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TOWER Management Review – Half Year to 31 March 2014

Key features of the result

- Solid result with General Insurance net profit up strongly on 1H13
- Gross written premium up 5% to $139.2 million, supported by rate increases due to rising reinsurance costs
- First half dividend of 6.5 cents per share (unimputed), up 30% plus $52.6 million returned to shareholders in 1H14 and $81.8 million bonds redeemed in April 2014
- Good solvency, with capital above regulatory minimum of $78 million, increasing longer term to $109 million above target solvency following completion of the Canterbury rebuild. In April 2014 TOWER became debt free
- Reported NPAT of $13.1 million, down from $44.2 million in 1H13, which included profit from asset sales and divested businesses
- Investment in brand, product and service to support growth in direct and alliance channels
- Improved customer satisfaction reflected in rising Net Promoter Score and lower policy lapse rates
- Focus on staff engagement, efficiency and cost structure to support growth in multiple channels
- Pacific NPAT recovered to $2.7 million, from a loss of $0.6 million in 1H13 and identified path to growth through strong brands and alliances
- Canterbury rebuild supports progress toward capital release

Financial summary

	HY14	HY13	change on pcp
General insurance			
Reported			
Gross written premium ($m)	139.2	132.5	5%
General insurance NPAT ($m)	11.8	(14.8)	na
Underlying[1]			
Claims ratio (%)	50.4%	52.1%	-170bp
Combined ratio (%)	88.3%	91.0%	-270bp
Underwriting profit ($m)	13.5	9.7	39%
General insurance NPAT ($m)	13.1	5.9	122%
Group			
Reported NPAT ($m)	13.1	44.2	-70%
EPS (c)[2]	4.96	(3.5)	na
DPS (c)	6.5	5.0	30%

1. Excludes impact of the Canterbury earthquakes and the discontinuation of the Australian business.
2. Includes profit attributable to shareholders from ongoing operations only

Summary

TOWER Limited reported net profit after tax (NPAT) of $13.1 million for the first half of financial year 2014. This compares to NPAT of $44.2 million in the previous corresponding period (pcp), which included significant abnormal profit and earnings from divested businesses.

General Insurance underlying NPAT increased by 122% on the pcp to $13.1 million. This measure excludes the impact of the Canterbury earthquakes and revaluation of Australian net assets and the associated foreign exchange loss.

Early shoots are visible from the execution of strategic priorities with customer retention, brand recognition and net promoter score, a key measure of customer satisfaction, improving during the half.

TOWER made significant progress to leverage technology shifts to improve its direct business, launching new products and services and providing better value and service to customers.

In the Pacific, despite claims remaining above averages, NPAT recovered to $2.7 million in 1H14. Earnings in 1H13 were affected by Cyclone Evan as well as increased withholding tax payments.

Net financing costs declined to $1.6 million. Abnormal items were a loss of $0.7 million, compared to a $30.7 million gain in 1H13 on asset divestments.

TOWER returned $52.6 million to shareholders through a voluntary share buy back during 1H14 and has since repaid $81.8 million in bonds. Total capital returned to shareholders in the last 13 months was $171.8 million.

TOWER will pay a first half dividend of 6.5 cents per share (unimputed), up 30% on pcp. This is in line with the policy of a 90-100% payout ratio of NPAT attributable to shareholders. Earnings per share (EPS) [1] were 4.96 cents, up from a loss of 3.50 cents in the pcp.

General Insurance

In General Insurance, gross written premium (GWP) increased 5.0% on the pcp, supported by rate growth to reflect earlier rises in reinsurance costs. Net earned premium (NEP) increased 7.7% to $115.6 million primarily due to premium increases and improved retention. Claims were $2.3 million higher than the pcp (net of reinsurance).

Large claim events in New Zealand and the Pacific cost $4.8 million before tax in the half, compared to $3.3 million in 1H13. The industry has seen a spike in weather events over the past two years, with recent events including the storms in October, as well as South Island floods and Cyclone Lusi in March.

Despite these pressures, the underlying[2] claims ratio declined to 50.4% from 52.1% in the pcp, and the underlying combined ratio decreased to 88.3% from 91.0% in the pcp. Underlying underwriting profit before tax increased 39% on the pcp to $13.5 million supported by premium growth.

The underlying expense ratio (management expenses and commissions to net earned premium) has been reduced from 38.9% in 1H13 to 37.9%. TOWER invested in brand, new products and service during the half. The Company has also focussed on staff engagement, efficiency and the ongoing cost structure to support future growth.

TOWER holds an estimated 4.6% share of the New Zealand general insurance market (of the market based on Estimated GWP for 12 months to 31 December 2013), placing it 5th in the market. More important is TOWER's position in the key Personal Lines market, with shares of 10.5% in Home, 10.2% in Contents and 6.4% in Motor lines. This highlights the substantial opportunity available to TOWER in New Zealand.

