Ambac

Operator
Greetings and welcome to the Ambac Financial Group Inc. fourth quarter 2019 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 fourth quarter 2019 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 annual report 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.

For the year ended December 31, 2019 Ambac reported a net loss of $216 million, or ($4.69) per diluted share, and Adjusted Earnings of $66 million or $1.44 per diluted share.

At December 31, 2019 our Book Value was $1.5 billion, or $32.41 per share, and Adjusted Book Value, was $1.3 billion, or $28.83 per share. David Trick will discuss these results in more detail a little later.

Overall, 2019 was a very strong performance year for Ambac as we continued to successfully deliver and execute on all key strategic priorities.

We made further material improvements to Ambac's financial strength, through the additional deleveraging of our capital structure resulting from our de-risking activities and significant litigation-related recoveries.

With regards to our de-risking activities, we began the year with the execution of the COFINA Plan of Adjustment, a significant transaction that allowed Ambac to fully address and materially reduce its largest single risk, representing approximately 78% of Ambac's total lifetime Puerto Rico exposure. Another key de-risking transaction completed in 2019 was the Ballantyne restructuring and commutation, one of our largest Ambac U.K. credit exposures.

This transaction reduced our Adversely Classified Credit net par exposure by $900 million, materially enhancing Ambac UK's regulatory capital levels to near compliance with Solvency II requirements.

During the year we also expanded our use of reinsurance to reduce and sculpt our insurance portfolio.

In one transaction we ceded $1.2 billion of public finance par exposure, representing almost 3% of our total insured net par. This transaction included over $500 million of Adversely Classified and Watch List Credits. And during the fourth quarter we executed a reinsurance transaction ceding $228 million of public finance par exposure, including over $150 million of Watch List credits.

Lastly, in December 2019, we negotiated the removal of Ambac's guarantee from a tranche of notes on an Adversely Classified and Watch List credit with net par in excess of $270 million.

On a full year basis, these and other efforts, combined with portfolio run-off decreased our insured portfolio by 19%, from $46.9 billion to $38.0 billion as of December 31, 2019, and decreased our Adversely Classified and Watch List Credits by 28% from $19.9 billion, to $14.3 billion.

Notably, our active de-risking efforts accounted for 50% of the decrease in total net par and 65% of the decrease in Adversely Classified and Watch List Credits.

The ongoing de-risking of our insured portfolio remains a key focus in 2020 and we will use all options at our disposal to manage our insured portfolio with the goal of reducing tail risk and improving the overall credit quality.

Turning now to Puerto Rico.

We are actively pursuing various de-risking strategies with respect to our remaining exposures in Puerto Rico, namely:

One – loss recovery and mitigation through restructuring negotiations.

Two – the exercise of contractual legal rights.

And three – active litigation.

In 2019, this strategy positioned us well to take the lead in the successful resolution of our COFINA related exposure.

The COFINA resolution validates how consensual transactions can be arrived at when parties act reasonably, respect legal rights, and avoid unreasonable and extreme scorched-earth approaches that could lead to severe long-term consequences for the entire U.S. municipal market.

This past Friday, the Oversight Board filed its Amended Commonwealth Plan of Adjustment reflective of the key terms of the Amended Plan Support Agreement.

Unfortunately, the Plan of Adjustment reflects the continued failure by the Oversight Board to engage and gain the support of key long-term stakeholders of Puerto Rico.

Ambac, joined by other financial guarantors, issued a statement highlighting the deficiencies and risks of the Amended Plan Support Agreement. Following the joint statement, other large creditors and major stakeholders, including the Bonistas del Patio, a group of on-island bondholders, and the Government of Puerto Rico, also voiced a lack of support for the Amended Plan Support Agreement.

It is also unclear why the Oversight Board chose to move forward with a flawed Amended Commonwealth Plan of Adjustment that is premised on demonstrably incorrect Commonwealth Fiscal Plan projections and insufficient public information about Puerto Rico's cash, assets, debt capacity and pension expense liability.

To the extent the Oversight Board continues to understate Puerto Rico's debt service capacity and its ability to pay, ignore legal rights and fails to engage with Puerto Rico's true stakeholders, we will have no choice but to continue to vigorously assert our legal rights.

As I have stated previously, we have and continue to be prepared to engage in productive consensual negotiations with the Oversight Board and its advisors to avoid costly protracted litigation, provide acceptable recoveries to a broad set of Commonwealth creditors, and restore access to capital markets.

Turning now to our loss recovery efforts on our outstanding RMBS and other litigations.

