J.P.Morgan

North America Equity Research
10 February 2025

Arch Capital

Momentum in MI and Reinsurance Drove Healthy Results

Neutral

ACGL, ACGL US
Price (10 Feb 25):$91.46

Price Target (Dec-25):$106.00

Arch's results exceeded expectations, as upside in the reinsurance and mortgage insurance business offset a shortfall in insurance. We maintain an upbeat long-term outlook for ACGL, but are Neutral on the stock due to concerns about downside risk to consensus EPS estimates and current valuation.

- **EPS upside; cutting 1Q25 forecasts for LA fires, maintaining 2Q25 and beyond.** ACGL announced 4Q24 operating EPS of $2.26, above our $1.85 estimate and consensus of $1.80. Compared with our model, part of the beat was due to lower cat losses (+$0.10 per share variance after taxes), more favorable P&C development (+$0.02), and a lower tax rate (+$0.07), but earnings would have exceeded estimates even adjusted for these items, which tend to fluctuate on a quarterly basis. We are cutting our 1Q25 EPS estimates from $2.41 to $1.52, but are maintaining our forecasts for future periods.
- **Business fundamentals were strong overall, except in the insurance division.** Mortgage insurance margins were robust (CR 13.4% versus our 17.9% assumption), helped by reserve releases, consistent with the trend in recent periods. Reinsurance margins were strong as well (CR 83.0% vs. 91.3%E), marked by lower attritional and cat losses. Conversely, insurance division margins were pressured by an uptick in attritional and cat losses, which drove weaker margins on both a reported basis (CR 98.5% vs. 93.1%E) and core (CR ex. cats and PYD 90.3% vs. 89.0%E). Insurance division reserve development was positive, but less so than in previous periods. However, management indicated that there were no major shifts in casualty reserves. Arch deployed $24 million for share repurchases in the quarter (our model assumed none) and management could continue buybacks if the stock stays close to the current level.
- **Our model projects ACGL to report strong results in the near term, but our long-term view of the reinsurance market is mixed.** We forecast Arch to report strong underwriting margins, and healthy top-line growth in its reinsurance and insurance businesses. Reinsurance margins should benefit from elevated reinsurance prices and favorable terms (higher attachment points, lack of aggregate covers). In mortgage insurance, top-line growth is likely to be weak, but we expect high home prices and the strong labor market to drive robust margins. On the other hand, despite our near-term optimism, we do not project margins in the reinsurance or MI businesses to sustain at recent levels in the long run.
- **We reiterate our Neutral rating.** In our view, Arch is a top-tier franchise, but in commoditized markets. Near term, tight reinsurance terms and the favorable housing and labor market environment should drive strong results in both the reinsurance and MI businesses. Still, we do not expect the company's margins and ROE to sustain at recent levels in the long run. The stock's valuation seems more reasonable following the pullback in late 2024, but it is still not too enticing given ACGL's long-term ROE and EPS growth potential.

Insurance - Life & Nonlife

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Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 25E ($)	8.69	7.80

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2024A	2025E	2026E
Q1	2.45	1.52	
Q2	2.57	2.19	
Q3	1.99	1.87	
Q4	2.26	2.22	
FY	9.28	7.80	9.30

Style Exposure

Quant Factors	Current %Rank	Hist %Rank (1=Top) 6M	1Y	3Y	5Y
Value	100	100	100	100	100
Growth	1	1	100	1	1
Momentum	51	1	1	1	51
Quality	51	51	1	1	1
Low Vol	1	1	1	51	1
ESGQ	12	12	14	90	97

4Q24 EPS: $2.26A vs. $1.85E

Positives: MI margins; reinsurance margins; insurance premiums

Negatives: insurance margins

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

See page 14 for analyst certification and important disclosures.

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Price Performance

	YTD	1m	3m	12m
Abs	-1.0%	1.4%	-10.2%	9.6%
Rel	-4.1%	-2.7%	-11.4%	-11.2%

Company Data

Shares O/S (mn)	376
52-week range ($)	110.75-78.69
Market cap ($ mn)	34,425.54
Exchange rate	1.00
Free float (%)	94.4%
3M ADV (mn)	1.89
3M ADV ($ mn)	179.5
Volatility (90 Day)	29
Index	S&P 500
BBG ANR (Buy | Hold | Sell)	12|4|1

