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FAF - Q1 2014 First American Financial Corporation Earnings Conference Call

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Eric Beardsley *Barclays Capital - Analyst*

Ryan Byrnes *Janney Montgomery Scott - Analyst*

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PRESENTATION

Operator

Thank you for standing by. All lines will be in a listen-only mode for today's conference. (Operator Instructions). 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 203-369-3402.

I will now turn the call over to Craig Barberio, Director of 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 first-quarter 2014 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 the 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 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 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 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. Investor 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 Corporation - CEO*

Good morning. I will begin with a review of our first-quarter financial highlights followed by an update on the market outlook and then conclude with a few comments regarding our recent capital management actions.

Total revenues in the first quarter were $1 billion, down 12% compared to 2013. EPS was $0.20 per share, down $0.13 from last year. The Title segment revenues in the first quarter were $925 million, down 13% compared to the same quarter last year. Title segment's pretax margin was 4.6%. We experienced a significant drop in closed orders driven by a 64% decline in closed refinance orders and a return to normal seasonality. However, the ongoing shift to higher premium commercial and purchased transactions drove our average revenue per direct Title order up 39%.

Our Commercial business continued to show strength with revenue growth at 25% with both transaction volumes and average fee per order up over last year. In addition, our purchase revenue was up 6% driven by higher average fee per order. Given the decline in closed orders, the Company continued its focus on overall expense management including a headcount reduction of over 500 excluding acquisitions closed during the quarter.

Revenues in our Specialty Insurance segment grew by 7% during the quarter driven by higher premiums in both our Home Warranty and Property & Casualty business. Our Home Warranty business continues its overall strong performance which contributed to the segment's pretax margin of 16%.

In terms of market outlook, April month to date purchase open orders are flat compared to last year. The spring selling season typically peaks during May and June so during the next few months, we will have a clearer read on the overall strength of the market. However at this point, we expect modest purchase revenue growth for the full year with the growth primarily coming from price rather than volume.

2014 will be a transition year as we continue to shift to a purchase led market. Our long-term outlook remains positive and given our confidence in the Company's future earnings and cash flow, we doubled our dividend to an annual rate of $0.96 per share. We also increased our share repurchase authorization to $250 million which we expect to deploy on an opportunistic basis over time.

These actions demonstrate our long-term commitment to create value for our shareholders while maintaining our financial flexibility to execute on our growth strategies.

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

Mark Seaton - *First American Financial Corporation - EVP and CFO*

Thank you, Dennis. Total revenue in the first quarter was $1 billion, down 12% compared with the first quarter of 2013. Net income was $22 million or $0.20 per diluted share compared with net income of $36 million or $0.33 per diluted share in the same quarter of last year. The current quarter results include net realized investment gains of $2.6 million and impairments of equity investments of $2.0 million which together had a negligible impact on earnings per diluted share.

The first quarter of last year included net realized investment gains of $0.05 per share.

In the Title Insurance and Services segment, direct premium and escrow fees were down 13% compared with last year due to lower refinance volumes which were down 64%. This decline in orders was partially offset by a 39% increase in the average revenue per order. The average revenue per order increased to $1723 driven by the continued shift in the order mix to higher premium purchase and commercial transactions. Additionally, the average revenue per order increased 6% for purchase transactions and 19% for commercial transactions reflecting continued growth in real estate values.

Agent premiums were down 13% reflecting the normal reporting lag in agent revenues of approximately one quarter. The agent split was 80.0% of agent premiums unchanged from last year. Information and other revenues totaled $137 million, down 10% compared with last year driven by lower demand for the Company's title plan information and default information products as a result of the slowdown in transaction activity.

Personnel costs were $300 million, down 5% primarily due to a reduction in employee benefits and overtime. The Title segment reduced headcount by 500 in the first quarter net of acquisitions. As a result, the Company recorded $3.5 million of severance expense. Other operating expenses were $170 million, down 10% from last year due to lower production-related expenses and temporary labor costs. The ratio of personnel and other operating expenses to net operating revenue was 82%.

In the first quarter, the provision for title policy losses and other claims was $46 million or 6.0% of title premiums and escrow fees compared with a loss rate of 8.7% in the same quarter of 2013. The current quarter rate reflects an ultimate loss rate of 6.0% for the current policy year with no reserve adjustments for prior policy years.

Pretax income for the Title Insurance and Services segment was $43 million in the first quarter compared with $64 million in the first quarter of 2013. Pretax margin was 4.6% down from 5% last year primarily attributable to a decline in order volumes.

