Arch Capital

Firing on All Cylinders

ACGL reported robust results, marked by upside in EPS and strong business trends. We view Arch as a premier franchise and believe that it is one of the best positioned carriers to benefit from the hard reinsurance market. However, we are Neutral on the stock due to valuation.

- **EPS upside; rasing forecasts.** Operating EPS of $1.73 was well above our $1.51 estimate and consensus of $1.45. The upside was driven by higher than assumed underwriting margins in all three divisions. Investment income was slightly better than expected as well, while catastrophe losses and prior-year reserve development were roughly in-line. We are raising our 2Q23 EPS estimate from $1.43 to $1.53 and our 2024 projection from $5.71 to $6.11.
- **Business trends were better than assumed.** Reinsurance results were especially robust, marked by strong premium growth (net written premium growth of 52% versus our 19% estimate) and better than assumed margins (CR 84.3% versus our 84.5% estimate; CR ex. cats and PYD 83.3% vs. 85.5%). Similarly, insurance margins were strong (CR 90.9% vs. 92.8%E; CR ex. cats and PYD 89.8% vs. 91.1%). Insurance net written premiums increased 19%, higher than our 17% assumption, helped by healthy growth in all major product lines with the exception of professional lines. MI earnings benefited from upside in margins (CR 20.0% vs. 25.0%E), which were lifted by the release of COVID-related reserves. Weaker than assumed MI written premiums was one of the only major negatives. As expected, ACGL did not repurchase stock in 1Q23. Management commentary on business trends was very upbeat.
- **We expect ACGL's near-term results to be healthy, but our long-term outlook is mixed.** Our model projects ACGL's results in the next few quarters to be marked by healthy margins and top-line growth in the re/insurance business and robust margins but weak premium growth in the MI division. Although MI margins should remain healthy, we forecast them to moderate from recent levels as the tailwind from reserve releases wanes. A weaker housing market and higher unemployment present key risks for MI results. Meanwhile, our long-term outlook for the P&C reinsurance business is cautious. ACGL is one of the best positioned insurers to benefit from the hard market, but we remain skeptical of sustained hard pricing and anticipate additional capacity entering the market over the next 1-2 years. Arch also has flexibility to supplement organic growth with repurchases, but buybacks are likely to be modest in the near term, partly due to ACGL's valuation multiple.
- **We maintain our Neutral rating.** In our opinion, ACGL is a top-tier insurance franchise, but in relatively commoditized markets. We believe that ACGL is among the best positioned carriers to take advantage of hard reinsurance pricing. On a cautious note, our long-term outlook for the reinsurance market remains negative. Moreover, we feel that ACGL's valuation is not too enticing given the company's long-term ROE and EPS growth potential.

Neutral

ACGL, ACGL US
Price (26 Apr 23):$72.29

▲ **Price Target (Dec-23):$67.00**
Prior (Dec-23):$62.00

Insurance - Life & Nonlife

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Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 23E ($)	5.30	5.82
Adj. EPS - 24E ($)	5.71	6.11

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2022A	2023E	2024E
Q1	1.10	1.73A	
Q2	1.34	1.53	
Q3	0.28	1.12	
Q4	2.14	1.44	
FY	4.87	5.82	6.11

Style Exposure

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

1Q23 EPS: $1.73A vs. $1.51E

Positives: Reinsurance & insurance margins; MI margins

Negatives: MI 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 15 for analyst certification and important disclosures.

Price Performance

	YTD	1m	3m	12m
Abs	15.2%	9.4%	11.6%	55.4%
Rel	9.6%	7.3%	11.8%	58.3%

Company Data

Shares O/S (mn)	372
52-week range ($)	73.19-41.05
Market cap ($ mn)	26,906.34
Exchange rate	1.00
Free float(%)	96.7%
3M - Avg daily vol (mn)	2.17
3M - Avg daily val ($ mn)	146.4
Volatility (90 Day)	27
Index	S&P 500
BBG BUY|HOLD|SELL	10|2|0

