J.P.Morgan

North America Equity Research
27 April 2022

# Arch Capital

## Healthy Overall Results

## Neutral

**ACGL, ACGL US**

Price (27 Apr 22): $47.93

▲ **Price Target (Dec-22): $52.00**
Prior (Dec-22): $51.00

**Insurance - Life & Nonlife**


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ACGL's results were healthy. We consider Arch a strong franchise but are Neutral due to a cautious view of the reinsurance market and valuation.

- **EPS below our forecast, but above consensus.** ACGL announced 1Q22 operating EPS of $1.10, below our $1.18 projection but above consensus of $1.06. The shortfall to our model was driven by investment income and higher expenses. Underwriting income beat in the mortgage insurance business, but missed in P&C reinsurance and insurance.
- **Operating fundamentals were healthy.** Overall margins were as expected on a reported basis (combined ratio of 78.7%), but slightly worse on a core basis (CR ex. cats and PYD of 80.8% vs. 80.3%E). Margins were especially strong in mortgage insurance, but weak in P&C insurance. The expense ratio in the insurance and reinsurance businesses ticked up. Management attributed this to higher incentive comp and a shift in business mix. The mix shift should benefit the loss ratio, while incentive comp should decline in 2Q22. Cat losses were elevated as well, but this was mostly due to Russia-related reserves, virtually all of which relate to IBNR, suggesting that ACGL booked conservatively to take advantage of healthy underlying business trends. Written premiums rose 5.0%, above our 1.2% assumption. On the other hand, investment income was below our expectation. ACGL spent $255 million on share repurchases in 1Q22, higher than our $100 million assumption.
- **Our outlook for business trends is mixed.** In our view, the company's results will be marked by healthy MI and re/insurance margins, strong re/insurance premiums, and weak MI premiums. Also, we expect share buybacks to slow from 2021 levels as ACGL focuses more on organic growth, particularly in re/insurance. Longer term, we anticipate healthy returns in the MI business, which generates the bulk of ACGL's underwriting earnings. However, margins are likely to compress from 2022 levels given the commoditized nature of the business, black box pricing, and higher capital requirements. Meanwhile, our long-term view of the reinsurance market is cautious, and we expect excess capacity, more 3rd party participation, increased mobility of capital, and broker consolidation to preclude a sustained hard market.
- **We maintain our Neutral rating.** In our opinion, Arch is a top-tier franchise, but in commoditized markets. Over time, ACGL has transitioned into more of an MI firm than a P&C reinsurer. Our long-term outlook for the MI business is upbeat, but we remain cautious on the reinsurance market. Also, we feel that the stock's valuation is not too enticing given the company's long-term ROE and growth profile.

**Quarterly Forecasts (FYE Dec)**

Adj. EPS ($)

| | 2021A | 2022E | 2023E |
|---|---|---|---|
| Q1 | 0.59 | 1.10A | |
| Q2 | 1.00 | 1.10 | |
| Q3 | 0.74 | 0.97 | |
| Q4 | 1.27 | 1.05 | |
| FY | 3.58 | 4.22 | 4.65 |

**Style Exposure**

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

**1Q22 EPS:** $1.10A vs. $1.18E

**Positives**
MI margins
Insurance and reinsurance premiums
Share repurchases

**Negatives**
Insurance margins
MI 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 12 for analyst certification and important disclosures.**

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## Price Performance


| | YTD | 1m | 3m | 12m |
|---|---|---|---|---|
| Abs | 7.6% | 0.6% | 7.0% | 18.4% |
| Rel | 19.8% | 8.4% | 10.3% | 18.4% |

## Company Data

| | |
|---|---|
| Shares O/S (mn) | 376 |
| 52-week range ($) | 50.73-36.53 |
| Market cap ($ mn) | 18,008.78 |
| Exchange rate | 1.00 |
| Free float(%) | 96.6% |
| 3M - Avg daily vol (mn) | 2.03 |
| 3M - Avg daily val ($ mn) | 95.5 |
| Volatility (90 Day) | 24 |
| Index | S&P 500 |
| BBG BUY\|HOLD\|SELL | 10\|2\|1 |

