GATOR
CAPITAL MANAGEMENT

Ambac: Undervalued Special Situation
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Executive Summary

We believe the equity of Ambac is severely mispriced due to several factors such as 1) being a post re-org equity, 2) having crossover ownership from distressed credit funds who are forced sellers due to redemptions in their funds, 3) being a run-off business, 4) having difficult to interpret financial statements; and, 5) having valuation dependent on the outcome of litigation. We also believe there are catalysts in 2016 that will help unlock value.

Background of Ambac

Company Description

Ambac Financial Group, Inc. (AMBC) is a holding company headquartered in New York, NY. Ambac's main subsidiary, Ambac Assurance Corporation (AAC), was a provider of finance guarantee insurance and related services in the municipal finance and structured finance markets. AAC is domiciled in the State of Wisconsin and is regulated by the Office of the Commissioner of Insurance for the State of Wisconsin (OCI).

AAC historically provided financial guarantee insurance (or municipal bond insurance) for municipal and structured finance obligations. AAC has not provided any guarantees (i.e., written any new business) since 2008, so the company is in "run-off". Its principal business now consists of mitigating losses through the pursuit of recoveries in respect to paid claims, litigation to recover losses or mitigate future losses, commutations of policies, purchases of Ambac-insured obligations and repurchases of surplus notes issued by Ambac Assurance or the Segregated Account and maximizing the return on its investment portfolio.

History

Ambac was formed in 1971 to insure municipal bonds. The business was stable and profitable for 35 years, but as the municipal bond insurance market became saturated in the late-1990s, Ambac ventured into adjacent areas of financial guarantee insurance. The two main areas of diversification were providing insurance wraps to RMBS transactions and wrapping AAA-rated tranches of CDOs. This diversification proved to be a horrible idea and by 2007 Q3, Ambac was reporting heavy losses.

In March 2010, AAC established a Segregated Account, under the control of the OCI as Rehabilitator, to facilitate an orderly run-off and/or settlement of certain liabilities, including policies relating to credit default swaps, residential mortgage-backed securities (RMBS), student loans, and other policy obligations with substantial projected impairments or transactions with contractual triggers based upon AAC's financial condition or the commencement of rehabilitation. The Segregated Account was capitalized with a $2.0 billion secured note from AAC and an excess of loss reinsurance agreement with AAC's general account subject to AAC maintaining a minimum surplus of at least $100 million.

Essentially, the Segregated Account is structured such that AAC is responsible for ensuring that the Segregated Account services its policies subject to AAC maintaining a $100 million surplus. However, pressures on the insured portfolio continued to mount, restricting dividends from AAC to AMBC, leading AMBC to declare bankruptcy in November 2010. AMBC emerged in May 2013, cancelling all existing common shares and issuing 45.0 million of new common shares to senior debt holders, as well as 5.0 million warrants with a $16.67 strike price and an April 2023 expiration to subordinated debt holders.

Ambac Investment Thesis

We believe there is an exceptional opportunity to take a position in Ambac equity. Here is our investment thesis:

1. **Valuation is compelling –** We believe Ambac is worth ~$44 per share or ~3x from the current stock price.

Since Ambac is in run-off, we believe we should value the company with adjusted book value and then layer in some assumptions about potential changes. Ambac presents its own measure of adjusted book value at $24.78 as of 2015 Q4. Below, we suggest several adjustments to the company's calculation.

As a starting point here is the company's calculation of adjusted book value:

	December 31, 2015	
($ in millions, other than per share amounts)	$ Amount	Per Share
Total Ambac Financial Group, Inc. stockholders' equity	$1,684.8	$37.41
Adjustments:		
Non-credit impairment fair value losses on credit derivatives	19.0	0.42
Effect of consolidating financial guarantee VIE	(302.8)	(6.72)
Insurance intangible asset	(1,212.1)	(26.91)
Ambac CVA on derivative product liabilities	(78.7)	(1.75)
Net unearned premiums and fees in excess of expected losses	1,056.6	23.46
Net unrealized investment (gains) losses in AOCI	(51.0)	(1.13)
Company Calculated Adjusted Book Value	$1,115.8	$24.78
Shares outstanding (in millions)	45.0	

