

Tower Limited

Claims Inflation Steals Wild Weather's Thunder

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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	PE relative					0.82	
52 week high / low					0.75 / 0.57	P/Book relative					0.87	
Market capitalisation (NZ\$m)					227.7	DCF					0.85	
Key WACC assumptions						DCF valuation summary (NZ\$m)						
Risk free rate					4.50%	Total firm value					483	
Equity beta					1.18	(Net debt)/cash					(45)	
WACC					10.6%	Less: Capitalised operating leases					(106)	
Terminal growth					1.8%	Value of equity					333	
Profit and Loss Account (NZ\$m)						Valuation Ratios						
Revenue (GEP)	2021A	2022A	2023E	2024E	2025E	EV/Sales (x)	2021A	2022A	2023E	2024E	2025E	
Normalised EBITDA	n/a	n/a	n/a	n/a	n/a	EV/EBITDA (x)	n/a	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	n/a	
Normalised EBIT	n/a	n/a	n/a	n/a	n/a	PE (x)	13.7	12.9	n/a	6.4	4.7	
Net interest	n/a	n/a	n/a	n/a	n/a	Price/NTA (x)	1.1	1.3	1.4	1.3	1.1	
Associate income	0	0	0	0	0	Free cash flow yield (%)	41.4	16.0	10.0	35.7	37.4	
Tax	(9.2)	(7.5)	(0.7)	(16.3)	(22.4)	Adj. free cash flow yield (%)	41.4	16.0	10.0	35.7	37.4	
Minority interests	0.6	0.1	0	0	0	Net dividend yield (%)	8.3	10.8	0.0	11.7	13.3	
Normalised NPAT	20.8	27.4	0.3	35.3	48.9	Gross dividend yield (%)	n/a	10.8	0.0	11.7	13.3	
Abnormals/other	(1.5)	(8.5)	(2.8)	0.7	0	Key Ratios						
Reported NPAT	19.3	18.9	(2.5)	36.0	48.9	Return on assets (%)	2021A	2022A	2023E	2024E	2025E	
Normalised EPS (cps)	4.4	4.7	(1.3)	9.3	12.9	Return on equity (%)	n/a	n/a	n/a	n/a	n/a	
DPS (cps)	5.0	6.5	0	7.0	8.0	Return on funds employed (%)	5.3	5.8	-1.6	11.2	14.0	
Growth Rates						EBITDA margin (%)	4.6	5.1	-1.5	10.2	13.0	
Revenue (%)	2021A	2022A	2023E	2024E	2025E	EBIT margin (%)	n/a	n/a	n/a	n/a	n/a	
EBITDA (%)	3.8	8.2	13.9	18.6	11.9	Capex to sales (%)	n/a	n/a	n/a	n/a	n/a	
EBIT (%)	n/a	n/a	n/a	n/a	n/a	Capex to depreciation (%)	3.1	4.1	3.1	2.7	2.4	
Normalised NPAT (%)	49.1	-4.0	n/a	n/a	38.4	Imputation (%)	n/a	n/a	n/a	n/a	n/a	
Normalised EPS (%)	49.1	6.7	n/a	n/a	38.4	Pay-out ratio (%)	n/a	0	0	0	0	
Ordinary DPS (%)	n/a	30.0	-100.0	n/a	14.3	115	140	0	75	62		
Cash Flow (NZ\$m)						Capital Structure						
EBITDA	2021A	2022A	2023E	2024E	2025E	Solvency capital	2021A	2022A	2023E	2024E	2025E	
Working capital change	n/a	n/a	n/a	n/a	n/a	Minimum solvency capital (MSC)	155.9	150.5	179.4	136.4	156.9	
Interest & tax paid	0	0	0	0	0	Total regulatory capital	56.6	52.3	66.3	66.5	77.1	
Other	0	0	0	0	0	Solvency ratio (%)	106.6	102.3	83.3	91.3	91.3	
Operating cash flow	98.1	59.8	44.7	104.6	109.5	275	287	271	205	203		
Capital expenditure	(12.0)	(17.3)	(14.7)	(15.1)	(15.4)	Operating Performance						
(Acquisitions)/divestments	(14.4)	(6.1)	(4.1)	0	0	Gross written premium	2021A	2022A	2023E	2024E	2025E	
Other	(24.9)	(21.1)	(7.1)	(8.2)	(8.9)	Gross earned premium	396.0	445.6	522.9	606.9	657.4	
Funding available/(required)	46.8	15.3	18.8	81.3	85.1	Reinsurance premium	386.6	418.3	476.4	564.9	632.2	
Dividends paid	(8.9)	(20.0)	0	(26.6)	(30.4)	Net earned premium	(58.8)	(66.3)	(84.3)	(95.6)	(106.1)	
Equity raised/(returned)	0	(30.6)	0	0	0	Net claims expense	327.9	352.1	392.1	469.3	526.1	
(Increase)/decrease in net debt	37.9	(35.4)	18.8	54.8	54.8	* includes Large event claims of	(202.3)	(224.9)	(306.2)	(317.8)	(348.2)	
						Management & sales expenses	(13.9)	(19.0)	(50.0)	(42.0)	(44.0)	
Balance Sheet (NZ\$m)						Underwriting profit	(123.3)	(129.9)	(135.4)	(148.5)	(156.3)	
Working capital	2021A	2022A	2023E	2024E	2025E	Investment and other revenue	27.2	23.6	(19.0)	35.5	55.4	
Fixed assets	148.0	183.2	237.2	275.3	298.2	Financing and other costs	0.2	1.2	13.0	17.1	16.9	
Intangibles	9.4	5.4	3.7	2.2	1.1	Profit before tax (from continuing operations)	(0.4)	(0.9)	(0.9)	(0.9)	(1.0)	
Right of use asset	120.6	132.5	136.1	135.3	135.1	Tax expense	27.6	25.2	-4.2	51.6	71.3	
Other assets	314.8	295.6	295.6	295.6	295.6	NPAT (from discontinued operation)	(9.2)	(7.5)	(0.7)	(16.3)	(22.4)	
Total funds employed	618.4	640.0	693.3	726.6	745.5	NPAT (Reported)	18.2	22.8	-2.5	36.0	48.9	
Net debt/(cash)	(116.1)	(84.5)	(103.3)	(158.1)	(212.8)	Key ratios						
Lease liability	39.4	35.1	31.2	27.3	23.4	Total GWP growth %		5.0%	12.5%	17.4%	16.1%	8.3%
Other liabilities	342.5	383.5	469.4	541.5	584.8	Total claims ratio %		54.3%	54.1%	68.3%	60.8%	59.8%
Shareholder's funds	349.9	306.0	296.0	315.9	350.2	MER %		37.1%	36.0%	34.0%	31.6%	29.7%
Minority interests	2.7	0	0	0	0	Combined ratio %		91.4%	90.1%	103.2%	92.4%	89.5%
Total funding sources	618.4	640.0	693.3	726.6	745.5							