Turning to the Specialty Insurance segment, total revenues were $87 million, up 7% compared with the same quarter of 2013 driven by higher premiums earned in both the Home Warranty and Property & Casualty business lines. The loss ratio for the segment was 52%, an increase from the 50% experienced last year. Our Home Warranty business had another seasonally strong quarter which contributed to a pretax margin for the Specialty Insurance segment of 16%.

Net expenses in the Corporate segment were $21 million in the first quarter, up 3% relative to the prior year.

In terms of cash flow, cash used for operations was $105 million, an increase of $54 million from the first quarter of last year driven by a reduction in operating earnings. Capital expenditures were $21 million, the majority of which are related to fixed asset purchases and capitalized software.

Turning to capital management, debt on our balance sheet totaled $457 million as of March 31. Our debt consists of $249 million of senior notes, $150 million drawn on our credit facility, $37 million of trustee notes, and $21 million of other notes and obligations. Our debt to capital ratio as of March 31 was 16%.

We intend to keep the $150 million outstanding on our credit facility for the foreseeable future and currently have an additional $450 million remaining on our $600 million line of credit.

Last quarter we discussed movement of some of our operating subsidiaries from being owned by our regulated insurance company to directly enter the holding company. These movements helped facilitate a 100% increase to our common dividend to an annual rate of $0.96 per share which reflects our positive long-term business outlook and our confidence in the future earnings and cash flow of our business.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Bose George, KBW.

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

Good morning. When Dennis commented on the purchase volume being flat and purchase orders been flat year-over-year in April, does that include the default orders as well?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

I am sorry. Bose, did you say does that include the default orders as well?

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

Yes, that is what I asked. Right.

Mark Seaton - *First American Financial Corporation - EVP and CFO*

No, it doesn't. It is really just resale orders and new home orders, it doesn't include defaults.

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

Okay, just curious what the trends are in that business?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

We are having a little trouble hearing you, Bose. We've got a little static on the line. Can you repeat that?

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

I was just curious what the trends are in terms of how default orders are doing year-over-year?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

In terms of open default orders, our open default orders are down 32% year-over-year and they are down 9% sequentially.

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

Okay, great. Thanks. In terms of personnel, are you anticipating any more cuts in the second quarter or do you think you guys are pretty much where you need to be?

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks for the question. We have been working hard at this now for the last three quarters and I think we are probably very close to what we need to be right now with our current order volume so we feel very good about the current mix.

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

Okay, great. A question on the commercial. The 19% increase in the commercial year-over-year this quarter, is that a decent run rate for future quarters or is there something in that 1Q 2013 number that is made it a little lower than usual?

Dennis Gilmore - *First American Financial Corporation - CEO*

Again, we had a very strong commercial quarter. We were up actually 25% but I do think it is a little -- we won't see those kind of growth rates the rest of the year. That was off a weak seasonal first quarter in 2013. So what we think is going to happen in commercial will be a strong performer for us for the rest of the year but not at those type of growth rates.

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

Okay, great. Thanks.

Operator

Eric Beardsley, Goldman Sachs.

Eric Beardsley - *Barclays Capital - Analyst*

Thank you. Just a follow-up on the commercial. What property types and geographies are you guys seeing the most strength and do you have a sense of what your market share in commercial is right now?

Dennis Gilmore - *First American Financial Corporation - CEO*

Let me break it down. First, we are seeing actually strength across almost all markets and all product types. So it is still very broad-based. We think that strength will continue throughout 2014 again but I do not think we will see the growth rates on a sequential basis that we saw in the first quarter.

We continue to play very well in this space and from a market share perspective, a little hard to nail down exactly but we carry a very nice share here in this space.

Eric Beardsley - *Barclays Capital - Analyst*

How are you thinking about exactly -- is it relative to your book value, share price or are you looking at potential acquisitions over the rest of the year?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

I'm sorry. Can you repeat the question? Again, we had a little static on our side.

Eric Beardsley - *Barclays Capital - Analyst*

Sure. I was just curious how you are thinking about using the share repurchase authorization in terms of the timing. I know you said you are thinking about it opportunistically but just curious opportunistically relative to what benchmarks, whether it is book value, the share price or if you are thinking about some acquisitions down the line?

Dennis Gilmore - *First American Financial Corporation - CEO*

Specifically to share repurchase, really no change to our plans. We are going to continue to be very supportive of share buybacks. It will be a key part of our strategy as it has been in the past but specifically, we will be opportunistic using our share repurchase in the future. So we will balance it against all our other needs for capital.

Eric Beardsley - *Barclays Capital - Analyst*

Great. Thank you.

