ACA Capital Holdings Inc
Form 10-Q
May 15, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

Form 10-Q

x	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarter Ended March 31, 2007

or

o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 1-33111

ACA Capital Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**75-3170112**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

140 Broadway
New York, New York 10005
(212) 375-2000
(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer x

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of May 14, 2007, 37,414,603 shares of Common Stock, par value $0.10 per share, were outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements of ACA Capital Holdings, Inc. and Subsidiaries (Unaudited)

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)
AS OF MARCH 31, 2007 AND DECEMBER 31, 2006
(Dollars in thousands)

	March 31, 2007	December 31, 2006
ASSETS		
Investments:		
Fixed-maturity securities available for sale at fair value, amortized cost of $5,004,901 and $5,043,239, respectively	$ 4,824,314	$ 5,026,276
Fixed-maturity securities trading at fair value, amortized cost of $309,529 and $251,884, respectively	308,012	251,825
Securities purchased under agreements to resell	3,679	10,248
Guaranteed investment contract	119,340	119,340
Total investments	5,255,345	5,407,689
Cash:		
Cash and cash equivalents	426,026	379,905
Restricted cash	70,221	67,061
Total cash	496,247	446,966
Accrued investment income	20,764	21,222
Derivative assets	23,784	19,730
Deferred policy acquisition costs, net	49,247	48,810
Deferred debt issuance costs, net	32,440	34,104
Receivable for securities sold	1,106	824
Prepaid reinsurance premiums	511	528
Deferred income taxes	55,171	
Other assets	73,840	58,321
Total assets	$ 6,008,455	$ 6,038,194
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
LIABILITIES		
Unearned premiums	$ 189,281	$ 189,537
Reserve for losses and loss adjustment expenses	44,108	42,113
Short-term debt	2,678,982	2,677,828
Long-term debt	2,095,236	2,125,914
Related party debt	100,000	100,000
Securities sold under agreements to repurchase	277,701	232,227
Derivative liabilities	44,239	33,874
Accrued interest payable	16,264	17,900
Accrued expenses and other liabilities	59,110	61,855
Payable for securities purchased	50,813	9,628
Current income tax payable	8,856	7,056
Deferred income taxes		258
Total liabilities	5,564,590	5,498,190
MINORITY INTEREST	19,189	30,190
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Common stock of 100,000,000 shares authorized at March 31, 2007 and December 31, 2006; 37,414,603 and 37,375,123 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively; par value of $0.10	3,741	3,737
Gross paid-in and contributed capital	440,266	438,935
Treasury stock at cost 851,847 shares at March 31, 2007 and December 31, 2006	(12,088)	(12,088)

Notes receivable from stockholders	(3,121)	(3,121)
Deferred compensation	(580)	(870)
Accumulated other comprehensive income net of deferred income tax of $(53,822) and $(1,760) at March 31, 2007 and December 31, 2006, respectively	(99,988)	(3,308)
Retained earnings	96,446	86,529
Total stockholders equity	424,676	509,814
Total liabilities, minority interest and stockholders equity	$ 6,008,455	$ 6,038,194

See notes to unaudited condensed consolidated financial statements.

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ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(Dollars and shares in thousands, except per share amounts)

	Three months ended March 31, 2007	2006
REVENUES:		
Gross premiums written	$ 5,041	$ 4,788
Less premiums ceded	(131)	(125)
Net premiums written	4,910	4,663
Decrease in unearned premium reserve - net	239	219
Premiums earned	5,149	4,882
Net insured credit swap revenue	3,699	14,180
Net investment income	89,920	77,712
Net realized and unrealized losses on investments	(3,708)	(1,967)
Net realized and unrealized gains on derivative instruments	2,080	3,642
Other net credit swap revenue	12,306	2,913
Fee income	6,332	4,118
Other income	56	51
Total revenues	115,834	105,531
EXPENSES:		
Loss and loss adjustment expenses	1,373	2,021
Policy acquisition costs	1,477	1,392
Other operating expenses	16,153	10,613
Interest expense	76,408	66,419
Depreciation and amortization	2,259	2,492
Total expenses	97,670	82,937
Income of minority interest	(879)	(1,155)
Income before income taxes	17,285	21,439
Provision for income tax expense	5,868	7,292
Net income	$ 11,417	$ 14,147
Share and Per Share Data		
Earnings per share		
Basic	$ 0.31	$ 0.62
Diluted	$ 0.31	$ 0.47
Weighted average shares outstanding		
Basic	36,540	22,806
Diluted	37,120	30,044