During the third quarter of 2019 we received proceeds of $142 million related to a cash settlement in connection with the SEC action against Citigroup, that allowed us to further de-lever our balance sheet and reduce future interest costs.

And in our main case against Bank of America/Countrywide, we received favorable appellate decisions in September, and in November the judge scheduled a four-week trial to begin on July 13th, 2020.

Consistent with their past practice, Bank of America is now seeking further appellate review and has asked the judge to postpone the trial to allow for potential appeals in our case and decisions on pending appeals in two non-Ambac RMBS cases.

At a status conference last week, the judge maintained the status quo pending his consideration of the Bank's request and scheduled another status conference in May. Our legal teams continue to actively prepare for trial as we look ahead to a final resolution of this case.

Moving on to operational developments.

During the year we took further steps to streamline our operating platform and capital structure including additional headcount reductions and the consolidation of our New York headquarters to a single floor plate at One World Trade.

We plan to continue to evaluate areas of realignment within the company in 2020 as we progress the run-off of the insured portfolio.

And lastly, with respect to new business opportunities, during 2019 we actively progressed our efforts of evaluating potential opportunities in certain business sectors that meet criteria that we believe will generate long-term shareholder value with attractive risk-adjusted returns.

As part of these efforts we identified and evaluated a number of new business opportunities, progressing some to advanced stages. Through this process, we have enhanced our capabilities and further narrowed our focus on key market opportunities that we believe will lead to attractive actionable opportunities.

In conclusion, I am very pleased with our tremendous accomplishments in 2019, driven by the strong leadership of the Board and senior management, as well as the dedication and hard work of all our employees. As we turn our attention to our 2020 goals, mindful of the challenges ahead, we will remain vigilant in our efforts to execute all key priorities which are aimed at enhancing long-term shareholder value.

I would now like to turn the call over to David Trick to discuss our financial results for the quarter. David?

David Trick, Chief Financial Officer

Thank you, Claude, and good morning everyone.

During the fourth quarter of 2019, Ambac reported a net loss of $(110) million or $(2.40) per diluted share, compared to net income of $66 million or $1.41 per diluted share in the third quarter.

The main driver of the fourth quarter net loss relative to third quarter net income was the $142 million one-time gain recognized in September from the SEC-Citigroup settlement and a $60 million increase in incurred loss and loss expenses primarily related to RMBS.

Adjusted Loss for the fourth quarter was $88 million, or $1.91 per diluted share compared to Adjusted Earnings of $77 million, or $1.63 per diluted share in the third quarter, the main differences between Adjusted Loss and the GAAP net loss for the quarter being insurance intangible amortization and foreign exchange.

Briefly touching on some highlights…

Premiums earned were $20 million in the fourth quarter versus $10 million during the third quarter. The increase was due to a reduction in the allowance for uncollectable premiums partially offset by the continued run-off of the insured portfolio.

Investment income for the fourth quarter was $42 million, down from $45 million for the third quarter of 2019. The decline resulted from a reduction in income associated with our sales of COFINA bonds, as we continue to reposition our portfolio, and lower income from AAC's investment in its own secured notes, due to lower rates and a partial redemption. Notable is that AAC's alternative investments contributed 7% of consolidated investment income in the fourth quarter, compared to 5% last quarter and around 0% for all of last year.

As we continue to diversify the portfolio to generate more attractive risk-adjusted long-term returns to defease our insurance and other obligations, we would expect alternative investments to contribute a greater proportion of investment income and potentially some short-term volatility.

Net realized investment gains were $9 million for the fourth quarter, which included $16 million of gains from sales of uninsured COFINA bonds partially offset by unrealized foreign exchange losses at Ambac UK related to their holdings of U.S. dollar-denominated investments. These foreign exchange losses have no impact on book value or adjusted book as they are more than offset by the appreciation of the British Pound, the functional currency of Ambac UK.

Loss and loss expenses incurred were $97 million in the fourth quarter, compared to $37 million in the third quarter.

RMBS losses of $40 million in the fourth quarter, compared to a benefit of $25 million in the third quarter, were driven by a reduction to estimated representation and warranty subrogation recoveries, associated with a reduction in the underlying losses and a change in assumptions, and higher related loss expenses incurred.

Fourth quarter Public Finance losses were $54 million, compared to $77 million in the third quarter, and included an increase in Puerto Rico reserves and related loss expenses, which were partially offset by the impact of higher interest rates.

Operating expenses for the fourth quarter decreased $2.4 million from the third quarter to $23 million. The decline was driven by a $2.0 million reduction in compensation-related expenses due to severance expenses incurred during the third quarter in connection with staff reductions and lower fourth quarter core compensation expense.

