J.P.Morgan

North America Equity Research
31 October 2024

Arch Capital

High Reinsurance Cat Losses Offset Robust MI Margins

Arch reported mixed 3Q24 results as weakness in the reinsurance business offset upside in MI and insurance. Our long-term outlook for ACGL remains positive and we view it as the best name for investors seeking to take advantage of the hard reinsurance market. Still, concerns about optimistic EPS estimates and valuation keep us Neutral on the stock.

- **EPS beat consensus, but below our forecasts; maintaining estimates.** ACGL announced 3Q24 operating EPS of $1.99, above consensus of $1.95, but below our $2.14 estimate. The shortfall to our model was driven by higher cat losses (-$0.53 worse), primarily in the reinsurance business, which more than offset lower re/insurance attritional losses and stronger than assumed MI results. Management attributed the uptick in cat losses primarily to international events, partly given the location of large cats and in part due to Arch's expanded presence in foreign markets. Unlike U.S. and Bermuda business, where reinsurance attachment points have increased, Arch participates in foreign treaties on a pro rata basis. Still, the cat load in the reinsurance business was at the highest level in the past two years. This, along with strong margins in MI, are the key drivers of us maintaining EPS forecasts.
- **Business fundamentals were strong overall.** Reinsurance results were pressured by high cat losses (19.3 points on CR vs. our 9.0% assumption), which more than offset strong underlying margins (CR ex. cats and PYD 74.8% vs. 80.2%E). Insurance division earnings beat due to stronger premiums. Insurance margins were close to our expectation on a reported basis (CR 93.2% vs. 93.1%E) and better on a core basis (89.0% vs. 91.0%E). As in recent quarters, MI margins were robust (CR 15.0% vs. 20.9%E), helped by reserve releases on recent years. Consistent with our assumption, Arch did not repurchase stock in 3Q. Management's tone on business trends was positive.
- **We expect ACGL's results to be strong in the near term, but our long-term outlook is less upbeat.** Our model projects ACGL to report robust margins, but modest top-line growth in its reinsurance and mortgage insurance businesses. Reinsurance margins should benefit from the uptick in prices and favorable terms (higher attachment points, lack of aggregate covers), while MI margins should be helped by elevated house prices and the strong labor market. Top line growth should be strong in the primary insurance business, but weak in MI. Meanwhile, we do not expect ACGL to repurchase shares given its stock price. Moreover, despite our near-term optimism, we do not expect margins in the reinsurance or MI businesses to sustain at recent levels in the long run.
- **We rate Arch Neutral.** In our view, ACGL is a top-tier franchise, but in commoditized markets. Hard reinsurance pricing and favorable housing and labor market conditions should enable Arch to generate strong results in the near term, but we do not expect the company's margins and ROE to sustain at recent levels in the long run. Moreover, we feel that ACGL's valuation is not attractive given its long-term ROE and EPS growth potential.

Neutral

ACGL, ACGL US
Price (30 Oct 24):$105.14
Price Target (Dec-25):$110.00

Insurance - Life & Nonlife

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Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2023A	2024E	2025E
Q1	1.73	2.45A	
Q2	1.92	2.57A	
Q3	2.31	1.99A	
Q4	2.49	2.35	
FY	8.45	9.36	8.69

Style Exposure

Quant Factors	Current %Rank	Hist %Rank (1=Top) 6M	1Y	3Y	5Y
Value	100	100	100	100	100
Growth	1	51	51	100	1
Momentum	1	1	1	51	100
Quality	51	51	1	1	1
Low Vol	1	1	1	51	1
ESGQ	12	12	13	91	97

3Q24 EPS: $1.99A vs. $2.14E

Positives: MI margins; insurance premiums

Negatives: re/insurance cat losses

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	41.6%	-6.0%	7.1%	26.9%
Rel	19.7%	-6.9%	0.1%	-12.7%

Company Data

Shares O/S (mn)	376
52-week range ($)	116.47-72.85
Market cap ($ mn)	39,553.67
Exchange rate	1.00
Free float (%)	96.6%
3M ADV (mn)	1.55
3M ADV ($ mn)	166.5
Volatility (90 Day)	23
Index	S&P 500
BBG ANR (BUY|HOLD|SELL)	12|4|1

