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FAF - Q3 2013 First American Financial Corporation Earnings Conference Call

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CORPORATE PARTICIPANTS

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

Dennis Gilmore *First American Financial Corporation - CEO*

Mark Seaton *First American Financial Corporation - CFO*

CONFERENCE CALL PARTICIPANTS

Mark DeVries *Barclays Capital - Analyst*

John Campbell *Stephens, Inc. - Analyst*

PRESENTATION

Operator

Welcome, and thank you for standing by. A copy of today's press release is available on First American's website at www.firstam.com/investors. Please note that the call is being recorded and will be available for replay from the Company's investor website and for a short time by dialing 402-280-9972. We will now turn the call over to Craig Barberio, Director Investor Relations, to make an introductory statement.

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

Good morning, everyone, and thank you for joining us for our third-quarter 2013 earnings conference call. Joining us on today's call will be our Chief Executive Officer, Dennis Gilmore; and Mark Seaton, Executive Vice President and Chief Financial Officer.

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 4 of today's news release and other statements that do not relate strictly to historical or current facts. 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 forward-looking statements are also described on page 4 of today's 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 personnel and other operating expense ratios. The Company is presenting these non-GAAP financial measures because they provide the Company's management and investors with additional insight into the operational efficiency and performance of the Company relative to earlier period 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 also 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.

I'll now turn the call over to Dennis Gilmore.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks, Craig. Good morning, and thank you for joining our call. Today, I'll cover the highlights of our third-quarter results and view our recent capital management activities and conclude with a few comments regarding our outlook. I'll then turn the call over to Mark, who will cover our financial results in more detail.

Total revenues in the third quarter were $1.3 billion, up 8% compared to last year. This increase is driven by continued strength in the purchasing commercial markets as well as growth in our agency business. Our earnings per share were $0.59 per share. This quarter's results include $7 million of realized investment losses, which impacted EPS by $0.04. Our title insurance segment delivered strong results with a pre-tax margin of 10.3%.

During the quarter, total closed orders per day declined 12% compared to last year, driven by a sharp decline in refinance transactions. Our closed orders per day were up 22% compared to last year, a sign that the housing market continues its recovery. Additionally, we benefited from rising home values, with our average fee per purchase transaction increasing [to] $1,800 dollars, up 7%. Our closed refinance orders per day fell 33% from the third quarter of last year, as interest rates have trended upwards since May. Refinance activity represented 52% of our closed orders in the quarter, down from 66% last year.

During the quarter, as our refinance activity dropped, we began to adjust our cost structure. We reduced our staffing level, including temporary staff, by more than 700. These reductions came primarily from our business units associated with the refinanced transactions. And as we enter the fourth quarter, we are continuing to adjust our cost structure in response to market activity.

Revenues in our national commercial division were $134 million, up 26% from last year. We continue to see broad-based strength in our commercial operations in terms of both geography and market segments.

Looking ahead, we are well-positioned in the commercial business and are optimistic on its long-term outlook.

Turning to capital management, we repurchased 2.2 million shares in the quarter for a total of $47 million. Year to date, we've repurchased 3 million shares for a total of $65 million. We currently have $83 million remaining under our original $150 million share repurchase authorization. We have not purchased shares thus far in the fourth quarter. However, we will continue to evaluate share repurchases as part of our ongoing capital management strategy.

Shifting to our outlook, we remain optimistic that the housing market is in the process of a multi-year recovery, and we expect to see continued growth in the purchase market in 2014 and beyond. Over the next few quarters, our financial results may be impacted by the decline we've experienced in refinance activity as well as the normal seasonality in the purchase market. However, we believe we are well positioned to capitalize on the ongoing housing recovery, and we will continue to focus on profitable growth in our core title business.

Our vision remains consistent to be the premier title insurance and settlement service provider in the US and in select markets abroad. I'd now like to turn the call over to Mark for a more detailed review of financial results.

Mark Seaton - *First American Financial Corporation - CFO*

Total revenue in the third quarter was $1.3 billion, up 8%, compared to the third quarter of 2012. Net income was $64 million, or $0.59 per diluted share, compared with net income of $103 million, or $.95 per diluted share, in the same quarter of last year. The current quarter results include net realized investment losses of $0.04 per share, compared with net realized investment gains of $0.27 per share last year. The third quarter 2012 also benefited from certain tax items that favorably impacted results by $0.06 per share.

