NEW ZEALAND EQUITY RESEARCH | INSURANCE | GENERAL INSURANCE
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Tower
FY21 Simplifying the Story

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Tower (TWR) released its FY21 result which showed the impact of a challenging period of weather and COVID impacted claims. The company reported underlying FY21 NPAT of NZ$20.8m, at the upper end of management's recent NZ$19m to NZ$21m guidance range and marginally ahead of our NZ$20.3m. The Board declared a 2H21 dividend of NZ2.5cps, slightly above our estimate of NZ2cps, and announced a NZ$30.4m share buyback reflecting TWR's excess capital. Management guided to underlying FY22 NPAT in the range of NZ$21m to $NZ25m, using conservative assumptions. This aligns with our views.

NZX Code	TWR
Share price	NZ$0.70
Spot Valuation	NZ$0.86 (from 0.85)
Risk rating	Medium
Issued shares	421.6m
Market cap	NZ$295m
Avg daily turnover	418.3k (NZ$306k)

Financials: Sep/	21A	22E	23E	24E
NPAT* (NZ$m)	18.7	22.4	27.7	31.3
EPS* (NZc)	4.4	5.3	6.6	7.4
EPS growth* (%)	55.4	20.0	23.3	13.0
DPS (NZc)	5.0	5.0	5.3	5.5
Imputation (%)	0	0	85	100

*Based on normalised profits

Valuation (x)	21A	22E	23E	24E
PE	15.8	13.2	10.7	9.4
EV/EBIT	n/a	n/a	n/a	n/a
EV/EBITDA	n/a	n/a	n/a	n/a
Price / NTA	1.3	1.3	1.3	1.3
Cash div yld (%)	7.1	7.1	7.5	7.9
Gross div yld (%)	7.1	7.1	10.0	10.9

What's changed?

- **Earnings**: We have made minor revisions to our revenue and underlying NPAT forecasts for FY22, FY23 and beyond. Underlying revenue and NPAT for FY22 have been raised +1.5% and +5.0%, respectively.
- **Dividend**: FY22 dividend forecast to be NZ5cps for the year, up from NZ4.5cps previously.
- **Valuation**: Spot valuation increased 1c to NZ$0.86.

Changes to forecasts relatively minor

We have made minor changes to our underlying NPAT forecasts for FY22 and FY23 following a stronger 2H21 Gross Written Premium (GWP) revenue trajectory. We now expect an underlying NPAT of NZ$23.5m in FY22 and NZ$28.7m in FY23. A more nimble TWR has shown moderate growth in GWP as it leverages its new digital platform to drive the Direct business and write additional Partnership deals. We remain comfortable in our longer-term growth prospects and GWP.

Capital return and dividends

Given the company's financial strength, the Board declared a final dividend of NZ2.5cps making NZ5cps in dividends for the full year. This is at the upper end of the range of its stated policy of 60% to 80% of cash NPAT. As anticipated, TWR's Board announced a significant NZ$30.4m return of excess capital. This was at the upper end of our NZ$15m to NZ$30m range of potential outcomes. This tax-efficient return of capital will be undertaken through a compulsory share buyback in March 2022 if shareholder approval and High Court orders are granted. The buyback will take place via a 1:10 compulsory repurchase at NZ$0.72 with a record date of 4 March 2022 and a payment date of 18 March 2022. Looking ahead, both the interim and final 2022 dividends will remain unimputed, while the FY23 dividend will likely be partially imputed. Our FY22 dividend estimate is NZ5cps pre capital return.

Valuation support

Our blended methodology (using price-to-NTA, price-to-book and DCF) valuation rises NZ1c to NZ$0.86. TWR trades at a discount to its key listed peers. Our valuation assumes some of this discount relative to peers closes; however, a discount remains due to TWR's relatively lower ROE. Improved investor sentiment is likely to transpire as management progresses with crucial growth drivers, finishes repricing customer risks , and completion of its IT system transition. Annualised dividends of NZ5cps appear a sustainable floor longer-term, producing a gross yield of ~7.1% (given the lack of imputation credits).