Here are adjustments that we make to the company's calculation of adjusted book value:

Mark Purchased Deferred Policy Obligations to Par	240	5.33
NPV of Installment Premiums	338.2	7.51
Mark Surplus Notes to Par	(243.4)	(5.41)
Mark Preferred Stock to Par	(386.0)	(8.58)
Our Modified Calculation of Adjusted Book Value	$1,064.6	$23.66

Then, we adjust for Ambac's outstanding warrants:

Paid capital assuming warrant exercised	69.5	16.67
Fully diluted shares	49.5	
Gator's Calculation of Adjusted Book Value	$1,134.1	$22.91

We then make other adjustments based on our view of various assets and liabilities (we explain each of adjustments and our rationale below):

(a) Expected Improvement in RMBS credit	$400	8.08
(b) Ambac wrapped RMBS held on balance sheet	$380	7.68
(c) Additional Excess Spread Recoveries	$625	12.63
(d) Additional Reserves for Puerto Rico	($350)	(7.07)
Gator's Target Price for Ambac	$2,189.1	~**$44.22**

In this valuation, we give no credit to the significant NOLs Ambac owns. Instead, we address NOLs in #7 below. We also do not include an upside to litigation recoveries, but discuss the possibility in #6 below.

(a) Improvement in RMBS credit – With steadily rising home prices, Ambac's estimates of future losses on Residential Mortgage Backed securities is consistently declining. Here's the recent history of expected RMBS loss payments versus RMBS outstanding:

	Expected Future RMBS Claims	RMBS Outstanding	RMBS Reserve Percentage
2012 Q4	3,141	19,117	16.4%
2013 Q1	2,863	18,267	15.7%
2013 Q2	2,685	17,447	15.4%
2013 Q3	2,400	16,667	14.4%
2013 Q4	2,202	16,026	13.7%
2014 Q1	2,031	15,452	13.1%
2014 Q2	1,895	14,876	12.7%
2014 Q3	1,801	14,295	12.6%
2014 Q4	1,588	13,686	11.6%
2015 Q1	1,539	13,107	11.7%
2015 Q2	1,468	12,588	11.7%
2015 Q3	1,258	12,009	10.5%
2015 Q4	1,222	11,387	10.7%

As you can see, the Estimated Future RMBS Claims have steadily dropped over the past three years. We believe there will be continued improvement and estimate that Future RMBS Claims will only be 67% of the current estimate.

(b) Ambac-wrapped RMBS held on-balance sheet – Ambac holds repurchased Ambac-wrapped RMBS on its balance sheet at market value. We think this is too conservative because the discount to par reflects potential credit losses, but since Ambac has already reserved for these credit losses, it is double counting losses by holding the RMBS at a discount and keeping its loss reserve.

(c) Additional Excess Spread Recoveries – Ambac has been receiving a high amount of excess spread from securitization where the company has already paid losses. Over the last 9 quarters, Ambac has received $900 million of excess spread but has only lowered its estimate of future excess spread by $60 million. We estimate that Ambac will continue to receive more excess spread recoveries than management's current estimate.

(d) Additional Reserves for Puerto Rico - We believe Ambac has set aside $250 million in reserves to deal with potential losses in Puerto Rico. We think this approximates what the ultimate losses will be. We believe Ambac could reinsure all of its Puerto Rico exposure and eliminate this risk today for $600 million. We assume that Ambac adds $350 million to reserves for Puerto Rico.

