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FAF - Q2 2014 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings and welcome to First American Corporation 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 the 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 now begin.

Craig Barberio - *First American Financial Corporation - IR*

Good morning, everyone, and thank you for joining us for our second-quarter 2014 earnings conference call. On today's call, our speakers will be 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 these forward-looking statements to reflect circumstances or events that occur after the date of 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 result to differ from those described in the forward-looking statements are also described on page 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 costs, 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. Investors should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial measures. With that, I now like to turn the call over to Dennis Gilmore.



Dennis Gilmore - *First American Financial Corporation - CEO*

Good morning and thanks. Today I will review our second-quarter financial highlights and also provide a few comments on our business outlook. Total revenues for the second quarter were \$1.1 billion, down 11% compared to the second quarter of 2013. Net income in the quarter was \$51 million or \$0.47 per diluted share. During the second quarter we benefited from normal seasonal growth in our purchase transactions and continued strength in our commercial business. Furthermore we realize the full benefit of expense management actions taken in previous quarters.

Our Title segment pretax margin was 8%. Closed orders per day in our Title segment fell 33% compared to last year, driven by a 57% decline in refinance orders. Although our refinance volumes declined sharply over the last year, they stabilized during the first quarter and we have seen a slight uptick in refinance orders during the second quarter as mortgage rates have fallen. Our closed purchase orders for the quarter were down 4% compared to last year. However, our average fee per purchase order increased 6%, driven by rising home prices. We expect a modest increase in total purchase revenue for the full year, primarily driven by rising home prices rather than transaction growth.

Our Commercial business continues its strong performance, generating \$132 million in revenue during the quarter, a slight decline from last year due to a number of transactions that were scheduled to close in June but slipped into July. As we enter the third quarter, our Commercial revenues were off to a strong start. On a year-to-date basis, revenue was up 7% and we expect this trend to continue throughout the rest of the year.

Our Title results were negatively impacted by our reserve strengthening of \$25 million for prior policy years. The majority of this amount was due to a large commercial claim from policy year 2007 and is net of anticipated recoveries. As we have previously discussed, the ultimate loss rate for policy years 2005 through 2008 have been well above historical norms. But we anticipate that our paid title claims will trend downward over the next few years as these legacy policy years continue to age. We also believe that our most recent policy years, 2009 through 2014, will continue to benefit from loss rates that are below our long-term averages.

Revenues in our Specialty Insurance segment grew by 9% during the quarter, driven by higher earned premiums in both our home warranty and our property and casualty businesses. Our home warranty business has experienced strong momentum, with revenue growth of approximately 30% over the last three years. The business continues to generate attractive returns on capital.

Looking forward, First American is well-positioned for the continue recovery of the purchase market, which we expect to see stronger growth beginning in 2015. The investments we have made in our people, our technology, and our data assets have laid the foundation for us to 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 - CFO*

Thank you, Dennis. Total revenue in the second quarter was \$1.1 billion, down 11% compared with the second quarter of 2013. Net income was \$51 million or \$0.47 per diluted share compared with net income of \$35 million or \$0.31 per diluted share in the same quarter of last year. The current-quarter results include net realized investment gains of \$6.3 million or \$0.04 per diluted share.

Additionally, the current quarter benefited from a 34% effective tax rate due to a lower effective foreign tax rate as well as the utilization of foreign net operating loss carry forwards. Our normalized tax rate is 38%. However we expect this tax rate to improve over time depending on the future profitability of our international division among other factors. 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 declined 57%.

This decline in orders was partially offset by a 27% increase in the average revenue per order. The average revenue per order increased to \$1830, 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, reflecting continued growth in home prices. Agent premiums were down 15%, reflecting the normal reporting lag in agent revenues of approximately one quarter. The agent split was 79.9% of agent premiums.

Information and other revenues totaled \$165 million, down 3% 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. This decline was significantly offset by revenues generated from our recent Interthinx acquisition.

Personnel costs were \$327 million, down \$13 million or 4% from the prior year. Excluding the \$13 million impact of recent acquisitions, personnel costs declined by 8% due to lower salary, overtime, and incentive compensation expenses. Other operating expenses were \$197 million, down \$19 million or 9% from last year. Excluding the \$9 million impact of recent acquisitions, other operating expenses declined 13% due to lower production-related expenses and temporary labor cost. The ratio of personnel and other operating expenses to net operating revenue was 76%.

In the second quarter, the provision for title policy losses and other claims was \$77 million or 8.9% of title premiums and escrow fees, compared with a loss provision rate of 14.8% in the same quarter of the prior year. The current-quarter rate reflects an ultimate loss rate of 6.0% for the current policy year with a \$25 million reserve strengthening for prior policy years. Pretax income for the Title Insurance and Services segment was \$85 million in the second quarter, compared with \$73 million in the second quarter of 2013. Pretax margin was 8.0%, up from 6.1% last year.

