J.P.Morgan

North America Equity Research
30 October 2023

Arch Capital

Firing on All Cylinders

Neutral

ACGL, ACGL US
Price (30 Oct 23):$82.88

▲**Price Target (Dec-24):$86.00**
Prior (Dec-24):$82.00

ACGL reported robust 3Q23 results, marked by upside in EPS, strong margins, and higher than assumed premiums. We consider Arch a premier franchise, but are Neutral on the stock due to valuation. Still, we feel that ACGL is the best name for those seeking to invest in the hard pricing theme.

- **Sizable EPS beat; raising forecasts.** ACGL announced 3Q23 operating EPS of $2.31, significantly above our $1.48 estimate and consensus of $1.55. Compared to our model, the upside was driven partly by more favorable prior-year development ($0.13 variance) and lower catastrophe losses ($0.08 variance). Still, EPS would have handily beaten projections, helped by favorable underlying loss trends and, to a lesser extent, higher investment income. We are raising our 4Q23 EPS projection from $1.60 to $1.70 and our 2024 forecast from $6.91 to $7.11.
- **Business trends exceeded relatively high expectations.** Reinsurance results were marked by robust margins (CR 80.0% versus our 90.3% estimate) and strong premium growth (NWP up 45%, exceeding our 36% assumption). Margins were better than assumed in the insurance division as well (CR 90.9% vs. 93.6%E), but premium growth was weaker (NWP +11% vs. +15%E). As in recent quarters, insurance premiums increased across most product lines except for professional lines, which is suffering from soft pricing and weak demand. Mortgage insurance margins were robust as well (CR 4.7% vs. 38.0%E), helped by favorable development (CR ex. PYD 38.2% vs. 45.0%E), while premium growth was weak (NWP -2% vs. -6%E). As assumed, ACGL did not repurchase stock in the third quarter. Management commentary on the operating environment was upbeat.
- **Our long-term outlook for ACGL is mixed, but we forecast the company to report robust results in the near term.** We expect strong margins and top-line growth in the reinsurance business, and healthy margins but weak premium growth in the MI business. In the MI division, reserve releases related to COVID delinquencies should wane, but we expect ongoing favorable development due to the strong labor market and increase in house prices. While higher interest rates are suppressing top-line growth in the MI business, they are a tailwind for margins. Meanwhile, results in the re/insurance business should benefit from firm pricing. Still, we expect additional capacity to enter the reinsurance market over the next 1-2 years and remain skeptical of a sustained hard market. Our model assumes no share repurchases over the next few quarters given ACGL's current stock price and management's intent to deploy capital into the business amid the favorable pricing backdrop.
- **We maintain our Neutral rating.** In our view, ACGL is a top-tier franchise, but in commoditized markets. We believe that ACGL is among the best positioned carriers to take advantage of hard reinsurance pricing. Still, our long-term outlook for the reinsurance market is cautious. Also, we believe that ACGL's valuation is full given its long-term ROE and EPS growth potential.

Insurance - Life & Nonlife

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Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 23E ($)	6.73	7.66

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2022A	2023E	2024E
Q1	1.10	1.73A	
Q2	1.34	1.92A	
Q3	0.28	2.31A	
Q4	2.14	1.70	
FY	4.87	7.66	7.11

Style Exposure

Quant Factors	Current %Rank	Hist %Rank (1=Top) 6M	1Y	3Y	5Y
Value	100	100	100	100	1
Growth	34	1	67	1	1
Momentum	34	34	34	1	67
Quality	1	1	34	1	1
Low Vol	1	1	1	34	1
ESGQ	12	12	13	91	97

3Q23 EPS: $2.31A vs. $1.48E

Positives: MI, reinsurance, and insurance margins; reinsurance written premiums

Negatives: insurance written premiums

Bloomberg: JPMA Bhullar <GO>

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

See page 13 for analyst certification and important disclosures.

