



Second Quarter 2018 Earnings Transcript

Operator

Greetings and welcome to the Ambac Financial Group Incorporated second 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 second 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 report under management's discussion and analysis of financial conditions 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. This has been another busy and productive quarter for Ambac.

In June we announced the execution of a support agreement with certain holders of our Auction Market Preferred Shares, or "AMPS", and in July launched a tender offer for all of the outstanding AMPS in our efforts to further deleverage and simplify Ambac's capital structure. This exchange offer was successfully closed on August 3rd. The transaction was completed with holders representing 84.4% of our outstanding AMPS who exchanged their positions for a consideration package consisting of surplus notes, cash and holding company warrants.

David will provide greater detail on the transaction shortly but the transaction delivered several benefits including:

- First - an increase in our financial and strategic flexibility with a discount capture of approximately \$227 million;
- Second - improvement in the quality of our Book Value and Adjusted Book Value;



Second Quarter 2018 Earnings Transcript

- And lastly, clarity with respect to our corporate governance structure and increased flexibility with respect to future potential capital distributions

We are pleased with the level of participation of the AMP holders and the outcome of the exchange offer as well as the other long-term benefits of this transaction for Ambac and its shareholders.

During the quarter the Company and its advisors were also actively involved in mediation discussions to resolve Ambac's largest Puerto Rico exposure, the COFINA senior bonds. Yesterday the FOMB released an overview summary of some of the key terms for securities forming part of a consensual COFINA Plan of Adjustments. Ambac has been a party to these negotiations and continues to be involved in the ongoing negotiations. As noted in the disclosure the announced transaction is subject to final terms as set forth in separate definitive written agreements. Because of the confidential nature of mediation, we cannot comment any further on what's been disclosed.

Now on to our financial results.

Yesterday, after market close, we reported net income for the second quarter of approximately \$4.3 million, or \$0.09 per diluted share, and adjusted earnings of approximately \$36.5 million or \$0.78 per diluted share. Book value decreased by \$1.00 to \$39.70 per share and Adjusted Book Value decreased \$0.72 to \$30.84 per share, primarily as a result of foreign exchange movements during the quarter.

During this quarter we also made meaningful progress in improving our risk profile, maximizing the risk-adjusted return on invested assets, strengthening our balance sheet, and through the AMPS transaction and debt redemptions, deleveraging and simplifying our capital structure.

I am pleased with our performance this quarter and what we have accomplished so far as it reflects the continued execution of our strategic priorities following the Segregated Account exit from rehabilitation in the first quarter of 2018.

Turning now to our active risk remediation activities for the quarter.

Our insured portfolio decreased by 5.2%, or \$3 billion, to \$56 billion as of June 30, down from \$60 billion as of March 31st, and our Adversely Classified and Watch List Credits were down 5.5% to \$23.1 billion from \$24.4 billion at March 31.

During the quarter, Ambac's derisking activities included:

- First the proactive termination of 11 adversely classified RMBS transactions, reducing net par exposure by \$284 million and
- The successful de-risking of a number of municipal finance exposures eliminating approximately \$133 million of net par exposure, including \$33 million of adversely classified net par exposure.

In addition, we also advanced transactions during the quarter that closed in July after quarter end, the impact of which will be reflected in our results next quarter, including:

- First, a student loan commutation transaction that will reduce our Adversely Classified Credits for Q3 by \$127 million;



Second Quarter 2018 Earnings Transcript

- And second, the refinancing of a European transaction that takes Ambac completely off risk and will reduce our ACC and Watch List credits by approximately \$30 million

Our focus on Watch List and Adversely Classified Credits has accelerated the overall de-risking of the insured portfolio, which will reduce long-term volatility, and, over time, improve the quality of our book value and adjusted book value.

Moving now to litigation, we sought to improve our position in appeal in the Bank of America/Countrywide litigations, and although the Court of Appeals ruled against us, we remain confident in the strength of our case and we are fully prepared to go to trial on our put-back and fraud claims. A trial date for our main case has been scheduled for February 25, 2019 and a hearing on certain pre-trial motions has been scheduled for the end of September. With the most recent appeals behind us we are now focused on aggressively progressing our case to trial in New York State Supreme Court.

