

Arch Capital Group(ACGL)

\$32.35 (As of 06/03/20)

Price Target (6-12 Months): **\$27.00**

Long Term: 6-12 Months

Zacks Recommendation: Underperform

(Since: 05/13/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

Zacks Rank: (1-5)

5-Strong Sell

Zacks Style Scores:

VGM:C

Value: C

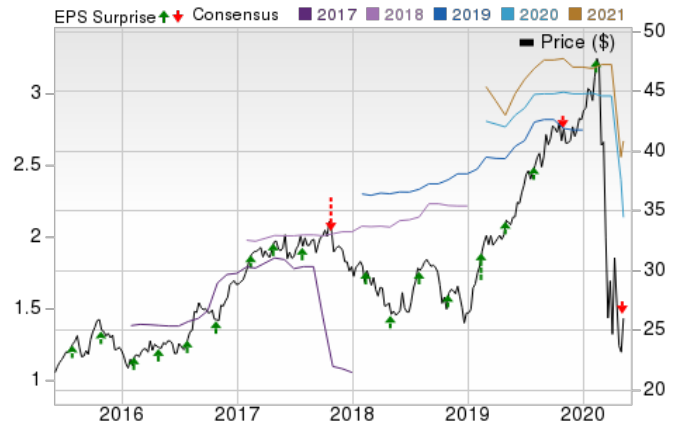
Growth: B

Momentum: F

Summary

Shares of Arch Capital have underperformed the industry year to date. Also, exposure to catastrophe loss induces volatility in underwriting results. Elevated expenses tend to weigh on operating margin expansion. Nevertheless, it boasts a strong product portfolio and has been maintaining an exemplary track record of premium growth. This apart, the insurer has been diversifying its Mortgage Insurance business via strategic acquisitions that also complement the company's strength in the specialty insurance and reinsurance businesses. Moreover, it effectively deploys capital to pursue growth initiatives as well as engage in share repurchases activity. However, its first-quarter earnings per share of 46 cents missed the Zacks Consensus Estimate by 14.8% and declined 31.3% year over year.

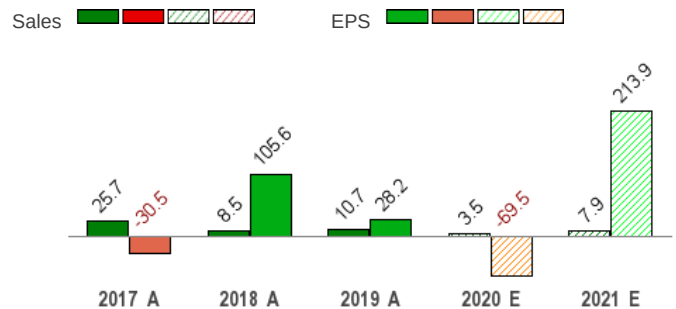
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$48.32 - \$20.93
20 Day Average Volume (sh)	2,869,080
Market Cap	\$13.1 B
YTD Price Change	-24.6%
Beta	0.73
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Insurance - Property and Casualty
Zacks Industry Rank	Bottom 19% (206 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-14.8%
Last Sales Surprise	NA
EPS F1 Est- 4 week change	-64.3%
Expected Report Date	08/03/2020
Earnings ESP	0.0%
P/E TTM	12.4
P/E F1	37.6
PEG F1	3.8
P/S TTM	2.0

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					7,167 E
2020	1,898 A				6,640 E
2019	1,527 A	1,620 A	1,601 A	1,669 A	6,416 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.67 E	\$0.70 E	\$0.65 E	\$0.72 E	\$2.70 E
2020	\$0.46 A	-\$0.01 E	\$0.07 E	\$0.33 E	\$0.86 E
2019	\$0.67 A	\$0.77 A	\$0.63 A	\$0.74 A	\$2.82 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 06/03/2020. The reports text is as of 06/04/2020.

