

Equity Research

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Financials

Ambac Financial Group, Inc.

2Q18 Preliminary Results Include Long-Awaited BAC Trial Date; AMPS Repurchase Deal Clears Hurdles

While Ambac Financial Group (AMBC) in a news release last evening announced its 2Q18 preliminary results, the ranges of operating performance metrics provided were not the most meaningful takeaways. Perhaps the most significant takeaway was AMBC's disclosure that some important dates have been set with regard to its representation and warranty (R&W) litigation against Bank of America (BAC, Not Rated): a hearing on pre-trial motions is set for September 27, while the trial is scheduled to begin on February 25, 2019.

AMBC

\$20.08

12 month target

\$26.00

BUY

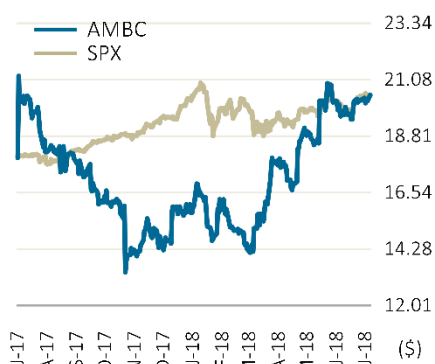
52 week range

\$13.35 - \$20.93

Market Cap (m)

\$929

Price Performance



Source: IDC

- ▶ We have noted that in prior R&W cases involving municipal bond insurers as the plaintiffs, and banks as the defendants, the serious negotiations have typically commenced following the conclusion of the summary judgment phase of the case. This phase represents a "lottery ticket" for each side in providing the potential to have the case abruptly and emphatically decided in their favor, so the sides are motivated to hear the outcome before proceeding. The summary judgment phase of AMBC's litigation against BAC/Countrywide ended on June 27 with a ruling by the New York Court of Appeals that affirmed the lower court's judgments.
- ▶ As such, we do not believe the AMBC-BAC matter will go to trial, but rather that it will be resolved in a settlement prior to the announced date and will provide AMBC with sufficient proceeds to pay down a significant amount of Ambac Assurance Corp.'s (AAC) obligations.
- ▶ Any BAC settlement amount in excess of the approximately \$1.843bn pledged to AMBC's secured notes and Tier 2 notes could be used to pay down additional secured notes, which have a coupon of Libor + 500. This would free up yet more cash flow that would accrete to AAC's value – a potential game-changer for the company and the stock.
- ▶ **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.

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	36	17	17	399	190
Diluted EPS (Adj.)	(2.02)	1.54	(3.30)	0.12	(3.63)	7.22	0.78	0.35	0.35	8.55	3.84
Adj. BVPS	27.05	28.27	24.56	24.25	24.25	31.47	31.96	32.00	32.04	32.04	34.03

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

Please Read: Important disclosures and analyst's certification appear in Appendix

- ▶ AMBC in its announcement disclosed that as of July 17, the early tender deadline for its exchange offer in which it would repurchase Auction Market Preferred Shares (AMPS) housed at its operating subsidiary at a sizable discount to par, approximately 85.7% of the aggregate liquidation preference for the outstanding AMPS had been tendered. That was above the 80% level required for the deal to be consummated. The deadline for the offer is August 1.
- ▶ AMBC also disclosed that its Wisconsin regulator yesterday provided all of the approvals required to execute the AMPS exchange offer. The deal 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.
- ▶ Assuming that 80% of the \$660.2mm aggregate liquidation preference of outstanding AMPS were tendered, AMBC would capture a sizable discount of \$217mm. That discount would grow to the extent that participation exceeds the 80% threshold.
- ▶ Management provided AMBC's preliminary 2Q18 results in ranges just as they had offered the company's preliminary 4Q17 results in February. They stated that revenue would be in a range of \$136mm to \$158mm, with the lower end of the range above the consensus estimate of \$99.2mm and our estimate of \$96.4mm.
- ▶ Meanwhile, management offered a preliminary range for 2Q18 net income that translated into earnings per share of (\$0.57) to \$0.97. The consensus estimate is \$0.43 while our estimate is \$0.78.
- ▶ AMBC stated that its financial guarantee portfolio net par outstanding declined sequentially during 2Q18 by \$3.1bn to \$56.5bn. It also disclosed that adversely classified credits decreased by 6.5% sequentially during the quarter to \$11.8bn primarily due to run-off and the termination of RMBS transactions thanks to the company's remediation efforts.

