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FAF - Q3 2012 First American Financial Corporation Earnings Conference Call

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Welcome and thank you for standing by. At this time, all participants are in listen-only mode. After the presentation, we will conduct a question-and-answer session.

Today's conference is being recorded. If you have any objections, you may disconnect at this time.

A copy of today's press release is available on First American's website at www.firstam.com/investor. Please note that the call is being recorded and will be available for replay from the Company's investor website for a short time by dialing 402-220-4725.

We will now turn the call over to Craig Barberio, Director of Investor Relations to make an introductory statement. You may begin.

Craig Barberio - *First American Financial Corporation - Director, IR*

Thank you, Jeff. Good morning, everyone, and thank you for joining us for our third-quarter 2012 earnings conference call. Joining us on today's call will be our Chief Executive Officer, Dennis Gilmore, Max Valdes, Executive Vice President and Chief Financial Officer, and Mark Seaton, Senior Vice President of Finance.

At this time, we would like to remind listeners that management's commentary and responses to your questions may contain forward-looking statements such as those described on page 5 in today's news release and other statements that do not relate strictly to historical or current fact.

The forward-looking statements speak only as of the date they are made and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made. Risks and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements. Factors that could cause the anticipated results to differ from those described in the forward-looking statements are described on page 5 of the news release.

Management's commentary contains and responses to your questions may also contain certain financial measures that are not presented in accordance with generally accepted accounting principles, including a personnel and other expense -- operating expense ratio and adjusted corporate debt expense. The Company is presenting these non-GAAP financial measures because they provide the Company's management and investors with additional insight into the operational efficiencies and performance of the Company, relative to earlier periods and relative to the Company's competitors. The Company does not intend for these non-GAAP financial measures to be a substitute for any GAAP financial information.

In the news release that we filed today which is available on our website, www.firstam.com, the non-GAAP financial measures disclosed in management's commentary are presented with and reconciled to the most directly comparable GAAP financial measures. Investors should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial measures.

With that, I will now turn the call over to our CEO, Dennis Gilmore.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks, Craig. And good morning and thank you for joining our call. I will begin with a review of the third-quarter highlights, followed by a few comments on the outlook for the fourth quarter and 2013.

We continue to see strong revenue growth in 2012. Third-quarter total revenues were $1.2 billion, up 25% compared to last year primarily driven by an increase in refinance transactions and we continue to see a rebound in the resale market with transaction volumes up 8%. In addition, our Commercial division delivered strong results with revenue of $106 million, up 19% compared to last year. Net income was $104 million or $0.95 per share. These results include net realized investment gains of $0.27 per share which were primarily due to the sale of the remaining stake in CoreLogic.

The Title segment generated pretax margin of 12.9%, including the impact of net realized investment gains that increased the margin by 160 basis points. We continue to demonstrate significant operating leverage in the quarter even though our expenses were slightly impacted by a strong build in open title orders throughout the third quarter.

Turning to the outlook. Third-quarter open orders were up 29% and so far in October open orders per day are running slightly ahead of September, driven by strong refinance transactions. The increase in open orders combined with a strong commercial pipeline indicates that closed orders should remain strong throughout the fourth quarter. Our outlook for the fourth quarter and our performance year-to-date puts us firmly on track to deliver at or above the high end of our goal of an 8 to 10% title margin for full year 2012.

Our financial performance has improved significantly in 2012 and we are optimistic to continued gradual improvements in the mortgage and real estate markets in 2013.

Given our outlook, I am pleased to report that our Board of Directors approved a 50% increase in our quarterly dividend beginning in the fourth quarter to $0.12 per share. This increased doubles our dividend from the level we established at the spinoff back in 2010.

Looking ahead, we remain committed to becoming the premier title and settlement service company in the US and our key markets abroad. We will maintain our efficient cost structure and continue to deliver strong margins while pursuing profitable growth in our title business.

I would now like to turn the call over to Max for a more detailed review of our financial results.

Max Valdes - *First American Financial Corporation - CFO and EVP*

Thank you, Dennis. The Company generated total revenues of $1.2 billion in the third quarter, up 25% compared with the same period of last year. Net income was $103.5 million or $0.95 per share compared with net income of $21 million or $0.20 per share last year.

