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AIG's 'Hostile' Takeover Attempt for American General

Is AIG's Stock Too High?

On Tuesday, after the market had closed, AIG announced an unsolicited $46-per share offer to acquire American General in a $23-billion stock transaction—a 25% premium over the closing price.

One wouldn't go so far as to call Hank Greenberg a corporate raider, but the fact remains: American General had previously agreed to be acquired by Britain's Prudential Plc. The value of that transaction—$26 billion when announced—had fallen due to the decline in Prudential's shares. Hank Greenberg, seizing the moment, made a big move at a time when his actions were likely to be met with acceptance from Wall Street, and scant resistance from American General. (Since the company was already in play, management could not easily rebuff a significantly higher offer.)

That AIG would attempt to use its richly valued stock to make acquisitions isn't surprising. On February 16 we wrote that we expected insurance companies to issue equity to take advantage of the favorable market for insurance stocks. We didn't expect AIG, "which sells for 548% of book value, to issue stock in a secondary offering. AIG is so large ($200-billion market cap) that it couldn't do an offering large enough to be meaningful. Hank Greenberg has said, however, that AIG is looking at acquisitions, and given his company's stupendous price-earnings (p/e) multiple, we'd be surprised if his currency of choice was not AIG stock."

Last September, in an article discussing the optimistic valuation accorded AIG's shares, we noted that because AIG's stock had an extremely high p/e ratio (37.4), it made a fine acquisition currency. We also noted that AIG hadn't been able to put that currency to good use. (Given AIG's multiple, almost any acquisition would be accretive to earnings the first year—although not necessarily in later years.)

In order for AIG to maintain its sky-high p/e ratio, at the very least it must continue to achieve the rapid and steady growth in earnings per share for which it is known and loved. Given AIG's size and its cyclical businesses—including property-casualty insurance, life insurance, investment, finance, financial services, and aircraft leasing—we've been skeptical (for several years) of AIG's ability to accomplish that. Consequently, we've felt that the risk in owning AIG's stock was greater than the reward.

Price-earnings ratios and cyclicity aside, acquisitions are one way for AIG to goose its earnings, at least for a while. But, as we observed, "AIG is so large that it's difficult for it to make acquisitions that, by themselves, materially alter its growth rate. At the margin, however, if it can use its stock to buy lower-multiple companies, then it can eke out incremental growth via an arbitrage of earnings multiples."

AIG's proposed takeover of American General would be an example of such an arbitrage.

Hostile?

Although AIG's offer for American General was unsolicited, there's some question as to whether it's "hostile," and whether AIG engages in hostile takeovers. *The New York Times* reported that Greenberg said his offer was "not hostile." *The Wall Street Journal* stated that "AIG has never pursued a hostile takeover."

One could get into a long discussion of what "hostile" means, which we aren't inclined to do. However, a deal is generally considered hostile if the CEO of the target doesn't want to be taken over—regardless of whether the deal is good for shareholders. We don't care if a deal is hostile or not, and neither do sharehold-

AIG's Price-Earnings Ratio

The rise and fall and rise of AIG's p/e ratio.

Year	Average annual p/e ratio
1972	32.6
1973	28.2
1974	17.5
1975	16
1976	12.4
1977	9.2
1978	8.9
1979	8.8
1980	8.7
1981	9.6
1982	9.7
1983	11.6
1984	15.5
1985	17.1
1986	15.6
1987	13.7
1988	9.2
1989	11.2
1990	10.9
1991	12.1
1992	12.6
1993	14.4
1994	13.2
1995	14.5
1996	16
1997	19.8
1998	26.7
1999	28.8
8/18/00	38.4
4/5/01	31.9

ers. They generally care about which deal gives them the best value.

Whether AIG engages in “hostile” deals, however, is a subject worth a few paragraphs. For example, AIG has been gradually increasing its ownership in 21st Century Insurance, and now has 63% of the company. Shareholders might rightly view AIG’s accumulation as a “creeping takeover”—one in which it gains control without paying the control premium that a tender offer for the entire company would necessitate.

AIG has also struck fear in the hearts of insurance companies in the past. In 1974, American Reinsurance filed suit to prevent AIG from buying more than 9.9% of American Re’s stock. In 1979, Mission Insurance Group rejected an unsolicited merger offer from AIG (which then owned 4.5% of Mission), stating that the deal was “not in the best interest of Mission and its stockholders.” (Mission was wrong.)

In 1981, AIG disclosed that it had acquired 8.53% of USLife, prompting that company’s chairman, Gordon Crosby, to state that USLife’s board was opposed to any attempt to take over the company, and that it was in USLife’s best interest to remain independent. In 1982, AIG sold its USLife shares back to USLife. (In 1997, USLife was acquired by American General in an all-stock transaction.)