* 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%

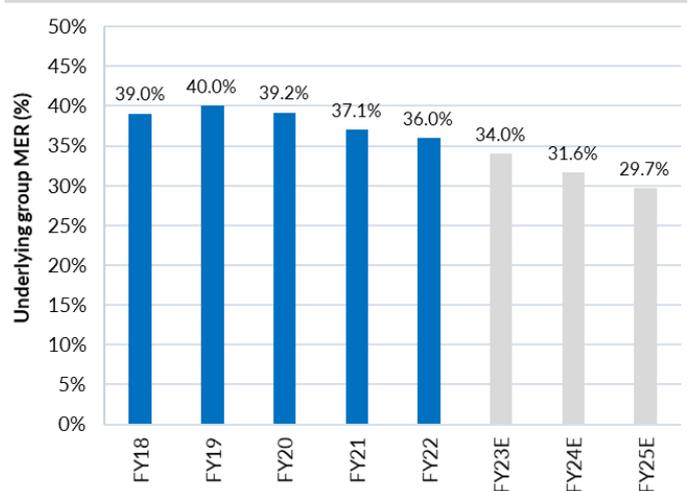
Source: Forsyth Barr analysis

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



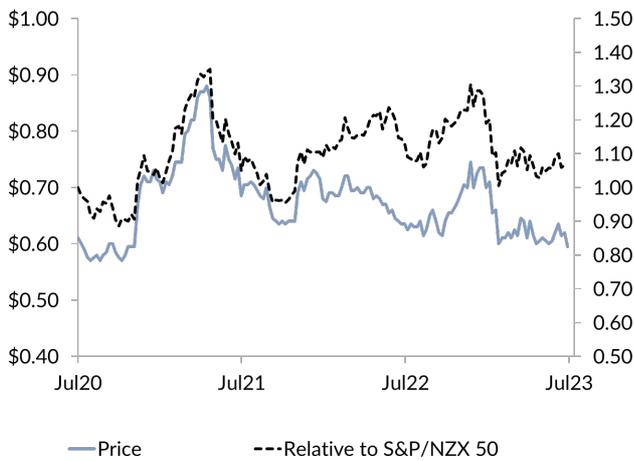
Source: Company, Forsyth Barr analysis

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

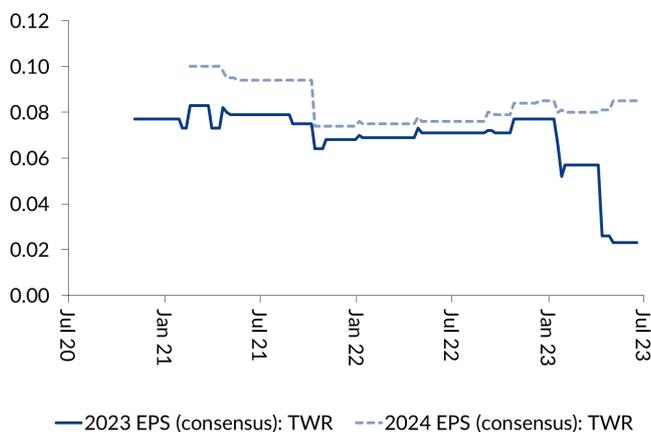
Figure 6. International valuation comparisons

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

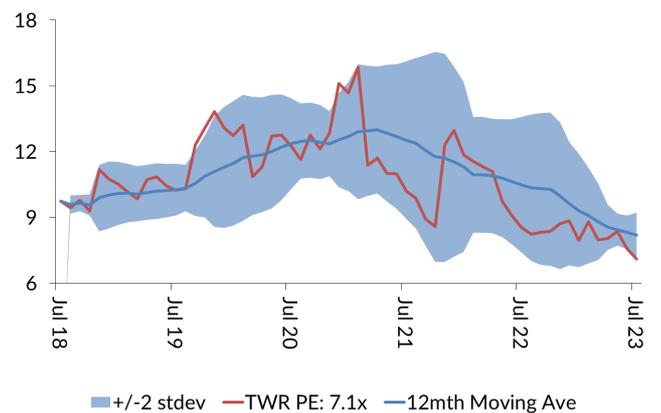
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (TWR) companies fiscal year end

Figure 7. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)



Source: Forsyth Barr analysis

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