Arch Capital

Momentum in Insurance and MI Drove Strong 2Q22 Results

Neutral

ACGL, ACGL US

Price (27 Jul 22): $44.28

▲ **Price Target (Dec-23): $54.00**
Prior (Dec-23): $53.00

ACGL reported strong 2Q22 results and we are raising our EPS forecasts. We consider Arch a strong franchise but remain Neutral on the stock due to a cautious outlook for the reinsurance market.

- **EPS upside; raising estimates.** ACGL reported operating EPS of $1.34, well above our $1.10 estimate and consensus of $1.09. Results were lifted by better than assumed reserve development ($0.12 better), but earnings would have beaten expectations regardless, helped by upside in premiums and investment income. We are raising our 3Q22 estimate from $0.98 to $0.99 and our 2023 projection from $4.78 to $4.86.
- **Business trends were healthy.** Compared with our model, earnings beat in the P&C insurance and MI divisions, but missed in reinsurance. Margins were better than expected on a reported basis (combined ratio 77.1% vs. 80.1%E) and on a core basis (CR ex. cats and PYD 80.7% vs. 81.3%E). Margins were especially strong in the insurance and MI businesses, but were weaker in reinsurance. Reserve development was better than anticipated (due to the MI and insurance division), while cat losses were roughly in-line. Meanwhile, investment income beat and should benefit from the rise in interest rates. Written premiums rose 12%, significantly higher than our 1% assumption. ACGL spent $321 million on share buybacks, above our $200 million assumption.
- **Our fundamental outlook is relatively upbeat.** We project the company's results in the near term to be marked by healthy MI and re/insurance margins, strong re/insurance premiums, and weak MI premiums. Longer term, we anticipate healthy returns in the MI business, which generates the majority of ACGL's underwriting earnings. However, the tailwind from reserve releases in the MI business should moderate in 2023 and margins should compress given the commoditized nature of the business, black box pricing, and higher capital requirements. Meanwhile, our long-term view of the reinsurance market remains downbeat, and we expect excess capacity, more 3rd party participation, increased mobility of capital, and broker consolidation to preclude a sustained hard market. ACGL has ample capacity to supplement organic growth with steady share repurchases, but we expect the pace of buybacks to moderate from recent levels.
- **We affirm our Neutral rating.** We consider Arch a top-tier franchise, but in commoditized markets. Over time, ACGL has transitioned into more of an MI firm than a P&C reinsurer. Our long-term outlook for the MI business is relatively upbeat, but we are cautious on the reinsurance market. Also, we feel that ACGL's valuation is not too enticing given the company's long-term ROE and growth profile.

Insurance - Life & Nonlife

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J.P. Morgan Securities LLC

Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 22E ($)	4.25	4.51

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2021A	2022E	2023E
Q1	0.59	1.10A	
Q2	1.00	1.34A	
Q3	0.74	0.99	
Q4	1.27	1.08	
FY	3.58	4.51	4.86

Style Exposure

Quant Factors	Current %Rank	Hist %Rank (1=Top) 6M	1Y	3Y	5Y
Value	100	100	100	100	100
Growth	100	100	100	100	1
Momentum	1	1	1	100	1
Quality	1	1	100	1	100
Low Vol	1	100	100	1	100
ESGQ	12	11	13	91	98

2Q22 EPS: $1.34A vs. $1.10E

Positives
MI margins
Insurance margins
Share repurchases

Negatives
Reinsurance margins

Bloomberg: JPMA Bhullar <GO>

Sources for: Style Exposure – J.P. Morgan Quantitative and Derivatives Strategy; all other tables are company data and J.P. Morgan estimates.

