

Tower

Hunga Tonga – Hunga Ha'apai

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Tower (TWR.NZ) has updated the market, saying it is in the early stages of assessing the impact of a powerful '1 in 1,000 year event' eruption near Tonga. It remains too early to properly determine or estimate the cost of repairs at this stage. Given the complexities of communication (telephone and internet networks have been down) and the prioritisation of the clean-up and health of the population, TWR's initial assessment of damage will only likely be able to be undertaken over the next week or two. TWR's excess for large events like this is NZ\$11.25m; we have NZ\$20m in our FY22 forecasts for large event expenses.

NZX Code	TWR	Financials: Sep/	21A	22E	23E	24E	Valuation (x)	21A	22E	23E	24E
Share price	NZ\$0.68	NPAT* (NZ\$m)	18.7	22.4	27.7	31.3	PE	15.3	12.8	10.4	9.2
Spot Valuation	NZ\$0.86	EPS* (NZc)	4.4	5.3	6.6	7.4	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	Medium	EPS growth* (%)	55.4	20.0	23.3	13.0	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	421.6m	DPS (NZc)	5.0	5.0	5.3	5.5	Price / NTA	1.3	1.3	1.3	1.2
Market cap	NZ\$287m	Imputation (%)	0	0	85	100	Cash div yld (%)	7.4	7.4	7.7	8.1
Avg daily turnover	353.8k (NZ\$264k)	*Based on normalised profits					Gross div yld (%)	7.4	7.4	10.3	11.2

What has happened?

- A large eruption has caused widespread damage and disruption in Tonga.
- Tonga, like New Zealand, sits within the 'Ring of Fire' surrounding the Pacific.
- TWR has 2,500 personal lines customers in Tonga, representing 0.8% of its total 310,000 customers.
- TWR has 300 commercial customers in Tonga.
- The company's Nuku'alofa branch has reopened since the event to start to assist customers.
- The excess for TWR's reinsurance programme for large events like this is NZ\$11.25m.
- TWR's reinsurance programme covers up to NZ\$873m of cover for catastrophe events.
- A new event cover, additional to the one already prepaid, has automatically been purchased.

Hunga-Tonga-Hunga-Ha'apai eruption

On Saturday, 15 January 2022, at 5:10pm local time, a large underwater eruption occurred near Tonga. The volcano, Hunga Tonga Hungaa Ha'apai, sits 65 km north of the capital, Nuku'alofa. The Hunga Tonga – Hunga Ha'apai volcano is 1.8 km high and 20 km wide, with the vast majority underwater. The eruption has covered the Pacific Island in ash, temporarily cut power, and severed the island's main fibre communication cable. It caused a 1.2m tsunami which hit the capital 20 minutes later. This devastated much of the coastal services and housing on the islands of Tonga and spread right across the Pacific. The violence of the eruption led to particles being forced upward at hypersonic speeds around 15–20 km into the atmosphere, creating an air pressure sound wave and sonic boom that was widely heard in New Zealand and across the world. Ash falling from the volcano has covered the surrounding islands. The fallout has contaminated both food and water supplies. It is likely to have a corrosive impact on housing, vehicles and air conditioning units.

Estimates unchanged – at this stage

Our stance towards large event claims expense each year is to include NZ\$20m of expenses in our estimates, in line with TWR's management's view. This event will utilise NZ\$11.25m of this amount. Given that TWR is only four months into FY22 it is too early to signal earnings risk to the downside. However, to date there has been a lower incidence of large weather events. Our FY22 underlying NPAT estimate (NZ\$22.4m) is retained and is consistent with management's FY22 underlying NPAT guidance of NZ\$21m to NZ\$25m.