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(Dollars in thousands, except for share amounts)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Par Value	Gross Paid in and Contributed Capital	Treasury Stock	Notes Receivable from Stockholders	Deferred Compensation	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders Equity
BALANCE January 1, 2006	2,786,857	$ 226,460	6,442,950	$ 644	$ 125,184	$ (5,500)	$ (1,355)	$ (2,030)	$ 11,132	$ 29,778	$ 384,313
Comprehensive income:											
Net income										14,147	14,147
Change in unrealized gain on investments, net of change in deferred income tax of $1,748									3,247		3,247
Change in derivative hedges, net of change in deferred income tax of $75									140		140
Total comprehensive income											17,534
Vesting of Series B senior conv. prf stock to CEO								290			290
Stock based compensation-stock options					226						226
Discharge of note receivable from stockholders							546				546
BALANCE March 31, 2006	2,786,857	$ 226,460	6,442,950	$ 644	$ 125,410	$ (5,500)	$ (809)	$ (1,740)	$ 14,519	$ 43,925	$ 402,909
BALANCE January 1, 2007		$	37,375,123	$ 3,737	$ 438,935	$ (12,088)	$ (3,121)	$ (870)	$ (3,308)	$ 86,529	$ 509,814
Effect of adoption of FIN 48										(1,500)	(1,500)
Comprehensive income:											
Net income										11,417	11,417
Change in unrealized loss on investments, net of change in deferred income tax of $(51,370)									(95,402)		(95,402)
Change in derivative hedges, net of change in deferred income tax of $(692)									(1,285)		(1,285)
Foreign exchange unrealized gain									7		7
Total comprehensive income											(85,263)
Vesting of CEO restricted common stock								290			290
Offering costs					(161)						(161)
Stock based compensation restricted stock					222						222
Stock based compensation stock options					863						863
Exercise of common stock options			39,480	4	407						411
BALANCE March 31, 2007		$	37,414,603	$ 3,741	$ 440,266	$ (12,088)	$ (3,121)	$ (580)	$ (99,988)	$ 96,446	$ 424,676

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006

(Dollars in thousands)

	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 11,417	$ 14,147
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,947	2,492
Accrual of discount and amortization of premium on investment net	(33)	(70)
Income of minority interest	879	1,155
Net realized losses on fixed-maturity securities-available-for-sale	2,205	1,968
Net realized and unrealized losses on fixed-maturity securities- trading	1,504	
Net realized and unrealized gains on derivative instruments	(2,080)	(3,642)
Net realized and unrealized (gains) losses on net insured credit swap revenue	15,063	(4,116)
Net realized and unrealized gains on other net credit swap revenue	(8,138)	(194)
Share based compensation expense	1,085	226
Discharge of note receivable from shareholders		546
Deferred compensation	290	290
Purchase of securities under agreement to resell	6,569	
Purchases of fixed-maturity securities-trading	(86,369)	
Proceeds from sales of fixed-maturity securities- trading	28,416	
Securities sold under agreement to repurchase	45,474	
Changes in assets and liabilities:		
Income taxes payable	1,800	150
Deferred income tax expense	1,092	3,409
Prepaid reinsurance premiums	17	122
Derivative liabilities	(684)	16,674
Accrued expenses and other liabilities	(17,532)	(7,490)
Deferred policy acquisition costs	(437)	(693)
Unearned premium reserve	(256)	(23,954)
Loss and loss adjustment expenses	1,995	1,695
Interest payable	(1,636)	637
Interest receivable	458	(1,164)
Other	(1,422)	6,104
Net cash provided by operating activities	1,624	8,292
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net deposit of restricted cash	(3,160)	(4,026)
Purchases of fixed maturity securities available for sale	(251,053)	(247,905)
Proceeds from sales of fixed maturity securities available for sale	57,140	59,226
Proceeds from maturities of fixed maturity securities available for sale	271,245	232,267
Net purchase of property and equipment	(401)	(197)
Net cash provided by investing activities	73,771	39,365
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of commercial paper net	1,154	1,001
Paydown on long-term debt	(30,678)	(39,298)
Payment of issuance costs for debt		(154)
Proceeds from exercise of common stock	411	
Offering costs	(161)	
Net cash used in financing activities	(29,274)	(38,451)
NET INCREASE IN CASH AND CASH EQUIVALENTS	46,121	9,206
CASH AND CASH EQUIVALENTS beginning of period	379,905	174,420
CASH AND CASH EQUIVALENTS end of period	$ 426,026	$ 183,626

SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Federal and local income taxes paid	$ 3,076	$ 3,108
Interest paid	$ 78,043	$ 65,782

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2007

1. BUSINESS, ORGANIZATION AND OPERATIONS

ACA Capital Holdings, Inc. (ACA or the Company), is a Delaware domiciled holding company that provides financial guaranty insurance products to participants in the global credit derivatives markets, structured finance capital markets and public finance capital markets, as well as providing asset management services. The Company s principal activities include financial guaranty insurance of public finance obligations, structured credit risk assumption through insured credit derivatives and collateralized debt obligation asset management. ACA conducts its business through three principal wholly-owned indirect subsidiaries. Its financial guaranty insurance business is conducted through ACA Financial Guaranty Corporation (ACA Financial Guaranty), a Maryland domiciled insurance company. ACA Financial Guaranty is licensed to conduct financial guaranty insurance business, which provides credit enhancement on public finance and other debt obligations, in all 50 states, the District of Columbia, Guam, the U.S. Virgin Islands and Puerto Rico. Standard & Poor s Rating Services (S&P) has assigned a financial strength rating of A to ACA Financial Guaranty. ACA Financial Guaranty also provides the credit support for the Company s Structured Credit business activities. The Company conducts its CDO Asset Management business primarily through ACA Service L.L.C. and ACA Management, L.L.C. This business encompasses the origination (in collaboration with investment banks), structuring and management of collateralized debt obligations (including collateralized loan obligations and other similarly securitized asset classes, collectively CDOs). In January 2007, the Company s wholly-owned indirect subsidiary, ACA Capital Management (U.K.) Pte. Limited, became authorized and regulated by the Financial Services Authority as an investment manager to manage CDOs in the United Kingdom and most of Europe.

The Company s business is composed of three distinct continuing lines of business or segments. They are Public Finance, Structured Credit and CDO Asset Management. A fourth line of business, Other, includes business in areas and markets in which the Company is no longer active. Although the Public Finance and Structured Credit businesses are reported in separate segments, together they form the Company s financial guaranty insurance business. Public Finance primarily provides financial guaranty insurance policies guaranteeing the timely payment of scheduled principal and interest on public finance and other debt obligations. Structured Credit structures and sells credit protection, principally in the form of insured credit default swaps (CDS), against a variety of asset classes in the institutional fixed income markets. CDO Asset Management focuses on CDO origination, structuring and management. The Company will at times assume risk in the CDOs it manages through investment in some portion of the capital structure.

ACA was originally incorporated in Delaware on January 3, 1997. On November 22, 2002, ACA changed its jurisdiction of incorporation from Delaware to Bermuda. During 2004, the Board of Directors determined that re-domesticating to Delaware would eliminate certain adverse consequences of remaining in Bermuda, facilitate ACA s access to U.S. capital markets, simplify its tax filings, accounting and operations, and reduce the costs of compliance with two sets of filing obligations and laws (as ACA stockholders are U.S. entities and individuals). On September 15, 2004, therefore, ACA re-domesticated from Bermuda to Delaware through a process called a discontinuation under Bermuda law and domestication under Delaware law. As a result, it became a Delaware domiciled holding company and changed its name from American Capital Access Holdings, Ltd. to its current name.

On November 9, 2006, the Company priced its initial public offering of 6,875,000 shares of newly issued common stock and 23,541 shares of existing common stock. The Company realized gross proceeds of $13 per share on the newly issued common stock, or $89.4 million. Net proceeds to the Company were $79.2 million, after issuance costs. On November 10, 2006, the Company s common stock commenced trading on the New York Stock Exchange under the symbol ACA. In conjunction with the initial public offering, the Company s senior convertible preferred stock, convertible preferred stock and series B senior convertible preferred stock all converted to common stock concurrently with the closing of our offering on November 15, 2006 at their conversion ratios of 6,000:1 shares, 6,000:1 shares and 6:1 shares, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements and should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2006 (Form 10-K), filed with the SEC on April 2, 2007. These unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, that we consider necessary for the fair presentation of our financial position and results of operations for these periods. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007.