Overview

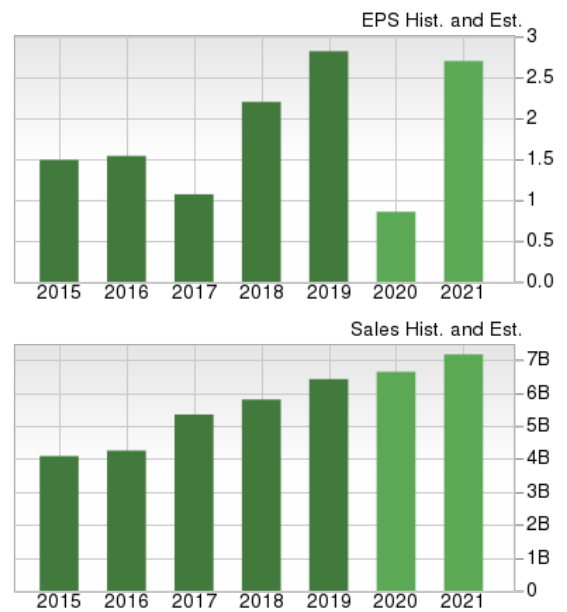
Established in 1995 and headquartered in Pembroke, Bermuda, Arch Capital Group Ltd. offers insurance, reinsurance and mortgage insurance across the world. Through its wholly owned subsidiaries, the property and casualty (P&C) insurer provides a wide range of products and services, which include primary and excess casualty coverages, professional indemnity, workers compensation and umbrella liability and employers liability insurance coverages to name a few. The company offers a full range of property, casualty and mortgage insurance and reinsurance lines, while maintaining focus on writing specialty lines of insurance and reinsurance.

Arch Capital classifies its operations into three underwriting segments and two other operating segments (non-underwriting). The underwriting segments are Insurance, Reinsurance and Mortgage. The other two operating (non-underwriting) segments are 'Other' and Corporate.

The **Insurance** (50.8% of 2019 gross premiums written) segment provides primary and excess casualty coverages, loss sensitive primary casualty insurance programs, professional indemnity, and other financial coverages as well as commercial automobile and inland marine products to name a few. This apart the segment deals in property, energy, marine, and aviation insurance, captive insurance programs, employers liability insurance coverages. This segment markets its products through a group of licensed independent retail and wholesale brokers.

Reinsurance (30.2%) segment primarily offers reinsurance for third-party liability and workers compensation exposures, reinsurance protection for catastrophic losses and commercial property risks; life reinsurance, risk management solutions accident and health, workers compensation catastrophe to name a few. This segment markets its reinsurance products through brokers, and directly to ceding companies.

Mortgage (19%) segment provides private mortgage insurance covering one-to-four family residential mortgages; mortgage insurance to cover previously originated residential loans; quota share reinsurance; and risk-sharing products. This segment sells its products directly as well as through brokers to its bank and credit union customers.



Reasons To Sell:

- ▼ **Exposure to Catastrophe Loss:** Being a P&C insurer, Arch Capital remains exposed to catastrophe loss caused by natural and man-made catastrophic events. Such a massive loss could render substantial volatility to the company's operational performance, which in turn, could affect the financial position and more importantly, the insurer's underwriting results. For its P&C business, the company incurred catastrophe losses of \$87 million in the first quarter on account of the COVID-19 pandemic. Given the present financial market volatility on account of the pandemic, underwriting income declined 40.8% year over year in the first quarter, while combined ratio deteriorated 980 bps. The company also expects the pretax underwriting results of its mortgage segment to remain at low levels during the remainder of 2020.
 - ▼ **Rising Expenses:** Arch Capital has been experiencing escalating operating expenses, primarily due to higher losses and loss adjustment costs, acquisition expenses, other operating costs, interest expense as well as corporate expenses. The company's operating expenses witnessed an increase of 10.9% in the last five years. The trend continued in first-quarter 2020, with the metric rising 13.6% year over year. Hence, a rise in expenses tends to weigh on the operating margin expansion, which in turn, will negatively impact the company's overall results. In the last five years, the company saw a margin contraction by 680 bps. Therefore, the company should strive for higher revenue growth rate than increase in expenses.
 - ▼ **Price Impact:** Shares of Arch Capital have lost 24.5% year to date, compared with the industry's decline of 16.1%. Exposure to cat loss inducing underwriting volatility and rising expenses weighing on margin expansion will likely weigh on the shares.
-

Risks

- **Strong Premium Growth:** Arch Capital has been displaying a brilliant track record of net premiums written. Consistent premium growth has been boosting better results, enabling the company to maintain sustained revenue growth over the past few years. Net premiums written improved 40.1% year over year in first-quarter 2020. However given the turmoil in financial markets created by the pandemic, Arch Capital expects premiums to slightly decline in the second and third quarters of 2020. Nevertheless, we expect the company to experience better results on the back of its diverse product and service portfolio.

Arch Capital has been effectively and efficiently catering to the evolving needs of its clients, which is a key to the company's success. The company believes that its customized products and services will help it to serve its clients more efficiently, compared to its peers, and drive long-term growth of the company.

