

# Tower 1H21 Result.

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Tower (TWR) reported a disappointing 1H21 result and we have again downgraded our estimates. We remain encouraged by the strong premium growth from the Tower Direct business and continued efficiency improvements, but now expect some permanent degradation to long-term claims ratios. While investors will no doubt welcome the long awaited return of dividends, TWR has taken a step backwards in its journey of restoring investor confidence.

NZX Code	TWR	Financials: Sep/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$0.77	NPAT* (NZ\$m)	28.0	21.7	30.8	37.1	PE	11.4	14.8	10.5	8.7
Spot Valuation	NZ\$0.95	EPS* (NZc)	6.7	5.2	7.3	8.8	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	Medium	EPS growth* (%)	-13.8	-23.1	41.7	20.5	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	421.6m	DPS (NZc)	0.0	4.9	5.5	6.2	Price / NTA	1.4	1.4	1.4	1.4
Market cap	NZ\$323m	Imputation (%)	0	0	25	100	Cash div yld (%)	0.0	6.4	7.2	8.2
Avg daily turnover	367.1k (NZ\$259k)	*Based on normalised profits					Gross div yld (%)	0.0	6.4	7.9	11.3

### What's changed?

- **Earnings:** Underlying NPAT -8.1%/-0.8%/-1.8% in FY21/FY22/FY23

### 1H21 performance disappointing

While there were positive aspects to the 1H21 result (e.g. +14% GWP growth in the Tower Direct business, +12% GWP growth in Partnerships [excluding closed books] and +265bps improvement in the MER to 36.5%), we struggle with the notion of "solid earnings with positive growth". We also question the timing of last week's downgrade; why didn't it occur earlier given the meaningful hit to 1H21 earnings? Underlying NPAT for 1H21 was down -33% vs 1H20, and while large events claims expenses weighed on the result (NZ\$9.3m in 1H21 vs NZ\$2.8m in 1H20) these have been well flagged and there has been no movement in this figure since the company's ASM in February 2021 where it reiterated FY21 guidance for greater than +5% growth in Underlying NPAT.

### Claims ratio dialled back

As foreshadowed in last week's announcement, TWR's performance has been hampered by an increase in large house claims and the "emerging" industry trends relating to inflationary pressures on building costs. In 1H21 large house claims increased in frequency to a reported all time high of 52, with TWR incurring NZ\$9.0m in claims and contributed 2.3% of the 3.6% increase in claims ratio relative to 1H20. While the 1H21 experience looks extreme relative to 1H20, it is not abnormal when considered in relation to average large house claims expense ratio over the previous six interim periods (5.0% vs 5.4% in 1H21). Early signs of building cost inflation in house claims contributed to a 1.1% headwind in the claims ratio, with TWR also calling out negative impact from motor (higher motor mix +1.9%, offset by lower motor claims -0.4%) while the Pacific business was a +1.4% benefit. While addressing claims inflation is a focus of the business, TWR is yet to move its rates in response. At our initiation we assumed a claims ratio (excluding large events) based on the median incurred over the last three years but have revised this up further in the short-term due to building cost inflation and also in the longer-term due to increasing share of new business weighted to Motor.

### Implied 2H21 performance not so ugly, but positive growth still unlikely in the short-term

Based on comments last week reiterating the NZ2.5cps dividend and a commitment to the 60-80% payout ratio despite the downgrade, we mistakenly assumed a greater hit to 2H21 earnings vs 1H21 earnings. The 1H21 earnings were a major miss on our estimates, but taking the half full approach the outlook for 2H21 is now less bad, and implies -1% to -14% Underlying NPAT growth against the prior year (after tax adjustment for large claims differences).