Market data (NZ$)	
Priced as at 24 Nov 2021	**0.70**
52 week high / low	0.89 / 0.57
Market capitalisation (NZ$m)	295.2

Spot valuation (NZ$)	0.86
1. PE relative	0.80
2. P/Book relative	0.86
3. DCF	1.00

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	1.15
WACC	10.1%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	429
(Net debt)/cash	4
Less: Capitalised operating leases	n/a
Value of equity	424

Profit and Loss Account (NZ$m)	2020A	2021A	2022E	2023E	2024E
Sales revenue	372.6	395.5	422.0	452.1	481.3
Normalised EBITDA	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Depreciation and amortisation	n/a	n/a	n/a	n/a	n/a
Normalised EBIT	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Net interest	n/a	n/a	n/a	n/a	n/a
Associate income	0	0	0	0	0
Tax	n/a	n/a	n/a	n/a	n/a
Minority interests	0.4	0.6	0.3	0	0
Normalised NPAT	**11.9**	**18.7**	**22.4**	**27.7**	**31.3**
Abnormals/other	0	0	0	0	0
Reported NPAT	**11.9**	**18.7**	**22.4**	**27.7**	**31.3**
Normalised EPS (cps)	2.9	4.4	5.3	6.6	7.4
DPS (cps)	0	5.0	5.0	5.3	5.5

Valuation Ratios	2020A	2021A	2022E	2023E	2024E
EV/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a
PE (x)	24.6	15.8	13.2	10.7	9.4
Price/NTA (x)	1.3	1.3	1.3	1.3	1.3
Free cash flow yield (%)	6.4	34.2	15.7	18.2	20.4
Net dividend yield (%)	0.0	7.1	7.1	7.5	7.9
Gross dividend yield (%)	0.0	7.1	7.1	10.0	10.9

Key Ratios	2020A	2021A	2022E	2023E	2024E
Return on assets (%)	n/a	n/a	n/a	n/a	n/a
Return on equity (%)	3.4	5.4	6.4	7.8	8.6
Return on funds employed (%)	0.0	0.0	0.0	0.0	0.0
EBITDA margin (%)	n/a	n/a	n/a	n/a	n/a
EBIT margin (%)	n/a	n/a	n/a	n/a	n/a
Capex to sales (%)	2.8	3.0	3.1	2.9	2.8
Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
Imputation (%)	0	0	0	85	100
Pay-out ratio (%)	0	113	94	80	74

Growth Rates	2020A	2021A	2022E	2023E	2024E
Revenue (%)	8.0	6.2	6.7	7.1	6.5
EBITDA (%)	n/a	n/a	n/a	n/a	n/a
EBIT (%)	n/a	n/a	n/a	n/a	n/a
Normalised NPAT (%)	-28.2	57.1	20.0	23.3	13.0
Normalised EPS (%)	-39.7	55.4	20.0	23.3	13.0
Ordinary DPS (%)	n/a	n/a	0.0	5.0	4.8

Capital Structure	2020A	2021A	2022E	2023E	2024E
Solvency capital	155.9	150.5	179.4	199.4	204.9
Minimum solvency capital (MSC)	56.6	52.3	66.3	66.3	66.3
Total regulatory capital	106.6	102.3	83.3	91.3	91.3
Solvency ratio (%)	275	287	271	301	309

Cash Flow (NZ$m)	2020A	2021A	2022E	2023E	2024E
EBITDA	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Working capital change	n/a	n/a	n/a	n/a	n/a
Interest & tax paid	0	0	0	0	0
Other	0	0	0	0	0
Operating cash flow	**18.9**	**100.9**	**46.5**	**53.8**	**60.1**
Capital expenditure	(10.5)	(12.0)	(13.1)	(13.3)	(13.5)
(Acquisitions)/divestments	(9.5)	(14.4)	(4.4)	0	0
Other	(9.4)	(24.5)	7.3	7.7	7.7
Funding available/(required)	**(10.5)**	**49.9**	**36.3**	**48.2**	**54.3**
Dividends paid	0	(10.5)	(21.1)	(22.1)	(23.2)
Equity raised/(returned)	44.9	0	0	0	0
(Increase)/decrease in net debt	**34.4**	**39.4**	**15.2**	**26.1**	**31.1**