- **Inorganic Growth:** Arch Capital has made significant efforts to boost its inorganic growth through prudent acquisitions. These in turn helped the company expand internationally, added capabilities, enhanced operations and diversify business. The company acquired Barbican Group Holdings in November 2019. In February of this year, Arch Capital has inked a deal with France-based corporate and investment bank Natixis to buy 29.5% stake in trade-credit insurance firm Coface. Valued at around \$520 million, the deal is in line with the company's efforts to develop uncorrelated sources of underwriting income.
- **Investment Results:** The company has been witnessing improvement in net investment income for the last several quarters, witnessing a CAGR of 15.7% over the past five years (2014-2019). However, this momentum did not persist in first-quarter 2020, when the metric slumped 7.5% year over year. The current low interest rate environment is likely to keep investment yields under pressure, which would consequently weigh on its overall investment income.
- **Robust Capital Position:** The P&C insurer has maintained a robust capital position over the years, reflecting its financial flexibility. The company's robust capital and liquidity position shield it from market volatility, enabling it to retain its financial strength and flexibility required to pursue new opportunities in keeping with its long-term strategy. Book value per share rose 12.9% year over year in first-quarter 2020. The company engages in several shareholder-friendly moves courtesy of its sound capital position. It bought back shares worth \$75.5 million in the first quarter but has suspended buyback for the rest of 2020.

The company's balance sheet also looks good. It has a solid cash balance of \$882.3 million, which improved 21.5% from 2019-end level. However, total debt to total capital was 13.2% as of Mar 31, 2020, which expanded 10 bps from 2019-end. Also, times interest earned, a measure to identify the company ability to service debt, stands at 11.03%, which compares favorably with the industry's figure of 4.3%. The company's times interest earned ratio has been improving over the years. The improvement in this ratio indicates that the firm will be able to meet current obligations in the near future without any difficulties. At a time when every entity is looking forward to preserve liquidity amid uncertainty as a result of the COVID-19 outbreak, an improving ratio is reassuring for investors.

Last Earnings Report

Arch Capital Q1 Earnings Miss, Revenues Rise Y/Y

Arch Capital reported first-quarter 2020 operating income per share of 46 cents, which missed the Zacks Consensus Estimate by 14.8%. Moreover, the bottom line deteriorated 31.3% year over year.

The quarter benefited from improving premiums across Insurance, Reinsurance and Mortgage segments, offset by higher expenses.

Quarter Ending **03/2020**

Report Date	May 04, 2020
Sales Surprise	NA
EPS Surprise	-14.81%
Quarterly EPS	0.46
Annual EPS (TTM)	2.60

Q1 in Detail

Gross premiums written increased 36.3% year over year to \$2.8 billion, largely fueled by higher premiums written across the Insurance, Reinsurance and Mortgage segments.

Net investment income declined 6.8% to \$113 million due to reinvestment of fixed income securities at lower yields available in the financial market.

Operating revenues of \$1.9 billion improved 24.3% year over year on the back of higher premiums earned.

Interest expenses were \$25.2 million, up 7.5% year over year.

Total expenses of \$1.6 billion increased 35% year over year on higher losses and loss adjustment expenses, acquisition expenses, other operating expenses, corporate expenses and interest expenses.

Arch Capital's underwriting income came in at \$154 million, down 40.8% year over year. Combined ratio deteriorated 980 basis points (bps) to 91.5%.

Segment Results

Insurance: Gross premiums written grew 28.2% year over year to \$1.2 billion, driven by increases in most lines of business, primarily due to new business opportunities, rate increases and growth in existing accounts. Underwriting loss came in at \$28.2 million against the underwriting profit of \$0.6 million year over year. Combined ratio deteriorated 400 bps to 103.9%.

Reinsurance: Gross premiums written rose 64.4% year over year to \$1.1 billion, driven by increases in most lines of businesses, primarily due to growth in existing accounts, new businesses, including premiums written through Barbican acquired in fourth-quarter 2019, and rate increases.

Underwriting loss came in at \$9.4 million against the underwriting profit of \$20.9 million. Combined ratio deteriorated 680 bps year over year to 102%.

Mortgage: Gross premiums written increased 3.6% year over year to \$368.9 million on the back of an increase in monthly premium business due to growth in insurance in force and lower ceded premiums. Underwriting income decreased 19% to \$197.6 million. Combined ratio deteriorated 1850 bps year over year to 44.1%. Arch MI U.S. generated \$16.8 billion of new insurance written compared with \$11.2 billion in the year-ago quarter, driven by higher mortgage refinance activity.

