J.P.Morgan

Arch Capital

Robust Margins Drove Strong 2Q23 Results

Neutral

ACGL, ACGL US
Price (26 Jul 23):$82.08

▲**Price Target (Dec-24):$82.00**
Prior (Dec-24):$75.00

ACGL's results were significantly better than assumed. EPS beat forecasts, margins were robust, and premiums rose at a strong pace. We consider Arch a premier franchise and one of the best positioned carriers to take advantage of hard reinsurance pricing. Still, we are Neutral on the stock due to valuation.

- **EPS upside; increasing projections.** ACGL reported 2Q23 operating EPS of $1.92, well above our $1.57 estimate and consensus of $1.59, driven by higher investment income and upside in underwriting margins in all major divisions. Compared with our model, cat losses lifted EPS by $0.01 and prior-year development was in-line. Although cat losses and PYD should fluctuate on a quarterly basis, the upside in investment income is likely to sustain. As a result, we are raising our 3Q23 EPS forecast from $1.15 to $1.22 and our 2024 projection from $6.34 to $6.69.
- **Business trends were strong.** Reinsurance results were marked by robust premium growth (NWP up 47% versus our 39% estimate) and better than assumed margins (CR 82.0% versus our 84.3% estimate). Similarly, insurance premiums increased 18% (versus 15%E) and margins were strong (CR 91.9% vs. 94.7%E; CR ex. cats and PYD 89.8% vs. 90.0%). As in 1Q23, insurance premiums increased across all major market segments with the exception of professional lines, which continues to suffer from soft pricing. MI earnings were significantly better than assumed as well, helped by favorable PYD (CR 15.0% vs. 30.0%E; CR ex. PYD 43.7% vs. 45.0%). Weak MI premiums was one of the only major negatives. As assumed, ACGL did not repurchase stock in 2Q23. Management comments on business trends were upbeat.
- **Our long-term outlook for ACGL is mixed, but we expect the company to report robust results in the near term.** ACGL's results in the next few quarters should be marked by strong margins and top-line growth in the reinsurance business and healthy margins but weak premium growth in the MI business. MI margins should remain healthy, but we project them to moderate from recent levels as reserve releases wane. Potential weakness in the housing market or uptick in unemployment would pressure MI results, although they do not pose a risk to near-term results. Meanwhile, the hard market is a key positive for near-term results in the reinsurance business. Still, our long-term view of the reinsurance business is cautious as we expect additional capacity to enter the market over the next 1-2 years. Our model assumes no share repurchases in 2023 given the current stock price and management's intent to deploy capital into the business amid hard reinsurance pricing.
- **We affirm our Neutral rating.** We consider ACGL a top-tier franchise, but in relatively commoditized markets. In our view, ACGL is among the best positioned carriers to take advantage of hard reinsurance pricing. Still, our long-term outlook for the reinsurance market remains negative. Also, we believe that ACGL's valuation is not enticing relative to the company's long-term ROE and EPS growth potential.

Insurance - Life & Nonlife

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Key Changes (FYE Dec)

	Prev	Cur
Adj. EPS - 23E ($)	5.94	6.44
Adj. EPS - 24E ($)	6.34	6.69

Quarterly Forecasts (FYE Dec)

Adj. EPS ($)

	2022A	2023E	2024E
Q1	1.10	1.73A	
Q2	1.34	1.92A	
Q3	0.28	1.22	
Q4	2.14	1.57	
FY	4.87	6.44	6.69

Style Exposure

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

2Q23 EPS: $1.92A vs. $1.57E

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

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 13 for analyst certification and important disclosures.

Price Performance

	YTD	1m	3m	12m
Abs	30.7%	15.2%	13.5%	85.5%
Rel	11.8%	9.8%	0.9%	69.1%

Company Data

Shares O/S (mn)	373
52-week range ($)	82.86-41.05
Market cap ($ mn)	30,607.63
Exchange rate	1.00
Free float(%)	96.9%
3M - Avg daily vol (mn)	2.05
3M - Avg daily val ($ mn)	153.2
Volatility (90 Day)	22
Index	S&P 500
BBG BUY|HOLD|SELL	12|2|0

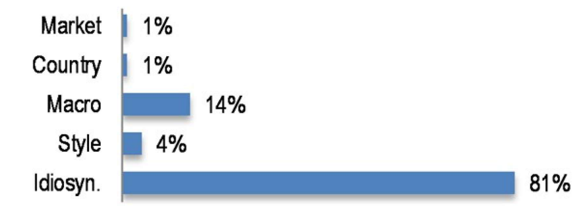
Key Metrics (FYE Dec)

