

Equity Research

**FINANCIAL**  
Insurance

November 12, 2007  
**Research Note**

Ticker:           AIG  
Market:           NYSE  
Price:             \$57.06  
52-week:         (\$54-\$73)

Stock Rating:  
**Outperform**

Company Profile:  
**Established Growth**

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# American International Group, Inc.

## Third Quarter: Weak Operating Results, No Major Write-Down; We Believe More Effective Capital Management Is Key

### FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$0.80/1.4%
Long-term EPS Growth Rate:	13%	Market Value (mil.):	\$145,504

### ESTIMATES\*

FYE	Q1	Q2	Q3	Q4	Annual	P/E
2006A	\$1.29	\$1.58	\$1.53	\$1.47	\$5.88	9.7x
2007E	\$1.68 A	\$1.77 A	\$1.35 A	\$1.43	\$6.23	9.2x
2008E	NA	NA	NA	NA	\$6.60	8.6x
Cal2008					\$6.60	8.6x
Cal2009					NA	NA

\* Estimates reflect the adoption of FAS 123R.

### --Highlights

- Operating EPS declined 12% to \$1.35, compared to our \$1.60 estimate and consensus of \$1.62. The shortfall relative to our estimate was relatively broad—domestic personal auto, domestic mortgage insurance, foreign property-casualty, domestic life, foreign life (primarily Japan), and the capital markets business. Lower partnership income or higher credit costs were predominant themes across most of these business segments, although the foreign life business continues to be disappointing and management has not laid out a concrete plan for revival, in our opinion.
- Investment write-downs and mark-to-market losses on the credit derivatives portfolio were much lower than we expected. Realized after-tax investment losses were only \$600 million and unrealized losses on investments were \$3.5 billion, including about \$1.6 billion within the RMBS portfolio, the vast majority of which should reverse while moving closer to maturity, in our opinion. AIGFP had a pretax market valuation adjustment of only \$342 million on for credit default swaps written on multisector CDOs, which should also reverse itself over time absent any real credit losses. The market valuation adjustment in October was an additional \$550 million, still not an alarming figure, in our opinion.

- AIG's subprime RMBS operating exposure is concentrated within the mortgage insurance, consumer finance, and capital markets divisions, as well as within the company's investment portfolio in most of its major business segments. These three businesses contributed less than 10% of earnings in 2006, although the specific segments within each of these divisions with direct exposure to subprime MBS markets is substantially lower than 10%. The mortgage insurance and consumer finance businesses are going to continue to suffer, but the primary risk exposure is within the capital markets division, in our opinion.
- Property-casualty operating earnings declined 2% to \$2.5 billion, and life insurance earnings declined 2% to \$2.5 billion. Net written premiums within property-casualty increased a respectable 4% in original currency and in line with of our estimate. Foreign life earnings continue to be disappointing, in our opinion, although new business production remains solid. Asset management earnings increased 31% and financial services earnings declined 46%, given weak results within consumer finance and capital markets.
- AIG has completed more than 90% of this year's \$5 billion share repurchase target. Management stated that it plans to more quickly execute the remaining \$3 billion of its current authorization. Management stated it believes the company has generated about \$1 billion of excess economic capital in the first nine months of 2007, including hybrid share issuance and after share repurchase and dividends. Management continues to work methodically on analyzing the best uses and the best way to efficiently access its nearly \$20 billion of economic excess capital.
- We are lowering our fourth-quarter EPS estimate to \$1.43 from \$1.70 and our 2008 EPS estimate to \$6.60 from \$6.85. The primary reason for the reductions include expected losses from the California wildfires (fourth quarter), greater losses in mortgage insurance and capital markets, and continued poor results within life insurance. Our partnership income estimates for 2008 were already down significantly from the very high run-rate in the first half 2007.
- Our rating remains Outperform. While we see no near-term fundamental catalyst, AIG has very valuable assets and is trading at ordinary insurance company valuation levels for arguably the premiere global insurance franchises in the world. We believe more aggressive capital management is key, and jettisoning certain underperforming businesses may also be desirable, in our opinion.