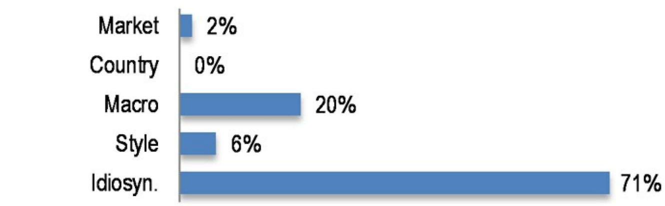
Key Metrics (FYE Dec)

$ in millions	FY24A	FY25E	FY26E
Financial Estimates			
NEP (Premium)	15,100	16,362	17,523
Underwriting income	2,661	2,369	2,393
Net investment income	1,495	1,803	2,045
Operating income	4,156	4,172	4,438
Adj. PBT	4,674	4,454	4,746
Adj. net income	3,542	3,235	3,458
Adj. EPS	9.28	7.80	9.30
BBG EPS	8.84	8.92	9.60
DPS	5.00	3.00	0.00
Investments	18,639	21,245	24,239
BVPS	53.11	59.47	68.49
NAVPS	53.11	59.47	68.49
Margins and Growth			
Adj. EPS growth	9.8%	(15.9%)	19.2%
Ratios			
Adj. tax rate	7.7%	15.0%	15.0%
Loss ratio	(55.2%)	(57.3%)	(58.3%)
Combined ratio	(28.1%)	(29.1%)	(30.2%)
Invest inc. % of Investments	-	-	-
Regulatory solvency ratio	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-
ROE	18.9%	15.2%	14.4%
Valuation			
Dividend yield	5.5%	3.3%	0.0%
Adj. P/E	9.9	11.7	9.8
P/ BV	1.7	1.5	1.3

Summary Investment Thesis and Valuation

We affirm our Neutral rating. Arch is a leading commercial re/insurance underwriter that should produce superior and less volatile underwriting margins compared to peers. In reinsurance, near-term results should benefit from the firm pricing environment and tight terms/conditions. Margins in the MI business should remain healthy in the near-term as well, but we expect the benefit from reserve releases to moderate compared to recent years. Meanwhile, our long-term outlook for the reinsurance market remains cautious, and we expect pricing to deteriorate further if margins remain close to recent levels. This, along with optimistic investor sentiment and concerns about downside risk to consensus estimates keep us Neutral on ACGL.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.12	0.14
Country: Bermuda	0.04	-0.02
Macro:		
JPM Forecast Revision EM	-0.43	-0.33
JPM Global Equity Sentiment	0.18	0.23
Markit EM Composite PMI SA	-0.32	-0.20
Quant Styles:		
Value	0.26	0.31
LowVol	0.04	0.14
DivYld	0.06	0.13

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 4Q24 results. ACGL will hold its earnings conference call at 11:00 AM Eastern on February, 11, 2025. Conference call participants need to register at this link: events.q4inc.com/attendee/117379889/guest. The call replay can be accessed at: ir.archcapgroup.com.

We are Neutral on Arch, but our overall view is relatively upbeat and we consider it an attractive stock for those seeking exposure to the firm reinsurance market. Arch is a premier re/insurance underwriter with a unique culture and approach to risk management that should generate superior, and less volatile, margins over time. The company also has a leading mortgage insurance franchise, a business that we view as structurally superior to P&C reinsurance. In primary P&C, Arch has expanded its position in wholesale/E&S through the current hard market and the acquisition of MidCorp should add scale and distribution to its middle market franchise. Our near term outlook for Arch is positive, and we forecast its results to benefit from tight terms/conditions in the reinsurance market as well as continued reserve releases in mortgage insurance. However, our longer term outlook is more muted, and we expect reinsurance prices to soften over the next 1-2 years if underwriting margins remain close to recent levels. The reinsurance market is plagued by structural issues such as low barriers to entry, lack of differentiation among carriers, and limited pricing power, all of which suggest greater competition if margins remain near recent levels. Also, investor sentiment on ACGL is bullish, and we feel that the stock's valuation is not particularly enticing. Still, our fundamental outlook for the company remains constructive and we could become more bullish if the stock pulls back.

