Genworth: Is The China Oceanwide Deal Really At Risk?

- ***Genworth's arbitrage spread with respect to its buyout by China Oceanwide has ballooned to over 60%.***
- ***We analyze in this writeup why such a large spread exists and whether it is justified, concluding that misinformation is largely responsible for the spread.***
- ***We believe the transaction has a 75% chance of completion at $5.43 per share and limited downside risk from the recent $3.30 closing stock price.***
- ***Genworth's Expected Value (or EV) is estimated to be $4.93/share currently, or 49% above the recent market quote for the shares.***

The buyout of Genworth Financial Inc. (NYSE: GNW) has been, to say the least, under a cloud of doubt recently. The stock last traded at $3.30/share on January 30th versus the $5.43/share cash buyout price agreed to with China Oceanwide last October (see merger announcement here). As the parties as recently as last week reiterated that they expect the deal to close in mid-2017 (see here), this means that an arbitrageur buying the stock at the current price stands to gain $2.13/share before taxes, or 65%, in about 6 months if the deal closes as expected.

In this article we examine (1) why the current arbitrage spread is so wide, (2) how likely the deal's closing really is, based on the interests of the various stakeholders involved, and (3) what a reasonable expected value (or EV) for Genworth is given the current state of play for the company. In doing so, we hope to clear up some (hopefully most) of the misinformation circulating in the marketplace regarding the Genworth buyout.

Based on the facts and reasons described herein, we reach the following conclusions:

(1) The merger arbitrage spread is mainly attributable to fears regarding the regulatory risk that the merger could be blocked, the perceived risk that China Oceanwide could attempt to renege on its agreement to acquire Genworth for $5.43/share and the potential for further substantial reserve increases when Genworth announces its Q4 2016 financial results on February 7, 2017. However, we believe these fears are largely unfounded. First, both China Oceanwide and Genworth's regulators are incentivized to see the transaction close (as are, obviously, Genworth's shareholders, given the current market value assigned to the company's shares). Second, while Chinese regulatory approval is admittedly a wild card, we incorporate this uncertainty into our 75% percentage estimate that the merger is consummated as scheduled. Finally, based on the disclosures in the definitive merger proxy statement and Genworth's prior earnings releases for Q1 through Q3 of 2016, we do not expect a massive reserve hit to occur in connection with the release of Q4 2016 financials, such that China Oceanwide would be entitled

to terminate the merger without the payment of a termination fee (and for that matter, due to the timing of Genworth's annual reserve reviews, neither do we expect this to occur with respect to financial results for Q1 or Q2 2017).

(2) There has been considerable misinformation in the marketplace recently regarding the transaction, namely that China Oceanwide could unilaterally cut the merger price by $2/share and/or that Genworth's financial position is hopeless if the China Oceanwide deal fails to close. None of these arguments, which have obviously taken a recent toll on the share price over the past week or two, hold up to closer scrutiny, as we explain further below. In fact, despite the arguments of the bears, Genworth's future prospects have actually brightened considerably since the announcement of the merger, mainly due to the substantial increase in long-term interest rates following the U.S. presidential election last November.

(3) We estimate that Genworth's current Expected Value (or EV) is $4.93/share, or 49% above the closing stock price of $3.30/share on January 30, 2017. Importantly, this estimate incorporates a 25% probability that the deal does not close, due to the risks we describe herein. However, even if one were to increase this to a 50% probability of not closing, our EV for Genworth would only fall to $4.43/share, still 34% above the most recent share price. In effect, we believe that at current levels a buyer of Genworth stock has relatively minimal downside risk but considerable upside potential, presenting quite a favorable risk/reward calculus for such a purchase.

REASONS FOR GENWORTH'S WIDE ARBITRAGE SPREAD

Genworth's share price has steadily declined since the announcement of the China Oceanwide deal in late October 2016. The total decline has been from $5.21/share immediately prior to the deal announcement to just $3.30/share as of the close of trading on Monday, January 31st, or 37%. And this despite being an all-cash deal (so it brings with it none of the price risk associated with the acquirer's stock in a stock-for-stock deal). It appears that the following risks currently appear to be highest in the minds of investors:

(1) China Oceanwide will get cold feet and attempt to either renegotiate or totally walk away from the deal;

(2) The regulators (either in the U.S. or China) will block the deal; and

(3) Genworth will experience a material adverse event or ratings downgrade event prior to closing, thereby allowing China Oceanwide to cancel the transaction without paying a termination fee.

Let's look more closely at each of these risk factors (note that we do not discuss whether Genworth shareholders will approve the transaction, as we believe this is a foregone conclusion, except in the unlikely scenario where another bidder for the company were to emerge between now and the March 7, 2017 special meeting to vote on the deal):

RISK THAT CHINA OCEANWIDE UNILATERALLY WALKS AWAY

With respect to (1), we view this risk as relatively small. First, according to the section in the definitive proxy statement for the transaction regarding the Background of the Merger, China Oceanwide opened its negotiations to buy Genworth nearly two years ago, with serious discussions regarding the acquisition beginning in January of 2016:

> In May 2015, representatives of Willis Securities, Inc., a financial advisor engaged by China Oceanwide USA Holdings Co. Ltd., an indirect subsidiary of China Oceanwide, contacted [Genworth CEO] McInerney by email to indicate that China Oceanwide was interested in a potential transaction with Genworth. From May 2015 to January 2016, several interactions took place between Willis Capital Markets & Advisory and Mr. Pehota during which Mr. Pehota expressed on several occasions that Genworth would be receptive to considering a potential transaction with China Oceanwide under acceptable terms and conditions. In November 2015, Willis Capital Markets & Advisory reaffirmed China Oceanwide's interest in Genworth and requested a meeting with Mr. McInerney.... On January 28, 2016, Mr. McInerney and Mr. Pehota met at Genworth's headquarters in Richmond, Virginia, with Mr. Xiaoxia Zhao, President and Chief Executive Officer of China Oceanwide's insurance group, Mr. Xuan Wang, a Vice President of China Oceanwide's insurance group and representatives of Willis Capital Markets & Advisory, to discuss China Oceanwide's potential interest in a transaction involving Genworth, and facts regarding China Oceanwide.

Thus, China Oceanwide was in active negotiations with Genworth for a full nine months (from the end of January to the end of October) before the parties finally agreed on a deal. Usually when a would-be acquirer puts that much effort into an acquisition (in the process beating out multiple other bidders), it would require something pretty serious to cause them to just walk away post-signing.

