

Alpha shares analysis

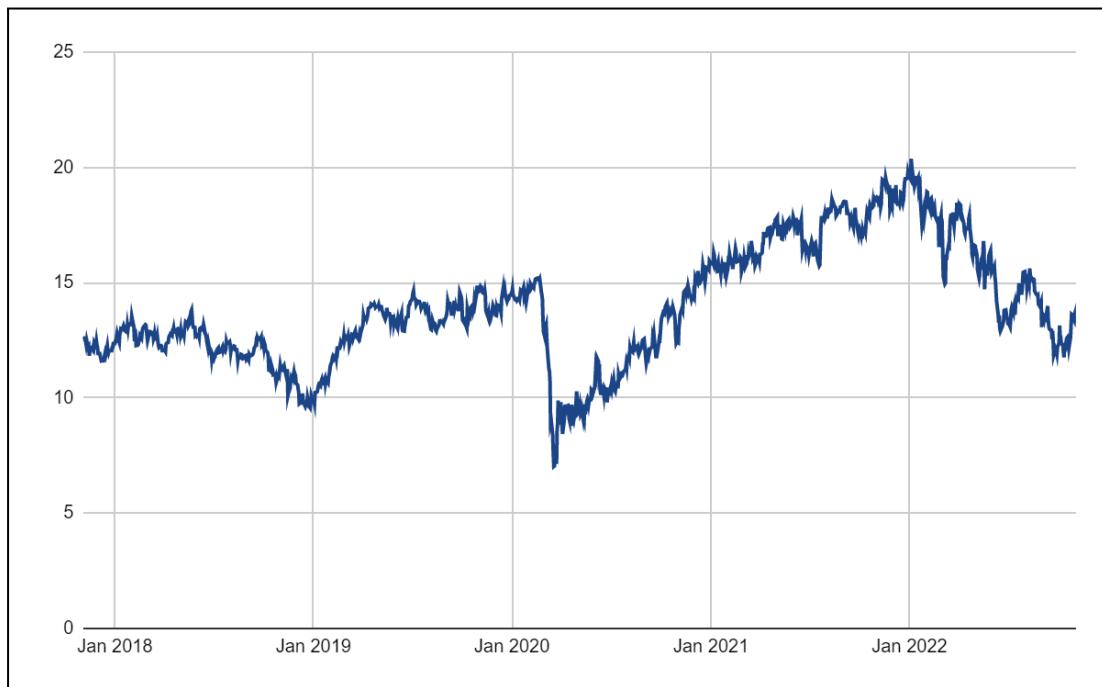
10 November 2022

Cash-generative holdings support 3i's dividend

At investment trust 3i, the ability to support its dividend payment looks healthier than a bias towards a much quieter private equity sector might suggest. The ability to make exits from investments and recycle capital has turned down, but strong cash flow underpins the dividend.

Analyst: Robin Hardy

3i – lights, camera, ACTION!



Source: FactSet

3i is a FTSE100 listed investment trust (a listed, closed end fund that invests in other businesses in whole or in part) with a long history. It was founded at the end of World War II as the Industrial and Commercial Finance Corporation (ICFC), by the Bank of England and other large banks, to help fund aspiring small to medium-sized enterprises (SMEs). Re-named Investors in Industry (thus 3i) it was floated on the London Stock Exchange (LSE) in 1994. Its main line of business is Private Equity or PE (the provision of

equity capital for unlisted companies and/or the means of taking listed companies into private hands), but there is also substantial investment in infrastructure (both in funds and projects directly).

It has a market capitalisation of almost £12bn and, unlike a trading business, its valuation is driven by the net asset value (NAV) of its investments. The significant volatility in revenues and profits is largely driven by the timing and scale of the disposal of investments, which is an inconsistent process. The last reported NAV per share was 1,321p and that stands against the share price of 1,221p so there is a small discount: investment trusts often trade at a discount reflecting both straight forward supply and demand imbalances for the listed stock by investors and the market's tacit view on the likely direction of the NAV.

