Ambac

First Quarter 2018 Earnings Transcript

Operator

Greetings and welcome to the Ambac Financial Group Incorporated first quarter 2018 earnings call. At this time, all participants are in a listen-only mode. A brief question and answer session will follow the formal presentation.

If anyone should require operator assistance during the conference, please press *0 on your telephone keypad.

As a reminder, this conference is being recorded. It is now my pleasure to introduce your hosts, Ms. Lisa Kampf, Head of Investor Relations; Claude LeBlanc, Chief Executive Officer; and David Trick, Chief Financial Officer.

I will now turn the call over to Lisa.

Lisa Kampf, Managing Director, Head of Investor Relations

Thank you. Good morning, and thank you, all, for joining today's conference call to discuss Ambac Financial Group's first quarter of 2018 financial results. We'd like to remind you that today's presentation may contain forward-looking statements which are based on management's current expectations and are subject to uncertainty and changes in circumstances. Any forward-looking statements are not guarantees of future performance of events.

Actual performance and events may differ, possibly materially, from such future-looking statements. Factors that could cause this include the factors described in our most recent SEC filed quarterly or annual report under management's discussion and analysis of financial condition and results of operations, and under risk factors.

Ambac is not under any obligation and expressly disclaims any obligation to update any forward-looking statement whether as a result of new information, future events, or otherwise. Today's presentation contains non-GAAP financial measures. The reconciliations of such measures to the most comparable GAAP figures are included in our earnings press release, which is available on our website at ambac.com. Please note that presentations have been posted to the events and presentations section of our IR website, which support our comments today.

I would now like to turn the call over to Mr. Claude LeBlanc.

Claude LeBlanc, Chief Executive Officer

Thank you, Lisa, and welcome to everyone joining today's call. The first quarter of 2018 was a transformational quarter for Ambac and I am pleased with our results, which include the successful conclusion of the Rehabilitation of the Segregated Account of Ambac Assurance Corporation, the impact of which is reflected in our results for this quarter.

The outcome of this milestone transaction, when combined with other material initiatives achieved during the quarter, resulted in significant value creation for our shareholders. As we will discuss in more detail later, we believe our consistent execution over time on key priorities has materially improved our fundamentals as well as increased our flexibility and options to consider future strategic opportunities.

Yesterday, after market closed, we reported net income for the first quarter of approximately $306 million, or $6.70 per diluted share, and adjusted earnings of approximately $330 million or $7.22 per diluted share. In addition, book value increased by $10.18 to $40.70 per share and Adjusted Book Value increased by $7.22 to $31.56 per share.

Following the exit from rehabilitation, Ambac is now operating in a new paradigm with reduced regulatory oversight, a simplified governance structure, materially reduced operating expenses and a significantly improved and simplified capital structure which we believe will provide us increased flexibility and capabilities to execute against our other goals.

Our key priority remains focused on the stabilization of our insurance operations through active de-risking initiatives including the following:

First the de-risking of our Adversely Classified and Watch List credits. As a reminder Watch List Credits is a new category we have added to our list for targeted de-risking activities. These are credits for which there may be a heightened potential for future adverse development in certain stress scenarios based on quantitative and qualitative assumptions. We believe the focus on de-risking both Adversely Classified and Watch List Credits will, over time, translate to material improvements in our risk profile, quality of book value and long term financial strength.

We also continue to focus on loss recoveries through active litigation and the ongoing rationalization of our capital structure and review of operating efficiencies.

Over the long term, we believe that our new operating paradigm will serve us well in managing our capital in a way that ensures long-term value creation, including positioning us to pursue potential new business activities.

Turning now to discuss our performance during the quarter.

First, during the quarter we successfully executed the close of the holistic restructuring transaction. As noted, in parallel we also took steps to simplify governance and materially reduce operating expenses associated with the rehabilitation of the Segregated Account.

We also remained keenly focused on our de-risking initiatives and during the quarter, our net par outstanding and Adversely Classified credits decreased by 5% and 10% respectively due in part to pro-active de-risking activities as well as the natural run-off of our portfolio. De-risking initiatives during the quarter included:

The negotiation and termination of the remaining RMBS policies in our UK insured portfolio, representing approximately $375mm in net par across six transactions.

