BTIG

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Financials

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Industry Report

Financials

What We Learned About Stocks within Our Financials Coverage Universe During the 2Q18 Earnings Season

As the conclusion of the 2Q18 earnings season draws near we have been reflecting on what we learned during the past three-plus weeks with regard to the stocks within our Financials coverage universe. In general, the earnings reports that we analyzed and the conference calls to which we listened provided confirmation of our investment theses and, in many cases, further boosted our level of conviction.

Strong rallies in the growth-oriented stocks within our coverage universe have resulted in most of them being fairly valued or overvalued, in our view. In contrast, many of the value-oriented names that we cover appear attractive, with the municipal bond insurers and private mortgage insurers looking particularly inexpensive relative to their inherent values and near-term prospects.

Among our takeaways from the 2Q18 earnings season are the following:

Municipal Bond Insurers

- While the 2Q18 earnings season was a highly consequential period for municipal bond insurers Ambac Financial Group (AMBC, Buy, $26 PT), Assured Guaranty (AGO, Buy, $52 PT) and MBIA (MBI, Buy, $14 PT), most of the significant takeaways involved consequential announcements of settlements and court rulings that were almost entirely positive for the group.
- The short thesis on AMBC, AGO and MBI has been based in large part on the expectation that Puerto Rico's bonds would be crushed during its ongoing debt restructuring. The upshot would be that the insurers would incur huge losses given their significant insured exposures to Puerto Rico's debt that would prompt their regulator to block capital flows from their operating subsidiaries to their holding companies. During the past few weeks that bearish stance has become increasingly untenable, in our view.
- In particular, the announcement by Puerto Rico's government and its financial oversight board on August 8 that they had reached an agreement in principle with holders of the COFINA sales tax bonds and the insurers in which the senior bondholders would realize a recovery of 93 cents on the dollar was a game-changer.

- The oversight board for more than a year had made it clear through their refusal to negotiate with bondholders and their certification of fiscal plans providing scant funding for debt service that they were not interested in reaching consensual agreements with creditors, even though such deals had been the outcome that authors of the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) had in mind when they drafted the legislation. The Puerto Rico government under Governor Ricardo Rossello was similarly disinclined to engage with the island's creditors.

- What inspired Puerto Rico's government and the oversight board to change their stance? We believe it is likely that they had been under increasing pressure from the U.S. Congress, and Rep. Rob Bishop (R – UT) in particular, to engage in negotations with bondholders. Bishop, one of the authors of PROMESA and the Chairman of the U.S. House Committee on Natural Resources that oversees U.S. territories including Puerto Rico, had sent several letters to the oversight board noting that their actions had been counter to the plain language of the legislation. He raised the stakes on June 29 when he filed an amicus brief on behalf of AMBC with the First Circuit Court of appeals.

- Bishop's amicus brief emphasized that PROMESA was written with the protection of creditor rights in mind, a point that had been consistently ignored by the oversight board, whose actions it slams. It further criticizes the board for jumping ahead to Title III bankruptcy when the law was designed to facilitate a consensual resolution. We believe this expression of legislative intent by one of PROMESA's authors would have made it much more difficult for the oversight board to argue in court that their actions had been consistent with the requirements of the legislation, and their likely realization of this reality may have driven them to the negotiating table.

- Another factor that may have led Puerto Rico and the oversight board to finally begin to negotiate with creditors was the improvement in the Commonwealth's economy in recent months, as well as the government's growing cash position driven by increasing tax revenues. That uptick flew in the face of board members' pessimistic commentary and dire economic projections in the aftermath of Hurricane Maria. Puerto Rico's Economic Activity Index (EAI) has increased for seven straight months as government aid and insurance claim disbursements have boosted economic activity, an improvement that Puerto Rico's banks noted during their 2Q18 earnings calls.

- Moreover, the Commonwealth last announced that it collected essentially the same amount of revenue during FY18 (ended June 30) as it had in FY17, a remarkable outcome given that much of the island had been without electricity during much of the fiscal year and that economic activity had stalled during the months following the storm.

- The oversight board last June voted down a Restructuring Support Agreement (RSA) for the Puerto Rico Electric Power Authority (PREPA) that would have enabled MBI and AGO, which had $1.15bn of gross insured exposure and $853mm of net insured exposure to the utility's debt as of June 30, to achieve a par recovery. We believe a ruling by the First Circuit last week likely spurred Puerto Rico's government and the board to re-engage in negotiations with the insurers.

- The First Circuit ruled that PREPA's bondholders, as well as MBI and AGO, have the ability to refile their motion for the appointment of a receiver as a means of protecting their collateral as they are entitled to do under the utility's bond indentures. Judge Laura Taylor Swain, who is overseeing the Title III proceedings, had cited Sections 305 and 306 of PROMESA in denying the creditors' motion to have a receiver appointed, but the First Circuit overruled her interpretation.