Financial Update

Arch Capital exited the quarter with cash of \$882.3 million, up 39.3% year over year. Debt was \$1.8 billion, up 0.03% year over year. As of Mar 31, 2020, book value per share was \$26.10, up 12.9% year over year.

Operating return on equity was 7.1% in the first quarter, down 520 basis points.

Net cash provided by operating activities was \$585.9 million, up 254.2% year over year.

Recent News

Arch Capital Estimates Losses Due to Coronavirus - Apr 15, 2020

Arch Capital provided estimates related to losses incurred and premium volumes due to the impact of COVID-19 on its business.

The pandemic has resulted in increased market volatility and uncertainty, reduced liquidity of capital markets, and led to social disruption as well as intervention by various governments across the world.

The global financial markets experienced extreme volatility in interest rates, credit spreads and equity markets during the first quarter of 2020, thanks to the pandemic.

The property and casualty insurer estimates first quarter pre-tax net losses of \$85 million to \$95 million across its P&C insurance and reinsurance segments.

The company also expects to incur pre-tax net losses of \$40 million to \$50 million across its mortgage segment, given the company's loss reserve selections, set at the higher end of their range of indications across the mortgage segment as of Mar 31, 2020.

These estimated losses across insurance, reinsurance, and mortgage segments take into account claims made as of Mar 31, 2020 and are based on information from modeling techniques. However, the losses actually incurred may differ from estimates as result of uncertainties and the evolving nature of the global pandemic.

The company estimates net investment income in the range of \$110 million to \$115 million in the first quarter. Further, it estimates total return in the range of -0.65% to -0.95% on its core investment portfolio (excluding Watford). The estimated range will be changed after finalizing the analysis of the investment returns.

Valuation

Arch Capital shares are down 24.5% in the year-to-date period and 8.6% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Finance sector are down 16.1% and 17.8% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are down 9.5% and 10.4%, respectively.

The S&P 500 index is down 3.1% in the year-to-date period but up 10.5% in the past year.

The stock is currently trading at 1.19x trailing 12-month book value, which compares to 1.26x for the Zacks sub-industry, 2.38x for the Zacks sector and 4.27x for the S&P 500 index.

Over the past five years, the stock has traded as high as 1.7x and as low as 0.82x, with a 5-year median of 1.35x. Our Underperform recommendation indicates that the stock will perform worse than the market. Our \$27 price target reflects 0.99x trailing 12-month book value.

The table below shows summary valuation data for ACGL

Valuation Multiples -ACGL					
		Stock	Sub-Industry	Sector	S&P 500
P/B TTM	Current	1.19	1.26	2.38	4.27
	5-Year High	1.7	1.67	2.9	4.56
	5-Year Low	0.82	0.93	1.71	2.83
	5-Year Median	1.35	1.46	2.53	3.66
P/S F12M	Current	1.91	1.4	5.8	3.51
	5-Year High	3.04	11.26	6.69	3.51
	5-Year Low	1.42	1.4	4.98	2.53
	5-Year Median	2.23	1.87	6.06	3.02
P/E F12M	Current	19.73	24.56	17.05	22.56
	5-Year High	28.77	31.55	17.05	22.56
	5-Year Low	7.67	21.01	11.57	15.23
	5-Year Median	15.93	25.52	13.96	17.49

As of 06/03/2020

Industry Analysis Zacks Industry Rank: Bottom 19% (206 out of 253)



Top Peers

Company (Ticker)	Rec	Rank
American Financial Group, Inc. (AFG)	Neutral	4
Chubb Limited (CB)	Neutral	4
Fidelity National Financial, Inc. (FNF)	Neutral	3
Everest Re Group, Ltd. (RE)	Neutral	4
RLI Corp. (RLI)	Neutral	3
Axis Capital Holdings Limited (AXS)	Underperform	5
Markel Corporation (MKL)	Underperform	5
Alleghany Corporation (Y)	Underperform	4

