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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
Strong track record in the European midmarket private equity market, maintaining resilient earnings in a challenging macroenvironment.	High concentration of the investment portfolio on financially leveraged retailer Action.
Strong leverage metrics supported by a relatively large asset base, compared with recourse liabilities.	Illiquid nature of most assets in 3i's portfolio, which could prove difficult to timely realize in a market downturn.
Permanent capital structure not subject to redemption risk even in a stress scenario.	Exposure to investment market volatility.

3i Group plc (3i)'s strong performance was dominated by a higher valuation of its largest holding, Action, and foreign exchange gains. S&P Global Ratings expects 3i's financial leverage to remain conservative, offsetting some of the rising concentration risk. Although Action represents a larger part of the portfolio, the higher portfolio size provides added cushion against a breach to S&P Global Ratings' stressed leverage threshold in the event of a worse-than-expected economic downturn. We estimate 3i's stressed leverage improved to 7.0x as of Sept. 30, 2022, and we expect it will remain comfortably above our 3.5x threshold over our rating horizon. Regarding 3i's invested companies, Action's leverage of about 2.0x, calculated as net debt to earnings, has continued to decline over the past 18 months. Action also acts to lower the leverage of the private equity investment portfolio, considering the leverage of the other invested companies is higher on average, but also declining to 4.1x as of Sept. 30, 2022. The overall portfolio leverage improved to 2.7x on the same date from 3.3x at fiscal year end March 31, 2022. The company reported that all multiples were within peer set ranges and that 20 out of 25 companies had valuation marks below the peer set average.

We view positively 3i's measures to improve liquidity and hedge future foreign exchange risks. 3i has increased its revolving credit facility (RCF) to £900 million as of September 30, 2022, from £500 million, which should enable it to continue to invest in new or existing companies, as realizations slow or become more uncertain. This also provides the company with additional financial flexibility at low cost in the event that 3i could not exit assets in time when fixed costs or debt repayments are due. 3i mainly hedged its foreign currency with respect to its Scandlines exposure (£554 million) but post Sept. 30, 2022, 3i implemented a medium-term foreign exchange hedging program to partially reduce the sensitivity of the group's future returns to euro and U.S. dollar exchange rate movements as part of its overall capital management approach.

Although we see some softening, we expect the group's investment returns and strong liquidity to support its operating performance. Although we do not make equity market forecasts, we believe that management has the ability to manage 3i's investment portfolio in a stressed environment--by delaying exits and holding investments for longer and carrying out full or partial realizations where possible. Management acknowledged the slowdown in business activity and some weakness in the consumer discretionary sector. Although Action is a discount retailer in the consumer discretionary sector, it reported global store expansions, 15.7% like-for-like sales growth, and greater footfall traffic across all countries in the first nine months of this year. We continue to expect Action to be a large contributing factor to 3i's gross investment returns.

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 performances.

Downside scenario

We could lower the ratings if 3i weakens its commitment to its conservative leverage and liquidity policy or if the investment portfolio's quality or performance deteriorates meaningfully.

Upside scenario

We see limited upside at this stage, given 3i's heavily concentrated investment portfolio, the illiquid nature of its investments, and its adequate liquidity position.

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 £16.4 billion as of end-September 2022, which is of limited size compared with the overall alternative investment market but has been performing well over the past 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 companies operating in the consumer, industrial, 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 30% of 3iN, amounting to £817 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

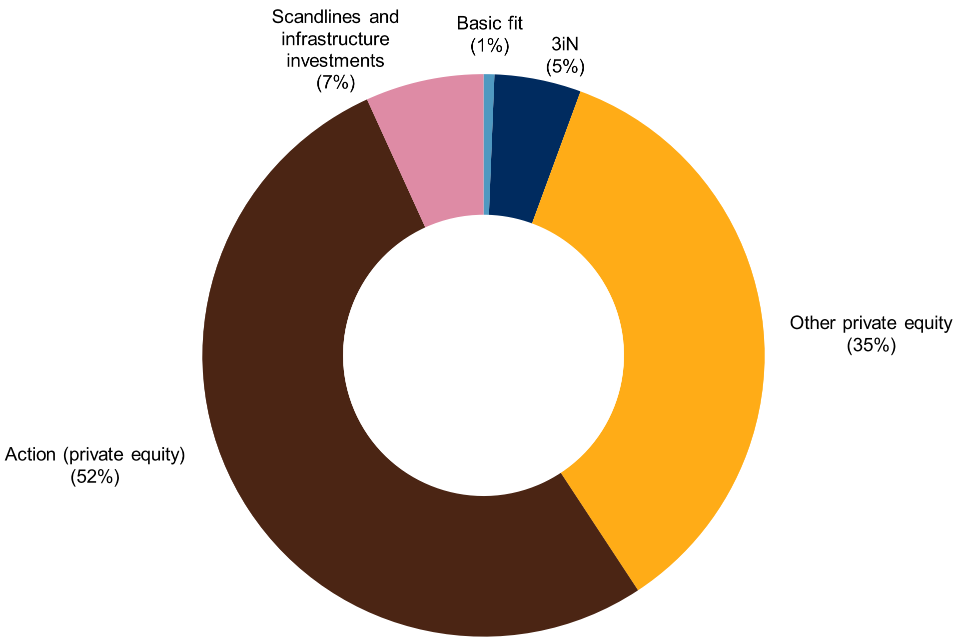
Our risk-adjusted leverage assessment is adequate, given that 3i's robust metrics do not take into account the company's high concentration, underlying leverage, and illiquid nature of more than 80% of its assets. To determine our risk-adjusted leverage, we first assess the portfolio's stressed leverage and modify this assessment by our view of the portfolio's risk position relative to that assessment.

