3i Group plc Additional information

About private equity

The private equity asset class – key characteristics

Private equity investors ("PE investors") typically make medium to long-term investments of equity capital in order to support the growth of a business. The investment objective is to achieve a blend of yield and capital return over the life of the investment, which provides an attractive return for the risk being taken.

PE investors sometimes invest funds from their own balance sheet. More typically, they invest funds raised from third-party investors organised through "Limited Partnership" ("LP") investment funds. LPs tend to commit capital to these funds for a seven to 10 year life, with the PE investor drawing down capital as investments are made. Returns to LPs come in the form of income through the life of the investment, together with capital distributions either on the realisation of the investment, at the end of the investment period, or sometimes through capital distributions at a number of points through the life of the investment.

The context for the investment influences the specific nature of the investment as well as the size of the equity holding that the PE investor will hold. In some cases, the PE investor may invest for a minority equity holding, perhaps to increase production capacity, to support market or product development, to fund an acquisition or perhaps to resolve a shareholder issue. In others, the PE investor may be effecting a change of ownership through a buyout or privatisation. Where there is a change of control of the business, the PE investor, the funds it manages, or a syndicate of PE investors often invests for a majority equity position. In these situations, the capital invested is used both to purchase the company from its existing owners as well as to fund the growth of the business.

Examples of a range of PE investments made by 3i can be found on www.3i.com.

About private equity

Investment objective and lifecycle

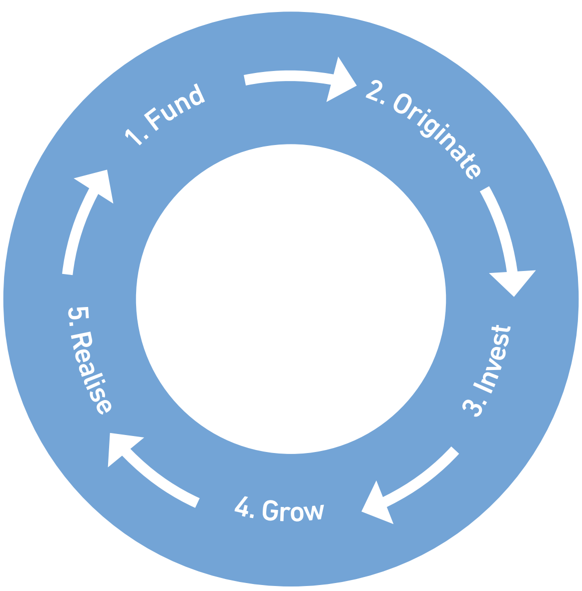
Investment objective

The objective of the PE investor is to earn attractive returns on its investment, commensurate with the risk being taken. The returns come in the form of income (interest, dividends or fees) and capital gains (eg the sale of shares on exit). The investor will invest capital and bring its knowledge, experience and network to support the growth of the companies in which it has invested and to improve their performance and value. The investor will usually prefer to crystallise its capital gain through a trade sale of the underlying business (eg a sale to a corporate purchaser), a sale to a financial purchaser (a "secondary" transaction) or a flotation on the public markets (an "IPO"). This preference tends to make PE investment medium to long term in nature, since time is required to implement the value growth strategy for the business. There will also be a wish to optimise the timing of the sale of an investment (the "exit" or "realisation").

Investment lifecycle

The lifecycle for an investment can be broken down into five distinct phases, with each requiring significant resource and capability on the part of the PE investor.

How do we invest?



1. Fund

PE investors typically raise investment funds from institutional investors, such as pension and endowment funds, sovereign wealth funds and insurance companies. The predominant vehicle through which PE firms invest is the independent, private, fixed-life, closed-end fund, usually organised as a "Limited Partnership". These funds typically have a fixed life of 10 years. Investments generally consist of an initial commitment of capital by investors in the fund which is then drawn down as the investment manager finds investment opportunities. Capital is returned to the investors via earnings, distributions and the sale of investments.

2. Originate

The ability to identify, access and create investment opportunities. This is a critical component of a PE investor's business model.

3. Invest

In this phase, the PE investor draws upon its knowledge, experience, network, commercial judgement and other capabilities to develop and validate its investment case. This is likely to involve building a potential board and management team and working with them to develop the strategy for value creation and exit; as well as conducting "due diligence" on all significant assumptions and inputs relevant to the investment case, including those relevant to responsible investing.