## --Discussion

### **Operating Results Disappointing—Foreign Life Remains a Problem**

Operating EPS declined 12% to \$1.35, compared to our \$1.60 estimate and consensus of \$1.62, and we continue to expect AIG's earnings to be much more volatile around consensus than historically. The company's annualized operating ROE was 13.4% compared to about 17.5% in the first half. Although disclosure continues to improve meaningfully over the past few years, AIG's businesses are inherently difficult to predict on a quarterly basis and the foreign life business is particularly challenging to analyze. The shortfall relative to our estimate was relatively broad—domestic personal auto, domestic mortgage insurance, domestic and foreign life (primarily Japan), and the capital markets business. We find the pressure in foreign life the most troublesome. Foreign life is the most critical segment to AIG, in our opinion, as it represents about one-third of the company's earnings, is AIG's highest book value per share multiple business, and has the best long-term growth characteristics of any major segment.

There is a lot of focus on the impact from lower partnership gains, but we had scaled back our expectations for gains here already. As of September 30, 2007, AIG had \$27.0 billion of partnership assets and the return on average partnership assets this quarter was still respectable at 8.8% on an annualized basis, and compared to our 10% estimate, about 19% in the first half, and the company's

long-term goal of 10%-15%. An 11-percentage-point difference in annualized returns on \$27.0 billion of assets on a quarterly basis equates to about \$0.19 per share.

Operating EPS exclude realized investment losses of \$0.23 and FAS No. 133 gains of \$0.07—which are volatile and difficult to predict. The impact of AIG Financial Product's unrealized valuation loss on super senior credit default swaps was \$0.09 and was included in the \$1.35 of operating EPS. We are not certain why this unrealized valuation loss was not included in the FAS No. 133 adjustment, as it is for the monoline financial guaranty companies.

### **Property-Casualty Earnings Weighed Down by Mortgage Insurance and Personal Lines**

Property-casualty insurance operating earnings declined 2% to \$2.5 billion, given a slight increase in net investment income despite a major decline other income and a lower underwriting margin, given poor results in mortgage insurance, personal lines, and foreign property-casualty insurance. Foreign property-casualty insurance was up against a difficult margin comparison and investment income fell off sharply outside of core interest income. Net written premium increased 4% as U.S. commercial insurance continues to face pressure from increasing price competition. Price competition continued to intensify during the third quarter in commercial lines globally. We see pricing under pressure through 2008 as underwriters react to record profitability in 2006 and 2007. The GAAP combined ratio was a higher-than-expected 90.3%, given the adverse impact from mortgage insurance and personal lines, and compared to our 87.3% estimate—despite favorable loss reserve development that aided the loss ratio by 2.9 percentage points, minimal catastrophe losses, and superior underwriting profitability in commercial lines. AIG continues to book accident year loss ratios within its U.S. commercial book a few percentage points higher in 2007 relative to 2006, given continued price declines and positive expected future claims inflation—consistent with overall industry trends. AIG lost money on an underwriting basis within personal lines given continued deterioration in pricing and lost \$257 million on an underwriting basis within mortgage insurance—a 214% combined ratio—given the massive deterioration in U.S. mortgage market. Similar to other competitors, AIG expects to lose money in its mortgage insurance business in 2008, as accounting rules do not allow mortgage insurers to increase reserves today for certain losses expected in the future.

### **Real Weak Quarter in Life, Management Needs to Communicate Clearer Plan to Turn it Around**

Life insurance and retirement savings operating earnings declined 6% to \$2.5 billion, compared to our \$2.7 billion estimate, with few bright spots, in our view. The decline in partnership income, \$6 million versus \$119 million last year and \$309 million last quarter is only part of the story, in our opinion. Foreign life earnings declined 2% to \$1.6 billion, given continued poor results in Japan/Other (over 50% of foreign life earnings). Earnings in non-Japan increased 6% to \$753 million, with stable growth in core markets. Earnings in Japan/Other declined 9% to \$845 million, despite an improvement in the fixed annuity business given higher spreads, accident and health and life insurance earnings were both down. The accident and health business in Japan continues to be hurt by the high visibility regulatory claims review. We do not have a lot of confidence that the business in Japan will turn soon and management has not provided any concrete solution to drive an improvement, in our opinion. Despite enhanced disclosure, analyzing foreign life earnings trends is difficult, to say the least, and management provides no guidance, and the little guidance in certain areas that it has provided in the past has not been real accurate.