## Key Metrics (FYE Dec)

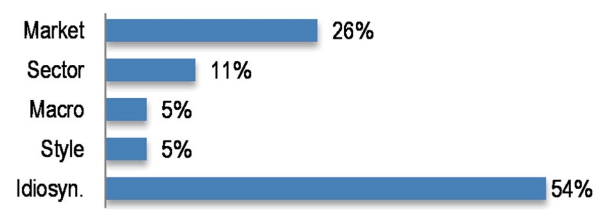
| $ in millions | FY21A | FY22E | FY23E |
|---|---|---|---|
| **Financial Estimates** | | | |
| NEP (Premium) | 8,082 | 9,137 | 10,214 |
| Underwriting income | 1,218 | 1,766 | 1,949 |
| Net investment income | 389 | 328 | 344 |
| Operating income | 1,607 | 2,094 | 2,293 |
| Adj. PBT | 2,368 | 1,554 | 2,030 |
| Adj. net income | 1,435 | 1,628 | 1,826 |
| Adj. EPS | 3.58 | 4.22 | 4.65 |
| BBG EPS | 3.33 | 4.40 | 5.18 |
| DPS | 0.00 | 0.00 | 0.00 |
| Investments | 11,771 | 12,070 | 13,327 |
| BVPS | 33.56 | 34.48 | 37.91 |
| NAVPS | 33.56 | 34.48 | 37.91 |
| **Margins and Growth** | | | |
| Adj. EPS growth | 163.9% | 17.7% | 10.2% |
| **Ratios** | | | |
| Adj. tax rate | 5.4% | 7.7% | 8.0% |
| Loss ratio | (53.5%) | (51.4%) | (52.0%) |
| Combined ratio | (25.3%) | (22.0%) | (23.1%) |
| Invest inc. % of Investments | - | - | - |
| Regulatory solvency ratio | - | - | - |
| Leverage (Debt/Debt+Equity) | - | - | - |
| ROE | 11.5% | 12.7% | 13.4% |
| **Valuation** | | | |
| Dividend yield | 0.0% | 0.0% | 0.0% |
| Adj. P/E | 13.4 | 11.4 | 10.3 |
| P/ BV | 1.4 | 1.4 | 1.3 |

## Summary Investment Thesis and Valuation

### Investment Thesis

We consider Arch a premier franchise and expect it to generate higher and less volatile underwriting margins than most peers. However, we remain Neutral on the stock given a cautious long-term outlook for the P&C reinsurance market. In our view, near-term results in the MI and re/insurance businesses will benefit from the economic recovery, a healthy housing market, and firm re/insurance pricing. Meanwhile, our long-term outlook is mixed as we expect MI returns to be held back by commoditized nature of the product, black box pricing, and higher capital requirements. Moreover, we remain negative on the P&C reinsurance business, and forecast excess capacity, greater third-party participation, increased mobility of capital, and consolidation among brokers to preclude sustained hard market.

## Performance Drivers




| Factors | 6M Corr | 1Y Corr |
|---|---|---|
| **Market**: MSCI US | 0.48 | 0.45 |
| **Sect**: Financials | 0.23 | 0.40 |
| **Ind**: Insurance | 0.37 | 0.55 |
| **Macro:** | | |
| US 10yr yield | 0.23 | 0.25 |
| Economic Surprise | -0.24 | -0.16 |
| Credit Spread | 0.06 | 0.16 |
| **Quant Styles:** | | |
| Value | 0.35 | 0.44 |
| Growth | -0.35 | -0.37 |
| LowVol | 0.12 | 0.15 |

Source: J.P. Morgan Quantitative and Derivatives Strategy for Performance Drivers; company data, Bloomberg Finance L.P. and J.P. Morgan estimates for all other tables. Note: Price history may not be complete or exact.

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# Investment Thesis

**Please see Page 5 for a detailed review of 1Q22 results.**

ACGL will hold its earnings conference call at 11:00 AM Eastern on April 28, 2022.

The dial-in number for the call is 484-747-6266, code: 4026115.

The dial-in for the call replay is 404-537-3406, code: 4026115.

