

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

Earnings changes

Figure 1. Earnings changes

NZ\$m	FY21E			FY22E			FY23E		
Operating Performance	Old	New	Change	Old	New	Change	Old	New	Change
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%

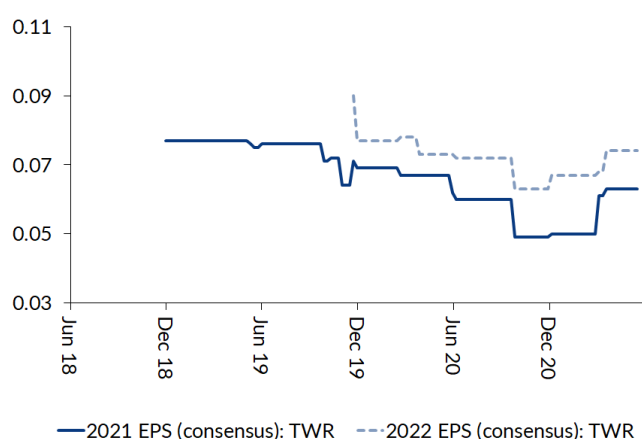
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 4. International valuation comparisons

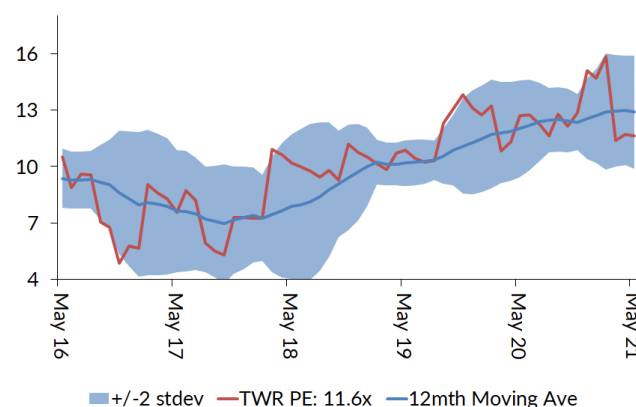
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect TWR's balance date - September)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Tower Ltd	TWR NZ	NZ\$0.81	NZ\$342	14.1x	10.8x	n/a	n/a	n/a	n/a	7.0%
HEARTLAND GROUP HOLDINGS *	HGH NZ	NZ\$1.88	NZ\$1,102	12.7x	12.1x	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%
EV = Current Market Cap + Actual Net Debt				TWR Relative:	1%	-27%	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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