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Tower
New Guidance on the Journey

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Given recent weather events, constraints due to COVID-19 and inflationary pressures there was always the risk Tower (TWR) would need to re-visit its earnings guidance for the upcoming FY21 result. Management has now done so, suggesting the change was driven by (1) an elevated number of individual fires in recent weeks and months; (2) further information on the impacts of supply chain constraints from COVID-19; and (3) ongoing industry-wide inflation impacts on both home and motor. As such, management has revised its prior Reported NPAT range of between NZ$22m and NZ$24m to a new range for the year ending 30 September 2021, of between NZ$19m to NZ$21m. Our forecasts were already below management's prior guidance range with Reported NPAT earnings estimated at NZ$20.3m. This now falls near the midpoint of the new management range and as such no changes in our earnings estimates have occurred. Our valuation and earnings will be further revisited at the release of the FY21 result on 24 November 2021.

With this report we transfer our coverage of TWR to James Lindsay, from Jeremy Simpson, with immediate effect.

NZX Code	TWR
Share price	NZ$0.67
Spot Valuation	NZ$0.95
Risk rating	Medium
Issued shares	421.6m
Market cap	NZ$283m
Avg daily turnover	421.6k (NZ$306k)

Financials: Sep/	20A	21E	22E	23E
NPAT* (NZ$m)	28.0	21.6	30.7	37.0
EPS* (NZc)	6.7	5.1	7.3	8.8
EPS growth* (%)	-13.8	-23.6	41.9	20.5
DPS (NZc)	0.0	5.2	5.5	6.2
Imputation (%)	0	0	25	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
PE	10.0	13.1	9.2	7.6
EV/EBIT	n/a	n/a	n/a	n/a
EV/EBITDA	n/a	n/a	n/a	n/a
Price / NTA	1.3	1.3	1.2	1.2
Cash div yld (%)	0.0	7.8	8.2	9.3
Gross div yld (%)	0.0	7.8	9.0	12.9

What's changed?

- **Earnings guidance:** TWR revised FY21 NPAT range to between NZ$19m to NZ$21m (from NZ$22m and NZ$24m)

Anomalies of fire events

A significantly higher incidence of fire related claims has occurred this year and especially so over the more recent past. Large house claims now number 97 totalling approximately NZ$21.3m as compared with 56 in FY20 totalling NZ$10.4m.

Supply chain constraints

Management has highlighted a number of other COVID-19 driven impacts on its supply chain costs. This will likely be a contributing factor for the near to medium term as the scarcity of building and motor supplies and industry contraints will take time to normalise.

Claims costs inflation

Ongoing building cost inflation has been evident in NZ for some time but these inflationary costs are now having a material impact on claims costs. Management has noted previously it was investigating actions to reassess fire and flood related costs due to NZ experiencing a surge of building cost inflation.

Tower Limited (TWR)

Market data (NZ$)	
Priced as at 22 Sep 2021	**0.67**
52 week high / low	0.89 / 0.57
Market capitalisation (NZ$m)	282.5

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	1.20
WACC	10.5%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	345.0	380.5	399.6	424.7	442.6
Normalised EBITDA	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Depreciation and amortisation	n/a	n/a	n/a	n/a	n/a
Normalised EBIT	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Net interest	n/a	n/a	n/a	n/a	n/a
Associate income	0	0	0	0	0
Tax	n/a	n/a	n/a	n/a	n/a
Minority interests	0.2	0.4	0.9	0.9	0.9
Normalised NPAT	**27.3**	**28.0**	**21.6**	**30.7**	**37.0**
Abnormals/other	(10.7)	(16.1)	(1.3)	(1.8)	(1.4)
Reported NPAT	**16.6**	**11.9**	**20.3**	**28.9**	**35.5**
Normalised EPS (cps)	7.8	6.7	5.1	7.3	8.8
DPS (cps)	0	0	5.2	5.5	6.2

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	6.8	10.3	5.0	6.3	4.2
EBITDA (%)	n/a	n/a	n/a	n/a	n/a
EBIT (%)	n/a	n/a	n/a	n/a	n/a
Normalised NPAT (%)	>100	2.7	-22.8	41.9	20.5
Normalised EPS (%)	84.7	-13.8	-23.6	41.9	20.5
Ordinary DPS (%)	n/a	n/a	n/a	5.2	13.5

