

Equity Research

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Industry Report

Financials

Municipal Bond Insurers

If Puerto Rico's Fiscal Plan Offers Zero Debt Service to Bondholders, Buy AGO, MBI, AMBC on Any Weakness

This Wednesday, January 10, looks to be a momentous day for municipal bond insurers Assured Guaranty (AGO, Buy, \$50 PT), MBIA (MBI, Buy, \$14 PT) and Ambac Financial Group (AMBC, Buy, \$26 PT) for a couple of reasons. First, it is the date on which the Puerto Rico government is required to submit a revised fiscal plan to the island's financial oversight board – a plan that many observers believe will include zero provision for debt service for bondholders and, by extension, for the insurers. Second, Judge Laura Taylor Swain on that day will hear arguments on a motion from a hedge fund and the UTIER union seeking to have the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) declared unconstitutional and the ongoing Title III bankruptcy cases dismissed.

- ▶ The fiscal plan that the oversight board certified last March provided for bondholders to receive 24% of the debt service they were scheduled to receive over the next 10 years. The post-Hurricane Maria plan that Puerto Rico's government will submit to the board on Wednesday will cover only five years, which some believe will make it easier to justify a zero for bondholders. AMBC CEO Claude Leblanc stated during the company's 3Q17 conference call that "the recommended five-year fiscal plan seems deliberately designed to show large expenditures for recovery, but not the actual recovery and rebuilding of the island in the later years."
- ▶ AGO and MBI last May filed a lawsuit objecting to the fiscal plan, a suit that the insurers withdrew after it became apparent after Hurricane Maria that a revised plan would be forthcoming. They did so in anticipation of refiling their suit after the new plan was certified. We believe the insurers will have even more fodder the second time around which to characterize the fiscal plan as disingenuous, particularly amidst evidence that Puerto Rico's post-Maria tax revenues and manufacturing activity are much stronger than most observers had expected.
- ▶ We believe shares of AGO, MBI and AMBC may come under pressure if, as we expect, reports begin to hit that tape about Puerto Rico's revised fiscal plan offering bondholders no debt service payments over the next five years. We would view such a pullback as a buying opportunity as the revised plan represents just the opening salvo in a battle whose outcome ultimately will be decided in court, in our view.

- ▶ While PROMESA clearly stated that the oversight board’s fiscal plan would need to “respect the relative lawful priorities or lawful liens, as may be applicable, in the constitution, other laws, or agreements of a covered territory or covered territorial instrumentality,” the consensus view at this point – reflected in the severely depressed prices of Puerto Rico’s bonds – is that the board will get away with ignoring the law that created the positions they occupy. Our bullishness on the insurers’ stocks is largely predicated on our belief that the courts will uphold the liens supporting their insured exposures; as the bondholders’ legal victories accumulate, the insurers’ shares will appreciate, in our view.
- ▶ Our positive view of shares of AGO, MBI and AMBC is also rooted in our belief that they each would be able to withstand a dire outcome for their insured exposures to Puerto Rico’s debt. In the case of AMBC, for example, that belief is shared by the company’s Wisconsin regulator. A December 11 court filing that was largely overlooked disclosed that “the Rehabilitator’s durability model, which has been continuously updated and incorporates many conservative assumptions, accounts for the risks associated with Puerto Rico; in fact, there is sufficient capital and reserves to pay 100% of potential losses under all 4 of the scenarios – base and stress cases, in the Rehabilitator’s model.”
- ▶ Meanwhile, an interesting source of upside optionality for the municipal bond insurer stocks is the legal challenge to PROMESA that will see two former U.S. Solicitors General on Wednesday each allocated 90 minutes to argue for and against the law’s unconstitutionality: Ted Olsen for the plaintiffs and Donald Verrilli for the defendants. The plaintiffs have asserted that the provisions within PROMESA for selecting the members of the oversight board – the members were chosen by the White House from a list provided by congressional leaders from both parties, with the President allowed one name of his choosing – violated the “appointments clause” of the U.S., which calls for all principal officers of the federal government to be appointed by the president, and then confirmed by the Senate.
- ▶ The thrust of the plaintiffs’ argument was offered in the objection and motion to dismiss the oversight board’s Title III bankruptcy petition they filed last September: “The Board is composed of seven voting members who have no superior officer save the President, yet were never subject to Senate confirmation. Moreover, six of them were effectively hand-picked by individual members of Congress pursuant to an intricate system of Balkanized lists designed to severely constrain the President’s appointment powers. There are no ‘historical analogues for this novel structure.’”
- ▶ The defendants countered by arguing that Puerto Rico is an “unincorporated territory” and that the oversight board members are territorial officers under the territorial clause of the U.S. Constitution rather than federal officers subject to the appointments clause. The territorial clause provides Congress with the power to “make all

needful rules and regulations respecting the territory or other property belonging to the United States.”