In 1983, AIG bought 8% of Progressive and was planning to purchase a 12.3% stake held by American Financial. This threat prompted a group of Progressive shareholders who held a 39% interest in the company to form a bloc opposing AIG’s accumulation of Progressive shares. As a result, AIG cancelled its agreement to buy American Financial’s 12.3% stake, and American Financial subsequently sold these shares back to Progressive.

The American Re, Mission, USLife, and Progressive situations differed from that of American General in at least one respect: none of those companies was already “in play,” and AIG would have had considerable difficulty accomplishing a takeover that was unwanted by those companies. (In order to acquire an insurance company—especially one with licenses in many states—the approval of each state’s regulator is generally required. A hostile insurance takeover is time consuming, and the regulatory roadblocks can make a deal impossible. Allegheny, for example, was unable to take over St. Paul.)

E-Madness: Internet vs. Insurance—An Update

Market caps of various companies, in billions of dollars.

Internet	12/10/99	01/14/00	10/13/00	04/04/01
America Online	$205	$141	$123	$155*
Yahoo	93	93	33	7
Amazon	36	22	10	3
CMGI	23	30	5	0.65
eBay	21	17	15	8.2
E*Trade	9	7	4	1.8
InsWeb	1	0.7	0.06	0.04
Quotesmith	0.2	0.2	0.03	0.006

Insurance	12/10/99	01/14/00	10/13/00	04/04/01
AIG	$172	$177	$214	$179
Marsh & McLennan	24	28	32	25
Allstate	22	19	24	30
Cigna	15	15	18	16
Hartford	10	10	16	14
Chubb	9	10	13	12
Progressive	6	5	5	7
W. R. Berkley	0.6	0.5	0.8	1.3

*Valuation is after stock merger with Time Warner

A final thought: Greenberg had breakfast with American General’s CEO, Robert Devlin, six months ago and, according to Greenberg, there was supposed to be some follow-up, but it never occurred. One presumes that if Devlin had wanted AIG to acquire American General, then he’d have picked up the phone and asked Greenberg to make a bid.

Anyway, Hank Greenberg is a genius, and if he says that his unsolicited offer to buy American General isn’t “hostile,” then who are we to disagree?

Thoughts on Speculation

Before discussing this deal further, we want to step back and examine the current stock-market environment, speculation, and p/e multiples, because these affect AIG’s ability to complete a deal, and because they’re driving forces in the industry.

We conducted a Dow Jones News Retrieval search to see how many times the words “stock,” “market,” and “bubble” appeared in articles during March. The number—1,710—was sizable, apparently demonstrating that reporters are good at identifying a stock-market bubble after it has burst. (In March 1999, for instance, these words appeared one-third as often as they did this past March.)

Although we labeled “Internet-stock mania” a “speculative bubble” in our March 1999 issue, we didn’t profess to know *when* it would end, even though we had thoughts about *how* it would end. As we wrote, “Whether one chooses to call the current U.S. economic environment a boom, bubble, bull market, or new era, it will, in all likelihood, be followed by what will be known as a bust, bear market, recession, or depression.”

While our call was accurate, it wasn’t necessarily something one could profit from. Indeed, the price of Internet and tech stocks continued to rise sharply for the next 12 months.

In December 1999 we noted that Yahoo’s market cap—then $93 billion—was equal to those of Marsh & McLennan, Allstate, Cigna, Hartford, Chubb, St. Paul, and Progressive *combined*.

Things have changed. Yahoo is now valued at $7 billion, while the insurance companies are worth $25 billion, $30 billion, $16 billion, $14 billion, $12 billion, $9 billion, and $7 billion, respectively, or a total of $113 billion.

How could Yahoo, which had $1.1 billion in revenues in 2000, *ever* carry a $93 billion valuation? (Indeed, one must make very optimistic assumptions to justify the company’s *current* valuation.) The answer is that Yahoo’s valuation was wildly speculative, and represented investors’ frenzied and unwarranted optimism about the company’s long-term prospects. Yahoo was priced for permanent perfection, and when that didn’t materialize, its absurd p/e ratio gave the company a long way to fall before it would be priced rationally. As James Grant, editor of the marvelous *Grant’s Interest Rate Observer* recently wrote, “Booms don’t last forever: they are cut short by their own excesses… However, busts, too, generate excesses that tend to hasten cyclical reversals, or at least to exaggerate their magnitude once they start.”

continued

We bring up Yahoo not just because we've written about it in the past, but because it's a good example of an extreme. Financial history is filled with companies that sported wildly high valuations during periods of mass euphoria, and depressed valuations (or no valuation) during the ensuing busts.