Moreover, China Oceanwide has much to gain from the acquisition of Genworth--this is not some bailout or charity acquisition. For example, by putting up $2.7 billion for Genworth's equity and infusing another $1.125 billion to refinance Genworth's existing debt and bolster its insurance subsidiaries' capital levels (or $3.825 billion in aggregate), China Oceanwide will acquire assets with a book value as of September 30, 2016 equal to $29.84/share (or $19.40 ex-AOCI) (see Q3 2016 earnings release here). Note that the ex-AOCI number excludes the unrealized appreciation on Genworth's bond portfolio (in other words, the higher number would reflect the value that Genworth would have obtained for its assets if it had sold its entire bond portfolio at prevailing market prices as of the end of Q3 2016). If we just take Genworth's most recent ex-AOCI net book value, this would represent a return to China Oceanwide of 153% on its Oceanwide $3.825 billion investment ($9.667 billion divided by $3.825 billion). That is what we would consider a trade with a serious margin of safety—of course, it's worth acknowledging the risks of valuations based on book value alone.

But, wait, there's more: namely, China Oceanwide will enjoy the benefits of the unstacking of Genworth's insurance subsidiaries. The following from Genworth's Q3 2016 10-Q filing describes how this is expected to occur mechanically:

> As previously announced, one of our strategic objectives has been to separate, then isolate, through a series of transactions, our long-term care insurance business from our other U.S. life insurance businesses. Our aim is to align substantially all of our in-force life insurance and annuity business under Genworth Life and Annuity Insurance Company ("GLAIC"), our Virginia domiciled life insurance company, and all long-term care insurance business under Genworth Life Insurance Company ("GLIC"), our Delaware domiciled life insurance company. In connection with these actions, we would separate GLAIC and GLIC ownership so that both subsidiaries are wholly-owned by an intermediate holding company. As part of this plan, Genworth Life Insurance Company of New York ("GLICNY"), our New York domiciled life insurance company, which is currently partially owned by GLAIC, would become a wholly-owned subsidiary of GLIC. To further isolate our long-term care insurance business from our other businesses, GLIC and GLICNY may ultimately be direct subsidiaries of Genworth Financial and no longer subsidiaries of Genworth Holdings. We have agreed to pursue a similar plan to separate and then isolate our long-term care insurance business from our other U.S. life insurance businesses in connection with the China Oceanwide transaction, but such plan has some important differences from the previously announced plan as discussed below.
>
> In connection with the proposed China Oceanwide transaction, based on China Oceanwide's $525 million capital commitment, together with the $175 million of cash previously committed by Genworth Holdings, Genworth Holdings will pursue the purchase of GLAIC from GLIC at fair market value and we will pursue a variety of reinsurance transactions. Doing so would achieve our strategic objective of separating and isolating our long-term care insurance business, and regulatory approval to do so is a condition to the closing of the China Oceanwide transaction. China Oceanwide has no future obligation and has expressed no intention to contribute additional capital to support our legacy long-term care insurance business.

Why is the unstacking so beneficial for China Oceanwide as the future owner of Genworth? Because it will allow (1) regular dividends to be paid from the life and annuity subsidiary up to the holding company in order to service the holdco's indebtedness and (2) ultimately, excess funds to be either distributed the holdco's new owner (i.e., China Oceanwide) or used to expand the company's operations via capital contributions to the other insurance subsidiaries. Currently these dividends are being blocked at the long-term care (or LTC) subsidiary level, since this subsidiary is "stacked" above the life and annuity subsidiary in Genworth's ownership structure and Genworth's insurance regulators are not allowing the LTC subsidiary to pay dividends upstream to the holding company. This problem, however, will be solved through the unstacking transactions. China Oceanwide's Chairman Lu desires to expand his company's insurance operations in Asia using the advice and expertise of Genworth's current management team and certain members of its board of directors, which it intends to retain following the closing of the transaction. With the unstacking completed, he will be able to do just that.

China Oceanwide stands to benefit even further from the transaction if the Chinese renminbi, which the Chinese government has been propping up over the past few years, were to decline further from the current 6.88 RMB/USD level. Assuming that all of China Oceanwide's $3.8 billion comes from funds converted into U.S. dollars from renminbi, each 1% that the yuan declines against the dollar following the consummation of the Genworth deal would equal $38 million saved by China Oceanwide. Some might question whether the yuan will actually decline further, given that the dollar has been seen as the strongest major currency over the past few years and the yuan has already depreciated about 10% over the past few years. However, according to the CME Group's website, current futures contracts show that the yuan is expected to decline to 7.54 (i.e., 1 divided by 0.13263) to the dollar by March 2020 (source):

Month	Options	Charts	Last	Change	Prior Settle	Open	High	Low	Volume	Hi / Low Limit	Updated
SEP 2018	OPT		-	-	0.13709	-	-	-	0	0.14159 / 0.13259	18:18:01 CT 30 Jan 2017
DEC 2018	OPT		-	-	0.13612	-	-	-	0	0.14062 / 0.13162	18:18:35 CT 30 Jan 2017
MAR 2019	OPT		-	-	0.13526	-	-	-	0	0.13976 / 0.13076	18:18:01 CT 30 Jan 2017
JUN 2019	OPT		-	-	0.13459	-	-	-	0	0.13909 / 0.13009	18:18:01 CT 30 Jan 2017
SEP 2019	OPT		-	-	0.13393	-	-	-	0	0.13843 / 0.12943	18:17:32 CT 30 Jan 2017
DEC 2019	OPT		-	-	0.13328	-	-	-	0	0.13778 / 0.12878	18:17:39 CT 30 Jan 2017
MAR 2020	OPT		-	-	0.13263	-	-	-	0	-	16:45:00 CT 30 Jan 2017

Thus, in acquiring Genworth not only does China Oceanwide get to trade expected depreciating renminbi for U.S. dollars, it gets to trade expected depreciating renminbi for U.S. dollar-denominated assets (in the form of Genworth's bond portfolio) at less than 40 cents on the dollar, marked as of the end of Q3 2016 (as shown above, by investing $3.825 billion in the transaction, China Oceanwide gets $9.667 billion in book value in assets ex-AOCI; and 3.825/9.667=39.6%)

RISK THAT REGULATORS BLOCK THE DEAL

U.S. REGULATORS - So we have established that the acquisition of Genworth at an overall purchase price equal to under 40% of net asset value obtained, combined with the unstacking of the insurance subsidiaries, appears to be a no-brainer from China Oceanwide's perspective. But what about from the perspective of Genworth's regulators? Here we see that the transaction is also a "win-win". The regulators obviously have no desire to see Genworth fail and have the burden of its future LTC claims borne by state guaranty funds (which cost then gets passed along to the other healthy insurance companies in the applicable jurisdictions). Just a few weeks ago, it was announced that LTC issuer Penn Treaty American Corp. will enter liquidation, with a multi-billion dollar negative impact on the guaranty funds (source):

A.M. Best Special Report: Penn Treaty Liquidation Presents Potential Shock to the Health Marketplace

December 06, 2016 02:32 PM Eastern Standard Time

OLDWICK, N.J.--(BUSINESS WIRE)--The U.S. health industry is bracing for what further action in the possible Penn Treaty liquidation could hold for the sector, as managed care providers have argued that they should not be liable for the failure of a long-term care insurer. According to a new **A.M. Best** special report, any action in the Penn Treaty case could set a precedent, and any changes in favor of health insurers would likely come at the expense of the life insurance industry.

