CAPITAL MANAGEMENT

Assured Guaranty

As a value investor, I enjoy buying companies at a large discount to intrinsic value, providing a very strong margin of safety.

Such an opportunity exists in the common stock of Assured Guaranty (AGO), which I've covered on Seeking Alpha for over 12 years now. The municipal bond insurer tends to only generate headlines when bad news occurs, such as the municipal defaults of Puerto Rico or Detroit, but beyond the headlines is a well-capitalized and market leading insurer trading at a massive discount to intrinsic value. I believe the current price should provide attractive returns for investors.

One of the most frustrating aspects of investing is when a management team destroys shareholder value. There are countless examples of this occurring, often through disastrous acquisitions. Other times, management fails to buy back stock when it is truly on sale, missing out on incredible compounding opportunities, or they buy it back when the stock is too expensive. With AGO, management gets it. From the beginning of the repurchase program in 2013 through August 6,2024, the company repurchased a total of 148 million common shares for $5.2B, representing 76% of the total shares outstanding as of January 1st, 2013.

I can't recall any buybacks made even close to book value, let alone adjusted book value per share, as the company has always traded at a discount since the Financial Crisis. AGO's currently authorized to purchase $275MM of its common shares.

Now the savvy skeptic who has read these research reports would say that clearly the intrinsic value of the company is below book value for AGO, since the stock has almost always traded at a discount, and the return on equity has been less than 10%. I would agree with that assessment but as we've experienced with other insurance companies that we've recommended such as MTG, RDN, NMIH, AIG, VOYA, etc., ROE can improve leading to higher valuations. At T&T Capital Management, we pounded the table for mortgage insurers during the peak of the lockdown/pandemic-driven recession of 2020 when the stocks traded at huge discounts to their net asset values, and the rallies have been robust, with the companies now trading at premiums to their growing book values.

AGO has too much capital, but management gets it and takes appropriate action. New business production is getting much more stable and higher interest rates are a big positive for investment income. The company got off track when it ventured into the asset management space but was able to profitably merge its interest into Sound Point, leading to a very capital efficient model, which will benefit shareholders moving forward. AGO had to weather horrific storms stemming from the Financial Crisis and the Puerto Rico default. The Puerto Rico saga has lasted a decade but is finally nearing its conclusion with resolution for PREPA hopefully coming in the near future, after a favorable ruling in the Court of Appeals. The court reversed several lower court findings, and said that bondholders had a perfected lean, not just on trust agreement accounts, but also on past, present and future net revenues. This should reduce future litigation costs and uncertainty in relation to reserves for the company.

I'm not naïve enough to believe that there won't be future defaults, as areas such as Healthcare pose challenges, but the exposure is less systemic and politically fraught than the previous crises were in my opinion. While AGO did have $21 million of economic loss development in the second quarter of 2024, primarily related to a few health care transactions, there was sufficient deferred premium revenue to absorb the development for the quarter, resulting in no loss expense The company has proven its ability to maintain profitability and capital strength, despite these incredible pressures, while also growing its book value per share metrics at very attractive rates.

On August 7th, AGO reported a very strong Q2, posting adjusted operating income of $80MM, or $1.44 per share. Adjusted operating shareholders' equity per share and adjusted book value per share were $109.88 and $161.65, respectively, at the end of Q2. New business production continues to be quite solid, with the company posting $155MM of present value of new business production (PVP), on $132MM of Gross Written Premium (GWP). These results were the second best direct GWP and the best direct PVP produced in a second quarter since 2009. First half PVP of $218MM is the most since 2009, with the sole exception of 2018, when AGO assumed a large portfolio from another insurer. AGO had a 58% market share of primary-market insured par sold. AGO's municipal issuance was 5.2% in Q2, down slightly from 6.5% at the same time last year.

The insured portfolio's below investment grade exposure is only 2.2%, which is one of its lowest levels in its history. Diving deeper into the portfolio, $624MM of BIG relates to PREPA, which is fully reserved in my estimation, with potential for reserve releases. The only real areas of current concern are some of the hospital systems, which have faced major cost pressures stemming from Covid and inflation.

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The thing about hospitals is that they are usually incredibly critical to their region, so while some operators might run into trouble and face liquidity issues, I wouldn't expect credit impairment to be too material, particularly with the levels of security that Assured Guaranty has in place. As I mentioned earlier, when a bond insurer is in the headlines, it is usually do to bad news. However, defaults must happen for investors and issuers to want bond insurance. I'd m much rather deal with a few distressed hospitals, than deal with Puerto Rico simply refusing to pay any debt and having Congress write an incredibly controversial and poorly executed law to deal with the situation.

AGO continues to be a cannibal in relation to buying back its own stock, repurchasing $152MM worth of shares in Q2, along with paying $17MM in dividends. These buybacks, along with retained earnings, have caused adjusted operating shareholders' equity to increase by 15% over the last year. Assured Guaranty has been simplifying its corporate structure, including merging AGM and AGC together on August 1st, which will result in a more efficient utilization of capital.

This merger allowed the company to take a $300MM special dividend on August 5th, after the quarter, following a $100MM special dividend in Q2.

These dividends provide capital for future buybacks, so I'd bet that the company will hit its target of $500MM of buybacks in 2024 and 2025.

At a recent price of $72.79, AGO trades at just 66% of adjusted operating shareholders' equity and 45% of adjusted book value per share. AGO has a clear path to grow all book value per share metrics via continued buybacks at these discounted prices and retained earnings. Puerto Rico risk is as minimal as it has ever been and there is some potential upside there based on the favorable Appeals court ruling. AGO's new business production has picked up steam and that business creates deferred future revenue streams, which ultimately will lead to a higher return on equity. For many years, the company was deleveraging but that is no longer the case, so as the insured portfolio grow, and as the company continues to buyback stock with excess capital, the ROE will expand, and I do see AGO trading closer to its future adjusted operating shareholders' equity. For now, my target price for AGO is approximately $90 per share which is roughly 75% of where I expect adjusted operating shareholders' book value per share to be by this time next year. Intrinsic value should continue to grow from there and I do believe that there is a considerable margin of safety at current prices, even if the economy weakens, which is my base case.

Tim Travis
CEO of T&T Capital Management
31102 Via Peralta, Coto De Caza, CA 92679 | (805) 886-8140 | ttcapitalonline.com