

Arch Capital

2024 closes with an EPS beat and large jump in book value per share

Reiterate Rating: BUY | PO: 100.00 USD | Price: 84.87 USD

4Q23 operating EPS of \$2.49

Arch's 4Q23 result came in ahead of our forecast of \$2.09 and Street consensus of \$2.00. The \$2.49 did not include an incremental \$3.10/sh of incremental deferred tax benefit associated with Bermuda adoption of a global minimum tax in 2025, which helped to drive book value per share up 22% in the quarter and 44% for the year to \$46.94. Compared with our forecast, Arch delivered much better result in "Other," which largely relates to its stakes in Coface and Somers Re (an incremental \$0.22/sh vs. our forecast). An underlying loss ratio of 78.8% was 200bps better than our forecast (\$0.16/sh); however, catastrophe loss activity of \$138mn was \$70mn above our forecast (-\$0.17/sh). Better loss reserve development in Mortgage, higher investment income and a lower-than-expected tax rate rounded out the beat.

Healthy P&C underwriting results continue

Insurance segment net premium written growth of 19% ran ahead of our forecast of 10%. Business mix with strong growth in Property and Construction lines offset by decline in Professional Lines matched trends in prior quarters. In the Reinsurance segment, which tends to contract little business in 4Q, it did appear that Arch pulled back from Casualty lines (down 19%) following significant growth in 4Q22 (up 49%). Our above-consensus EPS forecasts nonetheless assume that underwriting margins have peaked and will deteriorate modestly over the next three years.

Investment income rises ahead of expectations

Investment income of \$313mn included \$278mn from Arch's fixed income portfolios, implying a 4.7% yield. This jump from 4.4% in 3Q23 accelerates the path to an assumed 5% steady-state yield on the bond portfolio beginning in 2025. This lifts our already high-on-the-Street 2024 EPS forecast of \$8.45 to \$8.90 and takes 2025E to \$9.25. We are doubling our expectation of special common stock dividends to \$4/sh from \$2/sh payable at year-end 2025 and 2026 (which causes our 2026 forecast to fall a nickel).

Increasing price objective to \$100; remains Buy

The combination of increasing our 2025 EPS forecast to \$9.25 and the valuation multiple expansion of the peer group 2025 P/E multiple on which we base our ACGL valuation to 10.8x from 10.6x previously drives our PO to \$100 from \$94. With potential upside to our PO, an expectation for EPS beats over consensus, and strong cash flow generation being deployed back into the business, we continue to recommend ACGL shares as Buy.

Estimates (Dec) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	4.87	8.45	8.90	9.25	9.65
GAAP EPS	3.81	11.62	8.90	9.25	9.65
EPS Change (YoY)	36.0%	73.5%	5.3%	3.9%	4.3%
Consensus EPS (Bloomberg)			7.72	8.26	8.80
DPS	0	0	0	4.00	4.00
Valuation (Dec)					
P/E	17.4x	10.0x	9.5x	9.2x	8.8x
GAAP P/E	22.3x	7.3x	9.5x	9.2x	8.8x
Dividend Yield	0%	0%	0%	4.7%	4.7%

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14 February 2024

Equity

Key Changes

(US\$)	Previous	Current
Price Obj.	94.00	100.00
2024E EPS	8.45	8.90
2025E EPS	8.90	9.25
2026E EPS	9.70	9.65

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Stock Data

Price	84.87 USD
Price Objective	100.00 USD
Date Established	14-Feb-2024
Investment Opinion	B-1-9
52-Week Range	62.10 USD - 90.65 USD
Mkt Val (mn) / Shares Out (mn)	31,671 USD / 373.2
Free Float	97.0%
Average Daily Value (mn)	135.84 USD
BofA Ticker / Exchange	ACGL / NAS
Bloomberg / Reuters	ACGL US / ACGLOQ
ROE (2024E)	0%
Net Dbt to Eqty (Dec-2023A)	NA
ESGMeter™	High

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

iQprofileSM Arch Capital

Income Statement Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premiums	9,691	12,471	14,726	15,975	16,989
Net Investment Income	497	1,023	1,472	1,800	1,896
Total Revenue	10,236	13,696	16,291	17,875	18,985
Total Cost of Benefits and Claims	NA	NA	NA	NA	NA
S,G & A (Including Commissions)	NA	NA	NA	NA	NA
Total Operating Expenses	(8,226)	(10,182)	(12,562)	(13,790)	(14,727)
Pre-Tax Operating Earnings	2,009	3,514	3,729	4,085	4,257
Income Tax Expense	(124)	(275)	(298)	(501)	(532)
Operating Earnings After Tax	1,839	3,200	3,390	3,543	3,684
Net Income (Reported)	1,880	3,240	3,430	3,584	3,725
Diluted Shares	378	379	381	383	382
Operating Earnings Per Share	4.87	8.45	8.90	9.25	9.65
Net Income (Reported) Per Share	3.81	11.62	8.90	9.25	9.65

