

Tower Limited

Claims Inflation Steals Wild Weather's Thunder

JAMES LINDSAY

 James.Lindsay@forsythbarr.co.nz
 +64 9 368 0145

WILL TWISS

 will.twiss@forsythbarr.co.nz
 +64 9 368 0129

Tower (TWR) has downgraded its FY23 NPAT guidance by -NZ\$10m at the midpoint, citing an ongoing challenging claims environment impacted by inflation, motor crime and supply chain issues. The new underlying FY23 NPAT guidance range is -NZ\$2m to +NZ\$3m (previously +NZ\$8m to +NZ\$13m), reflecting a deterioration in TWR's claims ratio to 55% in the nine months ending 30 June 2023. This is being offset by solid re-pricing with +16.5% GWP growth year-to-date; however, annual customer pricing cycles versus the rapid escalation of claims inflation has driven the downgrade. TWR has had continued progress with operational efficiencies, ahead of expectations, as the management expense ratio (MER) has fallen further to ~34%. On the back of this update, we increase our claims expense estimates and further lower our MER forecasts over the next two years. We lower our underlying FY23 and FY24 NPAT numbers and remove our assumption of a 2H23 dividend as TWR's capital position recovery tracks behind our prior expectations. We also flag a possible risk to the 1H24 dividend if its capital position does not recover in time. Our blended spot valuation rises +1% to NZ\$0.85, aided by lower longer-term MER and business as usual (BAU) claims assumptions but offset through lower short-term earnings.

NZX Code	TWR	Financials: Sep/	22A	23E	24E	25E	Valuation (x)	22A	23E	24E	25E
Share price	NZ\$0.60	Rev (NZ\$m)	418.3	476.4	564.9	632.2	PE	12.8	n/a	6.4	4.6
Spot Valuation	NZ\$0.85 (from 0.84)	NPAT* (NZ\$m)	17.7	(4.9)	35.3	48.9	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	High	EPS* (NZc)	4.7	(1.3)	9.3	12.9	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	379.5m	DPS (NZc)	6.5	0.0	7.0	8.0	Price / NTA	1.3	1.4	1.3	1.0
Market cap	NZ\$226m	Imputation (%)	0	0	0	0	Cash div yld (%)	10.9	0.0	11.8	13.4
Avg daily turnover	133.3k (NZ\$86k)	*Based on normalised profits					Gross div yld (%)	10.9	0.0	11.8	13.4

What's changed?

- **Earnings:** Our FY23 underlying NPAT estimate falls -97% to NZ\$0.3m, while FY24 falls -3% but FY25 rises +9%.

Claims inflation and frequency impact the bottom line but pleasing progress in GWP growth and cost management

TWR continues to battle against a problematic claims backdrop of both cost inflation and increased claim frequency. Average motor claims costs have increased by +20% in the last year, while persistent wet weather and high levels of motor crime have led to heightened claim frequency. While TWR has aggressively passed on costs to customers (+26% in motor premiums), the lag between rate changes and premium renewals has caused TWR's claims ratio, excluding large events, to lift to 55% for the nine months. This is +340bps higher than 1H23 and well above the average claims ratio, excluding large events of ~48% across FY20, FY21 and FY22.

Year-to-date GWP growth compared to the same period last year is +16.5% as TWR passes on inflation and reinsurance costs to customers but at levels in FY23 behind experienced cost. TWR retained its guidance for FY23 GWP growth of between +15% and +20%. A focus on digital optimisation also continues to generate results for TWR, closing the MER gap with its larger Australian listed-peers, with IAG on ~24% and SUN on ~29% (see Figure 3).

Capital position incompatible with dividends for now

TWR has now paid out over 50% of claims from the Auckland floods and Cyclone Gabrielle events, helping improve its estimated solvency ratio to 134%. However, this is still well below historical norms of >200%, meaning a 2H23 dividend seems increasingly unlikely and we remove it from our estimates. The risk allowance associated with unpaid claims and unsettled reinsurance proceeds increases the minimum solvency capital which TWR must hold, cutting into its solvency ratio and reducing flexibility for dividends. We see some risk to the 1H24 dividend being paid unless the solvency ratio can recover to 200%+ by March 2024.

