

# Tower Limited

## FY23 Reinsurance Programme Update

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Tower (TWR) updated the market on its FY23 reinsurance programme with savings obtained for comprehensive cover. TWR's management commented that it was, "very pleased with the reinsurance programme" with "excellent coverage". TWR will pay a lower proportion of reinsurance going forward as a result of this renewal. We had signalled that global reinsurers were pulling away from providing aggregate cover. As such, news that no aggregate cover was taken as part of the reinsurance programme has not come as a complete surprise, albeit we had envisaged that cover would be in place for several more years. Management also noted that this is "one of the most challenging reinsurance markets we've seen in over 40 years". TWR has allocated NZ\$30m to large claims events in its budgets for FY23, reducing the likelihood of earnings volatility. The CEO said this is part of TWR continuing to show consistency and lower variability of outcomes in NPAT and dividends. We lift our FY22 NPAT estimates by +3% and marginally lift our FY23 numbers. Our spot valuation falls to NZ\$0.79 from NZ\$0.85, driven entirely by falls in peer group multiples.

NZX Code	TWR	Financials: Sep/	21A	22E	23E	24E	Valuation (x)	21A	22E	23E	24E
Share price	NZ\$0.64	NPAT* (NZ\$m)	18.7	22.6	29.0	32.0	PE	14.4	11.2	8.4	7.6
Spot Valuation	NZ\$0.85	EPS* (NZc)	4.4	5.7	7.6	8.4	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	Medium	EPS growth* (%)	55.4	28.4	34.2	10.6	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	379.5m	DPS (NZc)	5.0	5.5	6.0	6.5	Price / NTA	1.2	1.3	1.3	1.2
Market cap	NZ\$243m	Imputation (%)	0	0	0	0	Cash div yld (%)	7.8	8.6	9.4	10.2
Avg daily turnover	137.3k (NZ\$92k)	*Based on normalised profits					Gross div yld (%)	7.8	8.6	9.4	10.2

### What's changed?

- **Earnings:** FY22 NPAT +3% to NZ\$23.6m and FY23 +0.3% to NZ\$29.3m
- **Spot valuation:** Falls to NZ\$0.79 from NZ\$0.85

### Catastrophe reinsurance cover secured but aggregate cover dropped

Tower has increased its catastrophe upper limit to NZ\$934m to reflect expectations for business growth. This is a ~+7% lift on the NZ\$873m upper limit of catastrophe taken in FY22. The catastrophe cover excess of NZ\$11.8m is in line with prior years. Tower's reinsurance premiums for FY23 have increased by +6.7% relative to FY22 (after adjustments), with book growth and the hardening global reinsurance market taking effect. We consider this a good outcome in a challenging reinsurance environment. TWR will pay proportionally less for its reinsurance cover in FY23 at 13.6% of total income or Gross Written Premium (GWP), compared to 14.3% of total income in FY22 (excluding the aggregate programme). This reflects: 1) changes to the EQC cap moving from NZ\$150k to NZ\$300k per household, 2) the risk-based pricing work programme, 3) increasing confidence in TWR by reinsurers, 4) the removal of the aggregate cover, and 5) all previous reinsurers plus one new prominent global player on the reinsurance panel.

### Updated estimates and valuation

We lift our FY22 NPAT estimate to NZ\$23.8m, from NZ\$22.6m or +4%, with a mix of lower investment returns (the market-to-market impact of higher interest rates), a modest lowering of estimates of total claims and an increase in our GWP growth forecasts. Management said it has set aside NZ\$30m for FY23 large events, up from NZ\$20m in FY22 and differs from our NZ\$22m for FY23. Given the material lift in interest rates, we take this opportunity to increase our investment income estimates. In FY23 our NPAT estimates are broadly unchanged at NZ\$29.3m. We retain our estimates for a dividend of NZ5.5c in FY22 and NZ6.0c in FY23 (both unimputed). Our spot valuation falls to NZ\$0.79, driven entirely by a compression in peer P/E and P/B ratios, and our spot DCF remains flat at NZ\$0.95. TWR will announce its FY22 results on 23 November 2022, likely with an FY23 NPAT estimate range.

