

ARCH CAPITAL GROUP LTD.  
Form 10-Q  
August 08, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007

Or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the transition period \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-26456

**ARCH CAPITAL GROUP LTD.**

(Exact name of registrant as specified in its charter)

**Bermuda**

(State or other jurisdiction of incorporation  
or organization)

**Not Applicable**

(I.R.S. Employer Identification No.)

**Wessex House, 45 Reid Street  
Hamilton HM 12, Bermuda**

(Address of principal executive offices)

(Zip Code)

**(441) 278-9250**

Registrant's telephone number, including area code:

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common shares as of the latest practicable date.

<b>Class</b>	<b>Outstanding at July 31, 2007</b>
Common Shares, \$0.01 par value	70,869,221

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ARCH CAPITAL GROUP LTD.

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of  
Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of June 30, 2007, and the related consolidated statements of income for each of the three-month and six-month periods ended June 30, 2007 and 2006, and the consolidated statements of changes in shareholders' equity, comprehensive income and cash flows for each of the six-month periods ended June 30, 2007 and 2006. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2006, and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and cash flows for the year then ended (not presented herein), and in our report dated February 28, 2007 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2006, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP  
New York, New York  
August 8, 2007

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(U.S. dollars in thousands, except share data)

	(Unaudited) June 30, 2007	December 31, 2006
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2007, \$6,972,705; 2006, \$6,858,970)	\$ 6,923,478	\$ 6,876,548
Short-term investments available for sale, at fair value (amortized cost: 2007, \$1,110,053; 2006, \$956,926)	1,114,485	957,698
Short-term investment of funds received under securities lending agreements, at fair value	1,114,959	891,376
Other investments (cost: 2007, \$429,486; 2006, \$282,923)	461,835	307,082
<b>Total investments</b>	<b>9,614,757</b>	<b>9,032,704</b>
Cash	245,143	317,017
Accrued investment income	71,064	68,440
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value	1,085,757	860,803
Premiums receivable	1,041,921	749,961
Funds held by reinsureds	79,335	82,385
Unpaid losses and loss adjustment expenses recoverable	1,545,820	1,552,157
Paid losses and loss adjustment expenses recoverable	131,441	122,149
Prepaid reinsurance premiums	544,137	470,138
Deferred income tax assets, net	70,688	63,606
Deferred acquisition costs, net	309,651	290,999
Receivable for securities sold	54,954	190,168
Other assets	499,100	511,940
<b>Total Assets</b>	<b>\$ 15,293,768</b>	<b>\$ 14,312,467</b>
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 6,782,433	\$ 6,463,041
Unearned premiums	2,001,736	1,791,922
Reinsurance balances payable	382,488	301,679
Senior notes	300,000	300,000
Deposit accounting liabilities	43,559	45,107
Securities lending collateral	1,114,959	891,376
Payable for securities purchased	434,624	418,109
Other liabilities	529,902	510,614
<b>Total Liabilities</b>	<b>11,589,701</b>	<b>10,721,848</b>
<b>Commitments and Contingencies</b>		
<b>Shareholders Equity</b>		
Non-cumulative preferred shares (\$0.01 par value, 50,000,000 shares authorized)		
- Series A (issued: 2007 and 2006, 8,000,000)	80	80
- Series B (issued: 2007 and 2006, 5,000,000)	50	50
Common shares (\$0.01 par value, 200,000,000 shares authorized, issued: 2007, 71,273,285; 2006, 74,270,466)	713	743
Additional paid-in capital	1,716,295	1,944,304
Retained earnings	1,993,963	1,596,018
Accumulated other comprehensive income (loss), net of deferred income tax	(7,034)	49,424
<b>Total Shareholders Equity</b>	<b>3,704,067</b>	<b>3,590,619</b>
<b>Total Liabilities and Shareholders Equity</b>	<b>\$ 15,293,768</b>	<b>\$ 14,312,467</b>

See Notes to Consolidated Financial Statements



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(U.S. dollars in thousands, except share data)

	(Unaudited) Three Months Ended June 30, 2007		(Unaudited) Six Months Ended June 30, 2007	
	2007	2006	2007	2006
<b>Revenues</b>				
Net premiums written	\$ 757,895	\$ 794,558	\$ 1,629,640	\$ 1,668,277
(Increase) decrease in unearned premiums	(6,483 )	2,892	(132,735 )	(109,226 )
Net premiums earned	751,412	797,450	1,496,905	1,559,051
Net investment income	117,299	90,503	229,988	170,829
Net realized losses	(3,757 )	(32,202 )	(4,738 )	(35,585 )
Fee income	2,091	3,468	4,060	5,273
Other income	265		869	
<b>Total revenues</b>	<b>867,310</b>	<b>859,219</b>	<b>1,727,084</b>	<b>1,699,568</b>
<b>Expenses</b>				
Losses and loss adjustment expenses	425,663	462,255	845,724	930,433
Acquisition expenses	117,277	148,581	237,405	278,253
Other operating expenses	100,505	84,367	191,318	167,344
Interest expense	5,523	5,651	11,046	11,206
Net foreign exchange losses	6,450	1,146	16,192	11,399
<b>Total expenses</b>	<b>655,418</b>	<b>702,000</b>	<b>1,301,685</b>	<b>1,398,635</b>
<b>Income before income taxes</b>	<b>211,892</b>	<b>157,219</b>	<b>425,399</b>	<b>300,933</b>
Income tax expense	6,037	14,332	14,532	25,756
<b>Net income</b>	<b>205,855</b>	<b>142,887</b>	<b>410,867</b>	<b>275,177</b>
Preferred dividends	6,461	5,039	12,922	7,706
<b>Net income available to common shareholders</b>	<b>\$ 199,394</b>	<b>\$ 137,848</b>	<b>\$ 397,945</b>	<b>\$ 267,471</b>
<b>Net income per common share</b>				
Basic	\$ 2.75	\$ 1.88	\$ 5.44	\$ 3.66
Diluted	\$ 2.65	\$ 1.81	\$ 5.24	\$ 3.52
<b>Weighted average common shares and common share equivalents outstanding</b>				
Basic	72,494,823	73,188,101	73,209,439	73,044,473
Diluted	75,254,846	76,155,438	75,947,858	76,014,819