The facilitation of the refunding of a portion of a large Watch List municipal finance exposure.

The successful long-term remediation of two large RMBS exposures which resulted in sustainable credit improvements during the quarter.

And the successful reduction of our exposure to an adversely classified issuer in the healthcare sector.

As it relates to Puerto Rico, we have made continued progress in defending and protecting our rights and advancing our creditor position during the quarter.

There has been a great deal of activity in the 20 months since the Oversight Board was established, in the 16 months since Governor Rosselló took office, and in the 8 months since Hurricane Maria devastated Puerto Rico.

However, there's been little progress towards implementation of meaningful government reforms or consensual debt restructurings. What Governor Rosselló continues to announce as achievements or milestones are really more procedural matters, such as approval of bills, but not actual results.

Puerto Rico's future depends on hard decisions being made today to transform the island. The successful execution of the fiscal and structural reforms reflected in the certified Commonwealth Fiscal Plan will require discipline and resolve.

Unfortunately, rather than working cooperatively with the Oversight Board, the Rosselló administration appears unwilling to implement key labor and pension reforms dictated by the certified Fiscal Plan. And while Governor Rosselló continues to be at odds with the Oversight Board, the Oversight Board continues to ignore the concerns of creditors despite Congressman Bishop's March 29th letter calling for increased goodwill and cooperation with creditors.

Ambac believes that the Commonwealth's Fiscal Plan continues to have material deficiencies and significantly understates the financial metrics of the Commonwealth. The inability to arrive at a certified Fiscal Plan supported by the Board, the Commonwealth and creditors will likely result in protracted litigation which will only continue the uncertainty, and increase the cost and burden on the Commonwealth. Failure to progress matters in an efficient manner will only hurt the people of Puerto Rico.

In light of the Oversight Board's lack of meaningful creditor engagement, as well as continued allegations of corruption within the Rosselló administration, Ambac is encouraged that Congressman Bishop is taking a more active role in the oversight of Puerto Rico.

We look forward to Congress meaningfully re-engaging in the situation to ensure transparency and collaboration during the ongoing restructuring process for the benefit of the people of Puerto Rico. We plan to continue to actively pursue dialogue with both local and federal officials, engage with creditors and other parties regarding our debt restructuring, and progress all aspects of our strategy and litigation with respect to mitigating losses in Puerto Rico.

Next, with respect to our loss recovery initiatives, we were very pleased with the recent announcement by the New York Court of Appeals that oral arguments for our Bank of America and Countrywide appeal will be heard on June 6. Resolution of this case remains a key value driver for Ambac and we remain fully prepared and committed to pursuing our claims through trial, if necessary.

Now turning to our longer-term strategy. With the rehabilitation exit transaction now behind us, we are increasing our focus on capital management and potential strategic opportunities.

To date, capital at the holding company has been deployed strategically to support the creation of value through investments in AAC. As we consider opportunities to deploy capital in the future, our approach will be measured and disciplined and we will only target opportunities that we believe will continue to deliver long-term sustainable value to our shareholders.

In considering growth opportunities, we expect to focus on attractive opportunities that are available through mergers and acquisitions, and opportunities that are rapidly scalable. We also believe that opportunities continue to exist to deploy capital in Ambac's own capital structure in addition to other strategic growth opportunities. As we have previously stated, all capital allocation activities will continue to be measured against the return of capital to our shareholders.

While there is much work to be done, we are pleased with the momentum created through recent achievements and are optimistic about our ability to continue progressing and executing our remaining priorities.

I will now turn the call over to David to discuss our financial results, David?

David Trick, Chief Financial Officer

Thank you, Claude, and good morning.

For the first quarter of 2018, Ambac reported net income of $306 million, or $6.70 per diluted share compared to a net loss of $19 million, or $0.43 per diluted share, for the fourth quarter of 2017.

Adjusted Earnings in the first quarter were $330 million, or $7.22 per diluted share compared to Adjusted Earnings of $5 million, or $0.12 per diluted share in the fourth quarter.