**Tower Limited (TWR)**

<b>Market data (NZ\$)</b>						<b>Spot valuations (NZ\$)</b>					<b>0.95</b>
Priced as at 26 May 2021					<b>0.77</b>	1. PE relative					<b>0.96</b>
52 week high / low					<b>0.89 / 0.57</b>	2. PB relative					<b>0.95</b>
Market capitalisation (NZ\$m)					<b>324.7</b>	3. n/a					<b>n/a</b>
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>					
Risk free rate					<b>2.30%</b>	Total firm value					<b>n/a</b>
Equity beta					<b>1.20</b>	(Net debt)/cash					<b>n/a</b>
WACC					<b>10.1%</b>	Less: Capitalised operating leases					<b>n/a</b>
Terminal growth					<b>1.5%</b>	Value of equity					<b>n/a</b>
<b>Profit and Loss Account (NZ\$m)</b>						<b>Valuation Ratios</b>					
Sales revenue	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>		<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Normalised EBITDA	n/a	n/a	n/a	n/a	n/a	EV/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Depreciation and amortisation	n/a	n/a	n/a	n/a	n/a	EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a
Normalised EBIT	n/a	n/a	n/a	n/a	n/a	PE (x)	9.9	11.5	14.9	10.5	8.7
Net interest	n/a	n/a	n/a	n/a	n/a	Price/NTA (x)	1.4	1.4	1.4	1.4	1.4
Associate income	0	0	0	0	0	Free cash flow yield (%)	7.6	5.8	29.4	17.9	19.1
Tax	n/a	n/a	n/a	n/a	n/a	Net dividend yield (%)	0.0	0.0	6.3	7.1	8.1
Minority interests	0.2	0.4	0.9	0.9	0.9	Gross dividend yield (%)	0.0	0.0	6.3	7.8	11.3
Normalised NPAT	<b>27.3</b>	<b>28.0</b>	<b>21.7</b>	<b>30.8</b>	<b>37.1</b>	<b>Key Ratios</b>					
Abnormals/other	(10.7)	(16.1)	(1.3)	(1.8)	(1.4)	Return on assets (%)	n/a	n/a	n/a	n/a	n/a
Reported NPAT	<b>16.6</b>	<b>11.9</b>	<b>20.4</b>	<b>29.0</b>	<b>35.7</b>	Return on equity (%)	9.4	8.1	6.1	8.6	10.1
Normalised EPS (cps)	7.8	6.7	5.2	7.3	8.8	Return on funds employed (%)	0.0	0.0	0.0	0.0	0.0
DPS (cps)	0	0	4.9	5.5	6.2	EBITDA margin (%)	n/a	n/a	n/a	n/a	n/a
						EBIT margin (%)	n/a	n/a	n/a	n/a	n/a
<b>Growth Rates</b>						Capex to sales (%)	10.9	2.8	3.9	3.9	3.9
Revenue (%)	6.8	10.3	5.0	6.3	4.2	Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
EBITDA (%)	n/a	n/a	n/a	n/a	n/a	Imputation (%)	0	0	0	25	100
EBIT (%)	n/a	n/a	n/a	n/a	n/a	Pay-out ratio (%)	0	0	94	75	71
Normalised NPAT (%)	>100	2.7	-22.3	41.7	20.5	<b>Capital Structure</b>					
Normalised EPS (%)	84.7	-13.8	-23.1	41.7	20.5		<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Ordinary DPS (%)	n/a	n/a	n/a	13.2	13.5	Solvency capital	155.9	150.5	205.5	209.2	218.3
						Minimum solvency capital	56.6	52.3	59.4	59.4	59.4
<b>Cash Flow (NZ\$m)</b>						Total regulatory capital	106.6	102.3	83.3	84.4	84.4
