Arch Capital

Firing on All Cylinders

Neutral

ACGL, ACGL US
Price (29 Apr 24):$91.25

▲**Price Target (Dec-24):$96.00**
Prior (Dec-24):$92.00

ACGL reported robust 1Q24 results, as upside in the reinsurance and MI divisions offset a shortfall in insurance. We are Neutral on valuation, but view Arch as a premier reinsurance franchise and consider ACGL the best name for those seeking to invest based on the hard reinsurance pricing theme.

- **EPS beat; raising estimates.** ACGL announced 1Q24 operating EPS of $2.45, well above our $2.11 estimate and consensus of $2.07. Compared to our model, the upside was driven partly by lower cat losses (+$0.13 variance), more favorable prior-year development (+$0.03), and lower tax rate (+$0.04 variance), offset by a slight shortfall in investment income (-$0.01). We are raising our 2Q24 EPS forecast from $1.94 to $2.00 and our 2025 projection from $8.24 to $8.64, to reflect accretion from the Allianz mid-market commercial and entertainment insurance acquisition as well as higher than previously assumed premiums and margins in reinsurance and MI.
- **Business fundamentals were strong.** Reinsurance results were lifted by upside in both margins (CR 77.4% vs. our 83.8% estimate) and premiums (+31% vs. +7%E). Margins benefited from lower attritional losses (despite 3.0 points related to the Baltimore bridge) and expenses. MI margins were better than assumed as well (CR 14.4% vs. 19.9%E) and premiums earned were boosted by the cancellation of the Bellemeade deals. Conversely, insurance results fell short of expectations, with downside in margins (CR 94.1% vs. 91.3%E; including 2.1 points of attritional losses for the Baltimore bridge) and premiums (+7% vs. +12%E). As assumed, ACGL did not repurchase stock in 1Q. Management's tone on business trends was very upbeat, particularly in the property cat reinsurance and MI markets. High losses for the Baltimore bridge ($80 million pretax) was a key negative, which we attribute to ACGL's high exposure to the marine line and partly to its conservatism on reserving.
- **We expect ACGL's results to be strong in the near term, but our long-term outlook is mixed.** Our model projects robust margins and top-line growth in re/insurance, and healthy margins but weak premium growth in mortgage insurance. In the MI business, reserve releases related to COVID delinquencies will decline, but we anticipate ongoing favorable development because of the strong labor market and elevated house prices. Meanwhile, higher interest rates should hold back growth but boost premium persistency and margins. In reinsurance, margins should benefit from firm pricing, but sustained robust margins are likely to drive softening terms/conditions. We assume no share repurchases in the near term given ACGL's stock price and management's intent to deploy capital into the business amid the favorable pricing backdrop.
- **We maintain our Neutral rating.** We consider ACGL a top-tier franchise, but in commoditized markets. Although the company is well-positioned to benefit from hard reinsurance pricing, our long-term outlook for the reinsurance market is cautious. In addition, we feel that ACGL's valuation is not attractive given its long-term ROE and EPS growth potential.

Insurance - Life & Nonlife

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Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 24E ($)	7.92	8.48
Adj. EPS - 25E ($)	8.24	8.64

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)	2023A	2024E	2025E
Q1	1.73	2.45A	
Q2	1.92	2.00	
Q3	2.31	1.72	
Q4	2.49	2.31	
FY	8.45	8.48	8.64

Style Exposure

Quant Factors	Current %Rank	Hist %Rank (1=Top) 6M	1Y	3Y	5Y
Value	100	100	100	67	100
Growth	1	34	1	34	67
Momentum	34	34	34	34	67
Quality	34	1	1	1	1
Low Vol	1	1	1	34	1
ESGQ	12	12	13	91	98

1Q24 EPS: $2.45A vs. $2.11E

Positives: reinsurance margins and premiums; MI margins and 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	22.9%	-1.3%	14.4%	21.6%
Rel	16.0%	1.7%	11.0%	-0.8%

Company Data

Shares O/S (mn)	375
52-week range ($)	95.01-69.05
Market cap ($ mn)	34,246.12
Exchange rate	1.00
Free float(%)	96.6%
3M - Avg daily vol (mn)	1.71
3M - Avg daily val ($ mn)	151.2
Volatility (90 Day)	19
Index	S&P 500
BBG BUY|HOLD|SELL	12|4|1

