

Tower Limited

Successful FY24 Reinsurance Placement

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Tower (TWR) has successfully navigated a challenging reinsurance market to renew its cover for FY24. The revised reinsurance structure comes with higher excesses, however, the net financial outcome is favourable compared to our prior expectations regarding total reinsurance costs in FY24. Relative to key competitors, we view this reinsurance outcome as positive, helped by TWR's risk-based pricing being recognised by reinsurers and a lower catastrophe upper limit at NZ\$750m, down from NZ\$934m, given the rise in the EQC cap. We reduce our reinsurance expense estimates for FY24 and FY25. However, following Suncorp (SUN) and Insurance Australia Group's (IAG) FY23 results we reduce our GWP expectations in FY24 and FY25 after weaker than expected growth. We also revise our business-as-usual (BAU) claims costs upwards, reflecting trends seen in the results of SUN and IAG, and globally. After accounting for other minor amendments our FY23 underlying NPAT estimate is essentially unchanged while FY24 and FY25 forecasts fall -12% and -14% respectively. Our blended spot valuation slips -NZ4 cps to NZ\$0.81, representing 9.9x FY24 earnings.

NZX Code	TWR	Financials: Sep/	22A	23E	24E	25E	Valuation (x)	22A	23E	24E	25E
Share price	NZ\$0.62	Rev (NZ\$m)	418.3	476.4	556.2	615.4	PE	13.3	n/a	7.6	5.6
Spot Valuation	NZ\$0.81 (from 0.85)	NPAT* (NZ\$m)	17.7	(4.9)	31.1	42.1	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	High	EPS* (NZc)	4.7	(1.3)	8.2	11.1	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	379.5m	DPS (NZc)	6.5	0.0	7.0	8.0	Price / NTA	1.4	1.5	1.3	1.2
Market cap	NZ\$235m	Imputation (%)	0	0	0	0	Cash div yld (%)	10.5	0.0	11.3	12.9
Avg daily turnover	123.9k (NZ\$80k)	*Based on normalised profits					Gross div yld (%)	10.5	0.0	11.3	12.9

What's changed?

- **Earnings:** Our underlying NPAT estimates in FY23 are essentially flat at NZ\$0.3m while FY24 estimates fall -12% to NZ\$31.1m and FY25 drops -14% to NZ\$42.1m on lower GWP growth, increased BAU claims expectations and lower investment returns.
- **Spot valuation:** Our blended spot valuation falls -4% to NZ\$0.81, from NZ\$0.85.

FY24 reinsurance programme successfully placed

TWR has successfully renewed its reinsurance programme for FY24, starting 1 October 2023, amid market challenges driven by both local and global weather events. Due to the uplift in the Earthquake Commission's (EQC) cap, from NZ\$150k to NZ\$300k, TWR reduced its catastrophe upper limit from NZ\$934m to NZ\$750m. TWR has bought cover for two major catastrophe losses in FY24 of up to NZ\$750m each and a third event of up to NZ\$75m, inclusive of automatic reinstatement. The excess for the first two large events increased by +42% to NZ\$16.9m and an excess of NZ\$20.0m will apply for a third event. In the update, management forecasts are for reinsurance costs in FY24 to be 13.9% of total income compared to 15.7% in FY23. We note that these ratios are at the core reinsurance line of GWP and do not reflect other reinsurance-related costs.

TWR's FY24 discount to peers multiples has expanded

On our estimates, TWR trades on ~7.6x FY24 PE, implying a material >40% discount to its Australasian insurance peers. We acknowledge that, given capital constraints and muted profitability due to the two large recent events, a 2H23 dividend is unlikely and, in our view, there remains some risk to a 1H24 dividend. However, TWR has (1) made significant progress in leveraging its improved scale and digital capabilities for cost efficiencies, (2) achieved GWP growth similar to or above peers and (3) demonstrated tangible benefits of its risk-based pricing. In aggregate, despite the likelihood of no 2H23 dividend and risks capital won't recover in time for a 1H24 dividend, we consider the widening market multiple discount to peers unjustified.

