American International Group (AIG)

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AIG increased more than 4% after the company said it expects $800 million in claims related to the World Trade Center attacks. Earlier, the company had put that figure at a loss of $500 million. But the company said its third-quarter core earnings per share are on target and it would show "several hundred million" in profits for that quarter[1].

*Recommendation: **HOLD**. Target price: $81.65 based on 2001 estimates.*

AIG WORLD LEADERS IN INSURANCE AND FINANCIAL SERVICES

New York City-based AIG is a global insurance presence, offering life insurance, property/casualty lines, mortgage guaranty, financial services, and jet leasing in the US and internationally. Stock trading at $83.69[*].

52-Week range	$66.00 - $103.75
Shares outstanding (MM)	2,620
Market Cap. ($MM)	$219,400
Avg. Trading Vol. (000)	6,790
10/13 Bk Value / Shr	$18.30
10/13 Debt / Equity	1.16
Price/Book value	4.57x
Net Cash / Shr	$0.11
Dividend Yld.	0.20%
Growth rate	15.0%

Eduardo Bello
(eduardo.bello@yale.edu)
Peter Lawrence
(peter.lawrence@yale.edu)
Josh Twilley
(joshua.twilley@yale.edu)
Javier Fernandez
(javier.fernandez@yale.edu)

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[1] CBS Marketwatch (http://www.marketwatch.com)
[*] Hoovers (http://www.hoovers.com)

CONCLUSION

AIG is a leader in the insurance industry with solid earnings, sound management, and respectable growth potential. We believe that the market realizes this and prices AIG appropriately. Hence, we rate AIG as a hold. AIG's sound fundamentals make it unlikely to under-perform the insurance industry and limit it's idiosyncratic risk. However, AIG's comparatively rich valuation (32 P/E vs. 28 P/E for industry and 4.2 P/S vs. 3.2 P/S for industry) limits the stock's upside potential. Over the past year AIG has traded down almost 8%. However, this drop is well in line with the overall performance of the S&P and the insurance industry, and is not sufficient to make a value argument for AIG.

COMPANY SPECIFICS

American International Group (AIG) is a diversified financial services holding company that focuses on insurance products. In addition to being one of the largest domestic insurers (4th in written premium) AIG has a large international presence (30% of AIG's written premium) concentrated in the Pacific Rim and Western Europe. AIG's insurance holdings include both property and casualty (P&C) and life companies. These subsidiaries underwrite nearly every standard line of insurance product, including but not limited to; personal, commercial, business, disability, workers compensation, marine, and reinsurance, to name just a few. AIG also provides risk management consulting services to augment their P&C lines. Most of these products (both life and

P&C) are distributed through independent agents, but efforts are being made to expand into direct distribution. AIG has also become a large player in the mortgage market with $22 billion in mortgage guarantee risk. AIG is also one of the largest leasers of airplane engines.

ANALYSIS

The AIG has a market capitalization of over $220 billion and annual revenue toping $44 billion. A beta of 0.94 (slightly inflated due to post 9/11 volatility) reflects the market exposure of life products balanced out by the counter-cyclical potential and bond holdings of a P&C insurer. AIG's profit margin exceeds the industry average at 14% compared to 12.5%, but sales last year grew by half the rate of the industry average. This is not necessarily bad news as it is easy to write unprofitable premium. With an industry P&C combined ratio of over 110% last year, growth often destroyed value. However, over the past three years AIG managed average annual revenue growth of 12.6%, and average annual net income growth of 14.9%. With a triple-A bond rating and over $300 billion in assets AIG is by any measure a financially sound company.

Strategic acquisition and high margin product lines have made AIG one the most profitable insurers. With a non-life combined ratio of 95% AIG's P&C business is the envy of an industry that currently struggles with average combined ratios near 108%. AIG's outstanding combined ratio is due to a focus on high margin commercial, specialty, and group insurance. AIG's personal lines products have a combined ratio of 104.3%, reflecting the norm for non-direct providers. From Q3 2000 to Q3 2001 life income rose 19.7% and financial services income rose 22.3%. These sources of income are more cyclical than P&C income, as in a slower economy people will invest less in life policies and lease fewer jet engines (part of financial services). These are impressive growth numbers, but we see them as being unsustainable in the long term. This is beginning to show as income from assets under management, a key factor in income from life products, has fallen 6% over the course of 2001. This drop is due almost entirely to weak equity markets.

The weak nature of the P&C industry over the past three years, excessive capital, combined ratios topping 111% at their highs, and a comparatively low dividend yield of .2%, have led AIG to seek new investment opportunities for its steady stream of earnings. Some of this cash flow has been invested into more profitable life / investment products. AIG has also aggressively sought foreign investment opportunities. We see great opportunity in non-US insurance markets, but we are unconvinced that AIG's conglomerate style will add economic value beyond what an investor could expect by investing in these countries directly. The coordination, legal, and regulatory costs involved in selling insurance across boarders are significant. AIG realizes this and thus pursues a strategy of strategic acquisition, as opposed to direct expansion. In the aggregate these will likely be profitable ventures for AIG. However, we remain unconvinced that AIG can add anything to the target companies beyond what a standard risk adjusted return would expect. Efficient capital markets and reinsurance has made raising capital and passing risk nearly costless when compared to conglomeration. Still, in the third quarter of 2001 foreign general written premium was up 16.2% compared to a year ago, so there is no denying the growth potential.

