

## Equity Research

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### Mark Palmer

(212) 588-6582  
mpalmer@btig.com

### Giuliano Bologna

(212) 588-6583  
gbologna@btig.com

## Industry Report

## Financials

### Bond Insurers

#### With PREPA Restructuring Deal Off, What Will Happen Next, and What Does It Mean for MBI and AGO?

After 18 months of negotiations and the achievement of a tentative deal, the Puerto Rico Electric Power Authority (PREPA) and its creditors each announced early Saturday morning the talks had collapsed and the hard-won deal was off. So what does this mean for PREPA, for Puerto Rico's other debt issuers, and for bond insurers MBIA (MBI, Buy, \$11 PT) and Assured Guaranty (AGO, Buy, \$35 PT), which had gross insured exposure of \$1.354bn as of January 1 and net insured exposure of \$744mm as of September 30, respectively?

- ▶ Each side in the negotiations pointed at the other as the reason for the impasse. PREPA claimed that the creditors had been willing to extend the expiration of the restructuring support agreement (RSA) from Friday to February 12 to give Puerto Rico's legislature more time to pass a law enabling the restructuring, but that the Ad Hoc Group representing approximately 35% of bondholders had balked at relending the utility \$115mm in interest it had paid to them on January 1.
- ▶ PREPA said that while the deal had called for it to receive the funds to help it finance itself until the legislature approved the deal, the creditors had insisted that the \$115mm would not be paid until the Puerto Rico Electricity Commission (PREC) approved an increase in the island's electricity base rate, the deadline for which was May 23. According to an anonymous source cited by The New York Times, the creditors wanted the PREC to pass the rate increase and the securitization framework, which is a key part of the deal, by February 12.
- ▶ AGO and MBI were reported by the Times as supporting the deal under PREPA's interpretation. While the Ad Hoc Group of bondholders and the utility's fuel line lenders agreed to take a 15% haircut as part of the deal agreed to in December, the bond insurers would not take a haircut.
- ▶ So is a PREPA default inevitable now? If a couple of media reports are to be believed, that may not be the case. According to the Times article, PREPA "was still willing to keep the negotiations going." Meanwhile, Caribbean Business quoted "sources close to the negotiations" who described the creditors' move as "eleventh hour arm-twisting to pressure PREPA to guarantee that the deal would be made as quickly as possible."

- ▶ Such urgency on the part of the creditors makes sense insofar as some observers believe PREPA is incentivized to drag out the process until the U.S. Supreme Court rules on Puerto Rico's appeal of its Recovery Act, a law that created a bankruptcy-like framework for restructuring the debt of its public corporations, which are currently not eligible to file for bankruptcy protection. The act was found unconstitutional by a federal court in Puerto Rico last February, a ruling that was upheld by the U.S. Court of Appeals for the First Circuit last July. The Supreme Court is expected to hear the Commonwealth's appeal in April and to rule on the case in July.
- ▶ However, we note that if the creditors were to opt to declare that PREPA was in default, they could notify the PREPA bond trustee of such an event, a notification that could trigger a 30-day cure period for the utility. Absent a cure, the creditors could encourage the trustee to go to court and request the appointment of a receiver. As we have previously noted, the PREPA bond trustee, U.S. Bank National Association, on September 28 sent a notice to the utility warning that it that as of September 15 it had been able to send notices related to the need for cures or corrective actions, as well as enforcement actions related to defaults, without requiring a written request from the majority of principal holders. "The Trustee continues at this time to monitor and assess the negotiation process, and reserves all rights and remedies under the Trust Agreement, including, without limitation, the right to send cure notices and the right to pursue enforcement actions following an event of default," the notice stated.
- ▶ The enforcement action that would be most meaningful, in our opinion, would involve the trustee going to court to request the appointment of a receiver that would then manage PREPA, with the probable ability to raise electricity rates. As a reminder, MBI last September requested from the PREC a 4.2 cent per kilowatt hour increase in Puerto Rico's electricity base rate, an increase that the company believed would go a long way toward solving PREPA's financial difficulties and enable it to stay current on its debt service payments at least through 2016. However, the PREC rejected the request, citing a lack of supporting information. We agree that an increase in the Commonwealth's electricity base rate, while not a panacea for PREPA's heavy debt load, would ease the pressure on the utility's financial situation and would be made more palatable by the steep decline in the island's electricity prices during the past year thanks to the plunge in the price of oil, PREPA's primary fuel source.
- ▶ We believe it makes no sense for PREPA to allow the deal it struck with its creditors in December to be scuttled. Under the deal, the utility's obligations would be reduced by more than \$600mm and it would be provided with relief from debt-service obligations of almost \$800mm over a five-year period. PREPA's management and board or directors would not only lose that deal in the event that a receiver was appointed; they also would lose control of the utility. As for the theory that PREPA may be trying to stall until the Supreme Court can rule on

Puerto Rico's Recovery Act appeal, we believe the trustee could appoint a receiver well before the High Court's ruling if a default is declared soon.