The investment phase ultimately involves the financial structuring, negotiation and completion of a transaction. Relationships with banks, mezzanine finance providers, intermediaries and others are important to structuring an investment appropriately.

4. Grow

This phase involves "actually making it happen", creating value through the active management of the investment, from the time of investment through to exit. If the strategy involves corporate acquisitions or mergers, restructuring the business, achieving growth in turnover or operating profits, the PE investor will work with the management team of the portfolio company to ensure these are achieved. The ability to assess and strengthen the management team as the lifecycle proceeds is also important. This might involve having access to a pool of management talent with specific sector or operational expertise in order to match a particular need to a particular management skill set.

5. Realise

In this phase the PE investor and management team ultimately crystallise a return from their investment through a trade sale, a listing on a stock exchange or a sale to another PE firm ("a secondary"). Exit prospects and strategies to realise an investment will generally be reviewed on an ongoing basis during the investment's life.

About private equity

Returns and IRRs – an explanation

What is total return?

Total return is the gross portfolio return (income, realised profits from the sale of investments and other value movements generated from the portfolio) plus other fee income, less operating and financing costs and net carried interest payable. Total return can be expressed as a quantum or as a percentage of opening shareholders' funds.

What is an IRR measure?

The Internal Rate of Return ("IRR") is the interim return earned on an investment from the date of initial investment up until the particular point in time at which it is calculated. The calculation uses monthly cash flows generated from the investment to work out the annualised effective compound rate of return. For investments that have yet to be sold, and therefore have not generated a final cash inflow from sale proceeds, the investment value at the date of calculation of the IRR is used to calculate the return. An IRR can apply to a single asset or a pool of assets (eg all new investments made in a particular financial year can be pooled to calculate an IRR for that vintage year).

An IRR calculated using the current value of the asset as the terminal cash flow is called a Fund IRR. A cash-to-cash IRR does not include any sale or exit value for unsold assets and is a pure, more simple measure of cash invested compared to cash returned, as it does not include any judgemental asset valuation for the unsold assets.

What is a vintage and a vintage year?

A vintage is a collection of investments made during a defined period of time. The most common time period measured in the private equity industry is a year.

How does this apply to 3i?

How does 3i's gross portfolio return equate to the IRR measures?

The elements that make up the gross portfolio return are the same as those used in calculating the IRR.

Gross portfolio return is made up of the income, realised profits from the sale of investments, and the unrealised value movement generated from the portfolio.

Gross portfolio return (stated as a percentage of opening portfolio value) will equate to an IRR measure over time. So, if 3i achieves 20% gross portfolio returns each year, the long-term IRR will also move to 20%.

What is a vintage year at 3i and in what way is it a useful measure to track performance?

A vintage year at 3i includes all new investments made within our financial year, ie vintage year 2012 covers new investments made from 1 April 2011 to 31 March 2012. A 3i vintage year is made up of many investments. All will have their own individual cash flows and holding periods. Individual investments clearly have their own holding periods, illustrated by the two examples given.

3i discloses the vintage IRRs for private equity investments categorised as Buyouts and Growth Capital as, historically, these reflected the nature of external funds under management in the Private Equity business.

Why does 3i track the performance of vintage years?

Because we believe that this additional disclosure is helpful in understanding our performance. It also allows an assessment of the return generated from assets over the length of time they are held, as well as the performance between the beginning and end of a financial year, which is shown in the annual total return statement.

The annual total return analysis has limitations as a measure of longer term performance, as it is only a representation of how the assets have performed in one financial year and is heavily influenced by the valuation of the asset at the beginning and end of the year. The additional disclosure shows the evolution of how a vintage year is performing over time.

To achieve this longer term measure of performance over time, the IRR is the standard measure used across the private equity industry.

What IRR measures does 3i use to assess the performance of a vintage?

A cash-to-cash IRR cannot be meaningfully used to measure the performance of a vintage until the majority of assets in that vintage are realised. Therefore, 3i monitors the progress of each vintage and the evolution of the IRR using a combination of the Fund IRRs and the extent to which a vintage is realised, to assess the interim performance. Case A, depicted in Chart 1, is an example to show the interim cash-to-cash IRR of an asset and clearly indicates why, during the holding period of an asset, the Fund IRR gives a more appropriate measure of performance.