"Penn Treaty Liquidation Presents Potential Shock to the Health Marketplace"

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The Commonwealth Court of Pennsylvania had placed Penn Treaty into rehabilitation in 2009. The action was driven by the company's projected insolvencies due to its inadequate reserving after assumptions used to price long-term-care business were found to be markedly incorrect. Findings evidenced that policyholders were living longer than expected, medical-related expenses were higher than anticipated and lapse assumptions were much lower than estimated during initial pricing of the products.

According to a new *Best's Special Report*, titled, "Penn Treaty Liquidation Presents Potential Shock to the Health Marketplace," estimates are that the Penn Treaty companies in liquidation (Penn Treaty Network America Insurance Company and American Network Insurance Company) had up to $4 billion in liabilities with just $700 million in assets. The failure of the companies would be passed on to solvent health insurers operating in each of the states/jurisdictions in which the liquidated companies operated as part of the insurance guarantee assessments.

In the China Oceanwide transaction, a combined $700 million will be contributed to Genworth's LTC subsidiary to bolster its claims' paying ability, $525 million directly from China Oceanwide and another $175 million currently held by Genworth Holdings. The risk that Genworth's LTC claims could in the future fall on the guaranty funds is thus greatly reduced, which appeals to Genworth's regulators.

Note that Genworth CEO McInerney had the following exchanges with two analysts on the conference call regarding the China Oceanwide transaction, each of which indicated that the applicable U.S. regulators received the opportunity to provide input on what would be required to get the China Oceanwide transaction approved (and which information obviously was instrumental in structuring the deal ultimately agreed to between Genworth and China Oceanwide) (source here):

Sean Dargan				
Analyst, Wells Fargo Securities LLC				

Yes, thanks, Tom and good morning. I have a question regarding the ability to get regulatory approval. Anbang announced about a year ago its intention to buy Fidelity & Guaranty Life and they have still not received U.S. regulatory approval in all of their jurisdictions. I just noticed on the slide that one of the conditions precedent for the deal to close would be a destacking where the HoldCo would purchase GLAIC from GLIC. I'm just wondering how discussions around that point have gone with Delaware thus far.

Thomas J. McInerney				
President, Chief Executive Officer & Director, Genworth Financial, Inc.				

Sean, thank you for your question. Obviously it's a good one. Clearly we were aware of other transactions in the marketplace. As we said in our comments and our press release, it was very important to both China Oceanwide and Genworth that we engage in discussions with the regulators so that they understood the deal. And obviously, in those discussions we received good feedback from them, including from Delaware, and so, *it's our belief that the additional $1.1 billion of capital from China Oceanwide will facilitate regulatory approval*. And as you noted, Sean, we had previously agreed to invest $175 million in GLIC and China Oceanwide, under the deal, is investing $525 million. So in total, its $700 million, and the focus of that is to facilitate the restructuring of the U.S. life business. [emphasis added]

Ryan Krueger				
Analyst, Keefe, Bruyette & Woods, Inc.				

And as a follow up to Sean's question, during the last call you indicated there was a fair amount of pushback from industry participants on a full ownership transfer of GLAIC to the holding company but you thought you could get partial ownership transfer. The closing condition here calls for a full transfer. I guess have you gotten any indication at this point from Delaware that the additional capital contribution would make them more comfortable with that or can you just give us any update there?

Thomas J. McInerney
President, Chief Executive Officer & Director, Genworth Financial, Inc.

> So, I'd say, Ryan, that as we said, we've had discussions with all the regulators, including Delaware, and I think the goal of both China Oceanwide and Genworth was to structure the deal in a way that we felt it facilitated regulatory approval. We now have to do the formal filings of the Form As and others with all the regulators. It's ultimately their decision. *But clearly the transaction was very closely structured on a basis that we thought had the highest possible chance of receiving regulatory approval*. And we'll now go through the process. [emphasis added]

According to the merger proxy statement, Genworth made regulatory filings with respect to the unstacking with the Delaware Department of Insurance on December 21, 2016 and the Virginia Bureau of Insurance on January 3, 2017. Furthermore, Genworth made regulatory filings with respect to the Life Restructuring Reinsurance Transactions and the Recapture Transaction with the Delaware Department of Insurance and the Virginia Bureau of Insurance on December 16, 2016.

In addition, the proxy statement reveals that there are no antitrust concerns with the deal: Genworth and China Oceanwide filed the required notifications with the Antitrust Division and the Federal Trade Commission on December 7, 2016 and early termination of the applicable waiting period was granted on December 16, 2016. Nor should the U.S. regulators of Genworth's domestic mortgage insurance subsidiaries be expected to object to the China Oceanwide transaction, since the capital levels in such subsidiaries are currently adequate and in no way indirectly supported by dividends from Genworth's life insurance operations (i.e., they are not part of Genworth's "(un)stacking" issue). Finally, we do not believe that the transaction presents any of the typical national security concerns that might trouble the Committee on Foreign Investment in the United States (CFIUS). China Oceanwide is purely a financial buyer and will not acquire any sensitive national-security related technology in the transaction.

CHINESE AND OTHER FOREIGN REGULATORS - So the deal appears to be win-win from China Oceanwide's perspective as well as the perspective of Genworth's insurance regulators, but what about from the perspective of the Chinese regulators? We note that these regulators have recently been trying to restrict the outflow of capital from China, which has been weighing on the exchange value of the renminbi. China issued new regulations in late 2016 to govern the approval of foreign acquisitions, which rules were described in the press as follows (source):

> The draft rules on very large acquisitions...would mandate that prior approval be obtained for deals exceeding $1 billion in real estate or in

> industries outside the Chinese company's main area of business. Any acquisition would also require prior approval if it exceeded $10 billion.