2. **Three potential near-term catalysts –** We believe there are three near-term catalysts that could drive Ambac higher:
    a. A settlement with Bank of America regarding R&W claims – See #6 below.
    b. A successful election of the company's nominated directors at the shareholders meeting – A large shareholder and creditor, Canyon Capital, has nominated several directors for election at the Annual Meeting in May. Canyon has been publicly critical of management for not accelerating payments on the debt obligations that Canyon owns. Ambac's Board has also proposed two new directors with two existing directors stepping down. We believe shareholders will support the two Company nominated directors. Resolution of this proxy contest may be a catalyst for the shares.
    c. AAC Exiting Rehabilitation settlement with holders of Surplus Notes and Deferred Payment Obligations to restructure their holdings to enable AAC to exit Rehabilitation

3. **Continued value creation from continuing to repurchase own liabilities at a discount –** Management has been repurchasing Ambac's own securities in the secondary market. Purchases have been concentrated on Ambac-wrapped RMBS. These transactions are value creating for the company. For example, Ambac deferred policy obligations at 85 cents on the dollar and accrue interest at 5.1%. Ambac has already repurchased $1.4 billion or 34% of these notes. Ambac also owns $1.8 billion of its own-wrapped RMBS.

4. **Rapidly reducing financial guarantee exposures** – Ambac's financial guarantee obligations are rapidly declining at 8% to 10% per quarter. We expect this accelerated pace to continue through the end of 2017 as Ambac last issued policies in late 2007 and municipal bond are usually callable after 10 years. Because of this rapid run-off of existing exposures, Ambac is deleveraging very quickly. Ambac's leverage as measured by outstanding guarantees compared to claims paying resources declined from 26.4x to 18.9x during 2015. With the cash from a recent J.P Morgan settlement, we forecast this leverage ratio will decline to 15.7x as of March 31st.

5. **Special situation with no natural support from buy-side –** Investors recoil from analyzing Ambac for a variety of reasons, but we believe this has created the extraordinary opportunity.
    a. Post re-org equity – Ambac Financial emerged from bankruptcy on May 1, 2013. As you know, post re-org equities use fresh start accounting for the financial statements which has its quirks.

b. Crossover ownership from Distressed Credit funds – When Ambac emerged from bankruptcy, the former senior debt holders received shares of the company, so owners at the emergence were primarily distressed credit funds. Throughout 2015 and so far in 2016, the distressed debt fund community has been under pressure due to redemptions from their investors from losses on early energy investments and Puerto Rico. To the extent these funds also owned AMBC common, it has been an overhang on the stock.
c. Run-off business – Investors shy away from companies with no ongoing business. Ambac is not writing new financial guarantee business, so it is a liquidating pile of financial assets and liabilities. The catch is there are $5.8 billion of financial assets plus another $2.5 billion in potential payments from litigation plus a large pile of NOLs.
d. Difficult to understand financial statements – Ambac's financial statements have many parts that are difficult to understand.
e. Business model – Financial guarantee businesses are difficult to understand when they are healthy going concerns. There is no clarity about the type of business Ambac will become once it winds-down its financial guarantee insurance subsidiary.
f. Upside valuation dependent on litigation resolution – Many investors avoid businesses where the value is dependent on litigation because legal cases can take unexpected turns.
g. Only boutique Sell-side brokers cover the stock – Only four analysts publish research on Ambac. They work at the boutique firms Odeon, BTIG, R.W. Pressprich, and MKM Partners, so their work does not get wide distribution. Only Odeon has a positive recommendation on the stock.

6. **Additional upside from R&W Litigation Recoveries –** We believe there is $16 per share of additional potential upside to our base case if Ambac can recover $0.8 billion more than they've reserved for lawsuits due to R&W litigation. Ambac has reserved $1.8 billion in subrogation recoverable for these lawsuits, so we think Ambac will recover $2.7 billion. There are two counterparties in Ambac's litigation: Bank of America and Nomura. Here are some details of the cases with each counterparty:

   Bank of America – We believe Ambac could settle with BofA for $2.5 billion compared to our estimate of $1.65 billion of subrogation reserves. Ambac is suing BofA as successor to Countrywide and First Franklin for mortgages that did not meet the agreed upon underwriting standards for RMBS that these firms had Ambac guarantee. The main Ambac/B of A lawsuit is in the same court that the MBIA/BofA case was settled in MBIA's favor. The judge has said the same issues are appearing in the Ambac case as appeared in the MBIA case. We expect the next notable event will be a trial date set for 2H 2016 . We note that the start of a trial is often a catalyst for a settlement.