In August 2006, the Company s Board of Directors authorized a dividend of stock in order to effect a six-for-one stock split. All prior share and per share amounts have been restated to reflect the stock split.

3. RELEVANT RECENT ACCOUNTING PRONOUNCEMENTS

On April 18, 2007, the Financial Accounting Standards Board (FASB) released an exposure draft entitled *Accounting for Financial Guarantee Contracts an interpretation of FASB Statement No. 60* (the Proposed Statement). While FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, sets out accounting standards for property and casualty and life insurance enterprises, it has historically not specifically considered financial guaranty insurance. This new interpretation is intended to address the specific attributes of this type of insurance. The principal items addressed in the exposure draft relate to revenue recognition, the establishment of claim reserves and disclosures around such reserves. The Proposed Statement would be effective for financial statements issued for fiscal years beginning after December 31, 2007. While certain provisions of the Proposed Statement are still being analyzed, management believes that the cumulative effect of initially applying the Proposed Statement could be material to our financial statements. Until the final interpretation is issued by the FASB, the Company continues to apply the accounting policies as disclosed in its Form 10-K.

In February 2007, the FASB issued Financial Accounting Standard (FAS) 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159). FAS 159 permits reporting entities to choose to remeasure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The fair value option may be applied instrument by instrument, is irrevocable and is applied only to entire instruments and not to portions of instruments. FAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. FAS 159 is effective for fiscal years that begin after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided that the entity also elects to apply the provisions of FAS 157, which are described above. This early adoption election must be made within 120 days of the beginning of the fiscal year of adoption provided the entity has not yet issued interim period financial statements. Management is currently evaluating the potential impact, if any, which the adoption of FAS 159 will have on the Company s financial statements.

On January 1, 2007, the Company adopted FAS 155, *Accounting for Certain Hybrid Financial Instruments* (FAS 155), an amendment of FAS 133, *Accounting for Derivative Instruments and Certain Hedging Activities* (FAS 133) and FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140). The implementation of this statement did not have a material impact on the Company s financial statements.

On January 1, 2007, the Company adopted FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* (FIN 48). The adoption of FIN 48 resulted in a decrease to stockholders equity as of January 1, 2007 of $1.5 million (see Note 6).

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In September 2006, the FASB issued FAS 157, *Fair Value Measurements* (FAS 157). FAS 157 enhances existing guidance for measuring assets and liabilities using fair value, such as emphasizing that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management is currently evaluating the potential impact, if any, which the adoption of FAS 157 will have on the Company s financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 were put in effect at December 31, 2006. The adoption of this statement did not have a material impact on the Company s financial statements.

In April 2006, the FASB issued Staff Position (FSP) FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)* (FSP FIN 46(R)-6), FSP FIN 46(R)-6 addresses whether certain arrangements associated with variable interest entities (VIEs) should be treated as variable interests or considered as creators of variability, and indicates that the variability to be considered shall be on based on an analysis of the design of the entity. FSP FIN 46(R)-6 was adopted on June 15, 2006. The adoption of this statement did not have a material impact on the Company s financial statements.

In March 2006, the FASB issued FAS 156, *Accounting for Servicing of Financial Assets* (FAS 156), an amendment of FAS 140. FAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits for subsequent measurement using either fair value measurement with changes in fair value reflected in earnings or the amortization and impairment requirements of FAS 140. The subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value eliminates the necessity for entities that manage the risks inherent in servicing assets and servicing liabilities with derivatives to qualify for hedge accounting treatment and eliminates the characterization of declines in fair value as impairments or direct write-downs. FAS 156 is effective for an entity s first fiscal year beginning after September 15, 2006. The implementation of this statement did not have a material impact on the Company s financial statements.

In September 2005, Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts* , (SOP 05-1), was issued. This SOP provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacement of insurance and investment contracts other than those specifically described in FAS No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* . SOP 05-01 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The adoption of this SOP did not have a material impact on the Company s financial statements.

