

This article by Jake Rosser is excerpted from a letter of [Coho Capital Management](#).

Despite the rise in the markets, we continue to find value amongst the discarded, disdained and misunderstood. We detail one of our most recent purchases below:

We established a significant position in AIG warrants during the fourth quarter. This is the second time we have acquired shares of AIG, having sold our previously held shares in late 2012. We wrote about our decision to dispose of those shares in our 2013 letter:

“We fully exited our position in AIG during the fourth quarter, registering a gain of 28%. As detailed in last year’s annual letter, our thesis on AIG was premised upon the company achieving a double digit return on equity (ROE) through a rationalization of its complex web of assets and more disciplined underwriting. A key component of that thesis was dislodged in November when AIG suspended its guidance for a 10% plus ROE by 2015. AIG’s 10%+ ROE target has been outlined in SEC documents and been a key guidepost in communications with investors since the company’s re-IPO process in 2011. We can only conclude that AIG is no longer confident of achieving its goals.”

Our logic for selling was sound. AIG has continued to log uninspiring returns on equity and report dismal underwriting results. As is often the case at insurance companies with poor underwriting, AIG has been haunted by sins of the past. A cavalier attitude toward risk under former CEO Maurice Greenberg led to serial under-reserving. Investors had hoped the tide would turn when CEO Peter Hancock took over the helm in 2014, but reserve charges have continued. Most troubling was the fact that AIG was releasing reserves on more recent vintages, indicating the company’s risk management practices were no longer just a stain on Mr. Greenburg’s legacy but deficient under Hancock as well.

AIG’s elevated claims costs have been a significant detriment to growth in shareholder value in recent years, but future visibility has improved considerably due to a transaction with Berkshire to take on AIG’s insurance liabilities. Under the terms of the deal, struck last year, AIG paid Berkshire \$10.2 billion to absorb 80% of future losses on policies written for accident years through 2015. This is a watershed event for AIG as it allows the company to focus on the future and limits investors from downside scenarios.

Insurance for Your Insurance Investment

Former CEO, Peter Hancock, stepped down in May of last year and was succeeded by industry veteran Brian Duperreault. Mr. Duperreault is a rock-star CEO, known for his turn-around skills and cultivation of an Esprit de Corps culture in the firms he has led. After spending two decades at AIG, Duperreault was tapped to lead ACE Limited (now Chubb), originally a niche insurer with one product. Under Duperreault’s leadership ACE transformed into a best of breed property and casualty operator with industry-leading combined ratios (9 points better than industry peers).

In 2008 Duperreault took over the insurance broker, Marsh & McLennan, after the

company's sales collapsed in the wake of a bid rigging scandal uncovered by former New York Attorney General Eliot Spitzer. Duperreault was able to stabilize the company during regulatory investigations, and despite taking over during the nadir of the credit apocalypse, was able to improve margins by 6% and boost profitability.

Shareholders at both ACE and Marsh & McLennan were handsomely rewarded during Duperreault's tenure. During his decade at ACE, shareholders realized a more than fivefold return, outperforming the S&P 500 by 270%. Similarly, while presiding over Marsh & McLennan, Duperreault was able to move the company from defense to offense, while outperforming the S&P by 22%.

While Hancock failed to reverse AIG's record of poor underwriting, he did manage to shrink the firm to a more profitable base, taking out \$1.5 billion in annual expenses. In addition, he made highly accretive stock repurchases (since the stock was trading well below book value). From 2016 until the third quarter of 2017, AIG purchased \$18.1 billion worth of its stock, equivalent to 31% of its current market cap. The pared down cost structure and reduced share count should magnify any operational improvements made by Duperreault in ensuing years.

The Path Forward

Hancock's cost cutting moves have reduced corporate bloat but perhaps went too far, sparking a wave of attrition in recent years and a lingering morale problem. We suspect the talent drain, along with a rudderless culture, were primary inputs into undisciplined underwriting. We expect a cultural reset under Duperreault will bolster morale and enhance recruitment of industry talent. On that note, we are happy to report AIG is now poaching talent from Berkshire rather than the other way around, having recently hired 25-year Berkshire veteran Tom Bolt as its Chief Underwriting Officer. With Mr. Bolt in charge of underwriting, we expect a stewardship approach to pricing insurance risk and a firm pivot to placing profits ahead of growth.