Operator

Ryan Byrnes, Janney.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

Great, thanks for taking my call. I just had a question on kind of the re-stacking of the subsidiaries. Just wanted to see how far along in that process you guys are and to see if there is any more potential synergies or more capital that gets freed up from the process?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

This is Mark. We are substantially complete with it. It is something we started about two years ago and we have moved several of our cash flow subs from underneath our primary regulated insurance company which is First American Title Insurance Company underneath the Holding Company. So we have a couple more subs that we have identified here in 2014 that we expect to move by the end of the year but by the end of 2014, we will be finished with it.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

And with the process of it this year, does that create any more synergies as well or free up capital at all?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

It does free up cash flows to the Holding Company but I would say most of the work has already been done and the dividend that we set earlier in the first quarter assumed that -- took the actions that we expected to take for the rest of 2014 into consideration.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

Got you. Great. Thanks for that. And then quickly just you mentioned that there is a little bit of headcount reduction in the quarter, just wanted to figure out what kind of annualized cost save that 500 represents?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

Yes, it is somewhere between $3 million and $4 million annualized.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

Okay, great. Thanks for the answers, guys.

Operator

Brett Huff, Stephens.

Brett Huff - *Stephens Inc. - Analyst*

Good morning guys and congrats on a nice quarter in a tough environment. A question on -- can you just repeat what you said on the April orders? I apologize to make you repeat that but I couldn't write fast enough. Could you just give us that info again? I think that is something that a lot of folks are looking for and I want to make sure I had that right.

Dennis Gilmore - *First American Financial Corporation - CEO*

Sure, I will go with that. April orders month to date are flat right now over last year on a purchase -- specifically our purchase orders are flat from last year. But here is how we are looking at it. Flat from last year but we are really just now entering the spring cycle and we think that will go well through May, June, and potentially into July.

So sitting here today we are looking for some growth in our purchase business and as I mentioned on the script, most of that growth we are looking from price, not volume. But we are optimistic as we enter the spring cycle right now.

Brett Huff - *Stephens Inc. - Analyst*

And is that purchase number, is that open or closed orders that is year-to-date flat or both?

Dennis Gilmore - *First American Financial Corporation - CEO*

It is open.

Brett Huff - *Stephens Inc. - Analyst*

Okay. Thank you for that. Have you all, how is the new acquisition integration going, as planned, are there some upside surprises that you all have seen from the recent acquisition you all did, the (inaudible)?

Dennis Gilmore - *First American Financial Corporation - CEO*

First of all, we closed the transaction mid-March and the integration is on track, going very well and customer response has been very strong and I do definitely think we will have some positive surprise on the upside on the revenue side.

Brett Huff - *Stephens Inc. - Analyst*

Okay. Then last question from me is I know that you have sort of looked -- I think you are looking still maybe you would like to build some valuation scale at least I think that is what you said on the last call if I am remembering correctly. Is that still the case, would that be the place where we would expect to see M&A if M&A does happen?

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks for the question. It is pretty straightforward and we have been very consistent here. We are going to continue to source out tuck-in acquisitions for the title and settlement space where we think we have some opportunities to grow share. Then we are going to continue to look to build out our lender product offering specifically around our loan quality assurance offerings.

And specifically to the question you are asking, we do have some gaps in our valuation solutions and we are looking to fill those gaps but at the end of the day, we are going to be very disciplined like we have been, and we will only put out capital if we are going to get the right returns on that capital.

Brett Huff - *Stephens Inc. - Analyst*

Great. Thanks again for your time.

Operator

(Operator Instructions). Jeremy Campbell, Barclays.

Jeremy Campbell - *Barclays Capital - Analyst*

Good morning, guys. So just noticed that your ratio of closed to opens was pretty low this past quarter trending well below where you were historically. Was that partially due to the winter weather effect and would you expect that to be pulled through and maybe get a 2Q close ratio that is higher than normalized?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

Yes, Q1 was a little bit lower than what we have seen just because of the mix in the orders. But typically Q1 is always a seasonally low quarter in terms of the closing ratio and usually when we move on through the year Q2, Q3, Q4, the closing ratio will rise and we don't expect any change to that this year. So it should come up in future quarters.

Jeremy Campbell - *Barclays Capital - Analyst*

Got it. And then just a quick follow-up to that is if some of those delayed orders of closing in 1Q get pulled into the 2Q, did you already book those expenses on those orders that may not have closed in the first quarter? So would there maybe be an incremental expense benefit as we head to the next quarter?

Mark Seaton - *First American Financial Corporation - EVP and CFO*

Some of the expenses associated with those orders are booked in the first quarter like salary and personnel costs. Others expenses that we don't incur until the orders actually close like commission costs for example so I would say it is a mix. Some was in Q1, some will be in Q2.

Jeremy Campbell - *Barclays Capital - Analyst*

Got it. Thanks a lot. That is all I've got.

Operator

Thank you. There are no additional questions at this time. 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 203-369-3402. The Company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.