4. CDO ASSET MANAGEMENT BUSINESS

One of the ways the Company participates in the structured finance market is through structuring and managing CDOs originated in collaboration with investment banks. CDOs can be issued in funded, unfunded or partially funded form. Funded CDOs issue debt instruments and purchase investment assets, while unfunded CDOs synthetically acquire assets and issue liabilities (i.e., assets and liabilities are in derivative form). Partially funded CDOs are a combination of these two forms. From an accounting perspective, funded and partially funded CDOs are determined to be VIEs. Each time such CDOs are formed, the Company performs an analysis to determine whether it is the primary beneficiary and thus required to consolidate the CDO under the provisions of FSP FIN 46(R)-6.

The following table lists each of the Company s CDOs outstanding as of March 31, 2007 (dollars in millions):

CDO name	Year Deal Closed	Transaction Type	Collateral Type (1)	Notional Deal Size (3)	Consolidated	Original Investment in Retained Equity	Retained Equity %	First Optional Call Date(4)	Maturity Date
Asset-Backed CDOs:									
ACA ABS 2002-1	2002	Funded	Investment Grade	$ 404	Yes	$ 18.0	100	8/2005	8/2037
ACA ABS 2003-1	2003	Funded	Investment Grade	400	Yes	18.0	100	6/2007	6/2038
Grenadier Funding	2003	Funded	High-Grade	1,500	Yes	22.5	100	8/2008	8/2038
ACA ABS 2003-2	2003	Funded	Investment Grade	725	Yes	33.5	100	12/2007	12/2038
ACA ABS 2004-1	2004	Funded	Investment Grade	450	Yes	10.0	61	7/2007	7/2039
Zenith Funding	2004	Funded	High-Grade	1,511	Yes	13.0	52	12/2009	12/2039
ACA ABS 2005-1	2005	Funded	Investment Grade	452	No	4.4	24	4/2008	4/2040
ACA ABS 2005-2	2005	Funded	Investment Grade	450	No	2.1	10	9/2009	12/2044
Khaleej II	2005	Partially funded	Investment Grade	750	No	4.5	14	9/2009	9/2040
Lancer Funding	2006	Funded	High-Grade	1,500	No	1.5	10	7/2010	4/2046
ACA Aquarius 2006-1	2006	Partially funded	Investment Grade	2,000	No			9/2010	9/2046
ACA ABS 2006-1	2006	Funded	Investment Grade	750	No	1.4	5	12/2009	6/2041
ACA ABS 2006-2	2006	Funded	Investment Grade	750	No	3.5	11	1/2011	1/2047
ACA ABS 2007-1	2007	Partially funded	Investment Grade	1,500	No	1.4	5	3/2010	5/2047
Millbrook	2007	Unfunded	Investment Grade	62	No			3/2010	10/2052
Total Asset-Backed CDOs				13,204		133.8			
Corporate Credit CDOs:									
ACA CDS 2002-1	2002	Partially funded	Investment Grade	1,000	Yes	22.0	100	N/A	7/2007
ACA CDS 2002-2	2003	Unfunded	Investment Grade	1,000	No	25.0	100	N/A	3/2008
Argon 49	2005	Funded	Investment Grade	67 (2)	No			N/A	6/2015
Argon 57	2006	Funded	Investment Grade	67 (2)	No			N/A	6/2013
Tribune	2006	Unfunded	Investment Grade	356 (5)	No			N/A	9/2016
Dolomite	2007	Unfunded	Investment Grade	66 (2)	No			N/A	7/2014
Total Corporate Credit CDOs				2,556		47.0			
Leveraged Loan CDOs:									
ACA CLO 2005-1	2005	Funded	Non-Investment Grade	300	No	5.0	21	10/2009	10/2017
ACA CLO 2006-1	2006	Funded	Non-Investment Grade	350	No			7/2009	7/2018
ACA CLO 2006-2	2006	Funded	Non-Investment Grade	300	No	2.2	10	1/2011	1/2021
Total Leveraged Loan CDOs				950		7.2			
Total				**$ 16,710**		**$ 188.0**			

Note: As of March 27, 2007, the Company s risk under corporate credit CDO ACA CDS 2001-1 expired.

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(1) Investment grade collateral is rated BBB- or better; however certain of our investment grade CDOs include the ability to invest a minority portion (20% or less) in non-investment grade assets. High-grade is A- or better.

