Assured Guaranty Ltd. (AGO)
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Third Quarter 2023 Earnings Call

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Thank you operator. And thank you all for joining Assured Guaranty for our Third Quarter 2023 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 a replay of this call, or if you are reading the 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 most recent presentations and 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, along with 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.

We continued to build value for Assured Guaranty's shareholders and policyholders during the third quarter and first nine months of 2023. Adjusted book value per share of $148.03 and adjusted operating shareholders' equity per share of $99.18 both reached record highs at the end of the third quarter.

New business production has been strong this year, with significant contributions from U.S. public finance, international infrastructure finance, and global structured finance. For the fourth consecutive year, our PVP for the first three quarters reached or exceeded $240 million, coming in at $249 million for 2023.

In July, we completed our transactions with Sound Point Capital Management and Assured Healthcare Partners, which resulted in a $241 million pre-tax gain, net of expenses. We now continue our asset management diversification strategy through our 30% ownership interest in Sound Point. The earnings from that stake will be reflected for the first time in our fourth quarter reporting, furthering our strategy of generating fee-based earnings to complement our risk-based financial guaranty earnings. We also expect enhanced returns on our investment portfolio based on a broader range of alternative investment options with Sound Point. More generally, these changes will also result in a streamlining of some of our financial disclosures. Rob will expand on this in a few minutes.

In capital management, during the third quarter we completed our current debt restructuring efforts by refinancing $330 million of our senior obligations due next year. We also picked up the pace of our share repurchases, buying $64 million of shares in the quarter, and last week our board of directors increased our repurchase authorization by $300 million.

Before I go into greater detail about the quarter and year-to-date results, I want to tell you about two important management promotions. I'm pleased to announce that CFO Rob Bailenson will become Assured Guaranty's Chief Operating Officer, as of January 1, 2024.

Rob will assume responsibility over our financial guaranty underwriting and origination strategies worldwide, as well as other initiatives to grow our financial guarantee business and increase returns. He will also be working with me on setting the company's strategic direction and in assisting in executing other corporate priorities.

Additionally, we are fortunate to have an outstanding person to fill Rob's role as CFO, Ben Rosenblum. Ben is currently our Chief Actuary. Ben has managed, under Rob, many critical financial functions, including Accounting and Financial Reporting. As CFO, he will add Treasury, Tax and Investment Management to his portfolio of responsibilities. Ben's quantitative and management skills have helped us accomplish many business objectives since he joined us in 2004. Most recently, he was instrumental in completing the Sound Point transaction.

Rob and Ben have earned these promotions by making numerous significant contributions over their many years at Assured Guaranty. With their extensive understanding of our strategies, markets, business practices, and the unique characteristics of the financial guaranty business, I am confident they will provide great leadership in the years to come.

Turning to U.S. public finance, where total year-to-date municipal bond par issuance was down 9% year-over-year, we nonetheless achieved a nearly 10% increase in the par amount of bonds sold with our insurance, guaranteeing $14.1 billion for a 62% insured market share.

This includes $7.2 billion of par from 27 large transactions that each involved at least $100 million of insured par, up from $4.8 billion of par from 21 such transactions in the first three quarters of 2022.

Importantly, the industry has maintained relatively steady, high insured penetration rates this year, with a rate of 8.5% of new issue par sold for the first nine months of 2023, compared with 7.8% for the first nine months of 2022. The nine-month 2023 penetration rate is the highest in a decade.

And, in the third quarter of 2023, with overall par volume issued up only 3% year-over-year, we insured almost 50% more primary market par sold than we did in the third quarter of last year. Our insured par sold in the primary and guaranteed in the secondary markets totaled $4.4 billion, up from $3.4 billion in the third quarter of 2022.

We're also pleased with the increased activity we are seeing on bonds with underlying double-A ratings from S&P or Moody's. In that category, we insured approximately $2.8 billion of par during the first nine months of 2023, up from $2.3 billion of par for the first nine months of last year. We wrote 64 policies on such double-A transactions during the nine-month period, 55 of which were for new issues. We believe investors see our guaranty on high-quality credits as a mitigant to downgrade and market value risks.

