

Tower

Hopes for FY21 Growth Go Up in Smoke

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Tower (TWR) has downgraded its FY21 guidance for underlying NPAT from >NZ\$29.8m to NZ\$25–27m (-13% at the midpoint) a little over a week out from its 1H21 result. We have made preliminary adjustments to our forecasts based on the limited details released but expect to further refine our forecasts next week, subsequent to the release of its 1H21 result.

NZX Code	TWR	Financials: Sep/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$0.81	NPAT* (NZ\$m)	28.0	24.3	31.6	38.4	PE	12.1	14.1	10.8	8.9
Spot Valuation	NZ\$0.95 (from 0.96)	EPS* (NZc)	6.7	5.8	7.5	9.1	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	Medium	EPS growth* (%)	-13.8	-14.2	30.3	21.4	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	421.6m	DPS (NZc)	0.0	5.2	5.7	6.5	Price / NTA	1.5	1.6	1.6	1.5
Market cap	NZ\$342m	Imputation (%)	0	0	25	100	Cash div yld (%)	0.0	6.4	7.0	8.0
Avg daily turnover	361.7k (NZ\$255k)	*Based on normalised profits					Gross div yld (%)	0.0	6.4	7.7	11.1

What's changed?

- **Earnings:** Underlying profit after tax -11.9%/-4.7%/-0.8% in FY21/FY22/FY23 predominately reflecting adjustments to loss ratios and investment income assumptions

The good

1. Guidance for growth in Gross Written Premium (GWP) is marginally better than we expected, with TWR forecasting growth to be +5% or greater for FY21, despite declining GWP in the Pacific business. TWR also expects improvement in its management expense ratio (MER), consistent with our thesis for operating leverage.
2. TWR remains committed to its dividend policy of paying out 60–80% of cash earnings and has reconfirmed it expects to declare an interim dividend of NZ2.5cps next week.

The bad

1. TWR has called out higher house claims costs driven by an increasing frequency of large house claims (i.e claims totalling more than NZ\$50k). TWR incurred 52 large house claims totalling NZ\$9m in 1H21, up from 26 and NZ\$4.9m respectively in 1H20. The majority of these large claims relate to fire damage, for which TWR offers full replacement cost. This trend of increasing fire claims has continued into 2H21, with some hypothesising that the increasing number of people working from home is a contributing factor. Assuming this trend is being experienced across the market, claims inflation (whether it be from increasing fire frequency or general inflationary pressures) should be matched with rate escalation, such that there should be minimal degradation to longer term loss ratios, however, there may be a short term impact until policies rollover.
2. Investment income in 1H21 of NZ\$0.6m was materially lower than we were anticipating and compares to NZ\$2.2m in 1H20.

The potential for ugly?

1. TWR continues to set guidance based on current levels of actual large events – i.e. assuming no additional large events for the remaining of FY21 despite a median of NZ\$3.7m being incurred for large events over the last six interim periods. We continue to take a more conservative view on large event claims; we assume large events continue to follow similar trends to that incurred historically and as a result forecast FY21 underlying earnings of NZ\$24.6m (revised down -11.9% vs previous). If we were instead to take TWR's assumptions on large events our FY21 underlying earnings would be NZ\$25.6m.
2. Management has flagged the potential for an increase in the full year reinsurance costs, but can not quantify the potential worst case scenario, opening the door for increased downside risk, in our opinion.

Tower Limited (TWR)

