First Quarter 2021 Earnings Teleconference Transcript

Operator
Greetings and welcome to the Ambac Financial Group Inc. first quarter 2021 earnings call. At this time all participant lines are placed 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 2021 financial results.

We'd like to remind you that today's presentation may contain forward-looking statements about our business, including but not limited to: new business, credit outlook, market conditions, credit spreads, financial ratings, loss reserves, loss mitigation, loss recovery, investment returns, or other items that may affect our future results. These statements 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 us on today's call.

This morning, Ambac reported net income of $17 million or $0.08 per diluted share and Adjusted Earnings of $41 million or $0.59 per diluted share for the first quarter. At March 31, our Book Value was $1.1 billion, or $23.02 per share, and Adjusted Book Value was $908 million, or $19.66 per share.

Our first quarter results were positively impacted by material progress on our strategic priorities, including gains of $37 million realized from our junior surplus note transactions and the inclusion of operating results from our new MGU platform, Xchange. We also regained significant de-risking momentum during the quarter and materially progressed our specialty property and casualty insurance strategy.

Starting with a review of our de-risking activities, net par exposure was $31.4 billion at March 31, down 7 percent from year-end, and watchlist and adversely classified credits were $12 billion at March 31, down 8 percent from December 31st.

Active de-risking transactions accounted for 56 percent of the total decline in net par exposure for the quarter. Notable transactions completed during the quarter included:

- One – the execution of a material reinsurance transaction for certain public finance credits, with net par outstanding of approximately $823 million. Par ceded included general obligation, lease and tax-backed revenue, higher education and transportation exposures, as well as $158 million of watch list and adversely classified credits.

- Two – the successful exit of our Mets Queens baseball stadium exposure, a $540mm adversely classified credit, via the refinancing and quota share reinsurance transaction.

- And lastly, the negotiation of additional credit and liquidity improvements for AUK's largest COVID-affected exposure.

The US economy is experiencing a strong recovery year to date, with US GDP expected to have grown at an annualized rate of approximately 9 percent in the first quarter.

Higher retail sales, increased manufacturing output, and government stimulus, including the $1.9 trillion American Rescue Plan Act, with $350 billion slated for state and local governments, together with other fiscal and monetary stimulus in 2020 are driving the strong economic recovery.

Additional stimulus could come from the American Jobs Plan and $1.5 trillion projected in discretionary spending in the US budget for 2022.

Given these strong economic conditions we remain cautiously optimistic about the outlook for our insured portfolio which we believe will continue to improve particularly as vaccination rates continue to increase.

Turning now to Puerto Rico.

As reported on May 5, the Oversight Board has reached a Plan Support Agreement with Assured Guaranty and MBIA amongst other creditors.

This agreement impacts two of our revenue bond exposures, HTA and CCDA. However, the agreement does not include PRIFA, our largest remaining Puerto Rico exposure.

Ambac is not a signatory to the Plan Support Agreement, however we continue to believe that a consensual negotiated settlement, leading to a global resolution of Puerto Rico's bankruptcy, is in the best interests of the Commonwealth.

Barring such a settlement, Ambac will continue to pursue all of its legal rights and remedies to arrive at a resolution that respects the property rights and security interests of revenue bondholders. We are firmly of the opinion that Puerto Rico has ample debt paying capacity to structure a reasonable outcome on revenue bonds.

This can be achieved in a way that would not impinge on the Commonwealth's ability to flourish economically and to serve its residents who have had to suffer through this lengthy and costly bankruptcy process.

Regarding our loss recovery efforts, our fraud appeal in our main case against Bank of America/Countrywide was argued in April and we expect a decision from the First Department within the next couple of months. We are preparing to go to trial with or without our fraud case.

Assuming no change or developments that could impact the timing or nature of our case, we hope that Justice Robert Reed, recently appointed to our case, will schedule a trial date for the second half of this year or early 2022.

With regards to our capital management initiatives, during the quarter, we executed a note exchange transaction, resulting in the acquisition of all outstanding junior surplus notes in exchange for the issuance of surplus notes. This resulted in the extinguishment of $76 million in debt and accrued interest. David will speak to these transactions in more detail in a moment.

Turning now to our new business initiatives at AFG. The P&C industry continues to report healthy rate increases, and we expect pricing will continue to outpace estimated loss cost trends, leading to improved underwriting margins.

We believe that the improvements in combined ratios across the industry present a tremendous opportunity to generate strong risk adjusted returns as we rapidly progress the ramp up of Everspan and our P&C specialty business.

Everspan Group has made significant progress following its launch in February. Our license expansion initiatives for Everspan Insurance, our specialty admitted carrier, has progressed materially and Everspan now has full P&C authority in 26 jurisdictions.

Everspan Indemnity, our surplus lines carrier, is authorized for excess & surplus lines in all 50 states and is whitelisted in a majority of the states that maintain a registry.

I am also pleased to report that Everspan's first program was recently launched with Cardigan General Insurance Services, a subsidiary of Venbrook Group and a nationally recognized managing general agency that focuses on specialty programs and services.