- ▶ Would PREPA scuttle the deal so that Puerto Rico would have a stronger case to make to the U.S. Congress in its effort to have all of its debt-issuing entities receive the ability to file for Chapter 9 bankruptcy protection? We have heard some investors suggest as much insofar as the Commonwealth is arguing that a resolution of its debt situation would not be feasible without Chapter 9, an argument that would be undermined if PREPA achieves a consensual agreement with its creditors.
- ▶ We believe that would be a risky gambit insofar as Lisa Donahue, PREPA Chief Restructuring Officer, on January 12 told a subcommittee of the U.S. House Natural Resources Committee that "it would be in my opinion a disaster if PREPA runs out of cash ... it would be blackouts across the island." If Puerto Rico's effort to be granted Chapter 9 powers were to fail, which we believe remains the base case given the opposition of Congressional Republicans to such an approach, then PREPA would have given up an opportunity to prevent the ugly outcome that Donahue described.

## Appendix: Analyst Certification and Other Important Disclosures

### Analyst Certification

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.

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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#### Assured Guaranty Ltd. (AGO, Buy)

**Valuation:** Our \$35 price target is based on 0.65x our YE15E adjusted book value (ABV) per share of \$59.57, minus \$6.20 per share representing the estimated impact of potential losses related to AGO's insured exposure to Puerto Rico's debt.

**Risks:** The primary risk to achieving our target price include ratings downgrade risks, credit risk related to municipal bond and structured product exposures, and exposures to troubled Puerto Rico credits.

### Assured Guaranty Ltd. (AGO)



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

| Date      | Closing Price (\$) | Target Price (\$) | Analyst     | Rating  |
|-----------|--------------------|-------------------|-------------|---------|
| 05-Dec-11 | 12.23              | 35                | Mark Palmer | Buy     |
| 29-Feb-12 | 16.80              | 37                | Mark Palmer | Buy     |
| 07-Aug-12 | 11.72              | 35                | Mark Palmer | Buy     |
| 08-Aug-13 | 21.91              | 37                | Mark Palmer | Buy     |
| 07-Nov-14 | 24.53              | 39                | Mark Palmer | Buy     |
| 25-Feb-15 | 26.37              | 40                | Mark Palmer | Buy     |
| 07-May-15 | 26.11              | 41                | Mark Palmer | Buy     |
| 29-Jun-15 | 23.76              |                   | Mark Palmer | Neutral |
| 08-Jul-15 | 24.49              | 34                | Mark Palmer | Buy     |
| 05-Nov-15 | 29.47              | 35                | Mark Palmer | Buy     |

### MBIA, Inc. (MBI, Buy)

**Valuation:** Our \$11 price target on MBI is based on 50% of our estimate of the company's ABV per share of \$29.55 adjusted for estimated losses of \$6.81 per share related to the company's insured exposure to Puerto Rico's debt.

**Risks:** The primary risks to our valuation include greater than expected losses with respect to insured exposure to Puerto Rico's debt. Increased losses on the broader insured municipal portfolio. The potential negative impact of a credit rating downgrade on ability to write new business.

# MBIA, Inc. (MBI)



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

| Date      | Closing Price (\$) | Target Price (\$) | Analyst     | Rating  |
|-----------|--------------------|-------------------|-------------|---------|
| 30-Nov-11 | 9.70               | 22.50             | Mark Palmer | Buy     |
| 30-Jun-14 | 11.04              |                   | Mark Palmer | Neutral |
| 15-Aug-14 | 10.49              | 12                | Mark Palmer | Buy     |
| 12-May-15 | 9.09               | 13                | Mark Palmer | Buy     |
| 29-Jun-15 | 6.37               |                   | Mark Palmer | Neutral |
| 23-Jul-15 | 6.29               | 10                | Mark Palmer | Buy     |
| 05-Nov-15 | 8.28               | 11                | Mark Palmer | Buy     |

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