First Quarter 2019 Earnings Transcript

Operator

Greetings and welcome to the Ambac Financial Group Inc. first 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 first 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 quarterly or 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. During the first quarter we continued to make tremendous progress on the active de-risking of our insured portfolio, reducing our insured net par by over $2.5 billion - of which more than half was driven by our active de-risking strategy of Adversely Classified and Watch List Credits.

This represents a further 5.2% decline in our overall insured portfolio in the quarter, following the significant 25% reductions achieved in 2018.

The reduction in net par outstanding for the first quarter of 2019 includes the impact of one of our most successful de-risking efforts, the execution and implementation of the COFINA Plan of Adjustment, which became effective on February 12, 2019.

During the first quarter, the COFINA Plan of Adjustment, along with the associated commutations and subsequent distributions from the related trust, reduced our net par exposure to COFINA by 77%, or $620 million.

As a result, our COFINA net par decreased from $805 million as of December 31, 2018, to $185 million as of March 31, 2019, and our overall Puerto Rico net par exposure decreased from $1.9 billion to $1.3 billion over the same period.

In a few minutes, David will provide us with more details on the overall impact of the COFINA restructuring and the effects on our financial results this quarter.

In addition to the COFINA restructuring, there were many other significant de-risking transactions executed, including

- One, the execution of a commutation of an Adversely Classified public finance transaction which reduced net par exposure by $350 million;
- Two, negotiations that led to the refunding of bonds associated with two Watch List asset backed lease securitizations, which reduced net par exposure by $95 million; and
- Three, the final pay down of a Watch List aircraft securitization transaction which reduced net par by $77 million as a result of a previously negotiated remediation agreement.

In addition, following the end of the quarter, we successfully negotiated a lock-up agreement with bondholders and subsequently launched an Irish law “Scheme of Arrangement” in connection with the proposed restructuring and commutation of one of Ambac UK’s largest exposures, a $900 million insurance securitization. While no assurance can be given as to the outcome of the court process, if successfully completed, we anticipate that this transaction could close sometime during the second or third quarter of this year.

Collectively, these results illustrate our steadfast focus on reducing long-tail risk in our insured portfolio by utilizing various strategies to address risk factors that have or may result in material future losses to the company.

We are very pleased with the momentum created by our ongoing de-risking achievements and we are optimistic about our ability to continue progressing and executing this key component of our overall strategy.

Turning now to our review of our remaining Puerto Rico exposure. Overall, we continue to be encouraged by the continued signs of macroeconomic improvements for the Commonwealth.

The unemployment rate in March was 8.8%, one of the lowest unemployment rates in Puerto Rico going back at least 55 years. Private sector employment during March 2019 reached its highest level since 2015, growing year-over-year by 4%.

We are hopeful that this sustained economic momentum will eventually lead to a substantial revision to the financial projections in the Commonwealth Fiscal Plan.

Unfortunately, the Oversight Board approved a certified Fiscal Plan for the Commonwealth yesterday that revised projections for certain inputs, such as slower federal disaster aid rollout, and included updates to fiscal priorities, but remained unadjusted to correct for many of the deficiencies long recognized and identified by stakeholders.

As we have expressed in the past, we believe the Fiscal Plan is deeply flawed and the projected annual budget surplus/deficits – especially in the long term – do not accurately reflect the real potential future fiscal position and debt capacity of the Commonwealth government.

A credible Commonwealth Fiscal Plan is critical to developing consensual debt restructurings that properly respect the rights and expectations of investors and other creditors as well as the current and future needs of Puerto Rico.

Another area of increasing concern relates to the possible corruption in Puerto Rico and the long-term impact that this may have on the Commonwealth's ability to regain access to capital markets.

Over the last few weeks, federal and local authorities have been investigating possible corruption within different areas of the Puerto Rico government. There have also been high levels of mid-term turnover of Puerto Rico agency heads and Governor Rossello's cabinet Secretaries, now at least 40 people and counting.

