Operating review

Overview This review comments on the operations of our buy-out, growth capital and early stage technology businesses and covers the market conditions and our operating performance in Europe, the US and Asia Pacific. The review also comments on our third party fund management activities.

Go Fly Limited

The sale of Go Fly, the low cost airline, to easyJet in July 2002 crystallised a total return of £91 million (including £86 million of realised capital profits) on its investment (made in June 2001) of £56 million. 3i's industry knowledge, experience and contacts from earlier investments were valuable in allowing it to evaluate the investment opportunity and in winning management's support for a 3i-led deal. 3i's previous contact with British Airways was also important in the 3i-led proposal being selected as the preferred bidder in June 2001.

Featured: Barbara Cassani, CEO of Go Fly and Tom Sweet-Escott, 3i Director.

Buy-outs 3i continues to lead the pan European mid-market for buy-outs and this part of the business, led by Jonathan Russell, has performed strongly through the year. 3i's focus within this market is on transactions with a value from €25 million to €500 million. The vendors of these companies are typically large corporates disposing of non-core subsidiaries or private groups with succession issues. Market statistics for calendar year 2002 show that there were 153 transactions in this segment of which 3i invested in 18.

3i is also active in the smaller buy-out market (below €25 million). This is a more fragmented segment and one in which 3i's local network provides ideal access to the private vendors, management teams and local advisers involved.

During the year to 31 March 2003, 3i made 63 buy-out investments, with 3i and funds managed by 3i investing £482 million, of which 3i led 14 new mid-market deals investing £338 million including co-investment funds. Realisations from the buy-out portfolio were strong with total proceeds of £613 million, including £144 million from the sale of Go. These realisations were achieved at an aggregate equity uplift of 69%.

Our buy-out performance is driven by a clear product strategy, which is rigorously applied. This strategy is to build competitive advantage from our scale and local knowledge so that we see the market, select the most attractive investment opportunities and drive value from our portfolio.

We see the market through the local access that the 3i network provides, through our sector teams, through the relationships that we have built with large corporates and through the people programmes we run for chairmen, chief executives and independent directors.

We aim to select the most attractive opportunities through harnessing our international network and experience and by assembling the best team for the job from our regional, sector and buy-out specialists. A transaction like De Telefoongids (profiled on page 7), involved our local office in Amsterdam, two of our sector teams, Media and Communications, as well as members of our pan European buy-out team.

A panel of our most experienced buy-out investors ensures rigorous application of our investment process and provides additional guidance to try to ensure that we win the buy-outs that we want to do at an attractive price.

Once we have made an investment, it is critical that we add value. We do this through the investee company board, through our knowledge and experience and through our network.

3i's investment in Go (profiled on page 6) was a good demonstration of our approach to this market. Access to the original investment was gained through strong corporate relationships with British Airways and its advisers. Past experience, track record and relationships in the sector enabled 3i to take an informed view and win the transaction at the right price, £110 million. Through the efforts of the management team and staff, led by CEO Barbara Cassani, both market share and profitability levels increased. They were supported with the introduction of Keith Hamill as Chairman and non-executive directors, including Paul Sternbetz, who was formerly Operations Director for Southwest Airlines in the US. easyJet, a natural strategic buyer for Go, made a successful bid in July 2002 of £374 million for the business.

Our view is that the medium term outlook for buy-outs is improving. Economic conditions and depressed public markets are encouraging corporate restructuring and the selling off of non-core activities. Reduced levels of corporate mergers and acquisitions activity mean there is less competition from trade buyers. We believe that there is a significant amount of pent up demand, both in terms of corporates with subsidiaries to sell and of good management teams keen to gain their independence.

Growth capital Growth capital has always been a core part of 3i's business. It involves the provision of capital to accelerate the growth of established businesses and generally involves investing in a minority equity position. It is a product suited to a diverse range of growth opportunities, including acquisitions, increasing production capacity, market or product development, turnaround opportunities, shareholder succession and change of ownership situations.

