

Tower Limited

1H22 Growth Upset by Large Events

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Tower Limited's (TWR) 1H22 showed improving trends at the top line and reasonable cost control (where controllable) but again large claims expenses muddied the waters. Large events costs were NZ\$17.9m in 1H22 versus NZ\$9.3m in 1H21. Underlying NPAT was NZ\$3.0m, relative to that seen in 1H21 of NZ\$11.1m. Positively, TWR saw a solid +11% lift in Gross Written Premium (GWP), which was pleasing along with progress on the management-expense-ratio (MER), which fell to 35.8% from 37.1% in the prior period. The result also reflected negative market-to-market on the investment book given recent rate rises, costing NZ\$0.7m. The Board declared a 1H22 dividend of 2.5cps, unimputed, in-line with expectations. TWR's management reiterated guidance for FY22 underlying net profit after tax (NPAT) in the range of NZ\$21m to NZ\$25m. This can be achieved due to the reinsurance cover (capping large claims at NZ\$20m) limiting further large claims expenses in the 2H22. Given a further shift in Christchurch claims costs, WACC changes, and minor adjustments to earnings estimates, our spot valuation falls from NZ\$0.89 to NZ\$0.85.

NZX Code	TWR	Financials: Sep/	21A	22E	23E	24E	Valuation (x)	21A	22E	23E	24E
Share price	NZ\$0.69	NPAT* (NZ\$m)	18.7	22.6	29.0	32.0	PE	15.5	12.0	9.0	8.1
Spot Valuation	NZ\$0.85 (from 0.87)	EPS* (NZc)	4.4	5.7	7.6	8.4	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	Medium	EPS growth* (%)	55.4	28.4	34.2	10.6	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	379.5m	DPS (NZc)	5.0	5.5	6.0	6.5	Price / NTA	1.3	1.4	1.3	1.3
Market cap	NZ\$260m	Imputation (%)	0	0	0	0	Cash div yld (%)	7.3	8.0	8.8	9.5
Avg daily turnover	219.2k (NZ\$153k)	*Based on normalised profits					Gross div yld (%)	7.3	8.0	8.8	9.5

What's changed?

- **Earnings:** Our FY22 underlying NPAT estimates fall NZ\$1.3m or 6%, to NZ\$22.6m on higher claims.
- **Dividend:** We raise our DPS estimate for FY22 to 5.5cps, up from 5.0cps.
- **Spot Valuation:** Valuation -4cps to NZ\$0.85 given continued CHCH earthquake costs, WACC countered by earnings revisions.

Claims inflation being passed on

Management noted significant inflation in claims expenses, especially in housing/building materials (upper mid-teens percentages) and higher second-hand vehicle prices (high single digit growth). TWR appears to have done a reasonable job of passing these additional costs on to customers via higher premiums, thereby maintaining margins. Business-as-usual claims costs fell from 52% to 49% of net-earned-premium (NEP). This demonstrates the resilience of the model of re-pricing regularly while operating in an environment conducive to allowing the pass-through of inflationary costs. Significant large event expenses (from the effects of the year's Hunga-Tonga-Hunga-Ha'apai eruption, Cyclone Dovi and North Island flooding), totalling NZ\$17.9m, remained inside the NZ\$20m of aggregate large event costs set aside by management for FY22.

Outlook retained

TWR's management reiterated guidance for FY22 (to 30 September 2022) of underlying net profit after tax (NPAT) in the range of NZ\$21m to NZ\$25m, including NZ\$20m of aggregate large event costs. DPS was forecast by the Board at 5.5cps. We move our estimates for underlying NPAT to the middle of the range and lift our dividend forecast to the Board's guidance level. We expect solid underlying business growth following a 1H22 where GWP was up +11% on the prior period and customers rose +8,000 (or +2.6%) to 312,000 as new niche products gain traction. With interest rates returning to more normalised levels, post a prolonged period at artificially low levels, we see TWR's investment returns providing a significant uplift, aiding 2H22 and FY23 returns.