Tower Limited (TWR)
Market data (NZ\$)

Priced as at 28 Sep 2023	0.62
52 week high / low	0.75 / 0.57
Market capitalisation (NZ\$m)	235.3

Key WACC assumptions

Risk free rate	4.50%
Equity beta	1.18
WACC	10.6%
Terminal growth	1.8%

Profit and Loss Account (NZ\$m)	2021A	2022A	2023E	2024E	2025E
Revenue (GEP)	386.6	418.3	476.4	556.2	615.4
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	(9.2)	(7.5)	(0.4)	(14.7)	(19.4)
Minority interests	0.6	0.1	0	0	0
Normalised NPAT	20.8	27.4	0.3	31.1	42.1
Abnormals/other	(1.5)	(8.5)	(2.8)	0.7	0
Reported NPAT	19.3	18.9	(2.5)	31.8	42.1
Normalised EPS (cps)	4.4	4.7	(1.3)	8.2	11.1
DPS (cps)	5.0	6.5	0	7.0	8.0

Growth Rates	2021A	2022A	2023E	2024E	2025E
Revenue (%)	3.8	8.2	13.9	16.7	10.7
EBITDA (%)	n/a	n/a	n/a	n/a	n/a
EBIT (%)	n/a	n/a	n/a	n/a	n/a
Normalised NPAT (%)	49.1	-4.0	n/a	n/a	35.5
Normalised EPS (%)	49.1	6.7	n/a	n/a	35.5
Ordinary DPS (%)	n/a	30.0	-100.0	n/a	14.3

Cash Flow (NZ\$m)	2021A	2022A	2023E	2024E	2025E
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	98.1	59.8	44.4	91.7	100.2
Capital expenditure	(12.0)	(17.3)	(14.7)	(15.1)	(15.4)
(Acquisitions)/divestments	(14.4)	(6.1)	(4.1)	0	0
Other	(24.9)	(21.1)	(7.1)	(8.0)	(8.7)
Funding available/(required)	46.8	15.3	18.5	68.7	76.1
Dividends paid	(8.9)	(20.0)	0	(26.6)	(30.4)
Equity raised/(returned)	0	(30.6)	0	0	0
(Increase)/decrease in net debt	37.9	(35.4)	18.5	42.1	45.7

Balance Sheet (NZ\$m)	2021A	2022A	2023E	2024E	2025E
Working capital	148.0	183.2	237.2	267.3	290.9
Fixed assets	9.4	5.4	3.7	2.2	1.1
Intangibles	120.6	132.5	136.1	135.3	135.1
Right of use asset	25.6	23.3	20.7	18.1	15.6
Other assets	314.8	295.6	295.6	295.6	295.6
Total funds employed	618.4	640.0	693.3	718.7	738.2
Net debt/(cash)	(116.1)	(84.5)	(103.0)	(145.1)	(190.8)
Lease liability	39.4	35.1	31.2	27.3	23.4
Other liabilities	342.5	383.5	469.4	526.5	571.0
Shareholder's funds	349.9	306.0	295.7	310.0	334.7
Minority interests	2.7	0	0	0	0
Total funding sources	618.4	640.0	693.3	718.7	738.2

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend** Information on Forsyth Barr's Carbon and ESG (CESG) ratings can be found at www.forsythbarr.co.nz/corporate-news-events/cesg-report

Spot valuation (NZ\$)

PE relative	0.81
P/Book relative	0.75
DCF	0.87
	0.81

DCF valuation summary (NZ\$m)

Total firm value	468
(Net debt)/cash	(45)
Less: Capitalised operating leases	(106)
Value of equity	318

Valuation Ratios	2021A	2022A	2023E	2024E	2025E
EV/Sales (x)	n/a	n/a	n/a	n/a	n/a
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)	14.2	13.3	n/a	7.6	5.6
Price/NTA (x)	1.1	1.4	1.5	1.3	1.2
Free cash flow yield (%)	40.1	15.5	9.6	29.2	32.3
Adj. free cash flow yield (%)	40.1	15.5	9.6	29.2	32.3
Net dividend yield (%)	8.1	10.5	0.0	11.3	12.9
Gross dividend yield (%)	n/a	10.5	0.0	11.3	12.9

Key Ratios	2021A	2022A	2023E	2024E	2025E
Return on assets (%)	n/a	n/a	n/a	n/a	n/a
Return on equity (%)	5.3	5.8	-1.6	10.0	12.6
Return on funds employed (%)	4.6	5.1	-1.5	9.2	11.7
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 (%)	3.1	4.1	3.1	2.7	2.5
Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
Imputation (%)	n/a	0	0	0	0
Pay-out ratio (%)	115	140	0	85	72