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Price Performance

	YTD	1m	3m	12m
Abs	-0.6%	-1.5%	-7.6%	14.9%
Rel	15.0%	-4.7%	-3.8%	23.5%

Company Data

Shares O/S (mn)	369
52-week range ($)	50.73-37.44
Market cap ($ mn)	16,354.68
Exchange rate	1.00
Free float(%)	96.5%
3M - Avg daily vol (mn)	1.95
3M - Avg daily val ($ mn)	87.9
Volatility (90 Day)	26
Index	S&P 500
BBG BUY|HOLD|SELL	10|2|1

Key Metrics (FYE Dec)

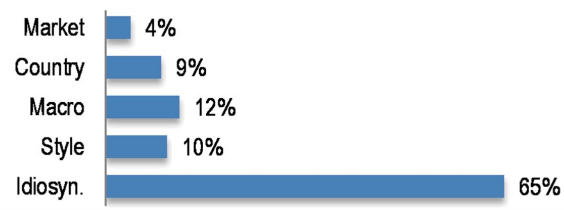
$ in millions	FY21A	FY22E	FY23E	FY24E
Financial Estimates				
NEP (Premium)	8,082	9,277	10,657	11,592
Underwriting income	1,218	1,868	1,959	2,096
Net investment income	389	404	365	391
Operating income	1,607	2,272	2,324	2,487
Adj. PBT	2,368	1,562	2,055	2,221
Adj. net income	1,435	1,789	1,850	2,002
Adj. EPS	3.58	4.51	4.86	5.39
BBG EPS	3.33	4.36	5.10	5.73
DPS	0.00	0.00	0.00	0.00
Investments	11,771	11,152	12,202	13,384
BVPS	33.56	33.19	37.39	42.21
NAVPS	33.56	33.19	37.39	42.21
Margins and Growth				
Adj. EPS growth	163.9%	25.8%	7.8%	10.9%
Ratios				
Adj. tax rate	5.4%	6.9%	8.0%	8.0%
Loss ratio	(53.5%)	(49.8%)	(51.8%)	(52.2%)
Combined ratio	(25.3%)	(19.7%)	(21.9%)	(22.5%)
Invest inc. % of Investments	-	-	-	-
Regulatory solvency ratio	-	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-	-
ROE	11.5%	14.5%	14.7%	14.7%
Valuation				
Dividend yield	0.0%	0.0%	0.0%	0.0%
Adj. P/E	12.4	9.8	9.1	8.2
P/ BV	1.3	1.3	1.2	1.0

Summary Investment Thesis and Valuation

Investment Thesis

We consider Arch a premier franchise and expect it to generate higher and less volatile underwriting margins than most peers. However, we remain Neutral on the stock given a cautious long-term outlook for the P&C reinsurance market. In our view, near-term results in the MI and re/insurance businesses will benefit from the economic recovery, a healthy housing market, and firm re/insurance pricing. Meanwhile, our long-term outlook is mixed as we expect MI returns to be held back by commoditized nature of the product, black box pricing, and higher capital requirements. Moreover, we remain negative on the P&C reinsurance business, and forecast excess capacity, greater third-party participation, increased mobility of capital, and consolidation among brokers to preclude sustained hard market.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.45	0.30
Country: Bermuda	0.42	0.33
Macro:		
JP Morgan EMBI Global Spread	-0.40	-0.28
Generic 1st 'CO' Future	-0.10	-0.20
JP Morgan GBI-EM Global Div	0.38	0.18
Quant Styles:		
Growth	0.14	0.19
Quality	0.23	0.12
Value	-0.02	-0.11

Source: J.P. Morgan Quantitative and Derivatives Strategy for Performance Drivers; company data, Bloomberg Finance L.P. and J.P. Morgan estimates for all other tables. Note: Price history may not be complete or exact

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Investment Thesis

Please see Page 5 for a detailed review of 2Q22 results.

ACGL will hold its earnings conference call at 11:00 AM Eastern on July 28, 2022.

Conference call participants need to register at this link: https://register.vevent.com/register/BIeb252ce756f74a119f128d5b3a33564d.

The call replay can be accessed at: ir.archcapgroup.com.

In our view, ACGL is a premier franchise, but we remain Neutral given our cautious long-term outlook for the reinsurance market. We believe that ACGL has an industry-leading reinsurance business with a unique culture and approach to underwriting that should generate superior returns and less volatile margins over time. In the primary P&C business, ACGL has grown premiums and improved margins with the tailwind of favorable pricing. Arch has also established itself as a top-tier competitor in mortgage insurance (MI), which we view as a structurally better business than reinsurance. Although higher interest rates, a weaker economy, and competition from the FHA are risks for the MI business, near-term results should benefit from the release of reserves set up at the onset of COVID. Meanwhile, firm pricing is a positive for P&C reinsurance and insurance results. On the other hand, our long-term outlook for reinsurance is downbeat given structural headwinds in the market (e.g., excess capital, low barriers to entry, limited pricing power, etc.). Also, valuation is not too enticing given Arch's long-term ROE and growth potential.