Turning to the Specialty Insurance segment, total revenues were \$91 million, up 9% 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 58.5%, a decrease from the 60.6% experienced last year. Pretax margin for the segment was 12.1%, driven by continued strength in our home warranty business.

Net expenses in the corpus segment were \$19 million in the second quarter, down 8% relative to the prior year. In terms of cash flow, cash provided by operations was \$150 million versus \$209 million in the second quarter of last year. The decline was primarily driven by a reduction in operating earnings adjourn the period. Capital expenditures were \$19 million due primarily to investments in software development and fixed assets.

Turning to capital management, debt on our balance sheet totaled \$455 million as of June 30. Our debt consists of \$249 million of senior notes, \$150 million drawn on our credit facility, \$36 million of trustee notes, and \$19 million of other notes and obligations. Our debt-to-capital ratio as of June 30 was 50%.

In May we amended and extended our revolving credit facility. The capacity on the new facility increased from \$600 million to \$700 million and the LIBOR spread fell 25 basis points to 175 basis points. Additionally our debt-to-capital covenant increased from 30% to 35%. As of June 30, we had \$550 million available on this 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) Bose George, KBW.

Bose George - Stephens Inc. - Analyst

Please discuss your order trends so far in July and just give us the purchase/refi mix.

Mark Seaton - First American Financial Corporation - CFO

Yes, so in July our purchase transactions are basically flat versus last year. So it is basically continuing on the same trend that we have seen for the last few months here on a year-to-date basis. The purchase mix in terms of refis, percentage of refis is 41% in July. It is a little bit down from the 42% in June.



I would say the one thing about our orders so far in July is we did have a lot of larger commercial deals that were expected to close at the end of June that spilled over into July. So really for the first 15 business days of July, our commercial revenue is up 56% versus last year. But to answer your question, we are about 41% refi versus purchase mix in July so far.

Bose George - *Stephens Inc. - Analyst*

Okay, great. Thanks. Actually on the commercial loan for you took the charges quarter, is there a reinsurance that limits the risk on larger commercial loans like that?

Dennis Gilmore - *First American Financial Corporation - CEO*

We do have a reinsurance program in place and we have had it for a number of years. So we do have reinsurance again in place on this transaction, but we are not meant to give any details on it right now.

Bose George - *Stephens Inc. - Analyst*

And then actually switching to Interthinx, just could you give us the impact of Interthinx on the P&L this quarter?

Mark Seaton - *First American Financial Corporation - CFO*

Yes, we did a few acquisitions really at the end of the first quarter and the beginning of the second quarter. And the impact of his acquisitions in the second quarter was \$22 million on the revenue side. In terms of profitability, it was basically breakeven. The vast majority of that was Interthinx.

This quarter we did have some one-time expenses associated with the integration mainly on the IT side and a little bit on the severance side. But the impact was \$22 million topline and basically breakeven on the bottom line.

Bose George - *Stephens Inc. - Analyst*

Okay. And just in terms of the expense side, how much of that was one-time?

Mark Seaton - *First American Financial Corporation - CFO*

There is probably about \$3 million to \$4 million in the quarter of one-time expenses and we're going to have some hit in the third quarter as well.

Bose George - *Stephens Inc. - Analyst*

Okay, great. Thanks.

Operator

Eric Beardsley, Goldman Sachs



Eric Beardsley - *Goldman Sachs & Co. - Analyst*

Hi, thank you. Just on the commercial revenue, you mentioned that some had slipped into July. Do you have a sense of what the dollar amount of transactions would have been in the second quarter in the commercial if they hadn't slipped?

Mark Seaton - *First American Financial Corporation - CFO*

Well, you know we have a forecast that we do. And our commercial forecast for the month of June came in about \$6 million light of our forecast. It is hard to really determine how much of that was just to our forecasting ability and how much of it was pushed to July, but we definitely see evidence that there were definitely a lot of large deals that were pushed. But it's hard to say exactly how much.

Dennis Gilmore - *First American Financial Corporation - CEO*

And I would just add that the commercial business has been very strong for us for a number of years. We think that strength will continue throughout 2014. We are actually on a year-over-year basis up 7%, so we think the trend will continue throughout 2014 and into 2015. So this is a business that can get lumpy in any one quarter but we look for strength to continue.

Eric Beardsley - *Goldman Sachs & Co. - Analyst*

I guess when you talk about that strength, on a year-over-year basis is that 7% growth a fair proxy? If we look at the brokers' growth and transaction volumes, we are still seeing high I guess teens and even 20% year-over-year growth. Is it possible that you could continue to see growth at that level?