Cash Flow (NZ$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**
Working capital change	n/a	n/a	n/a	n/a	n/a
Interest & tax paid	0	0	0	0	0
Other	0	0	0	0	0
Operating cash flow	**24.6**	**18.9**	**95.5**	**57.9**	**61.8**
Capital expenditure	(37.6)	(10.5)	(15.5)	(16.5)	(17.2)
(Acquisitions)/divestments	0	(9.5)	(14.0)	0	0
Other	(42.0)	(9.4)	(35.0)	(2.8)	(2.9)
Funding available/(required)	**(55.0)**	**(10.5)**	**30.9**	**38.7**	**41.7**
Dividends paid	0	0	(10.5)	(23.1)	(26.2)
Equity raised/(returned)	0	44.9	0	0	0
(Increase)/decrease in net debt	**(55.0)**	**34.4**	**20.4**	**15.6**	**15.6**

Balance Sheet (NZ$m)	2019A	2020A	2021E	2022E	2023E
Working capital	171.6	184.1	143.2	145.8	152.0
Fixed assets	9.1	10.0	11.0	12.0	12.9
Intangibles	106.7	119.6	128.8	131.9	133.0
Right of use asset	0	7.2	14.2	11.8	9.5
Other assets	278.1	277.6	302.7	302.7	302.7
Total funds employed	**565.5**	**598.6**	**599.8**	**604.2**	**610.2**
Net debt/(cash)	(47.1)	(80.1)	(99.1)	(114.7)	(130.3)
Lease liability	0	8.7	14.8	12.0	9.1
Other liabilities	319.9	322.9	327.6	343.7	357.8
Shareholder's funds	290.9	345.0	353.5	359.3	368.6
Minority interests	1.8	2.2	3.0	3.9	4.9
Total funding sources	**565.5**	**598.6**	**599.8**	**604.2**	**610.2**

Spot valuations (NZ$)	0.95
1. PE relative	0.96
2. PB relative	0.95
3. n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	n/a
(Net debt)/cash	n/a
Less: Capitalised operating leases	n/a
Value of equity	n/a

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a
PE (x)	8.6	10.0	13.1	9.2	7.6
Price/NTA (x)	1.2	1.3	1.3	1.2	1.2
Free cash flow yield (%)	8.7	6.7	33.8	20.5	21.9
Net dividend yield (%)	0.0	0.0	7.8	8.2	9.3
Gross dividend yield (%)	0.0	0.0	7.8	9.0	12.9

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	n/a	n/a	n/a	n/a	n/a
Return on equity (%)	9.4	8.1	6.1	8.5	10.0
Return on funds employed (%)	0.0	0.0	0.0	0.0	0.0
EBITDA margin (%)	n/a	n/a	n/a	n/a	n/a
EBIT margin (%)	n/a	n/a	n/a	n/a	n/a
Capex to sales (%)	10.9	2.8	3.9	3.9	3.9
Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
Imputation (%)	0	0	0	25	100
Pay-out ratio (%)	0	0	101	75	71

Capital Structure	2019A	2020A	2021E	2022E	2023E
Solvency capital	155.9	150.5	205.4	209.0	218.1
Minimum solvency capital	56.6	52.3	59.4	59.4	59.4
Total regulatory capital	106.6	102.3	83.3	84.4	84.4
Solvency ratio (%)	275	287	346	352	367

Operating Performance	2019A	2020A	2021E	2022E	2023E
Gross written premium	356.8	385.1	402.3	427.6	445.6
Gross earned premium	**345.0**	**380.5**	**399.6**	**424.7**	**442.6**
Reinsurance expense	(55.0)	(57.2)	(58.3)	(61.9)	(64.4)
Net earned premium	**290.0**	**323.3**	**341.2**	**362.8**	**378.2**
Net claims expense	(140.3)	(149.7)	(171.0)	(178.7)	(186.3)
Large event claims expense	(1.3)	(9.7)	(14.0)	(15.1)	(15.8)
Management and sales expenses	(116.0)	(126.6)	(123.7)	(127.0)	(126.7)
Underwriting profit	**32.4**	**37.3**	**32.4**	**42.1**	**49.5**
Investment and other revenue	7.0	6.4	1.2	2.8	4.4
Financing costs	(0.3)	(1.1)	0	0	0
Underlying profit before tax	**39.1**	**42.6**	**33.6**	**44.9**	**53.9**
Income tax expense	(11.6)	(14.1)	(11.1)	(13.3)	(16.0)
Underlying profit after tax	**27.5**	**28.5**	**22.5**	**31.6**	**37.9**
Abnormals	(10.7)	(16.2)	(1.3)	(1.8)	(1.4)
Reported profit / (loss) after tax	**16.8**	**12.3**	**21.2**	**29.8**	**36.5**