China Oceanwide is a conglomerate with operations described on its website as follows (source):

> China Oceanwide Holdings Group Co., Ltd., the backbone of the group, has a registered capital of 20 billion yuan. Thanks to over three decades' development, China Oceanwide Holdings Group has developed into an international group of integrated finance and industry dominated by finance and based on industry, with remarkable market influence and social contribution. It is the controlling shareholder and investor of several China Mainland and Hong Kong listed companies, including Oceanwide Holdings, Minsheng Holdings, China Oceanwide Holdings Limited, Minsheng Bank, and Legend Holdings, thus its comprehensive strength has been enhanced considerably. The Group now owns nearly 100 subsidiaries and more than 10,000 employees, with its businesses and operations present in key cities in China Mainland such as Beijing, Shanghai, Shenzhen, Hangzhou, Wuhan, Qingdao, Xi'an, Dalian, Ji'nan, Weifang and Hong Kong and other regions and countries such as United States, Indonesia and Australia.

Whether the Genworth acquisition would be within or outside of China Oceanwide's main area of business would be up to the Chinese regulators to determine. It should be noted that China Oceanwide already has insurance operations in China with registered capital of two billion renminbi (source). And obviously the deal falls well below the $10 billion threshold that mandates prior regulatory approval. Due to the potential for Chinese regulators to block the transaction, we have included in our expected value calculation (for which, please see below) a 25% probability that the deal does not go through.

With respect to other (non-Chinese) foreign regulators, Genworth will need to obtain the approval of certain Canadian, Australian and New Zealand regulators, due to the change of control of Genworth's Canadian and Australian mortgage insurance subsidiaries. For much the same reasons that we do not expect Genworth's U.S. mortgage insurance (or MI) regulators to balk at the deal, we also do not believe that the foreign MI regulators will object either.

RISK OF THE OCCURENCE OF A "COMPANY MATERIAL ADVERSE EVENT" OR "RATINGS DOWNGRADE EVENT" WITH RESPECT TO GENWORTH

If either a "Company Material Adverse Event" (or MAE) or a "Company Ratings Event" (or CRE), each as defined in the merger agreement, were to occur with respect to Genworth, then China Oceanwide would be entitled to terminate the merger without paying a termination fee. (Note: for the full text of the merger agreement, see here.) Below is the definition of MAE from Article X of the merger agreement:

> "**Company Material Adverse Effect**" means (x) any material adverse effect on the financial condition; properties, assets and liabilities (considered together); business; or results of operations of the Company and its Subsidiaries, taken as a whole, or (y) any Effect that prevents or materially delays or impairs the ability of the Company to perform its obligations under this Agreement and to consummate the transactions contemplated by this Agreement; provided, however, that, in the case of clause (x) above, none of the following, and no facts, events, changes, developments, circumstances or effects (each, an "**Effect**") arising out of the following, shall constitute or be taken into account in determining whether there has been a "Company Material Adverse Effect":
>
> (A) changes in conditions in the economy generally or credit, securities, financial or other capital markets generally in the United States or elsewhere;
>
> (B) geopolitical conditions, the outbreak of any acts of war (whether or not declared), armed hostilities, sabotage or terrorism, or any escalation or worsening of any such acts of war (whether or not declared), armed hostilities, sabotage or terrorism;
>
> (C) any volcano, tsunami, pandemic, epidemic, hurricane, tornado, windstorm, flood, earthquake or other natural disaster;
>
> (D) changes that are the result of factors generally affecting the industries in which the Company and its Subsidiaries operate;
>
> (E) changes in any applicable accounting principles (including changes in GAAP, SAP, accounting principles applicable to any of the Specified Entities and accounting pronouncements by the SEC, the National Association of Insurance Commissioners and the Financial Accounting Standards Board) or any statute, rule, regulation or other Law, or the rules and requirements of the National Association of Insurance Commissioners, or the enforcement or interpretation of any of the foregoing, after the date of this Agreement;
>
> (F) any change or announcement of a potential change in the credit, financial strength or claims paying ratings of the Company or any of its Subsidiaries or any of their respective businesses; provided that the exception in this clause shall not prevent or otherwise affect a determination that any Effect (not otherwise excepted under this definition) underlying such failure has resulted in, or contributed to, a Company Material Adverse Effect;
>
> (G) any failure by the Company to meet any forecasts, estimates or representations of revenues, premiums, expenses, earnings or other financial performance or results of operations for any period prior to the Closing; provided that the exception in this clause shall not prevent or otherwise affect a determination that any Effect (not otherwise excepted under this definition) underlying such failure has resulted in, or contributed to, a Company Material Adverse Effect;
>
> (H) the announcement of the transactions contemplated by this Agreement or the identity of or facts relating to Parent or any of its Affiliates, including any loss of, or adverse change in, the relationship, contractual or otherwise, of the Company or any of the Company's Subsidiaries with its customers, policyholders, reinsurers, producers, lenders, employees, agents or suppliers (provided that this clause (H) shall not apply if any representation or warranty set forth in Section 4.4 is not true and correct, and such representation and warranty relates to the consequences arising out of the execution, delivery and performance of this Agreement or the consummation of the transactions contemplated hereby);

> (I) any action expressly required to be taken pursuant to this Agreement (other than the obligation of the Company to conduct its operations in the Ordinary Course of Business pursuant to Section 6.1(a)), or taken or omitted to be taken at Parent's written request or with Parent's written consent; and
>
> (J) the suspension of trading in securities of the Company on NYSE or any publicly traded securities of the Specified Entities on the Toronto Stock Exchange or the Australian Securities Exchange, as applicable, or a decline in the price, or change in the trading volume, of any such securities; provided that the exception in this clause shall not prevent or otherwise affect a determination that any Effect (not otherwise excepted under this definition) underlying such suspension or decline has resulted in, or contributed to, a Company Material Adverse Effect;
>
> (K) any item set forth on Section 10.2 of the Company Disclosure Letter;
>
> provided, further, in the cases of clauses (A)-(E), that such Effect does not disproportionately adversely affect the Company and its Subsidiaries compared to other companies engaged in the industries in which the Company and its Subsidiaries operate (in which case only the incremental disproportionate adverse impact or impacts may be taken into account in determining whether there has been a Company Material Adverse Effect).

While somewhat convoluted, the key text in this definition states that the following is *not* an MAE: any material adverse effect on the financial condition, properties, assets and liabilities (considered together), business or results of operations of the Company and its Subsidiaries, taken as a whole, *that results from changes that are the result of factors generally affecting the industries in which the Company and its Subsidiaries operate*, *provided* that such Effect does not disproportionately adversely affect the Company and its Subsidiaries compared to other companies engaged in the industries in which the Company and its Subsidiaries operate (in which case only the incremental disproportionate adverse impact or impacts may be taken into account in determining whether there has been a Company Material Adverse Effect). (emphasis added)

So we see from this definition that reserve increases or other adverse financial events that result from factors generally affecting the life and annuity insurance and LTC industries should not constitute an MAE as long as such factors do not disproportionately adversely affect Genworth compared to other life and annuity insurance and LTC companies. Genworth's $435 million LTC reserve increase in Q3 2016 was made known to China Oceanwide prior to the signing of the merger agreement, so this cannot constitute an MAE. Future reserve increases could potentially constitute an MAE, however. Given that the merger is expected to close by the middle of 2017, we should only be concerned with potential reserve hits occurring when the company announces its Q4 2016 financial results on February 7th, its Q1 2017 financial results near the end of April 2017 and (possibly) its Q2 2017 financial results near the end of July 2017.