Operating Performance	2020A	2021A	2022E	2023E	2024E
Gross written premium	377.2	404.7	439.3	464.9	497.7
Gross earned premium	**372.6**	**395.5**	**422.0**	**452.1**	**481.3**
Reinsurance premium	(57.2)	(62.2)	(65.9)	(70.9)	(75.9)
Net earned premium	**315.3**	**333.3**	**356.1**	**381.2**	**405.4**
Net claims expense	(181.1)	(204.3)	(215.9)	(231.3)	(246.5)
Large event claims expense	(9.7)	(13.9)	(20.0)	(22.0)	(24.0)
Management & sales expenses	(126.6)	(123.3)	(131.4)	(135.3)	(139.5)
Underwriting profit	31.8	28.0	30.9	36.7	41.5
Investment and other revenue	6.4	1.3	3.3	5.3	5.6
Financing and other costs	(1.1)	(0.4)	(0.5)	(0.5)	(0.5)
Profit before tax	**20.3**	**28.5**	**33.6**	**41.4**	**46.6**
Tax expense	(7.9)	(9.1)	(11.2)	(13.8)	(15.4)
Profit after taxation (Reported)	**12.3**	**19.3**	**22.4**	**27.7**	**31.3**

Balance Sheet (NZ$m)	2020A	2021A	2022E	2023E	2024E
Working capital	184.1	146.9	151.0	159.8	171.1
Fixed assets	10.0	9.4	10.4	11.5	12.5
Intangibles	119.6	120.6	127.2	127.3	128.2
Right of use asset	7.2	25.6	23.2	20.8	18.4
Other assets	277.6	314.8	314.8	314.8	314.8
Total funds employed	**598.6**	**617.3**	**626.6**	**634.1**	**645.0**
Net debt/(cash)	(80.1)	(116.1)	(131.3)	(157.4)	(188.5)
Lease liability	8.7	39.4	46.7	54.4	62.0
Other liabilities	322.9	344.3	360.2	380.6	406.8
Shareholder's funds	345.0	346.9	348.0	353.5	361.6
Minority interests	2.2	2.8	3.1	3.1	3.1
Total funding sources	**598.6**	**617.3**	**626.6**	**634.1**	**645.0**

Key ratios					
Tower Direct GWP growth %	13.7%	26.4%	9.8%	5.0%	7.0%
Partnership GWP growth %	2.8%	-30.0%	8.0%	8.0%	8.0%
Pacific GWP growth %	-10.2%	5.0%	7.0%	6.0%	5.5%
Total GWP growth %	5.7%	7.3%	8.6%	5.8%	7.1%
Total claims ratio %	49%	54%	54%	55%	55%
MER %	39%	37%	37%	36%	34%
Combined ratio %	88%	91%	91%	90%	90%

Weathered the storm of 2021 events

Tower (TWR) has weathered one of the more challenging years for large claims, protected somewhat from the worst of event costs by its reinsurance programme. The 2H21 results reflected elevated levels of fires and floods.

Result summary

TWR reported a reasonable result given the headwinds of increased claims costs from floods and fires. GWP grew a solid +4.9% on FY20 results. This GWP result was +0.9% better than our forecasts. Underlying FY21 NPAT was NZ$20.8m and was in-line with management's updated NZ$19m to NZ$21m guidance range in September 2021. The underlying result compared to our NZ$20.3m forecast. Reported profit was NZ$19.3m, under our NZ$20.3m, mostly due to unforeseen IAS 38 SaaS accounting impacts.

Progress continued to be made over the year in digitising the business. This appears to be aiding in driving top line growth and providing continued efficiency improvements.

Figure 1. Result snapshot – half–on–half comparison 1H21 / 2H21

NZ$m	Reported 1H21	2H21	Change
Operating Performance			
Gross written premium	**193.9**	**210.1**	**8.4%**
Gross earned premium	195.3	199.7	2.2%
Reinsurance expense	(28.1)	(34.1)	21.4%
Net earned premium	167.1	165.5	-0.9%
Net claims expense	(80.5)	(98.2)	22.0%
Large event claims expense	(9.3)	(4.6)	-50.5%
Management and sales expenses	(61.0)	(49.0)	-19.6%
Underwriting profit	16.2	10.5	-35.0%
Net Investment	0.7	(0.3)	-139.9%
Other items	-	0.2	n/a
Underlying profit before tax	16.9	10.5	-38.0%
Income tax expense	(5.6)	(3.2)	-42.9%
Underlying NPAT	**11.3**	**7.3**	**-35.5%**
Abnormals	0.7	-	-100.0%
Reported profit/(loss) after tax	12.0	7.3	-39.0%
Underlying NPAT before large events	11.4	9.4	-18.0%
EPS (cps)	2.7	1.7	-37.6%
DPS (cps)	2.5	2.5	
Payout based on EPS	92%	130%	
Underlying ROE	3.2%	2.6%	-0.6%
Claims ratio (excluding large events)	48.2%	52.1%	398 bps
Large events claims ratio	2.8%	4.2%	140 bps
Total claims ratio	54.9%	54.3%	-60 bps
MER	37.6%	37.1%	-55 bps
Combined ratio	92.5%	91.4%	-115 bps
Actual solvency capital (ASC)	180.4	179.4	-0.6%
Solvency Margin	97.1	88.1	-9.3%
Solvency Ratio	309%	271%	n/a