There is a total of £14bn of capital deployed across all investments and a total of £23bn of assets are under management (AUM), the difference being between the two being: 1) unrealised profits with the private equity investments, and 2) third party assets in infrastructure that are managed alongside the trust's own capital.

Despite holding a large portfolio, the operations of the group are very lean with just 236 employees and an annual cost ratio of just 0.1 per cent of the AUM.

The private equity market

There are two distinct types of PE investment: 1) core, permanent capital for small businesses not traded on a public exchange: this is typically preferable to debt-funded businesses post the global financial crisis (GFC) and especially in today's climate, and; 2) funds used to buy out listed companies where the PE business believes the company is under-valued, can be 'asset stripped' to unlock value or can offer a high 'marriage value' through combination to or connection with other investments held in the PE portfolio.

In the first half of 2022, private equity transactions were 40 per cent higher than in the prior year as funds continued to flow in the PE investment firms and the technology and other growth stocks shake out from Q3 of 2021 left many valuations at multi-year lows. That does not, however, automatically mean a big pick up in valuations of investors' NAVs because the lowered valuations since the end of 2021 reflect a fundamental shift in perceived value rather than cheap valuations driven by an unjustified sell-off.

However, many PE houses are likely already to have been sizing up potential targets, so to find that the purchase price tumbled to between one third and a half of their 2021 peak levels made pursuing the investments irresistible. The selling through of investments, in contrast, slowed dramatically as the initial public offering (IPO) market seized up, making

it very difficult for PE investors to recycle capital, and having to rely more heavily on new inflows.

Infrastructure schemes typically showed great resilience during the coronavirus pandemic (transport excepted) and the outlook still feels rosy. Public sector budgets are tighter than ever while service requirements (especially in health) accelerate and the energy transition can only accelerate through this decade as 2030 deadlines for lowered carbon loom ever closer.

Public bodies are likely to increase outsourcing, although higher interest rates and inflation will inevitably become a drag. Schemes will become materially more expensive, many potentially unaffordable, so the future looks like something of a balancing act. If we do see a prolonged and relatively deep recession, a lack of tax receipts will likely lower public sector spending but outsourcing should still be expected to grow and there is always the lure of some major Keynesian spending to kick start economies in later years.

3i's operations

There are two divisions within 3i, with by far the largest being private equity.

Private Equity – this is a traditional PE investment operation providing equity capital to unlisted businesses which are then managed for (typically accelerated or 'sweated') growth before being sold on either to trade buyers, public markets via IPO or to other PE investors. PE investors demand a lot from the businesses in which they invest, typically demanding an Internal Rate of Return (IRR) of above 20 per cent. They will always look to exceed the returns being made by comparable listed companies or the returns the business made when it was, itself, listed. Often this involves the injection of higher levels of debt. Typically PEs will remain invested for a target period of no more than five years before looking to recycle the capital.

