J.P.Morgan

North America Equity Research
26 October 2022

Arch Capital

High Cat Losses Mar Otherwise Healthy Business Trends

Neutral

ACGL, ACGL US

Price (26 Oct 22): $48.79

▲ **Price Target (Dec-23): $57.00**
Prior (Dec-23): $54.00

Insurance - Life & Nonlife

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ACGL's results were hurt by elevated cat losses, but underlying business trends were healthy. *ACGL had pre-announced cat losses last week, but we did not adjust our model following the announcement.*

- **EPS miss; raising estimates.** ACGL reported operating EPS of $0.28 compared with our assumption of $0.71 and consensus of $0.23. The shortfall to our model was driven by high cat losses (-$0.73 variance after taxes), partly offset by higher favorable prior-year development (+$0.17) and net investment income (+$0.10). We are raising our 4Q22 EPS forecast from $1.09 to $1.25 and our 2023 projection from $4.90 to $5.30, primarily to reflect higher investment income (in 4Q22 and 2023) as well as more favorable development in the MI business (in 4Q22).
- **Underlying business trends were healthy.** MI results were robust, while insurance and reinsurance results were pressured by high cat losses. Cats hurt reported margins (CR 97.3% vs. 88.3%E), but core margins were close to our assumption (CR ex. cats and PYD 82.2% vs. 82.3%E). MI results were marked by sizable favorable development but weak top-line growth. Insurance earnings were suppressed by cats, but core margins and premium growth were better than assumed. Reinsurance premiums were robust as well, but margins were poor (both reported and core). Investment income was lifted by the rise in interest rates. Written premiums rose 31%, above our 26% assumption. ACGL spent $10 million on share buybacks, below our $200 million estimate.
- **Our long-term outlook for ACGL is mixed.** We expect ACGL's results to be marked by healthy MI and re/insurance margins, strong re/insurance premiums, and weak MI premiums. Longer term, we project 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 we see margins compressing given the commoditized nature of the business, its black box pricing, and higher capital requirements. Conversely, despite the current hard market, our long-term view of the reinsurance business remains cautious given structural headwinds such as increased 3rd-party participation, higher mobility of capital, and broker consolidation. Arch has flexibility to supplement organic growth with share repurchases, but we expect the pace of buybacks to slow from recent levels.
- **We maintain 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 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.

Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 22E ($)	4.24	3.97
Adj. EPS - 23E ($)	4.90	5.30

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2021A	2022E	2023E
Q1	0.59	1.10A	
Q2	1.00	1.34A	
Q3	0.74	0.28A	
Q4	1.27	1.25	
FY	3.58	3.97	5.30

Style Exposure

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

3Q22 EPS: $0.28A vs. $0.71E

Positives
MI margins
Insurance core margins
Re/insurance premiums

Negatives
Reinsurance margins
Share repurchases

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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See page 12 for analyst certification and important disclosures.

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Price Performance

	YTD	1m	3m	12m
Abs	9.5%	17.1%	10.3%	13.1%
Rel	29.1%	12.3%	12.6%	29.3%

Company Data

Shares O/S (mn)	369
52-week range ($)	50.73-40.24
Market cap ($ mn)	18,019.22
Exchange rate	1.00
Free float(%)	96.6%
3M - Avg daily vol (mn)	1.50
3M - Avg daily val ($ mn)	69.1
Volatility (90 Day)	29
Index	S&P 500
BBG BUY|HOLD|SELL	11|2|0

Key Metrics (FYE Dec)

