**	2002
Quoted equity investments and on IPO	**147**	425
Unquoted equity investments	**493**	303
Loan and fixed income shares	**336**	211
Total	**976**	939

	2003	2002
Net realised profit/(loss) – over opening valuation (£m)	**184**	(39)
Equity proceeds (£m)*	**640**	728
Uplift over opening equity valuation (%)*	**34**	1
Percentage of opening equity portfolio sold (%)*	**14**	19

* Excludes the disposal in 2002 of non-venture capital investments made in FTSE 350 companies.

Unrealised value movement on revaluation of investments (£m)	**2003**	2002
Provisions	**(379)**	(400)
Down rounds and reductions to fair value	**(361)**	(181)
Price-earnings ratios	**(244)**	–
Earnings growth	**48**	130
Other movements on unquoted investments	**(20)**	(136)
Quoted portfolio	**(209)**	(303)
Total	**(1,165)**	(890)

Unrealised value movement on revaluation of investments There has been a net unrealised value movement of £(1,165) million. The main drivers have been provisions for companies which may fail of £379 million, down rounds and reductions to fair value of £361 million and the effect of falling stock markets which amounted to £453 million. Reductions in the valuation of the early stage technology portfolio make up 62% of provisions and 75% of down round and fair value adjustments.

Our approach to the valuation of early stage technology investments has changed over the last year. At 31 March 2002, the valuations of early stage investments were reduced where a down round or further financing had taken place at a lower value. At 30 September 2002, valuations were reduced for down rounds that had already taken place and also for those that were anticipated to take place within the next six months. At the balance sheet date, 31 March 2003, valuations of early stage investments were reduced for down rounds that have occurred or are anticipated, and were also reduced to an estimated down round value or to a fair value, even where no further financing is anticipated, based on the most appropriate valuation criteria available.

The continued fall in stock markets has led to a decrease in the value of the quoted portfolio of £209 million and has also reduced the weighted average price-earnings ratio used to value the unquoted equity portfolio valued on an earnings basis from 10.0 at March 2002 to 8.1. This has resulted in a further value reduction of £244 million.

There has been an increase in investee companies' earnings, where these are used as a valuation basis at the start and end of the year, which has generated a valuation movement of £48 million; earnings of these portfolio companies have increased by 2%.

Unrealised value movement includes a net currency gain of £60 million (2002: £(1) million), mainly arising from the weakening of sterling resulting in an increase in the valuation of European investments partially offset by losses on related borrowings.

Investment During the year, we invested a total of £931 million (£716 million invested by 3i and £215 million of co-investment funds). This is lower than last year (March 2002: £1,039 million) but there was a 37% increase in the second half of the year reflecting improved investment opportunities in the market. Investment has been balanced and aligned more closely with our portfolio objectives with investment in buy-outs representing 52% of total investment in the year, growth capital 29% and early stage technology 19%. The majority of the technology investment, 78%, has been made in supporting our existing portfolio where those companies continue to look likely to deliver good returns over the medium term.

Investment across Europe was balanced with 43% of total investment being made in the UK and 47% in continental Europe. The US invested £74 million, 8% of total investment, reflecting the reduction in technology investment across the Group. Asia Pacific invested £22 million.

Investment by product (£m) year to 31 March

	Year	3i total	Co-investment funds total
Buy-outs	2003	312	170
	2002	226	135
Growth capital	2003	234	39
	2002	209	49
Early stage technology	2003	170	6
	2002	399	21

Investment by geography (£m) year to 31 March

	Year	3i total	Co-investment funds total
UK	2003	318	81
	2002	377	66
Continental Europe	2003	304	132
	2002	312	134
US	2003	74	
	2002	119	
Asia Pacific	2003	20	2
	2002	26	5

First and subsequent investment (£m)	**2003**	2002
New first investments	**585**	560
Further funding or drawdown on existing arrangements	**346**	479
Total	**931**	1,039

Balance sheet (£m) at 31 March 2003

Portfolio and other net assets	3,949
Net borrowings	1,013
Shareholders' funds	2,936

Balance sheet (£m) at 31 March 2002

Portfolio and other net assets	5,132
Net borrowings	1,187
Shareholders' funds	3,945

Cash flow and balance sheet Strong net realisation proceeds of £975 million and relatively low cash investment of £673 million were the main factors contributing to a cash inflow of £219 million, before a refinancing investment of £49 million in a joint venture, resulting in a net cash inflow of £170 million, reducing net borrowings to £1,013 million. This compares with a net cash outflow last year, after acquisitions, of £102 million.