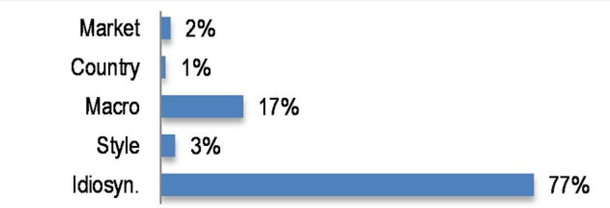
Key Metrics (FYE Dec)

$ in millions	FY22A	FY23E	FY24E
Financial Estimates			
NEP (Premium)	9,678	12,041	13,100
Underwriting income	1,796	1,757	1,680
Net investment income	497	895	1,080
Operating income	2,293	2,652	2,760
Adj. PBT	1,562	2,493	2,559
Adj. net income	1,840	2,185	2,296
Adj. EPS	4.87	5.82	6.11
BBG EPS	4.06	5.90	6.67
DPS	0.00	0.00	0.00
Investments	11,276	13,618	14,932
BVPS	32.62	38.94	43.66
NAVPS	32.62	38.94	43.66
Margins and Growth			
Adj. EPS growth	36.0%	19.4%	5.0%
Ratios			
Adj. tax rate	5.1%	8.1%	8.0%
Loss ratio	(51.9%)	(55.8%)	(57.2%)
Combined ratio	(22.5%)	(26.2%)	(27.2%)
Invest inc. % of Investments	-	-	-
Regulatory solvency ratio	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-
ROE	14.8%	16.5%	15.2%
Valuation			
Dividend yield	0.0%	0.0%	0.0%
Adj. P/E	14.8	12.4	11.8
P/ BV	2.2	1.9	1.7

Summary Investment Thesis and Valuation

Arch is a premier re/insurance franchise that has an established track record of generating 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 healthy, but margins should moderate as reserve releases slow. Meanwhile, in the P&C reinsurance business, hard pricing and tighter terms/ conditions should boost underwriting results in 2023. However, our long-term outlook for Arch's business is less upbeat. We expect MI returns to be held back by the commoditized nature of the product, black box pricing, and higher capital requirements. Additionally, we are negative on the P&C reinsurance business longer term and expect the entry of additional capacity to weigh on pricing over time.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.07	0.26
Country: Bermuda	0.15	0.12
Macro:		
JP Morgan EMBI Global Spread	-0.18	-0.26
JPM Global Equity Sentiment	0.15	0.23
JP Morgan GBI-EM Global Div	-0.03	0.19
Quant Styles:		
Size	0.08	0.17
LowVol	0.29	0.15
Quality	-0.07	0.09

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 1Q23 results. ACGL will hold its earnings conference call at 11:00 AM Eastern on April 27, 2023. Conference call participants need to register at this link: https://register.vevent.com/register/BI5551480d75704c3f9d1b6b156e52dc34 The call replay can be accessed at: ir.archcapgroup.com.

We consider ACGL a premier franchise that is well-positioned to benefit from hard reinsurance pricing, but are Neutral on the stock given its valuation. In our view, ACGL has an industry-leading reinsurance business with a unique culture and approach to underwriting that will generate above-average and less volatile margins over time. Additionally, Arch is a top competitor in the mortgage insurance (MI) market, which we view as a structurally better business than reinsurance. In primary P&C, ACGL has gained share and expanded margins, helped by the favorable pricing environment. Near term, we expect ACGL's results to be marked by strong margins and top-line growth in re/insurance, and moderating margins but poor premium growth in mortgage insurance. However, despite favorable dynamics in the reinsurance market currently, our long-term outlook remains cautious. We expect structural headwinds such as low barriers to entry and the commodity nature of the product to preclude sustained hard pricing. Lastly, ACGL's valuation is not enticing given the stock's recent outperformance.