Dennis Gilmore - *First American Financial Corporation - CEO*

Possible. But I think that we have seen those kind of numbers for approximately the last three years. So I do think the growth will start to mitigate at some point. But again very strong market for us, very strong performance.

Eric Beardsley - *Goldman Sachs & Co. - Analyst*

Great. And then just on the expense side, were there any headcount reductions in the last quarter other than deal-related? How should we think about expenses progressing from here?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, I will take that one. Pretty flat on the headcount for the quarter. We really did most of the heavy lifting on our cost structure the last three quarters, really driven from the interest rate increase in 2013. So the business right now is running very efficient, running -- it is sized appropriately for our transaction volumes right now. But I guess everybody knows this is a business that we always are watching expenses very closely. And if forward accounts change materially, we will have to adjust our cost structure.

Eric Beardsley - *Goldman Sachs & Co. - Analyst*

Great, thank you.

Operator

Mark Hughes, SunTrust.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you, good morning. Of the one-timers, the \$3 million to \$4million you had this quarter, you said some of that will extend into 3Q as well. Would it be about the same magnitude, little bit less?

Mark Seaton - *First American Financial Corporation - CFO*

It will be less. We closed the Interthinx acquisition in late March and we have been working very hard on the integration. I would say most of it has sort of been reflected in the second-quarter results. But there will be less than \$3 million to \$4 million that will spill over into the third quarter.

Dennis Gilmore - *First American Financial Corporation - CEO*

And I will just add that the integration itself is going very well. Very excited about this acquisition. We are going to try to wrap up most of the activities in the second and third quarter from an integration perspective, very focused on the market outlook now and pushing our sales efforts.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Right. Now should we assume the normalized tax rate, the 38% tax rate in the back half? Or will it be maybe a little bit lower?

Mark Seaton - *First American Financial Corporation - CFO*

I think the safe thing to do is to assume the 38%. You know, we are working on certain tax strategies that might lead to a lower tax rate than that in the back half, but those are really uncertain at this point. So I think 38% would be safe for the second half of the year.

The other thing that I would say, as I mentioned in my remarks, is we -- you know, we pay lower foreign effective tax rates in the international operations. So we feel like our 38% tax rate should come down over time. But I think 38% is safe for now.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Right. It sounds like the mix of commercial orders was a little more skewed to the smaller end in 2Q. It sounds like 3Q is off to a good start. Does the revenue per order get back up into the double digits in terms of year-over-year increase in the third quarter?

Mark Seaton - *First American Financial Corporation - CFO*

Just in terms of double-digit growth in the commercial ARPO?

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Yes.



Mark Seaton - *First American Financial Corporation - CFO*

I think in the back half I don't -- it is hard to say. I would be surprised if it was up double digits over last year. We do see a lot of seasonality in the commercial business. The fourth quarter is a very strong seasonal quarter for us. Our commercial ARPO in the second quarter was about \$6700. And in the fourth quarter of last year it was about \$8400. So we would expect a higher commercial ARPO in the second half for sure based on the seasonality. But for it to be up double digits would be a pretty strong growth rate.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Right. And then find a question, any sense on the revenue per order so far in Q3? You have been showing some nice improvement, accelerated a little bit this quarter to up 6%. This is in the purchase segment. Does that get a little bit better in Q3 or is that a good number?

Mark Seaton - *First American Financial Corporation - CFO*

It does -- it should get better in Q3. I don't think that the mix of purchase and refi will change dramatically in the third quarter. But again we are going to have -- based on everything we are seeing right now, we are going to have a higher mix of commercial. And of course since commercial has a higher ARPO, our average fee per file should increase in kind of the mid-single-digit range in the third quarter. And it should increase another mid-single digits in the fourth quarter.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you

Operator

[James Spoutan], [O'Day].

James Spoutan - *O'Day - Analyst*

Hello. My question is on the timing of the commercial payment in the quarter. What led to it coming through now? Just to get an understanding of how that works. And then secondly a bit related to that, how should we think about the pipeline of future claims and the seasoning of commercial business from the last part of the last cycle?

Dennis Gilmore - *First American Financial Corporation - CEO*

Sure. Let me take the first part of your question. This is a late development for policy year 2007, no question, so it is fairly unusual for us to have a claim of this magnitude develop this late, but always possible. So it is just how we run the business, how we deal with it.

The second part of your question as the frequency of claims I think was where you were driving on the question. Again, from time to time we will have large commercial claims. But they are infrequent and that is, again, the nature of this business.



James Spoutan - *O'Day - Analyst*

Okay. Should we think of the seasoning for commercial payments following a similar pattern to residential claims?

Dennis Gilmore - *First American Financial Corporation - CEO*

By and large, yes. And as we get out the five, six, seven years, we'd have seasoned the majority of the claims. But we do stay on risk for a number of -- for many years past that. But again, the majority of the seasoning occurs in the first five to six, seven years.

