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3i Group PLC

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3i Group PLC

Credit Highlights

Issuer Credit Rating
BBB+/Stable/A-2

Overview

Key strengths	Key risks
Permanent capital structure not subject to redemption risk even in a stress scenario.	High concentration of discount retailer Action in the investment portfolio.
Strong leverage metrics supported by a relatively large asset base, compared with recourse liabilities.	Illiquid nature of most assets in the portfolio, which could prove difficult to realize in a timely manner during a market downturn.
Strong track record in European midmarket private equity, maintaining resilient earnings in a challenging macroeconomic environment.	Exposure to investment market volatility.

S&P Global Ratings expect 3i Group PLC (3i)'s financial position will remain very strong in the next two years even with the potential issuance of new gross debt. Despite challenging market conditions, the portfolio value increased 29% to £18.4 billion year on year at March 31, 2023--the end of fiscal year 2023 (fiscal 2023)--on the back of a 56% increase (or £3.7 billion) in the valuation of its largest asset, discount retailer Action (Peer Holding III B.V.; BB-/Stable/--). Although we expect 3i to increase its total gross debt with a new issuance this year, we expect this to be moderate given the £200 million term note was repaid in March 2023. Overall, we estimate 3i's stressed leverage, calculated as stressed assets divided by recourse liabilities, at a still solid 6.0x-6.5x post the future issuance, and expect it to remain comfortably above our 3.5x threshold over the next two years. Stressed leverage does not account for the underlying leverage of invested companies but we note that, in fiscal 2023, reported leverage across the portfolio excluding Action decreased to 4.0x from 4.6x. In the same period, Action's reported leverage also decreased to 1.8x from 2.5x.

We view positively 3i's measures to maintain adequate liquidity and stable funding. At March 31, 2023, 3i had £412 million of cash on its balance sheet and access to its undrawn revolving credit facility (RCF) of £900 million, which was increased from £500 million during fiscal 2023. Cash proceeds from any future debt issuance would also add to liquidity. This ample position will enable 3i to continue to invest in new or existing companies, even if realizations are slow or become more uncertain. It also provides the company with additional financial flexibility in the event that it could not exit assets in time when fixed costs or debt repayments are due. The new debt issuance would provide another layer of stable long-term funding, and we view 3i's liabilities as remaining well spread. The issuance in euros will also partially reduce the sensitivity of the group's future returns to euro exchange rate movements as part of its overall capital management approach.

We note strong realizations and investment returns, primarily from Action, but muted investment momentum. Deployments have been subdued in the past three years. 3i's private equity team invested £381 million during fiscal 2023, including four small-to-midsize new investments totaling £221 million, and three bolt-on acquisitions totaling £63 million. Although there was market stress in the consumer retail sector that led some names to decrease in value--notably Luqom (-£242 million) and YDEON (-£115 million)--3i remains confident in their recovery. In the same period, 3i spent £25 million on further investments to support portfolio companies, including YDEON (£14 million). 3i is maintaining its disciplined approach when assessing new and bolt-on investments and delivering on its value accretive buy-and-build acquisition strategy. In fiscal 2023, realizations totaled £857 million and included the sales of Havea and Christ at uplifts of 50% and 45% respectively of their opening values. Benefiting from a permanent capital base, management has the option to manage 3i's investment portfolio in a stressed environment by delaying exits, holding investments for longer, and carrying out full or partial realizations where possible.

Outlook

The stable outlook reflects our expectation that the group will preserve a conservative financial leverage policy and adequate liquidity levels, while managing concentration risks in the investment portfolio and maintaining solid operating and financial performance.

Downside scenario

We could lower the rating in the next 12-24 months if the quality and liquidity of 3i's concentrated investment portfolio deteriorate on the back of a protracted recession, contrary to our base-case scenario. In particular, we would lower our rating if 3i's asset valuations--including that of its largest exposure, retailer Action--deteriorate to the extent that they push the stressed leverage ratio sustainably below 3.5x. We could also lower our rating if 3i departs from its conservative leverage and liquidity policy, notably regarding acquisitions and investments.