We are very excited about the Everspan - Cardigan partnership which will allow Cardigan to enhance their specialty transportation product offering and diversify their state footprint. Our first program was also backed by a strong and highly rated reinsurance panel.

Our management team's expertise and collaborative deal structuring approach has been positively received in the market.

Everspan has a significant number of submissions under active review, and we expect that continued favorable market conditions will provide a robust program pipeline for Everspan in the coming quarters.

We also exploring a number of strategic initiatives, including the potential acquisition of additional shell carriers, to support Everspan's short and long-term objectives.

Turning now to Xchange. The acquisition of Xchange under Pillar 2, which encompasses fee-based MGA and MGU businesses, was accretive to our first quarter results and we are pleased with our team's performance during the quarter.

With strong renewals on its Employer Stop Loss business and growing revenue generation in its Affinity business, Xchange is well positioned for growth in the coming quarters.

Consistent with its strategy, the team is pursuing opportunities for product diversification and expansion of its strong panel of insurance carrier relationships, as well as opportunities to develop additional revenue sources.

We are also actively exploring opportunities to grow the MGA/MGU Program Manager business via additional acquisitions and/or partnerships, as well as the establishment of de novo monoline MGAs in targeted specialty P&C lines of business.

With regards to Pillar 3 we continue to actively explore various investment opportunities in businesses which are complementary to our Pillars 1 and 2 strategies.

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

David Trick, Chief Financial Officer
Thank you, Claude, and good morning everyone.

For the first quarter of 2021, Ambac reported Net Income of $17 million or $0.08 per diluted share. This compares to a Net Loss of $14 million or $0.31 per diluted share in the fourth quarter of 2020.

Adjusted Earnings for the first quarter were $41 million, or $0.59 per diluted share, compared to Adjusted Earnings of $4 million, or $0.08 per diluted share in the fourth quarter. The variance between adjusted earnings and GAAP net income relates mostly to the exclusion of insurance intangible amortization, which amounted to $19 million in the first quarter.

Our first quarter results reflect the advancement of a number of our strategic initiatives, most notably our continued efforts to simplify and deleverage our capital structure. To that end, we executed two transactions which combined resulted in all junior surplus notes being extinguished in exchange for surplus notes, a GAAP gain from extinguishment of debt of $33 million and a net realized investment gain of $4 million.

In addition, our first quarter results were favorably impacted by the inclusion of Xchange's results for the first time, continued strong results from our investment diversification strategy and gains on interest rate derivatives, partially offset by incremental reserves taken on Puerto Rico.

Briefly turning to some more specifics – premiums earned were $14 million in the first quarter compared to $18 million during the fourth quarter. The decrease in the first quarter was driven by lower accelerated premiums as a result of the proactive de-risking of an international credit which produced $6 million of accelerated premium in the fourth quarter 2020, partially offset by an increase in normal earned premiums as a result of a reduction in the allowance of premiums receivable in the first quarter.

Although down slightly, investment income remained strong at $49 million, compared to $53 million in the fourth quarter. Performance was led by continued solid results in equities and hedge funds partially offset by losses from emerging markets debt and lower income from the Corolla trust certificates. AFG sold the Corolla trust certificates in exchange for AAC issued surplus notes as part of the junior surplus note exchange.

Included in first quarter investment income were gains on pooled funds of $27 million and income from available-for-sale securities of $22 million, compared to $31 million and $23 million in the fourth quarter, respectively.

Investments in pooled funds had a total return of 4.6 percent for the first quarter compared to 5.8 percent in the fourth quarter.

Other income of $5 million for the first quarter included commission revenue from Xchange of $7 million, partially offset by foreign exchange losses and certain expenses related to consolidated VIEs.

Loss and loss expenses incurred were $8 million in the first quarter compared to $9 million in the fourth quarter.

Domestic Public Finance losses incurred were $9 million stemming from increased Puerto Rico reserves related to the recent developments which Claude just discussed, partially offset by the benefit of higher discount rates. The benefit of $7 million in the fourth quarter reflected the favorable impact of higher discount rates and positive credit developments in general, resulting from the active management of the insured book, partially offset by an increase in Puerto Rico reserves.

Operating expenses were $33 million, up from $26 million in the fourth quarter. The increase was driven by the inclusion of Xchange's commissions to sub-producers and operating costs, costs related to the junior surplus notes exchange, and seasonal compensation costs.

While operating expenses increased this quarter, the increase, including non-recurring costs, was primarily driven by the inclusion of Xchange and the advancement of other strategic objectives all of which will generate both near term and long-term value. Nevertheless, we remain focused on prudently managing expenses across the entirety of the Ambac platform.

Turning to the balance sheet. As a result of the exchange transactions which eliminated all outstanding junior surplus notes and related accrued interest, AAC issued $279 million par of surplus notes with associated accrued interest of $183 million, lowering its debt and outstanding interest by $76 million. Out of this issuance, AFG received surplus notes of $40 million par with $26 million of accrued interest, which are eliminated in consolidation, in exchange for its equity investment in the Corolla Trust.