In the second half, we observed signs of increasing demand for growth capital, resulting from two main factors. Firstly, companies were unable to raise capital by achieving an IPO on European stock markets and, secondly, debt providers adopted a more cautious view on the level of finance they would advance. Both these factors are increasing demand for growth capital. Furthermore, as and when the economic outlook improves, we would expect deferred expansion and acquisition plans to be reactivated, giving rise to an increasing demand for growth capital. We believe that we are well placed to take advantage of these conditions.

De Telefoongids

In February 2003, 3i co-led the £345 million buy-out of the De Telefoongids telephone directories business from KPN (the Dutch telecommunications group), investing £22.6 million of its own capital. 3i's local presence in Amsterdam, the use of sector and buy-out specialists within its investment team, its prior investment experience and knowledge of telephone directories businesses and its ability, through its network, to source a CEO and a number of key managers with highly relevant directories business experience combined to help create a winning bid.

PaperPak

In September 2002, 3i led the £65 million buy-out of PaperPak, an international manufacturer and supplier of adult incontinence products. 3i's investment totalled £15.3 million. The combination of 3i's local presence in Stockholm, supported by buy-out specialists from London, and 3i's knowledge of the sector both persuaded the incumbent management team to work with 3i and enabled 3i to appraise and execute the investment opportunity. 3i also introduced a chairman with relevant strengths from its Partnership Programme and a non-executive director, with a background in healthcare and turnaround situations, from its Independent Directors Programme.

Featured: Alan Peterson (left), Chairman of PaperPak and Chris Williams, Director of 3i London Buy-out team.

Ten largest 3i-led buy-out investments in the year

Company	Business description	Country	Transaction size £m	3i and funds total investment £m
De Telefoongids	Telephone directories	The Netherlands	345	45
Westminster Health Care	Care homes operator	UK	301	55
SR Technics	Repair and maintenance of aeroplane engines and frames	Switzerland	293	70
Esmalglass	Manufacturer of frites and glazes for ceramic tiles	Spain	159	48
E2V technologies	Switching, sensing and imaging components	UK	77	21
Extec	Manufacturer of mobile crushing equipment	UK	68	15
PaperPak	Manufacturer of incontinence products	US/Europe	65	24
United Transport Tankcontainers	Tank container operation moving hazardous chemicals	The Netherlands	65	12
Partners for Finance/Legal Marketing Services	Specialist financial services	UK	37	9
Ascent Technology	IT software consultancy and supply	UK	17	10

Our strategy for this product targets investments from 3i of between £2 million and £30 million, across a range of sectors. This product is primarily focused on 3i's European and Asia Pacific markets and has historically had a less competitive environment than buy-outs.

Success in this market is determined by the ability to build long term relationships with local businesses and local intermediaries, as well as demonstrating the capability of helping these businesses to grow. This fits well with our strategy of local presence, sector specialisation, sharing knowledge and offering local businesses access to our international network of relationships.

Chris Rowlands was appointed to lead growth capital investment in September 2002 and he has brought a more focused approach to deal origination and the key processes for this product.

A Product Leadership Team, with representatives of each of the targeted regions in Europe, coordinates individual country activities, develops and implements strategy and operates as a forum for sharing ideas on a range of best practices.

Certain sectors are ideally suited to the growth capital product. A good example is the oil and gas sector. The North Sea exploration and production sector is undergoing significant change and a number of new independent businesses are emerging as the next generation of North Sea oil companies. In the oil and gas services sector, the ability to provide services on an international basis is an important competitive advantage, and capital is required to enable the development and international distribution of products and services. 3i's sector knowledge, local presence and international network combine to position us as

Parkdean Holidays plc

3i invested in Parkdean in November 1999 and achieved a full realisation, via a listing on AIM in May 2002, earning a total return of £3.8 million on its £7.0 million investment. Parkdean was set up to undertake a buy and build strategy in the UK caravan park business. 3i contributed to the successful implementation of this strategy through the provision of appropriate financial engineering, strategic support as the company made and integrated four acquisitions and through the introduction of Graham Wilson, an executive chairman who was well known to 3i, having worked on three previous 3i investments and who had a strong track record in the leisure industry and in making acquisitions.