The Company has more than 496,000 policies and 264,000 customers in New Zealand and seven Pacific territories through its own direct business and alliance partnerships.

TOWER made significant progress on the General Insurance strategy and strengthening its three core pillars of staff engagement, customer satisfaction and financial performance.

The Company moved forward with plans for the relocation of its Auckland office, which houses the majority of TOWER staff, to take place later in 2014. It has also progressed the introduction of the InsuranceFaces client management software to support productivity gains and improved customer service. InsuranceFaces is providing encouraging results in the

[1] EPS based on continuing operations as per accounting standards
[2] Underlying is before the impact of the Canterbury earthquakes and the discontinuation of the Australian business

FinTel business and wider implementation with TOWER's direct customer database begins by the end of the year.

TOWER continues to invest in its brand, service and positioning. The new lighthouse campaign has leveraged the brand's position as a New Zealand alternative to the foreign-owned insurers that dominate the New Zealand market.

There has been a strong response to the new multi-media campaign with customer "preference" (an indicator of the likelihood of a customer choosing TOWER) rising from 13% to 18%. Recall of the ads reached 40%, which is lifting brand awareness and providing an opportunity for new business.

TOWER has examined pricing on product bundling to drive value and retention for loyal customers and established a "save team" to directly address the lapse rate. The policy lapse rate improved modestly on pcp to 13.5%.

This investment in customer service and retention supported an increase in net promoter score (a key measure of customer satisfaction and loyalty) from +6 to +25 in just six months.

As part of the strategic priority to utilise technology to introduce new products and value-added services to customers, TOWER introduced the SmartDriver product in the motor segment of the business.

SmartDriver allows users to take advantage of a global trend in the utilisation of "telematics" data insights to access lower insurance premiums that are reflective of safe driving habits. The SmartDriver app has proved an extremely popular innovation, with downloads far exceeding initial expectations. The app has received positive reviews from users and achieved significant media coverage that has supported the TOWER brand and positioning as innovative and customer-focused.

SmartDriver allows TOWER to leverage more tailored risk assessment to sharpen pricing as part of its strategy to lift representation in the motor segment.

TOWER has also significantly improved its online presence to further enhance brand and leverage the sales and service opportunity through direct channels.

A focus on growth through direct and alliances has also yielded encouraging results, although the run-off from a legacy alliance continues to affect customer and policy numbers in that segment.

Canterbury rebuild

TOWER continues to lead the industry in settling earthquake claims with 81% of all claims now settled and closed.

TOWER's construction programme for rebuilds and repairs is gaining momentum, with 87 rebuild and major repairs completed over the six month period.

Priorities for the next six months include:

- Ensuring all customers who want TOWER to manage the rebuild or repair of their house are in the construction programme;
- Resolving the last of the EQC out of scope claims;
- Working closely with builders and sub trades to ensure work is completed to schedule; and
- Ensuring multi-unit building (MUB) customers are clear on their settlement options.

TOWER continues to support the Residential Advisory Service (RAS) to resolve claims where customers need independent advice on their claim.

TOWER is on track to substantially settle and complete all Canterbury earthquake related claims by the end of 2015.

Pacific Islands

The Pacific Islands is a significant and important business, accounting for 18% of group GWP and 21% of underlying NPAT in the six months to 31 March 2014. NPAT from the Pacific increased to $2.7 million from a loss of $0.6 million in the pcp.

The pcp was affected by the $3.3 million pretax impact of the devastating Cyclone Evan in Fiji and Samoa as well as a $2.4 million foreign withholding tax deduction from dividends paid by the Pacific Island subsidiaries during the period.

Cyclones in Tonga, $1.8 million in pretax impact of suspected arson activity in the Cook Islands and adverse foreign currency movements in Papua New Guinea restricted earnings in 1H14.

Papua New Guinea, Fiji and Samoa together represent 78% of the Pacific business with Cook Islands, Solomon Islands and Tonga the remaining 22% of GWP in 1H14.

Economic activity supported growth in the PNG business in 1H14. In Fiji, where TOWER has operated for 140 years, the Company's first television and online campaign delivered encouraging results. The online strategy in Fiji is now driving up to 20% of direct lead generation.

The net promoter score in the Pacific region of +42 showed positive customer feedback. TOWER continued to benefit from strong banking alliances across the region to build its presence in commercial and personal lines insurance.

Consistent and careful underwriting allows attractive margins across the Pacific where TOWER's strong brand and expertise offers an opportunity for growth.

TOWER Life (N.Z) Limited

Life insurance business, TOWER Life (N.Z.) Limited, reported NPAT of $3.7 million, well above the full year plan of $2.8 million due to one-off earnings improvements. The business has a closed book in run-off with no new business being written. Notwithstanding, TOWER

Life (N.Z.) is a stable business with a focus on customer service and productivity. The business moved to new Wellington premises (with centralised support) to help improve its efficiency. An annual bonus was paid to policyholders for the 2013 year, in line with the 2012 bonus rate.