Mortgage Insurance: Growth Poor, but Margins to be Strong

ACGL expanded in mortgage insurance mainly through acquisitions (CMG in 2014 and United Guaranty in 2016) during a time when market conditions were favorable overall, marked by appreciating home prices, relatively stringent lending standards at mortgage issuers, and disciplined pricing by mortgage insurers. Arch's MI business has generated healthy margins since these acquisitions, and despite the temporary setback from COVID-related delinquencies in 2020, results have been healthy overall. We expect near-term results in the business to benefit from significant reserve releases as loans delinquent at the onset of the pandemic become current on payments. On a cautious note, higher interest rates should suppress mortgage origination volumes and, while not imminent, a recession would drive an uptick in defaults and thereby pressure margins in the MI business.

P&C Reinsurance: Long-Term Outlook Negative

We project ACGL's reinsurance margins to be higher and less volatile than peers', but our long-term outlook for the market remains cautious. Arch has historically produced stronger results than most other reinsurers, which we attribute to its focus on specialty reinsurance (where pricing tends to be less competitive), conservative underwriting philosophy, ability to shift target segments based on changing market conditions, and judicious management of cat risk. In particular, ACGL prices business using the risk-free rate (leading to more conservative underwriting), and uses a long-term compensation plan for underwriters that pays based on underwriting margins over a multi-year period. The creation of 3rd party capital vehicles such as Premia Re has also allowed Arch to earn fee income from its reinsurance franchise. Although we view Arch as a top-tier reinsurer, our long-term outlook for the reinsurance market remains negative due to several structural headwinds, including the commoditized nature of the product and the ease of entry of new capital. Pricing remains firm overall, but we see the pace of price hikes moderating over the next year, which could weigh on top-line growth and margins. Furthermore, we believe that catastrophe risk has been systemically underpriced as prices have not kept up with the increasing frequency and severity of cat events.

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2Q22 Details

This evening, ACGL announced 2Q22 operating EPS of $1.34, exceeding our $1.10 estimate and consensus of $1.09. Results were lifted by better than assumed reserve development ($0.12 per share better), but earnings would have beaten expectations regardless, helped by upside in premiums and investment income. By division, earnings beat in P&C insurance and MI, but missed in reinsurance.

Table 1: 2Q22 Operating Earnings: Actual vs. Expected

$ in millions, except per share amounts

	2Q22E	2Q22A	Upside / (downside) to EPS	Comments
Underwriting Income by Division				
Mortgage	268	298	$0.08	strong margins (CR of -1.5% vs. 12.5%E) more than offset lower premiums
Insurance	41	98	$0.15	net written premiums +27.5% vs. +16.0%E; combined ratio (91.1% vs. 96.3%E)
Reinsurance	150	139	-$0.03	net written premiums +25.7% vs. +9.5%E; combined ratio (85.5% vs. 83.0%E)
Underwriting income	**459**	**535**	**$0.20**	
Net investment income	81	106	$0.07	pre-tax investment yield of 1.76% in 2Q22 vs.1.34% in 1Q22 and 1.47% in 2Q21
Earnings from affiliates	12	5	-$0.02	driven by lower earnings at Somers
Other income (losses) / COLI	1	(11)	-$0.03	poor equity market performance in COLI account
Other expenses / corporate	55	55	$0.00	
Interest expense	33	33	$0.00	
Pretax operating income	**466**	**548**	**$0.21**	
Income tax expense	37	31	$0.02	tax rate 5.7% vs. 8.0%E
Preferred dividends	10	10	$0.00	
Operating income	**419**	**506**	**$0.23**	
Weighted average dilutive shares	380.7	378.0	$0.01	share buybacks of $321 million versus our $200 million estimate
Operating EPS	**$1.10**	**$1.34**	**$0.24**	

Source: Company reports and J.P. Morgan estimates.

