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FAF - Q4 2014 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings and welcome to the First American Financial Corporation fourth-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 the call is being recorded and will be available for replay from the Company's investor website and for a short time by dialing 877-660-6853 or 201-612-7415 and enter the conference ID number 13598928. 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 of IR*

Good morning everyone, and thank you for joining us for our 2014 fourth-quarter and year -end 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'd 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.

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 Pages 4 and 5 of today's news release.

Management's commentary contains, and responses to your questions today 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 Company's operational efficiency and performance 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 will now turn the call over to Dennis Gilmore.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks, Greg. Good morning and thank you for joining our call. I'll begin with a review of 2014 followed by our fourth-quarter financial highlights and conclude with a few comments regarding our outlook for 2015.

Total Company revenues for 2014 were $4.7 billion, down 6% from last year. Our purchase revenues were up 5% and our commercial business had a record year with revenues up 9%.

The growth in both of these businesses helped to offset the significant decline in refinance activity during the year. Despite the decline in refinance activity we were able to build strong momentum throughout the year, finishing with an EPS of $2.15 and a title pretax margin of 8.7% for the year.

Turning to the fourth quarter total revenues for the company were $1.3 billion, up 3% compared to the fourth quarter of 2013. Net income in the quarter was $81 million, or $0.74 per share. Included in this quarter's results were $7 million of realized investment gains and impairments totaling $20 million, which combined reduced EPS by $0.08.

In the fourth quarter total revenues in the Title segment were $1.2 billion, a 3% increase compared to the fourth quarter of 2013. During the quarter we benefited from the overall strength in our purchase business. Closed purchase orders were up 3% and the average fee per file increased by 6%.

Our commercial business continues its strong performance generating $199 million in revenue, up 13% compared to last year driven by an increase in the average deal size. Our continued focus on driving an efficient cost structure produced significant operating leverage allowing us to deliver a strong pretax title margin of 10.8%, our highest margin of the year.

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 business. Pretax margins for our Specialty Insurance segment were 18.4%. Our home warranty business delivered record fourth-quarter results driven by continued operating efficiency and a decline in weather-related claims.

Turning to our market outlook. Given the backdrop of an improving economy we remain optimistic that the housing market will continue to strengthen in 2015. In January refinance activity rose sharply in response to the unexpected decline in mortgage rates, driving total open orders per day up 27% compared with January of last year. While the increase in refinance orders will provide short-term benefits it is uncertain how long this level of elevated refinance activity will continue.

With regards to the purchase market, our full-year expectation is for modest growth with some increase in transaction levels and continued home price appreciation. We also are anticipating continued strength in the commercial market but with some declining growth rates. Based on our positive long-term outlook our Company's Board of Directors recently approved a 4% increase in our common stock dividend to $1 per share annually.

In closing, the Company concluded a successful 2014. Looking forward to 2015, the investments First American continues to make in our people, our technology and our data assets positions us to capitalize on our ongoing housing recovery and to achieve our vision of being the premier title and insurance and settlement service provider. I'd 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 fourth quarter was $1.3 billion, up 3% compared to the fourth quarter of 2013. Net income was $81 million, or $0.74 per diluted share, compared with net income of $52 million, or $0.48 per diluted share, in the same quarter of last year.

The current quarter results include net realized investment gains of $7 million, or $0.04 per diluted share. In addition investment income in the current quarter includes impairment of investment in affiliates of $20 million, which reduced earnings per diluted share by $0.12.

In the Title Insurance and Services segment, direct premium escrow fees were up 9% compared with last year. This growth was driven by a 16% increase in the average revenue per order partially offset by a 6% decline in the number of direct title orders closed.

The average revenue per order increased to $2,171 driven by the continued shift in the order mix to higher premium purchase in commercial transactions. Additionally the average revenue per order increased 6% for purchase transactions and 13% for commercial transactions.

Agent premiums were down 3% reflecting the normal reporting lag in agent revenues of approximately one quarter. The agent split was 80% of agent premiums.

Information and other revenues totaled $155 million, up 8% compared with last year driven by the impact of recent acquisitions offset by lower demand for the Company's default information products. Personnel costs were $341 million, up $10 million, or 3% from the prior year. This increase was primarily due to higher incentive-based compensation driven by the improvement in both revenues and profitability.