Net income in the quarter benefited from $47.3 million in net realized investment gains or $0.27 per share which was primarily due to the sale of our remaining position in CoreLogic common stock.

In the Title Insurance and Services segment, total revenues were $1.1 billion, up 23% compared with the same quarter last year. Direct premium and escrow fees were up 29% this quarter driven by a 35% increase in closed orders which was partially offset by a 4% decline in the average revenue per order closed.

Average revenue per quarter closed was $1,502 compared to $1,569 for the same quarter of last year. Agent premiums were up 21% which is comparable to the increase in direct premiums we experienced in the second quarter, reflecting a normal reporting lag in agent revenues of approximately one quarter.

Agent retention was unchanged at 80.2% of agent premiums.

Information and other revenues totaled $158.8 million, flat compared to the same quarter last year. While US revenues increased 6%, they were offset by lower revenues in Canada due to a decline in mortgage transactions resulting primarily from the recent tightening of lending requirements.

Total investment income for the Title segment was $39.3 million, an increase of $21.1 million for the third quarter of 2011 reflecting higher net realized investment gains from the sale of CoreLogic common stock that was held at our primary insurance underwriter.

Personnel costs were $317.2 million, up 16% compared with the same quarter of last year. This increase was primarily due to higher incentive-based compensation driven by improved revenues and profitability and, to a lesser extent, higher staffing levels required to support the increased order volume compared to the prior year.

Other operating expenses were $197 million, up 12% from the same quarter of last year. This increase was primarily due to higher production-related expenses and temporary labor costs in response to higher order activity. The ratio of personnel and other operating expenses to net operating revenue declined to 73% from 77% last year, reflecting significant operating leverage.

In the third quarter, the provision for title losses was 6.6% of premium and escrow revenue, reflecting an ultimate loss rate of 5.6% for the current policy year and a net increase in the loss reserve estimates for prior policy years.

Year-to-date incurred claims were down $26 million and paid claims were down $18 million compared to last year. We expect this positive trend to continue as the loss policy years of 2005 to 2008 become more seasoned. We are also encouraged by the positive results we continue to see from our most recent policy years, 2009 to 2012.

Pretax income for the Title Insurance and Services segment was $141.9 million, generating a pretax margin of 12.9% compared to $52.8 million and 5.9% last year. The current quarter includes net realized investment gains that increased the pretax margin by 160 basis points while the third quarter of 2011 includes net realized losses that reduced the pretax margin by 20 basis points.

Turning to the Specialty Insurance segment, total revenues were $81.4 million, up 10% compared with the same quarter of the prior year. The loss ratio was 61% compared to 60% last year. Net realized investment gains increased by $2 million and as a result the third-quarter pretax margin was 10%, up from 9.2% last year.

Pretax income for corporate was $5.9 million, primarily a result of the $25.4 million gain from the sale of CoreLogic stock held at the holding company. Excluding the sale of the stock, corporate net expense was $19.5 million, in line with our expectations of $20 million per quarter.

Our tax rate in the third quarter was 33.3% reflecting adjustments related to the Company's ability to claim foreign tax credit. Year to date, the Company's tax rate was 34.8%.

Going forward, we expect our normalized tax rate to be approximately 38%.

With that, I will turn the call over to Mark.

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Thank you, Max. I will throw out a few comments on our capital and liquidity.

Cash provided by operations in the third quarter was $147 million, an increase of $82 million, relative to the third quarter of last year. The increase in operating cash flow was driven by improved earnings, reduced working capital and an 11% drop in paid title claims. Capital expenditures during the quarter were $21 million, up from $19 million in the same quarter of last year, primarily due to an increase in IT-related initiative.

Our cash and investment portfolio totaled $3.7 billion as of September 30 which include $1.4 billion of fiduciary funds. The portfolio is comprised of debt securities of $2.5 billion, cash and short-term deposits of $833 million, equity securities of $178 million and $193 million in less liquid long-term investments. Overall, we continue to have a high-quality portfolio.

Debt on our balance sheet totaled $272 million as of September 30. Our debt consists of $200 million funded on our credit facility, $42 million of trustee notes and $30 million of other notes. Our debt to capital ratio as of September 30 was 10.7%.

