

Equity Research

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Financials

Ambac Financial Group, Inc.

Agreement to Repurchase AMPS at Discount Another Step Toward Unlocking AMBC's Value

Ambac Financial Group (AMBC) took an important step in the ongoing simplification of its capital structure today after the market close in announcing that it had reached agreement with holders of approximately 89% of the Auction Market Preferred Shares (AMPS) housed at its operating subsidiary to repurchase their shares at a modest premium to their trading value but a sizeable discount to par.

- ▶ The agreement, which is contingent on approval by AMBC's Wisconsin regulator as well as other conditions, would move the company closer to the removal of a restriction to the future upstreaming of capital to its holding company to the benefit of shareholders while providing another milestone in the evolution of its equity story.
- ▶ The holders who were part of the agreement committed to tender 80%, or \$528.2mm, of the \$660.2mm aggregate liquidation preference of outstanding AMPS. Assuming that 80% of the AMPS are tendered, AMBC would capture a sizeable discount of \$217mm. That discount would grow to the extent that participation exceeds the 80% threshold.
- ▶ Assuming a participation rate of 80%, Ambac Assurance Corp. (AAC) in exchange for the tendered AMPS will provide holders with \$293.2mm in principal and interest outstanding of 5.1% senior surplus notes due 2020 that had been acquired by the subsidiary over the past few years and held in treasury. Meanwhile, AMBC will pay the holders \$10.6mm in cash and deliver to them 788,265 in warrants held in treasury to buy an equivalent amount of its stock at a strike price of \$16.67 for a total consideration of \$311.2mm, or about 59 cents on the dollar
- ▶ **Valuation:** Our \$26 price target for AMBC is based on a sum-of-the-parts analysis in which we assessed the value of AMBC's operating company, its holding company, and its adjusted operating earnings through FY19E.

AMBC

\$19.61

12 month target

\$26.00

BUY

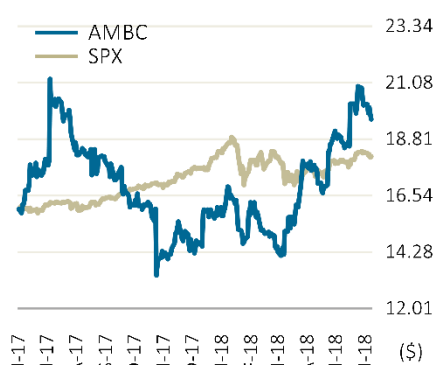
52 week range

\$13.35 - \$21.22

Market Cap (m)

\$890

Price Performance



Source: IDC

Estimates

	1Q17 A	2Q17 A	3Q17 A	4Q17 A	FY17 A	1Q18 A	2Q18 E	3Q18 E	4Q18 E	FY18 E	FY19 E
Net Income (Adj.)	(91)	70	(150)	6	(165)	330	16	16	16	379	189
Diluted EPS (Adj.)	(2.02)	1.54	(3.30)	0.12	(3.63)	7.22	0.35	0.35	0.34	8.11	3.82
Adj. BVPS	27.05	28.27	24.56	24.25	24.25	31.47	31.52	31.57	31.61	31.61	33.60

Source: BTIG Estimates and Company Documents (\$ in millions, except per share amount)