Business trends were healthy overall. Underwriting margins were better than expected on a reported basis (combined ratio 77.1% vs. 80.1%E) and on a core basis (CR ex. cats and PYD 80.7% vs. 81.3%E). Margins were especially strong in the P&C insurance and mortgage insurance businesses, but weaker than assumed in P&C reinsurance. Reserve development was better than anticipated (due to the MI and insurance division), while catastrophe losses were roughly in-line. Meanwhile, investment income beat and should benefit from the increase in interest rates. Written premiums rose 12%, significantly higher than our 1% assumption. ACGL spent $321 million on share repurchases in 2Q22, above our $200 million assumption.

Table 2: 2Q22 Key Financial Metrics

$ in millions

	2Q22E	2Q22A
Net premiums written	2,421	2,685
% change (y-o-y)	0.9%	11.9%
Net investment income	81	106
% change (y-o-y)	-27.0%	-4.7%
Loss ratio ex cats and PYD	50.7%	51.0%
Catastrophe losses	3.6%	3.5%
PYD (favorable) / unfavorable	-4.8%	-7.2%
Loss ratio	49.4%	47.4%
Expense ratio	30.6%	29.7%
Combined ratio	80.1%	77.1%
Combined ratio ex cats & PYD	81.3%	80.7%
Share buybacks ($ mil.)	200	321

Source: Company reports and J.P. Morgan estimates.

Mortgage Ins.: Strong Results, Lifted by Reserve Releases

Our outlook for top-line growth in the MI business is downbeat, but we expect margins to remain robust in the near term. The MI business reported underwriting income of $298 million in 2Q22, well above our $268 million estimate, with upside in margins (CR of -1.5% versus our 12.5% estimate) more than offsetting lower net earned premiums (-11.5% vs. -10.0%E). Margins were boosted by favorable development on COVID-related reserves (-40.7% on the combined ratio versus our estimate of -27.0%). Still, the combined ratio was better than assumed on a core basis as well (CR ex. cats and PYD 39.2% vs. 39.5%E). Net written premiums declined 12.5% to $294 million, slightly better than our expectation, with the year-on-year drop driven by lower gross written premiums and retention levels.

In 2020 and early 2021, MI margins were hurt by artificially high delinquencies attributable to homeowners availing themselves of government forbearance programs. With the expiry of the programs, a significant portion of previously delinquent loans have cured, particularly loans by borrowers who were taking advantage of the mortgage payment holiday but were not in financial stress. Meanwhile, for homeowners under stress who are truly unable to pay their mortgages, the strong appreciation in house prices has provided a cushion, limiting losses for mortgage insurers. After spiking in 2Q20, the number of delinquent loans has steadily declined, and we expect the trend to continue in the near term. This, in turn, should drive robust margins in the MI division. The percent of loans in default in the U.S. primary MI business was 1.8% at 6/30/22, an improvement from 2.1% at 3/31/22, 2.4% at 12/31/21, 2.7% at 9/30/2021, and 3.1% at 6/30/2021.

Table 3: Mortgage: Key Metrics

$ in millions

	2Q20	3Q20	4Q20	2020	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22E	2Q22A
Net written premiums	325	298	332	1,280	335	336	301	289	1,261	288	290	294
Premium Growth (y/y)	1.1%	-6.0%	5.1%	1.4%	3.3%	3.3%	0.8%	-12.8%	-1.5%	-14.0%	-13.6%	-12.5%
Losses and LAE ex. cats and	61.4%	44.9%	27.3%	39.2%	22.3%	16.1%	19.2%	14.8%	18.2%	17.6%	17.0%	18.8%
Catastrophe losses	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
PYD (favorable) / unfavorable	-0.1%	-1.3%	-2.4%	-1.4%	-3.4%	-13.1%	-15.5%	-24.2%	-13.7%	-36.5%	-27.0%	-40.7%
Loss ratio	**61.3%**	**43.6%**	**24.9%**	**37.8%**	**18.9%**	**3.0%**	**3.7%**	**-9.4%**	**4.4%**	**-18.9%**	**-10.0%**	**-21.9%**
Acquisition expense ratio	9.3%	10.2%	7.7%	9.6%	8.9%	9.0%	7.7%	4.4%	7.6%	3.6%	8.5%	3.4%
Operating expense ratio	10.3%	10.4%	12.5%	11.6%	14.6%	14.5%	14.8%	16.7%	15.1%	18.4%	14.0%	17.0%
Expense ratio	**19.6%**	**20.6%**	**20.2%**	**21.2%**	**23.6%**	**23.5%**	**22.6%**	**21.1%**	**22.7%**	**22.1%**	**22.5%**	**20.4%**
Combined ratio	**80.9%**	**64.2%**	**45.1%**	**59.0%**	**42.4%**	**26.5%**	**26.3%**	**11.6%**	**27.1%**	**3.2%**	**12.5%**	**-1.5%**
Combined ratio ex cats & PYD	81.0%	65.5%	47.5%	60.4%	45.8%	39.6%	41.8%	35.8%	40.9%	39.7%	39.5%	39.2%
Underwriting Income (Loss)	**76**	**131**	**189**	**593**	**200**	**250**	**234**	**269**	**953**	**285**	**268**	**298**