The value of the portfolio (excluding co-investment funds) has fallen during the year from £5,109 million to £3,939 million largely because of unrealised losses on the revaluation of investments. Early stage technology investments amount to £589 million,15% of the total portfolio. Buy-out and growth capital investments amount to 51% and 34% of the portfolio respectively.

At the balance sheet date, 63% of the portfolio by value was located in the UK, 30% in continental Europe, 5% in the US and 2% in Asia Pacific. By sector, the portfolio continues to be well diversified. Of the total portfolio, 5% is represented by quoted investments, 40% by loans and fixed income shares and 55% by unquoted equity investments, of which 28% have been valued at cost and 44% on an earnings basis.

The capital and funding structure of the Group is strong. At the balance sheet date, shareholders' funds amounted to £2.9 billion, net debt to £1.0 billion and private equity co-investment funds under management were £1.6 billion. The net effect of the reduction during the year in both shareholders' funds and net borrowings has increased gearing to 35% (March 2002: 30%).

The Group's net borrowing comprises long term borrowing, short term borrowing and liquid treasury assets and cash. Original long term borrowing of £1.6 billion, which is unsecured and primarily raised from the public issue of debt under the notes issuance programme, has been swapped to give a predominantly fixed rate position. Of the original long term borrowing, £197 million is repayable in 2003, with £754 million in 2006 and 2007 and £600 million in 2023 or later. Short term borrowing of £196 million is outweighed by cash and liquid treasury assets of £811 million.

At the balance sheet date, the Group had committed and undrawn borrowing facilities amounting to £634 million.

The Group continues to meet very comfortably the capital adequacy ratios set by the Financial Services Authority, in its role as supervisor of 3i Group plc's status as a deposit taker.

Pension Pension costs have been accounted for on the basis of SSAP 24. The charge for the year to 31 March 2003 to Group profits in respect of the main defined benefit scheme, the 3i Group Pension Plan ("the Plan") was £12 million (March 2002: £13 million), based on the triennial actuarial valuation at 30 June 2001. If the SSAP 24 charge continues to be based on the 30 June 2001 valuation, the charge for the year to 31 March 2004 would be £12 million. Details are included in note 11.

The progressive implementation of FRS17 "Accounting for Retirement Benefits" has been accompanied by considerable debate about its suitability as a measure of present and future pension liabilities. Mandatory implementation of FRS 17 in full has been deferred by the Accounting Standards Board. FRS 17 has not been fully implemented in these accounts, but the full effects had it been are disclosed in note 11 on page 48.

Due to substantial falls in stock markets and declines in interest rates used to calculate the present value of liabilities, the FRS17 figures show a significant deterioration during the year to a deficit on the Plan of £90 million (2002: deficit of £14 million). Recognising that in the short term at least, some of the deficit is unlikely to be made up simply by the recovery in asset values, the Group has contributed lump sums over the last two years of £13 million during the year to 31 March 2003 and £22 million during the year to 31 March 2002. It has also recommenced making monthly contributions with effect from 1 April 2002 which have amounted to £12 million in the current year. Total contributions in the year to 31 March 2003 were £25 million (2002: £22 million).

Changes have been made to the Plan which require existing members to contribute 1% of salary from 1 January 2003, increasing by 1% each year to 5% by 1 January 2007.

New employees joining 3i and the Plan after 1 September 2002 are required to contribute 5% of salary. At 31 March 2003, 578 employees were members of the Plan.

Our policy on pensions continues to be under active review in the light of changes in tax legislation and accounting and because funding deficits have arisen from the fall in capital markets.

Regulation of the Group 3i Group plc and relevant subsidiaries continue to be regulated by the Financial Services Authority.

Risk management 3i has a comprehensive framework to manage the risks that are inherent in its business. This framework includes a risk committee whose purpose is to monitor the identification, assessment and management of key risks across the business. The main risks comprise economic risk, treasury and funding risk, investment risk and operational risk.

