SYNCORA HOLDINGS LTD.
Q2 2018 CONSOLIDATED GAAP EARNINGS CALL

Moderator: Scott Beinhacker
August 15, 2018
8:30 a.m. ET

Operator: Good morning, my name is Shelly and I will be your conference operator today. At this time, I would like to welcome everyone to the Syncora Holdings Ltd. Q2 2018 GAAP Financial Results Conference Call.

All lines have been placed on mute to prevent any background noise. 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 one 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 the SHL Q2 2018 consolidated GAAP financial results investor call. I'm Scott Beinhacker, the Head of Investor Relations at Syncora.

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, syncora.com, specifically on the Investor Events page.

These documents include the Syncora Holdings Ltd. consolidated GAAP financial statements as of June 30, 2018 and for the six months ended June 30, 2018, the associated earnings release, together with the 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 and Syncora Guarantee 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 and SGI refer to Syncora Holdings Ltd. and Syncora Guarantee 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.

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 second quarter 2018 earnings investor call.

Before I turn the call over to David, who will share the details of our financial performance over the second quarter, I would like to spend a few minutes updating you on our accomplishments since our last earnings call in May and to also provide some details on our efforts towards achieving our ongoing strategic objectives.

On June 1st, we officially closed our reinsurance transaction with Assured Guaranty, which culminated in a 400 million dollar payment to our Surplus Note holders on June 27th. Consistent with our goal of capping exposure and de-levering our capital structure, the reinsurance transaction ceded 91% of our insured portfolio and capped our remaining insured exposure at 1.2 billion dollars, while the 400 million dollar payment reduced our total surplus note liability to approximately 429 million dollars.

On the asset monetization front, on July 16th, we closed the American Roads sale to American Roads AcquireCo LLC, a wholly owned subsidiary of DIF Infra 5 US LLC, for the cash consideration of approximately 219 million dollars, before payment of certain related expenses, with provisions that provide for the payment of additional amounts of up to 20 million dollars if specified conditions are met within 12 months of the date of the agreement. In addition, Syncora retained approximately 55 million dollars of cash from Pike Pointe and its subsidiaries, all of which was previously included in Syncora's consolidated balance sheet.

I know that many of you are wondering where we go from here and how Syncora can continue to improve stakeholder value now that we have achieved these significant strategic objectives. I would note that there is more to do in three key areas:

Our primary focus is on further de-risking the Company. To that end, we are developing strategies specific to the retained portfolio – those credits not reinsured to Assured – including commutations, reinsurance and other hedging strategies. Among the retained portfolio, there have been a couple positive developments, which I would like to update you on now. First, the Arkansas River Power Authority, or ARPA, successfully finalized its refinancing. As a result, a significant risk has rolled off Syncora's retained credit list, dropping our total retained risk by one hundred and six million dollars to just over 1.1 billion dollars. And second, the PFI/PPP availability-based credit that we previously identified as Newcastle Hospital and which is the largest credit exposure in our retained portfolio, has received an upgrade on its Moody's rating from Ba3 to Ba2. While this does not represent a material change to the credit, we felt it was an important development to mention. In addition, we understand that on July 31st, 2018, the Puerto Rico Oversight Board and an ad hoc group of bondholders reached a restructuring support agreement on uninsured PREPA bonds. We will continue to work with other creditors similarly-situated to us in our efforts to protect our interests in our PREPA exposure and monitor the remaining retained credits closely and will keep you apprised of any further noteworthy developments.

Second, on the reinsured portfolio, we plan on seeking to novate or purchase with a view towards novating to Assured those policies reinsured to Assured. This is a complicated undertaking and we will work to accomplish it as swiftly and efficiently as possible.

Third, we are continuing to work on reducing operating expenses on a run-rate basis as we transition certain services to Assured Guaranty under the reinsurance transaction – this is something that we're doing carefully and in a phased fashion to ensure that we continue to meet our regulatory reporting obligations while protecting the interests of policyholders.

All of these initiatives are meant to improve our financial position which would affect our ability to get approvals from our regulators to pay down surplus notes and to continue de-levering the capital structure, which has been our priority since the 2016 restructuring transaction. Under the terms of our surplus notes, we are required to request a surplus note payment of approximately one hundred and forty four million dollars, which is the entire past due amount along with what is currently owed on the long term and short term surplus notes, when we make our next semi-annual request to the NYDFS. We believe the large influx of capital from the sale of our American Roads asset, along with the continued de-risking of the Company, will present a positive case for authorizing another payment. I would remind you, however, that while we feel we have a strong financial argument for such a payment, the NYDFS has its own metrics when determining the amount they will allow us to pay and there can be no assurance that any such approvals will be obtained on a timely basis or at all.