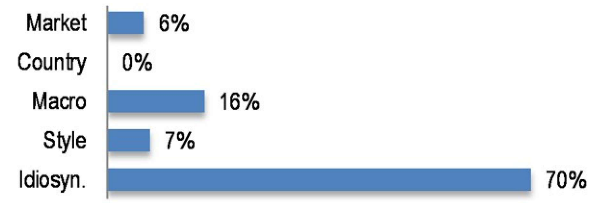
Key Metrics (FYE Dec)

$ in millions	FY23A	FY24E	FY25E
Financial Estimates			
NEP (Premium)	12,440	14,449	17,219
Underwriting income	2,612	2,337	2,310
Net investment income	1,023	1,458	1,824
Operating income	3,635	3,795	4,135
Adj. PBT	3,569	3,871	4,028
Adj. net income	3,201	3,203	3,271
Adj. EPS	8.45	8.48	8.64
BBG EPS	7.96	8.00	8.55
DPS	0.00	0.00	0.00
Investments	16,792	20,102	22,486
BVPS	46.94	55.17	62.42
NAVPS	46.94	55.17	62.42
Margins and Growth			
Adj. EPS growth	73.4%	0.4%	1.9%
Ratios			
Adj. tax rate	24.5%	9.5%	15.0%
Loss ratio	(50.2%)	(55.5%)	(57.9%)
Combined ratio	(21.4%)	(27.2%)	(29.2%)
Invest inc. % of Investments	-	-	-
Regulatory solvency ratio	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-
ROE	21.6%	16.7%	14.8%
Valuation			
Dividend yield	0.0%	0.0%	0.0%
Adj. P/E	10.8	10.8	10.6
P/ BV	1.9	1.7	1.5

Summary Investment Thesis and Valuation

We reiterate our Neutral rating. Arch is a leading re/insurance franchise with a track record of higher and less volatile underwriting margins than most peers. Still, we are Neutral because of our cautious long-term outlook for the P&C reinsurance market and the stock's valuation. In our view, near-term results in the MI business will be marked by weak premium growth and moderating margins as attritional loss ratios normalize higher. Over time, we expect MI returns to be held back by the commoditized nature of the product, black box pricing, and higher capital requirements, but results are likely to be robust in the near term given ongoing reserve releases. In P&C reinsurance, hard pricing and tighter terms/conditions should boost underwriting results in the near term, but our long-term outlook is negative as we remain skeptical of a sustained hard market.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.04	0.25
Country: Bermuda	-0.32	0.05
Macro:		
HSI Volatility Index	-0.27	-0.29
Markit EM Composite PMI SA	-0.46	-0.24
Emerging Central Bank Rate	0.32	0.21
Quant Styles:		
Quality	0.46	0.33
LowVol	0.42	0.28
Momentum	0.40	0.24

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 1Q24 results. ACGL will hold its earnings conference call at 11:00 AM Eastern on April 30, 2024. Conference call participants need to register at this link: https://register.vevent.com/register/BIf25213586ab34cff9e31ab202b71c30a. The call replay can be accessed at: ir.archcapgroup.com.

We are Neutral on valuation, but consider ACGL the best stock for investors seeking to take advantage of the hard reinsurance market. ACGL is an industry-leading reinsurance franchise with a unique culture and approach to underwriting that should generate above-average and less volatile margins over time. The company is also a leading mortgage insurer, a business that we believe is structurally better than P&C reinsurance. In primary P&C, ACGL has expanded its position in wholesale/E&S through the current hard market, and its pending acquisition of the Allianz book should bolster its middle market franchise. Our outlook for near-term business trends is upbeat as well, and we expect ACGL's results to benefit from firm prices and tight terms/conditions in the re/insurance market as well as ongoing reserve releases in the MI division. On the other hand, our long-term outlook is less upbeat, particularly in re/insurance, as we anticipate a turn in the pricing cycle if reinsurers' margins remain close to recent levels for the next 1-2 years. The reinsurance market suffers from structural issues such as low barriers to entry, lack of differentiation among carriers, and limited pricing power, and sustained robust margins should eventually drive an uptick in competition. Moreover, we feel that ACGL's valuation already reflects investor optimism for near-term results. Still, our overall view of Arch is upbeat and we could get more bullish if the stock pulls back.