(2) The original notional deal sizes for Argon 49 and Argon 57 were 50 million each, and that for Dolomite was 49 million and $1 million. For purposes of this chart, we have converted the amounts to U.S. dollars at the prevailing currency exchange rate on March 31, 2007.

(3) Notional deal size is defined as total liabilities at the deal s inception.

(4) Cash flow CDOs are generally callable once per quarter by a majority or greater vote of the equity holders following the conclusion of the reinvestment period, which is referred to as the First Optional Call Date.

(5) Tribune is comprised of 13 distinct trades some of which are denominated in Euros or Yen. For purposes of this chart, we have converted this amount to U.S. dollars at the prevailing currency exchange rates on March 31, 2007.

As of March 31, 2007 and December 31, 2006, consolidated liabilities include non-recourse debt from consolidated CDOs of $4,683.4 million and $4,711.8 million, respectively. Also, as of March 31, 2007 and December 31, 2006, investments include CDO related fixed maturity securities and guaranteed investment contracts of $4,447.5 million and $4,656.0 million, respectively, and cash of $333.9 and $265.0 million, respectively.

5. NET INSURED CREDIT SWAP REVENUE AND OTHER NET CREDIT SWAP REVENUE

Net insured credit swap revenue includes insured credit swap premiums received for credit protection the Company has sold under its insured credit swaps as well as realized and unrealized gains and losses related to those transactions. Realized losses arise upon the occurrence of credit events requiring payment by the Company under the related credit swap and, additionally, realized gains or losses could occur if a transaction is terminated in advance of its scheduled termination date. Unrealized gains and losses represent the adjustments for changes in fair value that are recorded in each reporting period, under FAS 133. The fair value of the Company s insured credit swaps are recorded as either a derivative liability or derivative asset in the consolidated balance sheets.

The following table disaggregates net insured credit swap revenue into its component parts for the three months ended March 31, 2007 and 2006:

	Three months ended March 31, 2007 (in thousands)	2006
Net insured credit swap revenue		
Insured credit swap premiums earned	$ 18,762	$ 10,064
Unrealized gains (losses) on insured credit swaps	(15,063)	3,895
Realized gains on insured credit swaps		221
Total net insured credit swap revenue	$ 3,699	$ 14,180

Other net credit swap revenue includes revenues received from a partially funded CDS CDO which sells credit protection under credit swaps for which it receives fixed quarterly fees as well as the residual returns on two synthetic equity participations. Other net credit swap revenue also includes net realized and unrealized gains and losses associated with these transactions, if any. These revenues are included in the Company s consolidated statement of operations.

The following table disaggregates other net credit swap revenue into its component parts for the three months ended March 31, 2007 and 2006:

	Three months ended March 31, 2007 (in thousands)	2006
Other net credit swap revenue		
Credit swap fees earned	$ 4,168	$ 2,719
Unrealized gains on credit swaps	8,138	194
Total other net credit swap revenue	$ 12,306	$ 2,913

6. INCOME TAXES

Effective January 1, 2007, the Company adopted the provisions of FIN 48. As a result of the implementation of FIN 48, the Company recorded a $1.5 million reserve for uncertain tax positions and a corresponding decrease to the 2007 opening retained earnings. The Company s effective tax rate would be increased if $1.5 million of unrecognized tax expense were recognized. It is unlikely that the unrecognized tax expense will significantly change in the next 12 months.

The Company files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2003.

The Company records interest and penalties related to unrecognized tax benefits in income taxes. $470,000 in accrued interest and penalties is included in the $1.5 million reserve for uncertain tax positions related to our adoption of FIN 48.

Our tax provision for interim periods is determined using an estimate of our annual effective tax rate. The 2007 effective tax rate is estimated to be lower than the 35% statutory rate primarily due to the Company s investment in securities exempt from federal income tax.

7. LITIGATION

In May 2006, the Company paid a judgment in the amount of $3.7 million in satisfaction of a damages award in connection with an employment contract dispute with a former executive of the Company plus accrued interest through the date of payment. Also in May 2006, the Company settled the former executive s attorney s fees at an additional amount of $0.6 million. The Company had recorded a reserve of $4.2 million to cover these costs in December 2005. A judicial satisfaction of the judgment has been filed and the Company has no additional liability with respect to this matter.

The Company is not aware of any pending or threatened litigation that it believes could reasonably be likely to result in a material adverse effect on the Company s financial position, results of operations or cash flows.