About private equity

Tracking our progress

To monitor a vintage year 3i uses a combination of Fund IRRs and money multiples. The Fund IRR gives a measure of performance and the money multiple shows how much cash has been returned compared to cost (eg Case A = 1.7x. Proceeds of 150 in year 4, plus yield of 19.5 through the life of the investment, divided by the total investment of 100) so that we can assess the extent to which that performance is "locked-in".

As the current external private equity funds that 3i manages are categorised as "Buyouts" or "Growth Capital", we have published the Fund IRRs within the Business review of our Annual report on this basis.

Examples

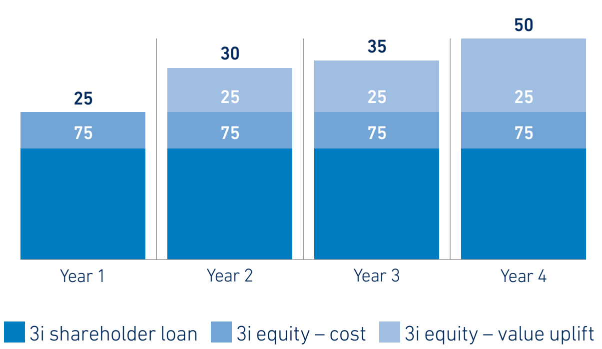
Case A and Case B show the investment lifecycle of two investments.

Case A is a successful investment, which over its life generated interest income, grew in value and was the subject of a successful exit, generating a 1.7x money multiple and an IRR of 20%.

Case B is an unsuccessful investment. At the end of the second year of our investment earnings had remained flat and the multiple used to value the investment remained unchanged. During the third year of our investment, the company lost a large contract, the effect of which would be to reduce its maintainable earnings. A decision was therefore taken to reduce the overall equity value to zero and the value of the shareholder loan by two-thirds. In year 4 the decision was taken to sell the business to one of Case B's competitors who saw some strategic value in Case B's remaining contracts and was prepared to pay a premium to our book value. The price paid was, however, at a significant discount to our original cost and resulted in a 0.6x money multiple and an IRR of (18)%.

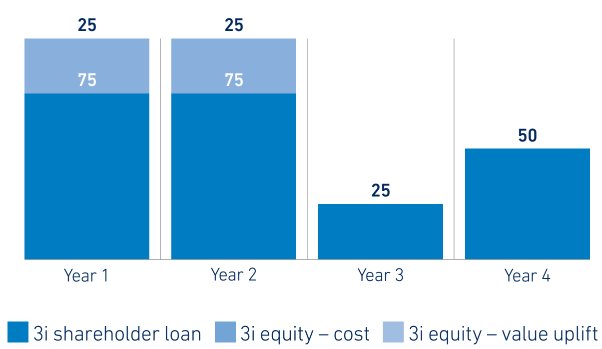
Chart 1: IRR evolution

Case A



	Year 1	Year 2	Year 3	Year 4
Investment	(100)	–	–	–
Yield	–	6.5	6.5	6.5
Value at year end	100	130	135	–
Proceeds	–	–	–	150
Fund IRR	0%	37%	22%	20%
Cash-to-cash IRR	(100%)	(94%)	(71%)	20%

Case B



	Year 1	Year 2	Year 3	Year 4
Investment	(100)	–	–	–
Yield	–	6.5	–	–
Value at year end	100	100	25	–
Proceeds	–	–	–	50
Fund IRR	0%	7%	(47%)	(18%)
Cash-to-cash IRR	(100%)	(94%)	(94%)	(18%)

About private equity

Carried interest – an explanation

What is carried interest?

Carried interest refers to the share of the profits generated in a successful private equity fund that is distributed to the carried interest holders (see below). This share has typically amounted to 15% to 20% of the net profit in the fund, once a pre-determined performance hurdle has been met. This ensures that investors in the fund have a minimum level of return before carried interest is paid.

Who is the carried interest holder?

This is typically the senior management team of the fund manager, but varies between private equity firms. It is usual for carried interest holders to co-invest in the fund in order to be entitled to receive carried interest.

Where does the term carried interest come from?

The investor who receives the carried interest is said to be carried by the other investors since they are willing to allocate a proportion of their profits to the carried interest holder.

How does carried interest ensure alignment of the parties in a private equity transaction?

The main parties in a private equity transaction are the management team of the underlying company in which the fund is investing, the investors in the fund and those who manage the fund. Each of these parties invests in the transaction. The private equity fund managers' investment is typically through a co-investment in the fund.

