

## Equity Research

August 10, 2016

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## Financials

### Ambac Financial Group, Inc.

#### While Investors Await Catalysts, AMBC's Efforts to Create Incremental Value Reflected in 2Q16 Report

Ambac Financial Group (AMBC) in the 2Q16 report it released yesterday after the market close added to the already long list of actions it has taken to create value for shareholders by announcing a settlement with an RMBS counterparty over a dispute unrelated to breaches in representations and warranties (R&Ws) as well as additional expense management efforts. It also continued to chip away at its insured portfolio and again recorded a sequential boost in its adjusted book value (ABV).

- ▶ At the same time, investors in AMBC continue to focus on three subjects that have the ability to drive significant movement in the company's share price: the restructuring of Puerto Rico's debt and its impact on AMBC's \$2.2bn in net insured exposure to that debt; the prospects for a settlement or positive judgment in its R&W litigation with Bank of America (BAC, Not Rated); and the possibility of an agreement with holders of surplus notes and deferred payment obligations (DPOs) that could accelerate the exit of the company's Segregated Account from rehabilitation.
- ▶ While the resolution of the situation in Puerto Rico may have been aided by the U.S. government's enactment of the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) in late June, the company is awaiting a ruling on an appeal of summary judgment rulings with an eye toward the potential scheduling of a trial date in mid-2017, and the status of discussions between management and surplus note and DPO holders is unclear.
- ▶ **We are reiterating our Neutral rating on AMBC.** While we are encouraged by the company's ability to create value through various self-help actions, we continue to seek clarity on the likelihood of the realization of the catalysts that could unlock its inherent value.
- ▶ **Valuation:** Based on our ABV per share multiple valuation for AMBC and our recovery analysis, we believe that AMBC's valuation is within +/- 15% from current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks.

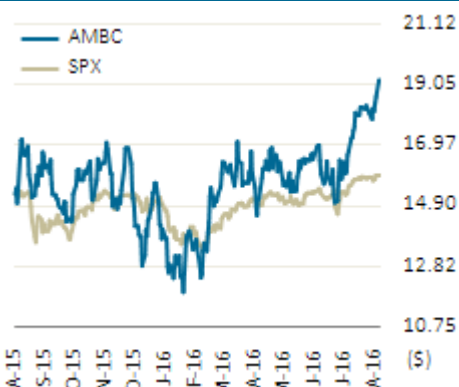
AMBC

\$19.20

### NEUTRAL

52 week range \$11.94 - \$19.20  
Market Cap (m) \$871

#### Price Performance



Source: IDC

## Estimates

	1Q15 A	2Q15 A	3Q15 A	4Q15 A	FY15 A	1Q16 A	2Q16 A	3Q16 E	4Q16 E	FY16 E	FY17 E
Sales	155	231	88	171	645	17	107	105	103	331	384
Net Income (Adj.)	215	282	(391)	387	493	9	58	39	37	143	85
Diluted EPS (Adj.)	4.57	6.05	(8.65)	8.56	10.72	0.21	1.29	0.84	0.80	3.11	1.85

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

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

- ▶ AMBC reported 2Q16 operating earnings per share of \$2.54, significantly outpacing the consensus estimate of \$0.70 and our estimate of \$0.74, as its ABV per share increased by 3% sequentially to \$29.94.
- ▶ AMBC during 2Q16 reduced its insurance portfolio net par outstanding by 7% sequentially to \$94.4bn, and it reduced adversely classified credits by 5.4% sequentially to \$18.0bn thanks to a \$481mm reduction in RMBS exposure, the cancellation of \$105mm of LIM bonds and the upgrade of \$318mm in public finance exposure.
- ▶ AMBC during the quarter reached a \$60mm settlement of a non-R&W dispute with an RMBS counterparty. As a consequence, the company achieved a nearly full recovery of its losses related to the transaction.
- ▶ AMBC continued to pare its expenses by reducing its headcount in an action expected to result in a reduction of more than 9% in overall compensation expenses that should drive \$5mm in run-rate annual savings.
- ▶ While AMBC's ability to buy back shares has been limited by shareholder concentration limits, the company continues to repurchase its warrants under a \$10mm program established last year. AMBC during 2Q16 bought back 228,500 warrants for \$1.61mm, bringing its total repurchases under the program to 860,000 for \$6.98mm, leaving 4,178,901 warrants outstanding. AMBC during the quarter also purchased \$7.4mm in surplus notes as well as \$9.6mm of accrued and unpaid interest on previously called surplus notes.

