Assured Guaranty Ltd. (AGO)
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First Quarter 2019 Earnings Call

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Thank you operator. And thank you all for joining Assured Guaranty for our first quarter 2019 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 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 most recent presentations, SEC filings, most current financial filings, and for the risk factors.

The 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 the reconciliations 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.

In the first quarter of 2019, Assured Guaranty once again established new per-share highs for shareholders' equity, operating shareholders' equity and adjusted book value. We continued to be the leading municipal bond insurance company and made further progress in building the markets for our financial guarantees in the international infrastructure and structured finance markets.

In terms of new business production, our diversified underwriting strategy once again proved its value during the quarter. Each of our financial guaranty businesses – U.S. public finance, international infrastructure finance and global structured finance – made a meaningful contribution.

For U.S. public finance, municipal bond yields declined throughout the first quarter of 2019, and fell more rapidly after the Fed announced an indefinite halt to interest rate increases. Lower yields limit demand for our guaranty as some investors forgo the extra security in favor of achieving more yield. The yield decline was most pronounced at the long end of the curve, where the negative effect on our premiums is greatest because they are calculated as a percentage of total debt service over the life of each transaction. Some of the yield pressure is due to the strongest net quarterly inflows to municipal bond mutual funds since that data was first collected in 1992, possibly because people preparing their federal tax returns were realizing that tax-exempt municipal bonds are one of the few remaining tax strategies, after so many of the tax deductions were eliminated or capped by the 2017 tax law changes.

Also during the quarter, credit spreads narrowed, particularly in the single-A and triple-B categories where we insure the majority of our transactions. The spread between A and AAA 30-year munis ended the quarter at 43 basis points, the tightest level in 11 years. Under these conditions, insured primary market penetration for the industry was approximately 5% of par volume and 16% of the deal count. However, as in recent quarters, more than half of the A-rated transactions utilized bond insurance in spite of the market pressures brought by low interest rates and tight spreads.

In terms of the overall municipal par issued in the first quarter, the 22% year-over-year growth was deceptively large because volume in the first quarter of 2018 was suppressed by a rush to issue bonds during the uncertainty about impending tax reform that prevailed near the end of 2017. Using the first quarter of 2017 as a more typical reference point, first quarter volume in 2019 would be down 13% on that basis.

During the quarter, Assured Guaranty led the municipal bond insurance primary market with 56% shares of both insured par issued and the insured transactions sold. Additionally, our secondary market business performed well, with secondary market par insured increasing 74% compared with last year's first quarter result. In total, we insured $2.4 billion of U.S. public finance par.

Our primary market business included the largest insured Green Bond transaction to date, where we insured almost $180 million of New York MTA's Transportation Revenue Green Bonds, which were issued with third-party climate bond certification. We look forward to adding value to more certified Green Bonds, which is a way we can help municipalities lower the cost of reaching their environmental impact goals.

We also closed another significant healthcare transaction, guaranteeing $81 million of taxable Massachusetts Development Finance Authority bonds for Tufts University Medical Center, part of the Wellforce Health System.

In international infrastructure finance, we have now recorded new business premiums in 14 consecutive quarters, which attests to the expanding understanding of and interest in our guarantees on the part of both investors and issuers outside the United States. On March 31st, we announced an innovative, £135 million Debt Service Reserve Guarantee for the Welsh Water group. The guarantee replaced existing bank facilities, which was the first of its kind for a large U.K. water and sewerage company. We believe this product will be attractive to similar companies who can benefit from a long-term alternative to bank liquidity facilities that are subject to annual renewal.

Brexit remains a wild card, but not one we expect to have a major impact on our future opportunities. We have strategies in place to deal with a number of Brexit scenarios, including a hard Brexit, and we are at various stages of executing these plans as events unfold.

Our global structured finance business produced solid first quarter results, generating $6.6 million of present value new business production, or PVP. Transactions we insured included a large collateralized loan obligation and secondary market wraps of whole business securitizations. We also insured an aircraft residual value insurance transaction. We see additional opportunities in these sectors this year, as well as in the life insurance sector.