Separately, following a litigation settlement with certain military housing parties, we successfully closed out the last remaining objection to the Second Amended Plan for the exit from rehabilitation of AAC's Segregated Account, putting an official end to the rehabilitation proceedings.

And finally, as it relates to Puerto Rico, we are pleased to see encouraging signs of economic stability and positive momentum as the Commonwealth continues to recover from the impact of Hurricane Maria. Improving consumer confidence and business sentiment, along with federal aid and private insurance funds, have resulted in a revival of economic activity. The steady rebound is a testament to the resiliency of the people of Puerto Rico and evidence that things on a macro-level are finally moving in the right direction.

Against this backdrop, the Oversight Board and other parties have publicly disclosed ongoing efforts to reach restructuring agreements with various creditors. While Ambac cannot comment on confidential negotiations, we continue to believe long-term, consensual solutions that stabilize Puerto Rico's financial profile, capital market access and ability to provide for its residents is in the best interest of all stakeholders.

To maintain the current positive trajectory and sustain an economic revival over the long-term, it will be critical that all stakeholders, especially the Rosselló administration and the Oversight Board, work together to achieve the best possible outcome for the people of Puerto Rico. Intergovernmental litigation is a wasteful use of time, energy and taxpayer money that will lead to sub-optimal outcomes.

There needs to be a much greater degree of goodwill and cooperation between Puerto Rican elected officials and the Oversight Board, not only to achieve their structural and spending reforms in the fiscal plan, but also to restore growth and opportunity to the people and businesses of Puerto Rico.

The Commonwealth's fiscal plan, budget and economic and disaster recovery plan will all be critical in this regard. However, the Commonwealth's fiscal plan and budget continue to lack transparency regarding data, assumptions and definitions, making reconciliation and due diligence difficult.

To ensure an effective process during the ongoing restructuring and recovery effort, Ambac looks forward to continued federal involvement and oversight.



Second Quarter 2018 Earnings Transcript

As we reflect on our significant achievements for the first half of the year, including the exit from rehabilitation, significant risk remediation transactions, governance changes and the recently completed AMPS transaction, we remain focused on our long-term strategic goals of creating long-term sustainable value for our shareholders.

We continue to take a measured and disciplined approach in analyzing opportunities to deploy capital whether it be in Ambac-issued or insured securities or 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.

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.

For the second quarter of 2018, Ambac reported net income of \$4.0 million, or \$0.09 per diluted share compared to net income of \$306 million, or \$6.70 per diluted share, for the first quarter of 2018. Adjusted Earnings in the second quarter were \$36 million, or \$0.78 per diluted share, compared to Adjusted Earnings of \$330 million, or \$7.22 per diluted share in the first quarter.

Compared to the first quarter, our second quarter results reflect higher losses incurred, higher interest expense, lower investment income and lower derivative gains, partially offset by higher realized investment gains and lower operating expenses. Much of this variability related to the execution of the rehabilitation exit transactions during the first quarter of 2018, and the resulting changes to our financial position, which became more apparent during the second quarter.

Consequently, I will focus today's prepared remarks on the main drivers of our second quarter results.

The Segregated Account Rehabilitation exit transactions had a meaningful impact on the size and composition of the investment portfolio, as well as the pace of recognition of discount accretion on AAC-insured RMBS. These transactions were the principal drivers to a decline in second quarter investment income, which amounted to \$67 million, a \$44 million or 39% decline from \$110 million, for the first quarter of 2018.

Included in second quarter net investment income were gains on invested assets, classified as trading, of \$3.6 million compared to losses of \$(1.6) million in the first quarter of 2018. The improved performance was driven mostly by the favorable performance of equity markets on investments at Ambac UK.

Net realized gains for the second quarter totaled \$47 million as compared to \$5 million in the first quarter. The principal source of these gains were the sale of Ambac-insured RMBS securities. The sales were executed in connection with our longer-term plans to re-balance the investment portfolio and to simplify our capital structure. Sales included securities held as collateral against our RMBS re-securitization, which was fully repaid by quarter end, and positions held as collateral against the Ambac Note which were paid down by \$113 million. These sales were executed at spreads well below the cost of funding for both pieces of debt.

In addition to reducing annual interest expense by about \$2.8 million, the repayment of the RMBS Securitization of \$61 million freed up about \$186 million of cash and securities held as collateral, providing us with additional flexibility.



