3i Group plc

Update to credit analysis

Summary
3i Group plc’s (3i) Baa1 senior unsecured debt rating is supported by the firm’s (1) limited outstanding debt, (2) conservative financial policies, and (3) proven track record of investment and asset management. We expect the firm to maintain its disciplined investment process, which has thus far supported good value creation. The rating is constrained by the speculative-grade nature of 3i’s investment portfolio.

3i is focused on private equity and infrastructure investments. The firm continues to benefit from a supportive operating environment, despite still-low economic growth in Europe and heightened uncertainty as the United Kingdom (Aa2 negative) prepares to leave the European Union. Strong markets have supported the value and performance of most of 3i’s investments, as well as its investment realisations.

Exhibit 1
3i Group’s proprietary investment split and net market value leverage (MVL)

The financial data presented in this chart is taken from the Investment Basis financial statements. The Investment Basis is an alternative (non-GAAP) performance measure.
Sources: Company annual reports and Moody’s Investors Service

Credit strengths
» Solid midmarket private equity franchise in the UK, the US and Northern Europe
» Limited leverage
» Conservative financial policy and disciplined investment process, supporting solid profitability
» Strong track record of asset management and investment realisation
Credit challenges

» High asset prices reduce the scope for profitable investment opportunities, constraining 3i’s investment activity

» Relatively low operating cash generation (excluding proceeds from disposals of investments), providing a weak interest coverage

Outlook

The outlook on 3i’s Baa1 senior unsecured rating is stable, indicating that we do not expect material changes in the firm’s credit profile over the next 12-18 months. The stable outlook reflects our expectation that 3i’s operating performance will remain solid and that the company will maintain a strong financial position and adequate liquidity to support its investments, if required.

Factors that could lead to an upgrade

» An improvement in the credit quality of the investment portfolio

» A reduced portfolio concentration

» An increase in operating cash generation on a sustained basis

Factors that could lead to a downgrade

» A significant increase in the firm’s leverage

» A reduction in the firm’s liquid resources

» A material deterioration in the quality of the firm’s investment portfolio

» A structural decline in recurrent cash inflows, materially reducing the firm’s operating cash generation

Key indicators

Exhibit 2

3i Group PLC

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<td>Net MVL</td>
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<td>-7.2%</td>
<td>-3.4%</td>
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<td>Asset Concentration [2]</td>
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[1] Financial years ending 31 March, GBP million, based on IFRS accounts if not stated otherwise

[2] Market Value of the three largest investments (excluding cash balances and considering 3i’s portfolio granularity) as a percentage of total portfolio market value (including cash balances), based on the Investment Basis financial statements.

Source: Source: Company Information, Moody’s Investors Service

Profile

3i Group plc (3i) is a UK-headquartered investment firm to which we have assigned a senior unsecured debt rating of Baa1 with a stable outlook, under our Investment Holding Companies and Conglomerates rating methodology. Its two main businesses are Private Equity and Infrastructure, which are focused on core investment markets in northern Europe and North America. The company’s private equity business had a total of £9.6 billion in assets under management (AUM) as of 30 September 2019, of which £6.9 billion is proprietary capital. 3i invests in midmarket companies, taking a majority stake. 3i’s infrastructure business holds £4.6 billion of assets. The company invests principally in midmarket economic infrastructure in Europe and North America, as well as in greenfield and operational projects.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.
Detailed credit considerations

Clearly defined investment strategy and disciplined process support solid profitability levels

3i applies a consistent and well-defined approach to making investment and divestment decisions, supporting the company’s profitability. 3i often monitors businesses for lengthy periods before deciding to invest in them, and adheres closely to the criteria governing the size of its target companies and the sectors they operate in. The company targets mid- to high-teens rates of return in percentage terms over a typical period of four to five years. It focuses on businesses with an enterprise value of €100 million-€500 million operating in the business and technology services, consumer and industrial sectors in northern Europe and North America. It selects companies with the ability to take advantage of developing the megatrends it has identified, and uses its extensive network of business leaders to identify and access opportunities. 3i’s network and focus on middle-market transactions in niche business sectors have allowed it to avoid more aggressive auction-driven acquisitions, which tend to be more expensive, reducing the expected return.