President Trump and the U.S. Senate need to act quickly to nominate and confirm the current members of the Oversight Board not only to maintain the momentum around consensual debt restructurings but also to ensure proper oversight of the Commonwealth and its fiscal framework. Federal action is critical to ensuring a high level of local government transparency, accountability and stability over the long-term.

As the situation in Puerto Rico evolves, there remains many challenges that need to be addressed given uncertainties relating to incomplete restructuring processes and various unresolved political and legal issues.

Switching now to our loss recovery efforts. Oral arguments were heard by the appellate court on May 2nd in our main RMBS litigation case against Bank of America and Countrywide. We are awaiting the court's decision so that this case can progress towards the confirmation of a trial date. While there are many unknowns at this moment - such as the timing and outcome of the issues heard on appeal and the trial court's schedule - we are hopeful that the trial and this case will occur late this year or early next year.

Turning now, to our continued efforts to improve the effectiveness and efficiency of our operating platform. During the quarter, we continued to evaluate and implement changes in operational areas that will provide greater efficiencies and over time lower our overall operating expense run rate. One example of this was a signing of a new lease for office space for our US headquarters at One World Trade. Our move is planned for later this summer and will provide Ambac with several benefits including the consolidation of our New York office space, material economic rent savings and increased operational flexibility.

With regards to new business initiatives, we continue to actively progress our evaluation of opportunities. We are pursuing strategies that we believe will optimize our business model, diversify our platform and drive long-term value to our shareholders. As we have previously stated, all capital allocation assessments will continue to be measured against the return of capital to our shareholders.

In closing, we are off to a very strong start in 2019 and we remain optimistic about our ability to continue progressing our strategy to deliver long-term value for our shareholders.

I would now like to turn the call over to David Trick to discuss our financial results in more detail. David

David Trick, Chief Financial Officer

Thank you Claude and good morning to everyone.

During the first quarter of 2019, Ambac incurred a net loss of $43 million or $0.94 per diluted share, compared to a net loss of $20 million or $0.45 per diluted share in the fourth quarter of 2018. First quarter Adjusted Loss was $9 million, or $0.20 per diluted share compared to Adjusted Earnings of $11 million, or $0.24 per diluted share in the fourth quarter.

Relative to the fourth quarter, our first quarter results reflect the strengthening of public finance loss reserves and lower realized investment gains, partially offset by higher investment income, lower derivative losses, and higher VIE income.

More specifically, premiums earned were $28 million during the first quarter versus $29 million during the fourth quarter. Normal earned premiums decreased by about $1 million to $16 million or 5% due to the continued reduction of the insured portfolio, including the cede of $1.5 billion of net par exposure in 4Q 2018.

Accelerated premiums of $12 million in the first quarter of 2019 were driven by active de-risking, primarily related to the COFINA Plan of Adjustment.

Investment income for the first quarter was $55 million, a $17 million increase from $37 million for the fourth quarter of 2018.

During the first quarter, the investment portfolio benefited from the rebound in the equity and credit markets, generating a $19 million favorable swing from the fourth quarter.

Net realized investment gains of $17 million for the first quarter were primarily driven by the conversion of our investment in AAC insured COFINA bonds into cash and new un-insured COFINA bonds, in connection with the closing of the COFINA Plan of Adjustment, and opportunistic COFINA bond sales.

Related to the COFINA Plan of Adjustment, Ambac-insured senior COFINA bondholders, who elected not to commute their bonds under the associated Ambac policy, received units issued by a trust, into which were deposited their Ambac-insured COFINA bonds, along with a ratable distribution of cash paid by COFINA, and new COFINA bonds, which will offset a portion of Ambac's remaining COFINA insurance liability over time.

This trust was determined to be a variable interest entity and was consolidated in Ambac's GAAP financial statements during the first quarter. In connection with the consolidation, a gain of $14.9 million was recognized as income from VIEs. The gain represents the difference between the net carrying value of liabilities under insurance accounting and the fair value of the net liabilities of the trust. $274.2 million of assets and $335.3 million of liabilities were consolidated related to the COFINA trust.