P&C Reinsurance: Near-Term View Positive; L-T Cautious

Our model projects disciplined pricing and terms to drive robust margins in the reinsurance business over the next year. ACGL has historically generated better and less volatile margins than reinsurance peers due to its focus on specialty business (where pricing is less competitive), conservative underwriting, ability to shift mix with changing conditions, and judicious management of catastrophe risk. Also, ACGL prices business using the risk-free rate (leading to conservative pricing), incentivizes underwriters with a long-term compensation plan based on margins over multiple years, and diversifies re/insurance underwriting income with fees from 3rd party capital vehicles such as Premia. **Still, we are cautious on long-term trends in the reinsurance market** because of its commoditized nature, the ease of entry of new capital, and a broad set of capital providers (including some, such as pension funds, with lower return thresholds). We are skeptical of a prolonged hard market and feel that strong margins in recent years will likely erode pricing discipline. As such, we expect a softening of pricing and terms over the next 1-2 years, especially in higher reinsurance layers, where more capital is forming. Any signs of softening of terms/conditions or new capacity will likely hurt sentiment on reinsurance stocks, which are well-liked.

MI: Margins to Normalize Lower, Growth Weak

ACGL expanded its position in mortgage insurance via acquisitions (CMG in 2014 and United Guaranty in 2016) when market conditions were favorable, marked by rising home prices, tight lending standards, and disciplined pricing by MI carriers. Arch's MI business has reported healthy margins since then and, despite the temporary setback from COVID-related delinquencies in 2020, results have been strong. We expect MI margins to be strong in the near-term, but normalize over time as reserve releases moderate. Results in the next few quarters should benefit from ACGL's conservative loss picks post-COVID, the strong labor market, and the increase in house prices. Meanwhile, higher rates are likely to continue suppressing new sales.

4Q24 Details

This evening, Arch announced fourth quarter 2024 operating EPS of $2.26, above our $1.85 estimate and consensus of $1.80. Part of the upside to our model was driven by lower cat losses (+$0.10 per share variance after taxes), more favorable P&C development (+$0.02), and a lower tax rate (+$0.07). Still, earnings would have exceeded estimates even adjusted for these items, which tend to fluctuate on a quarterly basis, as strong results in the mortgage insurance and reinsurance divisions offset a shortfall in insurance.

Table 1: 4Q24 Operating Earnings: Actual versus Expected

$ in millions, except per share amounts

	4Q24E	4Q24A	Upside / (downside) to EPS	Comments
Underwriting Income by Division:				
Mortgage	227	267	$0.11	net written premiums +8.6% vs. +9.2%E; combined ratio 13.4% vs. 17.9%E
Insurance	113	30	-$0.22	net written premiums +34.9% vs. +26.8%E; combined ratio 98.4% vs. 93.1%E
Reinsurance	168	328	$0.42	net written premiums +2.0% vs. +25.1%E; combined ratio 83.0% vs. 91.3%E
Underwriting income	**508**	**625**	**$0.31**	**net written premiums +17.1% vs. +24.6%E; combined ratio 85.1% vs. 86.9%E**
Net investment income	420	405	-$0.04	pre-tax investment yield of 4.32% in 4Q24 versus 4.40% in 3Q24 and 4.11% in 4Q23
Earnings from affiliates	35	64	$0.08	
Other income (losses) / COLI	1	38	$0.10	
Other expenses / corporate	132	156	-$0.06	
Interest expense	35	37	$0.00	
Pretax operating income	**796**	**939**	**$0.37**	
Income tax expense	80	63	$0.04	tax rate of 6.7% vs. 10.0%E
Preferred dividends	10	10	$0.00	
Operating income	**707**	**866**	**$0.42**	
Weighted average dilutive shares	382.7	382.8	$0.00	buybacks of $24 million versus our assumption of no repurchases
Operating EPS	**$1.85**	**$2.26**	**$0.42**	**no major unusual items**

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

Business fundamentals were healthy overall. Mortgage insurance margins were robust (CR 13.4% versus our 17.9% assumption), helped by reserve releases, consistent with the trend in recent periods. Reinsurance margins were strong as well (CR 83.0% vs. 91.3%E), marked by lower attritional and cat losses. Conversely, insurance division margins were pressured by an uptick in attritional and cat losses, which drove weaker margins on both a reported basis (CR 98.5% vs. 93.1%E) and core (CR ex. cats and PYD 90.3% vs. 89.0%E). Arch deployed $24 million for share repurchases in the quarter (our model assumed none).

