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EDITED TRANSCRIPT

FAF - Q3 2014 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings and welcome to the First American Corporation third-quarter earnings conference call. (Operator Instructions) A copy of today's press release is available on First American's website at www.firstam.com/investor. Please note that this call is being recorded and will be available for replay from the Company's Investor website.

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

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

Good morning, everyone, and thank you for joining us for our third-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 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. 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 the 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 not presented in accordance with generally accepted accounting principles, including personnel and other operating expense ratios, adjusted personnel cost, and adjusted other operating costs. 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 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. Investor should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial measures.

With that, I would now like to turn the call over to Dennis Gilmore.

Dennis Gilmore - *First American Financial Corporation - CEO*

Good morning. Today I'll review our third-quarter financial highlights and comment on our business outlook.

Total revenues for the third quarter were $1.3 billion, down 3% compared to the third quarter of 2013. Net income in the quarter was $81 million or $0.74 per diluted share.

In the third quarter, the Title segment delivered a pretax margin of 10.4%. A continued emphasis on operating efficiencies, coupled with seasonal strength in the purchase and commercial markets, had a favorable impact on results this quarter.

Total closed orders per day in the Title segment fell 20% compared to last year, driven by a continued decline in refinance orders. This decline was largely offset by a 20% increase in the average fee per order, due to the ongoing shift in the order mix to higher-premium purchase and commercial transactions.

Our closed purchase orders for the quarter were down 5% compared to last year. However, our average fee per purchase order increased 8%.

Our commercial business continued its strong performance, generating $149 million in revenue during the quarter, up 7% from last year.

Revenues in our Specialty Insurance segment grew by 10% during the quarter, driven by higher earned premiums in both our home warranty and our property and casualty business. Our Specialty Insurance segment's pretax margin was 11%.

Third-quarter results were particularly strong in our home warranty business, driven by a lower loss ratio, due to decline in weather-related claims, and continued operating efficiencies. In anticipation of the normal fourth-quarter seasonal slowdown in the residential purchase market, we have reduced headcount by approximately 300 through mid-October.

With the recent sharp decline in interest rates, refinance activity has jumped significantly to an average of 2,000 orders per day over the last week. If interest rates remain near their current level, these factors may help to soften the normal seasonal decline in earnings.

I am optimistic we will see continued improvement in the residential purchase market in 2015 and beyond. For example, recent statements from the Federal Housing Finance Agency are encouraging; they are providing greater clarity to lenders regarding buyback risk, and the Agency appears to be taking additional steps to increase access to credit. In my opinion, these efforts among others will help to stimulate the ongoing recovery of the housing market.

Looking forward, the investments First American have made in our people, our technology and our data assets have laid the foundation for us to capitalize on the ongoing housing recovery and achieve our vision of being the premier title insurance and settlement service provider.

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, CFO*

Thank you, Dennis. Total revenue in the third quarter was $1.3 billion, down 3% compared with the third-quarter 2013. Net income was $81 million or $0.74 per diluted share, compared with net income of $54 million or $0.59 per diluted share in the same quarter of last year.

The current quarter results include net realized investment gains of $14 million or $0.09 per diluted share. Additionally, the current quarter benefited from a 30% effective tax rate due to our lower effective foreign tax rate as well as certain nonrecurring tax benefits. We expect our normalized tax rate to fall to 36% primarily as a result of improved profitability in our international operations.

In the Title Insurance and Services segment, direct premium and escrow fees were down 3% compared with last year. This decline was driven by a 20% decrease in the number of direct title orders closed, largely offset by a 20% increase in the average revenue per order.

The average revenue per order increased to $1,926, driven by the continued shift in the order mix to higher-premium purchase and commercial transactions. Additionally, the average revenue per order increased 8% for purchase transaction and 10% for commercial transactions, reflecting higher-liability deals.

Agent premiums were down 10%, reflecting the normal reporting lag in agent revenues of approximately one quarter. The agent split was 79.6% of agent premiums, a 60 basis point improvement from last year.

Information and other revenues totaled $161 million, up 1% compared with last year, driven by the impact of the recent Interthinx acquisition, offset by lower demand for the Company's default information products.

Personnel costs were $346 million, down $5 million or 1% from the prior year. Excluding the $11 million impact of recent acquisitions, personnel costs declined by 5% due to lower salary, overtime, incentive compensation, and severance expenses.

Other operating expenses were $202 million, down $2 million or 1% from last year. Excluding the $9 million impact of recent acquisitions, other operating expenses declined 5% due to lower production-related expenses and temporary labor costs.