$ in millions	FY22A	FY23E	FY24E
Financial Estimates			
NEP (Premium)	9,678	12,277	13,988
Underwriting income	1,796	1,983	1,814
Net investment income	497	982	1,281
Operating income	2,293	2,965	3,095
Adj. PBT	1,562	2,765	2,878
Adj. net income	1,840	2,499	2,589
Adj. EPS	4.87	6.44	6.69
BBG EPS	4.06	6.26	6.84
DPS	0.00	0.00	0.00
Investments	11,276	14,164	16,272
BVPS	32.62	39.91	45.80
NAVPS	32.62	39.91	45.80
Margins and Growth			
Adj. EPS growth	36.0%	32.1%	3.9%
Ratios			
Adj. tax rate	5.1%	8.3%	8.0%
Loss ratio	(51.9%)	(54.5%)	(57.5%)
Combined ratio	(22.5%)	(25.1%)	(28.1%)
Invest inc. % of Investments	-	-	-
Regulatory solvency ratio	-	-	-
Leverage (Debt/Debt+Equity)	-	-	-
ROE	14.8%	18.5%	16.2%
Valuation			
Dividend yield	0.0%	0.0%	0.0%
Adj. P/E	16.8	12.7	12.3
P/ BV	2.5	2.1	1.8

Summary Investment Thesis and Valuation

Arch is a premier re/insurance franchise with a track record of higher and less volatile underwriting margins than most peers. Still, we are Neutral given our cautious long-term outlook for the P&C reinsurance market and the stock's valuation. In our view, near-term results in the MI business will be marked by weak premium growth and moderating margins as reserve releases wane. Over time, we expect MI returns to be held back by the commoditized nature of the product, black box pricing, and higher capital requirements. In P&C reinsurance, hard pricing and tighter terms/conditions should boost underwriting results in the near term, but our long-term outlook is negative as we expect the entry of additional capacity to preclude a sustained hard market.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI EM Latam	0.13	0.21
Country: Bermuda	0.24	0.10
Macro:		
JP Morgan EMBI Global Spread	-0.35	-0.25
Citi Economic Surprise - EM	0.11	0.20
JPM Global Equity Sentiment	0.16	0.20
Quant Styles:		
LowVol	0.28	0.16
Size	0.03	0.15
Quality	-0.14	0.11

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 2Q23 results. ACGL will hold its earnings conference call at 11:00 AM Eastern on July 27, 2023. Conference call participants need to register at this link: https://register.vevent.com/register/BI359117332c3a41bab38c33ff0d36f73b. The call replay can be accessed at: ir.archcapgroup.com.

In our view, ACGL is a key beneficiary of hard reinsurance pricing, but we are Neutral on the stock given its valuation. We believe that ACGL has an industry-leading reinsurance business with a unique culture and approach to underwriting that should produce above-average, and less volatile, margins over time. Also, Arch is a top competitor in the mortgage insurance (MI) market, which we consider a structurally better business than P&C reinsurance. In the primary P&C market, ACGL has gained share and expanded margins, helped by favorable pricing. In the near term, we expect ACGL to report strong margins and top-line growth in re/insurance, and moderating margins but poor premium growth in MI. Still, despite near-term tailwinds, our long-term outlook for the reinsurance market remains cautious and we expect structural dynamics such as the commodity nature of the product and low barriers to entry to preclude sustained hard pricing. Furthermore, we feel that ACGL's valuation is not enticing relative to reinsurance or MI peers.

P&C Reinsurance: N-T Outlook Upbeat; L-T Negative

We expect near-term results in ACGL's reinsurance business to benefit from hard pricing and tighter terms, but our long-term outlook for the market is cautious. Arch has historically generated better and less volatile margins than most reinsurers, which we attribute to its focus on specialty reinsurance (where pricing tends to be less competitive), conservative underwriting, ability to shift mix based on changing market conditions, and judicious management of catastrophe risk. In particular, ACGL prices business using the risk-free rate (leading to more conservative underwriting), and uses a long-term compensation plan for underwriters that pays based on underwriting margins over a multi-year period. Also, the creation of 3rd party capital vehicles such as Premia Re has allowed Arch to earn fee income. We view Arch as a top-tier reinsurer and expect firm pricing to boost results in 2023 and potentially 2024. Still, our long-term outlook for the reinsurance market is cautious given its commoditized nature, the ease of entry of new capital, and a broad set of capital providers (including some, such as pension funds, with lower return thresholds). We are skeptical of prolonged hard pricing and believe that 1-2 years of strong margins will attract new capacity into the market. In our opinion, any signs of additional capacity entering the market would hurt investor sentiment on reinsurance stocks, which have become consensus longs since late 2022.