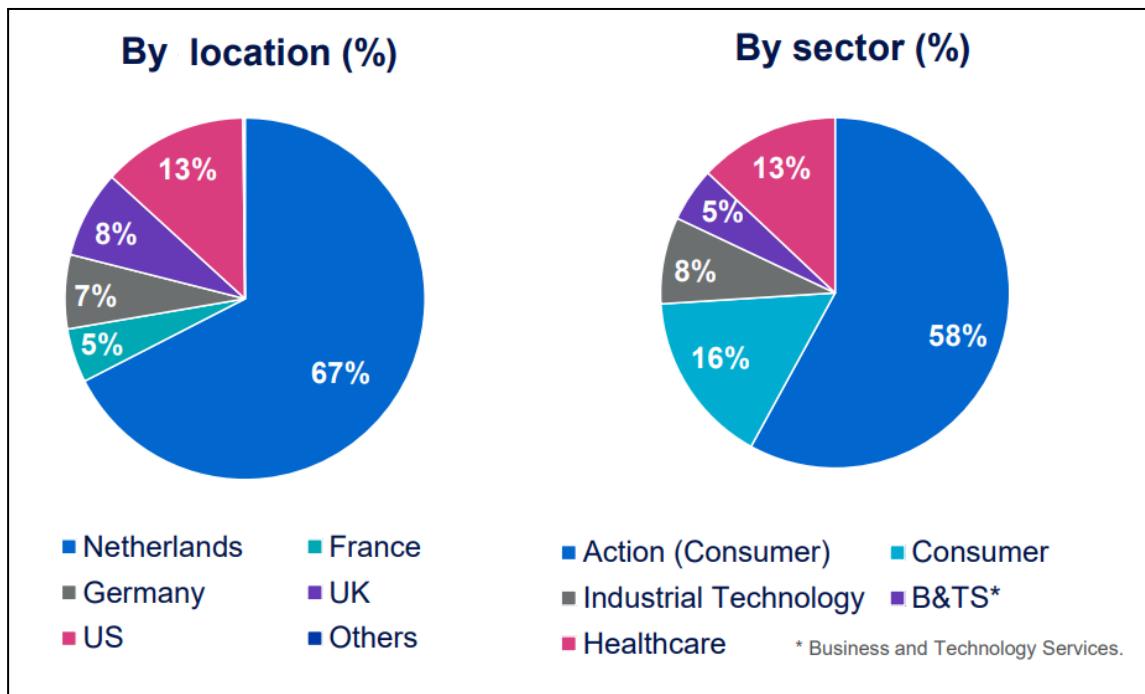
The group's portfolio is very top heavy with one asset accounting for over 50 per cent of the NAV. The company in question is Action, the Benelux-based Europe-wide non-food discount retailer (sometimes called value stores). Action sells low budget, non-food and some food products with long shelf lives. The product range is highly flexible with only 35 per cent of products consistently stocked and the remainder being 'buy while available' ranges sourced opportunistically. It is most comparable to B&M/Home Bargains in the UK or Dollar General in the USA. It operates over 1,700 outlets and generates more

than €5.5bn of revenue; 2022 delivered €932mn of Ebitda (earnings before interest, tax, depreciation and amortisation) and the company paid out €669mn in dividends.

The growth record is impressive, with Covid barely making a mark on trading in 2020 or in 2021 when sales grew 23 per cent and Ebitda 36 per cent. Some of 2021's growth was rebounding, but the 10-year CAGR (compound annual growth rate) for sales is 25 per cent, for Ebitda it's 26 per cent and store numbers 22 per cent.

Action has been held for much longer than is normal for a PE investment, with 3i first buying (for €130mn) in 2011. No other holding in the portfolio accounts for more than 4 per cent of the total NAV, with the balance of the top five investments – Cirteq Medical (complex medical devices such as pacemakers), Luqom (lighting products), Tato (specialist chemicals) and Q Holdings (medical and industrial precision mouldings) accounting for 13 per cent in aggregate.

3i's private equity portfolio



Source: 3i

Infrastructure – financial involvement in large-scale infrastructure schemes has long been a popular area of investment as the income returns are typically highly dependable and offer decent, steady if unspectacular growth. They are popular too with operators (typically public bodies, local government or national

government) as external capital eliminates the need to fund heavy capital investments, instead buying in use of the assets as a revenue or operating expense item. This division comes into two parts: directly owned and managed; managed third party assets. Most of the assets in both camps fall within the following sectors:

- Utilities, transport and logistics
- Communications
- Natural resources and energy
- Social infrastructure (health provision, education, community, play, youth, recreation, sports, faith, and emergency services)
- Healthcare

Investment can be either fully or partly outsourced by the operator and in exchange 3i's various investment vehicles grant operating contracts to their partners – typically for very long periods (often 25 years or more).

