

Equity Research

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Financials

Genworth Financial, Inc.

4Q15 Report Positives Overshadowed by Suspension of Life, Annuity Sales; Reducing PT to \$5 (from \$10)

The headlines arising from Genworth Financial's (GNW) 4Q15 report have inevitably focused on the company's decision to suspend all sales of traditional life insurance and fixed annuity products this quarter given the impact of the company's below investment grade credit ratings as reflected in recent sales volumes. However, we believe that move is overshadowing several of the positives emerging from GNW's report, most notably much-needed stability in the results of its troubled long-term care (LTC) unit as well as its Australia and Canada mortgage insurance units.

GNW

12 month target

\$2.79

\$5.00

BUY

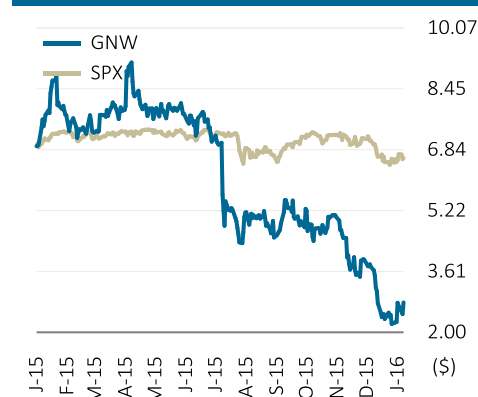
52 week range

\$2.22 - \$9.15

Market Cap (m)

\$1,389

Price Performance



Source: IDC

- **We are reiterating our Buy recommendation on GNW while reducing our price target to \$5 (from \$10)** based on 0.25x its FY16E book value ex. accumulated other comprehensive income (AOCI) of \$20.07. While the company faces significant challenges, we believe their impact is already reflected in a stock trading at just 0.14x its book value per share ex. AOCI as of YE15. Moreover, GNW's more than \$1bn in estimated liquidity – liquidity of \$1.374bn as of YE15, net of the \$321mm it used to retire an issue of senior notes last month – helps to preserve optionality as the company proceeds with its efforts to unlock value, in our view.
- Those efforts will begin with the source of GNW's most significant challenges –its LTC unit – as management announced it would initiate a restructuring of its U.S. Life business aimed at separating and isolating LTC. We believe this is a prudent and necessary step for the company to take, particularly if management's end-game strategy is to split-up the company, which would help to unlock its inherent value, led by the value of its U.S. mortgage insurance unit.
- We believe isolating LTC will be much easier for GNW if the unit's
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- **Valuation:** Our price target of \$5.00 is based on 0.25X our FY16E book value (ex-AOCI) per share of \$20.07

Estimates

	1Q15 A	2Q15 A	3Q15 A	4Q15 A	FY15 A	1Q16 E	2Q16 E	3Q16 E	4Q16 E	FY16 E	FY17 E
Diluted EPS (Adj.)	0.31	(0.39)	(0.57)	(0.59)	(1.24)	0.21	0.22	0.23	0.24	0.90	0.94
BVPS (Ex-AOCI)	21.31	20.77	20.31	19.72	19.69	19.59	19.72	19.86	20.01	20.07	20.46
Operating Income	295	245	(351)	(203)	(14)	222	230	236	242	931	964

Source: BTIG Research Estimates and Company Documents (\$ in millions, except per share amount)

Please Read: Important disclosures and analyst's certification appear in Appendix

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operating performance is stable, which it was during 4Q15. The unit posted net operating income of \$19mm during the quarter, its third profitable quarter in the past four.

