

Research Update:

# 3i Group PLC Outlook Revised To Positive From Stable On Financial Policy; 'BBB' Ratings Affirmed On Criteria Change

February 25, 2020

## Overview

- S&P Global Ratings has adopted new criteria for rating alternative investment funds (AIF), which we believe is a better fit for 3i Group PLC's business model, compared to those applied to asset managers (see "Alternative Investment Funds Methodology", published Jan. 13, 2020).
- Since 2012, 3i has shown a strong investment return, consistently conservative leverage policy, and adequate liquidity.
- We are revising our outlook on 3i to positive from stable, reflecting our view that we could raise the ratings if the company sustains its conservative financial policy, consistent operating performance even if we do not expect the repeated high cash returns of recent years, and if risks related to the concentration and illiquid nature of the investment portfolio do not materially increase further.
- We are affirming the 'BBB' long-term and 'A-2' short-term ratings on 3i under the new AIF criteria, as well as our 'BBB' issue-level rating on 3i's senior unsecured debt.

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## Rating Action

On Feb. 25, 2020, S&P Global Ratings revised its outlook on 3i Group PLC to positive from stable. We affirmed our 'BBB' long-term issuer credit rating and 'BBB' ratings on the company's senior unsecured debt, following implementation of the new AIF criteria. We also removed the ratings from under criteria observation.

## Rationale

The review follows application of new criteria for rating AIFs and captures our view of the credit trends at 3i. The persistence of its operating performance and conservative financial management supports the outlook revision to positive.

The ratings affirmation reflects our view of 3i's adequate risk adjusted leverage, strong funding, and adequate liquidity. We view positively 3i's long-term track record, strong governance, permanent capital, and stable investment strategy, offset by its concentrated portfolio and investments in illiquid, usually unlisted, midsize, leveraged corporate entities.

## **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 approximately £8.8 billion as of Dec. 31, 2019. 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 companies operating in the consumer, industrial, health care, and business and technology services sectors in Northern Europe. It has a bias toward Belgium, 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. It currently manages a portfolio of 32 private equity investments for growth and performance. 3i also owns 30% of 3i Infrastructure PLC (3iN), a FTSE 250 company, and acts as its investment manager. 3iN invests across midmarket economic infrastructure and greenfield projects in developed markets.

## **Risk-adjusted leverage**

Our assessment of adequate recognizes that stressed leverage metrics are quantitatively very strong. But we think the company's high concentration, the high leverage of many of its underlying assets, and the inherently illiquid nature of most of its investments are equally durable features. We calculate 3i's stressed leverage consistently above 6x over the past two years and do not expect any change in 2020. This is stronger than most peers rated under our AIF criteria and is commensurate with our view of its decreasing leverage since 2012. The investment portfolio is large compared to 3i's recourse liabilities, but is also composed of illiquid assets that could be challenging to fully realize in a 'BBB' stress scenario.

We use these assets in our stressed scenario (based on reported half-year and third-quarter data):

- About £430 million accessible cash;
- £198 million in listed equities, equivalent to the remaining share in Basic-Fit;
- £6.9 billion in private equities; and
- Infrastructure investments and Scandlines Aps (reported as a long-term corporate investment) amounting to about £1.7 billion.

In addition, we use these total recourse liabilities:

- £200 million 6.875% notes due in 2023; and
- £375 million 5.75% notes due in 2032.

When calculating our stressed leverage ratio, we apply a 50% haircut on listed stocks (Basic-Fit and 3iN listed as quoted investment) and a 60% haircut on unlisted stocks, commensurate with a 'BBB' stress scenario. For all other investments we consider higher risk by nature, we apply a 75%

haircut under our stress scenario. We only give credit to the minimum cash we have observed over the past two years.

Despite very favorable quantitative leverage metrics, our assessment is only adequate because 3i's robust metrics do not take into account its high concentration, underlying leverage, and the illiquid nature of most of its assets (more than 80%).

The largest investment, European nonfood discount retailer Action Holding BV, represents 39% of the total portfolio. 3iN, the second largest, is another 9% as of Dec. 31, 2019. The top 10 represented about 72% of the portfolio on the same date. While we view this concentration as a high risk in case of a market downturn, we acknowledge these assets also drove 3i's strong investment performance, as they are individually performing well since 3i acquired them. Still, we believe the size of the Action investment (close to £3.5 billion) complicates finding a buyer in a timely manner in a distressed scenario.