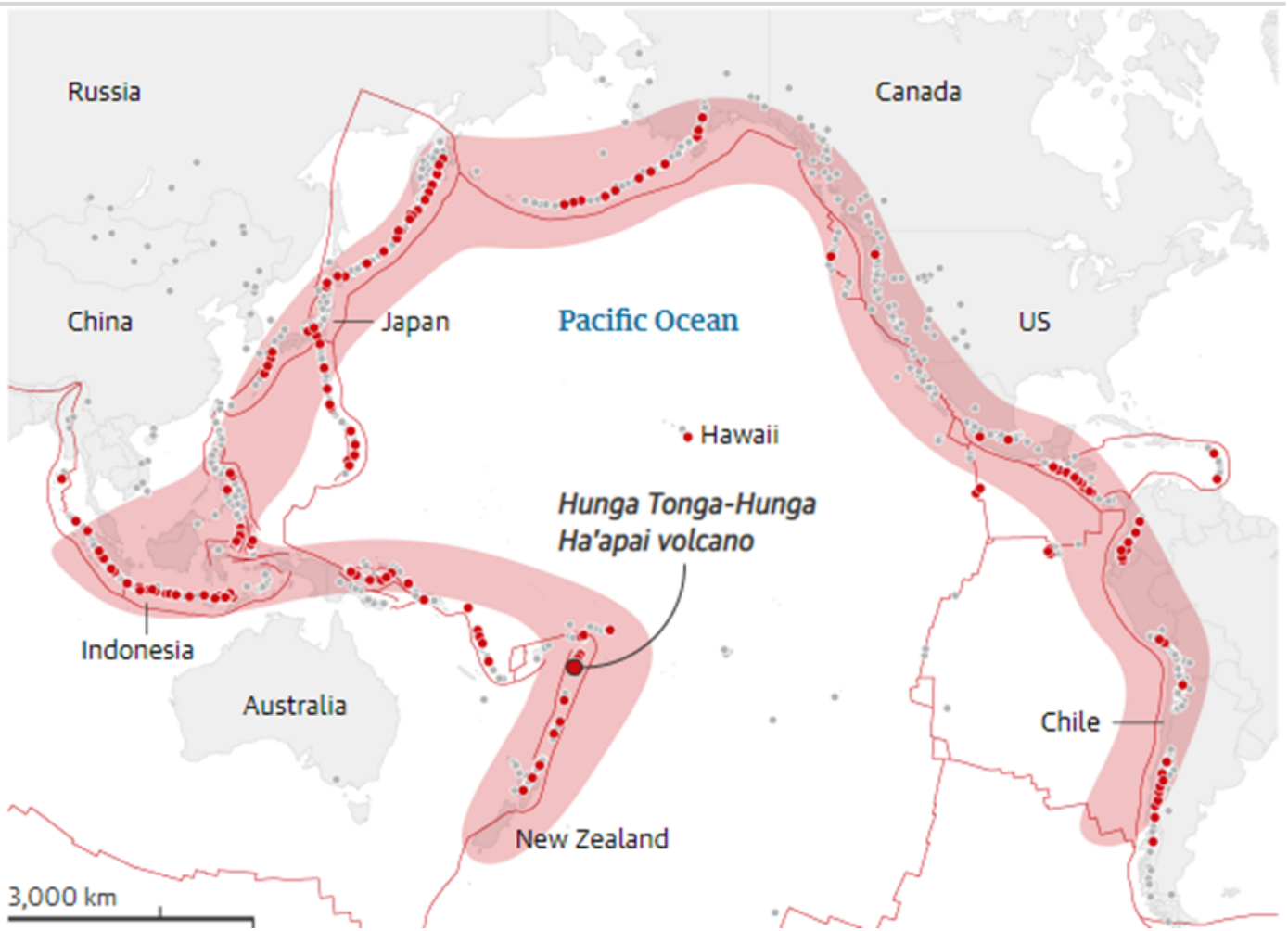
Tower Limited (TWR)