Other operating expenses were $192 million, down $15 million, or 7% from last year. This decline was primarily due to lower legal expenses as well as lower production-related costs given the decline in orders in the current quarter.

The ratio of personnel and other operating expenses to net operating revenue was 71.7%, significantly lower than the 76.7% we posted in the fourth quarter of last year. The provision for title policy losses and other claims was $65 million, or 6.5% of title premiums and escrow fees, compared with a loss provision rate of 5.8% in the same quarter of the prior year.

Pretax income for the Title Insurance and Services segment was $125 million in the fourth compared with $88 million in the fourth quarter of 2013. Pretax margin was 10.8% compared with 7.8% last year.

Turning to the Specialty Insurance segment, total revenues were $95 million, up 9% compared with last year, driven by higher premiums earned in both the home warranty and property casualty business lines. The loss ratio for the segment was 52%, a slight decrease from the 53% experienced last year. Pretax margin for the segment was 18.4% driven by continued strength in our home warranty business.

Net expenses in the Corporate segment were $19 million in the fourth quarter, up 7% relative to the prior year, driven by lower net realized gains. For the full year of 2014 net expenses in the Corporate segment were $75 million.

We expect this to increase to $100 million in 2015, primarily as a result of two factors. First, we will incur $14 million of interest expense throughout 2015 as a result of the $300 million senior notes transaction we closed in November. Second, we will incur an additional $9 million of expense related to our defined-benefit plans in 2015.

Although these plans are frozen we will record higher expense as a result of a lower discount rate used to determine the liabilities. This discount rate is selected at December 31 of each year to help determine the expense for the following year. If interest rates were to rise in the future we would expect our defined-benefit plan expenses to decline.

The effective tax rate for the quarter was 34%, lower than a normalized tax rate of 36% due to lower effective state and foreign tax rates. In terms of cash flow, cash provided by operations was $182 million versus $133 million in the fourth quarter of last year. The increase was primarily due to higher net income and lower paid claims during the current quarter. Capital expenditures were $33 million up from $26 million in the fourth quarter of last year due to increases in capitalized software, title plans and capitalized data.

Turning to capital management. Debt on our balance sheet totaled $587 million as of December 31. Our debt consists of $549 million of senior notes, $34 million of trusteed notes, and $4 million of other notes and obligations. Our debt to capital ratio as of December 31 was 19%.

In November we closed on $300 million 4.6% senior notes due 2024. We used $150 million of the proceeds to pay down our credit facility, invested $25 million to expand the capability of our trust company, and the remainder is currently held at our holding company. Today we have the entire amount available under our $700 million revolving 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 - *Keefe, Bruyette & Woods, Inc. - Analyst*

Good morning. The first is just on the title margin. The 10.4% you did was quite a bit stronger than we had expected. Just year over year, do you think you could generate a better margin than the little over 8% you did this year, leaving aside the two -- the comment you had mentioned about the deferred benefit and the interest expense?

Dennis Gilmore - *First American Financial Corporation - CEO*

This is Dennis. I'll take that question. When we look back at 2014, we came in close to 9% margin for the title company. And we actually had a slow start to the year. So we built all year long. So we're happy with that.

As we sit and look at 2015, we do think we can continue to increase our margin as long as we get the growth rates we're expecting in the marketplace. And we're going to continue to try to get better leverage out of the business and continue to try to improve our operating margins.

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

Switching to capital, your debt-to-capital, mid-teens. You've guided to a higher range that you'd like over time. Just curious about your thoughts on capital management and where you stand on buybacks, just given where the stock is on price-to-book.

Dennis Gilmore - *First American Financial Corporation - CEO*

In terms of debt-to-capital ratio, we finished the year at 19%. And we've talked about a target of 18% to 20%. So we're quite right in line where we want to be in terms of the debt-to-capital ratio today.

And we got -- we used to be sort of mid-teens in the middle of the year, but when we did that bond deal in November it brought us up to 19%. So we're comfortable with where our financial leverage is right now.

And in terms of the buybacks, it something that we're always evaluating. We did a significant buyback in 2013.

We didn't do any in 2014, but we did significantly expand the dividend. I would just say in terms of the buybacks, it's always something we're evaluating.

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

And then just sort of a related question in terms of the proceeds that you have from the debt issuance. are there acquisitions or other things that you're kind of thinking about?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes. So we used, just to recap. We used $150 million of the $300 million of proceeds to pay down the line. We put $25 million to invest organically in our trust company.