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

Reinsurance margins should benefit from hard pricing and tighter terms, but our long-term outlook remains cautious. ACGL has historically generated better and less volatile margins than most reinsurers, which we attribute 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. In particular, ACGL prices business using the risk-free rate (leading to more conservative pricing) and uses a long-term compensation plan for underwriters based on margins over multiple years. Furthermore, the creation of 3rd party capital vehicles such as Premia Re generates fee income for the firm. Still, our long-term outlook for reinsurance is cautious given 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 prolonged hard pricing and believe that 1-2 years of strong margins will erode pricing discipline. Barring an above-average hurricane season, we expect pricing momentum to slow, especially in higher layers of reinsurance programs, which are attracting more capital. Any signs of softening of terms/conditions or new capacity will likely hurt sentiment on reinsurance stocks, which are consensus longs.

MI: Margins to Normalize Lower, Growth Lackluster

ACGL expanded in mortgage insurance via acquisitions (CMG in 2014 and United Guaranty in 2016) when market conditions were favorable, with rising home prices, stringent lending standards at lenders, and disciplined pricing by MI carriers. Arch's MI business has generated healthy margins since and, despite the temporary setback from COVID-related delinquencies in 2020, results have been strong. We expect MI margins, which have been unsustainably strong, to revert to more normal levels as COVID-related reserve releases taper off. Still, ACGL's conservative loss picks post-COVID, the strong labor market, and appreciation of house prices should lift margins in the near term. Higher interest rates are a headwind for sales but should boost persistency.

1Q24 Details

This evening, ACGL reported first quarter 2024 operating EPS of $2.45, significantly above our $2.11 estimate and consensus of $2.07. Results were lifted by lower than assumed catastrophe losses (+0.13 variance to our model), more favorable prior-year development (+$0.03), and lower tax rate (+$0.04 variance), offset by a slight shortfall in investment income (-$0.01).

Table 1: 1Q24 Operating Earnings: Actual versus Expected

$ in millions, except per share amounts

	1Q24E	1Q24A	Upside / (downside) to EPS	Comments
Underwriting Income by Division:				
Mortgage	215	271	$0.15	net written premiums +6.1% vs. +1.3%E; combined ratio 14.5% vs. 19.9%E
Insurance	130	86	-$0.12	net written premiums +7.3% vs. +12.4%E; combined ratio 94.1% vs. 91.3%E
Reinsurance	272	379	$0.28	net written premiums +31.3% vs. +6.9%E; combined ratio 77.4% vs. 83.8%E
Underwriting income	**617**	**736**	**$0.31**	net written premiums +19.3% vs. +8.8%E; combined ratio 78.8% vs. 82.2%E
Net investment income	330	327	-$0.01	pre-tax investment yield of 4.14% in 1Q24 versus 4.11% in 4Q23 and 3.03% in 1Q23
Earnings from affiliates	30	55	$0.07	
Other income (losses) / COLI	13	21	$0.02	
Other expenses / corporate	51	74	-$0.06	
Interest expense	34	34	$0.00	
Pretax operating income	**905**	**1,031**	**$0.33**	
Income tax expense	91	88	$0.01	tax rate of 8.5% vs. 10.0%E
Preferred dividends	10	10	$0.00	
Operating income	**805**	**933**	**$0.34**	
Weighted average dilutive shares	380.5	380.5	$0.00	no share buybacks as expected
Operating EPS	**$2.11**	**$2.45**	**$0.34**	**no major unusual items**

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

Business trends were strong. Compared with our model, reinsurance and mortgage insurance results were significantly better than anticipated, while insurance results were in-line. Reinsurance results were lifted by strong margins (CR 80.1% versus our 82.9% estimate) and healthy premium growth (adjusted for one-time deals last year). As in recent quarters, MI results were lifted by robust margins (CR -3.3% vs. 32.0%E), helped by sizable releases of non-COVID reserves (-39.0% on CR vs. -12.0%E). Insurance margins were strong in an absolute sense, but fell short of our estimate (CR 93.2% vs. 91.4%E; CR ex. cats and PYD 89.9% vs. 89.7%E) due to higher than expected cat losses and an uptick in the expense ratio. Premium growth was better than anticipated as well (NWP +7.5% vs. +1.5%E) as upside in the reinsurance and insurance businesses offset a shortfall in MI. As assumed, Arch did not repurchase stock in the fourth quarter.

