SYNCORA HOLDINGS LTD.
3Q 2017 GAAP EARNINGS CALL

Moderator: Scott Beinhacker
November 14, 2017
8:30 a.m. ET

Operator: This is conference #5299919

Operator: Good morning. My name is (James) and I will be your conference operator today. At this time, I would like to welcome everyone to the Syncora Holdings Ltd. Q3 2017 GAAP Financial Results Conference Call. All lines have been placed on mute to prevent any background noise and, after the speakers remarks, there will be a question and answer session.

If you would like to ask a question during this time simply press star then the number 1 on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you. Mr. Scott Beinhacker you may begin your conference.

Scott Beinhacker: Good morning, and thank you for joining us today for our third quarter 2017 consolidated GAAP financial results investor call. I'm Scott Beinhacker, the Head of Investor Relations at Syncora. As a reminder, please feel free to reach me by phone at 212-478-3400 or by email at investorrelations@scafg.com.

Participating with me on the call today are Fred Hnat, our chief executive officer, and David Grande, our chief financial officer.

Before I turn the call over to my colleagues, I will remind everyone that during our call and the Q&A session, management will reference certain documents that we posted after the market closed yesterday to the investor relations section of our website, www.syncora.com specifically, on the investor events page.

These documents, which I hope you have had an opportunity to review, include: the Syncora Holdings Ltd. GAAP consolidated financial statements as of September 30, 2017 and for the nine months ended September 30, 2017, and the associated earnings release, together with a financial highlights deck.

Please note that, as in the past, while we will not be reviewing the presentation slide-by-slide during the call, we will make reference to a number of the slides as we discuss our financial results.

I would also like to remind everyone that during the call and the Q&A session, we may make projections or other forward-looking statements about future results, plans and events. We caution that these forward-looking statements are not a guarantee of future events, and that actual events may differ materially from those in these statements.

These forward-looking statements are subject to a number of risks and uncertainties, many of which are beyond the company's control, including, but not limited to, the factors described in our historical filings with the New York State Department of Financial Services and in Syncora Holdings Ltd.’s, Syncora Guarantee Inc.’s, and Syncora Capital Assurance Inc.'s consolidated GAAP and statutory financial statements, as applicable, which are posted on our website.

Forward-looking statements generally can be identified by the use of forward-looking terminology such as, "may, plan, seek, comfortable with, will, expect, intend, estimate, anticipate, believe or continue," or the negatives thereof, or variations thereon, or similar terminology.

You are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date they are made. The company assumes no obligation to update forward-looking statements, information in the press release, the financial highlights deck or as presented on the call to reflect the impact of circumstances or events that arise after the date the forward-looking statements are made.

References throughout the call to SHL, SGI, and SCAI refer to Syncora Holdings Ltd., Syncora Guarantee Inc., and Syncora Capital Assurance Inc., respectively, and the NYDFS refers to the New York State Department of Financial Services. Finally, references to numbers on the call are generally stated as approximations.

Lastly, to the extent possible, we have tried to address many of your questions and topics we received since our last earnings call in our prepared remarks. I look forward to receiving your feedback after the call.

And with that introduction, I would now like to turn the call over to our CEO, Fred Hnat.

Fred Hnat: Thank you, Scott and welcome everyone to our third quarter earnings investor call.

As in the past, we would like to provide updates on developments since our last earnings call in August, which will convey further progress, as well as ongoing challenges.

In particular, I want to provide you with a meaningful update on the progress we have made with respect to our efforts around a large reinsurance transaction. As discussed on prior earnings calls, we engaged in a competitive process to elicit bids from multiple parties for a strategic transaction with a goal of providing value to our stakeholders. We view value as being provided in two ways: first, the capping of a substantial portion of our future liabilities and reducing our overall risk profile and second, the potential for future distributions on our outstanding securities. Of course, with respect to payments to surplus noteholders, we are not able to predict whether, when or what amount, if any, the NYDFS may approve. At this point, we are engaged in advanced discussions with a single counterparty in respect of a potential 100% quota share reinsurance transaction of a high percentage of net par outstanding of SGI's and SCAI's insured portfolios. We will continue to work with the potential counterparty to reach an agreement in principle that would be beneficial to the Company and our stakeholders. The potential reinsurance transaction remains subject to continued negotiation of material terms and documentation as well as consummation of the merger of SCAI with SGI, regulatory approvals, third party consents, including those of our surplus noteholders and swap counterparties, and other customary conditions. Accordingly, no assurance can be given that any potential reinsurance transaction will be entered into, or if entered into, close on a timely basis or at all. As I have said before, if we are unable to meet these conditions, we have other strategies to deliver value to our stakeholders, including an orderly run-off of the portfolio.