The ratio of personnel and other operating expenses to net operating revenue was 74.5%.

In the third quarter, the provision for title policy losses and other claims was $65 million or 6.7% of title premiums and escrow fees, compared with a loss provision rate of 5.8% in the same quarter the prior year. The current quarter rate reflects an ultimate loss rate of 6.0% for the current policy year, with a $7 million net increase in the loss reserve estimates for prior policy years.

Pretax income for the Title Insurance and Services segment was $121 million in the third quarter, compared with $125 million in the third quarter of 2013. Pretax margin was 10.4%, compared with 10.3% last year.

Turning to the Specialty Insurance segment, total revenues were $95 million, up 10% compared with the same quarter the prior year, driven by higher premiums earned in both the home warranty and property/casualty business lines. The loss ratio for the segment was 60%, a decrease from the 64% experienced last year. Pretax margin for the segment was 11%, driven by continued strength in our home warranty business.

Net expenses in the corporate segment were $15 million in the third quarter, down 29% relative to the prior year. The improvement was due to decreased costs associated with the Company's defined-benefit pension plan.

In terms of cash flow, cash provided by operations was $121 million, versus $87 million in the third quarter of last year. The increase was primarily driven by lower tax payments and lower claims paid during the quarter. Capital expenditures were $26 million, up from $22 million in the third quarter of last year, due to an increase in capitalized software.

Turning to capital management, debt on our balance sheet totaled $451 million as of September 30. Our debt consists of $249 million of senior notes, $150 million drawn on our credit facility, $35 million of trustee notes, and $16 million of other notes and obligations. Our debt-to-capital ratio as of September 30 was 15%.

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

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Bose George, KBW.

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

Hey, guys. Good morning. I just wanted to clarify, what number did Dennis give for the order count -- open order count per day over the last few days?

Dennis Gilmore - *First American Financial Corporation - CEO*

The refinance order count has jumped over the last week to 2,000 a day.

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

2,000 a day? And what was the count for the last month? Is it essentially doubled from where it was?

Dennis Gilmore - *First American Financial Corporation - CEO*

No, we are up from about 1,500 orders a day to about 2,000 orders a day.

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

Okay.

Dennis Gilmore - *First American Financial Corporation - CEO*

Now, we are talking just specifically refinance.

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

Just the refi trend? Okay, great. In terms of -- actually, switching to your tax rate, is there any change in your tax rate going forward, just given what is happening with the foreign income? Or should we just use the normal 38% going forward?

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

there is a change to our tax rate. Historically, we've always talked about 38% to 39% being a normalized rate. But primarily because of the improvement in the profitability of our international operations, the normalized rate going forward we think is a lot closer to 36%.

Really we get there because we pay 35% federal tax; we pay about 2% in state tax; and then we get about a 1% benefit from our international tax rate, simply because the jurisdictions we do business in have a lower foreign effective tax rate than the US. So 36% is a good normalized rate going forward.

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

Okay, great. Then just actually one more on the order count. In terms of the cash percentage of the total, has that been pretty stable?

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

Yes, it's been pretty stable. It has hovered somewhere between 25% to 30%. And it's been like that for the last several quarters, so it hasn't really changed much recently.

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

Okay, great. Thanks.

Operator

Mark DeVries, Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Yes, thanks. Just two quick ones for me. First, the corporate personnel expense has been running like $10 million, $13 million a quarter; but this quarter it was $3 million. Mark, what is the right run rate for us on that going forward?

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

I would say it is somewhere between $8 million and $10 million. There were two things that happened this quarter in corporate. We had a $5 million benefit because of basically a pension trueup that we do typically this time of year, so $5 million was a benefit that hit corporate.

The other thing that happens in the personnel expense line item is we have a deferred comp plan that runs through corporate. So earnings investment income, let's say, on the deferred comp plan will run through the investment income line item at corporate, but it will also run through the personnel line item at corporate, too. And it is basically a wash when you look at pretax income, but that would cause volatility in the personnel line item.

But it wouldn't really have an impact on income in corporate. So I think $8 million to $10 million is a good run rate going forward.

Mark DeVries - *Barclays Capital - Analyst*

Okay, great. Then just can I get an update on how the pipeline is looking in your commercial business and what your outlook is there into the end of the year and into next?

Dennis Gilmore - *First American Financial Corporation - CEO*

Sure. It's strong actually. As you know, our revenues were up; we are up about 7% on a year-to-year basis, which is right in line with our expectation.

