J.P.Morgan

Arch Capital

Strong Franchise with Macro Tailwinds

Neutral

ACGL, ACGL US
Price (30 Jul 24):$98.20

▲ **Price Target (Dec-25):$108.00**
Prior (Dec-25):$106.00

ACGL's 2Q24 results were better than assumed, driven by upside in underwriting margins and investment income. We maintain a Neutral rating due to valuation, but consider ACGL a premier reinsurance franchise and the best name for investors seeking to take advantage of hard reinsurance pricing.

- **EPS upside; raising estimates.** ACGL reported 2Q24 operating EPS of $2.57, significantly above our $2.05 estimate and consensus of $2.18. Compared to our model, the beat was primarily due to better margins and a lower underlying loss ratio. Other items that contributed included: higher investment income ($0.04 per share after taxes), more favorable prior-year development (+$0.02), lower cat losses (+$0.01 variance), and lower tax rate (+$0.10 per share). We are raising our 3Q24 EPS forecast from $1.72 to $1.76 and our 2025 projection from $8.63 to $8.83, mostly to reflect higher future investment income.
- **Business fundamentals were strong.** Reinsurance results were marked by higher than assumed margins (CR 79.5% vs. our 84.7% estimate) and premiums (+14% versus our -3% estimate). Margins were helped by lower attritional losses, which more than offset higher cat losses and less favorable prior-year development. Similarly, insurance margins beat (CR 92.6% vs. 94.3%E), while premiums missed (+7% vs. +8%E). Unlike peers, ACGL noted insignificant adverse development on casualty business in both the reinsurance and insurance divisions. MI margins were better than assumed as well (CR 7.2% vs. 20.9%E), helped by reserve releases on recent years. As assumed, Arch did not repurchase stock in 2Q. Management's tone on business trends was very upbeat, especially on pricing in the reinsurance market and margins in MI. A shortfall in insurance and MI premiums was the only major negative.
- **We forecast ACGL to report robust results in the near term, but our long-term outlook is more muted.** In our view, ACGL will report strong margins and top-line growth in re/insurance, and strong margins but lackluster growth in mortgage insurance. Reinsurance margins should benefit from hard pricing. MI margins should be lifted by elevated house prices and the strong labor market. Also, higher interest rates should boost premium persistency and margins, but are likely to suppress growth in the MI division. Meanwhile, we assume no share repurchases in the near term given ACGL's stock price and management's intent to deploy capital into the business amid the favorable pricing backdrop. On a cautious note, we do not expect margins in both the reinsurance and MI divisions to sustain at recent levels in the long run and remain wary of softening terms/conditions in the reinsurance market over time.
- **We maintain our Neutral rating.** We view ACGL as a top-tier franchise, but in commoditized markets. Hard reinsurance pricing should enable Arch to report robust results in the near term, but our long-term outlook for the reinsurance market is cautious. Furthermore, we feel that ACGL's valuation is not attractive given its long-term ROE and EPS growth potential.

Insurance - Life & Nonlife

Jimmy S. Bhullar, CFA AC
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

Pablo S. Singzon
(1-212) 622-2295
pablo.s.singzon@jpmorgan.com

Kevin Wijendra
(1-212) 622-7054
kevin.wijendra@jpmorgan.com
J.P. Morgan Securities LLC

Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 24E ($)	8.53	9.13

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2023A	2024E	2025E
Q1	1.73	2.45A	
Q2	1.92	2.57A	
Q3	2.31	1.76	
Q4	2.49	2.35	
FY	8.45	9.13	8.83

Style Exposure

Quant Factors	Current %Rank	Hist %Rank (1=Top) 6M	1Y	3Y	5Y
Value	100	100	100	100	100
Growth	1	100	51	100	1
Momentum	1	1	1	51	100
Quality	51	1	1	100	1
Low Vol	1	1	1	51	1
ESGQ	12	12	13	91	98

2Q24 EPS: $2.57A vs. $2.05E

Positives: underwriting margins in all divisions, reinsurance premium growth, investment income

Negatives: insurance and MI premiums

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.