Prosol Gestion

In January 2003, 3i invested €14 million in Prosol Gestion, a specialist retailer of fresh, chilled and ambient food based in Lyon, France, to help fund the rapid roll-out of 70 new stores over the following five years and thereby to secure Prosol's leading position in this attractive product category. Three factors were key to 3i winning the deal against intense competition: 3i's local presence in Lyon; its ability to fund potential further rounds of investment; and its retail sector contacts, which were instrumental in allowing senior Prosol management to have direct access to senior management at a leading UK food retailer. 3i has recently introduced a non-executive director with relevant sector and roll-out experience.

a strong financial partner to such businesses. Major transactions by our Oil and Gas team in Aberdeen during the year included the investments in Petrofac Limited and Faroe Petroleum Limited, and the partial realisation, through an IPO on the London Stock Exchange, of our investment in John Wood Group plc. In addition, the sale of Orwell Group plc crystallised a total return for 3i of £35.0 million on our total investment of £2.9 million.

During the year, we invested £273 million (2002: £258 million) in growth capital transactions, 46% (2002: 32%) of which was in companies new to our portfolio.

However, despite difficult conditions for sales and IPOs, a good level of realisations was achieved, with proceeds of £270 million during the year and an equity uplift of 30%.

Early stage technology The continuing depressed state of the technology and capital markets meant that 3i's early stage technology business, which at 31 March 2003 represented 15% of our assets, had a difficult year. A negative return of £(671) million, arising principally from a reduction in the value of the portfolio to reflect these market weaknesses, severely impacted the performance of the Group as a whole.

ultrafilter AG

The sale in July 2002 of ultrafilter AG to US based Donaldson Corp. enabled 3i to crystallise its minority investment in the Haan (Germany) based specialist filter technology business. 3i´s initial growth investment in 1989 was followed by two further funding rounds, in 1996 and 2000, to support the expansion of ultrafilter's export business and an acquisition in northern Germany respectively. 3i's local presence in Dusseldorf enabled 3i to stay close to management throughout, providing strategic input during the earlier expansion and acquisition phases and at the latter exit stage. In addition, 3i was key in sourcing a new CFO when that position became vacant.

However, following a restructuring under the leadership of Rod Perry, we now have a tightly focused business which is targeted at four key sub-sectors.

We have also focused this activity on a smaller number of our locations and have refined the investment process. As a result, we now believe 3i is well positioned to take advantage of current market conditions and to seize the opportunity presented by an improved environment in the medium term.

We continue to develop and nurture our relationships with key larger corporates in each sub-sector, since these corporates are potentially customers, partners or ultimate buyers of our individual portfolio companies, and to share these relationships with our portfolio companies. The events we hold for portfolio CEOs and key larger corporates are one way in which we do this. For example, the 3i eSecurity CEO Conference at the IESE business school in Barcelona in November 2002 was attended by over 20 3i-backed companies and 25 corporates, including IBM, Sun Microsystems and Microsoft.

The year to 31 March 2003 saw total investment of £176 million, and realisation proceeds of £93 million, at an equity loss of 26% on the carrying value at 31 March 2002.

The two biggest early stage technology markets, Europe and the US, both experienced significant falls in aggregate investment during 2002. According to market statistics, the total amount invested in Europe fell 66% to $2.5 billion. Most of this investment was in support of existing venture capital backed businesses rather than in completely new opportunities. 3i also saw this pattern, with 78% of early stage technology investment during the financial year being in our existing portfolio.

The US market has shown a similar fall. According to market statistics, aggregate investment fell by 53% in 2002. Our US business is also now making a contribution to the rest of the Group, through the relationships we have been building with larger corporates such as IBM.

Balance and flexibility

A key theme underpinning our business is "balance and flexibility", which has a number of different aspects.

Firstly, our ability to balance the strengths of our international network with our local presence gives us a strong and unique source of competitive advantage, enabling us to originate an attractive deal flow and to assemble the "best team for the job". We can draw upon complementary skills and knowledge across international, sector and product boundaries.

We invest across each of the three product categories within private equity and venture capital – buy-outs, growth capital and early stage technology – with product specialists in each. We strive for balance in our investment activity in terms of product, geography and industry sector.