Since the beginning of the year, we have seen several developments in Puerto Rico. Reassuringly, general fund revenue results for the nine months ended March 31st were 8% above the revised projections in the most recent certified fiscal plan from October 2018. To add some perspective, the Commonwealth previously disclosed that for the eight months ended February 28, revenues were up more than 5% against the October revised projection and almost 33% against the original projection in June 2018's fiscal plan.

Additionally, the government announced that the number of private sector jobs now exceeds the level before Hurricane Maria, and according to the Puerto Rico Economic Development Bank, the unemployment rate declined from 10% to 8.8% between March of 2018 and March of 2019, a 12% annual decrease.

In early May, we joined an amended Restructuring Support Agreement for the Puerto Rico Electric Power Authority, along with a group of uninsured PREPA bondholders, the Commonwealth and the Oversight Board. We believe the settlement outlined in the new RSA can be the foundation for an effective, consensual plan of adjustment that assures reliable electrical power for the people of Puerto Rico, and we are committed to continuing to work cooperatively with PREPA and the other stakeholders along the path to plan confirmation.

There is an important distinction between Assured Guaranty and other creditors in the restructuring process. We have the ability to add value to the securitization exchange bonds we receive, by potentially attaching our guaranty to them. If we insure these bonds, we believe this could materially improve Assured Guaranty's overall recovery under the transaction, as well as generate new insurance premiums. For that reason, our economic results could differ from those reflected in the RSA. Additionally, by insuring the replacement bonds, our economic interest would continue to remain aligned with that of the debtor over the long term, and we would both benefit from the debtor's improved fiscal solvency and long-term economic success.

There is more work to be done to achieve a plan of adjustment based on the PREPA RSA, and other credits still need to be addressed. We believe strongly in our collateral and legal rights across all of our Puerto Rico exposures and will vigorously enforce these rights if consensual deals are not reached.

In another matter, Puerto Rico's Oversight Board is appealing the First Circuit's decision holding that PROMESA's procedure for appointing Board members is unconstitutional. It's impossible to know whether the High Court will agree to take the case. Meanwhile, there is the possibility that the president will appoint, and the Senate will confirm, all or some of the existing members. We believe Senate hearings would be a good place to air the differences between Congress's intent in passing PROMESA and the actual performance of the board, whose actions have frequently worked against the law's express goals of respecting constitutional priorities and contractual liens.

One of the Oversight Board's most troubling actions is an attempt to have some of the Commonwealth's G.O. bonds declared invalid and to claw back previously distributed principal and interest from bondholders, on the grounds that those bonds were issued in violation of the constitutional debt limit. Some might argue that we should accept the invalidation because our exposure to the bonds in question is much smaller than our exposure to the unchallenged G.O. bonds and it could increase the likelihood of a full recovery on the rest of the G.O.'s and perhaps better recovery on some of our other exposures. That view is not only bad business but also an atrocious disregard for the rule of law. Our position is that ALL of the general obligation bonds should be provided 100% recovery, because of the constitutional requirement that they must be paid before all other government expenses, and there is more than adequate funds to service the debt.

Furthermore, considering the representations and disclosures the Commonwealth presented when it issued the challenged bonds, and considering that it already accepted and spent the proceeds, we consider any challenge, much less invalidation, of those G.O. bonds illegal and immoral. It is very dangerous to allow a municipality to borrow money with all the disclosures and legal support required at the time of issuance, and then turn around and say "Sorry, we lied, and because we lied, we won't pay your debt service."

There are multiple Supreme Court cases going back to the 19th century that say you can't do that, and for obviously good reasons.

The point is surely known by the highly compensated lawyers and consultants on which the Commonwealth is showering hundreds of millions of dollars of local taxpayer money. So their position is merely a negotiating ploy that, among other things, is intended to drive down the market value of the bonds in order to try to justify less than 100% recovery.

The Commonwealth and Oversight Board are also trying to persuade the courts to reverse the historical treatment in bankruptcy of special revenue bonds. The authors of the relevant bankruptcy provisions enacted in 1988 and the entire municipal bond market understood that it is mandatory, not optional, for special revenue payments to continue uninterrupted throughout a bankruptcy. Yet the Title III Court and the First Circuit Court have ruled otherwise, with serious potential consequences for the stability of the special revenue bond market.