Jimmy S. Bhullar, CFA AC
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

Price Performance

	YTD	1m	3m	12m
Abs	32.2%	-2.7%	5.0%	27.1%
Rel	17.7%	-2.7%	-3.5%	8.1%

Company Data

Shares O/S (mn)	376
52-week range ($)	103.79-72.85
Market cap ($ mn)	36,923.20
Exchange rate	1.00
Free float(%)	96.6%
3M - Avg daily vol (mn)	1.62
3M - Avg daily val ($ mn)	161.0
Volatility (90 Day)	21
Index	S&P 500
BBG BUY|HOLD|SELL	12|4|1

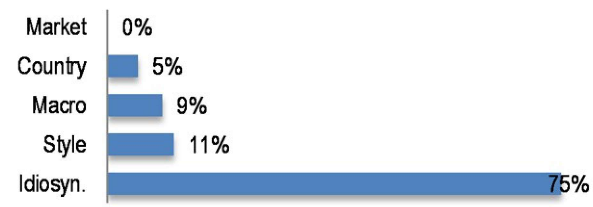
Key Metrics (FYE Dec)

$ in millions	FY23A	FY24E	FY25E	FY26E
Financial Estimates				
NEP (Premium)	12,440	14,513	16,786	18,300
Underwriting income	2,612	2,826	2,899	2,985
Net investment income	1,023	1,501	1,889	2,139
Operating income	3,635	4,326	4,788	5,125
Adj. PBT	3,569	4,668	4,681	5,020
Adj. net income	3,201	3,711	3,827	4,109
Adj. EPS	8.45	9.13	8.83	9.62
BBG EPS	7.96	8.55	8.86	9.24
DPS	0.00	0.00	0.00	0.00
Investments	16,792	20,963	23,902	27,130
BVPS	46.94	57.53	66.33	76.03
NAVPS	46.94	57.53	66.33	76.03
Margins and Growth				
Adj. EPS growth	73.4%	8.0%	(3.3%)	8.9%
Ratios				
Adj. tax rate	24.5%	8.7%	15.0%	15.0%
Loss ratio	(50.2%)	(52.2%)	(53.8%)	(54.7%)
Combined ratio	(21.4%)	(23.9%)	(24.9%)	(25.7%)
Invest inc. % of Investments	-	-	-	-
Regulatory solvency ratio	-	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-	-
ROE	21.6%	18.9%	16.5%	15.7%
Valuation				
Dividend yield	0.0%	0.0%	0.0%	0.0%
Adj. P/E	11.6	10.8	11.1	10.2
P/ BV	2.1	1.7	1.5	1.3

Summary Investment Thesis and Valuation

We affirm our Neutral rating. 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, keep us Neutral on ACGL.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.09	-0.03
Country: Bermuda	-0.07	-0.22
Macro:		
Emerging Central Bank Rate	0.30	0.21
HSI Volatility Index	-0.03	-0.19
JPM China A-shares Sentiment	0.18	0.16
Quant Styles:		
Momentum	0.24	0.29
Quality	0.27	0.23
Value	0.39	0.23

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.

Jimmy S. Bhullar, CFA AC
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

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Jimmy S. Bhullar, CFA AC
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

Investment Thesis

Please see Page 5 for a detailed review of 2Q24 results. ACGL will hold its earnings conference call at 11:00 AM Eastern on July 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 are Neutral on ACGL due to bullish sentiment and valuation, but consider it the best stock for investors seeking exposure to the firm reinsurance market. ACGL is an industry-leading reinsurance franchise with a unique culture and approach to underwriting that should generate above-average, and less volatile, margins over time. The company is also a leading mortgage insurer, a business that we believe is structurally better than P&C reinsurance. In primary P&C, Arch has expanded its position in wholesale/E&S through the current hard market, and its pending acquisition of the Allianz book should bolster its middle market franchise. Our near-term outlook is upbeat as we expect Arch's results to benefit from firm prices and tight terms/conditions in re/insurance, and ongoing reserve releases in mortgage insurance. However, our long-term view is more muted, particularly for reinsurance, as we anticipate a softening of the pricing cycle if underwriting margins stay close to recent levels for the next 1-2 years. The reinsurance market suffers from structural issues such as low barriers to entry, lack of differentiation among carriers, and limited pricing power, all of which suggest more competition if margins stay elevated. Moreover, investor sentiment on ACGL seems very bullish, and we think that the stock's valuation already reflects optimism for near-term results. Still, our fundamental outlook for the company is constructive, and we could get more bullish on the stock if it pulls back.