One key highlight again this quarter is that core, foreign life premium production (life, accident & health, and group) was very strong, with total premiums (first-year and single) increasing 148% to \$4.7 billion in the quarter and nearly 100% in the first nine months. The core life, accident & health, and group segments contribute more than 90% of foreign life earnings, but it is difficult for us to understand why the strong production is not translating into better earnings growth as total life insurance reserves increased by 22% over the last 12 months—although it appears that growth continues to be heavily aided by strong production in the U.K. market, given guaranteed rate products that benefited from higher interest rates (included in all other regions). That said, total foreign life premium production excluding Europe still more than doubled and first-year premiums increased 10%. Premium production continues to move toward single premium products from recurring premium products. Profit margins

are lower for single premium products versus recurring premiums, although management states the absolute dollar amount contribution is generally similar.

Operating earnings in domestic life and retirement savings declined 12% to \$892 million, driven by lower net investment income principally, in turn driven by lower partnership income—which also put pressure on spreads in certain core businesses. The domestic life business continues to face a difficult investment and competitive environment and AIG. As we have stated the past several quarters, we expect the domestic life business to continue to face headwinds—competition remains intense, although the steepening of the yield curve should eventually help. The retirement services business not only faced pressure on investment spreads, but pressure within fixed annuities is driving overall continued net outflows. The pressure on individual fixed annuity sales has been the result of the increase in short-term yields, the increasing competitiveness of alternatives such as CDs, as well as flat/inverted/volatile yield curve. Eventually shorter-term rates and the steepening of the yield curve should help the fixed annuity business. Gross and net sales within group retirement remain respectable, with production still being driven by low-cost mutual funds in lieu of group variable annuities.

### **Financial Services Well Below Expectations, Asset Management Above Expectations**

Earnings in Financial Services continue to vary by business, given that each business is driven by different factors. Overall financial services earnings declined 46% to \$307 million, after about a 15% decline in the first half. Poor results continue to be weighed down by challenges in consumer finance, given credit deterioration in the U.S., with earnings dropping 64% to \$80 million in the third quarter and 64% in the first nine months. The vast majority of the U.S. consumer finance business is subprime, although growth has been scaled back immensely over the past 12 to 18 months. ILFC (aircraft leasing) earnings increased 71% to \$269 million, given strong underlying lease rates and demand from Asia, but also gains on the sale of aircraft. The capital markets business, which includes AIG Financial Products credit enhancement business for super senior tranches of multisector CDOs, lost \$58 million after earning \$273 million last quarter. The loss was due to a market valuation adjustment of \$342 million for credit default swaps written on multisector CDOs, which should reverse itself over time absent any real credit losses. The market valuation adjustment in October was an additional \$550 million, still not an alarming figure, in our opinion. We had this "market valuation adjustment" included in our FAS No. 133 adjustment, which is excluded from operating earnings, given that the mark should reverse itself to zero over time, given that AIG typically holds these positions to maturity. We are not certain why this unrealized valuation loss was not included in the FAS No. 133 adjustment, as it is for the monoline financial guaranty companies (discussion extended in next section).

Asset management earnings increased 31% to \$358 million, but results here remain difficult to predict, given the impact from partnership income returns on investment spreads and performance fees and other gains on limited partnerships that AIG manages on behalf of third parties, but also invests in. However, certain gains are eliminated through minority interest.

