Operator

Greetings, and welcome to the Ambac Financial Group, Inc. Second Quarter 2021 Earnings Call. (Operator Instructions) As a reminder, this conference call is being recorded.

It is my pleasure to introduce your host, 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 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 outlooks, market conditions, credit spreads, financial ratings, loss reserves, loss mitigation, loss recoveries, 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 reports under Management's Discussion and Analysis of Financial Condition and Results of Operation and under Risk Factors. Ambac is not under any obligation and expressly disclaims any obligation to update any forward-looking statement whether as a result of new information, future events or otherwise.

Today's presentation contains non-GAAP financial measures. The reconciliations of such measures to the most comparable GAAP figures are included in our earnings press release, which is available on our website at ambac.com.

Please note that presentations have been posted to the Events and Presentations section of our IR website which support our comments today.

I would now like to turn the call over to Mr. Claude LeBlanc.

Claude LeBlanc – Chief Executive Officer

Thank you, Lisa, and welcome to everyone joining us on today's call.

Since our last earnings call we made material progress on our key strategic priorities leading to the further stabilization of our legacy insurance platforms and the advancement of our new specialty P&C insurance business. Major developments for the quarter include:

- First: Ambac's endorsement of Puerto Rico's plan support agreements which paves the way towards a resolution of all of our Puerto Rico exposures

- Second: The continued reduction in the net par of our insured portfolio and significant de-risking of Watchlist and Adversely Classified Credits
- Third: The launch of a senior secured note offering which successfully closed post quarter-end providing us with enhanced financial flexibility at a lower carry;
- Fourth: The strong market receptivity to Everspan's launch, driving a robust pipeline of specialty program submissions;
- And finally, as announced earlier this week, the addition of a new director to our holding company Board, Ms. Lisa Iglesias

I am very pleased to welcome Lisa who was appointed to the AFG and AAC boards as of August 4th. Lisa brings with her a wealth of insurance industry experience, which will broaden our Board's market and industry competencies as we continue to progress our strategic priorities.

We also announced the departure of Alex Greene, a member of our Board since 2015. Alex has been a valued Board member and it has been my sincere pleasure to work with him. His insight, dedication, and guidance throughout his tenure on the Board have been invaluable. I would like to thank Alex for his tremendous contributions to Ambac and wish him the very best in his future endeavors.

Turning now to our second quarter review.

Ambac reported a net loss of $29 million or $0.63 per diluted share and adjusted loss of $13 million or $0.30 per diluted share for the second quarter. At June 30, 2021 our Book Value was approximately $1.1 billion, or $23.01 per share, and Adjusted Book Value was $889 million, or $19.25 per share. David will discuss our financial results in more detail in a moment.

Looking at our insured portfolio net par exposure was $30 billion at June 30th, down 4 percent from March 31st. More importantly, Ambac's watchlist and adversely classified credits were reduced to $11 billion at June 30th, down 8 percent from last quarter. Over $600 million of the decrease in net par exposure was tied to our proactive de-risking efforts including the partial commutation of an infrastructure credit and the reinsurance of a structured insurance credit.

Moving now to Puerto Rico. On July 27th, Ambac reached a settlement on our insured PRIFA Rum Tax exposure. We also became a party to agreements for our GO, PBA, HTA and CCDA exposures that were previously entered into by Puerto Rico's Oversight Board and other major creditors. This is a significant achievement for Ambac following years of effort to arrive at a holistic, consensual agreement with Puerto Rico's Oversight Board.

Settlement consideration for our PRIFA exposure is comprised of 3 components:

1. Cash
2. A contingent value instrument or "CVI" tied to the future financial performance of Puerto Rico's sales and use tax; This CVI instrument is the same one being offered for the other revenue bond instrumentalities and
3. A second CVI tied to future collections of Puerto Rico's rum tax.

We refer to the two CVIs as a “double-barreled” arrangement because, together, they constitute an enhanced and diversified cash flow recovery when the Commonwealth receives excess rum tax collections, as opposed to the single sales and use tax CVI for the other revenue bonds.