In looking forward to the fourth quarter activity, we are off to a strong start. In the month of October, three U.S. public finance transactions between $350 million and $750 million sold or closed with our insurance - two airport transactions and a green bond transaction in the power sector.

Outside of U.S. public finance, our international public finance business produced $38 million of PVP year-to-date. We also have a promising pipeline of additional infrastructure business. In fact, during the fourth quarter, we are in the process of closing five transactions in the airport, water utility, higher education and student accommodation sectors, with par totaling almost $600 million.

In global structured finance, we produced $82 million of PVP year-to-date, assuring that 2023 will be our best year for direct structured finance production since 2009, and we have a number of future mandates expected to close this year.

The growth of our structured finance business further validates the three-pronged approach we take to writing financial guaranty business. By diversifying across U.S. public finance, global structured finance and international infrastructure markets, we can reduce production volatility over time as weaker conditions in one market can be offset by a more favorable environment in another.

Our last remaining non-paying Puerto Rico exposure is the power authority, PREPA, for which we continue our loss mitigation efforts. After mediation reached an impasse, the proposed PREPA plan of adjustment appears headed towards a contested plan confirmation hearing. We remain committed to resolving PREPA consensually, if possible, but we will protect our bond claims and enforce our creditor legal rights through litigation in the Title III Plan Confirmation and appeals process as necessary. Meanwhile, our outstanding PREPA insured exposure continues to reduce.

Overall, the strength of our insured portfolio has improved significantly in the last several years, largely because of our loss mitigation efforts. We now classify only 2.1% of our $242 billion insured portfolio as below investment grade, compared with 4.6% of the portfolio in 2017.

As I mentioned on our last call, during the third quarter, S&P reaffirmed its AA financial strength rating, with Stable Outlook, of our insurance companies, citing both our "very strong" financial risk profile and "very strong" business risk profile in its annual review of us. Its report describes many strengths supporting our AA rating, including S&P's view that we have "excellent capital and earnings with a meaningful capital adequacy buffer."

Additionally, in October, KBRA reaffirmed its AA+ insurance financial strength rating, with Stable Outlook, of our financial guaranty operating subsidiaries in its annual surveillance reports on AGM and AGC. It also commented that investor demand for our product may be further enhanced by economic conditions such as a tightening credit cycle and an economic environment of higher interest rates, volatile or widening credit spreads and economic uncertainty.

Our product is designed to provide value no matter the market environment, including when credit or market conditions are particularly uncertain. We believe that market disruptions during the pandemic and, more recently, volatility in the markets and the global economy; geopolitical unpredictability; and climate-related natural disasters, have resulted in a broader recognition of the protection and value our guaranty provides against unforeseen circumstances, and a greater appreciation for the capital and liquidity supporting our insurance policies.

We believe that concerns in the market can increase the demand for financial guaranty insurance, because it can help support price stability and provide greater certainty of execution for new issues in volatile pricing environments.

Our outlook is positive as we continue to focus on our core principles of:

- prudent capital management that is optimized for the benefit of our policyholders and shareholders
- disciplined risk management, and
- clear and well-executed strategies for new business production.

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.

I am pleased to report third quarter 2023 adjusted operating income increased to $206 million, or $3.42 per share. This represents an increase of 55% and 62%, respectively, compared with the third quarter of last year. The increase was primarily driven by the gain on the Sound Point and AHP transactions of $190 million, which is net of transaction expenses and deferred taxes.

The Sound Point and AHP transactions were strategic milestones towards our goal of increasing fee-based and alternative investment earnings in order to grow the returns of the Company while diversifying sources of income. With the Sound Point transaction, we will own a 30% interest in an asset manager with historically strong AUM growth that provides an array of alternative investment options.

In keeping with our commitment to invest a total of $1 billion in Sound Point managed alternative investments within two years, we committed $150 million to two Sound Point funds in the third quarter, and another $100 million since the end of the third quarter.