- With the First Circuit's ruling came the realistic prospect of the appointment of a receiver at PREPA who would have the ability to raise the utility's electricity rates to generate more revenue to cover debt service. Faced with this possibility, Puerto Rico's government and oversight board should be highly motivated to negotiate with PREPA's creditors, in our view.

- If the COFINA settlement were to be consummated and a new PREPA deal is forged, the impact on the bond insurers in terms of improving their risk profiles would be dramatic. In the case of AMBC, the COFINA senior bonds represented over 77% of the total interest and principal on Puerto Rico's debt, net of reinsurance, for which it was responsible as of June 30. Meanwhile, COFINA and PREPA together represented over 71% of the total interest and principal on the Commonwealth's debt for which it was responsible as of June 30.

Private Mortgage Insurers

- The 2Q18 earnings season was a positive one for each of the five private mortgage insurers (PMIs) within our coverage universe: Essent Group (ESNT, Buy, $54 PT), MGIC Investment Corporation (MTG, Buy, $18 PT), Radian Group (RDN, Buy, $26 PT), NMI Holdings (NMIH, Buy, $26 PT) and Genworth Financial (GNW, Neutral). Each of them beat consensus earnings estimates and the tones of their conference calls were uniformly upbeat.

- With that said, the most significant takeaway from the PMI space during 2Q18 was that industry pricing had stabilized at the nicely profitable levels at which it had been prior to the enactment of U.S. tax reform last December. During the past few months, each of the insurers implemented new pricing programs that essentially pass along the windfall from tax reform to their customers. However, the concerns expressed by some industry observers that competition would drive premium rates even lower than they had been prior to reform – qualms that had weighed heavily on the PMIs' shares – have proven to be unwarranted.

- Even so, the PMIs in instituting new pricing programs have evolved toward more granular and selective approaches, with risk-based pricing and electronic delivery through pricing engines – the so-called "black boxes" – moving toward becoming the norm in the space versus the traditional rate card.

- One benefit from such an approach was highlighted by ESNT management during the company's 2Q18 earnings call after they explained that their pilot program for a "black box" approach was still ongoing and would potentially be implemented across the company's platform during 2019. Inasmuch as ESNT management believes the next recession will be regional rather than national, the "black box" approach would give the PMIs more flexibility to reduce their exposure to regions of concern.

- Another takeaway from the PMIs 2Q18 earnings reports was the lack of an impact from the GSEs' new pilot programs that offered alternatives to private mortgage insurance: Freddie Mac's (FMCC, Not Rated) IMAGIN program announced in March and Fannie Mae's (FNMA, Not Rated) EPMI program launched in July. While the announcement of IMAGIN sparked a sell-off in the PMIs' shares, the insurers each reported that they had seen no impact from either of the programs thus far, and they shared reports that the programs had very limited uptake among customers.

- MTG noted during its 2Q18 call that even if the programs were successful they would account for about 2% to 3% of the PMIs' market opportunity over the coming 12-18 months.

- The PMIs expressed little optimism that GSE reform would be enacted before the end of 2018, but they were more optimistic about the potential for the Federal Housing Administration (FHA) to move to shrink its footprint in the mortgage insurance space during 2H18 particularly given recent comments from Brian Montgomery, who was confirmed as FHA commissioner in May. Montgomery's statements strongly implied that FHA premium rate cuts that likely would boost the agency's market share are unlikely in the near term given its tenuous capital levels.

- While the PMIs' 2Q18 reports demonstrated that industry pricing has stabilized, fears of GSE encroachment appear overblown, and the prospect of a government pullback from the mortgage insurance space appears more likely, the share prices of ESNT, MTG and RDN remain well below the levels at which they traded before the pricing and GSE concerns arose. Only NMIH currently trades above the level at which it traded prior to the group's sell-off as it had rallied by almost 58% since the second week of April. As such, we believe the PMIs' share price rebound is likely to have legs.

BTIG Covered Companies Mentioned in this Report

AMBAC FINANCIAL GROUP, INC. (AMBC, Buy, $26.00 PT; Current Price: $21.87; Analyst: Mark.Palmer)
ASSURED GUARANTY LTD. (AGO, Buy, $52.00 PT; Current Price: $40.97; Analyst: Mark.Palmer)
ESSENT GROUP LTD. (ESNT, Buy, $54.00 PT; Current Price: $40.99; Analyst: Mark.Palmer)
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MBIA, INC. (MBI, Buy, $14.00 PT; Current Price: $10.76; Analyst: Mark.Palmer)
MGIC INVESTMENT CORPORATION (MTG, Buy, $18.00 PT; Current Price: $12.59; Analyst: Mark.Palmer)
RADIAN GROUP, INC. (RDN, Buy, $26.00 PT; Current Price: $19.77; Analyst: Mark.Palmer)

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