EBITDA	n/a	n/a	n/a	n/a	n/a	Solvency ratio (%)	275	287	346	352	368
Working capital change	n/a	n/a	n/a	n/a	n/a	<b>Operating Performance</b>					
Interest & tax paid	0	0	0	0	0		<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Other	0	0	0	0	0	Gross written premium	356.8	385.1	402.3	427.6	445.6
Operating cash flow	<b>24.6</b>	<b>18.9</b>	<b>95.6</b>	<b>58.0</b>	<b>61.9</b>	Gross earned premium	<b>345.0</b>	<b>380.5</b>	<b>399.6</b>	<b>424.7</b>	<b>442.6</b>
Capital expenditure	(37.6)	(10.5)	(15.5)	(16.5)	(17.2)	Reinsurance expense	(55.0)	(57.2)	(58.3)	(61.9)	(64.4)
Acquisitions/divestments	0	(9.5)	(14.0)	0	0	Net earned premium	<b>290.0</b>	<b>323.3</b>	<b>341.2</b>	<b>362.8</b>	<b>378.2</b>
Other	(42.0)	(9.4)	(35.0)	(2.8)	(2.9)	Net claims expense	(140.3)	(149.7)	(171.0)	(178.7)	(186.3)
Funding available/(required)	<b>(55.0)</b>	<b>(10.5)</b>	<b>31.1</b>	<b>38.8</b>	<b>41.9</b>	Large event claims expense	(1.3)	(9.7)	(13.8)	(14.8)	(15.5)
Dividends paid	0	0	(10.5)	(23.2)	(26.3)	Management and sales expenses	(116.0)	(126.6)	(123.7)	(127.0)	(126.7)
Equity raised/(returned)	0	44.9	0	0	0	Underwriting profit	32.4	37.3	32.6	42.3	49.7
(Increase)/decrease in net debt	<b>(55.0)</b>	<b>34.4</b>	<b>20.6</b>	<b>15.6</b>	<b>15.6</b>	Investment and other revenue	7.0	6.4	1.2	2.8	4.4
						Financing costs	(0.3)	(1.1)	0	0	0
<b>Balance Sheet (NZ\$m)</b>						Underlying profit before tax	<b>39.1</b>	<b>42.6</b>	<b>33.8</b>	<b>45.1</b>	<b>54.1</b>
Working capital	171.6	184.1	143.2	145.8	152.0	Income tax expense	(11.6)	(14.1)	(11.2)	(13.4)	(16.0)
Fixed assets	9.1	10.0	11.0	12.0	12.9	Underlying profit after tax	<b>27.5</b>	<b>28.5</b>	<b>22.6</b>	<b>31.7</b>	<b>38.1</b>
Intangibles	106.7	119.6	128.8	131.9	133.0	Abnormals	(10.7)	(16.2)	(1.3)	(1.8)	(1.4)
Right of use asset	0	7.2	14.2	11.8	9.5	Reported profit / (loss) after tax	<b>16.8</b>	<b>12.3</b>	<b>21.3</b>	<b>29.9</b>	<b>36.6</b>
Other assets	278.1	277.6	302.7	302.7	302.7	<b>Key ratios</b>					
Total funds employed	<b>565.5</b>	<b>598.6</b>	<b>599.8</b>	<b>604.2</b>	<b>610.2</b>	Tower Direct GWP growth %	9.2%	13.7%	10.7%	8.8%	5.0%
Net debt/(cash)	(47.1)	(80.1)	(99.3)	(114.9)	(130.5)	Partnership GWP growth %	2.9%	2.8%	2.4%	3.0%	3.0%
Lease liability	0	8.7	14.8	12.0	9.1	Total GWP growth %	6.2%	7.9%	4.5%	6.3%	4.2%
Other liabilities	319.9	322.9	327.6	343.7	357.8	Total claims ratio %	49%	49%	54%	53%	53%
Shareholder's funds	290.9	345.0	353.6	359.4	368.8	MER %	40%	39%	36%	35%	34%
Minority interests	1.8	2.2	3.0	3.9	4.9	Combined ratio %	89%	88%	90%	88%	87%
Total funding sources	<b>565.5</b>	<b>598.6</b>	<b>599.8</b>	<b>604.2</b>	<b>610.2</b>						