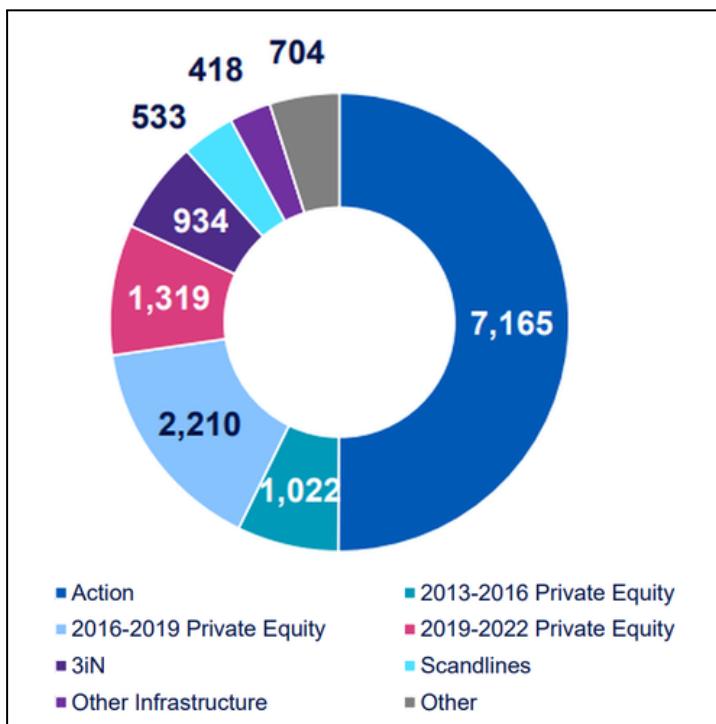
The largest element here is 3i Infrastructure plc or 3iN which is listed on the LSE, allowing 3i investors good visibility into the fund's valuation and a high level of disclosure. The plc owns 30 per cent of 3iN, which has a market capitalisation of £2.9bn.

The remainder of the portfolio is split between three funds that own and/or operate around 120 assets with an aggregate value of around £2.5bn. Assets include: East Belfast Airport, East Surrey Pipeline ('last mile' gas), SmartCarte (airport trolleys), Infinis (UK's largest landfill-gas-fired electricity generator) and TCR (Europe's largest independent airport ground support equipment provider).

Scandlines – There is also a substantial, remnant investment (£533mn) in the Danish/Germany ferry operator Scandlines which was sold off in 2018, but where 3i retained a 35 per cent, sleeping minority investment. This business did suffer during the Covid pandemic with routes closed but it is now back in full operation and once again paying healthy dividends. There is a long-term threat to this business in the form of a proposed fixed link development – the 18km Fehmarn Belt fixed link crossing (an immersed tunnel – a sunken concrete tube rather than a bored tunnel), which would hit demand for a ferry.

Continued below

3i's total portfolio in £mn – March 2022



Source: 3i

Valuation and conclusions

3i is trading on a discount to its net book value, with the share price around 8 per cent below historic book value. This is not unusual for investment trusts, especially when the economic climate starts getting tougher but 3i is trading at one of its lowest price-to-book valuations seen in the last 20 years. That might be fine if the private equity investment portfolio was crammed with over-ripe technology valuations or there was a pressing need to IPO a range of investments to be able to recycle capital to be ready for the foot of the next economic cycle. However, neither is the case.

A lopsided PE portfolio might be a problem for some investors as it, nominally, raises the risk profile and after a hefty re-valuation of the holding in Action in 2022, that skew is greater than ever. This should not really be a problem, however, for a number of reasons:

1. Action is already growing very rapidly.
2. Discount retailers should be winners in a tougher economic climate.
3. Action can be seen as an excellent proxy for the inaccessible Aldi or Lidl, adding an additional attraction to buying 3i.

4. There is neither pressure nor apparent desire to trade out of Action despite holding it for almost 12 years.
5. The returns from holding Action are impressive – initial investment €130mn in 2011, a £501mn valuation by 2014 and by 31 March 2022, £7.2bn.
6. The dividends from Action (on 3i's 52.7 per cent stake) totalled €353mn last year, almost three times the initial capital investment only a little over a decade ago.
7. The discount on the 3i plc shares' NAV is similar to that of other major investment trusts such as Herald, Witan or Scottish Mortgage. However, these other investment companies are loaded with materially more high ratio valuation sector exposures, especially technology.

Focussing on dividends, it is understandable that for a majority private equity trust, there may be concerns about available cash flow. Cash flow from PE houses often relies heavily on exiting matured investment and the IPO market is in hibernation, with fewer companies floating shares on public markets. Most PE investments are running very hard for growth, re-investing free cash flow and labouring under often heavy debt burdens that risk becoming materially more onerous as interest rates rise: they might normally be expected to be absorbing cash rather than throwing it off, as we have with Action.