Management teams of companies backed with private equity are incentivised by the potential capital gain on their investment in the company.

Investors in private equity funds benefit from the growth in value of these underlying companies.

Managers of the fund are entitled to the carried interest benefit if the overall performance of the fund is successful, and if the fund generates returns above the pre-determined hurdle.

Alignment is therefore achieved as each of these parties share the profits earned if the investment is successful.

When is carried interest paid and how is it calculated?

Carried interest is usually based on the performance of the fund as a whole, but in some funds is paid on an investment-by-investment basis. Usually investors receive their initial capital back plus all returns up to the performance hurdle.

Typically, this hurdle is based on the Internal Rate of Return ("IRR") of the fund since its inception – for more information on IRRs see Returns and IRRs. An IRR-based hurdle is the most appropriate mechanism in the private equity industry due to the focus on cash-to-cash returns.

Once the hurdle has been met, most funds allocate cash flows above the hurdle disproportionately to the carried interest holder for a short period, known as the "catch up" phase, until the carried interest holder has received the correct proportion of the overall profits in the fund.

Why are investors in a private equity fund willing to forego a proportion of profit in carried interest?

Generally investors value the alignment that carried interest provides.

Carried interest functions in a similar way to a performance fee. It is directly linked to the success of the investment fund.

In return for paying carried interest, fund investors demand "active" management of their capital. Specifically, the key objectives of the fund manager are to:

- invest fund investors' capital in high quality companies;
- develop and implement a value-creation strategy for each company in the portfolio;
- participate in the strategic and operational policymaking through board representation;
- earn an appropriate yield on the investment; and
- provide a profitable exit through a trade sale, IPO, or sale to another private equity firm.

In summary, investors are prepared to pay the manager a performance fee in the form of carried interest because it: (i) aligns interest between all parties in the transaction and (ii) incentivises the manager to source the best investment opportunities and drive value from the portfolio through active management.

About private equity

What other return does the fund manager receive?

The fund will pay a priority profit share (often called the "management fee") to cover the costs of the fund manager. This has typically been1% to 2% of the investors' commitments to the fund annually until the fund is fully invested.

How does this apply to 3i?

Why does 3i have both carried interest receivable and carried interest payable?

3i's carried interest receivable is due from the external funds in each of its business lines that 3i manages or advises.

3i's carried interest payable is due to investment executives employed by 3i. Assets in a vintage are grouped together in pools (typically covering two years of investment), which are specific to a particular investment team. The executives in that team purchase the rights to the carried interest and, if the pool achieves its performance hurdle, they will receive an allocation of investment profits in the form of carried interest. Carried interest relating to investments which do not involve external funds is structured in the same way as the industry standard, with similar terms and conditions.

Both carried interest receivable and payable are accrued in line with underlying realised and unrealised profits in the fund but cash payments are not made until the cash is returned to investors, as noted above, and the performance hurdle has been achieved.

Why does 3i have co-investment arrangements alongside its carried interest schemes?

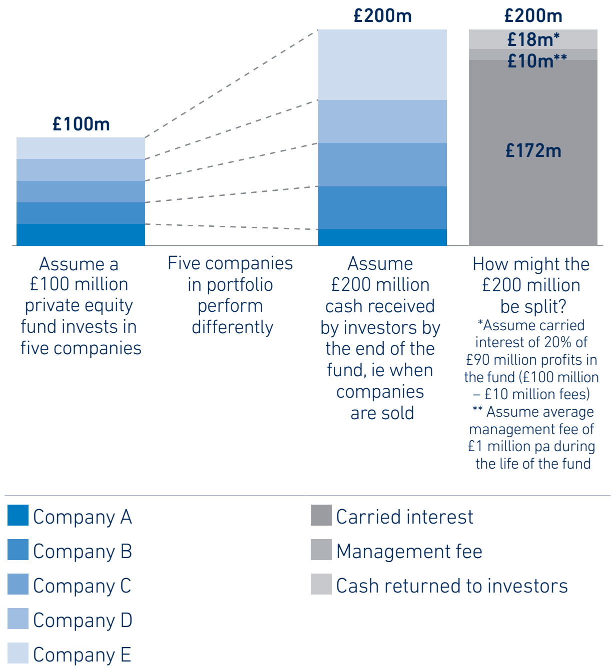
In line with market practice, 3i requires those investment executives who acquire carried interest rights also to invest alongside 3i. The terms of these "co-investment" arrangements are changed from time to time but have typically involved investment executives personally investing up to 2% of the total 3i and funds commitment to each new investment. Gains or losses from the co-investments accrue to the investment executives and provide further alignment with 3i and the fund investors.