**We consider AGCL a premier franchise, but are Neutral on the stock given our cautious long-term outlook for the reinsurance market.** In our view, ACGL has an industry-leading reinsurance business with a unique culture and approach to underwriting that will generate superior and less volatile margins over time. Arch has also established itself as one of the top competitors in the mortgage insurance (MI) market, which we view as a structurally superior business to reinsurance. Plus, ACGL has been driving premium growth and margin improvement in its primary insurance business. In the near term, we expect ACGL's MI results to benefit from healthy housing and labor market conditions, and P&C margins to benefit from firm pricing. On a negative note, ACGL could incur losses in aviation and political risk coverages due to the Russia/Ukraine conflict. Furthermore, our long-term outlook for the reinsurance business remains cautious given structural headwinds in the market (e.g. excess capital, low barriers to entry, limited pricing power, etc.). Lastly, top-line growth in the MI business is likely to slow as higher interest rates weigh on mortgage originations. Lastly, the stock's valuation does not seem compelling given the company's long-term ROE and growth potential.

## Mortgage Insurance: Strong Margins, but Weak Growth

ACGL expanded in mortgage insurance primarily through acquisitions (CMG in 2014 and United Guaranty in 2016) during a time when market conditions were favorable overall, marked by appreciating home prices, relatively stringent lending standards at mortgage issuers, and disciplined pricing by mortgage insurers. Since these acquisitions, Arch's MI business has generated healthy margins. Despite the temporary setback from COVID-related delinquencies in 2020, reserve releases have been a tailwind (and are likely to remain as such through 2022) as loans delinquent early during the pandemic have become current on payments. On a cautious note, we expect higher interest rates to suppress mortgage origination volumes, and although not imminent, a recession could result in higher defaults and weaker MI margins.

## P&C Reinsurance: Long-Term Outlook Remains Negative

**We expect ACGL's reinsurance margins to be better and less volatile than peers', but our long-term outlook for the market remains cautious.** Arch has historically produced stronger results than most other 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 (naturally leading to more conservative underwriting) and deploys a long-term compensation framework for underwriters that pays based on underwriting margins over a multi-year period. Also, the creation of 3rd party capital vehicles such as Premia Re has allowed Arch to earn fee income from its reinsurance franchise. While we consider Arch a top-tier reinsurer, our long-term outlook for the reinsurance market is negative due to several structural headwinds, including the commoditized nature of the product and the ease of entry of new capital. Pricing remains firm overall, but we expect the pace of price hikes to moderate over the next year, which could weigh on top-line growth and margins. Moreover, we believe that catastrophe risk has been systemically underpriced as prices have not kept up with increasing frequency and severity.

# 1Q22 Details

This evening, Arch reported first quarter 2022 operating EPS of $1.10, lower than our $1.18 projection but above consensus of $1.06. Compared with our model, underwriting income beat in the mortgage insurance business, but missed in P&C reinsurance and insurance. Investment income and other income (primarily earnings from affiliates including Somers/Watford and Coface and corporate expenses) were weaker than assumed as well.

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

$ in millions, except per share amounts

| | 1Q22E | 1Q22A | Upside / (downside) to EPS | Comments |
|---|---|---|---|---|
| **Underwriting Income by Division** | | | | |
| Mortgage | 254 | 285 | $0.08 | strong margins (CR of 3.2% vs. 23.0%E) more than offset lower earned premiums |
| Insurance | 82 | 63 | -$0.05 | net written premiums +21.3% vs. +16.2%E; combined ratio (93.8% vs. 92.3%E) |
| Reinsurance | 148 | 109 | -$0.10 | net written premiums +14.0% vs. +9.3%E; combined ratio (86.6% vs. 83.0%E) |
| **Underwriting income** | **484** | **458** | **-$0.07** | |
| Net investment income | 90 | 80 | -$0.02 | pre-tax investment yield of 1.34% vs 1.46% in 4Q21 and 1.31% in 1Q21 |
| Other income (losses) | (48) | (72) | -$0.06 | higher corporate expenses |
| Interest expense | 32 | 33 | $0.00 | |
| Income tax expense | 40 | 12 | $0.07 | tax rate 5.6% vs. 8.0%E |
| **Operating income** | **453** | **422** | **-$0.08** | |
| Weighted average dilutive shares | 384.2 | 384.2 | $0.00 | share buybacks of $255 million versus our $100 million estimate |
| **Operating EPS** | **$1.18** | **$1.10** | **-$0.08** | **no major unusual items** |

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

**On a total company basis, underwriting margins were in-line with our forecast, while investment income was weaker.** The combined ratio was 78.7% on a reported basis (as expected) and 80.8% excluding cat losses and prior year development (slightly worse than our 80.3% forecast). Margins were especially strong in the mortgage insurance business, but weak in insurance. The expense ratio in the insurance and reinsurance businesses ticked up, which management attributed to higher incentive comp and a shift in business mix. Net written premiums increased 5.0% to $2.6 billion, exceeding our $2.5 billion (+1.2%) assumption. On the other hand, investment income was below our expectation. ACGL spent $255 million on share repurchases in 1Q22, significantly above our $100 million assumption.