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Price Performance

	YTD	1m	3m	12m
Abs	32.0%	4.0%	7.3%	46.2%
Rel	24.8%	8.0%	17.4%	39.9%

Company Data

Shares O/S (mn)	373
52-week range ($)	87.51-54.82
Market cap ($ mn)	30,922.53
Exchange rate	1.00
Free float(%)	96.9%
3M - Avg daily vol (mn)	1.67
3M - Avg daily val ($ mn)	132.9
Volatility (90 Day)	22
Index	S&P 500
BBG BUY|HOLD|SELL	13|3|0

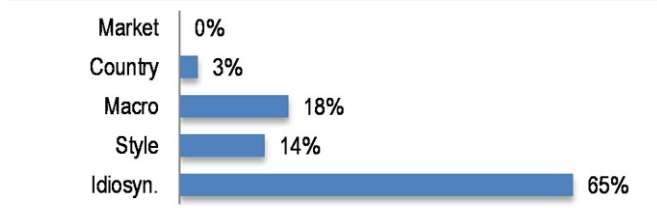
Key Metrics (FYE Dec)

$ in millions	FY22A	FY23E	FY24E
Financial Estimates			
NEP (Premium)	9,678	12,353	13,904
Underwriting income	1,796	2,476	1,789
Net investment income	497	1,002	1,348
Operating income	2,293	3,479	3,137
Adj. PBT	1,562	3,161	3,049
Adj. net income	1,840	2,999	2,649
Adj. EPS	4.87	7.66	7.11
BBG EPS	4.06	7.02	7.38
DPS	0.00	0.00	0.00
Investments	11,276	14,441	16,705
BVPS	32.62	40.61	46.86
NAVPS	32.62	40.61	46.86
Margins and Growth			
Adj. EPS growth	36.0%	57.2%	(7.2%)
Ratios			
Adj. tax rate	5.1%	8.6%	8.0%
Loss ratio	(51.9%)	(51.3%)	(57.6%)
Combined ratio	(22.5%)	(22.7%)	(28.0%)
Invest inc. % of Investments	-	-	-
Regulatory solvency ratio	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-
ROE	14.8%	22.0%	16.2%
Valuation			
Dividend yield	0.0%	0.0%	0.0%
Adj. P/E	17.0	10.8	11.7
P/ BV	2.5	2.0	1.8

Summary Investment Thesis and Valuation

Arch is a premier re/insurance franchise with a track record of higher and less volatile underwriting margins than most peers. Still, we are Neutral given 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 reserve releases moderate. Over time, we expect MI returns to be held back by the commoditized nature of the product, black box pricing, and higher capital requirements. 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 expect the entry of additional capacity in the next 1-2 years to preclude a sustained hard market.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.18	0.11
Country: Bermuda	-0.08	0.14
Macro:		
JP Morgan EMBI Global Spread	-0.01	-0.24
JPM China A-shares Sentiment	0.02	-0.18
JPM Global Equity Sentiment	0.13	0.16
Quant Styles:		
LowVol	0.36	0.34
Growth	0.20	0.13
Value	-0.10	-0.12

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 3Q23 results. ACGL will hold its earnings conference call at 11:00 AM Eastern on October 31, 2023. Conference call participants need to register at this link: https://register.vevent.com/register/BI0ec22b5703ba41ee9cf7b1c3f7e591fb. The call replay can be accessed at: ir.archcapgroup.com.

We view ACGL as the best investment for those seeking to take advantage of the firm pricing theme but are Neutral on the stock due to valuation. In our view, ACGL has an industry-leading reinsurance business with a unique culture and approach to underwriting that should produce above-average and less volatile margins over time. Also, Arch is a top competitor in the mortgage insurance (MI) market, which we consider a structurally better business than P&C reinsurance. In primary P&C, ACGL has gained share and expanded margins, helped by firm prices. We expect ACGL's near-term results to benefit from higher prices and tighter terms/conditions in the reinsurance market. In MI, our model projects moderating, but healthy, margins and weak premium growth. Despite our near-term optimism, our long-term outlook for the reinsurance market remains cautious because of structural concerns such as low barriers to entry and limited pricing power. We expect additional capacity to enter the market in the next 1-2 years and remain skeptical of sustained hard prices. Moreover, investor sentiment on the stock is very bullish and its valuation seems full.

