

Equity Research

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Financials

Genworth Financial, Inc.

What is the Downside for GNW Shares if the China Oceanwide Deal Fails to Receive Regulatory Approval?

Almost immediately after Genworth Financial (GNW) on October 21 announced that it has agreed to be acquired by China Oceanwide (715 HK, Not Rated) for \$5.43 per share in cash, doubts about whether the deal would be consummated began to be reflected in the company's share price. GNW shares now stands almost 28% below the level at which they traded prior to the announcement and almost 31% below the negotiated takeout price.

- ▶ Unless another bidder emerges for GNW – a possibility that we have characterized as unlikely given ongoing uncertainty at GNW's troubled long term care (LTC) insurance unit, and taking into account the \$1.1bn in additional capital that China Oceanwide agreed to contribute as part of the deal – the upside for the stock is capped at \$5.43. So then what is the potential downside for GNW shares if the deal fails to receive regulatory or shareholder approval, or if it otherwise falls apart before its expected close in mid-2017?
- ▶ Following the release of GNW's 3Q16 results on November 3 we published our sum-of-the-parts (SOTP) analysis of the company which yielded a value of \$3.99 per share. We have updated our SOTP analysis, which has increased to \$4.23 given appreciation in shares of GNW's Canadian and Australian mortgage insurance units in which the company holds stakes of 57% and 52%, respectively (see page 4).
- ▶ However, both of these analyses assumed that the intrinsic value of each of GNW's subsidiaries could be fully unlocked, which is far from a given in light of the execution risk associated with realizing that value, the company's inability to refinance the \$597mm in debt set to mature in May 2018, and potential liquidity challenges at its holding company.
- ▶ **Valuation:** Based on our SOTP valuation for GNW, we believe that the value of the company's shares is within +/- 15% from current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks.

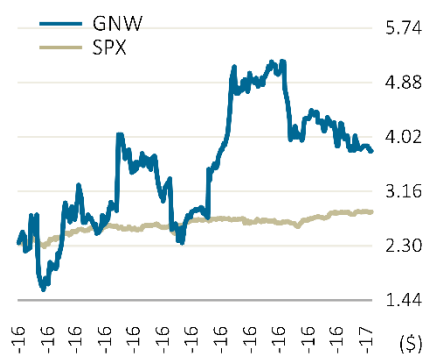
GNW

\$3.80

NEUTRAL

52 week range \$1.61 - \$5.22
Market Cap (m) \$1,892

Price Performance



Source: IDC

Estimates

	1Q15 A	2Q15 A	3Q15 A	4Q15 A	FY15 A	1Q16 A	2Q16 A	3Q16 A	4Q16 E	FY16 E	FY17 E
Diluted EPS (Adj.)	0.31	(0.39)	(0.57)	(0.59)	(1.24)	0.11	0.34	(0.76)	0.19	(0.12)	0.88
BVPS (Ex-AOCI)	21.31	20.77	20.31	19.72	19.69	19.76	20.07	19.40	19.61	19.61	20.10
Operating Income	295	245	(351)	(203)	(14)	150	351	(125)	204	580	893

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

- ▶ In the event that the China Oceanwide deal failed to be consummated, GNW would have few options to address the 2018 maturity and its liquidity challenges. We believe the company could seek to monetize its stake in Genworth Australia (GMA AU, Not Rated) which has a current market value of \$700mm, to address the May 2018 maturity. With that said, the Australian unit has been a consistent generator of dividends to support GNW's holdco debt, even during the financial crisis, and such dividends would cease with a sale.
- ▶ Some have suggested that GNW could raise additional cash by executing a partial initial public offering of its U.S. mortgage insurance unit. Given the \$2.76bn at which we have valued the unit, we believe an IPO for 20% of that amount would produce about \$513mm – \$550mm net of banking fees – or \$12mm less than the amount that China Oceanwide has pledged to inject into the company's U.S. Life unit to facilitate the isolation of the LTC business.
- ▶ The sale and public offering associated with this scenario carry meaningful execution risk, in our view, especially given the potential for investors to question the ability of these units to maintain their respective market shares, as well as their valuations, in the aftermath of a rejection of the China Oceanwide deal. GNW shares likely would trade meaningfully lower following the announcement that the deal had been nixed – perhaps below the stock's all-time low of \$1.21 at which it traded in 2009 when it appeared that bankruptcy had been a real possibility for the company – which could cause current and prospective mortgage insurance customers to become concerned about GNW's viability as a counterparty.
- ▶ Another concern is whether GNW could execute a "destacking" transaction even if it was able to raise the cash necessary to facilitate it. Under the company's plan, Genworth Life and Annuity Insurance Company (GLAIC), domiciled in Virginia, would be transferred from Genworth Life Insurance Company (GLIC), domiciled in Delaware, to GNW. As such, GLAIC and its \$1.6bn of net worth, would no longer be an asset of GLIC, and GNW would inject \$200mm into GLIC as compensation.
- ▶ The plan is subject to the approval of various state insurance regulators, most notably Delaware Insurance Commissioner Trinidad Navarro, the former sheriff of New Castle County who had been a licensed insurance agent before serving as a police officer for 20 years, who was elected in November and now oversees GLIC.
- ▶ Navarro in this scenario would need to approve the removal of a \$1.6bn asset from GLIC and its LTC policyholders, some of whom filed a class action lawsuit against the company on December 28 in which they claimed that GNW had depleted reserves intended to support LTC policies, for compensation of \$200mm. Given the tail risk associated with GLIC's LTC book, this appears to be a challenging ask.
- ▶ For GNW's acquisition by China Oceanwide to close, the insurer would need to receive approvals from its shareholders (a vote is expected to