## 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 2Q16A	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	41.40	39.33	37.37	170.90	131.69
Net investment income	354.80	382.90	231.89	300.95	72.98	64.75	64.20	64.36	266.29	60.82	70.76	63.72	63.41	258.71	245.43
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)	(18.88)	-	-	(66.95)	-
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	11.44	-	-	50.18	-
<b>Net other than temporary impairment losses recognized in earnings</b>	<b>(63.84)</b>	<b>(5.99)</b>	<b>(46.76)</b>	<b>(25.79)</b>	<b>(3.12)</b>	<b>(1.02)</b>	<b>(9.15)</b>	<b>(12.37)</b>	<b>(25.66)</b>	<b>(9.33)</b>	<b>(7.44)</b>	-	-	<b>(16.78)</b>	-
Net realized investment gains	17.35	72.10	50.53	58.78	54.10	(5.35)	2.11	2.62	53.48	1.10	14.90	-	-	16.00	-
<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	0.23	-	-	0.49	-
Unrealized gains (losses)	31.03	(22.93)	193.37	20.86	(2.92)	9.89	35.26	(3.31)	38.92	12.61	3.72	-	-	16.34	-
<b>Net change in fair value of credit derivatives</b>	<b>48.03</b>	<b>(9.22)</b>	<b>205.66</b>	<b>23.91</b>	<b>(2.50)</b>	<b>10.29</b>	<b>36.95</b>	<b>(3.05)</b>	<b>41.70</b>	<b>12.87</b>	<b>3.96</b>	-	-	<b>16.82</b>	-
Derivative products	(280.82)	(125.00)	114.20	(181.09)	(37.77)	51.00	(65.08)	9.31	(42.54)	(83.42)	(36.33)	-	-	(119.76)	-
Net unrealized gains (losses) on extinguishment of debt	3.12	(177.58)	-	(74.72)	(0.09)	(1.25)	1.42	-	0.08	1.24	3.59	-	-	4.82	-
Other income	25.54	106.10	13.86	12.50	(0.79)	(1.16)	7.15	1.94	7.15	8.00	6.92	2.00	2.00	18.92	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)	8.99	-	-	(18.18)	-
<b>Total revenues before expenses and reorganization items</b>	<b>295.76</b>	<b>685.69</b>	<b>872.85</b>	<b>328.67</b>	<b>155.49</b>	<b>230.75</b>	<b>87.69</b>	<b>170.73</b>	<b>644.66</b>	<b>16.90</b>	<b>106.73</b>	<b>105.06</b>	<b>102.77</b>	<b>331.46</b>	<b>384.32</b>
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)	(52.50)	(30.00)	(30.00)	(217.78)	(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	39.01	38.82	38.62	167.34	152.57
Insurance intangible amortization	-	-	89.93	151.83	24.52	25.87	39.68	27.30	117.38	28.01	28.00	27.02	26.75	109.76	104.33
Interest expense	128.09	112.32	108.12	127.48	27.91	28.17	29.89	30.56	116.53	30.43	30.71	30.71	30.71	122.56	122.22
Goodwill impairment	-	-	-	-	-	-	514.51	-	514.51	-	-	-	-	-	-
<b>Total expenses before reorganization items</b>	<b>2,128.85</b>	<b>934.98</b>	<b>75.07</b>	<b>(164.79)</b>	<b>(61.09)</b>	<b>(55.34)</b>	<b>475.87</b>	<b>(224.85)</b>	<b>134.59</b>	<b>4.05</b>	<b>45.22</b>	<b>66.54</b>	<b>66.08</b>	<b>181.89</b>	<b>299.13</b>
<b>Pretax loss from continuing operations before reorganization items</b>	<b>(1,833.09)</b>	<b>(249.29)</b>	<b>797.78</b>	<b>493.46</b>	<b>216.58</b>	<b>286.10</b>	<b>(388.18)</b>	<b>395.58</b>	<b>510.07</b>	<b>12.85</b>	<b>61.51</b>	<b>38.51</b>	<b>36.69</b>	<b>149.57</b>	<b>85.20</b>
Reorganization items	49.86	7.22	2.55	0.21	-	-	-	-	-	-	-	-	-	-	-
<b>Pre-tax loss from continuing operations</b>	<b>(1,882.95)</b>	<b>(256.51)</b>	<b>795.23</b>	<b>493.25</b>	<b>216.58</b>	<b>286.10</b>	<b>(388.18)</b>	<b>395.58</b>	<b>510.07</b>	<b>12.85</b>	<b>61.51</b>	<b>38.51</b>	<b>36.69</b>	<b>149.57</b>	<b>85.20</b>
Provision for income taxes	77.42	2.85	8.17	9.56	1.71	3.92	2.84	8.90	17.36	3.44	3.16	-	-	6.60	-
