

Equity Research

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Financials

Ambac Financial Group, Inc.

With Proxy Contest Approaching, AMBC's 1Q16 Report Again Shows Value Creation Through Self-Help

Eight days before Ambac Financial Group's (AMBC, Neutral) annual shareholder meeting, when it will face a proxy contest over board representation, the company yesterday after the market close offered the latest evidence that its self-help initiatives have been translating into shareholder value.

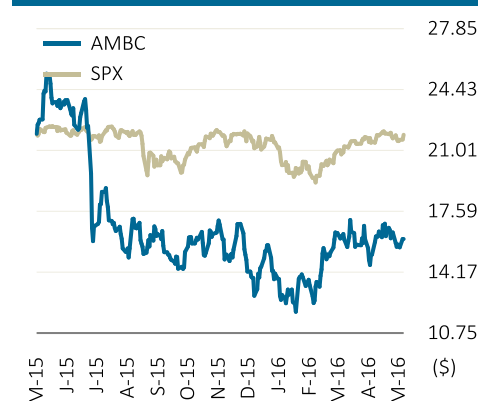
AMBC

\$16.03

NEUTRAL

52 week range \$11.94 - \$25.32
Market Cap (m) \$737

Price Performance



Source: IDC

- ▶ AMBC's 1Q16 report was highlighted by a 17% sequential increase in adjusted book value (ABV) per share to \$29.10 amidst an assortment of value-creating actions. That increase was on top of the 39% sequential increase in its ABV per share in 4Q15. The company during the quarter purchased \$512mm in distressed obligations – its highest amount in that category since it emerged from bankruptcy in May 2013 – including \$325mm in insured RMBS and \$168mm in insured Local Media Insight bonds.
- ▶ Additionally, AMBC during 1Q16 commuted \$387mm net par of its student loan exposures. That reduction, equal to 18.5% of the company's student loan book, brought its student loan insured exposure down to \$1.7bn.
- ▶ **We are reiterating our Neutral rating on AMBC.** While we continue to be impressed by the company's demonstrated ability to create value and reduce its risk profile through aggressive insured portfolio remediation, we continue to seek additional clarity on the timing and likelihood of the realization of catalysts that would unlock its inherent value.
- ▶ **Valuation:** Based on our adjusted book value per share multiple valuation for AMBC and our recovery analysis, we believe the company's valuation is within +/- 15% from current levels over the next 12 months. BTIG does not put price targets on Neutral-rated stocks.

Estimates

	1Q15 A	2Q15 A	3Q15 A	4Q15 A	FY15 A	1Q16 A	2Q16 E	3Q16 E	4Q16 E	FY16 E	FY17 E
Sales	155	231	88	171	645	17	113	110	107	347	399
Net Income (Adj.)	215	282	(391)	387	493	9	34	32	29	104	53
Diluted EPS (Adj.)	4.57	6.05	(8.65)	8.56	10.72	0.21	0.74	0.68	0.63	2.27	1.15

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

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

- ▶ AMBC reported 1Q16 operating income per share of \$4.82, beating the consensus estimate of \$0.57 (just two estimates) and our estimate of \$1.31. In addition to the benefits from its self-help initiatives, the company's earnings were bolstered by a \$105.3mm benefit in loss and loss expenses driven by better performance in its insured RMBS exposures.
- ▶ While AMBC has been busy remediating its insured portfolio, it has also been active in its efforts to mitigate potential losses on its \$2.2bn of insured exposure to Puerto Rico's debt. While management has been focused in large part on defending its insured exposure to Cofina senior debt which represents about 37% of its total insured exposure to the Commonwealth's debt, this morning they announced that they had opened a new legal front with a lawsuit aimed at blocking the clawback of money from the Puerto Rico Highway and Transportation Authority (PRHTA).
- ▶ AMBC has about \$471mm of insured exposure to PRHTA's debt, or about 21% of its total exposure to Puerto Rico's debt. We estimate that the company's losses on its insured exposure to Puerto Rico's debt will result in a loss of \$5.79 in ABV.