Tower Limited (TWR)

Market data (NZ\$)						Spot valuation (NZ\$)					
Priced as at 19 Jul 2023						0.60					
52 week high / low						0.75 / 0.57					
Market capitalisation (NZ\$m)						227.7					
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate						4.50%					
Equity beta						1.18					
WACC						10.6%					
Terminal growth						1.8%					
Profit and Loss Account (NZ\$m)						Valuation Ratios					
Revenue (GEP)	2021A	2022A	2023E	2024E	2025E	2021A	2022A	2023E	2024E	2025E	
Revenue (GEP)	386.6	418.3	476.4	564.9	632.2	EV/Sales (x)	n/a	n/a	n/a	n/a	
Normalised EBITDA	n/a	n/a	n/a	n/a	n/a	EV/EBITDA (x)	n/a	n/a	n/a	n/a	
Depreciation and amortisation	n/a	n/a	n/a	n/a	n/a	EV/EBIT (x)	n/a	n/a	n/a	n/a	
Normalised EBIT	n/a	n/a	n/a	n/a	n/a	PE (x)	13.7	12.9	n/a	6.4	
Net interest	n/a	n/a	n/a	n/a	n/a	Price/NTA (x)	1.1	1.3	1.4	1.3	
Associate income	0	0	0	0	0	Free cash flow yield (%)	41.4	16.0	10.0	35.7	
Tax	(9.2)	(7.5)	(0.7)	(16.3)	(22.4)	Adj. free cash flow yield (%)	41.4	16.0	10.0	35.7	
Minority interests	0.6	0.1	0	0	0	Net dividend yield (%)	8.3	10.8	0.0	11.7	
Normalised NPAT	20.8	27.4	0.3	35.3	48.9	Gross dividend yield (%)	n/a	10.8	0.0	11.7	
Abnormals/other	(1.5)	(8.5)	(2.8)	0.7	0						
Reported NPAT	19.3	18.9	(2.5)	36.0	48.9						
Normalised EPS (cps)	4.4	4.7	(1.3)	9.3	12.9						
DPS (cps)	5.0	6.5	0	7.0	8.0						
Growth Rates						Key Ratios					
Revenue (%)	2021A	2022A	2023E	2024E	2025E	2021A	2022A	2023E	2024E	2025E	
Revenue (%)	3.8	8.2	13.9	18.6	11.9	Return on assets (%)	n/a	n/a	n/a	n/a	
EBITDA (%)	n/a	n/a	n/a	n/a	n/a	Return on equity (%)	5.3	5.8	-1.6	11.2	
EBIT (%)	n/a	n/a	n/a	n/a	n/a	Return on funds employed (%)	4.6	5.1	-1.5	10.2	
Normalised NPAT (%)	49.1	-4.0	n/a	n/a	38.4	EBITDA margin (%)	n/a	n/a	n/a	n/a	
Normalised EPS (%)	49.1	6.7	n/a	n/a	38.4	EBIT margin (%)	n/a	n/a	n/a	n/a	
Ordinary DPS (%)	n/a	30.0	-100.0	n/a	14.3	Capex to sales (%)	3.1	4.1	3.1	2.7	
Cash Flow (NZ\$m)						Capital Structure					
EBITDA	2021A	2022A	2023E	2024E	2025E	2021A	2022A	2023E	2024E	2025E	
EBITDA	n/a	n/a	n/a	n/a	n/a	Solvency capital	155.9	150.5	179.4	136.4	
Working capital change	n/a	n/a	n/a	n/a	n/a	Minimum solvency capital (MSC)	56.6	52.3	66.3	66.5	