While the value of these instruments is subject to credit, market and other risks, as Puerto Rico emerges from bankruptcy and its government and economy stabilizes, we believe the double-barreled CVI structure will provide enhanced recoveries for our PRIFA bonds.

With Ambac and FGIC joining the other financial guarantors, Puerto Rico is now much closer to exiting bankruptcy with broad consensual creditor support for the Commonwealth’s proposed plan of adjustment. A confirmation hearing has been scheduled to begin on November 8th of this year with a possible effective date sometime late in the fourth quarter or sometime during the first quarter of 2022.

We will have greater visibility regarding the ultimate impact of the settlement for Ambac in the coming quarters as the bankruptcy process moves forward. The net impact of our settlement had a negligible effect on our aggregate Puerto Rico net reserve estimates for the quarter.

On the litigation front, our team continues to prepare for trial on our contract claim against Bank of America/Countrywide and as we previously stated we are eager to get a trial date scheduled as soon as possible.

Turning now to the management of our capital structure. Immediately post quarter end, we closed on a senior secured debt offering, effectively refinancing our current senior secured notes. We seized the opportunity to take advantage of favorable market conditions and extend the term of the current note from 2023 to 2026. While we certainly do not expect our main RMBS litigation to last until 2026, we believe it was prudent to extend the tenor of the notes to provide Ambac enhanced financial flexibility. David will provide additional details about the debt refinancing in a moment.

Turning now to our new business initiatives at AFG. The P&C industry continues to report healthy rate increases, in most classes of business, and we believe that pricing will continue to outpace estimated loss cost trends in the near to medium term, leading to improved underwriting margins.

Everspan Group, our specialty P&C insurance platform, has made significant progress following its launch in February. Everspan Insurance, our admitted carrier, now has full P&C authority in 40 jurisdictions.

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

Everspan’s first program with Cardigan, related to Non-Emergency Medical Transport, began writing insurance coverage in May.

Since its launch, Everspan has seen a robust program pipeline with submissions across various classes of business and distribution sources.

The Everspan team anticipates launching additional programs in the third quarter.

To further build out Everspan Group we have filed Form A's for several additional shell carriers to add to our platform. These Form A's are pending regulatory approval and we hope to close on the acquisitions as early as the fourth quarter.

The addition of these shells will support a diverse portfolio of programs and minimize the chance that our business partners encounter channel conflicts.

Turning to Pillar 2 of our specialty program insurance strategy, which encompasses fee-based MGA and MGU businesses including Xchange.

Xchange continues to perform well in the current environment and our outlook remains favorable. The team at Xchange is actively exploring opportunities to broaden its carrier network and distribution channels.

We remain active in sourcing additional opportunities to grow Pillar 2 through further acquisitions and de novo start-ups.

Turning to Pillar 3. During the quarter, the holding company made minority investments in certain insurance related businesses, including insurtech platforms, that we believe will be synergistic to our specialty property & casualty program insurance and MGA/MGU businesses.

I am excited about the progress we have made to date on our specialty program insurance platform and we see significant opportunities ahead to advance our strategy.

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

David Trick – Chief Financial Officer

Thank you, Claude --- and good morning everyone.

For the second quarter of 2021, Ambac reported a Net Loss of $29 million, or $0.63 per diluted share, compared to Net Income of $17 million, or $0.08 per diluted share, in the first quarter of 2021.

Adjusted loss for the second quarter was $13 million, or $0.30 per diluted share, compared to adjusted earnings of $41 million, or $0.59 per diluted share in the first quarter. The difference between adjusted earnings and GAAP net income for the second quarter relates mostly to the exclusion of $13 million of insurance intangible amortization from the Adjusted Loss.

Compared to the first quarter, which included a $37 million gain from the Corolla and junior surplus note exchanges, second quarter results included favorable loss development which produced an incurred benefit, partially offset by interest rate derivative losses, and an increase in the provision for deferred taxes.

Briefly turning to some highlights...

Premiums earned were $11 million in the second quarter compared to $14 million during the first quarter. The decrease was driven by a smaller reduction in the allowance for premiums receivable and the continued run-off of the insurance portfolio.