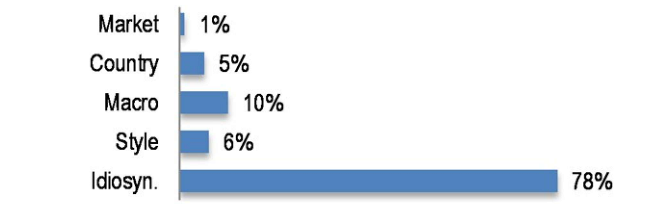
Key Metrics (FYE Dec)

$ in millions	FY23A	FY24E	FY25E	FY26E
Financial Estimates				
NEP (Premium)	12,440	14,889	17,093	18,530
Underwriting income	2,612	2,798	2,846	2,890
Net investment income	1,023	1,532	1,947	2,204
Operating income	3,635	4,330	4,793	5,094
Adj. PBT	3,569	4,903	4,923	5,249
Adj. net income	3,201	3,619	3,534	3,780
Adj. EPS	8.45	9.36	8.69	9.28
BBG EPS	7.96	8.99	9.03	9.42
DPS	0.00	1.25	1.00	1.00
Investments	16,792	18,975	22,740	25,883
BVPS	46.94	54.32	63.71	72.61
NAVPS	46.94	54.32	63.71	72.61
Margins and Growth				
Adj. EPS growth	73.4%	10.8%	(7.2%)	6.8%
Ratios				
Adj. tax rate	24.5%	8.5%	15.0%	15.0%
Loss ratio	(50.2%)	(54.0%)	(55.4%)	(56.4%)
Combined ratio	(21.4%)	(26.7%)	(27.5%)	(28.4%)
Invest inc. % of Investments	-	-	-	-
Regulatory solvency ratio	-	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-	-
ROE	21.6%	19.1%	15.8%	14.7%
Valuation				
Dividend yield	0.0%	1.2%	1.0%	1.0%
Adj. P/E	12.4	11.2	12.1	11.3
P/ BV	2.2	1.9	1.7	1.4

Summary Investment Thesis and Valuation

We rate Arch Neutral. Arch is a leading re/insurance franchise with a track record of higher and less volatile underwriting margins than most peers. Hard pricing and tighter terms/ conditions should boost underwriting results in the reinsurance business in the near term. Meanwhile, near-term results in the MI business should benefit from low attritional losses and reserve releases. On the other hand, our long-term outlook for the reinsurance market is cautious. This, along with current valuation, keeps us Neutral on ACGL.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.08	-0.08
Country: Bermuda	-0.11	-0.22
Macro:		
US 10 Year Yield	0.18	0.22
JPM China A-shares Sentiment	0.32	0.21
Emerging Central Bank Rate	0.24	0.21
Quant Styles:		
Momentum	0.25	0.27
Value	0.30	0.23
DivYld	0.30	0.20

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 3Q24 results. ACGL will hold its earnings conference call at 11:00 AM Eastern on October 31, 2024. Conference call participants need to register at this link: edge.media-server.com/mmc/p/52ojwcq3/. The call replay can be accessed at: ir.archcapgroup.com.

We rate ACGL Neutral given bullish sentiment and valuation, but we consider it the best stock for investors seeking exposure to the firm reinsurance pricing theme. Arch 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, Arch has expanded its position in wholesale/E&S through the current hard market and the acquisition of MidCorp should bolster its middle market franchise. Our near term outlook for Arch is upbeat, and we expect its results to benefit from firm prices and tight terms/conditions in re/insurance as well as ongoing reserve releases in mortgage insurance. However, our longer term is more muted and we expect reinsurance prices to soften over the next 1-2 years if underwriting margins stay close to recent levels. The reinsurance market suffers from structural issues such as low barriers to entry, lack of differentiation among carriers, and limited pricing power, all of which suggest more competition if margins stay elevated. Furthermore, investor sentiment on ACGL seems very bullish, and we feel that the stock's valuation already reflects optimism for near-term results. Still, our fundamental outlook for the company remains constructive and we could get more bullish on the stock if it pulls back.