Capital Structure	2021A	2022A	2023E	2024E	2025E
Solvency capital	155.9	150.5	179.4	136.4	156.6
Minimum solvency capital (MSC)	56.6	52.3	66.3	66.5	77.1
Total regulatory capital	106.6	102.3	83.3	91.3	91.3
Solvency ratio (%)	275	287	271	205	203

Operating Performance	2021A	2022A	2023E	2024E	2025E
Gross written premium	396.0	445.6	522.9	589.4	641.4
Gross earned premium	386.6	418.3	476.4	556.2	615.4
Reinsurance premium	(58.8)	(66.3)	(89.1)	(85.3)	(93.4)
Net earned premium	327.9	352.1	387.4	470.9	522.0
Net claims expense	(202.3)	(224.9)	(306.3)	(329.6)	(359.9)
* includes Large event claims of	(13.9)	(19.0)	(50.0)	(42.0)	(44.0)
Management & sales expenses	(123.3)	(129.9)	(131.9)	(142.3)	(148.8)
Underwriting profit	27.2	23.6	(20.3)	31.0	46.8
Investment and other revenue	0.2	1.2	14.1	15.7	15.7
Financing and other costs	(0.4)	(0.9)	(0.9)	(0.9)	(1.0)
Profit before tax (from continuing operations)	27.6	25.2	-4.5	45.8	61.5
Tax expense	(9.2)	(7.5)	(0.4)	(14.7)	(19.4)
Profit after taxation	18.4	17.7	-4.9	31.1	42.1
NPAT (from discontinued operation)	(0.2)	5.1	2.3	0.7	0
NPAT (Reported)	18.2	22.8	-2.5	31.8	42.1

Key ratios	2021A	2022A	2023E	2024E	2025E
Total GWP growth %	5.0%	12.5%	17.4%	12.7%	8.8%
Total claims ratio %	54.3%	54.1%	69.2%	63.2%	62.5%
MER %	37.1%	36.0%	33.5%	30.2%	28.5%
Combined ratio %	91.4%	90.1%	103.6%	93.4%	91.0%

Earnings revisions

Figure 1. Earnings revisions

	FY23			FY24			FY25		
	Old	New	Change	Old	New	Change	Old	New	Change
Gross written premium	526.0	526.0	+0%	606.9	589.4	-3%	657.4	641.4	-2%
Gross earned premium	479.6	479.6	+0%	564.9	556.2	-2%	632.2	615.4	-3%
Reinsurance Expense	(81.3)	(86.0)	+6%	(95.6)	(85.3)	-11%	(106.1)	(93.4)	-12%
Net earned premium	398.4	393.7	-1%	469.3	470.9	+0%	526.1	522.0	-1%
Net Claims Expense	(222.3)	(222.4)	+0%	(243.3)	(255.6)	+5%	(270.4)	(282.4)	+4%
Large event claims expense	(50.0)	(50.0)	+0%	(42.0)	(42.0)	+0%	(44.0)	(44.0)	+0%
Management expenses	(126.1)	(122.6)	-3%	(138.1)	(131.9)	-4%	(145.2)	(137.8)	-5%
Net Commission Expense	(9.3)	(9.2)	-0%	(10.4)	(10.4)	+1%	(11.1)	(11.0)	-1%
Underwriting profit	(12.7)	(14.0)	+10%	35.5	31.0	-13%	55.4	46.8	-16%
Net Investment Income	13.0	14.1	+8%	17.1	15.7	-8%	16.9	15.7	-7%
Other income (costs)	0.6	0.6	n/a	(0.9)	(0.9)	n/a	(1.0)	(1.0)	n/a
Profit before tax	0.9	0.7	-30%	51.6	45.8	-11%	71.3	61.5	-14%
Tax expense	(0.7)	(0.4)	-43%	(16.3)	(14.7)	-10%	(22.4)	(19.4)	-14%
Profit after taxation from discontinued operation	-	-	n/a	-	-	n/a	-	-	n/a
Underlying Profit after tax	0.3	0.3	+1%	35.3	31.1	-12%	48.9	42.1	-14%
Canterbury impact on outstanding claims	(2.0)	(2.0)	n/a	-	-	n/a	-	-	n/a
Other non-underlying items	(0.8)	(0.8)	n/a	0.7	0.7	n/a	-	-	n/a
Reported Profit after tax	(2.5)	(2.5)	-0%	36.0	31.8	-12%	48.9	42.1	-14%

Source: Forsyth Barr analysis

Peer comparisons

In a similarly difficult reinsurance market TWR's competitors Suncorp (SUN) and IAG have recently announced completion of their respective reinsurance programmes and FY23 results.

