Assured Guaranty Ltd. (AGO)
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Q2 2014 Earnings Call

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Managing Director, Corporate Communications and Investor Relations

Thank you operator and thank you all for joining Assured Guaranty for our second quarter 2014 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, future rep and warranty settlement agreements, or other items that may affect our future results.

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In turning to the presentation, our speakers today are Dominic Frederico, President and Chief Executive Officer of Assured Guaranty Limited; and Rob Bailenson, our Chief Financial Officer. After their remarks, we'll open the call to your questions. As the webcast is not enabled for Q&A, please dial into the call if you'd 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 second quarter 2014 earnings call.

Assured Guaranty produced solid results in the second quarter and first half of 2014. In addition to recording $233 million of operating income year-to-date, we generated $58 million of PV premiums, which is 71% ahead of where we were at this point last year.

Additionally, we continued to successfully execute our capital management strategies. In particular, we took further steps toward optimizing our capital mix, which included a very successful $500 million debt offering and additional share repurchases. From January 1, 2013 through August 1 of this year, we repurchased over 26.6 million shares, which is equivalent to 14% of our January 1, 2013 share count. Rob will give you more detail on both the debt issue and our current share buyback activity.

Of course, as we think about buying back shares, it's important to remember that the maintenance of our strong financial strength ratings is critical. Right now, we have more available capital than we can put to work given the low interest rate environment - and that excess capital keeps growing through the amortization of our existing portfolio. We can therefore continue to buy back shares while still maintaining a very high level of capital protection for our insured portfolio.

In fact, in S&P's July 2nd full annual report on Assured Guaranty, the rating agency showed our capital adequacy cushion to be $1.45 to $1.55 billion at year-end 2013, up from $450 to $500 million a year earlier. The capital adequacy cushion is the amount of capital we would have at the end of their simulated AAA depression test. S&P repeated that $1.45 to $1.55 billion range in its July 14th FAQ about bond insurers' exposure to Puerto Rico, in which it also made clear that this cushion means, in S&P's exact words: "These cushions are additional losses, actual or theoretical - beyond what we already assess in our analysis of each bond insurer's exposure to issuers in Puerto Rico - that means Assured could incur and still retain the current ratings."

As we've said in the past, our obligation is to pay debt service only as it comes due on the original schedule, thus allowing us to maintain our strong liquidity position.

Assuming that Puerto Rico's Recovery Act survives a constitutional challenge, it would be applicable only to certain public corporations. As of July 31st, we have $772 million of insured net par exposure to the Puerto Rico Electric Power Authority, or PREPA, and $1.7 billion of additional net par that is subject to the Act. Our total exposure to credits under the Act is spread across five different credits with distinct revenue streams, which should contribute to strong recovery rates if we end up making debt service payments on any of these credits.

In looking specifically at PREPA – widely considered the weakest credit of the group - we would be looking at an average annual net debt service of about $64 million over the next ten years. With $12 billion of claims-paying resources across our group, and the approximate $400 million of investment income we generate each year from our $11.6 billion investment portfolio, even a 100%-severity loss would obviously be manageable.

That logic also applies to the other four exposures subject to the Act, which together have an aggregate net principal and interest requirement of approximately $113 million per year over the next ten years.

Detroit is another credit that continues to draw a lot of attention. As I discussed on our last call, we have a tentative settlement regarding the unlimited tax general obligation bonds. The Company continues to participate in court ordered mediation with respect to the proposed treatment of the Detroit water and sewer bonds in the plan of adjustment.

As always, we will continue to pursue our strong legal rights in this matter to prevent any impairment of the DWSD coupons or their call protections.

It is important to keep in mind that in the defaults of Jefferson County, Alabama; Harrisburg, Pennsylvania; and Stockton, California, our eventual outcomes were better than many had anticipated when the news first broke, and significantly above what we were initially offered by the issuers. Without minimizing the challenges Puerto Rico and Detroit face, we are well positioned to negotiate forcefully for fair outcomes that acknowledge and respect our legal rights.

The silver lining in occasional distressed situations like Detroit and Puerto Rico is that they reinforce the value of our product – value not only from the protection of principal and interest in case of default but also value from additional benefits, such as our role in lifting the burden of workout negotiations from investors and, importantly, the greater liquidity and price stability that our insured bonds have exhibited relative to uninsured bonds of the same issuer.

We think the market's growing appreciation of the value of our insurance, along with S&P's upgrade of our financial strength rating to AA with a stable outlook on March 18th, is contributing to an increase in demand for our product.

