China Oceanwide acquisition of Genworth Update

(July 6, 2020)

Last week, Genworth Financial Inc. (GNW) and China Oceanwide Holdings Group Co. Ltd. (CO) agreed to extend (again) the deadline for their proposed merger, to no later than September 30, 2020. This is now the 15th extension of the original agreement from October 2016. There are some new conditions that are part of this latest extension, which include that CO must demonstrate to GNW that it has \$1.0 billion of funds available from its sources in Mainland China to fund the acquisition. Additionally, CO must also demonstrate that Hony Capital (Beijing) Co. Ltd. or other third parties agreed to provide CO \$1.0 billion or more from sources outside of China to fund the transaction. If both conditions are not met by August 31, 2020, GNW has the right to independently terminate the merger agreement. It should be noted that both sides have been able to terminate the deal all along with no penalty.

The extension gives CO three more months to finalize financing for the transaction purchase price of \$5.43 per share of GNW stock, which may include debt funding of up to \$1.8 billion through Hony Capital or other third parties. CO also indicated that financing was delayed due to the COVID-19 pandemic and uncertain macroeconomic conditions.

In this press release there was quite a bit less discussion as to needed regulatory approvals, though GNW stated that they need confirmation from the Delaware Insurance Department that the acquisition of Genworth Life Insurance Company (a DE domiciled company) can proceed, which they expect to receive once CO has its financing in place. CO would still need approval from the Chinese government and other Chinese regulatory bodies to convert the currency and transfer of funds.

In the event that the merger of GNW and CO does not occur, GNW plans to take steps to secure funding for upcoming debt maturities in 2021 of \$1.1 billion, as well as to cover costs associated with litigation with AXA regarding some former GNW European subsidiaries that were sold to AXA in 2015. GNW management stated that such actions could include a new debt offering, and/or an initial public offering of 19.9% ownership in GNW's U.S. Mortgage Insurance business, subject to market conditions.

Review of the Genworth U.S. Life Insurers

The table below shows the Total ALIRT Scores for the three major Genworth U.S. life insurers for the last five years and as of 3/31/2020, with commentary on each insurer following thereafter. Financial results for the three major GNW U.S. life insurers improved somewhat in 2019, but operating performance deteriorated in the first quarter 2020 for each insurer. Genworth Life Insurance Company (GLIC) and Genworth Life Insurance Company of New York (GLNY) continue to face challenges with respect to their long-term care insurance business and below average risk-based capitalization, while Genworth Life & Annuity Insurance Company (GLAIC) has been impacted by individual life insurance operating losses incurred in each year 2015-2019, as well as operating losses related to variable annuities during periods where equity markets are weak (2018 and the first quarter 2020).

Total ALIRT Scores for the Genworth U.S. Life Insurers

	2015	2016	2017	2018	2019	3/31/20
Genworth Life Insurance Company	40	38	34	31	35	29
Genworth Life & Annuity Ins. Co.	42	37	32	35	46	36
Genworth Life Ins. Co. of New York	31	31	22	21	33	29

Genworth Life Insurance Company

- Genworth Life Insurance Company (GLIC) primarily offers long-term care insurance, though the company also has in force fixed and indexed annuities (GNW and GLIC ceased sales of life insurance and fixed annuities in early 2016) and a modest amount of legacy life insurance.
- GLIC's ALIRT Score declined from 2015-2018 due to ongoing operating losses since 2014, which are largely related to underwriting losses and reserve strengthening in GLIC's long-term care insurance business. The operating losses, coupled with net capital losses in 2014, 2015, 2017, and 2018, contributed to a steep decline in the company's surplus position, which fell 33% since year end 2013. The majority of this reduction occurred in 2018, as total surplus fell 24% on large operating losses and net capital losses.
- The lower surplus boosted GLIC's leverage ratios and investment risk to surplus measures and led to a significant reduction in the company's risk-based capital ratio to its current low level.
- As mentioned earlier, GNW continues to receive and seek state regulatory approval for rate increases for long-term care insurance, which may help ameliorate losses in GLIC's long-term care insurance.
- The Total ALIRT Score for Genworth Life Insurance Company (GLIC) was a low 29 at 3/31/20, which was down six points from year end 2019. GLIC's score was impacted by sizeable operating losses (see below), as well as large unrealized capital losses. These factors drove an 11% decline in surplus, which boosted asset leverage and investment risk to surplus measures.
- GLIC is also impacted by the high long-term care insurance exposure, above average asset and operating leverage, and elevated investment risk to surplus measures (especially BBB-rated and Level 3 bonds).
- Management stated that the operating losses incurred in the first quarter resulted in large part from higher term life insurance reserves, nearly all of which was due to the 2000 issue year as the 20-year level premium policies began entering their post-level premium period. Management further stated that the policies issued in 2000 exhibit significant seasonality, as reserves increase during the first half of each year followed by reserve decreases in the second half of each year.