- ▶ Meanwhile, the company's three mortgage insurance units each delivered solid performances during 4Q15 in the midst of an uncertain environment. The U.S. mortgage insurance unit posted net operating income of \$41mm, up sequentially from \$37mm. That result is significant insofar as it demonstrated that GNW's issues as a company are apparently not having a negative impact on its mortgage insurance operations in the U.S., which is by no means a given in light of significant competition in the space.
- ▶ At the same time, GNW's Australia and Canada units both performed well during 4Q15, results that were reassuring given the dependence of those countries on commodities, the prices of which have plunged of late. The Australian unit reported net operating income of \$22mm during the quarter, up by \$1mm sequentially, while the Canadian unit posted net operating income of \$37mm, down by just \$1mm sequentially. Somewhat remarkably, the Australian unit's loss ratio declined by 12 points sequentially to 17%. The Canadian unit's loss ratio increased by a relatively modest 2% to 3%.
- ▶ GNW reported 4Q15 adjusted operating income per share of \$0.20, in line with the consensus estimate while outpacing our estimate of \$0.17. However, the company did take a hit to its book value during the quarter as it revised assumptions in its Universal Life business line related to persistency, mortality and long-term interest rates that translated into an after-tax charge of \$194mm. As a consequence, GNW's book value ex. AOCI declined by \$0.59 per share sequentially during the quarter.
- ▶ We believe GNW's focus on isolating its LTC unit is driven in large part by the rationale of Standard & Poor's when it downgraded the company's credit ratings to junk levels in November 2014—which was that the move was based on volatility in that unit. As such, we believe that the company's actions could result not only in higher credit ratings, but also in more strategic flexibility—particularly with regard to a potential split—than it currently has.
- ▶ We appreciate that some investors regard GNW as a survival game at this point, and while we acknowledge the company's challenges, we also believe investors should regard its optionality thanks to its liquidity and the fact that several of its units are discrete and capable of monetization. One factor we believe should be recognized is that companies such as GNW are not banks and therefore are not susceptible to the same "run" challenges as such financial institutions—a distinction that we believe has been overlooked as the Financials space has sold off during the past few weeks.