P&C Reinsurance: N-T Outlook Positive, L-T Cautious

Near-term results in ACGL's reinsurance business should benefit from hard pricing and tighter terms/conditions, but our long-term outlook for the market remains 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 philosophy, ability to shift target segments based on changing market conditions, and judicious management of cat risk. In particular, ACGL prices business using the risk-free rate (leading to more conservative underwriting), and uses a long-term compensation plan for underwriters that pays based on underwriting margins over a multi-year period. In addition, the creation of 3rd party capital vehicles such as Premia Re has allowed Arch to earn fee income from its reinsurance franchise. We consider Arch a top-tier reinsurer and expect firm pricing to boost results through 2023. Still, our long-term outlook for the reinsurance market remains cautious given various structural issues, including its commoditized nature, the ease of entry of new capital, and a broad set of capital providers (some of which, such as pension funds, have lower return thresholds). We are skeptical of prolonged hard pricing and believe that any signs of additional capacity entering the market would hurt sentiment on reinsurance stocks, which have become consensus longs since late 2022.

Mortgage Insurance: Growth to be Poor, Margins to Moderate

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, near-term MI margins will remain healthy, although the benefit of COVID-related reserve releases should taper through 2023. Meanwhile, higher interest rates are likely to suppress mortgage origination volumes, and although not imminent, a recession would increase defaults and pressure margins.

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1Q23 Details

This evening, ACGL reported operating EPS of $1.73, considerably above our $1.51 estimate and consensus of $1.45. The upside was driven by higher than assumed underwriting margins in all three divisions, with reinsurance results especially robust. Investment income was slightly better than expected as well, while catastrophe losses and prior-year reserve development were roughly in-line.

Table 1: 1Q23 Operating Earnings: Actual versus Expected

$ in millions, except per share amounts

	1Q23E	1Q23A	Upside / (downside) to EPS	Comments
Underwriting Income by Division:				
Mortgage	216	243	$0.07	margins (CR 19.9% vs. 25.0%E) benefited from elevated reserve release
Insurance	93	114	$0.06	margins better than expected (CR 90.9% vs. 92.8%E)
Reinsurance	195	213	$0.05	premium growth strong, margins slightly better (84.3% vs. 84.5%E)
Underwriting income	**503**	**570**	**$0.18**	
Net investment income	189	199	$0.03	pre-tax investment yield of 3.03% in 1Q23 vs. 2.80% in 4Q22 and 1.34% in 1Q22
Earnings from affiliates	17	39	$0.06	
Other income (losses) / COLI	1	8	$0.02	
Other expenses / corporate	48	53	-$0.01	
Interest expense	32	32	$0.00	
Pretax operating income	**631**	**731**	**$0.27**	
Income tax expense	50	67	-$0.04	effective tax rate of 9.2% vs. assumed tax rate of 8.0%E
Preferred dividends	10	10	$0.00	
Operating income	**570**	**654**	**$0.22**	
Weighted average dilutive shares	376.7	377.6	$0.00	no share buybacks vs. $100 million assumption
Operating EPS	**$1.51**	**$1.73**	**$0.22**	**no significant unusual items**

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

Business trends were strong. Reinsurance results were especially robust, marked by strong premium growth (net written premium growth of 52% versus our 19% estimate) and better than assumed margins (CR 84.3% versus our 84.5% estimate; CR ex. cats and PYD 83.3% vs. 85.5%). Similarly, insurance division margins were strong (CR 90.9% vs. 92.8%E; CR ex. cats and PYD 89.8% vs. 91.1%). Insurance net written premiums increased 19% from 1Q22, higher than our 17% assumption, helped by healthy growth in all major product lines with the exception of professional lines. MI earnings benefited from upside in margins (CR 20.0% vs. 25.0%E), which were boosted by the release of COVID-related reserves. Weaker than assumed MI written premiums was one of the only notable negatives in results. As expected, ACGL did not repurchase stock in the first quarter. Management commentary on the operating environment in all three divisions was very upbeat.