Relative to the fourth quarter, our first quarter results reflect lower loss and loss expenses; higher gains from interest rate derivatives, securities sales, and extinguishment of debt; and lower taxes, partially offset by lower income from VIEs and higher operating and interest expenses.

The principal driver of first quarter results was the completion of the segregated account rehabilitation exit transaction, which simplified our capital structure, enhanced our capital position, and improved our operational and strategic flexibility.

Turning to some more specifics on our financial results...

Premiums earned were $31 million during the first quarter versus $32 million during the fourth quarter. Normal earned premiums decreased during the quarter to $22 million from $23 million or 5% due to the reduction of the insured portfolio.

Accelerated premium increased by $0.6 million, or 7%, to $9 million. This increase occurred despite a 7% reduction in public finance calls, mainly due to the change in mix of transactions called. Public finance calls were down 39% from the first quarter of 2017.

The Segregated Account Rehabilitation exit transaction had a meaningful impact on the size and composition of the investment portfolio. Following the closing of the transaction, cash and investments declined by approximately $1.6 billion to $4.7 billion at March 31, 2018. The decline resulted from the satisfaction of Ambac's $1.5 billion of owned Deferred Amounts and the payment of $1.4 billion of cash, partially offset by Ambac's receipt of $768 million of Secured Notes, $240 million from the issuance of Tier 2 notes, and higher fair values of investments.

Net investment income increased to $110 million for the first quarter of 2018 from $107 million for the fourth quarter of 2017, driven by income from AAC-insured non-RMBS bonds and the newly issued Secured Notes, partially offset by losses in equity and hedge funds in the Ambac UK investment trading portfolio and the impact of a smaller investment portfolio. Mark-to-market losses on invested assets classified as trading were $(1.6) million in the first quarter of 2018 compared to a gain of $3.1 million in the fourth quarter of 2017.

As a result of the smaller, post-transaction investment portfolio, Ambac's investment income is expected to be significantly lower in future periods.

Losses and loss expenses incurred were a benefit of $247 million for the first quarter of 2018, compared to an expense of $102 million for the fourth quarter. The benefit in the first quarter included $288 million of discount captured on deferred amounts as a result of the transaction.

Losses and loss expenses, excluding the benefit from the transaction, totaled $41 million, including RMBS incurred losses of $46 million, driven by the negative impact of interest rates on excess spread and loss expenses incurred; incurred losses of $18 million in the fourth quarter of 2017 included a $22 million benefit from the termination of 20 RMBS transactions during the quarter; a Public Finance-incurred benefit of $11 million compared to a loss of $42 million for fourth quarter 2017. The benefit this quarter was primarily due to an increase in discount rates partially offset by additions to our Puerto Rico reserves; an Ambac UK-incurred benefit of $15 million primarily as a result of foreign exchange gains; and interest on deferred amounts for the period up to the closing of the transaction of $21 million.

Our macro hedge produced gains of $26 million in the first quarter compared to $23 million in the fourth quarter, continuing to serve as an effective partial hedge against the impact of rising rates in our insured and investment portfolios.

First quarter operating expenses were $36.4 million, an increase of $7.5 million from the fourth quarter. The increase was due to higher compensation and transaction costs.

The increase in compensation costs was driven by the timing of the recognition of $2.8 million of equity based short-term performance awards and higher accruals for long-term performance based equity compensation of approximately $1 million, partially offset by lower cash bonuses. Short and long-term performance-based equity compensation accounted for $4.4 million, or 28%, of first quarter compensation versus less than $1 million, or 6%, in the fourth quarter. The increase is related to timing, the impact on performance factors related to the transaction, and a shift towards more equity-based compensation.

Non-compensation costs related to the transaction, were $8.4 million compared to $5.2 million for the fourth quarter of 2017, and OCI advisory fees were $4.5 million for the first quarter of 2018 versus $5 million for the fourth quarter of 2017.

Restructuring and OCI fees equated to approximately 63% and 62% of non-compensation expenses during the first quarter of 2018 and for fourth quarter of 2017, respectively. Beginning with the second quarter Ambac will not incur any additional transaction costs. OCI-related costs are expected to run at approximately $500,000 per quarter, excluding legal costs associated with ongoing litigation relating to the rehabilitation plan.