Mortgage Insurance: Growth Weak; 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 view, MI margins will remain healthy in the near term, but will moderate from recent levels as the benefit of COVID-related reserve releases tapers off. Meanwhile, higher interest rates are likely to suppress mortgage origination volumes. A recession would increase defaults and pressure margins, but this is not imminent.

2Q23 Details

This evening, ACGL announced 2Q23 operating EPS of $1.92, significantly above our $1.57 estimate and consensus of $1.59. Compared with our model, underwriting income beat in all major divisions, and was especially strong in mortgage insurance. Investment income was considerably higher than assumed as well, and the tailwind is likely to sustain in future periods. Meanwhile, catastrophe losses and prior-year development were close to our assumption.

Table 1: 2Q23 Operating Earnings: Actual versus Expected

$ in millions, except per share amounts

	2Q23E	2Q23A	Upside / (downside) to EPS	Comments
Underwriting Income by Division:				
Mortgage	198	253	$0.15	margins boosted by reserve release (CR 15.0% vs. 30.0%E)
Insurance	71	108	$0.10	margins above expectations (CR 91.9% vs. 94.7%E)
Reinsurance	224	245	$0.06	premium growth robust, margins better (82.0% vs. 84.3%E)
Underwriting income	**492**	**606**	**$0.30**	
Net investment income	216	242	$0.07	pre-tax investment yield of 3.50% in 3Q23 vs. 3.03% in 2Q23 and 1.76% in 2Q22
Earnings from affiliates	25	22	-$0.01	
Other income (losses) / COLI	8	10	$0.01	
Other expenses / corporate	51	45	$0.02	
Interest expense	32	33	$0.00	
Pretax operating income	**659**	**802**	**$0.38**	
Income tax expense	53	66	-$0.04	effective tax rate of 9.1% vs. assumed tax rate of 8.0%E
Preferred dividends	10	10	$0.00	
Operating income	**596**	**726**	**$0.34**	
Weighted average dilutive shares	378.9	378.4	$0.00	no share buybacks as expected
Operating EPS	**$1.57**	**$1.92**	**$0.35**	**no significant unusual items**

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

Business trends were robust. Reinsurance results were marked by robust premium growth and upside in underwriting margins (CR 82.0% versus our 84.3% estimate). Similarly, insurance premiums increased 18% (versus 15%E) and margins were strong (CR 91.9% vs. 94.7%E; CR ex. cats and PYD 89.8% vs. 90.0%). MI earnings were significantly better than assumed as well, helped by favorable PYD (CR 15.0% vs. 30.0%E; CR ex. PYD 43.7% vs. 45.0%). Weak MI premiums was one of the only major negatives. As assumed, ACGL did not repurchase stock in 2Q23.

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Table 2: 2Q23 Key Financial Metrics

$ in millions

	2Q23E	2Q23A
Net premiums written	3,294	3,428
% change (y-o-y)	22.7%	27.7%
Net investment income	216	242
% change (y-o-y)	103.4%	127.5%
Loss ratio ex cats and PYD	54.3%	50.2%
Catastrophe losses	4.1%	4.0%
PYD (favorable) / unfavorable	-3.8%	-3.9%
Loss ratio	54.5%	50.3%
Expense ratio	29.4%	29.5%
Combined ratio	83.9%	79.8%
Combined ratio ex cats & PYD	83.7%	79.6%
Share buybacks ($ mil.)	-	-

