Operating and financial review

Economic and market conditions After almost two years of geo-political and economic uncertainty and difficult stock markets, we have seen signs of stronger economic activity. This has been evidenced by a number of indicators, including our own Barometer survey of business confidence across Europe.

The Barometer survey taken in March 2003, which was affected by the considerable anxiety over the Iraq war, produced a record low score of minus 117. Our survey covering August showed a significant improvement to minus 17 and our latest survey, taken in October, came out at plus 11, the first positive result since the end of 2000.

The period also saw strong growth in stock market indices, in anticipation of growth in corporate profits. In addition, the level of mergers and acquisitions ("M&A"), a key driver of activity in our market, picked up through the summer after being at a subdued level since 2000.

The private equity and venture capital markets are also starting to show increased activity after a slow first half of 2003. Market statistics for the first half show aggregate European investment 8% down on the first half of 2002, with buy-outs being flat, growth capital being down 24% and early stage investment down by 18%.

Market statistics for the US venture market for the second quarter of 2003 showed a slight increase in investment levels after a two and a half year decline.

Conditions for realisations were difficult for most of the period, though we are now beginning to see the re-emergence of trade buyers as corporates re-enter the M&A market. There are also indications that IPO markets, particularly in the UK and US, may be re-opening.

Total return The Group achieved a positive total return of £359 million for the six months to 30 September 2003, which equates to 12.2% on opening shareholders' funds. This return is lower than those on a number of quoted market indices, largely because of a lag in recognising value increases in our portfolio. Only our quoted assets and unquoted investments valued using the earnings basis are directly linked to stock market movements. These made up 6% and 24% respectively of our opening portfolio.

The main drivers of our total return were a good level of profitable realisations and growth in the value of our portfolio, the latter being primarily due to higher price-earnings ratios ("P/Es") used to value our investee companies.

Total return	6 months to 30 September 2003 £m	6 months to 30 September 2002 £m
Total operating income before interest payable	**130**	153
Interest payable	**(50)**	(55)
Management expenses	**(70)**	(76)
Realised profits on disposal of investments	**129**	118
Unrealised profits/(losses) on revaluation of investments	**215**	(701)
Other (tax and currency)	**5**	(9)
– Revenue return	**76**	48
– Capital return	**283**	(618)
Total return	**359**	(570)

Summary of changes to 3i portfolio	6 months to 30 September 2003 £m	6 months to 30 September 2002 £m
Opening portfolio	**3,939**	5,109
Investment	**211**	315
Realisation proceeds	**(503)**	(619)
Realised profits on disposal of investments	**129**	118
Unrealised profits/(losses) on revaluation of investments	**215**	(701)
Other	**15**	29
Closing portfolio	**4,006**	4,251

First and subsequent investment	6 months to 30 September 2003 £m	6 months to 30 September 2002 £m
New first investments	**158**	222
Further funding or drawdown on existing arrangements	**115**	171
Total	**273**	393

Improved results in each of our business areas underpinned the overall Group return. Returns in the smaller buy-out and growth capital businesses, aided by good levels of realisations, were particularly strong at 15% and 13% respectively on the opening portfolio. The mid-market buy-out return of 8% included a number of significant valuation uplifts on recent investments as they moved from being valued on a cost basis for the first time. Our early stage technology business produced a small negative total return despite some profitable realisations and a significantly lower level of value reductions. Although there was a significant rise in quoted technology indices during the period, we have not increased the valuations of early stage technology investments unless there has been a financing "up round".

Investment We invested £273 million, including co-investment funds, which compares with £393 million for the equivalent period last year. The period of economic uncertainty during the latter half of 2002 and the early months of this year led to a deferral of many strategic decisions by businesses and investors. This lowered our new investment pipeline coming into the period. Since then, economic confidence has improved and corporate activity has risen.

Buy-out transactions represented 51% of our investment and growth capital 28%. Early stage technology represented 21%, with 80% of this to support existing portfolio companies.

Continental European investment rose to 67% of total investment following several significant buy-out investments. UK investment represented 23%, the US 7% and Asia Pacific 3%.