During the third quarter, we sold our remaining stake in CoreLogic at an average price of $23.28 per share. This sale generated proceeds of $208 million of which $70 million was received by our primary insurance subsidiary and $138 million was received by the holding company.

The fund at the regulated insurance company had been reinvested into our portfolio as a contribute toward the capitalization of our underwriter. The funds at the holding company have been used to pay down $140 million on our credit facility, subsequent to the end of the quarter. Although we intend to increase our debt to capital ratio over time, paying down the credit facility generated the best immediate return.

I would now like to turn the call back over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mark DeVries, Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Thanks. Why was the information in other revenue line down 5% Q over Q? Is there some seasonality to that that we should be aware of?

Dennis Gilmore - *First American Financial Corporation - CEO*

Actually, what is happening up there is it is really being impacted by our Canadian operations. They have tightened down credit standards pretty aggressively in Canada which has driven down the transaction volumes. So that is what caused our revenue to be down and -- or flat in that category. And we are going to watch it very closely. We will adjust our cost if we need to.

Mark DeVries - *Barclays Capital - Analyst*

Okay and what do you -- do you view that as more of a recurring impact on that business with the volumes or might that snap back or what should we expect there?

Dennis Gilmore - *First American Financial Corporation - CEO*

We are just going to watch it at this point. At this point I think it is going to be more reoccurring, but again we are going to watch the market very closely.

Mark DeVries - *Barclays Capital - Analyst*

Sorry if you gave this. Did you provide the purchase refi mix of your closed orders in the quarter?

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Yes. The next mix in the quarter -- well in terms of the close, I will just give you the -- the monthly in July was 64%. In August it was 65%. September, it was 67% and October, it was 66%. That is the mix of closed orders that were refi. For the quarter it was 65%.

Mark DeVries - *Barclays Capital - Analyst*

And how did that compare, that mix, remind us to the second quarter. Was it a little heavier refi?

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Yes, it is a little bit heavier refi. In the second quarter it was about -- in terms of closed orders it was about 60% refi. So the close orders, the mix has gone up in the third quarter.

Mark DeVries - *Barclays Capital - Analyst*

So follow-up to that, to what do you guys attribute -- I guess the fee per file was actually up a little bit on a Q for Q basis even though I guess refi was a higher percentage of the mix. Do you have an explanation for that?

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Yes. Really, you think that average revenue per quarter would be lower as you mentioned this because we had a refi mix. But we really saw a significant increase in the average revenue per commercial order which was up 15%. So that was really what drove the increase in HARP, We are just closing bigger commercial deals than we did last quarter.

Mark DeVries - *Barclays Capital - Analyst*

Then, finally, could you just elaborate on your decision to sell all of the CoreLogic stock this quarter. What was the thinking behind that?

Dennis Gilmore - *First American Financial Corporation - CEO*

Sure. If you recall, we built -- this was part of our capital scheduling when we spun the Company and we had five years to sell that investment. And it was our assessment that CoreLogic had performed well and it was an appropriate time to sell the remaining holdings.

Mark DeVries - *Barclays Capital - Analyst*

Thanks.

Operator

Jim Ryan, Morningstar.

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Jim Ryan - *Morningstar - Analyst*

Good morning. I have a question regarding HAMP mortgages. Can you track or give any information as to what percentage of the third quarter refis were due to HAMP? And then as a follow-up to that, from what I've read, there's still quite a few HAMP eligible loans out there. What are your thoughts on that?

Dennis Gilmore - *First American Financial Corporation - CEO*

First part of your question, we are running right now in the 15% to 20% range on the HARP refinance program right now. And the second part of your question, we have read the same thing -- that there could be over 1 million loans potential still left that are eligible for refinancing under HARP.

At this point, we are optimistic. We are optimistic the program will run a little longer than we initially thought; so we think it will go all the way through the fourth quarter and into 2013.

Jim Ryan - *Morningstar - Analyst*

Terrific. And then one longer-term question. Once the refi boom starts trailing down, and you think in terms of managing your cost? I mean there has been so much automation, is there that much staffing that can be reduced to reflect a huge falloff in refis or anything like that?

Dennis Gilmore - *First American Financial Corporation - CEO*

Really, what will happen there is it depends on the speed of the transition from a refinance to purchase market. But irregardless, we intend to adjust our cost structure dependent of whatever market we are operating in.