How does 3i account for carried interest?

3i accounts for carried interest on an accruals basis. As realisations are made and valuations are adjusted, 3i reviews the impact on each carry scheme in place and amends its carried interest accruals accordingly.

3i's accounting policy means that movements in gross portfolio return are fully reflected in the calculation of carried interest payable and receivable, ultimately reducing year-on-year volatility to 3i's total return.

Worked example



About infrastructure

The Infrastructure asset class – key characteristics

Infrastructure assets generally have a strong market position, often operating within regulated markets, or with revenues underpinned by strong, long-term contracts. Infrastructure assets can be described as "essential", either because they support economic activity and economic growth, such as utilities and transport infrastructure, or because they support important social functions, such as education or healthcare facilities.

Infrastructure assets are typically characterised by the following features:

- Strong market positions;
- Capital-intensive businesses;
- Some degree of inflation linkage;
- Low cyclical volatility;
- Predictable, income-oriented returns when operational;
- Potential for capital growth.

Infrastructure assets typically have only a low correlation with other asset classes, including equities and fixed income. The quality and predictability of cash flows tends to result in attractive distributions to shareholders.

Infrastructure investments can take the form of both minority and majority investments.

Investment objective

The objective of the Infrastructure investor is to earn returns on its investment, commensurate with the risk being taken. The Infrastructure asset class offers the possibility of diversifying investments across the risk/return spectrum. As shown in the diagram below, asset returns typically range between 8% and 15% or greater, depending on the risks associated with the investment.

The returns from social infrastructure come mainly in the form of income (interest and dividends). Returns from core infrastructure tend to be generated through both income and capital growth, with income being a very important component of the return. Capital gains become more important as one moves along the risk-return spectrum, and returns from hybrid infrastructure tend to be generated principally from capital growth. Investments tend to be longer term in nature at the lower end of the risk return spectrum, while returns from earlier stage investments tend to be crystallised through a trade sale of the underlying business (ie a sale to a corporate purchaser), a sale to a financial purchaser (a "secondary" transaction) or a flotation on the public markets (an "IPO").

Infrastructure market characteristics

Social infrastructure/ PPP/PFI	Core infrastructure	Hybrid infrastructure
8% – 12% Expected return	10% – 16% Expected return	>15% Expected return
■ High inflation correlation ■ Mainly government-backed revenue streams ■ Lower risk/return profile ■ Strong yield when fully operational.	■ Dynamic businesses owning their asset base, not concessions with a finite life ■ Low volatility across economic cycles and strong market position ■ Asset management skills key to driving value – operational expertise – management of long-term performance – management incentives	■ High risk characteristics – country risk – market/volume risk – GDP correlation ■ Operational expertise in building out the assets and running the business is more important

Yield ← → Capital growth

About debt management

The Debt Management asset class – key characteristics

There are many types of debt investment, however 3i's Debt Management business and its direct peers invest in and/or manage funds that invest in "sub-investment grade senior debt" and "subordinated secured debt" supporting leveraged buyouts. Senior secured loans and high yield bonds that are rated below BBB-/BAA3 by any of the three rating agencies (Standard & Poors, Moody's or Fitch), are classified as sub-investment grade.

Banks arrange and underwrite this debt, which is typically structured on a deal-by-deal basis. Arranging banks then distribute (or "syndicate") debt to other banks and specialist institutional investors. The final maturities of the assets range from five to seven years.

Debt managers invest into this type of debt through various structured vehicles, such as "collateralised loan obligations" or "collateralised debt obligations" (often shortened to "CLOs" and "CDOs").