Market data (NZ\$)						Spot valuations (NZ\$)					0.95
Priced as at 17 May 2021					0.81	1. PE relative					0.98
52 week high / low					0.89 / 0.57	2. PB relative					0.92
Market capitalisation (NZ\$m)					341.5	3. n/a					n/a
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate					2.30%	Total firm value					n/a
Equity beta					1.20	(Net debt)/cash					n/a
WACC					10.1%	Less: Capitalised operating leases					n/a
Terminal growth					1.5%	Value of equity					n/a
Profit and Loss Account (NZ\$m)						Valuation Ratios					
	2019A	2020A	2021E	2022E	2023E		2019A	2020A	2021E	2022E	2023E
Sales revenue	345.0	380.5	402.2	424.3	443.2	EV/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
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)	10.4	12.1	14.1	10.8	8.9
Normalised EBIT	n/a	n/a	n/a	n/a	n/a	Price/NTA (x)	1.5	1.5	1.6	1.6	1.5
Net interest	n/a	n/a	n/a	n/a	n/a	Free cash flow yield (%)	7.2	5.5	27.2	16.6	18.4
Associate income	0	0	0	0	0	Net dividend yield (%)	0.0	0.0	6.4	7.0	8.0
Tax	n/a	n/a	n/a	n/a	n/a	Gross dividend yield (%)	0.0	0.0	6.4	7.7	11.1
Minority interests	0.2	0.4	0.3	0.3	0.4	Key Ratios					
Normalised NPAT	27.3	28.0	24.3	31.6	38.4		2019A	2020A	2021E	2022E	2023E
Abnormals/other	(10.7)	(16.1)	(1.8)	(1.4)	(1.1)	Return on assets (%)	n/a	n/a	n/a	n/a	n/a
Reported NPAT	16.6	11.9	22.5	30.2	37.3	Return on equity (%)	9.4	8.1	7.0	9.0	10.6
Normalised EPS (cps)	7.8	6.7	5.8	7.5	9.1	Return on funds employed (%)	0.0	0.0	0.0	0.0	0.0
DPS (cps)	0	0	5.2	5.7	6.5	EBITDA margin (%)	n/a	n/a	n/a	n/a	n/a
						EBIT margin (%)	n/a	n/a	n/a	n/a	n/a
Growth Rates						Capex to sales (%)	10.9	2.8	3.8	3.8	3.8
	2019A	2020A	2021E	2022E	2023E	Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
Revenue (%)	6.8	10.3	5.7	5.5	4.5	Imputation (%)	0	0	0	25	100
EBITDA (%)	n/a	n/a	n/a	n/a	n/a	Pay-out ratio (%)	0	0	90	76	71
EBIT (%)	n/a	n/a	n/a	n/a	n/a	Capital Structure					
Normalised NPAT (%)	>100	2.7	-13.3	30.3	21.4		2019A	2020A	2021E	2022E	2023E
Normalised EPS (%)	84.7	-13.8	-14.2	30.3	21.4	Solvency capital	155.9	150.5	191.7	194.8	203.2
Ordinary DPS (%)	n/a	n/a	n/a	10.6	13.8	Minimum solvency capital	56.6	52.3	52.9	52.9	52.9
						Total regulatory capital	106.6	102.3	101.9	102.9	102.9
Cash Flow (NZ\$m)						Solvency ratio (%)	275	287	363	368	384
	2019A	2020A	2021E	2022E	2023E	Operating Performance					
EBITDA	n/a	n/a	n/a	n/a	n/a		2019A	2020A	2021E	2022E	2023E
Working capital change	n/a	n/a	n/a	n/a	n/a	Gross written premium	356.8	385.1	404.7	426.9	446.0
Interest & tax paid	0	0	0	0	0	Gross earned premium	345.0	380.5	402.2	424.3	443.2
Other	0	0	0	0	0	Reinsurance expense	(55.0)	(57.2)	(60.2)	(61.7)	(64.3)
Operating cash flow	24.6	18.9	92.8	56.6	62.7	Net earned premium	290.0	323.3	342.0	362.6	378.9
Capital expenditure	(37.6)	(10.5)	(15.5)	(16.3)	(17.1)	Net claims expense	(140.3)	(149.7)	(169.6)	(177.7)	(183.3)
(Acquisitions)/divestments	0	(9.5)	(14.0)	0	0	Large event claims expense	(1.3)	(9.7)	(13.7)	(14.8)	(15.5)
Other	(42.0)	(9.4)	(12.1)	(2.8)	(2.9)	Management and sales expenses	(116.0)	(126.6)	(124.4)	(126.9)	(128.8)
Funding available/(required)	(55.0)	(10.5)	51.2	37.5	42.8	Underwriting profit	32.4	37.3	34.2	43.2	51.3
Dividends paid	0	0	(21.8)	(24.1)	(27.4)	Investment and other revenue	7.0	6.4	1.2	2.7	4.2
Equity raised/(returned)	0	44.9	0	0	0	Financing costs	(0.3)	(1.1)	(0.4)	(0.4)	(0.4)
(Increase)/decrease in net debt	(55.0)	34.4	29.5	13.4	15.4	Underlying profit before tax	39.1	42.6	35.1	45.5	55.2
						Income tax expense	(11.6)	(14.1)	(10.5)	(13.6)	(16.4)
Balance Sheet (NZ\$m)						Underlying profit after tax	27.5	28.5	24.6	32.0	38.7
	2019A	2020A	2021E	2022E	2023E	Abnormals	(10.7)	(16.2)	(1.8)	(1.4)	(1.1)
Working capital	171.6	184.1	143.8	145.1	151.6	Reported profit / (loss) after tax	16.8	12.3	22.8	30.6	37.6
Fixed assets	9.1	10.0	10.9	11.8	12.7	Key ratios					
Intangibles	106.7	119.6	129.7	133.1	135.0						
Right of use asset	0	7.2	14.0	11.7	9.4	Tower Direct GWP Growth	9.2%	13.7%	9.3%	6.8%	5.0%
Other assets	278.1	277.6	286.6	286.6	286.6	Partnership GWP Growth	2.9%	2.8%	5.0%	4.0%	4.0%
Total funds employed	565.5	598.6	585.1	588.4	595.2	GWP growth %	6.2%	7.9%	5.1%	5.5%	4.5%
Net debt/(cash)	(47.1)	(80.1)	(109.6)	(123.0)	(138.4)	Total claims ratio %	49%	49%	54%	53%	52%
Lease liability	0	8.7	14.8	12.0	9.1	MER %	40%	39%	36%	35%	34%
Other liabilities	319.9	322.9	331.6	344.6	359.5	Combined ratio %	89%	88%	90%	88%	86%
Shareholder's funds	290.9	345.0	345.8	351.9	361.8						
Minority interests	1.8	2.2	2.5	2.8	3.2						
Total funding sources	565.5	598.6	585.1	588.4	595.2						