- ▶ We believe the willingness of AMBC's Wisconsin regulator to allow the company to execute on the repurchase of the AMPS just months after it received approval to have its Segregated Account exit rehabilitation would represent a very positive signal with regard to the regulator's view of the company's prospects
- ▶ We also think AMBC's move to address the AMPS prior to a potential settlement of its representation and warranty (R&W) litigation with Bank of America (BAC, Not Rated) that we view as likely to occur later this year was prudent insofar as the price of the AMPS likely would have been driven higher by the announcement of a deal.
- ▶ While AMBC's agreement with the AMPS holders reduced the company's adjusted book value (ABV) per share by \$1.59 to \$29.98, we believe that the benefits accrued by the company from the deal both in terms of economics and additional financial and strategic flexibility outweigh the modest decline in ABV per share.
- ▶ Management said the removal of the majority of the AMPS from AMBC's capital structure would address securities that had been a complicating factor in their analysis and decision-making with regard to the company's balance sheet. The deal would also remove from AAC's Articles of Incorporation the right of AMPS holders to elect AAC directors in certain circumstances.
- ▶ The conditions that must be satisfied for the transaction to be closed include approval by AMBC's Wisconsin regulator, receipt of certain tax opinions, participation by holders of at least 80% of the outstanding liquidation preference of the AMPS, and a vote in favor of the deal by at least two-thirds of the aggregate liquidation preference of the AMPS at a special meeting of Ambac Assurance Corp.'s shareholders.
- ▶ AMBC is required to launch the exchange offer to all holders of AMPS by July 13. The agreement would terminate if the repurchases have not been executed by September 7.