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

We expect ACGL's reinsurance results in the near term to benefit from hard pricing and tighter terms, but our long-term outlook for the market is cautious. Arch has historically generated better and less volatile margins than most reinsurers, which we attribute to its focus on specialty reinsurance (where pricing tends to be less competitive), conservative underwriting, ability to shift mix based on changing market conditions, and judicious management of catastrophe 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. Furthermore, the creation of 3rd party capital vehicles such as Premia Re has allowed Arch to earn fee income. Overall, we consider Arch a top-tier reinsurer and expect firm pricing to boost results through 2024. Still, our long-term outlook for the reinsurance market 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 attract new capacity into the market. In our view, any signs of additional capacity entering the market would hurt investor sentiment on reinsurance stocks, which have become consensus longs since late 2022.

MI: Margins to Moderate but Stay Healthy; Growth Weak

ACGL expanded in mortgage insurance through acquisitions (CMG in 2014 and United Guaranty in 2016) when market conditions were favorable, marked by appreciating home prices, stringent lending standards at mortgage issuers, and disciplined pricing by mortgage insurers. 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. In our opinion, MI margins will remain healthy in the near term, but will moderate from recent levels as the benefit of COVID-related reserve releases tapers off. Still, margins should remain healthy overall given the strong labor market and appreciation of house prices. Although higher interest rates should suppress mortgage origination volumes, they bode well for margins as they are extending duration of policies and prompting homeowners to stay in their houses (where they have built considerable equity) longer than in recent years.

3Q23 Details

This evening, ACGL announced third quarter operating EPS of $2.31, well above our $1.48 estimate and consensus of $1.55. Compared to our model, underwriting income was better than assumed in all three divisions, and was especially strong in reinsurance and mortgage insurance. Margins were lifted by favorable prior-year development, but were stronger than assumed on a core basis as well. Also, investment income was slightly higher than our forecast.

Table 1: 3Q23 Operating Earnings: Actual versus Expected

$ in millions, except per share amounts

	3Q23E	3Q23A	Upside / (downside) to EPS	Comments
Underwriting Income by Division:				
Mortgage	171	282	$0.29	margins benefited from reserve release (CR 4.7% vs. 38.0%E)
Insurance	90	129	$0.10	margins better than assumed (CR 90.9% vs. 93.6%E)
Reinsurance	147	310	$0.43	premium growth strong, margins healthy (80.0% vs. 90.3%E)
Underwriting income	**408**	**721**	**$0.83**	
Net investment income	267	269	$0.01	pre-tax investment yield of 3.68% in 3Q23 vs. 3.50% in 2Q23 and 2.06% in 3Q22
Earnings from affiliates	20	54	$0.09	
Other income (losses) / COLI	1	(3)	-$0.01	
Other expenses / corporate	40	44	-$0.01	
Interest expense	33	34	$0.00	
Pretax operating income	**623**	**963**	**$0.90**	
Income tax expense	50	77	-$0.07	effective tax rate of 8.0% vs. assumed tax rate of 8.0%E
Preferred dividends	10	10	$0.00	
Operating income	**563**	**876**	**$0.83**	
Weighted average dilutive shares	379.2	379.4	$0.00	no share buybacks as expected
Operating EPS	**$1.48**	**$2.31**	**$0.82**	**no significant unusual items**

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

Business trends exceeded high expectations. Reinsurance results were marked by robust margins (CR 80.0% versus our 90.3% estimate) and strong premium growth (NWP up 45%, exceeding our 36% assumption). Margins were better than assumed in the insurance division as well (CR 90.9% vs. 93.6%E), but premium growth was weaker (NWP +11% vs. +15%E). As in the past few quarters, management indicated that insurance premiums rose across all major market segments with the exception of professional lines, which continues to suffer from soft pricing. Mortgage insurance margins were robust as well (CR 4.7% vs. 38.0%E), helped by favorable development (CR ex. PYD 38.2% vs. 45.0%E), while premium growth was weak (NWP -2% vs. -6%E). As anticipated, Arch did not repurchase stock in the quarter.