Turning to Moody's, on July 15th Moody's published a request for comment on proposed revisions to the rating criteria for bond insurers. Moody's said they do not expect any ratings to change if the revisions are implemented as proposed. However, under the proposed criteria, it is hard to conceive how a bond insurer could ever achieve a Aa Moody's rating. In one subcategory, for instance, no bond insurer could be rated Aa unless the industry writes $250 billion of new bond insurance per year – the equivalent to 80% of all the municipal bonds issued in 2013. This seems designed to be an impossible hurdle. Just consider the fact that about 16% of the par issued in 2013 was AAA and another 48% was in the AA in category. The reality is that our target market of single-A and Baa rated credits was only 30% of the market, representing $95 billion of 2013 volume – to put a standard for AA of 80% seems specifically designed to be unachievable.

In the same proposal, Moody's would significantly reduce the importance of a financial guarantor companies' insured portfolio quality and capital adequacy in their new criteria. Yet recent industry experience has clearly shown that the quality of an insurer's guaranteed risks and the adequacy of its capital are the two most important components of its financial strength and the key factors that provide protection to investors in insured bonds.

We think it's very important that the market participants take the opportunity to read this proposal and provide their feedback to Moody's by the September 15th deadline.

Turning to production, we have seen a positive trend in U.S. municipal insured volume, with year-to-date insured par sold in the primary market up 30% for the industry despite a 16% decline in overall new issuance. Insurance penetration was 5.5% of par sold during the second quarter, the highest quarterly level since third quarter 2011. That 5.5% penetration compares with 4.6% in the first quarter of this year and 3.9% in last year's second quarter. Looking at just single-A transactions, which represent a significant portion of our target market, more than half of the second quarter 2014 transactions were insured, and represented 21% of the single-A par sold in the second quarter.

But keep in mind, demand for bond insurance is still limited by interest rates that are materially below historical norms and credit spreads that remain tight.

Hopefully, we will start to see some upward movement in interest rates now that the Fed seems to be on course to end its quantitative easing program by October. Higher interest rates should make insurance more affordable.
As for our own municipal production during the second quarter, the $2.5 billion of new U.S. municipal issues sold with AGM or MAC insurance is a billion dollars more than in the first quarter, a 72% increase. We guaranteed 54% of the insured par sold in the primary market during the quarter.

Additionally, we insured $311 million of U.S. municipal bonds in the secondary market during the second quarter, bringing our total secondary market par insured to $492 million for the half – an 83% increase over first half 2013 – and this brings our total first half U.S. municipal par insured to $4.4 billion.

Taking a closer look at our second-quarter production, our $2.45 billion of U.S. municipal insured par written had an average rating in the A category, and generated $16 million of PV premium. This clearly reflects our pricing discipline when you consider that our only other active competitor reported $1.78 billion par of similar business written - but generated only $5.3 million of PV premium. Therefore, our competitor's premium to par ratio was approximately 30 basis points, compared with 65 basis points for Assured Guaranty.

I'm also pleased to say that, a year after its launch, our U.S. municipal-only subsidiary MAC is now licensed in 48 states and the District of Columbia, having received its California license in July.

In structured finance during the second quarter, we closed four transactions. These included a $200 million diversified payment rights future flow transaction issued by Garanti, Turkey's second largest private bank, and a private capital relief transaction.

In summary, we continue to manage our capital to optimize shareholder value through share repurchases while maintaining our strong financial condition.

We continue to find opportunities to mitigate losses as our legacy troubled exposures amortize.

Demand for our municipal bond insurance has increased, and we have promising structured finance and international opportunities.

As always, I look forward to updating you on our activities during the second half of the year.

Now I'll turn the call over to Rob.

Robert Bailenson
Chief Financial Officer

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

As Dominic mentioned, we accessed the capital markets in the second quarter, and I am very pleased to report that we issued $500 million of 10-year senior notes with a 5% coupon. Market support for this transaction was excellent, with bids from over 130 individual investors generating a $2.4 billion book for the offering. Our initial target was an offering of $300 million, but with a book that was eight times oversubscribed, we decided to increase the issuance to $500 million. This offering will lead to a reduced overall cost of capital, and is another step toward achieving an optimal capital mix for our company.

We also continued to repurchase common shares throughout the second quarter, and into July. We repurchased 7.1 million shares in the second quarter of 2014 and an additional 5.7 million shares since June 30th. This brings our total repurchases since January of 2013, to 26.6 million shares for a total of $609 million. The average cost per share was $22.91. This week, our Board authorized an additional $400 million of share repurchases, which brings our total current authorization to $455 million.

Stock buybacks are contingent on our available free cash flow, capital position, maintenance of our ratings and other factors.

Turning to our operating results, we had $101 million of operating income in the second quarter of 2014, or 56 cents per share, compared with $98 million or 52 cents per share in the second quarter of 2013. The increase in operating income per share was primarily attributable to share repurchases. Operating income was up slightly and included a few notable variances in premiums and losses.

Premiums earned and credit derivative revenues included $25 million of accelerations in the second quarter of 2014, compared with $60 million in the second quarter of 2013. Scheduled net earned premiums were also lower due mainly to the amortization of structured finance par.