Source: Company reports and J.P. Morgan estimates.

We expect MI margins to be robust and benefit from additional reserve releases. Under U.S. GAAP accounting, Arch has to set reserves for its primary U.S. MI business based on reported delinquencies (unlike for P&C lines, an IBNR component is not permitted under U.S. GAAP for primary MI business). An increase in reported delinquencies at the onset of COVID caused Arch and its MI peers to establish corresponding reserves despite the healthy labor market and appreciation in house prices. However, a meaningful portion of these delinquencies resulted from homeowners taking advantage of the government's forbearance protection programs (mainly to preserve liquidity), not actual financial hardship. As such, the majority of these delinquent loans have actually cured following the expiration of forbearance programs (initially set for 12/31/20, but then extended through 9/30/21 and, in some cases, year-end 2021 or beyond), resulting in the release of previously incurred reserves. The interplay of cures on previously delinquent loans and how new delinquencies emerge in response to the economic environment, which is beginning to soften, will be the key driver of MI margins through 2022 and 2023. Overall, we project MI margins to remain robust given strong labor and housing markets, cures on previously delinquent loans, and the equity cushion accumulated by homeowners due to the appreciation in house prices. On a cautious note, top-line growth in the business is likely to be sluggish as higher interest rates reduce mortgage originations. Also, a weaker economy could deflate home prices and lead to higher defaults on mortgages, particularly among borrowers that have weaker credit profiles.

ACGL has become a formidable competitor in the mortgage insurance market through acquisitions and could expand further via M&A in the future. ACGL entered the mortgage re/insurance business in 2011, but was only marginally involved in the market at the onset, competing as a primary insurer through credit unions and as a reinsurer through the GSE credit risk transfer program. The company's 2014 acquisition of CMG Mortgage Insurance from Cuna Mutual gave it a bigger foothold as it received a ratings upgrade for its MI business (from BBB+ to A- at S&P) and gained distribution into the bank channel. Following the deal, Arch became a top 10 competitor in the domestic private MI market. Arch's market position strengthened further following its 2017 acquisition of United Guaranty (UGC) from AIG, which catapulted the company to a top-3 competitor (as part of the deal, AIG retained 50% of mortgage insurance blocks originated by UGC prior to 2017). The company has also expanded its presence in foreign MI markets through M&A, including its recent acquisition of Westpac's mortgage insurance business in Australia (closed in August 2021).

Insurance: Margins Drove Upside, Growth Healthy

The insurance business reported strong premium growth and better than expected margins. Underwriting income in 2Q22 was $98 million, well above our $41 million estimate, driven by a lower combined ratio (91.1% versus our 96.3% estimate) and better than expected premium growth. The underwriting margin benefited from lower catastrophe losses (1.5% vs. 5.0%E) and higher favorable development (-0.4% vs. -0.3%E). Margins were better than assumed on a core basis as well (CR ex. cats and PYD of 90.0% vs. 91.5%E). Similar to the past few quarters, the expense ratio rose from the previous year due to a business mix shift to lines such as travel and professional liability that have higher expense ratios but lower loss ratios (the overall combined ratio improved from 2Q21). Top-line growth was robust, with premiums rising 27.5% to $1.2 billion versus our 16.0% estimate.