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Table 2: 3Q23 Key Financial Metrics

$ in millions

	3Q23E	3Q23A
Net premiums written	3,302	3,355
% change (y-o-y)	21.2%	23.2%
Net investment income	267	269
% change (y-o-y)	107.6%	109.1%
Loss ratio ex cats and PYD	54.4%	49.9%
Catastrophe losses	6.5%	5.5%
PYD (favorable) / unfavorable	-3.1%	-4.7%
Loss ratio	57.8%	50.7%
Expense ratio	29.5%	27.2%
Combined ratio	87.3%	78.0%
Combined ratio ex cats & PYD	83.9%	77.1%
Share buybacks ($ mil.)	-	-

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

Mortgage Ins.: Favorable Development Drove Robust Margins

We expect mortgage insurance (MI) results to be marked by weak premium growth, healthy persistency, and strong (but lower) margins. Higher interest rates should suppress mortgage insurance volumes. Also, we expect moderating reserve releases from cures of COVID-related delinquencies to drive a decline in margins to more normal levels in the next few quarters. However, division results were significantly better than assumed in the third quarter and, although we believe that margins in the business will eventually moderate, there could be ongoing upside in the near term. The MI division generated underwriting income of $283 million in 3Q23, well above our $171 million estimate, driven by upside in margins (CR 4.7% vs. 38.0%E) and higher earned premiums (+3.9% from 3Q22 vs. -5.3%E). The upside in margins was due to a lower attritional loss ratio (21.4% vs. 25.0%E), much greater than assumed favorable reserve releases (-33.5% vs. -7.0%E), and a lower expense ratio (16.8% vs. 20.0%E). On a core basis, CR ex. cats and PYD was 38.2%, also better than our 45.0% assumption. Management attributed the reserve releases to better than expected cure rates and more favorable assumptions (lower average per claim reserve and lower ultimate loss per notice of default) for business issued in accident years 2020-2022. Meanwhile, attritional losses benefited from lower estimated claim rates, partially offset by higher new delinquencies. Similar to recent periods, the negative for MI was gross written premiums, which decreased -4.0%, the fourth consecutive quarterly decline. Net written premiums declined as well (-1.8%), but not as much as gross written premiums due to higher retentions and growth in the credit risk transfer business, which offset lower mortgage originations in the Australia segment.

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In 2020 and early 2021, MI margins were hurt by artificially high delinquencies caused by homeowners availing of government forbearance programs. However, after an initial spike in 2Q20, the number of delinquent loans has steadily declined. With the expiry of the 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. Meanwhile, 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 1.7% at 9/30/23, slightly up from 1.6% at 6/30/23 and flat with 1.7% at 9/30/22.

Table 3: Mortgage Insurance Key Metrics

$ in millions

	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23E	3Q23A
Net written premiums	301	289	1,261	288	294	276	275	1,133	261	265	259	271
Premium Growth (y/y)	0.8%	-12.8%	-1.5%	-14.0%	-12.5%	-8.2%	-5.1%	-10.2%	-9.4%	-9.8%	-6.3%	-1.9%
Losses and LAE ex. cats and PYD	19.2%	14.8%	18.2%	17.6%	18.8%	21.0%	25.2%	20.7%	25.3%	24.3%	25.0%	21.6%
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	-15.5%	-24.2%	-13.7%	-36.5%	-40.7%	-45.1%	-72.1%	-48.6%	-24.6%	-28.7%	-7.0%	-33.5%
Loss ratio	**3.7%**	**-9.4%**	**4.4%**	**-18.9%**	**-21.9%**	**-24.1%**	**-46.9%**	**-28.0%**	**0.7%**	**-4.4%**	**18.0%**	**-11.9%**
Acquisition expense ratio	7.7%	4.4%	7.6%	3.6%	3.4%	2.4%	4.4%	3.5%	2.4%	2.4%	3.0%	0.7%
Operating expense ratio	14.8%	16.7%	15.1%	18.4%	17.0%	16.5%	15.4%	16.8%	16.9%	17.0%	17.0%	16.0%
Expense ratio	**22.6%**	**21.1%**	**22.7%**	**22.1%**	**20.4%**	**18.8%**	**19.8%**	**20.3%**	**19.3%**	**19.4%**	**20.0%**	**16.7%**
Combined ratio	**26.3%**	**11.6%**	**27.1%**	**3.2%**	**-1.5%**	**-5.2%**	**-27.1%**	**-7.7%**	**19.9%**	**15.0%**	**38.0%**	**4.8%**
Combined ratio ex cats & PYD	41.8%	35.8%	40.9%	39.7%	39.2%	39.9%	45.0%	41.0%	44.5%	43.7%	45.0%	38.3%
Underwriting Income (Loss)	**234**	**269**	**953**	**285**	**298**	**299**	**374**	**1,257**	**243**	**253**	**171**	**282**