Table 2: 4Q24 Key Financial Metrics

$ in millions

	4Q24E	4Q24A
Net premiums earned	3,848	4,143
% change (y-o-y)	15.1%	23.9%
Net premiums written	4,064	3,819
% change (y-o-y)	24.6%	17.1%
Net investment income	420	405
% change (y-o-y)	34.1%	29.4%
Loss ratio ex cats and PYD	52.6%	51.6%
Catastrophe losses	10.5%	9.5%
PYD (favorable) / unfavorable	-3.3%	-3.5%
Loss ratio	59.7%	57.5%
Expense ratio	27.2%	27.5%
Combined ratio	86.9%	85.1%
Combined ratio ex cats & PYD	79.7%	79.1%
Share buybacks ($ mil.)	-	24

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

Mortgage Ins.: Margins Strong, Gross Premium Growth Weak

We expect mortgage insurance (MI) premiums to decline at a low-single-digit pace and margins to gradually compress as reserve releases moderate. Although the absolute level of MI earnings should stay healthy, we project margins to decline as reserve releases moderate. Also, higher interest rates are likely to continue to weigh on new business. On a positive note, the cancelation of the Bellemeade transactions and higher interest rates should boost retention, partially offseting lower sales.

In 4Q24, the MI business posted underwriting income of $267 million, well above our $227 million estimate, due to better margins (CR 13.4% vs. 17.9%E) and higher earned premium growth (+11.3% vs. -0.5%E). Most of the upside in margins was driven by lower attritional claims (16.4% vs. 23.0%E) as reserve releases were only modestly better than expected (-22.3% vs. -22.0%E) and the expense ratio was worse (19.3% vs. 16.9%E). Management attributed the reserve releases to better than expected cure rates and the higher expense ratio to lower ceding commissions as well as the costs of a one-time voluntary separation program. Gross premiums were weak (13th consecutive quarter of decline), but net written and net earned premium growth benefited from the termination of the Bellemeade agreements in 4Q23. Overall, we expect the positive drivers of MI margins (higher interest rates, lower inventory of houses, etc.) to suppress gross premium growth through 2025.

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During COVID (2020 and early 2021), MI margins were hurt by artificially high delinquencies as homeowners took advantage of government forbearance programs. However, since the initial spike in 2Q20, the number of delinquent loans has been steadily declining . Since the expiry of forbearance 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 distress. In addition, rising house prices have provided a cushion to homeowners under stress who are struggling to pay their mortgages, limiting losses for MI carriers. The percent of loans in default in the U.S. primary MI business was 2.09% at 12/31/2024, up from 1.96% at 9/30/2024 and 1.74% at 12/31/23.

Table 3: Mortgage Insurance Key Metrics

$ in millions

	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24	3Q24	4Q24E	4Q24A
Net written premiums	275	1,133	261	265	271	255	1,052	277	276	282	278	277
Premium Growth (y/y)	-5.1%	-10.2%	-9.4%	-9.8%	-1.9%	-7.1%	-7.1%	6.1%	4.2%	4.1%	9.2%	8.6%
Losses and LAE ex. cats and PYD	25.2%	20.7%	25.3%	24.3%	21.6%	18.3%	22.4%	22.7%	20.2%	22.5%	23.0%	16.4%
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	-72.1%	-48.6%	-24.6%	-28.7%	-33.5%	-39.0%	-31.3%	-25.7%	-29.0%	-22.8%	-22.0%	-22.3%
Loss ratio	**-46.9%**	**-28.0%**	**0.7%**	**-4.4%**	**-11.9%**	**-20.7%**	**-8.9%**	**-3.0%**	**-8.8%**	**-0.3%**	**1.0%**	**-5.9%**
Acquisition expense ratio	4.4%	3.5%	2.4%	2.4%	0.7%	0.4%	1.5%	0.0%	0.0%	-0.3%	0.4%	1.0%
Operating expense ratio	15.4%	16.8%	16.9%	17.0%	16.0%	17.1%	16.8%	17.4%	16.0%	15.7%	16.5%	18.3%
Expense ratio	**19.8%**	**20.3%**	**19.3%**	**19.4%**	**16.7%**	**17.5%**	**18.2%**	**17.4%**	**16.0%**	**15.3%**	**16.9%**	**19.3%**
Combined ratio	**-27.1%**	**-7.7%**	**19.9%**	**15.0%**	**4.8%**	**-3.3%**	**9.3%**	**14.4%**	**7.2%**	**15.0%**	**17.9%**	**13.4%**
Combined ratio ex cats & PYD	45.0%	41.0%	44.5%	43.7%	38.3%	35.7%	40.6%	40.1%	36.2%	37.8%	39.9%	35.7%
Underwriting Income (Loss)	**374**	**1,257**	**243**	**253**	**282**	**286**	**1,064**	**271**	**287**	**269**	**227**	**267**