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Table 2: 1Q23 Key Financial Metrics

$ in millions

	1Q23E	1Q23A
Net premiums written	3,034	3,424
% change (y-o-y)	15.2%	30.0%
Net investment income	189	199
% change (y-o-y)	135.5%	147.4%
Loss ratio ex cats and PYD	54.5%	52.6%
Catastrophe losses	2.7%	2.7%
PYD (favorable) / unfavorable	-4.4%	-4.3%
Loss ratio	52.8%	51.0%
Expense ratio	29.5%	29.6%
Combined ratio	82.4%	80.6%
Combined ratio ex cats & PYD	84.0%	82.2%
Share buybacks ($ mil.)	100	-

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

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Mortgage Ins.: Earnings Benefited From Reserve Release

We expect mortgage insurance (MI) results to be marked by slow new business growth and strong persistency, and healthy (but lower) margins. Higher interest rates are a headwind for growth, while moderating reserve releases on COVID-related delinquencies should drive a decline in margins as the year progresses. The MI business reported underwriting income of $243 million, higher than our $216 million estimate, driven by upside in margins (CR 20.0% vs. 25.0%E) and net earned premiums (+2.2% from 1Q22 vs. -2.8%E). As in recent quarters, the earnings beat was mainly driven by the release of COVID-related reserves (-24.6% vs. -20.0%E ; $73 million vs. $56 million in dollar terms), although core margins were better than anticipated as well (CR ex. cats and PYD 44.5% vs. 45.0%E). The attritional loss ratio was slightly worse (25.3% vs. 25.0%E) but was more than offset by a lower expense ratio (19.3% vs. 20.0%E). On a negative note, net written premiums decreased for the sixth straight quarter, down 9.4% to $261 million, worse than our $274 million estimate. Management attributed the drop to higher ceded premiums and lower gross written premiums due to the combined impact of lower originations in Australia as well as a decline in US MI single premium business.

In 2020 and early 2021, MI margins were hurt by artificially high delinquencies caused by homeowners availing of government forbearance programs. However, after initially spiking in 2Q20, the number of delinquent loans has steadily declined. In particular, 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 stress. Meanwhile, the significant appreciation in house prices has provided a cushion to homeowners under stress who are truly struggling to pay their mortgages, limiting losses for MI carriers. The percent of loans in default in the U.S. primary MI business was 1.7% at 3/31/23, down from 1.8% at 12/31/22 and 2.1% at 3/31/22.

Table 3: Mortgage Insurance Key Metrics

$ in millions

	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23E	1Q23A
Net written premiums	335	336	301	289	1,261	288	294	276	275	1,133	274	261
Premium Growth (y/y)	3.3%	3.3%	0.8%	-12.8%	-1.5%	-14.0%	-12.5%	-8.2%	-5.1%	-10.2%	-4.9%	-9.4%
Losses and LAE ex. cats and PYD	22.3%	16.1%	19.2%	14.8%	18.2%	17.6%	18.8%	21.0%	25.2%	20.7%	25.0%	25.3%
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	-3.4%	-13.1%	-15.5%	-24.2%	-13.7%	-36.5%	-40.7%	-45.1%	-72.1%	-48.6%	-20.0%	-24.6%
Loss ratio	**18.9%**	**3.0%**	**3.7%**	**-9.4%**	**4.4%**	**-18.9%**	**-21.9%**	**-24.1%**	**-46.9%**	**-28.0%**	**5.0%**	**0.7%**
Acquisition expense ratio	8.9%	9.0%	7.7%	4.4%	7.6%	3.6%	3.4%	2.4%	4.4%	3.5%	3.0%	2.4%
Operating expense ratio	14.6%	14.5%	14.8%	16.7%	15.1%	18.4%	17.0%	16.5%	15.4%	16.8%	17.0%	16.9%
Expense ratio	**23.6%**	**23.5%**	**22.6%**	**21.1%**	**22.7%**	**22.1%**	**20.4%**	**18.8%**	**19.8%**	**20.3%**	**20.0%**	**19.3%**
Combined ratio	**42.4%**	**26.5%**	**26.3%**	**11.6%**	**27.1%**	**3.2%**	**-1.5%**	**-5.2%**	**-27.1%**	**-7.7%**	**25.0%**	**19.9%**
Combined ratio ex cats & PYD	45.8%	39.6%	41.8%	35.8%	40.9%	39.7%	39.2%	39.9%	45.0%	41.0%	45.0%	44.5%
Underwriting Income (Loss)	**200**	**250**	**234**	**269**	**953**	**285**	**298**	**299**	**374**	**1,257**	**216**	**243**

