Ambac

Second Quarter 2017 Earnings Transcript

August 10, 2017

Operator
Good morning. My name is Lisa and I will be your conference facilitator today. At this time, I would like to welcome everyone to the Ambac Financial Group, Inc. second quarter 2017 earnings teleconference.

Our hosts for today's call are Lisa Kampf, Head of Investor Relations; Claude LeBlanc, Chief Executive Officer; and David Trick, Chief Financial Officer.

Today's call is being recorded and will be available for replay beginning at 11:30 Eastern Standard Time. The dial-in number is 1-800-585-8367 domestic or 416-621-4642 internationally, using ID number 55278932.

At this time, all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation.

If you would like to ask a question at that time, please press *1 from your touchtone phone. If at any point your question has been answered, you may remove yourself from the queue by pressing the pound key. If you should require operator assistance, please press *0. We ask that you please pick up your handset to allow optimal sound quality.

It is now my pleasure to turn the floor over to Ms. Lisa Kampf. Please go ahead.

Lisa Kampf, Head of Investor Relations
Thank you. Good morning and thank you all for joining today's conference call to discuss Ambac Financial Group's second quarter 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 forward-looking statements. Factors that could cause this include the factors described in our most recent SEC-filed quarterly or annual reports 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 we have posted slides on our website to accompany this call. I would like to turn the call over to Claude LeBlanc.

Claude LeBlanc, Chief Executive Officer

Thank you Lisa, and welcome to everyone joining today's call. I am pleased to report we've had another very active and successful quarter, resulting in the achievement of several key strategic milestones over the past few months.

Our results for the quarter, along with our recent announcement that we reached agreement on a holistic restructuring transaction to conclude the rehabilitation of AAC's Segregated Account, with the full support of our regulator, reflects our ongoing commitment to advance our stated strategic objectives, where the ultimate goal is to deliver value to our shareholders. The progress represented by these achievements is the result of our proactive approach towards managing the risks in our insured portfolio and improving the overall quality of our balance sheet.

Yesterday, after the market closed, we reported net income for the second quarter of $7.1 million, or $0.16 per diluted share and adjusted earnings of $70.4 million or $1.54 per diluted share. In addition, book value increased $1.08 to $37.00 per share and Adjusted Book Value increased $1.26 to $28.35 per share. David Trick will go into more detail regarding our financial results for the quarter momentarily.

Active management of our assets and liabilities contributed materially to the results, was accretive to both our earnings and our regulatory capital position, and materially reduced our risk profile, during the quarter. I'd like to take a moment to highlight a few of the transactions:

First, AAC successfully commuted an insured interest rate swap at a material discount, which led to the termination of the associated $185 million adversely classified insured structured finance transaction. This transaction, combined with other actions, contributed to a 4% reduction in Adversely Classified Credits during the second quarter, to $15.2 billion from $15.8 billion at March 31.

Second, Ambac U.K. successfully negotiated a de-risking transaction resulting in a reduction of future expected losses associated with an Ambac U.K.- insured structured finance deal.

Third, Ambac also purchased $33.4 million par of AAC general account surplus notes and the remaining $4 million of unpaid accrued interest related to certain surplus notes that were previously repurchased under a call option.

Lastly, AAC acquired additional insured Puerto Rico and other bonds during the second quarter. AAC now owns approximately 30% and 12% of its insured COFINA and PRIFA bonds, respectively.

Going forward, we will remain proactive and aggressive in our pursuit and execution of similar transactions, in our ongoing efforts to reduce risks and strengthen our balance sheet.

As I mentioned earlier, we recently announced that we had successfully reached agreement on a holistic restructuring transaction which, if consummated, will conclude the rehabilitation of AAC's Segregated Account and materially improve Ambac's overall financial condition.

This transaction represents a major milestone for Ambac and we believe it will create material near term and potential significant future value for our shareholders as a result of: one, a material increase in book and adjusted book value; two, the deleveraging of our balance sheet; three, a significant reduction in future operating expenses, because of reduced regulatory oversight and the elimination of certain other costs and restrictions; four, streamlining of our governance structure; and fifth, improvement to Ambac's overall operating flexibility, which will provide for greater optionality as we explore new business initiatives.