**Tower Limited (TWR)**

<b>Market data (NZ\$)</b>						<b>Spot valuation (NZ\$)</b>					
Priced as at 30 Sep 2022						0.64					
52 week high / low						0.74 / 0.60					
Market capitalisation (NZ\$m)						242.9					
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>					
Risk free rate						4.00%					
Equity beta						1.10					
WACC						10.1%					
Terminal growth						1.5%					
Total firm value						449					
(Net debt)/cash						0					
Less: Capitalised operating leases						(48)					
Value of equity						401					
<b>Profit and Loss Account (NZ\$m)</b>						<b>Valuation Ratios</b>					
	2020A	2021A	2022E	2023E	2024E		2020A	2021A	2022E	2023E	2024E
Sales revenue (GEP)	372.6	395.5	426.6	474.2	520.9	EV/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
<b>Normalised EBITDA</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	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)	22.5	14.4	10.8	8.3	7.1
<b>Normalised EBIT</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	Price/NTA (x)	1.2	1.2	1.3	1.3	1.2
Net interest	n/a	n/a	n/a	n/a	n/a	Free cash flow yield (%)	7.8	41.5	19.2	26.7	27.5
Associate income	0	0	0	0	0	Net dividend yield (%)	0.0	7.8	8.6	9.4	10.2
Tax	(7.9)	(9.1)	(12.1)	(14.9)	(17.3)	Gross dividend yield (%)	0.0	7.8	8.6	9.4	10.2
Minority interests	0.4	0.6	0.1	0	0	<b>Key Ratios</b>					
<b>Normalised NPAT</b>	<b>11.9</b>	<b>18.7</b>	<b>23.6</b>	<b>29.3</b>	<b>34.3</b>		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
<b>Reported NPAT</b>	<b>11.9</b>	<b>18.7</b>	<b>23.6</b>	<b>29.3</b>	<b>34.3</b>	Return on equity (%)	3.4	5.4	7.5	9.1	10.4
Normalised EPS (cps)	2.9	4.4	5.9	7.7	9.1	Return on funds employed (%)	0.0	0.0	0.0	0.0	0.0
DPS (cps)	0	5.0	5.5	6.0	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
<b>Growth Rates</b>											
	2020A	2021A	2022E	2023E	2024E	Capex to sales (%)	2.8	3.0	3.1	3.1	3.1
Revenue (%)	8.0	6.2	7.9	11.1	9.8	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	0	0
EBIT (%)	n/a	n/a	n/a	n/a	n/a	Pay-out ratio (%)	0	113	93	78	72
Normalised NPAT (%)	-28.2	57.1	26.4	24.1	17.2	<b>Capital Structure</b>					
Normalised EPS (%)	-39.7	55.4	33.9	30.2	17.2		2020A	2021A	2022E	2023E	2024E
Ordinary DPS (%)	n/a	n/a	10.0	9.1	8.3	Solvency capital	155.9	150.5	179.4	171.2	174.0
						Minimum solvency capital (MSC)	56.6	52.3	66.3	73.5	73.2
<b>Cash Flow (NZ\$m)</b>						Total regulatory capital	106.6	102.3	83.3	91.3	91.3
	2020A	2021A	2022E	2023E	2024E	Solvency ratio (%)	275	287	271	233	238
<b>EBITDA</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>Operating Performance</b>					
Working capital change	n/a	n/a	n/a	n/a	n/a		2020A	2021A	2022E	2023E	2024E