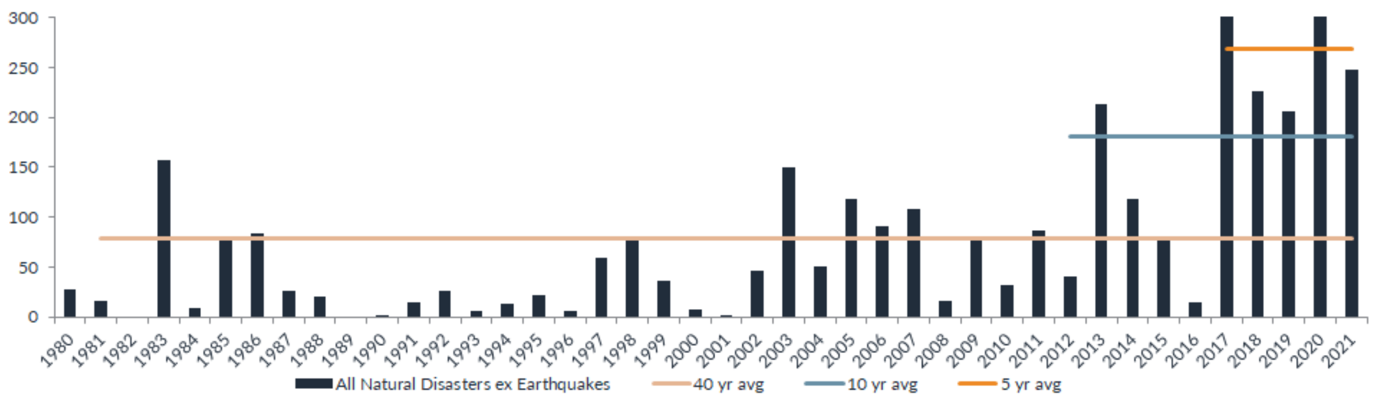
Key ratios					
Tower Direct GWP growth %	9.2%	13.7%	10.7%	8.8%	5.0%
Partnership GWP growth %	2.9%	2.8%	2.4%	3.0%	3.0%
Total GWP growth %	6.2%	7.9%	4.5%	6.3%	4.2%
Total claims ratio %	49%	49%	54%	53%	53%
MER %	40%	39%	36%	35%	34%
Combined ratio %	89%	88%	91%	88%	87%

Large events & COVID-19 hiding core business improvements

In a period of heightened weather and supply chain impacts, likely associated with climate change and COVID-19, shareholders in TWR should remain aware they are taking on general insurance risk. TWR's reinsurance package has provided a level of earnings protection from large flooding events but has not aided in reducing recent elevated large house claim costs. However, TWR's management team appears to be working hard to manage these risks, and is launching new programmes to better align premiums to risk across their fire, flood and motor books and diversifying into new categories like marine, pet and travel insurance. In the context of a fairly unprecedented number of events this year, it remains unclear when policy price rises to customers will fairly reflect the elevated large event environment and how permanent or transitory these events are.

There has been a clear trend of increasing cost of natural disasters (excluding earthquakes) in NZ, driven in part by climate change, as illustrated in Figure 2 below. Over the last five years total industry costs of natural disasters has been a staggering NZ$270m per annum up from the ten year average of ~NZ$181m and well above the 30 year average of ~NZ$79m. As a base case we assume large events claims expenses will likely continue at elevated levels going forward.

Figure 1. Cost of All Natural Disasters ex Earthquakes in NZ (CPI inflated, NZ$m)



Source: Forsyth Barr analysis and ICNZ

No change to earnings forecasts

Our FY21 reported NPAT forecasts (NZ$20.3m) is close to the midpoint of the new range. TWR paid an interim dividend of 2.5c per share and in this release said it "*expects to pay a final dividend in line with its policy at the full year*" of between 60–80% of cash earnings '*where prudent to do so*'. At the interim result in May 2021 TWR indicated a combined full year dividend of between 5c and 5.5c was achievable based on the then guidance range of between NZ$25m and NZ$27m NPAT. As such, there remains some risk to the 2H21 dividend payment given its earnings update, however, a final dividend of 2.5c remains achievable given the high levels of excess capital allowing the dividend to remain prudent in spite of the elevated claims costs this year.

Excess capital of NZ$97.1m at the 1H21 provides a sound buffer to risks associated with large events and enables TWR to maintain dividends at reasonable levels in spite of 'event' driven earnings volatility. Further options regarding possible bolt-on acquisitions or capital returns remain.