The transaction has been positively received, evidenced by the increase in Ambac security prices and the receipt of several additional creditor commitments since the announcement in mid-July. The DPO beneficial interest owners and General Account Surplus noteholders who fully support the transaction now total 34% and 52%, respectively, of the total outstanding balances held by third parties.

While the process of reaching agreement on a holistic restructuring transaction is now behind us, there are many steps involved in bringing this transaction to a close. We are working diligently alongside our external professionals and the OCI through the detailed and multifaceted execution process.

Towards that end, the Wisconsin state court overseeing the rehabilitation of AAC's Segregated Account has scheduled a pretrial hearing for November 30, 2017 and a confirmation hearing from December 12, 2017 through December 14, 2017. Based on these dates, it is likely that the closing will occur in early 2018; however, there is still a possibility that the transaction may close by year-end.

During the quarter we also remained focused on our RMBS litigation efforts, which remain a key value-driver as we aggressively pursue remedies to protect our rights and recover losses.

In our main RMBS suit against Countrywide, our request to appeal certain rulings of the intermediate appellate court to the New York Court of Appeals, the highest state appellate court in New York, was recently granted.

The rulings we requested to appeal are one, the applicability of the contractual sole remedy provisions; two, the applicability of insurance law to Ambac's fraudulent inducement and material breach claims; and three, Ambac's rights to reimbursement for its attorneys' fees and expenses in enforcing its rights.

We believe our claims against Countrywide are strong and we are preparing to go to trial, hopefully by mid-next year.

While, our other cases are not as far along as Countrywide, we are prosecuting each in a diligent, aggressive and prudent manner to progress them to more deterministic phases.

With regard to Puerto Rico, our primary focus is defending our rights and interests, and seeking to ensure that the Commonwealth and its instrumentalities are complying with their obligations. At the same time, we are proactively exploring ways to efficiently limit and mitigate our losses and ultimately bring closure to our various exposures.

In particular, we have been actively involved in the PROMESA Title III cases filed on behalf of the Commonwealth, COFINA and HTA. Among other actions, we have filed an adversary proceeding, challenging the constitutionality and legality of the Commonwealth's clawback of funds pledged to HTA bonds, and a Fiscal and Economic Growth Plan and related laws. Our HTA lawsuit also asserts that HTA revenues must continue to be applied to HTA's bonds even in Title III, and that reserve funds are property of the bondholders and not subject to Title III's automatic stay.

We are also a party to litigation concerning events of default at COFINA, and which COFINA bondholders are entitled to the COFINA funds held by the trustee. Ambac's position is that there have been covenant defaults which have resulted in Events of Default under the bond documents, and that COFINA senior bondholders have absolute priority over COFINA's subordinate bondholders with respect to the funds held by the trustee. Ambac insures only COFINA's senior debt.

We are monitoring developments in these and other cases, and are in regular conversation with other creditors of the Commonwealth and its instrumentalities. With the Title III cases and related litigation still in the early stages, it's currently unclear when the issues raised in those cases will be fully resolved. That said, we will vigilantly assert our rights and exercise remedies to protect our interests, while seeking to work with the Oversight Board and the Commonwealth to achieve durable solutions to Puerto Rico's economic and liquidity problems.

In particular, we are hopeful that the new mediation process will serve as a productive venue for achieving consensual resolution of the challenges facing Puerto Rico. The way forward, Ambac believes, is to have a much-needed focus on capital market access and debt sustainability as an engine of economic growth. To that end, Ambac stands ready to engage constructively with the Commonwealth, the Oversight Board, and other creditors and stakeholders in pursuing holistic, consensual solutions. However, should mediation be unsuccessful, Ambac will litigate and assert our rights and demand that the Oversight Board honor the laws that are in place.

Finally, during the quarter we advanced our initiatives to evaluate operational improvements and future business plans for Ambac. We are reviewing strategic options, focusing on strategies that will create long-term sustainable shareholder value. We look forward to providing you with an update on these initiatives and other related matters next quarter.

I'll now turn the call over to David Trick to walk you through our second quarter financial results. David?