<b>Net income (loss)</b>	<b>(1,960.37)</b>	<b>(259.35)</b>	<b>787.05</b>	<b>483.70</b>	<b>214.87</b>	<b>282.18</b>	<b>(391.02)</b>	<b>386.68</b>	<b>492.70</b>	<b>9.41</b>	<b>58.36</b>	<b>38.51</b>	<b>36.69</b>	<b>142.98</b>	<b>85.20</b>
Noncontrolling interests	0.06	(2.68)	(0.46)	(0.38)	0.16	(0.52)	(0.04)	(0.31)	(0.71)	-	(0.29)	-	-	(0.29)	-
<b>Net income (loss) attributable to shareholders</b>	<b>(1,960.43)</b>	<b>(256.68)</b>	<b>787.52</b>	<b>484.07</b>	<b>214.71</b>	<b>282.70</b>	<b>(390.98)</b>	<b>386.98</b>	<b>493.41</b>	<b>9.41</b>	<b>58.65</b>	<b>38.51</b>	<b>36.69</b>	<b>143.27</b>	<b>85.20</b>
<b>Net loss</b>	<b>(1,960.37)</b>	<b>(259.35)</b>	<b>787.05</b>	<b>483.70</b>	<b>214.87</b>	<b>282.18</b>	<b>(391.02)</b>	<b>386.68</b>	<b>492.70</b>	<b>9.41</b>	<b>58.36</b>	<b>38.51</b>	<b>36.69</b>	<b>142.98</b>	<b>85.20</b>
Unrealized gains on securities	120.64	221.15	133.44	252.60	(17.45)	(113.84)	8.38	(20.06)	(159.73)	59.79	48.17	-	-	107.96	-
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)	(17.78)	(55.15)	-	-	(72.93)	-
Amortization of postretirement benefit	0.75	(3.79)	11.03	(0.82)	(0.03)	(0.22)	(0.22)	(0.66)	(0.69)	0.79	(0.26)	-	-	0.53	-
<b>Total other comprehensive income net of tax</b>	<b>171.53</b>	<b>161.92</b>	<b>187.21</b>	<b>208.19</b>	<b>(51.28)</b>	<b>(73.57)</b>	<b>(22.75)</b>	<b>(103.34)</b>	<b>(205.44)</b>	<b>42.80</b>	<b>(7.24)</b>	-	-	<b>35.56</b>	-
<b>Total comprehensive income (loss)</b>	<b>(1,788.84)</b>	<b>(97.43)</b>	<b>974.26</b>	<b>691.88</b>	<b>163.59</b>	<b>208.61</b>	<b>(413.77)</b>	<b>283.34</b>	<b>287.26</b>	<b>52.21</b>	<b>51.12</b>	<b>38.51</b>	<b>36.69</b>	<b>178.54</b>	<b>85.20</b>
<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)	-	(0.29)	-	-	(0.29)	-
Currency translation adjustments	0.05	(0.21)	0.67	(0.43)	(0.33)	0.40	(0.27)	(0.72)	(0.37)	-	-	-	-	-	-
<b>Total comprehensive income (loss) attributable to Ambac financial group</b>	<b>(1,788.95)</b>	<b>(94.55)</b>	<b>974.05</b>	<b>692.69</b>	<b>163.76</b>	<b>208.73</b>	<b>(413.45)</b>	<b>284.36</b>	<b>288.34</b>	<b>52.21</b>	<b>51.41</b>	<b>38.51</b>	<b>36.69</b>	<b>178.83</b>	<b>85.20</b>
<b>Diluted EPS</b>	<b>(\$6.48)</b>	<b>(\$0.85)</b>	<b>\$17.11</b>	<b>\$10.31</b>	<b>\$4.57</b>	<b>\$6.05</b>	<b>(\$8.65)</b>	<b>\$8.56</b>	<b>\$10.72</b>	<b>\$0.21</b>	<b>\$1.29</b>	<b>\$0.84</b>	<b>\$0.80</b>	<b>\$3.11</b>	<b>\$1.85</b>
Diluted shares outstanding	302.44	302.47	46.04	46.93	46.95	46.70	45.17	45.19	46.01	45.24	45.38	45.60	45.83	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	\$45.46	\$46.31	\$47.11	\$47.11	\$48.94
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	\$70.21	\$71.05	\$71.86	\$71.86	\$73.69

Source: BTIG 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

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**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.

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**Distribution of BTIG's Research Recommendations (as of June 30, 2016):**

**BUY: 61.6%; NEUTRAL: 35.7%; SELL: 2.7%**

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**BUY: 84.6%; NEUTRAL: 15.4%; SELL: 0%**

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### Company Valuation and Risk Disclosures

#### 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 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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Additional Information Available Upon Request

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