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

In our view, MI margins will benefit from reserve releases, but the tailwind should abate relative to recent levels. Higher reported delinquencies at the onset of COVID caused 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 arose from homeowners taking advantage of the government's forbearance protection programs (mainly to preserve liquidity), not actual financial hardship. However, under U.S. GAAP accounting, Arch still 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 not permitted under U.S. GAAP for primary MI business). With most of these delinquent loans curing following the expiration of forbearance programs (initially set for 12/31/20, but then extended through 9/30/21 and, in some cases, year-end 2021 or beyond), ACGL has been releasing previously incurred reserves. The interplay of cures on previously delinquent loans and how new delinquencies emerge given the economic environment, which is beginning to soften, will be the key driver of MI margins through 2023. Overall, despite an expected decline, we forecast MI margins to remain healthy given strong labor and housing markets, cures on previously delinquent loans, and the equity cushion accumulated by homeowners due to the appreciation in house prices. On a cautious note, top-line growth is likely to be weak as higher interest rates reduce mortgage originations. Also, a weaker economy could deflate home prices and lead to higher defaults on mortgages, albeit a material increase in losses seems unlikely in the near term. Barring a recession, we expect core margins to stay healthy, but a declining tailwind from reserve releases should suppress reported results even if economic trends stay favorable.

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

Insurance: Lower Claims Drove Earnings Upside

The insurance business reported better than expected underwriting margins and premium growth. Underwriting income in 1Q23 was $114 million, above our $93 million estimate, driven by a favorable combined ratio (CR 90.9% vs. 92.8%E). The expense ratio was higher than assumed (35.0% vs. 34.1%E), but was more than offset by better attritional loss experience (54.8% vs. 57.0%E) as well as lower catastrophe losses and higher reserve releases. Net premiums written increased +19.1% from 1Q22, higher than our +16.7% assumption, which ACGL attributed to new business, higher prices, and an increase in reinsurance retentions. All major product lines in the insurance division experienced premium growth with the exception of professional lines, where management noted soft pricing.

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Table 4: Insurance Key Metrics

$ in millions

	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23E	1Q23A
Net written premiums	995	964	1,154	1,036	4,148	1,207	1,228	1,369	1,217	5,021	1,409	1,437
Premium Growth (y/y)	20.0%	43.3%	40.0%	23.7%	31.2%	21.3%	27.5%	18.6%	17.4%	21.0%	16.7%	19.1%
Losses and LAE ex. cats and PYD	61.0%	60.2%	59.5%	57.5%	59.5%	55.5%	56.0%	56.0%	56.2%	56.0%	57.0%	54.8%
Catastrophe losses	5.1%	3.2%	12.2%	2.0%	5.6%	3.1%	1.5%	13.4%	2.8%	5.3%	2.0%	1.6%
PYD (favorable) / unfavorable	-0.7%	-0.3%	-0.5%	-0.3%	-0.4%	-0.1%	-0.4%	-0.1%	-0.3%	-0.2%	-0.3%	-0.5%
Loss ratio	**65.4%**	**63.1%**	**71.2%**	**59.2%**	**64.6%**	**58.5%**	**57.1%**	**69.3%**	**58.7%**	**61.0%**	**58.7%**	**55.9%**
Acquisition expense ratio	15.6%	15.8%	16.2%	18.8%	16.7%	19.1%	19.4%	19.6%	19.6%	19.4%	19.5%	19.5%
Operating expense ratio	16.7%	15.4%	14.8%	14.9%	15.4%	16.2%	14.6%	13.9%	13.8%	14.6%	14.6%	15.5%
Expense ratio	**32.4%**	**31.2%**	**31.0%**	**33.7%**	**32.1%**	**35.3%**	**34.0%**	**33.5%**	**33.5%**	**34.0%**	**34.1%**	**35.0%**
Combined ratio	**97.7%**	**94.3%**	**102.3%**	**93.0%**	**96.8%**	**93.8%**	**91.1%**	**102.8%**	**92.1%**	**95.1%**	**92.8%**	**90.9%**
Combined ratio ex cats & PYD	93.3%	91.4%	90.6%	91.3%	91.6%	90.8%	90.0%	89.5%	89.6%	90.0%	91.1%	89.8%
Underwriting Income (Loss)	**18**	**49**	**(21)**	**71**	**117**	**63**	**98**	**(34)**	**98**	**225**	**93**	**114**