The contagion effect of the unwillingness of the Commonwealth and Oversight Board to repay Puerto Rico's debt is already becoming evident. Rating agencies are reexamining, and in some cases changing, revenue bond ratings based on the increased uncertainty about the security arrangements for special revenue bonds. And, more generally, the market must now reevaluate what "full faith and credit" really means and reconsider how much yield is required to compensate for political risk – the possibility that officials will be unwilling to pay for the general obligation commitments made by their predecessors.

Assured Guaranty is prepared to take every case as far as necessary to preserve the security arrangements and laws that underpin the municipal bond market and specifically our legal rights under our insurance policies.

All the rating agencies that follow us have published opinions that our Puerto Rico exposures are manageable, including Moody's about two weeks ago, and we have few, if any, other credits in our insured portfolio that are truly problematic. Our claims-paying resources remain near $12 billion, even as our net par exposure has declined 63% since 2009. We are in a very strong financial position and will continue to provide financial protection to our insureds.

Looking at our pipeline of probable business and our other strategic objectives, we feel confident that 2019 will be a rewarding year. We estimate that the trend in our declining par exposure will reverse in the near term, as we begin insuring business at a higher rate than our insured exposure amortizes. We have and will still have significant excess capital that we will continue to manage through share buybacks and dividends. And we continue to look for appropriate alternative investments to diversify our corporate profile.

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.

The Company's results were strong in the first quarter of 2019 as we once again reached record high operating shareholders' equity and adjusted book value per share of $62.00 and $86.95, respectively. These milestones demonstrate the ongoing value created for our shareholders through various strategic initiatives. Dominic just reviewed our new business production and the progress we have made on resolving our Puerto Rico exposure, and I will cover our share repurchase program later on, but first I will review the first quarter of 2019 operating results.

In the first quarter, operating income was $86 million or $0.82 per share, compared with $155 million or $1.33 per share in the first quarter of 2018. Lower net earned premiums from refundings and higher loss and loss adjustment expenses were the primary drivers of the variance.

Net earned premiums were $118 million in the first quarter of 2019 compared with $145 million in the first quarter of 2018. As expected, after the passage of the 2017 Tax Act and consistent with the amortization of our insured portfolio subject to call, accelerations due to refundings and terminations declined to $26 million in the first quarter of 2019, compared with $52 million in the first quarter of 2018.

First quarter 2019 loss and loss adjustment expenses were higher than first quarter 2018, mainly due to higher U.S public finance losses, offset by lower losses in RMBS. As we have said in the past, loss and loss adjustment expenses reported in income in any given period differs from economic loss development due to the consideration of unearned premium reserve in the calculation of loss and loss adjustment expenses under GAAP accounting rules.

Total economic loss development was a benefit of $2 million in the first quarter of 2019, which primarily consisted of a $65 million benefit in U.S. RMBS, offset by increased loss and loss adjustment expenses for certain Puerto Rico exposures. The benefit in RMBS was mainly related to a general increase in excess spread and the improved performance of second lien transactions. The economic development attributable to changes in discount rates was a benefit of $4 million in the first quarter of 2019.

In terms of strategic initiatives, we have continued to repurchase shares in order to efficiently manage our capital position. During the first quarter of 2019, we repurchased 1.9 million shares for $79 million, at an average price of $41.62 per share. Since the beginning of 2013 and through the end of the first quarter, we have repurchased a total of 96.5 million shares. The cumulative effect of these repurchases was a benefit of approximately $15.84 per share in operating shareholders' equity, and approximately $27.83 in adjusted book value per share.

Since the end of the quarter, we have repurchased an additional 853,000 shares at an average price of $46.25 for a total of $40 million, bringing the current year-to-date share repurchases to $119 million, or 2.8 million shares. Cumulative repurchases since 2013 represent about half of the shares that were outstanding at the start of the program.

As of today, our remaining share repurchase authorization is approximately $279 million. We currently have approximately $260 million in cash and investments available for liquidity needs and capital management activities at the holding companies.

