

## Equity Research

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## Financials

### MBIA, Inc.

#### "Zombie CLO" Fears Arise Again, Are Just as Unwarranted as When They First Arose in Sept. 2013

Ever since a financial blog in September 2013 suggested that MBIA (MBI, Buy, \$13 PT) faced a significant risk given its exposure to three collateralized loan obligations (CLOs) called Zohar CDO 2003-1, Zohar II 2005-1, and Zohar III, the stock has periodically come under pressure when someone highlights the potential for those "Zombie CLO" exposures to cause great harm to the company's share price.

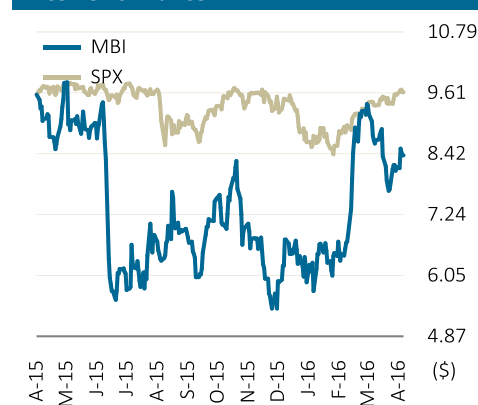
- ▶ So it is with a sense of déjà vu that we are again seeing MBI shares selling off in part due to concerns about the Zohar structures. And once again, we point out that regardless of what happens to Zohar or to MBIA Insurance Corp., the structured product insurance unit in which the CLOs are housed, **it will have no impact whatsoever on the value of MBI stock.**
- ▶ We have ascribed zero value to MBIA Insurance Corp. in calculating our \$13 price target for MBI. Importantly, in an adverse scenario in which severe Zohar-related losses were to trigger a liquidity crisis at the structured product insurance unit that resulted in its seizure by the New York State Department of Financial Services (NYSDFS), the lack of any cross default with MBI's holding company debt – **MBI removed the potential for such a cross default when it amended the indentures of its holding company debt in December 2012** – would result in no impact on the rest of the company or on our equity valuation.
- ▶ To be clear, the Zohar outcome does impact the L+11.26% surplus notes issued by MBIA Insurance Corp. as well as the credit default swaps referencing the debt at that subsidiary, but it will not impact MBI shares except insofar as investors believe misleading headlines about the situation.
- ▶ **Valuation:** Our \$13 price target on MBI is based on 50% of our estimate of the company's pro forma ABV per share of \$32.24 adjusted for estimated losses of \$5.49 per share related to its insured exposure to Puerto Rico's debt.

**MBI** **\$8.39**  
12 month target \$13.00

### BUY

52 week range \$5.41 - \$9.81  
Market Cap (m) \$1,103

#### Price Performance



Source: IDC

## Estimates

	1Q15 A	2Q15 A	3Q15 A	4Q15 A	FY15 A	1Q16 E	2Q16 E	3Q16 E	4Q16 E	FY16 E	FY17 E
Diluted EPS (Adj.)	0.37	0.36	(0.23)	0.54	1.08	0.09	0.08	0.07	0.06	0.31	0.24
Operating Income	68	63	(35)	82	178	12	10	9	8	39	29