The exchange transactions were beneficial to both AAC and AFG in several ways.

For AAC, the exchange lowered AAC's outstanding debt and accrued interest by $76 million with no cash outlay and reduced its annual interest expense by approximately $4 million, further simplified the capital structure and reduced the duration of outstanding debt.

And for AFG, the surplus notes received in the exchange improved liquidity relative to the investment in Corolla equity, exceeded on a fair value basis the carrying value of the Corolla equity, and have an expected duration shorter than the corolla equity. Through its investment in AAC, AFG is also the residual beneficiary of the deleveraging of AAC.

During the first quarter, we also early redeemed another $16 million of the AAC secured notes mostly through the sale of a portion of the securities collateral at market levels below the cost of the secured debt.

Shareholder's equity decreased $(0.55) per share to $23.02 per share, or approximately $1.1 billion at March 31st, 2021. The decrease was due net unrealized losses on securities of $24 million, and a $13 million increase to the redemption value of Xchange's noncontrolling interest, partially offset by net income of $17 million and $6 million of foreign exchange translation gains.

Adjusted Book Value decreased to $908 million or $19.66 per share at March 31st, 2021, from $919 million or $20.05 per share at December 31, 2020.

This $0.39 decrease was driven by the $13 million increase to the redemption value of Xchange's noncontrolling interest, and the impact on expected future premiums from the reinsurance transaction and the Mets Queens Ballpark de-risking, partially offset by $41 million of Adjusted Earnings. Unlike book value, adjusted book value is not impacted by changes in unrealized gains and losses.

AFG on a stand-alone basis, excluding investments in subsidiaries, as of March 31, 2021, had cash, investments and net receivables of approximately $274 million, or $5.94 per share, including approximately $155 million of liquid assets.

The decrease in assets of $92 million, or $2.05 per share from December 31st was mostly related to the capitalization of Everspan.

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

Claude LeBlanc, Chief Executive Officer
Thank you, David. I am very pleased with our accomplishments during the first quarter of 2021. We remain focused on all of our strategic priorities and expect our momentum to continue as we progress our efforts in the coming quarters. 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 using speaker equipment, it may be necessary to pick up your handset before pressing the * key. One moment please while we poll for your questions.

Once again ladies and gentlemen, to join the question queue please press *1 on your telephone keypad. Thank you. Our first question comes from the line of Giuliano Bologna with Compass Point. Please proceed with your question.

Giuliano Bologna, Compass Point
Good morning. I think it'd be interesting to touch on some of the developments, obviously getting deals on the Puerto Rico side is positive. So, when we look at the loss reserves and the losses, every methodology kind of in the first quarter, is anything related to those -- are the new announced transactions included in this scenario analysis that you're using for the first quarter or is that rolled in during the second quarter?

David Trick, Chief Financial Officer
Hi, Giuliano. It's David Trick. Thanks for the question. No, we fully incorporated everything we learned through, I think it was the announcement on May 5, into our reserving process. And as you may recall, we were scheduled to release earnings on Thursday, but given the announcement that came out, we wanted to fully analyze and consider, that's why we delayed earnings to today. So, we incorporated everything into our scenario analysis that we know of as of and through May 5.

Giuliano Bologna, Compass Point
That sounds good. And then thinking about the March litigation and kind of the primary and case that's out there against Countrywide, are there any big milestones in terms of hearings or anything coming up in the near term that we should potentially be focused on there?

Claude LeBlanc, Chief Executive Officer
So, at this point, we're just waiting to hear back from the First Department on our appeal of the fraud case. And we expect that will come through, hopefully in the next – it could be as soon as the next week or two, or could take a few months. And then following that, we're hoping that we'll have the opportunity to meet with Justice Reed to establish a trial date, which we hope could be as early as later this year or early 2022.

Giuliano Bologna, Compass Point
So, that sounds very good. And then one final one, just thinking about, so the holding companies have liquidity and liquid assets. Is there any plan in terms of, how you want to manage that? Obviously you're

looking for more expansion and potentially more transactions on that side to keep adding new business lines or is there -- are there other uses of capital internally where you may need to capitalize some again for the business lines that you're building out? Or how do you think about the excess, beyond that?

David Trick, Chief Financial Officer
Sure, Giuliano. A couple of things. I think you touched really on most of it. There are other transactions or let's call it external transactions that we're looking at as we've talked about regularly. And in addition to that, we're looking at potential other, sort of de novo transactions, particularly in sort of Pillar II sector. But you know, in terms of Everspan, I think Everspan is pretty well capitalized at this point. There is some sort of capitalization and I should say operating investments we may make there. But I think from a Everspan standpoint, we're set. So, it's really those other types of transactions, de novo, start-up opportunities and potential other third-party acquisitions that we would be looking to allocate capital towards in the future.

Giuliano Bologna, Compass Point
That sounds good. I appreciate it. And I'll jump back in the queue.

Claude LeBlanc, Chief Executive Officer
Thanks, Giuliano.

Operator
Thank you. There are no further questions at this time. This concludes today's conference.
We thank you for participating. You may now disconnect your lines. Thank you.