AIG: Response to The Economist article (2/28/2002) on AIG

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	2/28/02	SCB	YTD Rel.	EPS			P/E		Price/	
	Price	Rating	Perform.	2001	2002E	2003E	2002E	2003E	Book	Yield
AIG	$74	O	-3%	2.80	3.55	4.05	20.8	18.3	3.8	0.2%
SPX	$1,107			44.00	51.00	56.25	21.7	19.7	3.7	1.4%

O – Outperform, M – Market-Perform, U – Underperform

- **The current issue of *The Economist* contains a very critical article about AIG, including doubts about its valuation. We generally hold *The Economist's* reporting in high regard, so it is a worthy effort to respond to the issues it raises. In general, we do not agree with its overall conclusions, but we do agree with some of the points it makes. We encourage investors to read the article themselves in the February 28 print edition. We are responding to the article's points in the order presented (we have inevitably skipped some elements of the article's detail):**

Investment Conclusion

Despite our criticism of much of *The Economist's* article, our dispute is with their facts, not their intentions, with which we fully concur. Now is indeed the time to rethink how much we should expect from publicly traded companies, and AIG cannot be excluded from this discussion. However, AIG has shown itself willing to comply with rules as long as other must follow them, too (this does not preclude AIG from bargaining to its advantage, of course). AIG has shown a willingness to offer up more disclosure when required or appropriate, and if further disclosure were mandated for all companies, AIG would have to comply.

We consider AIG's current valuation very attractive and rate the stock Outperform. We must also acknowledge that current uncertainties around disclosure, accounting, and other items may put pressure on AIG's valuation in the short term. But we are long-term investors, and if our analysis is reasonable, then the analysis will remain as the uncertainty fades with time. Buying in moments of uncertainty is usually a time when money can be made. Money can also be lost, as Enron has taught us, and investors have every reason to be cautious and learn these lessons as they come. All we can say is that we have done our best work and conclude that AIG is a good investment at current levels.

- ***Analyst complacency*: Article claims that analysts and insurance industry figures dare not challenge CEO "Hank" Greenberg for fear of reprisals—Greenberg is known to send "blistering phones calls" to critical analysts; Greenberg claims to complain "only when the facts are wrong, but he cannot recall a critical report where the facts were right"**

  ***Response*: We come from the insurance industry (12 years experience), not Wall Street, and have no reason to talk up AIG, neither for its investment banking (where Bernstein does no business) nor for the love of them as a competitor. Our only job is to help investors make money buying and selling insurance equities. If we found something worthy of**

concern, we'd report it to you, promptly. We have written a word or two that has earned us an AIG phone call, and it is correct that Greenberg DOES challenge the facts. We have not been able to find areas of serious concern, and we have looked for them. On the contrary, as we continue to analyze the company from different perspectives, we come up with the same result again and again—that AIG makes its money by being properly paid for risk-taking and then well-managing that risk once on the balance sheet. It is this preponderance of evidence, and no single fact, that makes up our Outperform rating on AIG.

- ***Valuation***: Article cites a study commissioned for *The Economist* by Seabury Insurance Capital (with no disclosure of the analysis itself, by the way) that indicates AIG is overvalued compared to insurance peers by $120 billion (62% of current market cap), or by $100 billion (52% of market cap) compared to sum-of-the-parts financial peers

Response: First we compare this analysis to standard valuation measures, price/earnings (forward) and price/book:

Valuation scenario	Price/earnings (2002E)	Price/book
Market ($193bn)	21.1	3.8
Financial peers ($93bn)	10.2	1.8
Insurance peers ($73bn)	8.0	1.4

Any insurance investor can immediately see the problem—Seabury's implied valuations are well below current averages for *all* insurance companies, hardly comparable to the valuations of top peers. We estimate current insurance averages, not yet overvalued in our view, are about 14.0 P/E and 1.9 P/B, which would put AIG's "overvaluation" at $50-65 billion depending on the measure used. Given that AIG does better than the industry averages in almost all cases, this is a conservative methodology. Unless Seabury thinks all insurers are currently overvalued by 25-40%, *The Economist's* numbers do not sync up with market reality. While one is free to come to this conclusion, a proper framing of the market implications would have been reasonable. We don't get a significantly different answer considering other financial institutions (it would close the gap further, if anything), so we will work with the $50-65 billion figure.

$50-65 billion would still be meaningful, implying 26-34% overvaluation. However, readers of our research know that we use a discounted cash flow model to value all of our companies, and an important component of that model is a real options module that attempts to value innovation potential. For AIG, this is significant. Of our current low-end valuation of $236 billion ($90 per share), $92 billion of this ($35 per share) comes from real option value, which represents our estimate of what AIG can do in the future that it does not do now. Subtracting this value gives us a revised valuation of $142 billion ($54 per share), compared to $73-93 billion implied by Seabury and $128-143 billion from the industry comparable analysis. Our valuation ex-real options compares most closely to the high-end industry comparable valuation, which is in turn based upon price/book. Readers of our research know that our DCF model produces values in line with, but not completely equivalent to, price/book valuation, so this result is expected.