3i's balance sheet enables us to take a view of the relative attractiveness of the new investment and realisations markets. In an uncertain environment, we have sought to achieve a balance between these two key aspects of our business, but we are able to flex their respective levels in line with our view of market conditions. We are also able to take a balanced and flexible view with regard to the period we hold individual investments.

We aim for balance as regards our people. Our culture embraces a balanced lifestyle between work and family; and in our people we seek a rounded set of qualities – we recognise the need for strong technical and task-oriented skills and the benefits of competitive behavioural instincts, but equally emphasise other qualities such as sound judgement, the ability to work in a team, as well as communication, motivational and influencing skills.

Finally, we aim to take a balanced outlook in planning our business activity, recognising the risks that face us and our need to manage them, but also having an eye for opportunity and ensuring we are well placed to exploit it.

The key factor in the weak investment performance of early stage technology companies has been the depressed state of the markets for their products and services. The most important cause of this has been the significantly reduced levels of expenditure by corporates on information technology and related applications. A number of 3i's investments have underperformed as their business models have been undermined by significantly lower levels of demand than expected.

A number of technology companies have also experienced difficulty in translating a strong product into a commercial success. An example is Weston Medical, a 3i investment that achieved an IPO in 2001. Weston's needle-free injection product was technically respected but the company was unable to translate that into commercial success, and recently went into receivership.

In the context of the reported performance of 3i's early stage technology investments made in the period 1999 through 2001, the "J-Curve" phenomenon (so named because the reported performance of a portfolio or vintage of technology investments tends to dip in the early years before rising again, as poor and failing investments become apparent before the successful ones) is interesting. While the continuing depressed markets and the difficulty of commercialising newly developed products have adversely affected the reported performance of that portfolio, the J-Curve phenomenon would hold that the performance of the remaining portfolio should improve as more of the underlying businesses achieve success and the investments are realised.

The financial performance of the early stage technology portfolio was also adversely affected by falls in value. Valuation of technology companies usually involves reference to valuation ratios of listed companies or the price at which similar companies have been acquired. However, the absence of an active market for IPOs and a low level of mergers and acquisitions activity have diminished the usefulness of these traditional benchmarks. Another benchmark involves reference to the value at which private companies in the early stage technology sector are currently raising capital. During the year, capital has generally been raised through funding rounds at lower capitalisations than previous rounds, even when a company is meeting its milestones, and they have therefore become known as "down rounds". Our valuations reflect the impact of actual down rounds undertaken by our portfolio companies, and also at 31 March 2003 the application of this benchmark to companies with no imminent plans to seek funding. The combined down round effect during the year was a £361 million reduction in value of which £269 million was in respect of early stage technology investments.

In conclusion, the early stage technology business has seen a significant loss of value this year but the portfolio has been valued using prudent assumptions regarding the outlook for market conditions, and the business has been reshaped for the market we now face.

Europe Economic conditions across Europe weakened during the year. In general, manufacturing sectors experienced difficult conditions but the downturn has spread to all sectors, including retail and services, largely driven by weakening consumer demand.

The prevailing economic uncertainty continues adversely to affect the levels of private equity investment, as institutional investors, banks and equity providers have become more cautious and vendors of businesses have become increasingly unwilling to sell in the face of falling prices. Additionally, expansion and acquisition plans have been deferred and spending on information technology by corporates has reduced. Offsetting

Adaytum Software Inc

The sale of Adaytum Software, Inc. a provider of financial planning software products to businesses, in January 2003 crystallised a total profit for 3i of £6.5 million on its total investment of £6.1 million, made over six investment rounds since January 1997. A key element in the successful development of the business was the expansion into and establishment of a strong base in the US, both of which were facilitated through 3i's contacts there, with venture capital firms and others.

Featured: Guy Haddleton, former CEO, Adaytum Software, Inc.

PlaceWare Inc

In January 2003, PlaceWare Inc, a provider of web conferencing services that enable businesses to conduct real-time, interactive presentations and meetings over the internet, announced that it had entered into an agreement to be acquired by Microsoft Corp, providing 3i with realisation proceeds of $14 million on its November 2001 investment of $7 million. 3i led the private placement financing round in 2001 and subsequently helped PlaceWare build its European business by facilitating approaches to 3i's network of portfolio companies. 3i's board representative at PlaceWare established the initial contact with Microsoft that ultimately led to the sale and also played a lead role in the sale negotiations.

these negative factors, economic conditions have encouraged corporate restructuring and the selling off of non-core assets, which has created opportunities for buy-outs.