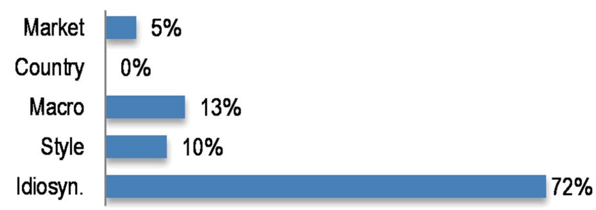
$ in millions	FY21A	FY22E	FY23E	FY24E
Financial Estimates				
NEP (Premium)	8,082	9,394	10,870	11,817
Underwriting income	1,218	1,486	1,840	2,110
Net investment income	389	402	381	419
Operating income	1,607	1,889	2,220	2,529
Adj. PBT	2,368	1,082	1,951	2,262
Adj. net income	1,435	1,432	1,754	2,041
Adj. EPS	3.58	3.97	5.30	5.94
BBG EPS	3.33	4.01	5.39	6.02
DPS	0.00	0.00	0.00	0.00
Investments	11,771	11,186	12,140	13,361
BVPS	33.56	32.84	36.74	41.63
NAVPS	33.56	32.84	36.74	41.63
Margins and Growth				
Adj. EPS growth	163.9%	10.8%	33.5%	12.1%
Ratios				
Adj. tax rate	5.4%	5.0%	8.0%	8.0%
Loss ratio	(53.5%)	(54.3%)	(53.1%)	(52.4%)
Combined ratio	(25.3%)	(24.3%)	(23.2%)	(22.6%)
Invest inc. % of Investments	-	-	-	-
Regulatory solvency ratio	-	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-	-
ROE	11.5%	11.6%	14.1%	15.1%
Valuation				
Dividend yield	0.0%	0.0%	0.0%	0.0%
Adj. P/E	13.6	12.3	9.2	8.2
P/ BV	1.5	1.5	1.3	1.2

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 reserve releases on COVID MI and BI claims as well as firm re/insurance pricing. Longer term, however, our outlook is mixed as we expect MI returns to be held back by the commoditized nature of the product, black box pricing, and higher capital requirements. Moreover, we remain negative on the P&C reinsurance business, and we forecast greater third-party participation, increased mobility of capital, and consolidation among brokers to preclude a prolonged hard market.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.42	0.33
Country: Bermuda	-0.04	0.10
Macro:		
JP Morgan GBI-EM Global Div	0.25	0.27
JP Morgan EMBI Global Spread	-0.16	-0.21
HSI Volatility Index	-0.03	-0.17
Quant Styles:		
Quality	0.39	0.26
Size	0.39	0.18
Momentum	-0.01	0.15

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 3Q22 results.

ACGL will hold its earnings conference call at 11:00 AM Eastern on October 27, 2022.

Conference call participants need to register at this link: https://register.vevent.com/register/BIa7ea95074caf4d93bea16ccfdc6856f5.

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

We consider ACGL a premier franchise but are Neutral on the stock given our cautious long-term outlook for the reinsurance market. ACGL has an industry-leading reinsurance business with a unique culture and approach to underwriting that we expect to drive superior returns and less volatile margins over time. Also, Arch is a top competitor in the mortgage insurance (MI) market, which we think is structurally better than reinsurance. In primary P&C, ACGL has gained share and expanded margins, helped by the favorable pricing environment. In the near term, ACGL's results should benefit from reserve releases in the MI book and healthy re/insurance margins given hard reinsurance P&C pricing. Higher rates are hurting MI volumes but should boost investment income. Longer-term, we remain cautious on the reinsurance market given structural factors such as low barriers to entry and limited pricing power. Also, ACGL's valuation is not enticing considering its long-term ROE and growth potential as well as multiples for MI and reinsurance peers.

Mortgage Insurance: Growth to Be Weak, Margins Healthy

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

P&C Reinsurance: N-T Encouraging, L-T Cautious

Expected hardening of reinsurance pricing is a positive, but our long-term outlook for the market remains cautious. Arch has historically produced higher and less volatile reinsurance margins than most 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. Also, the creation of third-party capital vehicles such as Premia Re has allowed Arch to earn fee income from its reinsurance franchise. Although we view Arch as a top-tier reinsurer and expect firmer reinsurance pricing should boost results through 2023, our long-term outlook for the reinsurance market remains cautious given structural headwinds, including the commoditized nature of the product, ease of entry of new capital, and a broader set of capital providers (many, such as pension funds, that have lower return thresholds). Hence, we are skeptical of a prolonged hard market. Moreover, 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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3Q22 Details

This evening, ACGL announced 3Q22 operating EPS of $0.28 compared with our assumption of $0.71 and consensus of $0.23. Compared with our model, MI results beat, helped by favorable reserve development, while insurance and reinsurance missed, primarily due to higher than initially assumed cat losses. Investment income was significantly better than assumed as well. MI results were marked by sizable favorable development but weak top-line growth. Insurance earnings were suppressed by cats, but core margins and premium growth were better than assumed. Reinsurance premiums were robust as well, but margins were poor (both reported and core). Investment income was lifted by the rise in interest rates.

