Operator

Greetings and welcome to the Ambac Financial Group Incorporated third 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 third 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 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 Operation, 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. This was another active quarter for Ambac during which we executed several key transactions in line with our strategic priorities.

First, Ambac, together with other creditors, the Oversight Board, COFINA and the Puerto Rico Fiscal Agency and Financial Advisory Authority executed a Plan Support Agreement and term sheet for the restructuring of COFINA bonds.

And on October 19th, the Oversight Board filed the COFINA Plan of Adjustment and Disclosure statement, reflecting the terms of the Plan Support Agreement.

This is a significant development for one of Ambac's largest adversely classified credits, and if confirmed by the court overseeing COFINA's Title III proceeding, would favorably resolve 78% of Ambac's Puerto Rico-insured debt service. I will provide more details on Puerto Rico in a moment.

Second, in August we completed the exchange offer for our Auction Market Preferred Shares, or AMPS, which we discussed in detail during our last earnings call and the effects of which are reflected in our results this quarter. To remind everyone, this transaction provided us with several material benefits:

- First – we captured a discount of approximately $250 million, or 45%, on $557 million of outstanding AMPS, which we believe provides us with increased financial and strategic flexibility

- Second – through this transaction we further de-leveraged Ambac's capital structure, and reduced certain financial and other risks

- And third – we believe this transaction further improves the quality and strengthens the Book Value and Adjusted Book Value of Ambac Financial Group.

During the quarter we also continued to actively de-risk Ambac's insured portfolio with a particular focus on Watch List and Adversely Classified credits. As part of these actions, following the close of the quarter, we executed a reinsurance transaction with a third party to reinsure the full amount of certain public finance insurance policies totaling $1.5 billion of performing par exposure with total principal and interest of approximately $3.4 billion, primarily comprising of non-callable capital appreciation bonds and including approximately $240 million of Adversely Classified and Watch List Credits.

With our continued efforts to actively de-risk Watch List and Adversely Classified Credits, we are accelerating our efforts to reduce and sculpt our insured risk exposures, improve the quality of our book value and increase the optionality of our platform.

Now briefly on our results announced yesterday.

After market close, we reported a net loss of $22.2 million, or a loss of $0.48 per diluted share for the third quarter of 2018.

Including the impact of the AMPS transaction I mentioned earlier, we reported a net loss attributable to common stockholders of $103.8 million, or $2.27 per diluted share, and an adjusted loss of approximately $76.0 million or $1.66 per diluted share.

Book Value, also reflecting the financial impact of the AMPS exchange transaction, decreased by $0.93 to $38.77 per share, and Adjusted Book Value decreased by $2.34 to $28.50 per share.

David will discuss our financial results in more detail in a moment.

Now turning to our operational highlights.

During the quarter, we kept our focus on improving our risk profile, maximizing risk-adjusted returns on invested assets, and strengthening our balance sheet both through the AMPS transaction as well as additional principal paydowns on the secured notes issued as part of the holistic restructuring transaction that closed earlier this year.

With regards to our de-risking activities, in addition to the reinsurance transaction discussed earlier, other notable risk-mitigating transactions during the third quarter included:

- One – the negotiated termination of a $720 million Watchlist credit, reducing consolidated VIE assets and liabilities by approximately $6 billion dollars
- Two – an agreement to sell airplanes in an aircraft securitization which will significantly reduce Ambac's exposure to this asset class and will ultimately decrease our Adversely Classified Credits by approximately $224 million
- Third – a student loan commutation transaction that reduced our Adversely Classified Credits by $127 million
- And four – a structured finance reinsurance transaction, which reduced our exposure by $139 million, reducing our Watchlist credits by $83 million

Our active de-risking activities to date have helped reduce our total insured par exposure by $10.5 billion to approximately $52.2 billion dollars.

Turning now to Puerto Rico. As we discussed previously, Puerto Rico's economy continues to revitalize, and recent debt restructuring progress is laying the foundation for a return to the capital markets.

