Assured Guaranty: the bear case $AGO

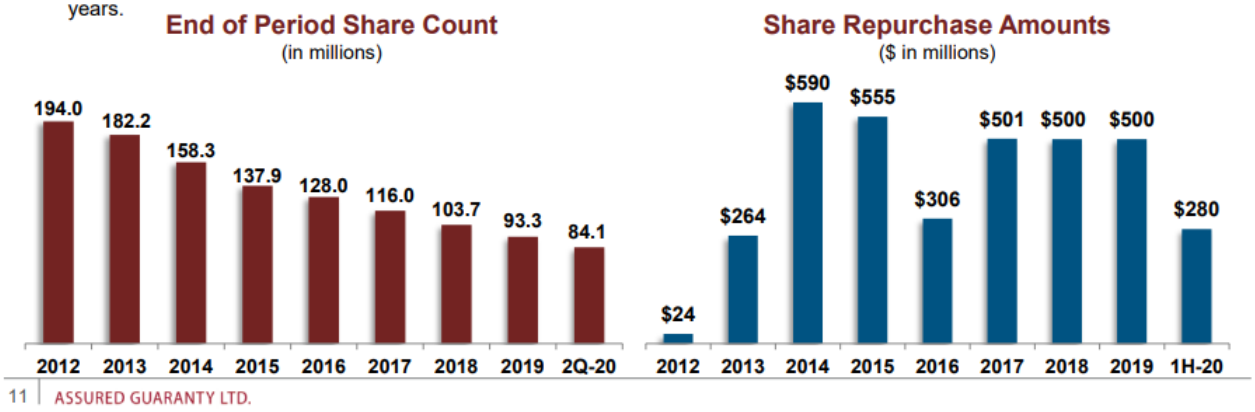
A consistent theme of this blog is my love of companies that repurchase their shares. My love of repurchases is pretty simple: if you believe a company's stock is undervalued, than there's basically no investment the company can make that has the same risk/reward as the company buying back their own shares.

Whenever a company combines a big and consistent share repurchase plan with a continually lagging share price, a running joke among its holders will be "what happens after the company buys back its last share?" Yes, it's not a very good joke (investors aren't exactly known for their humor!), but it's there nonetheless.

Why mention that "joke?" Well, because whenever I look at or think about Assured Guaranty (AGO), I can't help but think they might be the first company that turns the joke into reality and actually manages to buy back all of their shares. Over the past ~8 years, the company has retired ~60% of their shares, and with the share price continuing to languish, AGO is accelerating their share repurchases; YTD, they've bought back ~10% of their shares, and if shares continue to languish I wouldn't be surprised if they bought back ~25% of their stock over the next year. At current prices, I honestly think they could buy back roughly all of their shares within the next five years assuming their economics hold.

Assured Guaranty Overview
Track Record of Creating Shareholder Value

- **We have returned excess capital to shareholders by distributing dividends and repurchasing our common shares**
  - Since 2013, when we started our capital management strategy of repurchasing our common shares, through August 6, 2020, we have repurchased nearly 116.1 million shares, or approximately 60% of our shares outstanding at the beginning of the repurchase program in 2013, for approximately $3.5 billion.
  - In the second quarter of 2020, we repurchased 6.0 million shares for $163.8 million at an average price per share of $27.49.
    - In the first half of 2020, the Company repurchased 9.6 million shares. The Company needs to purchase only an additional 1.6 million shares to match the shares repurchased in 2019. At the June 30 price of $24 per share, this would take approximately $38 million
    - Between July 1, 2020 and August 6, 2020, the Company repurchased an additional 0.8 million common shares for approximately $18.5 million at an average price per share of $23.17.
    - As of August 6, 2020, the Company's remaining share repurchase authorization was $149.3 million.
  - Since our 2004 IPO, we have more than tripled our quarterly dividend per share. In February 2020, our Board of Directors authorized an increase in the quarterly dividend to $0.20 per share. We have raised our quarterly dividends for nine consecutive years.



I realize suggesting a company is on track to buy back all of their shares is both completely impossible and a wildly bullish opening statement. In fact, it's much more bullish than I am on the company, and there's the rather major assumption that their current economics hold in allowing them to buy back that many shares. That's certainly not guaranteed. It may not even be likely.

So why lead the article with such a hyperbolic opening paragraph? Because I wanted to grab your eye. AGO is something of a black box; I've read their annual reports (and the reports of their peers MBI and AMBC) 3 times in the past month and probably 15x in the past two years, and every time I read through it I'm still updating assumptions and models.