occur during 1Q17), regulators in the U.S., Canada and Australia, and Chinese government regulatory entities. One wild card is whether the Trump Administration would respond to the calls from some within Congress to block acquisitions of U.S. firms by Chinese companies.

- ▶ In light of GNW's statement following the acquisition announcement that its Board of Directors had received positive initial feedback from regulators regarding the deal, as well as the \$1.1bn in additional capital that China Oceanwide agreed to contribute, we estimate the likelihood that the transaction will close in mid-2017 at 60%.
- ▶ Given the challenges GNW would face to unlock its \$4.23 per share in value based on our SOTP analysis, including debt maturities of \$397mm in 2020 and \$1.086bn in 2021, we generously peg the expected value of the company's shares if the China Oceanwide deal is rejected at their all-time low of \$1.21. A 60% chance of realizing \$5.43 and a 40% chance of realizing \$1.21 yields an expected value for GNW shares of \$3.74 – \$0.03 less than the level at which the stock closed yesterday.
- ▶ Even if we were to assign a downside of \$0 to GNW shares and assign a 40% likelihood to that outcome, the resulting expected value would be \$3.26, or about 14% below yesterday's close – not nearly enough to justify a short, in our view, particularly given the pain that shorts would experience if announcements of regulatory approvals signaling the successful consummation of the China Oceanwide deal were to occur.
- ▶ Given this analytical framework, we view GNW shares as exceedingly difficult to play from both the long and the short sides at this point, and we remain on the sidelines at Neutral. Investors in GNW shares concerned about mark-to-market risk need to get comfortable with the notion that the stock could trade in pennies in the immediate aftermath of an announcement that the China Oceanwide deal had been nixed, in our view.

Genworth Financial SOTP Analysis

	Equity (Ex-AOCI)	Book Value Per Share	P/B Multiple	Estimated Value
U.S Life Insurance	7,713.00	15.43	0.00	0.00
Runoff	612.00	1.22	0.50	306.00
Book Value Total	8,325.00	16.65	0.04	306.00

	LTM Operating Income	Value per GNW share	Multiple	Estimated Value
U.S. Mortgage Insurance	230.00	5.52	12.00	2,760.00

	Market Value of Shares	Market Value per GNW share	Multiple	Estimated Value
Genworth Australia market value	700.41	1.40	1.00	700.41
Genworth Canada market value	1,311.92	2.62	1.00	1,311.92
Market Value Total	2,012.33	4.02	2.00	2,012.33
Corporate & Other	-2,965.00	-5.93	1.00	-2,965.00
Total value				2,113.33
Diluted shares outstanding				500.00
Estimated value per share				4.23

