



## Ambac Financial Group, Inc. (NASDAQ: AMBC)

### Company Background:

Ambac is a monoline municipal bond insurance company. During the 2002-08 timeframe, Ambac wrote credit default swaps on collateralized debt-obligations (or “CDOs”) and insured non-agency mortgage bonds (or “RMBS”). The losses from this diversification forced Ambac to seek bankruptcy protection in 2010. In bankruptcy, Ambac’s debt was converted into equity and the old shareholders were wiped out. Ambac emerged from bankruptcy on May 1, 2013.

Post-bankruptcy, Ambac presents an interesting asymmetrical risk/reward situation because of the potential that management has over-reserved for losses and is able to recover some portion of the previously paid losses. If the company realizes lower losses than currently estimated, there is potentially significant upside for shareholders.

### Investment Thesis:

**1. Potentially conservative reserves** – Ambac has \$9 billion of gross loss reserves on its balance sheet and has paid \$1.4 billion in losses since 2009. Against these combined \$10.4 billion of paid and reserved losses, Ambac estimates it can recover \$2.5 billion. Often a bond insurer will pay a loss claim to insure the bond holder receives timely principal and interest, then the insurer will seek to recover this payment through other means. Gator Capital believes that both the ultimate gross losses will be lower and the recovery of paid losses will be higher than Ambac’s current estimates.

*a. Large majority of losses came from loans that did not meet underwriting standards* – Gator believes Ambac was defrauded by the issuers of the residential mortgage-backed securities. The issuers put loans that did not meet

the agreed to underwriting standards into their RMBS issues. Ambac underwrote these securities to have zero losses and if the loans had been the quality represented by the issuers, the losses would have been substantially lower. Ambac deserves to recover a large portion of losses paid on these securitizations. Through Ambac’s insurance contract with the issuers, Ambac has the right to recover losses on loans that did not meet the agreed to underwriting standards.

*b. Recovery from R&W lawsuits* – Ambac is seeking recovery of losses by suing the issuers. Ambac has a benefit from its peers who already have sued and won large settlements from many of the same issuers. The largest settlement was MBIA’s agreement with Bank of America earlier this year. Ambac’s lawsuit against Bank of America is in front of the same judge who presided over the MBIA/Bank of America case, so it looks like Ambac can follow MBIA’s playbook.

*c. Estimates of recoveries appear conservative* - In Ambac’s financial statements, management shows gross losses and estimated recoveries. Ambac management estimates that they’ll recover 24% of the gross losses. On a portion of the gross losses, management has not estimated any recoveries. This is not because they do not believe there will be recoveries on these losses, rather, it is because they have not gone through the rigorous testing required to make an estimate of potential recoveries.

*d. Repurchasing Obligations at a Discount* – Ambac is mitigating their losses by selectively repurchasing bonds they have guaranteed from the market. Because of Ambac’s financial position, Ambac is often able to repurchase these bonds at a discount to face value. This discount immediately offsets the potential gross loss on these credits.

*e. Benefit from improving housing market* – The most volatile part of Ambac’s insurance book are the residential mortgage-backed securities (RMBS) that the company has guaranteed. The potential losses on this portion of the portfolio benefit from improving home prices. To the extent that home prices continue to recover, Ambac will realize lower losses.

*f. Potential Impact on Stock Price to Different Recovery Scenarios*

– Below is a table showing Ambac’s leverage to different percentages of recoveries. Ambac’s current assumption is for a 24% recovery of losses. As you can see from the chart, there is significant upside to the stock price if Ambac’s management is able to recover the gross losses. Ambac’s stock currently trades at \$21.

**2. Net Operating Loss Carryforwards** – Ambac has at least \$3 billion of net-loss carryforwards (NOLs) to shield future income from taxes. These will prove especially valuable if management is able to recover losses. However, these NOLs provide a secondary source of value if Ambac’s management is not able to do better than their recovery assumption. There is between \$20 and \$30 per share of value in Ambac’s NOLs if they are not used to offset gains from lower losses. Ambac management has talked about entering new businesses to utilize the NOLs.

Loss Recovery Percentage	24%	40%	55%	70%
Add'l \$ Recovered	\$0	\$1.7B	\$3.2B	\$4.8B
\$ Per Share	\$0	\$33	\$64	\$98

**3. Not widely followed** - Ambac is not widely followed within the investment community because it

recently emerged from bankruptcy, operates in an out-of-favor sector, and has complicated financial statements. So far, only one boutique brokerage firm has published a sell-side research report.

**4. Potential turnover of shareholder base** – As Ambac exited bankruptcy, its shareholders were mainly distressed debt investors. This investor base made money as Ambac’s bonds were converted into equity. A portion of this investor base probably has exited their investment by selling shares without wanting to wait to see if Ambac’s management can recover more than they estimate from their losses.

**Risks:**

This new position in Ambac is risky and may decline. The potential value is dependent on recoveries from lawsuits with counterparties who may not have incentive to settle in a timely manner. Gator Capital has not bought a full position in case Ambac’s stock declines in the interim.

**1. Losses from additional municipal defaults** – Ambac has risk of additional losses from bonds it has insured for municipals. A prime example is bonds Ambac has insured for Detroit which declared bankruptcy this summer.

**2. Not able to recapture recoveries from Reps and Warranties** – Ambac may not be able to recover monies from MBS issuers as part of the Reps and Warranties lawsuits.

**3. Management never executes on new business opportunities** – Ambac’s management may never execute on entering a new business.



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