Finally, I would like to update you on our exploration of new business ventures that could potentially make use of our NOLs. I would like to stress that nothing is concrete in our approach at this time. Due to Section 382 of the Internal Revenue Code, restrictions on changes in ownership, under our current structure we would be limited in our ability to raise significant amounts of capital through issuances of equity so as to avoid endangering the NOLs. As a result, we are unable to do anything of real significance until the third or fourth quarter of 2019 when the Section 382 restrictions reset. That being understood, we are in the process of reviewing business ventures that create growth and profits that could potentially be offset against our NOLs. In our evaluation of business opportunities, we have identified potential asset classes for an asset management business. One of the possible approaches to a new business initiative would be to create a separate vehicle to create scale for additional third-party investment to maximize returns and utilize the NOLs. In fact, we have already made investments in some higher yielding assets in areas where the Company has very strong core competencies, like CLO equity, which ultimately could be transferred to the separate vehicle. Broadly speaking, management intends for any new business to be profitable from the outset, without unduly increasing operating expenses, which we've been working so hard to reduce. In short, the business would need to stand on its own and any use of the NOLs would be additive.

I am very pleased to report all the progress we have made since our last call. We will continue working on the initiatives I just described and I look forward to updating you on further developments.

With that, I would like to turn the call over to David Grande to discuss our second quarter 2018 financial performance and provide insured portfolio highlights.

David Grande: Thank you Fred. As Scott mentioned, last night we posted our second quarter 2018 GAAP earnings release, consolidated financial statements and financial highlights deck to our website. In addition to these materials, the Company posted the SGI statutory-basis Quarterly Statements as of June 30, 2018 as well. One reporting change that I'd like to mention is that the Company will no longer publish its Quarterly Operating Supplement, which had previously provided additional statutory financial information, as we believe it provides less meaningful information now that the reinsurance agreement has gone effective. Furthermore, in a little while, I'll also highlight certain other key changes to our financial highlights deck, also primarily stemming from the reinsurance agreement.

Before I jump into the numbers for the quarter, I'd like to take a minute to discuss some very significant changes to the presentation of our GAAP financial statements. As a result of the reinsurance agreement entered into with Assured Guaranty and to better reflect how management now manages its business, we have enhanced the balance sheet and footnotes presentation to separate information between the business that we are retaining and the business that we are ceding, all while still adhering to the requirements under Generally Accepted Accounting Principles. This new presentation will aid the users of our financial statements by providing greater transparency into the net insurance risks still being retained by Syncora.

Turning now to our earnings for the six months ended June 30, overall we had GAAP net loss attributable to SHL of 107.5 million dollars or 1 dollar and 24 cents per common share, as compared to a net loss of 69.5 million dollars or 80 cents per common share for the same period last year.

In addition, since we sold American Roads during the third quarter, this will be the last quarter that we will classify the American Roads entity as held for sale on a go-forward basis on the Consolidated Balance Sheets and will reflect the gain on sale in the third quarter. For the current period, the income from discontinued operations was 10.8 million dollars and is included in the 107.5 million dollar overall net loss attributable to SHL.

Non-GAAP operating loss was 45.3 million dollars or a loss of 52 cents per common share, as compared to a loss of 39.1 million dollars or a loss of 45 cents per common share for the same period last year.

Non-GAAP adjusted book value per share decreased from year-end as well. As of June 30, 2018, adjusted book value per common share was 4 dollars and 93 cents as compared to 7 dollars and 2 cents as of December 31, 2017. A little later I will also discuss the drivers of the decrease to adjusted book value, and I will cover a couple of new non-GAAP adjustments that we introduced this period as well.

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

Turning to the highlights for the six months ended June 30:

First, there was 23.1 million dollars of net premiums earned, which was lower than the 27.4 million of net premiums earned for the same period last year primarily as a result of $3.3 million of premiums ceded to Assured Guaranty under the reinsurance agreement effective June 1st and the continued run-off of our book of business. Total premium accelerations decreased by only 100 thousand dollars to $13.8 million for the six months ended June 30, 2018.