Income Statement

Ambac Financial Group Inc. Operating Model (\$ millions)	Dec-14 2014A	Dec-15 2015A	Mar-16 1Q16A	Jun-16 2Q16A	Sep-16 3Q16A	Dec-16 4Q16A	Dec-16 2016A	Mar-17 1Q17A	Jun-17 2Q17A	Sep-17 3Q17A	Dec-17 4Q17A	Dec-17 2017A	Mar-18 1Q18A	Jun-18 2Q18E	Sep-18 3Q18E	Dec-18 4Q18E	Dec-18 2018E	Dec-19 2019E
Net premiums earned	246.36	312.60	52.80	41.40	53.22	49.87	197.29	47.61	43.15	52.99	31.52	175.28	30.88	26.97	26.43	25.90	110.18	131.78
Net investment income	300.95	266.29	60.82	70.76	90.92	90.87	313.37	81.56	85.16	87.18	107.06	360.95	110.24	69.40	68.81	68.22	316.66	269.45
Total other than temporary impairment losses	(26.63)	(66.69)	(48.07)	(18.88)	(15.91)	(6.84)	(89.70)	(21.15)	(1.76)	(25.66)	(6.04)	(54.63)	(0.34)	-	-	-	(0.34)	-
Portion of loss recognized in other comprehensive income	0.84	41.03	38.74	11.44	13.05	4.65	67.88	17.21	-	12.15	5.09	34.45	0.04	-	-	-	0.04	-
Net other than temporary impairment losses recognized in earnings	(25.79)	(25.66)	(9.33)	(7.44)	(2.85)	(2.19)	(21.82)	(3.94)	(1.76)	(13.51)	(0.96)	(20.17)	(0.30)	-	-	-	(0.30)	-
Net realized investment gains	58.78	53.48	1.10	14.90	11.75	11.54	39.28	(4.90)	4.18	6.15	(0.07)	5.37	4.86	-	-	-	4.86	-
Change in fair value of credit derivatives:																		
Realized gains and other settlements	3.04	2.79	0.25	0.23	0.23	0.20	0.91	0.20	1.13	0.13	0.12	1.59	0.11	-	-	-	0.11	-
Unrealized gains (losses)	20.86	38.92	12.61	3.72	1.51	1.35	19.19	0.85	5.49	0.05	8.40	14.78	(0.45)	-	-	-	(0.45)	-
Net change in fair value of credit derivatives	23.91	41.70	12.87	3.96	1.73	1.55	20.11	1.05	6.62	0.18	8.52	16.37	(0.35)	-	-	-	(0.35)	-
Derivative products	(181.09)	(42.54)	(83.42)	(36.33)	(14.51)	83.99	(50.27)	(1.51)	34.07	3.98	23.03	59.57	25.54	-	-	-	25.54	-
Net unrealized gains (losses) on extinguishment of debt	(74.72)	0.08	1.24	3.59	0.02	-	4.85	2.74	2.18	-	-	4.92	3.12	-	-	-	3.12	-
Other income	12.50	7.15	8.00	6.92	2.69	(0.17)	17.45	(0.09)	0.47	0.05	(1.13)	(0.71)	(0.51)	-	-	-	(0.51)	-
Income (loss) on variable interest entities	(32.21)	31.57	(27.16)	8.99	2.06	2.03	(14.09)	3.70	(1.22)	(4.05)	21.24	19.67	0.57	-	-	-	0.57	-
Total revenues before expenses and reorganization items	328.67	644.66	16.90	106.73	145.03	237.49	506.15	126.23	172.85	132.97	189.20	621.25	174.06	96.37	95.24	94.12	459.78	401.23
Losses and loss expense	(545.57)	(768.71)	(105.28)	(52.50)	(69.20)	215.49	(11.49)	135.01	66.10	209.81	102.27	513.19	(247.40)	-	-	-	(247.40)	-
Underwriting and operating expenses	101.47	102.70	28.01	28.00	21.47	36.19	113.66	27.98	31.05	33.79	28.69	121.52	36.43	23.68	22.50	21.37	103.99	84.43
Insurance intangible amortization	151.83	169.56	50.89	39.01	44.55	40.15	174.61	37.53	33.47	45.69	34.17	150.85	28.64	28.06	27.50	26.95	111.15	102.52
Interest expense	127.48	116.53	30.43	30.71	31.49	31.71	124.34	31.57	28.23	29.15	30.99	119.94	48.07	56.42	56.42	56.42	217.33	127.68
Goodwill impairment	-	514.51	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total expenses before reorganization items	(164.79)	134.59	4.05	45.22	28.31	323.55	401.12	232.09	158.86	318.43	196.12	905.50	(134.25)	108.17	106.42	104.75	185.08	314.63
Pretax loss from continuing operations before reorganization items	493.46	510.07	12.85	61.51	116.72	(86.06)	105.03	(105.86)	13.99	(185.47)	(6.92)	(284.25)	308.31	(11.80)	(11.18)	(10.63)	274.70	86.60
Reorganization items	0.21	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Pre-tax loss from continuing operations	493.25	510.07	12.85	61.51	116.72	(86.06)	105.03	(105.86)	13.99	(185.47)	(6.92)	(284.25)	308.31	(11.80)	(11.18)	(10.63)	274.70	86.60
Provision for income taxes	9.56	17.36	3.44	3.16	15.28	8.83	30.71	19.58	6.88	5.44	12.56	44.46	2.61	-	-	-	2.61	-
Net income (loss)	483.70	492.70	9.41	58.36	101.44	(94.89)	74.32	(125.44)	7.11	(190.91)	(19.48)	(328.72)	305.70	(11.80)	(11.18)	(10.63)	272.10	86.60
Noncontrolling interests	(0.38)	(0.71)	-	(0.29)	(0.04)	(0.20)	(0.53)	-	-	-	-	-	-	-	-	-	-	-