Next, I would like to provide an update on the progress made around the potential sale of our American Roads assets. On our last call, I informed you that we had just commenced a process to evaluate a sale of American Roads. Recently, we completed the first round of bidding for the sale of American Roads and had a strong response with a number of submissions. We are working with our advisors to evaluate each bid in order to select a smaller group of bidders to conduct deeper due diligence to assist in their second round bids. Our goal is to have a final agreement on material terms during the first quarter of 2018 and close a sale in the second quarter of 2018.

In the past we have described our current position with respect to our exposures in Puerto Rico. As everyone is aware, Puerto Rico was hit by Hurricane Maria, a devastating storm that has caused massive loss and injuries to the people of Puerto Rico, as well as to property. Our thoughts are first and foremost with the people of Puerto Rico. As recovery efforts are underway, it is not possible to predict the actual effect (financial or otherwise) to the island of Puerto Rico and this story will be developing for some time. In the meantime, bond prices for both GO bonds and PREPA bonds have decreased significantly in the face of uncertainty from the effects of Hurricane Maria. In addition, there have been press reports of lawmakers mentioning the possibility of finding a way to reduce or avoid the repayment of the amounts owed to creditors like Syncora. There has also been a discussion of the flight of human capital from the island that could negatively affect the economic recovery of Puerto Rico. As David will discuss later, all of these have factored into increasing our loss reserves for this period. We will continue to work with the Commonwealth, PREPA and other creditors to protect our interests and the interests of our stakeholders in making sure the rule of law is followed.

With respect to Reliance Rail, we are very pleased to report that the parties to the transaction, including Syncora, have been working hard to facilitate a refinancing of the debt obligations related to the largest and one of our most complex credits. We are optimistic that a refinancing will occur and, if it does, that the net result will be a significant reduction in the risk of our insured portfolio, which should greatly improve our liquidity mismatch and the overall stability of our financial condition.

We continue to focus on the level of our operating expenses in our continued efforts to perform our functions in as cost-effective a manner as possible while still operating at the high level necessary for a company in our industry. For the nine months ended September 30th, 2017, operating expenses were 31.6 million dollars, as compared to 55.7 million dollars for the same period last year. This represents a 43 percent reduction.

We also continue to work towards merging SCAI and SGI at year end. We believe that the merger will help address potential liquidity issues at SCAI, without adding risk to SGI, while providing a more straightforward and efficient organizational structure for Syncora as a whole. We have received approval from one of our regulators and continue to work on obtaining the required third party consents and additional regulatory approval for a year-end effective date. I would like to direct you to Slide 26 in the Financial Highlights Deck for a description of the pro forma statutory-basis financial effect of the merger.

We have discussed previously our efforts to utilize the significant amount of net operating losses (or NOLs) held by Syncora. As we see positive events for the Company on the horizon that will reduce our overall risk and potentially enable us to gain approval for additional payments to our stakeholders, we continue to evaluate possible new business activities that would generate income that would enable Syncora to utilize the NOLs. In connection with any new business effort, it is expected that we will look to work with our current stakeholders and others to provide or raise capital that could be deployed in any such effort. As the Section 382 ownership shift incurred in connection with the August 2016 restructuring transaction does not reset until August 2019, as compared to amounts that could potentially be raised after the 2019 reset date, Syncora will not be able to raise a meaningful amount of equity for a new business until that time.

As we approach year-end, we have significant momentum with respect to our key strategic initiatives and we believe that the progress on reinsurance and the sale for the American Roads asset, together with our ongoing efforts to cap exposure, monetize positions and further stabilize the insured portfolio, will have a positive effect on our financial condition. At the same time, we continue to make every effort to preserve and improve our position on more challenging credits. We will continue to build on the current momentum to provide value for our stakeholders.

Now, I would like to turn the call over to David Grande to discuss our third quarter 2017 financial performance and provide insured portfolio highlights.

David Grande: Thank you Fred. As Scott mentioned, last night we posted to our website our third quarter 2017 GAAP earnings release and consolidated financial statements. In addition, we have posted our financial supplement titled "Third Quarter 2017 Highlights," which we refer to as our financial highlights deck.

Looking at our earnings year-to-date, our overall performance continues to be driven by loss development activity and by the steady run-off of our book of business. For the nine months ended September 30th, 2017 we had a GAAP net loss attributable to SHL of 125.7 million dollars or a loss of 1 dollar and 45 cents per common share, as compared to net income attributable to SHL of 12.6 million dollars or 2 dollars and 7 cents per common share for the same period last year. For purposes of our earnings per share calculation for the 2016 period, we included 115.2 million dollars which related to the extinguishment of the Series A perpetual non-cumulative preference shares at that time.

As I discussed on last quarter's earnings call, as a result of our decision to sell American Roads, we now meet the criteria to classify the American Roads entity as held for sale on the Consolidated Balance Sheets, and as a discontinued operation within the Consolidated Statements of Operations. The income from discontinued operations of 10.3 million dollars is included in the net loss attributable to SHL of 125.7 million dollars.

