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FAF - Q4 2013 First American Financial Corporation Earnings Conference Call

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Mark DeVries *Barclays Capital - Analyst*

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Ryan Burns *- Analyst*

Eric Beardsley *Barclays Capital - Analyst*

PRESENTATION

Operator

Welcome, and thank you all for standing by.

(Operator Instructions)

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 a replay from the Company's investor website, and for a short time by dialing in 203-369-0421. We will now turn the call over to Craig Barberio, Director of Investor Relations to make an introductory statement.

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

Good afternoon, everyone, and thank you for joining us for our fourth-quarter and year-end 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 today may contain forward-looking statements, such as those described on pages 4 and 5 of 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 the circumstances or events that occur after the date the forward-looking statements are made. Risk 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 these forward-looking statements are also described on pages 4 and 5 of today's news release.

Management's commentary contains, and responses to your questions may also contain certain financial measures that are 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 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 today's news release that we filed, 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. With that, I will now turn the call over to Dennis Gilmore.

Dennis Gilmore - *First American Financial Corp - CEO*

Thanks for joining our call. I will begin with a review of 2013 results, followed by our fourth-quarter highlights. I will also discuss our recently announced agreement to acquire Interthinx, and conclude with a few comments on our 2014 outlook. Company revenues for 2013 were $5 billion, up 9% compared to 2012. Revenue growth was led by our purchase business which grew by 26%, as both transaction volumes and real estate prices increased in 2013. Commercial revenue grew by 23%, its strongest year ever. Refinance volumes were strong in the first half of 2013, but declined sharply throughout the second half of the year due to higher interest rates. Given this decline in refinance activity, the Company focused on expense management, reducing headcounts by 1,300 during the third and fourth quarters. We finished the year with an EPS of $1.71 and a title segment margin of 7.6%.

Turning to the fourth quarter, total revenues for the Company were $1.2 billion, a 4% decline compared to last year. Driven by lower revenues in our title segment, EPS was $0.48 per share. Title segments revenues in the fourth quarter were $1.1 billion, down 6% compared to the same period in 2012 with a pretax margin of 7.8%. Closed orders in the quarter were at the lowest level of the year, driven by 61% decline in closed refinance orders. In response to the sharp decline in volumes, headcounts were reduced by 600 in the fourth quarter, and reductions continue into 2014. However, the shift in the mix of title revenues from refinance to higher premiums purchase and commercial transactions, drove our average revenue per direct title order up 34%, helping to offset the sharp decline in closed orders during the quarter.

Turning to our specialty insurance segment which had a strong quarter, total revenues in our property and casualty and our home warranty business were 10 -- up 10%, with a pretax margin of 17%. Last week, we announced the signing of an agreement to acquire Interthinx, a leading provider of loan quality analytics, decision support tools, and loan review services for the mortgage industry. Interthinx is complementary to our core title and settlement service business. It deepens our relationships with our lender clients, by expanding our current product offerings to include new solutions that solve critical compliance and loan quality needs. The extensive market and regulatory changes over the past several years have led to a more demanding loan origination requirements. To help comply with these requirements, our clients have expressed a desire for tighter integration between loan origination activity, loan quality verification, and title and settlement services.

With the acquisition of Interthinx, First American will be in a unique position to provide the industry's most robust loan quality solutions by providing fraud analytic, identity, income and collateral verification services. This acquisition also represents a key step in our ongoing efforts to leverage our significant data assets, and will enable us to create innovative solutions for the mortgage industry, and enhance our title and settlement offerings. The early feedback from our clients have been extremely positive. This transaction is expected to be accretive to our earnings this year, with an anticipated closing by March 31.

Our capital management strategy remains consistent. First, make value-creating investments in our core business. Second, continue to acquire businesses that fit with our core strategy, including companies that enhance our risk profile offerings. Third, return excess capital to our shareholders through dividends and share repurchases.

Regarding the 2014 outlook, we expect volumes to soften relative to 2013, as a result of a weaker refinance market. We expect continued growth in our higher premium resale and commercial businesses. However, the strength of the purchase market will not be evident until we enter the spring selling season. We will continue to focus on gaining profitable market share, and aggressively managing our expenses. I now would like to turn the call over to Mark for a more detailed review of our financial results.