As noted previously, we remain focused on reducing our core operating expenses, but we anticipate that we will experience volatility quarter-to-quarter associated with normal course operations and various other events.

Interest expense for the first quarter of 2018 increased $17 million to $48 million from $31.0 million in the fourth quarter of 2017. The increase resulted from a net increase in debt resulting from the secured note and the Tier 2 note issued in connection with the transaction.

While material, we expect the increase in interest expense to be temporary given that the secured and Tier 2 notes, subject to call protections, will be repaid with proceeds from our R&W litigations. Excluding these notes, interest expense for the first quarter was $22 million. In addition, when factoring in interest accrued on Deferred

Amounts, total interest expense for the first quarter was actually down $8 million. Assuming no changes in debt levels, total interest expense should be lower by about 9 percent in the second quarter.

Now turning to taxes. The provision for the first quarter of 2018 was $2.6 million compared to a provision of $12.6 million for the fourth quarter of 2017. The provision for the first quarter included $1 million of state income taxes and $1.6 million in deferred taxes associated with foreign subsidiaries.

The provision in the fourth quarter of 2017 included $1.9 million of costs related to the passage of the new tax law, along with $8.7 million of Ambac UK current taxes and $2 million of state taxes.

Total comprehensive income for the first quarter was $460 million which led to an increase in Ambac's stockholders' equity at March 31, 2018 to $1.8 billion, or $40.70 per share from $1.4 billion or $30.52 per share at December 31, 2017.

Adjusted Book Value was $1.4 billion, or $31.56 per share at March 31, 2018 compared to $1.1 billion or $24.34 per share at December 31, 2017.

That concludes my formal remarks. I will now turn the call back to Claude for some brief closing remarks.

Claude LeBlanc, Chief Executive Officer

Thanks David. I would like to summarize what David and I have discussed today.

Post-rehabilitation exit, we believe Ambac is well-positioned to advance its near and long-term strategic priorities to create additional sustainable value for our shareholders. Ambac's key components of value and value drivers include:

One: Value at the holding company with approximately $400 million of assets.

Two: Our expertise in credit, risk management, public finance, structured finance and financial services.

Three: Our significant NOLs that can be utilized organically as well as in strategic transactions, leveraging Ambac's underlying resources in a public company holding structure with a substantial operating infrastructure.

And four: An improved capital and liability structure following the execution of the segregated account rehabilitation transaction with the extinguishment of all Deferred Payment Obligations and newly-issued debt secured by rep and warranty litigation proceeds.

In conclusion, we believe we are well positioned today and we are optimistic about our future and we remain keenly focused on identifying opportunities that will drive value to our shareholders. We look forward to updating you as our plans progress. I will now turn it back to the operator.

Operator
Thank you. We will now be conducting a question and answer session. If you would like to ask a question, please press *1 on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press *2 if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the * keys. Once again to ask a question please press *1.

Our first question is from Andrew Gadlin with Odeon Capital.

Andrew Gadlin, Analyst, Odeon Capital Group
Hi good morning. I wanted to follow up on some of the comments on one-times this quarter, from closing the transaction. David on interest expense you said that it should be about nine percent lower, is that lower than the $48 million this quarter?

David Trick, Chief Financial Officer
That's total interest expense, Andrew. So, that'd be including the deferred interest amounts in the first quarter. So, including deferred interest amounts in the first quarter, interest expense was about $69 million in the first quarter, and it will be closer to about $62 million in the second quarter. So, going forward, the biggest component of interest expense in the near-term is going to be the new debt during the first quarter as I mentioned, or we'll call it the old debt, surplus notes and some of the re-securitization debt ran us about $22 million. On a go-forward basis during the second quarter we estimate that will be about a $16 million expense. So, if you want to bi-furcate the two if you will, there's about a $16 million or so run-rate of senior and junior surplus notes going forward, and the remainder of the debt expense would be associated with the new debt, which was secured by the rep & warranties.

Andrew Gadlin, Analyst, Odeon Capital Group
Is some of that amortization the discount on senior and junior surplus notes?