Market data (NZ\$)						Spot valuation (NZ\$)					
Priced as at 21 Jan 2022						0.86					
52 week high / low						0.89 / 0.57					
Market capitalisation (NZ\$m)						286.7					
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate						2.30%					
Equity beta						1.15					
WACC						10.1%					
Terminal growth						1.5%					
Profit and Loss Account (NZ\$m)						Valuation Ratios					
	2020A	2021A	2022E	2023E	2024E		2020A	2021A	2022E	2023E	2024E
Sales revenue	372.6	395.5	422.0	452.1	481.3	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)	23.9	15.3	12.8	10.4	9.2
Normalised EBIT	n/a	n/a	n/a	n/a	n/a	Price/NTA (x)	1.3	1.3	1.3	1.3	1.2
Net interest	n/a	n/a	n/a	n/a	n/a	Free cash flow yield (%)	6.6	35.2	16.2	18.8	21.0
Associate income	0	0	0	0	0	Net dividend yield (%)	0.0	7.4	7.4	7.7	8.1
Tax	n/a	n/a	n/a	n/a	n/a	Gross dividend yield (%)	0.0	7.4	7.4	10.3	11.2
Minority interests	0.4	0.6	0.3	0	0						
Normalised NPAT	11.9	18.7	22.4	27.7	31.3	Key Ratios	2020A	2021A	2022E	2023E	2024E
Abnormals/other	0	0	0	0	0	Return on assets (%)	n/a	n/a	n/a	n/a	n/a
Reported NPAT	11.9	18.7	22.4	27.7	31.3	Return on equity (%)	3.4	5.4	6.4	7.8	8.6
Normalised EPS (cps)	2.9	4.4	5.3	6.6	7.4	Return on funds employed (%)	0.0	0.0	0.0	0.0	0.0
DPS (cps)	0	5.0	5.0	5.3	5.5	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	2020A	2021A	2022E	2023E	2024E	Capex to sales (%)	2.8	3.0	3.1	2.9	2.8
Revenue (%)	8.0	6.2	6.7	7.1	6.5	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	85	100
EBIT (%)	n/a	n/a	n/a	n/a	n/a	Pay-out ratio (%)	0	113	94	80	74
Normalised NPAT (%)	-28.2	57.1	20.0	23.3	13.0						
Normalised EPS (%)	-39.7	55.4	20.0	23.3	13.0	Capital Structure	2020A	2021A	2022E	2023E	2024E
Ordinary DPS (%)	n/a	n/a	0.0	5.0	4.8	Solvency capital	155.9	150.5	179.4	199.4	204.9
						Minimum solvency capital (MSC)	56.6	52.3	66.3	66.3	66.3
Cash Flow (NZ\$m)	2020A	2021A	2022E	2023E	2024E	Total regulatory capital	106.6	102.3	83.3	91.3	91.3
EBITDA	n/a	n/a	n/a	n/a	n/a	Solvency ratio (%)	275	287	271	301	309
Working capital change	n/a	n/a	n/a	n/a	n/a						