Net income (loss) attributable to shareholders	484.07	493.41	9.41	58.65	101.47	(94.69)	74.84	(125.44)	7.11	(190.91)	(19.48)	(328.72)	305.70	(11.80)	(11.18)	(10.63)	272.10	86.60
Net loss	483.70	492.70	9.41	58.36	101.44	(94.89)	74.32	(125.44)	7.11	(190.91)	(19.48)	(328.72)	305.70	(11.80)	(11.18)	(10.63)	272.10	86.60
Unrealized gains on securities	252.60	(159.73)	59.79	48.17	24.72	(64.78)	67.90	51.34	12.65	(0.43)	(125.00)	(61.45)	-	-	-	-	-	-
Loss: reclassification adjustment for net gain	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Gain (loss) on foreign currency translation	(43.60)	(45.03)	(17.78)	(55.15)	(13.32)	(35.87)	(122.13)	12.59	29.29	24.62	-	66.51	-	-	-	-	-	-
Amortization of postretirement benefit	(0.82)	(0.69)	0.79	(0.26)	(0.25)	(0.26)	0.02	2.29	(0.34)	(0.34)	-	1.61	-	-	-	-	-	-
Total other comprehensive income net of tax	208.19	(205.44)	42.80	(7.24)	11.14	(100.91)	(54.21)	66.22	41.60	23.85	(125.00)	6.67	-	-	-	-	-	-
Total comprehensive income (loss)	691.88	287.26	52.21	51.12	112.58	(195.80)	20.11	(59.23)	48.71	(167.05)	(144.48)	(322.05)	305.70	(11.80)	(11.18)	(10.63)	272.10	86.60
Less: comprehensive income (loss) attributable to the noncontrolling interest	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net income (loss)	(0.38)	(0.71)	-	(0.29)	(0.04)	(0.20)	(0.53)	-	-	-	-	-	-	-	-	-	-	-
Currency translation adjustments	(0.43)	(0.37)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total comprehensive income (loss) attributable to Ambac financial group	692.69	288.34	52.21	51.41	112.62	(195.60)	20.64	(59.23)	48.71	(167.05)	(144.48)	(322.05)	305.70	(11.80)	(11.18)	(10.63)	272.10	86.60
Diluted EPS	\$10.31	\$10.72	\$0.21	\$1.29	\$2.22	(\$2.09)	\$1.64	(\$2.77)	\$0.16	(\$4.20)	(\$0.43)	(\$7.23)	\$6.70	(\$0.25)	(\$0.24)	(\$0.22)	\$5.83	\$1.75
Operating EPS	\$13.58	\$25.13	\$1.38	\$2.65	\$3.14	(\$0.28)	\$6.86	(\$2.02)	\$1.54	(\$3.30)	\$0.12	(\$3.63)	\$7.22	\$0.35	\$0.35	\$0.34	\$8.11	\$3.82
Common shares outstanding	45.09	45.17	45.18	45.21	45.23	45.23	45.21	45.29	45.37	45.40	45.40	45.37	45.47	46.15	46.85	47.55	46.50	49.36
Diluted shares outstanding	46.93	46.01	45.24	45.38	45.79	45.23	45.72	45.29	45.77	45.40	45.40	45.47	45.65	46.34	47.03	47.74	46.69	49.56
GAAP Book Value per Share - Diluted	\$29.81	\$37.28	\$38.56	\$39.58	\$41.70	\$37.89	\$37.89	\$35.87	\$36.57	\$33.21	\$30.42	\$30.42	\$40.41	\$40.16	\$39.92	\$39.70	\$39.70	\$41.45
Adjusted Book Value per Share - Diluted	\$7.47	\$24.70	\$29.02	\$29.88	\$32.04	\$29.44	\$29.44	\$27.05	\$28.27	\$24.56	\$24.25	\$24.25	\$31.47	\$31.52	\$31.57	\$31.61	\$31.61	\$33.60

Source: BTIG Estimates and Company Documents

BTIG Covered Companies Mentioned in this Report

AMBAC FINANCIAL GROUP, INC. (AMBC, Buy, \$26.00 PT; Current Price: \$19.61; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

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I, Mark Palmer, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

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Ambac Financial Group, Inc. (AMBC, Buy, \$26.00 PT)

Valuation: Our \$26 price target for AMBC is based on a sum-of-the-parts analysis in which we assessed the value of AMBC's operating company, its holding company, and its adjusted operating earnings through FY19E.

Risks: The primary risks to achieving our recommendation and price target include the possibility that reserves against losses associated with RMBS and other insured instruments may prove inadequate, that fiscal stress of state and local governments could translate into increased losses, declines in value of investment portfolio could impede Ambac's ability to pay its liabilities and Ambac Assurance Corp. may be unable to exit rehabilitation.

Ambac Financial Group, Inc. (AMBC)

(\$)



Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
16-May-13	23.67	31	Mark Palmer	Buy
04-Mar-14	34.49	NA	Mark Palmer	Neutral
01-Mar-17	22.35	28	Mark Palmer	Buy
11-May-17	17.18	26	Mark Palmer	Buy

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