With respect to Genworth's Q4 2016 results, we can triangulate from the merger proxy statement and prior 2016 earnings releases as to what to expect regarding the company's Q4 non-GAAP operating income (the main metric covered by the company's analysts to measure its core earnings power). The proxy states on page 91 that the company's Base Forecast for its consolidated non-GAAP operating income for fiscal 2016 was a negative $207 million, or minus $0.41/share. In addition, from the Q3 2016 earnings press release and Q1 2016 earnings press release, we see that consolidated non-GAAP operating income for the first three quarters of fiscal 2016 totaled a negative $179 million (Q3: negative $405 million; Q2: positive $123 million; Q1: positive $103 million).

Thus, we can conclude from these disclosures that Q4 2016's non-GAAP operating income as of the date the Base Forecast was prepared was expected to be approximately minus $28 million (negative $207 million for all of 2016 compared to negative $179 million YTD through Q3 2016), or just under a $0.06/share operating loss in Q4. (Note that the definitive proxy was filed on January 25, 2017, presumably well after the closing of the books for Q4; it would be strange indeed for Genworth's management to schedule a vote on March 7th on the merger and issue the proxy if it had knowledge that a massive write-down that could jeopardize the transaction was about to be announced.) While a $0.06/share operating loss in Q4 2016 would not exactly be outstanding, it would fall far short of anything that could constitute an MAE pursuant to the definition of that term. We believe that the main driver behind the expected Q4 2016 operating deficit would be the completion the company's active life review (or ALR), which occurs annually in the company's fourth quarter. However, since this is an annual occurrence, this item would not be expected to recur in Q1 or Q2 of FY 2017, which are the remaining fiscal quarters to be concerned with (and, in any event, the $28 million operating loss would actually be a substantial improvement from Q4 2015's operating loss of $82 million). Nor do we expect any further LTC reserve increases in Q4 of FY 2016 or Q1 or Q2 of FY 2017, since the company completed its annual comprehensive review of LTC reserve levels in Q3 2016. In sum, once Q4 2016 results are out of the way a week from now, the company should expect smoother financial sailing until the merger closes sometime around mid-year 2017.

With respect the occurrence of a "Company Ratings Event", the definition of CRE from Article X of the merger agreement is as follows:

> "**Company Ratings Event**" means the change or the public announcement of a change in the financial strength rating assigned to Genworth Mortgage Insurance Corporation to below "BB (negative outlook)" by Standard & Poor's Corporation that is primarily and directly attributable to (x) the actions or inactions of the Company, its Affiliates or their respective Representatives that does not relate to an Excluded Effect, or (y) an adverse change in the condition (financial or otherwise) of Genworth Mortgage Insurance Corporation and its businesses not resulting from or arising out of an Excluded Effect; provided, however, no downgrade arising out of or resulting primarily from the following clauses (A) through (H) below (each, an "**Excluded Effect**") shall constitute or be taken into account in determining whether there has been a "Company Ratings Event":
>
> (A) changes in conditions in the economy generally or credit, securities, financial or other capital markets generally in the United States or elsewhere;
>
> (B) geopolitical conditions, the outbreak of any acts of war (whether or not declared), armed hostilities, sabotage or terrorism, or any escalation or worsening of any such acts of war (whether or not declared), armed hostilities, sabotage or terrorism;
>
> (C) any volcano, tsunami, pandemic, epidemic, hurricane, tornado, windstorm, flood, earthquake or other natural disaster;
>
> (D) changes that are the result of factors generally affecting the industries in which Genworth Mortgage Insurance Corporation operates;

(E) changes in any applicable accounting principles (including changes in GAAP, SAP, accounting principles applicable to any of the Specified Entities and accounting pronouncements by the SEC, the National Association of Insurance Commissioners and the Financial Accounting Standards Board) or any statute, rule, regulation or other Law, or the rules and requirements of the National Association of Insurance Commissioners, or the enforcement or interpretation of any of the foregoing, after the date of this Agreement;

(F) the identity of or facts relating to Parent or any of its Affiliates, including any loss of, or adverse change in, the relationship, contractual or otherwise, of the Company or any of the Company's Subsidiaries with its customers, policyholders, reinsurers, producers, lenders, employees, agents or suppliers (provided that this clause (F) shall not apply if any representation or warranty set forth in Section 4.4 is not true and correct, and such representation and warranty relates to the consequences arising out of the execution, delivery and performance of this Agreement or the consummation of the transactions contemplated hereby);

(G) the suspension of trading in securities of the Company on NYSE or any publicly traded securities of the Specified Entities on the Toronto Stock Exchange or the Australian Securities Exchange, as applicable, or a decline in the price, or change in the trading volume, of any such securities; provided that the exception in this clause shall not prevent or otherwise affect a determination that any effect (not otherwise excepted under this definition) underlying such suspension or decline has resulted in, or contributed to, a Company Ratings Event; and

(H) any item disclosed in any publicly available Company Reports filed since December 31, 2014 (and publicly filed at least two days prior to the date hereof), excluding any disclosures set forth in the section titled "risk factors" or in any other section to the extent they are forward-looking statements or cautionary, predictive or forward-looking in nature;

provided, further, in the case of clauses (A)-(E), that such event does not disproportionately adversely affect Genworth Mortgage Insurance Corporation compared to other companies engaged in the industries in which Genworth Mortgage Insurance Corporation operates (in the case where such event does disproportionally adversely affect Genworth Mortgage Insurance Corporation, only the downgrade arising out of or resulting from the incremental disproportionate adverse impact or impacts may be taken into account in determining whether there has been a Company Ratings Event).