Second Quarter 2018 Earnings Transcript

Losses and loss expenses incurred were \$33 million for the second quarter of 2018, compared to a benefit of \$247 million for the first quarter. Losses incurred in the second quarter were driven by Military Housing loss expenses and additions to Puerto Rico and AUK loss reserves, partially offset by the impact of de-risking transactions and credit improvements in RMBS, and to a lesser degree other sectors, including student loans. The benefit in the first quarter included \$288 million of discount captured on Deferred Amounts as a result of the rehabilitation exit transactions.

More specifically:

- The RMBS benefit of \$ 26 million, was driven by a \$10 million benefit from the termination of 11 RMBS transactions during the quarter as well as improved collateral performance. These improvements were partially offset by a \$17 million reduction in our estimate of Representation and Warranty recoveries, driven mostly by positive transaction performance, and additions to our LAE reserves.
- Loss and loss expenses in the first quarter of 2018 were driven by the negative impact of interest rates on excess spread and loss expenses incurred.
- Public Finance incurred losses were \$44 million compared to a benefit of \$11 million for the first quarter 2018. The second quarter losses were due to the Military Housing litigation settlement and modifications in assumptions in the analysis of our Puerto Rico reserves. The benefit in the first quarter was primarily due to an increase in discount rates partially offset by additions to Puerto Rico reserves
- Ambac UK-incurred losses of \$24 million were primarily as a result of \$17 million of foreign exchange rate movements and some adverse development related to higher interest rates on one of AUK's remaining adversely classified credits.
- Other benefits were \$10 million in the second quarter related to our remediation efforts on various transactions, including with regards to student loans

Our macro hedge produced gains of \$9 million in the second quarter compared to \$26 million in the first quarter. As forward interest rates increased during the quarter, albeit at a lower level than in the first quarter, the macro hedge continued to serve as an effective partial hedge against the impact of rising rates in our insured portfolio.

Second quarter operating expenses were \$26 million, a decrease of \$10 million or 28% from the first quarter. The decrease was due to nearly \$12 million of lower expenses relating to the rehabilitation exit transactions and regulatory oversight costs, and \$3 million related to the timing of certain compensation costs. These improvements were partially offset by approximately \$2.5 million of expenses related to the AMPS exchange transaction, and \$2.4 million of performance based compensation related to the rehabilitation exit transactions.

Going forward, for at least the near-term, OCI advisory fees are expected to run approximately \$600k per quarter.

As noted previously, we remain focused on reducing our core operating expenses, but likely will experience volatility quarter-to-quarter associated with normal course operations and various other events, such as is the case of the AMPS transaction.

Interest expense for the second quarter of 2018 increased \$14 million to \$62 million from \$48 million in the first quarter of 2018. The increase resulted from a full quarter's worth of expense related to the new debt issued in the first quarter in connection with the rehabilitation exit transactions, specifically the Ambac Note and the Tier 2 Notes. Interest on the new debt accounted for \$46.5 million or 75% of second quarter interest expense with legacy surplus notes accounting for the majority of the remainder.



Second Quarter 2018 Earnings Transcript

In addition to redeeming in full the RMBS securitization and a portion of the Ambac Note, our capital management activity for the quarter included agreeing to terms on the AMPS transaction, as Claude mentioned.

These transactions, particularly the AMPS transaction, progressed our objective of simplifying our capital structure and economically de-leveraging our balance sheet. The AMPS transaction, which closed on August 3rd, resulted in the capture of \$252 million of discount (on a fair value basis) compared to the liquidation preference of the AMPS and a reduction of the outstanding consolidated liquidation preference from over \$660 million to only \$103 million. This was accomplished through the issuance of approximately \$286 million fair value of surplus notes (including accrued interest), the payment of \$11 million of cash, and the issuance of approximately \$8 million in fair value of warrants.

As the AMPS were carried on the balance sheet at fair value at the time Ambac emerged from bankruptcy, we will realize an \$83 million reduction to Net income attributable to common shareholders in the third quarter of 2018 and a reduction to Total Ambac Financial Group, Inc. stockholders' equity and adjusted book value of approximately \$75 million.