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

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

- ▶ Some observers, including the analysts at Moody's Investor Services, have opined that MBI might try to put in place an intercompany loan from National Public Finance Guarantee Corp., its municipal bond insurance unit and the source of virtually all of the company's equity value, akin to the one put in place when MBIA Insurance Corp. needed liquidity to sustain it during its legal battles with Bank of America (BAC, Not Rated) and other counterparties. However, MBI management has made it clear that the potential for such a loan, and the possibility of allowing value to escape from National Public Finance Guarantee Corp. to facilitate it, is essentially zero.
- ▶ While MBI paid a \$149mm claim on its exposure to the Zohar I CLO last November, CEO Jay Brown stated during the company's 4Q15 conference call on March 1 that he believed it would achieve 100% on recoveries on the Zohar I notes. Brown also explained during that call that management was working on a plan to address the \$776mm in Zohar II notes scheduled to mature in January 2017. Again, even if that plan fails it will have no impact on MBI's equity valuation.
- ▶ While concerns about MBI's \$1.35bn of gross insured exposure are more valid given pending defaults on Puerto Rico's debt, we believe that with the shares trading at 0.24x the company's pro forma adjusted book value (ABV) per share of \$32.24, a severe downside scenario is already baked into the stock price.
- ▶ Our price target of \$13 for MBI is based on 0.50x of our estimate of the company's pro forma ABV per share of \$32.24 adjusted for estimated losses of \$5.49 per share related to its insured exposure to Puerto Rico's debt (see page 3).
- ▶ We note that when we use the steep haircuts to various Puerto Rico debt issues that were included in the Commonwealth's latest proposal to creditors to calculate the impact on MBI, the result is a loss of \$7.42 of ABV. Applying a 0.50x multiple to the \$24.82 in ABV that would remain in that scenario results in a price of \$12.41, which is 57% higher than the current share price.

## MBIA Puerto Rico Exposures and Loss Estimates

Discount rate	3.00%
Assumed tax rate	35%
Diluted shares outstanding	131.50
Estimated PV impairment per share	\$9.44
Current reserves per share on National balance sheet for PR	\$1.00
Net estimated reserve strengthening per share after reserve assumption per share	\$8.44
Net after tax reserve per share	\$5.49

Present value impairment of principal and interest (in \$mm)	Assumed Impairment	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040	2041	2042	2043	2044	2045	Total	Total per share
Puerto Rico Electric Power Authority	5.0%	-	8.4	8.7	5.5	7.8	5.0	6.1	5.6	5.2	4.8	4.4	2.2	2.0	1.9	1.7	1.6	2.0	1.8	1.7	1.6	1.4	-	-	-	-	-	-	-	-	-	-	79.5	0.60
Puerto Rico Commonwealth GO	25.0%	-	48.0	18.1	25.8	39.3	49.7	14.5	13.4	12.4	11.4	10.5	10.0	9.2	8.5	7.9	7.2	0.1	0.1	0.1	0.1	0.1	-	-	-	-	-	-	-	-	-	-	286.4	2.18
Puerto Rico Highway and Transportation Authority Transportation Revenue (PRHTA)	40.0%	-	15.9	13.4	14.7	11.5	11.2	13.9	12.9	11.9	11.0	10.1	14.6	13.5	12.5	11.5	10.6	26.4	24.5	22.6	20.9	19.2	3.4	3.2	2.9	2.7	2.5	0.0	0.0	0.0	0.0	0.0	317.5	2.41
Puerto Rico Sales Tax Financing Corporation (COFINA)	25.0%	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2.3	2.1	2.0	1.8	1.7	104.4	96.7	89.4	82.5	75.9	458.8	3.49
Puerto Rico Government Development Bank GO	25.0%	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Puerto Rico Highway and Transportation Authority Highway Revenue (PRHTA)	40.0%	-	1.8	8.3	2.1	5.8	5.8	1.1	1.0	0.9	0.9	0.8	2.9	2.7	2.5	2.3	2.1	0.1	0.1	0.1	0.1	0.1	-	-	-	-	-	-	-	-	-	-	41.1	0.31
University of Puerto Rico System Revenue	40.0%	-	2.8	3.1	2.5	2.6	2.3	3.8	3.5	3.3	3.0	2.8	1.8	1.7	1.6	1.4	1.3	0.9	0.9	0.8	0.7	0.7	-	-	-	-	-	-	-	-	-	-	41.6	0.32
Inter American University of Puerto Rico Inc.	40.0%	-	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.8	0.7	0.7	0.7	0.6	0.6	0.5	0.5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	11.5	0.09
Puerto Rico Industrial Development Company	40.0%	-	5.1	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5.1	0.04
<b>Total</b>		-	83.0	52.6	51.6	67.9	74.8	40.3	37.4	34.6	31.9	29.3	32.1	29.7	27.5	25.3	23.3	29.5	27.3	25.3	23.3	21.4	5.7	5.3	4.9	4.5	4.1	104.4	96.7	89.4	82.5	75.9	1,241.5	9.44