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Table 2: 1Q24 Key Financial Metrics

$ in millions

	1Q24E	1Q24A
Net premiums written	3,725	4,085
% change (y-o-y)	8.8%	19.3%
Net investment income	330	327
% change (y-o-y)	65.9%	64.3%
Loss ratio ex cats and PYD	53.8%	52.5%
Catastrophe losses	3.3%	1.7%
PYD (favorable) / unfavorable	-3.4%	-3.7%
Loss ratio	53.7%	50.5%
Expense ratio	28.5%	28.3%
Combined ratio	82.2%	78.8%
Combined ratio ex cats & PYD	82.2%	80.9%
Share buybacks ($ mil.)	-	-

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

Mortgage Ins.: Favorable Claims Experience Lifted Results

We expect mortgage insurance (MI) results to be marked by weak gross premium growth, high persistency, and strong (but normalizing) margins. Higher interest rates should suppress mortgage insurance volumes, while reserve releases should moderate over time. Still, MI results have been significantly better than expected in recent periods, and we feel that there is a greater likelihood of upside to our prospective forecasts than downside. Also, net premium growth should benefit from higher retention following the cancelation of the Bellemeade transactions. In 1Q24, the MI division generated underwriting income of $271 million, well above our $215 million estimate, driven by better than assumed margins (CR 14.5% vs. 19.9%E) and higher earned premium growth (+3.0% vs. -11.1%E). The upside in margins was due to a greater than anticipated tailwind from favorable reserve development (-25.7% vs. -22.0%E) and a lower attritional loss ratio (22.7% vs. 24.5%E). Management attributed the reserve releases to favorable cure rates, and the lower attritional losses to lower claim rates, partially offset by higher delinquencies. Gross premium growth in the MI market was sluggish (10th consecutive quarter of decline), but net written and net earned premium growth benefited from the termination of Bellemeade agreements in 4Q23. In our view, factors boosting margins in the MI business (higher rates, lower inventory of houses, etc.) will continue to suppress gross premiums growth.

In 2020 and early 2021, MI margins were hurt by artificially high delinquencies caused by homeowners availing themselves of government forbearance programs. However, after an initial spike in 2Q20, the number of delinquent loans has been steadily declining. Following the expiry of forbearance programs, a significant portion of previously delinquent loans has cured, particularly loans by borrowers who were taking advantage of the mortgage payment holiday but were not in financial distress. In the meantime, higher 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 1.65% at 3/31/2024, flat with 1.65% at 3/31/2023 and lower than 1.74% at 12/31/23.

Table 3: Mortgage Insurance Key Metrics

$ in millions

	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24E	1Q24A
Net written premiums	288	294	276	275	1,133	261	265	271	255	1,052	264	277
Premium Growth (y/y)	-14.0%	-12.5%	-8.2%	-5.1%	-10.2%	-9.4%	-9.8%	-1.9%	-7.1%	-7.1%	1.3%	6.1%
Losses and LAE ex. cats and PYD	17.6%	18.8%	21.0%	25.2%	20.7%	25.3%	24.3%	21.6%	18.3%	22.4%	24.5%	22.7%
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	-36.5%	-40.7%	-45.1%	-72.1%	-48.6%	-24.6%	-28.7%	-33.5%	-39.0%	-31.3%	-22.0%	-25.7%
Loss ratio	**-18.9%**	**-21.9%**	**-24.1%**	**-46.9%**	**-28.0%**	**0.7%**	**-4.4%**	**-11.9%**	**-20.7%**	**-8.9%**	**2.5%**	**-3.0%**
Acquisition expense ratio	3.6%	3.4%	2.4%	4.4%	3.5%	2.4%	2.4%	0.7%	0.4%	1.5%	0.4%	0.0%
Operating expense ratio	18.4%	17.0%	16.5%	15.4%	16.8%	16.9%	17.0%	16.0%	17.1%	16.8%	17.0%	17.4%
Expense ratio	**22.1%**	**20.4%**	**18.8%**	**19.8%**	**20.3%**	**19.3%**	**19.4%**	**16.7%**	**17.5%**	**18.2%**	**17.4%**	**17.4%**
Combined ratio	**3.2%**	**-1.5%**	**-5.2%**	**-27.1%**	**-7.7%**	**19.9%**	**15.0%**	**4.8%**	**-3.3%**	**9.3%**	**19.9%**	**14.4%**
Combined ratio ex cats & PYD	39.7%	39.2%	39.9%	45.0%	41.0%	44.5%	43.7%	38.3%	35.7%	40.6%	41.9%	40.1%
Underwriting Income (Loss)	**285**	**298**	**299**	**374**	**1,257**	**243**	**253**	**282**	**286**	**1,064**	**215**	**271**