In the title insurance and settlement services segment, direct premium escrow fees were up 6% compared to last year due to a 19% increase in the average revenue per order, partially offset by an 11% decline in closed orders driven by lower refinance activity. The average revenue per order increased to $1800, driven by the continued shift in the order mix to higher-premium resale and commercial transactions. Additionally, the average revenue per order increased 7% for resale transactions and 11% for commercial transactions, reflecting growth and asset values.

Agent premiums were up 24%, reflecting a normal reporting lag in agent revenues of approximately one quarter. The agent split was 80.2% of agent premiums, unchanged from last year.

Information and other revenues totaled $159 million, essentially flat compared to last year, driven by higher demand for the Company's default and commercial title information products, largely offset by lower demand for title plant information due to the decline in refinanced title owners during the quarter.

Personnel costs were $351 million, up 11%, primarily due to higher staffing levels and higher incentive compensation driven by increased revenues. Given the employee reductions that occurred this quarter, the Company recorded $8 million of severance expense.

Other operating expenses were $205 million, up 4% from last year, primarily due to higher production-related expenses. The ratio of personnel and other operating expenses to net operating revenue was 74%, compared with 73% last year due to the higher personal costs.

In the third quarter, the provision for title losses was 5.8% of title premiums and escrow fees. The loss rate reflects an ultimate loss rate of 5.8% for the current policy year with no reserve adjustments for prior policy years.

Pre-tax income for the title insurance and services segment was $125 million in the third quarter, compared with $142 million in the third quarter of 2012. Pre-tax margin was 10.3%, down from 12.9% last year primarily attributable to a $25 million decline in net realized investment gains this quarter.

Turning to the specialty insurance segment, total revenues were $86 million, up 6%, compared to the same quarter of the prior year, driven by higher premiums earned in both the home warranty and property-casualty business lines. The ratio -- the loss ratio for the segment was 64%, an increase from the 61% experienced last year. Higher severity on fire-related claims and several small natural hazard events in the property-casualty business contributed to the higher loss ratio.

Pre-tax margin for the specialty insurance segment was 4.7%, which includes $1.5 million of net realized investment losses this quarter. Net expenses in the corporate segment were $22 million in the third quarter, in line with recent quarterly trends. In terms of cash flow, cash provided by operations was $87 million, down from $147 million in the third quarter of last year. Operating cash flow in the third quarter of 2012 was unusually high, partly due to the utilization of net operating loss carry-forwards that reduced cash tax payments.

Capital expenditures during the quarter were $22 million, the majority of which are related to capitalized software and fixed asset purchases. Debt on our balance sheet totaled $321 million as of September 30. Our debt consists of $250 million of senior notes, $39 million of trust deed notes, and $32 million of other notes and obligations. Our debt-to-capital ratio as of September 30 was 11.9%. We continue to have the entire amount available on a $600 million credit facility.

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. Can you give us what the refi percentage of closed orders was for the quarter? Do you have that?

Mark Seaton - *First American Financial Corporation - CFO*

Yes. In the third quarter, it was 52%.

Mark DeVries - *Barclays Capital - Analyst*

And do you have any read on the first few weeks of October?

Mark Seaton - *First American Financial Corporation - CFO*

In October so far, we're running at about 44%. And, as you can imagine, it's been trending down the last few months. In August, it was 51%; in September, it was 48%; and in October, it's 44%. But refi's have pretty much leveled off at this point, at least in the last couple of weeks. So I wouldn't expect it to change too dramatically over the next month or two.

Mark DeVries - *Barclays Capital - Analyst*

Got it. And I think, Dennis, you indicated you haven't bought any stock back so far this month. Should we think of book values being the level at which you're more likely to be active buying back your stock than where we are now?

Dennis Gilmore - *First American Financial Corporation - CEO*

Well, I wouldn't classify it that way. The book value is one of the metrics we look at. We also look at BCF, we look at price-to-earnings, and we look at the overall just market environment we're operating in. And we're going to be opportunistic on our share repurchase as we go forward.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it. And I'm sorry, Mark, can you also just give us kind of where you are on in orders opened and closed per day in October?

Mark Seaton - *First American Financial Corporation - CFO*

So far in October, we're running about 4,500 a day. 48% of that is refi.