But let me probably comment more on how we look at 2013 now. We envision 2013 to have a better refinance in the extent we initially anticipated, and we envisioned 2013 to have an improved actual resell market. So at this point we are becoming progressively more optimistic on the prospects for 2013.

Jim Ryan - *Morningstar - Analyst*

Thank you.

Operator

Bose George, KBW.

Bose George - *Keefe, Bruyette, & Woods - Analyst*

Good morning. Given your comment on the margin impact of higher open orders, is it fair to assume that the margins could trend up a bit as that gap between closed and open orders converge, assuming the mix has been purchased and refi is stable?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, we saw that dynamic actually hit us this quarter. We thought it was a good quarter with good operating leverage in the business, but the good news was we were building inventory throughout the quarter, which really in our business that means your expenses are frontloaded to opening the border. And we will see the benefit of those expenses in our closed orders in the fourth quarter; probably impacted us about 1/2 point in margin in the third quarter.

Bose George - *Keefe, Bruyette, & Woods - Analyst*

Great, thanks. Then just for the Canadian business, can you just remind us what percentage of the premiums are coming from that business?

Dennis Gilmore - *First American Financial Corporation - CEO*

It is a very small number but it shows up in the information line. That is why you are seeing the impact. It is not a significant number for us in overall business. Less than 10%.

Operator

(Operator Instructions). Brett Huff, Stephens Inc.

Brett Huff - *Stephens Inc. - Analyst*

Good morning. Just a quick follow-up. On the fee per file, I think somebody asked you sort of the details of this quarter. What is your sense for next quarter given what you know now and maybe even any commentary you might have on next year on the fee per file?

Max Valdes - *First American Financial Corporation - CFO and EVP*

Well, typically, I would say in the fourth quarter we expect it to inch up slightly from where it is in the third quarter. Just given the fact that the fourth quarter is typically a strong commercial quarter and as you know those have higher fees per file. So we would expect it to be slightly higher, but not significantly higher in the fourth quarter.

Brett Huff - *Stephens Inc. - Analyst*

And then on the backlog question, Dennis, I think you mentioned that you guys are building open inventory and expect that to close. When you talk to your bank partners or your bank customers, are they also in a position where they have some open inventory and they are going to see some loans close ? I mean is that a -- are the banks mirroring what your inventory is, I guess?

Dennis Gilmore - *First American Financial Corporation - CEO*

Just as a broad statement I would say, yes. Everybody is very busy right now. Everybody's inventory is at high levels. And so, we think that the build that we are seeing from October even into September will continue and we think we will see -- our closing ratios by the way are staying very similar to what we have been seeing. So business is closing. It's just full pipelines right now.

Brett Huff - *Stephens Inc. - Analyst*

Okay. And then on the incremental margins, you mentioned that you were pleased with those. When I do the math it looks like they were about 35% or 40%. I think in the past you felt comfortable with that range. How long is that sustainable as you think through what your demand curve, what you think the demand curve looks like next year?

Dennis Gilmore - *First American Financial Corporation - CEO*

We are going to continue to run in those kinds of ranges. If not, we are going to try to improve upon them. So that's how we are running the business right now.

It will probably come back down to again when we transition more from our refinance to purchase markets we will just have to watch as we go through that process. But we are comfortable with those kind of leverage ranges.

Brett Huff - *Stephens Inc. - Analyst*

And then in terms of staff, you mentioned that it sounds like there were some temp folks you had to hire and even maybe permanent staff you staffed up. Can you give us a sense of, I guess maybe sequentially your -- or whatever metric you might want to use in terms of production staff as a result of -- as a result of the higher refi volumes, what you guys had to do?

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Yes. Just in the last, since the second quarter we have had to staff up a little bit to service the orders. We've hired about 200 employees and about 100 temps. And the temps show really up in other operating expenses so it will be split between the two line items.

Brett Huff - *Stephens Inc. - Analyst*

That's all I needed. Thanks for your help.

Operator

This concludes today's question-and-answer session and this concludes this morning's call. Would like to remind listeners that today's call will be available for replay on the Company's website or by dialing 402-220-4725. The Company would like to thank you for your participation.

This concludes today's conference call. You may now disconnect.