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

We expect MI margins to continue to benefit from reserve releases, but to a lesser extent than in prior quarters. Higher reported delinquencies at the onset of COVID led Arch and its MI peers to establish corresponding reserves despite the healthy labor market and appreciation in house prices. A meaningful portion of these delinquencies was due to homeowners taking advantage of the government's forbearance protection programs (to preserve liquidity), not actual financial hardship. Under U.S. GAAP accounting, Arch had to establish reserves based on reported delinquencies despite the high likelihood that these delinquencies would eventually cure (unlike other P&C lines an IBNR component is disallowed under U.S. GAAP for primary MI business). With most of these delinquent loans curing 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), ACGL has been releasing previously incurred reserves. At the moment, more than 80% of MI reserves are from accident years after COVID, suggesting less of a benefit from the release of reserves related to COVID delinquencies. Even with this expected decline, however, we expect MI margins to remain healthy given 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 in the MI book. On a cautious note, top-line growth in the MIS business is likely to be 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 stay favorable.

ACGL has become a leading competitor in the MI market through acquisitions and could expand further via M&A, although deals seem unlikely in the near term. 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 in 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 it to a top-3 spot (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: Shortfall Margins and Premiums Drove Miss

ACGL's insurance business reported lower than expected underwriting margins and premium growth. The division generated underwriting income of $86 million in 1Q24, considerably below our $130 million estimate. Underwriting margins were weaker than assumed on both a reported (CR 94.1% vs. 91.3%E) and core (CR ex. cats and PYD 92.7% vs. 89.6%E) basis. Premium growth missed as well on both a net written (+7.3% vs. +12.4%E) and earned basis (+15.4% vs. +19.0%E). The company reflected the Baltimore bridge collapse in its loss ratio (+201 bps on CR) but core margins would have fallen short of expectations regardless. Cat losses were roughly in line with our expectation (1.9% on CR versus 2.0%E).

Table 4: Insurance Key Metrics

$ in millions

	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24E	1Q24A
Net written premiums	1,207	1,228	1,369	1,217	5,021	1,437	1,454	1,522	1,449	5,862	1,615	1,542
Premium Growth (y/y)	21.3%	27.5%	18.6%	17.4%	21.0%	19.1%	18.4%	11.2%	19.1%	16.8%	12.4%	7.3%
Losses and LAE ex. cats and PYD	55.5%	56.0%	56.0%	56.2%	56.0%	54.8%	55.2%	55.7%	55.1%	55.2%	55.5%	57.5%
Catastrophe losses	3.1%	1.5%	13.4%	2.8%	5.3%	1.6%	2.6%	2.6%	3.8%	2.7%	2.0%	1.9%
PYD (favorable) / unfavorable	-0.1%	-0.4%	-0.1%	-0.3%	-0.2%	-0.5%	-0.5%	-0.8%	-0.5%	-0.6%	-0.3%	-0.5%
Loss ratio	**58.5%**	**57.1%**	**69.3%**	**58.7%**	**61.0%**	**55.9%**	**57.3%**	**57.5%**	**58.4%**	**57.3%**	**57.2%**	**58.9%**
Acquisition expense ratio	19.1%	19.4%	19.6%	19.6%	19.4%	19.5%	19.9%	19.1%	19.1%	19.4%	19.1%	19.0%
Operating expense ratio	16.2%	14.6%	13.9%	13.8%	14.6%	15.5%	14.7%	14.3%	15.7%	15.0%	15.0%	16.2%
Expense ratio	**35.3%**	**34.0%**	**33.5%**	**33.5%**	**34.0%**	**35.0%**	**34.6%**	**33.4%**	**34.8%**	**34.4%**	**34.1%**	**35.2%**
Combined ratio	**93.8%**	**91.1%**	**102.8%**	**92.1%**	**95.1%**	**90.9%**	**91.9%**	**90.9%**	**93.2%**	**91.7%**	**91.3%**	**94.1%**
Combined ratio ex cats & PYD	90.8%	90.0%	89.5%	89.6%	90.0%	89.8%	89.8%	89.1%	89.9%	89.6%	89.6%	92.7%
Underwriting Income (Loss)	**63**	**98**	**(34)**	**98**	**225**	**114**	**108**	**129**	**99**	**450**	**130**	**86**