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

Reinsurance margins should benefit from hard pricing and tighter terms, but our long-term outlook remains downbeat. 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. Also, ACGL prices business using the risk-free rate (leading to more 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 erode pricing discipline. As such, barring an above-average hurricane season, we expect pricing momentum to slow, especially in higher layers of reinsurance programs, which are attracting more capital. Any signs of softening of terms/conditions or new capacity will likely hurt sentiment on reinsurance stocks, which are consensus longs.

MI: Margins to Normalize Lower, Growth Modest

ACGL expanded 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. Over the next few years, however, we expect MI margins to revert lower to more normal levels as reserve releases taper off. Still, ACGL's conservative loss picks post-COVID, the strong labor market, and appreciation of house prices are near-term positives for margins. Higher interest rates will suppress new sales, but should boost persistency in the business.

Jimmy S. Bhullar, CFA AC
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

2Q24 Details

This evening, ACGL announced second quarter 2024 operating EPS of $2.57, well above our $2.05 estimate and consensus of $2.18. Compared with our model, earnings beat in all three divisions, helped by robust margins. Reinsurance results were marked by higher than assumed margins (CR 79.5% vs. our 84.7% estimate) and premiums (+14% versus our -3% estimate). Margins benefited from lower attritional losses, which more than offset higher cat losses and less favorable prior-year development. Similarly, margins beat in both the insurance (CR 92.6% vs. 94.3%E) and MI divisions (CR 7.2% vs. 20.9%E). As anticipated, Arch did not repurchase stock in the second quarter. A shortfall in insurance and MI premiums was the only major negative.

Table 1: 2Q24 Operating Earnings: Actual versus Expected

$ in millions, except per share amounts

	2Q24E	2Q24A	Upside / (downside) to EPS	Comments
Underwriting Income by Division:				
Mortgage	217	287	$0.18	net written premiums +4.2% vs. +5.0%E; combined ratio 7.4% vs. 20.9%E
Insurance	86	109	$0.06	net written premiums +7.2% vs. +8.2%E; combined ratio 92.6% vs. 94.3%E
Reinsurance	268	366	$0.26	net written premiums +13.9% vs. -3.1%E; combined ratio 79.5% vs. 84.7%E
Underwriting income	**571**	**762**	**$0.50**	net written premiums +10.3% vs. +2.3%E; combined ratio 78.7% vs. 83.9%E
Net investment income	345	364	$0.05	pre-tax investment yield of 4.39% in 2Q24 versus 4.14% in 1Q24 and 3.50% in 3Q23
Earnings from affiliates	50	45	-$0.01	
Other income (losses) / COLI	1	26	$0.07	
Other expenses / corporate	51	68	-$0.04	
Interest expense	35	35	$0.00	
Pretax operating income	**881**	**1,094**	**$0.56**	
Income tax expense	88	103	-$0.04	tax rate of 9.4% vs. 10.0%E
Preferred dividends	10	10	$0.00	
Operating income	**783**	**981**	**$0.52**	
Weighted average dilutive shares	381.8	381.6	$0.00	no share buybacks as expected
Operating EPS	**$2.05**	**$2.57**	**$0.52**	**no major unusual items**

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

Business trends were better than assumed overall. By business driver, the upside to our model was driven primarily by better margins and a lower underlying loss ratio. In addition, results benefited from higher investment income ($0.04 per share after taxes), more favorable prior-year development (+$0.02), lower cat losses (+$0.01 variance), and lower tax rate (+$0.10 per share).