## 1H21 Result Summary

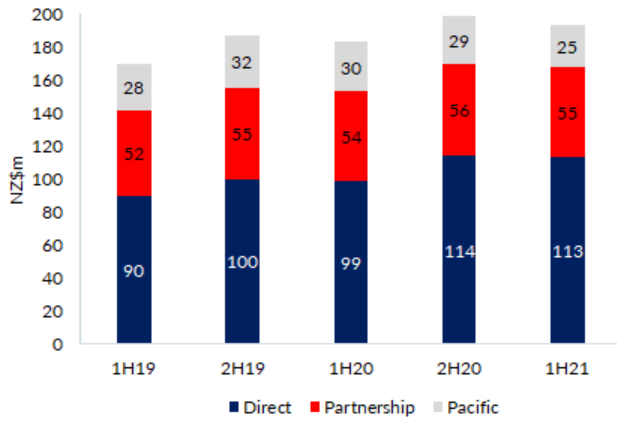
Figure 1. 1H21 Results Summary

NZ\$m	1H20	1H21	Change	1H21E FBMST	Actual vs estimate
<b>Operating Performance</b>					
<b>Gross written premium</b>	<b>183.6</b>	<b>193.9</b>	<b>5.6%</b>	<b>195.4</b>	<b>-0.8%</b>
Gross earned premium	187.3	195.3	4.3%	194.9	0.2%
Reinsurance expense	(27.9)	(28.1)	0.7%	(29.3)	-3.9%
<b>Net earned premium</b>	<b>159.4</b>	<b>167.1</b>	<b>4.8%</b>	<b>165.6</b>	<b>0.9%</b>
Net claims expense	(71.1)	(80.5)	13.2%	(76.2)	5.7%
Large event claims expense	(2.8)	(9.3)	232.1%	(10.0)	-7.0%
Management and sales expenses	(62.5)	(61.0)	-2.4%	(60.9)	0.1%
<b>Underwriting profit</b>	<b>22.9</b>	<b>16.2</b>	<b>-29.3%</b>	<b>18.5</b>	<b>-12.4%</b>
Net Investment	2.2	0.7	-68.2%	0.6	16.7%
Other items	(0.4)	-	n/a	(0.2)	n/a
<b>Underlying profit before tax</b>	<b>24.7</b>	<b>16.9</b>	<b>-31.6%</b>	<b>18.9</b>	<b>-10.6%</b>
Income tax expense	(7.9)	(5.6)	-29.1%	(5.6)	-0.7%
<b>Underlying NPAT</b>	<b>16.9</b>	<b>11.3</b>	<b>-33.1%</b>	<b>13.3</b>	<b>-14.8%</b>
Reported NPAT	14.9	12.0	-19.8%	12.4	-3.5%
<b>Underlying NPAT before large events</b>	<b>18.8</b>	<b>17.5</b>	<b>-6.8%</b>	<b>20.3</b>	<b>-13.7%</b>
EPS (cps)	3.5	2.7	-21.9%	2.9	-5.9%
DPS (cps)	-	2.5	n/a	2.5	0.0%
Claims ratio excluding large events	44.6%	48.2%	357 bps	46.0%	(217) bps
Large events claims ratio	1.8%	5.6%	381 bps	5.1%	(43) bps
Total claims ratio	46.4%	53.7%	738 bps	52.0%	(170) bps
MER	39.0%	36.5%	(250) bps	36.8%	29 bps
Combined ratio	85.4%	90.3%	493 bps	88.8%	(147) bps
Reported solvency capital	150.4	180.4	19.9%		
Solvency Margin	97.5	122.1	25.2%		
Solvency Ratio	284%	309%	n/a		

