

Equity Research

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Industry Report

Financials

Municipal Bond Insurers

More Noise Ahead of Judicial Process in Puerto Rico Has Created Buying Opportunity in AGO, MBI, AMBC

Shares of municipal bond insurers Assured Guaranty (AGO, Buy, \$49 PT), MBIA (MBI, Buy, \$14 PT) and Ambac Financial Group (AMBC, Buy, \$26 PT) came under renewed pressure yesterday amidst investor concerns that a \$4.9bn loan for Hurricane Maria relief requested from the U.S. Congress by Puerto Rico Governor Ricardo Rossello would, if approved, reduce the recoveries on the Commonwealth-issued bonds insured by the monolines.

- ▶ The Community Disaster Loan under consideration by Congress would be authorized under the Stafford Disaster Relief and Emergency Assistance Act. According to the U.S. Code of Federal Regulations, if FEMA as the administrator of such a loan determines that the revenues collected during the three-year period following the disaster are insufficient to meet the affected territory's operating budget – including unreimbursed disaster-related expenses – then loan repayment can be cancelled. As Governor Rossello pointed out, approximately 92% of such loans are ultimately cancelled.
- ▶ Given our view that it is highly likely that the \$4.9bn loan will ultimately be cancelled and that any debt service associated with it in the interim would be on the margin relative to Puerto Rico's overall budget, we view the concerns about AGO, MBI and AMBC getting primed and facing reduced recoveries on their insured exposures as unwarranted. Moreover, we believe many of the estimates we have heard offered up with regard to the monolines' losses on their insured exposures to the Commonwealth's debt are flawed insofar as they fail to fully account for such mitigants as loss and LAE reserves, contingency reserves, unearned premium reserves, and factors such as AGO being the only entity capable of providing the island with access to the capital markets once the restructuring has been completed.
- ▶ What else changed in the past 24 hours that would cause continued weakness in the monoline stocks today? For one thing, President Trump on Twitter this morning suggested that there would be limits to the extent of U.S. aid to Puerto Rico even as a \$36.5bn emergency funding package works its way through Congress. We would put this latest comment in the same category as Trump's comments last week that Puerto Rico's debt would be wiped out: highly unlikely to have an actual impact on the situation other than to trigger fears that cause downward pressure on the prices of the island's bonds and monoline equities.

- ▶ Also occurring yesterday was Moody's announced reduction in its estimated recoveries on Puerto Rico's general obligation (GO) bonds and its Cofina sales tax bonds from a range of 65-80% to a range of 35-65% consistent with a Ca rating. We believe such an assessment is premature and would warn investors against making the overly negative assumptions that many investors made regarding the insurers at the onset of Detroit's bankruptcy in 2014.
- ▶ As we have seen in past municipal debt restructurings – we view Detroit's bankruptcy as a noteworthy example given the perceived depth of that city's economic problems and a significant population exodus – the entities assigned to lead the restructuring and their advisors typically make the first moves in the process by offering a low-ball recovery to creditors and then framing it as their final offer. Such had been the case in Detroit when the city's emergency manager, Kevyn Orr, first offered 20 cents on the dollar to holders of unlimited tax general obligation (UTGO) bonds before reducing that offer to 15 cents.
- ▶ After going through the judicial process and asserting their rights under the bond indentures and the liens underlying their exposures, Detroit UTGO holders including AGO and MBI settled for 74 cents on the dollar. We view this as a relevant example inasmuch as Puerto Rico's oversight board and its restructuring advisors have set the tone by putting forth a fiscal plan that covers approximately 24% (\$787mm) of the annual debt service for the next decade, which they initially declared to be immutable after certifying it on March 13. Not allowing a crisis to go to waste, we expect the oversight board to soon present a revised fiscal plan that covers even less of the annual debt service.
- ▶ With that said, we believe that once the judicial process has proceeded to the point that AGO, MBI and AMBC can assert the liens and guarantees underlying their insured exposures to Puerto Rico's debt that the situation will evolve from one dominated by the oversight board and its advisors to one in which the insurers' legal rights and associated leverage will come to the fore as they had in Detroit. As we have noted previously, the fiscal plan certified by the oversight board did not account for Medicaid funding from the U.S. under the fallacious justification that the receipt of such funding on an annual basis was not a certainty – the Trump Administration's FY18 Budget proposal allowed for \$1.59bn. The plan also included \$600mm for potential expense overages in what looks very much like a slush fund.
- ▶ We believe it is highly likely that AGO and MBI in particular have been using the downdraft to buy back significant amounts of their stocks and perhaps to commute insured exposures to Puerto Rico's debt. Meanwhile, AMBC, which cannot buy back its stock given a 5% ownership by a single entity, has already repurchased about 30% of its insured Cofina senior bonds, and we believe the company may be