Interest & tax paid	0	0	0	0	0	Total regulatory capital	106.6	102.3	83.3	91.3	
Other	0	0	0	0	0	Solvency ratio (%)	275	287	271	205	
Operating cash flow	98.1	59.8	44.7	104.6	109.5	Operating Performance					
Capital expenditure	(12.0)	(17.3)	(14.7)	(15.1)	(15.4)	2021A	2022A	2023E	2024E	2025E	
(Acquisitions)/divestments	(14.4)	(6.1)	(4.1)	0	0	Gross written premium	396.0	445.6	522.9	606.9	
Other	(24.9)	(21.1)	(7.1)	(8.2)	(8.9)	Gross earned premium	386.6	418.3	476.4	564.9	
Funding available/(required)	46.8	15.3	18.8	81.3	85.1	Reinsurance premium	(58.8)	(66.3)	(84.3)	(95.6)	
Dividends paid	(8.9)	(20.0)	0	(26.6)	(30.4)	Net earned premium	327.9	352.1	392.1	469.3	
Equity raised/(returned)	0	(30.6)	0	0	0	Net claims expense	(202.3)	(224.9)	(306.2)	(317.8)	
(Increase)/decrease in net debt	37.9	(35.4)	18.8	54.8	54.8	* includes Large event claims of	(13.9)	(19.0)	(50.0)	(42.0)	
Balance Sheet (NZ\$m)						Management & sales expenses					
Working capital	2021A	2022A	2023E	2024E	2025E	(123.3)	(129.9)	(135.4)	(148.5)	(156.3)	
Working capital	148.0	183.2	237.2	275.3	298.2	Underwriting profit	27.2	23.6	(19.0)	35.5	
Fixed assets	9.4	5.4	3.7	2.2	1.1	Investment and other revenue	0.2	1.2	13.0	17.1	
Intangibles	120.6	132.5	136.1	135.3	135.1	Financing and other costs	(0.4)	(0.9)	(0.9)	(0.9)	
Right of use asset	25.6	23.3	20.7	18.1	15.6	Profit before tax (from continuing operations)	27.6	25.2	-4.2	51.6	
Other assets	314.8	295.6	295.6	295.6	295.6	Tax expense	(9.2)	(7.5)	(0.7)	(16.3)	
Total funds employed	618.4	640.0	693.3	726.6	745.5	Profit after taxation	18.4	17.7	-4.9	35.3	
Net debt/(cash)	(116.1)	(84.5)	(103.3)	(158.1)	(212.8)	NPAT (from discontinued operation)	(0.2)	5.1	2.3	0.7	
Lease liability	39.4	35.1	31.2	27.3	23.4	NPAT (Reported)	18.2	22.8	-2.5	36.0	
Other liabilities	342.5	383.5	469.4	541.5	584.8	Key ratios					
Shareholder's funds	349.9	306.0	296.0	315.9	350.2	Total GWP growth %	5.0%	12.5%	17.4%	16.1%	
Minority interests	2.7	0	0	0	0	Total claims ratio %	54.3%	54.1%	68.3%	60.8%	
Total funding sources	618.4	640.0	693.3	726.6	745.5	MER %	37.1%	36.0%	34.0%	31.6%	
						Combined ratio %	91.4%	90.1%	103.2%	92.4%	