Income Statement

Ambac Financial Group Inc. 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 1Q16A	Jun-16 2Q16E	Sep-16 3Q16E	Dec-16 4Q16E	Dec-16 2016E	Dec-17 2017E
Net premiums earned	405.97	414.60	313.77	246.36	65.72	60.88	71.54	114.46	312.60	52.80	50.16	47.65	45.27	195.88	159.55
Net investment income	354.80	382.90	231.89	300.95	72.98	64.75	64.20	64.36	266.29	60.82	60.52	60.21	59.91	241.47	231.92
Total other than temporary impairment losses	(90.36)	(15.66)	(47.42)	(26.63)	(10.36)	(1.39)	(31.74)	(23.20)	(66.69)	(48.07)	-	-	-	(48.07)	-
Portion of loss recognized in other comprehensive income	26.51	9.67	0.65	0.84	7.24	0.37	22.59	10.83	41.03	38.74	-	-	-	38.74	-
Net other than temporary impairment losses recognized in earnings	(63.84)	(5.99)	(46.76)	(25.79)	(3.12)	(1.02)	(9.15)	(12.37)	(25.66)	(9.33)	-	-	-	(9.33)	-
Net realized investment gains	17.35	72.10	50.53	58.78	54.10	(5.35)	2.11	2.62	53.48	1.10	-	-	-	1.10	-
<i>Change in fair value of credit derivatives:</i>															
Realized gains and other settlements	17.00	13.71	12.29	3.04	0.42	0.41	1.69	0.27	2.79	0.25	-	-	-	0.25	-
Unrealized gains (losses)	31.03	(22.93)	193.37	20.86	(2.92)	9.89	35.26	(3.31)	38.92	12.61	-	-	-	12.61	-
Net change in fair value of credit derivatives	48.03	(9.22)	205.66	23.91	(2.50)	10.29	36.95	(3.05)	41.70	12.87	-	-	-	(3.05)	-
Derivative products	(280.82)	(125.00)	114.20	(181.09)	(37.77)	51.00	(65.08)	9.31	(42.54)	(83.42)	-	-	-	(83.42)	-
Net unrealized gains (losses) on extinguishment of debt	3.12	(177.58)	-	(74.72)	(0.09)	(1.25)	1.42	-	0.08	1.24	-	-	-	1.24	-
Other income	25.54	106.10	13.86	12.50	(0.79)	(1.16)	7.15	1.94	7.15	8.00	2.00	2.00	2.00	14.00	7.20
Income (loss) on variable interest entities	(214.37)	27.78	(10.30)	(32.21)	6.96	52.60	(21.44)	(6.56)	31.57	(27.16)	-	-	-	(27.16)	-
Total revenues before expenses and reorganization items	295.76	685.69	872.85	328.67	155.49	230.75	87.69	170.73	644.66	16.90	112.68	109.87	107.18	346.63	398.66
Losses and loss expense	1,859.46	683.63	(236.27)	(545.57)	(150.95)	(147.48)	(133.21)	(337.07)	(768.71)	(105.28)	(30.00)	(30.00)	(30.00)	(195.28)	(80.00)
Underwriting and operating expenses	141.31	139.03	113.30	101.47	37.43	38.09	25.01	54.36	154.88	50.89	50.64	50.38	50.13	202.04	198.03
Insurance intangible amortization	-	-	89.93	151.83	24.52	25.87	39.68	27.30	117.38	28.01	27.73	27.45	27.18	110.37	106.55
Interest expense	128.09	112.32	108.12	127.48	27.91	28.17	29.89	30.56	116.53	30.43	30.43	30.43	30.43	121.72	121.11
Goodwill impairment	-	-	-	-	-	-	514.51	-	514.51	-	-	-	-	-	-
Total expenses before reorganization items	2,128.85	934.98	75.07	(164.79)	(61.09)	(55.34)	475.87	(224.85)	134.59	4.05	78.79	78.26	77.74	238.84	345.69
Pretax loss from continuing operations before reorganization items	(1,833.09)	(249.29)	797.78	493.46	216.58	286.10	(388.18)	395.58	510.07	12.85	33.88	31.60	29.45	107.78	52.97
Reorganization items	49.86	7.22	2.55	0.21	-	-	-	-	-	-	-	-	-	-	-
Pre-tax loss from continuing operations	(1,882.95)	(256.51)	795.23	493.25	216.58	286.10	(388.18)	395.58	510.07	12.85	33.88	31.60	29.45	107.78	52.97
