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3i Group PLC

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Credit Highlights

Issuer Credit Rating
BBB/Positive/A-2

Overview

Key strengths	Key risks
Very strong stressed leverage supported by relatively large asset base relative to 3i's historically low recourse liabilities level.	High concentration of the investment portfolio on financially leveraged retailer Action.
Sound liquidity resources to face the current economic downturn, and also in line with management's conservative guidance.	Illiquid nature of most assets in 3i's portfolio could prove difficult to realize in a market downturn.
Permanent capital structure not subject to redemption risk even in a stress scenario.	Sensitive valuation to market volatility.

While COVID-19 negatively affected the valuation of 3i's asset base, we expect it to recover gradually in 2021-2022. We incorporate into our base case our expectation that the group's asset valuations will gradually recover over 2021-2022. In our opinion, the quality and prospects of 3i's concentrated portfolio remain sound, despite the negative impact of the global health crisis on the valuation of some of its holdings. We consider that the group's ample cash position, this year's debt issuance, and the absence of bond maturities in coming quarters allows 3i to withstand the crisis quite well.

We expect 3i's medium-term performance to remain resilient with conservative financial leverage despite the current troubled economic conditions. 3i's conservative financial policy and sound liquidity will, in our view, be key to supporting the group's business strategy over the next two years. We believe that despite the concentration of the portfolio, key investments such as Action and 3iN will continue to drive the strong performance of 3i. Indeed, these investments' have performed well since the end of the full lockdown policy, despite the current economic conditions.

Outlook

The positive outlook points to our expectation that the group's asset valuations will gradually recover over the next two years, after having declined in the beginning of 2020, in line with many peers. We also anticipate that 3i will preserve its conservative financial leverage policy and maintain adequate liquidity, while concentration risks in the investment portfolio will not materially increase.

Downside scenario

We could revise the outlook to stable in the next 12 months if the quality and liquidity of 3i's concentrated investment portfolio deteriorated, on the back of an extended economic and market crisis, contrary to our base-case scenario. In particular, we would revise the outlook in case of further lockdowns in Europe related to the COVID-19 crisis. Although we view this scenario as remote, this would likely depress 3i's asset valuations, including that of its largest exposure, retailer Action, and would likely push the stressed leverage ratio below 3.5x. We could also revise the outlook to stable if 3i were to depart from its conservative leverage and liquidity policy, notably with respect to acquisitions and investments.

Upside scenario

We could raise the rating in the next 24 months if we observed a recovery in operational and financial performance in 2021. This would indicate that the more concentrated investment portfolio could withstand such economic downturns as we are currently experiencing. An upgrade would also depend on 3i keeping a conservative financial leverage policy and sound 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 group reported a total portfolio of approximatively £8.7 billion as of end-June, 2020. 3i 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 the U.S. and U.K. 3i has a bias toward Belgium, the Netherlands, France, Germany, the U.K., and North America, and the group's investment strategy has been steady since 2012. In addition to private equity, 3i 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 risk-adjusted leverage assessment is adequate given that 3i's robust metrics do not take into account the group's high concentration, underlying leverage, and illiquid nature of most of its assets (>80%).

Stressed leverage should remain robust and resilient while the adverse impact of COVID-19 on asset valuation steadily reverses. We continue to view 3i's stressed leverage as very strong, being consistently above 3.5x over the past two years. Although this ratio increased toward the threshold in the first quarter of financial year (FY) 2020, on the back of the £400 million issuance and the weaker asset values, we noted a steady recovery of most key asset values by the end of this quarter.

Indeed, COVID-19 adversely affected the valuation of 3i's assets in the last quarter of FY2020. Overall, the valuation of the portfolio decreased by £172 million year-on-year, while the investment portfolio stood at £8.1 billion on March 31, 2020. Since then, 3i's investment portfolio value recovered to reach £8.7 billion on June 30, 2020.