Table 4: Insurance: Key Metrics

$ in millions

	2Q20	3Q20	4Q20	2020	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22E	2Q22A
Net written premiums	672	824	838	3,163	995	964	1,154	1,036	4,148	1,207	1,118	1,228
Premium Growth (y/y)	7.1%	17.1%	21.6%	19.7%	20.0%	43.3%	40.0%	23.7%	31.2%	21.3%	16.0%	27.5%
Losses and LAE ex. cats and	63.1%	62.9%	64.3%	63.6%	61.0%	60.2%	59.5%	57.5%	59.5%	55.5%	56.5%	56.0%
Catastrophe losses	12.5%	10.3%	8.3%	9.5%	5.1%	3.2%	12.2%	2.0%	5.6%	3.1%	5.0%	1.5%
PYD (favorable) / unfavorable	-0.3%	-0.2%	-0.2%	-0.2%	-0.7%	-0.3%	-0.5%	-0.3%	-0.4%	-0.1%	-0.3%	-0.4%
Loss ratio	**75.3%**	**73.0%**	**72.4%**	**72.9%**	**65.4%**	**63.1%**	**71.2%**	**59.2%**	**64.6%**	**58.5%**	**61.3%**	**57.1%**
Acquisition expense ratio	15.7%	14.2%	13.5%	14.6%	15.6%	15.8%	16.2%	18.8%	16.7%	19.1%	19.0%	19.4%
Operating expense ratio	17.3%	17.0%	15.8%	17.0%	16.7%	15.4%	14.8%	14.9%	15.4%	16.2%	16.0%	14.6%
Expense ratio	**32.9%**	**31.3%**	**29.3%**	**31.6%**	**32.4%**	**31.2%**	**31.0%**	**33.7%**	**32.1%**	**35.3%**	**35.0%**	**34.0%**
Combined ratio	**108.3%**	**104.2%**	**101.7%**	**104.5%**	**97.7%**	**94.3%**	**102.3%**	**93.0%**	**96.8%**	**93.8%**	**96.3%**	**91.1%**
Combined ratio ex cats & PYD	96.1%	94.1%	93.6%	95.2%	93.3%	91.4%	90.6%	91.3%	91.6%	90.8%	91.5%	90.0%
Underwriting Income (Loss)	**(57)**	**(31)**	**(13)**	**(129)**	**18**	**49**	**(21)**	**71**	**117**	**63**	**41**	**98**

Source: Company reports and J.P. Morgan estimates.

ACGL has attractive opportunities in the primary P&C market, and our outlook for premium growth and margins is constructive. After shrinking its "cycle managed" business (now dubbed as wholesale/large capacity) from 2012 to 2017, ACGL is seeing healthy growth in this part of its primary P&C book, driven by price increases in the broader market, particularly E&S. This, coupled with consistent performance in the less opportunistic parts of its book (specialty small/middle market and franchise), should drive healthy results in the business. On a cautious note, we believe that the market is past the midpoint of the current pricing cycle, and that exposure growth could decelerate if the economy slows. Hence, while favorable tailwinds in the insurance business should persist as premiums are earned, we expect the pace of price increases on new business to moderate through 2022 and 2023.

Reinsurance: Cats Drove Miss; L-T Outlook Downbeat

Reinsurance results were marked by healthy premium growth but lower earnings. Underwriting income in 2Q22 was $139 million, below our $150 million estimate, mainly due to higher catastrophe losses ($66 million vs. $26 million estimate). This, in turn, resulted in an elevated combined ratio (85.5% vs. 83.0%E). On a core basis, underwriting margins were roughly in-line with a higher AY loss ratio (55.3% vs. 55.0E%) mostly offset by a lower expense ratio (27.5% vs. 28.0%E). The company has paid marginal claims related to the Russia/Ukraine war and virtually all Russia/Ukraine losses booked by ACGL thus far (for both insurance and reinsurance businesses) are related to IBNR. Net written premium growth was robust, up 25.7% to $1.2 billion, higher than our 9.5% expectation.