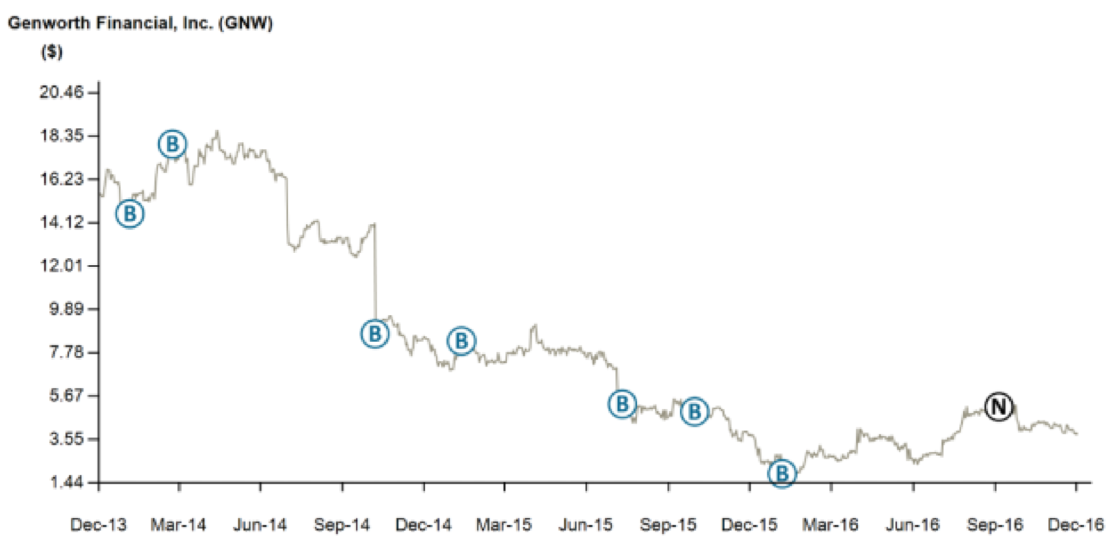
The key text in this definition states that the following is *not* a CRE: any downgrade by S&P of the financial strength rating of Genworth Mortgage Insurance Corporation (GMICO) to below "BB (negative outlook)" arising out of or resulting primarily from factors generally affecting the industries in which Genworth Mortgage Insurance Corporation operates. Again, given the financial results we expect Genworth to announce during the period up to closing in mid-2017, we would not expect a CRE to occur. Note that S&P currently has a "BB+" financial strength rating on GMICO (source), which rating was placed on Creditwatch with Developing Implications after the China Oceanwide merger was announced (source).

CLEARING UP ADDITIONAL MISINFORATION CIRCULATING IN THE MARKETPLACE REGARDING THE GENWORTH-CHINA OCEANWIDE MERGER

While it must be admitted that there are obvious risks involved in the Genworth-China Oceanwide transaction coming off totally as planned, we believe that much of the uncertainty regarding completion of the merger has resulted from misinformation gaining credence in the marketplace. This has been especially the case following dual negative analysts' notes issued during the week of January 23rd, the combined effect of which largely caused a 13% stock price decline in Genworth shares over the most recent five trading days (from $3.80 to the recent $3.30 level). Below we attempt to "analyze the analysts" who put out these notes to determine whether their arguments make any rational sense or not.

BTIG NOTE FROM JANUARY 24, 2017

First, let's take a look at the note issued by BTIG on January 24th by analyst Mark Palmer (available in PDF format here and also as described in a Seeking Alpha news item here). First, by way of background, page 8 of the note indicates that Mr. Palmer's track record with respect to making calls on Genworth stock is as follows:



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

According to Palmer, Genworth was a "Buy" when it traded between $12.62 and $17.93 in late-2013 through early-2014, exactly at the time when he should have been warning investors to sell, since the share price collapsed by over 50% during the period between the issuance of his March 2014 "buy" rating and November of that year. Palmer continued to urge investors to buy Genworth when it was above $8/share through mid-February 2015, just before the share price collapsed to around $5/share by August of that year. Not to be deterred by making bad calls, Palmer reiterated his buy rating at $5/share that month, just ahead of the share price dropping further to under $2/share in February 2016. Palmer, perhaps exhausted from making so many unfortunate calls on the stock, finally stepped to the sidelines in early October 2016, no longer offering a target price and changing his rating to "neutral". Suffice it to say that Palmer's track record making predictions with respect to Genworth has been less than stellar (to put it mildly).

Well, what about Palmer's arguments in his research note, do they have any validity? The main point of his note is to answer the rhetorical question "What is the Downside for GNW Shares if the China Oceanwide Deal Fails to Receive Regulatory Approval?" His answer is that BTIG "generously peg[s] the expected value of the company's shares if the China Oceanwide deal is rejected at their all-time low of $1.21"--which value Genworth shares hit in early 2009, in the depths of the financial crisis.

With all due respect to Palmer, however, we strongly disagree with his "expected value" of $1.21/share if the deal were to fall apart for the following reasons:

(1) Palmer admits that his sum-of-the-parts (SOTP) analysis of Genworth results in a valuation of $4.23/share, up from an SOTP valuation of $3.99/share as of September, *even though he inexplicably values Genworth's entire U.S. life insurance operations (with a book value of $15.43/share, or nearly $7.7 billion in aggregate value) at zero(!)*;

(2) Palmer unaccountably fails to include any value in his SOTP valuation for the $210 million termination fee (worth $0.42/share) that Genworth would expect to receive due to a termination of the merger owing to either China Oceanwide's unjustified refusal to close or the refusal by Chinese regulators to approve the transaction; and

(3) While Genworth's shares could indeed temporarily trade as low as $1.21/share post-deal failure when the arbs exit the stock, for purposes of calculating the downside expected value it would be unlikely to "level out" at such a figure (which indicates restructuring is likely in the near future). We believe this because Genworth has enough liquidity at the holdco level to (1) pay off its 2018 bonds in the amount of $597 million and (2) still retain a buffer well in excess of 1.5 years worth of debt service capacity (as per their Q3 2016 earnings release: "The holding company ended the quarter with $1,165 million of cash and liquid assets, representing a buffer of approximately $720 million in excess of one and a half

times annual debt service and restricted cash and liquid assets"); moreover, Genworth retains the ability to monetize the equity value of their various mortgage insurance subsidiaries (note that BTIG values Genworth's equity in its U.S. mortgage insurance subsidiary at $2.76 billion). Therefore any type of restructuring risk would not be likely to occur until 2020 at the earliest, giving the company up to three years to address their debt maturity issues. Finally, we do not believe the $1.21/share downside figure is a reasonable figure to use in an EV calculation since the stock consistently traded in the $3 to $5 per share range in the 6-month period immediately preceding the China Oceanwide merger announcement.

Palmer assigns just a 60% chance that the merger closes successfully, while our expectation is a 75% chance of a successful close (for which, see below). Combining a far too low downside expected valuation of $1.21/share with a 60% probability of the merger closing produces an overall BTIG expected value for Genworth shares of $3.74/share, which is ironically 13% above the last quoted share price (so despite his excessive bearishness and flawed assumptions, logically even Palmer would now have to conclude that the shares are a "buy"). Unfortunately, it seems that Palmer's analysis of the Genworth-China Oceanwide arbitrage is a classic case of "garbage in, garbage out".