P&C Reinsurance: Firm Pricing to Lift Near-Term Results

In our view, ongoing firm pricing and terms will drive robust margins in the reinsurance business over the next year. ACGL has historically generated better and less volatile margins than most reinsurers because of 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 addition, ACGL prices business using the risk-free rate (leading to conservative pricing), deploys a long-term compensation plan for underwriters based on margins over multiple years, and supplements re/insurance underwriting earnings with fee income from 3rd party capital vehicles such as Premia. **Still, our long-term outlook for reinsurance remains cautious** 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 prolonged hard pricing and believe that 1-2 years of strong margins will likely erode pricing discipline. As such, we anticipate an eventual softening of pricing and terms, especially in higher reinsurance layers, 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 Modest

ACGL grew in mortgage insurance via acquisitions (CMG in 2014 and United Guaranty in 2016) when market conditions were favorable, marked by rising home prices, stringent lending standards, and disciplined pricing by MI carriers. Arch's MI business has generated 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 next few quarters, but normalize over time as reserve releases taper off. Results in the next few quarters should benefit from ACGL's conservative loss picks post-COVID, the strong labor market, and the increase house prices. Meanwhile, lower rates bode well for new sales, although they should weigh on persistency.

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3Q24 Details

Yesterday evening, Arch reported third quarter 2024 operating EPS of $1.99, above consensus of $1.95, but below our $2.14 estimate. The shortfall to our model was driven by higher cat losses (-$0.53 worse), primarily in the reinsurance business, which more than offset lower re/insurance attritional losses and stronger than assumed MI results. By division, MI results beat on strong margins, insurance earnings were lifted by upside in premiums, and reinsurance results fell short on high cat losses.

Table 1: 3Q24 Operating Earnings: Actual versus Expected

$ in millions, except per share amounts

	3Q24E	3Q24A	Upside / (downside) to EPS	Comments
Underwriting Income by Division:				
Mortgage	217	269	$0.14	net written premiums +4.1% vs. +2.2%E; combined ratio 15.0% vs. 20.9%E
Insurance	107	120	$0.03	net written premiums +19.6% vs. +9.4%E; combined ratio 93.2% vs. 93.1%E
Reinsurance	258	149	-$0.28	net written premiums +24.5% vs. 19.9%E; combined ratio 92.2% vs. 86.0%E
Underwriting income	**581**	**538**	**-$0.11**	net written premiums +20.6% vs. +13.7%E; combined ratio 86.6% vs. 84.2%E
Net investment income	383	399	$0.04	pre-tax investment yield of 4.40% in 3Q24 versus 4.39% in 2Q24 and 3.68% in 3Q23
Earnings from affiliates	40	36	-$0.01	
Other income (losses) / COLI	1	38	$0.10	
Other expenses / corporate	51	137	-$0.22	
Interest expense	35	35	$0.00	
Pretax operating income	**919**	**839**	**-$0.21**	
Income tax expense	92	67	$0.07	tax rate of 8.0% vs. 10.0%E
Preferred dividends	10	10	$0.00	
Operating income	**817**	**762**	**-$0.14**	
Weighted average dilutive shares	382.3	382.3	$0.00	no share buybacks as expected
Operating EPS	**$2.14**	**$1.99**	**-$0.14**	**no major unusual items**

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

Business trends were healthy overall. Reinsurance results were pressured by high cat losses (19.3 points on CR vs. our 9.0% assumption), which more than offset strong underlying margins (CR ex. cats and PYD 74.8% vs. 80.2%E). Insurance division earnings beat due to stronger premiums. Insurance margins were close to our expectation on a reported basis (CR 93.2% vs. 93.1%E) and better on a core basis (89.0% vs. 91.0%E). As in recent quarters, MI margins were robust (CR 15.0% vs. 20.9%E), helped by reserve releases on recent years. Investment income was better than expected as well, and benefited from assets acquired as part of the MidCorp deal. Consistent with our assumption, Arch did not repurchase stock in the third quarter.