3i invests on its own account and on behalf of third parties. The company has increased its AUM across its two business lines in recent years, reflecting both higher investment values and increased fundraising. Its AUM in private equity totaled £9.6 billion as of 30 September 2019, increasing from £8.3 billion in March 2019. AUM at 3i’s infrastructure division rose to £4.6 billion from £3.7 billion over the same period. 3i’s proprietary investments totaled £8.6 billion (£7.1 billion in September 2018).

In the first six months to 30 September 2019, 3i invested £312 million (£859 million in fiscal year (FY) 2019). £221 million was invested in private equity with the acquisition of two new companies, while several bolt-on acquisitions were also completed with some self-funded by the portfolio companies. In infrastructure, investments of £91 million were added. Realisations totaled £71 million in the first six months ended September 2019 (£1.24 billion in FY 2019).

While 3i has been a net realiser of investments in recent years, it expects the trends to reverse this year. In FY 2020, it expects lower realisation levels than recent years as most of the companies in its portfolio are still in the development phase. We expect 3i to continue to focus on maximising the value of its larger investments and to maintain a conservative investment approach as high asset prices are reducing the scope for profitable investment opportunities in the current competitive investment environment.

3i’s private equity portfolio consists largely of speculative-grade investments, with about 70% of its investee companies holding debt-to-EBITDA ratios of 4x-5x. 3i’s rigorous investment and management process to some extent offsets the risks related to the relatively high leverage of its portfolio, and its relatively high exposure to a small number of investee companies.

3i’s largest investment creates portfolio concentration

In recent years, 3i has been reducing the number of its private equity investments, which had fallen to 33 as of September 2019 (see Exhibit 2). The company previously guided that its desired number of investments is around 30-40, although availability of investment opportunities and changes in market conditions could cause it to diverge from this figure.
3i’s single largest private equity investment is a Northern European discount retailer (Action), which the firm values at around £3.2 billion, corresponding to around 38% of the group’s total portfolio. In November 2019, 3i announced its plans to increase its holding in Action to around 50% from 45.3%. The proposed transaction will provide liquidity to investors in EuroFund V, which is coming to the end of its life, and is likely to be completed in January 2020. Action’s good performance is illustrated by its ability to return capital to 3i. Action distributed £834 million to 3i since the private equity firm’s initial investment in 2011. Ferry operator Scandlines is the second-largest investment (6% of the portfolio). Since last year, Scandlines has been reclassified as a corporate asset. 3i expects to hold it longer than the average investment period for its private equity portfolio companies. Scandlines completed a refinancing in August 2019, returning capital proceeds to 3i of £70 million, in addition to a dividend income of £21 million. A further £6 million of dividend income was received earlier in the period. Scandlines and 3iN (3i Infrastructure) are core to the 3i portfolio as they generate strong capital returns and cash, while retaining some growth potential.

3i’s relatively high exposure to Action creates some concentration risk. The lower numbers of companies within the firm’s private equity portfolio could also lead to less granular income streams from investment realisations in the future.

Beyond Action, 3i’s portfolio across private equity and infrastructure is evenly diversified by sector, given the firm’s size and target market. The portfolio is most exposed to Northern Europe, the US and the UK (see Exhibit 4), which benefit from solid macroeconomic fundamentals.

A conservative and consistent financial policy offsets the risks of a speculative-grade portfolio
3i holds large cash balances to support its business during periods of high market volatility. The company had a total of £625 million in cash and cash equivalents as of September 2019, largely held in Aaa-rated money market funds and bank deposits, accounting for 6.1% of its total assets. The firm also has access to a £350 million committed credit facility (undrawn as of September 2019), provided by well-rated banks. 3i’s strong liquidity gives the company some flexibility regarding its investment policy, and should allow it to withstand unexpected market shocks.

The company aims to maintain or grow the dividend each year, paying an interim dividend that will be set at 50% of the previous year’s total dividend. However, in setting the dividends, 3i intends to maintain a conservative financial approach. For the first half of FY2020, the total dividend was 17.5 pence per share (50% of total FY2019 dividend), up from 15.0 pence a year earlier.
Low market value leverage
3i had outstanding gross debt of £575 million as of September 2019. In line with the company’s expectations, its realisation levels decreased to £71 million as of 30 September 2019 (year-to-date) from £1,057 million as of 30 September 2018. As a result, cash levels came down with net debt balance close to zero. 3i’s market value leverage based on the Investment Basis financial statement was -0.01% as of the half year ended 30 September 2019, remaining consistent with an Aaa score for the sub factor.