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

Mortgage Ins.: Earnings Upside Driven by Reserve Release

In our view, mortgage insurance (MI) results will be marked by lackluster premium growth, robust persistency, and strong (but lower) margins. Higher interest rates should suppress mortgage insurance volumes, and we expect moderating reserve releases from cures of COVID-related delinquencies to drive a decline in margins to more normal levels. The MI business reported underwriting income of $253 million in 2Q23, well above our $198 million estimate, driven by better than expected margins (CR 15.0% vs. 30.0%E) and better net earned premiums (-0.6% from 2Q22 vs. -6.9%E). Similar to recent quarters, the earnings upside was primarily due to the release of reserves, and management implied that cures for both COVID-impacted and non-COVID impacted cohorts (accident years 2020 to 2022) were responsible for the tailwind (-28.7% on CR vs. -15.0%E; $84 million vs. $41 million in dollar terms). Core margins were better than assumed as well (CR ex. cats and PYD 43.7% vs. 45.0%E) due to a lower attritional loss ratio (24.3% vs. 25.0%E) as well as a lower expense ratio (19.4% vs. 20.0%E). On a negative note, gross written premiums declined 6.7%, the third straight quarterly decline. Net written premiums declined by an even greater magnitude due to a lower retention ratio compared to 2Q22. Management attributed the drop in gross written premiums to lower originations in the Australian market and a decrease in U.S. primary mortgage insurance business, partially offset by higher credit risk transfer transactions.

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 distress. 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 1.6% at 6/30/23, down from 1.7% at 3/31/23 and 1.8% at 6/30/22.

Table 3: Mortgage Insurance Key Metrics

$ in millions

	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23E	2Q23A
Net written premiums	336	301	289	1,261	288	294	276	275	1,133	261	271	265
Premium Growth (y/y)	3.3%	0.8%	-12.8%	-1.5%	-14.0%	-12.5%	-8.2%	-5.1%	-10.2%	-9.4%	-7.6%	-9.8%
Losses and LAE ex. cats and PYD	16.1%	19.2%	14.8%	18.2%	17.6%	18.8%	21.0%	25.2%	20.7%	25.3%	25.0%	24.3%
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	-13.1%	-15.5%	-24.2%	-13.7%	-36.5%	-40.7%	-45.1%	-72.1%	-48.6%	-24.6%	-15.0%	-28.7%
Loss ratio	**3.0%**	**3.7%**	**-9.4%**	**4.4%**	**-18.9%**	**-21.9%**	**-24.1%**	**-46.9%**	**-28.0%**	**0.7%**	**10.0%**	**-4.4%**
Acquisition expense ratio	9.0%	7.7%	4.4%	7.6%	3.6%	3.4%	2.4%	4.4%	3.5%	2.4%	3.0%	2.4%
Operating expense ratio	14.5%	14.8%	16.7%	15.1%	18.4%	17.0%	16.5%	15.4%	16.8%	16.9%	17.0%	17.0%
Expense ratio	**23.5%**	**22.6%**	**21.1%**	**22.7%**	**22.1%**	**20.4%**	**18.8%**	**19.8%**	**20.3%**	**19.3%**	**20.0%**	**19.4%**
Combined ratio	**26.5%**	**26.3%**	**11.6%**	**27.1%**	**3.2%**	**-1.5%**	**-5.2%**	**-27.1%**	**-7.7%**	**19.9%**	**30.0%**	**15.0%**
Combined ratio ex cats & PYD	39.6%	41.8%	35.8%	40.9%	39.7%	39.2%	39.9%	45.0%	41.0%	44.5%	45.0%	43.7%
Underwriting Income (Loss)	**250**	**234**	**269**	**953**	**285**	**298**	**299**	**374**	**1,257**	**243**	**198**	**253**

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

We expect MI margins to benefit from reserve releases, but the tailwind should abate compared to recent levels. 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 were due to 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 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. Still, despite an expected decline, we forecast 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. On a cautious note, top-line growth is likely to be weak as higher interest rates reduce mortgage originations. A weaker economy could deflate home prices and lead to higher defaults on mortgages, but a material uptick in losses seems unlikely in the near term. Barring a recession, we expect core margins to stay healthy, although a declining tailwind from reserve releases will drive a drop in margins and earnings from levels in recent years 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: Upside in Margins and Premiums Lifted Results

Insurance division results were marked by better than expected underwriting margins and premium growth. Underwriting income in 2Q23 was $108 million, ahead of our our $71 million estimate, driven by healthy margins (CR 91.9% vs. 94.7%E). A better than assumed attritional loss ratio, lower cat losses, and more favorable development offset a higher expense ratio. Net premiums written increased 18.4% from 2Q22, exceeding our 14.7% assumption, which ACGL attributed to new business, higher prices, and an increase in reinsurance retentions. All major products in the insurance division reported premium growth except for professional lines, where pricing has been more challenging.