James Spoutan - *O'Day - Analyst*

Got it, thank you.

Operator

Mark DeVries, Barclays.

Mark DeVries - *Barclays - Analyst*

Yes, thanks. First just wanted to clarify your comment, Mark, on the commercial revenues being up 56% year-over-year, I think I heard that right. Is that just the first two weeks of the quarter versus the first two weeks of quarter last year?

Mark Seaton - *First American Financial Corporation - CFO*

Yes.

Mark DeVries - *Barclays - Analyst*

Or are revenues already strong enough that you could be up 56% on a full quarter basis?

Mark Seaton - *First American Financial Corporation - CFO*

No, no the 56% is just for the first 15 business days in July 2014 versus the 15 business days of July 2013. So we wouldn't expect it to be up at that rate for the quarter or for the whole month of July. We just saw some strong closings really in the first week that spilled over.

Mark DeVries - *Barclays - Analyst*

Got it. Good. And then in the release and I think on the call, Dennis, you commented that you are optimistic in 2015 to see stronger growth in the purchase market. Is that assuming just broader macro growth or are you making investments that you think are going to help you gain some market share in 2015?

Dennis Gilmore - *First American Financial Corporation - CEO*

For my perspective it is actually both. I am probably a little more optimistic than what we are reading in the press right now in the spring buying season, by the way. It has been good for us, not great but good. We're running a little less than we were last year but we are coming off a very



strong year. We kind of look at 2014 right now as probably a trough and we think we look at see continued growth in the purchase market going into 2015 and beyond. That is a market that we are very well-positioned in.

Mark DeVries - *Barclays - Analyst*

Okay. And then on investments you are making to gain share in it?

Dennis Gilmore - *First American Financial Corporation - CEO*

We continue to focus in on share growth and the top 10 states where we feel we have some underrepresentation. So we have made good headway there. On a trailing 12 month basis from the first quarter, we are actually up about one point.

Mark DeVries - *Barclays - Analyst*

Okay, got it. Thank you.

Operator

(Operator Instructions) Ryan Byrnes, Janney Capital

Ryan Byrnes - *Janney Montgomery Scott LLC - Analyst*

Great, thanks, guys. I just wanted to quickly talk about the redomiciling of the holding company to Nebraska. I just wanted to get the thought process behind that and see if that frees up any capital going forward for you guys.

Dennis Gilmore - *First American Financial Corporation - CEO*

I will take the first part of that question and then I will kick it over to Mark for the capital part of it. From an overall perspective, what we've done is look at the regulatory environment across the country. Really we concluded that Nebraska offered the Company some advantages. We think it is a very efficient, a very effective regulator. They have a lot of experience regulating large title insurers and at the end of the day we felt it was the right decision for our company to redomesticate there.

From a capital perspective, I'm going to kick the question over to Mark. Or for the surplus, excuse me.

Mark Seaton - *First American Financial Corporation - CFO*

So in terms of the surplus redomestication, we are going to have a release of our SPR, a one-time release. But that release is going to maybe offset by certain factors. So we are still working through what the ultimate reserves and surplus are going to be once we redomicile to Nebraska. But we think that if anything it will be a positive to our surplus. But at the same time I don't think it is going to be material.

Ryan Byrnes - *Janney Montgomery Scott LLC - Analyst*

Okay. Great, and then you had also mentioned there were some international net operating losses you guys utilized in the quarter. Are there still some more for you guys to cultivate? Or are we near the end of that just from a tax ration -- rate perspective?



Dennis Gilmore - *First American Financial Corporation - CEO*

There are still more NOLs that we have, that we will use in the future, yes.

Ryan Byrnes - *Janney Montgomery Scott LLC - Analyst*

Okay. And can you guys quantify those or --?

Mark Seaton - *First American Financial Corporation - CFO*

As of June 30, it was \$50 million.

Ryan Byrnes - *Janney Montgomery Scott LLC - Analyst*

Okay great. And then my last one, it is actually pretty nuanced. The net investment in the corporate segment, it tends to bounce around kind of quarter-to-quarter. I'm just trying to figure out what is in there and how we should think about that.

Mark Seaton - *First American Financial Corporation - CFO*

We have a deferred comp plan for certain of our employees here. We recognize the earnings of the gains or losses of the investments in the investment income line item in our corporate segment. There is going to be a corresponding increase or decrease in our personnel expense line item. So you will see volatility in the investment income, but you will see the exact same volatility on the personnel side, personnel cost side.

Ryan Byrnes - *Janney Montgomery Scott LLC - Analyst*

Got you. Great, thanks for the answers, guys.

Operator

Thank you, everyone. This concludes today's conference. Thank you for your participation. You may now disconnect your lines at this time.

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