- ▶ If the plaintiffs were to prevail in the case, Puerto Rico could revert to the pre-PROMESA state of affairs in which the Commonwealth, lacking the ability to file for bankruptcy, would be more likely to engage in consensual negotiations with bondholders and the insurers, in our view. We believe that at the very least the current oversight board members, whose apparent intent is to minimize bondholders’ recoveries, would be replaced by new members who would need to be confirmed by the Senate. While there are no guarantees that new board members would be creditor-friendly, from the standpoint of bondholders they could not be any worse than the current group.

BTIG Covered Companies Mentioned in this Report

ASSURED GUARANTY LTD. (AGO, Buy, \$50.00 PT; Current Price: \$33.82; Analyst: Mark.Palmer)

AMBAC FINANCIAL GROUP, INC. (AMBC, Buy, \$26.00 PT; Current Price: \$15.98; Analyst: Mark.Palmer)

MBIA, INC. (MBI, Buy, \$14.00 PT; Current Price: \$7.70; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

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I, Mark Palmer, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

I, Giuliano Bologna, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Regulatory Disclosures

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Company Valuation and Risk Disclosures

Assured Guaranty Ltd. (AGO, Buy, \$50.00 PT)

Valuation: Our \$50 price target is based on 0.65x our YE18E adjusted book value (ABV) per share of \$81.14, minus \$3.82 per share representing the estimated impact of potential losses related to AGO's insured exposure to Puerto Rico's debt.

Risks: The primary risk to achieving our target price include ratings downgrade risks, credit risk related to municipal bond and structured product exposures, and exposures to troubled Puerto Rico credits.

Assured Guaranty Ltd. (AGO)



Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
05-Dec-11	12.23	35	Mark Palmer	Buy
29-Feb-12	16.80	37	Mark Palmer	Buy
07-Aug-12	11.72	35	Mark Palmer	Buy
08-Aug-13	21.91	37	Mark Palmer	Buy
07-Nov-14	24.53	39	Mark Palmer	Buy
25-Feb-15	26.37	40	Mark Palmer	Buy
07-May-15	26.11	41	Mark Palmer	Buy
29-Jun-15	23.76	NA	Mark Palmer	Neutral
08-Jul-15	24.49	34	Mark Palmer	Buy
05-Nov-15	29.47	35	Mark Palmer	Buy
04-Nov-16	32.10	37	Mark Palmer	Buy
22-Nov-16	35.24	41	Mark Palmer	Buy
23-Feb-17	42.38	49	Mark Palmer	Buy
03-Nov-17	36.51	50	Mark Palmer	Buy

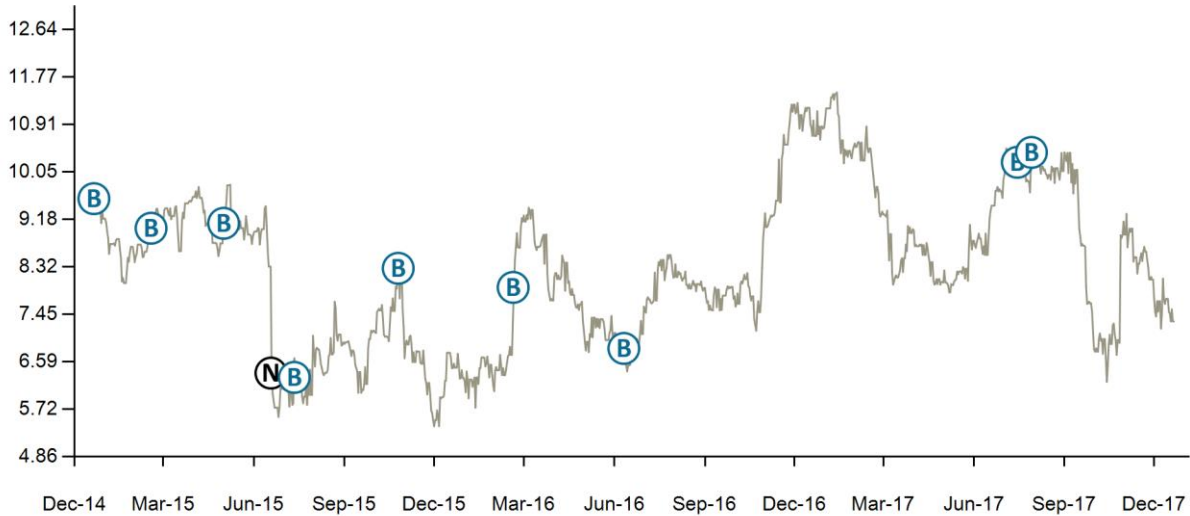
MBIA, Inc. (MBI, Buy, \$14.00 PT)

Valuation: Our \$14 price target is based on 0.60x on our estimate of the company's pro forma ABV of \$30.82 adjusted for estimated losses of \$6.72 per share related to the company's insured exposure to Puerto Rico's debt. Our new valuation reflects our assumption that MBI will now realize no tax benefit on its Puerto Rico-related losses.