Balance Sheet Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Fixed Income Securities	19,683	23,553	30,744	33,271	34,221
Total Cash and Investments	28,148	34,773	41,615	44,177	45,162
Total Assets	47,991	58,906	66,726	70,250	72,258
Reserves	NA	NA	NA	NA	NA
LT Debt	2,725	2,726	2,726	2,726	2,726
Total Liabilities	35,070	40,551	44,143	45,728	46,518
Total Equity	12,910	18,353	22,583	24,522	25,740
Total Equity (Ex FAS 115)	12,910	18,353	22,583	24,522	25,740
Book Value per Share (Reported)	32.62	46.94	57.66	62.14	66.33
Book Value per Share (Ex FAS 115)	37.06	48.75	57.33	62.14	66.33

Ratios (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Expense Ratio	NM	NM	NM	NM	NM
Loss Ratio	NM	NM	NM	NM	NM
Combined Ratio	NA	NA	NA	NA	NA
Avg Assets / Avg Eq (Ex FAS 115) Ratio	3.5x	3.4x	3.1x	2.9x	2.8x

Growth Rates (YoY) (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premium	24.7%	28.7%	18.1%	8.5%	6.3%
Net Investment Income	43.2%	106.0%	43.9%	22.3%	5.3%
Total Revenue	21.9%	33.8%	18.9%	9.7%	6.2%
Operating Earnings per Share	36.0%	73.5%	5.3%	3.9%	4.3%
Asset	6.4%	22.7%	13.3%	5.3%	2.9%
Reported Book Value per Share	-2.8%	43.9%	22.8%	7.8%	6.7%

Performance Metrics (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Operating ROE	NA	NA	NA	NA	NA
Operating ROE (Ex FAS 115)	NA	NA	NA	NA	NA
Operating Return on Average Assets	4.0%	6.0%	5.4%	5.2%	5.2%
Operating Margin	18.0%	23.4%	20.8%	19.8%	19.4%
Long Term Debt to Cap Ratio (Ex FAS 115)	17.4%	12.9%	10.8%	10.0%	9.6%
Net Income % Operating Income	100.0%	100.0%	100.0%	100.0%	100.0%
Amtz of DAC % Pretax Profit bef Amtz of DAC	0%	0%	0%	0%	0%

Company Sector

Insurance - Non-Life

Company Description

Originating in the wake of 2001's 9/11 terrorist attack, Arch was founded with an aim to address the liability crisis originating out of severe underwriting losses in the 1997-2001 period. The company has pivoted its strategy a number of times - property-catastrophe, mortgage insurance, etc. - as market conditions have warranted capital deployment elsewhere, and the strategy realignments have contributed to a best-in-class pace of compounding tangible book value.

Investment Rationale

At the outset of the COVID-19 recession, the accounting practices in private mortgage insurance require reserving for losses whether or not they are expected to result in a claim. This is a challenge for immediate-term operating earnings growth. However, in the out-years, as loans begin to cure and Arch's significant growth in P&C lines begins to work through the income statement, we believe it translates into earnings significantly higher than Street expectations.

Stock Data

Average Daily Volume

1,600,580

Quarterly Earnings Estimates

	2023	2024
Q1	1.73A	2.20E
Q2	1.92A	2.40E
Q3	2.31A	1.90E
Q4	2.49A	2.40E

Price objective basis & risk

Arch Capital (ACGL)

Our price objective is \$100 is based on parity with the large-cap P&C peer year-ahead P/E multiple (10.8x) on our 2025 EPS forecast. While there is no impact from a Bermudian income tax in 2024, we are also reducing the multiple by the impact we expect such a tax to have in 2025. This is a premium to the historical trading range (90% of the peer group P/E) given Arch's above-average growth, margin outlook and tactical capital management strategy.

Downside risks are depression-like scenarios leading to a collapse in homeownership rates, however, Arch does have \$3 billion of collateralized reinsurance protection, partly mitigating this material risk. While Arch had been generally under-exposed to natural catastrophe losses in recent years, the company has been recently increasing its exposure to such events as the price of underwriting that risk has been increasing.