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Table 2: 3Q24 Key Financial Metrics

$ in millions

	3Q24E	3Q24A
Net premiums written	3,815	4,047
% change (y-o-y)	13.7%	20.6%
Net investment income	383	399
% change (y-o-y)	42.6%	48.3%
Loss ratio ex cats and PYD	53.3%	52.2%
Catastrophe losses	5.6%	11.4%
PYD (favorable) / unfavorable	-3.3%	-3.0%
Loss ratio	55.6%	60.5%
Expense ratio	28.6%	26.0%
Combined ratio	84.2%	86.6%
Combined ratio ex cats & PYD	81.9%	78.2%
Share buybacks ($ mil.)	-	-

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

Mortgage Ins.: Robust Margins Lifted Earnings

We forecast the mortgage insurance (MI) business to report modest premium growth, high persistency, and robust (albeit normalizing) margins. Higher interest rates are a headwind for mortgage insurance volumes, while reserve releases should moderate over time. Still, MI results have been significantly above expectations in recent periods and we feel that there is a greater chance of upside to our prospective forecasts than downside. In addition, earned premium growth should benefit from higher retention following the cancelation of the Bellemeade transactions, while a decline in rates should be a positive for new business volumes.

In 3Q24, the MI business generated underwriting income of $269 million, well above our $217 million estimate, driven by better margins (CR 15.0% vs. 20.9%E) and higher earned premium growth (+6.8% vs. -7.4%E). The upside in margins resulted from higher reserve releases (-22.8% vs. -20.0%E), a lower attritional loss ratio (22.5% vs. 24.0%E), and a lower expense ratio (15.3% vs. 16.9%E). Similar to 2Q24, the company attributed the reserve releases to favorable cure rates (primarily on mortgages issued at attractive rates in the past few years). On a negative note, the attritional loss ratio was higher than the 3Q23 level, which management noted was due to higher delinquencies. Gross premiums were lackluster (12th consecutive quarter of decline), but net written and net earned premium growth benefited from the termination of the Bellemeade agreements in 4Q23. We believe that the factors boosting margins in the Mortgage Insurance business (higher rates, lower inventory of houses, etc.) will continue suppressing gross premium growth.

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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 have cured, particularly loans by borrowers who were taking advantage of the mortgage payment holiday but were not in financial distress. In addition, 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 1.96% at 9/30/2024, up from 1.82% at 6/30/2024 and 1.65% at 9/30/23.

Table 3: Mortgage Insurance Key Metrics

$ in millions

	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24	3Q24E	3Q24A
Net written premiums	276	275	1,133	261	265	271	255	1,052	277	276	277	282
Premium Growth (y/y)	-8.2%	-5.1%	-10.2%	-9.4%	-9.8%	-1.9%	-7.1%	-7.1%	6.1%	4.2%	2.2%	4.1%
Losses and LAE ex. cats and PYD	21.0%	25.2%	20.7%	25.3%	24.3%	21.6%	18.3%	22.4%	22.7%	20.2%	24.0%	22.5%
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	-45.1%	-72.1%	-48.6%	-24.6%	-28.7%	-33.5%	-39.0%	-31.3%	-25.7%	-29.0%	-20.0%	-22.8%
Loss ratio	**-24.1%**	**-46.9%**	**-28.0%**	**0.7%**	**-4.4%**	**-11.9%**	**-20.7%**	**-8.9%**	**-3.0%**	**-8.8%**	**4.0%**	**-0.3%**
Acquisition expense ratio	2.4%	4.4%	3.5%	2.4%	2.4%	0.7%	0.4%	1.5%	0.0%	0.0%	0.4%	-0.3%
Operating expense ratio	16.5%	15.4%	16.8%	16.9%	17.0%	16.0%	17.1%	16.8%	17.4%	16.0%	16.5%	15.7%
Expense ratio	**18.8%**	**19.8%**	**20.3%**	**19.3%**	**19.4%**	**16.7%**	**17.5%**	**18.2%**	**17.4%**	**16.0%**	**16.9%**	**15.3%**
Combined ratio	**-5.2%**	**-27.1%**	**-7.7%**	**19.9%**	**15.0%**	**4.8%**	**-3.3%**	**9.3%**	**14.4%**	**7.2%**	**20.9%**	**15.0%**
Combined ratio ex cats & PYD	39.9%	45.0%	41.0%	44.5%	43.7%	38.3%	35.7%	40.6%	40.1%	36.2%	40.9%	37.8%
Underwriting Income (Loss)	**299**	**374**	**1,257**	**243**	**253**	**282**	**286**	**1,064**	**271**	**287**	**217**	**269**