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

We believe that ACGL has attractive opportunities in the primary P&C market, and we expect premium growth and margins to remain healthy. After shrinking its "cycle managed" business (now dubbed as wholesale/large capacity) from 2012 to 2017, ACGL is seeing healthy growth in this part of its primary book, driven by price increases in the broader market, particularly E&S. Results in less opportunistic parts of ACGL's book (specialty small/middle market and franchise) have been strong as well. On a cautious note, we believe that the market is past the midpoint of the current hard pricing cycle, and that exposure growth could decelerate if the economy slows. As such, although tailwinds in the insurance business should persist as premiums are earned and certain lines of business see harder pricing (e.g. property coverage), we expect overall price increases to moderate through 2023.

Reinsurance: Robust Results, Near-Term Outlook Upbeat

ACGL's reinsurance business reported strong premium growth and better than expected margins. Underwriting income in 1Q23 was $213 million, higher than our $195 million estimate, driven by strong premium growth (net earned premium growth of +65.3% vs. +56.0%E) and slightly better margins (CR of 84.3% vs. 84.5%E). Core margins were strong (CR ex. cats and PYD 83.3% vs. 85.5%), helped by favorable claims and expenses, while higher catastrophe losses and lower favorable development were partial offsets. Net written premium growth was very strong, up 51.5% to $1.7 billion, well above our +18.6% forecast. Similar to the insurance segment, management attributed premium growth to new business, higher prices, and an increase in retentions/ less retrocession. Management was upbeat on ACGL's position in the market amid constricted capacity from competitors. Furthermore, Arch noted that primary insurers have been retaining more risk.

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Table 5: Reinsurance Key Metrics

$ in millions

	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23E	1Q23A
Net written premiums	999	925	621	709	3,254	1,139	1,163	1,079	1,543	4,924	1,351	1,726
Premium Growth (y/y)	25.3%	63.6%	2.8%	44.5%	32.4%	14.0%	25.7%	73.6%	117.6%	51.3%	18.6%	51.5%
Losses and LAE ex. cats and PYD	56.3%	62.9%	57.4%	54.9%	57.9%	52.6%	55.3%	58.4%	57.4%	56.2%	58.5%	56.6%
Catastrophe losses	22.7%	2.5%	32.6%	6.7%	15.4%	6.7%	7.1%	39.1%	0.0%	12.9%	4.0%	4.4%
PYD (favorable) / unfavorable	-3.8%	-2.5%	-9.6%	-6.4%	-5.6%	-2.8%	-4.5%	-4.9%	-4.5%	-4.3%	-5.0%	-3.4%
Loss ratio	**75.2%**	**62.9%**	**80.4%**	**55.2%**	**67.8%**	**56.5%**	**57.9%**	**92.6%**	**52.9%**	**64.9%**	**57.5%**	**57.6%**
Acquisition expense ratio	18.3%	18.1%	19.1%	20.0%	18.9%	21.4%	20.4%	20.8%	19.9%	20.5%	20.0%	21.1%
Operating expense ratio	9.4%	6.1%	6.7%	7.9%	7.5%	8.7%	7.1%	6.3%	5.6%	6.8%	7.0%	5.6%
Expense ratio	**27.7%**	**24.2%**	**25.8%**	**27.9%**	**26.4%**	**30.1%**	**27.5%**	**27.1%**	**25.5%**	**27.3%**	**27.0%**	**26.7%**
Combined ratio	**102.9%**	**87.1%**	**106.2%**	**83.1%**	**94.2%**	**86.6%**	**85.5%**	**119.7%**	**78.5%**	**92.2%**	**84.5%**	**84.3%**
Combined ratio ex cats & PYD	84.0%	87.1%	83.2%	82.8%	84.3%	82.7%	82.9%	85.5%	83.0%	83.5%	85.5%	83.3%
Underwriting Income (Loss)	**(20)**	**96**	**(39)**	**133**	**170**	**109**	**139**	**(197)**	**263**	**314**	**195**	**213**