Total comprehensive income for the second quarter was a loss of \$49 million resulting in stockholders' equity at June 30, 2018 of \$1.8 billion, or \$39.70 per share - down \$45 million and \$1.00 per share from March 31, 2018.

Adjusted Book Value was \$1.4 billion, or \$30.84 per share at June 30, 2018, \$33 million or \$0.72 per share lower than at March 31, 2018.

The decline in book value and adjusted book value was a result of the impact of unrealized foreign exchange losses related to the 6% depreciation in the British pound relative to the USD. Volatility of the pound in the near term is expected to continue as uncertainty related to Brexit continues.

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

Claude LeBlanc, Chief Executive Officer

Thanks David.

We have had a busy first half of the year and as we move into the second half of 2018 we will continue to strive to execute on our strategic priorities to create additional sustainable value for our shareholders

We are optimistic about our future and remain keenly focused on taking concrete steps to create long-term value for our shareholders. Thank you for joining us today. I will now turn the call back to the operator.

Operator

Thank you. The floor is now open for questions. If you would like to ask a question please press *1 on your telephone keypad at this time. 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 star keys. Once again that is *1 to register questions at this time.

Our first question is coming from Andrew Gadlin of Odeon Capital Group. Please go ahead.



Second Quarter 2018 Earnings Transcript

Andrew Gadlin, Odeon Capital Group

Hi good morning. I was wondering if you could talk about last night's COFINA deal and the language there regarding monolines that new bonds could be issued in trusts-secured custody receipts structure. What would that mean potentially? For Ambac.

Claude LeBlanc, Chief Executive Officer

Good morning, Andrew. Thanks for your question. As we noted in our opening remarks we are restricted in disclosing information surrounding the settlement, as a result of the mediation confidentiality. But I think there have been a number of structures involving custodial receipts that have been done in other like municipal finance bankruptcies in the past, so I could refer you to those. We can reference you to the information that was published by the FOMB but really can't speak more to it than what's in that document.

Andrew Gadlin, Odeon Capital Group

Were any of those other structures, did any of them involve monolines? Could we understand whether this would effectively defease your exposure?

Claude LeBlanc, Chief Executive Officer

I can't really comment on those aspects and I think, again, depending on the structures, the actual economics and flow of securities and cash have been treated differently. But there are examples if you look back at Jefferson County, Detroit, amongst other restructurings that you can get a sense of the types of structures that have been used in the past.

Andrew Gadlin, Odeon Capital Group

Ok thanks. And then, good progress on running off some of the watchlist securities. Can you talk about some of the efforts underway in terms of is the focus across the board or are you more focused right now on military housing, student loans, etc.?

Claude LeBlanc, Chief Executive Officer

I think it's a blend of things. We certainly have an across-the-board focus to bring down our overall and watchlist and ACC exposures but we do target certain, what I'll call, heightened exposures. We also look at things opportunistically obviously so I think it's a broad coverage and obviously strategies behind our approach in each case so we don't discuss the details there, but we are, as we've indicated, very heavily focused on these credits for our de-risking activities. And military housing will certainly be in the mix but it's really the full spectrum of credits in those categories.

Andrew Gadlin, Odeon Capital Group

Ok thanks. And then can you discuss the circumstances around the deferral of tolling payments coming from AAC to the Hold Co? Any idea when that could be lifted and what sort of triggers OCI is looking for there?

Claude LeBlanc, Chief Executive Officer

They have not indicated any triggers. I think the OCI has, there've been so many transactions, we just exited rehab, or the AAC Segregated Account exited rehab, we have been involved in the AMPS transaction, so I think there's a volume issue I think that they're working through, and they've indicated that they would like more time to review the tolling payment before it's paid. So, we're just waiting to hear back from them. They may request additional information. We don't know at this time.

Andrew Gadlin, Odeon Capital Group

And no sense on timing, I'll take it?



Second Quarter 2018 Earnings Transcript

Claude LeBlanc, Chief Executive Officer

No specific sense on timing at this point. The payment was due in May so it's obviously past the payment date and they requested that we withhold the payment so, again, we're patiently waiting and we'll be working with them to address any questions and allow them to complete the review.

Andrew Gadlin, Odeon Capital Group

Ok. Thank you very much.

Claude LeBlanc, Chief Executive Officer

Thank you.