### **Subprime RMBS Exposure Appears Manageable, Disclosure in Problem Areas Still Light, In Our Opinion**

AIG's subprime RMBS exposure is concentrated within the mortgage insurance, consumer finance, and capital markets divisions, as well as within the company's investment portfolio in most of its major business segments. These three businesses contributed less than 10% of earnings in 2006, although the specific segments within each of these divisions with direct exposure to subprime MBS markets is substantially lower than this. As we mentioned last quarter, mortgage insurance will absolutely be a drag through 2008 and U.S. consumer finance also faces continued challenges. The capital markets business, AIG Financial Products (AIGFP), should actually be a major beneficiary given increase market volatility and the increased demand for credit enhancement solutions, but accounting rules complicate analyzing the impact on AIGFP. The company's mortgage insurance division lost \$215 million this quarter (\$0.05 per share) after losing \$76 million last quarter (\$0.02 per share after-tax) given higher losses. The consumer finance division (which includes international businesses) earnings declined 64% to \$80 million after more than a 70% decline in the first half. Capital markets

earnings, which include AIGFP, lost \$58 million this quarter, after earnings increased 29% to \$273 million last quarter.

The issue in the capital markets division is the credit enhancement business, in which AIG provides credit protection in derivative form (credit default swaps) for CDOs—backed corporate debt and consumer debt, including mortgages—at super senior levels (a level actually above the triple-A rated tranche). The \$342 million market valuation adjustment this quarter (\$0.09 per share after-tax) was taken on AIG's \$78 billion super senior CDS book for multisector CDOs (supported primarily by RMBS, including subprime)—including \$63 billion that include any subprime exposure (104 deals), and \$19 billion of the \$63 billion represents mezzanine CDOs (59 deals) (supported by triple-B collateral). AIG guarantees another \$335 billion of super senior CDO risk backed by corporate debt and non-U.S. residential debt. Mezzanine CDOs have caused particular concern because the collateral within the CDO is typically rated triple-B and lower—the rating category of subprime RMBS deals from 2006 and 2007 that has suffered the vast majority of losses. However, AIG provided some details regarding this exposure that are comforting, principally surrounding collateral vintage exposures, in our opinion. The year in which a multisector CDO was created is not as critical as the vintage of the underlying collateral, meaning not every multisector CDO is alike, even the dreaded mezzanine CDOs that have become a "four-letter word." For instance, a 2007 multisector CDO could be populated with over 50% of 2005 vintage collateral, or vice versa, a 2003 multisector CDO that is actively managed (no static) could have 50% of 2005 vintage collateral. While AIG has not provided any detail on a transaction-by-transaction basis, the company stated that it stopped writing "super senior" protection that included subprime RMBS collateral starting in December 2005, and that its total exposure (after deducting all subordination) to the subprime RMBS 2006 and 2007 vintage collateral is only 9.6% of \$63 billion, or only \$323 million after deducting all subordination. This level of disclosure tells us that AIG was relatively disciplined regarding subprime RMBS exposure the past few years, but it does not mean that the company could not face modest losses in a stressed scenario or its capital requirements related to this business could not go up dramatically. Furthermore, there are other mortgage exposures in these transactions in addition to subprime that include prime and Alt-A exposures, including limited second lien exposure. However, unlike the investment banks, because AIG is a provider of credit risk to maturity and is not in the business of trading these exposures, the company has no liquidity risk and is not forced to mark these positions to market through earnings in the same fashion as the investment bank, which explains why AIG and the monoline financial guarantors (Ambac [ABK \$26.16], MBIA [MBI \$34.49], etc.) are not taking the same level of write-downs as the investment banks. However, AIGFP also has investments of \$3.5 billion in multisector CDOs, including \$2.4 billion in mezzanine CDOs, which we believe have more risk because AIG actually owns the underlying assets and appears to have less protection (\$1.6 billion after deducting subordination). But any unrealized gains in these assets are still not running through income, as we understand it.