So we've got another $125 million of that that's at the holding company that's just really dry powder. And we're looking at acquisitions right now, which we do continually. But we're going to be opportunistic in terms of how we deploy that excess cash.

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

Thanks, and good quarter.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

Mark DeVries, Barclays.

Mark DeVries - *Barclays Capital - Analyst*

First question is a follow-up on the pretax margin for the title business. As with Bose, it was much better than we expected. And Dennis I heard you say you think if you get the volume growth rates you're expecting, you can expect that to be higher. I'm just kind of wondering if there are s any call-outs, Mark, any one-time items that made that margin unusually strong in the quarter or whether it reflects some sustained efficiencies that we could expect to see maintain these margins next year, even if we're in kind of a static environment?

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

Thanks for the question, Mark. Yes, there weren't any, I would say noteworthy items that happened in this quarter. I mean, there's always things that are benefits and things that happen in the quarter, but there's nothing that we felt like we needed to point out.

So I would say that the fourth quarter margin is a real normalized margin. Now, when we look forward to next year obviously we've got seasonality. Q1 is typically a tough quarter for us, just given volumes. But we think that generally that the expense structure that we have and the margins we have are sustainable going forward.

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Mark DeVries - *Barclays Capital - Analyst*

Got it. Although it looks like the seasonality is not going to bear itself out this year, given the open order count you've got. The second question. Just kind of wondering, Dennis, if you can give us an update on your thoughts around market share opportunities in 2015, both kind of organic or inorganic?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, we actually had really nice progress in 2014 regarding our market share objectives. We set out for the Company to grow in the 1% to 1.5% range per year. And on our trade-in 12 month over third quarter 2014 we are up about 1.2%, so right in line with what we are expecting.

We hope for that, and we expect that momentum to continue going forward into 2015. Specifically we're driving for growth in the top 10 states, and we had good success there. And then we continue to look for tuck-in acquisitions on the Title side. We've looked at quite a few deals. We're continuing to look at deals right now. We're just being very disciplined on the capital deployment.

Mark DeVries - *Barclays Capital - Analyst*

Great. Last question is just on potential for growth in the average fee per file as we look into 2015. I think, as we've talked about in the past, there is generally a kind of 50% relationship between HPA and the benefit to your average transaction. But I'm kind of wondering is do have a mix benefit where the greatest velocity that we're seeing in transactions is coming from the states that are experiencing the highest home price appreciation? So if we think about kind of benefit of home price appreciation to revenues, it may actually be better than if we just think about national home price appreciation?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, you're actually right on that assumption. Again, we think of it along the lines on a global basis or a national basis around that 50% mark. We've seen better performance over the last year because of where we're getting our orders and what's happening in that marketplace.

With regards to price appreciation, though, our call right now is it will slow going into 2015, probably in the 3% to 5% range, somewhere in that range for home price appreciation is what we're thinking for 2015 right now. So we do think we'll see an increase in the ARPO in 2015, but that's a slowing rate.

Mark DeVries - *Barclays Capital - Analyst*

Great. Thanks.

Operator

John Campbell, Stephens.

John Campbell - *Stephens Inc. - Analyst*

Congrats on a great quarter.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

John Campbell - *Stephens Inc. - Analyst*

So good open orders for January, obviously. I think that was up about 31% sequential. A little surprising to see that type of resurgent refi off a pretty modest decline in 30-years. And it looks like the 30-year might have lifted a little bit of late. So just curious how that's impacting just February to date?

Dennis Gilmore - *First American Financial Corporation - CEO*

Let me give you a little insight. When we started our budget planning -- or excuse me, when we wrapped up our planning for last year going into 2015, we were actually anticipating refinances to drop in 2015. And like everybody we were a little caught from the unexpected lowering of interest rates.

We saw the immediately benefit going into January. Again, like we said, our total orders in January were up 27%. The trend's continued into February. But again, I want to caution everybody we don't know how long this environment will last.

It could and just as quick as it started. But at the end of the day it is going to help us a little bit in the first quarter. And that's always nice when it's our toughest quarter.

John Campbell - *Stephens Inc. - Analyst*

Absolutely. That's helpful. And then just -- Dennis, just a higher level question. What's more important to you guys just kind over the near term? Is it gaining a point or two in market share, or maybe a point or two in title pretax margin? And just if you guys are willing to trade a little bit of margin for some of that growth, Mark, you might be able to help us with this. But maybe if you guys can put us in a range, or general expectation for agent retention for the year?