Income Statement

Ambac Financial Group Inc. Operating Model (\$ millions)	Dec-14 2014A	Dec-15 2015A	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	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	313.37	81.56	85.16	87.18	107.06	360.95	110.24	69.40	69.10	68.51	317.25	270.65
Total other than temporary impairment losses	(26.63)	(66.69)	(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	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)	(21.82)	(3.94)	(1.76)	(13.51)	(0.96)	(20.17)	(0.30)	-	-	-	(0.30)	-
Net realized investment gains	58.78	53.48	39.28	(4.90)	4.18	6.15	(0.07)	5.37	4.86	50.00	-	-	54.86	-
Change in fair value of credit derivatives:														
Realized gains and other settlements	3.04	2.79	0.91	0.20	1.13	0.13	0.12	1.59	0.11	-	-	-	0.11	-
Unrealized gains (losses)	20.86	38.92	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	20.11	1.05	6.62	0.18	8.52	16.37	(0.35)	-	-	-	(0.35)	-
Derivative products	(181.09)	(42.54)	(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	4.85	2.74	2.18	-	-	4.92	3.12	-	-	-	3.12	-
Other income	12.50	7.15	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	(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	506.15	126.23	172.85	132.97	189.20	621.25	174.06	146.37	95.53	94.41	510.37	402.42
Losses and loss expense	(545.57)	(768.71)	(11.49)	135.01	66.10	209.81	102.27	513.19	(247.40)	30.00	-	-	(217.40)	-
Underwriting and operating expenses	101.47	102.70	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	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	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	401.12	232.09	158.86	318.43	196.12	905.50	(134.25)	138.17	106.42	104.75	215.08	314.63
Pretax loss from continuing operations before reorganization items	493.46	510.07	105.03	(105.86)	13.99	(185.47)	(6.92)	(284.25)	308.31	8.20	(10.89)	(10.33)	295.29	87.79
Reorganization items	0.21	-	-	-	-	-	-	-	-	-	-	-	-	-
Pre-tax loss from continuing operations	493.25	510.07	105.03	(105.86)	13.99	(185.47)	(6.92)	(284.25)	308.31	8.20	(10.89)	(10.33)	295.29	87.79
Provision for income taxes	9.56	17.36	30.71	19.58	6.88	5.44	12.56	44.46	2.61	-	-	-	2.61	-
Net income (loss)	483.70	492.70	74.32	(125.44)	7.11	(190.91)	(19.48)	(328.72)	305.70	8.20	(10.89)	(10.33)	292.69	87.79
Noncontrolling interests	(0.38)	(0.71)	(0.53)	-	-	-	-	-	-	-	-	-	-	-
Net income (loss) attributable to shareholders	484.07	493.41	74.84	(125.44)	7.11	(190.91)	(19.48)	(328.72)	305.70	8.20	(10.89)	(10.33)	292.69	87.79
Net loss	483.70	492.70	74.32	(125.44)	7.11	(190.91)	(19.48)	(328.72)	305.70	8.20	(10.89)	(10.33)	292.69	87.79
Unrealized gains on securities	252.60	(159.73)	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)	(122.13)	12.59	29.29	24.62	-	66.51	-	(50.00)	-	-	(50.00)	-
Amortization of postretirement benefit	(0.82)	(0.69)	0.02	2.29	(0.34)	(0.34)	-	1.61	-	-	-	-	-	-
Total other comprehensive income net of tax	208.19	(205.44)	(54.21)	66.22	41.60	23.85	(125.00)	6.67	-	(50.00)	-	-	(50.00)	-
Total comprehensive income (loss)	691.88	287.26	20.11	(59.23)	48.71	(167.05)	(144.48)	(322.05)	305.70	(41.80)	(10.89)	(10.33)	242.69	87.79
Less: comprehensive income (loss) attributable to the noncontrolling interest	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net income (loss)	(0.38)	(0.71)	(0.53)	-	-	-	-	-	-	-	-	-	-	-
Currency translation adjustments	(0.43)	(0.37)	-	-	-	-	-	-	-	-	-	-	-	-
Total comprehensive income (loss) attributable to Ambac financial group	692.69	288.34	20.64	(59.23)	48.71	(167.05)	(144.48)	(322.05)	305.70	(41.80)	(10.89)	(10.33)	242.69	87.79
Diluted EPS	\$10.31	\$10.72	\$1.64	(\$2.77)	\$0.16	(\$4.20)	(\$0.43)	(\$7.23)	\$6.70	\$0.18	(\$0.23)	(\$0.22)	\$6.27	\$1.77
Operating EPS	\$13.58	\$25.13	\$6.86	(\$2.02)	\$1.54	(\$3.30)	\$0.12	(\$3.63)	\$7.22	\$0.78	\$0.35	\$0.35	\$8.55	\$3.84
Common shares outstanding	45.09	45.17	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	45.72	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	\$37.89	\$35.87	\$36.57	\$33.21	\$30.42	\$30.42	\$40.41	\$40.59	\$40.36	\$40.14	\$40.14	\$41.92
Adjusted Book Value per Share - Diluted	\$7.47	\$24.70	\$29.44	\$27.05	\$28.27	\$24.56	\$24.25	\$24.25	\$31.47	\$31.96	\$32.00	\$32.04	\$32.04	\$34.03

Source: BTIG Estimates and Company Documents

BTIG Covered Companies Mentioned in this Report

AMBAC FINANCIAL GROUP, INC. (AMBC, Buy, \$26.00 PT; Current Price: \$20.08; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

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I, Giuliano Bologna, 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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