Risks: The primary risks to our valuation include greater than expected losses with respect to insured exposure to Puerto Rico's debt. Increased losses on the broader insured municipal portfolio. The potential negative impact of a credit rating downgrade on the company's ability to write new business and regulatory risks.

MBIA, Inc. (MBI)

(\$)



Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
30-Nov-11	9.70	22.50	Mark Palmer	Buy
30-Jun-14	11.04	NA	Mark Palmer	Neutral
15-Aug-14	10.49	12	Mark Palmer	Buy
12-May-15	9.09	13	Mark Palmer	Buy
29-Jun-15	6.37	NA	Mark Palmer	Neutral
23-Jul-15	6.29	10	Mark Palmer	Buy
05-Nov-15	8.28	11	Mark Palmer	Buy
01-Mar-16	7.93	13	Mark Palmer	Buy
21-Jun-16	6.82	14	Mark Palmer	Buy
26-Jul-17	10.21	13	Mark Palmer	Buy
09-Aug-17	10.38	14	Mark Palmer	Buy

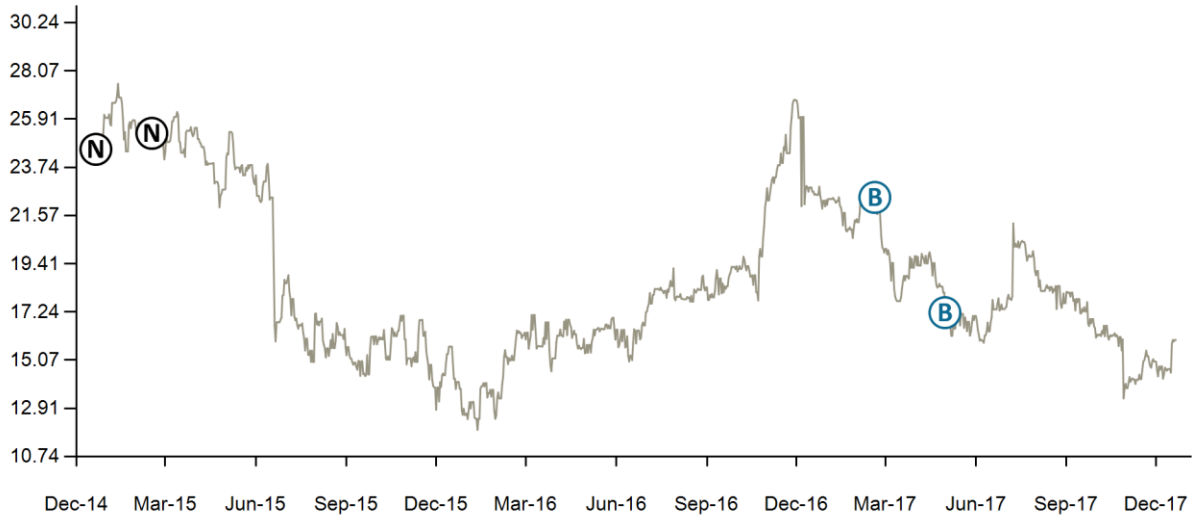
Ambac Financial Group, Inc. (AMBC, Buy, \$26.00 PT)

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

Risks: The primary risks to achieving our recommendation and price target include the possibility that reserves against losses associated with RMBS and other insured instruments may prove inadequate, that fiscal stress of state and local governments could translate into increased losses, declines in value of investment portfolio could impede Ambac's ability to pay its liabilities and Ambac Assurance Corp. may be unable to exit rehabilitation.

Ambac Financial Group, Inc. (AMBC)

(\$)



Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
16-May-13	23.67	31	Mark Palmer	Buy
04-Mar-14	34.49	NA	Mark Palmer	Neutral
01-Mar-17	22.35	28	Mark Palmer	Buy
11-May-17	17.18	26	Mark Palmer	Buy

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BTIG LLC had an investment banking services client relationship during the past 12 months with: Ambac Financial Group, Inc. (AMBC), Assured Guaranty Ltd. (AGO), MBIA, Inc. (MBI)

BTIG LLC makes a market in the shares of: MBIA, Inc. (MBI)

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