Jimmy S. Bhullar, CFA AC
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

Table 2: 2Q24 Key Financial Metrics

$ in millions

	2Q24E	2Q24A
Net premiums written	3,507	3,781
% change (y-o-y)	2.3%	10.3%
Net investment income	345	364
% change (y-o-y)	42.5%	50.4%
Loss ratio ex cats and PYD	53.2%	49.2%
Catastrophe losses	5.6%	5.5%
PYD (favorable) / unfavorable	-3.3%	-3.5%
Loss ratio	55.5%	51.2%
Expense ratio	28.4%	27.5%
Combined ratio	83.9%	78.7%
Combined ratio ex cats & PYD	81.6%	76.7%
Share buybacks ($ mil.)	-	-

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

Mortgage Ins.: Healthy Margins Drove Earnings Upside

In our view, the mortgage insurance (MI) business will report modest gross premium growth, high persistency, and robust (albeit normalizing) margins. High interest rates are a headwind for mortgage insurance volumes and reserve releases should moderate over time. Still, MI results have been significantly above expectations in recent periods, and we believe that there is a greater chance of upside to our prospective forecasts than downside. Also, net premium growth should benefit from higher retention following the cancelation of the Bellemeade transactions. A decline in rates would be a positive for new business volumes as well.

In 2Q24, the MI business reported underwriting income of $287 million, well above our $217 million estimate, driven by better margins (CR 7.4% vs. 20.9%E) and higher earned premium growth (+4.4% vs. -8.4%E). The upside in margins resulted from higher reserve releases (-29.0% vs. -20.5%E), a lower attritional loss ratio (20.4% vs. 24.0%E), and a lower expense ratio (16.0% vs. 17.4%E). As in 1Q24, the company attributed the reserve releases to favorable cure rates and the lower attritional losses to modest claims, partially offset by higher delinquencies. Gross premium growth in the MI market was sluggish (11th consecutive quarter of decline), but net written and net earned premium growth benefited from the termination of the Bellemeade agreements in 4Q23. We expect the factors boosting margins in the MI business (higher rates, lower inventory of houses, etc.) to continue suppressing gross premium growth.

In 2020 and early 2021, MI margins were hurt by artificially high delinquencies caused by homeowners availing themselves of government forbearance programs. However, after an initial spike in 2Q20, the number of delinquent loans has been steadily declining. Following the expiry of forbearance programs, a significant portion of previously delinquent loans has cured, particularly loans by borrowers who were taking advantage of the mortgage payment holiday but were not in financial distress. In the meantime, higher house prices have provided a cushion to homeowners under stress who are struggling to pay their mortgages, limiting losses for MI carriers. The percent of loans in default in the U.S. primary MI business was 1.82% at 6/30/2024, up from 1.65% at 3/31/2024 and lower than 1.61% at 6/30/24.

Table 3: Mortgage Insurance Key Metrics

$ in millions

	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24E	2Q24A
Net written premiums	294	276	275	1,133	261	265	271	255	1,052	277	278	276
Premium Growth (y/y)	-12.5%	-8.2%	-5.1%	-10.2%	-9.4%	-9.8%	-1.9%	-7.1%	-7.1%	6.1%	5.0%	4.2%
Losses and LAE ex. cats and PYD	18.8%	21.0%	25.2%	20.7%	25.3%	24.3%	21.6%	18.3%	22.4%	22.7%	24.0%	20.2%
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	-40.7%	-45.1%	-72.1%	-48.6%	-24.6%	-28.7%	-33.5%	-39.0%	-31.3%	-25.7%	-20.5%	-29.0%
Loss ratio	**-21.9%**	**-24.1%**	**-46.9%**	**-28.0%**	**0.7%**	**-4.4%**	**-11.9%**	**-20.7%**	**-8.9%**	**-3.0%**	**3.5%**	**-8.8%**
Acquisition expense ratio	3.4%	2.4%	4.4%	3.5%	2.4%	2.4%	0.7%	0.4%	1.5%	0.0%	0.4%	0.0%
Operating expense ratio	17.0%	16.5%	15.4%	16.8%	16.9%	17.0%	16.0%	17.1%	16.8%	17.4%	17.0%	16.0%
Expense ratio	**20.4%**	**18.8%**	**19.8%**	**20.3%**	**19.3%**	**19.4%**	**16.7%**	**17.5%**	**18.2%**	**17.4%**	**17.4%**	**16.0%**
Combined ratio	**-1.5%**	**-5.2%**	**-27.1%**	**-7.7%**	**19.9%**	**15.0%**	**4.8%**	**-3.3%**	**9.3%**	**14.4%**	**20.9%**	**7.2%**
Combined ratio ex cats & PYD	39.2%	39.9%	45.0%	41.0%	44.5%	43.7%	38.3%	35.7%	40.6%	40.1%	41.4%	36.2%
Underwriting Income (Loss)	**298**	**299**	**374**	**1,257**	**243**	**253**	**282**	**286**	**1,064**	**271**	**217**	**287**

