One day after the AIG article was published by the Economist Magazine, Sanford Bernstein published a response defending the current market value of AIG. After studying Bernstein's valuation of AIG and the assumptions they used, we found almost total agreement between their and our analysis. The most basic correction that Seabury Insurance Capital LLC needs to represent, contrary to Sanford Bernstein's assertion, is that we never said that AIG was overvalued – not once. What we said was that for investors to pay the current market price for AIG's stock, they must believe that AIG has significantly higher growth than its peers. What is the relevance of this observation? Well, value creation in a company flows primarily from three sources: return on equity, risk and long-term growth, i.e., the growth of long -term earnings. In part of the analysis, Seabury benchmarked AIG to three large diversified global insurance/financial services companies. Seabury's analysis revealed that the risk of all the companies (AIG plus these peers) was about the same. AIG appeared to create modestly more current value (ROE) than the average of these peers. Having established that two of the three variables in the shareholder value model were approximately the same, there is only one source of value creation left that can account for AIG's higher valuation – long-term growth. The relevance of this observation was to try and understand which part of AIG's financial performance investors were willing to pay so high a market premium.

Our observations on Sanford Bernstein's Peer Average P/E and P/B

Seabury's valuation of AIG is based on the latest annual report of AIG and its peers. To be as objective as possible, Seabury used market share prices and historical accounting figures to calculate different valuation ratios. We claimed that if AIG is going to grow as fast as its peers, its market value would have to be lower than its current value. But, if one believes that AIG is going to grow much faster than its peers, its market value would be fair.

Sanford Bernstein's insurance peer average P/E ratio is 14.0 (based on expected 2002 earnings). AIG's net income of the last 4 quarters is $5.5 billion. If we assume AIG's 2002 net income will be 30% higher than the net income of the last four quarters, its market value should be $100 billion[1]. Using Sanford Bernstein's insurance peer average P/B ratio of 1.9, AIG should be worth $96 billion[2]. Taking the midpoint between the $100 billion and $96 billion, we get $98 billion. Seabury valued AIG to be worth as high as $93 billion. The 'overvaluation' (of AIG in comparison to its peers) is about $100 billion according to Seabury or about $95 billion according to Sanford Bernstein's insurance peer average P/E and P/B.

[1] $5.5 billion * (1+30%) * 1.4 = $100 billion. Sanford Bernstein believes that AIG's 2002 net income is $8.8 billion, which is 60% higher than its net income of the last 4 quarters. Applying the same formula, AIG's valuation would be $123 billion based on peer analysis.
[2] AIG's book value as of 9/31/01 is $50.8 billion. $50.8 billion * 1.9 = $96 billion.

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Sanford Bernstein explained AIG's 'overvaluation' in excess of its peers' value using real option values, or some value for innovation. We believe that the real option value should not be added since the insurance peers' market values have already incorporated their own real option value, or value for innovation. To justify additional real option value for AIG, we have to assume that AIG has more new business opportunities and has more capacity to innovate.

Our observations on Sanford Bernstein Valuation of AIG:

According to Sanford Bernstein, AIG's market value should be $144 billion if you believe the following assumptions:

- AIG's earning net income will be $8.8 billion for the year 2002, although AIG's total net income of the last four quarters is $5.5 billion.
- After achieving an annual net income of $8.8 billion in 2002, AIG's earnings will continue to grow (without issuing new stock to finance new growth) by about 15.8% per year for the next 15 years. Seabury believes the U.S. P&C market only grows at the rate of inflation, about 2% to 3%. Property & Casualty makes up almost half of AIG's earnings revealing just how much other parts of AIG must grow if AIG's P&C business can't deliver; although to be fair, the 2% to 3% P&C growth in the US is not, for the most part, made up of "Special Risk" business and AIG excels at Special Risk.
- While enjoying tremendous growth, AIG will experience insignificant risk such that its shareholders are happy to earn a 10% return for providing equity capital, making AIG significantly less risky than the stock market on average. Seabury's position on this issue is: According to CAPM, the required return is the risk free rate (for a matching duration) plus the product of the firm's beta times the market risk premium. Seabury calculates this as being around 13% to 15% for AIG.