David Trick, Chief Financial Officer
Yes, it is.

Andrew Gadlin, Analyst, Odeon Capital Group
Got it. Ok. So, it'll be roughly $55 million a quarter going forward? Is that what you're saying?

David Trick, Chief Financial Officer
We do have some floating rate debt in there so you're looking at something in the neighborhood of about $62 million in the near-term.

Andrew Gadlin, Analyst, Odeon Capital Group
Ok. And then on the operating expenses I think you flagged within the presentation and then in your remarks about $13 million of costs related to either completing the Rehabilitation exit or just ongoing oversight from OCI which is dropping. Is that about the right number about $13 million?

David Trick, Chief Financial Officer
That's correct.

Andrew Gadlin, Analyst, Odeon Capital Group
And about $4 million for bonus expenses that are seasonal, meaning Q1-heavy and then lighter in the rest of the year?

David Trick, Chief Financial Officer
Most of that is correct. There are some performance factors that go into the calculation of equity compensation because we've moved to more objective metrics in terms of calculating those amounts but a significant component of that relates to the uplift from the actual transaction itself.

Andrew Gadlin, Analyst, Odeon Capital Group
Got it. So, roughly, $20 million of op-ex per quarter, is that the right way to think about things?

David Trick, Chief Financial Officer
That's not an unreasonable number.

Andrew Gadlin, Analyst, Odeon Capital Group
And then, on the $110 million of investment income, how much of that is one-time benefits from your owned RMBS portfolio and what's a good number to be thinking about for run-rate? I mean I could use the roughly 6% yield on the investment book going forward if it takes me to something like $60, $65 million per quarter of investment income, you know, absent any shocks to the portfolio. Is that a good way to think about it?

David Trick, Chief Financial Officer
Yeah, the consolidated portfolio is about $4.8 billion, and I guess I would think about that in terms of investment income going forward in kind of yields in the middle-single digits going forward.

Andrew Gadlin, Analyst, Odeon Capital Group
Ok. Thank you very much.

David Trick, Chief Financial Officer
Thank you.

Operator
Our next question is from Mark Palmer with BTIG.

Mark Palmer, Analyst, BTIG
Yes, good morning. Looking at the Loss and LIE expense line, there's a benefit there of $11.3 million in the quarter that's attributed primarily to an increase in loss reserve on discount rates. Also in there is a mention of an addition to Puerto Rico-related reserves. Just wanted to put that into context in terms of what would drive an increase in reserves during the quarter particularly as in-so-far as it seems like developments in Puerto Rico were largely positive during the quarter. And also, with regard to COFINA, there's a court hearing this morning related to COFINA and I guess efforts to move that dispute to the Puerto Rico Supreme Court, just want to get your sense of where things stand with regard to that dispute and what you see as key dates and factors that investors should be watching for there.

David Trick, Chief Financial Officer
Thanks Mark. From the public finance side you're right, there's a benefit from the increase in interest rates, a lot of our public finance exposures as you know are very long-dated, so as that discount curve increases, we do capture a benefit from the higher discount rates. So, in terms of the Puerto Rico reserves itself, I wouldn't say we saw or observed any material shift one way or the other in the quarter, but as you know we review every item during each quarter and we re-evaluate reserves every quarter, and I wouldn't consider any of the shifting between each of our exposures as particularly material. We re-evaluate each item and we tweak the numbers around the margin and nothing shifts materially but on that we saw a bit of an increase on a couple of our exposures during the quarter that was more than offset by the discount rate. So, I wouldn't say there was any particular major factor that contributed to the additions that we made to the quarter, just some massaging around the edges.

Claude LeBlanc, Chief Executive Officer
And Mark I'll handle the COFINA question. You're correct, the hearing on the motion of certifying COFINA is scheduled for this morning. We'll look forward to you hearing the outcome of that. I think our perspective is that the COFINA statute is clear in its transfer of property to COFINA, as well as the dedicated sales tax not being available resources to the Commonwealth and we think the Federal Court can apply the unambiguous statute without needing guidance from the Commonwealth court on this matter. However, the Federal Court should not be determining the validity and constitutionality of a state law based on state law arguments. And, to the extent the Court determines it is necessary to reach those issues we think that that should be certified by the Supreme Court. So, again, we'll look forward to hearing decisions by Justice Swain today or at least hearing the motions today.