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

In our view, MI margins will continue to benefit from reserve releases, but to a lesser extent than in recent 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 the 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 these previously incurred reserves. Currently, 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. Despite an expected decline, we project 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 resulting in homeowners' staying in their existing houses (where they have more equity) longer then typical and are thereby improving persistency in the MI book. On a cautious note, top-line growth is likely to be weak as higher interest rates reduce mortgage originations. While 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

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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: Strong Margins Offset Weaker Premiums

The insurance business reported strong underwriting margins and lower than expected written premium growth. In 3Q23, the division reported underwriting income of $129 million, well above our $90 million estimate, due to upside in margins (CR 90.9% vs. 93.6%E). Net earned premium growth (+19.0% vs. +18.8%E) was roughly in-line. Most of the margin beat was from lower catastrophe losses (2.6% vs. 4.0%E), but favorable development (-0.8% vs. -0.3%E), a lower attritional loss ratio (55.7% vs. 55.9%E), and a lower expense ratio (33.4% vs. 34.0%E) contributed as well. Net written premiums grew +11.2% from 3Q22, slower than our +14.9% assumption. Management noted that net written premium growth benefited from new business, higher prices, growth in existing accounts, and higher reinsurance retentions, partly offset by a decline in professional lines writings, where pricing has been more challenging.

Table 4: Insurance Key Metrics

$ in millions

	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23E	3Q23A
Net written premiums	1,154	1,036	4,148	1,207	1,228	1,369	1,217	5,021	1,437	1,454	1,573	1,522
Premium Growth (y/y)	40.0%	23.7%	31.2%	21.3%	27.5%	18.6%	17.4%	21.0%	19.1%	18.4%	14.9%	11.2%
Losses and LAE ex. cats and PYD	59.5%	57.5%	59.5%	55.5%	56.0%	56.0%	56.2%	56.0%	54.8%	55.2%	55.9%	55.7%
Catastrophe losses	12.2%	2.0%	5.6%	3.1%	1.5%	13.4%	2.8%	5.3%	1.6%	2.6%	4.0%	2.6%
PYD (favorable) / unfavorable	-0.5%	-0.3%	-0.4%	-0.1%	-0.4%	-0.1%	-0.3%	-0.2%	-0.5%	-0.5%	-0.3%	-0.8%
Loss ratio	**71.2%**	**59.2%**	**64.6%**	**58.5%**	**57.1%**	**69.3%**	**58.7%**	**61.0%**	**55.9%**	**57.3%**	**59.6%**	**57.5%**
Acquisition expense ratio	16.2%	18.8%	16.7%	19.1%	19.4%	19.6%	19.6%	19.4%	19.5%	19.9%	19.5%	19.1%
Operating expense ratio	14.8%	14.9%	15.4%	16.2%	14.6%	13.9%	13.8%	14.6%	15.5%	14.7%	14.5%	14.3%
Expense ratio	**31.0%**	**33.7%**	**32.1%**	**35.3%**	**34.0%**	**33.5%**	**33.5%**	**34.0%**	**35.0%**	**34.6%**	**34.0%**	**33.4%**
Combined ratio	**102.3%**	**93.0%**	**96.8%**	**93.8%**	**91.1%**	**102.8%**	**92.1%**	**95.1%**	**90.9%**	**91.9%**	**93.6%**	**90.9%**
Combined ratio ex cats & PYD	90.6%	91.3%	91.6%	90.8%	90.0%	89.5%	89.6%	90.0%	89.8%	89.8%	89.9%	89.1%
Underwriting Income (Loss)	**(21)**	**71**	**117**	**63**	**98**	**(34)**	**98**	**225**	**114**	**108**	**90**	**129**

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

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Arch's primary P&C business is benefiting from favorable pricing, but we expect margin improvement in the business to be less than implied by price hikes. 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 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 the increase in prices, we do not anticipate a material improvement in primary commercial lines margins at Arch and peers due to headwinds from higher inflation and reinsurance costs. 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 have been weak through 2023 given elevated cat losses. In contrast, reinsurers' cat losses have not increased to the same extent. We feel that 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 1/1/2023 reinsurance renewals.