Interest & tax paid	0	0	0	0	0	Operating Performance	2020A	2021A	2022E	2023E	2024E
Other	0	0	0	0	0	Gross written premium	377.2	404.7	439.3	464.9	497.7
Operating cash flow	18.9	100.9	46.5	53.8	60.1	Gross earned premium	372.6	395.5	422.0	452.1	481.3
Capital expenditure	(10.5)	(12.0)	(13.1)	(13.3)	(13.5)	Reinsurance premium	(57.2)	(62.2)	(65.9)	(70.9)	(75.9)
(Acquisitions)/divestments	(9.5)	(14.4)	(4.4)	0	0	Net earned premium	315.3	333.3	356.1	381.2	405.4
Other	(9.4)	(24.5)	7.3	7.7	7.7	Net claims expense	(181.1)	(204.3)	(215.9)	(231.3)	(246.5)
Funding available/(required)	(10.5)	49.9	36.3	48.2	54.3	Large event claims expense	(9.7)	(13.9)	(20.0)	(22.0)	(24.0)
Dividends paid	0	(10.5)	(21.1)	(22.1)	(23.2)	Management & sales expenses	(126.6)	(123.3)	(131.4)	(135.3)	(139.5)
Equity raised/(returned)	44.9	0	0	0	0	Underwriting profit	31.8	28.0	30.9	36.7	41.5
(Increase)/decrease in net debt	34.4	39.4	15.2	26.1	31.1	Investment and other revenue	6.4	1.3	3.3	5.3	5.6
						Financing and other costs	(1.1)	(0.4)	(0.5)	(0.5)	(0.5)
Balance Sheet (NZ\$m)	2020A	2021A	2022E	2023E	2024E	Profit before tax	20.3	28.5	33.6	41.4	46.6
Working capital	184.1	146.9	151.0	159.8	171.1	Tax expense	(7.9)	(9.1)	(11.2)	(13.8)	(15.4)
Fixed assets	10.0	9.4	10.4	11.5	12.5	Profit after taxation (Reported)	12.3	19.3	22.4	27.7	31.3
Intangibles	119.6	120.6	127.2	127.3	128.2						
Right of use asset	7.2	25.6	23.2	20.8	18.4	Key ratios					
Other assets	277.6	314.8	314.8	314.8	314.8	Tower Direct GWP growth %	13.7%	26.4%	9.8%	5.0%	7.0%
Total funds employed	598.6	617.3	626.6	634.1	645.0	Partnership GWP growth %	2.8%	-30.0%	8.0%	8.0%	8.0%
Net debt/(cash)	(80.1)	(116.1)	(131.3)	(157.4)	(188.5)	Pacific GWP growth %	-10.2%	5.0%	7.0%	6.0%	5.5%
Lease liability	8.7	39.4	46.7	54.4	62.0	Total GWP growth %	5.7%	7.3%	8.6%	5.8%	7.1%
Other liabilities	322.9	344.3	360.2	380.6	406.8	Total claims ratio %	49%	54%	54%	55%	55%
Shareholder's funds	345.0	346.9	348.0	353.5	361.6	MER %	39%	37%	37%	36%	34%
Minority interests	2.2	2.8	3.1	3.1	3.1	Combined ratio %	88%	91%	91%	90%	90%
Total funding sources	598.6	617.3	626.6	634.1	645.0						