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**Table 2: 1Q22 Key Financial Metrics**

$ in millions

| | 1Q22E | 1Q22A |
|---|---|---|
| Net premiums written | 2,540 | 2,634 |
| % change (y-o-y) | 1.2% | 5.0% |
| Net investment income | 90 | 80 |
| % change (y-o-y) | -9.0% | -18.6% |
| Loss ratio ex cats and PYD | 51.8% | 49.2% |
| Catastrophe losses | 1.9% | 4.0% |
| PYD (favorable) / unfavorable | -3.5% | -6.1% |
| Loss ratio | 50.2% | 47.2% |
| Expense ratio | 28.5% | 31.5% |
| Combined ratio | 78.7% | 78.7% |
| Combined ratio ex cats & PYD | 80.3% | 80.8% |
| Share buybacks ($ mil.) | 100 | 255 |

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

## Mortgage Ins.: Strong Margins Offset Lower Premiums

**MI results were marked by a shortfall in premiums but strong margins, and our outlook remains upbeat given favorable housing and labor market trends.** The MI division generated underwriting income of $285 million in 1Q22, well above our $254 million estimate, with upside in margins (CR of 3.2% versus our 23.0% estimate) more than offsetting lower net earned premiums (-13.9% vs. -3.8%E). Margins benefited from favorable development on COVID-related reserves established in 2020 (-36.5% vs. -15.5%E), which more than compensated for a slightly worse core combined ratio (39.7% vs. 38.5%E). Net written premiums declined 14.0% to $288 million, close to our expectation, due to lower gross written premiums. Management attributed the decline to lower mortgage volumes in the U.S., offset by growth in Australia.

Through 2020 and early 2021, MI margins were pressured by artificially high delinquencies attributable to homeowners availing themselves of government forbearance programs. However, with forbearance programs having expired, more loans are curing, particularly those where borrowers were taking advantage of forbearance programs but were not in financial stress. The significant appreciation in house prices is driving lower delinquencies as well. The number of delinquent loans has declined steadily since spiking in 2Q20 and, barring an economic recession, we expect the trend to continue. The percent of loans in default in the U.S. primary MI business was 2.1% at 3/31/22, an improvement from 2.4% at 12/31/21, 2.7% at 9/30/2021, and 3.9% at 3/31/2021.

**Table 3: Mortgage: Key Metrics**

$ in millions

| | 1Q20 | 2Q20 | 3Q20 | 4Q20 | 2020 | 1Q21 | 2Q21 | 3Q21 | 4Q21 | 2021 | 1Q22E | 1Q22A |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Net written premiums | 325 | 325 | 298 | 332 | 1,280 | 335 | 336 | 301 | 289 | 1,261 | 291 | 288 |
| Premium Growth (y/y) | 5.7% | 1.1% | -6.0% | 5.1% | 1.4% | 3.3% | 3.3% | 0.8% | -12.8% | -1.5% | -13.1% | -14.0% |
| Losses and LAE ex. cats and | 21.4% | 61.4% | 44.9% | 27.3% | 39.2% | 22.3% | 16.1% | 19.2% | 14.8% | 18.2% | 16.0% | 17.6% |
| 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 | -1.8% | -0.1% | -1.3% | -2.4% | -1.4% | -3.4% | -13.1% | -15.5% | -24.2% | -13.7% | -15.5% | -36.5% |
| **Loss ratio** | **19.6%** | **61.3%** | **43.6%** | **24.9%** | **37.8%** | **18.9%** | **3.0%** | **3.7%** | **-9.4%** | **4.4%** | **0.5%** | **-18.9%** |
| Acquisition expense ratio | 11.2% | 9.3% | 10.2% | 7.7% | 9.6% | 8.9% | 9.0% | 7.7% | 4.4% | 7.6% | 9.5% | 3.6% |
| Operating expense ratio | 13.3% | 10.3% | 10.4% | 12.5% | 11.6% | 14.6% | 14.5% | 14.8% | 16.7% | 15.1% | 13.0% | 18.4% |
| **Expense ratio** | **24.5%** | **19.6%** | **20.6%** | **20.2%** | **21.2%** | **23.6%** | **23.5%** | **22.6%** | **21.1%** | **22.7%** | **22.5%** | **22.1%** |
| **Combined ratio** | **44.1%** | **80.9%** | **64.2%** | **45.1%** | **59.0%** | **42.4%** | **26.5%** | **26.3%** | **11.6%** | **27.1%** | **23.0%** | **3.2%** |
| Combined ratio ex cats & PYD | 45.9% | 81.0% | 65.5% | 47.5% | 60.4% | 45.8% | 39.6% | 41.8% | 35.8% | 40.9% | 38.5% | 39.7% |
| **Underwriting Income (Loss)** | **198** | **76** | **131** | **189** | **593** | **200** | **250** | **234** | **269** | **953** | **254** | **285** |