Reinsurance: Robust Results, Near-Term Outlook Positive

The reinsurance business reported robust margins and premium growth. Underwriting income in 3Q23 was $310 million, much higher than our $147 million assumption, reflecting strong underwriting margins (CR of 80.0% vs. 90.3%E). The attritional loss ratio (49.9% vs. 58.3%E), catastrophe losses (9.3% vs. 10.0%E), and the expense ratio (9.3% vs. 10.0%E) were favorable compared to our model, and only partly offset by slightly lower favorable reserve development (-2.8% vs. -5.0%E). On a core basis, the combined ratio (ex. cats and PYD) came in at 73.5%, better than our 85.3% assumption. Net written premium growth was strong, up 44.8% to $1.6 billion, above our +36.3% assumption, which management attributed to growth in property coverage (ex. cats) and other specialty lines, as well as higher retentions. Management sounded upbeat on Arch's positioning amid capacity constraints at some competitors, and noted that it expects the prices and terms/conditions to remain firm longer than previous hard market cycles. Also, ACGL affirmed our view that most primary insurers are retaining more risk given higher reinsurance pricing, implying higher potential catastrophe loads for primary insurers and lower for reinsurers relative to historical levels.

Table 5: Reinsurance Key Metrics

$ in millions

	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23E	3Q23A
Net written premiums	621	709	3,254	1,139	1,163	1,079	1,543	4,924	1,726	1,709	1,470	1,562
Premium Growth (y/y)	2.8%	44.5%	32.4%	14.0%	25.7%	73.6%	117.6%	51.3%	51.5%	47.0%	36.3%	44.8%
Losses and LAE ex. cats and PYD	57.4%	54.9%	57.9%	52.6%	55.3%	58.4%	57.4%	56.2%	56.6%	50.8%	58.3%	49.9%
Catastrophe losses	32.6%	6.7%	15.4%	6.7%	7.1%	39.1%	0.0%	12.9%	4.4%	6.3%	10.0%	9.3%
PYD (favorable) / unfavorable	-9.6%	-6.4%	-5.6%	-2.8%	-4.5%	-4.9%	-4.5%	-4.3%	-3.4%	-1.8%	-5.0%	-2.8%
Loss ratio	**80.4%**	**55.2%**	**67.8%**	**56.5%**	**57.9%**	**92.6%**	**52.9%**	**64.9%**	**57.6%**	**55.3%**	**63.3%**	**56.4%**
Acquisition expense ratio	19.1%	20.0%	18.9%	21.4%	20.4%	20.8%	19.9%	20.5%	21.1%	21.6%	20.0%	19.7%
Operating expense ratio	6.7%	7.9%	7.5%	8.7%	7.1%	6.3%	5.6%	6.8%	5.6%	5.1%	7.0%	4.0%
Expense ratio	**25.8%**	**27.9%**	**26.4%**	**30.1%**	**27.5%**	**27.1%**	**25.5%**	**27.3%**	**26.7%**	**26.7%**	**27.0%**	**23.7%**
Combined ratio	**106.2%**	**83.1%**	**94.2%**	**86.6%**	**85.5%**	**119.7%**	**78.5%**	**92.2%**	**84.3%**	**82.0%**	**90.3%**	**80.0%**
Combined ratio ex cats & PYD	83.2%	82.8%	84.3%	82.7%	82.9%	85.5%	83.0%	83.5%	83.3%	77.5%	85.3%	73.5%
Underwriting Income (Loss)	**(39)**	**133**	**170**	**109**	**139**	**(197)**	**263**	**314**	**213**	**245**	**147**	**310**

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

We remain skeptical of sustained hard reinsurance pricing, but market trends are holding up better than our initial expectations and we believe that Arch is better positioned than peers in the current 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 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 given the expected entry of additional capacity. Factors that contributed to a multi-year soft market prior to 2018 (glut of capital, greater fluidity/speed of capital, more providers of capacity, broker consolidation) are still prevalent, and should preclude a prolonged hard reinsurance market. On a positive note, ACGL's reinsurance results could benefit from the release of COVID-related reserves, a significant proportion of which remain in IBNR. Similarly, loss reserves for Ian could ultimately prove to be too conservative (most primary companies booked lower Ian-related losses than reinsurers).