Our average deal size also is up about 10%; so our average fee is going up also. We are seeing strength really across all the geographic areas and all the product types right now.

So we have a lot of momentum going into the fourth quarter, and we think 2015 will be another very good year for commercial.

Mark DeVries - *Barclays Capital - Analyst*

Okay, great. Thank you.

Operator

Eric Beardsley, Goldman Sachs.

Eric Beardsley - *Goldman Sachs - Analyst*

Hi, thank you. Just wonder if you could help us think about the year-over-year growth in the purchase ARPO: roughly 8%, up from 6% the past couple quarters. What led to that acceleration?

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

We have been seeing growth in ARPO every month this year when you look on a year-over-year basis. Historically, the Rule of Thumb is that we are going to get about half of it from housing price increases. So if you think housing prices are up, say, 6% normally you would think that we would get about a 3% increase in our purchase ARPO.

It was higher than that this quarter at 8% just because there's other things going on like geographic mix, etc. But typically, we have been running at about 5% to 6% this year. We just got a little bit higher this quarter.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. I think you mentioned something about higher-liability deals. Was that related to commercial, or was that something on purchase?

Dennis Gilmore - *First American Financial Corporation - CEO*

That was commercial.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. Then just as we think about the geographic mix, could you provide any color on, I guess, where you saw the most relative strength or weakness in terms of your purchase orders?

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

Well, this quarter we saw strength in Texas; we saw strength in Florida; we saw strength in New York, just primarily because of the commercial transactions.

California, this quarter, was a little bit weaker than normal. But typically I would say Florida and Texas and New York we saw strength in. And those are going to have, obviously, higher-liability transactions associated with (technical difficulty) in those states.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. Then -- sorry, just on the purchase side, in terms of residential?

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

Really that was the residential comment, except for New York. In New York it was more commercial.

But in terms of the purchase side, it is Texas and Florida were strong this quarter. We saw a little bit of weakness in California.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. Just on the higher-liability piece, could you just help us explain what the moving parts to that are, and how that affects the ARPO?

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

Are you talking about purchase or commercial?

Eric Beardsley - *Goldman Sachs - Analyst*

I guess both.

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

Well, really our -- the fees that we get are just a function of the price of the house; or in the case of a refi, the amount of the mortgage. So obviously the higher the liability of the deal, the higher the ARPO that we are going to get. And that really holds true for both commercial and purchase.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. So it is really just the higher liability would just be more on the refi side as opposed to the purchase side, assuming the total value hasn't changed?

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

I would say it's both. I would say it is on the purchase and the refi side.

And on the commercial side, too, we are just seeing a lot more higher-quality assets being traded that just have higher liabilities associated with them. And therefore we are getting higher fees from them.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. Then just on the headcount reduction, just wanted to confirm. Is it 300 since the end of the second quarter? Was that the right number?

Dennis Gilmore - *First American Financial Corporation - CEO*

No, it is really through the third quarter. We started to trim back because of anticipated decline with the seasonal reduction in the purchase orders. So we are just getting ahead of the curve for what we think is going to be the normal slowdown going into the fourth quarter on purchase.

Eric Beardsley - *Goldman Sachs - Analyst*

Got it. So that is 300 since the end of September or so?

Dennis Gilmore - *First American Financial Corporation - CEO*

No, it's actually through the quarter.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. All right, great. Thank you.

Operator

Mark Hughes, SunTrust.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you. Good morning. The loss outlook, you had a 6% current-year loss provision, but a little unfavorable development. How do you think that is going to play out in the subsequent quarters? Do you think you will get -- is the trend a little more negative on the prior accident years?

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

Well, to answer your question, I think at least through the end of the year, we would expect to book at a rate that is similar to the one that we booked in the third quarter. Something we obviously will constantly evaluate, though, going forward.

This quarter, we did add $7 million to our reserves for prior policy years. But I would say that claims this quarter actually were better than our internal expectations. They were about $3 million better in terms of what we thought they were going to be.

But we just felt like we were going to take a cautious, measured approach and build a little bit to our reserves. But I think, to answer your question, Mark, a good number to assume is something similar to what we booked in the third quarter.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Similar as in the 6.0% for the current accident year, or the 6.7%?

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

I would say 6.7%, mid 6%s.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Right. Then the refi revenue per order was also up nicely. Is that something that may be sustained?