Estimated amortization of principal and interest (in \$mm)	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040	2041	2042	2043	2044	2045	Total	
Puerto Rico Electric Power Authority	-	173.7	183.9	120.3	176.7	114.8	145.1	138.5	131.9	125.3	118.7	60.7	57.9	55.1	52.4	49.6	63.7	60.8	57.9	55.0	52.1	-	-	-	-	-	-	-	-	-	-	-	1,994.2
Puerto Rico Commonwealth GO	-	197.8	77.0	112.8	177.0	230.4	69.1	66.0	62.8	59.7	56.5	55.2	52.7	50.2	47.7	45.1	0.5	0.5	0.5	0.5	0.4	-	-	-	-	-	-	-	-	-	-	-	1,362.3
Puerto Rico Highway and Transportation Authority Transportation Revenue (PRHTA)	-	40.9	35.6	40.2	32.4	32.4	41.6	39.7	37.8	35.9	34.0	50.4	48.1	45.9	43.6	41.3	105.9	101.1	96.3	91.5	86.6	15.8	15.1	14.4	13.7	13.0	0.1	0.1	0.1	0.1	0.1	1,153.4	
Puerto Rico Sales Tax Financing Corporation (COFINA)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	17.1	16.3	15.6	14.8	14.0	900.3	859.4	818.5	777.5	736.6	4,170.1	
Puerto Rico Government Development Bank GO	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
Puerto Rico Highway and Transportation Authority Highway Revenue (PRHTA)	-	4.5	22.0	5.8	16.3	16.8	3.2	3.1	2.9	2.8	2.6	9.9	9.5	9.0	8.6	8.1	0.3	0.3	0.3	0.3	0.3	-	-	-	-	-	-	-	-	-	-	-	126.7
University of Puerto Rico System Revenue	-	7.3	8.3	6.7	7.1	6.7	11.4	10.9	10.4	9.9	9.4	6.3	6.0	5.7	5.4	5.1	3.8	3.6	3.4	3.2	3.1	-	-	-	-	-	-	-	-	-	-	-	133.7
Inter American University of Puerto Rico Inc.	-	2.6	2.6	2.6	2.6	2.6	2.8	2.7	2.6	2.4	2.3	2.3	2.2	2.1	2.0	1.8	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	35.8
Puerto Rico Industrial Development Company	-	13.1	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	13.1
Total																																	8,989.4