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

Reserve releases should continue to lift MI margins, but to a lesser extent than in prior quarters. Higher reported delinquencies at the onset of COVID led Arch and its MI peers to establish corresponding reserves despite the healthy labor market and appreciation in house prices. A meaningful portion of these delinquencies was due to homeowners taking advantage of the government’s forbearance protection programs (to preserve liquidity), not actual financial hardship, so actual losses were well below those suggested by initial delinquencies. In recent quarters, over 80% of MI reserves are from accident years after COVID, suggesting less of a benefit from the release of reserves related to COVID delinquencies. Even with this expected decline, however, we expect MI margins to remain healthy given the strong labor and housing markets, cures on previously delinquent loans, and the equity cushion accumulated by homeowners due to the appreciation in house prices. Higher interest rates are a positive for margins as well as they are causing homeowners to stay longer in their existing houses (where they have more equity), thereby improving persistency in the MI book. On a cautious note, top-line growth in the MI business is likely to be weak as higher interest rates reduce mortgage originations. Although a weaker economy could deflate home prices and lead to higher mortgage defaults, a material uptick in losses seems unlikely in the near term. Barring a recession, we expect core margins to stay healthy, though declining reserve releases will drive margins and earnings lower even if economic trends stay favorable.

ACGL has become a leading competitor in the MI market through acquisitions and could expand further via M&A, although deals seem unlikely in the near term. ACGL entered the mortgage re/insurance business in 2011 but was only marginally involved in the market at the onset, competing as a primary insurer through credit unions and as a reinsurer through the GSE credit risk transfer program. The company's 2014 acquisition of CMG Mortgage Insurance from Cuna Mutual gave it a bigger foothold as it received a ratings upgrade for its MI business (from BBB+ to A- at S&P) and gained distribution in the bank channel. Following the deal, Arch became a top 10 competitor in the domestic private MI market. Arch's market position strengthened further following its 2017 acquisition of United Guaranty (UGC) from AIG, which catapulted it to a top-3 spot (as part of the deal AIG retained 50% of mortgage insurance blocks originated by UGC pre 2017). Arch has also expanded in foreign MI markets through M&A, including its acquisition of Westpac's mortgage insurance business in Australia (closed in August 2021).

Insurance: Healthy Margins Offset Lower Premiums

ACGL's insurance business reported modestly weaker premium growth, but better than expected underwriting margins, helped by lower catastrophe losses. Underwriting income in 2Q24 was $109 million, better than our $86 million estimate. Margins were stronger than assumed on a reported basis (CR 92.6% vs. 94.3%E), but worse on a core basis (CR ex. cats and PYD 90.8% vs. 89.6%E). Lower catastrophe losses (2.0% vs. 5.0%E) more than offset slightly worse attritional losses (55.6% vs. 55.5%E), lower reserve releases (-0.2% vs. -0.3%E), and higher expenses (35.3% vs. 34.1%E). Gross written premium growth (+7.5% vs. +8.0%E), net written premium growth (+7.2% vs. +8.2%E), and net earned premium growth (+11.3% vs. +13.6%E) were slightly softer.