The company’s gross debt/EBITDA was 0.47x as of September 2019.

3i’s solid financial position mitigates some of the risks within 3i’s private equity portfolio, which comprises speculative-grade investments with an average leverage of around 4x debt/EBITDA as of September 2019.

Exhibit 5
3i’s private equity portfolio leverage [1] and group leverage [2]

![Exhibit 5](image)

[1] Based on Investment Basis financial statements. The portfolio leverage in September 2019 represents 89% of the private equity portfolio by value, while the portfolio leverage from 2014-17 represents around 99% on average of the private equity portfolio by value. [2] Leverage is calculated as debt/EBITDA, based on IFRS financial statements.

Source: Company annual reports and Moody’s Investors Service

Operating cash flow is likely to grow in line with infrastructure business
3i’s cash operating income is adequate to cover its operating expenses, but also reliant on Scandlines and 3iN. Scandlines is likely to generate solid cash flow, while the company’s infrastructure funds will provide another ongoing revenue stream. 3i’s infrastructure expertise has also allowed the company to develop complementary fund management initiatives to further support its operating cash position. In FY2018, 3i completed its first infrastructure investment in North America and launched two infrastructure funds in Europe to complement the mandate for 3iN. Cash income from the infrastructure business amounted to £25 million in the first six months as of September 2019.

3i maintains a tight discipline in managing its operating expenses. In the half-year ended 30 September 2019, cash operating expenses were £79 million, slightly higher than the £69 million in the year-earlier period, because of higher variable compensation costs.

Liquidity analysis
While, as expected, 3i’s liquid assets have declined, with cash of £625 million at 30 September 2019 (£1,070 million as of March 2019), compared with debt of £575 million, its liquidity remains strong. In addition to its liquid assets, the company benefits from an undrawn credit facility of £350 million. 3i has demonstrated consistency in its liquidity, having been in a negative net debt position for the last five years. As of 30 September 2019, the company’s Moody’s-adjusted net debt had a zero balance.

ESG considerations
Environmental
Through its portfolio of companies, and in particular its infrastructure business, 3i is exposed to moderate environmental risks. However, we view these as very contained as 3i invests in non-regulated infrastructure and benefits from a tight control and efficient risk framework.
Social
Along with its asset manager peers, 3i is exposed to social risks through its reliance on human capital, the importance and the large volume of customer data, and the challenges and opportunities from changing population dynamics. However, these are tightly monitored and controlled by an efficient risk framework. Every six months, the private equity and infrastructure businesses carry out reviews of each of their material portfolio companies and include an ESG assessment, which seeks to track identified ESG risks and identify emerging risks and opportunities.

Governance
Like all other corporate credits, the credit quality of 3i is influenced by a wide range of governance-related issues, relating to financial, managerial, ownership or other factors, all of which can be exacerbated by regulatory oversight and intervention. 3i displays good and transparent corporate governance practices. 3i’s board is accountable for the long-term sustainable success of the company by approving the group’s strategic objectives and monitoring its performance against those objectives. It has delegated the day-to-day management of the business to the CEO who regularly reports back to the board on financial and operational performance, risk management and progress in delivering the strategic objectives. The board counts seven nonexecutive directors (out of nine) who provide challenge, strategic guidance and hold management to account.
Rating methodology and scorecard factors

Exhibit 6
Rating factors
3i Group plc

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Source: Moody’s Investors Service

Notes:
1. All ratios are based on “adjusted” financial data and incorporate Moody’s global standard adjustments for non-financial corporations.
2. As of 09/30/2019.
3. This represents Moody’s forward view, not the view of the issuer, and unless noted in the text, does not incorporate significant acquisitions and divestures.

Sources: Company annual reports and Moody’s Investors Service.
Endnotes

1 The financial data presented in this paragraph is taken from the Investment Basis financial statements. The Investment Basis is an alternative (non-GAAP) performance measure.

2 The financial data presented in this paragraph is taken from the Investment Basis financial statements. The Investment Basis is an alternative (non-GAAP) performance measure.
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