Anomalies of fire events

Management has noted a significantly higher incidence of fire related claims this year and especially so over the last few days, weeks and months that have pushed the expected NPAT range lower. As an example, management provided specific details of four total loss house fires in the past week. Blair Turnbull, CEO, noted "*FY21 large house claims now number 97 claims, totalling approximately NZ$21.3m compared to 56 in FY20 totalling NZ$10.4m.*" While no single driver appears to exist, there are a few common themes including:

- Overloaded power boards linked to more people working from home during lockdowns and using multi-boxes to run additional 'home office' equipment.
- Poorly maintained stoves.
- Lack of maintenance of fireplaces potentially exacerbated by an inability, due to COVID-19 restrictions, to get flues cleaned.

While the incidence of fire events is an unfortunate occurrence it remains part of the business of general insurance.

Supply chain constraints

In this update management has also highlighted a number of other COVID-19 driven impacts on its supply chain costs. Supply constraints driven by COVID-19 have had wide ranging implications globally and have created a number of anomalies in NZ as well. This has included TWR seeing "*a 14% rise in the value of second-hand vehicles*" as new car sales have fallen due to semiconductor chip shortages. In addition, inflation has been seen in the cost of automotive repairs in part from shortages in parts and staffing. Whether these global pandemic impacts will have long term implications is more difficult to determine but they will likely be a contributing factor for a further few quarters or years to come as the scarcity of building and motor supplies will take time to normalise.

Our previously noted view that the small countering benefit of fewer motor claims due to COVID-19 lockdowns would not be enough to offset other large event claims was evident in this update.

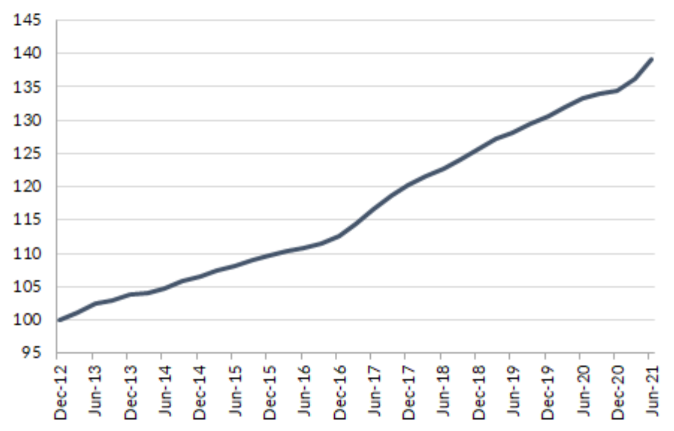
Claims costs increasing

A third factor mentioned impacting on FY21 were the effects of ongoing **inflation** and its impact on claims costs. This should come as little surprise as increases in building costs have been evident in NZ for some time. Management has noted previously that it was instigating action to reassess fire related costs due to NZ experiencing a surge of building cost inflation. This is being done via:

- Higher premiums flowing through to policyholders over the next year as policies roll
- Reviewing and strengthening claim management processes
- Re-assessing how claims are handled
- Undertaking efforts to manage supply chain increases
- Further rating and underwriting actions.

The company highlighted "***increased costs of house materials which rose 4.6% in the June quarter** alone due to supply chain constraints*." The cost of new housing supply has risen relentlessly over recent years underpinned by higher land prices, materials price increases driven by high demand and capacity constraints, especially in labour. Price indices suggest residential construction cost inflation is currently tracking at around 3% p.a., however, anecdotally increases have been far in excess of this.

Figure 2. Cordell Housing Price index (Dec 2012 – June 2021)



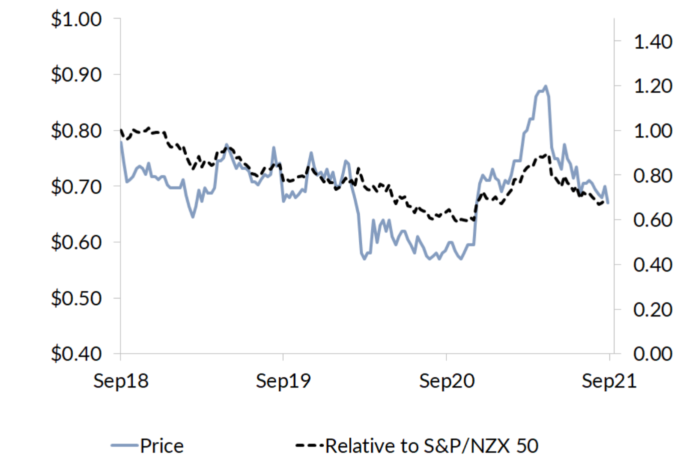
Source: Core Logic, Forsyth Barr analysis

As seen in Figure 1, Corelogic's Cordell Housing Price index which "*measures the rate of change of construction costs within the residential market and covers freestanding and semi-detached single and two storey dwelling homes*" has continued to rise steadily over the past decade.