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

Arch's primary P&C business is benefiting from favorable pricing but, despite firm pricing, we expect margins in the business to stay roughly flat. After shrinking its "cycle managed" business (now called as wholesale/large capacity) from 2012 to 2017, ACGL is seeing strong growth in this part of its primary book, driven by price hikes in the broader market, particularly in E&S. Results in less opportunistic parts of ACGL's book (specialty small/middle market and franchise) have been healthy as well. High inflation and rising reinsurance costs are driving an uptick in insurance pricing, especially in property and cat-exposed lines. Despite these price increases, we do not

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anticipate a material improvement in primary commercial lines margins at Arch and peers because of headwinds from higher inflation and reinsurance costs. Also, 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, but **we feel that assessing results on a non-cat basis is not as relevant given the significant increase in reinsurance retentions at primary companies.** On an overall combined ratio basis, results for most primary insurers were weak in 2023, precisely because of elevated cat losses. In contrast, reinsurers' cat losses have not increased to the same extent. In our opinion, consensus EPS forecasts for commercial lines insurers do not adequately reflect the shift in cat loads from reinsurers to primary carriers following the uptick in retention levels with 2023 reinsurance renewals.

Reinsurance: Upside Driven by Strong Margins

The reinsurance business exceeded expectations on both margins and premiums. The business generated underwriting income of $379 million in 1Q24, well above our $272 million estimate. The combined ratio was 77.4%, lower than our 83.8% assumption, as lower attritional losses (53.7% vs. 56.8%E), catastrophe claims (1.8% vs. 5.0%E), and expenses (24.4% vs. 25.2%E), more than offset lower than expected favorable development (-2.5% vs. -3.2%E). Claims in 1Q24 include 3.0 points related to the Baltimore bridge collapse ($50 million reported in attritional losses), as well as gross catastrophe claims of 1.9 points ($32 million) spread across several global events. Gross written premium (GPW) growth was robust (+40.9% vs. +4.2%E), reflecting favorable pricing conditions in the reinsurance market (particularly property cat), incremental client demand, and ACGL's increased appetite to write risk. Strong GPW growth, along with lower retentions, translated to better net written premium growth (+31.3% vs. +6.9%E). Management sounded upbeat on Arch's positioning amid capacity constraints in the property cat market. The increase in reinsurance attachment points in early 2023 shifted the risk of cat losses from reinsurers to primary carriers, and management indicated that terms remain fairly consistent with last year.