Investment income for the second quarter was $42 million, down approximately $7 million from $49 million in the first quarter. The decrease was due to lower, but still strong, results from pooled, mostly alternative, investments. The total return on pooled funds was approximately 3.1% in the second quarter vs. 4.6% in the first quarter. The yield on the remainder of the portfolio was relatively unchanged on a slightly smaller base.

Second quarter pooled fund income totaled $20 million and income from available-for-sale securities totaled $22 million, compared to $27 million and $22 million in the first quarter, respectively.

Other Income, which includes commission revenue earned from Xchange and Everspan program fees, was $7 million for the second quarter compared to $5 million in the first quarter.

Loss and loss expenses were a benefit of $26 million in the second quarter compared to an expense of $8 million in the first quarter.

Positive development in the insured structured finance portfolio generated a benefit of $16 million in the second quarter driven by improved credit factors and the positive impact of lower interest rates on excess spread, partially offset by the negative impact of lower discount rates and incremental loss expense costs.

The Public Finance insured portfolio also experienced positive development, resulting in an $11 million benefit, driven by an improved outlook on certain COVID exposed credits and a military housing project, partially offset by incremental loss expense costs and lower discount rates. The signing of plan support agreements related to our remaining exposure to Puerto Rico had a negligible impact on our Puerto Rico reserves, which continue to represent the vast majority of our public finance reserves. Domestic Public Finance losses incurred of $9 million in the first quarter were driven by increased Puerto Rico reserves partially offset by the benefit of higher discount rates.

Net losses on derivative contracts, which are positioned as a partial economic hedge against interest rate exposure in the financial guarantee and investment portfolios, of $11 million for the second quarter compared to gains of $25 million for the first quarter were driven by lower forward interest rates. Counterparty credit adjustments on uncollateralized derivative assets contributed about $3 million to the second quarter loss while contributing $9 million of gains in first quarter.

Operating expenses were $28 million, down from $33 million in the first quarter. The second quarter decrease was mostly due to cyclical and non-recurring costs incurred in the first quarter, including seasonal compensation costs and expenses related to the Corolla and junior surplus notes exchanges.

Notably, consolidated expenses also include expenses of Xchange Benefits, which we acquired at year end 2020, and Everspan, which continues to ramp up its platform. Collectively these items accounted for approximately 27% of consolidated expenses.

The provision for income taxes was $11 million in the second quarter compared to only $2 million in the first quarter. The increase related to a higher provision for deferred taxes resulting from the UK enactment of a tax increase from 19% to 25% effective April 1, 2023.

Turning to the balance sheet…

In July, Ambac Assurance, through a newly formed VIE, issued One Billion, one hundred seventy five million ($1,175 million) par amount of LIBOR plus 4.5% senior secured notes due 2026. These notes are secured by the first $1.4 billion in RMBS litigation proceeds and the capital stock of Ambac UK. Proceeds of the offering of One Billion, one hundred sixty three million ($1,163 million), along with other temporary sources of liquidity, were used to fully redeem the outstanding balance of the LSNI notes.

As Claude stated, we don't expect our RMBS litigation to extend to 2026 but given the lack of certainty as to the timing of our RMBS trials, and favorable market conditions, we believe it was prudent to refinance our senior secured notes which allowed us to reduce our cost of carry and increase our financial flexibility.

Shareholder's equity was effectively flat compared to the end of the first quarter at $23.01 per share, or $1.1 billion at June 30, 2021; the second quarter net loss of $29 million was materially offset by an increase in unrealized gains on securities of $26 million.

Adjusted Book Value decreased to $889 million or $19.25 per share at June 30, 2021, from $908 million or $19.66 per share at March 31, 2021.

This $0.41 decrease was driven by the Adjusted Loss, net of earned premium. Unlike book value, ABV is not impacted by changes in unrealized gains and losses.

At June 30th, AFG, on a stand-alone basis, excluding investments in subsidiaries, had cash, investments and net receivables of approximately $281 million, or $6.08 per share, including approximately $149 million of liquid assets.

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 second quarter and believe we have developed strong momentum going into the second half of the year that will help drive our growth strategy and position our platform for success in the future.