Interest & tax paid	0	0	0	0	0	Gross written premium	377.2	404.7	448.6	499.8	542.0
Other	0	0	0	0	0	<b>Gross earned premium</b>	<b>372.6</b>	<b>395.5</b>	<b>426.6</b>	<b>474.2</b>	<b>520.9</b>
<b>Operating cash flow</b>	<b>18.9</b>	<b>100.9</b>	<b>46.6</b>	<b>64.8</b>	<b>66.8</b>	Reinsurance premium	(57.2)	(62.2)	(67.0)	(68.6)	(75.5)
Capital expenditure	(10.5)	(12.0)	(13.3)	(14.9)	(16.1)	<b>Net earned premium</b>	<b>315.3</b>	<b>333.3</b>	<b>359.6</b>	<b>405.5</b>	<b>445.4</b>
(Acquisitions)/divestments	(9.5)	(14.4)	(4.4)	0	0	Net claims expense	(181.1)	(204.3)	(216.3)	(259.9)	(287.5)
Other	(9.4)	(24.5)	(2.8)	(3.2)	(3.4)	* includes Large event claims of	(9.7)	(13.9)	(20.0)	(30.0)	(31.5)
<b>Funding available/(required)</b>	<b>(10.5)</b>	<b>49.9</b>	<b>26.1</b>	<b>46.8</b>	<b>47.3</b>	Management & sales expenses	(126.6)	(123.3)	(130.3)	(134.9)	(139.4)
Dividends paid	0	(10.5)	(20.9)	(22.8)	(24.7)	<b>Underwriting profit</b>	<b>31.8</b>	<b>28.0</b>	<b>36.0</b>	<b>33.7</b>	<b>41.5</b>
Equity raised/(returned)	44.9	0	(30.4)	0	0	Investment and other revenue	5.3	0.2	0.5	11.4	11.1
<b>(Increase)/decrease in net debt</b>	<b>34.4</b>	<b>39.4</b>	<b>(25.2)</b>	<b>24.0</b>	<b>22.6</b>	Financing and other costs	(1.1)	(0.4)	(0.9)	(0.9)	(0.9)
						<b>Profit before tax</b>	<b>20.3</b>	<b>28.5</b>	<b>35.7</b>	<b>44.2</b>	<b>51.7</b>
<b>Balance Sheet (NZ\$m)</b>						Tax expense	(7.9)	(9.1)	(12.1)	(14.9)	(17.3)
	2020A	2021A	2022E	2023E	2024E	<b>Profit after taxation (Reported)</b>	<b>12.3</b>	<b>19.3</b>	<b>23.6</b>	<b>29.3</b>	<b>34.3</b>
Working capital	184.1	146.9	154.2	171.8	186.3	Abnormals	(1.3)	(1.1)	0	0	0
Fixed assets	10.0	9.4	10.5	11.8	13.0	<b>Comprehensive profit</b>	<b>11.0</b>	<b>18.2</b>	<b>23.6</b>	<b>29.3</b>	<b>34.3</b>
Intangibles	119.6	120.6	125.5	129.2	133.1	<b>Key ratios</b>					
Right of use asset	7.2	25.6	23.2	20.8	18.4						
Other assets	277.6	313.0	313.0	313.0	313.0	Tower Direct GWP growth %	13.7%	26.4%	11.8%	11.5%	9.0%
<b>Total funds employed</b>	<b>598.6</b>	<b>615.5</b>	<b>626.4</b>	<b>646.6</b>	<b>663.9</b>	Partnership GWP growth %	2.8%	-30.0%	13.0%	14.0%	8.0%
Net debt/(cash)	(80.1)	(116.1)	(90.9)	(115.0)	(137.5)	Total GWP growth %	5.7%	7.3%	10.8%	11.4%	8.4%
Lease liability	8.7	39.4	36.6	33.4	30.0	Total claims ratio %	49.3%	54.3%	53.8%	58.4%	59.4%
Other liabilities	322.9	342.5	365.8	406.7	440.3	MER %	39.2%	37.1%	36.2%	33.3%	31.3%
Shareholder's funds	345.0	347.0	314.9	321.5	331.2	Combined ratio %	88.5%	91.4%	90.0%	91.7%	90.7%
Minority interests	2.2	2.7	0	0	0						
<b>Total funding sources</b>	<b>598.6</b>	<b>615.5</b>	<b>626.4</b>	<b>646.6</b>	<b>663.9</b>						