Tower Limited (TWR)

Market data (NZ\$)						Spot valuation (NZ\$)					0.85
Priced as at 26 May 2022					0.69	PE relative					0.83
52 week high / low					0.78 / 0.63	P/Book relative					0.81
Market capitalisation (NZ\$m)					261.8	DCF					0.95
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate					4.00%	Total firm value					444
Equity beta					1.10	(Net debt)/cash					0
WACC					10.1%	Less: Capitalised operating leases					(48)
Terminal growth					1.5%	Value of equity					396
Profit and Loss Account (NZ\$m)						Valuation Ratios					
Sales revenue (GEP)	2020A	2021A	2022E	2023E	2024E	EV/EBITDA (x)	2020A	2021A	2022E	2023E	2024E
Normalised EBITDA	n/a	n/a	n/a	n/a	n/a	EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a
Depreciation and amortisation	n/a	n/a	n/a	n/a	n/a	PE (x)	24.2	15.6	12.1	9.0	8.2
Normalised EBIT	n/a	n/a	n/a	n/a	n/a	Price/NTA (x)	1.3	1.3	1.4	1.4	1.3
Net interest	n/a	n/a	n/a	n/a	n/a	Free cash flow yield (%)	7.2	38.5	17.3	21.0	23.1
Associate income	0	0	0	0	0	Net dividend yield (%)	0.0	7.2	8.0	8.7	9.4
Tax	(7.9)	(9.1)	(11.5)	(14.7)	(16.0)	Gross dividend yield (%)	0.0	7.2	8.0	8.7	9.4
Minority interests	0.4	0.6	0.1	0	0	Key Ratios					
Normalised NPAT	11.9	18.7	22.6	29.0	32.0	Return on assets (%)	2020A	2021A	2022E	2023E	2024E
Abnormals/other	0	0	0	0	0	Return on equity (%)	n/a	n/a	n/a	n/a	n/a
Reported NPAT	11.9	18.7	22.6	29.0	32.0	Return on funds employed (%)	3.4	5.4	7.2	9.0	9.8
Normalised EPS (cps)	2.9	4.4	5.7	7.6	8.4	EBITDA margin (%)	0.0	0.0	0.0	0.0	0.0
DPS (cps)	0	5.0	5.5	6.0	6.5	EBIT margin (%)	n/a	n/a	n/a	n/a	n/a
Growth Rates						Capex to sales (%)	2.8	3.0	3.1	3.1	3.1
Revenue (%)	2020A	2021A	2022E	2023E	2024E	Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
EBITDA (%)	8.0	6.2	7.8	8.1	6.3	Imputation (%)	0	0	0	0	0
EBIT (%)	n/a	n/a	n/a	n/a	n/a	Pay-out ratio (%)	0	113	97	79	77
Normalised NPAT (%)	-28.2	57.1	21.2	28.0	10.6	Capital Structure					
Normalised EPS (%)	-39.7	55.4	28.4	34.2	10.6	Solvency capital	2020A	2021A	2022E	2023E	2024E
Ordinary DPS (%)	n/a	n/a	10.0	9.1	8.3	Minimum solvency capital (MSC)	155.9	150.5	179.4	170.3	175.3
Cash Flow (NZ\$m)						Total regulatory capital	106.6	102.3	83.3	91.3	91.3
EBITDA	2020A	2021A	2022E	2023E	2024E	Solvency ratio (%)	275	287	271	232	252
Working capital change	n/a	n/a	n/a	n/a	n/a	Operating Performance					
Interest & tax paid	0	0	0	0	0	Gross written premium	2020A	2021A	2022E	2023E	2024E
Other	0	0	0	0	0	Gross earned premium	377.2	404.7	447.8	473.9	505.8
Operating cash flow	18.9	100.9	45.4	55.1	60.5	Reinsurance premium	372.6	395.5	426.2	460.8	489.8
Capital expenditure	(10.5)	(12.0)	(13.3)	(14.1)	(15.0)	Net earned premium	(57.2)	(62.2)	(66.8)	(72.4)	(77.4)
(Acquisitions)/divestments	(9.5)	(14.4)	(4.4)	0	0	Net claims expense	315.3	333.3	359.4	388.4	412.4
Other	(9.4)	(24.5)	(2.8)	(3.0)	(3.2)	* includes Large event claims of	(181.1)	(204.3)	(221.0)	(240.0)	(255.8)
Funding available/(required)	(10.5)	49.9	24.8	38.0	42.2	Management & sales expenses	(9.7)	(13.9)	(20.0)	(22.0)	(24.0)
Dividends paid	0	(10.5)	(20.9)	(22.8)	(24.7)	Underwriting profit	(126.6)	(123.3)	(130.3)	(134.3)	(138.5)
Equity raised/(returned)	44.9	0	(30.4)	0	0	Investment and other revenue	31.8	28.0	31.1	37.1	41.2
(Increase)/decrease in net debt	34.4	39.4	(26.4)	15.2	17.6	Financing and other costs	5.3	0.2	3.7	7.5	7.8
Balance Sheet (NZ\$m)						Profit before tax	20.3	28.5	34.1	43.7	48.1
Working capital	2020A	2021A	2022E	2023E	2024E	Tax expense	(7.9)	(9.1)	(11.5)	(14.7)	(16.0)
Fixed assets	184.1	146.9	153.9	162.9	173.9	Profit after taxation (Reported)	12.3	19.3	22.6	29.0	32.0
Intangibles	10.0	9.4	10.5	11.6	12.6	Abnormals	(1.3)	(1.1)	0	0	0
Right of use asset	119.6	120.6	125.4	126.5	128.9	Comprehensive profit	11.0	18.2	22.6	29.0	32.0
Other assets	7.2	25.6	23.2	20.8	18.4	Key ratios					
Total funds employed	277.6	313.0	313.0	313.0	313.0	Tower Direct GWP growth %	13.7%	26.4%	11.8%	5.0%	6.5%
Net debt/(cash)	598.6	615.5	626.0	634.8	646.8	Partnership GWP growth %	2.8%	-30.0%	12.0%	8.0%	8.0%
Lease liability	(80.1)	(116.1)	(89.7)	(104.9)	(122.5)	Total GWP growth %	5.7%	7.3%	10.7%	5.8%	6.7%
Other liabilities	8.7	39.4	36.6	33.6	30.3	Total claims ratio %	49.3%	54.3%	55.1%	55.9%	56.4%
Shareholder's funds	322.9	342.5	365.2	386.0	411.5	MER %	39.2%	37.1%	36.2%	34.6%	33.6%
Minority interests	345.0	347.0	314.0	320.2	327.5	Combined ratio %	88.5%	91.4%	91.3%	90.4%	90.0%
Total funding sources	2.2	2.7	0	0	0						
	598.6	615.5	626.0	634.8	646.8						