All this paints the picture of a healthy company that has continuously shown best in industry performance. AIG's stock valuation reflects a market expectation that this best in industry performance will continue. While we are optimistic about the future for AIG, and feel that many of the high expectations may be met, we are unable to give a buy rating in the face of its comparatively high valuation. We rate AIG as a hold.

The result of the September 11 tragedy has created an unusually good climate within the property and casualty industry. Because of the tragedy, we expect the trend toward commercial self-insuring to diminish, as firms begin to realize the extreme dangers associated with self-insuring. In addition, customers are less sensitive, and in fact expect, an increase in premium prices as a result of the tragedy. Thus, not only is the property and casualty market expected to grow, but the revenue per premium is expected to increase as well. Finally, insurance companies are now aware of the possibility of terrorist attacks, and will rewrite policies accordingly. This has been seen both through anecdotal evidence of insurance companies sending out new contracts, and through corporate strategy sessions. Thus, we believe the renewed sense of risk associated with terrorism will not amount to large increase in premium costs. These benefits are offset by the one time charge associated with costs stemming from the tragedy. Insurance companies need the expected revenue to help finance this cost. However, the increased premiums and market growth are seen as long term improvements. AIG, the top commercial insurer in the industry, should see the greatest benefit from these changes in the property and casualty insurance landscape.

GROWTH

AIG's growth potential continues to be evident as of today. Life Insurance and Financial Services represent the key business lines in terms of growth, with foreign operations playing an important role. Not considering negative FX exposure during the last 6 months, revenue in local currency in the foreign markets has increased in over 20%. Japan for example, continues to see impressive growth in premiums underwritten becoming one of the most important markets for AIG. Financial services, which includes leasing and consumer financing has also seen over 20% annualized growth and currently represents over 15% of the group's total pre-tax income.

General insurance, through which Property and Casualty insurance is sold, has seen steady growth and improved conditions in the pricing environment, both in the domestic and the foreign markets. Expectations for price increases in the P&C sector will help AIG reach an over 15% revenue increase in the coming years, not considering growth in sales volume. The only business line that is not showing high levels of growth is the Asset Management division, which was negatively affected by market conditions in the last few quarters (although its has grown in terms of variable annuities and mutual funds sold). This division however, is the smallest contributor to revenues and earnings.

Although combined ratio is already considered the best in the industry totaling less than 100%, it continues to show improvement, which in some cases has reached 90% for certain business lines. Therefore, there is no reason why not to expect future improvements resulting in better bottom line earnings. We believe that AIG will see a 20% - 18% growth in the next few years declining to a target growth of 15% until 2010. Future changes to these expectations will depend on continued global expansion and acquisitions.

Appendix 1.

COMPARABLES

	EPS			P/E		
Company Name	FY2000	FY2001	FY2002	FY2000	FY2001	FY2002
The Hartford	$ 4.29	$ 4.71	$ 4.92	13.0	12.7	12.1
Allstate	$ 2.68	$ 2.44	$ 3.08	12.4	13.8	10.9
AIG	$ 2.45	$ 1.99	$ 3.50	32.5	24.6	21.3
Berkshire Hathaway	$ 615	$ 1,250	$ 2,160	32.5	94.4	40.9
CNA	$ 2.69	$ (5.40)	$ 1.66	12.0	(8.7)	10.4
Industry				19.4	18.5	13.1

Company Name	Ticker	Recent Price	Current Yield	Beta	Net Margin	Combined Ratio
The Hartford	HIG	$ 57.85	1.79%	1.02	6.7%	1.02
Allstate	ALL	$ 33.85	2.06%	0.98	6.6%	1.08
AIG	AIG	$ 83.65	0.22%	0.94	14.1%	1.03
Berkshire Hathaway	BRK.A	$ 73,900	0.00%	0.76	8.6%	1.17
CNA	CNA	$ 27.27	0.00%	0.65	-4.3%	1.12
Industry			1.98%	1.03	12.5%	1.10

Source: Yahoo Finance. http://finance.yahoo.com
Standard & Poors Stock Report
Market Guide Provestor Plus Report

Appendix 2.

ESTIMATES 2001

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Previous Year Net Earnings	5,636.00	6763.20	8115.84	9576.69	11300.50	12995.57	14944.91	17186.64	19764.64	22729.33
Growth	20%	20%	18%	18%	15%	15%	15%	15%	15%	15%
New Net Earnings	6763.20	8115.84	9576.69	11300.50	12995.57	14944.91	17186.64	19764.64	22729.33	26138.73
# Shares	2,318.00	2,318.00	2318	2318	2318	2318	2318	2318	2318	2318
EPS	2.92	3.50	4.13	4.88	5.61	6.45	7.41	8.53	9.81	11.28
Other	-2160	0	0	0	0	0	0	0	0	0
Final	**1.99**	**3.50**	**4.13**	**4.88**	**5.61**	**6.45**	**7.41**	**8.53**	**9.81**	**11.28**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Perpetuity
Growth	@15%	@15%	@12%	@12%	@12%	@10%	@10%	@10%	@10%	@10%	@3%
Future Earnings	1.99	3.50	4.13	4.88	5.61	6.45	7.41	8.53	9.81	11.28	147.24

PV	**$81.65**

Source: Yahoo Finance. http://finance.yahoo.com
Damodaran, 2001. http://www.stern.nyu.edu/~adamodar/