Stressed leverage: 3i's stressed leverage sits at comfortable levels, considering the challenging environment ahead

We continue to view 3i's stressed leverage assessment as very strong--our highest assessment--as it has consistently been above our 3.5x threshold over the past two years. We calculate the group's stressed leverage by applying different haircuts on its assets to reflect typical market movements in a 'BBB' or moderate 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 in a 'BBB' stress scenario, and the total stressed assets adequately covered 3i's recourse liabilities. As of September 2022, this ratio increased to 7.0x compared with 6.2x in March 2022, on the back of stronger asset values. We believe that there is enough liquidity to absorb any potential asset value declines in a market downturn.

Chart 1

Overview Of 3i's Assets As Of Sept. 30, 2022



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

We use the following assets in our stressed scenario (based on 3i's end-September 2022 reported data):

- Cash and cash equivalents of £212 million;
- Public equity of £920 million comprised of the quoted investment Basic-Fit (£103 million) and 3iN (£817 million);
- Private equity of £15,497 million i.e., all other investments including Scandlines and infrastructure and excluding Basic-Fit and 3iN; and

- Other (high-risk assets): Nil.

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 listed as a quoted investment) and a 60% haircut on unlisted stocks, which is commensurate with a 'BBB' stress scenario. The stressed leverage as of Sept. 30, 2022, improved to 7.0x on the back of a higher portfolio valuation. This would mean the portfolio would have to fall by 50% or incur £8 billion in losses before it breaches the "strong" threshold of 3.5x.

Risk position: Remains weak from 3i's highly concentrated portfolio and illiquid assets but foreign currency risk has lessened

The group's portfolio consists of only 41 names (an increase of nine versus Sept. 30, 2020) and is highly concentrated. In particular, its investment in European discount retailer Action represented 52.5% of the total portfolio as of end-September 2022. (Action is not rated, but we upgraded its parent Peer Holding III B.V. in April 2022 to BB-/Stable/--, on strong earnings.) Over the past few years, the portfolio size has increased in tandem with the growth of Action's performance. In the 12 months ended Oct. 2, 2022, Action generated strong sales, earnings growth, and cash, driving the unrealized value growth of £1,156 million. At March 31, 2022, Action had also paid a £284 million dividend that boosted 3i's operating profit to £340 million. Viewed differently, Action also adds to the portfolio's market volatility as 3i's portfolio valuation is increasingly more sensitive to Action's performance. Under our risk position assessment, we take into account 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, have speculative-grade ratings. Moreover, as 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 equity in their portfolio. Nevertheless, we regard positively the strategy implemented since 2012 that led 3i to focus on well-known sectors and to have a limited number of investments.

Table 1

Top 10 Largest Exposures Represent 79.2% Of The Investment Portfolio As Of End-September 2022

	Valuation basis	Valuation Sept. 2022 (Mil. £)	Share of total portfolio (%)
Action	Earnings	8,612	52.5
3iN	Quoted	817	5.0
Cirtec Medical	Earnings	613	3.7
Scandlines	DCF	554	3.4
Havea	Imminent sale	478	2.9
Tato	Earnings	437	2.7
Sanisure	Earnings	422	2.6
nexeye	Earnings	401	2.4

Table 1

Top 10 Largest Exposures Represent 79.2% Of The Investment Portfolio As Of End-September 2022 (cont.)