Economic risk 3i invests mainly in European companies and continues to develop its operations in the US and Asia Pacific. However, the majority of the portfolio is still in UK companies and there is an element of exposure to the UK economic cycle. To mitigate this, 3i has invested in different sectors of the UK economy with different economic cycles. In addition, an increasing proportion of assets is invested in continental Europe, in the US and Asia Pacific, which may have different economic cycles.

Treasury and funding risk
The overall funding objective continues to be that each category of investment asset is broadly matched with liabilities and shareholders' funds, with corresponding characteristics in terms of risk and maturity, and that funding needs are met ahead of planned investment. This objective continued to be met during the year to 31 March 2003.

All assets and liabilities are held for non-trading purposes and, as a result, the Group does not have a trading book. The Group does not trade in derivatives and does not enter into transactions of either a speculative nature or unrelated to the Group's investment activities. Derivatives are used to manage the risks arising from the Group's investment activities.

The main funding risks faced by the Group are interest rate risk and exchange rate risk. The level of these risks is mitigated by the overall funding objective and the Board regularly reviews and approves policies on the approach to each of these risks.

3i's policy for exchange rate risk management is not generally to hedge its overall portfolio in continental Europe or the US. In line with its funding policy, part of those assets are funded by borrowings in local currency and, as a result, a partial hedge exists. 3i's largest exposure is £0.7 billion in respect of net assets denominated in euros in continental Europe. The level of exposure to exchange rate risk is reviewed on a periodic basis.

Day to day management of treasury activities is delegated to executive Directors and the Group Treasurer. Regular reports on the Group's funding position have been considered during the year by the Board. There has been no change during the year or since the year end to the major funding risks faced by the Group, or to the Group's approach to such risks.

Investment risk This includes investing in companies that may not perform as expected, being over exposed to one sector of the economy and the portfolio valuation being partly based on stock market valuations.

Investment levels are set, allocated and monitored by product area and geography. Within this framework, 3i invests in all sectors of the economy, except those, such as property, where the opportunity to invest in venture capital backed businesses meeting 3i's investment criteria is limited. Management periodically reviews the portfolio, which is well diversified by industry sector, to ensure that there is no undue exposure to any one sector.

3i's investment criteria focus on management ability and market potential. Investment appraisal and due diligence is undertaken in a rigorous manner by drawing on our international network and experts in individual industry sectors. In general, proposed investments over £5 million are presented to the Group's Investment Committee or Technology Investment Committee, which are committees of senior management including executive Directors.

The valuation of a large proportion of 3i's equity portfolio is based on stock market valuations for the relevant industry sector. Quoted investments are valued using the mid-market price at the balance sheet date. About 44% of the unquoted equity portfolio is valued using stock market price-earnings ratios for the relevant industry sector discounted for non marketability. Accordingly, stock market valuations for individual sectors are an important factor in determining the valuation of 3i's portfolio and the total return.

There are regular reviews of holdings in quoted companies and exposure to individual sectors in order to monitor the level of risk and mitigate exposure where appropriate. In particular, the level of future funding of technology companies is kept under review. However, it is not possible to protect against the risks of a downturn in stock markets generally or in any specific sector.

Accordingly, the valuation of 3i's portfolio and opportunities for realisation depend on stock market conditions and the buoyancy of the wider mergers and acquisitions market.

Operational risk This includes operational events such as human resources risks, legal and regulatory risks, IT systems problems, business disruption and shortcomings in internal controls.

Line management at all levels is responsible for identifying, assessing, controlling and reporting operational risks. This is supported by a framework of core values, Group standards and controls, a code of business conduct and delegated authorities.

The ability to recruit, develop and retain capable people is of fundamental importance to achieving our strategic objectives. We operate in a competitive industry and aim to remunerate our staff in line with market practice and to provide superior development opportunities.

A group-wide business continuity strategy is in place. This strategy has been assessed against a detailed business impact analysis and independently benchmarked against best practice.

Summary Net asset value per share has fallen, mainly due to the fall in stock markets and the reduction in the valuation of the early stage technology portfolio which at the balance sheet date represented 15% of the total portfolio. 3i did, however, experience a smaller fall in net asset value than its stock market benchmarks.

3i continues to have the financial capacity to increase investment should economic and market opportunities improve.

Michael Queen
Finance Director
14 May 2003