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

**We project MI margins to remain robust.** U.S. accounting rules require Arch to set reserves for the primary U.S. MI business based on reported delinquencies (unlike for P&C lines, an IBNR component is not permitted under U.S. GAAP for primary MI business). Despite a strong housing market and improved labor market conditions, delinquencies rose after the onset of the pandemic and Arch, like its mortgage insurance peers, had to establish corresponding reserves. However, we believe that a meaningful portion of delinquencies resulted from homeowners' taking advantage of the government's forbearance protection programs (mainly to preserve liquidity), not the result of actual financial hardship. As such, actual losses on most delinquent loans being reported to MI companies should be very low, and we anticipate a high level of cures with 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). The interplay of cures on previously delinquent loans and how new delinquencies emerge in response to the economic environment will be the key driver of MI margins through 2022. We believe that the strong labor and housing markets, coupled with cures on previously delinquent loans, will drive robust margins in the business over the next few quarters. The strong housing market, and the ensuing equity cushion accumulated by homeowners, is contributing to reserve releases, a phenomenon that is likely to continue in the near future. On a cautious note, top-line growth in the business is likely to be sluggish given lower mortgage originations following the increase in interest rates.

**ACGL has become a formidable competitor in the mortgage insurance market through acquisitions, and could expand further via M&A in the future.** 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 into the bank channel. Following the deal, Arch became a top 10 competitor in the domestic private MI market. Arch's market position strengthened further following its 2017 acquisition of United Guaranty (UGC) from AIG, which catapulted the company to a top-3 competitor (as part of the deal, AIG retained 50% of mortgage insurance blocks originated by UGC prior to 2017). The company has also expanded its presence in foreign MI markets through M&A, including its recent acquisition of Westpac's mortgage insurance business in Australia (closed in August 2021).

## Insurance: Lower Margins Drove Miss, Growth Robust

**The insurance business reported strong premium growth, but lower than expected margins.** Underwriting income in 1Q22 was $63 million, below our $82 million assumption, driven by a higher than assumed combined ratio (93.8% versus our 92.3% estimate). The loss ratio was better than assumed (58.5% vs. 60.3%E) despite high cat losses and reserves for the Russia/Ukraine war (3.1% vs. 2.0%E). However, this was more than offset by a higher acquisition and operating costs (expense ratio of 35.3% vs. 32.0%E). Management attributed the increase in the expense ratio partly to higher incentive comp and in part to a business mix shift to lines such as travel and professional liability that have higher expense ratios but lower loss ratios, and profit commissions. The company expects incentive comp to moderate in 2Q22, implying an improvement in the expense ratio. Underwriting results were slightly worse than expected on a core basis as well (CR ex. cats and PYD of 90.8% versus our 90.5% estimate). Meanwhile, top-line growth was robust, with premiums rising 21.3% to $1.2 billion versus our 16.2% estimate, which management attributed to firm pricing.