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend** Information on Forsyth Barr's Carbon and ESG (CESG) ratings can be found at www.forsythbarr.co.nz/corporate-news-events/cesg-report

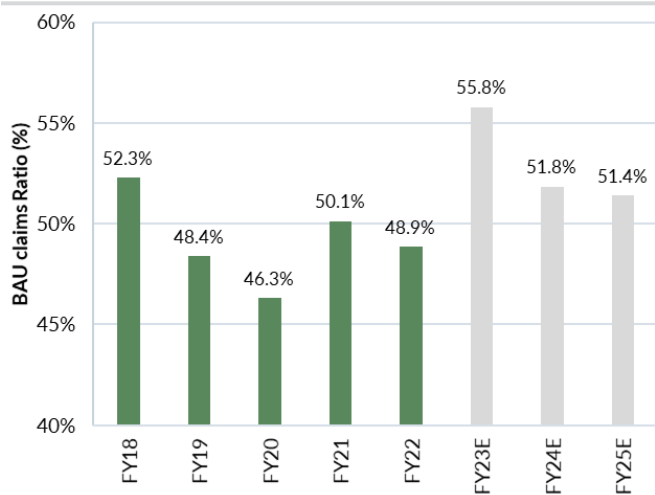
Earnings revisions

Figure 1. Description

	FY23			FY24			FY25		
	Old	New	Change	Old	New	Change	Old	New	Change
Gross written premium	524.7	526.0	+0%	604.5	606.9	+0%	646.2	657.4	+2%
Gross earned premium	485.2	479.6	(1%)	564.6	564.9	+0%	625.3	632.2	+1%
Reinsurance Expense	(84.1)	(81.3)	(3%)	(95.5)	(95.6)	+0%	(105.2)	(106.1)	+1%
Net earned premium	401.0	398.4	(1%)	469.1	469.3	+0%	520.1	526.1	+1%
Net Claims Expense	(207.3)	(222.3)	+7%	(237.1)	(243.3)	+3%	(268.3)	(270.4)	+1%
Large event claims expense	(50.0)	(50.0)	+0%	(42.0)	(42.0)	+0%	(44.0)	(44.0)	+0%
Management expenses	(132.5)	(126.1)	(5%)	(142.9)	(138.1)	(3%)	(148.8)	(145.2)	(2%)
Net Commission Expense	(7.8)	(9.3)	+19%	(8.6)	(10.4)	+21%	(9.0)	(11.1)	+23%
Underwriting profit	3.5	(12.7)	(466%)	38.4	35.5	(8%)	50.0	55.4	+11%
Net Investment Income	13.6	13.0	n/a	15.9	17.1	n/a	16.2	16.9	n/a
Other income (costs)	(0.9)	0.6	n/a	(0.9)	(0.9)	n/a	(1.0)	(1.0)	n/a
Profit before tax	16.1	0.9	(94%)	53.4	51.6	(3%)	65.2	71.3	+9%
Tax expense	(5.4)	(0.7)	(88%)	(16.8)	(16.3)	(3%)	(20.5)	(22.4)	+9%
Profit after taxation from discontinued operations	-	-	n/a	-	-	n/a	-	-	n/a
Underlying Profit after tax	10.8	0.3	(97%)	36.6	35.3	(3%)	44.8	48.9	+9%
Canterbury impact on outstanding claims	(2.0)	(2.0)	n/a	-	-	n/a	-	-	n/a
Other non-underlying items	3.2	(0.8)	n/a	-	0.7	n/a	-	-	n/a
Reported Profit after tax	12.0	(2.5)	(121%)	36.6	36.0	(2%)	44.8	48.9	+9%

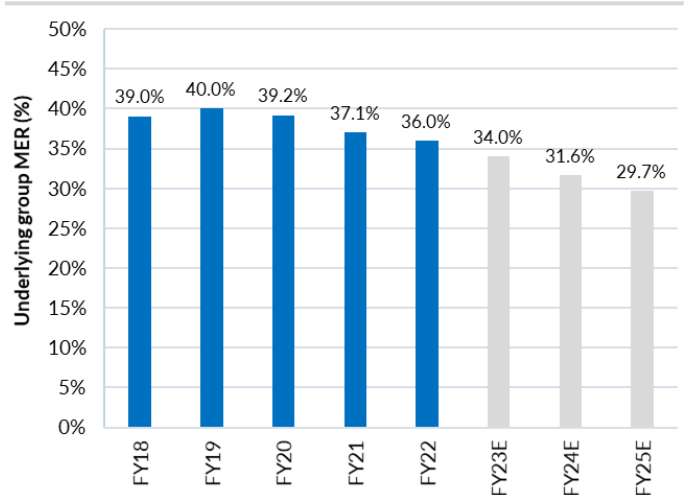
Source: Forsyth Barr analysis

Figure 2. TWR – BAU claims ratio (excluding large events)



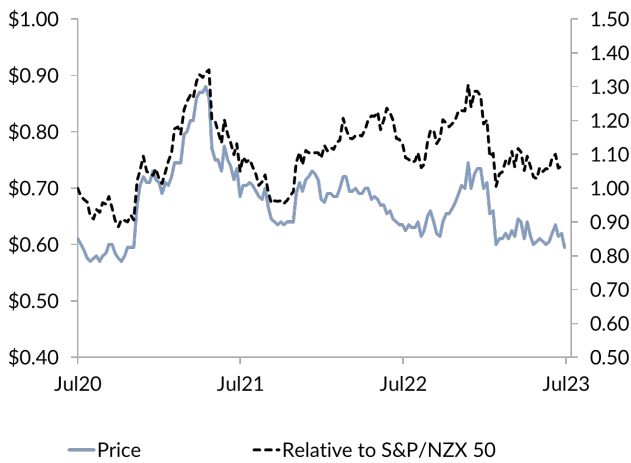
Source: Company, Forsyth Barr analysis

Figure 3. TWR – Underlying group MER (%)



Source: Company, Forsyth Barr analysis

Figure 4. Price performance



Source: Forsyth Barr analysis

Figure 5. Substantial shareholders

Shareholder	Latest Holding
Bain Capital Credit LP	20.0%
ACC	9.6%
Salt Funds Management	8.0%
Investment Services Group	5.4%
NZ Funds Management	5.2%