Loss and loss expense reserves incurred were $12 million in the first quarter, compared to a benefit of $42 million in the fourth quarter. The change was mostly due to the strengthening of Public Finance reserves partially offset by favorable development in the RMBS, Student Loan, Ambac UK and other credit portfolios.

Loss and loss expenses in the Public Finance portfolio in the first quarter were $69 million, which were primarily due to the strengthening of reserves for our non-COFINA Puerto Rico exposures.

The first quarter benefit in the RMBS portfolio of $39 million was the result of credit improvements and the impact of lower interest rates on excess spread, partially offset by higher loss expenses.

Favorable development in Ambac UK, student loans and other exposures collectively produced a benefit of $18 million in the first quarter, as a result of positive credit developments, lower interest rates and foreign exchange gains.

Net losses on derivative contracts were $(16) million for the first quarter and $(45) million for the fourth quarter, both due to declines in forward interest rates. The fourth quarter also included a $4 million counterparty credit adjustment.

Interest rate derivative losses in the first quarter were more than offset by approximately $54 million of gains recognized in the insured and investment portfolios driven by forward interest rate movements.

As it relates to expenses, first quarter operating expenses were $25 million, an increase of $4 million from the fourth quarter. This increase was mostly due to higher cyclical costs related to incentive compensation, including equity grants and payroll taxes.

Every first quarter we experience an increase in compensation expense as equity grants made mostly in connection with our short-term incentive program, are expensed upon grant as compared to cash bonuses which are accrued for throughout the year.

Non-compensation expenses were $10.3 million for the first quarter, up slightly from $9.7 million in the fourth quarter due mostly to incremental spend on advisors partially offset by reduced core operating expenses.

As a reminder, I noted last quarter that we will experience higher rent expense in 2019 despite materially lower economic or actual rent payments associated with our upcoming headquarters move and consolidation.

While we remain focused on reducing our core operating expenses, but as noted previously and experienced this quarter, we do expect that there will be volatility quarter to quarter related to the nature of our operations and the pursuit of our strategic priorities.

Turning briefly to the balance sheet. Shareholder's equity increased $0.51 to $35.63 per share at March 31, 2019, due mostly to unrealized investment portfolio gains of $56 million and translation gains of nearly $15 million primarily related to Ambac UK, and partially offset by the net loss of the quarter.

On an absolute basis, Adjusted Book Value increased modestly to $1,253 million at March 31, 2019 from $1,251 million at year end 2018. The increase was related to changes in foreign exchange rates and the impact of lower interest rates on the value of expected installment premiums, partially offset by the first quarter Adjusted Loss. Adjusted Book Value on a per share basis declined $0.06 to $27.52 per share at March 31, 2019.

Despite the modest decline in Adjusted Book Value per share, we believe the quality of Adjusted Book Value increased materially during the quarter as the net $1.1 billion decline in Adversely Classified and Watch List Credits translated to eliminating approximately $24 per share of higher risk exposure.

On a stand-alone basis, as of March 31, 2019, AFG held cash, investments and receivables of approximately $469 million or $10.35 per share.

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

Claude LeBlanc, Chief Executive Officer

Thank you, David.

The results of this quarter reflect our ongoing commitment to execute on strategies that we believe will deliver long-term value to our shareholders. We would like to thank our long-term value driven shareholders for your continued support. Operator, please open the call 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 that are 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
Hi. Good morning. Claude, you mentioned in your prepared remarks you discussed the Ballantyne restructuring transaction which is in process, could you give us any more information on the magnitude of the benefit that could be realized from successful completion of that deal.

Claude LeBlanc, Chief Executive Officer
Sure, let me pass that one to David.