Table 4: Insurance Key Metrics

$ in millions

	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23E	2Q23A
Net written premiums	964	1,154	1,036	4,148	1,207	1,228	1,369	1,217	5,021	1,437	1,409	1,454
Premium Growth (y/y)	43.3%	40.0%	23.7%	31.2%	21.3%	27.5%	18.6%	17.4%	21.0%	19.1%	14.7%	18.4%
Losses and LAE ex. cats and PYD	60.2%	59.5%	57.5%	59.5%	55.5%	56.0%	56.0%	56.2%	56.0%	54.8%	56.0%	55.2%
Catastrophe losses	3.2%	12.2%	2.0%	5.6%	3.1%	1.5%	13.4%	2.8%	5.3%	1.6%	5.0%	2.6%
PYD (favorable) / unfavorable	-0.3%	-0.5%	-0.3%	-0.4%	-0.1%	-0.4%	-0.1%	-0.3%	-0.2%	-0.5%	-0.3%	-0.5%
Loss ratio	**63.1%**	**71.2%**	**59.2%**	**64.6%**	**58.5%**	**57.1%**	**69.3%**	**58.7%**	**61.0%**	**55.9%**	**60.7%**	**57.3%**
Acquisition expense ratio	15.8%	16.2%	18.8%	16.7%	19.1%	19.4%	19.6%	19.6%	19.4%	19.5%	19.5%	19.9%
Operating expense ratio	15.4%	14.8%	14.9%	15.4%	16.2%	14.6%	13.9%	13.8%	14.6%	15.5%	14.5%	14.7%
Expense ratio	**31.2%**	**31.0%**	**33.7%**	**32.1%**	**35.3%**	**34.0%**	**33.5%**	**33.5%**	**34.0%**	**35.0%**	**34.0%**	**34.6%**
Combined ratio	**94.3%**	**102.3%**	**93.0%**	**96.8%**	**93.8%**	**91.1%**	**102.8%**	**92.1%**	**95.1%**	**90.9%**	**94.7%**	**91.9%**
Combined ratio ex cats & PYD	91.4%	90.6%	91.3%	91.6%	90.8%	90.0%	89.5%	89.6%	90.0%	89.8%	90.0%	89.8%
Underwriting Income (Loss)	**49**	**(21)**	**71**	**117**	**63**	**98**	**(34)**	**98**	**225**	**114**	**71**	**108**

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

We feel that Arch has attractive opportunities in the primary P&C market, and project premium growth and margins to remain strong. After shrinking its "cycle managed" business (now dubbed as wholesale/large capacity) from 2012 to 2017, ACGL is seeing strong growth in this part of its primary book, driven by price hikes in the broader market, particularly E&S. Results in less opportunistic parts of ACGL's book (specialty small/middle market and franchise) have been healthy as well. High inflation and rising reinsurance costs are driving an uptick in insurance pricing, especially in property and cat-exposed lines. However, we believe that the tailwind from price hikes in the primary market is unlikely to drive improvement in margins as elevated inflation and the spike in reinsurance costs present bigger headwinds. Management teams, and 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 relevant given the significant increase in reinsurance retentions at primary companies. On an overall combined ratio basis, results for most primary insurers have been weak given elevated cat losses. Reinsurers' cat losses have been high as well, but to a significantly lesser extent. We feel that consensus EPS forecasts for commercial lines insurers do not adequately reflect the shift in cat loads from reinsurers to primary companies following higher retentions with 2023 reinsurance renewals.

Reinsurance: Strong Results, Near-Term Outlook Upbeat

The reinsurance business generated robust premium growth and healthy margins. Underwriting income in 2Q23 was $245 million, above our $224 million estimate, driven by strong underwriting margins (CR of 81.9% vs. 84.3%E). Core margins were better than expected as well (CR ex. cats and PYD 77.4% vs. 85.3%), as a better attritional loss ratio (50.8% vs. 58.3%E) more than offset higher cat losses and less than expected favorable development. Net written premium growth was robust, up 47.0% to $1.7 billion, above our +38.8% assumption. Similar to the insurance segment, management attributed premium growth to new business, higher prices, and an increase in retentions/less retrocession. Management sounded upbeat on ACGL's position in the market amid constricted capacity from competitors, and noted that it expects the market to remain firm longer than previous hard market cycles. Arch affirmed our view that most primary insurers have started to retain more risk given higher reinsurance pricing, implying higher potential cat loads for primary insurers and lower for reinsurers relative to historical levels in the near term.