ACGL had pre-announced cat losses last week, but we did not adjust our model following the announcement. This note compares reported results with our initial assumptions, which we feel better reflects underlying business trends. Comparisons with the consensus number are not valid as it included a hodgepodge of projections adjusted and not adjusted for the pre-announcement.

Table 1: 3Q22 Operating Earnings: Actual vs. Expected

$ in millions, except per share amounts

	3Q22E	3Q22A	Upside / (downside) to EPS	Comments
Underwriting Income by Division				
Mortgage	255	299	$0.12	favorable PYD (45.1% vs. 26.0%E) and strong core margins more than offset
Insurance	19	(34)	-$0.14	cat losses drove miss; core margins and premium growth better than expected
Reinsurance	14	(197)	-$0.57	cat losses elevated, core margins weaker; strong premium growth was a positive
Underwriting income	**288**	**69**	**-$0.59**	
Net investment income	86	129	$0.11	pretax investment yield of 2.06% in 3Q22 vs.1.76% in 2Q22 and 1.41% in 3Q21
Earnings from affiliates	8	9	$0.00	
Other income (losses) / COLI	(3)	(15)	-$0.03	poor equity market performance in COLI account
Other expenses / corporate	48	44	$0.01	lower corporate expenses
Interest expense	33	33	$0.00	
Pretax operating income	**298**	**114**	**-$0.49**	
Income tax expense	24	(2)	$0.07	tax benefit vs. assumed tax rate of 8.0%E
Preferred dividends	10	10	$0.00	
Operating income	**264**	**106**	**-$0.42**	
Weighted average dilutive shares	372.8	373.7	$0.00	share buybacks of $10 million versus our $200 million estimate
Operating EPS	**$0.71**	**$0.28**	**-$0.43**	

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

Underlying business trends were healthy. Mortgage insurance results were robust, while insurance and reinsurance results were pressured by high cat losses. Catastrophe losses hurt reported margins (CR 97.3% vs. 88.3%E), but core margins were close to our assumption (CR ex. cats and PYD 82.2% vs. 82.3%E). Written premiums and investment income exceeded our expectations as well. Conversely, share repurchases were lower.

Table 2: 3Q22 Key Financial Metrics

$ in millions

	3Q22E	3Q22A
Net premiums written	2,625	2,724
% change (y-o-y)	26.5%	31.2%
Net investment income	86	129
% change (y-o-y)	-2.5%	45.9%
Loss ratio ex cats and PYD	51.2%	53.0%
Catastrophe losses	10.4%	22.3%
PYD (favorable) / unfavorable	-4.4%	-7.2%
Loss ratio	57.1%	68.1%
Expense ratio	31.1%	29.2%
Combined ratio	88.3%	97.3%
Combined ratio ex cats & PYD	82.3%	82.2%
Share buybacks ($ mil.)	200	10

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

Mortgage Ins.: Earnings Lifted by Reserve Release

We expect growth in the MI business to be weak, but margins should remain robust in the near term. The MI business reported underwriting income of $299 million, higher than our $255 million estimate, with upside in margins (combined ratio of -5.2% versus our 14.5% estimate) more than offsetting lower net earned premiums (-9.6% vs. -6.1%E). As in recent quarters, margins benefited from favorable development on COVID-related reserves (-45.1% vs. -26.0%E). Margins were better on a core basis as well (CR ex. cats and PYD 39.9% vs. 40.5%E). Net written premiums declined 8.2% to $276 million, worse than our expectation.

In 2020 and early 2021, MI margins were pressured by artificially high delinquencies attributable to homeowners availing themselves of government forbearance programs. However, after spiking initially in 2Q20, the number of delinquent loans has steadily declined, benefiting MI margins. 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, the significant appreciation in house prices has afforded a cushion to homeowners under stress who are truly struggling to pay their mortgages, limiting losses for MI carriers. The percent of loans in default in the U.S. primary MI business was 1.7% at 9/30/22, an improvement from 1.8% at 6/30/22, 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.