Figure 2. FY23 result comparisons

	GWP growth	Reinsurance expense growth	Reported insurance profit growth
IAG (New Zealand)	+12%	+7%	-80%
SUN (New Zealand)	+14%	+71%	-64%
TWR (FB forecasts)	+17%	+34%	-113%

Source: Company reports, Forsyth Barr analysis

Suncorp's FY23

Suncorp (SUN) released its FY23 result on 17 August 2023. Gross Written Premiums (GWP) in SUN's NZ business grew by +14.3%, reflecting targeted price increases required to address material rises in reinsurance, natural hazard costs and economy-wide inflation. Despite this growth, SUN's NZ general insurance profitability fell -57% to NZ\$65m, split between a 1H23 profit of NZ\$75m and a 2H23 loss of -NZ\$10m. Weak profitability was driven by operating expense growth of +10.5% and higher claims and reinsurance costs. SUN's NZ FY23 loss ratio was 66.8% (but in the 2H23 it was 73.0%) and its reinsurance ratio was 22.9% in 2H23, up from 14.2% in 1H23. SUN NZ achieved a management expense ratio (MER) of 30.2% for FY23.

A third consecutive La Niña weather pattern across Australia and New Zealand led to 15 separate weather events and around 130,000 natural hazard claims, with the group exceeding its natural hazard allowance by +NZ\$95m in NZ. The CEO commentary talked about the weather events underscoring the challenges facing the insurance industry in NZ, especially with the reassessment of risk by reinsurance partners due to floods, fires and other natural disasters. The impacts of these weather events and broader inflationary pressures continue to impact the reinsurance cost across NZ's industry. The group's natural hazard allowance for FY24 is A\$1,360m, and its comprehensive reinsurance program was placed successfully. However, the changes to the reinsurance program will see the need for a further +A\$340m increase in capital. Higher running yields more than offset any unfavourable market-to-market movements across the group's investment portfolio.