	Valuation basis	Valuation Sept. 2022 (Mil. £)	Share of total portfolio (%)
Luqom	Earnings	341	2.1
Royal Sanders	Earnings	322	2.0
Top 10 Total		12,997	79.2

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

Historically, with unhedged exposures in the U.K., currency risks also created volatility in 3i's accounts as shown in the first half of this year 2022. The company's only foreign exchange hedge was a notional €500 million of its long-term investment Scandlines. As of Sept. 30, 2022, 88% of the group's assets were denominated in euro (71%) or U.S. dollars (17%), and the group recorded a foreign exchange gain of £711 million net of derivatives during the first half of fiscal 2023 compared with £98 million in the first half of fiscal 2022. From Sept. 30, 2022, 3i implemented a medium-term foreign exchange hedging program to partially reduce the sensitivity of the group's future returns to euro and U.S. dollar exchange rate movements as part of its overall capital management approach.

The volume of buyout transactions across the market has slowed considerably compared with 2021 and 3i is maintaining its discipline when assessing new and bolt-on investments. Strong earnings growth and cash generation from some of its portfolio companies operating in the value-for-money consumer, healthcare, specialty industrials, and business and technology service sectors more than offset softer performance from companies in the discretionary retail sector, which are experiencing challenging consumer headwinds.

Funding And Liquidity: Adequate

Funding: We consider 3i's permanent capital base as a key strength.

The group benefits from its permanent capital structure as it is not subject to redemption risk even in stress scenarios. Aside from its proprietary capital, 3i also bears £975 million of long-dated debt and a £900 million RCF that remains undrawn as of today. We believe that 3i has a strong capital structure flexibility given the low balance-sheet gearing.

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 investment opportunities arise or if 3i's level of cash reserves reaches 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.

Liquidity: 3i has cautiously increased liquidity and we view liquidity as adequate

3i's liquidity could facilitate opportunistic investments in line with the group's strategy. In the first half of fiscal 2023, 3i has added £400 million to its £500 million RCF. Realizations were slower but we understand 3i will always have an exit plan before it makes an investment. When the timing of sales is delayed, it continues to focus on maximizing value.

We project liquidity sources would exceed liquidity uses by about 1.4x in a 'BBB' stress scenario, pointing to an adequate liquidity cash flow assessment.

Liquidity sources include:

- Cash balances of £212 million;
- RCF of £900 million maturing in 2027;
- £51.5 million of listed stocks (only Basic-Fit) after applying a 50% haircut; and
- Other sources mainly dividend and realizations of £350 million.

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

- £200 million of debt repayment;
- £400 million of dividends;
- £188 million of operating expenses; and
- £300 million-£500 million estimated use 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 for 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 use the minimum cash position over the last two years (£212 million as of March 2022). We also apply the appropriate haircuts to assets in a 'BBB' scenario, including 50% for the sale of Basic-Fit, which is the only public listed stock in 3i's portfolio aside from 3iN.

Its next debt repayment of £200 million is due in 2023 and we believe 3i has sufficient liquidity sources to repay it, notably the proceeds from the sale of its investment in Havea of £476 million in October 2022. 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. Furthermore, 3i is subject to regulatory requirements under the European Alternative Investment Fund Managers Directive. The group 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.

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 investments returns, operating cash profit and gearing. We see some softening in market conditions. Realizations are lower but recurring. 3i has made a number of bolt-on investments and continues its buy-and-build approach. Management has also demonstrated a history of not incurring unexpected declines in earnings or cash flow emerging from operational risks.

Risk management: 3i's risk management processes are 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. For example, at the height of the market, 3i did not overly invest in technology names whose valuations were suffering in the higher interest rate environment. It has greater exposure to infrastructure and healthcare sectors which should provide some protection against inflation. Consistency of the team and very low turnover are qualities that underpin the management.

Transparency and complexity: 3i has a focused strategy with comprehensive reporting

As 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: The rating on 3i is 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 sized private equity firm, as peers. Compared with 3i, Mercantile Investment Trust is less concentrated and operates with lower leverage, justifying the rating difference. Pershing Square's debt level is twice as high as 3i's, but is counterbalanced by its stronger liquidity assessment. Pershing also expanded the use of derivatives and could do so again in a stress scenario, while 3i's strategy of investing in known industries and focusing on reducing the number of investments is less risky. We believe that our 'BBB+' rating on 3i is well placed among peers and thus, do not include any adjustments.

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 3.750% notes maturing in 2023, 2032, and 2040, respectively. We do not notch down because the debt is not subordinated or secured. There are also no covenants on any of the previously mentioned lines.

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
- 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

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

Ratings Detail (As Of December 16, 2022)*	
3i Group PLC	
Issuer Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+

Ratings Detail (As Of December 16, 2022)*(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/Negative/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.