NEW ZEALAND EQUITY RESEARCH | INSURANCE | GENERAL INSURANCE
2 NOVEMBER 2021

Tower
Tidying up the Pacific

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Tower (TWR) has announced the purchase of an additional 22% stake in Samoan headquartered National Pacific Insurance (NPI), taking TWR's stake from 71% to 93%, costing NZ$3.4m. TWR will now move to compulsorily acquire the remaining 7% of shareholders. This simplifies the ownership of the Pacific, as NPI was the only partial shareholding TWR had in the Pacific and is a good use of the company's excess capital.

NZX Code	TWR
Share price	NZ$0.64
Spot Valuation	NZ$0.95
Risk rating	Medium
Issued shares	421.6m
Market cap	NZ$270m
Avg daily turnover	428.0k (NZ$311k)

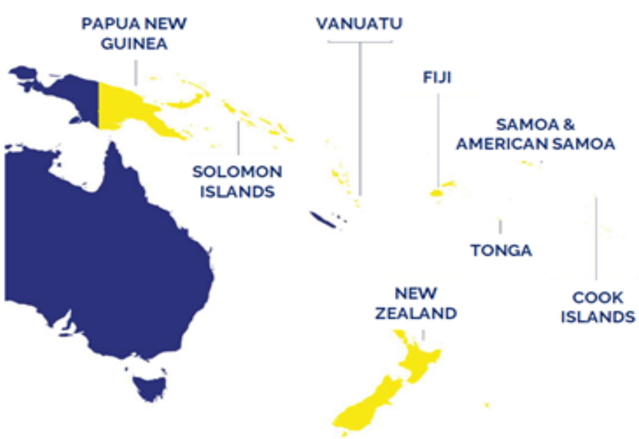
Financials: Sep/	20A	21E	22E	23E
NPAT* (NZ$m)	28.0	21.6	30.7	37.0
EPS* (NZc)	6.7	5.1	7.3	8.8
EPS growth* (%)	-13.8	-23.6	41.9	20.5
DPS (NZc)	0.0	5.2	5.5	6.2
Imputation (%)	0	0	25	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
PE	9.5	12.5	8.8	7.3
EV/EBIT	n/a	n/a	n/a	n/a
EV/EBITDA	n/a	n/a	n/a	n/a
Price / NTA	1.2	1.2	1.2	1.1
Cash div yld (%)	0.0	8.1	8.5	9.7
Gross div yld (%)	0.0	8.1	9.4	13.5

What has occurred?

- TWR has continued its programme of simplification across its operations and announced the purchase of an additional 22% stake in Samoan headquartered National Pacific Insurance. The acquisition moves TWR's stake from 71% to 93% costing NZ$3.4m.
- National Pacific Insurance (NPI) has offices in Western Samoa, American Samoa and Tonga and collectively these countries represent 24% of the region's 2020 GWP for TWR.
- TWR has stated that it will now move to compulsorily acquire the remaining 7% of NPI. At the same price this will cost an additional NZ$1.1m.
- This appears a very logical step in tidying up TWR's Pacific operations and a good use of the company's excess capital.

Figure 1. Tower's Pacific Operations



Source: Company, Forsyth Barr analysis

Market data (NZ$)	
Priced as at 01 Nov 2021	**0.64**
52 week high / low	0.89 / 0.57
Market capitalisation (NZ$m)	269.9

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	1.20
WACC	10.6%
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)	8.2	9.5	12.5	8.8	7.3
Price/NTA (x)	1.2	1.2	1.2	1.2	1.1
Free cash flow yield (%)	9.1	7.0	35.4	21.4	22.9
Net dividend yield (%)	0.0	0.0	8.1	8.5	9.7
Gross dividend yield (%)	0.0	0.0	8.1	9.4	13.5

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%

Tower's Pacific operations

TWR operates in eight Pacific Islands, contributing 15% of the Group's gross written premiums (GWP) in 2020. Revenues throughout the Pacific Islands have been under pressure over the past few years, seeing the region's share of group revenues fall from 16.9% in 2018 towards our estimates of ~12.5% of Group GWP in 2021. This has occurred mainly due to two factors:

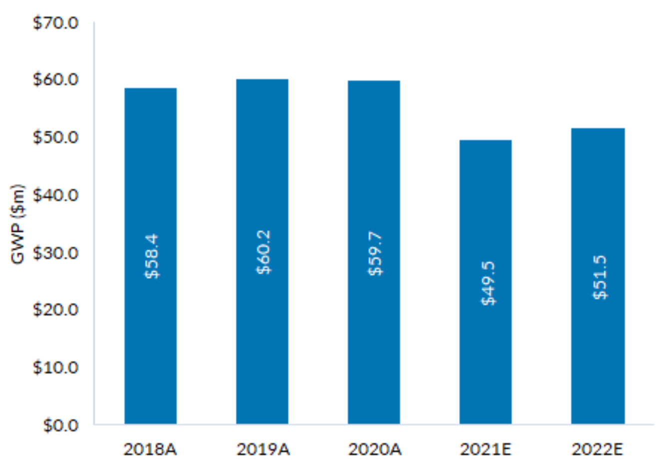
- First is **COVID-19**, where the impacts of the global pandemic over the region have been significant despite excellent vaccination progress in some countries. Travel bans and the lack of international tourists has had an economic impact.
- Second and likely more influential factor is that TWR has 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. Operational excellence is being pushed through the company, as seen in similar programmes in NZ of product simplification and more detailed risk assessments. The drive for more centralisation of processes has been implemented across the Pacific Islands to standardise and simplify underwriting, risk, and claims management processes. This should enable better control of the business.

In 2021, TWR started a large **digitisation project** transferring the personal lines operations off the legacy platform and onto the new cloud-based EIS platform architecture as NZ has done. This process began in Fiji and will likely take a further eighteen months to two years to entirely transition all Pacific operations. Digitalisation will improve customer accessibility as many customers in the Pacific live on outer islands or in rural communities. Offering a fully online product will allow simplification and likely improve customer experiences. A decision to move the **commercial business** to EIS has been made but the timing is yet to be determined. Management intends to complete this transition as soon as practical in the absence of other projects. Given transition would greatly help achieve ambitions for growth in the corporate and partnership business, it would seem logical to proceed as quickly as possible. However, it appears likely to be implemented on a similar timeframe to the completion of the personal line's customers, which is likely to be finished by the end of FY23.

We forecast the impacts on GWP of COVID-19, product rationalisation, and risk mitigation strategies will see GWP bottoming shortly. GWP fell -6.3% in the 1H 2020 compared to 2H 2019, a further -1.3% in the 2H of 2020 and then -14.4% in the 1H of 2021. We forecast an additional 5% half-on-half fall in the 2H of 2021 in GWP in the Pacific. However, **we now forecast TWR will experience a return to +4% GWP growth in the Pacific in 2022 and then +7% to +8% GWP growth for the following few years**. A renewed focus on core products, and management driving to go after large client bases and new partners, could see strong GWP growth over the coming years. There is also potential for acquisitions in the region or expanding into adjacent and complementary Pacific islands.

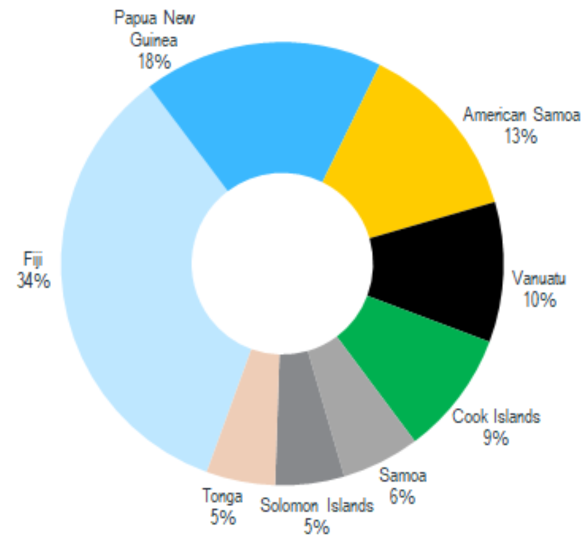
It should be noted that COVID-19 remains an ongoing risk to the region due to the severe economic impacts regionally. Further, new, more virulent COVID-19 strains that result in delaying the opening of these economies could have detrimental effects.

Figure 2. TWR Pacific Islands GWP



Source: Forsyth Barr analysis

Figure 3. TWR GWP Country Split (FY20)



Source: Forsyth Barr analysis

Figure 4. Pacific Islands financials (NZ$m)