Genworth Life & Annuity Insurance Company

- Genworth Life and Annuity Insurance Company (GLAIC) is licensed to sell in all states except New York. New business is minimal, as the company suspended all sales of traditional life and fixed annuities in March 2016 (it began selling small amounts of fixed and indexed annuities again in 2018), though the company continues to service this business. GLAIC also has legacy variable life insurance and variable annuities.
- GLAIC's Total ALIRT Score declined in each year 2014-2018 (from 50 in 2014 to 35 in 2018), which tracked a decline in the company's total surplus position, which fell in each year 2014-2018.
- As was the case for GNW overall, GLAIC incurred large operating losses in individual life insurance in each year 2015-2018, which averaged $194 million annually (pretax) over the four years. The losses reflected increases in policy reserves as a result of adverse mortality in GLAIC's universal life insurance, as well as the impact of the decades-long low interest rate environment. Operating losses in individual life insurance continued in 2019 (albeit at a narrowed pace).
- The Total ALIRT Score for GLAIC equaled 36 at 3/31/20, which was down ten points versus 12/31/19. This decrease was mostly related operating losses incurred in the quarter (see below). Net capital gains helped to offset the operating loss somewhat, but surplus still declined 19.3% from year end 2019, which boosted GLAIC's asset leverage and investment risk to surplus measures.
- GLAIC's first quarter 2020 operating losses were primarily attributable to its variable annuity products, due to the lower stock markets (which make it more likely that an insurer will have to tap some of its own funds to cover a policyholder's living or death benefit guarantee), and the adoption of new variable annuity reserving and capital guidelines in the first quarter 2020.
- Additionally, GLAIC's score remains adversely impacted by negative cash flow and premium growth, high reinsurance usage, above average operating
- GLAIC's score benefits from its above average investment yield, lack of health (long-term care) insurance exposure, and solid risk-based capitalization.

Genworth Life Insurance Company of New York

- Genworth Life Insurance Company of New York (GLNY) largely writes long-term care insurance in New York. GNW (including GLNY) ceased new sales of life insurance and fixed annuities in early 2016.
- GNW increased policy reserves numerous times over the last several years, both as a result of its own internal analysis as well as under agreements with its state regulator, the New York Department of Financial Services (NYDFS).
- Management stated that a portion of the statutory reserve increases are the result of NYDFS' refusal to allow future rate increases to be included in the asset adequacy analysis until they are approved. In 2018, the NYDFS approved a long-term care insurance rate increase for GLNY, which was only the second increase approved by the NYDFS (the first was in 2014). As a result of the approved rate increase, GLNY did not have to post additional asset adequacy analysis reserves in 2018, though the company did increase overall long-term care insurance reserves substantially during 2018.
- The markedly lower surplus produced sharply higher asset and operating leverage measures, as well as much higher investment risk to surplus measures, and these are key factors in the very low total ALIRT Score. The risk-based capital ratio of 291% at year end 2019 remained well below industry average and reflected the lower surplus and the significant share of premiums in traditional long-term care insurance.
- The ALIRT Score for GLNY remained low at 29 for 3/31/20, though this remains higher than the year end 2018 score of 21. GLNY's weak ALIRT Score reflects high asset leverage, significant use of unaffiliated reinsurance, poor operating results, high health insurance exposure (LTC focus), negative cash flow and premium growth, and high exposures to Class 2 (BBB rated) bonds, mortgage/asset backed securities, and level 3 bonds.
- However, we note that net capital gains helped support surplus growth in the first three months of 2020, while GLNY continues to benefit from strong investment yields and a small variable annuity business.
- As was the case with GLAIC, GLNY incurred operating losses related to its variable annuity business in the first quarter 2020, due to the lower stock markets and the adoption of changes in variable annuity reserving and capitalization guidelines. This was offset by earnings in life insurance and fixed annuities, and GLNY reported positive pretax earnings in the first quarter 2020.
- In addition, strong net capital gains related to hedging for equity market risks helped to offset the losses incurred for individual variable annuities.

General Commentary

Management for GNW and CO both stated that they are still committed to completing the merger, and GNW management stated that CO believes the original purchase price ($5.43 per GNW common share) is still reasonable, as the price increases GNW and its life insurers received from state insurance regulators for its long-term care insurance. The benefits of this price increase have served to offset the sale of the Canadian mortgage insurance business.

CO has committed $1.5 billion of capital infusions into GNW (at the holding company level), which it plans to contribute in three equal installments of $500 million starting by January 31, 2021, the final tranche to be infused by July 31, 2021 (assumes the transaction closes by September 30, 2020). These contributions are to be made to the GNW holding company, and not into any insurers specifically. These proceeds, combined with cash and liquid assets of $575 million at the GNW holding company, would go a long way toward meeting the $1.1 billion of GNW's maturing debt in 2021, as well as costs associated with the litigation with AXA.

The AXA litigation involves two former subsidiaries of GNW that were sold to AXA in 2015. These companies were alleged to have mis-sold payment protection insurance to U.K. residents. AXA sued GNW through the High Court of Justice, Business, and Property Courts of England and Wales, and The Court ruled against GNW in late December 2019, and AXA presently estimates its total costs related to this judgment of approximately $700 million at 3/31/2020. GNW stated that it is negotiating with AXA as to a final settlement of this matter.