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Table 3: Mortgage: Key Metrics

$ in millions

	3Q20	4Q20	2020	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22E	3Q22A
Net written premiums	298	332	1,280	335	336	301	289	1,261	288	294	292	276
Premium Growth (y/y)	-6.0%	5.1%	1.4%	3.3%	3.3%	0.8%	-12.8%	-1.5%	-14.0%	-12.5%	-2.8%	-8.2%
Losses and LAE ex. cats and	44.9%	27.3%	39.2%	22.3%	16.1%	19.2%	14.8%	18.2%	17.6%	18.8%	18.0%	21.0%
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	-1.3%	-2.4%	-1.4%	-3.4%	-13.1%	-15.5%	-24.2%	-13.7%	-36.5%	-40.7%	-26.0%	-45.1%
Loss ratio	**43.6%**	**24.9%**	**37.8%**	**18.9%**	**3.0%**	**3.7%**	**-9.4%**	**4.4%**	**-18.9%**	**-21.9%**	**-8.0%**	**-24.1%**
Acquisition expense ratio	10.2%	7.7%	9.6%	8.9%	9.0%	7.7%	4.4%	7.6%	3.6%	3.4%	4.5%	2.4%
Operating expense ratio	10.4%	12.5%	11.6%	14.6%	14.5%	14.8%	16.7%	15.1%	18.4%	17.0%	18.0%	16.5%
Expense ratio	**20.6%**	**20.2%**	**21.2%**	**23.6%**	**23.5%**	**22.6%**	**21.1%**	**22.7%**	**22.1%**	**20.4%**	**22.5%**	**18.8%**
Combined ratio	**64.2%**	**45.1%**	**59.0%**	**42.4%**	**26.5%**	**26.3%**	**11.6%**	**27.1%**	**3.2%**	**-1.5%**	**14.5%**	**-5.2%**
Combined ratio ex cats & PYD	65.5%	47.5%	60.4%	45.8%	39.6%	41.8%	35.8%	40.9%	39.7%	39.2%	40.5%	39.9%
Underwriting Income (Loss)	**131**	**189**	**593**	**200**	**250**	**234**	**269**	**953**	**285**	**298**	**255**	**299**

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

In our view, MI margins will continue to benefit from additional reserve releases. Under U.S. GAAP accounting, Arch sets 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 led 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, most of these delinquent loans have 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 healthy 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, although a material increase in losses seems unlikely in the near term.

ACGL has become a formidable competitor in the mortgage insurance market through acquisitions and could expand further via M&A. 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 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). Arch has also expanded in foreign MI markets through M&A, including its recent acquisition of Westpac's mortgage insurance business in Australia (closed in August 2021).

Insurance: Cats Drove Miss, Core Margins Strong

The insurance business reported elevated cat losses but better than expected core margins and robust premium growth. The division generated an underwriting loss of $34 million in 3Q22, worse than expected income of $19 million, driven primarily by cat losses ($159 million vs. $84 million est.). ACGL had pre-announced catastrophe losses on October 18, but we did not adjust our model following the announcement. On a core basis, underwriting results were better, marked by upside in net written premium growth (+18.6% vs. +17.6%E) and stronger margins (CR ex. cats and PYD of 89.5% vs. 91.7%E). Both the accident year loss ratio (56.0% vs. 56.2%E) and the expense ratio (33.5% vs, 35.5%E) were more favorable than our assumption. Similar to the past few quarters, the acquisition expense ratio rose from the prior year due to a business mix shift to lines such as travel and professional liability that have higher expense ratios, partly offset by a lower operating expense ratio given the benefit of high premium growth.