Upside scenario

We could raise the rating if the company continues to increase its capital buffer, mitigating concentration concerns, while maintaining adequate liquidity.

Fund Overview And Investment Strategy

3i is a U.K.-based investment trust company that primarily invests in private equity and infrastructure assets. It is listed on the London Stock Exchange and is part of the FTSE 100. The company reported a total portfolio of £18.4 billion in the fiscal year ended March 31, 2023, which is of limited size compared with the overall alternative investment market, but it has been performing well over the past few years. The group has one of the longest track records in European midmarket private equity, investing in companies with enterprise values of €100 million-€500 million. It focuses on the consumer, industrial technology, health care, and business and technology services sectors primarily in the Netherlands, France, Germany, the U.K., and North America. 3i's investment strategy has been steady since 2012. In addition to private equity, the group focuses on infrastructure. 3i owns 29% of 3iN, amounting to £841 million, and acts as its investment manager. 3iN is a FTSE 250 company that invests across midmarket economic infrastructure and greenfield projects in developed markets.

Risk-Adjusted Leverage: Adequate

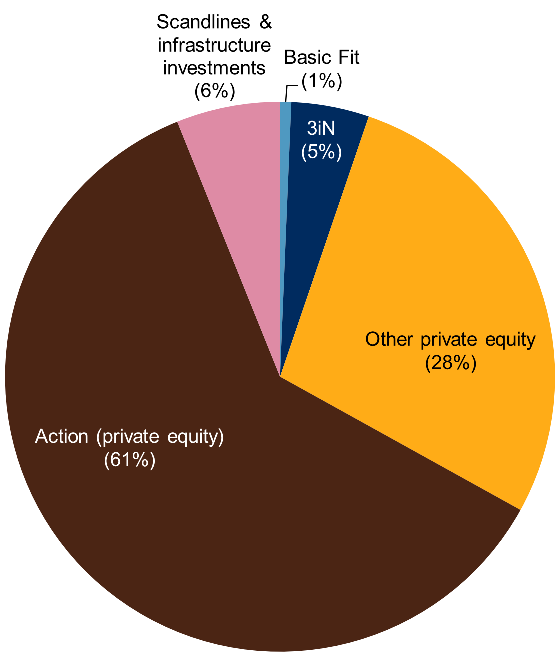
Our risk-adjusted leverage assessment is adequate, given that 3i's robust metrics do not take into account the company's high concentration, underlying leverage, and mostly illiquid assets. To determine our risk-adjusted leverage, we first assess the portfolio's stressed leverage and modify this assessment by our view of the portfolio's risk position relative to that assessment.

Stressed leverage: At comfortable levels

We continue to view 3i's stressed leverage assessment as very strong--our highest assessment--since it has consistently been above our 3.5x threshold over the past three years. We calculate the group's stressed leverage by applying different haircuts on its assets to reflect typical market movements in a 'BBB' stress scenario and compare the total stressed assets to cover the total recourse liabilities. We applied a higher haircut to the portion of the investment portfolio that is composed of illiquid assets, which could be challenging to fully realize quickly in such a stress scenario. At March 31, 2023, this ratio was above 6.0x. We believe that there is a sufficient capital buffer to absorb large asset value declines in a market downturn. 3i has no appetite for structural gearing at the group level but, at present, has a tolerance to operate within a range of £1.0 billion net debt to £0.5 billion net cash.

Chart 1

3i's assets as of March 31, 2023, depict a more concentrated portfolio



Source: S&P Global Ratings based on company reports.