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

It is something that we saw that was unique this quarter. Typically we haven't seen much of an adjustment in the refi ARPO. But we feel like it was just an anomaly, and I wouldn't expect increases going forward like the one we saw this quarter.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

In the D&A, it was up a little bit sequentially. Should we expect it to be at the same level?

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

It should come down a little bit. D&A in the Title segment was $22 million this quarter. Typically we have been running about $18 million.

One of the things we did was we finished a purchase price allocation for the Interthinx acquisition, so that is going to add about $2 million a quarter in the Title segment of increased amortization of intangibles. This quarter we actually had $4 million higher, just because we had a catch-up from the second quarter.

So I think a good run rate to use going forward for depreciation is about $20 million in the Title segment.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Okay. Then final question. Any more even subjective thoughts on what it might mean, this higher access to credit, other regulatory steps that you are seeing out of the government and others? How meaningful do you think that will be next year?

Dennis Gilmore - *First American Financial Corporation - CEO*

Well, I mentioned that in my script, actually. Obviously, I am optimistic that the recovery in housing will continue into 2015 and beyond.

We've got -- we have a few things happening here. The economy continues to improve; the job outlook continues to improve.

And then just specifically, we are seeing better clarity on the regulatory front, which I think just adds to better certainty for the lenders. So we think better clarity there, and we think that the credit box will continue to slightly expand. So I think you take all of these issues together, we look for an optimistic 2015.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you.

Operator

(Operator Instructions) Brett Huff, Stephens.

James Rutherford - *Stephens Inc. - Analyst*

Hello, this is James Rutherford in for Brett. Good morning and thanks for taking the questions. First question is on capital allocation. Given that you guys doubled the dividend earlier in the year, and with the current leverage where it is now, where are your minds on capital allocation in terms of the dividend going forward and leverage?

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

Well, in terms of leverage, we are at 15% now. Our target is to be somewhere in the 18% to 20% range. That is where we would like to be, and I think so over time you will see us creep up to that 18% to 20% target.

In terms of the dividend, and we talked about it earlier this year. We doubled the dividend. It is something we feel strongly about and something that we discuss with our Board on a regular basis. But we are big proponents of a dividend going forward.

James Rutherford - *Stephens Inc. - Analyst*

Okay. Then on the refi strength that you have been seeing given the rates, if that continues to be stronger than expected, are there any changes that you have to make to your cost structure or headcount that might impact margins or just anything in the business going forward?

Dennis Gilmore - *First American Financial Corporation - CEO*

At this stage, no; we can handle the business coming in.

James Rutherford - *Stephens Inc. - Analyst*

Okay. Then the last question was on Interthinx and integration, how that is going. Up to this point it's been pretty positive so far.

Is that going well? And then are there any cross-sell opportunities coming up as you integrate?

Dennis Gilmore - *First American Financial Corporation - CEO*

Actually -- thanks for the question. The integration has gone very well. We are effectively done at this stage.

We have had, also, a really good fit with the company from a culture standpoint, so our employee base has been very stable. Business is doing well.

We are very, very enthusiastic about the analytic piece of that business. We are a little ahead of our game right there, ahead of our schedule there. And we do see cross-sell opportunities with our lenders.

So going well. We are very happy with the acquisition at this stage.

James Rutherford - *Stephens Inc. - Analyst*

Okay, great. Thanks for the questions -- answers.

Operator

Ryan Byrnes, Janney Capital.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

Great. Good morning, everybody. Just had one quick question. When you guys note you are trying to get double-digit Title margins, for your internal goals how do you guys think about realized gains? Because I realize that is a bit of a tailwind the last couple years.

But obviously not sure that will always persistent; and if I look at -- if I back that out of my Title margins, I get you guys sub-10% right now. Just wanted to see how you guys think about that.

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

We exclude realized gains or losses when we talk about our objective of a 10% Title margin. Every quarter we are going to have noise in the realized gain or loss item, but we look at it excluding that.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

Perfect. Thank you.

Operator

Mark DeVries, Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Yes, sorry if I missed this. Did you comment on how purchase orders are trending right now?

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

Purchase orders, Mark, when we just look at -- in October, they are running at about 1,800 orders a day. The last 4 or 5 months they've been somewhere between 2,000 and 2,200 a day; and we are starting to see the normal seasonal decline that you would typically see in October.

So our expectation for October is 1,800 a day, and that is exactly where we were at this time last year. Last October it was about 1,800 a day.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it. Thanks.

Operator

Thank you. We have reached the end of our question-and-answer session, and this does conclude today's teleconference. We thank you for your participation and you may disconnect your lines at this time.