So the main question is whether or not our real options value, or some value for innovation, is reasonable. We have always said that an assessment of AIG's future innovation potential is the key to whether or not one thinks AIG is expensive. Our estimate is based upon a reasonable range of scenario testing of AIG's potential to gain additional market share in high ROE businesses. The real options formula haircuts the valuation for the possibility that these ventures will not be successful, thus trying to avoid exuberant valuations like those seen during the tech boom. We are perfectly willing to debate differences on what this value ought to be, but we would strongly disagree that AIG's innovation potential is worth $0. Our best estimate is $35 per share, and we provide our current valuation model (unlike *The Economist*) in Exhibit 1.

- ***Ownership and subsidiary structure***: Article claims AIG has many international subsidiaries, including 50 in Bermuda. Article also complaints about 14% ownership of AIG by Starr International, a private company set up for the long-term compensation of AIG executives, whose real ownership is inscrutable.

  Response: Many of *The Economist's* complaints apply to other insurers, and we find it a bit disturbing that a quality publication like *The Economist* is not properly framing its comments to indicate this. If having Bermuda domiciles is a problem, lots of companies have this problem. Generally cited for the tax advantages, the real advantage of Bermuda is speed to market owing to regulatory ease. Post-Enron, investors may well be worried about the use of such subsidiaries, but this is hardly unique to AIG. We would be all for greater disclosure from Bermuda and other foreign companies, and if the disclosure were uniform, AIG would not have much recourse to complain, but there is no reason to single AIG out.

  As for Starr International, the article itself states that Starr was endowed in 1970 with AIG stock expressly for the future compensation of AIG executives. We'd be perfectly happy if the ownership of this company were disclosed, but the answer will be lots of AIG executives (800 per the article). Starr is a private company, so it would seem reasonable to require such disclosure from all private companies if Starr must disclose. Starr is a foreign company that probably does avoid some US taxation—again, we doubt this is unique to AIG. We have no issue with *The Economist* or anyone else raising the issue of more disclosure, but it would be more honest to raise the issue generally rather than specifically to one company.

- ***Disclosure***: Article criticizes AIG's disclosure as voluminous and impossible to piece together. Disclosure by segment is cursory at best. A significant portion of insurance premiums are ceded to parties unknown.

  Response: We agree that AIG is hard to analyze, but not impossible. Piecing together various data sources is exactly how one must analyze AIG, and it is what we do for a living—we might be wrong, but we would defend our work as reasonable. Even if AIG disclosed more, it would not change the fact that it is a hard company to analyze, not unlike many insurers and financial institutions. However, we do agree that additional details would be good for certain segments, particularly the life business (which AIG has now said it will add). The reinsurance comment again applies to all insurance companies, although for the US business one can use Schedule F of the Annual Statement to get a complete list of all reinsurers (not lines of business). It is important to remember that the NAIC Annual Statement may be a better document of disclosure for many aspects of US insurance companies than the 10K, and it should be considered an integral part of any thorough analysis.

- ***Derivatives and ratings***: Article notes that credit exposure to derivatives has increased. AIG's triple-A rating may be damaged by any crisis of confidence. Triple-A rating driven by "conventional" analysis, rather than more "quantitative" approaches that use market data.

  Response: No one is more concerned than AIG about its triple-A rating. As CEO Howard Smith has said, no deal at AIG is allowed to threaten the triple-A. That is why AIG has companywide credit and market risk committees that assess individual and aggregate credit exposure. We do acknowledge that an external analysis of AIG's derivative positions is difficult, but again this is not unique to AIG. If the lesson learned from Enron (and to be fair, other crises like Long Term Capital) is to never use derivatives again, we would submit that the market has learned the wrong lesson. We also happen to disagree with the idea that looking at stock volatility—a symptom often awash in short-term subjectivity—is a more "quantitative" method than looking at underlying sources of volatility.

  On a more general note, the financial press overall seems to be pushing for a post-Enron standard that requires outside investors to *completely* understand all aspects of a company. Any complexity is right out, or so it would seem. Besides flying in the face of the specialization required by modern capitalism, it's an impossible standard. How many ordinary investors understand how to build a computer, or write a database program, or manufacture drugs, or run a newspaper for that matter? Investors can't be expected to understand fully every investment they make—they must rely on management, the Board, and other experts to help them make some (not all) of their decisions. Granted, Enron shows us when that can go horribly awry, but it is wrong to now assume that all companies are guilty and that investors can only trust themselves. There is plenty of room for some reform and improvements to disclosure. Some punishment may even be in order. But there are limits to what will actually help investors.