continuing to do so amidst the current panic-like conditions in the Puerto Rico debt market.

- ▶ While volatility in shares of the monolines may continue in the near term, particularly as holders of Puerto Rico's debt short the stocks to hedge their positions, all three insurers we cover are trading at valuations that are baking in extremely dire scenarios that are unlikely to be realized, in our view. As such, we believe the recent sell-off has created a compelling opportunity to buy AGO, MBI and AMBC at discount prices.

BTIG Covered Companies Mentioned in this Report

ASSURED GUARANTY LTD. (AGO, Buy, \$49.00 PT; Current Price: \$36.93; Analyst: Mark.Palmer)

AMBAC FINANCIAL GROUP, INC. (AMBC, Buy, \$26.00 PT; Current Price: \$16.50; Analyst: Mark.Palmer)

MBIA, INC. (MBI, Buy, \$14.00 PT; Current Price: \$7.13; Analyst: Mark.Palmer)

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.

Regulatory Disclosures

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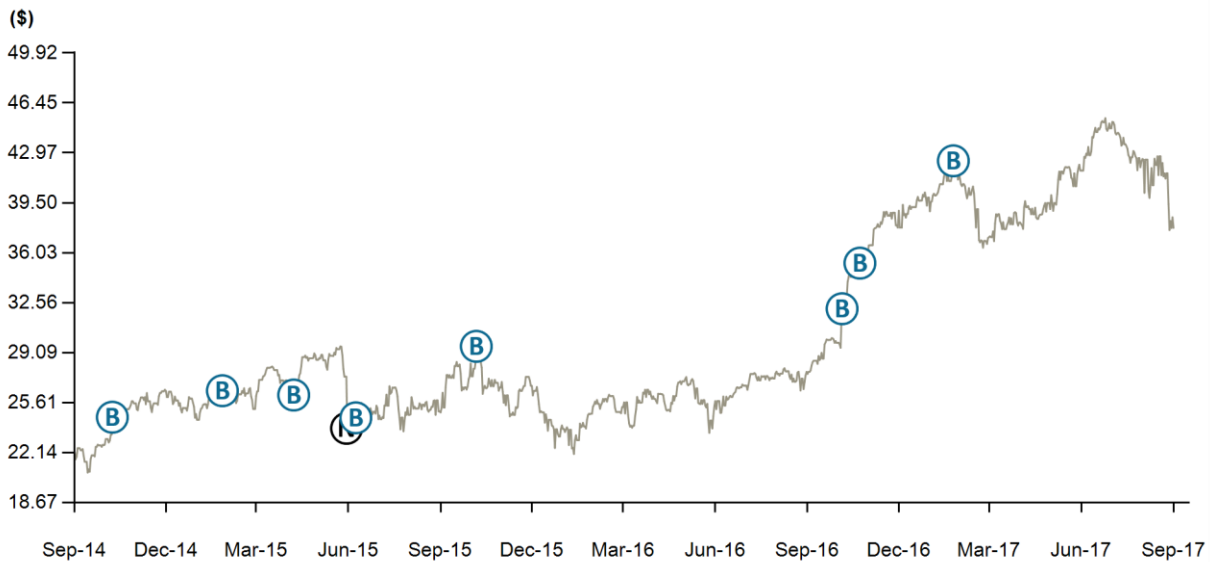
Company Valuation and Risk Disclosures