Including funds managed by Sound Point, AHP and others, as of September 30, 2023, we had $630 million in alternative investments. Our inception to date annualized returns across all alternative investments is 12%.

Before I get into a discussion of the third quarter, I wanted to highlight a few financial reporting changes resulting from the Sound Point and AHP transactions.

- First, while we are still reporting an asset management segment, it now primarily consists of our 30% share of Sound Point's earnings, net of any amortization of intangible assets associated with the Sound Point investment. Because all Sound Point reporting is on a one-quarter lag, our share of Sound Point results will first be reported in the fourth quarter.

- And second, the Sound Point and AHP transactions triggered the deconsolidation of all AssuredIM CLOs and CLO warehouses, as well as the AHP funds. However, due to the significant ownership interests and other control rights that we maintain in certain funds, we continue to consolidate three AssuredIM funds that are now being managed by Sound Point - a CLO fund, and two asset-based funds, with a total net-asset-value of $272 million. The net impact of CIVs to adjusted operating income was a loss of $10 million, which primarily consists of a loss on deconsolidation of the CLOs and AHP funds.

In the Insurance segment, adjusted operating income was $59 million in the third quarter of 2023, compared with $159 million in the third quarter of 2022. The decline was primarily attributable to increased reserves on PREPA exposures, and a lower benefit on RMBS transactions compared with the third quarter of 2022. Economic loss development in the third quarter of 2023 for RMBS transactions was a benefit of $48 million primarily due to higher recoveries for charged-off loans.

Higher earnings generated by the investment portfolio partially offset increases in loss expense.

- Net investment income on available-for-sale fixed-maturity securities increased by $32 million due to the acceleration of accretion on loss mitigation securities and higher short-term interest rates and average investment balances.

- Equity in earnings on alternative investments was a gain of $25 million in the third quarter of 2023, compared with losses of $11 million in the third quarter of 2022.

- In addition, fair value gains on Puerto Rico contingent value instruments were $4 million in the third quarter of 2023 compared with losses of $8 million in the prior year period.

Net earned premiums and credit derivative revenues increased to $99 million in the third quarter of 2023, from $92 million in the third quarter of last year. Accelerations were $15 million in the third quarter of 2023, compared with $12 million in the third quarter of last year. Deferred premium revenue remained steady at approximately $3.6 billion as new business production replenished the amortization of deferred premium revenue.

Total operating and compensation expenses across all segments were $91 million in the third quarter of 2023, down from $94 million in the third quarter of last year. The third quarter of this year includes $14 million in Sound Point and AHP transaction expenses, and no longer includes asset management segment expenses, which were $24 million in the third quarter of last year.

As you know our effective tax rate fluctuates from period to period based on the proportion of income in different tax jurisdictions. On a year-to-date basis, the effective tax rate was 18.4% for 2023 compared with 8.1% for 2022.

In addition to advancing our key objectives in asset management, alternative investments, and new business production, we continue to focus on capital management. In the third quarter, we increased the pace of share repurchases to $64 million or 1.1 million shares. Last week, the Board of Directors increased the share repurchase authorization by $300 million. We also achieved a great execution on the refinancing of $330 million of debt that was scheduled to mature in mid-2024. Our next debt maturity is now in September of 2028. The refinancing provides us the flexibility to pursue other capital management strategies, including share repurchases.

At the holding company level, we currently have cash and investments of approximately $146 million, of which $67 million resides in AGL. These funds are available for debt service and corporate operating expenses, as well as share repurchases and other strategic initiatives.

The transformation of our asset management segment, the efficiency of our capital management activities and focus on new business origination and earnings growth continue to drive adjusted operating shareholders equity, and adjusted book value per share to new records of over $99 and $148, respectively.

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

Thank you.

QUESTION & ANSWER SESSION

Operator

[Operator Instructions] First question comes from Tommy McJoynt with KBW.