David Trick, Chief Financial Officer
Andrew sure, I can't give you too many specifics in part because the transaction is still a live transaction and is subject to several matters before it actually becomes official and could close. The biggest one of course, being as we disclosed in the 10Q, approval by the court in Ireland that has jurisdiction over the transaction, but we do highlight and provide some details in the 10Q, I believe it's on page 48 for everyone who would like to take a look at some of the details that we do disclose. We do make reference there to the fact that the transaction, if it does close, will have a significant impact on our AUK reserves, and we do disclose the fact that our gross AUK reserves are about $285 million. So if the transaction does close, of course AUK will have to make some payments in order to affect what is effectively a commutation. So that will reduce those reserves and in addition to that, it will have a positive economic effect, so another portion or significant portion of the reserves will be reduced by hopefully what will effectively be a gain on the transaction. And, it will have effects throughout other parts of the income statement, so to the extent of the gain, our UK subsidiary is a tax payer, so there will be some tax effects as well. There will be some effects on our intangible amortization, there will be effects on accelerated premiums and there will be some effects on expenses with regards to success fees that we have related to advisors who are assisting on the transaction. So there will be a number of

effects, but the way we describe it in the 10Q I think is a fair description which will be that'll be significant in a positive way.

Andrew Gadlin, Odeon Capital Group
Got it, thanks very much. Last quarter we were discussing the Citigroup SEC settlement and you were hopeful that we would know more by this time. That certainly fits with the disclosures and statements that have been made to the court, but there's been nothing filed recently. Do you have any idea what's holding that up and when we might know more?

Claude LeBlanc, Chief Executive Officer
Unfortunately, we have not heard too much more from the SEC. We, as we reported last quarter there has been a delay we understand relating to the federal shutdown that took place at the beginning of the year, which may still be causing challenges in processing through some of these decisions but, we remain optimistic that it is progressing and hope to hear back from the SEC in the coming months.

Andrew Gadlin, Odeon Capital Group
Okay, thank you. And then final question, regarding the tolling payments from AAC to Holdco., including the ones that I think was about $37 or so million last year, that was retained by AAC do you have any update or any thoughts on when we might get more information the release of those tolling payments?

Claude LeBlanc, Chief Executive Officer
It's something that we continue to be in active discussions with the regulator, as you know we had a change in commissioner and also a reintegration of Ambac with the general staff at the OCI in the last year so, I believe we're making significant progress and I believe significant risk reductions which we've implemented. They're still analyzing that and a number of other transactions that we have completed but we remain optimistic that will be released at some point in the not to distant future.

Andrew Gadlin, Odeon Capital Group
Okay thank you very much.

Operator
Thank you. Our next question comes from the line of Derek Pilecki with Gator capital. Please proceed with your question.

Derek Pilecki, Gator Capital
Thank you. I was wondering if you could some more clarity about your thoughts of the Countrywide trial date being set? When do you expect a ruling from the appellate court? When do you expect the trial judge to set the trial date?

Claude LeBlanc, Chief Executive Officer
Thanks Derek. So I think we had the oral arguments last week, we believe they went very well for Ambac. I think the feedback we've been receiving in trying to analyze timing surrounds the nature, number and complexity of some of the arguments that could take some time for review by the first department. So I think at this point it's difficult to assess the exact timing but I think the guidance

suggests it could be a number of months. It's hard to put book ends around that, but we believe, hopefully sometime by the late summer, or early fall, we should get to a point where there should be a decision issued, if not sooner, and it could be much sooner. That is the timing of the arguments and decisions that we're currently assuming or estimating, and with that, given the approach and demeanor of Judge Sherwood, who clearly wanted to progress the case quickly, we remain optimistic, obviously depending on his schedule, that he will be looking to a trial date as soon as decisions are reached by the appellate court. So our timing still remains on a base case that we're optimistic that possibly either later sometime this year or early next year, we could have a trial date set.

Derek Pilecki, Gator Capital
Moving on to Puerto Rico reserves, I was surprised there was an addition to reserves this quarter, especially given the improvement in the economy in Puerto Rico and the settlement of the COFINA deal. Could you give more clarity what the thinking is there?