As of September 2018, the Puerto Rico Economic Activity Index increased by 5.2%, the first year-over-year increase after almost six years of negative growth. September's unemployment rate of 8.4% was the lowest unemployment rate in Puerto Rico since 1942, when Puerto Rico first began collecting unemployment figures.

Additionally, Puerto Rico's government bank account balances have swelled to almost $11 billion as of September 28th, an $876 million increase from August 31st. However, it's unclear to what extent the positive economic momentum is reflected in the Commonwealth's Fiscal Plan over the long-term or how all of this will impact bondholder recoveries.

Looking beyond the stimulative effect of recovery activity, Commonwealth stakeholders came together during the third quarter to consensually restructure and resolve contentious litigation around Puerto Rico's most important debt issuance - the COFINA sales and use tax securitization.

The Oversight Board filed the COFINA Plan of Adjustment and Disclosure Statement as part of the COFINA Title III case on October 19th. The Oversight Board also filed a motion in the Commonwealth Title III case to approve the settlement of the Commonwealth-COFINA dispute under Bankruptcy Rule 9019.

As described in publicly-available documents, the Commonwealth-COFINA settlement would entitle COFINA to a portion of the Pledged Sales Tax Base Amount, on a "first dollar" basis. The COFINA restructuring further provides for the COFINA portion of the sales tax revenues to be held in segregated accounts, includes a non-impairment covenant, as well as other strong protections. The COFINA debt restructuring, as filed by the Oversight Board, would provide holders of Ambac-insured senior COFINA bonds the ability to choose between one of two debt election options.

Pursuant to the Plan, under the first option, Ambac-wrapped senior COFINA bondholders can commute their Ambac insurance policy and receive a consideration package with a nominal value equal to approximately 93% of the prepetition claim amounts. This consideration package consists of new COFINA bonds and cash, paid by COFINA, under the COFINA Plan. In addition, commuting policyholders will also receive a cash payment from Ambac equivalent to 5.25% of prepetition claim amounts in exchange for their Ambac-insured bonds.

Under the second option, Ambac-insured bondholders can elect to exchange their existing bonds for trust certificates which will be supported by consideration deposited into a trust comprised of the same plan consideration package, paid by COFINA, as well as rights subject to offsets under the existing Ambac financial guaranty policy. Ambac will not be insuring the new COFINA bonds or the trust certificates.

If confirmed by the Title III courts, the proposed COFINA restructuring represents a consensual solution to approximately 24% of the total Commonwealth central government and instrumentality bond debt, and will yield more than $17 billion in debt service savings to the Commonwealth. Final terms of the COFINA Plan of Adjustment and related documentation remain subject to change and court approval and local legislative action. A confirmation hearing is scheduled to be heard during the first quarter of next year.

In the meantime, we will continue to work actively to progress all aspects of our strategy and litigation with respect to mitigating losses in Puerto Rico.

Now turning to our active litigation matters.

In September and this past Monday, the judge in our main RMBS case versus Bank of America Countrywide heard six motions brought by the defendants. We expect the court to rule on the motions before the end of the year but cannot predict the timing of the rulings. It is very likely that one or more decisions will be appealed and it could take several months or longer for the appellate court to decide on any issues on appeal. Depending on the issue, the trial judge or the appellate court may postpone the trial – currently scheduled for February 25th, 2019 – until such issues on appeal are decided.

Our legal team is actively preparing for trial and we remain committed to vigorously pursuing our rights.

Finally, as it relates to new business:

We continue to actively evaluate various options for long-term growth, particularly given the milestones achieved in 2018.

We remain committed to exploring various types of transactions and strategic opportunities of different magnitudes.

We have been evaluating opportunities in credit, insurance, asset management and other financial service businesses as potential sectors for select business transactions that are synergistic to Ambac and which we can leverage our core competencies. As we have stated previously, we will be measured and disciplined in our approach as we pursue opportunities to deploy our capital with the goal of creating sustainable long-term shareholder value. We would like to thank you for your continued support as we advance our strategic priorities.

I will now turn the call over to David to discuss the financial results for the quarter. David?

David Trick, Chief Financial Officer

Thank you, Claude, and good morning.