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

In our view, reserve releases will continue to lift MI margins, but the tailwind should moderate over time. Higher reported delinquencies at the onset of COVID led Arch and its MI peers to establish conservative reserves despite the healthy labor market and appreciation in house prices. A significant portion of these delinquencies represented homeowners availing themselves of the government's forbearance protection programs (to preserve liquidity), not actual financial hardship. As such, actual losses have come in well below those suggested by initial delinquencies, allowing ACGL to release reserves. In recent quarters, the vast majority of MI reserve releases have been from post-COVID accident years. Even with likely moderation, however, we forecast MI margins to remain robust due to the strong labor and housing markets, cures on previously delinquent loans, and the equity cushion accumulated by homeowners due to the appreciation in house prices. Higher interest rates are a positive for margins as well, as they are causing homeowners to stay longer in their existing houses (where they have more equity), thereby improving persistency. Meanwhile, top-line growth in the MI business is likely to stay weak as higher interest rates reduce mortgage originations. Although a weaker economy could deflate home prices and lead to higher mortgage defaults, a material uptick in losses seems unlikely in the near term. Barring a recession, we expect core margins to stay healthy, though declining reserve releases will drive margins and earnings lower even if economic trends remain favorable.

ACGL has been an active acquirer of MI businesses in the past, but we do not anticipate deals in the near term. Arch has become a leading franchise in the mortgage re/insurance since its entry to the market in 2011. The company 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. ACGL'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 in the bank channel. Following the deal, ACGL became a top 10 competitor in the domestic private MI market. Arch further solidified its market position with its 2017 acquisition of United Guaranty (UGC) from AIG, which moved it into the top-3 by market share (as part of the deal AIG retained 50% of mortgage insurance blocks originated by UGC pre 2017). Arch has also expanded in foreign MI markets through M&A, including its acquisition of Westpac's mortgage insurance business in Australia (closed in August 2021).

Insurance: Higher Cats and AY Loss Picks Drove Miss

The insurance business reported weak results, marked by a shortfall in margins but strong premium growth. The insurance division reported underwriting income of $30 million in 4Q24, well short our $113 million estimate. Margins were worse than our estimates on both a reported (CR 98.5% vs. 93.1%E) and a core basis (CR ex. cats and PYD 90.3% vs. 89.0%E). The loss ratio increased (66.3% vs. 61.1%E) due to higher catastrophe losses (8.3% vs. 4.5%E) and attritional losses (58.1% vs. 57.0%E) as well as lower reserve releases (-0.1% vs. -0.4%E). Also, expenses were slightly higher than assumed as well (32.2% vs. 32.0%E). Moreover, catastrophe losses in the primary insurance division were high, which the company attributed partly to inland flooding caused by Helene as well as the addition of the MidCorp book. Meanwhile, top-line growth was better, with upside in gross written premium growth (+28.4% vs. +23.4%E), net written premium growth (+34.9% vs. +26.8%E), and net earned premium growth (+33.4% vs. +13.3%E). Besides the addition of the MidCorp business, management cited growth in short-tail and liability-occurrence lines as drivers of premium growth.

Management called out the addition of the MidCorp portfolio, increases in accident year loss picks, and a shift in business mix towards casualty as the drivers of the higher loss ratio. The expense ratio benefited by 2.9 points from acquisition accounting (acquisition expense on the MidCorp block, a component of the expense ratio, was replaced with purchase intangibles, the amortization of which is reflected in the consolidated income statement, but not in the combined ratio).

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Table 4: Insurance Key Metrics