Table 4: Insurance Key Metrics

$ in millions

	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24E	2Q24A
Net written premiums	1,228	1,369	1,217	5,021	1,437	1,454	1,522	1,449	5,862	1,542	1,573	1,558
Premium Growth (y/y)	27.5%	18.6%	17.4%	21.0%	19.1%	18.4%	11.2%	19.1%	16.8%	7.3%	8.2%	7.2%
Losses and LAE ex. cats and PYD	56.0%	56.0%	56.2%	56.0%	54.8%	55.2%	55.7%	55.1%	55.2%	57.5%	55.5%	55.6%
Catastrophe losses	1.5%	13.4%	2.8%	5.3%	1.6%	2.6%	2.6%	3.8%	2.7%	1.9%	5.0%	2.0%
PYD (favorable) / unfavorable	-0.4%	-0.1%	-0.3%	-0.2%	-0.5%	-0.5%	-0.8%	-0.5%	-0.6%	-0.5%	-0.3%	-0.2%
Loss ratio	**57.1%**	**69.3%**	**58.7%**	**61.0%**	**55.9%**	**57.3%**	**57.5%**	**58.4%**	**57.3%**	**58.9%**	**60.2%**	**57.4%**
Acquisition expense ratio	19.4%	19.6%	19.6%	19.4%	19.5%	19.9%	19.1%	19.1%	19.4%	19.0%	19.1%	19.5%
Operating expense ratio	14.6%	13.9%	13.8%	14.6%	15.5%	14.7%	14.3%	15.7%	15.0%	16.2%	15.0%	15.8%
Expense ratio	**34.0%**	**33.5%**	**33.5%**	**34.0%**	**35.0%**	**34.6%**	**33.4%**	**34.8%**	**34.4%**	**35.2%**	**34.1%**	**35.3%**
Combined ratio	**91.1%**	**102.8%**	**92.1%**	**95.1%**	**90.9%**	**91.9%**	**90.9%**	**93.2%**	**91.7%**	**94.1%**	**94.3%**	**92.6%**
Combined ratio ex cats & PYD	90.0%	89.5%	89.6%	90.0%	89.8%	89.8%	89.1%	89.9%	89.6%	92.7%	89.6%	90.8%
Underwriting Income (Loss)	**98**	**(34)**	**98**	**225**	**114**	**108**	**129**	**99**	**450**	**86**	**86**	**109**

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

Arch's primary P&C business is benefiting from favorable pricing, but we do not expect further margin expansion from current levels. After shrinking its "cycle managed" business (now called as wholesale/large capacity) from 2012 to 2017, ACGL is seeing strong growth in this part of its primary book, driven by price hikes in the broader market, particularly in E&S. Results in less opportunistic parts of ACGL's book

Jimmy S. Bhullar, CFA AC
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

(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 firm pricing, 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, reserve development could become less of a tailwind because of adverse loss trends emerging in older accident years. Management teams at insurance underwriters as well as many investors are optimistic about improving non-cat margins at commercial insurers, but **we feel that assessing results on a non-cat basis is not as relevant given the significant increase in reinsurance retentions at primary companies.** On an overall combined ratio basis, results for most primary insurers were weak in 2023, precisely because of elevated cat losses. In contrast, reinsurers' cat losses have not increased to the same extent. In our opinion, consensus EPS forecasts for commercial lines insurers do not adequately reflect the shift in cat loads from reinsurers to primary carriers following the uptick in retention levels with 2023 reinsurance renewals.

Reinsurance: Strong Results Overall

Reinsurance results were marked by upside in margins and premium growth. The business generated underwriting income of $366 million in 2Q24, well above our $268 million estimate, driven by stronger premium growth and better margins (CR 79.5% vs. 84.7%E, CR ex. cats and PYD 71.9% vs. 80.9%E). Catastrophe losses (9.4% vs. 7.0%E) and lower reserve releases (-1.8% vs. -2.0%E) were unfavorable to our model, but were more than offset by lower attritional losses (48.9% vs. 55.7%E) and expenses (23.0% vs. 25.2%E). Premium growth was healthy (gross written premiums +15.6% vs. +1.7%E, net written premiums +13.9% vs. -3.1%E, net earned premiums +32.5% vs. 30.3%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.