[As we have previously disclosed, from time to time, we ask] our insurance regulators to approve the release of capital from our insurance subsidiaries in order to fund share repurchases. For example, as a first step, we sought, and in March, we received, approval for a $100 million dividend from MAC to its ultimate parent companies, AGM and AGC.

This MAC dividend will ultimately be recorded as statutory net investment income for AGC and AGM, which is expected to increase the normal dividend paying capacity for AGM by $61 million for 2019, and for AGC by $39 million for 2020.

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

QUESTION & ANSWER SESSION

Operator
[Operator Instructions] And our first question today comes from Geoffrey Dunn with Dowling & Partners.

Geoffrey Dunn, *Dowling & Partners*
Thanks. Good morning. I guess first question, can you give any additional color on the economic development with respect to Puerto Rico in the quarter? Was there any residual COFINA in it? Was there any true-up related to the PREPA RSA? Or is it just general exposure development that we're seeing in the $61 million?

Robert Bailenson
As you know, Geoff, we respond to all information that happens in the quarter. And so in the case of the First Circuit upholding Judge Swain's ruling on special revenues, we reacted to that information because we expect that will then cause any court or any court validation to take a longer time and therefore, because timing is going out further for recoveries as well as continuing to pay losses, we adjusted our probabilities for any GO or HTA credit. On the other side, the RSA actually was a benefit, and we adjusted our probabilities with respect to PREPA. But net-net, we had an increase in reserves -- economic loss development for Puerto Rico.

Geoffrey Dunn
And no COFINA in there? That was done in Q4?

Robert Bailenson
No. That -- there was nothing for COFINA.

Geoffrey Dunn
Okay. And then can you give any additional color, whether it be a range or percentage or anything like that in terms of what the various fees and economic opportunity on wrapping the bonds might do in terms of reducing your loss? Obviously, I don't think the par amortization or the amortization schedule for the new bonds is out. On the surface, you're looking at a 20%-plus type of hit on PREPA. You put the other stuff in there, I think you said in your release, it should be a lot lower economically. But can you frame that up any better for us?

Dominic Frederico
Sure. If you think about it, the way that RSA is structured, Geoff, is they're really providing by the surcharge a level of debt service, so a fixed amount of payment into the new bond structure. So if you can think about the new bonds being issued, say, at 5.25% on the A bonds and like 7.5% on the B bonds and the way it's structured in the surcharge is to provide cash flow to service that debt. So you get a given amount of par relative to that interest rate against the debt service payments that are being provided. If you then go out and insure those bonds, you lower the interest rate. Therefore, you will increase the principal amount of the par that you will be receiving or will be able to be serviced through the fixed charge going through the surcharge on the electric bills. So it's a pickup of par that will then further improve your recovery against the bonds that you're retiring and then two, you get paid a premium relative to the insurance of the new bonds as well. So if you think about a 50 basis point improvement in the interest rate, what does that then do to a fixed stream of cash flow relative to the new par that, that debt service will be able to provide for. That's how you think about the economics being improved.

Geoffrey Dunn
I guess a pointed question. Do you think this could be a single-digit relative write-off for you? I guess that's a no comment?

Dominic Frederico
That's a no comment, and remember as we look at this much like COFINA, we have the option. So it's at our option, and we're going to look at a) what the government is at the time, what other covenants or requirements are going to be made through the operational kind of independence and the operational efficiency of the utility. So we can always do it uninsured or do it insured. It's got to be our choice, much like COFINA where we still hold those bonds, and we still have the option of insuring them to further improve the economics or not, depending on how we feel about the government and its behavior.

Geoffrey Dunn
And Rob, do you have a breakout of the primary versus secondary?

Robert Bailenson
Yes. I knew you were going to ask that. You are consistent, Geoffrey. So primary, we had $10.1 million PVP for about $1.678 billion of par. And in secondary, we had $21.5 million of PVP for $338 million of par.

Operator
And our next question comes from Allan Weinstein with Elliott Investments.

Allan Weinstein, *Elliot Investments*
Dominic, I wanted to thank you again for your comments about GO issuance post-2012. It's about time that someone stood up for the rights of municipal bondholders, and I very much appreciate your comments about the validity and claw-back attempt on GO issuance. So thank you for that. My question has to do with getting over the hurdle with PREPA and combining your interest with MBIA. Currently, MBIA, as you know, trades at about 35% of adjusted book value. Have you given any consideration to partnering or making some kind of acquisition where you could control the outcome of PREPA by controlling MBIA's holdings?