Hunga Tonga – Hunga Ha'apai eruption on the 'Ring of Fire'

The small islands of Hunga Tonga and Hunga Ha'apai form a volcanic island located some 65km north-west of Tonga's main island. It has been active on and off for a number of years. The previously twin islands of Hunga Tonga and Hunga Ha'apai were merged by a volcanic eruption in 2009. This recent, more explosive eruption, separated the islands again and reduced them in size. The volcano forms part of the highly active Tonga – Kermadec Island volcanic arc, a subduction zone extending from New Zealand north-northeast to Fiji. The island is formed at the boundary where the Pacific Plate subducts under the Indo-Australian Plate on what is commonly known as the 'Ring of Fire'.

Figure 1. Pacific 'Ring of Fire'



Source: Reuters, Forsyth Barr analysis

Tonga

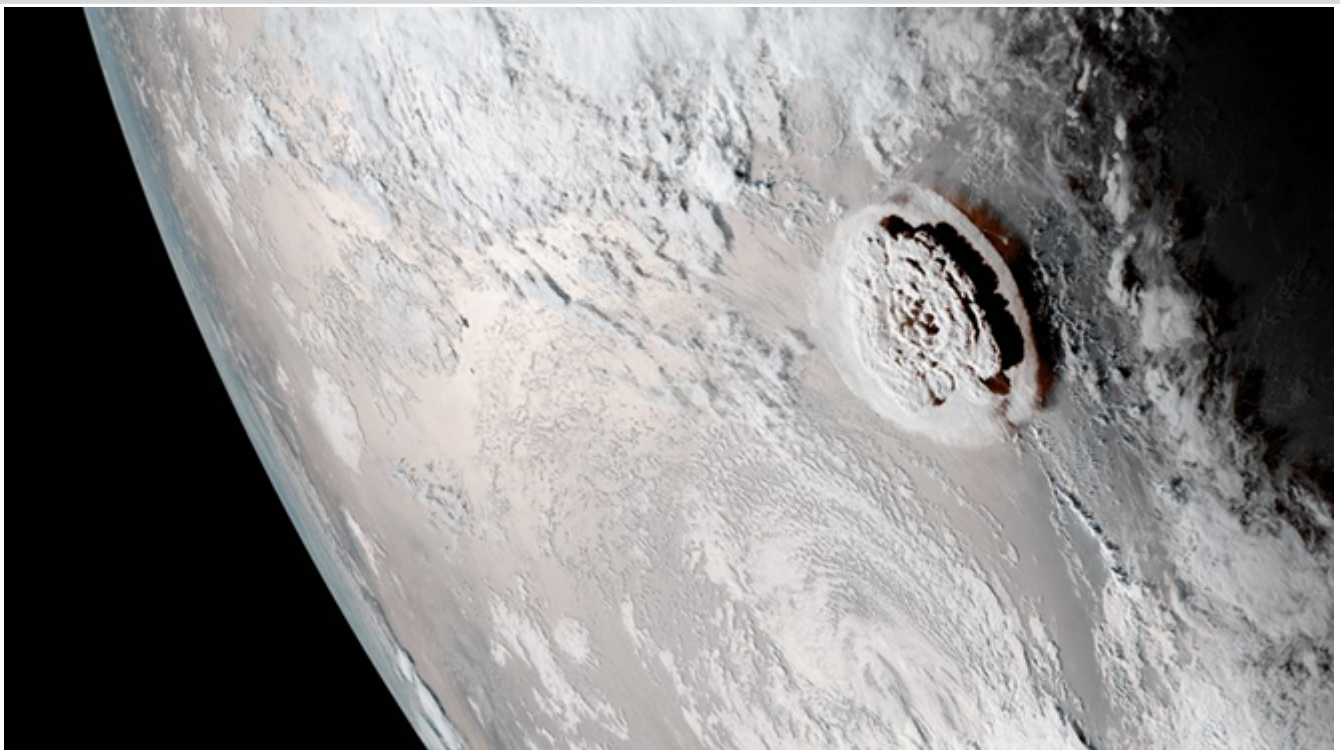
Tonga is an island nation home to some 106,000 people with 70% of them residing on the main island, Tongatapu. This is part of an archipelago consisting of 169 islands of which thirty-six are inhabited. Tonga is about 1,800km north of New Zealand. The International Red Cross estimates that up to 80,000 people there could be affected by the most recent eruption.

Figure 2. A photo of Hunga Tonga — Hunga Ha’apai erupting



Source: Tonga Geological

Figure 3. A photo of the Hunga Tonga — Hunga Ha’apai eruption from space



Source: NASA

TWR's Pacific operations

Across the Pacific

TWR operates in eight Pacific Islands, contributing ~13% of the company's gross written premiums (GWP). Revenues throughout the Pacific Islands have been under pressure over the past few years, seeing the region's share of group revenues fall from 17.4% in FY18. This has occurred mainly due to two factors:

- The first is COVID-19, where the impacts of the global pandemic over the region have been significant despite excellent vaccination progress in some countries. Travel bans and the lack of international tourists have also had an economic impact.
- The second and likely more influential factor is that TWR has been refocussing its operations toward its core products and letting unwanted business lapse. This has been a calculated move to manage risk and define what core products for growth would look like. This focus on managing risk appears reasonable in a relatively high-risk market.

The combined impacts on GWP of COVID-19 and the product rationalisation and risk mitigation strategies saw half-on-half GWP fall -6.3% in 1H20, -1.3% in 2H20, -14.4% in the 1H21 but start to rebound in 2H21. We forecast that TWR will experience a return to GWP growth in the Pacific from FY22 and onwards, see Figure 8.