BTIG Research Estimates and Company Reports

## Income Statement

MBIA Operating Model (\$ Millions)	Dec-11 2011A	Dec-12 2012A	Dec-13 2013A	Dec-14 2014A	Mar-15 1Q15A	Jun-15 2Q15A	Sep-15 3Q15A	Dec-15 4Q15A	Dec-15 2015A	Mar-16 1Q16E	Jun-16 2Q16E	Sep-16 3Q16E	Dec-16 4Q16E	Dec-16 2016E	Dec-17 2017E
Scheduled premiums earned	457.0	372.0	304.0	258.0	55.0	51.0	47.0	46.0	199.0	43.7	41.5	39.4	37.5	162.1	140.7
Refunding premiums earned	148.0	232.0	153.0	139.0	46.0	40.0	37.0	50.0	173.0	47.5	46.3	45.2	44.0	183.0	161.1
<b>Total premiums earned</b>	<b>605.0</b>	<b>604.0</b>	<b>457.0</b>	<b>397.0</b>	<b>101.0</b>	<b>91.0</b>	<b>84.0</b>	<b>96.0</b>	<b>372.0</b>	<b>91.2</b>	<b>87.8</b>	<b>84.6</b>	<b>81.5</b>	<b>345.1</b>	<b>301.9</b>
Net investment income	408.0	214.0	166.0	179.0	37.0	37.0	38.0	40.0	152.0	40.4	40.8	41.2	41.6	164.0	170.7
Fees and reimbursements	27.0	61.0	21.0	40.0	1.0	2.0	1.0	2.0	6.0	5.0	5.0	5.0	5.0	20.0	21.0
Realized gains (losses) and other settlements on insured derivatives	(2,370.0)	(406.0)	(1,545.0)	(444.0)	(9.0)	(3.0)	(18.0)	2.0	(28.0)	-	-	-	-	-	-
Unrealized losses on insured derivatives	(440.0)	1,870.0	1,777.0	903.0	37.0	63.0	21.0	36.0	157.0	-	-	-	-	-	-
Other than temporary impairments recognized in AOCI	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>Net change in fair value of insured derivatives</b>	<b>(2,810.0)</b>	<b>1,464.0</b>	<b>232.0</b>	<b>459.0</b>	<b>28.0</b>	<b>60.0</b>	<b>3.0</b>	<b>38.0</b>	<b>129.0</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Net gains (losses) on financial instruments at fair value and foreign exchange</b>	<b>(99.0)</b>	<b>55.0</b>	<b>69.0</b>	<b>78.0</b>	<b>30.0</b>	<b>45.0</b>	<b>(55.0)</b>	<b>43.0</b>	<b>63.0</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Investment losses related to other-than-temporary impairments	(125.0)	(58.0)	13.0	(99.0)	3.0	(9.0)	(1.0)	(2.0)	(9.0)	-	-	-	-	-	-
Other-than-temporary impairments recognized in AOCI	24.0	(47.0)	15.0	84.0	(4.0)	2.0	(2.0)	(1.0)	(5.0)	-	-	-	-	-	-
<b>Net investment losses related to other-than-temporary impairments</b>	<b>(101.0)</b>	<b>(105.0)</b>	<b>28.0</b>	<b>(15.0)</b>	<b>(1.0)</b>	<b>(7.0)</b>	<b>(3.0)</b>	<b>(3.0)</b>	<b>(14.0)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Other net realized gains (losses)	21.0	8.0	(28.0)	26.0	20.0	(1.0)	(1.0)	(1.0)	17.0	-	-	-	-	-	-
<i>Revenues of consolidated VIEs</i>															
Net investment income	73.0	67.0	43.0	50.0	12.0	13.0	12.0	49.0	86.0	-	-	-	-	-	-
Net gains (losses) on financial instruments at fair value and foreign exchange	40.0	18.0	160.0	50.0	(10.0)	6.0	13.0	33.0	42.0	-	-	-	-	-	-
Net gains (losses) on extinguishment of debt	280.0	49.0	61.0	6.0	-	(1.0)	-	-	(1.0)	-	-	-	-	-	-
<b>Total revenues</b>	<b>(1,556.0)</b>	<b>2,435.0</b>	<b>1,209.0</b>	<b>1,270.0</b>	<b>218.0</b>	<b>245.0</b>	<b>92.0</b>	<b>297.0</b>	<b>852.0</b>	<b>136.6</b>	<b>133.6</b>	<b>130.8</b>	<b>128.1</b>	<b>529.2</b>	<b>493.6</b>
Losses and loss adjustments	(81.0)	50.0	117.0	133.0	(6.0)	46.0	39.0	44.0	123.0	15.0	15.0	15.0	15.0	60.0	60.0
Amortization of deferred acquisition costs	64.0	50.0	46.0	44.0	13.0	13.0	11.0	13.0	50.0	11.1	10.5	10.0	9.5	41.0	31.6
Operating	309.0	382.0	327.0	195.0	35.0	32.0	35.0	38.0	140.0	38.2	38.4	38.6	38.8	153.9	157.0
Interest	300.0	283.0	236.0	210.0	50.0	50.0	49.0	50.0	199.0	48.8	47.5	46.3	45.2	187.8	169.7
Expenses of consolidated VIEs															
Operating	29.0	17.0	11.0	8.0	4.0	3.9	3.0	3.0	13.9	2.9	2.9	2.8	2.7	11.3	10.2
Interest	62.0	55.0	45.0	39.0	10.0	9.0	10.0	10.0	39.0	9.0	9.0	9.0	9.0	36.0	36.0
<b>Total expenses</b>	<b>683.0</b>	<b>837.0</b>	<b>782.0</b>	<b>629.0</b>	<b>106.0</b>	<b>153.9</b>	<b>147.0</b>	<b>158.0</b>	<b>564.9</b>	<b>124.9</b>	<b>123.3</b>	<b>121.7</b>	<b>120.1</b>	<b>490.0</b>	<b>464.5</b>
<b>Pre-tax income</b>	<b>(2,239.0)</b>	<b>1,598.0</b>	<b>427.0</b>	<b>641.0</b>	<b>112.0</b>	<b>91.1</b>	<b>(55.0)</b>	<b>139.0</b>	<b>287.1</b>	<b>11.7</b>	<b>10.4</b>	<b>9.1</b>	<b>8.0</b>	<b>39.2</b>	<b>29.0</b>
Provision (benefit) for income taxes	(920.0)	364.0	166.0	72.0	44.0	28.0	(20.0)	57.0	109.0	-	-	-	-	-	-
<b>Net income</b>	<b>(1,319.0)</b>	<b>1,234.0</b>	<b>261.0</b>	<b>569.0</b>	<b>68.0</b>	<b>63.1</b>	<b>(35.0)</b>	<b>82.0</b>	<b>178.1</b>	<b>11.7</b>	<b>10.4</b>	<b>9.1</b>	<b>8.0</b>	<b>39.2</b>	<b>29.0</b>
<b>Diluted EPS</b>	<b>(6.69)</b>	<b>6.33</b>	<b>1.35</b>	<b>3.02</b>	<b>0.37</b>	<b>0.36</b>	<b>(0.23)</b>	<b>0.54</b>	<b>1.08</b>	<b>0.09</b>	<b>0.08</b>	<b>0.07</b>	<b>0.06</b>	<b>0.31</b>	<b>0.24</b>
Diluted shares outstanding	197.02	194.90	193.92	188.27	182.74	173.20	155.20	151.50	165.66	131.50	129.00	126.50	124.00	127.75	119.75