$ in millions

	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24	3Q24	4Q24E	4Q24A
Net written premiums	1,217	5,021	1,437	1,454	1,522	1,449	5,862	1,542	1,558	1,820	1,837	1,954
Premium Growth (y/y)	17.4%	21.0%	19.1%	18.4%	11.2%	19.1%	16.8%	7.3%	7.2%	19.6%	26.8%	34.9%
Losses and LAE ex. cats and PYD	56.2%	56.0%	54.8%	55.2%	55.7%	55.1%	55.2%	57.5%	55.6%	57.4%	57.0%	58.1%
Catastrophe losses	2.8%	5.3%	1.6%	2.6%	2.6%	3.8%	2.7%	1.9%	2.0%	4.9%	4.5%	8.3%
PYD (favorable) / unfavorable	-0.3%	-0.2%	-0.5%	-0.5%	-0.8%	-0.5%	-0.6%	-0.5%	-0.2%	-0.7%	-0.4%	-0.1%
Loss ratio	**58.7%**	**61.0%**	**55.9%**	**57.3%**	**57.5%**	**58.4%**	**57.3%**	**58.9%**	**57.4%**	**61.6%**	**61.1%**	**66.3%**
Acquisition expense ratio	19.6%	19.4%	19.5%	19.9%	19.1%	19.1%	19.4%	19.0%	19.5%	17.5%	17.7%	17.8%
Operating expense ratio	13.8%	14.6%	15.5%	14.7%	14.3%	15.7%	15.0%	16.2%	15.8%	14.2%	14.3%	14.3%
Expense ratio	**33.5%**	**34.0%**	**35.0%**	**34.6%**	**33.4%**	**34.8%**	**34.4%**	**35.2%**	**35.3%**	**31.6%**	**32.0%**	**32.2%**
Combined ratio	**92.1%**	**95.1%**	**90.9%**	**91.9%**	**90.9%**	**93.2%**	**91.7%**	**94.1%**	**92.6%**	**93.2%**	**93.1%**	**98.4%**
Combined ratio ex cats & PYD	89.6%	90.0%	89.8%	89.8%	89.1%	89.9%	89.6%	92.7%	90.8%	89.0%	89.0%	90.2%
Underwriting Income (Loss)	**98**	**225**	**114**	**108**	**129**	**99**	**450**	**86**	**109**	**120**	**113**	**30**

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

Arch's primary P&C business is benefiting from healthy commercial lines pricing, but we believe margins are likely to deteriorate in the near term. After shrinking its "cycle managed" business (now called wholesale/large capacity) from 2012 to 2017, ACGL is deploying capital in this part of its primary book due to favorable conditions in the broader market, particularly in E&S. Results in less cyclical parts of ACGL's primary business (specialty small/middle market and franchise) have been healthy as well. Despite the favorable market environment, we do not anticipate a material improvement in primary commercial lines margins at Arch and peers because of headwinds from adverse development of casualty reserves as well as higher inflation and reinsurance costs. Also, pricing has deteriorated in certain lines (particularly in property), and reserve development could become less of a tailwind because of adverse loss trends emerging in older accident years. Management teams at insurance underwriters as well as many investors are optimistic about improving non-cat margins at commercial insurers. However, we feel that assessing results on an underlying basis is not as relevant given the significant increase in reinsurance retentions at primary carriers. In our view, consensus EPS forecasts for commercial lines insurers do not fully reflect the shift in cat loads from reinsurers to primary carriers following the uptick in retention levels with 2023 reinsurance renewals.

Reinsurance: Robust Margins Lifted Earnings

ACGL's reinsurance business reported robust results, as lower cat losses and more favorable PYD offset a modest shortfall in premiums. Underwriting income of $328 million was well above our $168 million estimate, primarily due to higher margins (CR 83.0% vs. 91.3%E). The upside in margins was driven by lower catastrophe losses (12.2% vs. 17.0%E) and, to a lesser extent, better reserve releases (-4.0% vs. -3.2%E). Underlying margins were better as well (CR ex. cats and PYD 74.8% vs. 77.5%E) due to upside in the attritional loss ratio (50.7% vs. 53.0%E) and expense ratio (24.1% vs. 24.5%E). Meanwhile, premium growth was below our assumption (gross written premiums -1.5% vs. +22.0%E, net written premiums +2.0% vs. 25.1%E, net earned premiums +17.5% vs. 19.3%E). The tightening of terms and conditions at 2023 renewals shifted the risk of cat losses from reinsurers to primary carriers, and management indicated that terms remained consistent with 2025 renewals. Arch expects to incur losses of $450-550 million related to the LA wildfires, assuming industry wide insured losses between $35 and $45 billion, and management believes that the likelihood of industry wide insured losses from the event reaching $50 billion (as highlighted by some peers) is very low.