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

We are skeptical of a sustained hard reinsurance market, but ACGL is better positioned than most peers to take advantage of favorable market conditions in the near term. ACGL's reinsurance business was initially established to take advantage of the hard market for casualty risk in the early 2000s. Over the years, however, management has shifted Arch Re's business mix away from casualty coverage 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. Firm pricing has benefited results in recent years and should drive continued strong premiums and margins in the near term, especially following Hurricane Ian. Still, we expect the pace of price hikes to moderate longer term and remain skeptical of a sustained hard 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, we believe that loss reserves which were set up for Ian could ultimately prove to be too conservative (most primary companies booked lower Ian-related losses than reinsurers).

Raising EPS Estimates

We are raising 2Q23 EPS from $1.43 to $1.53, 2023 EPS from $5.30 to $5.82, and 2024 EPS from $5.71 to $6.11. We do not expect MI reserve releases to recur at the 1Q23 level in future periods, but are increasing our assumptions for overall investment income as well as margins and premium growth in the reinsurance and insurance divisions. In our opinion, cat losses (which would affect reinsurance and insurance margins) and housing market trends (which affect MI margins and premium growth) are the key sources of potential variance in reported results and our projections.

Investment Thesis, Valuation and Risks

Arch Capital *(Neutral; Price Target: $67.00)*

Investment Thesis

We consider Arch a premier re/insurance franchise, but are Neutral on the stock due to 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 the mortgage insurance (MI) market, which we consider structurally better than P&C reinsurance. In insurance, ACGL has grown premiums and improved margins, helped by the firm pricing market. In the near term, we expect MI results to remain healthy even as margins continue to normalize and reserve releases taper off. Additionally, hard pricing should boost premium growth and margins in the re/insurance 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. Lastly, the stock's valuation is not too compelling considering ACGL's long-term ROE and EPS growth potential.

Valuation

We are raising our December 2023 price target from $62 to $67 to reflect the increase in our EPS and book value estimates. Our price target assumes a 1.4x multiple on our 12/31/23E BV ex. AOCI forecast, a 1.5x multiple on our 12/31/23E BV forecast, and an 11.0x multiple on our 2024 EPS estimate, and we corroborate this approach with a sum-of-the-parts analysis that values ACGL's re/insurance business separately from mortgage insurance. Our target multiples for ACGL reflect its current business mix, which has become more skewed to mortgage insurance. ACGL trades at 2.1x BV and 12.5x 2023E EPS compared to 1.7x and 9.8x for the reinsurance sector, 0.9x and 7.1x for MI peers, and 1.8x and 14.4x 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.
- **Management remains proactive with share repurchases.** ACGL repurchased more stock than expected in 2H21 and 1H22, partly to take advantage of its depressed trading multiples. A continuation of the trend could drive upward revisions in EPS forecasts as well as boost sentiment on the stock.

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

- **The housing market deteriorates.** Given Arch's meaningful exposure to mortgage insurance and the more systematic nature of mortgage insurance risk, rising unemployment, higher mortgage defaults, and decreasing home values would pressure the company's results and hurt sentiment on the stock.

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- **ACGL and/or peers raise capital to take advantage of the hard reinsurance market.** This, in turn, could result in a reversal in pricing trends and potentially drive reduction in EPS estimates as well as hurt sentiment on the sector.
- **The pace of reserve development moderates.** Favorable reserve development has been a notable contributor to ACGL's results in recent years. A slowdown in the pace of development could pressure margins and returns.
- **Cat losses stay elevated.** While prices for cat re/insurance have hardened, the frequency and severity of losses have increased by a larger magnitude over time. This implies that reinsurance prices need to rise significantly for carriers to earn adequate returns, especially if cat losses are close to those in recent years.