Mark DeVries - *Barclays Capital - Analyst*

Got it. And just one last question. Commercial, are you guys looking for continued strength in that in 4Q? I guess normally that's the seasonally -- the best quarter of the year for commercial activity; and kind of what is your outlook for commercial as you go into 2014.

Dennis Gilmore - *First American Financial Corporation - CEO*

Clearly, one of our stronger-performing groups we've had in the Company over the last couple of years. We're going to look for strength into the fourth quarter and carrying on into 2014. So we think it will continue to be a strong performer all the way through 2014. Probably not the same year-over-year growth we saw between 2012 and 2013, but, again, strong performer.

Mark DeVries - *Barclays Capital - Analyst*

Okay, thanks. That's helpful.

Operator

(Operator Instructions) Ryan (inaudible).

Unidentified Participant

Great. Thank you. Congrats on the quarter, guys. Also just going back to, I guess, your sensitivity on capital management. I guess if you guys trade in a significant premium to book value, would you guys ever do, I guess, special dividends?

Dennis Gilmore - *First American Financial Corporation - CEO*

We'll consider it, but it's probably not our first choice. We're more focused on the long-term dividend of business. It's going to be a key part of our capital management strategy.

Unidentified Audience Member

Okay, great. And then just secondly, I guess, your debt to capital ratio, you're kind of just hovering on 12. Just want to see what you guys would -- what your target -- or where you guys would like to be ultimately.

Mark Seaton - *First American Financial Corporation - CFO*

We feel like our debt-to-capital ratio of 12 is definitely on the low end. We feel comfortable taking it up to 20%. We don't think that we can have a -- we think we can stomach a 20% debt to cap and still maintain our ratings, which are important for our commercial business and our international business. So we don't have any near-term plans to take it up. I think over a long period of time, we'll trend towards the 20% level.

Unidentified Participant

Okay, great. (Inaudible) with my last one would be just the tax rate. It bumped up; it was a little around 40% again this quarter. Just wanted to figure out why it fluctuates on a quarterly basis and where we should try to model that going forward, or how do you guys think about it.

Mark Seaton - *First American Financial Corporation - CFO*

The long-term tax rate, I would say, is 39%. There was some issues that happened this quarter that caused it to be about 40%. But really the 39% comes from our federal tax rate of 35%. We pay state taxes, which is roughly 3%. And then there's permanent differences; there's certain things we can deduct for tax purposes, like meals and entertainment. That adds another 1%. And there's other moving pieces, but I think 39% is a good run rate going forward.

Unidentified Participant

Got you, great. Thanks for the answers, guys.

Operator

Brett Huff, Stephens Inc.

John Campbell - *Stephens, Inc. - Analyst*

This is John Campbell in for Brett Huff, good morning. Just from a high-level view, could you guys give us your thoughts on the new QM rules? And maybe just in your conversations with banks, what they're saying as far as how well they feel they're prepared for the changes?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, this is Dennis. We're ready to go. I think that our clients, our customers, are going to be prepared to go. So at this point, we see, really, no major impact to the business as we move forward into 2014. Obviously, we have to modify our systems for the closing aspect of it, but we see it as kind of business as usual as long as the volumes stay -- hang in.

John Campbell - *Stephens, Inc. - Analyst*

Okay, great. And then -- so the NBA is looking at -- I think they're at 14% year-over-year growth to purchase next year is kind of what they're estimating. How does that compare to what you guys are seeing internally?

Dennis Gilmore - *First American Financial Corporation - CEO*

Exactly what we're looking at right now. We've had good growth in our purchase market in 2013; clearly going to be one of our high points, I think, going into 2014. We are currently using the NBA forecast right now at $1.1 trillion for the 14% growth rate. That's what we're using for modeling purposes going into 2014. And that feels about right to us, by the way, from a market perspective.

John Campbell - *Stephens, Inc. - Analyst*

Okay, great. And then last question -- how many shares have you guys bought back to date?

Dennis Gilmore - *First American Financial Corporation - CEO*

To date, about 3 million.

John Campbell - *Stephens, Inc. - Analyst*

Okay great. Thanks for taking our questions.

Operator

We have no more questions at this time, and that concludes this morning's call. We would like to remind listeners that today's call will be available for replay on the Company's website or by dialing 402-280-9972. The Company would like to thank you for your participation, and this concludes today's conference call. You may now disconnect.