Table 5: Reinsurance: Key Metrics

$ in millions

	2Q20	3Q20	4Q20	2020	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22E	2Q22A
Net written premiums	565	604	491	2,457	999	925	621	709	3,254	1,139	1,013	1,163
Premium Growth (y/y)	50.3%	38.4%	44.9%	53.3%	25.3%	63.6%	2.8%	44.5%	32.4%	14.0%	9.5%	25.7%
Losses and LAE ex. cats and	60.5%	60.2%	58.0%	61.8%	56.3%	62.9%	57.4%	54.9%	57.9%	52.6%	55.0%	55.3%
Catastrophe losses	25.3%	23.3%	16.1%	19.1%	22.7%	2.5%	32.6%	6.7%	15.4%	6.7%	3.0%	7.1%
PYD (favorable) / unfavorable	-6.0%	-7.4%	-6.9%	-5.6%	-3.8%	-2.5%	-9.6%	-6.4%	-5.6%	-2.8%	-3.0%	-4.5%
Loss ratio	**79.8%**	**76.1%**	**67.2%**	**75.3%**	**75.2%**	**62.9%**	**80.4%**	**55.2%**	**67.8%**	**56.5%**	**55.0%**	**57.9%**
Acquisition expense ratio	18.9%	15.4%	16.9%	16.4%	18.3%	18.1%	19.1%	20.0%	18.9%	21.4%	20.0%	20.4%
Operating expense ratio	8.1%	7.5%	7.2%	7.8%	9.4%	6.1%	6.7%	7.9%	7.5%	8.7%	8.0%	7.1%
Expense ratio	**26.9%**	**22.9%**	**24.1%**	**24.1%**	**27.7%**	**24.2%**	**25.8%**	**27.9%**	**26.4%**	**30.1%**	**28.0%**	**27.5%**
Combined ratio	**106.8%**	**99.0%**	**91.3%**	**99.5%**	**102.9%**	**87.1%**	**106.2%**	**83.1%**	**94.2%**	**86.6%**	**83.0%**	**85.5%**
Combined ratio ex cats & PYD	87.5%	83.1%	82.1%	85.9%	84.0%	87.1%	83.2%	82.8%	84.3%	82.7%	83.0%	82.9%
Underwriting Income (Loss)	**(33)**	**6**	**53**	**16**	**(20)**	**96**	**(39)**	**133**	**170**	**109**	**150**	**139**

Source: Company reports and J.P. Morgan estimates.

Our long-term outlook for the reinsurance market is cautious, but we expect Arch Re to generate superior results compared to peers. ACGL's reinsurance business was initially established to take advantage of the hard market for casualty risk in the early 2000s. Over the years, however, management has shifted Arch Re's business mix away from casualty coverage towards other specialty lines such as surety, accident and health, agriculture, and trade credit, which are generally less competitive and present more attractive risk-reward. Firming pricing has benefited results in recent years and should drive continued strong premiums and margins in the near term. Still, we expect the pace of price hikes to moderate and remain skeptical of a sustained hard market given the industry's significant excess capacity and additional capital entering the market. Factors that contributed to a multi-year soft market prior to 2018 (glut of capital, greater fluidity/speed of capital, more providers of capacity, broker consolidation) are still prevalent, and should preclude a prolonged hard reinsurance market. On a positive note, results in the next 1-2 years could benefit from the release of COVID-related business interruption reserves given favorable court decisions in most cases thus far.

Raising EPS Estimates

We are increasing our 3Q22 EPS estimate from $0.98 to $$0.99 and our 2023 projection from $4.78 to $4.86. Our 2022 EPS forecast is increasing as well, from $4.25 to $4.51, partly to reflect upside in 2Q22 results. Our updated model reflects the benefit of better assumed margins in the insurance business, higher than anticipated share buybacks in 2Q22 (and an ensuing lower share count for future periods), and higher net investment income. In our view, catastrophe losses and trends in the housing market (which would affect reserve releases) will be the key sources of variance between reported results and our projections.