1H22 continues to display encouraging underlying growth

TWR reported 1H22 underlying NPAT of NZ\$3m, down relative to that reported in 1H21 of NZ\$11m. The key difference was the NZ\$17.9m in large event claims for the period. This followed the Tongan eruption on 15 January 2022 costing NZ\$7.6m, the NZ\$3.6m for Cyclone Dovi, and the NZ\$6.7m for North Island storms. The 1:1000 year Tongan eruption cost came in below TWR's reinsurance excess of NZ\$11.3m for catastrophe events. Collectively these are within the NZ\$20m Tower has set aside for large events in FY22.

At the top line, TWR continued to demonstrate solid underlying business growth with 1H22 GWP up +11% on the prior period, at NZ\$215.9m. This is a commendable outcome and reflects progress in TWR's core direct markets, success with new product development (pet, marine, and travel) and the passing on of claims inflation. The combined effect has seen an improvement in client retention, with 1H22 customers rising +8,000 (or +2.6%) to 312,000 as new niche products gain traction.

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

	Reported 1H21	Reported 1H22	Change
Gross written premium	194.6	216.1	11%
Gross earned premium	195.9	207.1	6%
Reinsurance expense	(28.1)	(33.4)	19%
Net earned premium	167.8	173.7	4%
Net claims expense	(92.2)	(98.9)	7%
Large event claims expense	(9.3)	(17.9)	92%
Management and sales expenses	(42.0)	(46.0)	10%
Net Commission expense	(8.1)	(4.7)	-42%
Underwriting profit	16.2	6.2	-62%
Net Investment	0.5	(0.9)	
Other items	0.1	0.3	
Underlying profit before tax	16.7	5.6	
Income tax expense	(5.6)	(2.6)	
Profit after taxation (Reported Profit)	11.1	3.0	-73%
Other items	(1.4)	-	
Total comprehensive profit for the year (after tax)	9.7	3.0	-69%
EPS (cps)	2.5	0.7	
DPS (cps)	2.5	2.5	
Payout based on cash EPS (%)	100%	357%	
Underlying ROE (%)	3.2%	1.6%	
Claims ratio (excluding large events) (%)	48.2%	48.6%	49 bps
Large events claims ratio (%)	5.6%	10.3%	474 bps
BAU claims ratio (%)	53.7%	58.9%	523 bps
MER (%)	37.1%	35.8%	(70) bps
Combined ratio (%)	90.9%	94.8%	452 bps