TOWER continues to receive approaches about its Life business and will continue to evaluate these. The book value of the business at 31 March 2014 was $39.1 million.

Financial review

Balance sheet

Following the repayment of the corporate bonds, on 15 April 2014, TOWER Limited is debt free. Cash and call deposits increased to $286.6 million at the end of 1H14, up from $255.2 million a year earlier. Following the divestment of operating assets and a number of capital returns, total assets reduced to $1,545.3 million and shareholders' equity is now $327.6 million.

Interest and Tax

Interest costs include $3.5 million relating to the bonds that were redeemed on 15 April 2014. TOWER's average tax rate in 1H14, for the General Insurance business, was 31%. The rate reflects the average of the New Zealand and Pacific Islands corporate rates plus withholding tax in 1H14.

Reinsurance costs

TOWER has taken advantage of easing reinsurance costs to extend earthquake cover to $585 million with a retention of $10 million. In this way, the Company is lowering its long-term risk profile.

Since 2011, reinsurance costs have more than doubled. However, reinsurance costs have now stabilised year on year. Reinsurance costs as a percentage of Gross Earned Premium eased from a peak of 17.8% in 1H13 to 16.9% in 1H14.

Capital management

During 1H14 the Company returned $52.6 million via a voluntary share buy back. In the last 13 months TOWER has returned $171.8 million to shareholders.

Further surplus capital was applied to the redemption of $81.8 million in bonds in April 2014 which will save $6.9 million in interest per annum.

During 1H14, NZ$20 million in capital reserves were released on transfer of the run-off business underwritten by TOWER's Australian branch. The transfer saw Gordian RunOff Limited assume the insurance liabilities and ongoing obligations of the run-off business.

A number of shareholders have asked the company to consider a way for them to cost-effectively dispose of their small holdings. The Board is pleased to respond to this and intends to operate a share cancellation programme for small parcel shareholders.

Given the additional Minimum Solvency Margin (MSM) requirement while the Canterbury rebuild completes, TOWER is currently carrying $43 million in solvency above the regulatory minimum at the business level. This would increase to $74 million with completion of the Canterbury rebuild and removal of the MSM. In addition, TOWER, after repayment of the bonds and prior to dividend and small shareholder cancellation, holds $35 million at the corporate level, bringing the current total to $78 million above the regulatory minimum.

Dividends

In line with its 90-100% dividend payout policy, the TOWER Board has increased the first half dividend by 30% on pcp to 6.5 cents per share in light of the solid first half result. The dividend is not imputed and TOWER's dividend reinvestment plan will not operate for this dividend. The dividend record date is 13 June 2014 and payment date is 30 June 2014.

Strategy

TOWER aims to deliver attractive shareholder returns by growing a general insurance business that is seen as a leading light in New Zealand and the Pacific Islands.

The Company has established three pillars of its New Zealand General Insurance strategy: staff engagement, customer satisfaction and financial performance.

TOWER seeks to:

- Drive growth and efficiency through staff engagement;
- Unlock significant brand potential through customer service;
- Maintain a leading position in attractive Pacific markets;
- Deliver financial performance;
- Efficiently manage risk and capital for better returns; and
- Capitalise on the opportunities presented by industry consolidation.

The Company is investing in staff engagement and efficiency. The current underlying expense ratio of 37.9% is high compared to its peers. New technology is expected to support an improvement in expense ratios in the next two years and top line growth should assist further.

TOWER intends to utilise technology to lower costs and improve the value proposition. The Company is seeking to grow its share of the motor market. TOWER is building a customer-focused culture and delivering on claims and risk management with industry-leading results in Canterbury.

The Company is establishing better products, sharper pricing, lower costs and better customer service to position for growth in General Insurance.

In the Pacific, TOWER is utilising its strong brand, alliances and experience to pursue growth opportunities.

TOWER continues to examine further capital returns for shareholders where possible.

Outlook

For the industry, growth in reinsurance costs and premiums has eased post the Canterbury earthquakes but both the cost of compliance and capital requirements have increased.

Technological change will continue to have a significant impact on the industry with opportunities to improve service and offers. Customers are highly informed and mobile. Price and service will remain key drivers of choice.

Industry consolidation is likely to remain a trend in New Zealand insurance. TOWER will look to actively participate in this where there is benefit to shareholders. However, with industry concentration an increased risk of new entrants remains.

For TOWER, the revenue growth and cost containment focus continues in the second half. New product development will remain a priority and the business is on track to go live with a new client management system, InsuranceFaces.

Weather events remain a concern with April 2014 unfavourable and $4.8 million in large event claims for the month.

TOWER expects to make further progress towards substantially settling and completing all Canterbury earthquake related claims by the end of 2015.

In the Pacific, a marketing reinvigoration will be ongoing.

Finally, capital management will remain a key driver of shareholder returns.

Michael Boggs
Chief Financial Officer
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