Source: Forsyth Barr analysis

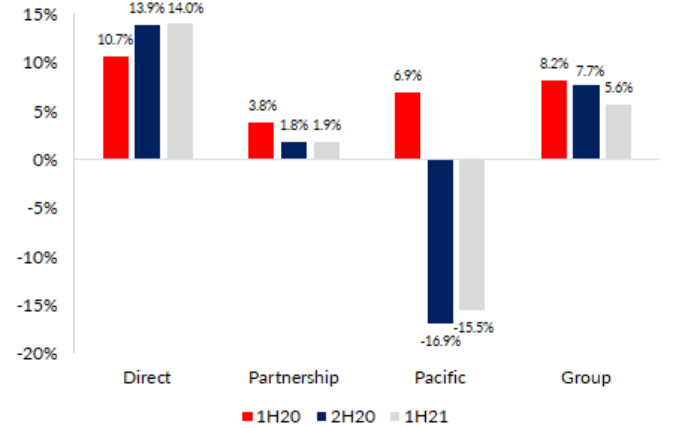
## Key Charts

Figure 2. GWP by Business Unit



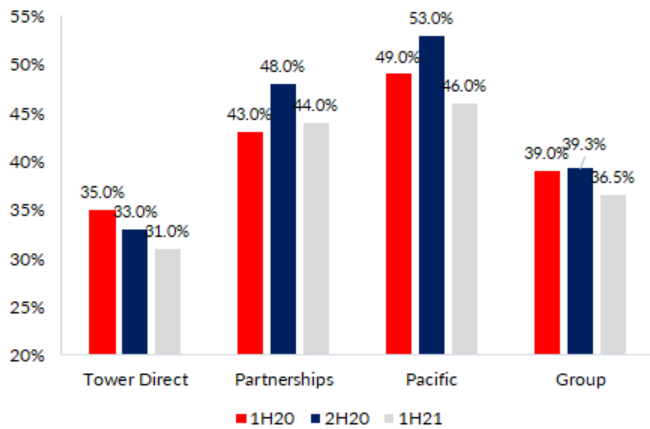
Source: Forsyth Barr analysis

Figure 3. GWP Growth by Business Unit



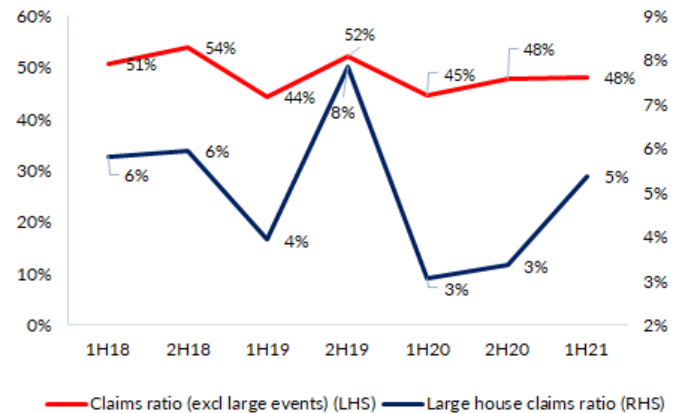
Source: Forsyth Barr analysis

Figure 4. Continued improvement in MER



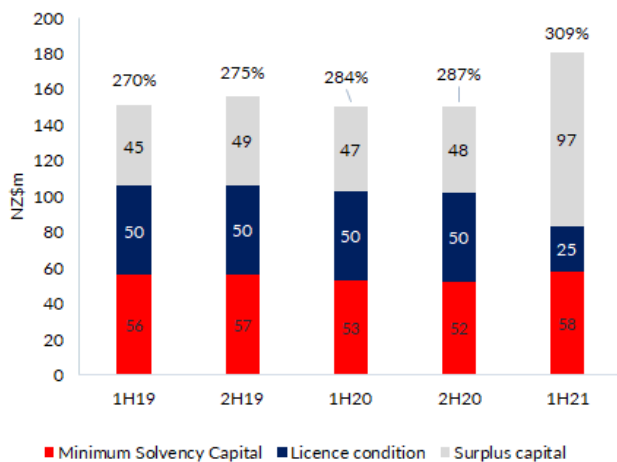
Source: Forsyth Barr analysis

Figure 5. Claims ratios (excl large event claims)