WELLS FARGO NOTE FROM JANUARY 25, 2017

Next, let's examine Wells Fargo's January 25th note. The note was issued by analyst Sean Dargan. While we don't have access to the actual note, it was summarized by Seeking Alpha Editor Jason Aycock as a Genworth news item (see here), and for purposes of this writeup we will assume that the news item accurately reflects the note's content. Again as background regarding this analyst's track record on Genworth, Dargan appears to have downgraded Genworth to sell with a $7 price target in early May 2015 when the stock traded just above $8/share (see here) and then upgraded the shares to neutral with the same $7 price target in August 2015 when the stock traded just above that price target (see here). As we saw above in reviewing the BTIG analyst's track record, Genworth's share price dropped to sub-$2 in the six months following the issuance of Dargan's neutral rating and $7 price target. Again, this hardly inspires much confidence in Mr. Dargan's predictive abilities when it comes to Genworth. However, to be fair we should independently examine his arguments from the recent note to determine whether they have any validity.

The main thrust of Dargan's note is that he apparently believes that there is an 80% chance that China Oceanwide will cut its $5.43/share "offer" for Genworth to just $3.43/share (ironically, last Friday's closing price). Dargan's rationale for believing this seems to be that "EPS estimates don't matter so much now…with shareholders' minds set on the success or failure of the deal. But China Oceanwide could cut [the] price after seeing an expected 2016 loss of $0.41/share vs. estimates for a $0.04 gain".

Let's unpack this bearish thesis a bit. First off, there is no "offer" on the table for Genworth from China Oceanwide that can be unilaterally renegotiated by the acquirer. What exists is a binding legal agreement (the merger agreement) that states that, assuming the conditions precedent (or CPs) in Article VII thereof are satisfied, China Oceanwide must (not "may if it desires", not "has the option if it so chooses") purchase the common stock of Genworth for precisely $5.43/share. The obligation to proceed with this share purchase is not optional (again, assuming the CPs to closing are satisfied) and clearly does not constitute an "offer" subject to further negotiation. Importantly, Section 9.5.C. of the merger agreement has a specific performance provision that allows Genworth to enforce its rights to force the closing to occur, as follows:

> C. The parties agree that irreparable damage would occur in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. *It is accordingly agreed that the parties shall be entitled to an injunction or injunctions to prevent breaches of this Agreement and to enforce specifically the performance of the terms and provisions of this Agreement (including that the Company shall be entitled to cause Parent to enforce its rights under the Equity Commitment Letter*

> *pursuant to the terms thereof)*, without proof of actual damages (and each party hereby waives any requirement for the securing or posting of any bond in connection with such remedy), this being in addition to any other remedy to which such party is entitled at law or in equity; *provided* that, after any termination of this Agreement, the provisions of this Section 9.5 shall survive only with respect to those provisions of this Agreement which survive the termination of this Agreement pursuant to the provisions of the second sentence of Section 9.1. If, prior to the End Date, any party hereto brings any Proceeding in accordance with this Section 9.5 to enforce specifically the performance of the terms and provisions hereof by any other party, the End Date shall be automatically extended (1) for the period during which such Proceeding is pending, plus 10 Business Days or (2) by such other time period established by the Tribunal or court presiding over such action, as the case may be. [emphasis added]

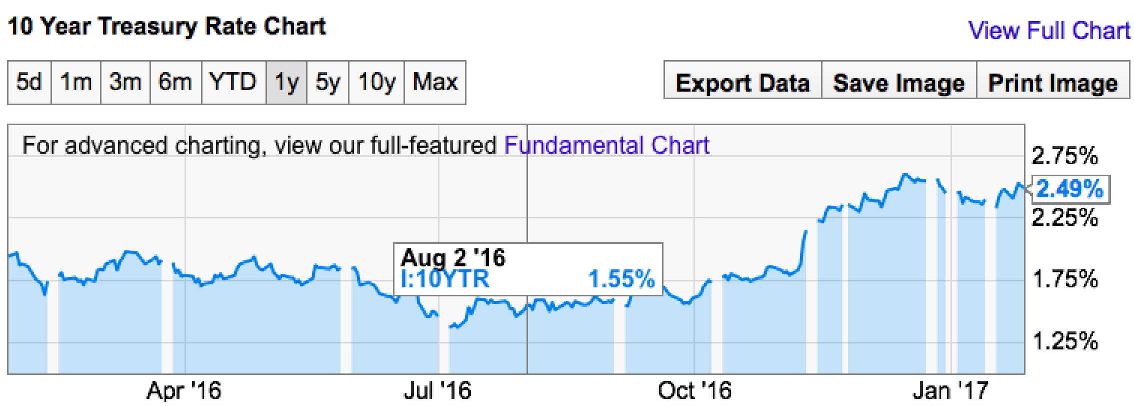
This means that, in the event China Oceanwide were to refuse to close without legal justification, it *cannot* just walk away by paying the $210 million termination fee. Instead, while Genworth (not China Oceanwide) would have the option to terminate the merger and collect this fee for such a failure, alternatively Genworth could opt to enforce its rights via the specific performance provision cited above. The failure by the Wells Fargo analyst to grasp this basic legal point demonstrates a pretty surprising lack of knowledge on his part.

Second, Dargan states that China Oceanwide would attempt to renegotiate the purchase price because the definitive merger proxy filed last week revealed that Genworth in its Base Forecast projects a non-GAAP operating loss of $0.41/share for 2016, which he claims differs significantly from current analyst estimates. We note initially that, *first*, this Base Forecast was also included in the preliminary proxy filing made on December 21, 2016 and nothing new or surprising was included in the forecast included in the definitive proxy and, *second*, fiscal 2016 is already over, so 2016's numbers are a lot less important than what happens in fiscal 2017. Dargan's argument, however, is truly bizarre due for a different reason, namely that *China Oceanwide received the Base Forecast before it ever signed the merger agreement*. This fact is clearly stated on page 87 of the proxy statement:

> In connection with China Oceanwide's due diligence of Genworth, in each of August 2016 and September 2016, Genworth's management provided China Oceanwide and its financial advisors with (1) the March projections and (2) the September projections as adjusted to account for the impact of an assumed $1.125 billion capital contribution by China Oceanwide to Genworth and in the case of the September 2016 projections, certain illustrative impacts related to accounting for the transaction. *In addition, the Base Forecast was also provided to China Oceanwide and its financial advisors prior to the signing of the merger agreement*. [emphasis added]

Therefore Dargan's thesis that the Base Forecast set forth in the proxy statement provides some justification for China Oceanwide to renegotiate the $5.43/share purchase price is without any factual or rational foundation (moreover, Genworth's press release announcing the filing of the definitive proxy, which was issued earlier *the same day* that Dargan's note came out, clearly stated that both parties still expect the transaction to close as scheduled in the middle of this year). We would thus advise investors to put zero credence into Dargan's argument on this point.