Table 5: Reinsurance Key Metrics

$ in millions

	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24	3Q24	4Q24E	4Q24A
Net written premiums	1,543	4,924	1,726	1,709	1,562	1,557	6,554	2,266	1,947	1,945	1,948	1,588
Premium Growth (y/y)	117.6%	51.3%	51.5%	47.0%	44.8%	0.9%	33.1%	31.3%	13.9%	24.5%	25.1%	2.0%
Losses and LAE ex. cats and PYD	57.4%	56.2%	56.6%	50.8%	49.9%	48.5%	51.3%	53.7%	48.9%	52.2%	53.0%	50.7%
Catastrophe losses	0.0%	12.9%	4.4%	6.3%	9.3%	5.1%	6.3%	1.8%	9.4%	19.3%	17.0%	12.2%
PYD (favorable) / unfavorable	-4.5%	-4.3%	-3.4%	-1.8%	-2.8%	-1.3%	-2.3%	-2.5%	-1.8%	-1.9%	-3.2%	-4.0%
Loss ratio	**52.9%**	**64.9%**	**57.6%**	**55.3%**	**56.4%**	**52.3%**	**55.3%**	**53.0%**	**56.5%**	**69.6%**	**66.8%**	**58.9%**
Acquisition expense ratio	19.9%	20.5%	21.1%	21.6%	19.7%	22.5%	21.2%	19.9%	19.4%	19.8%	20.5%	20.1%
Operating expense ratio	5.6%	6.8%	5.6%	5.1%	4.0%	5.2%	4.9%	4.5%	3.6%	2.9%	4.0%	4.0%
Expense ratio	**25.5%**	**27.3%**	**26.7%**	**26.7%**	**23.7%**	**27.8%**	**26.2%**	**24.4%**	**23.0%**	**22.6%**	**24.5%**	**24.1%**
Combined ratio	**78.5%**	**92.2%**	**84.3%**	**82.0%**	**80.0%**	**80.1%**	**81.5%**	**77.4%**	**79.5%**	**92.2%**	**91.3%**	**83.0%**
Combined ratio ex cats & PYD	83.0%	83.5%	83.3%	77.5%	73.5%	76.3%	77.4%	78.1%	71.9%	74.8%	77.5%	74.8%
Underwriting Income (Loss)	**263**	**314**	**213**	**245**	**310**	**330**	**1,098**	**379**	**366**	**149**	**168**	**328**

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

We are skeptical of a prolonged hard reinsurance market, but recent catastrophes bode well for market discipline and ACGL seems better positioned than peers. ACGL's reinsurance segment was initially established to take advantage of the hard market for casualty coverage in the early 2000s. Over the years, however, management has increased Arch Re's exposure to other specialty lines including surety, accident and health, agriculture, and trade credit, which are generally less competitive and have more attractive risk-reward. The hard pricing environment has boosted results in recent years and has led management to increase exposure to property coverages, which in turn has contributed to strong premium growth and margins. Longer term, however, we expect reinsurance pricing to deteriorate. 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 prolonged hard pricing. On a positive note, ACGL's reinsurance results could benefit from the release of COVID-related reserves, a portion of which remain in IBNR. Similarly, loss reserves for Ian and other cat events could ultimately prove to be too conservative.

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Cutting 1Q25 EPS Estimate

We are reducing our 1Q25 operating EPS estimates from $2.41 to $1.52 and our 2025 projection from $8.69 to $7.80, respectively, for the LA wildfires. Meanwhile, our projections for quarters beyond 1Q25 are unchanged. Our estimates for 2025 and beyond are below consensus levels, which we feel are optimistic. We consider catastrophe losses (which would affect reinsurance and insurance margins) and housing market conditions (which affect MI margins and premium growth) the key sources of potential upside or downside in reported results versus our projections.

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Arch Capital *(Neutral; Price Target: $106.00)*

Investment Thesis

Arch is a superior re/insurance underwriter, but bullish investor sentiment and optimistic consensus estimates keep us from being more constructive on the stock. In our view, ACGL's leading reinsurance business will report higher and less volatile underwriting margins over time given its unique culture and approach to underwriting. The reinsurance business should benefit from firm pricing and tight terms/conditions in the near term, but our long-term outlook for the market is downbeat. We believe that structural issues such as low barriers to entry, lack of differentiation by carrier, and limited pricing power will drive a softening of reinsurance prices over the next one to two years. Meanwhile, Arch is a top competitor in mortgage insurance (MI), which we believe is a structurally better business than P&C reinsurance. We expect MI results to be marked by strong margins in the near term, but we expect reserve releases to moderate from recent years and premium growth to remain weak. Also, investor sentiment on ACGL is bullish, and we believe that consensus EPS forecasts are too optimistic.

Valuation

We are maintaining our December 2025 price target of $106. Our price target assumes a 1.8x multiple on our 12/31/25E BV ex. AOCI forecast, a 1.9x multiple on our 12/31/25E BV forecast, and an 11.0x multiple on our 2026 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 less skewed to MI. ACGL trades at 1.7x BV and 11.7x 2025E EPS compared to 1.3x and 8.4x for the reinsurance sector, 1.1x and 8.4x for MI peers, and 1.9x and 12.4x for the broader P&C group.