Source: Company sources, Forsyth Barr analysis

Earnings revisions

We have made minor changes to our revenue and underlying NPAT forecasts for FY22, FY23 and beyond. Underlying NPAT forecasts have been raised +5.0% and +4.4%, respectively. This followed strength in both NZ and Pacific GWP during the 2H21 which came in above our estimates. While the NZ growth appears sustainable we have mildly lowered our FY22 and FY23 estimates for the Pacific operations.

Figure 2. Forecast Underlying earnings revisions

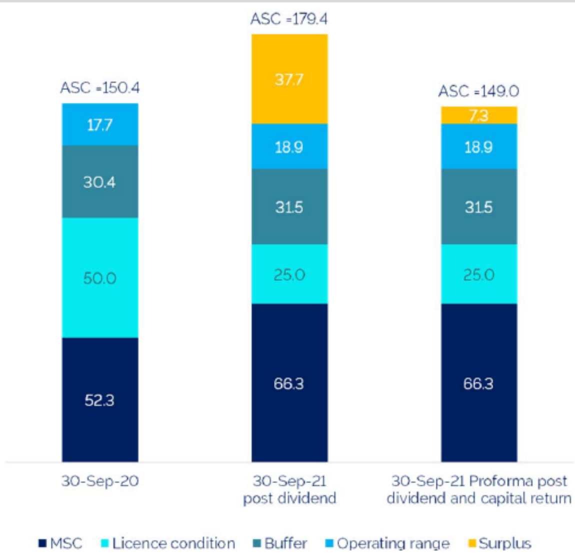
NZ$m		FY22E			FY23E	
Operating Performance	Old	New	Change	Old	New	Change
Gross written premium	**432.3**	**438.7**	**1.5%**	**464.3**	**464.3**	**0.0%**
Gross earned premium	416.8	422.6	1.4%	448.3	452.7	1.0%
Reinsurance expense	(64.4)	(65.9)	2.3%	(69.5)	(70.9)	2.0%
Net earned premium	352.3	356.7	1.2%	378.8	381.8	0.8%
Net claims expense	(168.4)	(173.7)	3.1%	(183.3)	(187.0)	2.0%
Large event claims expense	(20.0)	(20.0)	0.0%	(22.0)	(22.0)	0.1%
Management and sales expenses	(133.3)	(131.6)	-1.3%	(137.3)	(135.6)	-1.3%
Underwriting profit	**30.6**	**31.4**	**2.8%**	**36.2**	**37.2**	**2.8%**
Investment and other revenue	3.3	3.3	0.0%	5.3	5.3	-0.1%
Financing costs	-	-	n/a	-	-	n/a
Underlying profit before tax	33.9	34.7	2.5%	41.5	42.5	2.5%
Income tax expense	(11.5)	(11.2)	-2.4%	(13.9)	(13.8)	-1.2%
Underlying profit after tax	**22.4**	**23.5**	**5.0%**	**27.5**	**28.7**	**4.4%**
Reported profit/(loss) after tax	22.4	22.4	0.2%	27.5	27.7	0.4%

Source: Forsyth Barr analysis

Capital — dividends and buyback

The Board declared a final dividend of NZ2.5cps making NZ5cps in dividends for the full year. This is at the upper end of the range of their stated policy of 60% to 80% of cash NPAT. Given management commentary we consider this to be the floor in dividends going forward, with upside potential in years where claims experiences are below the conservative stance management have taken to forecasts. Given accumulated losses on the balance sheet, both the interim and final 2022 dividends should remain unimputed, while the 2023 interim dividend may be partially imputed and the final 2023 dividend looks likely to be fully imputed. As anticipated, TWR's Board announced a significant NZ$30.4m return of excess capital. This was at the upper end of our NZ$15m to NZ$30m range of potential outcomes. This tax-efficient return of capital will be undertaken through a compulsory share buyback in March 2022 if shareholder approval and High Court orders are granted. Under the new disclosure methods, TWR considers it has excess capital of NZ$37.7m over and above the minimum solvency (MSC), licence condition (LC), buffer and operating range capital levels. See Figure 3 below.