Impact on TWR of Hunga Tonga – Hunga Ha'apai

Too early to tell

While it is too early to make accurate financial impact assessments, we know TWR has 2,500 personal lines and 300 commercial customers in Tonga. It will take weeks or months before claims are lodged. Initial assessments of the damage will take one to two weeks to complete. The Tongan personal lines customers represent 0.8% of TWR's total customer base. The company's Nuku'alofa branch has just opened to start the process of assisting customers. Communication to the island has been extremely limited due to the island's main fibre connection being severed. Initial calls with TWR's five staff in Tonga, via limited 2G communications, have been made, and it's our understanding power has been restored.

The excess for TWR's reinsurance programme for large events is NZ\$11.25m and forms part of a reinsurance programme providing up to NZ\$873m of cover for large catastrophe events such as this. This catastrophe programme has an automatic reinstatement of cover, ensuring protection is available for future events.

TWR will have residential and commercial buildings impacted by the tsunami. This is given the widespread nature of the impacts and the often low level of housing and commercial buildings on the island.

Impacts

While the impact is limited to TWR's excess for large events of NZ\$11.25m, there may be significant costs in excess of this, born by reinsurers, in repairing the damage from:

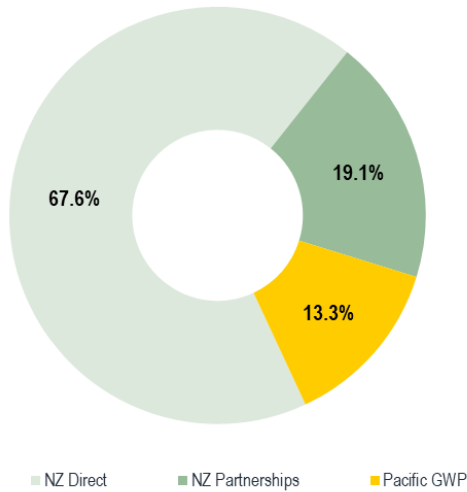
- Corrosive ash on roofing structures.
- Damage from fallout weight in gutters and on roofs.
- Ash impacting air conditioning units.
- Water inundation for some housing and commercial clients.
- Corrosion of interior surfaces from ash dust for domestic and commercial customers.
- Possible complete house destruction from the tsunami.
- Loss of cars and damage from fallout and the tsunami.
- Windows blowing out from the sonic boom.

Further update likely at the AGM

TWR is expected to update the market again at its AGM which is planned to be held at 10.00am, 2 February 2022.

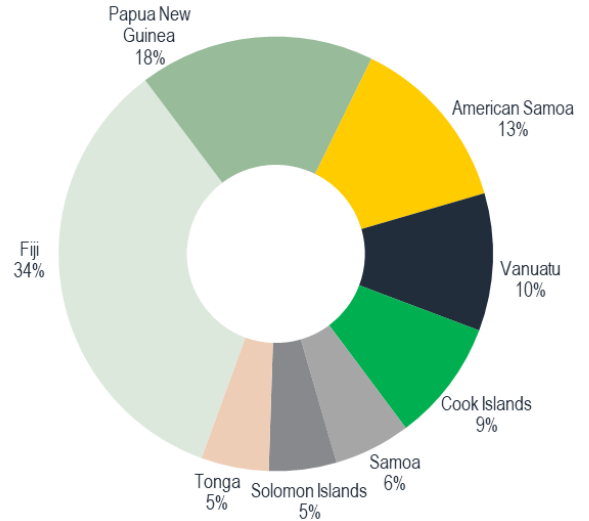
Key Charts

Figure 4. TWR GWP Segmental Split (FY21)