Second, net investment income decreased by $2.1 million from $23.5 million for the six month ended June 30, 2017 to $21.4 million for the six months ended June 30, 2018. The decrease was primarily due to lower income on remediation bonds as compared to the prior period.

Third, fees and other income increased by 11.1 million dollars to 14.3 million dollars for the six months ended June 30, 2018 primarily as a result of the sale of a real estate development option in the first quarter as we previously described in last quarter's earnings conference call.

Fourth, 24.7 million dollars of mark-to-market losses on our CDS contracts, as compared to 3.1 million dollars of mark-to-market gains for the same period last year. These losses were primarily due to lower non-performance risk spreads.

Fifth, net losses and loss adjustment expenses were $14.6 million for the six months ended June 30, 2018, as compared to $41.9 million for the six months ended June 30, 2017. The decrease was primarily due to positive developments on our public finance book, partially offset by RMBS adverse developments and additional loss adjustment expenses related to the sale of American Roads.

Sixth, interest expense, which includes both non cash accretion on SGI's surplus note balance and the accrual of interest, increased by 6.8 million dollars to 49.4 million dollars for the first six months of this year from 42.6 million dollars for the same period last year. In addition, we recorded a 91.4 million dollar loss on debt prepayment as a result of the payment made on SGI's long-term surplus notes which have not yet been fully accreted to par. As Fred mentioned, on June 27th, we made a net 400 million dollar payment on our long-term and short-term surplus notes.

And **lastly**, even though we've implemented significant cost reduction initiatives, operating expenses were higher as compared to the same period last year primarily as a result of expenses incurred in connection with the reinsurance agreement.

As I just discussed, income from discontinued operations, which represents the results of American Roads, was 10.8 million dollars for the six months ended June 30, 2018 as compared to 6.0 million dollars for the same period last year.

I'd like to now turn back to our non-GAAP adjusted book value reconciliation where, as I mentioned earlier, we've introduced two new adjustments this period. Both of these adjustments relate to deferrals of a gain and loss that are not recognized under Generally Accepted Accounting Principles. However, with the closing of the reinsurance agreement with Assured Guaranty, management reviewed certain of its financial accounts and made these non-GAAP adjustments to reflect the underlying economics of these transactions.

The first was the addition of the deferred gain on insurance cash flow certificates which represent the excess of amounts paid to effectively defease or, in-substance, commute the company's exposure on certain of its financial guarantee policies over the amount of future expected claims payments on those policies. Under GAAP, the benefit representing the expected future losses in excess of the remediation costs paid is not recognized immediately, but rather amortized over the life of the underlying policy. However, since these remediation costs have already been paid, management adds these amounts back as we consider the effect of these deferred gains to be economic in nature.

The second was the elimination of the deferred loss on reinsurance which is also amortized, but over the life of the underlying reinsured contracts. The deferred loss on reinsurance is calculated as the difference between the amount paid for reinsurance and the amount of liabilities relating to those underlying reinsured contracts. Similar to the deferred gain on insurance cash flow certificates, since the reinsurance payment has already been made, management believes that the loss is economic in nature and should not be deferred.

Overall, as I mentioned earlier, adjusted book value per share decreased by 2 dollars and 9 cents. This decrease was primarily driven by the reinsurance agreement in two ways. First, in addition to the approximately $360 million of cash consideration paid, SGI also assigned over all future installment premiums for the reinsured policies. As these future installment premiums previously represented positive adjusted book value items, we no longer have this benefit. And second, since a portion of the consideration we paid for reinsurance was for the cession of almost all of our CDS policies, we've effectively crystalized an economic loss on those policies where we previously said that these mark-to-market losses will generally reverse to zero over time. Both of these items were partially offset by the net benefit of the recognition of the two new deferred items that I just discussed.

In addition, I also want to note that our GAAP equity and adjusted book value as of June 30th does not include the positive results of the gain on sale of American Roads as that transaction closed during the third quarter.

As it relates to our retained insured portfolio, and as outlined on slides 11 and 12 of the financial highlights deck, as of June 30, 2018, SHL reduced its total net par exposure by 13.7 billion dollars, to 1.1 billion dollars primarily as a result of the reinsurance cessions to Assured. Post-reinsurance, the average internal rating of our retained portfolio was bb, which is lower than the bbb+ from year end 2017, and total credit count decreased from 495 credits as of December 31, 2017 to 21 credits as of June 30, 2018.