Ambac incurred a net loss of $22.2 million, or $0.48 per diluted share, excluding the impact of the AMPS exchange transaction of $81.7 million, during a third quarter of 2018. Including the impact of the AMPS exchange transaction, Ambac reported a net loss attributable to common stockholders of $104 million, or $2.27 per diluted share. These results compare to net income of $4 million, or $0.09 per diluted share, for the second quarter of 2018. Ambac also incurred an Adjusted Loss in the third quarter of $76 million, or $1.66 per diluted share, compared to Adjusted Earnings of $36 million, or $0.78 per diluted share, in the second quarter.

The loss attributable to common stockholders and the Adjusted Loss led to a $0.93 decline in shareholders equity, to $38.77 per share, and a $2.34 per share decline in Adjusted Book Value, to $28.50 per share, respectively, at September 30th, 2018.

The AMPS transaction progressed our objective of simplifying our capital structure and economically de-leveraging our balance sheet. The transaction resulted in the capture of $253 million of discount compared to the liquidation preference of the AMPS repurchased and the reduction of the outstanding consolidated liquidation preference of AMPS from over $660 million to only $103 million. This was accomplished through the issuance, on a fair value basis, of approximately $286 million of surplus notes, including accrued interest, the payment of $11 million of cash, and the issuance of approximately $8 million of warrants.

The AMPS were carried on the balance sheet at approximately 40% of their liquidation preference, equating to their fair value at the time Ambac emerged from bankruptcy. The fair value of the consideration package paid was approximately 55% of the liquidation preference, resulting in the realization of an $82 million reduction to net income attributable to common stockholders. Coupled with the warrant issuance of $8 million, stockholders' equity and adjusted book value decreased by $74 million as a result of the transaction.

In addition to the AMPS transaction, our third quarter results reflect, relative to the second quarter, lower investment income and lower realized investment gains, and to a lesser degree, higher interest and operating expenses, partially offset by higher interest rate derivative gains from our macro hedge.

Investment income for the third quarter of 2018 was $58 million, an $8 million or 13% decline from $67 million for the second quarter of 2018. This decline reflected a reduction of the size of the investment portfolio and a lower allocation to higher-yielding Ambac-insured RMBS, partially offset by gains on invested assets classified as trading.

Net realized gains for the quarter totaled $30 million as compared to $47 million in the second quarter. The principal source of these gains were the sale of Ambac-insured RMBS securities. These sales were executed in connection with our efforts to re-balance the investment portfolio subsequent to the impact of the Segregated Account's exit from Rehabilitation and in connection with the redemption of $72 million of the Ambac Note.

Ever to date redemptions of the Ambac Note of $186 million, repayment of the secured borrowing during the second quarter, and the payment of loss and loss expenses of $229 million during the third quarter contributed to the decline in investment income when coupled with the reallocation of assets to more liquid positions.

Losses and loss expenses incurred were $34 million for the third quarter of 2018, compared to $33 million for the second quarter. Losses incurred in the third quarter were primarily driven by loss expenses incurred in connection with our remediation efforts partially offset by net positive credit developments.

The negative impact of rising interest rates on both the insured and investment portfolios continued to be partially mitigated by the macro hedge which produced gains of $17 million during the third quarter compared to gains of $9 million in the second quarter.

Third quarter operating expenses were $28 million, an increase of $2 million or 9% from the second quarter.

The slight increase was due mostly to higher professional fees related to the AMPS exchange transaction of $3.3 million, partially offset by lower expenses relating to regulatory oversight costs and net lower compensation costs, inclusive of higher severance costs in connection with further right-sizing.

Total operating expenses related to the AMPS transaction in the third quarter of 2018 amounted to $5.9 million.

We remain focused on reducing our core operating expenses, but similar to the second and third quarters of 2018, which contained costs associated with various strategic initiatives consistent with our stated objectives, we expect to experience volatility quarter-to-quarter associated with normal course operations and various other events.

Interest expense for the third quarter of 2018 increased $3 million to $66 million from $63 million in the second quarter of 2018.