Source: Forsyth Barr analysis

Online brand presence developing with a digitisation of the business

Given TWR's efforts to grow its digital positioning, we continue to track TWR's online presence. TWR has seen a consistent but gradual improvement in website visitor traffic over the last year relative to other comparative brands (AA Insurance, AMI and State); see Figure 6 below. We consider this an indicator of success from the work the management team has been undertaking on delivering a more customer-orientated technology platform.

Digitisation is driving costs down and customer experience up. TWR's Net Promotor Score (NPS) was 40% compared to 34% a year ago. Online quotes rose +41% over 1H22 as compared to 1H21. Some 63% of TWR's sales come from digital channels for its Direct business, up from 58% in 1H21 and 53% in 1H20. Its online portal, My Tower, has 165,000 registrations.

Earnings revisions and valuation update

Updated estimates

We make minor changes in our estimates for FY22 and FY23, principally reflecting movements in interest rates and a lowering of management expenses. This has seen our FY22 underlying NPAT estimates fall by 5% to NZ\$22.6m, in the middle of the guidance range and fall by 3% in FY23 to NZ\$29.0m.

Figure 2. TWR – Underlying earnings forecast revision

	FY22E			FY23E		
	Old	New	Change	Old	New	Change
Gross written premium	448.6	447.8	0%	474.7	473.9	0%
Gross earned premium	427.5	426.2	0%	462.8	460.8	0%
Reinsurance expense	(66.6)	(66.8)	0%	(72.2)	(72.4)	0%
Net earned premium	360.9	359.4	0%	390.6	388.4	-1%
Net claims expense	(176.1)	(178.0)	1%	(192.2)	(195.0)	1%
Large event claims expense	(20.0)	(20.0)	0%	(22.0)	(22.0)	0%
Management and sales expenses	(132.6)	(130.3)	-2%	(136.7)	(134.3)	-2%
Underwriting profit	32.3	31.1	-4%	39.6	37.1	-6%
Investment and other revenue	3.1	3.7	21%	4.8	7.5	56%
Financing costs	-	(0.8)	n/a	-	(0.9)	n/a
Underlying profit before tax	35.4	34.1	-4%	44.4	43.7	-2%
Income tax expense	(11.4)	(11.5)	0%	(14.5)	(14.7)	2%
Underlying profit after tax	23.9	22.6	-5%	29.9	29.0	-3%
Reported profit/(loss) after tax	22.8	22.6	-1%	28.8	29.0	0%

Source: Forsyth Barr analysis

Valuation impacts of normalising rates and market multiples

Since NZ interest rates have returned to more normalised levels, in line with their 15-year average, we have moved to update our cost of capital assumptions (outlined in our *WACCed: The Short Road to Normalising Rates* report, on 13 May 2022). Our risk-free rate is now 4.0%. WACC is a vital component of discounted-cash-flow (DCF) valuations. The New Zealand Government 10-year bond rates have increased +1.2% since our last review on 4 February 2022 and is up ~+3.0% since the low in late September 2020. This has been the most significant increase in interest rates in New Zealand for 30+ years and (re)-establishes New Zealand as one of the highest interest rate economies amongst developed markets. Our interpolated 10-year rate (used for our WACC assumptions) rises +120bps from ~2.8% to ~4.0%, representing our risk-free rate. Historically, market multiples have had a strong inverse correlation to bond rates, and the equity market has taken notice of the increasing rates, with the NZX50 Index down -14.6% year-to-date. In isolation, these WACC adjustments would have reduced our spot DCF by -12%. However, given the NZ\$30.4m of capital return and consequently lower number of shares, due to the buyback, the valuation impact is not as significant, with our revised DCF of NZ\$0.95.