Taking the consensus 52p dividend for the year to March 2023, the cost of the dividend for 3i is a little over £500mn. The dividends from Action alone would almost cover this and there is cash from other sources flowing in:

- Fees payable on the Infrastructure assets under management and direct income from Infrastructure operating assets of £91mn.
- £27mn dividend from the listed 3iN stake.
- £13mn from the remnant investment in Danish/German ferry company Scandlines.
- Cash from realisations of c.£550mn with realised profits at £25mn, although this might be hard to match into 2023.

So, there is plenty of capacity to continue the long-run record of a strong dividend – the payment has not increased every year (flat in 2008 and 2015), but has not declined in a decade and has a CAGR of 19 per cent in the last 10 years.

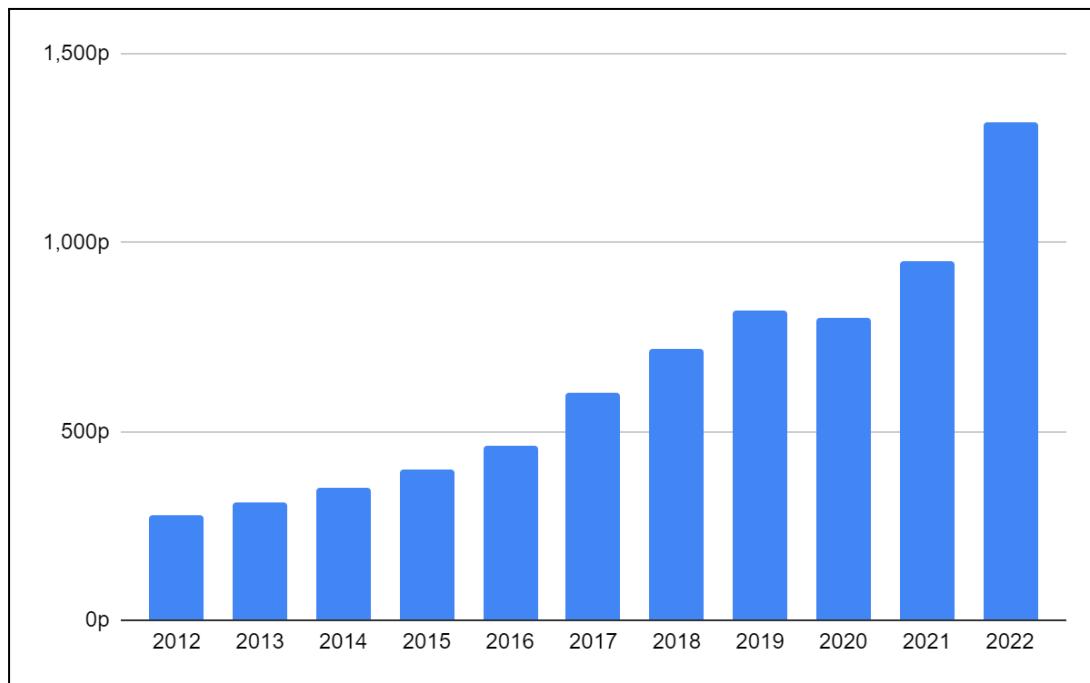
What if Action was to be sold or IPO'd? The strong cash flow would stop but 3i would receive, perhaps £8bn which is more than enough to assure healthy returns for shareholders in some form: either a share of the spoils, cash dividends paid from the receipts or cash return from new investments (which would only need to return 3.5 per

cent). Overall, one has to conclude that the dividend is not only safe at today's levels, but can be expected to sustain a healthy rate of growth.

In contrast, however, NAV growth is likely to become more difficult in the next couple of years, largely because of rising interest rates used in the normal valuation method of discounted cash flow (DCF). Even assured income levels from long-term contracts in infrastructure risk being accorded a lower future value on this basis.