## Amendments to FY22 and FY23 estimates

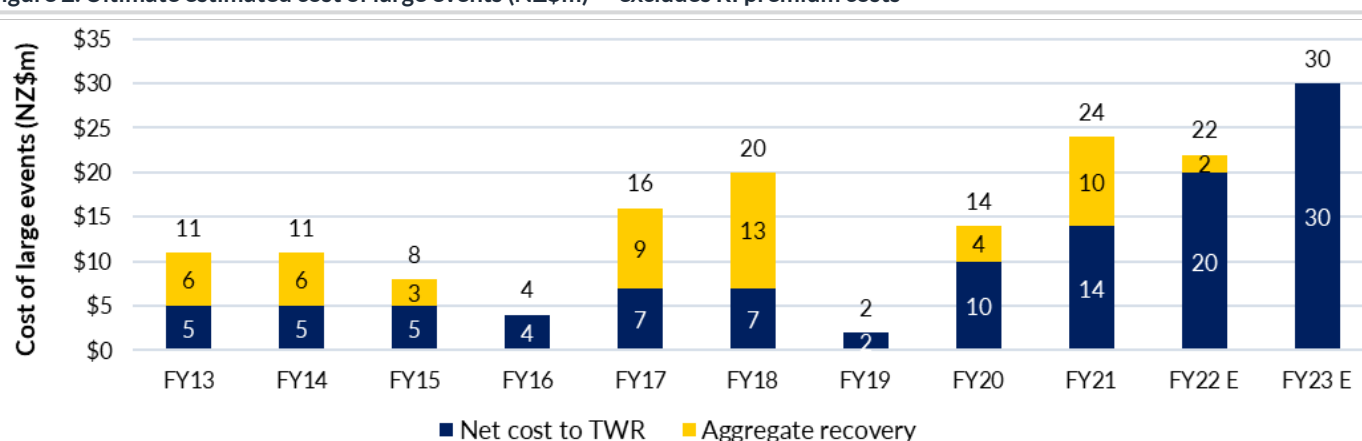
We make several amendments to our FY22 and FY23 estimates, given the announcement on reinsurance. Additionally, we consider the substantial movement in interest rates by lowering our FY22 estimates for TWR's investment income (given the market-to-market movements) and raising our investment income estimates for FY23 and beyond based on the higher ongoing running yield. Further, in FY23 we raise our estimates of GWP growth given continued above system growth (Figure 2), reflecting the lowered reinsurance costs and lifting total net claims expense – given the move to increase the budget of large event claims to NZ\$30m. The net effect of these changes is summarised by: 1) a lift in our FY22 NPAT estimate to NZ\$23.8m, up from NZ\$22.6m prior, and 2) a lift in our FY23 NPAT estimates to NZ\$29.3m, up from NZ\$29.2m prior, despite also including NZ\$30m for large event expenses.

Figure 1. Earnings revisions

	FY22E			FY23E		
	Old	New	Change	Old	New	Change
<b>Gross written premium</b>	448.6	448.6	0%	474.7	499.8	5%
Gross earned premium	427.5	426.6	0%	462.8	474.2	2%
Reinsurance expense	(66.6)	(67.0)	1%	(72.2)	(68.6)	-5%
Net earned premium	360.9	359.6	0%	390.6	405.5	4%
<b>Net claims expense</b>	(176.1)	(173.3)	-2%	(192.2)	(206.9)	8%
Large event claims expense	(20.0)	(20.0)	0%	(22.0)	(30.0)	36%
Management and sales expenses	(132.6)	(130.3)	-2%	(136.7)	(134.9)	-1%
<b>Underwriting profit</b>	32.3	36.0	12%	39.6	33.7	-15%
Investment and other revenue	3.3	0.5	-85%	5.3	11.4	114%
Financing costs	-	(0.8)	n/a	-	(0.9)	n/a
Underlying profit before tax	35.6	35.7	1%	44.9	44.2	-2%
Income tax expense	(11.5)	(12.1)	5%	(14.6)	(14.9)	2%
Underlying profit after tax	24.0	23.6	-2%	30.3	29.3	-3%
<b>Reported profit / (loss) after tax</b>	23.0	23.6	3%	29.2	29.3	0%

Source: Company data, Forsyth Barr analysis

Figure 2. Ultimate estimated cost of large events (NZ\$m) – excludes RI premium costs



Source: Company data, Forsyth Barr analysis

Figure 2 (above) illustrates the reason why TWR is moving away from the aggregate structure. The FY23 number is the amount TWR is budgeting for in FY23, as disclosed in its NZX announcement.