- ***How AIG makes its money***: Long section that boils down to: 1) AIG is aggressive and meritorious; 2) AIG knows what it and its competitors are doing at all times; 3) AIG is a hard place, and has chased away many, including Hank's sons; 4) AIG innovates well and quickly, putting competitors to shame; 5) AIG is highly efficient, with a very low cost structure; 6) AIG is known for not paying claims quickly; 7) AIG's hardball tactics have locked it out of some markets for financial guaranties, where pay first and sue later is the norm

  Response: We agree with most of this. About all we can say is when capitalism requires all its players to be nice to each other, we will be living in a very different world than we do now. The hard-nosed approach AIG takes is a big factor in its success, and a major reason why its competitors are both jealous and less successful.

  Points 6) and 7) require further comment. AIG's own response to 6) is exactly right: "We would not be the biggest if we failed to pay". There are many other options available for insurance buyers, as cries of excess capital constantly remind us, and AIG continues to attract business. As for 7), we have written extensively about the interaction of insurance and the capital markets. We happen to think that certain highly customized capital markets transactions are actually better suited as insurance products, with claims denial and all. Products that require heavy customization may have complex triggers and terms, and we strongly disagree that the capital markets "pay first, sue later" model is the right one for these. As will all things capitalist, the market will ultimately sort this out, but we believe that insurance and capital markets with continue to drift towards customization and standardization, respectively. Those products that end up in the insurance world will not follow capital markets rules, and insurers should not be apologetic about advocating for what they think is correct.

Exhibit 1 AIG DCF valuation

Valuation

all amounts in millions of US dollars

Valuation components	*Embedded*	*Franchise*	*Real options*	*Total*	*Value per share*	*Value/ embedded*	*Normalized earnings*	*Value/ earnings*	*ex. real options*
General insurance equity	13,713	22,434	16,708	52,856	20.04	3.9	2,629	20.1	13.8
Life insurance equity	30,096	29,255	24,368	83,719	31.74	2.8	3,930	21.3	15.1
Financial products equity	11,770	39,718	50,767	102,256	38.76	8.7	2,239	45.7	23.0
Excess equity	(2,442)	-	-	(2,442)	(0.93)	1.0			
Total	53,137	91,408	91,844	**236,389**	89.61	4.4	8,797	26.9	16.4
per share	20.14	34.65	34.82	89.61					
Book value:				51,939	19.60				
Value/book:	1.02	1.76	1.77	4.55					
Market capitalization:				**196,093**	**74.00**				
Price/book:				3.78					
				upside:	21.1%				

Definitions and assumptions:

Total value = embedded value + franchise value + real option value
  Embedded value = economic book value; for life and financial, this is AIG's stated equity;
    for general, the balance sheet restatement determines embedded value
  Franchise value = present value of return in excess of cost of capital;
    we assume all units must earned risk-adjusted equity return of 13%
  Real option value = value of option to proceed on new opportunities;
    new opportunity measured as franchise value with a strike price to act

Normalized earnings = average future earnings discounted at cost of capital
Value/embedded = analogous to economic price/book ratio
Value/earnings = analogous to economic price/earnings ratio
  ex. real options adjusts the ratio to exclude real options value
Expected profit = normalized earnings
Expected ROE = expected return on risk capital
Period = length of time excess returns are possible

Franchise valuation	(1) Exp. Profit	(2) Cost of capital.	(3) Exp. ROE	(4) Growth	(5) Period	(6) Franchise
General insurance equity	2,629	10.0%	20.0%	12.0%	15	22,434
Life insurance equity	3,930	10.0%	15.0%	16.0%	15	29,255
Financial equity	2,239	10.0%	25.0%	20.0%	15	39,718
Totals	8,797	10.0%	18.4%	15.8%	15	91,408

Real option valuation	Exp. Profit	Cost of capital.	Exp. ROE	Growth	Period	Franchise	# of options	Term	Volatility	Strike	Option
General insurance equity	342.8	10.0%	25.0%	20.0%	15	6,083	10	3	30.0%	6,083	16,708
Life insurance equity	600.0	10.0%	20.0%	20.0%	15	8,871	10	3	30.0%	8,871	24,368
Financial equity	875.0	10.0%	35.0%	20.0%	15	18,482	10	3	30.0%	18,482	50,767
Totals	1,818					33,436					91,844

$$\text{Franchise value} = (1)/(3) \times [(3)-(2)] \times \frac{1 - [(1+(4))/(1+(2))]^{(5)}}{1 - (1+(4))/(1+(2))}$$

$$= A \times B \times C$$

A = annual risk capital
B = excess return on risk capital
C = growth-adjusted duration of excess return
(i.e. if growing faster than cost of capital, duration of excess return increases)

Option value = number of options x value of individual option
Individual option value = Black-Scholes value of franchise at exercise price (opportunity cost)
for conservatism, we assume opportunity is at least equal to expected franchise value
other option parameters are invariant across companies to maintain consistency

Source: Company reports, Bernstein analysis