Industry anecdotes suggest that while these pressures are impacting the September quarter these cost pressures have likely more to go, and supply chain induced materials shortages will bite further over the next three to six months. In a June business confidence survey undertaken by ANZ the bank highlighted that a net 94% of construction businesses expect further cost increases over the next three months and a net 74% expect to increase their own prices. CPI data highlighted that the cost of new houses rose +7.4% in the year to June.

More specifically on the escalation of building material costs, Steel and Tube (STU.NZ) lifted their prices by +5% to +15% in March 2021 followed by Summit Steel instigating +15% to +21% price rises in April 2021 and Fletcher Building's (FBU.NZ) EasySteel increases in May 2021. Also, in April, Drymix lifted its bagged concrete and cement prices by +7%, and Keyland Ply increased prices +6% to +12% across its range of decking, timber and plywood. Lumber supplies and prices have hit the headlines as well this year.

Figure 3. Price performance



Source: Forsyth Barr analysis

Figure 4. 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%

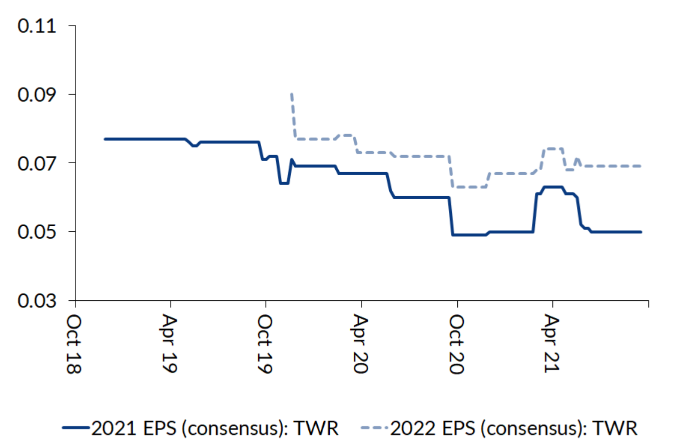
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 5. 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$0.67**	**NZ$283**	**13.1x**	**9.2x**	**n/a**	**n/a**	**n/a**	**n/a**	**8.2%**
HEARTLAND GROUP HOLDINGS *	HGH NZ	NZ$2.33	NZ$1,374	15.2x	14.4x	n/a	n/a	n/a	n/a	5.2%
INSURANCE AUSTRALIA GROUP	IAG AT	A$4.87	A$12,375	<0x	17.0x	n/a	n/a	n/a	11.7x	4.5%
SUNCORP GROUP	SUN AT	A$12.17	A$15,947	15.7x	16.3x	n/a	n/a	n/a	53.1x	5.1%
QBE INSURANCE GROUP	QBE AT	A$11.20	A$16,625	11.8x	17.0x	n/a	n/a	n/a	11.7x	3.3%
			Compco Average:	**14.2x**	**16.2x**	**n/a**	**n/a**	**n/a**	**25.5x**	**4.5%**
EV = Current Market Cap + Actual Net Debt			**TWR Relative:**	**-8%**	**-43%**	**n/a**	**n/a**	**n/a**	**n/a**	**81%**

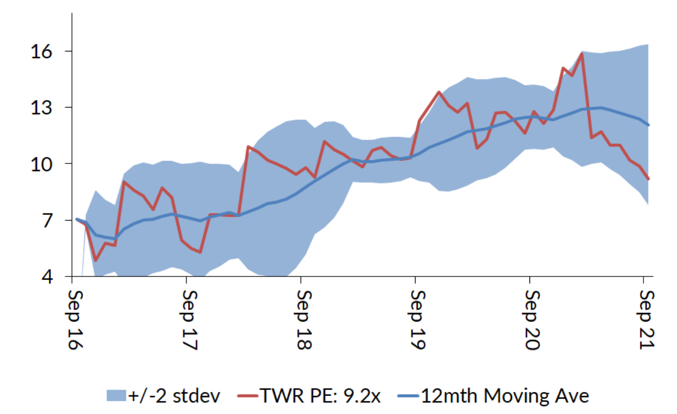
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 6. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)



Source: Forsyth Barr analysis

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