Perhaps that complexity alone should make AGO (and its peers) a pass. Perhaps it means I just need to work harder. I'm not sure.

What I am sure of is that AGO trades at <25% of "adjusted" book value and is a voracious share repurchaser. The combination of an extremely cheap stock with massive share repurchases can be the recipe for a stock to rocket higher.

AGO may be too cheap, or it may be too complex. Again, I don't know. But I know it's interesting and at least worth looking at, so I wanted to put some thoughts out there with the hope that if anyone has done any work on it and has any other thoughts they'd reach out.

One quick editors note: this post ran extremely long, so I'm going to split it up. Today, I'll focus more on the bear case, and tomorrow I'll post some more on the bull case. In addition, in tomorrow's post I'll throw in answers to any question and/or try to incorporate any insightful reader comments, so please do feel free to reach out if you're knowledgable on the company.

Ok, that out the way, let's dive a bit more into AGO. AGO is a financial guarantor. Basically, a guarantor is a company with a high credit rating (ideally AAA, thought AGO is currently AA and I doubt the ratings agencies ever makes a guarantor AAA again) who guarantees the debt of someone rated lower. An example might show this best: say the borrowing cost for a triple A borrower is 2% and the borrowing cost for a triple B company is 6%. If a triple B company is looking to raise debt, they could borrow on their own and pay 6%.... or they could have a guarantor step in and guarantee the debt, in which case

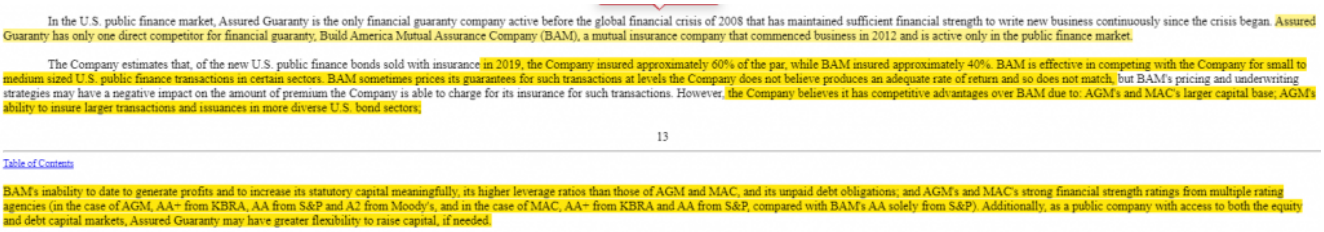
they could borrow at 2%. The guarantor might charge them 2% annually for the privilege. All in, the triple B company has just borrowed at 4% versus the 6% the market would have charged them.

If you think about that example closely, I think it illustrates the bear case nicely as well. This is financial engineering and leveraging, pure and simply. It's not like the triple B company suddenly became less risky; the guarantor is just subsidizing their borrowing at lower rates. The guarantor is either taking on too much risk and will eventually blow up (just as anyone who bought a bunch of bonds at 4% that should be priced at 6% would) or the market has systematically undervalued the triple B credits and the guarantor is such a good risk analyst that they can take advantage of the market.

It doesn't take much imagination to see the bear case coming to pass. In fact, we've already seen it happen once before. In the financial crisis, basically every financial guarantor blew up (Confidence Game details this well; it's the story of how Bill Ackman shorted MBIA on an expanded version of this bear thesis). And, again, this bear case is not unknown; David Einhorn is currently short AGO (well, he was in 2018; no clue if he remains short or not) on basically the same thesis: AGO is a black box and a melting ice cube insuring bad risks.

Fast forward from the financial crisis to today, and AGO is basically the only financial guarantor left. MBIA, Syncora, and Ambac all blew up in the financial crisis and are now in some form of run off. AGO survived the crisis thanks to a large helping of luck, some fortuitous capital raising, the fact that they were much smaller and less exposed than their peers at the time of the crisis, and perhaps a little management skill as well. That makes AGO basically the only

game in town; they consistently guarantee ~60% of the municipal bonds that chose to get insurance. Their only competitor is Build America Mutual Assurance (BAM), a mutual insurer (it's owned by its policy issuers), which has a variety of issues. I'll let AGO's 10-k tell the story; obviously consider the source but I think it basically tells this piece straight.



In the U.S. public finance market, Assured Guaranty is the only financial guaranty company active before the global financial crisis of 2008 that has maintained sufficient financial strength to write new business continuously since the crisis began. Assured Guaranty has only one direct competitor for financial guaranty, Build America Mutual Assurance Company (BAM), a mutual insurance company that commenced business in 2012 and is active only in the public finance market.