At NZ\$0.685 we see TWR trading below its peer group average of 16.8x FY22 P/E, see Figure 12. In FY22, we forecast an unimputed dividend of 5.5cps, representing a >7% gross yield. We do not envisage imputation credits being attached to dividends until FY24 given historical tax losses. **Our blended spot valuation, a combination of comparative value and DCF, falls NZ4cps to NZ\$0.85.**

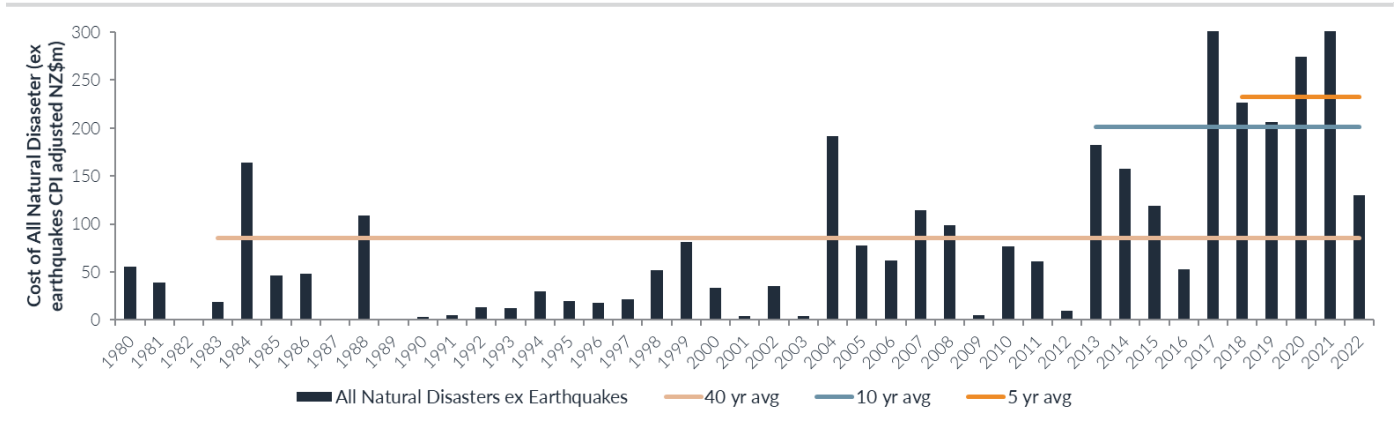
New Zealand Government moves on the environment

The effects of climate change are now quite visible on a global basis. Locally, TWR is doing a reasonable job in managing these risks, with new flood pricing, passing on inflationary costs, and we anticipate further pricing resets in 2H22. While it will not necessarily change the nature of TWR’s weather related expense risk it is relevant to note that the NZ Government has announced a tentative start in addressing climate change. In May 2022, the government released its first emissions reduction plan (ERP), covering the period from 2022 to 2035, in three five-year emissions budget periods as a proposed pathway to meeting the country’s commitments. Our "New Zealand's First Emissions Reduction Plan- Time for Action" 24 May report considered the four most significant actions outlined by the New Zealand Government in the ERP are:

1. A new target of 50% of total final energy consumption from renewable sources by 2035 (up from 28% in 2020).
2. Agriculture will have an emissions pricing mechanism by 2025 — either developed by industry or via inclusion in the ETS.
3. A commitment to increase zero-emissions vehicles to 30% of the light fleet by 2035.
4. The development of an energy strategy, a hydrogen road-map and a regulatory framework for offshore wind energy.

TWR’s efforts to re-assess and re-price the risks of flooding, a continuation of passing on building cost inflation and shortly to complete a reassessment of coastal risks , erosion and wind storm are timely given the growing cost of weather-related large events in New Zealand and across the Pacific. We anticipate new coastal pricing to come into effect in 2H22. From this reassessment we do not foresee a large reduction in policy numbers near the foreshore, however, those most at risk will likely see premiums continue to rise. Over time we do foresee at-risk areas and specific houses where some properties will not be offered insurance, given the risks of either rising sea levels or flooding. Now that intensive background data analytics have been undertaken, and given the one-year insurance cycle for TWR, this allows time for re-assessing to reflect risks on specific properties, necessary given the data:

Figure 3. Cost of All Natural Disasters excluding Earthquakes in NZ (CPI inflated, NZ\$m)