Analyst Certification

I, Joshua Shanker, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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US - Insurance Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Aflac	AFL	AFL US	Joshua Shanker
	Allstate Corp.	ALL	ALL US	Joshua Shanker
	American International Group	AIG	AIG US	Joshua Shanker
	Arch Capital	ACGL	ACGL US	Joshua Shanker
	Assurant	AIZ	AIZ US	Grace Carter, CFA
	Axis Capital	AXS	AXS US	Joshua Shanker
	BRP Group, Inc.	BRP	BRP US	Joshua Shanker
	Cincinnati Financial Corporation	CINF	CINF US	Grace Carter, CFA
	Corebridge Financial	CRBG	CRBG US	Joshua Shanker
	Everest Group Ltd	EG	EG US	Joshua Shanker
	Intact Financial	YIFC	IFC CN	Grace Carter, CFA
	Intact Financial	IFCZF	IFCZF US	Grace Carter, CFA
	MetLife	MET	MET US	Joshua Shanker
	Progressive	PGR	PGR US	Joshua Shanker
	RenaissanceRe	RNR	RNR US	Joshua Shanker
	The Hartford	HIG	HIG US	Joshua Shanker
	Voya	VOYA	VOYA US	Joshua Shanker
	W.R. Berkley	WRB	WRB US	Joshua Shanker
NEUTRAL				
	Aon	AON	AON US	Joshua Shanker
	Brown & Brown	BRO	BRO US	Grace Carter, CFA
	Lincoln National	LNC	LNC US	Joshua Shanker
	Marsh McLennan	MMC	MMC US	Joshua Shanker
	Principal Financial Group	PFG	PFG US	Joshua Shanker
	Prudential Financial	PRU	PRU US	Joshua Shanker



US - Insurance Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	The Hanover	THG	THG US	Grace Carter, CFA
	Trupanion	TRUP	TRUP US	Joshua Shanker
	Unum	UNM	UNM US	Joshua Shanker

UNDERPERFORM

	Arthur J. Gallagher & Co.	AJG	AJG US	Joshua Shanker
	Chubb Ltd	CB	CB US	Joshua Shanker
	CNA Financial	CNA	CNA US	Joshua Shanker
	Goosehead Insurance Inc.	GSHD	GSHD US	Joshua Shanker
	Selective	SIGI	SIGI US	Grace Carter, CFA
	Travelers Cos	TRV	TRV US	Joshua Shanker
	Willis Towers Watson	WTW	WTW US	Joshua Shanker

iQmethodSM Measures Definitions**Business Performance**

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

Numerator

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

Numerator

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

EV = Current Share Price × Current Shares + Minority Equity + Net Debt +

Other LT Liabilities

Enterprise Value

Denominator

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill

Amortization

Shareholders' Equity

Sales

N/A

N/A

Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

Denominator

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

Basic EBIT + Depreciation + Amortization

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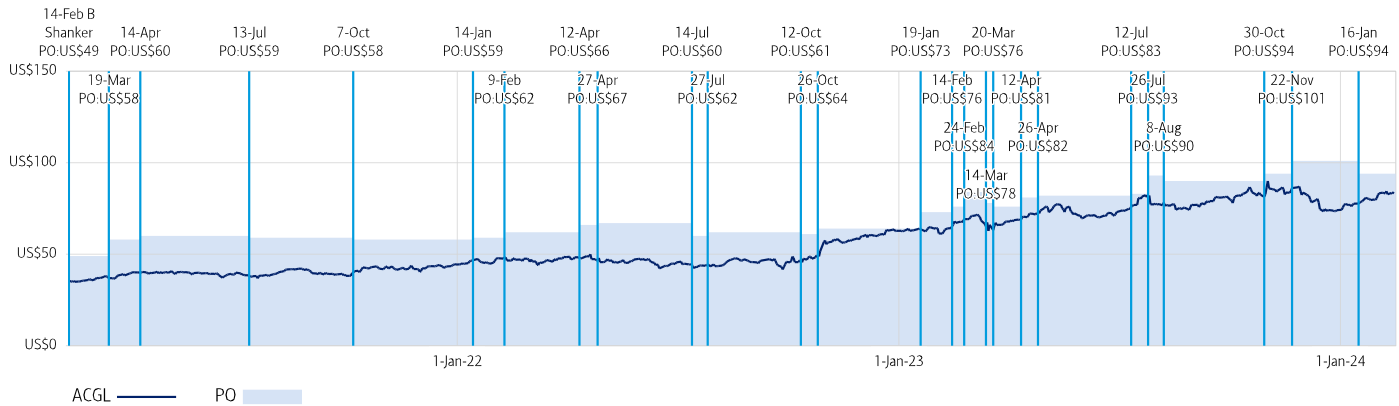
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Arch Capital (ACGL) Price Chart



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Equity Investment Rating Distribution: Financial Services Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	156	53.79%	Buy	94	60.26%
Hold	72	24.83%	Hold	48	66.67%
Sell	62	21.38%	Sell	35	56.45%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

^{R1} Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster ^{R2}
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

^{R2} Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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