Dennis Gilmore - *First American Financial Corporation - CEO*

Couple price to that question, and then I'll throw it over to Mark, but if you step back and at the highest level, we really don't want to gain share to trade it to return. So we're looking to both do better on our share and better on our returns, is how we're thinking about it. On the agent?

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

on the agent retention, we've been at about 80% for a couple of years now. And I wouldn't expect that to change in 2015. We can make very good returns on capital on our agency business at an 80% split.

John Campbell - *Stephens Inc. - Analyst*

Okay. That's helpful. And then last one for me. Another good result out of Specialty Insurance. Noticed a pretty big drop in salaries as a percent of rev looking at last year. Is that something structural? I mean, did you guys reduced headcount in the quarter?

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

Yes. We had some expense management activities that we did, especially in the third quarter of 2014 when volumes really started to slow, and there was a little bit more in Q4. And so really what happened in Q4 is we get the benefit of some of our expense management initiatives. And it was also offset by strength in the market. And so we have been managing the cost structure prudently, we think.

John Campbell - *Stephens Inc. - Analyst*

Okay. Great. Thanks, guys.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

Eric Beardsley, Goldman Sachs.

Eric Beardsley - *Goldman Sachs - Analyst*

Thank you. Just wondering if you've had to add any headcount to staff up for the little refi wave we've seen here thus far?

Dennis Gilmore - *First American Financial Corporation - CEO*

So far no. We're watching the expenses really closely. Again, the jump in the refinance activity was a little unexpected. So I think it could end just as fast as the 10-year moves on us. Bottom line, we're managing this as aggressively as we can. First step will be to add additional overtime. Probably then some temps, and ultimately if we need to we'll add staff.

Eric Beardsley - *Goldman Sachs - Analyst*

in terms of the ARPO growth trends, have you seen similar year-over-year increases thus far in 2015 as you had over the last few quarters where you're growing on the purchase side 6% to 7%?

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

Well, so far -- I mean, in Q4 our average revenue per order for purchase transaction was about $1,900. And one month doesn't really make a trend, but so far January it's been about a little bit less than that, about $1,880. I would say that we've kind of started 2015 kind of how we ended 2014.

Eric Beardsley - *Goldman Sachs - Analyst*

Great. In the past you've talked about the success ratio in terms of how you can manage your expenses as revenue grows. If we're having some of these ARPO benefits but your orders are somewhat flat, can you do better because you have less coming through the pipes?

Dennis Gilmore - *First American Financial Corporation - CEO*

We can potentially do better. In the past we've talked about a 60% success ratio, and when net operating ratio rises $1 we want to spend $0.60 in labor and OpEx expenses. And we really hit that in 2014 for the full year.

But that number is lumpy. In the fourth quarter the success ratio was like negative 10%. So at any one quarter it could be lumpy, but for a full-year basis or a trailing 12-month basis were looking at 60% and we're going to target that in 2015. There's always a chance we could exceed that based on ARPOs, but we're focused on the 60% number.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. Great. Thank you.

Operator

Mark Hughes, SunTrust.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Was there any catch-up in incentive compensation in the fourth quarter? You mentioned that was one of the things that drove personnel expenses, was that a little higher, in fact, in 4Q?

Dennis Gilmore - *First American Financial Corporation - CEO*

There was no catch-up. We had a few million dollars of some benefits that we flowed back that helped us, roughly $4 million or $5 million, but other than that, it was a very normal quarter.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

How about your latest thoughts on the cash from operations cash flow for 2015? You had a very good 4Q and presumably cash payments for losses will continue to moderate. What's your latest thinking there?

Dennis Gilmore - *First American Financial Corporation - CEO*

Happy with the cash flow in the fourth quarter. As you know, first quarter is always difficult with cash flow simply because we've got a lot of bonus payments that we make and on the operating side it's slower. So we're typically cash flow negative in the first quarter. But for the full year we're happy with where our cash flow is.

We would expect it to continue to increase over the next couple of years as our earnings rise and as our paid claims fall. So our paid claims in 2014 fell 8% from 2013. And paid claims are lumpy, but we would expect that to continue to decline over the next few years, just given the fact that some of these legacy policies that we wrote are becoming seasoned.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you.