Earnings changes

Figure 1. Earnings changes

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	Change	Old	New	Change	Old	New	Change
Operating Performance									
Gross written premium	400.9	404.7	0.9%	423.0	426.9	0.9%	441.9	446.0	0.9%
Gross earned premium	398.5	402.2	0.9%	420.4	424.3	0.9%	439.2	443.2	0.9%
Reinsurance expense	(59.7)	(60.2)	0.8%	(61.2)	(61.7)	0.8%	(63.8)	(64.3)	0.8%
Net earned premium	338.7	342.0	1.0%	359.2	362.6	0.9%	375.4	378.9	0.9%
Net claims expense	(164.4)	(169.6)	3.2%	(173.8)	(177.7)	2.2%	(181.6)	(183.3)	0.9%
Large event claims expense	(14.0)	(13.7)	-2.1%	(15.2)	(14.8)	-2.2%	(15.8)	(15.5)	-2.2%
Management and sales expenses	(123.6)	(124.4)	0.7%	(125.7)	(126.9)	0.9%	(127.6)	(128.8)	0.9%
Underwriting profit	36.7	34.2	-6.9%	44.5	43.2	-3.0%	50.3	51.3	1.9%
Investment and other revenue	3.4	1.2	-64.2%	3.6	2.7	-25.1%	5.7	4.2	-25.2%
Financing costs	(0.4)	(0.4)	0.0%	(0.4)	(0.4)	0.0%	(0.4)	(0.4)	0.0%
Underlying profit before tax	39.8	35.1	-11.9%	47.8	45.5	-4.7%	55.6	55.2	-0.8%
Income tax expense	(11.9)	(10.5)	-12.0%	(14.2)	(13.6)	-4.8%	(16.6)	(16.4)	-0.9%
Underlying profit after tax	27.9	24.6	-11.9%	33.5	32.0	-4.7%	39.1	38.7	-0.8%
Abnormals	(1.8)	(1.8)	0.0%	(1.4)	(1.4)	0.0%	(1.1)	(1.1)	0.0%
Reported profit / (loss) after tax	26.2	22.8	-12.7%	32.1	30.6	-4.9%	37.9	37.6	-0.8%
EPS (cps)	6.1	5.3	-12.8%	7.5	7.2	-4.9%	8.9	8.8	-0.8%
DPS (cps)	5.6	5.2	-8.7%	6.0	5.7	-4.7%	6.5	6.5	-0.8%
Payout	86%	89%		75%	75%		70%	70%	
Underlying ROE	8%	7%	-11.7%	10%	9%	-4.3%	11%	11%	-0.3%