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

We expect reserve releases to continue to lift MI margins, although the tailwind should moderate over time. 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 represented homeowners taking advantage of the government's forbearance protection programs (to preserve liquidity), not actual financial hardship. Thus, actual losses ultimately came in well below those suggested by initial delinquencies, allowing ACGL to release reserves. In more recent quarters, over 80% of MI reserves have been from accident years after COVID, suggesting a waning benefit from COVID-related reserve releases. Even with this 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. On a cautious note, 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 stay favorable.

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ACGL has become a leading competitor in the MI market through acquisitions, and could expand further via M&A, but we do not anticipate deals 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: Results Lifted by the MidCorp Deal

The insurance business reported higher premium growth and an in-line combined ratio. The insurance division generated underwriting income of $120 million in 3Q24, above our $107 million estimate. Margins were relatively consistent with our estimates on a reported basis (CR 93.2% vs. 93.1%E), but better on a core basis (CR ex. cats and PYD 89.0% vs. 91.0%E). Lower expenses (31.6% vs. 35.5%E) and higher reserve releases (-0.7% vs. -0.4%E) were offset by higher catastrophe losses (4.9% vs. 2.5%E) and higher attritional losses (57.4% vs. 55.5%E). Gross written premium growth (+14.6% vs. +10.0%E), net written premium growth (+19.6% vs. +9.4%E), and net earned premium growth (+25.0% vs. +9.6%E) were significantly higher than expected. The expense ratio benefited 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).

Table 4: Insurance Key Metrics

$ in millions

	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24	3Q24E	3Q24A
Net written premiums	1,369	1,217	5,021	1,437	1,454	1,522	1,449	5,862	1,542	1,558	1,666	1,820
Premium Growth (y/y)	18.6%	17.4%	21.0%	19.1%	18.4%	11.2%	19.1%	16.8%	7.3%	7.2%	9.4%	19.6%
Losses and LAE ex. cats and PYD	56.0%	56.2%	56.0%	54.8%	55.2%	55.7%	55.1%	55.2%	57.5%	55.6%	55.5%	57.4%
Catastrophe losses	13.4%	2.8%	5.3%	1.6%	2.6%	2.6%	3.8%	2.7%	1.9%	2.0%	2.5%	4.9%
PYD (favorable) / unfavorable	-0.1%	-0.3%	-0.2%	-0.5%	-0.5%	-0.8%	-0.5%	-0.6%	-0.5%	-0.2%	-0.4%	-0.7%
Loss ratio	**69.3%**	**58.7%**	**61.0%**	**55.9%**	**57.3%**	**57.5%**	**58.4%**	**57.3%**	**58.9%**	**57.4%**	**57.6%**	**61.6%**
Acquisition expense ratio	19.6%	19.6%	19.4%	19.5%	19.9%	19.1%	19.1%	19.4%	19.0%	19.5%	19.5%	17.5%
Operating expense ratio	13.9%	13.8%	14.6%	15.5%	14.7%	14.3%	15.7%	15.0%	16.2%	15.8%	16.0%	14.2%
Expense ratio	**33.5%**	**33.5%**	**34.0%**	**35.0%**	**34.6%**	**33.4%**	**34.8%**	**34.4%**	**35.2%**	**35.3%**	**35.5%**	**31.6%**
Combined ratio	**102.8%**	**92.1%**	**95.1%**	**90.9%**	**91.9%**	**90.9%**	**93.2%**	**91.7%**	**94.1%**	**92.6%**	**93.1%**	**93.2%**
Combined ratio ex cats & PYD	89.5%	89.6%	90.0%	89.8%	89.8%	89.1%	89.9%	89.6%	92.7%	90.8%	91.0%	89.0%
Underwriting Income (Loss)	**(34)**	**98**	**225**	**114**	**108**	**129**	**99**	**450**	**86**	**109**	**107**	**120**