Mark Seaton - *First American Financial Corp - EVP, CFO*

Thank you, Dennis. Total revenue in the fourth quarter was $1.2 billion, down 4% compared to the fourth quarter of 2012. Net income was $52 million or $0.48 per diluted share, compared with net income of $93 million or $0.85 per diluted share in the same quarter of last year. The current quarter results include net realized investment gains of $2.4 million, an impairment of equity investments of $7.8 million, which together reduced net income by $0.03 per diluted share. The fourth quarter of 2012 included net realized investment gains of $0.04 per share.

In the title and insurance services segment, direct premium and escrow fees were down 12% compared to last year, due to a 35% decline in closed orders, driven by the lower refinance volumes which were down 61% relative to the prior year. This decline in orders was partially offset by a 34% increase in the average revenue per order. The average revenue per order increased to $1,878, driven by the continued shift in the order mix to higher premium purchase and commercial transactions. Additionally, the average revenue per order increased 4% for purchase transactions and 15% for commercial transactions, reflecting continued growth in real estate values. Agent premiums were up 5%, reflecting the 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 $144 million, down 11% compared to last year driven by lower demand for the Company's title plan information and default information products, due to the slowdown in transaction activity during the quarter. Personnel costs were $331 million, down 3% primarily due to lower incentive-based compensation. The title segment reduced headcount by 600 in the fourth quarter. As a result, the Company recorded $5 million of severance expenses.

Other operating expenses were $207 million, down 2% from last year, primarily due to lower production-related expenses. The ratio of personnel and other operating expenses to net operating revenue was 77%. In the fourth quarter, the provision for title policy losses and other claims was $56 million, or 5.8% of title premiums and escrow fees, compared with the loss provision rate of 7.0% in the same quarter of the prior year. Incurred title claims in the fourth quarter continue to be in line with our expectations. Pretax income for the title insurance and services segment was $88 million in the fourth quarter, compared with $153 million in the fourth quarter of 2012. Pretax margin was 7.8%, down from 12.7% last year, primarily attributable to a decline in order volumes.

Turning to the specialty insurance segment, total revenues were $88 million, up 10% compared with the same quarter of the prior year, driven by higher premiums earned in both the home warranty and property and casualty business lines. The loss ratio for the segment was 53%, an increase from the 51% experienced last year. Our home warranty business had another seasonally strong quarter, which contributed to a pretax margin for the specialty insurance segment of 17%. Net expenses in the corporate segment were $18 million, which includes $4 million of realized gains. In terms of cash flow, cash provided by operations was $133 million, down from $178 million in the fourth quarter of last year, primarily driven by a reduction in net income from the prior year. Capital expenditures were $26 million, the majority of which were related to fixed asset purchases and capitalized software.

Turning to capital management, debt on our balance sheet totaled $310 million as of December 31. Our debt consists of $249 million of senior notes, $38 million of trust deed notes, and $23 million of other notes and obligations. Our debt to capital ratio as of December 31 was 11%. To finance the Interthinx transaction, we intend to draw $150 million from our revolving credit facility. On a pro forma basis, our debt to capital ratio will be 16%, and we will have $450 million remaining on our $600 million credit facility. However, we are reviewing longer-term debt financing alternatives with the intent to enhance our holding company liquidity, and extend the duration of our liabilities.

Over the last two years, we have moved some of our operating subsidiaries, including home warranty, database solutions and certain title operations from being owned by our primary regulated insurance company, to directly under the holding company. This allows dividends paid by these subsidiaries to flow directly to the holding company, providing greater financial flexibility for capital management activities, including acquisitions, share repurchases and dividends. We expect this reorganization to be substantially complete by year end, at which point we will have increased the annual expected dividend payments from operating subsidiaries by approximately 50%. I would now like to turn the call back over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question is from Mr. Mark DeVries of Barclays. Your line is open, sir.

Mark DeVries - *Barclays Capital - Analyst*

Yes, thanks. My first question is around expense management. I think you normally guide us to expect a success ratio in kind of the 60% range where in the quarter where expenses -- where your revenues dropped, you would look to take out $[0.60] on every $1 from your expenses. You came up a decent amount short of that this quarter. Can you talk about why, and kind of what the outlook is for expenses as we go into 2014?