Our below investment grade credits, or BIG exposures, were 0.5 billion dollars as of June 30, 2018, a reduction of 0.7 billion dollars from year end also primarily as a result of the reinsurance agreement. 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 significantly by 34 percent in total to 0.47 as of June 30, 2018.

Lastly, given the cession of the vast majority of our credits to Assured, we have updated our supplemental exposure information on page 23 of the financial highlights deck to now include all of our retained insured exposures, as opposed to those with net par outstanding greater than 40 million. We believe this revised disclosure will be very useful to our stakeholders.

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 would like to remind everyone in order to ask a question please press star then the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from Andrew Gadlin From Odeon Capital Grup. Your line is now open.

Andrew Gadlin Hey, good morning. Fred, I was wondering if you could talk a little more about the new business strategy and some of the things you're doing, particularly in CLOs.

Fred Hnat Sure. Good morning, Andrew. Thanks for the question. As far as new business is concerned, as I mentioned in my prepared remarks, we're in an exploratory phase of various businesses. We focused on asset management as one very good area, good fit for Syncora. We have purchased CLO equity investments over the last year in SGI's investment portfolio. We would only build that out and develop an asset management platform if we believe that doing so would enhance shareholder value.

So we have the NOL, which is a strategic advantage, but our view is the business needs to stand on its own merits to justify making a long-term commitment to it.

Andrew Gadlin: And can you talk about the team that will be working on this, Fred?

Fred Hnat: Yes. Sure. We have in-house here -- we've been doing CLO debt credit enhancements since 2001. We have a credit team here that's been reviewing the investments in CLO equity that we've made to date. We have a modeling team that has extensive experience modeling CLOs and conducting analytics in the leveraged loan space. Our head of surveillance, Drew Hoffman, oversees that team, and David Grande and I are also involved.

But I think looking back at our history in CLOs, it's been a good story. We had a portfolio, I think, at its peak of $15 billion of CLO debt insured. Never paid a claim, never had a loss on any of those transactions.

So I think there's good credit experience in-house. We're taking a moderate approach to this initially by making investments under the insurance platform. And over time, the vision would be to set up a separate vehicle that would more fully use our NOL assets.

Andrew Gadlin: And presumably, that would be at SHL instead of SGI?

Fred Hnat: That would be SHI, which is the U.S. parent company. Syncora Holdings Inc.

Andrew Gadlin: Got it. Thanks. And then, Fred, can you talk a little about the requirement that you have to request, I think you said $144 million of past due amounts the next semiannual pay-down period, which would be this December

Fred Hnat: Right. We are obligated under the MTA to request all due amounts under the surplus notes to the insurance, New York Department of Financial Services on a semiannual basis. So the next phase of that would be in December of this year.

Andrew Gadlin: And then assuming you get it, maybe this December, maybe it's next year, whenever, what does that imply for the pay-down trajectory for the remaining surplus notes outstanding?

Fred Hnat: I'd be reluctant to speculate as to what approvals we'll get and where we come out on that. And it will really be up to the NYDFS to determine how much and on what time frame those payments will be made.

But based on where we are today, we monetized the American Roads asset, I think we are in a very good position to go to the NYDFS and make a significant request.

Andrew Gadlin: Got it. And then I think this is more of a question for David. And thank you for answering my questions. David, if I wanted to do a simple a pro forma June 30th balance sheet to reflect the sale of American Roads, is there a simple couple of line items that have to be adjusted? And can you tell us the magnitude of those changes?

David Grande: Sure. It’s a good question, Andrew. So when we’re talking about GAAP, we have a single line item presentation for assets and liabilities held-for-sale, those are the American Roads LLC assets on the balance sheet. So really, by simply unwinding those accounts and increasing the cash by the sales price of 219, that Fred just mentioned, you can get there.

So if I -- so I can quickly throw some numbers at you. So we have assets of entity held-for-sale of $167 million, but then there's liabilities held-for-sale of $12 million. So that's $155 million of carrying value. And then the sales price of 219, when you take that difference, that's about $65 million. We have, I think, 87 million shares outstanding. And so when you do the math, that gets you approximately $0.75 per share that will be recognized in Q3 from a GAAP perspective.

Andrew Gadlin: And what about on a STAT perspective?