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

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Arch's primary P&C business is benefiting from healthy pricing, but we think further margin expansion is unlikely. After shrinking its "cycle managed" business (now called wholesale/large capacity) from 2012 to 2017, ACGL is seeing strong growth in this part of its primary book, driven by favorable conditions 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. 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 higher inflation and reinsurance costs. Also, price increases have slowed for select 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 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 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: High Catastrophe Losses Drove Miss

ACGL's reinsurance business reported higher than expected catastrophe losses, but healthy premium growth. Underwriting income in 3Q24 was $149 million, well below our $258 million estimate, marked by lower reported margins (CR 92.2% vs. 86.0%E). The downside in margins was driven primarily by higher catastrophe losses (19.3% vs. 9.0%E) and, to a lesser extent, lower reserve releases (-1.9% vs. -3.2%E). These were partly offset by a lower attritional loss ratio (52.2% vs. 55.7%E) and a lower expense ratio (22.6% vs. 24.5%E). On a core basis, margins were better than assumed (CR ex. cats and PYD 74.8% vs. 80.2%E). Premium growth was strong (gross written premiums +29.2% vs. +20.0%E, net written premiums +24.5% vs. 19.9%E, net earned premiums +22.6% vs. 19.3%E). Management was upbeat on Arch's positioning in the property cat market despite pricing moderation from last year. 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 consistent. Arch indicated that Helene accounted for less than half of its cat losses in 3Q24, and a greater proportion of its claims were driven by international events (Canada hailstorms, Europe floods, and Asia typhoons) given its increased presence in foreign markets. Unlike in the U.S./Bermuda, where reinsurance attachment points have increased, Arch participates in many international treaties on a pro rata basis and has more exposure to losses in lower layers of reinsurance programs.

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Table 5: Reinsurance Key Metrics

$ in millions

	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24	3Q24E	3Q24A
Net written premiums	1,079	1,543	4,924	1,726	1,709	1,562	1,557	6,554	2,266	1,947	1,873	1,945
Premium Growth (y/y)	73.6%	117.6%	51.3%	51.5%	47.0%	44.8%	0.9%	33.1%	31.3%	13.9%	19.9%	24.5%
Losses and LAE ex. cats and PYD	58.4%	57.4%	56.2%	56.6%	50.8%	49.9%	48.5%	51.3%	53.7%	48.9%	55.7%	52.2%
Catastrophe losses	39.1%	0.0%	12.9%	4.4%	6.3%	9.3%	5.1%	6.3%	1.8%	9.4%	9.0%	19.3%
PYD (favorable) / unfavorable	-4.9%	-4.5%	-4.3%	-3.4%	-1.8%	-2.8%	-1.3%	-2.3%	-2.5%	-1.8%	-3.2%	-1.9%
Loss ratio	**92.6%**	**52.9%**	**64.9%**	**57.6%**	**55.3%**	**56.4%**	**52.3%**	**55.3%**	**53.0%**	**56.5%**	**61.5%**	**69.6%**
Acquisition expense ratio	20.8%	19.9%	20.5%	21.1%	21.6%	19.7%	22.5%	21.2%	19.9%	19.4%	20.5%	19.8%
Operating expense ratio	6.3%	5.6%	6.8%	5.6%	5.1%	4.0%	5.2%	4.9%	4.5%	3.6%	4.0%	2.9%
Expense ratio	**27.1%**	**25.5%**	**27.3%**	**26.7%**	**26.7%**	**23.7%**	**27.8%**	**26.2%**	**24.4%**	**23.0%**	**24.5%**	**22.6%**
Combined ratio	**119.7%**	**78.5%**	**92.2%**	**84.3%**	**82.0%**	**80.0%**	**80.1%**	**81.5%**	**77.4%**	**79.5%**	**86.0%**	**92.2%**
Combined ratio ex cats & PYD	85.5%	83.0%	83.5%	83.3%	77.5%	73.5%	76.3%	77.4%	78.1%	71.9%	80.2%	74.8%
Underwriting Income (Loss)	**(197)**	**263**	**314**	**213**	**245**	**310**	**330**	**1,098**	**379**	**366**	**258**	**149**

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

We are skeptical of a sustained hard market, but Milton bodes well for near-term renewals 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 has led management to increase exposure to property coverages, which in turn have contributed to strong premium growth and margins. Longer term, however, we remain skeptical of a sustained hard reinsurance market and expect the pace of price hikes to moderate. 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.