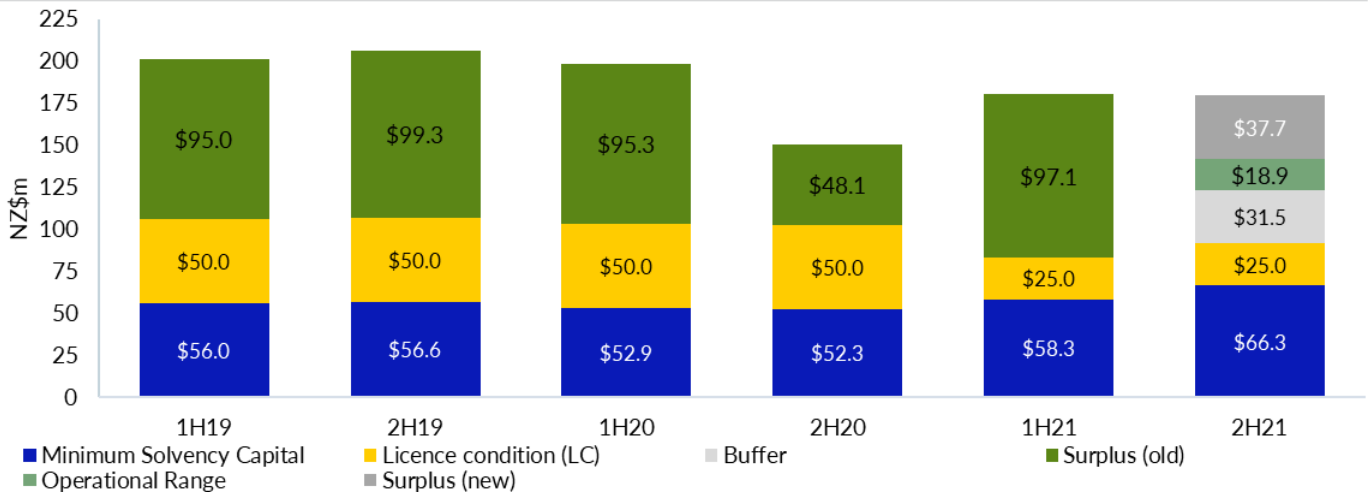
Source: Company data, Forsyth Barr analysis

Figure 5. TWR Pacific Islands Business GWP Country Split



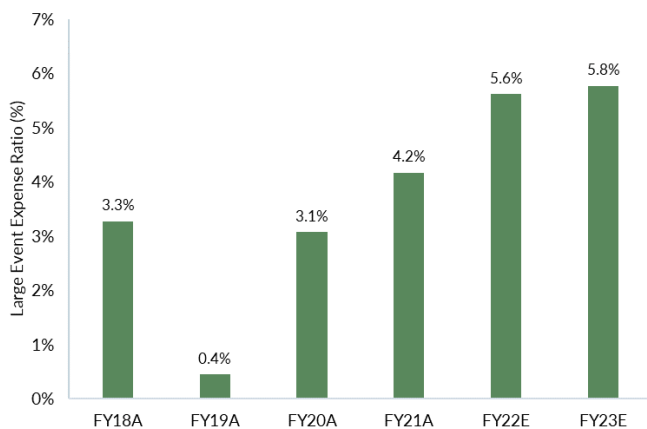
Source: Company data, Forsyth Barr analysis

Figure 6. TWR Solvency Position



Source: Company data, Forsyth Barr analysis

Figure 7. TWR Large Events ratio



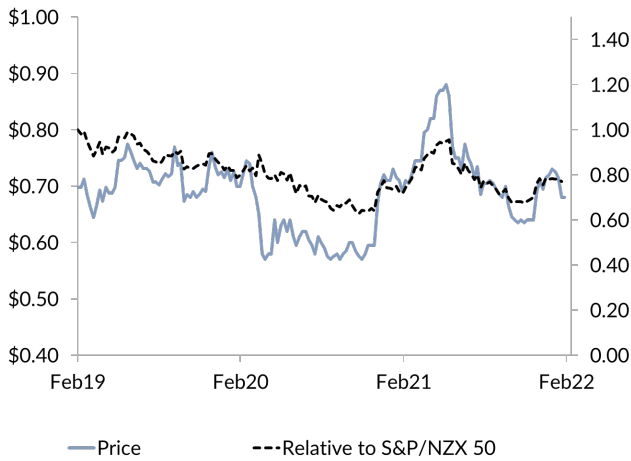
Source: Company data, Forsyth Barr analysis