The Company estimates that, of the new U.S. public finance bonds sold with insurance in 2019, the Company insured approximately 60% of the par, while BAM insured approximately 40%. BAM is effective in competing with the Company for small to medium sized U.S. public finance transactions in certain sectors. BAM sometimes prices its guarantees for such transactions at levels the Company does not believe produces an adequate rate of return and so does not match, but BAM's pricing and underwriting strategies may have a negative impact on the amount of premium the Company is able to charge for its insurance for such transactions. However, the Company believes it has competitive advantages over BAM due to: AGM's and MAC's larger capital base; AGM's ability to insure larger transactions and issuances in more diverse U.S. bond sectors;

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BAM's inability to date to generate profits and to increase its statutory capital meaningfully; its higher leverage ratios than those of AGM and MAC; and its unpaid debt obligations; and AGM's and MAC's strong financial strength ratings from multiple rating agencies (in the case of AGM, AA+ from KBRA, AA from S&P and A2 from Moody's, and in the case of MAC, AA+ from KBRA and AA from S&P, compared with BAM's AA solely from S&P). Additionally, as a public company with access to both the equity and debt capital markets, Assured Guaranty may have greater flexibility to raise capital, if needed.

Again, even ignoring the BAM piece, there are some weird dynamics at play for credit guarantee just because providing a guarantee is just such a weird product (I mean, any type of insurance is a weird product when you think about it, but credit insurance is weird cubed). Consider AGO's market share: most investors would love to buy into a business that consistently took 60% of the market because it would probably indicate some pricing power / scale advantages.... but with insurance, your worry is that you're taking a huge percentage of the market because you're underwriting risks you don't realize and are thus under-pricing them. Berkshire could win 100% of the market starting tomorrow by guaranteeing every bond issuer who wanted a guarantee for $1/year. Would BRK do that? No, they're way too rational. But with enough funding, another competitor might, and they could report $1/year in profits until some of the credits inevitably went bad and blew them up. The worry with AGO is the chance they've been doing exactly that for years: underwriting muni insurance at way too low a rate for the risks they've taken, and risking inevitable collapse when that inevitably comes home to roost. Maybe that sounds silly, but that's basically a word for word description of what blew AIG up (as detailed in the Big Short, though

technically I guess it was credit protection and not financial guaranty that did them in. Tomatoe tomatoe).

I think that bear case (that credit insurance is fundamentally a flawed product) has always existed. Today, however, there are two added twists to that bear case that add to the risk of AGO. The first of those risks is Puerto Rico. Puerto Rico has been involved in a messy bankruptcy for years, and the bankruptcy has been made worse by Hurricane Maria in 2017 (a category 5 storm that absolutely devastated Puerto Rico) and COVID this year (which has hit Puerto Rico harder than most). AGO has insured ~$4.5B of Puerto Rico related debt, so your big risk here is that AGO takes a big bath on this debt. More specifically, AGO has reserved some level of losses for Puerto Rico, but your risk is that it turns out those reserves are woefully inadequate. The second big risk is similar: COVID has absolutely devastated the economy and will wreck municipal budgets for years to come. It seems near inevitable that there will need to be some restructuring of muni/state debt on the back of COVID, and if that happens AGO will be on the hook for paying out any bonds they've insured. Again, an insurer needs to reserve for losses, so in a perfect world AGO's reserves would cover any increase in defaults here, but your risk is that AGO's reserves are inadequate. Curiously, despite the current environment, AGO's loss reserves have barely budged this year (see table below, from their Q2'20 10-Q). Perhaps that's right; the municpal bond market is generally trading at record tight spreads, so the market is basically saying losses won't be a concern, but it seems to me that an event like COVID should have resulted in a much larger reserve increase than we've seen so far.

Net Reserve (Salvage)

	As of June 30, 2020	As of December 31, 2019
	(in millions)	
Public finance:		
U.S. public finance	$ 341	$ 328
Non-U.S. public finance	5	5
Public finance	346	333
Structured finance:		
U.S. RMBS (1)	(84)	(78)
Other structured finance	41	40
Structured finance	(43)	(38)
Total	$ 303	$ 295

(1) Excludes net reserves of $37 million and $33 million as of June 30, 2020 and December 31, 2019, respectively, related to consolidated FG VIEs.

