Assured Guaranty Ltd. (AGO)
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Third Quarter 2016 Earnings Call

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Thank you operator. And thank you all for joining Assured Guaranty for our 2016 third quarter financial results conference call.

Today's presentation is made pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. The presentation may contain forward-looking statements about our new business and credit outlooks, market conditions, credit spreads, financial ratings, loss reserves, financial results or other items that may affect our future results. These statements are subject to change due to new information or future events. Therefore, you should not place undue reliance on them, as we do not undertake any obligation to publicly update or revise them, except as required by law.

If you are listening to the replay of this call, or if you are reading a transcript of the call, please note that our statements made today may have been updated since this call.

Please refer to the Investor Information section of our website for our recent presentations, SEC filings, most current financial filings, and for the risk factors.

This presentation also includes references to non-GAAP financial measures. We present the GAAP financial measures most directly comparable to the non-GAAP financial measures referenced in this presentation, as well as a reconciliation between such GAAP and non-GAAP financial measures, in our current Financial Supplement and Equity Investor Presentation, which are on our website at AssuredGuaranty.com.

Turning to the presentation, our speakers today are Dominic Frederico, President and Chief Executive Officer of Assured Guaranty Ltd., and Rob Bailenson, our Chief Financial Officer. After their remarks, we will open the call to your questions. As the webcast is not enabled for Q&A, please dial in to the call if you would like to ask a question.

I will now turn the call over to Dominic.

Dominic Frederico, President and Chief Executive Officer

Thank you, Robert, and welcome to everyone joining today's call.

By continuing to execute on our strategic objectives, Assured Guaranty delivered excellent results in the third quarter of 2016. In addition to earning $508 million of operating income, we further positioned the company for long-term success through acquisitions and new business originations, while also enhancing returns to shareholders through share repurchases and our quarterly dividends.

One of our key strategies has been to identify and acquire legacy financial guaranty companies whose insured portfolios are consistent with our risk profile. On July 1st, we closed on our third acquisition, CIFG, which added $293 million to operating shareholders' equity and $512 million to adjusted book value at the acquisition date. At quarter-end, adjusted book value was a record $66.34 per share, 8.4% higher than when the year began. The effects of our CIFG acquisition are reflected for the first time in this reporting period, and Rob will give you details about the rest of our key financial results later on this call.

In this near-zero interest rate environment, which impacts new business opportunities, we continue to prioritize our acquisition strategy. We recently announced another important pending acquisition: MBIA UK Insurance Limited, the European operating subsidiary of MBIA Insurance Corporation. By acquiring MBIA UK, we will add a seasoned portfolio of almost exclusively European insured transactions that totaled approximately $13 billion of net par as of June 30th, 2016, further increasing the geographic diversification of our insured portfolio.

We expect this acquisition to be accretive to Assured Guaranty's earnings per share, operating shareholders' equity and adjusted book value. Additionally, we believe this transaction provides a boost to our prospects in the European market by reinforcing the message that Assured Guaranty is committed to providing funding solutions for infrastructure finance in Europe. The MBIA UK acquisition is slated to close in January, subject to receipt of regulatory approvals and the satisfaction of other customary closing conditions.

As we have noted before, our international diversification gives us a unique industry advantage in terms of both risk management and business opportunities. This is also true of our structured finance business, which in the third quarter contributed $23 million of present value production, or PVP. This was driven by a transaction where we provided excess of loss reinsurance on an insurance reserve financing. This transaction was generated, negotiated and closed in Bermuda through AG Re's specialty insurance subsidiary AGRO, and it illustrates the flexibility that unit provides us to offer innovative capital management solutions.

Turning to U.S. public finance, we were very pleased with our performance in a quarter that saw the lowest municipal interest rates and some of the tightest credit spreads since our industry began. For the first time, 30-year AAA municipal yields fell below 2%, giving many issuers the most attractive yields they have ever seen.