**Table 4: Insurance: Key Metrics**

$ in millions

| | 1Q20 | 2Q20 | 3Q20 | 4Q20 | 2020 | 1Q21 | 2Q21 | 3Q21 | 4Q21 | 2021 | 1Q22E | 1Q22A |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Net written premiums | 829 | 672 | 824 | 838 | 3,163 | 995 | 964 | 1,154 | 1,036 | 4,148 | 1,156 | 1,207 |
| Premium Growth (y/y) | 33.4% | 7.1% | 17.1% | 21.6% | 19.7% | 20.0% | 43.3% | 40.0% | 23.7% | 31.2% | 16.2% | 21.3% |
| Losses and LAE ex. cats and | 64.0% | 63.1% | 62.9% | 64.3% | 63.6% | 61.0% | 60.2% | 59.5% | 57.5% | 59.5% | 58.5% | 55.5% |
| Catastrophe losses | 6.9% | 12.5% | 10.3% | 8.3% | 9.5% | 5.1% | 3.2% | 12.2% | 2.0% | 5.6% | 2.0% | 3.1% |
| PYD (favorable) / unfavorable | -0.1% | -0.3% | -0.2% | -0.2% | -0.2% | -0.7% | -0.3% | -0.5% | -0.3% | -0.4% | -0.3% | -0.1% |
| **Loss ratio** | **70.8%** | **75.3%** | **73.0%** | **72.4%** | **72.9%** | **65.4%** | **63.1%** | **71.2%** | **59.2%** | **64.6%** | **60.3%** | **58.5%** |
| Acquisition expense ratio | 15.0% | 15.7% | 14.2% | 13.5% | 14.6% | 15.6% | 15.8% | 16.2% | 18.8% | 16.7% | 16.5% | 19.1% |
| Operating expense ratio | 18.1% | 17.3% | 17.0% | 15.8% | 17.0% | 16.7% | 15.4% | 14.8% | 14.9% | 15.4% | 15.5% | 16.2% |
| **Expense ratio** | **33.1%** | **32.9%** | **31.3%** | **29.3%** | **31.6%** | **32.4%** | **31.2%** | **31.0%** | **33.7%** | **32.1%** | **32.0%** | **35.3%** |
| **Combined ratio** | **103.9%** | **108.3%** | **104.2%** | **101.7%** | **104.5%** | **97.7%** | **94.3%** | **102.3%** | **93.0%** | **96.8%** | **92.3%** | **93.8%** |
| Combined ratio ex cats & PYD | 97.1% | 96.1% | 94.1% | 93.6% | 95.2% | 93.3% | 91.4% | 90.6% | 91.3% | 91.6% | 90.5% | 90.8% |
| **Underwriting Income (Loss)** | **(28)** | **(57)** | **(31)** | **(13)** | **(129)** | **18** | **49** | **(21)** | **71** | **117** | **82** | **63** |

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

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**ACGL has attractive opportunities in insurance, and our outlook for premium growth and margins is constructive.** After shrinking its "cycle managed" business (now dubbed as wholesale/large capacity) from 2012 to 2017, ACGL is seeing healthy growth in this portion of the book, driven by price increases in the broader market, particularly in E&S. This, coupled with consistent performance in the less opportunistic parts of its book (specialty small/middle market and franchise) and the healthy economy (which should benefit exposure units in most lines, but especially travel), should drive healthy results in the business. On a cautious note, we believe that the market is past the midpoint of the current pricing cycle. As such, although the favorable tailwinds being experienced by the insurance business should persist as premiums are earned, we expect the pace of price increases on new business to moderate through 2022 and 2023.

## Reinsurance: High Expenses Drove Miss; Outlook Downbeat

**Reinsurance results were marked by healthy premium growth, but lower than expected earnings.** Underwriting income in 1Q22 was $109 million, below our $148 million estimate, due to an elevated combined ratio (86.6% vs. 83.0%E). Similar to the insurance business, the shortfall in underwriting margins was mainly driven by elevated acquisition and operating costs, which ACGL attributed to higher incentive comp as well as a shift in business mix, profit commissions, and seasonal expense items. Claims were in-line with a lower AY loss ratio (52.6% vs. 57.0%E) mostly offset by higher catastrophe claims, which included losses related to Russia/Ukraine in lines such as marine cargo, political violence, and aviation. Management disclosed that to date there have been no filed Russia/Ukraine claims, and that virtually all Russia/Ukraine losses booked by ACGL in 1Q22 (for both insurance and reinsurance businesses) are related to IBNR. Core margins were better (CR ex. cats and PYD of 82.7% vs. 83.5%E). Net written premium growth was healthy, up 14.0% to $1.1 billion, higher than our 9.3% expectation.