Table 5: Reinsurance Key Metrics

$ in millions

	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	4Q22	2022	1Q23	2Q23E	2Q23A
Net written premiums	925	621	709	3,254	1,139	1,163	1,079	1,543	4,924	1,726	1,613	1,709
Premium Growth (y/y)	63.6%	2.8%	44.5%	32.4%	14.0%	25.7%	73.6%	117.6%	51.3%	51.5%	38.8%	47.0%
Losses and LAE ex. cats and PYD	62.9%	57.4%	54.9%	57.9%	52.6%	55.3%	58.4%	57.4%	56.2%	56.6%	58.3%	50.8%
Catastrophe losses	2.5%	32.6%	6.7%	15.4%	6.7%	7.1%	39.1%	0.0%	12.9%	4.4%	4.0%	6.3%
PYD (favorable) / unfavorable	-2.5%	-9.6%	-6.4%	-5.6%	-2.8%	-4.5%	-4.9%	-4.5%	-4.3%	-3.4%	-5.0%	-1.8%
Loss ratio	**62.9%**	**80.4%**	**55.2%**	**67.8%**	**56.5%**	**57.9%**	**92.6%**	**52.9%**	**64.9%**	**57.6%**	**57.3%**	**55.3%**
Acquisition expense ratio	18.1%	19.1%	20.0%	18.9%	21.4%	20.4%	20.8%	19.9%	20.5%	21.1%	20.0%	21.6%
Operating expense ratio	6.1%	6.7%	7.9%	7.5%	8.7%	7.1%	6.3%	5.6%	6.8%	5.6%	7.0%	5.1%
Expense ratio	**24.2%**	**25.8%**	**27.9%**	**26.4%**	**30.1%**	**27.5%**	**27.1%**	**25.5%**	**27.3%**	**26.7%**	**27.0%**	**26.7%**
Combined ratio	**87.1%**	**106.2%**	**83.1%**	**94.2%**	**86.6%**	**85.5%**	**119.7%**	**78.5%**	**92.2%**	**84.3%**	**84.3%**	**82.0%**
Combined ratio ex cats & PYD	87.1%	83.2%	82.8%	84.3%	82.7%	82.9%	85.5%	83.0%	83.5%	83.3%	85.3%	77.5%
Underwriting Income (Loss)	**96**	**(39)**	**133**	**170**	**109**	**139**	**(197)**	**263**	**314**	**213**	**224**	**245**

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

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We remain skeptical of sustained hard reinsurance pricing, but market trends are holding up better than our initial assumptions and we feel Arch is 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 should drive continued strong premiums and margins in the near term, especially following Hurricane Ian. Nonetheless, 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 the other hand, ACGL's reinsurance results could benefit from the release of COVID-related reserves, a significant proportion of which remain in IBNR. Similarly, we feel 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 3Q23 EPS from $1.15 to $1.22, 2023 EPS from $5.94 to $6.44, and 2024 EPS from $6.34 to $6.69. The increase in our estimates is primarily due to higher assumed investment income, which is benefiting from an uptick in yields as well as robust premium growth. We consider catastrophe losses (which would affect reinsurance and insurance margins) and housing market trends (which affect MI margins and premium growth) the key sources of potential variance in reported results and our projections.

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Arch Capital *(Neutral; Price Target: $82.00)*

Investment Thesis

We view Arch as a premier re/insurance franchise but are Neutral on the stock due to bullish investor sentiment and current valuation. In our opinion, ACGL has an industry-leading reinsurance business that will generate superior and less volatile underwriting margins over time due to its unique culture and approach to the market. Also, Arch is a top competitor in mortgage insurance (MI), which we consider structurally better than P&C reinsurance. In the near term, we expect MI results to remain healthy, but margins should compress from recent levels as reserve releases taper off. Meanwhile, hard pricing should boost premium growth and margins in the reinsurance segment. On the other hand, our long-term outlook for the reinsurance business remains cautious and we are skeptical of sustained hard pricing given structural issues such as low barriers to entry, increased participation by third-party capital, and limited pricing power. In addition, the stock's valuation is not compelling relative to ACGL's long-term ROE and EPS growth potential.