During the quarter, we adhered to our strict underwriting process and disciplined pricing strategy. While this has cost us some market share, we nevertheless remained the market leader not only in insured par sold but also in the number of transactions that used bond insurance. Our third quarter 2016 primary-market transactions represented $3.2 billion of new issue par, which was 56% of all the insured par sold during the quarter and 45% more than the par written by any other bond insurer. It is our view that market participants are differentiating among double-A rated guarantors, with some investors willing to pay more for the comfort of our large capital base, our guaranty's broad acceptance by municipal bond investors and the significantly higher relative market liquidity of our insured bonds.

Additionally, we continued to see a positive response for Assured Guaranty's insurance on larger deals, which typically have a strong institutional investor base. Year-to-date through September, we were selected to insure more than $100 million of par on 13 different transactions, totaling approximately $1.9 billion of insured par, four of which sold in the third quarter.

While we have the scale to make insuring large public finance transactions a key element in our business production strategy, small and medium-size transactions represent the bulk of our business, and we clearly continue to add value and provide great service for those transactions. Of the $10.1 billion of par of new issues sold with our insurance during the first nine months, $4.1 billion – representing 554 of the 672 transactions we insured − came from transactions of $25 million or less.

Additionally, our municipal secondary market business has been growing. This year through the third quarter, we have insured $1 billion of secondary market par, 21% more than in all of last year and producing nearly one-and-a-half times our secondary market PVP of 2015.
During the first three quarters of 2016, we increased U.S. public finance PVP by more than 12% over that of the nine months of 2015, while insuring 17% less par exposure and maintaining a comparable credit risk profile. Our financial results continue to significantly outperform those of the next most active bond insurer.

While we are only one month into the fourth quarter and many things can change, it's worth noting that October was our strongest month for U.S. public finance so far this year. During October, five additional transactions each selected Assured Guaranty to insure par of approximately $100 million or more for their new offerings.

Companywide, we produced $129 million of PVP in the first nine months of the year, 25% more than in the same period of last year.

Now for an update on Puerto Rico. On the last call, I discussed the commonwealth's July 1st default on its general obligation and other debt. Subsequently, on August the 31st, appointments were announced to the Financial Oversight Board created by the PROMESA legislation. The board members represent a range of viewpoints, but on the whole we think they have appropriate backgrounds and will take a reasonable and serious approach to reform and restructuring on the island.

It appears that the choice of an executive director will be deferred to January. This coincides with the commencement of a new administration for the next elected Governor. We sincerely hope the next governor will take a more responsible approach to solving the many challenges facing Puerto Rico than the current governor has taken.

It also appears this will be a highly engaged oversight board, especially while they operate without an executive director. The board has taken a number of actions since it first met on September 30th. It requested and obtained a fiscal plan from the current Puerto Rico administration, as well as a commitment to supply ongoing cash flow reporting. It asserted its right to approve financial transactions and debt exchanges by entities covered by PROMESA, rejecting a transaction of one public corporation. It demanded additional fiscal plans from each of six public corporations, including certain credits we insure, namely the electric utility PREPA, the water and sewer authority PRASA and the highways and transportation authority HTA. Also, the board has sought to intervene in pending litigation.

Regrettably, the fiscal plan submitted to the oversight board by the outgoing governor fails to address the root causes of the island's current fiscal mismanagement, disregards creditor rights and fails to provide a realistic roadmap to economic recovery.

With regard to the PREPA negotiations, we continue to make progress. The Restructuring Agreement still needs court validation and rating agency ratings to go forward.

Puerto Rico-related bonds we insure continue to hold their value relative to comparable uninsured bonds. To give one example, HTA bonds with our insurance have generally been trading at par or higher while identical or nearly identical uninsured bonds have been trading around 27 cents on the dollar. This ability of our guaranty to help provide market value protection when an issuer develops real or perceived credit problems has been demonstrated in a variety of situations. It is a very important and valuable benefit of Assured Guaranty bond insurance.

In recent rating agency developments, Kroll Bond Rating Agency awarded a double-A rating to Assured Guaranty Corp. on September 20th. As a result, each of Assured Guaranty's U.S. financial guaranty subsidiaries now carries financial strength ratings of double-A plus or double-A flat, with stable outlooks, from two major rating agencies.