Source: ICNZ, Forsyth Barr analysis

Our updated data set displays a trend of the increasing cost of natural disasters (excluding earthquakes) in New Zealand, driven logically in part by climate change. Over the past forty years the average annual cost in New Zealand of all natural disasters, excluding earthquakes, has been NZ\$86m, inflation-adjusted. This has grown more recently, with the ten-year average industry cost being NZ\$201m per annum and the five-year average of NZ\$232m. Given TWR’s market share, in basic terms, the NZ\$20m level where TWR’s aggregate reinsurance cover commences, its cap on large claims, appears suitable to provide cover in the most extreme years of risk. Still, it provides limited benefit in more recent periods (see Figure 4 below). We surmise that global reinsurance providers continue to pull away from providing aggregate cover. Still, given TWR’s growth and leading risk management mitigation tools, the risk of complete aggregate withdrawal appears low. We forecast the level at which TWR’s aggregate cover commences, for reinsurance, to increase by NZ\$2m per annum. We conservatively build this into forecasts as our estimate of large event claims.

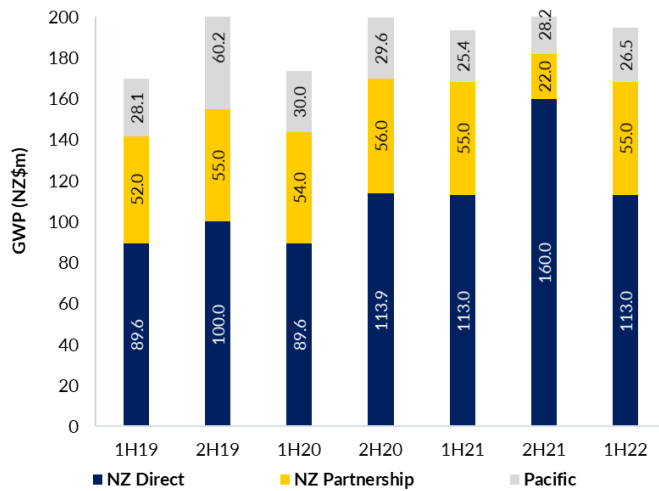
Figure 4. Estimating the share of natural disaster costs (NZ\$m)

	%TWR estimated personal lines market share (%) : 9.3%	40-year Maximum	10-year Average	5-year Average
Natural event total cost in period, excluding earthquakes (NZ\$m)		341	201	232
Crude calculation of TWR’s exposure (per annum) based on NZ market share (NZ\$m)		32	19	22
TWR’s lower limit of current aggregate reinsurance cover, in FY22 (NZ\$m)		20	20	20
Reinsurance cover (NZ\$m)		12	n/a	2

Source: Company data, ICNZ data, Forsyth Barr analysis

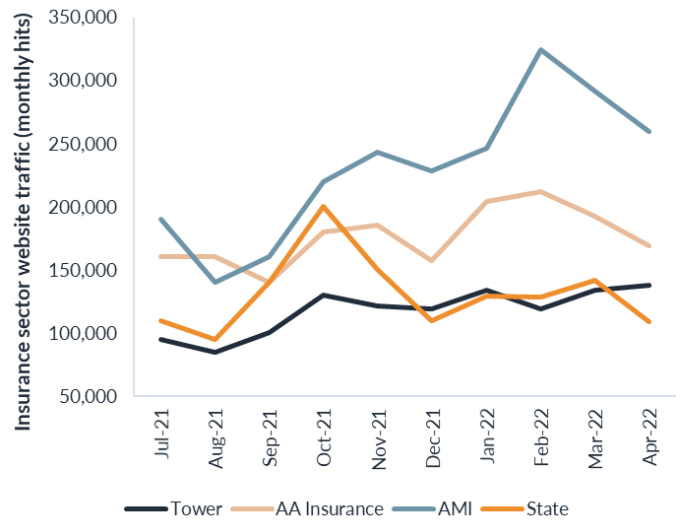
Key charts

Figure 5. TWR – GWP by Division (half-on-half growth)