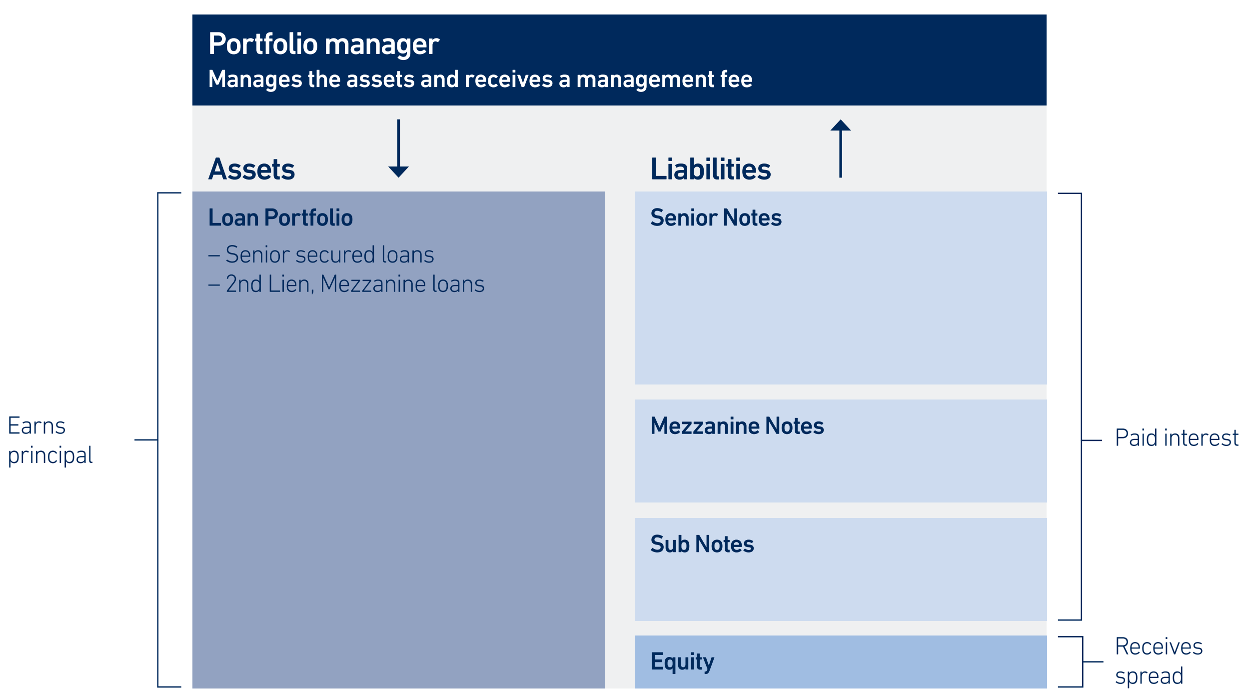
A CLO is a fund that is backed by a portfolio of leveraged loans. In a typical CLO structure, the liabilities are subdivided into different risk classes (eg AAA, AA, A etc), with the most senior considered to be the safest securities. These tranches are then sold to different investors with varying risk appetites. The senior tranches benefit from first ranking security over the shares and assets of the company, while the subordinated tranches benefit typically from a second (second lien or mezzanine), or third (mezzanine or PIK) ranking charge. This is shown in the diagram below.

This structure involves the arbitrage of the low cost of liabilities against the interest margin generated from the loan portfolio. Payments (deriving from the interest arbitrage and repayment of principal) are made to the investors in order of the seniority of the instruments they have purchased.

Investment objective

The objective of institutional investors in subordinated secured debt and sub-investment grade debt, is the ability to generate yield in structured vehicles that offer diversified portfolios with suitable risk/return profiles. The investment philosophy is that whilst the risk of a single loan is high, the risk/return is reduced across a diversified portfolio.

The manager or advisor of a CLO fund receives performance fees on the AUM (senior and subordinated fees typically in the range of 50bps–100bps). Senior fees are typically paid at the top of the payment waterfall whilst subordinated fees are contingent upon the achievement of set fund performance criteria and/or coverage tests.



3i and transparency

Transparency on Corporate responsibility ("CR")

3i takes a very open approach to corporate responsibility issues.

The Corporate responsibility section of our annual report and the CR section of our Investor relations website contain a significant amount of information on the subject.

Visit www.3igroup.com/cr

Transparency with our portfolio

From first meeting to realisation, we aim to take an open and straightforward approach to doing business with our portfolio companies.

Board membership, combined with our "Active Partnership" style of investing, provides numerous opportunities for communication and feedback with our portfolio.

Events held for the management teams of our portfolio companies provide additional occasions to interact with a wide range of 3i staff.

In addition, we periodically undertake independent research to find out what portfolio companies think about 3i.