Dominic Frederico
Well, as you know, our goal is to combine or consolidate the entire remaining financial guaranty industry, which we've done in a very accretive way to the ultimate book value and bottom line of the company as well as continue to improve the perception of our insurance policy by improving the rating on those specific bonds that we wind up acquiring through the acquisition of the company and therefore, the insurance that they provide.

As you know, we look at everybody all the time. We continue to evaluate opportunities. As we move along resolving more of Puerto Rico's exposures, which tend to be one of the bigger -- when you think of us in the acquisition world number one we have to look at what is the capital structure of the target? Are there 3 mouths at the table? Two mouths? Is it just equity? Is there surplus notes? Is there preferred stock? Is there deferred payment obligations? So there's always a complex kind of view of the equity side. And then #2 we re-underwrite every credit in the portfolio and charge what we determine to be reasonable relative to today's both market conditions and capital charges. Puerto Rico tends to be one of the more contentious credits that you would look at in anybody's portfolio. So as those get resolved, it simplifies the underwriting side of our acquisition opportunity. We still have to deal with the capital side. So as we move along Puerto Rico and hopefully, there'll be more activity as we go through the year, I think it does provide a greater opportunity for Assured to continue its consolidation strategy.

More importantly, as those companies start to reach kind of the final conclusion of whatever they're dealing with in their capital structure and portfolios, it then becomes a good opportunity for them to either reload their business purpose and in effect, go on to their new direction or liquidate the company and basically pay out their shareholders. So we think Puerto Rico in a lot of ways is a good accelerant to further opportunities relative to our consolidation goals.

Operator
And our next question comes from Bose George with KBW.

Bose George, *Keefe, Bruyette, & Woods*
Yes, good morning. Just one more on the PREPA RSA. Do you think there's a road map to get from the current level to the 67% that's needed if MBIA does not join in?

Dominic Frederico
Well, you need 67%, and that's currently written in the RSA agreement. It doesn't mean it has to stay there. So that's number one. Number two, they have voting rights to anywhere between 13% and 17%. The number continues to move. So you think about that still leaves 83% out there or 87% depending on your perspective, and you need 67%, and we've got I think something around 50% now. So your guess is as good as mine, but I'm sure the government will go back and do whatever's necessary to try to force this vote to get over the necessary threshold or they'll change the threshold, one of the two. Remember, in the Title VI, it's a different voting requirement than in the Title III. So that's one thing you have to keep in mind, the plan of adjustment requires a different voting calculation than the Title VI does.

Bose George
So under Title III, it could end up being just a lower number that's required to get it over...

Dominic Frederico
Remember, Title III you have to have a qualifying quorum to vote and then you need a majority of that qualifying quorum, right? So it’s a different threshold. I think it’s 67% you need is the quorum for a vote and then majority of the vote of the 67% or whatever the number is that's above the 67%. That's Title III. Title VI on the voluntary restructuring, it's what they implied or what they provided for in the RSA that doesn't mean that can't be changed.

Bose George
Okay. Great. That's helpful. And then just going back to Geoff's question just on the potential -- quantifying the benefit. Can you just repeat your answer, that 50 basis points, so if we look at that...

Dominic Frederico
You guys are the quants, right, you can figure out what the…if you have a given fixed amount of debt service and you lower the interest rate, pick a number, 50 basis points, 75 basis points - how much additional par can be serviced by that level payment of debt service.

Bose George
Okay. So look at the duration and sort of present value that and sort of look at the benefit that way.

Dominic Frederico
Right, and then you'll figure out what the enhancement to par insured or the par value of the bonds against the original 67 and $0.10 on the B bonds and therefore, you can calculate what the ultimate recovery is.

Robert Bailenson
As well as a premium that's going to be charged in the transaction.

Operator
Ladies and gentlemen, this will conclude the call. I'd like to turn the conference back over to Robert Tucker for any closing remarks.

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

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines at this time, and have a nice day.