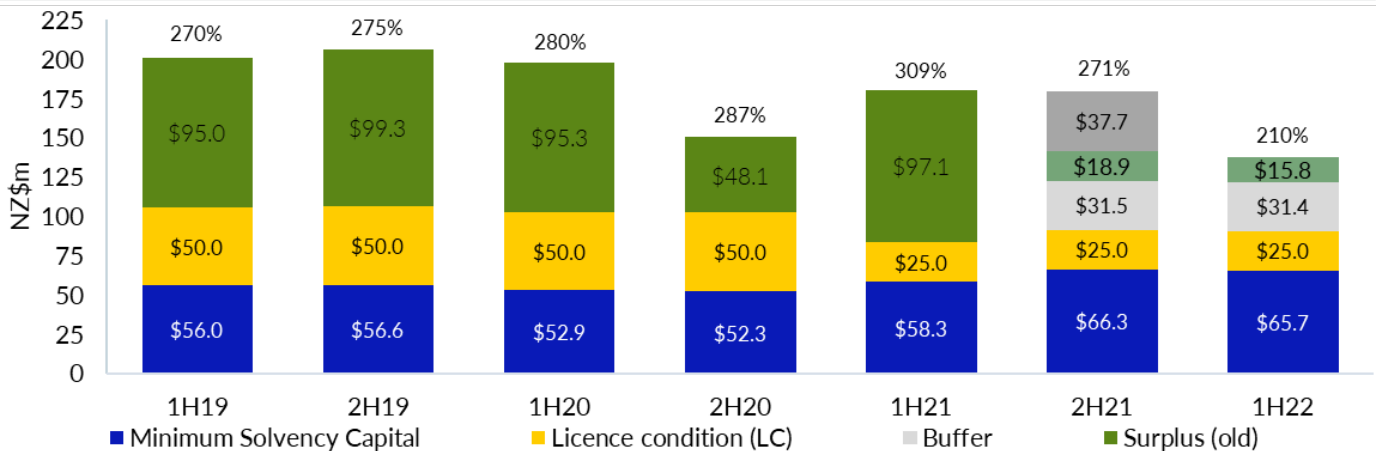
Source: Company data, Forsyth Barr analysis

Figure 6. TWR – Website traffic of combative brands



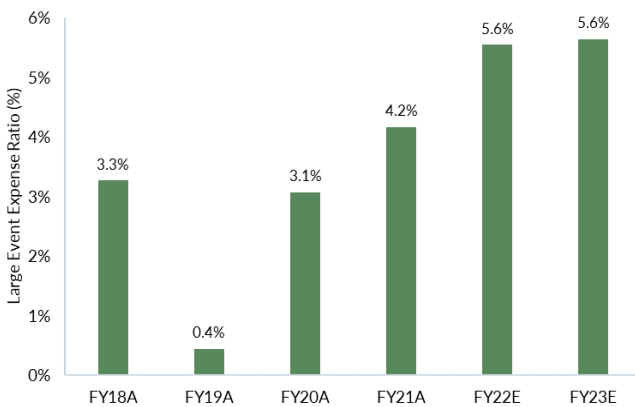
Source: Web traffic data, Forsyth Barr analysis

Figure 7. TWR – Solvency Position (NZ\$m)



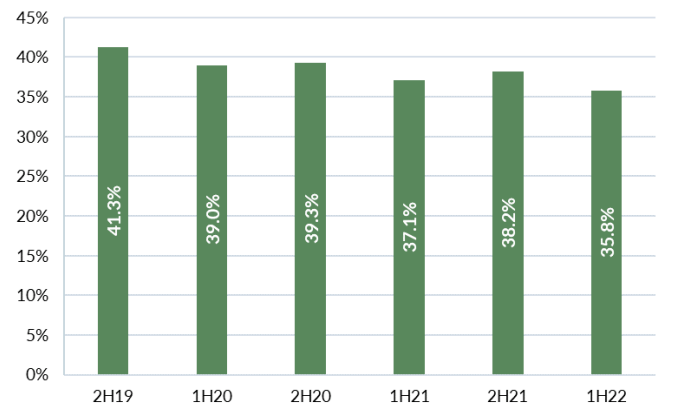
Source: Company data, Forsyth Barr analysis

Figure 8. TWR – Large event expense ratio (%)