Pacific GWP	2019 Actual	2020 Actual	1H21 Actual	2H21 Estimate	2021E Estimate	2022E Estimate
Gross written premium	**60.2**	**59.7**	**25.4**	**24.1**	**49.5**	**51.5**
Gross earned premium	59.3	60.9	27.6	24.6	52.2	50.9
Reinsurance expense	(17.2)	(18.4)	(8.5)	(7.6)	(16.1)	(15.3)
Net earned premium	**42.2**	**42.4**	**19.1**	**17.0**	**36.1**	**35.7**
Net claims expense	(14.6)	(19.4)	(3.2)	(4.3)	(7.5)	(12.8)
Net commission expense	(2.9)	(2.5)	(0.8)	(0.8)	(1.7)	(1.7)
Underwriting Expense	(13.6)	(13.2)	(6.5)	(5.8)	(12.3)	(12.1)
Underwriting Profit	**11.0**	**7.4**	**8.5**	**6.2**	**14.7**	**9.1**
Net investment income	0.0	0.8	0.1	0.1	0.2	0.2
Other	1.1	0.1	0.0	-	0.0	-
Profit before tax	**12.1**	**8.2**	**8.6**	**6.3**	**14.9**	**9.2**
Tax	(4.6)	(3.5)	(2.6)	(1.9)	(4.5)	(2.8)
Profit after tax	**7.6**	**4.8**	**6.0**	**4.4**	**10.4**	**6.4**
GWP growth yoy	3.0%	-0.8%	-15.5%	-18.7%	-17.1%	4.0%
GWP Half-on-Half growth			-14.4%	-5.0%		
Reinsurance ratio	28.9%	30.3%	30.8%	30.8%	30.8%	30.0%
Claims ratio	34.7%	45.6%	16.9%	25.0%	20.7%	35.8%
Commission expense ratio	6.9%	5.8%	4.4%	4.8%	4.6%	4.8%
Underwriting expense ratio	32.2%	31.1%	34.1%	34.0%	34.0%	34.0%
Reported MER	44.7%	51.0%	46.0%			
NPAT Margin of GWP	13%	8%			21%	13%

Source: TWR, Forsyth Barr analysis

National Pacific Insurance

National Pacific Insurance (NPI) has offices in Western Samoa, American Samoa and Tonga. These three countries represented 24% of TWR's Pacific operations in terms of GWP in 2020. NPI offers home & contents, motor, travel and business insurance. NPI's history dates back to 1977 when the Government of (then Western) Samoa was a key driver in establishing the company. Tower NZ was involved from the beginning, initially in an advisory capacity before taking a shareholding in the company at its listing in 1980.

With NPI's 2020 GWP of NZ$14.3m, the increase in shareholding from 71% to 93% effectively acquires an additional $3.1m in GWP for $3.4m. NPI's financials are already consolidated into TWR's accounts. NPAT margin over the entire Pacific business has ranged from 8% of GWP in 2020 to a forecast ~21% in 2021 due to fluctuations in weather events and claims costs. In a more normalised year of weather and claims we forecast a 13% NPAT margin, as we do in 2022. At this level, this would appear an attractive acquisition P/E multiple of 8.4x forecast NPAT.

We believe the benefits of fully consolidating these operations gives three additional regional benefits. Firstly, it provides Tower with the opportunity to re-brand the Samoan, Tongan and American Samoan operations to 'Tower', from National Pacific Insurance, to provide brand continuity across the region. Secondly, and potentially more importantly, it will allow TWR to fully consolidate IT systems onto the one EIS platform. This system integration is crucial as it will further streamline operations and remove duplication and cost from the Pacific. It will also allow TWR to go after new corporate partners with one brand and digital platform. The partnership business, both in NZ and in the Pacific, will be a crucial part of TWR's plan for growth. Having advanced digital connectivity and Application Programming Interfaces (APIs) is an essential component in enabling this. Thirdly, it further allows for more seamless integration of staff and processes at the Pacific Operations Hub in Suva, Fiji.

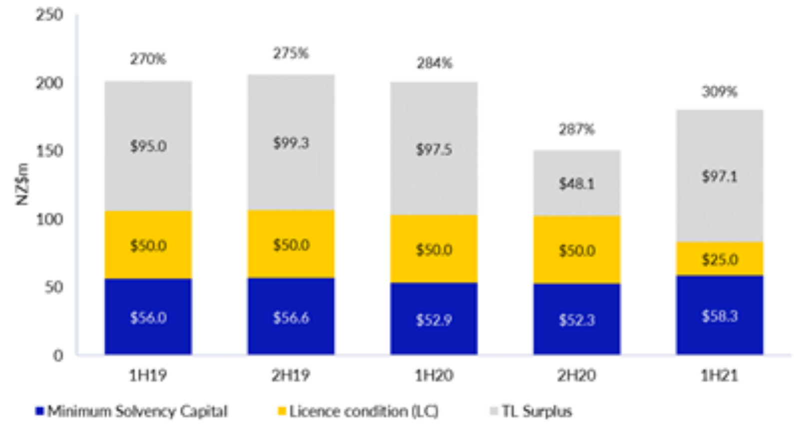
Timetable & Capital requirements

The initial 22% stake in National Pacific Insurance has settled and was fully funded from TWR's existing sources of funds. However, the announced move to compulsorily acquire the remaining shares in National Pacific Insurance could take some months. Post the compulsory acquisition, the 29% uplift in shareholding to full control will cost $4.5m. Once completed, it's anticipated that changes to the brand may take an additional six months.

This ongoing simplification of the operations is an excellent use of TWR's surplus funds. It displays the benefit of having excess capital available to proceed where acquisitions become available and hold strategic sense. TWR's strong capital position, as seen in Figure 6, gives the Tower Board and management a degree of flexibility to manage both dividends and capital structure despite this year's elevated weather event costs in NZ, albeit balanced somewhat by low claims events in the Pacific.