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

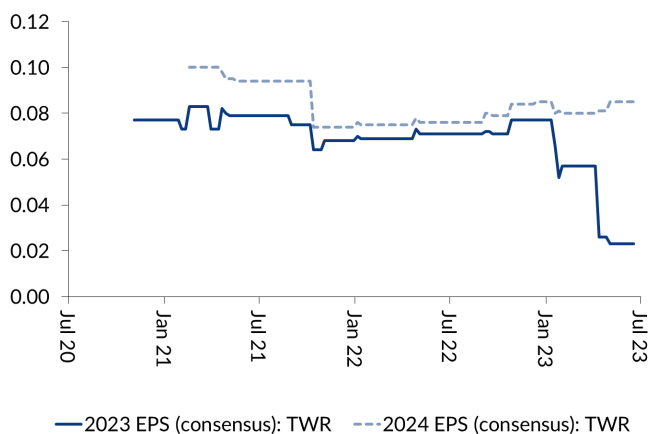
Figure 6. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE 2023E	PE 2024E	EV/EBITDA 2023E	EV/EBITDA 2024E	EV/EBIT 2023E	EV/EBIT 2024E	Cash Yld 2024E
Tower Ltd	TWR NZ	NZ\$0.60	NZ\$226	<0x	6.4x	n/a	n/a	n/a	n/a	11.8%
Heartland Group Holdings *	HGH NZ	NZ\$1.77	NZ\$1,256	11.5x	10.3x	n/a	n/a	n/a	n/a	6.9%
Insurance Australia Group	IAG AT	A\$5.73	A\$13,980	23.4x	15.1x	n/a	n/a	n/a	10.6x	5.0%
Suncorp Group	SUN AT	A\$13.33	A\$16,883	13.6x	12.4x	n/a	n/a	n/a	47.5x	6.1%
QBE INSURANCE GROUP	QBE AT	US\$10.33	US\$15,417	13.1x	9.5x	n/a	n/a	n/a	8.6x	5.7%
Compco Average:				15.4x	11.8x	n/a	n/a	n/a	22.2x	5.9%
TWR Relative:				n/a	-46%	n/a	n/a	n/a	n/a	99%

EV = Mkt cap+net debt+lease liabilities+min interests-investments

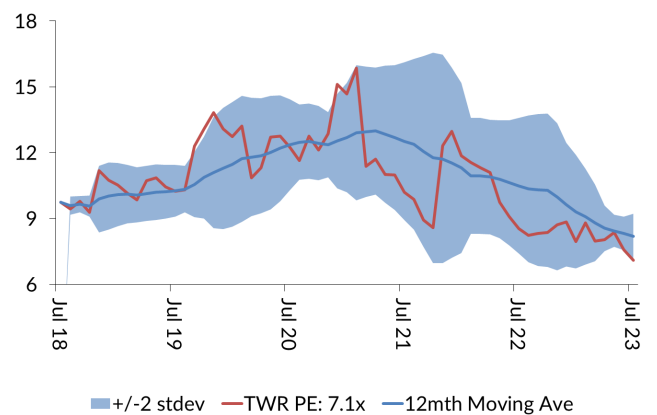
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 7. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)



Source: Forsyth Barr analysis

Important information about this publication

Forsyth Barr Limited (“**Forsyth Barr**”) holds a licence issued by the Financial Markets Authority to provide financial advice services. In making this publication available, Forsyth Barr (and not any named analyst personally) is giving any financial advice it may contain. Some information about us and our financial advice services is publicly available. You can find that on our website at www.forsythbarr.co.nz/choosing-a-financial-advice-service. Please note the limitations in relation to distribution generally, and in relation to recipients in Australia in particular, as set out under those headings below.

This publication has been commissioned by Tower Limited (“**Researched Entity**”) and prepared and issued by Forsyth Barr in consideration of a fee payable by the Researched Entity. Forsyth Barr follows a research process (including through the Analyst certification below) designed to ensure that the recommendations and opinions in our research publications are not influenced by this arrangement and the other interests of Forsyth Barr and related parties disclosed below. However, entities may not be willing to continue to pay for research coverage that includes unfavourable views.

Any recommendations or opinions in this publication do not take into account your personal financial situation or investment goals, and may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser.

Past performance is not indicative of future performance. Estimates of future performance are based on assumptions that may not be realised. If provided, and unless otherwise stated, the closing price provided is that of the primary exchange for the issuer’s securities or investments.

This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. However, that information has not been independently verified or investigated by Forsyth Barr. If there are material inaccuracies or omissions in the information it is likely that our recommendations or opinions would be different. Any analyses or valuations will also typically be based on numerous assumptions (such as the key WACC assumptions); different assumptions may yield materially different results.