We use the following assets in our stressed scenario based on 3i's March 31, 2023, reported data and include the proceeds of a potential €500 million (£440 million) term debt issuance:

- Cash and cash equivalents of about £250 million assuming outflows for operational uses, dividends, and carried interest payables;
- Public equity of £962 million comprising the quoted investment Basic-Fit (£121 million) and 3iN (£841 million); and
- Private equity of £17,426 million, namely all other investments including Scandlines and infrastructure and excluding Basic-Fit and 3iN.

In addition, we use the following total recourse liabilities:

- The expected issuance of a €500 million (£440 million) note due in 2029;
- The £375 million, 5.750% note due in 2032; and
- The £400 million, 3.750% note due in 2040.

When calculating our stressed leverage ratio, we apply a 50% haircut on listed stocks (Basic-Fit and 3iN listed as quoted investments) and a 60% haircut on unlisted stocks, which is commensurate with a 'BBB' stress scenario. Of the top-20 private equity investments, which account for 94% of portfolio value, 15 were earnings accretive and generated value growth of £4.25 billion. We continue to believe the portfolio could expand considering the resilient performance of Action, whose value increased £3.71 billion in the same period. Some companies in the retail and discretionary consumer segment, such as Luqom and YDEON, led to a combined £357 million unrealized value decrease.

Risk position: Remains weak from 3i's highly concentrated portfolio and illiquid assets

The group's portfolio consists of 39 private-equity names but is highly concentrated. In particular, its investment in European discount retailer Action represented 60.8% of the total portfolio on March 31, 2023. Over the past four years, the portfolio size has strongly increased relatively in tandem with Action's performance. During the 12 months ended March 31, 2023, Action generated strong sales and earnings growth and high dividends, contributing most of the £3,769 million unrealized gain in 3i's portfolio as well as 3i's portfolio income. Action is proving cash generative, paying dividends of £284 million in fiscal 2022 and £325 million in fiscal 2023. Viewed differently, however, Action also adds to the portfolio's market volatility since the total valuation is increasingly sensitive to Action's performance. Action's earnings multiple was unchanged at 18.5x based on an EBITDA run rate of £1,493 million at April 2, 2023, (£1,012 million at April 3, 2022). Under our risk position assessment, we consider this structural concentration risk in 3i's portfolio, which partly offsets the quantitatively strong stressed leverage metric, in our view.

As part of 3i's strategy, most companies held are highly leveraged, and with a few exceptions, are on speculative-grade ratings. Moreover, since 3i's portfolio is primarily focused on unlisted companies, a large part of its assets could take more time to divest, even at a discount, when compared with peers that hold mostly listed equities in their portfolio. Nevertheless, we regard positively the strategy implemented since 2012 that led 3i to focus on well-known sectors, primarily in the U.S. and Europe, and a more limited number of investments.

Table 1

Top 10 largest exposures represent 83% of the investment portfolio as of March 31, 2023

	Valuation basis	Valuation Mar. 2023 (mil. £)	Percent of total portfolio (%)
Action	Earnings	11,188	60.8
3iN	Quoted	841	4.6
Scandlines	DCF	554	3.0
Cirtec Medical	Earnings	552	3.0
Tato	Earnings	411	2.2
nexeye	Earnings	393	2.1
SaniSure	Earnings	389	2.1
Royal Sanders	Earnings	369	2.0
AES Engineering	Earnings	351	1.9
Evernex	Earnings	305	1.7
Top-10 total		15,353	83.5

DCF--Discretionary cash flow. Source: S&P Global Ratings based on company reports.

Foreign exchange and interest rate risks are well-managed. Historically, with unhedged exposures in the U.K., currency risks have caused some volatility in 3i's accounts. In fiscal 2023, £652 million of the £4,966 million gross investment return was due to foreign-exchange-related gains. In third-quarter fiscal 2023, 3i implemented a medium-term hedging program to partially reduce the sensitivity of its future returns to euro and U.S. dollar exchange rate movements as part of its overall capital management approach. The partial hedge, which is still in place, led to foreign currency gains of £122 million, including the company's notional €600 million foreign exchange hedge of its long-term investment Scandlines. Interest rate risk is limited. Across its private-equity portfolio, over 70% of the term debt is hedged at a weighted-average tenor of more than three years with the interest rate capped at a weighted-average hedge rate below 2%.