Thomas McJoynt, *Keefe, Bruyette, & Woods*

Looking at the gross written premium and the PVP in the quarter, there was a sizable decline. And while I understand the structured finance side can be lumpy, should we read anything into this such as a pullback or a tightening of credit from your underwriting standpoint? Or is this simply a function of what the market gave you and you're really trying to write as much new business as you can?

Dominic Frederico

It's really a function of mix of business in the quarter. There was a rapid or a start of decline in the BBB issuance in the quarter, which obviously is where we eat most of our pudding. So that affected what we were able to write. So we wrote a lot of what I'll call, down the middle of the road, flow business, highly rated. Now the rates that are available to us in the marketplace.

Robert Bailenson

And Tommy, as we said, as Dominic said in the fourth quarter, we're seeing a strong flow in public finance.

Thomas McJoynt

Got it. Okay. And then switching gears on the capital standpoint, is your leverage position, your debt to capital, a constraining factor that could inhibit you from doing more buybacks at some point? And when you and perhaps your regulators look at the opportunity for buybacks and what that could mean for your debt-to-capital ratios, do you look at a capital number that includes or excludes the other comprehensive income, given the swings that we've seen there?

Robert Bailenson

Well, the regulator would look at excluding other comprehensive income looking on a statutory basis. And we look – we generally look at our debt-to-capital ratios with respect to the rating agency constraints. And yes, it's true that as you – if, in fact, you somehow shrink your capital that you also have to delever. But with our refinancing that we did this year and that we're able to push our maturity of 5 years, we have flexibility going forward of what we can do in capital management.

Dominic Frederico

Yes. At this point time, it's not a constraint.

Robert Bailenson

But it's always something that we look at.

Thomas McJoynt

Okay. Got it. And then just last question. What's your initial understanding of the potential tax regime changes in Bermuda and how that could impact your business? And to the extent that the effective tax rates do increase there, do you think that your business could pass through those rate increases in order to maintain returns?

Robert Bailenson

Yes. And at the end of the day, as you know, the global minimum tax is going to be effective in 2024. So because Bermuda had a no tax jurisdiction, we would have had to pay whatever income that Bermuda makes, 15% would go to the U.K. because we're a U.K. tax resident. So if Bermuda initiates tax, then we just would not have to pay that tax to the U.K., we would just pay that tax to Bermuda.

And yes, we believe that, obviously, would be profitable. And also, just remember, it's still significantly lower whatever tax – it was significantly lower than the U.S. And there's a significant amount of capital here in Bermuda that earns at a lower tax rate, and we constantly evaluate and do tax planning based on that.

Operator

We now turn to Giuliano Bologna with Compass Point.

Giuliano Bologna, *Compass Point*

Congratulations on another successful quarter. It's great to see the continued strong performance. One thing I was curious of asking and I may have missed this during prepared remarks, I'm curious if there's any commentary about special dividends or how do you think about your ability to request special dividends at this point or – and then also how do you think about topping off capital to holding company on kind of a go-forward basis that way.

Dominic Frederico

Well, Giuliano, I'm pleased to report that we filed applications with both regulators for a special dividend approval. So we're now just in waiting mode, which we're optimistic of this to be approved. So that's part of the capital management strategy, part of the capital buyback strategy. So we're doing exactly what we said we would do.

Giuliano Bologna

That's great. And then one thing I would be curious about, on the new business front. The higher interest rate environment obviously drives lot of demand but it's not linear the way it flows through. I'm curious when you think about market penetration rates on the muni side and where that could go over the next couple of years, obviously, assuming we stay at a higher-for-longer environment.

Dominic Frederico

Well, as I said in my comments, penetration rates are at all-time high relative to the last, let's say 10 years. And to give you some really startling statistics, as we said in the quarter, there was not a lot of BBB issuance because I think there's a wait-and-see in terms of the interest rate marketplace and going to finance side and then have the opportunity to look later on the life that the rates are a lot lower. But to give you some statistics in the third quarter on a transaction basis, 84.7% of all BBB issuance took insurance, 84.7%.