Operator

Kevin Kaczmarek, Zelman and Associates.

Kevin Kaczmarek - *Zelman and Associates - Analyst*

Closed purchase orders in the fourth quarter seemed like they accelerated pretty nicely year over year relative to the third quarter. But it looks like, I guess, January open purchase orders was flat. Can you give us some color on what was driving the fourth quarter purchases and any reason why the year-over-year strength wouldn't carry over to the first quarter?

Dennis Gilmore - *First American Financial Corporation - CEO*

There's really -- I can't give you any insight why the fourth quarter was up. It's just probably more natural, just a natural environment as you're closing out to get done before year end.

The other party question is you move into the January timeframe. Our purchase orders are flat. And we're actually projecting our purchase orders to be up slightly going into 2015.

Again, we're thinking mid-single digits, in that kind of range. But we will have a much, much better idea on this as we look out over the next 60 to 90 days as the spring buying season kicks off.

So we're coming out of 2014 where we basically had flat purchase orders, down just slightly on an [order] count. And we're looking for that to again modestly increase going into 2015.

Kevin Kaczmarek - *Zelman and Associates - Analyst*

Okay, great. Thanks. Have you seen any effect of lower oil prices, especially within commercial in some of the more energy-intensive state like Texas? And I guess at what point do you start to change of thinking into expanding into some of those bigger states if the lower oil prices continue?

Dennis Gilmore - *First American Financial Corporation - CEO*

Couple points. First, we've seen, at this stage, no impact to our business. But it's our expectation that if we continue to stay at this kind of a price for oil that we will see some reduction in some of these energy-based states from a commercial transaction. I think that would be a national occurrence. The second component is we're watching our underwriting criteria very closely on all our energy deals right now.

Kevin Kaczmarek - *Zelman and Associates - Analyst*

Okay. Great. Thanks.

Operator

Chris Gamaitoni, Autonomous Research.

Chris Gamaitoni - *Autonomous Research - Analyst*

I just wanted to clarify a comment you made earlier. When you said the title margin could grow in 2015, was that on a year-over-year basis or relative to the fourth quarter?

Dennis Gilmore - *First American Financial Corporation - CEO*

On a year-over-year basis.

Chris Gamaitoni - *Autonomous Research - Analyst*

Thank you. That's very helpful. And then on the -- can you just give us some clarity on the continued charges, impairment charges, and maybe how much more could occur in the future?

Dennis Gilmore - *First American Financial Corporation - CEO*

we had $20 million of impairment this quarter. All of it hit the Title segment. It was really three or four investments, legacy investments, that we made over a decade ago in different title-related companies that we just took a look at and realized that we couldn't support the value. So we wrote it down and we don't next expect any similar impairments going forward.

Chris Gamaitoni - *Autonomous Research - Analyst*

Perfect. And any outlook for the title loss ratio?

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

Yes. So we booked 6.5% in the fourth quarter. I think that's a good number to use for 2015. So the way we're thinking about it now is for the first half of the year we will -- we're intending to book at 6.5% and then will reevaluate it.

It can always be higher than that if we have adverse claims development above our expectations. But our expectation now is somewhere in the 6.5% range for 2015.

Chris Gamaitoni - *Autonomous Research - Analyst*

Perfect. Thank you.

Operator

Jason Deleeuw with Piper Jaffray.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

Good morning. Congrats on a strong quarter. On the title adjusted pretax margin, it was very strong 12% this quarter versus 8% a year ago. And your title revenue was up about 3% year over year.

So there's a lot of operating leverage there. And I'm just trying to get a better sense for how much of that is due to commercial and how much of that is just due that you've improved the title margin performance in the residential side also?

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

Hey, Jason. I'd say it's a combination of both. We had a strong commercial quarter, really the strongest commercial quarter we've ever had. And the commercial business has higher margins than the residential business.

So some of it is certainly a mix that helps us. But in addition to that I would say that our residential margins are stronger now, just because of the fact that we're running it more efficient than we had been before. So I think it's coming from both different -- both areas.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

That's great. And then when I think about the total Company pretax margins with the corporate expense increase, do you guys think you can overcome that and on a Company-wide basis have pretax margins expand in 2015?