Dennis Gilmore - *First American Financial Corp - CEO*

Yes, this is Dennis. Thanks for the question. A couple of things, number one, we aggressively started lowering our headcounts in the quarter by 600, and we really won't see the benefit of that until the first quarter and beyond. And by the way, we think that is in that $45 million to $50 million range, just on the salaries alone there. The second thing is, we had a number of non-recurring items going on in the other OpEx line to about $18 million in the quarter. And then Mark, can go into the detail if you want -- but those won't recur in the quarter. The third thing we had happening, going on in the year, and it impact us in the second half, is we have been aggressively adding to our revenue-attached employee base. And that is always an investment in the business, and we won't see the benefit of that investment probably until 2014, is when we are looking for return there. And just to kind of wrap it all up, we are going to continue to aggressively manage our expenses across our revenue lines.

Mark DeVries - *Barclays Capital - Analyst*

Okay. And Mark, could you give us, on the detail on that -- non-recurring expense that Dennis --?

Mark Seaton - *First American Financial Corp - EVP, CFO*

Yes. Well, in the quarter, we had about $5 million of severance expense. We had a legal settlement of about $5 million, and we had a premium tax true-up for $3 million that ran through the other operating expense line items. So that was about $13 million of unanticipated items that hit in the fourth quarter.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it. That's helpful. And next question, just around commercial revenues. I mean, that continues to surprise to the upside. Could you give us just some high-level comments on kind of what your expectations are for that business in 2014 and 2015?

Dennis Gilmore - *First American Financial Corp - CEO*

Sure, first of all we had great performance out of our commercial group, company-wide all through 2014 -- excuse me -- all through 2013. We actually had a record year in our commercial division in 2013. We clearly see the strength continuing, going into 2014. I do think it will moderate off of the 2013 growth, but we look for a strong 2014. And it is really coming across all geographic areas, and really almost all asset bases right now. So we look for continued strength in commercial going into 2014.

Mark DeVries - *Barclays Capital - Analyst*

I appreciate the conservative assumption that it is going to moderate. But as we look out at just kind of TMBS maturities for the next couple years, it looks like there is a case to be made that it could accelerates. I mean, are you thinking about that at all, and as you kind of plan for the next year?

Dennis Gilmore - *First American Financial Corp - CEO*

Well, we are, but again, if we look back over the last couple of years we have had growth rates compounding over 20% for the last couple of years. So I do think, that 2014 will -- I don't know of 2014 is going to grow at that rate. I think it will definitely go down somewhat. And I think the MBA right now, if I am not mistaken is forecasting, commercial to grow on a 7% rate in 2014. Okay. Got it. Finally, just on your Interthinx acquisition. Can you talk a little bit about how you are evaluating the acquisition costs expected, synergies and how you are going to be funding that?

Mark Seaton - *First American Financial Corp - EVP, CFO*

Well, in terms of funding it, we are going to draw $150 million from the line, and we are going to look to term that debt out with other debt instruments. We are reviewing alternatives right now. So our debt-to-cap, as I mentioned is going to go from 11% to about 16%. The acquisition itself, we are looking at somewhere around $6 million of $8 million of cost synergies. And there is going to be some one-time integration costs that hit in 2014, so obviously we are not going to realize all of those in 2014, but certainly by the time we get to 2015, we expect to capture those.

Mark DeVries - *Barclays Capital - Analyst*

Okay. And any sense for what the cost of that term debt might end up looking like?

Mark Seaton - *First American Financial Corp - EVP, CFO*

Well, it is too early to tell right now. On our line, we pay LIBOR plus 200 basis points, so it is probably somewhere north of that, but it is too early to tell at this point.

Mark DeVries - *Barclays Capital - Analyst*

Okay, great. Thanks.

Dennis Gilmore - *First American Financial Corp - CEO*

Thank you.

Operator

The next question will be coming from Brett Huff. Your line is open, sir.

Brett Huff - *Stephens Inc. - Analyst*

Hello?

Dennis Gilmore - *First American Financial Corp - CEO*

Good morning.