Components of Net Reserves (Salvage)

	As of June 30, 2020	As of December 31, 2019
	(in millions)	
Loss and LAE reserve	$ 1,076	$ 1,050
Reinsurance recoverable on unpaid losses (1)	(9)	(38)
Loss and LAE reserve, net	1,067	1,012
Salvage and subrogation recoverable	(795)	(747)
Salvage and subrogation reinsurance payable (2)	31	30
Salvage and subrogation recoverable, net	(764)	(717)
Net reserves (salvage)	$ 303	$ 295

To put that reserve in perspective, AGO is insuring $232B of debt as of the end of Q2'20. If we ignore the salvage and subrogation recoverable, AGO has ~$1.1B ($1,076m, to be exact) in reserves. That reserve is <1% of the amount of debt they've insured. Given the state of budgets across the country, it just seems implausible to me that AGO won't pay out significantly more than their reserves. Of course, that's probably too simplistic an argument from me. If AGO insurers a $100m 30 year bond today and tomorrow it defaults with zero recovery, AGO still doesn't have to pay out the $100m until the bond actually comes due, so the present value of that payment is <$100m and AGO will be earning interest on the premiums that issuer paid for the next 30 years. Plus it's unlikely that these bonds are defaulting as pure zeros; more likely is they default in exchange for a creditor haircut of some form (so if AGO insured a $100m bond that defaults, it's more likely the creditors take a haircut to like $70m or so and AGO just has to make up the $30m difference). Still, the fact remains that AGO's reserves have barely budged since the pandemic, and that seems wrong to me.

Small swings in reserves can make a big difference here. The bull case for AGO is that their adjusted book value is ~$105/share, or ~$8.8B (you can see all the adjustments they

use to get from normal book value, which clocks in at ~$75/share, to adjusted in their investor relations decks; diving into those adjustments is beyond the scope of this article so I'll just say I'm comfortable with the adjustments). AGO's current reserve before salvage is ~$1.1B, or <1% of their underwriting. If losses actually turn out to be ~4%, reserves should be >$9B. That's be a huge swing; increasing reserves to that level would wipe out almost all of AGO's book value.

Is that reasonable? Probably not. But I just wanted to highlight that AGO's reserves are pretty skimpy compared to the amount of business they underwrite, and it doesn't take much in the way of increased losses or reserves to eat into AGO's book value.

One last risk while I'm here: not to get too political, but I increasingly worry about rule of law in the country. If states and municipalities are running into budget troubles, I worry that financial creditors (i.e. the people who own bonds) will be disadvantaged versus other creditor classes (like pensions). Detriot's bankruptcy is probably the best example of this; the quote below is from AMBC's 10-K and I think best illustrates this. Again, this isn't a political statement, as I think both parties have been very opening to ignoring rule of law if it benefits some of their key supporters.

Our experience with the city of Detroit in 2013 in its bankruptcy proceeding was not favorable and renders future outcomes with other public finance issuers even more difficult to predict and may increase the risk that we may suffer losses that could be sizable. We agreed to settlements regarding our insured Detroit general obligation bonds that provide better treatment of our exposures than the city planned to include in its plan of adjustment, but nevertheless required us to incur a loss for a significant portion of our exposure. An additional troubling precedent in the Detroit case, as well as other municipal bankruptcies, is the preferential treatment of certain creditor classes, especially the public pensions. The cost of pensions and the need to address frequently sizable unfunded or underfunded pensions is often a key driver of stress for many municipalities and their related authorities, including entities to whom we have significant exposure, such as Chicago Public Schools, the State of New Jersey and many others. Less severe treatment of pension obligations in bankruptcy may lead to worse outcomes for traditional debt creditors. Variability of outcomes applies to even what is generally considered more secure municipal financings, such as dedicated sales tax revenue bonds that capture sales tax revenues for debt service ahead of any amounts being deposited into the general fund of an issuer. In the case of the Puerto Rico COFINA sales tax bonds that were part of the Commonwealth of Puerto Rico's Title III proceedings, Ambac Assurance and other creditors agreed to settle at a recovery rate equal to about 93% of pre-petition amounts owed on the Ambac insured senior COFINA bonds. In the COFINA case, the senior bonds still received a reduction or "haircut" despite the existence of junior COFINA bonds, which received a recovery rate equal to about 56% of pre-petition amounts owed. The amounts were confirmed as part of the COFINA Plan of Adjustment on February 4, 2019.

Alright, I'm going to stop the bear case here. Again, I'll post the bull case and incorporate reader questions/comments, so please feel free to reach out between now and then if you're knowledgable!