David Trick, Chief Financial Officer

Thank you Claude and good morning.

Before I address the specific results for the quarter, I note that, following our announcement last month of our holistic restructuring transaction to conclude the rehabilitation of the Segregated Account, we posted on our website, as part of a broader Investor presentation, a summary pro-forma March 31, 2017 balance sheet reflecting regulatory capital accretive transactions expected to be executed and the impact of the amendment, exchanges and issuance of the Tier 2 note. It is important to note, that the items identified in the one column of the pro-forma titled regulatory capital accretive transactions, other than approximately $2.6 million of accelerated premiums, which will be recognized in the third quarter, were executed and reflected in our second quarter results.

The impact of the amendment, exchanges, and Tier 2 note provided in those pro-formas will be recognized primarily upon closing of the transaction, other than the estimated impact of accelerated income on our investments in Ambac-insured RMBS which is likely to be realized through closing of the transaction.

Now I will walk through our second quarter 2017 results.

During the second quarter of 2017, Ambac produced net income of $7.1 million, or $0.16 per diluted share compared to a net loss of $125.4 million, or $2.77 per diluted share, for the first quarter of 2017. Adjusted Earnings in the second quarter were $70.4 million, or $1.54 per diluted share compared to an Adjusted Loss of $91.2 million, or $2.01 per diluted share in the first quarter.

These positive results reflect the impact of transactions successfully executed during the quarter related to our pro-active asset and liability management program Claude discussed earlier, as well as lower public finance incurred losses and lower foreign taxes.

During the quarter, we did however, experience higher operating expenses as a result of an increase in legal and consulting fees related to the holistic restructuring transaction.

Premiums earned were $43.2 million during the second quarter versus $47.6 million during the first quarter. Normal earned premium decreased during the quarter to $30.0 million from $31.3 million or 4% primarily due to the continued runoff of the insured portfolio, including previously pre-refunded policies. Accelerated premium declined by approximately $3.1 million to $13.2 million due to a lower level of call activity and a change in mix of public finance insured transactions called, particularly a lower level of health care calls.

Premium receipts were $16 million during the second quarter, a decline of $2 million versus the first quarter due to the continued runoff of the portfolio in addition to relative timing differences.

Net investment income for the second quarter and the first quarter of 2017 was $85.2 million and $81.6 million, respectively. Net investment income for the second quarter of 2017 increased as a result of improved performance from AAC's investment in insured RMBS securities and a higher allocation to insured non-RMBS bonds, partially offset by lower investment income from corporate and other invested assets.

Mark-to-market gains on invested assets classified as trading were $3.0 million in the second quarter of 2017 compared to $7.2 million in the first quarter of 2017. Lower equity and hedge fund returns in the Ambac UK investment portfolio accounted for the quarter over quarter decline in trading income.

During the second quarter, we acquired $241.9 million of distressed Ambac-insured securities, including $25.9 million of insured RMBS and $216.0 million of other insured securities, including Puerto Rico insured bonds. Our investment in Deferred Amounts, including interest thereon, totaled $1.5 billion or 41% of the total amount outstanding as of June 30, 2017.

Losses incurred were $66.1 million for the second quarter, down from $135.0 million for the first quarter. The second quarter incurred loss was primarily driven by adverse development in the public finance portfolio, offset by improved credit performance in RMBS and a benefit associated with an additional loss mitigation transaction related to an Ambac UK insured structured finance deal. This compares to the first quarter which was driven by adverse loss development in Puerto Rico, partially offset by the benefit realized from the Ballantyne litigation settlement.

More specifically: Public Finance produced incurred losses of $52.3 million, due to adverse development in two military housing deals and several other insured exposures, including Puerto Rico, which was driven primarily by a decrease in discount rates. These developments were partially offset by favorable developments in a few transactions, including those from our active remediation efforts.

Student loans produced incurred losses of $20.3 million, resulting entirely from higher expected long-term default rates, and to a much lesser degree, higher prepayment rates. We decided to increase our forecasted default rates after undertaking a review of actual historical default and severity rates. This impact was partially offset by the benefit of lower interest rates during the quarter.