Investment Thesis, Valuation and Risks

Arch Capital Group Ltd. *(Neutral; Price Target: $54.00)*

Investment Thesis

We view Arch as a premiere franchise, but remain Neutral given our cautious outlook for the reinsurance market. In our opinion, ACGL has an industry-leading reinsurance business that we expect to deliver superior and less volatile underwriting margins over time due to its unique culture and approach to the market. Also, Arch has established itself as one of the top competitors in the mortgage insurance (MI) market, which we consider a structurally better business to P&C reinsurance. In insurance, ACGL has been able to grow premiums and improve margins, helped by the hard P&C market. Our model projects near-term results in the MI business to benefit from reserve releases. Additionally, firm P&C pricing should drive top-line growth and margins in both the insurance and reinsurance segments. However, our long-term outlook for the reinsurance business remains cautious due to structural issues facing the market, including its excess capital position, relatively low barriers to entry, increased participation by third-party capital providers, and limited pricing power. Moreover, we believe that the stock's valuation is not too compelling given the company's long-term ROE and EPS growth potential.

Valuation

We are raising our year-end 2023 price target from $53 to $54. Our price target assumes a 1.4x multiple on our 12/31/23E BV ex. AOCI forecast, a 1.3x multiple on our 12/31/23E BV forecast and an 11.0x multiple on our 2024 EPS estimate, and we corroborate this approach with a sum-of-the-parts analysis that values ACGL's re/insurance business separately from mortgage insurance. Our target multiples for ACGL reflect its current business mix, which has become more skewed to mortgage insurance. Although mortgage insurance continues to generate higher returns than re/insurance, especially on legacy business from 2009 to 2016, we are concerned about greater competition in the mortgage insurance market. ACGL trades at 1.4x BV and 9.1x 2023E EPS compared to 1.1x and 7.1x for the reinsurance sector, 1.0x and 6.3x for MI peers, and 1.4x and 11.4x for the broader P&C group.

Risks to Rating and Price Target

In our opinion, ACGL could outperform and exceed our price target if:

- **The pricing environment remains firm.** Prices for most P&C lines have been firm for the past several years. An extended hard market could drive upside to our EPS estimates and lift sentiment on the stock.
- **Management sustains insurance underwriting margins close to the recent level.** In our view, investor sentiment could improve if ACGL is able to sustain insurance combined ratios in the low to mid-90s, a significant improvement from ~100% previously, as the tailwind from the current hard market recedes.
- **Management remains proactive with share repurchases.** ACGL has repurchased more stock than expected in recent quarters, partly to take advantage of its depressed trading multiples. A continuation of the trend could drive upward revisions in EPS forecasts as well as boost sentiment on the stock.

We feel that the stock could underperform the group and fail to reach our target if:

- **The housing market deteriorates.** Given Arch's meaningful exposure to mortgage insurance and the more systematic nature of mortgage insurance risk, rising unemployment or higher mortgage defaults would pressure the company's results and hurt sentiment on the stock.
- **Price increases in the reinsurance market slow.** Although primary and reinsurance pricing has been improving since 2018, we do not anticipate sustained hardening. A reversal in pricing trends could drive downside risk in EPS estimates as well as dampen sentiment on the sector.
- **The pace of reserve development moderates.** Favorable reserve development has been a notable contributor to ACGL's results in recent years. A slowdown in the pace of development could pressure margins and returns.
- **Cat losses stay elevated.** While prices for cat re/insurance have hardened, the frequency and severity of catastrophe losses has increased by a larger magnitude over time. This implies that reinsurance prices need to increase significantly for underwriters to earn adequate returns, especially in a scenario where cat losses approximate those in the 2018-2020 period.

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Date	Rating	Price ($)	Price Target ($)
29-Jul-19	OW	44.24	44
12-Nov-19	N	40.79	40
14-Apr-20	N	29.22	34
04-May-20	N	23.11	30
04-Jan-21	N	36.07	36
09-Feb-21	N	34.15	38
28-Apr-21	N	40.49	40
01-Jul-21	N	38.94	44
28-Oct-21	N	42.33	46
09-Feb-22	N	48.20	48
01-Apr-22	N	48.42	51
27-Apr-22	N	46.51	52
06-Jul-22	N	44.44	53

Source: Bloomberg Finance L.P. and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Dec 15, 2003. All share prices are as of market close on the previous business day.

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IB clients**	50%	44%	34%
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