Income Statement

Genworth Financial Operating Model	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Dec-16	Dec-17
\$ millions	2013A	1Q14A	2Q14A	3Q14A	4Q14A	2014A	1Q15A	2Q15A	3Q15A	4Q15A	2015A	1Q16E	2Q16E	3Q16E	4Q16E	2016E	2017E
Premiums	5,148	1,307	1,343	1,395	1,386	5,431	1323	1134	1145	1157	4,759	1151	1165	1202	1226	4,745	4,816
Net investment income	3,271	805	813	805	819	3,242	803	793	783	781	3,160	811	801	803	808	3,223	3,255
Net investment gains (losses)	(37)	(17)	34	(27)	(10)	(20)	-16	8	-51	-16	(75)	0	0	0	0	-	-
Insurance and investment product fees and other	1,021	227	225	231	229	912	225	222	223	234	904	227	224	225	236	913	922
Total revenues	9,403	2,322	2,415	2,404	2,424	9,565	2,335	2,157	2,100	2,156	8,748	2,189	2,190	2,230	2,271	8,881	8,993
Benefits and other changes in policy reserves	4,895	1,194	1,256	1,986	2,184	6,620	1243	1232	1290	1435	5,200	1181	1214	1251	1162	4,808	4,856
Interest credited	738	183	184	185	185	737	180	181	179	180	720	184	185	188	182	738	745
Acquisition and operating expenses, net of deferrals	1,659	378	404	398	405	1,585	380	295	314	433	1,422	361	354	345	424	1,485	1,500
Amortization of deferred acquisition costs and intangibles	569	134	138	143	156	571	121	101	563	207	992	123	103	103	155	485	490
Goodwill impairment	-	-	-	550	299	849	-	-	-	-	-	0	0	0	0	-	-
Interest expense	492	127	120	114	118	479	116	103	105	104	428	118	105	106	105	434	439
Total Benefits and Expenses	8,353	2,016	2,102	3,376	3,347	10,841	2,040	1,912	2,451	2,359	8,762	1,967	1,960	1,994	2,029	7,950	8,029
Income before income taxes	1,050	306	313	(972)	(923)	(1,276)	295	245	(351)	(203)	(14)	222	230	236	242	931	964
Provision for income taxes	324	87	85	(185)	(215)	(228)	91	70	(134)	(36)	(9)	67	69	71	73	279	289
Tax rate	30.9%	28.4%	27.2%	19.0%	23.3%	17.9%	30.8%	28.6%	38.2%	17.7%	64.3%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%
Net income (loss)	726	219	228	(787)	(708)	(1,048)	204	175	(217)	(167)	(5)	155	161	165	170	652	675
Income (loss) from discontinued operations	-	-	-	-	-	-	-	(314)	(21)	(73)	(408)	-	-	-	-	-	-
Less: net income attributable to noncontrolling interests	152	35	52	57	52	196	50	54	46	52	202	50	50	50	50	200	200
Net income (loss) available to common stockholders	574	184	176	(844)	(760)	(1,244)	154	(193)	(284)	(292)	(207)	105	111	115	120	452	475
Earnings per share - diluted	\$1.15	\$0.37	\$0.35	(\$1.70)	(\$1.53)	(\$2.51)	\$0.31	(\$0.39)	(\$0.57)	(\$0.59)	(\$1.24)	\$0.21	\$0.22	\$0.23	\$0.24	\$0.90	\$0.94
Net operating income per share - diluted	\$1.24	\$0.37	\$0.31	(\$0.65)	(\$0.83)	(\$0.80)	\$0.31	\$0.24	\$0.13	(\$0.17)	\$0.51	\$0.21	\$0.22	\$0.23	\$0.24	\$0.90	\$0.94
Total stockholders' equity, excluding AOCI	11,891	12,032	12,243	11,231	10,477	10,477	10,632	10,381	10,101	9,814	9,814	9,794	9,881	9,971	10,066	10,066	10,340
Total AOCI	2,542	3,483	4,215	3,934	4,446	4,546	4,692	3,309	3,478	3,010	3,110	3,135	3,160	3,185	3,210	3,310	3,510
Total stockholders' equity	14,812	15,515	16,458	15,165	14,923	14,923	15,324	13,690	13,579	12,824	12,824	12,929	13,041	13,156	13,276	13,276	13,750
Book value per share	\$29.55	\$31.27	\$32.68	\$30.54	\$30.04	\$30.04	\$30.72	\$27.39	\$27.30	\$25.77	\$25.73	\$25.86	\$26.03	\$26.21	\$26.39	\$26.47	\$27.20
Book value per share (excluding AOCI)	\$23.73	\$24.25	\$24.31	\$22.62	\$21.09	\$21.09	\$21.31	\$20.77	\$20.31	\$19.72	\$19.69	\$19.59	\$19.72	\$19.86	\$20.01	\$20.07	\$20.46
Weighted average diluted shares	501.2	502.7	503.6	496.6	496.7	499.9	498.9	499.9	497.4	497.6	498.5	500.0	501.0	502.0	503.0	501.5	505.5

Source: BTIG Research Estimates and Company Documents

Appendix: Analyst Certification and Other Important Disclosures

Analyst Certification

I, Mark Palmer, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

I, Giuliano Bologna, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

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Company Valuation and Risk Disclosures

Genworth Financial, Inc. (GNW, Buy)

Valuation: Our price target of \$5.00 is based on 0.25X our FY16E book value (ex-AOCI) per share of \$20.07

Risks: The primary risks to achieving our price target include an accelerated rate of deterioration within GNW's U.S. Mortgage Insurance portfolio, credit downgrades that could hamper new business generation in all segments, a slowdown in the Chinese economy that could negatively affect the company's mortgage insurance units in commodity-focussed Australia and Canada, tail risk associated with the company's Long-Term care exposures, and reinvestment risk given the current low interest rate environment.

Genworth Financial, Inc. (GNW)



Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
11-Apr-12	7.54	11	Mark Palmer	Buy
08-May-13	10.68		Mark Palmer	Neutral
08-Oct-13	12.62	17.50	Mark Palmer	Buy
04-Feb-14	14.53	18	Mark Palmer	Buy
24-Mar-14	17.93	22	Mark Palmer	Buy
06-Nov-14	8.66	16	Mark Palmer	Buy
11-Feb-15	8.33	15	Mark Palmer	Buy
10-Aug-15	5.24	13	Mark Palmer	Buy
30-Oct-15	4.87	10	Mark Palmer	Buy

Other Disclosures

Additional Information Available Upon Request

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