On August the 8th, Moody's affirmed all of our current ratings on Assured Guaranty companies, maintained the stable outlook for AGM's A2 rating and revised to stable from negative the outlook for AGC's A3 rating. Moody's said the ratings reflect Assured Guaranty's strong overall capital profile and core earnings power, our ability to underwrite transactions in both the public finance and structured finance markets worldwide through our multiple insurance operating subsidiaries, and the ongoing improvement in our capital adequacy, as well as our leadership position in the financial guaranty insurance sector. Specifically, with regard to its improved outlook for AGC, Moody's cited AGC's strengthening capital adequacy profile, noting that our recent acquisitions of Radian Asset Assurance and CIFG increased AGC's capital resources, invested assets and future premium earnings.

Looking ahead, I'm pleased to say that our board of directors has authorized the company to buy back an additional $250 million of common shares. Share repurchases are an important way we manage the excess capital we are generating as our legacy portfolio amortizes faster than we can add new business in the current environment. There are, however, practical and regulatory constraints, as well as rating agency considerations, that limit how much we can buy back in any given time frame.

Additionally, we hope to put some of this excess capital to work in ways that can generate higher returns within our limited tolerance for risk. To this end, our new Alternative Investments group is conducting a disciplined search for acquisitions or business opportunities where there is a strategic and financial fit with our company. Of course, such opportunities must not interfere with our central mission of providing the strongest financial guaranty insurance available.

I will now turn the call over to Rob.

Robert Bailenson - Chief Financial Officer

Thank you, Dominic, and good morning to everyone on the call.

This quarter we recorded operating income of $508 million. The CIFG acquisition generated approximately $308 million dollars of operating income, or $2.32 per share in the third quarter, and added an incremental $3.85 to adjusted book value per share, bringing adjusted book value to $66.34 per share.

The primary components of the CIFG contribution to pretax operating income were:

- a $357 million bargain purchase gain, representing the excess of the fair value of net assets acquired over the purchase price, offset by
- a $98 million loss due to the settlement of pre-existing reinsurance agreements between CIFG and Assured, primarily related to Puerto Rico exposures previously assumed by Assured from CIFG.

The CIFG acquisition also increased statutory capital by $310 million and claims-paying resources by $388 million.

In addition to the CIFG acquisition, operating income benefited from significant refunding activity in the quarter due to the low interest rate environment. Operating net premiums earned and credit derivative revenues from refundings and terminations were $130 million in the third quarter of 2016, compared to $105 million in the third quarter of 2015.

Operating loss and loss adjustment expense in the third quarter of 2016 was a benefit of $17 million. Economic loss development was also a benefit of $44 million, which includes a $29 million benefit caused by the increase in discount rates. The other primary drivers of the favorable development were improved performance in the US RMBS portfolio, and a benefit resulting from purchases of insured bonds to mitigate losses. This is offset in part by reserve increases in certain Puerto Rico exposures.

The effective tax rate on operating income in the third quarter of 2016 was 3.8% in the aggregate, and 11.7% excluding the non-taxable bargain purchase gain. This compares with 24.1% in the third quarter of 2015. The decline in the effective tax rate compared with the third quarter of 2015 was also attributable to the proportion of income in non-taxable jurisdictions.

I will now address our holding company liquidity and capital management activities. As of October 31st, we had $40 million in cash and investments at the Bermuda holding company and $128 million at the US holding companies.

With respect to share repurchases, we bought back 2.1 million shares in the third quarter of 2016 for $55 million, at an average price of $26.83 per share. Including the additional $20 million in shares that we repurchased since the end of the third quarter, cumulative share repurchases since we started our share repurchase program in January 2013, represent a 34% reduction in our shares outstanding. These repurchases have contributed approximately $8.17 per share to operating shareholders' equity and $13.85 to adjusted book value per share.