Source: BTIG Estimates and Company Documents

Income Statement

Genworth Financial Operating Model	Dec-13	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	2014A	1Q15A	2Q15A	3Q15A	4Q15A	2015A	1Q16A	2Q16A	3Q16A	4Q16E	2016E	2017E
Premiums	5,148	5,431	1323	1134	1145	1157	4,759	794	1127	1108	1102	4,131	4,399
Net investment income	3,271	3,242	803	793	783	781	3,160	789	779	805	801	3,174	3,152
Net investment gains (losses)	(37)	(20)	-16	8	-51	-16	(75)	-19	30	20	0	31	-
Insurance and investment product fees and other	1,021	912	225	222	223	234	904	221	300	217	216	954	867
Total revenues	9,403	9,565	2,335	2,157	2,100	2,156	8,748	1,785	2,236	2,150	2,119	8,290	8,417
Benefits and other changes in policy reserves	4,895	6,620	1243	1232	1290	1435	5,200	860	1193	1662	1217	4,932	4,855
Interest credited	738	737	180	181	179	180	720	177	173	173	182	705	712
Acquisition and operating expenses, net of deferrals	1,659	1,585	380	295	314	433	1,422	394	327	269	346	1,336	1,287
Amortization of deferred acquisition costs and intangibles	569	571	121	101	563	207	992	99	112	94	93	398	363
Goodwill impairment	-	849	-	-	-	-	-	-	-	-	-	-	-
Legal Expense	-	-	-	-	-	-	-	-	-	-	-	-	-
Interest expense	492	479	116	103	105	104	428	105	80	77	77	339	308
Total Benefits and Expenses	8,353	10,841	2,040	1,912	2,451	2,359	8,762	1,635	1,885	2,275	1,915	7,710	7,525
Income before income taxes	1,050	(1,276)	295	245	(351)	(203)	(14)	150	351	(125)	204	580	893
Provision for income taxes	324	(228)	91	70	(134)	(36)	(9)	23	110	222	57	412	250
Tax rate	30.9%	17.9%	30.8%	28.6%	38.2%	17.7%	64.3%	15.3%	31.3%	28.0%	28.0%	71.0%	28.0%
Net income (loss)	726	(1,048)	204	175	(217)	(167)	(5)	127	241	(347)	147	168	643
Income (loss) from discontinued operations	-	-	-	(314)	(21)	(73)	(408)	(19)	(21)	15	-	(25)	-
Less: net income attributable to noncontrolling interests	152	196	50	54	46	52	202	55	48	48	50	201	200
Net income (loss) available to common stockholders	574	(1,244)	154	(193)	(284)	(292)	(207)	53	172	(380)	97	(33)	443
Net operating income per share - diluted	\$1.24	(\$0.80)	\$0.31	\$0.24	\$0.13	(\$0.17)	\$0.51	\$0.21	\$0.25	\$0.13	\$0.19	\$0.78	\$0.88
Total stockholders' equity, excluding AOCI	11,891	10,477	10,632	10,381	10,101	9,814	9,814	9,870	10,045	9,669	9,791	9,791	10,084
Total AOCI	2,542	4,546	4,692	3,309	3,478	3,010	3,110	4,185	5,088	5,202	5,177	5,277	5,427
Total stockholders' equity	14,812	14,923	15,324	13,690	13,579	12,824	12,824	14,055	15,133	14,871	14,968	14,968	15,411
Book value per share	\$29.55	\$30.04	\$30.72	\$27.39	\$27.30	\$25.77	\$25.73	\$28.14	\$30.24	\$29.84	\$29.98	\$29.98	\$30.71
Book value per share (excluding AOCI)	\$23.73	\$21.09	\$21.31	\$20.77	\$20.31	\$19.72	\$19.69	\$19.76	\$20.07	\$19.40	\$19.61	\$19.61	\$20.10
Weighted average diluted shares	501.2	499.9	498.9	499.9	497.4	497.6	498.5	499.4	500.4	498.3	499.3	499.4	501.8

Source: BTIG Estimates and Company Documents

BTIG Covered Companies Mentioned in this Report

GENWORTH FINANCIAL, INC. (GNW, Neutral, \$N/A PT; Current Price: \$3.80; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

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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

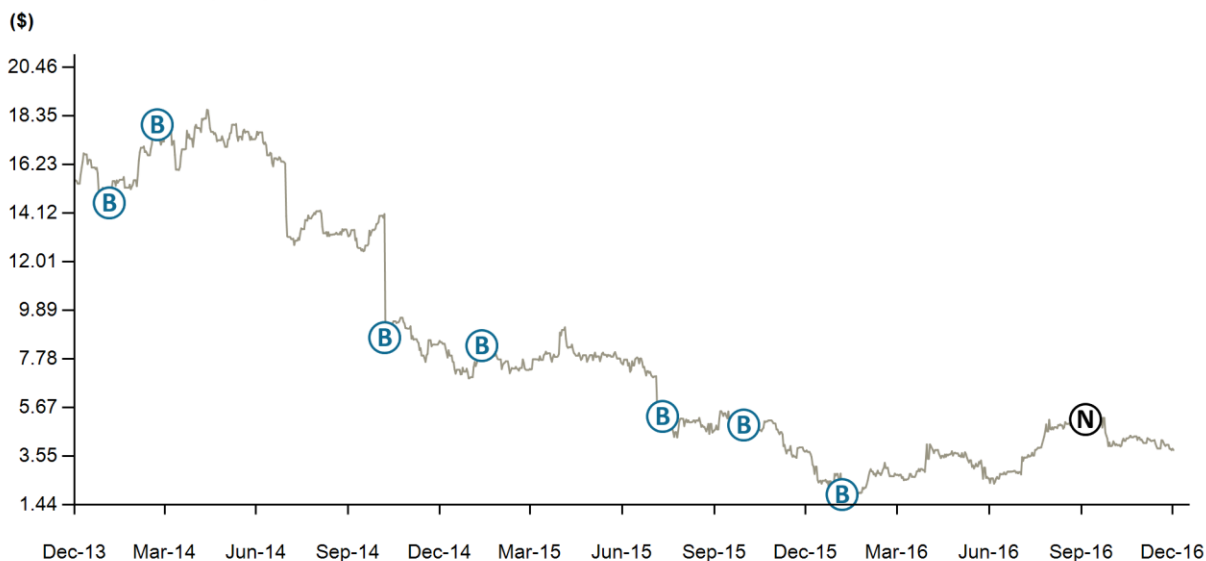
Genworth Financial, Inc. (GNW, Neutral)

Valuation: Based on our SOTP valuation for GNW, we believe that the value of the company's shares is within +/- 15% from current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks. Click here to enter text.

Risks: The primary risks to our rating 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. Upside risks include a de-stacking of the GNW's life insurance business and progress towards a split of GNW's life insurance and mortgage insurance businesses.

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	N/A	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
05-Feb-16	1.86	5	Mark Palmer	Buy
05-Oct-16	5.12	N/A	Mark Palmer	Neutral

Other Disclosures

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