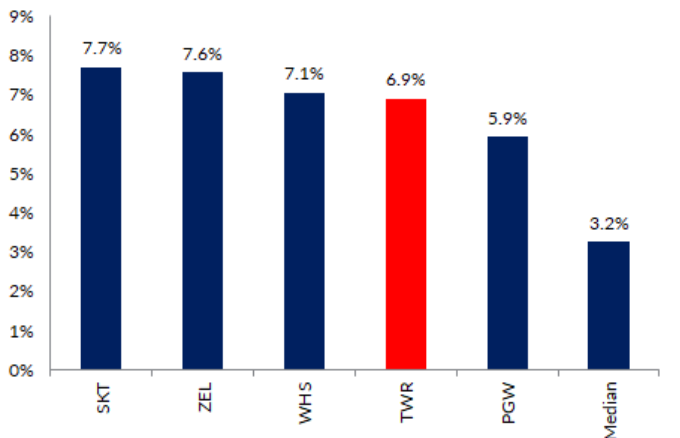
Source: Forsyth Barr analysis

Figure 6. Strong capital and solvency structure



Source: Forsyth Barr analysis

Figure 7. 12month forward cash yield



Source: Forsyth Barr analysis

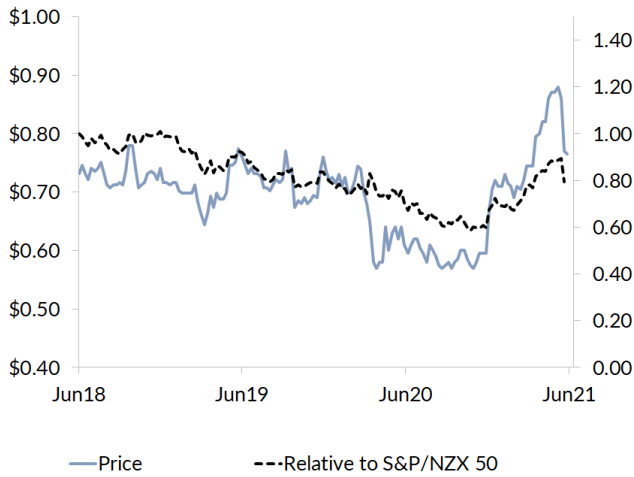
## Earnings changes

Figure 8. Earnings revisions

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	Change	Old	New	Change	Old	New	Change
<b>Operating Performance</b>									
<b>Gross written premium</b>	404.7	402.3	-0.6%	426.9	427.6	0.1%	446.0	445.6	-0.1%
Gross earned premium	402.2	399.6	-0.6%	424.3	424.7	0.1%	443.2	442.6	-0.1%
Reinsurance expense	(60.2)	(58.3)	-3.1%	(61.7)	(61.9)	0.3%	(64.3)	(64.4)	0.1%
<b>Net earned premium</b>	<b>342.0</b>	<b>341.2</b>	<b>-0.2%</b>	<b>362.6</b>	<b>362.8</b>	<b>0.1%</b>	<b>378.9</b>	<b>378.2</b>	<b>-0.2%</b>
Net claims expense	(169.6)	(171.0)	0.8%	(177.7)	(178.7)	0.6%	(183.3)	(186.3)	1.6%
Large event claims expense	(13.7)	(13.8)	0.7%	(14.8)	(14.8)	0.1%	(15.5)	(15.5)	0.2%
Management and sales expenses	(124.4)	(123.7)	-0.6%	(126.9)	(127.0)	0.1%	(128.8)	(126.7)	-1.7%
<b>Underwriting profit</b>	<b>34.2</b>	<b>32.6</b>	<b>-4.7%</b>	<b>43.2</b>	<b>42.3</b>	<b>-2.1%</b>	<b>51.3</b>	<b>49.7</b>	<b>-3.1%</b>
Investment and other revenue	1.2	1.2	0.6%	2.7	2.8	3.1%	4.2	4.4	3.3%
Financing costs	(0.4)	-	n/a	(0.4)	-	n/a	(0.4)	-	n/a
<b>Underlying profit before tax</b>	<b>35.1</b>	<b>33.8</b>	<b>-3.5%</b>	<b>45.5</b>	<b>45.1</b>	<b>-0.9%</b>	<b>55.2</b>	<b>54.1</b>	<b>-1.9%</b>
Income tax expense	(10.5)	(11.2)	7.2%	(13.6)	(13.4)	-1.3%	(16.4)	(16.0)	-2.2%
<b>Underlying profit after tax</b>	<b>24.6</b>	<b>22.6</b>	<b>-8.1%</b>	<b>32.0</b>	<b>31.7</b>	<b>-0.8%</b>	<b>38.7</b>	<b>38.1</b>	<b>-1.8%</b>
Reported profit / (loss) after tax	22.8	21.3	-6.8%	30.6	29.9	-2.0%	37.6	36.6	-2.6%
EPS (cps)	5.3	4.8	-9.3%	7.2	6.9	-3.9%	8.8	8.5	-4.2%
DPS (cps)	5.2	4.9	-5.8%	5.7	5.5	-3.7%	6.5	6.2	-4.0%
Payout based on cash EPS	89%	92%		75%	75%		70%	70%	
Underlying ROE	7%	6%	-9.2%	9%	9%	-3.1%	11%	10%	-4.1%
Claims ratio excluding large events	49.6%	50.1%	52 bps	49.0%	49.3%	26 bps	48.4%	49.3%	87 bps
Large events claims ratio	4.0%	4.0%	4 bps	4.1%	4.1%	0 bps	4.1%	4.1%	2 bps
Total claims ratio	53.6%	54.2%	56 bps	53.1%	53.3%	26 bps	52.5%	53.4%	89 bps
MER	36.4%	36.2%	(14) bps	35.0%	35.0%	0 bps	34.0%	33.5%	(50) bps
Combined ratio	90.0%	90.4%	44 bps	88.1%	88.3%	26 bps	86.5%	86.9%	39 bps