Loss expense in the second quarter of 2014 for the U.S. RMBS and other structured finance sector was $52 million lower than second quarter 2013 due primarily to the continued improvement in the performance of the underlying RMBS exposures. Loss expense in the public finance sector was relatively flat compared with second quarter of 2013. Public finance loss expense for the second quarter of 2014 included an increase in Puerto Rico losses, while the second quarter of 2013 included losses on Detroit. Both second quarter 2014 and second quarter 2013 included an R&W benefit with various counterparties.

For the second quarter of 2014, economic loss development was $23 million, which included $137 million of economic loss development on various credits, primarily additions to our Puerto Rico reserves, offset in part by positive economic development of $114 million, primarily attributable to improvements in the RMBS portfolio.

Operating shareholders' equity per share has been steadily increasing over the last several years and has hit $35.31 as of June 30, 2014, while ABV per share rose to $50.82 per share, primarily as a result 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.

Q&A

Operator

Thank you. [Operator Instructions] And the first question comes from Sean Dargan with Macquarie.

Sean Dargan, Macquarie

Thanks. Good morning. I have a question about some of the assumptions baked into your economic loss development. Yesterday a competitor indicated that in their probability weighted analysis, the range they are looking at for PREPA losses – for PREPA, loss severity was between 10% and 35%. Directionally, is that kind of how you're thinking about PREPA?

Dominic Frederico

I'll answer that. We don't really give out that kind of information. In our reserve analysis, as per the GAAP requirements, you do the scenario assessments. I will say there is a range of potential outcomes that go from fairly optimistic, realistic and then go into the pessimistic, so we have a wide range and I don’t feel comfortable in giving you our exact percentages.

Sean Dargan

Are you in the pessimistic range now?

Dominic Frederico

No. Remember, it takes… each of them gets a probability weighting. So it really depends on how much weight we give to each of those specific additions. I think our reserve, as we've said, we added to the reserve in the current quarter as we continue to monitor the activity there, and we think it's incredibly reasonable at this time relative to all the facts that we can ascertain for the continuing developments in Puerto Rico.

Sean Dargan

Okay thanks. And one follow up. In regards to how you are thinking about deploying capital in the near future, I think there is a block of FG business that may be on the market that has its own Puerto Rico liabilities. Just wondering your thoughts on adding portfolios and what kind of return hurdles you would need to do so?

Dominic Frederico

Well, as you know our goal is to, in effect, consolidate the industry once we determine that A, the transaction makes sense from a return point of view and two, we're comfortable with the existing portfolio of the specific company. If there are troubled credits obviously in any portfolio we would analyze, we would either set aside, or attempt to get paid or set up some other vehicle to handle those specific exposures, especially in light of if we believe we've got enough exposure to a given name that is part of the troubled credit analysis. And your point is which is the better transaction? I think you're getting at buyback or acquisition. We say you've got to be cognizant of both. Remember, buyback is always going to be limited to the amount of free cash, and the amount of dividend capacity coming out of the operating entities. We still believe that would leave us with excess capital within the operating groups. And this does give us an opportunity to put that capital to work at very high returns, and especially given the fact that capital for the current period of time is still going to be retained by that specific operating entity.

Sean Dargan

Great. Thank you.

Dominic Frederico

You're welcome.

Operator

Thank you. And the next question comes from Geoffrey Dunn with Dowling & Partners.

Geoff Dunn, Dowling & Partners

Rob, first, could you update us on holding company liquidity, as well as the U.S. HoldCo liquidity please?

Rob Bailenson

Sure. As of June 30, Jeff, we had $585 million at the U.S. holding companies, and we have about $46 million at AGL.

Geoff Dunn

Okay.

Rob Bailenson

Also the unencumbered assets at AG Re is sitting at about $217 million.

Geoff Dunn

Okay. And then, Dominic, on the municipal business, you highlighted the PVP-to-par ratio of 65 bps. We saw that ratio fall to a similar number a year ago, and it's solidly below kind of that 100-plus threshold that we tend to look for. What is it about last year / this year? I think last year, the answer was credit spreads. But what is it about what's going on in the second quarter business profile that, that ratio fell off so much?

Dominic Frederico

Well Jeff, A, I don't think that it fell off that much. I think I've looked at it from quarter-to-quarter, and it was fairly flat. I have to go back and look at my notes for the prior year. There always is the issue of mix of business and I'm trying to remember, last year's second quarter, I don't know whether the JeffCo sewer bonds rewrite enters into that. But there will be – especially on some of these workout credits, some aberrational kind of results that will blow-up the numbers in any given quarter. I think as we look at the 66, we think it's more than reasonable relative to spreads and interest rates and still provides an adequate return on the capital. And remember, when we look at our capital allocation, we charge each deal with capital to the legal term. And obviously in most cases, you wind up having the capital refunded to you at the call because the bonds are called. So we typically understate our return and, as I said, the 66, I thought it was, basis point average, we were quite pleased with the return scenario.