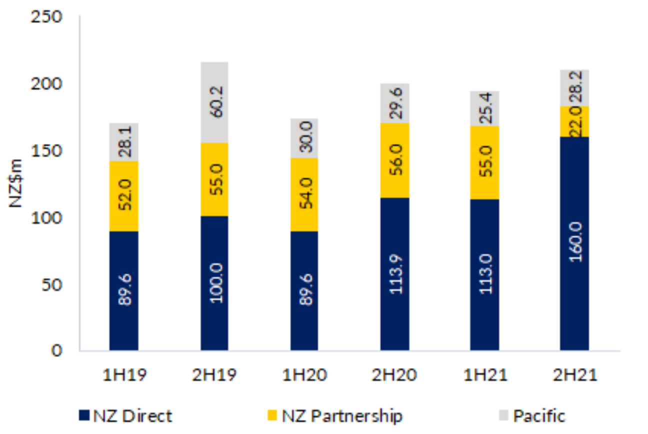
Figure 3. TWR Solvency — NZ Parent



Source: Company sources

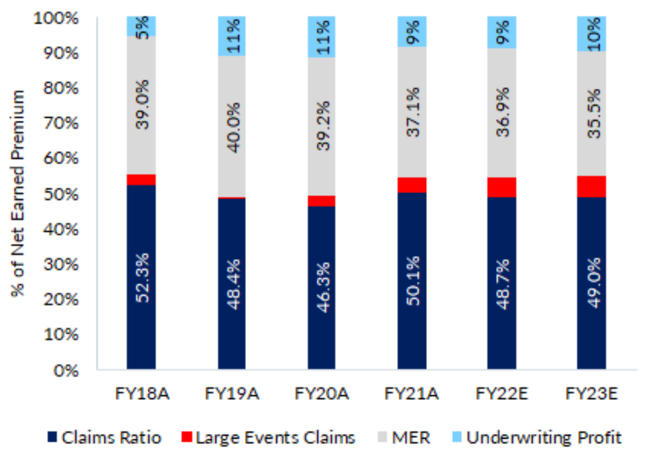
Key Charts

Figure 4. TWR GWP by Division



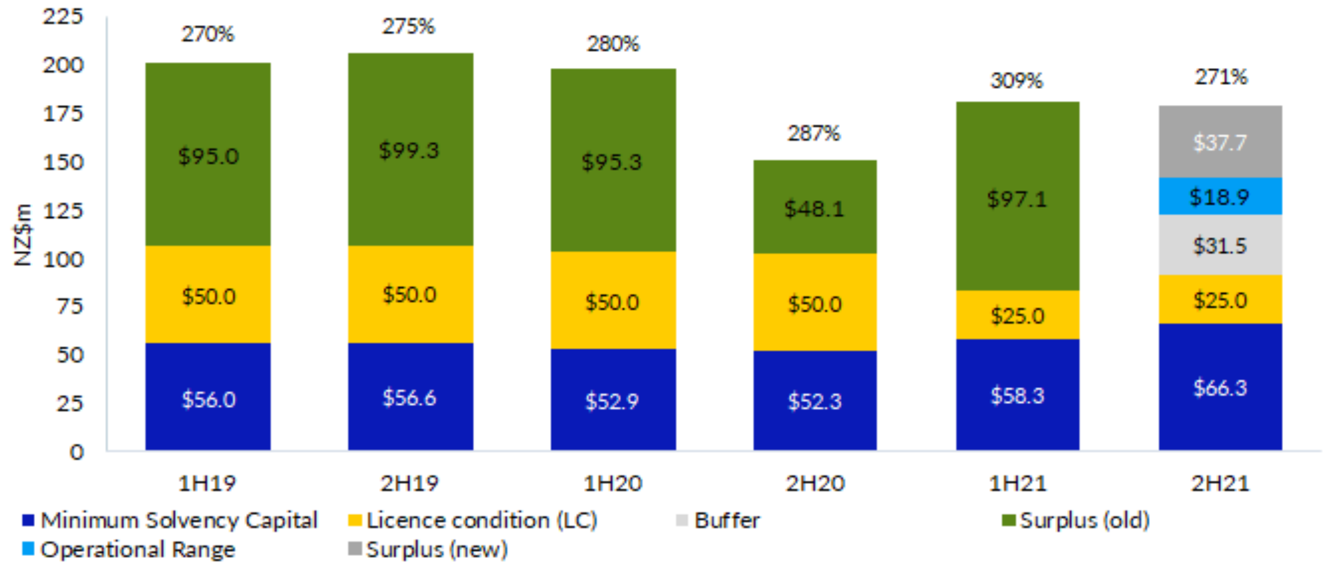
Source: Company, Forsyth Barr analysis

Figure 5. TWR Combined ratio and components



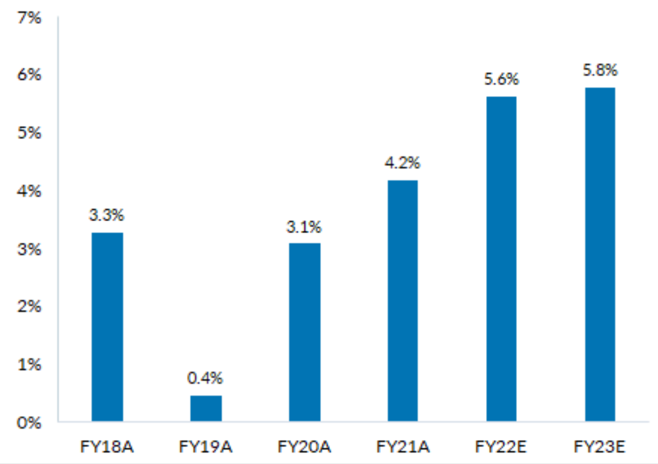
Source: Company, Forsyth Barr analysis

Figure 6. TWR Solvency Position



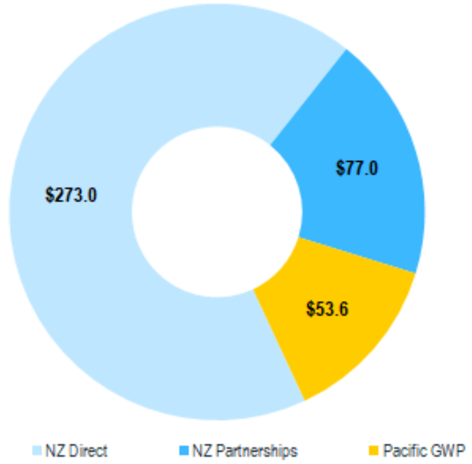
Source: Company, Forsyth Barr analysis