Not only do Dargan's arguments make no logical or legal sense, he apparently includes no discussion of the fact that Genworth as an acquisition target is actually *more attractive today* than when the merger was originally executed due to the subsequent significant rise in interest rates, which increase is quite bullish for the financial outlook of life insurance companies such as Genworth and would give Genworth bargaining leverage if China Oceanwide were to threaten to back out of the merger transaction. Below is a chart showing the yield for 10-year Treasury bonds over the past year (note that yields have increased approximately 1.00% since August 2016 and almost 0.75% in just the three months since the U.S. presidential election) (source):



Going forward, Genworth will thus be able to reinvest (1) premium streams received on its life insurance and LTC policies and (2) proceeds from interest payments and maturities on its $58 billion portfolio at significantly higher rates than were available just a few months ago. Assuming a 10-year weighted average maturity for its bonds, each 1% increase in interest rates would mean that the $5.8 billion that Genworth could reinvest annually from bond maturities would translate into an extra $58 million in pre-tax interest payments than would otherwise be the case.

Importantly, Genworth also has recently been obtaining premium rate increase approvals on its LTC policies from its insurance regulators in various states, which will further increase the cash flows to its LTC business (thereby supporting capital levels). Genworth will further be able invest these higher cashflows at higher prevailing interest rates. In Q3 2016, the company achieved a favorable impact in its LTC business of $35 million after-tax versus the prior year's quarter related to premium increases from in force rate actions approved and implemented to date, and this amount is expected to increase over time as further premium increases continue to be implemented.

In summary, we believe that Messrs. Palmer and Dargan are way off base in their recent respective analyses of the China Oceanwide deal. In fairness to both, however, it should be noted that insurance analysts are tasked with covering a number of different companies simultaneously, so their ability to correct analyze or assess recent events with respect to any single company is limited (by definition, an analyst covering ten different companies will on average likely only be able to devote a few hours of his or her time per week to any individual company). In addition, they are not experts in mergers and acquisitions or arbitrage calculations, which lie wholly outside of their limited area of expertise. So the deficiencies in analysis that we have noted above are actually to be expected.

PROBABILITY OF CLOSING AND EXPECTED VALUE OF THE GENWORTH RISK ARBITRAGE

Given the foregoing analysis, we conclude that the Genworth acquisition by China Oceanwide has a 75% chance of successful completion; admittedly this is an educated guess, but it remains our best estimate based on the totality of the facts known to us today. As for the upside scenario, obviously a holder of Genworth shares will receive $5.43 in cash when the deal completes. For the downside scenario, we first look Genworth's market valuation during the past year. This indicates that shares consistently traded in the $3 to $5 range between the announcement of Q1 2016 results at the end of April 2016 and prior to merger announcement at the end of October 2016, with an average unaffected stock price around the $3.75/share mark:

Although Genworth announced additional LTC reserve increases concurrently with the China Oceanwide merger announcement, amounting to an after-tax charge of $283 million in Q3 2016, this hit would be mostly counterbalanced by the fact that Genworth would be entitled to a $210 million termination fee if either (1) China Oceanwide were to unilaterally walk away from the deal or (2) Chinese regulators were to block the transaction (which risks we deem the most likely downside risks). Dividing the $73 million delta between these two amounts by the 498 million shares outstanding results in a negative $0.15/share adjustment to our base $3.75/share downside case. Moreover, to be conservative we will further deduct an additional $0.18/share from the base downside case given that, in comparison with the April to October 2016 trading window, we are now about 8 months closer to Genworth's debt maturities (note that, as discussed above, we believe that Genworth has ample liquidity to redeem all of its 2018 note maturities). Therefore, when we subtract a total of $0.33/share from the $3.75/share downside base case, we arrive at an adjusted downside base case of $3.42/share, which happens to be $0.12/share above the most recent closing price.

Thus, given the current set of facts we see little further downside risk in the stock, but significant potential upside since we believe the merger will likely close in 2017. (While timing on deals involving multiple regulatory approvals is notoriously chancey, we think that closing by the merger end date of August 31, 2017 (per Section 8.2(a) of the merger agreement), or seven months from now, is still a reasonable estimate.) *Note that we have erred on the side of conservatism by assigning no incremental value to Genworth's stand-alone worth due to (1) the significant increase in long-term interest rates since the China Oceanwide merger was announced or (2) the potential emergence of another bidder for the company*.

Given these estimates, we calculate the expected value, or EV, of the Genworth arbitrage at $4.93/share, or a massive 49% above the current stock price, as follows:

	Amount Received	**Weighting**	**Expected Value**
Merger Closes	$5.43	0.75	$4.07
Merger Blocked	$3.42	0.25	$0.86
Total			**$4.93**

Even if one were to assign just a 50% probability to the China Oceanwide merger successfully closing, the EV of the Genworth arbitrage would still be $4.43/share, a more than ample 34% above the most recent market quotation. These calculations would be as follows:

	Amount Received	**Weighting**	**Expected Value**
Merger Closes	$5.43	0.50	$2.72
Merger Blocked	$3.42	0.50	$1.71
Total			**$4.43**

Assuming that one would need to hold the shares for 7 months, the internal rate of return (or IRR) for the Genworth arbitrage would be the following:

(1) An IRR of 85% in the 75% upside / 25% downside probability scenario (or 49.4% X 12/7); and

(2) An IRR of 59% in the 50% upside / 50% downside probability scenario (or 34.2% X 12/7).

Either way, these IRRs are highly appealing in an environment where the overall market has recently been making new highs and trades at increasingly elevated valuations versus historical norms, thereby limiting expected returns in the near term (next one to three years).

CONCLUSION

Warren Buffett, not exactly an investment slouch, once made the following remark regarding the proper approach to investing (source): "You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right--that's the only thing that makes you right. And if your facts and reasoning are right, you don't have to worry about anybody else."

The facts and reasoning we have assembled regarding the Genworth-China Oceanwide arbitrage inevitably lead us to the conclusion that the expected value of Genworth's equity currently stands at $4.93/share, a massive 49% above the most recent closing price on the NYSE. We thus heed Buffett's aphorism and conclude that we are indeed right despite the fact that others, including those trading the shares in the open market and even the company's analysts, clearly disagree with us. As such, we conclude that the Genworth arbitrage remains a highly attractive investment opportunity.

Disclosure: We are long GNW.