We also take into account that most holdings are highly leveraged, and except for a few, our ratings would likely be speculative-grade. Moreover, 3i's portfolio is primarily focused on unlisted companies, so a large part of its assets could take more time to divest even at a discount when we compare to peers that hold mostly listed equity. Last, we consider negatively the currency risk that creates volatility in 3i's accounts. The company's only foreign exchange hedge is a notional €500 million of its long-term investment in Scandlines.

The unhedged portfolio, resulting mostly from assets denominated in euros and U.S. dollars, hinders total return and net asset value (NAV) when the U.K. pound sterling appreciates against other currencies.

## **Funding and liquidity**

We view 3i as adequate, with its permanent capital structure as a rating strength not subject to redemption risk even in a stress scenario. Aside from its proprietary capital, 3i also bears £575 million in debt and an undrawn £350 million revolving credit facility. We believe 3i has strong capital structure flexibility given the balance sheet's low leverage and the fact 3i has usually traded at a premium to NAV for the past five years, easing an eventual equity raise, if sought. However, we note current sound metrics could swiftly deteriorate if 3i lowered its cash buffer to seize acquisition opportunities.

3i's strategy is to use investments proceeds and available cash to reinvest in new assets, as it aims for no structural group leverage. In an extreme stress case, we believe the committed credit facilities could be of use if exceptional investment opportunities arise or cash reserves reach a low point. Furthermore, we believe 3i's renowned franchise and longstanding relationship with financial institutions that also advise on deals support its funding profile.

Our quantitative cash flow assessment estimates liquidity sources can cover uses by 1.25x in a 'BBB' scenario in the next 12 months.

Expected liquidity sources over the next 12 months, post haircuts:

- About £430 million available cash and cash equivalents;
- £99 million public equities;
- £350 million revolving credit facility maturing in 2021; and
- £55 million in management fees and other income from investments.

Expected liquidity uses over the next 12 months:

- About £120 million in operating expenses;
- £39 million interest paid;
- About £340 million estimated dividends; and
- £250 million estimated for opportunistic acquisitions and investments.

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

As part as 3i's business strategy, we believe that in a market downturn, opportunities for investments at a discounted value could arise and 3i could partake. We also consider cash could be provided to already owned companies during a stress or to enable them to carry bolt-on investments. Nevertheless, we estimate such deals would remain commensurate with 3i's capacity and would not jeopardize debt repayment.

## **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. However, 3i is subject to regulatory requirements under the European Alternative Investment Fund Managers Directive. 3i also set up 3i Investments (Luxembourg) S.A., regulated by local Commission de Surveillance du Secteur Financier, to manage any disruptive Brexit scenario. As a U.K. investment trust, 3i's capital gains are exempt from tax.

## **Outlook**

S&P Global Ratings' positive outlook on 3i reflects our expectation that the group will preserve its conservative financial leverage policy and maintain adequate liquidity, while concentration risks in the investment portfolio will not materially increase.

## **Upside scenario**

An upgrade primarily depends on 3i keeping conservative financial leverage and adequate liquidity over the long term, including the extension beyond 2021 of current committed backup facilities. We could raise the long-term rating in the next 12-24 months if concentration risk in the investment portfolio did not materially increase and if we observed a consistent operating and financial performance, even if we do not expect 3i to repeat the high cash returns realized in recent years.

## **Downside scenario**

We could revise the outlook to stable if the quality and liquidity of 3i's concentrated investment portfolio deteriorated or, if contrary to our base case, 3i demonstrated a reduced commitment to a conservative leverage and liquidity policy.

## Ratings Score Snapshot

<b>Issuer Credit Rating</b>	BBB/Positive/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
<b>Anchor</b>	bbb
<b>Modifiers</b>	
Track record and investment performance	Neutral
Risk management	Neutral
Transparency and complexity	Neutral
Comparable rating analysis	Neutral
<b>Stand-alone credit profile</b>	bbb

## Related Criteria

- Criteria | Financial Institutions | Other: Alternative Investment Funds Methodology, Jan. 13, 2020
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
<b>3i Group PLC</b>		
Issuer Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
<b>Ratings Affirmed</b>		
Senior Unsecured	BBB	BBB

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