As for the investment portfolio overall, realized after-tax investment losses were only \$600 million and unrealized gains on investments were \$3.5 billion, including about \$1.6 billion within the RMBS portfolio. These markdowns do not flow directly through income because AIG intends to hold these securities to maturity. Given the very high credit quality of the company's RMBS exposure (75% of unrealized loss related to triple-A exposure), we would expect the vast majority of unrealized losses to reverse while reaching maturity. Importantly, management states that it has no direct private equity investments in portfolio companies exposed to the residential market, it has no knowledge of indirect exposures through private equity funds, and it has no investments in hedge fund managers focused on residential mortgages. The company's holdings within its "insurance" investment portfolio in the residential mortgage market were \$93.1 billion as of September 30, 2007, or about 11% of total invested assets and down about \$1.5 billion during the quarter. Direct subprime RMBS investments totaled \$25.9 billion with a weighted average expected life of 3.9 years, 89% are triple-A, 8% are AA-rated, and only \$400 million triple-B and below. The subprime mortgage market would have to get dramatically worse than some of the most pessimistic scenarios for double-A-rated RMBS deals to incur even modest losses. The holdings of subprime-related CDO paper in AIG insurance portfolios are only \$234 million, although AIGFP does have exposure in this sector as we have detailed.

### **Working Methodically to Manage Capital More Aggressively**

AIG repurchased 30.6 million shares in the third quarter and 69.0 million shares through November 5, completing over 90% of this year's \$5 billion target. Management stated that it plans to more quickly execute the remaining \$3 billion of capacity of its current \$8 billion authorization—more aggressive than the message sent last quarter. Management stated it believes the company has generated about \$1 billion of excess economic capital in the first nine months of 2007, including hybrid share issuance and after share repurchase and dividends. Management continues to work methodically on analyzing the best uses and the best way to efficiently access its nearly \$20 billion of economic excess capital. While the capital management plan when announced in early March 2007 was a big step for AIG, given the aggressive capital management plans taken by other large-cap financial services peers, the plan appears somewhat timid, in our opinion.

### **Lowering Estimates**

We are lowering our fourth-quarter EPS estimate to \$1.43 from \$1.70 and our 2008 EPS estimate to \$6.60 from \$6.85. The primary reason for the reductions include expected losses from the California wildfires (management estimates \$0.05 per share losses), greater losses in mortgage insurance and capital markets and continued poor results within life insurance. Our partnership income estimates for 2008 were already down significantly from the very high run-rate in the first half 2007—less than 50% of the first half 2007 run-rate. We include 1.2 percentage points of catastrophe losses in our combined ratio estimate for 2008 (\$600 million, pretax, or \$0.16 per share after-tax) with modest favorable loss reserve development. A 100-basis-point change in the combined ratio changes our 2008 EPS estimate by about \$0.12.

### **Reiterate Outperform Rating, Stock Has Never Been Cheaper - Valuable Assets to Work With**

While we see no near-term fundamental catalyst, AIG has very valuable assets and is trading at ordinary insurance company valuation levels (less than 1.5 times book) for arguably the premiere global insurance franchises in the world and the best play on the growth in Asia within insurance (about one-third of earnings), in our opinion. We believe more aggressive capital management is key and jettisoning certain underperforming businesses may be desirable, in our opinion. Former CEO Hank Greenberg has recently filed a 13-D, stating that he anticipates holding discussions with third parties and shareholders that could result in the disposition of certain AIG businesses, as well as input on the concern over the direction and management of AIG generally. Mr. Greenberg is a major shareholder and controls a greater amount of stock in the aggregate, and we support any constructive dialogue that maximizes shareholder value. We support the idea of jettisoning some lower multiple, capital intensive businesses in order free up even more capital—ILFC, Transatlantic, and mortgage are easy targets. It is difficult to understand how any capital is shared between certain related or disparate businesses, for instance consumer finance, or geographically, so whether there could be broader changes that would impact the life or property-casualty insurance franchises becomes more challenging to analyze.

Additional information is available upon request.



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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	12
Market Perform (Hold)	40	Market Perform (Hold)	5
Underperform (Sell)	1	Underperform (Sell)	1

\*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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