Clearly a big swing factor is Action, but this investment should remain healthy. There is already strong trading momentum even before considering the likely migration effect from other retailers to this discounter as household budgets come under pressure. In 2022, the revaluation of Action was substantial at £2.6bn or 268p per share and other valuation reassessments added another 130p to the NAV leading to a 39 per cent overall rise. Can this continue?

3i's growth in NAV per share



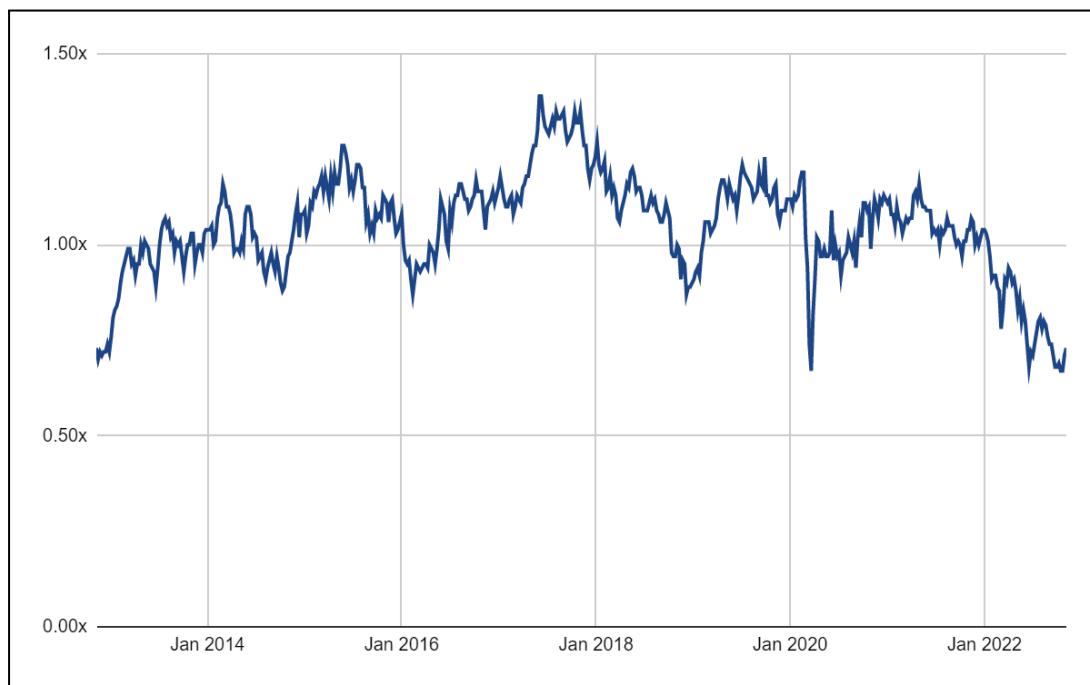
Source: 3i

Action's increased book value last year was purely due to better than expected trading and not to any change in the valuation basis. While the strong performance is likely to continue, the basis of valuation is less likely to be stable into 2023 and more likely to worsen as sector valuations and the discount rate rise. Overall, however, there does still seem to be scope for Action's value to grow but at a far lower rate than in the last financial year.

As a minor positive, currency is likely to flatter sterling valuations of overseas assets by a few per cent, but it is hard to see valuations growing so fast this year: the second, third and fourth largest investments last year grew by 93 per cent and it is difficult to see that being repeated. That said, analysts' consensus (albeit there are only three NAV estimates listed on FactSet) suggests another 18 per cent rise this year (to March 2023), then 13 per cent, then 12 per cent and 10 per cent growth into March 2026. That suggests that the NAV will have doubled again in the five years from 2021 to 2026: that is a CAGR of 14.8 per cent.

While the 10-year CAGR for the NAV is 17 per cent, that is skewed by the growth in 2022. In the nine years to 2021, the CAGR was a still strong, but lower at 14.5 per cent. To be able to match that in the next couple of years seems a big ask – NAV is likely to grow, but probably less than consensus currently predicts. Nonetheless, with a larger than normal (for 3i) NAV discount and with asset value growth still likely to be in high single digits, fair value for the stock does feel closer to 1,400-1,450p than today's 1,235p.

3i's historic price to historic NAV ratio



Source: FactSet

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