Table 5: Reinsurance Key Metrics

$ in millions

	2Q22	3Q22	4Q22	2022	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24E	2Q24A
Net written premiums	1,163	1,079	1,543	4,924	1,726	1,709	1,562	1,557	6,554	2,266	1,656	1,947
Premium Growth (y/y)	25.7%	73.6%	117.6%	51.3%	51.5%	47.0%	44.8%	0.9%	33.1%	31.3%	-3.1%	13.9%
Losses and LAE ex. cats and PYD	55.3%	58.4%	57.4%	56.2%	56.6%	50.8%	49.9%	48.5%	51.3%	53.7%	55.7%	48.9%
Catastrophe losses	7.1%	39.1%	0.0%	12.9%	4.4%	6.3%	9.3%	5.1%	6.3%	1.8%	7.0%	9.4%
PYD (favorable) / unfavorable	-4.5%	-4.9%	-4.5%	-4.3%	-3.4%	-1.8%	-2.8%	-1.3%	-2.3%	-2.5%	-3.2%	-1.8%
Loss ratio	**57.9%**	**92.6%**	**52.9%**	**64.9%**	**57.6%**	**55.3%**	**56.4%**	**52.3%**	**55.3%**	**53.0%**	**59.5%**	**56.5%**
Acquisition expense ratio	20.4%	20.8%	19.9%	20.5%	21.1%	21.6%	19.7%	22.5%	21.2%	19.9%	21.0%	19.4%
Operating expense ratio	7.1%	6.3%	5.6%	6.8%	5.6%	5.1%	4.0%	5.2%	4.9%	4.5%	4.2%	3.6%
Expense ratio	**27.5%**	**27.1%**	**25.5%**	**27.3%**	**26.7%**	**26.7%**	**23.7%**	**27.8%**	**26.2%**	**24.4%**	**25.2%**	**23.0%**
Combined ratio	**85.5%**	**119.7%**	**78.5%**	**92.2%**	**84.3%**	**82.0%**	**80.0%**	**80.1%**	**81.5%**	**77.4%**	**84.7%**	**79.5%**
Combined ratio ex cats & PYD	82.9%	85.5%	83.0%	83.5%	83.3%	77.5%	73.5%	76.3%	77.4%	78.1%	80.9%	71.9%
Underwriting Income (Loss)	**139**	**(197)**	**263**	**314**	**213**	**245**	**310**	**330**	**1,098**	**379**	**268**	**366**

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

Jimmy S. Bhullar, CFA [AC]
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

We are skeptical of a prolonged hard market, but trends are holding up better than expected and ACGL seems better positioned than peers in this environment. ACGL's reinsurance segment was initially established to take advantage of the hard market for casualty coverage in the early 2000s. Over the years, however, management has shifted Arch Re's business mix away from casualty risks towards other specialty lines such as surety, accident and health, agriculture, and trade credit, which are generally less competitive and have more attractive risk-reward. The hard pricing environment has boosted results in recent years and is causing management to increase its exposure to property coverages. This, in turn, should drive continued strong premiums and margins. 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.

Raising EPS Estimates

We are raising 3Q24 EPS from \$1.72 to \$1.76 and 2025 EPS from \$8.63 to \$8.83. Our 2024 EPS estimate is increasing as well, from \$8.53 to \$9.13. Our revised model reflects higher run-rate investment income. We did not materially alter our assumptions for premiums or margins, but feel that underwriting income is more likely to exceed than miss our assumptions. We consider catastrophe losses (which would affect reinsurance and insurance margins) and housing market conditions (which affect MI margins and premium growth) the key sources of potential variance in reported results and our projections.