Against this background, market statistics show that the total amount of private equity monies invested in Europe in 2002 increased to €27.2 billion from €24.3 billion in 2001, but was still below the €35.0 billion invested in 2000.

Across Europe, £835 million (2002: £889 million) was invested by 3i (including co-investment funds) in 357 companies during the year. In the UK, investment amounted to £399 million, compared with £443 million the previous year.

Despite difficult conditions, we achieved a strong level of realisations at good prices, comfortably in excess of the valuations we placed on those businesses at March 2002.

In total, realisation proceeds across Europe during the year amounted to £965 million, compared with £927 million the previous year.

There has been a significant reduction in the valuation of our portfolio, caused by increased provisions and value reductions as a result of down rounds and weaker business performance. At 31 March 2003, our portfolio in Europe amounted to £3,669 million, of which £2,494 million was in the UK.

During the year, we announced the closure of three of our offices in Europe (Hamburg, Berlin and Dublin) and we reduced the number of staff in our European business. These changes were made to align resources with the market and to reflect changes in our investment processes. 3i now has 27 offices across Europe.

US The US venture market has continued to be depressed throughout the year.

3i continues to develop its business in the US and to focus on managing the existing portfolio with a view to achieving realisations in the next few years.

During the year, £74 million (down from £119 million in 2002) was invested in 33 companies, of which £56 million was in new investments.

Our people programmes continue to deliver

Our people programmes continue to deliver At 3i, we believe that a strong board significantly improves a company's performance and that strong boards have clarity of purpose, the right people and good process.

Our people programmes focus on sourcing and developing people for four key board roles: Chairmen, Chief Executives, Finance Directors and Independent Directors.

The Independent Directors Programme ("IDP") is a pool of successful business people who are available to become a chairman or an independent director of 3i-backed businesses.

IDP members come from a wide range of industries and company backgrounds. Today, the programme has over 600 members in Europe, Asia Pacific and North America and they hold board positions in over 1,000 3i-backed situations.

The CEO programme provides 3i with access to talented and ambitious CEOs.

These programmes, which operate as a centre of excellence on people issues across 3i, deliver real value through deal origination, assessing opportunities, and building and realising value from our portfolio.

They have also enabled us to develop innovative training materials and approaches to board best practice for the people with whom we work. Events for members, such as "How do you know a good Finance Director when you see one?" are highly participative and draw on the combined experience of those attending and our 3i teams.

Asia Pacific The Japanese market has not developed as rapidly as we had expected, and the flow of quality deals has not been sufficient to justify the resourcing of our Tokyo office, which was closed in February 2003. The Japanese market will continue to be serviced out of the Hong Kong and Singapore offices, as will other markets in the region.

The Asia Pacific business invested £22 million during the year, including the first investment by the Hong Kong office, which was in a Korean multiplex cinema operator.