Operator

Thank you. Once again if you do have a question please press *1 on your telephone keypad at this time. Our next question is coming from Sean Lobo of Vulcan Capital. Please go ahead.

Sean Lobo, Vulcan Capital

Hi guys. Good morning. Congrats on getting the AMPS deal done. From an administrative perspective, have those securities been distributed to holders of the AMPS yet or is that still in progress?

David Trick, Chief Financial Officer

The new securities including the warrants and the surplus notes have been distributed as of August 3rd.

Sean Lobo, Vulcan Capital

August third. Ok. Gotcha. Great looking quarter. That's all I have. Thanks a lot.

Claude LeBlanc, Chief Executive Officer

Thank you.

Operator

Once again that is *1 to register any questions at this time. One moment please while we pause for additional questions. Our next question is a follow-up coming from Andrew Gadlin of Odeon Capital. Please go ahead.

Andrew Gadlin, Odeon Capital

Thanks very much. One follow up. It looks like AFG sold some of its surplus notes this quarter. Is that right?

David Trick, Chief Financial Officer

That's right. Just a few million dollars.

Andrew Gadlin, Odeon Capital

Can you talk about that decision and what drove that?

David Trick, Chief Financial Officer

Yeah I think we've commented in the past. You know, we're, at the holding company, certainly, we're managing capital against a couple different goals, one of which of course is the return on investment of that capital at the holding company but we're also trying to balance liquidity against various different strategic objectives we have at AFG. And so we had an opportunity to sell the securities at what we thought was a reasonable price and so we took the opportunity to generate some cash at the holding company.



Second Quarter 2018 Earnings Transcript

Andrew Gadlin, Odeon Capital

Ok. Thank you very much.

Operator

Thank you. Our next question is coming from Ed Gushing of Height Capital. Please go ahead.

Ed Groshans, Height Capital

Good morning and thank you for taking my questions. Just first you mentioned loss and loss adjustment expense relative to Puerto Rico. Was it more the settlement with COFINA that resulted in some of the adjustments or were there other factors that led to the loss and loss adjustment expansion for your Puerto Rico exposure?

David Trick, Chief Financial Officer

It's a multitude of factors and I wouldn't say it's specific to any discussions going on with COFINA. It's a holistic approach that we take to assessing the cost of future remediation activities and, certainly, time and effort spent around COFINA factors into that but it's generally just a forward looking view of what our future costs may be and I wouldn't point to any one specific thing as the driver to that.

Ed Groshans, Height Capital

Ok but COFINA is one of, you know, relative to your other exposures, outsized, right?

David Trick, Chief Financial Officer

That's right but I would not say that the LAE expenses are necessarily like a loss reserve would be, tied directly to the particular size of an exposure. It's more tied sometimes to the complexity of the exposure, the time with which we think a remediation effort may take, and other factors that are not necessarily purely the size.

Ed Groshans, Height Capital

All right, thank you for that. And on previous calls you started talking about new business activities and a new focus for Ambac, going forward moving away from bond insurance. Could you just give us an update on those activities?

Claude LeBlanc, Chief Executive Officer

Sure. As we've indicated, that is a component of our overall strategy. Our core strategy remains on the de-risking the portfolio, capital management, expense management. We have started working towards looking at new business activities and are active in that process but we've also indicated that it's not something we're going to rush into, it's going to be a very disciplined approach and we will update the market as things progress. So we have nothing substantial to update this quarter but we will continue our efforts and update the market in due course.

Ed Groshans, Height Capital

Ok. Does the completion of the rehabilitation, accelerate, is probably not the right word, but, quicken the process towards looking at those different opportunities?

Claude LeBlanc, Chief Executive Officer

Yeah I think there's a number of things that, you know, the AMPS transaction, the rehab, resolution of COFINA if and when that is completed. I think all these things certainly help in terms of allowing us to re-prioritize time on those efforts but I would say that everything's happening and moving in parallel and we're focusing on all these initiatives together but clearly the flexibility of having some of these items behind us are a benefit.



Second Quarter 2018 Earnings Transcript

Ed Groshans, Height Capital

Ok great I appreciate that. Thank you very much.

Claude LeBlanc, Chief Financial Officer

Sure.

Operator

Thank you. 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.