Arch Capital *(Neutral; Price Target: $108.00)*

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. Arch 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 1-2 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 raising our December 2025 price target from $106 to $108 to reflect our higher EPS and book value estimates. Our price target assumes a 1.7x multiple on our 12/31/25E BV ex. AOCI forecast, a 1.7x 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 2.0x BV and 11.1x 2025E EPS compared to 1.4x and 7.7x for the reinsurance sector, 1.2x and 9.0x for MI peers, and 2.0x and 11.7x 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 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.
- **The company announces a sizable share repurchase program.** Steady repurchases by leading reinsurers could help prolong the hard market as well as drive an uptick in EPS forecasts.

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

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

- **The pace of reserve development moderates.** Favorable reserve development has been a notable contributor to ACGL's results in recent years. A slowdown in the pace of development could pressure margins and returns.

Jimmy S. Bhullar, CFA [AC]
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

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)	(140)	(146)
Acquisition & operating expenses	(2,312)	(2,660)	(3,178)
Amortization of acquisition costs (net)	-	-	-
Other expenses	-	-	-
Total expenses	**-**	**-**	**-**
Pretax income	3,569	4,668	4,681
Income taxes	873	(406)	(702)
Total net income	4,403	4,222	3,939
Total operating income	3,201	3,711	3,827
Weighted average diluted shares	379	406	433
EPS - operating	**8.45**	**9.13**	**8.83**

Income Statement - Quarterly	1Q24A	2Q24A	3Q24E	4Q24E
Earned premiums	-	-	-	-
Policy charges and fee income	-	-	-	-
Net investment income	-	-	-	-
Other income	-	-	-	-
Total revenues	**-**	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-	-
Interest credited	-	-	-	-
Interest expense	(34)A	(35)A	(35)	(36)
Acquisition & operating expenses	(607)A	(633)A	(689)	(731)
Amortization of acquisition costs (net)	-	-	-	-
Other expenses	-	-	-	-
Total expenses	**-**	**-**	**-**	**-**
Pretax income	1,221A	1,366A	903	1,179
Income taxes	(101)A	(97)A	(90)	(118)
Total net income	1,110A	1,259A	803	1,051
Total operating income	933A	981A	774	1,022
Weighted average diluted shares	381A	382A	440	435
EPS - operating	**2.45A**	**2.57A**	**1.76**	**2.35**

Balance Sheet and Capital Data	FY23A	FY24E	FY25E
Shareholders' equity	-	-	-
Shareholders' equity ex. AOCI	-	-	-
Shares outstanding	373	377	371
Book value per share	46.94	57.53	66.33
Book value per share (ex. AOCI)	48.75	59.68	68.51
Capital for share repurchases	-	-	-
Capital for dividends	-	-	-
Dividends	0.00	0.00	0.00

Ratio Analysis	FY23A	FY24E	FY25E	FY26E
EPS growth - operating	73.4%	8.0%	(3.3%)	8.9%
Book value per share (ex. AOCI) growth	31.5%	22.4%	14.8%	14.2%
Return on equity (ROE)	21.6%	18.9%	16.5%	15.7%
Return on equity (ex. AOCI)	-	-	-	-
Dividend payout ratio	0.0%	0.0%	0.0%	0.0%
Total revenue growth	-	-	-	-
Total expense growth	-	-	-	-
Tax rate	24.5%	8.7%	15.0%	15.0%

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

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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 ($)	Price Target ($)
28-Oct-21	N	42.33	46
09-Feb-22	N	48.20	48
01-Apr-22	N	48.42	51
27-Apr-22	N	46.51	52
06-Jul-22	N	44.44	53
27-Jul-22	N	44.24	54
26-Oct-22	N	49.22	57
04-Jan-23	N	62.46	58
31-Mar-23	N	67.86	62
26-Apr-23	N	72.59	67
06-Jul-23	N	73.62	75
26-Jul-23	N	81.36	82
30-Oct-23	N	81.36	86
08-Jan-24	N	76.81	80
14-Feb-24	N	84.06	88
08-Apr-24	N	94.90	92
29-Apr-24	N	90.90	96
11-Jul-24	N	97.50	106

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Jimmy S. Bhullar, CFA [AC]
(1-212) 622-6397
jimmy.s.bhullar@jpmorgan.com

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