8. SEGMENT INFORMATION

The Company s reportable segments are as follows:

(1) Structured Credit, which structures and sells credit protection, principally in the form of insured CDS, against a variety of asset classes in the institutional fixed income markets;

(2) Public Finance, which provides insurance guaranteeing the timely payment of principal and interest on public finance and other debt obligations;

(3) CDO Asset Management, which originates, structures and manages assets, primarily corporate obligations or asset-backed securities, in funded, partially funded or synthetic CDOs; and

(4) Other, which primarily includes trade credit insurance business and financial guaranty insurance on certain other sectors, each of which the Company is no longer engaged in.

The Company s reportable segments are strategic business units that offer different products and services. They are managed separately since each business requires different marketing strategies, personnel skill sets and technology.

Where determinable, the Company specifically assigns assets to each segment, otherwise, the Company allocates assets based on estimates. In general, allocation percentages for assets are determined based on each line s estimated capital utilization from a rating agency perspective.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates segment performance based on its income (loss) before income taxes. Reportable segment results are presented net of material inter-segment transactions. The following tables summarize the Company s operations and allocation of assets as of and for the three months ended March 31, 2007 and 2006 (dollars in thousands):

	Three months ended March 31, 2007				
	Structured Credit	**Public Finance**	**CDO Asset Management**	**Other**	**Consolidated Totals**
REVENUES:					
Gross premiums written	$ 87	$ 4,672	$	$ 282	$ 5,041
Premiums earned	$ 87	$ 4,878	$	$ 184	$ 5,149
Net insured credit swap revenue	4,645	1,146	(2,092)		3,699
Net investment income	5,745	4,277	78,846	1,052	89,920
Net realized and unrealized losses on investments	(1,512)	(29)	(2,160)	(7)	(3,708)
Net realized and unrealized gains on derivative instruments	(4)		2,084		2,080
Other net credit swap revenue	(37)		12,343		12,306
Fee and other income	115	91	6,182		6,388
Total revenues	9,039	10,363	95,203	1,229	115,834
EXPENSES:					
Loss and loss adjustment expenses		1,025		348	1,373
Policy acquisition costs		1,463		14	1,477
Other operating expenses	6,290	2,907	6,945	11	16,153
Interest expense	3,290	386	72,640	92	76,408
Depreciation and amortization	138	114	2,007		2,259
Total expenses	9,718	5,895	81,592	465	97,670
Income of minority interest	83		(962)		(879)
Income before income taxes	(596)	4,468	12,649	764	17,285
Provision for income tax expense	(202)	1,517	4,294	259	5,868
Net income	$ (394)	$ 2,951	$ 8,355	$ 505	$ 11,417
Segment Assets	$ 351,608	$ 552,466	$ 4,984,141	$ 120,240	$ 6,008,455

	Three months ended March 31, 2006				
	Structured Credit	**Public Finance**	**CDO Asset Management**	**Other**	**Consolidated Totals**
REVENUES:					
Gross premiums written	$ 278	$ 4,082	$	$ 428	$ 4,788
Premiums earned	$ 296	$ 4,177	$	$ 409	$ 4,882
Net insured credit swap revenue	12,740	662	778		14,180
Net investment income	852	3,871	72,095	894	77,712
Net realized and unrealized losses on investments	(136)	(736)	(926)	(169)	(1,967)
Net realized and unrealized gains on derivative instruments			3,642		3,642
Other net credit swap revenue	(14)		2,927		2,913
Fee and other income	130	98	3,941		4,169
Total revenues	13,868	8,072	82,457	1,134	105,531
EXPENSES:					
Loss and loss adjustment expenses		1,376		645	2,021
Policy acquisition costs		1,272		120	1,392
Other operating expenses	3,917	2,112	4,584		10,613
Interest expense	83	403	65,848	85	66,419
Depreciation and amortization	206	188	2,098		2,492

Total expenses	4,206	5,351	72,530	850	82,937
Income of minority interest			(1,155)		(1,155)
Income before income taxes	9,662	2,721	8,772	284	21,439
Provision for income tax expense	3,286	925	2,984	97	7,292
Net income	$ 6,376	$ 1,796	$ 5,788	$ 187	$ 14,147
Segment Assets	$ 43,914	$ 454,213	$ 5,167,487	$ 95,582	$ 5,761,196