David Grande: So on a STAT perspective, it's little bit different because we request a -- requested and got approved a permitted practice to carry American Roads -- or I guess, more specifically, to carry Pike Pointe including American Roads as a (contra) reserve. And so because of that, the accounting is little bit different and that the subsequent events is actually recognized in Q2. So for Q2, we took the gain already through our statutory surplus, and that was about $25 million approximately.

Andrew Gadlin: Got it. And so on a statutory basis, because that's really the number I focus on, is it as simple as taking from the losses which is negative $190 million, basically add in $220 million -- $219 million of loss on the loss reserve side, and then on the cash side, adding in that same amount? So that no change to surplus, but it's just the -- these two line items. Is that the way to think about it?

David Grande: Not necessarily because there was also a distribution that was made between Pike and SGI. So our Q1 of salvage balance was approximately $250 million. We did a $25 million distribution, so that got the carrying value down to about $225 million. And then when you take the sales price of $219 million plus the cash that was already in Pike Pointe, that kind of gets you back up to the $250 million salvage. So the salvage number will stay the same, but we recognized a gain because of the closing of the sale.

Andrew Gadlin: And that's why I assume -- going back now to a GAAP basis, that's why the assets and discontinued operations drops in the quarter?

David Grande: That's right, yes.

Andrew Gadlin: Because of that distribution?

David Grande: That's right, yes.

Andrew Gadlin: Got it, OK. Thank you very much, David.

David Grande: OK.

Operator: Your next question comes from line of Rob Halder from NatAlliance Securities. Your line is now open.

Rob Halder: Good morning, guys and congrats on getting the AGO and American Roads deals done. Fred, I guess the first question is for you. Some of your monoline compatriots have had pretty strongly worded thoughts on Puerto Rico and Puerto Rican exposures, especially after the PREPA settlement and PREPA decision. How are you guys thinking about that? Because clearly, you're not a party to the PREPA settlement that had been announced. And then following that, there was the appellate court decision. So how are you thinking about your Puerto Rican exposure kind of following that? And it sounds like you guys are, based on your disclosures, looking at and likely to file a renewed motion for relief from the automatic stay in front of Swaine. So just wondering if you could comment on that.

Fred Hnat: Sure. Rob, we said in past earnings calls, our exposure is relatively low on PREPA and on the general obligation bonds that we insure relative to other bond insurers and ad hoc holders. We're no less frustrated with how poorly managed, frankly, PREPA has been and highly politicized. They've gone through repeated management and board turnover. So, we were pleased with the decision that came down from the First Circuit last week overturning Judge Swaine's ruling that PROMESA basically precluded the court from granting relief on a receiver without an Oversight Board consent. That's good directionally for us.

Neither PREPA nor our other Puerto Rican credits have been reinsured to Assured Guaranty. So our approach is to remain very proactive in our remediation efforts. We're going to continue to try to de-risk that credit when the opportunity presents itself. We'll continue asserting our rights as -- legal rights alongside other creditors, just as we did with the receiver suit, and try to contribute creatively to solutions where we can and restructuring proposals.

Rob Halder: Got you. And then my different line of questioning. In your description of the Company's ongoing strategic plan in the financials, there was something that you didn't seem to mention on the call, you were talking in the consolidated financials about considering acquiring or tendering for the amps, SGI's preferred securities at a discount. How are you thinking about that? And I know you have a $65 million permission from the surplus notes and the regulator with kind of a one-year clock. So that's ticking, and I'm wondering where that stands at this point?

Fred Hnat: That's right. Rob, there are around $130 million of Twin Reef preferred securities outstanding and we are exploring opportunistic ways to enhance shareholder value, which could include taking them out at a discount when it's viewed as being accretive to common equity.

So you mentioned we did receive that consent as part of our reinsurance consent process from the surplus noteholders to do up to $65 million, and that would be -- that's the maximum amount of cash outlay we would be able to make under those consents. We would also need approval from the NYDFS to do that, so that's an uncertainty.

As it stands today, the Twin Reefs are -- they're a very low cost instrument given that they’re noncumulative and perpetual. So as we progress through the coming months, we'll be considering where we go with Twin Reefs.

Rob Halder: OK, great. Thank you.

Operator: There are no further questions. I will now turn the call back over to Mr. Beinhacker.

Scott Beinhacker: Thank you, operator, and thanks, everyone, for joining us on the call. We look forward to talking to you again after the release of our Q3 2018 financial statements.

In the meantime, if you have any questions, please feel free to reach out to me at (212) 478-3400 or through our dedicated Investor Relations e-mail, 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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