We continue to focus on reducing core operating expenses, and although our cost cutting actions may be met with some volatility as a result of short-term events related to executing our strategic priorities, we are seeking and implementing sustainable reductions to long-term operating expense. Consistent with this objective and as one example, our premises expense declined by a half million in the fourth quarter compared to the third quarter and is expected to decline by an additional half-million or more in the first quarter of 2020, all as a result of our corporate relocation.

Interest expense for the fourth quarter was $66 million, relatively flat compared to the third quarter.

At year end 2019 we redeemed $149 million of AAC's outstanding secured notes, using mostly the proceeds from the Citi-SEC settlement. We anticipate this redemption will have a favorable impact on interest expense in 2020, subject to changes in LIBOR, of approximately $12 million.

Turning to the balance sheet, shareholder's equity of $1.5 billion decreased $(2.03) per share from September 30, 2019, to $32.41 per share at December 31, 2019, primarily due to the net loss for the quarter and unrealized losses on securities of $38 million, partially offset by foreign currency translation gains of $54 million.

Adjusted Book Value decreased to $1.31 billion at December 31, 2019 from $1.38 billion at September 30, 2019. On a per share basis, Adjusted Book Value decreased $(1.48) to $28.83 per share at December 31, 2019.

This decrease was primarily driven by the adjusted loss for the fourth quarter, and $10 million of premiums ceded under a new reinsurance transaction, partially offset by the impact of changes in foreign exchange rates.

As for AFG on a stand-alone basis, as of December 31, 2019, AFG had cash, investments and net receivables of approximately $483 million or $10.61 per share.

I will now turn the call back to Claude for some brief closing remarks.

Claude LeBlanc, Chief Executive Officer
Thank you, David.

I would like to thank my colleagues and our board of directors for their hard work throughout the year in helping us to meet and in many cases exceed our goals.

I would also like to thank our shareholders for your ongoing support. We appreciate your feedback during the year and we look forward to updating you on our progress as we continue to advance our strategic priorities to create long term value for our shareholders.
Operator, please open the call for questions. Thank you.

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 * key.

Our first question comes from the line of Giuliano Bologna with BTIG. Please proceed with your question.

Giuliano Bologna, *BTIG*
Thank you, good morning and thanks for taking my questions. I guess, starting off on the secured note side. You repaid about $142 million of that note with the proceeds from the Citi CDO case. And then kind of going forward, you'll receive -- you should receive call it somewhere in the low $40 million range in cash proceeds, and that will be rolled into the notes again. Is there any sense of kind of the potential savings, and how long that continues to go on for?

David Trick, Chief Financial Officer
Yes, Giuliano. So that's right. The cash flow will circulate, if you will, and we'll pay down additional amounts in the first quarter from recirculating of the pay down as well as additional cash flows from other sources of collateral and potential other cash flows. So on an annualized basis, that -- just based on what we paid down in the fourth quarter, reduced interest expense by about $12 million, depending on where LIBOR goes, which factors in that the recirculation of that -- those cash flows from the pay down at the end of the year.

Giuliano Bologna, *BTIG*
That makes sense. And then thinking about kind of the rest of the debt structure, obviously, there are a few different tranches outstanding. Are there any other opportunities out there to kind of pay down or reduce debt across the structure? Or does it make sense to continue going after the secured notes in the near-term because they're cash pay and expenses?

David Trick, Chief Financial Officer
Yes, subject to, I would say, liquidity and other capital allocation considerations, we will continue to look at opportunities to reduce that outstanding secured balance. And as for the rest of the capital structure, we've said before that our objective is to simplify and optimize the capital stack. And as we've done with some transactions in the past, we'll continue to keep our eyes open and continue to explore opportunities to do that. Specific, [there’s nothing] I can tell you today that would be appropriate to give you more specifics on things that we're considering.

Giuliano Bologna, *BTIG*
That makes sense. I appreciate that. Then it's nice to see how kind of your operating expense is coming down, and obviously, the additional benefit kind of going forward on the premise expense, which is good to see on a go-forward basis because it will definitely bring down your kind of operating cash flow or operating draw on cash flow. But then thinking about as you prep for litigation and -- or prep for going to trial, are there any kind of enhanced ligation-related expenses that might be transient in the first half?

David Trick, Chief Financial Officer
On a go-forward basis, it's hard to say. But we did, as we noted in our loss adjustment expense true-ups in the fourth quarter, we did take additional LAE expense on both the RMBS front as well as Puerto Rico, which are the two areas where we are the most litigious, so we did reevaluate our reserves there at the end of the year and trued those balances up to what we believe appropriate at this time.