RMBS produced an incurred benefit of $15.9 million in the second quarter, driven by improvements in credit performance and lower interest rates, primarily in first-liens. The RMBS incurred benefit included a reduction of just over $8 million in our estimate of R&W recoveries, linked to the overall improvement in performance. Our estimated representation and warranty recovery amount as of June 30, 2017 is now just under $1.9 billion net of reinsurance.

Ambac UK produced an incurred benefit of $34.5 million. The main source of the benefit was Ambac UK's successful negotiation of another loss mitigation transaction, further reducing future expected losses on the largest distressed transaction in that portfolio. Foreign exchange rates also provided a benefit of about $11.8 million, as the Pound, Ambac UK's functional currency, strengthened relative the Dollar and Euro.

Net gains reported in interest rate derivatives for the second quarter were $34.1 million compared to $1.5 million of losses in the first quarter. The net gain for the second quarter included $43.4 million of gains associated with the commuted insured interest rate swap, linked to an adversely classified insured structured finance transaction, partially offset by a loss of $9.4 million from the macro-hedge stemming from lower forecasted interest rates. The interest rate driven loss was more than offset by interest rate related gains in the insured and investment portfolios.

Second quarter operating expenses increased by $3.1 million from the first quarter to $31.1 million. The increase compared to first quarter 2017 was mainly due to a $5.8 million increase in legal and consulting fees, related to our recently announced holistic restructuring transaction, partially offset by the elimination of legal contingency expenses and lower compensation expenses.

As we noted previously, we remain focused on reducing our core operating expenses, but also anticipate that we will experience volatility quarter-to-quarter associated with normal course operations and various other initiatives, including those related to the Segregated Account and our ongoing efforts towards a successful exit from rehabilitation.

That said, restructuring and OCI fees accounted for a total of just over $11.4 million in the second quarter, compared to approximately $5.7 million in the first quarter. These amounts equate to approximately 60% and 40% of non-compensation expenses during the second and first quarters of 2017, respectively. Upon completion of the holistic restructuring transaction, we expect to be able to eliminate all such restructuring costs and the majority of our OCI related costs.

With regards to taxes, the second quarter provision was $6.9 million, compared to $19.6 million for the prior quarter. The second quarter provision was driven by $6.6 million of foreign taxes resulting from the positive loss development related mostly to Ambac UK's risk remediation efforts. The first quarter included $19.3 million of foreign taxes mostly associated with the impact of the Ballantyne litigation settlement on Ambac UK.

Second quarter total comprehensive income of $48.7 million led to an increase in stockholders' equity at June 30, 2017 to $1.7 billion, or $37.00 per share, up $49.3 million from March 31, 2017. Second quarter comprehensive income was driven by $29.3 million of foreign exchange translation gains and $12.6 million of unrealized gains on investment securities.

Adjusted Book Value was up $57.5 million to nearly $1.3 billion, or $28.35 per share at June 30, 2017 compared to just over $1.2 billion or $27.09 per share at March 31, 2017. The main contributor to the increase in ABV was second quarter Adjusted Earnings and foreign exchange gains.

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 want to emphasize that the board, executive management and all employees at Ambac remain committed to and are working diligently towards generating future value for shareholders. We believe our recent achievements serve as strong evidence of this commitment and focus, which we plan to progress.

Looking forward towards the second half of 2017, we are continuing these strategies by focusing on finalizing the transactions to conclude the rehabilitation of the Segregated Account; reducing and managing the adversely classified credits in our insured portfolio, including Puerto Rico; actively prosecuting our RMBS rep and warranty litigations; and progressing our strategic planning process.

We look forward to updating you on our progress later in the year. Operator, we will now open the call up for questions.

Q&A

Operator
At this time I would like to remind everyone in order to ask a question press * then the number 1 on your telephone keypad. We'll pause for just a moment to compile a Q&A roster.

And our first question comes from the line of Andrew Gadlin from Odeon Capital Group. Your line is open.

Andrew Gadlin, Odeon Capital Group
Hi good morning. Claude you talked a little bit about the strategy with Countrywide pursuing a trial date in mid next year while simultaneously appealing the first Department's rulings, can you talk about how you prosecute those at the same time and what would happen if in fact you got some of the decisions from the first Department overturned while you're in a trial setting in the Supreme Court?