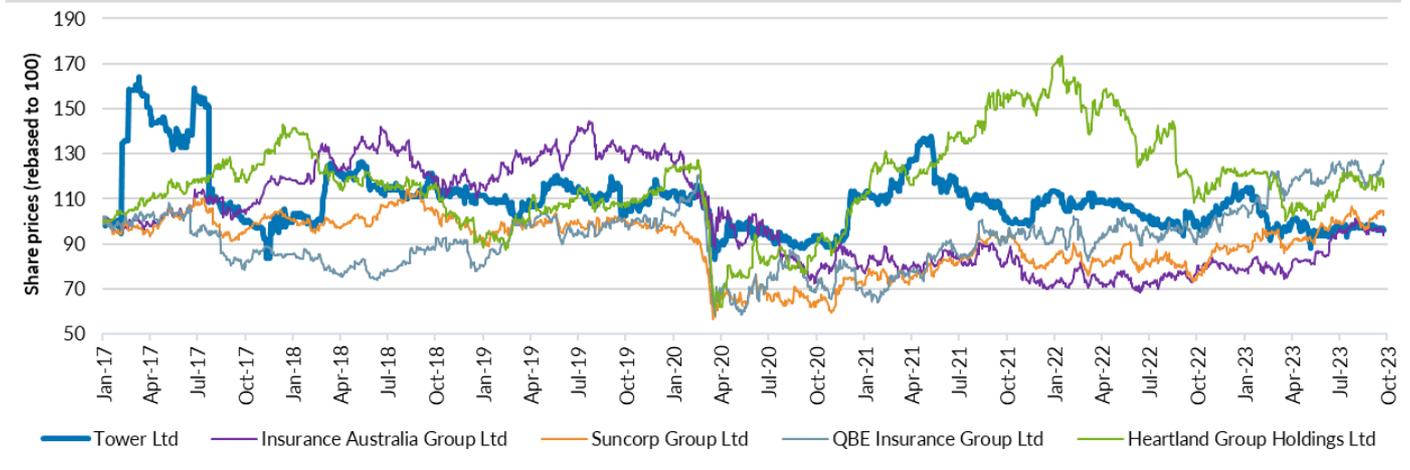
IAG's FY23

IAG's released its FY23 result on 21 August 2023. IAG's NZ operations, which represent ~22% of group GWP, achieved an insurance profit of A\$44m in FY23 compared to A\$220m in FY22. The fall in profitability was driven by a challenging 2H23, during which IAG NZ experienced a -A\$92m loss and the combined ratio was 111.9%. On a more positive note, IAG's NZ operations saw GWP growth of ~+12% in NZD. "Both Business and Direct divisions delivered strong growth, +15.5% and +11.2% respectively in local currency. This was driven predominantly by premium rate increases with relatively stable retention and new business levels". When allowing for the estimated impact of the Earthquake Commission (EQC) cap change on 1 October 2022, GWP growth was +13.8%.

IAG's bank partner distribution channel represented ~13% of NZ's GWP in FY23, down from ~14% in FY22. The NZ reported insurance margin of 2.4% (FY22 12.8%) was impacted by the two major weather events in early 2023. Group FY23 reinsurance expense of A\$5,512m compares to A\$5,063m in FY22, so reinsurance costs were up +8.9%. The net costs of the Auckland flooding event in January 2023 and Cyclone Gabrielle in February 2023, NZ's second and third largest peril events on record, were A\$28m. This amount was reduced by recoveries under IAG's reinsurance program. The company commented that, "Underwriting expenses increased modestly from \$218 million in FY22 to \$225 million in FY23, while the administration expense ratio has improved from 12.7% in FY22 to 12.3% in FY23 reflecting: 1) The impact of higher net earned premium in FY23; 2) Continued disciplined cost management, partially offset by; 3) Ongoing technology and system investment in the Enterprise Platform".

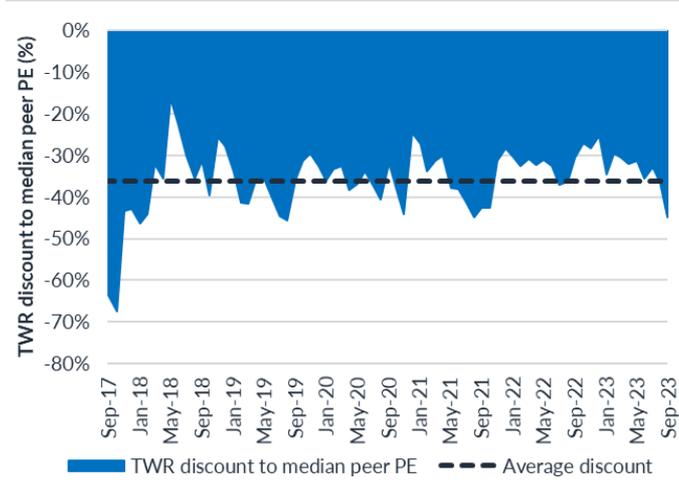
Multiple comparisons

Figure 3. Peer share price performance



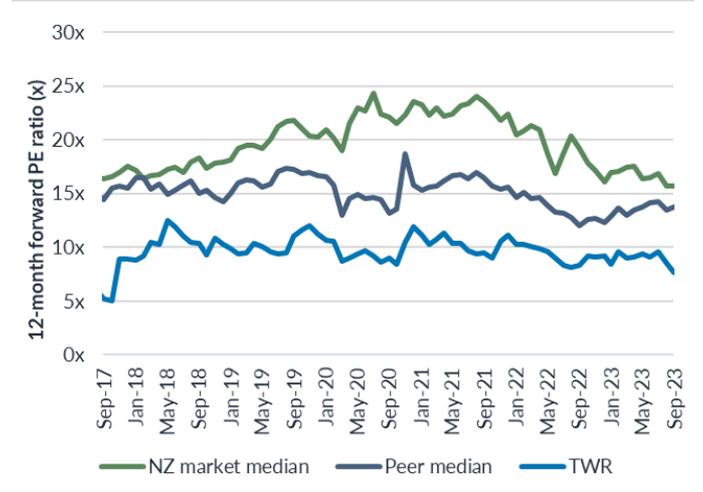
Source: Refinitiv, Forsyth Barr analysis