**Table 5: Reinsurance: Key Metrics**

$ in millions

| | 1Q20 | 2Q20 | 3Q20 | 4Q20 | 2020 | 1Q21 | 2Q21 | 3Q21 | 4Q21 | 2021 | 1Q22E | 1Q22A |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Net written premiums | 797 | 565 | 604 | 491 | 2,457 | 999 | 925 | 621 | 709 | 3,254 | 1,092 | 1,139 |
| Premium Growth (y/y) | 76.6% | 50.3% | 38.4% | 44.9% | 53.3% | 25.3% | 63.6% | 2.8% | 44.5% | 32.4% | 9.3% | 14.0% |
| Losses and LAE ex. cats and | 68.4% | 60.5% | 60.2% | 58.0% | 61.8% | 56.3% | 62.9% | 57.4% | 54.9% | 57.9% | 57.0% | 52.6% |
| Catastrophe losses | 12.7% | 25.3% | 23.3% | 16.1% | 19.1% | 22.7% | 2.5% | 32.6% | 6.7% | 15.4% | 2.5% | 6.7% |
| PYD (favorable) / unfavorable | -2.0% | -6.0% | -7.4% | -6.9% | -5.6% | -3.8% | -2.5% | -9.6% | -6.4% | -5.6% | -3.0% | -2.8% |
| **Loss ratio** | **79.1%** | **79.8%** | **76.1%** | **67.2%** | **75.3%** | **75.2%** | **62.9%** | **80.4%** | **55.2%** | **67.8%** | **56.5%** | **56.5%** |
| Acquisition expense ratio | 14.6% | 18.9% | 15.4% | 16.9% | 16.4% | 18.3% | 18.1% | 19.1% | 20.0% | 18.9% | 19.0% | 21.4% |
| Operating expense ratio | 8.3% | 8.1% | 7.5% | 7.2% | 7.8% | 9.4% | 6.1% | 6.7% | 7.9% | 7.5% | 7.5% | 8.7% |
| **Expense ratio** | **23.0%** | **26.9%** | **22.9%** | **24.1%** | **24.1%** | **27.7%** | **24.2%** | **25.8%** | **27.9%** | **26.4%** | **26.5%** | **30.1%** |
| **Combined ratio** | **102.0%** | **106.8%** | **99.0%** | **91.3%** | **99.5%** | **102.9%** | **87.1%** | **106.2%** | **83.1%** | **94.2%** | **83.0%** | **86.6%** |
| Combined ratio ex cats & PYD | 91.3% | 87.5% | 83.1% | 82.1% | 85.9% | 84.0% | 87.1% | 83.2% | 82.8% | 84.3% | 83.5% | 82.7% |
| **Underwriting Income (Loss)** | **(9)** | **(33)** | **6** | **53** | **16** | **(20)** | **96** | **(39)** | **133** | **170** | **148** | **109** |

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

**Our long-term outlook for the reinsurance market is cautious, but we expect Arch Re to generate superior results compared to peers.** ACGL's reinsurance business was initially established to take advantage of the hard market for casualty risk in the early 2000s. Over the years, however, management has shifted Arch Re's business mix away from casualty coverage towards other specialty lines such as surety, accident and health, agriculture, and trade credit, which are generally less competitive and present more attractive risk-reward. We were previously concerned about an uptick in losses related to COVID, especially for business interruption, but court developments thus far have favored the re/insurers over claimants. Firming pricing has benefited recent results as well, and should drive continued strong premiums and margins in the near term. Still, we expect the pace of price hikes to moderate and remain skeptical of a sustained hard market given the industry's significant excess capacity and additional capital entering the market. Factors that contributed to a multi-year soft market prior to 2019 (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, results in the next 1-2 years could benefit from the release of COVID-related business interruption reserves given favorable court decisions in most cases thus far.

# Raising EPS Estimates

We are raising our 2Q22 EPS from $1.07 to $1.10, our 2022 forecast from $4.21 to $4.22, and our 2023 EPS from $4.53 to $4.65. Our updated model reflects higher than assumed share buybacks in 1Q22 (and an ensuing lower share count for future periods) as well as modest revisions in our margin and premium assumptions. In our view, catastrophe losses and trends in the housing market (which would affect reserve releases) will be the main sources of variance between reported results and our projections. A prolonged Russia/Ukraine war could drive additional losses as well, but ACGL's current reserves seem conservative based on events thus far.