Assured Guaranty Ltd. (AGO, Buy, \$49.00 PT)

Valuation: Our \$49 price target is based on 0.65x our YE18E adjusted book value (ABV) per share of \$80.32, minus \$4.23 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	NA	Mark Palmer	Neutral
08-Jul-15	24.49	34	Mark Palmer	Buy
05-Nov-15	29.47	35	Mark Palmer	Buy
04-Nov-16	32.10	37	Mark Palmer	Buy
22-Nov-16	35.24	41	Mark Palmer	Buy
23-Feb-17	42.38	49	Mark Palmer	Buy

MBIA, Inc. (MBI, Buy, \$14.00 PT)

Valuation: Our \$14 price target is based on 0.65x on our estimate of the company's pro forma ABV of \$26.26 adjusted for estimated losses of \$5.19 per share related to the company's insured exposure to Puerto Rico's debt. Our new valuation reflects our assumption that MBI will now realize no tax benefit on its Puerto Rico-related losses.

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 the company's ability to write new business and regulatory risks.

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	NA	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	NA	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
21-Jun-16	6.82	14	Mark Palmer	Buy
26-Jul-17	10.21	13	Mark Palmer	Buy
09-Aug-17	10.38	14	Mark Palmer	Buy

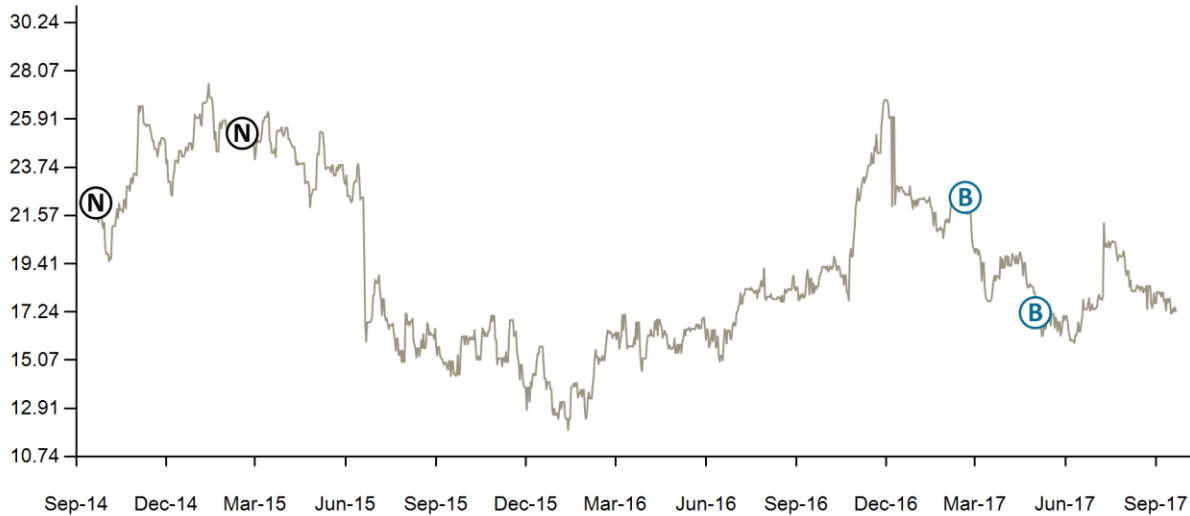
Ambac Financial Group, Inc. (AMBC, Buy, \$26.00 PT)

Valuation: Our \$26 price target for AMBC is based on a sum-of-the-parts analysis in which we assessed the value of AMBC's operating company, its holding company, and its adjusted operating earnings through FY19E.

Risks: The primary risks to achieving our recommendation and price target 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, declines in value of investment portfolio could impede Ambac's ability to pay its liabilities and Ambac Assurance Corp. may be unable to exit rehabilitation.

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	NA	Mark Palmer	Neutral
01-Mar-17	22.35	28	Mark Palmer	Buy
11-May-17	17.18	26	Mark Palmer	Buy

Company-Specific Regulatory Disclosures

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