Brett Huff - *Stephens Inc. - Analyst*

I want to get just a sense from you on what your -- can you just give us more detail on your purchase outlook, in terms of unit volumes and/or home price appreciation just roughly? I am not sure if you just use the MBA sort of outlook or if you have a particular spin on it. And then, particularly some seasonality, it seems that 1Q might be a little bit harder, just given weather and et cetera, but any commentary on that would be helpful too?

Dennis Gilmore - *First American Financial Corp - CEO*

Sure. Right now, we are forecasting off the MBA. They are looking at a 4% increase in the purchase transaction. I think that might be a little pessimistic, so we think it will be a tad better than that we think. No question though the year started a little rough, because of the weather.

Our orders have come in line on our January forecast, but we really won't know the overall strength of the purchase market, until we get well into the spring buying season. Bottom line, we are optimistic. We are optimistic, that we are going to continue see growth there. We are actually a little bit more optimistic again than the MBA, and we are also thinking that we may see some price appreciation again in 2014.

Brett Huff - *Stephens Inc. - Analyst*

Okay. And then, Mark, I think this is a question for you. The impairment is included in the 7.8% -- it negatively impacted the 7.8% title pretax margin, or did that run through corporate?

Mark Seaton - *First American Financial Corp - EVP, CFO*

Yes, that -- the vast majority of that ran through the title segment.

Brett Huff - *Stephens Inc. - Analyst*

Okay. So we thought the title was a little -- or margin was a little light, and I think that is probably why. And then, in terms of staffing cuts, Dennis, I think you mentioned that there is more to come. How do you kind of decide when it is appropriate to cut or not? Is there a metric that you look at, or how does that kind of work internally when you debate that number?

Dennis Gilmore - *First American Financial Corp - CEO*

Well, I guess, not a lot of debate. What we do is we match our revenues against our expense lines. We -- obviously, our early indicator will be orders per employee, and if we are seeing that drop, we will continue to adjust our staff. What we do also, is look at the business segments themselves. For example, as you would imagine, our refinance businesses have taken the bulk of the staff cuts. And at the same time, we have added to them on the commercial operation. So we will target in on the orders. We will target in on what type of orders they are.

Brett Huff - *Stephens Inc. - Analyst*

Okay. And then, two last questions for me. One, can you give us a revenue, profit and valuation thoughts, such that you can on Interthinx? And then the second question is, what is the outlook for a dividend raise, and/or a buyback in the future? And then I will get off? Thanks for your help.

Mark Seaton - *First American Financial Corp - EVP, CFO*

I will take that first part of that, and I will hand it over for Dennis for the second part. On Interthinx, there is certain customer sensitivities around the numbers. But I would just say that in general, it is about $100 million revenue business, and the margins -- the pretax margins there, are somewhat higher than our overall title insurance segment for 2013.

Dennis Gilmore - *First American Financial Corp - CEO*

Yes, on the -- specifically on the dividend raise, I am not going to comment directly on that. But really, what I will tell you, is our capital deployment strategy still remains very consistent. First and foremost, we will always invest in the business. Second, we will look for strategic acquisition opportunities that are going to give us the necessary return for us. And then, we are always going to evaluate the appropriateness of our dividend and our share repurchase, and we will look to return capital to shareholders when appropriate.

Brett Huff - *Stephens Inc. - Analyst*

Great. Thank you for your help.

Mark Seaton - *First American Financial Corp - EVP, CFO*

Thanks, Brett.

Operator

Thank you. The next question is coming from [Ryan Burns].

Ryan Burns - - *Analyst*

Yes, great. I am actually all set. Brett, asked all my questions. Thank you.

Mark Seaton - *First American Financial Corp - EVP, CFO*

Okay. Thanks, Ryan.

Operator

Thank you. And the next question will be coming from [Eric Beardsley]. Your line is open, sir.

Eric Beardsley - *Barclays Capital - Analyst*

Hello, thanks. In the past, you have talked about what percentage of your personnel and other OpEx is fixed. As you have gone through these expense cuts, where do you think that stands today?

Mark Seaton - *First American Financial Corp - EVP, CFO*

Yes, it has changed a little bit. Right now, in terms of our personnel costs, it is about 22% variable, if you just look at our fourth-quarter costs. When you look at our other operating expense line item, it is about 49% variable. So obviously, that changes every quarter, but that is where we stood in Q4.