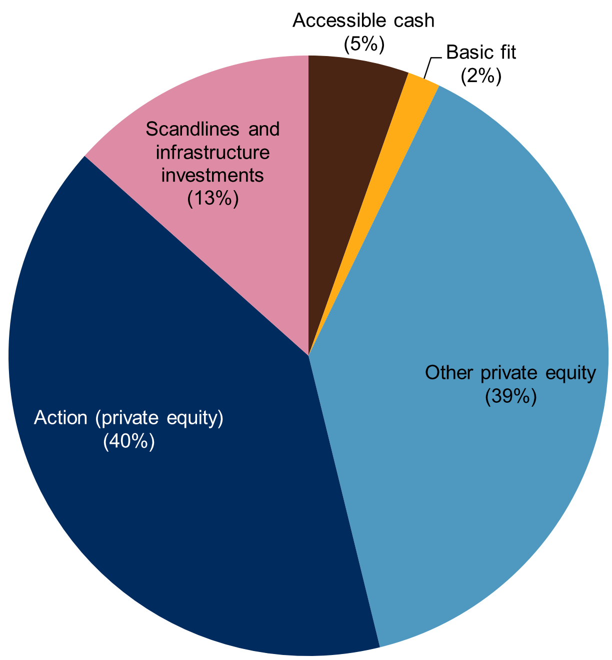
Provided that the economy recovers in 2021-2022, we believe that 3i's asset value will continue to gradually recover from the negative impact of COVID-19 over the next 12 to 18 months; and as such continue to support our very strong assessment for the stressed leverage.

The investment portfolio is fairly 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 the following assets in our stress scenario (based on end-June 2020 data reported by 3i):

- Around £500 million accessible cash;
- £163 million in listed equities, equivalent to the remaining share in Basic-Fit;
- £7.3 billion in unlisted equity (private equity); and
- Infrastructure investments and Scandlines (reported as a long-term corporate investment) amounting for about £1.2 billion.

Chart 1

Overview Of 3i's Assets As Of June 30, 2020



Source: S&P Global Ratings.

In addition we use the following total recourse liabilities:

- £200 million 6.875% notes due in 2023;
- £375 million 5.750% notes due in 2032; and
- £400 million 3.750% notes due in 2040.

When calculating our stressed leverage ratio, we apply a 50% haircut on listed stocks (Basic-Fit and 3i Infrastructure PLC listed as quoted investments) and a 60% haircut on unlisted stocks, which is commensurate with a 'BBB' stress scenario. For all other investments that we consider as having a higher risk by nature we apply a 75% haircut under our stress scenario. We only give credit to £500 million of cash, consistent with 3i's financial policy of a tolerance for £500 million net debt and an increase in gross debt following the latest issuance. This is lower than the cash on hand after the £400 million notes' issuance because we assume that 3i may in the medium term use part of its cash to support invested companies if they come under stress, for potential bolt-on acquisitions, and for new investments as opportunities arise in the current market conditions.

Risk position: Portfolio concentration could heavily weigh on 3i's business performance if economic conditions were to deteriorate further

Structural concentration risks in 3i's portfolio partly offset the quantitatively strong stressed leverage metric, in our view. In particular, its investment in European discount retailer, Action, represents a large 43% of the total portfolio as of end-June 2020. Nevertheless, this high-risk exposure continues to prove its resilience and drive 3i's strong performance through this uncertain environment. Indeed, although some of the stores were closed due to the lockdowns in March and April, like-for-like sales have completely recovered in core markets since full lockdown ended, demonstrating a rapid recovery from the disruption caused by the pandemic. Since mid-May 2020, all stores have reopened and are fully operational.

3i's strategy to deliver returns through earnings growth typically also involves most companies held being highly levered, and beside a few exceptions would have speculative grade ratings. For instance, we rate Action Dutch-based holding parent Peer Holding III B.V. at 'B+'. Moreover, 3i's portfolio being primarily focused on unlisted companies, 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 in their portfolio. Nevertheless, we regard positively the strategy implemented since 2012 that leads 3i to focus on well-known sectors and a reduced number of investments in its portfolio (32 as of end-June 2020).

Table 1

Top 10 Largest Exposures Represent 77% Of The Investment Portfolio As Of End-June 2020

	Valuation basis	Valuation March 2020 (Mil. £)	Valuation June 2020 (Mil. £)	Cumulative Value June 2020 (% of total portfolio)
Action	Earnings	3536	3733	43%
3iN	Quoted	665	786	52%
Scandlines	DCF	429	452	57%
Cirtec Medical	Earnings	302	349	61%
WP	Earnings	244	248	64%
Tato	Earnings	196	239	66%
Royal Sanders	Earnings	198	234	69%
Evernex	Earnings	217	231	72%
Hans Anders	Earnings	196	222	74%
Havea	Earnings	182	213	77%
Total		6165	6707	

Source: 3i's FY2021 Q1 press release.