Duperreault's tenure at Marsh & McLennan, provides a useful template on how he might approach rebuilding AIG's competitiveness. Just as he did at Marsh & McLennan, we expect Duperreault to first capitalize on AIG's areas of strength. While AIG does not possess a moat, it does maintain some advantages over competitors. For example, the company's global reach and multi-product line portfolio make it one of the few firms capable of servicing large corporate clients. Duperreault has been vocal about his desire to fully leverage AIG's multi-line capabilities to spur organic growth. Duperreault is well-versed on AIG's strengths having spent 22 years at the firm and at one time having been considered the heir apparent to Hank Greenberg.

Unlike Hancock, who tried to shrink AIG to prosperity, Duperreault is focused on growth. Mr. Duperreault compiled a savvy track record for capital allocation at ACE and Marsh & McLennan and has indicated that acquisitions would be a core component of his strategy at AIG as well. As of the drafting of this letter, AIG announced its first major acquisition under Duperreault, acquiring Validus Re, a Bermuda based reinsurer, for \$5.6 billion. The acquisition will complement AIG's product suite by adding reinsurance, as well as

distribution on the Lloyd's of London platform. In addition, the deal is expected to be immediately accretive to EPS and ROE. Most important, Validus is known for its sophisticated risk modeling capabilities as evidenced by its average combined ratio of 87% during the last decade. Such skills will no doubt prove useful in helping AIG better price risk in its underwriting efforts.

A more diverse franchise should lead to higher ROE than AIG's current heavy reliance on property and casualty insurance. We suspect asset-management, life insurance and international operations will be key areas of focus for AIG's acquisition pipeline. The company still has plenty of dry power with \$7 billion of cash on hand, \$6 billion in annual earnings, and approximately \$9 billion in debt capacity.

Valuation

AIG warrants have a current strike price of \$44.00 and mature in January 2021, giving us three years in which to realize value. Unlike a long-dated call option, AIG's warrants benefit from anti-dilutive properties, by adjusting the strike price downward for dividends and providing a slight bump in the number of shares receivable. The math is variable but current projections suggest a strike price just under \$43.00 at warrant maturity.

With AIG currently trading at \$64.68, the warrants, at \$22.76, are well in the money and only trade at a 10% premium to the shares despite a three-year horizon for which to realize value. However, if you take into consideration a lower warrant strike price in the future, due to the anti-dilutive provisions, then the premium paid for the warrants drops to 5%.

AIG's current book value per share, excluding Accumulated Other Comprehensive Income (AOCI), is \$74.00. The company should be able to grow its book value in-line with its earnings growth. Prior to suspending financial guidance last year, AIG had guided to a year-end ROE of 9.5%. However, to be conservative, let's assume AIG only earns a ROE of 7% this year, 8% in 2019, and 9% in 2020.

After adjusting for dividend payouts, this results in a price per share of \$89.03. If we assume the market gives AIG no credit for improving ROE and shares still trade at the same discount to tangible book value of .87, then shares should fetch \$77.45 by the end of 2020. At warrant expiration, the strike price should be approximately \$43.00, yielding a return on the warrants of 51%. Of course, anything can happen, but current pricing affords a comfortable measure of downside support.

In a more optimistic scenario, the return profile is asymmetric. If AIG achieves an 8% ROE in 2018, a 10% ROE in 2019 and 2020, then book value per share grows to \$92.47 after adjusting for dividends. If we assume the market is willing to value AIG at the current average P/B value of 1.4X for property and casualty insurers, then AIG's price per share should reach \$129.46. Such a scenario provides a nearly fourfold return on AIG warrants.

Summary

We don't believe AIG's issues are structural in nature. The company has retreated from

insurance lines where it was not competitive, rightsized its cost structure, and bought back a boatload of shares. The reinsurance deal with Berkshire removes the reserve overhang and future underwriting should be aided by the stewardship of Mr. Duperreault. We expect the combination of a world-class CEO, attractive valuation, accretive capital deployment, and multi-year ROE recovery to translate into substantial gains for holders of AIG warrants. Mr. Duperreault is one of the most accomplished and widely respected CEOs in insurance. We think AIG will be his swan song.