Funding And Liquidity: Adequate

Funding: The permanent capital base is a key strength

The group benefits from its permanent capital structure since it is not subject to redemption risk even in stress scenarios. Aside from its proprietary capital, 3i also bears about £1,215 million of long-dated debt if including the proposed issuance and a £900 million RCF that currently remains undrawn. We believe that 3i has a strong capital structure and financial flexibility given the low balance-sheet gearing.

3i's strategy is to use investment proceeds and available cash to reinvest in new assets, because it aims to have very low to no structural gearing. In an extreme case of stress, the committed credit facilities could, in our view, be of use if exceptional investment opportunities arise or if 3i's cash reserves reach a low point. However, we view the latter scenario as remote. Furthermore, we believe that 3i's renowned franchise, and its long-standing relationships with financial institutions that also act as advisors on deals, support its funding profile.

Liquidity: Further supported by large dividends from Action and our adequate assessment in a potential stress scenario

3i's liquidity could facilitate opportunistic investments in line with the group's strategy. We project liquidity sources would exceed liquidity uses about 1.5x in a 'BBB' stress scenario, pointing to an adequate liquidity cash flow assessment.

Liquidity sources include:

- Cash balances of £412 million and proceeds of £440 million from the new debt issue;
- The RCF of £900 million;
- £60.5 million of listed stocks (only Basic-Fit) after applying a 50% haircut;
- Dividend and interest income with a 50% haircut of £212.5 million, although this amount could be substantially lower if Action does not pay a dividend; and
- Fee income of £72 million.

Assuming no share repurchases, liquidity uses in a 'BBB' stress scenario over a 12-month horizon include:

- £511 million of announced dividend distributions;
- £200 million of operating expenses;
- £250 million of carried interest payable; and
- £300 million-£500 million estimated for opportunistic acquisitions and further investments to support the portfolio.

We consider that cash could be provided to 3i's existing companies to support strategies amid current economic conditions or any liquidity issues. Although simulated at about £300 million-£500 million in our liquidity assessment, we estimate in any case that such deals will remain commensurate with 3i's capacity and would not jeopardize any upcoming debt repayment.

When calculating the liquidity ratio, we assume that 3i would not divest its largest assets, Action and 3iN, in a timely manner in an extreme stress scenario. We also apply the appropriate haircuts to assets in a 'BBB' scenario, including 50% for the sale of Basic-Fit, which is the only publicly listed stock in 3i's portfolio aside from 3iN.

Action has provided strong dividends over the past two years. Although we haircut dividends and interest income by 50%, consistent dividend payments by Action, regardless of the macroeconomic environment, could improve our view of liquidity. We expect 3i's liquidity profile to remain adequate and supportive of the group's strategy, since our assessment largely accounts for any opportunistic use of liquidity.

Other Key Credit Considerations

3i is listed on the London Stock Exchange, with its shares widely held, and is a constituent of the FTSE 100, which reinforces its sound governance. It is not regulated, but some subsidiaries, including 3i Investments PLC, are regulated by the U.K. Financial Conduct Authority. Furthermore, 3i is subject to regulatory requirements under the European Alternative Investment Fund Managers Directive. The group also has a subsidiary, 3i Investments (Luxembourg) S.A., regulated by local Commission de Surveillance du Secteur Financier. As a U.K. investment trust, 3i's capital gains are exempt from tax.

Track record and investment performance: We expect management to maintain its successful strategy

The management team under long-serving CEO Simon Borrows has set strategic objectives with key performance indicators linked to them, such as gross investment returns, operating cash profit, and gearing. Mr. Borrows is also Chairman of Action's board. Despite difficult market conditions during the year, realizations were higher. Management has also demonstrated a history of not incurring unexpected declines in earnings or cash flow emerging from operational risks.