The increase reflected the issuance of surplus notes from the AMPS exchange transaction, partially offset by lower interest expense resulting from the principal paydowns of the Ambac Note and the full redemption of the RMBS-secured borrowing in the second quarter of 2018.

Interest on debt backed by representation and warranty litigation accounted for $45.4 million, or 69%, of third quarter interest expense.

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

Claude LeBlanc, Chief Executive Officer

Thanks David.

We have had a very active and successful 2018 thus far and remain committed to progressing our strategic priorities to create long-term sustainable value for our shareholders.

We remain keenly focused on taking measured steps, big and small, to optimize our business model in a way that provides optionality to create value and drive growth. Thank you for joining us today. I will now turn the call back to the operator to open for questions.

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. One moment please while we hold for questions.

Our first question comes from the line of Andrew Gadlin with Odeon Capital Group. Please proceed with your question.

Andrew Gadlin, Odeon Capital Group
Hey good morning. I was wondering if you could discuss the two subsequent events disclosed, that small Goldman Sachs settlement in November, as well as the reinsurance deal. Are the financial impacts from those events included in the Q3 numbers?

David Trick, Chief Financial Officer
Hey Andrew, thanks for calling in. The Goldman Sachs settlement was part of a class-action suit that we filed a claim in. As a result of that, it was launched by I think two pension funds who made a claim back in 2016, never really expecting anything material to come of it and, in November we received about $27 million as a result of the settlement, and that will be booked in the fourth quarter. Now I had a little bit of a hard time hearing the second part of your question, was that related to the reinsurance transaction?

Andrew Gadlin, Odeon Capital Group
Correct.

David Trick, Chief Financial Officer
Yeah. The reinsurance transaction from a financial statement impact was not booked in the third quarter, that too closed in the fourth quarter, and the result of that will begin to be reflected starting in the fourth quarter of 2018.

Andrew Gadlin, Odeon Capital Group
And will the impact be meaningful from the reinsurance deal?

David Trick, Chief Financial Officer
The reinsurance will have a meaningful impact on fourth quarter. You'll probably see the biggest impact will be from how we calculated adjusted book value, and that'll have an impact on the amount of UPR that is included in adjusted book value.

Andrew Gadlin, Odeon Capital Group
And can you give a sense of the order of magnitude, what the impact will be?

David Trick, Chief Financial Officer
Less than 50 cents per share

Andrew Gadlin, Odeon Capital Group
Got it. Ok. And then Claude thank you for your comments and explanation of the COFINA settlement and certificate process. I was wondering if you could talk about a couple of elements there. In terms of that commutation effort that you guys will be launching, would that be expected to go alongside the completion of the COFINA deal or is that something that could happen months after hopefully COFINA is approved?

Claude LeBlanc, Chief Executive Officer
So I think we are, you know, obviously it's a very complex transaction and we're still working through a lot of the detail with the OB [Oversight Board] on their plan of adjustment. And the detail of what is public is in that plan. I guess I would say that anything we might do or consider vis-à-vis commutation would likely be done following the confirmation date, and at this point we have not made any decisions relating to actions relating to our securities.

Andrew Gadlin, Odeon Capital Group
And then you also have this unique litigation angle against Bank of New York. Would that be pursued alongside that, or does that have to wait for plan confirmation? How should we think about that?

Claude LeBlanc, Chief Executive Officer
Sorry you're referring to the Bank of New York litigation related to the plan?

Andrew Gadlin, Odeon Capital Group
Yeah. Related to COFINA on their non-acceleration. When can we start to see movement there? I know that's been stayed.

Claude LeBlanc, Chief Executive Officer
At this stage we have not made any determinations vis-à-vis litigation. I think it's still something we're evaluating and, again, something that we'll evaluate through to the, likely, the confirmation date before we make any decisions.

Andrew Gadlin, Odeon Capital Group
Got it. Thank you. Alright, that's it for me. Thanks.

Operator
Once again if anyone would like to ask a question please press *1 on your telephone keypad. 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. Thank you for your participation.