# Investment Thesis, Valuation and Risks

## Arch Capital Group Ltd. *(Neutral; Price Target: $52.00)*

**Investment Thesis**

We consider Arch a premiere franchise, but remain Neutral given our cautious outlook for the reinsurance market and the stock's valuation. In our view, ACGL has an industry-leading reinsurance business that we expect will deliver superior and less volatile underwriting margins over time due to its unique culture and approach to the market. In addition, Arch has established itself as one of the top competitors in the mortgage insurance (MI) market, which we view as a structurally superior business to P&C reinsurance. Also, ACGL has been able to grow premiums and improve margins in its insurance business, helped by the hard P&C market. In the near term, we expect results in the MI business to benefit from the healthy housing and labor markets. Furthermore, firm P&C pricing should drive top-line growth and margins in both the insurance and reinsurance segments. Longer term, however, we are cautious on the reinsurance business due to structural concerns (including the market's excess capital, low barriers to entry, limited pricing power, etc.). Moreover, we believe that 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 2022 price target from $51 to $52** to reflect higher EPS and book value estimates. Our price target assumes a 1.4x multiple on our 12/31/22E BV ex. AOCI forecast, a 1.4x multiple on our 12/31/22E BV forecast and an 11.0x multiple on our 2023 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 in recent years. Although mortgage insurance continues to generate higher returns than re/insurance, especially on legacy business from 2009 to 2016, we believe that an uptick in competition in the mortgage insurance market is weighing on multiples for MI stocks. ACGL trades at 1.5x BV and 11.4x 2022E EPS compared to 1.2x and 9.7x for the reinsurance sector, 1.0x and 7.0x for mortgage insurance peers, and 1.4x and 12.7x for the broader P&C group.

### Risks to Rating and Price Target

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

- **The pricing environment continues to improve.** Pricing in several lines of business (reinsurance, specialty, casualty) has been favorable for several years running. Sustained improvement could drive upside to our EPS estimates and lift sentiment on the stock.
- **Management is able to maintain and/or improve insurance underwriting margins.** In our view, investor sentiment will improve if ACGL is able to sustain an insurance combined ratio in the low to mid-90s even as the benefit of the hard market recedes.
- **Management remains proactive with share repurchases.** ACGL has deployed more capital towards buybacks than our assumptions in recent quarters. A continuation of the trend could drive upward revisions in EPS forecasts and 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 growing exposure to mortgage insurance and the more systematic nature of mortgage insurance risk, rising unemployment or higher mortgage defaults would pressure the company's results and hurt sentiment on the stock.
- **Price increases in the reinsurance market slow.** Although primary and reinsurance pricing has been improving since 2018, we do not anticipate sustained hardening. A reversal in pricing trends could drive downside risk in EPS estimates as well as dampen sentiment on the sector.
- **The pace of reserve development moderates.** Favorable reserve development has been a notable contributor to ACGL's results in recent years. A slowdown in the pace of development could pressure margins and returns.
- **Cat losses stay elevated.** While prices for cat re/insurance have hardened, the frequency and severity of catastrophe losses has increased by a larger magnitude over time. This implies that reinsurance prices need to increase significantly for underwriters to earn adequate returns, especially in a scenario where cat losses approximate those in the 2018-2020 period.

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Arch Capital (ACGL, ACGL US) Price Chart


| Date | Rating | Price ($) | Price Target ($) |
|---|---|---|---|
| 30-Apr-19 | OW | 33.30 | 37 |
| 29-Jul-19 | OW | 38.20 | 44 |
| 12-Nov-19 | N | 40.79 | 40 |
| 14-Apr-20 | N | 29.22 | 34 |
| 04-May-20 | N | 23.11 | 30 |
| 04-Jan-21 | N | 36.07 | 36 |
| 09-Feb-21 | N | 34.15 | 38 |
| 28-Apr-21 | N | 40.49 | 40 |
| 01-Jul-21 | N | 38.94 | 44 |
| 28-Oct-21 | N | 42.33 | 46 |
| 09-Feb-22 | N | 48.20 | 48 |
| 01-Apr-22 | N | 48.42 | 51 |

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.

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