Also, we believe that the negative impact of the pandemic on the portfolio valuation already reflects the risk of market volatility in uncertain times. Nevertheless, currency risks are subsisting and could create more volatility in 3i's accounts. The group's only significant foreign exchange hedge is a notional €500 million of its long-term investment, Scandlines. The unhedged portfolio, resulting mostly from assets denominated in Euro and US Dollars, negatively affects total return and Net Asset Value (NAV) when the British Sterling appreciates against other currencies.

Funding And Liquidity

We view 3i's funding and liquidity as adequate. Our view reflects the very strong funding profile of 3i underpinned by its stable permanent capital base, combined with the adequate liquidity profile supporting 3i's business strategy.

Funding: We consider 3i's permanent capital base and longstanding relationship with financial institutions as rating strengths. 3i benefits from its permanent capital structure as the group is not subject to redemption risk even in stress scenarios. Aside from its proprietary capital, 3i also bears £975 million of debt and a £400 million revolving credit facility that remains undrawn as of today. We believe 3i has a strong capital structure flexibility, given the balance-sheet low gearing and the fact that the group has, over the past three years, usually traded at premium to NAV, hence easing any possible equity raise.

3i's strategy is to use investment proceeds and available cash to reinvest in new assets, as 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 opportunities of investment arises or if 3i's level of cash reserves reach a low point. But we view this last scenario as remote. Furthermore, we believe that 3i's renowned franchise and its longstanding relationship with financial institutions that also act as advisors on deals, support its funding profile.

3i's liquidity could facilitate opportunistic investments in line with the group's strategy. We consider liquidity to be adequate, despite sound cash balances on June 30, 2020 and the extension of its revolving credit facility (£400 million maturing 2025). This is because we note that 3i will use £438 million for carried interest payables following the sale of the Eurofund V interest in Action, and because we believe that in current market conditions, opportunities to invest at a discounted value could arise and 3i could partake these opportunities. We also consider that cash could be provided to already-owned companies, to support their strategy in current economic conditions or any liquidity issue. Indeed, in the first quarter of FY2021, 3i did inject £17 million in Basic-Fit to provide expansion capital and also £20 million equity in Hans Anders to support the business. We estimate in any case that such deals will remain commensurate with 3i's capacity and would not jeopardize any upcoming debt repayment.

Our quantitative cash flow assessment estimates liquidity sources can cover liquidity uses by above 1.4x in a 'BBB' scenario in the next 12 months.

We expect liquidity sources over the next 12 months will be, post haircuts:

- About £500 million of available cash and cash equivalents;
- About £82 million of public equities;
- £400 million of the revolving credit facility maturing in 2025; and
- £50 million-£75 million of dividend income from 3iN investments.

In July 2020, 3i distributed £168 million of dividends. Therefore, we expect remaining liquidity uses over the next 12 months will be:

- About £160 million of operating expenses; and
- £350 million estimated use for opportunistic acquisitions and further supporting the investment portfolio.

When calculating the liquidity ratio, we assume that 3i will 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 a 50% for the sale of Basic-Fit, which is the only public listed stock in 3i's portfolio aside from 3iN.

We expect 3i's liquidity profile to remain adequate and supportive of the group's strategy in the next two years as our assessment accounts largely 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. 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.

Issue Ratings

We rate 3i's senior unsecured notes in line with the 'BBB' issuer credit rating. We count three lines that are pari-passu: the £200 million 6.875% notes, £375 million 5.750% notes, and the £400 million 3.75% notes maturing in 2023, 2032, and 2040, respectively. We do not notch up or down because debt is not subordinated or secured. There are also no covenants on any of the previously mentioned lines.

Ratings Score Snapshot

Table 2

RSS Table	Table
Issuer Credit Rating	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
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, 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

Ratings Detail (As Of September 15, 2020)*		
3i Group PLC		
Issuer Credit Rating		BBB/Positive/A-2
Senior Unsecured		BBB
Issuer Credit Ratings History		
25-Feb-2020	*Foreign Currency*	BBB/Positive/A-2
27-Mar-2012		BBB/Stable/A-2
24-Feb-2010		BBB+/Stable/A-2
25-Feb-2020	*Local Currency*	BBB/Positive/A-2
27-Mar-2012		BBB/Stable/A-2
24-Feb-2010		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.

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