Realisations We generated realisation proceeds of £503 million and realised profits of £129 million. The aggregate uplift over 31 March 2003 valuations on equity realisations was 61%. Including sales and redemptions of loans and fixed income shares, 10% of the opening portfolio was realised.

Realised profits are stated net of write-offs of £25 million (2002: £32 million).

The majority of the realisations were from our smaller buy-out and growth capital portfolios.

Unrealised value movement The unrealised value movement on the revaluation of investments was £215 million, representing a strong improvement on the £701 million value reduction for the same period last year.

The weighted average P/E applied to investments valued on an earnings basis rose from 8.1 at 31 March to 10.7 at 30 September. The impact of increased P/E ratios generated value growth of £235 million. The quoted investments we retained increased in value by £44 million (2002: £192 million reduction).

A small number of recent investments in our mid-market buy-out portfolio generated most of the increase in value arising from "first time uplift".

Realisation proceeds	6 months to 30 September 2003 £m	6 months to 30 September 2002 £m
Quoted equity proceeds and IPO	**73**	112
Unquoted equity proceeds	**298**	257
Loan and fixed income shares	**132**	250
Total	**503**	619

Net realised profit over opening valuation (£m)	**129**	118
Equity proceeds (£m)	**371**	369
Uplift over opening equity valuation (%)	**61**	49
Percentage of opening equity portfolio sold (%)	**10**	7

Unrealised profits/(losses) on revaluation of investments	6 months to 30 September 2003 £m	6 months to 30 September 2002 £m
Price-earnings ratios	**235**	(212)
Earnings growth	**8**	38
First time valuation uplift from cost	**59**	(17)
Provisions	**(65)**	(141)
Down rounds and restructuring	**(68)**	(130)
Other movements on unquoted investments	**2**	(47)
Quoted portfolio	**44**	(192)
Total	**215**	(701)

Provisions for investments in companies which might fail were £65 million (2002: £141 million), and valuation reductions relating to down rounds and restructuring provisions fell significantly to £68 million from £130 million in the six months to 30 September 2002 and £361 million for the 12 months to 31 March 2003.

The British Venture Capital Association recently issued new best practice Valuation Guidelines. 3i adopted these guidelines at 30 September 2003. There was no material impact on the overall valuation of the portfolio.

The portfolio Following two difficult years, the health of our portfolio has stabilised. In line with our strategy, the portfolio remains balanced in terms of both product and geography. At 30 September, 53% of the portfolio is represented by buy-outs, 33% by growth capital investments and 14% by early stage technology investments. Geographically, 62% of our portfolio is in the UK, 32% in continental Europe, 4% in the US and 2% in Asia Pacific.

Income and costs Total operating income before interest payable was £130 million (2002: £153 million). The decrease from 2002 is a result of the realisation of a small number of higher yielding investments, a lower level of special interest receipts on the sale or restructuring of assets and a fall in deal-related fees due to the lower level of investment activity.

Net interest payable has decreased in line with the reduction in net borrowings.

Management expenses were £6 million lower than in the same period last year, as cost reduction measures taken over the past two years continue to work through.

Cash flows and capital structure There was a net cash inflow of £225 million during the period. We raised €550 million through the issue of convertible bonds in August. The bonds are due in 2008 and have a conversion price of 842p (a 45% premium to the "reference price" of 580p) and an annual coupon rate of 1.375%. Net borrowings decreased by £206 million and our gearing reduced to 25% at 30 September from 35% at 31 March.

Outlook Improving business confidence, rising stock markets and increased levels of M&A activity are helpful to our industry. In addition, within each of 3i's businesses there are specific factors indicating a more positive outlook – in buy-outs, the continuing pressure on corporates to focus on their core activities is generating opportunities and vendors' pricing expectations are now more realistic; in growth capital, opportunities are being created as businesses re-launch deferred growth strategies; and, in early stage technology, we are starting to see increased levels of technology spending in some sectors by major corporates.

Our new investment pipeline is currently strong and we expect to increase investment levels in the second half.

Brian Larcombe
Chief Executive
5 November 2003