The boom-and-bust cycle isn't limited to technology stocks—over the years it has embraced virtually every industry, from automobiles, oil & gas, telephones, utilities, and conglomerates, to electronics, specialty retail, entertainment, restaurants, finance, and, yes, insurance.

All of which brings us back to AIG. We first expressed concern about the company's p/e and price-to-book ratio back in October 1998 when its stock price was $49—$27 lower than it is now. We revisited the subject in our September 2000 issue, when AIG's stock was $86. Although AIG's excellent record of earnings growth is one of the factors in its stock's superior returns, it isn't the only factor. AIG's p/e ratio has been in a long-term bull market of its own; more than quadrupling since its bottom in 1979.

A recent Merrill Lynch study showed that since 1980, AIG's average p/e ratio based on *forward consensus estimates* has been 13.8. The lowest p/e ratio—6.8—was recorded in June 1982, and the highest—35.1—occurred in December 2000. Perhaps coincidentally, AIG's average p/e, according to the Merrill study, is not very different from the S&P 500's average p/e over the last 129 years—14.5.

If one can infer anything about valuations from the past it is this: they fluctuate considerably. In 1929, for example, the Dow Jones Industrial Average (DJIA) was priced at 4.5 times book value. Three years later, when the DJIA hit its all-time low, it was valued at one-half of book. (The p/e ratio wasn't meaningful in 1932, as the companies in the DJIA lost money.)

Although the S&P 500's p/e ratio has averaged 14.5 over the long term, stocks have often traded way above, or way below, that figure. Valuations, however, have historically reverted to the mean, and then some. Every period in which stocks have traded in excess of a 14.5 multiple has been followed by a period in which valuations fell well below that figure. History, of course is just a guide, not a blueprint for the future. The past does not have to repeat itself.

Thus, the history of AIG's valuation doesn't foretell how AIG's stock will be valued in the future. Nonetheless, the past is still worth considering. In 1972, AIG's p/e ratio was 32.6—about what it is today. Despite the fact that AIG's earnings continued to rise steadily, AIG's shares lost two-thirds of their value over the next two years, and AIG's stock price didn't get back to its 1972 high until 1978—even though earnings had quadrupled and book value had tripled during that period.

AIG is a great company, but there's considerable risk in owning a financial-services company selling for 32 times earnings. AIG's high valuation leaves little room for error or disappointment.

In order for AIG's shares to appreciate, two things must happen: earnings per share must grow, and the p/e ratio must remain the same or go higher. Steadily rising earnings per share are essential because investors, in anticipation of such, have bid up AIG's stock to an extreme p/e ratio, which, of course, facilitates AIG's use of its stock to acquire lower-multiple companies, thus providing a boost to earnings per share. As AIG gets larger—and it is already huge—greater than average growth becomes more difficult.

While it's wise for AIG to use its high-multiple stock to make acquisitions, one concerned with security analysis must ask a basic question: if AIG, which trades at 32 times earnings, buys American General for 18 times earnings, should AIG's 32 multiple be applied to American General's supposedly lower-growth business once that business becomes part of AIG? According to Greenberg, the answer is yes. At yesterday's conference call he spoke of cross-marketing and cost savings, and said, "I'm comfortable that two and two here will make five, if not seven."

In the 1960s, under the guise of "synergy"—a *2+2=5* equation—conglomerates, which had staggeringly high p/e ratios, acquired diverse, lower-multiple businesses including bakeries, foundries, machine shops, and insurance companies. For a while, the market was willing to apply the conglomerates' high p/e multiples to the earnings acquired from the acquisition of slower-growth businesses. Eventually, however, the merry-go-round came to a halt.

In theory, AIG—or any business with a high p/e ratio—can be a perpetual growth machine by endlessly performing the arbitrage of using its high p/e stock to acquire earnings that are selling at a lower p/e. In practice, this is difficult to do, and, of course, is dependant upon, among other things, always having a high p/e multiple.

Investors in AIG would do well to remember that AIG, which traded at 32.6 times earnings in 1972, traded at 8.7 times earnings in 1980, 9.2 times earnings in 1988, and 13.2 times earnings in 1994.

Although Yahoo traded at 100 times revenues last year, we doubt that AIG's p/e ratio has much room for expansion. Absent any change in the p/e, investors' returns will mirror AIG's growth, which many analysts peg at about 15% annually.

If that growth fails to materialize for some reason—or if earnings actually decline, as they did in 1984—it's a safe bet that AIG will trade at a much lower multiple. ■

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