Risks to Rating and Price Target

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

- **Re/insurance pricing stays firm for a prolonged period.** A prolonged hard market could drive upside to our EPS forecasts and boost sentiment on the stock.
- **Management sustains insurance underwriting margins close to the recent level.** We believe 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, even as the tailwind from the current hard market abates.
- **Arch announces a sizable share repurchase program.** Steady repurchases by leading reinsurers could help prolong the hard market as well as drive an uptick in EPS forecasts.

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

- **Greater capacity enters the reinsurance market.** This, in turn, could result in further softening of pricing and drive a reduction in EPS estimates and hurt investor sentiment.
- **The housing market deteriorates.** Given Arch's meaningful exposure to mortgage insurance and the more systematic nature of mortgage insurance risk, rising unemployment, higher mortgage defaults, and decreasing home values would pressure the company's results and hurt sentiment on the stock.
- **The tailwind from 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.

Arch Capital: Summary of Financials

Income Statement - Annual	FY24A	FY25E	FY26E
Earned premiums	-	-	-
Policy charges and fee income	-	-	-
Net investment income	-	-	-
Other income	-	-	-
Total revenues	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-
Interest credited	-	-	-
Interest expense	(141)	(152)	(158)
Acquisition & operating expenses	(2,651)	(3,024)	(3,245)
Amortization of acquisition costs (net)	-	-	-
Other expenses	-	-	-
Total expenses	**-**	**-**	**-**
Pretax income	4,674	4,454	4,746
Income taxes	(362)	(668)	(712)
Total net income	4,272	3,746	3,994
Total operating income	3,542	3,235	3,458
Weighted average diluted shares	382	415	372
EPS - operating	**9.28**	**7.80**	**9.30**

Income Statement - Quarterly	1Q25E	2Q25E	3Q25E	4Q25E
Earned premiums	-	-	-	-
Policy charges and fee income	-	-	-	-
Net investment income	-	-	-	-
Other income	-	-	-	-
Total revenues	**-**	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-	-
Interest credited	-	-	-	-
Interest expense	(37)	(38)	(38)	(39)
Acquisition & operating expenses	(724)	(744)	(777)	(779)
Amortization of acquisition costs (net)	-	-	-	-
Other expenses	-	-	-	-
Total expenses	**-**	**-**	**-**	**-**
Pretax income	1,220	1,126	981	1,126
Income taxes	(183)	(169)	(147)	(169)
Total net income	1,027	947	824	947
Total operating income	900	819	696	820
Weighted average diluted shares	592	374	372	369
EPS - operating	**1.52**	**2.19**	**1.87**	**2.22**

Balance Sheet and Capital Data	FY24A	FY25E	FY26E
Shareholders' equity	-	-	-
Shareholders' equity ex. AOCI	-	-	-
Shares outstanding	376	380	374
Book value per share	53.11	59.47	68.49
Book value per share (ex. AOCI)	55.02	61.37	70.42
Capital for share repurchases	-	-	-
Capital for dividends	-	-	-
Dividends	5.00	3.00	0.00

Ratio Analysis	FY24A	FY25E	FY26E	FY27E
EPS growth - operating	9.8%	(15.9%)	19.2%	-
Book value per share (ex. AOCI) growth	12.9%	11.5%	14.8%	-
Return on equity (ROE)	18.9%	15.2%	14.4%	-
Return on equity (ex. AOCI)	-	-	-	-
Dividend payout ratio	44.7%	33.2%	0.0%	-
Total revenue growth	-	-	-	-
Total expense growth	-	-	-	-
Tax rate	7.7%	15.0%	15.0%	-

Source: Company reports and J.P. Morgan estimates.
Note: $ in millions (except per-share data).Fiscal year ends Dec

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Arch Capital (ACGL, ACGL US) Price Chart

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.

Date	Rating	Price ($)	Price Target ($)
01-Apr-22	N	48.42	51
27-Apr-22	N	46.51	52
06-Jul-22	N	44.44	53
27-Jul-22	N	44.24	54
26-Oct-22	N	49.22	57
04-Jan-23	N	62.46	58
31-Mar-23	N	67.86	62
26-Apr-23	N	72.59	67
06-Jul-23	N	73.62	75
26-Jul-23	N	81.36	82
30-Oct-23	N	81.36	86
08-Jan-24	N	76.81	80
14-Feb-24	N	84.06	88
08-Apr-24	N	94.90	92
29-Apr-24	N	90.90	96
11-Jul-24	N	97.50	106
30-Jul-24	N	97.01	108
10-Oct-24	N	113.09	110
03-Jan-25	N	91.38	106

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