Provision for income taxes	77.42	2.85	8.17	9.56	1.71	3.92	2.84	8.90	17.36	3.44	-	-	-	3.44	-
Net income (loss)	(1,960.37)	(259.35)	787.05	483.70	214.87	282.18	(391.02)	386.68	492.70	9.41	33.88	31.60	29.45	104.34	52.97
Noncontrolling interests	0.06	(2.68)	(0.46)	(0.38)	0.16	(0.52)	(0.04)	(0.31)	(0.71)	-	-	-	-	-	-
Net income (loss) attributable to shareholders	(1,960.43)	(256.68)	787.52	484.07	214.71	282.70	(390.98)	386.98	493.41	9.41	33.88	31.60	29.45	104.34	52.97
Net loss	(1,960.37)	(259.35)	787.05	483.70	214.87	282.18	(391.02)	386.68	492.70	9.41	33.88	31.60	29.45	104.34	52.97
Unrealized gains on securities	120.64	221.15	133.44	252.60	(17.45)	(113.84)	8.38	(20.06)	(159.73)	-	-	-	-	-	-
Loss: reclassification adjustment for net gain	(48.61)	54.90	-	-	-	-	-	-	-	-	-	-	-	-	-
Gain (loss) on foreign currency translation	1.53	(0.54)	42.74	(43.60)	(33.81)	40.49	(30.91)	(82.62)	(45.03)	-	-	-	-	-	-
Amortization of postretirement benefit	0.75	(3.79)	11.03	(0.82)	(0.03)	(0.22)	(0.22)	(0.66)	(0.69)	-	-	-	-	-	-
Total other comprehensive income net of tax	171.53	161.92	187.21	208.19	(51.28)	(73.57)	(22.75)	(103.34)	(205.44)	-	-	-	-	-	-
Total comprehensive income (loss)	(1,788.84)	(97.43)	974.26	691.88	163.59	208.61	(413.77)	283.34	287.26	9.41	33.88	31.60	29.45	104.34	52.97
<i>Less: comprehensive income (loss) attributable to the noncontrolling interest</i>															
Net income (loss)	0.06	(2.68)	(0.46)	(0.38)	0.16	(0.52)	(0.04)	(0.31)	(0.71)	-	-	-	-	-	-
Currency translation adjustments	0.05	(0.21)	0.67	(0.43)	(0.33)	0.40	(0.27)	(0.72)	(0.37)	-	-	-	-	-	-
Total comprehensive income (loss) attributable to Ambac financial group	(1,788.95)	(94.55)	974.05	692.69	163.76	208.73	(413.45)	284.36	288.34	9.41	33.88	31.60	29.45	104.34	52.97
Diluted EPS	(\$6.48)	(\$0.85)	\$17.11	\$10.31	\$4.57	\$6.05	(\$8.65)	\$8.56	\$10.72	\$0.21	\$0.74	\$0.68	\$0.63	\$2.27	\$1.15
Diluted shares outstanding	302.44	302.47	46.04	46.93	46.95	46.70	45.17	45.19	46.01	45.24	45.70	46.15	46.61	46.01	46.01
GAAP Book Value per Share - Diluted	(\$10.41)	(\$10.73)	\$21.25	\$35.66	\$39.14	\$43.83	\$36.06	\$43.33	\$43.33	\$44.46	\$45.20	\$45.89	\$46.52	\$46.52	\$47.63
Adjusted Book Value per Share - Diluted	\$1.02	(\$1.55)	\$59.07	\$60.35	\$61.91	\$65.54	\$67.68	\$71.67	\$71.67	\$70.83	\$71.57	\$72.25	\$72.88	\$72.88	\$73.99

Source: BTIG Research Estimates and Company Documents

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.

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, Neutral)

Valuation: Based on our Adjusted Book Value (ABV) per share multiple valuation for Ambac Financial Group and our recovery analysis, we do not believe that Ambac's valuation is within +/- 15% from current levels over the next 12 months. BTIG does not put price targets on Neutral-rated stocks.

Risks: The primary risks to achieving our recommendation 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, and that declines in value of investment portfolio could impede Ambac's ability to pay its liabilities.

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		Mark Palmer	Neutral

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