That means only 15% of the BBB issuance did not take insurance. That's a tremendous statistic for the insurance industry. I think it's reflective of the higher rate marketplace. Our problem is we just need more volume in the market to really drive more premium growth, which we can see in the future. As Rob mentioned, we're having a great fourth quarter start. We expect the fourth quarter to be spectacular on the public finance side as well as our other marketplaces as well.

Giuliano Bologna

That's very helpful. I realize it's very early in the process with the Sound Point transaction. I'm curious just even if we start from a high level, do you expect contribution to be positive starting next quarter because you referenced that you get the first full quarter.

Dominic Frederico

Absolutely, and we are on 30% of a $50 billion asset manager, Giuliano. So we expect it to be positive all the way through. We wouldn't have done it otherwise.

Operator

[Operator Instructions] Now we turn to Geoffrey Dunn with Dowling & Partners.

Geoffrey Dunn, *Dowling & Partners*

Dominic, I was wondering if you could just talk about how the market for new business has evolved in the last two years? Obviously, we've had a lot of movement on rates and spreads, but can you give either qualitatively or quantitatively how the market has changed over the past two years with respect to penetration rates, pricing terms, conditions? I mean, net-net, it seems like it all should be positive, but obviously, it gets distorted from what we see with mix change and all that stuff. So wondering if you could just dig a little bit more into that.

Dominic Frederico

Well, Geoff, I would say it's all positive except for one thing, which is issuance. So let's talk about it. So number one, interest rates are higher that's a real benefit to our business across the board, both what we can charge for premium in addition to how many people would seek insurance now to try to save some financing costs.

Issuance has been is, a) the municipalities has been awash with cash due to the relief that they got through the pandemic. So they have run out of their checkbooks, which has taken quite a long time, so we didn't have any need to finance. And then two, because of the volatility in the marketplace and the interest rate environment, people are a little concerned that there's always a prediction that rates are going to come back down, so whether I should wait to finance in 6 months or 9 months because I will get a better rate.

So I think we've got conditions that support the growth of the business and support the insurance industry through the interest rate process. Like I said, they haven't had a need to borrow, but we know in the municipality world, it's not a matter of if, it's only a matter of when and the when is coming. And because of the higher rates, we think we're in great shape to make significant production gains across the board.

Spreads, of course, in a volatile market, tend to be a little bit volatile. They're a little tight now, but we expect them to widen out as well, which will further benefit production. So I think it may tell two stories; the interest rate environment helps, but the issuance market is lower because of the awash in cash that came out of the pandemic relief as well as the fact that people are looking for better rates for finance.

Geoffrey Dunn

And if I remember, we were like 6% and change penetration rate 2 years ago and now you -- I think you said 8.5% year-to-date?

Dominic Frederico

Right. And like I said, if you break it down between the where we're actually strong in the marketplace in the A and the BBB. So to give you another statistic, I told you, 84.7% of BBB transaction grabbed insurance, 59.5% of the A transaction grabbed insurance.

So think of it both in the BBB and A space well over 50% penetration rates, which is what I had predicted 1,000 years ago based on penetration rates that I expect based on us being AA rated and what's available in the market.

And also, the fact that we're in the other two markets of structured finance and international infrastructure really provides us further support and a little stability in the earnings that we can see and the production that we can make. And of course, as you know, the returns on those businesses are even higher – significantly higher than the domestic public finance business.

Geoffrey Dunn

And then one last follow-up, given what you just said about BBB and A penetration, you also indicated that you're gaining traction in AA. So is your view that it's an 8% to 10% type of penetration rate? Or is it still – I think years ago, when you were talking about maybe recovering at 15%. What's your view on the ultimate penetration...

Dominic Frederico

I still think we can get to 50% of the 50%, which is 25%. That's my view, and I still stick to it. And as I said, if I look at the BBB and the A penetration, we're there, we just need to get more participation than AA. Now I think we'll get to the numbers. So I think easily over 10% in a normalized marketplace. If we continue to see high interest rates and spreads wide now, that penetration rate will grow as well.

Operator

This concludes the question-and-answer session. I would now like to turn the conference back over to our host, Robert Tucker for 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.