Figure 7. TWR Large Events ratio



Source: Company, Forsyth Barr analysis

Figure 8. TWR GWP Segmental Split (FY21)



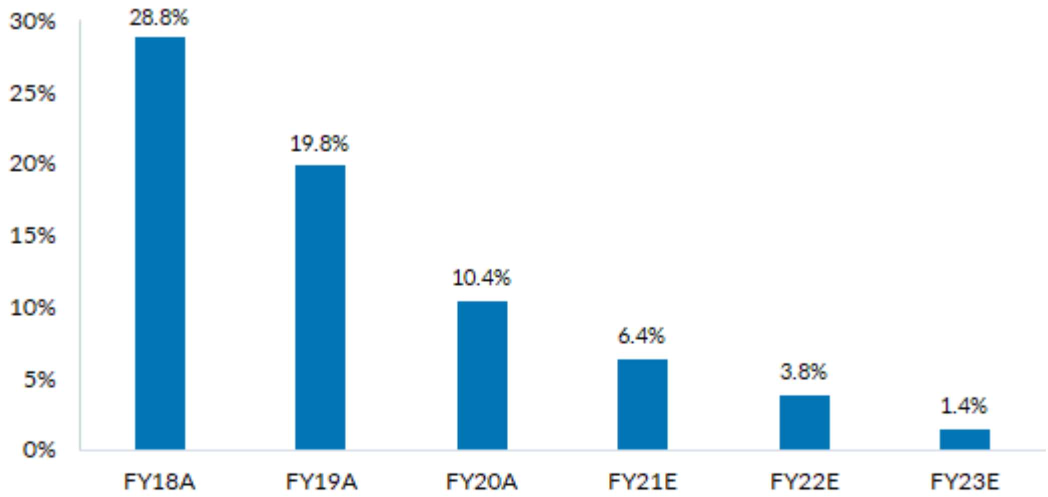
Source: Company, Forsyth Barr analysis

Update on the CHCH earthquake book

A sequence of four major earthquakes and over 14,000 aftershocks between September 2010 and June 2012 was the most damaging natural disaster in NZ's recorded history. It has resulted in around 650,000 insurance claims and some NZ$31 billion of indirect costs.