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

It just depends on what the market does. I mean obviously if the revenue and the market's going to be flat in 2015, no we're not going to be able to overcome that additional corporate expenses. But if we get some help from the purchase market and from the commercial market, and it depends on what happens with refi, then I think there's a chance. But it all depends on the market.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

And then on the commercial side with -- could you give us a little bit of sense for how much of that is just new commercial title activity versus refinance?

Dennis Gilmore - *First American Financial Corporation - CEO*

This is Dennis. It's really both.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

Okay. Is there -- I mean, when you think about 2015 do you think there would be any kind of change in terms of that mix as we go into 2015 versus what you just had this past year?

Dennis Gilmore - *First American Financial Corporation - CEO*

I really don't. I think again, going into 2015 we're going to see strength in our commercial business really kind of across the board, product types, (inaudible). I think the trend will continue. As I said in my script, though, I do think since we're running on such on such an elevated level at commercial right now I do think that we will start to see slowing growth trends in that segment.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

And then on the energy impact to commercial, how important is energy to your commercial business? Is there any way you can help us understand the size?

Dennis Gilmore - *First American Financial Corporation - CEO*

It's a component of our business but we don't anticipate to be a material change in our revenue base going into 2015.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

Okay. And then on the share gains you guys talk about, is that coming from the direct channel, agent channel or both? Can you just give us a little bit of color on that?

Dennis Gilmore - *First American Financial Corporation - CEO*

It's coming actually from both. And we're going to again, I'll just restate it. We're going to continue without effort going into 2015. We think we have momentum going into 2015.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

And then the last thing on the -- it sounds like you're expecting, I think you said mid-single digit increase in purchase orders for the year. But so far it looks -- sounds like we're running about flat year over year. And I guess we share the same view that you guys have, and I guess what are you guys looking at, what are the considerations you have when you think about that forecast you have for this year on purchase units?

Dennis Gilmore - *First American Financial Corporation - CEO*

We look at what's happening in our marketplace across the country, number one. We look at all the external forecast. We look at our current pipeline. We have a great visibility out 90 days.

And again, our take is kind of a lower end of the range, in that mid-single digits on transaction growth. We will have a much better idea what really is going to happen over the 60 to 90 days. But we'll probably take in a little more conservative approach than some of the external forecasts. But we're comfortable where we are right now.

Jason Deleeuw - *Piper Jaffray & Co. - Analyst*

That's great. Congratulations on the great quarter.

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

Thanks Jason.

Operator

James Spalton, Odey Asset Management.

James Spalton - *Odey Asset Management - Analyst*

Hi, there. Could I ask a follow-up question to the one about the paid claims, which is what is the relationship, or what relationship do you expect over the next couple of years between the provision rates of 6.5% that you've set out and the paid claims rate? Would you expect that to trend in line, or would you expect it to diverge as it did perhaps in the back end of the last cycle?

Dennis Gilmore - *First American Financial Corporation - CEO*

Right now I'd say that the paid claims ratio is running higher than the provision ratio, simply because we wrote a lot of policies back in 2005, 2006, 2007, 2008 when revenue was much higher and the market was stronger. But those policies end up having significantly higher loss rates than the current -- last few years.

So last year in 2014 we paid $272 million of title claims. The normalized level of paid claims is somewhere around $215 million, give or take. And so we would expect --

James Spalton - *Odey Asset Management - Analyst*

Sorry. Is that $215 million or $258 million?

Dennis Gilmore - *First American Financial Corporation - CEO*

$215 million. And so we would expect our paid claims to, over the next couple of years, gradually come down to that normalized level. And once it does, then our paid claims ratio, our loss expense ratio will come in line.

James Spalton - *Odey Asset Management - Analyst*

Thanks very much. And could I ask a second question, which apologies if you covered this earlier in the call. For modeling purposes, should we think about the structure of the commercial ARPO being similar to the residential in terms of its -- the fee for it has from loan size or from valuation movements in the underlying market?

Dennis Gilmore - *First American Financial Corporation - CEO*

I'll answer it this way. Our average fee for our commercial transactions for last year was about $7,700. Now, it was much higher in the fourth quarter simply because we just had a lot of bigger deals close in the fourth quarter. But for the year it was $7,700.

The average fee that we get for purchase transaction all of last year was about $1,900. So it's a few times higher on the commercial side than the purchase side. Not sure if that answered your question.

James Spalton - *Odey Asset Management - Analyst*

Sorry. To clarify what I was meaning was in terms of the variability between, say, $7,700 and over $9,000. In terms of -- what I was asking was could you explain to us how we can model that?