Forsyth Barr does not undertake to keep current this publication; any opinions or recommendations may change without notice to you.

In giving financial advice, Forsyth Barr is bound by duties under the Financial Markets Conduct Act 2013 (“**FMCA**”) to:

- exercise care, diligence, and skill,
- give priority to the client’s interests, and
- when dealing with retail clients, comply with the Code of Professional Conduct for Financial Advice Services, which includes standards relating to competence, knowledge, skill, ethical behaviour, conduct, and client care.

There are likely to be fees, expenses, or other amounts payable in relation to acting on any recommendations or opinions in this publication. If you are Forsyth Barr client we refer you to the Advice Information Statement for your account for more information.

Analyst certification: The research analyst(s) primarily responsible for the preparation and content of this publication (“**Analysts**”) are named on the first page of this publication. Each such Analyst certifies (other than in relation to content or views expressly attributed to another analyst) that (i) the views expressed in this publication accurately reflect their personal views about each issuer and financial product referenced; and (ii) no part of the Analyst’s compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that Analyst in this publication.

Analyst holdings: The following Analyst(s) have a threshold interest in the financial products referred to in this publication: N/A. For these purposes, a threshold interest is defined as being a holder of more than \$50,000 in value or 1% of the financial products on issue, whichever is the lesser.

Other disclosures: Forsyth Barr and its related companies (and their respective directors, officers, agents and employees) (“**Forsyth Barr Group**”) may have long or short positions or otherwise have interests in the financial products referred to in this publication, and may be directors or officers of, and/or provide (or be intending to provide) corporate advisory or other services to, the issuer of those financial products (and may receive fees for so acting). Members of the Forsyth Barr Group may buy or sell financial products as principal or agent, and in doing so may undertake transactions that are not consistent with any recommendations contained in this publication. Other Forsyth Barr business units may hold views different from those in this publication; any such views will generally not be brought to your attention. Forsyth Barr confirms no inducement has been accepted from the issuer(s) that are the subject of this publication, whether pecuniary or otherwise, in connection with making any recommendation contained in this publication. In preparing this publication, non-financial assistance (for example, access to staff or information) may have been provided by the issuer(s) being researched.

Corporate advisory engagements: Other than confidential engagements, Forsyth Barr has not within the past 12 months been engaged to provide corporate advisory services to the Researched Entity.

Complaints: Information about Forsyth Barr’s complaints process and our dispute resolution process is available on our website – www.forsythbarr.co.nz.

Disclaimer: Where the FMCA applies, liability for the FMCA duties referred to above cannot by law be excluded. However to the maximum extent permitted by law, Forsyth Barr otherwise excludes and disclaims any liability (including in negligence) for any loss which may be incurred by any person acting or relying upon any information, analysis, opinion or recommendation in this publication. The information contained within this publication is published solely for information purposes and is not a solicitation or offer to buy or sell any financial instrument or participate in any trading or investment strategy.

Distribution: This publication is not intended to be distributed or made available to any person in any jurisdiction where doing so would constitute a breach of any applicable laws or regulations or would subject Forsyth Barr to any registration or licensing requirement within such jurisdiction.

Recipients in Australia: This publication is only available to “wholesale clients” within the meaning of section 761G of the Corporations Act 2001 (Cth) (“**wholesale clients**”). In no circumstances may this publication be made available to a “retail client” within the meaning of section 761G. Further, this publication is only available on a limited basis to authorised recipients in Australia. Forsyth Barr is a New Zealand company operating in New Zealand that is regulated by the Financial Markets Authority of New Zealand and NZX. This publication has been prepared in New Zealand in accordance with applicable New Zealand laws, which may differ from Australian laws. Forsyth Barr does not hold an Australian financial services licence. This publication may refer to a securities offer or proposed offer which is not available to investors in Australia, or is only available on a limited basis, such as to professional investors or others who do not require prospectus disclosure under Part 6D.2 of the Corporations Act 2001 (Cth) and are wholesale clients.

Terms of use: Copyright Forsyth Barr Limited. You may not redistribute, copy, revise, amend, create a derivative work from, extract data from, or otherwise commercially exploit this publication in any way. By accessing this publication via an electronic platform, you agree that the platform provider may provide Forsyth Barr with information on your readership of the publications available through that platform.