Source: Forsyth Barr analysis

Figure 2. Price performance



Source: Forsyth Barr analysis

Figure 3. 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

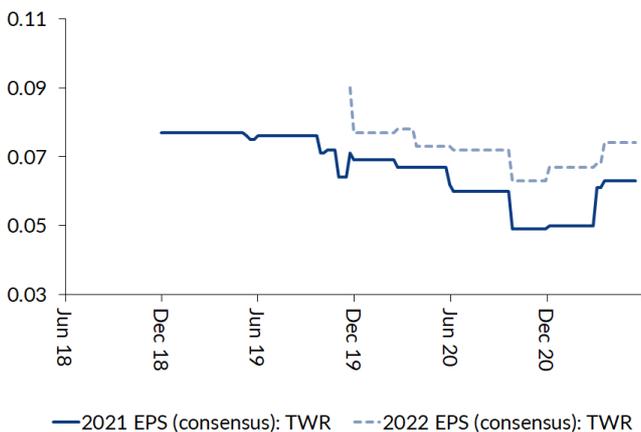
Figure 4. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
				2021E	2022E	2021E	2022E	2021E	2022E	
Tower Ltd	TWR NZ	NZ\$0.81	NZ\$342	14.1x	10.8x	n/a	n/a	n/a	n/a	7.0%
HEARTLAND GROUP HOLDINGS *	HGH NZ	NZ\$1.88	NZ\$1,102	12.7x	12.1x	n/a	n/a	n/a	n/a	5.9%
INSURANCE AUSTRALIA GROUP	IAG AT	A\$4.83	A\$11,906	15.4x	15.8x	n/a	n/a	n/a	11.3x	5.0%
SUNCORP GROUP	SUN AT	A\$10.25	A\$13,150	14.6x	14.5x	n/a	n/a	n/a	55.1x	5.5%
QBE INSURANCE GROUP	QBE AT	US\$10.45	US\$15,415	13.1x	17.0x	n/a	n/a	n/a	12.0x	3.6%
Compco Average:				13.9x	14.9x	n/a	n/a	n/a	26.1x	5.0%
TWR Relative:				1%	-27%	n/a	n/a	n/a	n/a	41%

EV = Current Market Cap + Actual Net Debt

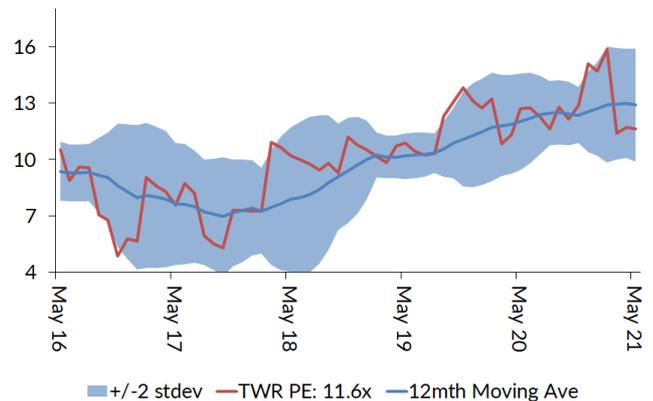
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 5. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 6. One year forward PE (x)



Source: Forsyth Barr analysis

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