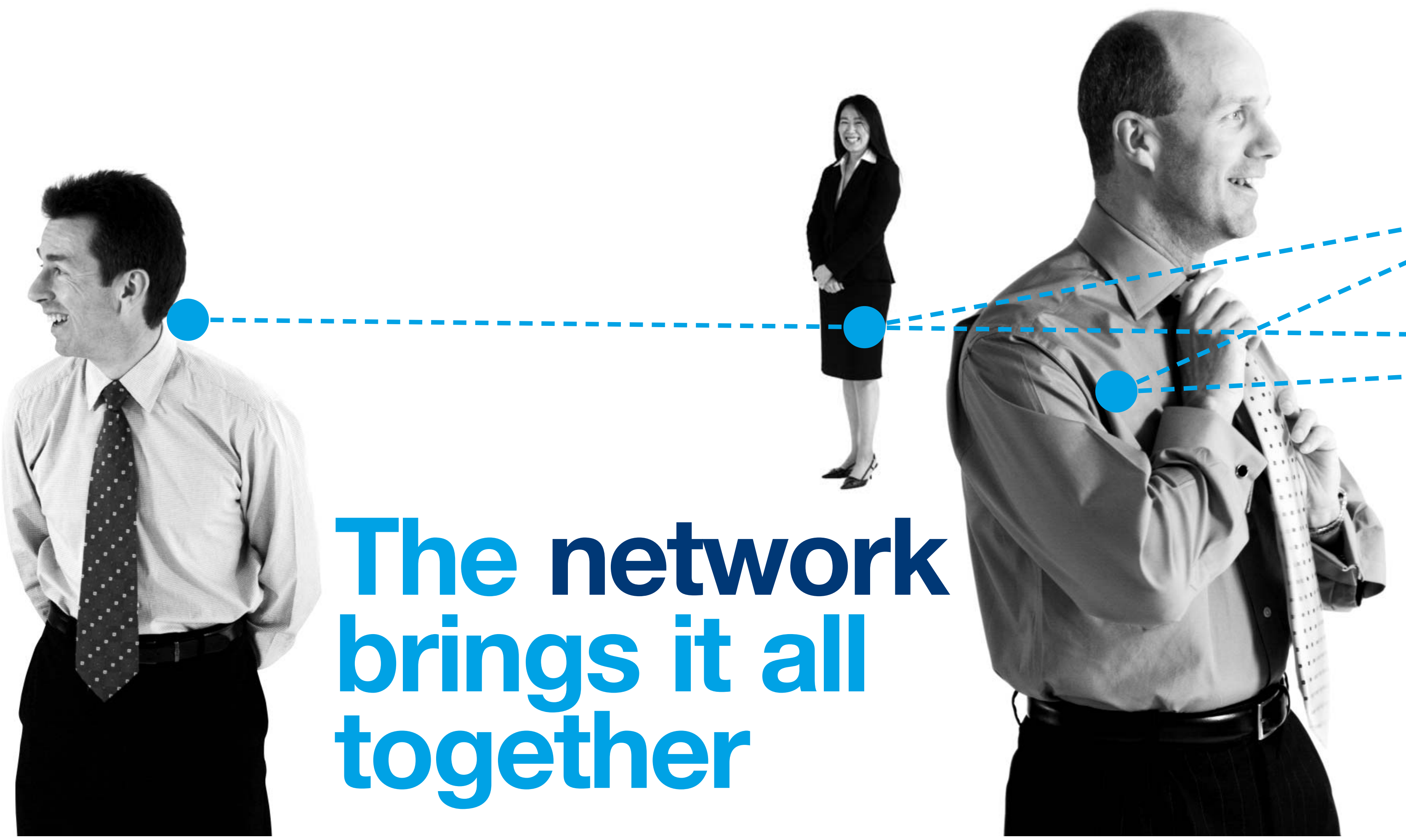
Conditions for realisations in the region were depressed during the year. Despite this, £9 million of realisation proceeds were generated.

Private equity fund management 3i manages third party co-investment funds primarily in our mid-market buy-out business, where capital raised is co-invested alongside our capital, enabling us to invest in companies without 3i itself holding a majority interest in the underlying business.

Since 1994, 3i has raised funds with total third party commitments of £2.3 billion. Funds are usually raised from institutional investors, typically pension funds and insurance companies seeking exposure to private equity and who are attracted by 3i's market leading position, business model and track record. The funds raised are typically invested on a 50:50 basis alongside 3i's capital.

During the year, we earned fee income of £34 million (2002: £35 million) from the management of funds and, in addition, received £7.3 million (2002: £1.6 million) in respect of carried interest on realisations. At 31 March 2003, the invested portfolio managed on behalf of third party investors was valued at £1,158 million (2002: £1,264 million), excluding undrawn commitments.

Since the balance sheet date, 3i has announced the successful first closing of its pan European mid-market buy-out fund, Eurofund IV. Third party investors have committed €0.4 billion and intend to invest a further €0.2 billion over the life of the fund and 3i intends to invest up to €1.5 billion. It is expected that further closings will take place over the coming months and the final closing of Eurofund IV will take place by the end of the year.