Risk management: Consistent and supportive of its strategy

The board reviews 3i's strategic objectives and risk appetite at least annually. It is responsible for 3i's risk assessments, risk management process, and for the protection of the group's reputation and brand integrity. The group's risk management framework is designed to support the delivery of its strategic objectives. The board considers the most significant risks that 3i faces and uses quantitative analyses, such as vintage controls, which consider the portfolio concentration by geography and sector, and liquidity reporting, where appropriate. 3i's risk appetite policy, which is consistent with previous years, is built on rigorous and comprehensive investment procedures and conservative capital management. It has greater exposure to infrastructure and health care sectors which should provide some protection against inflation. The consistency of the team and very low turnover are qualities that underpin the management.

Transparency and complexity: A focused strategy with comprehensive reporting

Since it is listed on the London Stock Exchange, 3i is subject to comprehensive market reporting requirements. The company has consistent reporting across both International Financial Reporting Standards rules and its own management method to present a clearer picture of investments that should not be consolidated, in the group's view. 3i's business is not complex and is focused on execution with a set risk appetite, mostly investing in key known industries.

Comparable rating analysis: Well-placed among peers

We view listed investment funds The Mercantile Investment Trust PLC (AA-/Stable/A-1+), a U.K. mid-cap equity investment trust fund, and Pershing Square Holdings Ltd. (BBB+/Stable/--), a similar size private equity firm, as peers. Compared with 3i, Mercantile Investment Trust is invested in liquid equity securities and less concentrated, justifying the rating difference. Pershing Square's debt level is roughly twice as high as 3i's, but is counterbalanced by its stronger liquidity assessment, focusing on listed equities. We believe that our 'BBB+' rating on 3i is well placed among peers and thus do not include any adjustments.

Issue Ratings

The proposed note maturing in 2029 will rank pari passu with the company's existing notes. At fiscal year-end 2023, 3i's term debt consisted of £375 million maturing in 2032 and £400 million maturing in 2040. We expect the new note to carry a more favorable interest rate than the 6.875%, £200 million note repaid in March 2023. We estimate that total gross debt will remain below £1.3 billion after the issuance. We do not notch down because the debt is not subordinated and since 3i does not hold any other secured debt. There are also no covenants on any of the previously mentioned lines or for the proposed debt.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Stable/A-2
Risk-adjusted leverage	Adequate
Stressed leverage	Very Strong
Risk position	Weak
Funding and liquidity	Adequate
Funding	Strong
Liquidity	Adequate
Preliminary anchor	bbb+
Jurisdictional risk	0
Anchor	bbb+
Modifiers	
Track record and investment performance	Neutral
Risk management	Neutral
Transparency and complexity	Neutral
Comparable rating analysis	Neutral
Stand-alone credit profile	bbb+
Group credit profile	BBB+

Related Criteria

- Criteria | Financial Institutions | Other: Alternative Investment Funds Methodology , Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- General Criteria: Group Rating Methodology , July 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011

Related Research

- 3i Group PLC, Dec. 16, 2022
- 3i Group PLC, Feb. 14, 2022
- 3i Group Upgraded To 'BBB+' On Robust Operating Performance; Outlook Stable, July 23, 2021

Ratings Detail (As Of May 31, 2023)*	
3i Group PLC	
Issuer Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+

Ratings Detail (As Of May 31, 2023)*(cont.)		
Issuer Credit Ratings History		
23-Jul-2021	*Foreign Currency*	BBB+/Stable/A-2
25-Feb-2020		BBB/Positive/A-2
27-Mar-2012		BBB/Stable/A-2
23-Jul-2021	*Local Currency*	BBB+/Stable/A-2
25-Feb-2020		BBB/Positive/A-2
27-Mar-2012		BBB/Stable/A-2
Sovereign Rating		
United Kingdom		AA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.