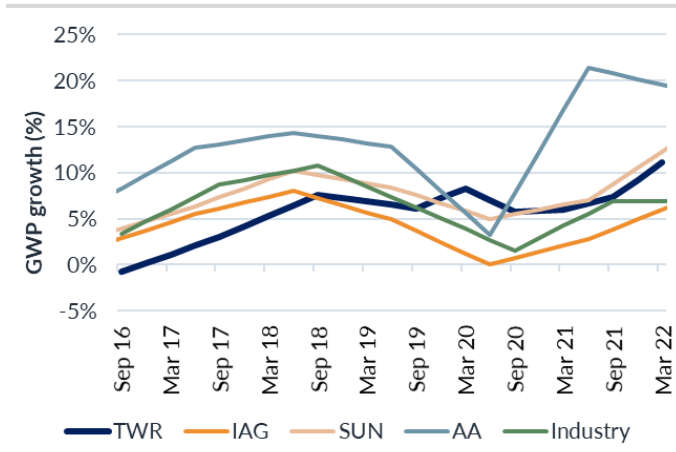
**Reinsurance ratios**

The renegotiation of reinsurance will help lower TWR's reinsurance ratio in FY23 – which has appeared high relative to its Australian peers over recent years, see Figure 4. TWR's Australian peers have been able to diversify risk across two markets of Australia and New Zealand, and have a much larger premium base to spread these costs over. The quoted figures in the release excludes:

1. Aggregate reinsurance premiums, from both the FY22 and FY23 calculation
2. Premiums paid to the provider of TWR's roadside assistance cover
3. Other items that go through TWR's reinsurance line

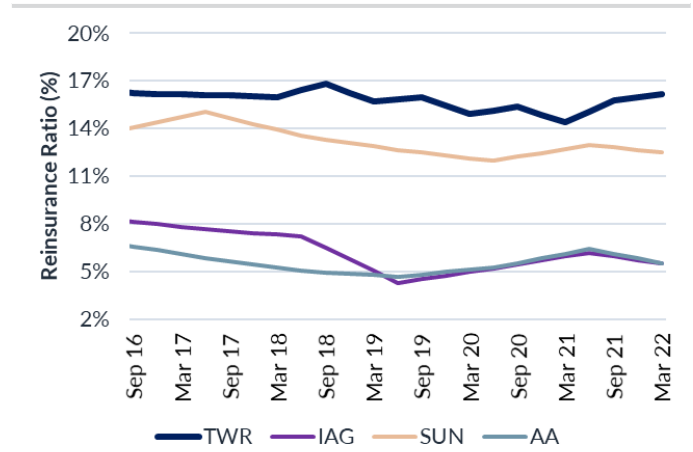
As such, the numbers TWR provided in the NZX release will be lower than what appears in TWR's reported results and the historical numbers in Figure 4 below.