Claude LeBlanc, Chief Executive Officer
Sure. At a high level you know I think the economy you're right is improving, and we note that and that's clearly a positive. I think on the negative, what we're seeing, which is a myriad of things, but the significant litigation that has been launched by parties in the last number of months in addition to the status of the oversight board and the decisions surrounding the appointments clause, also the corruption that seems to be continuing and prevalent in Puerto Rico. A number of these factors are leading us to reexamine the assumptions in our models based on the timing of expected resolutions of Puerto Rico matters. So those are some of the factors that drove consideration around losses and again a lot of this is timing. There is also interest rate movements which affected the loss reserves amongst others. I should also point out though that part of the reserve increase on the municipal side went beyond simply Puerto Rico. There was also loss reserves that were increased or established relating to instrumentalities tied to the events of the California wildfires of late last year that were also part of the adverse development. I don't know David if you want to add anything to that.

David Trick, Chief Financial Officer
No. I think that covers it.

Derek Pilecki, Gator Capital
In the release, it said that you sold your COFINA bonds. Could you just talk strategically what the thought process there was in it? How do you think you had a place at all the value there or would they have been a good long-term holding? Have you redeployed the money into other assets?

David Trick, Chief Financial Officer
Sure. So we didn't sell all of the COFINA bonds that were part of the, as we call them COFINA 2.0 collateral that came in based on the AAC insured bonds we owned. So we still are long about $220 million or so of fair value of COFINA bonds and the rest were sold. You know, the thinking behind that was that we were involved in a de-risking transaction from COFINA and therefore we wanted to de-risk and so on a net basis of course, while we were still long some of the new bonds, we have materially reduced our exposure to COFINA. We saw a good value for the bonds, or what we thought was good value for the bonds, and we continue to see that the bonds we hold continue to show good value and

good liquidity. Other than the taxable bonds, which we'll probably be sitting on longer than the residual tax-exempts that we own as we await some rulings form the IRS with regards to their tax status. So some of the cash has been redeployed, we are evaluating and discussing that now in terms of how to redeploy the remainder of the cash.

Derek Pilecki, Gator Capital
Great. And last question David, could you just update us on total claims paid in Puerto Rico and if you have any assumed recovery of those monies on the balance sheet?

David Trick, Chief Financial Officer
We do have assumed recoveries in the balance sheet. We paid something of the magnitude of $25 or $30 million in the first quarter with regards to Puerto Rico claims. We have another additional payment coming up in the latter part of July which is about $80 million or so. So we do continue to re-evaluate those balances on the balance sheet. As Claude has eluded to in his comments, part of the shift in value of the loss reserves of the quarter relate to the timing. Part of that of course is the timing of recoveries we have booked on the balance sheet as well, but we have not gone as far as to disclose the specific gross payments and gross recoveries that we have on the balance sheet. I think that would be a little more detail than we usually go into and cause probably a lot of confusion, but none the less, our aggregate claims paid to date in Puerto Rico is about $424 million.

Derek Pilecki, Gator Capital
Great thank you.

Operator
Thank you. Our next question comes from the line of Charles Post with Sterling Grace. Please proceed with your question.

Charles Post, Sterling Grace Municipal Securities
I was wondering if you could update us on the percentage of rum bonds you own now. I see a dollar amount there but for two categories so just for you to provide the percentage.

David Trick, Chief Financial Officer
Sure, that's unchanged, we didn't buy any additional bonds in the first quarter so that's about 38% of insured bonds that we own.

Charles Post, Sterling Grace Municipal Securities
Thank you. And then on the junior surplus notes, do you guys still own those?

David Trick, Chief Financial Officer
The junior, you mean at our holding company at AFG?

Charles Post, Sterling Grace Municipal Securities
Yeah

David Trick, Chief Financial Officer
No. We monetized those a few quarters back.

Charles Post, Sterling Grace Municipal Securities
Ok. So that you said about $75 million so that's just totally gone now?

David Trick, Chief Financial Officer
Yes, correct. Those are gone.

Charles Post, Sterling Grace Municipal Securities
Ok great. Thank you.

David Trick, Chief Financial Officer
Sure.

Operator
Thank you. There are no further questions at this time. This concludes today's teleconference. Thank you for your participation. You may disconnect your lines at this time and have a wonderful day.