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9. STOCK PLANS AND STOCK BASED COMPENSATION

In 2001, the Company adopted the American Capital Access Holdings, Incorporated Omnibus Incentive Compensation Plan (the Prior Plan) under which 2,188,584 shares of the Company s common shares were reserved for issuance to employees, directors and consultants. In 2003, the Company s Board of Directors approved the increase of the number of shares reserved for issuance by 72,954. In 2004, the Board of Directors approved the ACA Capital Holdings, Inc. Amended and Restated 2004 Stock Incentive Plan effective September 30, 2004 (as amended on October 4, 2004, the 2004 Plan) amending and restating the Prior Plan and increasing the total options available under the 2004 Plan (including those previously distributed under the Prior Plan) to 4,241,538. In August 2006, the Board of Directors approved the Amended and Restated 2006 Stock Incentive Plan, to become effective upon completion of the IPO (the 2006 Plan) which increased the total options available under the 2006 Plan, including all shares subject to existing awards thereunder pursuant to the Prior Plan and the 2004 Plan, to 6,327,972. The 2006 Plan became effective November 9, 2006. The 2006 Plan permits the grant of nonqualified and qualified stock options, incentive stock options, restricted stock, stock units, unrestricted stock, dividend equivalent and cash-based awards. The objectives of the 2006 Plan are to optimize the profitability and growth of the Company through annual long-term incentives that are consistent and linked with the Company s goals.

Unless otherwise provided by the Company, depending upon which version of plan the options were granted under, each option vests ratably either annually over 3 years or every 6 months over 3 1⁄2 years, beginning at the date of grant.

On September 30, 2004, the Company granted 335,214 restricted shares at a fair market value of $10.38 per share, to the Company s president and chief executive officer (the Executive). The total value at the grant date of the restricted stock totaled $3.5 million. The restricted stock vests one-third per year over a three-year period provided the Executive has been continuously employed by the Company or a subsidiary throughout the applicable vesting period. In both the first three months of 2007 and 2006, the vested portion of the restricted stock totaled $0.3 million, which was recognized in the Company s consolidated statement of operations.

In December 2004, the FASB issued FAS 123(R), *Shared Based Payments* (FAS 123(R)) that requires compensation cost related to share-based payment transactions to be recognized in an issuer s financial statements. The compensation cost, with limited exceptions, is measured based on the grant-date fair value of the equity or liability instrument issued. FAS 123(R) replaces FAS 123, *Accounting for Stock Based Compensation* (FAS 123) and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issue to Employees* (APB 25).

Effective January 1, 2006, the Company adopted FAS 123(R) using the prospective application as permitted by FAS 123(R). Under this application, we are required to record compensation expense for all awards granted after the date of adoption. Awards granted prior to the date of adoption of FAS 123(R) continue to be accounted for under APB 25. Compensation cost is recognized over the periods that an employee provides service in exchange for the award. The Company recorded stock-based compensation expense of $1.1 million and $0.2 million for the three months ended March 31, 2007 and 2006, respectively, $0.1 million and $0 million of which, respectively, was deferred related to policy acquisition costs. The Company recorded a tax benefit of $0.4 million and $0.1 million for the three months ended March 31, 2007 and 2006, respectively.

The fair value of the stock options granted was estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the following table. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term (estimated period of time outstanding) of the stock options granted was estimated using the simplified method, in which the expected term equals the average of the graded vesting term and the contractual term. Expected volatility was estimated based on the historical volatility of comparable public companies for a period equal to the stock option s expected term, ending on the day of grant, and calculated on a monthly basis.

	March 31, 2007		March 31, 2006	
Expected life (years)	6.00		6.00	
Risk free interest rate	4.71	%	4.55	%
Volatility	25.00	%	25.00	%
Dividend yield	0.00	%	0.00	%

Utilizing these assumptions, the weighted-average per-share fair value of stock options granted in the first three months of 2007 and 2006 was $5.19 and $4.45, respectively.

A summary of option activity for the three months ended March 31, 2007 and 2006 is as follows:

	2007		2006	
	Activity	Weighted Average Exercise Price Per Share	Activity	Weighted Average Exercise Price Per Share
Outstanding, beginning of period	3,897,048	$ 11.50	3,042,306	