Table 4: Insurance: Key Metrics

$ in millions

	3Q20	4Q20	2020	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22E	3Q22A
Net written premiums	824	838	3,163	995	964	1,154	1,036	4,148	1,207	1,228	1,356	1,369
Premium Growth (y/y)	17.1%	21.6%	19.7%	20.0%	43.3%	40.0%	23.7%	31.2%	21.3%	27.5%	17.6%	18.6%
Losses and LAE ex. cats and	62.9%	64.3%	63.6%	61.0%	60.2%	59.5%	57.5%	59.5%	55.5%	56.0%	56.2%	56.0%
Catastrophe losses	10.3%	8.3%	9.5%	5.1%	3.2%	12.2%	2.0%	5.6%	3.1%	1.5%	7.0%	13.4%
PYD (favorable) / unfavorable	-0.2%	-0.2%	-0.2%	-0.7%	-0.3%	-0.5%	-0.3%	-0.4%	-0.1%	-0.4%	-0.3%	-0.1%
Loss ratio	**73.0%**	**72.4%**	**72.9%**	**65.4%**	**63.1%**	**71.2%**	**59.2%**	**64.6%**	**58.5%**	**57.1%**	**63.0%**	**69.3%**
Acquisition expense ratio	14.2%	13.5%	14.6%	15.6%	15.8%	16.2%	18.8%	16.7%	19.1%	19.4%	19.5%	19.6%
Operating expense ratio	17.0%	15.8%	17.0%	16.7%	15.4%	14.8%	14.9%	15.4%	16.2%	14.6%	16.0%	13.9%
Expense ratio	**31.3%**	**29.3%**	**31.6%**	**32.4%**	**31.2%**	**31.0%**	**33.7%**	**32.1%**	**35.3%**	**34.0%**	**35.5%**	**33.5%**
Combined ratio	**104.2%**	**101.7%**	**104.5%**	**97.7%**	**94.3%**	**102.3%**	**93.0%**	**96.8%**	**93.8%**	**91.1%**	**98.5%**	**102.8%**
Combined ratio ex cats & PYD	94.1%	93.6%	95.2%	93.3%	91.4%	90.6%	91.3%	91.6%	90.8%	90.0%	91.7%	89.5%
Underwriting Income (Loss)	**(31)**	**(13)**	**(129)**	**18**	**49**	**(21)**	**71**	**117**	**63**	**98**	**19**	**(34)**

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 upbeat. 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

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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, although favorable tailwinds in the insurance business should persist as premiums are earned and certain lines of business are likely to see harder pricing following Hurricane Ian (e.g., property coverage), we expect overall price increases to moderate through 2023.

Reinsurance1: N-T Outlook Positive, L-T Outlook Downbeat

The reinsurance business reported poor margins but strong premium growth. Underwriting losses in 3Q22 were $197 million, worse than expected income of $14 million, driven primarily by cat losses ($392 million vs. $166 million est.). ACGL had pre-announced catastrophe losses on October 18, but we did not adjust our model for these. Management indicated that its catastrophe loss pick for the reinsurance business was more top-down driven and assumes industry insured losses of $50-60 billion. Reinsurance margins were weaker than assumed excluding cats and PYD as well, with a higher AY loss ratio (58.4% vs. 55.2E%) more than offsetting a lower expense ratio (27.1% vs. 28.3%E). ACGL attributed the year-on-year increase in the expense ratio to more quota share business in the quarter, which has a higher ceding commission than excess of loss, partly offset by a lower operating expense ratio. On a positive note, net written premium growth was robust, up 73.6% to $1.1 billion, well above our 57.1% expectation. Management indicated that unlike some of its reinsurance peers, it is eager to increase its exposure to property cat given even more favorable pricing conditions following Hurricane Ian.