In its FY21 result TWR updated its reserving of Christchurch Earthquake Claims (CEQ) claims. As at 31 September 2021 there was NZ$18.8m of net outstanding CEQ claims. There remains 33 open claims after 56 closures during the financial year with 30 newly opened or reopened properties. TWR uses a 75% confidence interval (CI) in calculating this remaining estimate of claims costs related to the Christchurch earthquakes. This is under what is believed that Suncorp & IAG both use at 90% CI for making capital assessments. TWR's last remaining CEQ claims are likely to be at either the extremes of the litigious policyholders or those newly opened claims. Given progress over the year the value at risk has fallen materially. While TWR could see future claims above estimates, the overall quantum and risk to the balance sheet has subsided materially. The Statute of Limitations may reduce the number of new claims rising above the EQC threshold and being passed to TWR related to these earthquakes. By the end of 2022 the first Canterbury earthquakes are getting towards this limit.

Figure 9. TWR Canterbury earthquake Net Outstanding Claims as % of today's market capitalisation



Source: Company, Forsyth Barr analysis

We estimate the additional cost of moving to a 90% CI is around NZ$10m. As such, this has now been taken off our excess capital assessment of TWR to provide a level of cautiousness. This conservatism impacts of our valuation assumption by ~2.4cps.

On the 18th March 2021, the Reserve Bank of New Zealand (RBNZ) recognised TWR had made progress with CHCH claims and decided to reduce the "*minimum solvency margin required to be held by Tower under its license condition from $50m to $25m*". This is represented as License Condition (LC) capital required by the RBNZ to be held by TWR. The License Condition capital will be reviewed again by the RBNZ in March 2022. Given TWR's progress on CEQ claims and the most recent assessment of outstanding claims at NZ$18.8m, plus the additional strengthening, our assessment of future CEQ claims at NZ$28.8m appears reasonable.

How reinsurance works at TWR

TWR announced some changes to its reinsurance programme. The reinsurance programme is reassessed annually and renewed on 1 October at the start of each financial year. TWR is required to hold cover and one prepaid reinstatement of cover for an event at any time. Events are categorised as either being 'catastrophe' or 'large' depending on a threshold. Initially, any claim which exceeds NZ$11.25m is classified as a 'catastrophe event', with TWR 's reinsurers accepting risk associated with such events up to a maximum of NZ$873m in the first instance. This cap is calculated on the modelled losses of a one in a 1,000-year event on TWR's whole portfolio, plus a loading for additional costs. A 'drop–down' provides a lower threshold for 'catastrophe cover' whereby if there is a second event, TWR can reduce its financial exposure for claims exceeding NZ$10m in the subsequent event, up to a maximum NZ$828m.

A "large event" is a non-NZ earthquake event above NZ$1m to a maximum NZ$11.25m (unless there has already been a 'catastrophe' event, in which case the maximum is $10m for the second catastrophe event only). Total losses between NZ$20m to NZ$40m and below the threshold for a catastrophe event from aggregate 'large' events during the financial year are covered by reinsurers, providing TWR with protection. After the NZ$40m maximum, the liability falls on TWR for further losses from the aggregation of 'large' events. The pricing of the reinsurance programme is an annual negotiation for around 25% of total reinsurance repriced annually and takes place in September. Every three years a more detailed review is undertaken for 75% of the book.

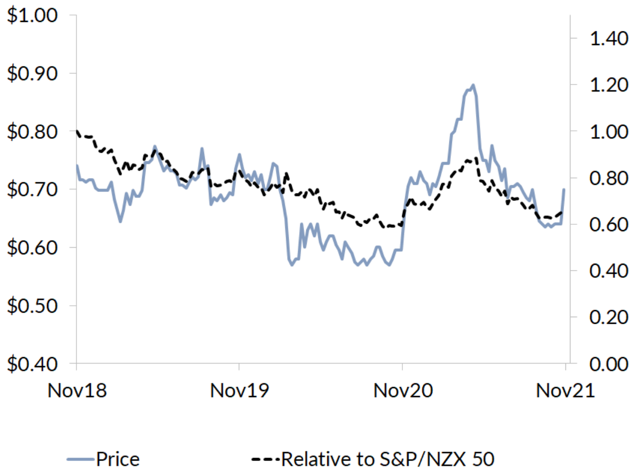
TWR has provided the following schematic detailing the high-level structure of their reinsurance:

Figure 10. Reinsurance Programme Overview

Source: Company reports

For example, if TWR had an initial catastrophe event of NZ$400m TWR pay the first NZD$11.25m while reinsurers pay the remaining $388.75m. TWR then purchases another event to reinstate a second reinsurance cover for protection up to NZ$45m, implying if there is a third catastrophe event, TWR will pay for the first NZD$13.75m while reinsurers will cover up to NZD$31.25m of the remainder.

Figure 11. Price performance



Source: Forsyth Barr analysis

Figure 12. Substantial shareholders

Shareholder	Latest Holding
Bain Capital Credit LP	20.0%
ACC	8.4%
Salt Funds Management	7.0%
Investment Services Group	6.5%
NZ Funds Management	5.2%

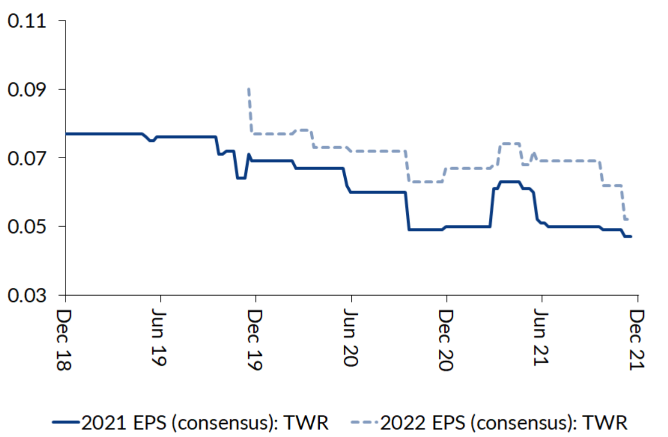
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 13. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect TWR's balance date - September)			(m)	2022E	2023E	2022E	2023E	2022E	2023E	2023E
Tower Ltd	**TWR NZ**	**NZ$0.70**	**NZ$295**	**13.2x**	**10.7x**	**n/a**	**n/a**	**n/a**	**n/a**	**7.5%**
Heartland Group Holdings *	HGH NZ	NZ$2.28	NZ$1,345	14.1x	13.4x	n/a	n/a	n/a	n/a	5.5%
Insurance Australia Group	IAG AT	A$4.64	A$11,438	18.5x	14.8x	n/a	n/a	n/a	10.4x	5.2%
Suncorp Group	SUN AT	A$11.23	A$14,179	15.6x	13.1x	n/a	n/a	n/a	46.0x	6.1%
QBE INSURANCE GROUP	QBE AT	US$8.94	US$13,205	13.2x	11.5x	n/a	n/a	n/a	8.4x	5.2%
			Compco Average:	**15.4x**	**13.2x**	**n/a**	**n/a**	**n/a**	**21.6x**	**5.5%**
EV = Current Market Cap + Actual Net Debt			**TWR Relative:**	**-14%**	**-19%**	**n/a**	**n/a**	**n/a**	**n/a**	**36%**

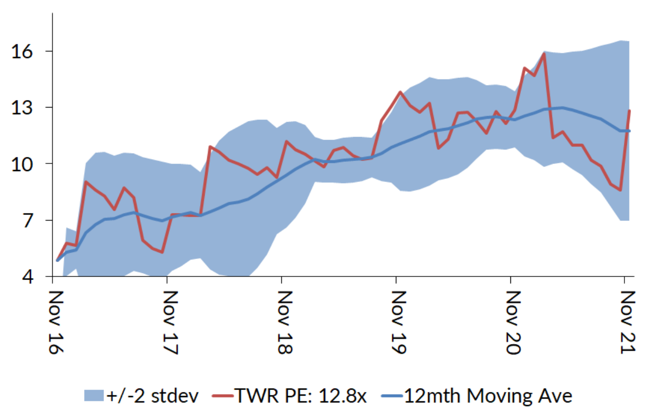
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 14. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 15. One year forward PE (x)



Source: Forsyth Barr analysis

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