Because TWR does not yet have imputation credits available for attaching to the distribution of dividends, **we'd anticipate the company contemplates a buyback at some stage in the future for a portion of excess funds if other uses cannot be found**. We calculate this could be in the order of NZ$15m to NZ$30m over time.

Figure 5. TWR Solvency Position



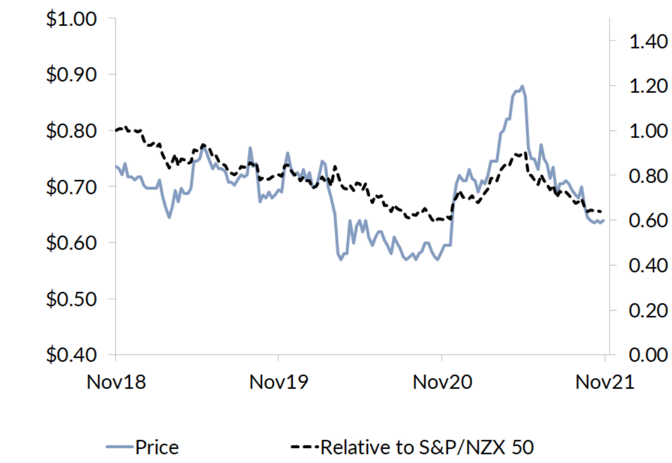
Source: TWR, Forsyth Barr analysis

Full Year result

TWR is due to announce its 2021 full year result on the 24 November 2021. The investor briefing will be held at 10am (NZ time), 8.00am (AEST) via webcast at: http://www.tower.co.nz/company/investor-centre

Pre-registration for the dial-in call can be done via: https://apac.directeventreg.com/registration/event/3398645

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. 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%

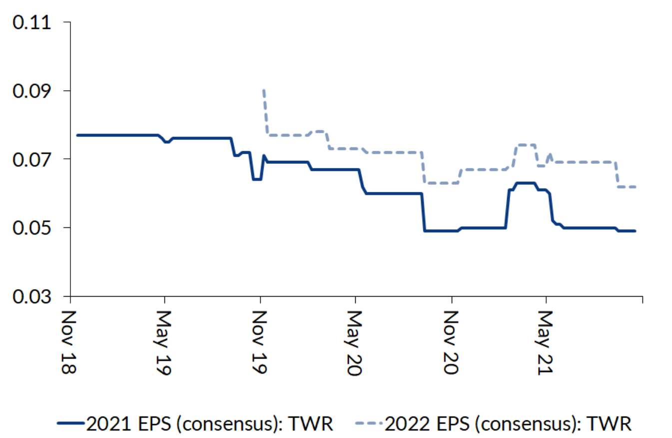
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 8. 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$0.64**	**NZ$270**	**12.5x**	**8.8x**	**n/a**	**n/a**	**n/a**	**n/a**	**8.5%**
Heartland Group Holdings *	HGH NZ	NZ$2.35	NZ$1,386	15.4x	14.6x	n/a	n/a	n/a	n/a	5.2%
Insurance Australia Group	IAG AT	A$4.80	A$11,832	<0x	16.2x	n/a	n/a	n/a	11.2x	4.7%
Suncorp Group	SUN AT	A$11.72	A$15,036	14.9x	15.5x	n/a	n/a	n/a	52.5x	5.5%
QBE INSURANCE GROUP	QBE AT	US$8.89	US$13,132	9.5x	13.6x	n/a	n/a	n/a	9.5x	4.0%
			Compco Average:	**13.2x**	**15.0x**	**n/a**	**n/a**	**n/a**	**24.4x**	**4.9%**
EV = Current Market Cap + Actual Net Debt			**TWR Relative:**	**-6%**	**-41%**	**n/a**	**n/a**	**n/a**	**n/a**	**76%**

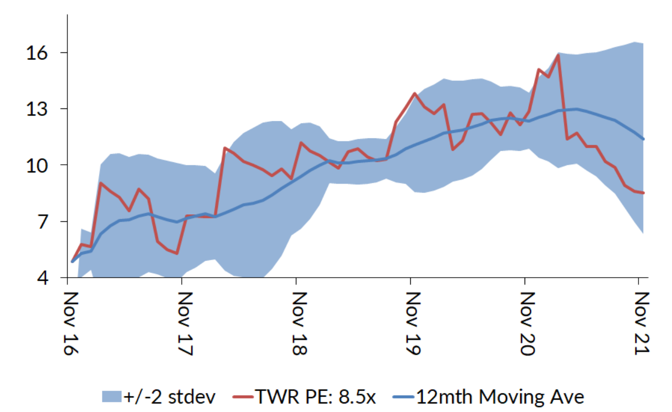
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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