If the CO acquisition of GNW does not occur, GNW management stated that GNW and its insurers may face additional ratings pressure (especially for its U.S. mortgage insurance business) and increased limitations on liquidity and debt servicing capabilities. None of GNW's three major U.S. life insurers have the legal ability to pay any shareholder dividends at this time, given large historical operating losses for each company, and thus GNW would be relying on other sources of funds and liquidity to meet 2021 maturing debt, litigation expenses, and other holding company expenses.

GNW's total cash and liquid assets at the holding company equaled $575 million at 3/31/2020. This would be insufficient to meet GNW's holding company debt of $1.1 billion that matures in 2021, which includes $378 million that matures in February and $691 million in September. There is also the ultimate cost of the litigation mentioned above with AXA, which is unknown at this time but could approach $700 million.

GNW stated that one of the steps it may take in the event the merger with CO does not occur is to raise additional debt. Whether this would be successful is another matter, considering the economic turmoil at present, and GNW's specific financial challenges. ALIRT notes that other companies have received debt financing in recent months despite the difficult financial picture, but that is no guarantee that a GNW debt issuance would be successful, especially if credit market conditions deteriorate.

Much the same is true for a partial initial public offering of GNW's U.S. mortgage insurance operations. This business has been profitable of late, with annual net income that averaged $360 million over the last five years, $569 million for 2019, and $148 million for the first quarter 2020. In stable economic conditions this business could be a strong candidate for a public offering, but in light of the economic difficulties brought on Covid-19 and the associated government edicts and lockdowns, mortgage insurance earnings may deteriorate going forward. This could lead to a lower potential valuation for a partial IPO, especially if credit and equity market conditions deteriorate.

Other options could include sales of existing blocks of business, dividends from GNW's mortgage insurers or other subsidiaries, or other asset sales.

However, these measures largely relate to the GNW holding company and its obligations, and as a result the constituencies most impacted if the CO acquisition of GNW occurs would be GNW shareholders and bondholders. For the three U.S. life insurers themselves, CO's commitment is a great deal smaller, as CO committed to infuse $175 million into GLIC and $100 million into GLNY. These proposed infusions would equal 6% and 20%, respectively, of these life insurers' 3/31/2020 total surplus. CO has stated that it does not plan any additional capital support for GLIC, GLNY, or GLAIC at this time.

As a result, whether or not CO acquires GNW, the task for the GNW U.S. life insurers remains the same: Continue to manage the blocks of business in a mostly run-off status, while soliciting rate increases from state insurance regulators for traditional long-term care insurance. As is the case for any life insurer, there is the possibility of heightened investment losses in light of the weak economic conditions.

However, if the CO acquisition does not finalize, the task for GNW to meet its near term holding company obligations may become larger, specifically as regards the upcoming debt maturities in 2021 and costs surrounding the ongoing litigation with AXA. This could lead to rating downgrades for GNW and its insurers, continued weakness in the share price of GNW, adverse publicity, a possible further restructuring of GNW, and in the event GNW could not meet its holding company obligations on schedule a possible bankruptcy of the GNW holding company. These items could have a material impact on GNW shareholders' and bondholders', but the effects on the life insurers would be indirect in this matter.

Conclusion

GNW and CO extended their merger deadline again last week, with a current date of September 30, 2020. As part of this extension, CO must provide GNW evidence that it has access to material funds both through CO's mainland China businesses as well as through third party financing. If such evidence is not forthcoming by the end of August 2020, GNW can unilaterally terminate the agreement to merge.

The primary beneficiaries should China Oceanwide complete its acquisition of Genworth Financial would be (1) GNW shareholders and (2) GNW bondholders, as China Oceanwide has committed $1.5 billion to the GNW holding company should the transaction close. This would cover the maturing debt at the GNW holding company in 2021, and at least a portion of possible losses related to litigation with AXA. If the transaction doesn't happen, GNW stated that it will seek additional financial flexibility, through either a debt issuance or a partial initial public offering of a portion of its U.S. mortgage insurance business. The success of neither of these actions is guaranteed, especially given the uncertain economic circumstances.

In the CO/GNW combination does not occur, GLIC, GLNY, and GL&A may see their public rating agency ratings downgraded yet again, but they are already so low that it wouldn't really make much difference. Neither of the three entities are legally able to pay any shareholder dividends that could get to the GNW holding company (GL&A can pay dividends up to GLIC, but then they would be "trapped" in GLIC).

With all that said, the merger impact on the three Genworth life insurers is unchanged. The long-term care writers still need to seek rate increases, and this need does not change if the ownership of the Genworth life insurers changes. The capital promised by China Oceanwide for Genworth Life Insurance Company (GLIC) and Genworth Life Insurance Company of New York (GLNY) is small ($175 million and $100 million respectively), especially for GLIC. Whoever ends up as the owner of Genworth and its insurers, the two issuers of long-term care insurance (GLIC and GLNY) will need to continue to solicit and receive rate increases for this business.

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