Non-GAAP operating loss was 123.5 million dollars or a loss of one dollar and 42 cents per common share for the nine months ended September 30, 2017, as compared to income of 98.7 million dollars or 1 dollar and 60 cents per common share for the same period last year.

A full description of the limitations in using non-GAAP financial measures and the adjustments made to derive our non-GAAP operating income and Adjusted Book Value, is included in the earnings release.

Turning to the drivers of our results, for the third quarter of 2017, our performance continued to be affected by adverse loss developments in Puerto Rico. For the nine months ended September 30th, Puerto Rico accounted for 173.3 million dollars of losses consisting of 154.1 million dollars of incurred losses and 19.2 million dollars of other-than-temporary impairments on remediation bonds. Partially offsetting this adverse loss development on Puerto Rico is 44 million dollars of continued positive reserve developments on our RMBS exposures. For the same period last year, we had net incurred gains of 101.4 million dollars.

Other significant drivers for the period included:

First, 38.6 million dollars of net premiums earned, which was lower than last year as a result of lower premium accelerations and from the continued run-off of our book of business. Total premium accelerations were 19.9 million dollars for the nine months ended September 30, 2017, as compared to 25.7 million dollars for the same period in 2016.

Second, 45.6 million dollars of mark-to-market gains on our CDS contracts, as compared to 52.3 million dollars of mark-to-market losses for the same period last year. These gains were primarily due to higher non-performance risk spreads.

Third, interest expense, which includes both non-cash accretion on SGI's surplus note balance and the accrual of interest increased by 12.3 million dollars to 65.9 million dollars for the nine months ended September 30, 2017 from 53.6 million dollars for the same period last year. In addition, as I discussed on our last call, on July 24th we made a net 27.5 million dollar surplus note payment which reduced accrued interest by 23.2 million dollars and principal by 4.3 million dollars. As of September 30, 2017, total surplus note claims, including principal and accrued interest was 821.3 million dollars.

And Fourth, lower operating expenses mainly as a result of headcount reductions since last year.

As I just discussed, Income from discontinued operations represents the results of American Roads which was 10.3 million dollars for the nine months ended September 30, 2017 as compared to 10.4 million dollars for the same period last year.

As shown on slide 9 of the financial highlights deck, SHL's adjusted GAAP common shareholders' equity decreased from year end 2016 by 101.1 million dollars to 302.6 million dollars, or 3 dollars and 49 cents of GAAP book value per common share as of September 30, 2017. Similarly, SHL's adjusted book value decreased by 139.2 million dollars to 344.9 million dollars, or 3 dollars and 98 cents per common share. The decrease to shareholders' equity was primarily driven by the items I just discussed on the consolidated statements of operations.

I'd like to now cover some highlights of our insured portfolio. As outlined on slides 11 and 12 of the financial highlights deck, for the nine months ended September 30th, 2017, SHL reduced its total net par exposure by 3.8 billion dollars or 19 percent, to 16.6 billion dollars. The reduction in total net par exposure was driven mainly by 3.2 billion dollars in public finance refundings, 689 million dollars in amortizations, and 489 million dollars in terminations and commutations. This reduction in net par outstanding was also partially offset by a 477 million dollar increase as a result of the weakening U.S. dollar and 91 million dollars of accretion. The average internal rating of our portfolio was unchanged from year end 2016 at bbb+, and total credit count decreased 30 percent from 819 credits as of December 31, 2016 to 575 credits as of September 30, 2017.

Our below investment grade credits, or BIG exposures, were 2.1 billion dollars, or 12 percent of Syncora's total insured portfolio as of September 30th,, 2017. In addition, our BIG flag list leverage ratio, as shown on slide 15 of the deck and defined as our BIG exposure divided by our claims paying resources, decreased by 15.2 percent in total, which was primarily driven by decreases in BIG exposures at SGI.

With that, let me turn the call back over to Scott for a brief question and answer period.

Scott Beinhacker: Thank you, David. With that operator, let's open the call to questions. Operator, would you please provide instructions for those analysts on the call?

Operator: At this time, I'd like to remind everyone in order to ask a question please press star followed by the number one on your telephone keypad. And we'll pause for just a moment to compile the Q&A roster.

And your first question comes from Andrew Gadlin.

Andrew Gadlin: Good morning, I want to follow up on a couple of things in the commentary earlier. Did you say, Fred, that you thought that the merger of SGI and SCAI could be completed by year-end?

Fred Hnat: Good morning Andrew. Yes, that's right. That's the timeframe that we're shooting for. And we have some bases to cover in terms of getting further consents and one regulatory approval. But yes, year end.

Andrew Gadlin: And presumably, this will help with further payments on the surplus notes going forward?