Remember, we're writing typically category 1, category 2, low capital charge, S&P risk. So it's disproportionate to a certain extent relative to a more diversified book. As we said, we averaged an A rating this quarter across the entire portfolio of new business written, so that mix also will contribute to it as well, Geoff.

Geoff Dunn

So barring workouts and the material change in mix, you think this is a good proxy for current market conditions?

Dominic Frederico

Yeah, I think we maintained discipline. I would like it to be higher, and I think as interest rates would move higher with the wider spreads and therefore provide us better opportunities, but I am not displeased at the current level of activity in the quarter and especially in light of facing rather stiff pricing competition from the competitor in the market that was literally half our premium rate.

Geoff Dunn

Okay, great. Thank you.

Operator

[Operator Instructions] And we have a question from Ted Wachtell from Millennium.

Ted Wachtell, Millennium Partners

Hi there, good morning.

Management

Good morning.

Ted Wachtell

I wanted to ask you about your disclosure on the Puerto Rico exposure, because you show them net versus gross and net, and MBIA shows them in a gross fashion. So A, how come you don't give us gross exposures? And B, is there any additional exposure over the net to Puerto Rico via entities that you reinsured with who could be less than quality counterparties that we should be aware of?

Dominic Frederico

Okay. So first, we do show total gross par for all of Puerto Rico. We don't show it by the entities, you're right. And then obviously we can easily add that disclosure. More importantly, to your real question is, as we look at our reinsurance, we are very, very comfortable with the strength of the reinsurance and, specifically to your question, out of approximately $1.2 billion of reinsurance, there is $20 million of reinsurance to a ceding company that I would consider -- assuming company, rather -- that I would consider potentially an issue -- and it's $20 million, part of $1.2 billion -- therefore we don’t consider it significant. That's why we look at it net, because all the people in our reinsurance panels are all very well capable of fully paying their share of the losses.

Ted Wachtell

Okay. You just mentioned that you could easily break that out, I would love to see you break that out going forward the way MBIA does.

Dominic Frederico

Duly noted.

Ted Wachtell

Thank you.

Operator

Thank you. Thank you. And the next question comes from Larry Vitale with Moore Capital.

Larry Vitale, Moore Capital

Hi, thanks. Good morning, guys.

Dominic Frederico

Hey, Larry.

Larry Vitale

So I just wanted to get confirmation that the unencumbrance of the contingency reserves at both AGC and AGM took place in July?

Dominic Frederico

Larry, we did have a bet on whether this question was going to be asked by you – Rob won.

Rob Bailenson

I said it was going to be your first question, and it's a good one. We're actively discussing this with our regulators, and we're confident that it's going to be done very shortly.

Larry Vitale

Okay. And, can you remind us of the amounts -- it was $125 million at AGC and $133 million at AGM?

Rob Bailenson

Yeah, it's going to be roughly $244 million, when we get the release.

Dominic Frederico

Larry, just to give you a further clarification. New York sent us an email yesterday approving it and we're still waiting for the letter. So, we would expect that Maryland would follow suit since they seem to be all working together.

Rob Bailenson

Yeah, we really expect it to happen very shortly, Larry.

Larry Vitale

Okay, all right. That's helpful. And then I just wanted to go through the various categories of cash burn going forward with the new debt. So, HoldCo expenses are what $8 million a quarter or thereabouts?

Rob Bailenson

Yeah, roughly.

Larry Vitale

Okay. That's what you've guided us to in the past, and you're paying, what, about $19 million a quarter in dividends? And then the new run rate on interest expense is $26.25 million?

Rob Bailenson

I think – I have to check those numbers but I think that those are fairly close.

Larry Vitale

Okay. And that ...

Dominic Frederico

We have a job in our treasury department, if you want it.

Larry Vitale

Rob, you said -- and Dominic, you may have mentioned it as well. You said the words optimal capital structure. What is your optimal capital structure? And that's my last question.

Dominic Frederico

We knew that that question was coming too. So, you've got to look at it from who is giving us the requirements. Obviously, the one we pay most attention to is our own and then secondarily to S&P. When we look at S&P, we think, remember, they look at stat capital. So, we think the optimum mix is 70:30; 70 equity, or stat, and 30 of other items including debt, reinsurance, soft capital facilities, et cetera.

Larry Vitale

Okay. All right. Perfect. Thank you, guys.

Dominic Frederico

Thank you.

Rob Bailenson

No problem.

Operator

Thank you. And as there are no more questions at the present time, I would like to hand the call – turn the call back to management for any closing comments.

Robert Tucker

Great. 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.

Operator

Thank you. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect. Have a nice day.