Table 5: Reinsurance: Key Metrics

$ in millions

	3Q20	4Q20	2020	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22E	3Q22A
Net written premiums	604	491	2,457	999	925	621	709	3,254	1,139	1,163	976	1,079
Premium Growth (y/y)	38.4%	44.9%	53.3%	25.3%	63.6%	2.8%	44.5%	32.4%	14.0%	25.7%	57.1%	73.6%
Losses and LAE ex. cats and	60.2%	58.0%	61.8%	56.3%	62.9%	57.4%	54.9%	57.9%	52.6%	55.3%	55.2%	58.4%
Catastrophe losses	23.3%	16.1%	19.1%	22.7%	2.5%	32.6%	6.7%	15.4%	6.7%	7.1%	18.0%	39.1%
PYD (favorable) / unfavorable	-7.4%	-6.9%	-5.6%	-3.8%	-2.5%	-9.6%	-6.4%	-5.6%	-2.8%	-4.5%	-3.0%	-4.9%
Loss ratio	**76.1%**	**67.2%**	**75.3%**	**75.2%**	**62.9%**	**80.4%**	**55.2%**	**67.8%**	**56.5%**	**57.9%**	**70.2%**	**92.6%**
Acquisition expense ratio	15.4%	16.9%	16.4%	18.3%	18.1%	19.1%	20.0%	18.9%	21.4%	20.4%	20.3%	20.8%
Operating expense ratio	7.5%	7.2%	7.8%	9.4%	6.1%	6.7%	7.9%	7.5%	8.7%	7.1%	8.0%	6.3%
Expense ratio	**22.9%**	**24.1%**	**24.1%**	**27.7%**	**24.2%**	**25.8%**	**27.9%**	**26.4%**	**30.1%**	**27.5%**	**28.3%**	**27.1%**
Combined ratio	**99.0%**	**91.3%**	**99.5%**	**102.9%**	**87.1%**	**106.2%**	**83.1%**	**94.2%**	**86.6%**	**85.5%**	**98.5%**	**119.7%**
Combined ratio ex cats & PYD	83.1%	82.1%	85.9%	84.0%	87.1%	83.2%	82.8%	84.3%	82.7%	82.9%	83.5%	85.5%
Underwriting Income (Loss)	**6**	**53**	**16**	**(20)**	**96**	**(39)**	**133**	**170**	**109**	**139**	**14**	**(197)**

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

We remain cautious on the reinsurance market longer term but expect Arch Re to generate superior results 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 toward other specialty lines such as surety, accident and health, agriculture, and trade credit, which are generally less competitive and have more attractive risk-reward. Firm pricing has benefited results in recent years and should drive continued strong premiums and margins in the near term, especially following Hurricane Ian. Still, we expect the pace of price hikes to moderate longer term and remain skeptical of a sustained hard market given the expected entry of additional capital into 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. Separately, we are skeptical of industry catastrophe models as they have consistently under-estimated the frequency and severity of catastrophe events, resulting in overall rate inadequacy. On a positive note, ACGL's reinsurance results could benefit from the release of COVID-related reserves, a significant proportion of which remain in IBNR.

Raising EPS Estimates

We are raising our 4Q22 EPS estimate from $1.09 to $1.25 and our 2023 forecast from $4.90 to $5.30. Meanwhile, our 2022 EPS projection is declining from $4.24 to $3.97 due to downside in 3Q22 results. Our updated model reflects higher than previously assumed net investment income (in 4Q22 and 2023) and more favorable prior-year development in the MI business (in 4Q22), partly offset by a higher beginning share count for future periods due to lower share buybacks in 3Q22. In our view, catastrophe losses (which would affect reinsurance and insurance margins) and housing market trends (which affect MI margins and premium growth) are the key sources of potential variance in reported results and our projections.

Investment Thesis, Valuation and Risks

Arch Capital Group Ltd. *(Neutral; Price Target: $57.00)*

Investment Thesis

We consider Arch a premiere franchise, but we remain Neutral on the stock given our cautious outlook for the insurance market. We believe that ACGL has an industry-leading reinsurance business that will generate 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 structurally better than P&C reinsurance. In insurance, ACGL has been able to grow premiums and improve margins, helped by the firm pricing market. We expect near-term results in the MI business to benefit from reserve release. Additionally, healthy P&C pricing should boost premium growth and margins in the insurance and reinsurance segments. Still, our long-term outlook for the reinsurance business is cautious due to structural issues facing the market, including low barriers to entry, increased participation by third-party capital, and limited pricing power. Furthermore, 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 Dec 2023 price target from $54 to $57 to reflect updates to our EPS and book value forecasts**.** Our price target assumes a 1.3x multiple on our 12/31/23E BV ex. AOCI forecast, a 1.4x 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 1.5x BV and 9.2x 2023E EPS compared to 1.2x and 7.7x for the reinsurance sector, 0.9x and 6.3x for MI peers, and 1.8x and 12.7x 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, 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, higher mortgage defaults, and decreasing home values 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 have 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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Arch Capital (ACGL, ACGL US) Price Chart

Date	Rating	Price ($)	Price Target ($)
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
27-Jul-22	N	44.24	54

Source: Bloomberg Finance L.P. and J.P. Morgan; price data adjusted for stock splits and dividends.
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