Table 5: Reinsurance Key Metrics

$ in millions

	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24E	1Q24A
Net written premiums	1,139	1,163	1,079	1,543	4,924	1,726	1,709	1,562	1,557	6,554	1,846	2,266
Premium Growth (y/y)	14.0%	25.7%	73.6%	117.6%	51.3%	51.5%	47.0%	44.8%	0.9%	33.1%	6.9%	31.3%
Losses and LAE ex. cats and PYD	52.6%	55.3%	58.4%	57.4%	56.2%	56.6%	50.8%	49.9%	48.5%	51.3%	56.8%	53.7%
Catastrophe losses	6.7%	7.1%	39.1%	0.0%	12.9%	4.4%	6.3%	9.3%	5.1%	6.3%	5.0%	1.8%
PYD (favorable) / unfavorable	-2.8%	-4.5%	-4.9%	-4.5%	-4.3%	-3.4%	-1.8%	-2.8%	-1.3%	-2.3%	-3.2%	-2.5%
Loss ratio	**56.5%**	**57.9%**	**92.6%**	**52.9%**	**64.9%**	**57.6%**	**55.3%**	**56.4%**	**52.3%**	**55.3%**	**58.6%**	**53.0%**
Acquisition expense ratio	21.4%	20.4%	20.8%	19.9%	20.5%	21.1%	21.6%	19.7%	22.5%	21.2%	21.0%	19.9%
Operating expense ratio	8.7%	7.1%	6.3%	5.6%	6.8%	5.6%	5.1%	4.0%	5.2%	4.9%	4.2%	4.5%
Expense ratio	**30.1%**	**27.5%**	**27.1%**	**25.5%**	**27.3%**	**26.7%**	**26.7%**	**23.7%**	**27.8%**	**26.2%**	**25.2%**	**24.4%**
Combined ratio	**86.6%**	**85.5%**	**119.7%**	**78.5%**	**92.2%**	**84.3%**	**82.0%**	**80.0%**	**80.1%**	**81.5%**	**83.8%**	**77.4%**
Combined ratio ex cats & PYD	82.7%	82.9%	85.5%	83.0%	83.5%	83.3%	77.5%	73.5%	76.3%	77.4%	82.0%	78.1%
Underwriting Income (Loss)	**109**	**139**	**(197)**	**263**	**314**	**213**	**245**	**310**	**330**	**1,098**	**272**	**379**

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

We are doubtful of sustained hard pricing, but trends are holding up better than expected and ACGL seems better positioned than peers in this environment. 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 shifted Arch Re's business mix away from casualty risks towards other specialty lines such as 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 is causing management to increase its exposure to property coverages. This, in turn, should drive continued strong premiums and margins in the near term. Still, we expect the pace of price hikes to moderate longer term and remain skeptical of a sustained hard reinsurance 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 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 could ultimately prove to be too conservative (most reinsurers booked higher Ian-related losses than primary carriers). Nonetheless, ACGL management is leaning into the hard market and the company seems better positioned to take advantage of the current environment than most peers.

Raising EPS Estimates

We are raising 2Q24 EPS from $1.94 to $2.00 and 2025 EPS from $8.24 to $8.64. Our 2024 EPS estimate is increasing as well, from $7.92 to $8.48 to reflect upside in 1Q24 results. Our revised model reflects higher than previously assumed margins for the reinsurance and MI businesses as well as accretion from the acquisition of the Allianz mid-markets book. 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 variance in reported results and our projections.

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Arch Capital *(Neutral; Price Target: $96.00)*

Investment Thesis

We consider Arch a premier re/insurance franchise, but bullish investor sentiment and valuation keep us from being more positive on the stock. Arch is a leading reinsurance business that we project to report superior and less volatile underwriting margins over time because of its unique culture and approach to the market. Also, Arch is a top competitor in mortgage insurance (MI), which we consider structurally better business than P&C reinsurance. In the near term, we expect MI results to be marked by weak premium growth and compressing, albeit still robust margins. In reinsurance, firm pricing should boost both premium growth and margins in the near future. However, our long-term view of the reinsurance business is cautious. The reinsurance business suffers from structural issues such as low barriers to entry, lack of differentiation by carrier, and limited pricing power. As such, we expect sustained high margins to erode price discipline and lead to an uptick in competition. Lastly, investor sentiment on ACGL is bullish and the stock's valuation is not compelling relative to the company's long-term ROE and EPS growth potential.

Valuation

We are raising our December 2024 price target from $92 to $96 to reflect our higher EPS and book value forecasts. Our price target assumes a 1.7x multiple on our 12/31/24E BV ex. AOCI forecast, a 1.7x multiple on our 12/31/24E BV forecast, and an 11.0x multiple on our 2025 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 mortgage insurance. ACGL trades at 1.9x BV and 10.8x 2024E EPS compared to 1.4x and 7.4x for the reinsurance sector, 1.1x and 8.2x for MI peers, and 2.5x and 14.0x 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 an extended period.** A prolonged 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, even as the tailwind from the current hard market recedes.
- **The company 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:

- **Additional capacity enters the reinsurance market.** This, in turn, could result in a reversal in pricing trends and potentially drive a reduction in EPS estimates as well as hurt sentiment on the sector.
- **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 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.