Is it a percentage or a fee overall loan amount that comes through? What are the particular drivers?

Dennis Gilmore - *First American Financial Corporation - CEO*

It's difficult to model. It's based on a per thousand of liability. That's kind of how we charge. So it's just a difficult thing to be able to model.

James Spalton - *Odey Asset Management - Analyst*

Okay.

Dennis Gilmore - *First American Financial Corporation - CEO*

And I would say it generally increases throughout the year. So the commercial ARPO is going to start lower in Q1 and rise throughout the year. But other than that, it's just a -- it's tough.

James Spalton - *Odey Asset Management - Analyst*

Okay. Thank you.

Operator

Geoffrey Dunn, Dowling & Partners.

Geoffrey Dunn - *Dowling & Partners Securities - Analyst*

I guess first on the loss provision. It stayed up here probably longer than I would have expected. And now we're looking at similar levels for 2015. How can we think about what we need to see to have that provision start coming down more in line with where your peers are?

Dennis Gilmore - *First American Financial Corporation - CEO*

We just a more time to go by. I mean, we feel good about the adequacy of our reserves right now. We feel good about the rates that we're getting for the current years.

But we're just -- we're kind of at the higher end of the range, simply because of the history that we've had in reserves strengthening from the past. We feel good about the reserve on the balance sheet. And we're just reserving a higher rate until we're sure that when we take it down it's going to stay down.

Geoffrey Dunn - *Dowling & Partners Securities - Analyst*

Okay. And then just to get a little more granular. Excluding the impairment, your revenues were up in Title this quarter.

You were able to take operating expenses down $10 million. And I think -- it looks to me like the margins are actually almost closer to 12% if you make that adjustment.

Was there any specific cost that you are able to squeeze out of the operating expense side in the quarter? I'm just trying to get a feel for what might be sustainable here.

Dennis Gilmore - *First American Financial Corporation - CEO*

We feel like the current quarter is sustainable for a fourth quarter. If you're looking at year-over-year trends, Q4 of last year we had a $5 million legal settlement that we had. We also had a premium tax true-up for about $4 million.

There was $9 million of expense that had in the fourth quarter of last year that we didn't have this year. So on a year-over-year basis I think the expense management, if you will, is a little bit overstated. But when you look at the Q4 P&L there's really no noise in it. It's a normal P&L, other than the impairment in the top line.

Geoffrey Dunn - *Dowling & Partners Securities - Analyst*

So looking at it sequentially, just probably some sort of variable adjustment?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes.

Geoffrey Dunn - *Dowling & Partners Securities - Analyst*

Okay, great. Thank you.

Operator

Ryan Byrnes, Janney Capital Markets.

Ryan Byrnes - *Janney Capital Markets - Analyst*

Good morning, guys. Just had one question for you guys. On an earlier title insurance call, they kind of pointed out to a meaningful expense for kind of CFPB expected changes and kind of the cost associated with getting prepared for those new regulations. Just wanted to see your thoughts on that change?

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

Well, yes. We are incurring expenses associated with upgrading our technology, training our people. There's a lot of work that's going into the integrated disclosures rules in August 1. So there's an expense side of that equation and then there's a revenue risk side of that equation that maybe Dennis can comment on.

Dennis Gilmore - *First American Financial Corporation - CEO*

So we've been -- on the first part of your question, we have been very focused on this over the last part of 2014. That focus we'll continue going into 2015. Specifically so our shareholders understand. We've got new disclosure forms coming online in August 1. And so we're going to make sure our Company is ready to go and we're well-positioned for that.

The second part of that question is, there's some discussion about the concept of an owner's title policy being optional. Owner's policies have always been -- or buyer's policies have always been optional. We don't really see that as an issue.

As we sit here today, probably the biggest issue we think that could disrupt things would be just the implementation of the new disclosing -- disclosure forms and could it slowdown the market on a temporary basis in that quarter. But we'll have a much better feel as we get quarter closer to implementation date.

Ryan Byrnes - *Janney Capital Markets - Analyst*

Great. Thanks for the answer, guys.

Operator

There are no additional questions at this time. That concludes this morning's call.

Would like to remind listeners that today's call will be available for replay on the Company's website or by dialing 877-660-6853 201-612-7415. And enter the conference ID number 13598928.

The Company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.