Fred Hnat: A merger of SGI and SCAI would combine their capital resources and facilitate payment on surplus notes, yes.

Andrew Gadlin: OK. Great. Then…

Fred Hnat: Go ahead.

Andrew Gadlin: Please.

Fred Hnat: I was going to say that it would enhance the liquidity position of SGI, which would be the surviving entity in the merger.

Andrew Gadlin: Got it. You said in your comments that because of Section 382 limitations of raising equity capital, any plans to do that would be on hold until 2019. Does this mean that all new business initiatives are on hold until then?

Fred Hnat: We are reviewing business initiatives conceptually. The capital raising efforts would be limited by Section 382 until 2019, but obviously, we are in the background internally working on strategies for new business.

Andrew Gadlin: OK, thanks. Then I was wondering if you could discuss the process of working with DFS, as you mentioned earlier in your remarks, there's a lot of different initiatives at work here, and the purpose of the refinancing -- sorry, the reinsurance would be to enable larger payments on the surplus notes.

So given all these different initiatives, how are you -- can you talk a little bit about the process of working with DFS? Do they have their own models? Are they kind of running your models? Are they are able to get back to you with considerations? To what extent are they looking at other bidders and trying to flex reinsurers who own Puerto Rico risk to say are we taking care of policyholders if we shift them over?

Fred Hnat: So, that's a great set of questions, Andrew. Obviously, we don't and we can't speak for our regulator and all of their processes. We have previewed the reinsurance transaction at a very high level with the NYDFS. We're in touch with them on a wide range of issues. And we're not aware of what they do internally in every case, but we would expect them on the reinsurance transaction to go through their usual process -- processes, their own analyses in evaluating the reinsurance transaction, looking at both credit and structure. I'd note that the NYDFS, for example, does their own analysis every time they review a surplus note payment for Syncora when we make that request.

Right now we're in the middle of our examination with the NYDFS, and we know that they look closely both at individual credits like Puerto Rico and overall risk concentration.

We have no reason to think that their approach would be any different for a reinsurer. And the reinsurance process with the DFS probably puts Syncora and its potential reinsurer under an even larger microscope. I hope that's helpful.

Andrew Gadlin: Yes, it is. And looking at this at a high-level, you're in negotiations with a single counterpart. What's the biggest hold up? Because you've been working on this for some time. The biggest hold up knowing how it would impact with DFS would allow you to do? Or is it just pricing with this other counterparty?

Fred Hnat: Andrew, unfortunately, I can't really get into the details of our discussions and negotiations with the counterparty. It is a complicated process. It's a long process that has many aspects, and involves a regulator, among other things. But I could not go into detail in discussing what timing considerations there are.

Andrew Gadlin: OK, understood. Thanks very much. I'll get back in queue.

Fred Hnat: Thank you Andrew.

Operator: Your next question comes from the line of Robert Halder. Go ahead please, your line is open.

Robert Halder: Good morning guys. Just two quick questions for you. First is more procedural. Understanding that the timing of the merger on the question that you just answered, did you guys say that you feel like you need to merge SCAI and SGI ahead of the reinsurance transaction … completing that reinsurance transaction?

Fred Hnat: That's right. That's our objective and that's our current -- our plan.

Robert Halder: OK. And then, secondly, given Puerto Rico and I understand that PROMESA is own animal. But I'm just wondering, how PROMESA and what is happening in Puerto Rico has changed the way that you guys are reserving for other muni exposures, especially with some of the stress that we've seen in other sectors of the muni market?

Fred Hnat: Well, there's been stress in the muni market, but other than Puerto Rico, our muni portfolio is performing fairly well. On that note, I would note that we're not involved with, our heavily exposed to, the municipalities that have been in the news more recently.

As David mentioned, our BIG flag list leverage ratio decreased by 15 percent. So, Puerto Rico is a unique situation. I don't think it changes our reserving process of for other municipalities.

We -- more and our municipal portfolio, we have not had many flag list additions over the course of the year. Some of our insured credits have actually stabilized since the credit crisis, and we've also seen continued runoff of the municipal portfolio through refundings, although that's expected to taper off now, with most of the economic refundings have already been done.

Robert Halder:OK, great. Thank you.

Operator: And with that, I'd like to turn the call back over to Mr. Beinhacker for some closing remarks.

Scott Beinhacker: Thank you operator, and thanks everyone for joining us on the call. I hope you found it helpful. We look forward to talking to you again after the release of our year-end financial statements. In the mean time, if you have any questions at all, and as a means of continuing our dialogue, please feel free to reach out to me 212-478-3400 or through our dedicated investor relations email, (investorrelations@scafg.com).

A transcript and replay of this call will be available on our website later today. Thank you all for listening.

Operator: This concludes today's conference call. You may now disconnect.

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