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Arch Capital: Summary of Financials

Income Statement - Annual	FY23A	FY24E	FY25E
Earned premiums	-	-	-
Policy charges and fee income	-	-	-
Net investment income	-	-	-
Other income	-	-	-
Total revenues	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-
Interest credited	-	-	-
Interest expense	(133)	(139)	(145)
Acquisition & operating expenses	(2,312)	(2,668)	(3,247)
Amortization of acquisition costs (net)	-	-	-
Other expenses	-	-	-
Total expenses	**-**	**-**	**-**
Pretax income	3,569	3,871	4,028
Income taxes	873	(366)	(604)
Total net income	4,403	3,465	3,384
Total operating income	3,201	3,203	3,271
Weighted average diluted shares	379	378	379
EPS - operating	**8.45**	**8.48**	**8.64**

Income Statement - Quarterly	1Q24A	2Q24E	3Q24E	4Q24E
Earned premiums	-	-	-	-
Policy charges and fee income	-	-	-	-
Net investment income	-	-	-	-
Other income	-	-	-	-
Total revenues	**-**	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-	-
Interest credited	-	-	-	-
Interest expense	(34)A	(35)	(35)	(35)
Acquisition & operating expenses	(607)A	(668)	(681)	(712)
Amortization of acquisition costs (net)	-	-	-	-
Other expenses	-	-	-	-
Total expenses	**-**	**-**	**-**	**-**
Pretax income	1,221A	879	758	1,014
Income taxes	(101)A	(88)	(76)	(101)
Total net income	1,110A	781	672	903
Total operating income	933A	752	644	874
Weighted average diluted shares	381A	376	374	378
EPS - operating	**2.45A**	**2.00**	**1.72**	**2.31**

Balance Sheet and Capital Data	FY23A	FY24E	FY25E
Shareholders' equity	-	-	-
Shareholders' equity ex. AOCI	-	-	-
Shares outstanding	373	378	373
Book value per share	46.94	55.17	62.42
Book value per share (ex. AOCI)	48.75	57.34	64.63
Capital for share repurchases	-	-	-
Capital for dividends	-	-	-
Dividends	0.00	0.00	0.00

Ratio Analysis	FY23A	FY24E	FY25E	FY26E
EPS growth - operating	73.4%	0.4%	1.9%	-
Book value per share (ex. AOCI) growth	31.5%	17.6%	12.7%	-
Return on equity (ROE)	21.6%	16.7%	14.8%	-
Return on equity (ex. AOCI)	-	-	-	-
Dividend payout ratio	0.0%	0.0%	0.0%	-
Total revenue growth	-	-	-	-
Total expense growth	-	-	-	-
Tax rate	24.5%	9.5%	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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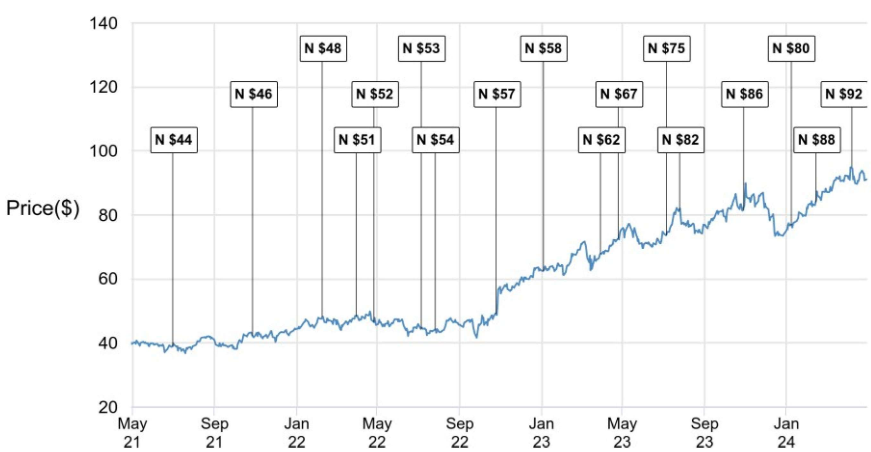
Arch Capital (ACGL, ACGL US) Price Chart



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-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
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

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