Valuation

We are raising our December 2024 price target from $75 to $82 to reflect our higher EPS and book value estimates. Our price target assumes a 1.5x multiple on our 12/31/24E BV ex. AOCI forecast, a 1.6x multiple on our 12/31/24E BV forecast, and an 11.0x multiple on our 2025 EPS estimate, and we corroborate this approach with a sum-of-the-parts analysis that values ACGL's re/insurance business separately from mortgage insurance. Our target multiples for ACGL reflect its current business mix, which has become more skewed to mortgage insurance. ACGL trades at 2.2x BV and 12.3x 2024E EPS compared to 1.4x and 8.1x for the reinsurance sector, 1.1x and 7.7x for MI peers, and 1.8x and 11x for the broader P&C group.

Risks to Rating and Price Target

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

- **Re/insurance pricing stays firm for an extended period.** A prolonged hard market could drive upside to our EPS estimates and lift sentiment on the stock.
- **Management sustains insurance underwriting margins close to the recent level.** In our view, investor sentiment could improve if ACGL is able to sustain insurance combined ratios in the low to mid 90s, a significant improvement from ~100% previously, even as the tailwind from the current hard market recedes.

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

- **Additional capacity enters the reinsurance market.** This, in turn, could result in a reversal in pricing trends and potentially drive a reduction in EPS estimates as well as hurt sentiment on the sector.
- **The housing market deteriorates.** Given Arch's meaningful exposure to mortgage insurance and the more systematic nature of mortgage insurance risk, rising unemployment, higher mortgage defaults, and decreasing home values would pressure the company's results and hurt sentiment on the stock.
- **The pace of reserve development moderates.** Favorable reserve development has been a notable contributor to ACGL's results in recent years. A slowdown in the pace of development could pressure margins and returns.

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Arch Capital: Summary of Financials

Income Statement - Annual	FY22A	FY23E	FY24E
Earned premiums	-	-	-
Policy charges and fee income	-	-	-
Net investment income	-	-	-
Other income	-	-	-
Total revenues	**-**	**-**	**-**
Insurance and annuity benefits	-	-	-
Interest credited	-	-	-
Interest expense	(130)	(131)	(131)
Acquisition & operating expenses	(1,740)	(2,285)	(2,654)
Amortization of acquisition costs (net)	-	-	-
Other expenses	-	-	-
Total expenses	**-**	**-**	**-**
Pretax income	1,562	2,765	2,878
Income taxes	(80)	(231)	(230)
Total net income	1,436	2,494	2,608
Total operating income	1,840	2,499	2,589
Weighted average diluted shares	378	388	387
EPS - operating	**4.87**	**6.44**	**6.69**

Income Statement - Quarterly	1Q23A	2Q23A	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	(33)A	(33)	(33)
Acquisition & operating expenses	(533)A	(561)A	(590)	(601)
Amortization of acquisition costs (net)	-	-	-	-
Other expenses	-	-	-	-
Total expenses	**-**	**-**	**-**	**-**
Pretax income	781A	736A	535	713
Income taxes	(64)A	(67)A	(43)	(57)
Total net income	705A	661A	483	646
Total operating income	654A	726A	478	641
Weighted average diluted shares	378A	378A	393	407
EPS - operating	**1.73A**	**1.92A**	**1.22**	**1.57**

Balance Sheet and Capital Data	FY22A	FY23E	FY24E
Shareholders' equity	-	-	-
Shareholders' equity ex. AOCI	-	-	-
Shares outstanding	370	374	372
Book value per share	32.62	39.91	45.80
Book value per share (ex. AOCI)	37.06	43.44	49.35
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%	32.1%	3.9%	-
Book value per share (ex. AOCI) growth	9.9%	17.2%	13.6%	-
Return on equity (ROE)	14.8%	18.5%	16.2%	-
Return on equity (ex. AOCI)	-	-	-	-
Dividend payout ratio	0.0%	0.0%	0.0%	-
Total revenue growth	-	-	-	-
Total expense growth	-	-	-	-
Tax rate	5.1%	8.3%	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-Jan-21	N	36.07	36
09-Feb-21	N	34.15	38
28-Apr-21	N	40.49	40
01-Jul-21	N	38.94	44
28-Oct-21	N	42.33	46
09-Feb-22	N	48.20	48
01-Apr-22	N	48.42	51
27-Apr-22	N	46.51	52
06-Jul-22	N	44.44	53
27-Jul-22	N	44.24	54
26-Oct-22	N	49.22	57
04-Jan-23	N	62.46	58
31-Mar-23	N	67.86	62
26-Apr-23	N	72.59	67
06-Jul-23	N	73.62	75

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