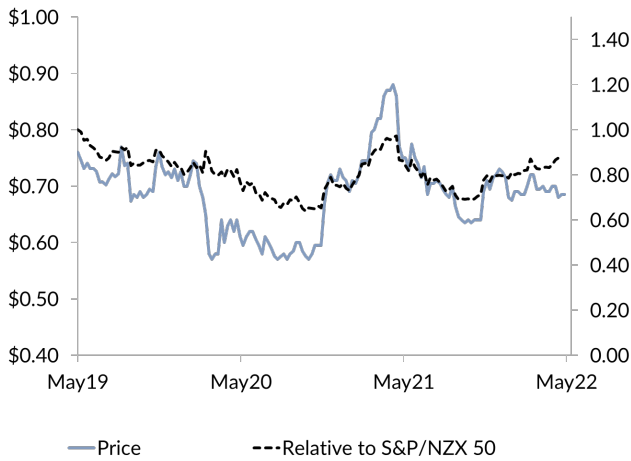
Source: Company data, Forsyth Barr analysis

Figure 9. TWR – Group MER Half-on-half (% of NEP)



Source: Company data, Forsyth Barr analysis

Figure 10. Price performance



Source: Forsyth Barr analysis

Figure 11. Substantial shareholders

Shareholder	Latest Holding
Bain Capital Credit LP	20.0%
ACC	9.6%
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

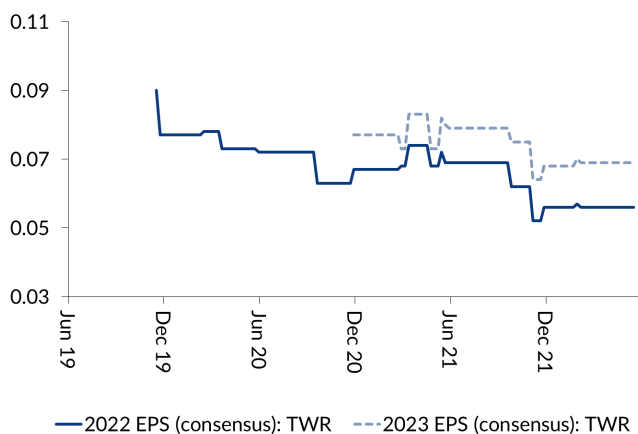
Figure 12. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2023E
				2022E	2023E	2022E	2023E	2022E	2023E	
Tower Ltd	TWR NZ	NZ\$0.69	NZ\$260	12.0x	9.0x	n/a	n/a	n/a	n/a	8.8%
Heartland Group Holdings *	HGH NZ	NZ\$2.15	NZ\$1,275	13.8x	13.4x	n/a	n/a	n/a	n/a	5.9%
Insurance Australia Group	IAG AT	A\$4.51	A\$11,118	21.2x	14.3x	n/a	n/a	n/a	10.1x	5.6%
Suncorp Group	SUN AT	A\$12.16	A\$15,353	17.2x	13.3x	n/a	n/a	n/a	52.0x	6.0%
QBE INSURANCE GROUP	QBE AT	US\$8.69	US\$12,895	15.1x	10.6x	n/a	n/a	n/a	9.4x	5.2%
Compco Average:				16.8x	12.9x	n/a	n/a	n/a	23.8x	5.7%
TWR Relative:				-28%	-31%	n/a	n/a	n/a	n/a	55%

EV = Current Market Cap + Actual Net Debt

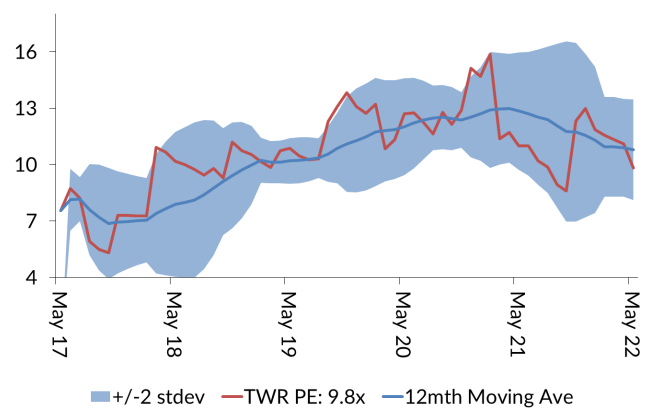
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 13. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 14. One year forward PE (x)



Source: Forsyth Barr analysis

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