As Dominic mentioned, on November 2nd, our Board of Directors approved an incremental $250 million in share repurchases, which brings our current remaining authorization to $345 million as of that date.

I am very pleased with the quarter's results, and the significant increase in value we have been able to achieve with the successful execution of the Company's key strategic initiatives - in particular - the CIFG acquisition, and the continuation of our share repurchase program.

I'll now turn the call over to our operator, to give you the instructions for the Q&A period.

Question and Answer Session

Chas Tyson - Keefe, Bruyette & Woods

Hey, guys. Good morning. Just wanted to (multiple speakers). I just wanted to ask about capital return. It seems on the 2Q call you'd indicated you wanted to get 2016 capital return up to 2014 or 2015 levels. It seems like on this morning's call that you're saying that there's some practical and regulatory constraints, and rating agency considerations. Can you just help us square prior comments with how you're thinking about that potential special dividend at this point?

Dominic Frederico

Sure, so we said, Chas, back in the second quarter that we'd like to maintain the same basic volume and amount of share repurchase that we've been able to achieve over the last couple of years. And it was our intention to do that, or is our intention. However, we also said we needed the approval of a special dividend from our regulator, and principally here it's the New York DFS.

So we've applied for the special dividend. Like anything else, we sit here and wait for the potential approval of that special dividend request. Once given, then I think we would be once again active in the market at a higher level of volume and activity to continue to move along the same basic objective of being aggressive with the management of our capital.

Rob Bailenson

Chas, this would be over a long period of time. So on average we're trying to get that level.

Chas Tyson

Okay, yes. Can you just talk about how you think about sizing the request? Maybe you can't give the exact color. But is the goal just to get one year's worth of capital return back up to the prior levels, or is this kind of a longer-term request that will get multiple years up to that longer-term level?

Dominic Frederico

Well, the capital management is a longer-term strategy. The dividend request is more strategic, right, in how you want to position yourself with the regulators, especially as we think we will get more color over the, not only the financial strength of Assured Guaranty as it improves, as well as dealing with some of the existing credit concerns, and specifically Puerto Rico. So time helps in those regards.

Number two, we said that we'd give you a very good estimate of what the available cash flows coming out of the operating company to provide the necessary amount of free cash to go out and buy shares, which in effect, as you can well know, requires that we get special dividends approved every year to maintain that volume.

So when you look at your special dividend request, you say okay, how do I want to position it strategically? Because I really want to be able to make the regulators appreciate that this is an ongoing part of our strategic objectives and view. And therefore get them in a position where an annual approval doesn't take as long as the initial approval and becomes kind of an accepted practice within the Company.

So we want to maintain the volume. We need a special dividend request. We are requesting the special dividend, or have requested it. We would anticipate doing that annually to continue to provide the necessary funding so that we can continue the capital management that we believe the Company needs to exercise, especially over, say, the next 2 to 3 years while we still see basically the interest rate environment that we are stuck in that specifically or significantly hampers new business opportunities.

Chas Tyson

Okay, that helps. And then one last one on PREPA. I know you said that, the rating agency and validation process, I see that PREPA's been designated as a covered instrumentality by the oversight board. Do you essentially see that as going through a Title VI process under PROMESA at this point? And does that -- do you think that changes anything about the agreement that you have in place, whether your side of it or the people that hadn't signed on to the agreement?

Dominic Frederico

No. I think the current potential impact of PROMESA we believe is a positive relative to the PREPA restructuring, or the PREPA negotiation. And we consider that still going on course. And we would believe that the PROMESA board would support the PREPA restructuring as currently constituted. And since it's already been not only accepted by us, the majority of the creditors, the regulatory -- the utility board, the government itself as well as the existing governor, we believe that makes the most sense. And therefore it's still got to go on this rather slow path. But we expect it to be accomplished.

Chas Tyson

Okay. Thank you very much, guys.

Dominic Frederico

You're welcome.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Robert Tucker for any closing remarks.

Robert Tucker

Thank you, operator. I'd like to thank everyone for joining us on today's call. If you have additional questions, please feel free to give us a call. Thank you very much.