Source: Forsyth Barr analysis

**Figure 9. Price performance**



Source: Forsyth Barr analysis

**Figure 10. Substantial shareholders**

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

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

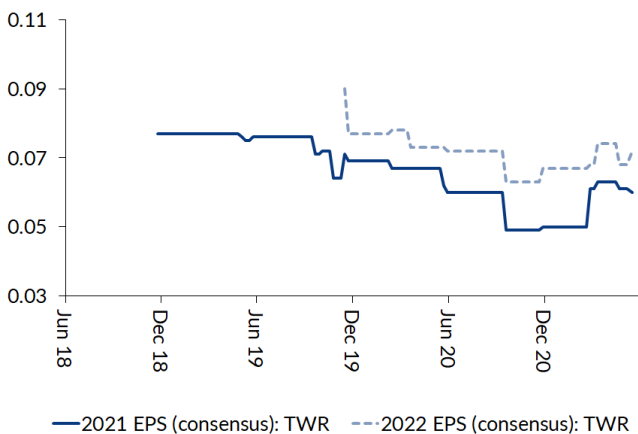
**Figure 11. International valuation comparisons**

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect TWR's balance date - September)										
			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Tower Ltd	TWR NZ	NZ\$0.77	NZ\$323	14.8x	10.5x	n/a	n/a	n/a	n/a	7.2%
HEARTLAND GROUP HOLDINGS *	HGH NZ	NZ\$1.89	NZ\$1,107	12.7x	12.2x	n/a	n/a	n/a	n/a	5.9%
INSURANCE AUSTRALIA GROUP	IAG AT	A\$4.93	A\$12,153	15.8x	16.2x	n/a	n/a	n/a	11.5x	4.9%
SUNCORP GROUP	SUN AT	A\$10.87	A\$13,946	15.3x	15.3x	n/a	n/a	n/a	55.6x	5.2%
QBE INSURANCE GROUP	QBE AT	US\$10.86	US\$16,020	13.6x	17.7x	n/a	n/a	n/a	12.5x	3.4%
<b>Compco Average:</b>				<b>14.4x</b>	<b>15.3x</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>26.5x</b>	<b>4.8%</b>
<b>TWR Relative:</b>				<b>3%</b>	<b>-32%</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>48%</b>

EV = Current Market Cap + Actual Net Debt

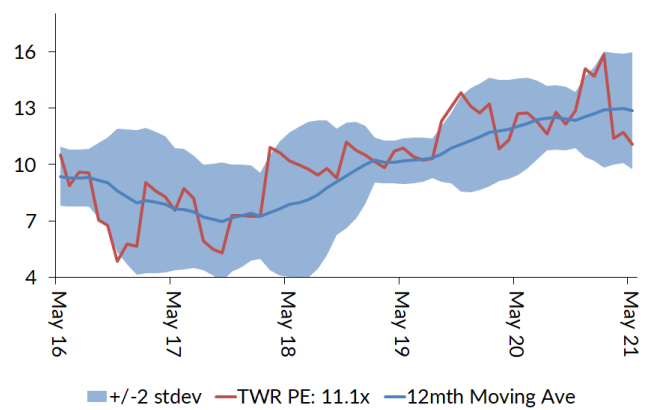
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

**Figure 12. Consensus EPS momentum (NZ\$)**



Source: Forsyth Barr analysis

**Figure 13. One year forward PE (x)**



Source: Forsyth Barr analysis

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