Increasing EPS Estimates

We are raising 4Q23 EPS from $1.60 to $1.70 and 2024 EPS from $6.91 to $7.11. Our 2023 EPS forecast is increasing as well, from $6.73 to $7.66. Our updated estimates mainly reflect better than expected loss experience, even excluding the impact of catastrophes and prior year development. We consider catastrophe losses (which would affect reinsurance and insurance margins) and housing market trends (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: $86.00)*

Investment Thesis

We view Arch as a premier re/insurance franchise, but are Neutral on the stock due to bullish investor sentiment and current valuation. In our opinion, 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 is a top competitor in mortgage insurance (MI), which we consider structurally better than P&C reinsurance. In the near term, we expect MI results to be marked by weak premium growth and compressing, but healthy, margins as reserve releases taper off. Meanwhile, hard pricing should boost premium growth and margins in the reinsurance segment. On the other hand, our long-term outlook for the reinsurance business remains cautious and we are skeptical of sustained hard pricing given structural issues such as low barriers to entry, increased participation by third-party capital, and limited pricing power. Furthermore, investor sentiment on ACGL is very 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 $82 to $86 to reflect updated EPS and book value forecasts. Our price target assumes a 1.5x multiple on our 12/31/24E BV ex. AOCI forecast, a 1.6x 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 more skewed to mortgage insurance. ACGL trades at 2.2x BV and 11.7x 2024E EPS compared to 1.6x and 8.5x for the reinsurance sector, 1.0x and 7.8x for MI peers, and 2.0x and 11.4x for the broader P&C group.

Risks to Rating and Price Target

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

- **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.

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	FY22A	FY23E	FY24E
Earned premiums	-	-	-
Policy charges and fee income	-	-	-
Net investment income	-	-	-
Other income	-	-	-
Total revenues	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-
Interest credited	-	-	-
Interest expense	(130)	(133)	(139)
Acquisition & operating expenses	(1,740)	(2,262)	(2,640)
Amortization of acquisition costs (net)	-	-	-
Other expenses	-	-	-
Total expenses	**-**	**-**	**-**
Pretax income	1,562	3,161	3,049
Income taxes	(80)	(271)	(244)
Total net income	1,436	2,850	2,765
Total operating income	1,840	2,999	2,649
Weighted average diluted shares	378	392	373
EPS - operating	**4.87**	**7.66**	**7.11**

Income Statement - Quarterly	1Q23A	2Q23A	3Q23A	4Q23E
Earned premiums	-	-	-	-
Policy charges and fee income	-	-	-	-
Net investment income	-	-	-	-
Other income	-	-	-	-
Total revenues	**-**	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-	-
Interest credited	-	-	-	-
Interest expense	(32)A	(33)A	(34)A	(34)
Acquisition & operating expenses	(533)A	(561)A	(575)A	(593)
Amortization of acquisition costs (net)	-	-	-	-
Other expenses	-	-	-	-
Total expenses	**-**	**-**	**-**	**-**
Pretax income	781A	736A	795A	849
Income taxes	(64)A	(67)A	(72)A	(68)
Total net income	705A	661A	713A	771
Total operating income	654A	726A	876A	743
Weighted average diluted shares	378A	378A	379A	437
EPS - operating	**1.73A**	**1.92A**	**2.31A**	**1.70**

Balance Sheet and Capital Data	FY22A	FY23E	FY24E
Shareholders' equity	-	-	-
Shareholders' equity ex. AOCI	-	-	-
Shares outstanding	370	374	372
Book value per share	32.62	40.61	46.86
Book value per share (ex. AOCI)	37.06	44.50	50.76
Capital for share repurchases	-	-	-
Capital for dividends	-	-	-
Dividends	0.00	0.00	0.00

Ratio Analysis	FY22A	FY23E	FY24E	FY25E
EPS growth - operating	36.0%	57.2%	(7.2%)	-
Book value per share (ex. AOCI) growth	9.9%	20.1%	14.1%	-
Return on equity (ROE)	14.8%	22.0%	16.2%	-
Return on equity (ex. AOCI)	-	-	-	-
Dividend payout ratio	0.0%	0.0%	0.0%	-
Total revenue growth	-	-	-	-
Total expense growth	-	-	-	-
Tax rate	5.1%	8.6%	8.0%	-

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 ($)	Price Target ($)
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
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

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