Source: BTIG Research Estimates and Company Documents

## 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.

### Regulatory Disclosures

#### Analyst Stock Ratings Definitions

**BTIG LLC's ("BTIG") ratings, effective May 10, 2010, are defined as follows:**

**BUY** – A stock that is expected at initiation to produce a positive total return of 15% or greater over the 12 months following the initial recommendation. The BUY rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

**SELL** – A stock that is expected at initiation to produce a negative total return of 15% or greater over the next 12 months following the initial recommendation. The SELL rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

**NEUTRAL** – A stock that is not expected to appreciate or depreciate meaningfully over the next 12 months.

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**Distribution of BTIG's Research Recommendations (as of March 31, 2016):**

**BUY: 62.6%; NEUTRAL: 34.1%; SELL: 3.3%**

**Distribution of BTIG's Investment Banking Services (as of March 31, 2016):**

**BUY: 92.9%; NEUTRAL: 7.1%; SELL: 0%**

For purposes of FINRA ratings distribution rules, BTIG's stock ratings of Buy, Neutral and Sell fall into Buy, Hold and Sell categories, respectively.

### Company Valuation and Risk Disclosures

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

**Valuation:** Our \$13 price target on MBI is based on 50% of our estimate of the company's ABV per share of \$32.24 adjusted for estimated losses of \$5.49 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
01-Mar-16	7.93	13	Mark Palmer	Buy

## Company-Specific Regulatory Disclosures

BTIG LLC expects to receive or intends to seek compensation for investment banking services in the next 3 months from: MBIA, Inc. (MBI)

BTIG LLC has received compensation for investment banking services in the past 12 months from: MBIA, Inc. (MBI)

BTIG LLC had an investment banking services client relationship during the past 12 months with: MBIA, Inc. (MBI)

BTIG LLC managed or co-managed a public offering of securities in the past 12 months for: MBIA, Inc. (MBI)

## Other Disclosures

Additional Information Available Upon Request

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