Claude LeBlanc, Chief Executive Officer
Thanks and good morning Andrew. Great question. So, we obviously, as one of our key strategies we are focused on the resolution of this key litigation. We were very pleased with the decisions to grant us leave on these appeals. I think the process and timing involving the appeals will work independently, but in parallel with the trial process and we will be working on establishing the trial schedule with the judge. We hope in the coming few months, that we expect will happen in parallel to the extent decisions are reached in the appeals during that process, we expect that those will also be factored into the judges' decision process as we move to the trial. So again we expect it to be in parallel, that's where we are hoping and planning for and we will be looking forward to progressing the trial schedule as soon as we can.

Andrew Gadlin, Odeon Capital Group
Thanks very much.

Operator
And again if you'd like to ask a question that's * 1 on your telephone keypad. Our next question comes from the line of Andrew Hain from Stifel. Your line is open.

Andrew Hain, Stifel
Hi, good morning.

Claude LeBlanc, Chief Executive Officer
Good morning.

Andrew Hain, Stifel
Quick question on the exchange, if you get the necessary court approval in December, how soon after that could you sort of effectuate or complete the exchange or what kind of timeline are we looking at?

Claude LeBlanc, Chief Executive Officer

Thanks, good question. We are still working through the timeline. At this point there are some - some of the aspects of the transaction that can be sequenced, others that will be parallel. We still believe that assuming we get a hearing, final hearing set for late December that it is likely that we should be able to have the exchange completed either prior to or immediately subsequent to the court decision, which would allow us to close in early 2018 or possibly even by year end, if we're able to effectuate the exchange immediately prior to the completion of the hearing.

Andrew Hain, Stifel
Okay great.

Claude LeBlanc, Chief Executive Officer
The scheduling is still being evaluated, but again we are contemplating and exploring both a sequencing of the exchange to the plan hearing or something that could happen in parallel, so by the time we get to the end of the hearing we would have both completed.

Andrew Hain
Okay, great. And I might have missed it in the paperwork, is there a minimum participation threshold for the exchange you guys have outlined?

Claude LeBlanc
There is. It is set at 85%, and that's a condition waivable only by Ambac.

Andrew Hain, Stifel
Oh okay great. And then just lastly, if I may, just get some clarity on your bond buybacks, the 33 million you repurchased during the quarter those were the 5.1 senior surplus notes?

David Trick
Yes it was and that was at the holding company.

Andrew Hain, Stifel
Okay and then in your 8-K you guys had filed on the 20th of July, I think you had also had a chart in the back that you had repurchased about $45 million junior surplus notes, did I read that right?

David Trick
We had entered into an agreement to acquire those notes that's correct. That was something that occurred in the third quarter.

Andrew Hain, Stifel
Right, so that was mid-July and then - so there were two transactions right? There was a repurchase of the notes and then there was an option to repurchase the additional $45 million, am I reading that right?

David Trick
I think that is correct.

Andrew Hain, Stifel
Did you guys disclose your option price there, your strike there on the $45 million?

David Trick
No, we did not.

Andrew Hain, Stifel
Can you do that or will you do that?

David Trick
To be specific, those are the Corolla notes that were issued as part of a financing transaction related to the junior surplus notes back in 2014.

Andrew Hain, Stifel
Yep I understand that, I just didn't know if you guys would be willing to disclose your option price.

David Trick
Not at this time.

Andrew Hain, Stifel
Okay great. Thank you very much for the…

Claude LeBlanc
Andrew let me go back here; I just want to clarify one point on the exchange offer participation threshold of 85%. That is for the surplus notes only, general account surplus notes and that includes AFG's participation.

Andrew Hain, Stifel
Okay, great. Thanks for the questions guys, appreciate it.

Claude LeBlanc
Thanks for the questions.

David Trick
Thank you.

Operator
And again if you'd like to ask a question that's * 1 on your telephone keypad. And we have no further questions in queue. Ladies and gentlemen this concludes your conference call for today. We thank you for participating. You may now disconnect.