I think the other major dates coming up, that we're expected to hear on are the general bar date at the end of May, I think is going to be an important date, and we're also looking forward to hearing the Assured HTA First Circuit Court Appeal Briefing on May 21st, but I think the general bar date I think is probably the biggest date in the calendar as we look forward to legal procedures going forward. I will say today's decision by the Court we view as more procedural than anything else at this point in time.

Mark Palmer, Analyst, BTIG
Thank you.

Operator
Our next question is from Derek Pilecki of Gator Capital.

Derek Pilecki, Gator Capital
Hey good morning. On page 8 of your operating supplement you show estimated future gross RMBS claims. And it increased from $910 million in the December quarter to $982 million this quarter and it seems like a large increase given the housing market, I wonder if you can comment on that.

David Trick, Chief Financial Officer
Sure, Derek. Thanks. That increase is really just attributable to the change in interest rates. So those numbers are gross numbers, not present-valued. So, as interest rates have moved up, the amount of excess spread that's offsetting future outflows has decreased, and so that effect has resulted in a net increase in gross future payments on RMBS positions.

Derek Pilecki, Gator Capital
So, this has been a pretty consistent phenomenon over the past six quarters that claims presented have been staying the same or going up but the amount of RMBS or par outstanding is going down. Are we at a point now where the excess spread estimates are right-sized, or will this be a continuing factor?

David Trick, Chief Financial Officer
It's going to be dependent on interest rates, so every quarter obviously we collect RMBS subrogation recoveries and I believe this quarter was about $37 million or so of recoveries that we collected this quarter. So, the amount of just pure subrogation that is due will be coming down by a factor of collections, so our rate sensitivity will actually decline with the passage of time. But we still will experience volatility in that number based on our rate movements and that's a big part of why we've had in place this macro-hedge as we refer to it, and for a long time of course we were on the wrong side of that but it's really begun to pay off in the last few quarters.

Derek Pilecki, Gator Capital
In Q4 you purchased a significant portion of your Puerto Rico bonds outstanding, and then Puerto Rico bonds in general increased in price during the quarter. So, do we see that benefit in the Other Comprehensive Income line item on the balance sheet?

David Trick, Chief Financial Officer
Yes, total comprehensive income, you'll notice there's a rather significant uplift in unrealized gains on the investment portfolio and a good portion of that was attributable to the uplift in Puerto Rico bonds as well as our RMBS positions with the post-transaction uplift and value of those securities as well.

Derek Pilecki, Gator Capital
And then in mid-March I believe you spoke at an investment conference and mentioned you'd consider buying back stock synthetically. Have you taken any action since that conference to do so?

Claude LeBlanc, Chief Executive Officer
We have not, Derek. It is something that we continue to evaluate and as we've outlined we have a number of capital management initiatives that we're considering, and are considering our options vis-à-vis buybacks amongst other initiatives including further investments in AAC securities, and strategic initiatives.

Derek Pilecki, Gator Capital
Ok. Thank you very much

David Trick, Chief Financial Officer
Thank you.

Operator
Our next question is from Andrew Gadlin with Odeon Capital.

Andrew Gadlin, Analyst, Odeon Capital Group
Hey guys sorry just one more follow-up. On the 5.1% of senior surplus notes, do you guys have an idea of whether the coupon payment will be made in June this year?

Claude LeBlanc, Chief Executive Officer
At this point we don't have a final determination or decision by the regulator.

Andrew Gadlin, Analyst, Odeon Capital Group
Any idea when you'll get that? Would you put out a press release like the company has done in the past?

Claude LeBlanc, Chief Executive Officer
We won't.

Andrew Gadlin, Analyst, Odeon Capital Group
Ok. Thanks so much.

Claude LeBlanc, Chief Executive Officer
Sure.

David Trick, Chief Financial Officer
Thank you.

Operator
There are no further questions at this time. This concludes today's teleconference. We thank you for participating. You may disconnect your lines at this time and thank you for your participation.