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Business

Ignore Carillion's collapse – 3i Infrastructure is a risk worth taking right now

Questor
Stock Picks

The 3i Group subsidiary's dividend is up and has assets likely to appreciate further, writes *James Ashton*

EVEN after last week's market sell-off, one stock that has performed strongly since being tipped in this column is 3i Group. The private-equity investor did not look cheap in April last year and some of the premium has since come off the shares but the value of the portfolio has risen sharply. Much of the excitement centres on Dutch discount retailer Action, which 3i is expanding rapidly across the continent. It contributes more than 30pc of the value of 3i's portfolio and chief executive Simon Borrows is unlikely to realise the asset until his team has worked out just how far the format can go. I don't mind waiting because I followed my own advice and bought the shares.

What is less well understood than the £9bn mother ship is 3i Infrastructure, a subsidiary with its own listing that is managed and 34pc-owned by 3i Group. Its portfolio is set up to be less risky than its parent and deliver stronger returns.

3i Infrastructure
Buy
Strong balance sheet with strength for further investment; Dividend up 10pc

The idea that infrastructure is a steady investment class has been tested by the collapse of Carillion and Labour Party threats to overhaul public-private partnerships should it form the next government. The care home industry in particular offers a warning of what can happen when state funding tightens considerably. But the £1.4bn takeover last month of the John Laing Infrastructure Fund shows that investors still see value to be had. The offer for the mainly UK-based portfolio of schools, roads, trains and street-lighting projects was priced at a 20pc premium to the latest published net asset value.

3i Infrastructure is highly unlikely to succumb to a takeover because of 3i Group's blocking stake. But some of its assets appear primed to appreciate further. Cross London Trains (XLT) has already increased in value by 32pc in the last financial year. The company, one-third owned by 3i Infrastructure, was set up to buy and lease the rolling stock used on the Thameslink passenger franchise that runs north and south through London. After an initial 20-year period, XLT will retain ownership and be free to lease them elsewhere.

All 115 trains in the fleet are now in service. Because the risk has fallen, the group is hinting heavily that it can reduce the discount rate – the tool which assesses present and future costs – on this asset further. We will find out how much XLT can be written up by in interim figures due on Nov 8. 3i Infrastructure has form, recording a 40pc internal rate of return when it disposed of Eversholt Rail, another rolling stock company.

Another notable investment is Wireless Infrastructure Group, which runs over 2,000 UK mobile phone towers independently of the mobile operators. Splitting off such infrastructure is a growing trend, particularly for debt-laden groups such as Vodafone, which recently raised the prospect of a disposal. Wig also plans to invest in more fibre and masts to boost urban coverage. 3i Infrastructure upped its stake to 93pc last December when it bought out co-investor Barings. Now Wig is vying to build and operate a wireless network for Transport for London so commuters can finally have seamless coverage on their way to work.

3i Infrastructure has sufficient balance sheet strength to make another sizeable investment soon. Following some significant activity, analysts at Canaccord Genuity estimate that two thirds of its portfolio is less than three years old. That might impact short-term returns, they point out. It has enjoyed a strong period, delivering annualised net asset value and total shareholder returns of 17.7pc and 18.4pc respectively, against targeted returns of 8-10pc. Exits have included Anglian Water and Elenia, a Finnish power distributor.

With a market value of £2bn, the shares are flat on this time last year after enduring some volatility. They trade at a 12pc premium to 218.3p, the net asset value estimated by JP Morgan Cazenove for the half-year stage, which rises to 223.2p at the end of the current financial year. In addition, the targeted dividend has been raised 10pc to 8.65p and should grow progressively from there. Like 3i Group, the stock is not cheap, but the recent refashioning of the portfolio and a reputation for marking valuations conservatively suggests there is an upside to come. Buy.

Key numbers

- **Market value: £2bn**
- **Turnover:**
- **Pre-tax profits:**
- **Yield: 3.5pc**
- **Most recent year's dividend: 7.85p**