Third party unquoted co-investment funds under management (£bn)
at 31 March

1999	1.5
2000	2.3
2001	2.1
2002	2.0
2003	1.6

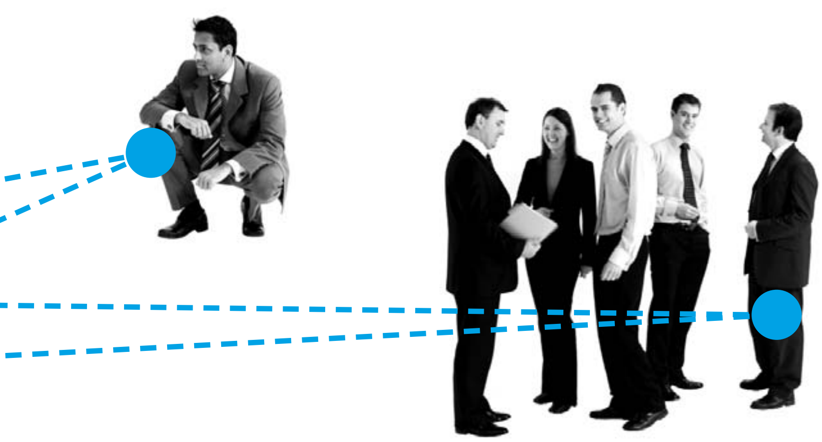
Third party quoted funds under management (£bn)
at 31 March

1999	0.5
2000	0.8
2001	0.9
2002	0.8
2003	0.5

Quoted fund management 3i's Asset Management team manages the Group's portfolio of quoted investments (comprising principally our holdings in investments that have achieved an IPO) as well as the portfolios of the 3i Group Pension Plan and of three quoted specialist investment companies – 3i Smaller Quoted Companies Trust plc, which invests in smaller UK companies, 3i Bioscience Investment Trust plc, which invests internationally in life science and healthcare companies, and 3i European Technology Trust plc, which invests in quoted companies across Europe whose focus is on technology.

At the balance sheet date, total third party funds under management by 3i Asset Management were £452 million. Fees earned from quoted fund management amounted to £4 million for the year, a reduction from £7 million last year, mainly due to the fall in capital markets.

Summary Despite a tough year, we have focused the business on the three product areas of buy-outs, growth capital and early stage technology. We believe we have the right structures and processes in place to gain access to and select the most profitable opportunities and then to enhance value and generate profit from the investments that we make. In an environment of low growth and low inflation, this strategy will enable 3i to provide superior returns for our shareholders.



3i's relationships deliver tangible benefits every day. Investments such as De Telefoongids in The Netherlands or Fonecta in Finland demonstrate that, without our teams on the ground in local business communities and our sector network and credibility, our pan European buy-out business would not have developed so quickly. Relationships with large corporates and key corporate finance houses enable exits like the sale of Bristan to Masco Corporation to maximise value.

Our people programmes enable us to take informed views of businesses at an early stage in the bidding process, assemble the best board for the job and increase our chances of winning the deals we want to do. They also help us reduce costs and avoid weak investments through earlier withdrawal.

When it comes to adding value to investments, relationships like those with IBM, which enabled a small software company deNovis to link up with IBM in winning a substantial contract with a large insurance company in the US, can propel an exciting business with potential into a commercial success. The leadership and sector insights that our Portfolio Chief Executives gain from our regular sector focused CEO summits at the IESE business school in Barcelona and INSEAD in Fontainbleau add a different kind of value. They learn, and they partner and forge new commercial relationships as a result. As the attendee from PlaceWare, one of our US investments, put it: "The conference was the most interesting portfolio event that I have ever attended. The concept of bringing your companies together in a beautiful location, to educate them with top academia, introduce them to peer group, industry leaders and target customers is truly superb networking".

Our network comprises many important groups of people. For example, management teams, larger corporates, our people programmes, intermediaries such as corporate finance advisers and search consultants, academic institutions, government and last, but not least, our staff.

Why does it deliver? Put simply, because we add value to the people in it. We have the systems in place to make it work in terms of IT knowledge management. More importantly, we ensure through our performance management systems and individual objectives that there is the right attitude. But above all, the network delivers because it is built on thousands of good relationships.