Strong organic growth of existing businesses accounts for the $144 billion valuation according to Sanford Bernstein. New business opportunities will drive AIG's value higher. AIG's market value would be $236 billion if $92 billion of real option value is added. The real option value measures the value of the opportunities to create new businesses that AIG has not yet acted on. Sanford Bernstein estimated AIG's real option value is $92 billion. To have this real option value, Sanford Bernstein made the following assumptions:

- Sanford Bernstein assumes that AIG currently has 10 different and distinct opportunities to enter into new businesses in the domestic P&C market. Each of these opportunities will create a company with a market value of $6.1 billion over its book value. AIG has 3 years to exercise these 'real options'. Seabury would like to point out that: Chubb's market value over book value is about $6.1 billion. In other words, Sanford Bernstein assumes that AIG has the opportunity to create 10 P&C companies, each one creates about the same value as Chubb.

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- In addition to opportunities in domestic P&C market, Sanford Bernstein also assumes AIG currently has 10 different and distinct opportunities to enter into new businesses in the global life market. Each of these opportunities will create a life company with a market value of $8.9 billion over its book value. AIG has three years to exercise these 'real options'. Seabury would like to point out that: John Hancock's market value over book value is about $5.8 billion. In other words, Sanford Bernstein assumes that AIG currently has opportunities to create 10 life companies, each one creates more value than John Hancock. To put this assumption in an international context, AXA's market value over its book value is $13.6 billion, and ING's is $29.8 billion. Sanford Bernstein assumes that AIG has the opportunity to create 2 AXA's and 2 ING's.
- In addition to opportunities in the domestic P&C and global life markets, Sanford Bernstein also assumes that AIG currently has 10 different and distinct opportunities to enter into new businesses in the 'Financial equity' markets. Each of these opportunities will create a company with a market value of $18.5 billion over its book value. AIG has three years to exercise these 'real options'. Goldman Sachs's market value is $24 billion over its book value, Merrill Lynch's is $22.8 billion. In other words, Sanford Bernstein assumes that AIG has opportunities to create about 8 financial companies, each one creates about the same value as Goldman Sachs.
- Putting all 30 investment opportunities together, Sanford Bernstein assumes that AIG currently has opportunities to create new companies with a combined market value of $334 billion over book value. This is equivalent to two Citigroups or two and a half AIG's. The present value of the $334 billion is $92 billion according to Sanford Bernstein. The value of the company according to Sanford Bernstein is $146 billion from existing business and $92 billion from real option values for a total value of $236 billion.

The real option value is highly sensitive to the number of opportunities before AIG. If AIG only had 1 (rather than 10) opportunity in each of the three business lines cited above, its real option value would be $9 billion rather than $92 billion. We (Seabury) cannot verify or even guess at the number or size of AIG's new business opportunities, but we maintain that if anyone agrees with all of Sanford Bernstein's assumptions of AIG's new business opportunities, he or she will probably be happy to pay an extra $35 per share for AIG's stock.

Final Remarks

As we stated in the beginning, we are in almost total agreement with Sanford Bernstein:

- If investors value AIG using Sanford Bernstein's peer average P/E and P/B, its market value would be about $100 billion and the 'overvaluation' would be about

$100 billion**. In this regard, Sanford Bernstein's position is not in conflict with Seabury's original position.**

- If investors believe that AIG will grow the profit of its existing businesses at the pace Sanford Bernstein has assumed and that it has as many opportunities to create hundreds of billion of dollars in real option value, as Sanford Bernstein has assumed, investors will find AIG's stock to be fairly valued. This position is not in conflict with Seabury's original position of saying that AIG is fairly valued by investors if they believe that AIG will grow two-thirds faster than its competitors for the next 25 years. We just don't think this is in the realm of possibility.

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