This completes our prepared remarks. I will turn the call back to the operator and open the call for questions.

Operator

(Operator Instructions) Our first question is from Frank Liguori a private investor.

Frank Liguori – Private Investor

Well, Claude, as it relates to Puerto Rico, are we saying that after all is said and done, whenever it's confirmed, the bulk of all of the reserves that are on the books will be needed?

Claude LeBlanc – Chief Executive Officer

So, at this point, what we're saying is that we believe we're adequately reserved for Puerto Rico as to the actual reserve numbers at the effective date of the plan. That will depend on a number of factors relating to the value of the consideration that is being put forward in the plan for each of the instrumentalities. And obviously, there's some significant complexities relating to some of these securities, different plans, all of them have cash, I guess, some have bonds.

And then CVI, SUT CVIs in the case of HTA, CCDA and, the GOs. And in the case of PRIFA, separate CVI related to rum tax collection. So, as we get more information in progressing the plan and clarification of some of the terms of these securities, we will have a better view in terms of the ultimate realization, which could result in adjustments to the reserves. But at this point, we believe we're adequately reserved based on all the information that we have at the present time.

Frank Liguori – Private Investor

Also, just one more question, if I may. As it relates to the major litigation, I see that the new notes are secured by the first $1.4 billion or so of any settlement. Now as we all know and have all experienced litigation can be a very fickle thing, and it seems to be in our case, so we can't get the litigation. It's been years and years. But assuming if, that happens, we got an awfully big bet on litigation. Has anyone, any judge or anyone in the process suggested arbitration to short circuit what could be a lengthy and expensive trial and maybe get a quicker resolution?

Claude LeBlanc – Chief Executive Officer

Yes. I think you're right. I mean this has been going on for some time, and we can't really comment on any nature of discussions we have had in the past or currently. But I think your assumption that judges would typically suggest arbitration, and at various points in time try to resolve things, is on point. Obviously, our approach has been to look for settlement if appropriate, at the appropriate levels. And I think we view ourselves as being commercial individuals that we would look for settlement if it was available.

History has shown that oftentimes these things do wait until getting close to trial before they settle, which is why we've been pressing aggressively to get to trial and are hopeful that potentially later this year or early next year, we will be there.

Operator

Our next question is from Giuliano Bologna with Compass Point.

Giuliano Bologna – Compass Point

I guess moving on to a slightly different topic, somewhat on the capital management side. You've obviously taken a lot of initiatives when it comes to effectively rolling up the Corolla Trust and the junior surplus notes and now on the secured note side of the platform. I'd be curious looking forward if there are any opportunities on the surplus note side, given that, that will become the perimeter or the larger security over time in your

debt cap stack? And if there are any opportunities there either whether it be buying some of them back or trying to figure out a way to settle those out over time?

David Trick – Chief Financial Officer

Giuliano, thanks. I think we've commented on this in the past, and we do think there are opportunities. We are clearly opportunistic when it comes to managing the capital stack and it is one of our stated strategic priorities to continue to simplify our capital structure. When we start getting into discussions around specific transactions, but not really an area we want to go too deeply into. But I will say when it comes to surplus notes, it does get more complex.

There are obviously regulatory capital issues that come into play there. Their regulatory approvals that come into play and in context of the multiple initiatives ongoing with regards to litigation, and Puerto Rico is also capital management, liquidity considerations that we have to focus on. So, we are definitely focused on it, but I can't really specifically say that there is a particular transaction coming or what that may look like other than that's something we're focused on, but certainly more complex when it gets to surplus notes.

Giuliano Bologna – Compass Point

That makes sense. And obviously, much bigger kind of capital consideration. But I'd be curious, and this is more of a technicality question, but are there any restrictions on your ability to buy those securities or separate from the element or what you may or may not want?. Are there any major restrictions, obviously, outside of capital consideration?

David Trick – Chief Financial Officer

Yes. We do have some capacity, I'll call it, limited capacity beyond which we would be required to get regulatory approval.

Operator

This does conclude our question-and-answer session, and this also concludes today's teleconference. We thank you for participating. You may disconnect your lines at this time and thank you for your participation.