Eric Beardsley - *Barclays Capital - Analyst*

Okay, great. Thanks. And I guess, as you go through the first quarter where we are expecting additional declines in refi, do your fourth-quarter expense cuts and what you have done so far in the first quarter fully reflect that? Or do you think that there is more room to go, based upon where volumes are coming in?

Dennis Gilmore - *First American Financial Corp - CEO*

There is continued more room -- we have continued our cuts going into the first quarter.

Eric Beardsley - *Barclays Capital - Analyst*

Okay. Is there any way to size those?

Dennis Gilmore - *First American Financial Corp - CEO*

At this stage, no, I would rather not. But we are going to continue to is just match our revenue -- I mean, our expense lines to our revenue. So we will continue to watch our expenses very aggressively.

Eric Beardsley - *Barclays Capital - Analyst*

Okay, great. Thank you.

Operator

Thank you. The next question is coming from [Jeffrey Bond]. Your line is open.

Ryan Burns - - *Analyst*

Thanks, good morning. Just a point of clarification, are you allocating more regional business to your commercial segment? I noticed that your year-over-year number went up.

Mark Seaton - *First American Financial Corp - EVP, CFO*

We are, we are, Jeff. And historically, we have just disclosed our national commercial services division revenue. But this quarter, we started providing additional disclosures around our order counts if you look at page 11 of the press release that we issued this morning. Historically, we have just disclosed total open orders and total closed orders, and now we bifurcate it with purchase orders, refinance orders, commercial orders and other orders to foot. And we disclose that for opened, closed, and average revenue per order. And so, those numbers are total commercial, including our national business, and commercial that is done in our local operations. And so, that is the number, the commercial number that we are going to start reporting on going forward.

Ryan Burns - - *Analyst*

Okay. So the $177 million this quarter, is all of your commercial across the board, which is why the year comparison is up $10 million to $[156] million?

Mark Seaton - *First American Financial Corp - EVP, CFO*

Yes, for our US commercial business all across the board, and most of it is our National Commercial Services business. But you are right, it is everything.

Ryan Burns - *- Analyst*

Okay, great. And then, this is probably more for Dennis. Obviously, the Interthinx deal -- I guess, my first reaction when it was announced was, it is a business that seems like it could fit you or CoreLogic. I know you are not looking to rebuild the CoreLogic, so can you talk a little bit about the types of deals, vertical, whatnot that make sense for FAF going forward, that doesn't kind of re-create your neighbor?

Dennis Gilmore - *First American Financial Corp - CEO*

Yes, we are definitely not looking to re-create CoreLogic, that is for sure. What we are looking to you do always is, we take a look at our businesses number one, our core title business and our core specialty insurance business, and we will look to do consolidation opportunities there in all of those product lines. So maybe where we have a geographic coverage gap, or where we are looking at some bulk, and we have a good cost stakeout, we will look at those kind of transactions.

And then, second, we are going to continue to look, Jeff, to expand our product lines around those key segments for us. And in specifically, in the Interthinx deal, we do a great job around the title and the vesting aspect of it, and what we wanted to do is move up the value chain there, and get some of the activity going on free -- at the beginning of the origination process, in segments we thought were growth segments. So what intrigued us about Interthinx, for example, is because of the regulatory changes going on right now, we have seen higher demand for those products early on in the origination cycle, and that flows really nicely into our title offerings. And then, the last aspect of the transaction, that we will look to continue to do in the future, is it gives us a nice opportunity, a very nice opportunity to leverage our databases across the organization.

Ryan Burns - *- Analyst*

Is there any add-on sector in particular that you think incrementally make sense that you could identify?

Dennis Gilmore - *First American Financial Corp - CEO*

Well, I think there are still some gaps in our overall product offerings for our lender customers right now. With Interthinx, we pick up a nice component of valuation, but I still think there is some opportunities for us to add to our valuation services.

Ryan Burns - *- Analyst*

Okay, great. Thank you.

Dennis Gilmore - *First American Financial Corp - CEO*

Thank you.

Operator

Thank you. There are no additional questions at this time.

Dennis Gilmore - *First American Financial Corp - CEO*

Thank you.

Operator

Thank you, that concludes this morning's call. We would like to remind listeners that today's call will be available for a replay on the Company's website or by dialing 203-369-0421. The Company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.