Figure 4. TWR – discount to median 12-month forward peer PE



Source: Refinitiv, Forsyth Barr analysis

Figure 5. TWR, peers and NZ market median PE ratios



Source: Refinitiv, Forsyth Barr analysis

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
Bain Capital Credit LP	20.0%
ACC	9.6%
Salt Funds Management	8.0%
Pacific International Insurance Pty Ltd	5.8%
NZ Funds Management	5.2%

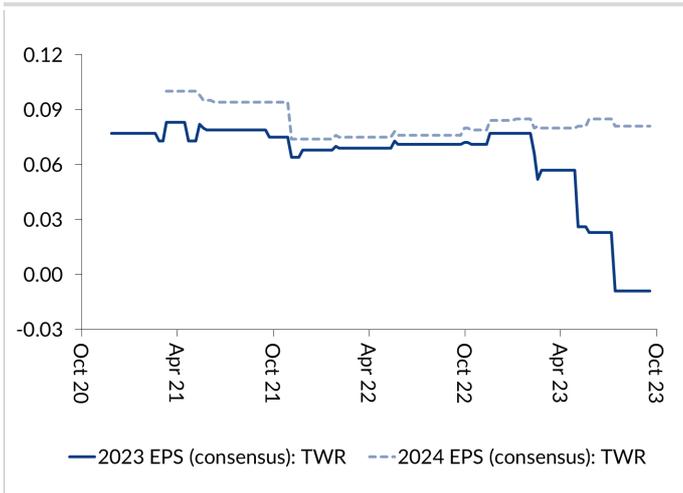
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 8. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE 2023E	PE 2024E	EV/EBITDA 2023E	EV/EBITDA 2024E	EV/EBIT 2023E	EV/EBIT 2024E	Cash Yld 2024E
(metrics re-weighted to reflect TWR's balance date - September)										
Tower Ltd	TWR NZ	NZ\$0.62	NZ\$235	<0x	7.6x	n/a	n/a	n/a	n/a	11.3%
Heartland Group Holdings *	HGH NZ	NZ\$1.73	NZ\$1,237	12.2x	10.3x	n/a	n/a	n/a	n/a	7.0%
Insurance Australia Group	IAG AT	A\$5.67	A\$13,816	16.6x	15.8x	n/a	n/a	n/a	10.0x	4.8%
Suncorp Group	SUN AT	A\$13.96	A\$17,733	14.8x	12.9x	n/a	43.6x	n/a	49.8x	5.5%
QBE INSURANCE GROUP	QBE AT	US\$10.12	US\$15,124	13.1x	9.4x	n/a	n/a	n/a	8.7x	5.6%
Compco Average:				14.2x	12.1x	n/a	43.6x	n/a	22.8x	5.7%
EV = Mkt cap+net debt+lease liabilities+min interests-investments				TWR Relative:		n/a	-37%	n/a	n/a	97%

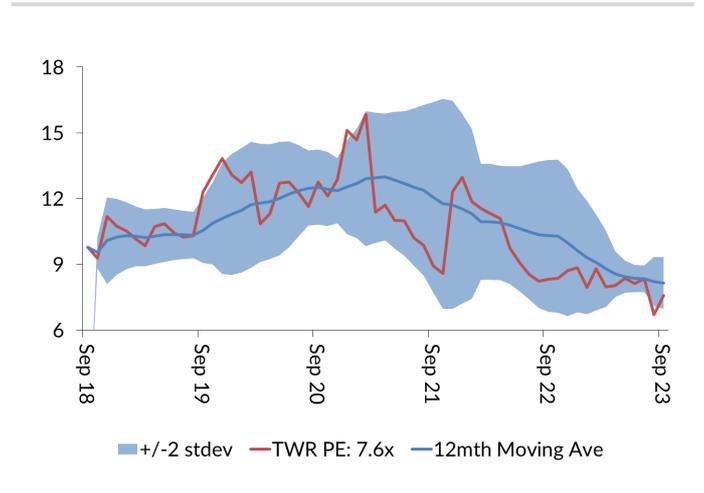
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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