Industry Comparison Industry: Insurance - Property And Casualty				Industry Peers		
	ACGL	X Industry	S&P 500	AXS	RE	Y
Zacks Recommendation (Long Term)	Underperform	-	-	Underperform	Neutral	Underperform
Zacks Rank (Short Term)	5	-	-	5	4	4
VGM Score	C	-	-	D	B	F
Market Cap	13.12 B	1.18 B	22.50 B	3.29 B	10.73 B	7.83 B
# of Analysts	3	2	14	3	2	1
Dividend Yield	0.00%	1.23%	1.88%	4.20%	2.91%	0.00%
Value Score	C	-	-	C	B	C
Cash/Price	0.08	0.25	0.06	0.39	0.13	0.28
EV/EBITDA	7.75	5.25	12.98	8.89	8.74	5.40
PEG Ratio	3.81	2.07	3.05	NA	NA	NA
Price/Book (P/B)	1.19	1.04	3.11	0.76	1.25	1.00
Price/Cash Flow (P/CF)	10.19	9.63	12.18	8.74	9.63	16.97
P/E (F1)	38.09	13.30	22.19	47.23	12.45	18.71
Price/Sales (P/S)	1.95	0.78	2.40	0.66	1.30	0.95
Earnings Yield	2.66%	6.80%	4.31%	2.13%	8.03%	5.35%
Debt/Equity	0.26	0.26	0.76	0.48	0.08	0.19
Cash Flow (\$/share)	3.17	3.12	7.01	4.47	22.15	32.24
Growth Score	B	-	-	F	C	F
Hist. EPS Growth (3-5 yrs)	14.25%	4.86%	10.87%	-22.09%	-18.46%	-15.93%
Proj. EPS Growth (F1/F0)	-69.62%	-0.00%	-10.74%	-67.20%	-19.75%	23.05%
Curr. Cash Flow Growth	21.44%	5.61%	5.48%	-8.72%	310.65%	25.33%
Hist. Cash Flow Growth (3-5 yrs)	15.01%	7.31%	8.55%	-11.78%	-5.41%	-8.44%
Current Ratio	0.52	0.45	1.29	0.56	0.32	0.33
Debt/Capital	19.85%	20.55%	44.75%	30.01%	7.36%	17.98%
Net Margin	19.61%	3.92%	10.59%	0.73%	8.25%	0.69%
Return on Equity	9.93%	7.52%	16.29%	-0.38%	8.48%	3.26%
Sales/Assets	0.18	0.31	0.55	0.20	0.31	0.31
Proj. Sales Growth (F1/F0)	3.48%	0.00%	-2.65%	-6.50%	10.09%	0.00%
Momentum Score	F	-	-	A	D	D
Daily Price Chg	6.48%	3.15%	2.42%	4.58%	3.50%	4.04%
1 Week Price Chg	-0.28%	1.43%	4.60%	-1.21%	-3.53%	2.42%
4 Week Price Chg	38.13%	11.50%	13.40%	7.46%	29.67%	11.20%
12 Week Price Chg	-9.84%	-4.13%	12.78%	-18.85%	-6.44%	-5.97%
52 Week Price Chg	-8.62%	-16.85%	0.89%	-35.44%	-15.81%	-21.06%
20 Day Average Volume	2,869,080	142,190	2,528,787	761,365	527,450	71,765
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	-14.34%	0.00%	0.00%
(F1) EPS Est 4 week change	-64.26%	-1.44%	-0.14%	-10.63%	-14.20%	-21.84%
(F1) EPS Est 12 week change	-71.30%	-18.00%	-16.00%	-83.89%	-32.81%	-28.13%
(Q1) EPS Est Mthly Chg	-101.88%	-2.52%	-0.02%	7.33%	-61.53%	-56.83%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	C
Growth Score	B
Momentum Score	F
VGM Score	C

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

Disclosures

This report contains independent commentary to be used for informational purposes only. The analysts contributing to this report do not hold any shares of this stock. The analysts contributing to this report do not serve on the board of the company that issued this stock. The EPS and revenue forecasts are the Zacks Consensus estimates, unless indicated otherwise on the reports first page. Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts personal views as to the subject securities and issuers. ZIR certifies that no part of the analysts compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report.

Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Any opinions expressed herein are subject to change.

ZIR is not an investment advisor and the report should not be construed as advice designed to meet the particular investment needs of any investor. Prior to making any investment decision, you are advised to consult with your broker, investment advisor, or other appropriate tax or financial professional to determine the suitability of any investment. This report and others like it are published regularly and not in response to episodic market activity or events affecting the securities industry.

This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. ZIR or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. ZIR is not a broker-dealer. ZIR may enter into arms-length agreements with broker-dealers to provide this research to their clients. Zacks and its staff are not involved in investment banking activities for the stock issuer covered in this report.

ZIR uses the following rating system for the securities it covers. **Outperform-** ZIR expects that the subject company will outperform the broader U.S. equities markets over the next six to twelve months. **Neutral-** ZIR expects that the company will perform in line with the broader U.S. equities markets over the next six to twelve months. **Underperform-** ZIR expects the company will underperform the broader U.S. equities markets over the next six to twelve months.

No part of this report can be reprinted, republished or transmitted electronically without the prior written authorization of ZIR.