See Notes to Consolidated Financial Statements

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**  
(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30,	
	2007	2006
<b>Non-Cumulative Preferred Shares</b>		
Balance at beginning of period	\$ 130	\$
Preferred shares issued		130
Balance at end of period	130	130
<b>Common Shares</b>		
Balance at beginning of year	743	733
Common shares issued, net	6	6
Purchases of common shares under share repurchase program	(36 )	
Balance at end of period	713	739
<b>Additional Paid-in Capital</b>		
Balance at beginning of year	1,944,304	1,595,440
Cumulative effect of change in accounting for unearned stock grant compensation		(9,646 )
Series A non-cumulative preferred shares issued		193,388
Series B non-cumulative preferred shares issued		120,866
Common shares issued	405	410
Exercise of stock options	13,373	15,572
Common shares retired	(257,162 )	(658 )
Amortization of share-based compensation	14,457	7,510
Other	918	274
Balance at end of period	1,716,295	1,923,156
<b>Deferred Compensation Under Share Award Plan</b>		
Balance at beginning of year		(9,646 )
Cumulative effect of change in accounting for unearned stock grant compensation		9,646
Balance at end of period		
<b>Retained Earnings</b>		
Balance at beginning of year	1,593,907	901,348
Adjustment to adopt SFAS No. 155, <i>Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140</i>	2,111	
Balance at beginning of year, as adjusted	1,596,018	901,348
Dividends declared on preferred shares	(12,922 )	(7,706 )
Net income	410,867	275,177
Balance at end of period	1,993,963	1,168,819
<b>Accumulated Other Comprehensive Income (Loss)</b>		
Balance at beginning of year	51,535	(7,348 )
Adjustment to adopt SFAS No. 155, <i>Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140</i>	(2,111 )	
Balance at beginning of year, as adjusted	49,424	(7,348 )
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	(67,513 )	(64,272 )
Foreign currency translation adjustments, net of deferred income tax	11,055	(5,444 )
Balance at end of period	(7,034 )	(77,064 )
<b>Total Shareholders Equity</b>	<b>\$ 3,704,067</b>	<b>\$ 3,015,780</b>

See Notes to Consolidated Financial Statements





## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30,	
	2007	2006
<b>Comprehensive Income</b>		
Net income	\$ 410,867	\$ 275,177
Other comprehensive loss, net of deferred income tax		
Unrealized decline in value of investments:		
Unrealized holding losses arising during period	(72,486 )	(97,560 )
Reclassification of net realized losses, net of income taxes, included in net income	4,973	33,288
Foreign currency translation adjustments	11,055	(5,444 )
<b>Other comprehensive loss</b>	(56,458 )	(69,716 )
<b>Comprehensive Income</b>	<b>\$ 354,409</b>	<b>\$ 205,461</b>

See Notes to Consolidated Financial Statements

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(U.S. dollars in thousands)**

	<b>(Unaudited)</b>	
	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Operating Activities</b>		
Net income	\$ 410,867	\$ 275,177
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses	4,854	35,673
Other income	(869 )	
Share-based compensation	14,457	7,510
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	324,793	473,996
Unearned premiums, net of prepaid reinsurance premiums	135,525	117,298
Premiums receivable	(290,437 )	(224,498 )
Deferred acquisition costs, net	(18,702 )	(5,971 )
Funds held by reinsureds	3,050	82,879
Reinsurance balances payable	79,254	105,193
Deferred income tax assets, net	(3,757 )	(5,555 )
Other liabilities	1,737	18,331
Other items, net	16,231	(56,879 )
<b>Net Cash Provided By Operating Activities</b>	<b>677,003</b>	<b>823,154</b>
<b>Investing Activities</b>		
Purchases of fixed maturity investments	(8,933,304 )	(8,196,081 )
Proceeds from sales of fixed maturity investments	8,407,340	7,440,922
Proceeds from redemptions and maturities of fixed maturity investments	305,847	96,360
Purchases of other investments	(185,357 )	(63,813 )
Proceeds from sales of other investments	62,309	6,062
Net purchases of short-term investments	(141,217 )	(279,297 )
Change in securities lending collateral	(223,583 )	131,153
Purchases of furniture, equipment and other	(8,998 )	(8,679 )
<b>Net Cash Used For Investing Activities</b>	<b>(716,963 )</b>	<b>(873,373 )</b>
<b>Financing Activities</b>		
Purchases of common shares under share repurchase program	(254,973 )	
Proceeds from common shares issued, net	7,427	11,212
Proceeds from preferred shares issued, net of issuance costs		