**Figure 3. Gross Written Premium (GWP) growth across NZ's leading personal insurers**

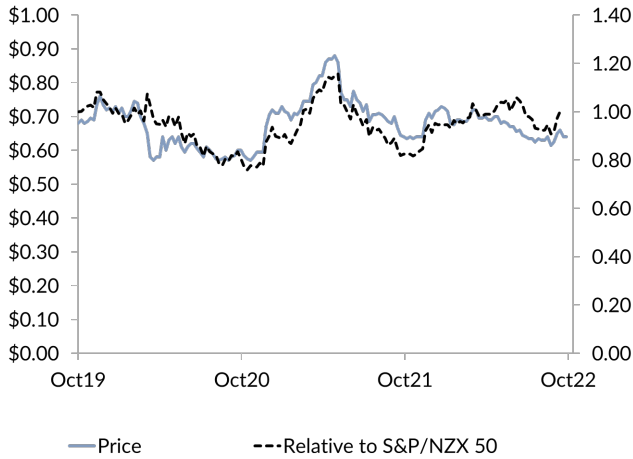


Source: Company data, Forsyth Barr analysis

**Figure 4. Reinsurance ratios across NZ's leading general insurers**



Source: Company data, Forsyth Barr analysis



**Figure 5. Substantial shareholders**

Shareholder	Latest Holding
Bain Capital Credit LP	20.0%
ACC	9.6%
Salt Funds Management	7.0%

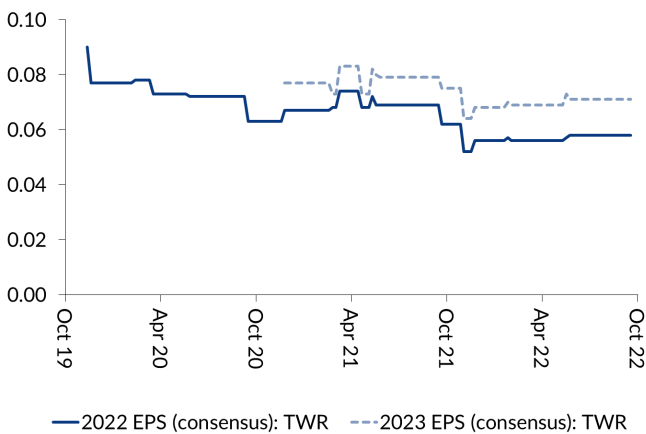
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 6. 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
(metrics re-weighted to reflect TWR's balance date - September)										
Tower Ltd	TWR NZ	NZ\$0.64	NZ\$243	11.2x	8.4x	n/a	n/a	n/a	n/a	9.4%
Heartland Group Holdings *	HGH NZ	NZ\$1.63	NZ\$1,150	10.1x	9.9x	n/a	n/a	n/a	n/a	7.4%
Insurance Australia Group	IAG AT	A\$4.58	A\$11,290	28.0x	14.0x	n/a	n/a	n/a	9.9x	5.6%
Suncorp Group	SUN AT	A\$10.11	A\$12,780	16.8x	10.8x	n/a	n/a	n/a	49.1x	7.1%
QBE INSURANCE GROUP	QBE AT	US\$7.51	US\$11,146	15.1x	9.5x	n/a	n/a	n/a	8.0x	5.9%
<b>Compco Average:</b>				<b>17.5x</b>	<b>11.0x</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>22.3x</b>	<b>6.5%</b>
<b>EV = Mkt cap+net debt+lease liabilities+min interests-investments</b>				<b>TWR Relative:</b>		<b>-36%</b>	<b>-24%</b>	<b>n/a</b>	<b>n/a</b>	<b>44%</b>

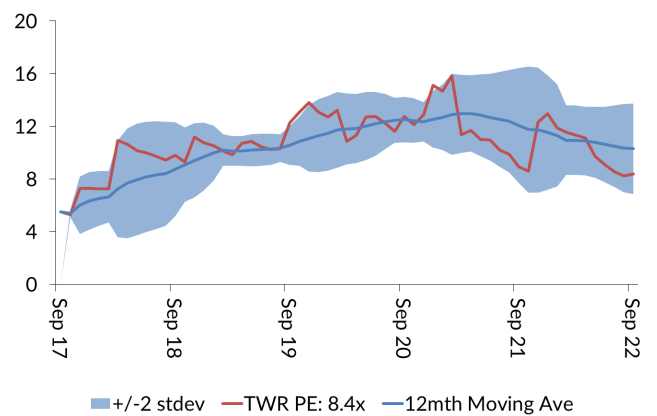
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ABA) companies fiscal year end

**Figure 7. Consensus EPS momentum (NZ\$)**



Source: Forsyth Barr analysis

**Figure 8. One year forward PE (x)**



Source: Forsyth Barr analysis

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