Giuliano Bologna, *BTIG*
That makes sense. Well that covers my main questions. I appreciate the time. Thank you.

Operator
Thank you. Ladies and Gentlemen as a reminder if you would like to join the question queue please press *1 on your telephone keypad at this time. We'll pause a moment to allow for any other questions.

Thank you. Our next question comes from the line of Frank Lavore, a private investor. Please proceed with your question.

Frank Lagore, Private Investor
Good morning Claude and thank you for taking my question. Claude, as with respect to Puerto Rico, it sounds like the Oversight Board is somewhat off track. Are there ongoing negotiations with either the Board or the Commonwealth? And whom would you have to negotiate with, the Commonwealth or the Board? And as it relates to the Bank of America appeal, can you shed some light on what they are appealing? It seems like the appeal process has been ongoing now for about 6 months, haven't these appeals been heard before?

Claude LeBlanc, Chief Executive Officer
Thank you, good morning, Frank. On your first question, there are ongoing discussions between our advisers and management with the advisers to the Oversight Board as well as other creditors. So I think that's an ongoing process. There are formal mediation processes that go on periodically. But that's more on the formal side of things, but I think you can be reassured that there is always ongoing discussions between creditors certainly and -- at the appropriate times between the creditors and the OB. So I think I'll leave my comments to that, but I think it is, obviously, a fluid situation, and we are active in our discussions and deliberations around finding a resolution to Puerto Rico. But I would agree also that what's been put forward by the Oversight Board is not something that provides for a good entry to negotiation at this time.

As it relates to Bank of America, I think their appeals are really going back to the initial decisions that were confirmed by Justice Sherwood and appeal to the first department where we prevailed again. And this is a final set of appeals that Bank of America is making to the funnel and the highest court in the state of New York, the Court of Appeals, which they're entitled to ask for, and we're just waiting to see whether that appeal will be granted. If it's not granted, we will be in front of Justice Sherwood in May to discuss -- on a conference to discuss the timing of the trial, which has remained set for the July time frame.

Frank Liguore, Private Investor
And if the appeal is granted, what is the process?

Claude LeBlanc, Chief Executive Officer
It is unclear, but I think there's a reasonable chance that if it is granted, that the -- there would be a delay in the trial. I think that's not something that we would be deciding, but I think there's more risk certainly that the trial could be delayed.

Frank Liguore, Private Investor
And who has to decide on the appeal, the court or the judge?

Claude LeBlanc, Chief Executive Officer
It's the first department.

Frank Liguore, Private Investor
I see. So that would be the Court of Appeals?

Claude LeBlanc, Chief Executive Officer
It's the first department. That's the first level above the Supreme Court that reviews these cases. And then they decide whether or not it goes to the Court of Appeals, which is the highest court.

Frank Liguore, Private Investor
Okay. One final point. It sounds like you're narrowing down your search for an operating company or some kind of strategic acquisition. Can you shed any more light on that?

Claude LeBlanc, Chief Executive Officer
We've talked and indicated in the past that we are looking at companies that reflect certain key metrics that we've agreed to with the Board. And we review annually. The focus is on businesses that reflect our core competencies. So I would say, in credit and insurance. And we've looked at a variety of opportunities that range from capital-light insurance or credit originators to various servicing platforms and fee-based businesses, both in the insurance and credit space. So we continue our focus in those markets. And we have, over time, identified opportunities that we believe could be very attractive to Ambac, and we believe, would deliver long-term value to our shareholders. So we continue our efforts to focus on this sector, and we -- as we indicated in the past, we're going to be very disciplined in our approach, and anything we do is measured against the return of capital to our shareholders. So we have

a very disciplined approach, and we'll see if we can identify the right opportunity in the coming year.

Frank Liguore, Private Investor
Well thank you very much. Finally, how are you feeling about the New York Stock Exchange?

Claude LeBlanc, Chief Executive Officer
Well, being on New York Stock exchange, our recent move, we're pleased with that. It offers us a lot of benefits to being back in a big board where we once were at the beginning. So I think we're very pleased to be back. And it's also going to translate to some meaningful cost savings for us as well. So I think the benefits of both being back in our true home and also the benefits from cost savings, I think, translates to a win-win for us.

Frank Liguore, Private Investor
Thank you very much, Claude.

Claude LeBlanc, Chief Executive Officer
Thank you.

Operator
Thank you. This concludes our question and answer session and thus concludes our call today. Thank you ladies and gentlemen for your time and interest today. You may disconnect your lines and have a wonderful day.