Figure 8. TWR Pacific Islands GWP



Source: Company data, Forsyth Barr analysis

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
Bain Capital Credit LP	20.0%
ACC	8.4%
Salt Funds Management	7.0%
Investment Services Group	6.5%
NZ Funds Management	5.2%

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

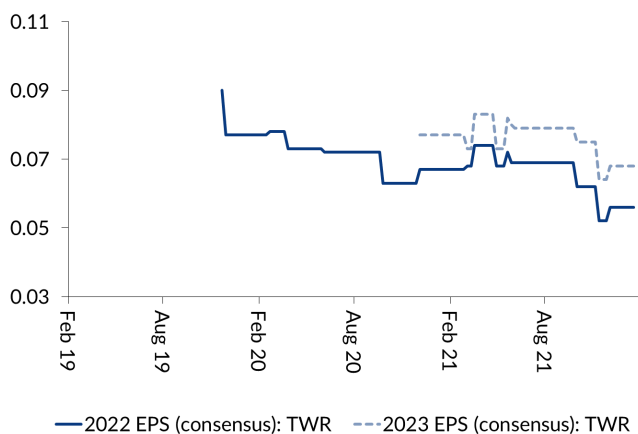
Figure 11. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE 2022E	PE 2023E	EV/EBITDA 2022E	EV/EBITDA 2023E	EV/EBIT 2022E	EV/EBIT 2023E	Cash Yld 2023E
Tower Ltd	TWR NZ	NZ\$0.68	NZ\$287	12.8x	10.4x	n/a	n/a	n/a	n/a	7.7%
Heartland Group Holdings *	HGH NZ	NZ\$2.51	NZ\$1,480	15.6x	14.8x	n/a	n/a	n/a	n/a	5.0%
Insurance Australia Group	IAG AT	A\$4.41	A\$10,871	18.6x	14.3x	n/a	n/a	n/a	9.9x	5.5%
Suncorp Group	SUN AT	A\$11.52	A\$14,545	16.1x	13.4x	n/a	n/a	n/a	45.9x	6.0%
QBE INSURANCE GROUP	QBE AT	US\$8.72	US\$12,874	13.3x	11.6x	n/a	n/a	n/a	8.4x	5.5%
Compco Average:				15.9x	13.5x	n/a	n/a	n/a	21.4x	5.5%
TWR Relative:				-20%	-23%	n/a	n/a	n/a	n/a	40%

EV = Current Market Cap + Actual Net Debt

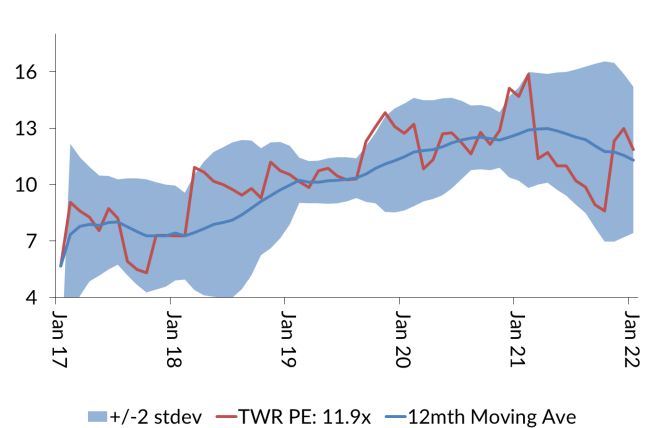
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

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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