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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)	(128)	(128)
Acquisition & operating expenses	(1,740)	(2,203)	(2,462)
Amortization of acquisition costs (net)	-	-	-
Other expenses	-	-	-
Total expenses	**-**	**-**	**-**
Pretax income	1,562	2,493	2,559
Income taxes	(80)	(201)	(205)
Total net income	1,436	2,250	2,314
Total operating income	1,840	2,185	2,296
Weighted average diluted shares	378	376	376
EPS - operating	**4.87**	**5.82**	**6.11**

Income Statement - Quarterly	1Q23A	2Q23E	3Q23E	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	(32)	(32)	(32)
Acquisition & operating expenses	(533)A	(544)	(562)	(565)
Amortization of acquisition costs (net)	-	-	-	-
Other expenses	-	-	-	-
Total expenses	**-**	**-**	**-**	**-**
Pretax income	781A	642	467	603
Income taxes	(64)A	(51)	(37)	(48)
Total net income	705A	581	420	545
Total operating income	654A	576	415	540
Weighted average diluted shares	378A	377	371	375
EPS - operating	**1.73A**	**1.53**	**1.12**	**1.44**

Balance Sheet and Capital Data	FY22A	FY23E	FY24E
Shareholders' equity	-	-	-
Shareholders' equity ex. AOCI	-	-	-
Shares outstanding	370	370	360
Book value per share	32.62	38.94	43.66
Book value per share (ex. AOCI)	37.06	42.45	47.27
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%	19.4%	5.0%	-
Book value per share (ex. AOCI) growth	9.9%	14.5%	11.4%	-
Return on equity (ROE)	14.8%	16.5%	15.2%	-
Return on equity (ex. AOCI)	-	-	-	-
Dividend payout ratio	0.0%	0.0%	0.0%	-
Total revenue growth	-	-	-	-
Total expense growth	-	-	-	-
Tax rate	5.1%	8.1%	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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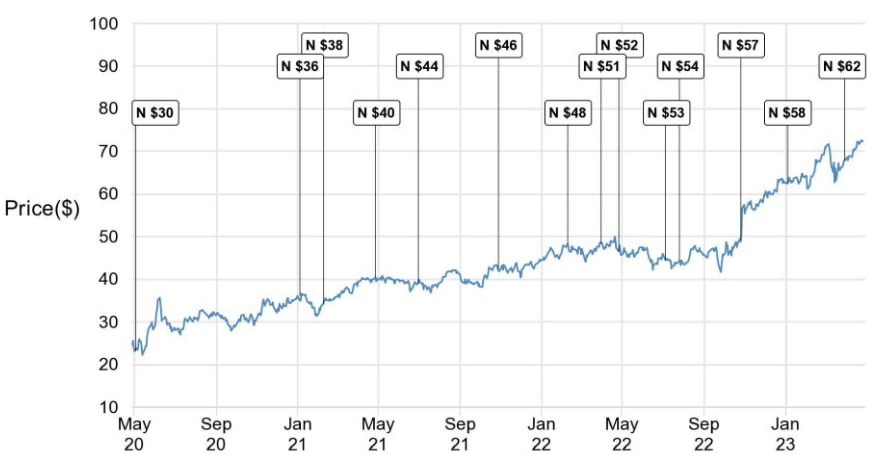
Arch Capital (ACGL, ACGL US) Price Chart



Date	Rating	Price ($)	Price Target ($)
04-May-20	N	23.11	30
04-Jan-21	N	36.07	36
09-Feb-21	N	34.15	38
28-Apr-21	N	40.49	40
01-Jul-21	N	38.94	44
28-Oct-21	N	42.33	46
09-Feb-22	N	48.20	48
01-Apr-22	N	48.42	51
27-Apr-22	N	46.51	52
06-Jul-22	N	44.44	53
27-Jul-22	N	44.24	54
26-Oct-22	N	49.22	57
04-Jan-23	N	62.46	58
31-Mar-23	N	67.86	62

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