Maintaining EPS Estimates

We are maintaining our 4Q24 and 2025 operating EPS forecasts at $2.35 and $8.69, respectively. Our estimates for 2025 and beyond are below consensus levels, which we feel are too 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: $110.00)*

Investment Thesis

We view Arch as a premier re/insurance franchise, but bullish investor sentiment and valuation keep us from being more positive on the stock. ACGL is a leading reinsurance business that we project to report superior and less volatile underwriting margins over time given its unique culture and approach to the market. Also, Arch is a top competitor in mortgage insurance (MI), which we consider a structurally better business than P&C reinsurance. In the near term, we expect MI results to be marked by improving premium growth and healthy margins, with reserve releases more than offsetting higher attritional losses. In reinsurance, firm pricing should boost both premium growth and margins as well. However, our long-term outlook for the reinsurance business 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 if margins stay close to recent levels over the next one to two years. Also, investor sentiment on ACGL is bullish and the stock's valuation does not seem compelling relative to the company's long-term ROE and EPS growth potential.

Valuation

We are maintaining our December 2025 price target of $110. Our price target assumes a 1.8x multiple on our 12/31/25E BV ex. AOCI forecast, a 1.8x 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 1.8x BV and 12.1x 2025E EPS compared to 1.4x and 8.3x for the reinsurance sector, 1.3x and 8.8x for MI peers, and 2.0x and 11.8x 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 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.
- **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:

- **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 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

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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)	(2,619)	(3,033)
Amortization of acquisition costs (net)	-	-	-
Other expenses	-	-	-
Total expenses	**-**	**-**	**-**
Pretax income	3,569	4,903	4,923
Income taxes	873	(419)	(738)
Total net income	4,403	4,444	4,145
Total operating income	3,201	3,619	3,534
Weighted average diluted shares	379	387	407
EPS - operating	**8.45**	**9.36**	**8.69**

Income Statement - Quarterly	1Q24A	2Q24A	3Q24A	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)A	(35)A	(35)
Acquisition & operating expenses	(607)A	(633)A	(681)A	(698)
Amortization of acquisition costs (net)	-	-	-	-
Other expenses	-	-	-	-
Total expenses	**-**	**-**	**-**	**-**
Pretax income	1,221A	1,366A	1,086A	1,230
Income taxes	(101)A	(97)A	(98)A	(123)
Total net income	1,110A	1,259A	978A	1,097
Total operating income	933A	981A	762A	943
Weighted average diluted shares	381A	382A	382A	401
EPS - operating	**2.45A**	**2.57A**	**1.99A**	**2.35**

Balance Sheet and Capital Data	FY23A	FY24E	FY25E
Shareholders' equity	-	-	-
Shareholders' equity ex. AOCI	-	-	-
Shares outstanding	373	377	380
Book value per share	46.94	54.32	63.71
Book value per share (ex. AOCI)	48.75	54.85	64.24
Capital for share repurchases	-	-	-
Capital for dividends	-	-	-
Dividends	0.00	1.25	1.00

Ratio Analysis	FY23A	FY24E	FY25E	FY26E
EPS growth - operating	73.4%	10.8%	(7.2%)	6.8%
Book value per share (ex. AOCI) growth	31.5%	12.5%	17.1%	13.9%
Return on equity (ROE)	21.6%	19.1%	15.8%	14.7%
Return on equity (ex. AOCI)	-	-	-	-
Dividend payout ratio	0.0%	10.9%	9.8%	9.2%
Total revenue growth	-	-	-	-
Total expense growth	-	-	-	-
Tax rate	24.5%	8.5%	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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Date	Rating	Price ($)	Price Target ($)
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
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

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