Transparency with investors

We aim to provide investors in 3i Group plc, and all of the funds we manage or advise, with the highest standards of communications. We do this in many ways, including our Investor relations website and regular investor meetings, as well as through the various other forms of interaction that take place. 3i also holds an event for the governance officers of its leading institutional investors each year. This event is usually attended by our Chairman, Senior Independent Director and members of the senior management team.

With significant external funds under management, 3i also has a targeted communications approach for the investors in specific funds. A dedicated Funds Investor Relations team ensures that there is a high standard of transparency and communication with investors in these funds.

A list of the funds, together with data about their size and how much has been invested from them is included in our Annual report.

Visit www.3igroup.com

Transparency with the media

3i has taken a very open approach to dealing with the press.

The media centre on our website was specifically designed for journalists.

Visit www.3i.com/media

Transparency with our staff

We believe that it is important to keep our staff well informed about what 3i is doing.

As we have a relatively small number of employees, we are able to achieve this through a combination of using efficient web-based tools such as our online portal and a lot of individual or team based discussions.

Our "One 3i" approach underpins this and a staff survey, highlighted in the Corporate responsibility section of our Annual report, is undertaken each year to ensure that we continue to improve. The results of this survey are communicated to employees and staff engagement is a key non-financial performance measure.

3i and transparency – Our approach and track record

Our approach

We have a bias to openness and a culture of pioneering on transparency issues, because we believe that this is good for our business. As a public company and a private equity, infrastructure and debt management business, 3i operates in a highly regulated environment. We also respect the responsibilities we have towards our portfolio companies and to those that we do business with around the world. Our approach, therefore, is to balance these factors, consider carefully what information might be helpful to those with an interest in 3i, and then to find the best way of communicating it.

Our track record

3i's approach to transparency has been encouraged and reinforced by the benefits we believe that we derive from having a good track record on this very important issue. Long before becoming a public company, 3i's annual reports went beyond what was required from a legal perspective. Since listing on the London Stock Exchange in 1994, we have also aimed to be amongst the best in our peer group, whether our peers are other listed companies or privately held asset managers. From surveys of investors, press comment and the numerous awards acknowledging our efforts in this area, we feel this has been an important element in 3i's differentiation.

3i and transparency – The Walker guidelines for Private Equity companies

3i is fully compliant with the Walker guidelines on transparency and disclosure for private equity in the UK.

The background to these guidelines is that in 2007, in response to the growing debate about the role of private equity in the UK, the BVCA suggested a review to examine ways in which levels of disclosure in companies backed by the UK private equity industry could be improved.

The review was led by Sir David Walker, the highly respected City figure, who consulted widely and invited representations from within the private equity industry, with interested parties and among other financial institutions, pension funds and the investment community, as well as more broadly with portfolio companies, trade unions and employer representatives.

3i also endorsed the voluntary code which resulted in the "Guidelines for Disclosure and Transparency in Private Equity", which was published in November 2007 and to which there have been minor revisions subsequently.

Sir David Walker's recommendations with respect to reporting for private equity firms and their relevant portfolio companies were on a "comply or explain" basis. An overview of the guidelines, together with the third annual review of conformity with the guidelines at December 2011, can be found at www.walker-gmg.co.uk.

3i is fully compliant with the Walker guidelines both at the firm and portfolio company levels.

Our annual and half-yearly reports are fully compliant. In addition, our 3i.com and 3igroup.com websites provide substantially more information than is required by the Walker guidelines. We also have high levels of employee engagement and a well developed approach to communicating with our shareholders and the investors in our funds.

3i's website, 3i.com, contains a large number of endorsements from the management teams of our portfolio companies which work with 3i. Regular surveys of journalists' views on the industry and on the Company, undertaken by Ipsos MORI, show high levels of trust in 3i and satisfaction with press communications. 3i has a well developed compliance function which ensures that arrangements are in place to deal with conflicts of interest. 3i provides extensive information on the leadership of the UK firm and the Group as a whole.

Only existing or former of the Group's portfolio companies, Civica, Environmental Scientifics Group (ESG), formerly Inspicio, Enterprise and NCP Services, met the criteria for the 2011 review and all four were compliant. 3i infrastructure plc, a company for which 3i acts as investment adviser and in which it also holds a third of the equity, had two investments, Anglian Water Group and Eversholt Rail, which met the criteria for 2011. Both were compliant with the guidelines.