   Nomura – We believe Ambac could settle with Nomura for $200 million compared to our estimate of $150 million of subrogation reserves. We believe the Nomura loans that they had Ambac wrap were some of the worst loans securitized during the financial crisis.

7. **Additional value in NOLs –** Ambac has $1.0 billion valuation allowance against a deferred tax asset arising from net operating loss carryforwards. If management were able to generate some additional income by entering a new business, there is potential to reverse these carryforwards. We ascribe a zero value to these NOLs but note $1.0 billion is equal to $20 per share or more than the current stock price.

8. **Consistent insider buying –** We note that the CEO has consistently made open market purchases of the stock. He purchased approximately $2.5 million of stock over the course of the past 9 months. He made purchases in July, November and December 2015 and in January and March of 2016. There have also been purchases by the Chairman and other Board members.

Risks

We believe the risks to Ambac common present themselves out quite quickly when first analyzing the stock. We believe the discounted price of the stock more than compensates us for taking these risks. Below I address the two largest risks to Ambac.

1. **Puerto Rico –** While Puerto Rico has presented headline risk over the past 9 months, we believe Ambac will have low losses on the island. We believe the current legislation in Congress will progress and a Control Board will be imposed on Puerto Rico. The Federal Control Board will cut unnecessary spending, will work to complete the audit of Puerto Rico's finances, will work to repay Puerto Rico's current debt, and will work to reopen Puerto Rico's access to the capital markets.

   We believe the debt situation in Puerto Rico is manageable, but the current governor has taken the island down an unfortunate path of trying to restructure its debts. Even if the current debt is restructured, the core problem of higher spending than tax revenues won't change. The debts will just have to be restructured again in a few years unless government spending is rationalized.

   We believe Ambac will have low losses in Puerto Rico, but the headline risk will continue to weigh on the stock. We believe Ambac could end the uncertainty and reinsure its Puerto Rico risk with one of its peers. If Ambac were to pursue this option, we believe it would cost $7 per share and we have this scenario built into our $44 price target. If Ambac's Puerto Rico losses are greater than $600 million, then there would be downside to our price target. If Ambac retains the risk, we believe the losses could be lower.

2. **Disappointing settlement in R&W cases –** If Ambac settled with Bank of America, for less than $1.7 billion, there would be downside to our $44 price target. We believe this is unlikely because the setting of subrogation recoveries has to be based on evidence that the company's auditors approve. An example may be an offer of settlement for the counterparty. We also know that Ambac has been adding to the subrogation recovery at the margin for at least the last four quarters.

Although the risks seem severe, we believe the stock price adequately compensates us for these risks. The worst case scenario would be if AAC, the insurance subsidiary wasn't able to dividend any money to AFG, the parent or holding company. In a downside scenario where either litigation recoveries do not meet the company's estimate of $1.8 billion or Puerto Rico losses exceed $600 million, we believe AFG, still has value of $10.

Downside Valuation of Ambac Financial:

Investment portfolio at AFG	$250	$5.00
Value of NOLs at AFG	$200	$4.00

Equity in Surplus Note Securitization	$80	$1.60
NOL Tolling Payments from AAC	$100	$1.00
Total	$630	$10.60

Base & Upside Scenario Analysis

We have a base case scenario where we think Ambac is worth $44. There are three potential upside scenarios that we do not include in our base case.

	Upside	Stock Price
Current Stock		$16
Downside Scenario		$10
Base Case		**$44**
Additional Upside Scenarios from Base Case		
Favorable R&W settlements	+$18	
No losses in PR	+$5	
Monetize NOLs	+$20	

Conclusion

We believe Ambac is severely undervalued due to the complexity and lack of sponsorship on the buyside. However, we see multiple catalysts that could help revalue the shares. As time passes and Ambac's guarantees decline, the company deleverages itself and the story become cleaner.

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