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# EDITED TRANSCRIPT

FAF - Q2 2015 First American Financial Corp Earnings Conference Call

EVENT DATE/TIME: JULY 23, 2015 / 3:00PM GMT





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## CORPORATE PARTICIPANTS

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**Dennis Gilmore** *First American Financial Corp. - CEO*

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

## CONFERENCE CALL PARTICIPANTS

**Mark Hughes** *SunTrust Robinson Humphrey - Analyst*

**Mark DeVries** *Barclays Capital - Analyst*

**Eric Beardsley** *Goldman Sachs - Analyst*

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

**John Campbell** *Stephens Inc. - Analyst*

**Kevin Kaczmarek** *Zelman & Associates - Analyst*

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

## PRESENTATION

**Operator**

Greetings and welcome to the First American Financial Corporation second-quarter 2015 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 for a short time by dialing 877-660-6853 or 201-612-7415 and enter the conference ID 13614230. We will now turn the call over to Craig Barberio, Director of Investor Relations, to make an introductory statement. Thank you.

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

Good morning, everyone, and thank you for joining us for our second-quarter 2015 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.

Risks and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements. Factors that could cause the anticipated results to differ from those described in the forward-looking statements are also described on page 4 of today's news release.

Management's commentary contains, and responses 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 and success ratios. The Company is presenting these non-GAAP financial measures because they provide the Company's management and investors with additional insight into the operational efficiency and performance of the Company relative to earlier periods and relative to the Company's competitors. The Company does not intend for these non-GAAP financial measures to be a substitute for any GAAP financial information.

In 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'll now turn the call over to Dennis Gilmore.

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Thanks, Craig. Thanks for joining our call. Today I'll review our second-quarter financial and operating results and then provide a few comments regarding our outlook for the remainder of 2015.

Overall, our financial results this quarter were strong, and the business continues to demonstrate solid operating leverage on revenue growth. Revenues in the second quarter were $1.3 billion, up 15% from last year. The increase was driven by strength in our purchase, residential and commercial businesses. Earnings per share were $0.85 compared with $0.47 per share last year.

Entering 2015, we began to see improvements in the housing market, demonstrated by a healthy spring selling season. In the second quarter revenues in our purchase business were up 13%, driven by a 7% increase in closed orders and a 6% increase in the average fee per file. Purchase orders are following the typical season's decline, but through July 21 are up 6% relative to last year.

With the decline in interest rates in the beginning of 2015, our refinance ticket business began to accelerate, which drove a 55% increase in refinance revenue during the quarter. However, as interest rates have begun to increase in the middle of the quarter, our refinance orders started to decline. In June, we opened 1,500 orders per day, and we expect our refinance revenue to continue to normalize throughout the remainder of the year.

Our commercial business continues to demonstrate outstanding performance in the second quarter, with revenues up 29% compared to last year. Our average revenue per commercial order was up 21%, driven by an increase in the average size and the number of large transactions closed in the quarter. We continue to see broad strength across our various market segments.

Our title insurance pre-tax margin was 12.6% in the second quarter compared with 8% last year. We continue to benefit from improved market conditions and our ongoing focus on expense management. Our success ratio was 47% during the second quarter, significantly better than our 60% target. Throughout the second quarter, we relied primarily on overtime and temporary labor to handle the short-term increase in refinance volumes. As a result, our US headcount increased by only 2% despite a 13% increase in closed orders per day compared to the prior quarter.

Revenues in our specialty insurance segment were $98 million, up 7% compared to last year. Our pre-tax margin was 10.8%, slightly lower compared to last year due to higher weather-related claims in our home warranty business. Overall, the segment performed well during a seasonally difficult quarter.

As we discussed on our last call, we continue to focus on the implementation of the new integrated mortgage disclosure rule, with an effective date now delayed from August 1 to October 3, 2015. Given the magnitude of the change, we still anticipate some temporary delays in closing on orders opened after October 3. However, any delays will be dealt with during our normally seasonally slow fourth and first quarters, which will help facilitate the transition. We believe the implementation of the new rule will present an opportunity for First American as a settlement service provider that is prepared to deliver the highest quality of work in this new environment.

Looking forward, we are optimistic and expect the improving economy to continue to strengthen the housing market. 2015's spring selling season was encouraging and increases our confidence in the outlook for sustained growth in the purchase market. Also, market conditions for our commercial business remain strong. I believe the Company is well positioned to continue to deliver strong financial results as the housing market improves.

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 Corp. - EVP, CFO*

Thank you, Dennis. Total revenue in the second quarter was $1.3 billion, up 15% compared with the second quarter of 2014. Net income was $93 million, or $0.85 per diluted share, compared with net income of $51 million, or $0.47 per diluted share, in the same quarter of last year. The current quarter results include net realized investment gains of $4 million, or $0.02 per diluted share.

In the title insurance and services segment, direct premium escrow fees were up 20% compared with last year. This growth was driven by a 15% increase in the number of direct title holders closed and a 7% increase in the average revenue per order. The average revenue per order increased to $1,953, driven by higher average fees for commercial, purchase, and refinance orders. The average revenue per order increased 21% for commercial transactions, 7% for refinance, and 6% for purchase transactions. We continue to see a large number of commercial deals close, which had a positive effect on our average revenue per order.

Agent premiums were up 17%, reflecting the normal reporting lag in agent revenues of approximately one quarter. The agent split was 80.1% of agent premiums.

Information and other revenues totaled $170 million, up 3% compared with last year. Excluding the impact of a recent acquisition, information and other revenue was essentially flat. The quarter benefited from higher demand for certain of the Company's non-insured services and products, reflecting growth in transaction activity, largely offset by lower demand for the Company's default information products.

Personnel costs were $370 million, up $43 million, or 13%, from the prior year. This increase was primarily due to higher incentive-based compensation driven by the improvements in revenues and profitability.

Other operating expenses were $205 million, up $8 million, or 4%, from last year. This increase was primarily due to higher production-related expenses and temporary labor costs, given the increase in order volumes. The ratio of personnel and other operating expenses to net operating revenue was 71.8%, an improvement from the 75.6% we posted in the second quarter of last year.

The provision for title policy losses and other claims was $67 million, or 6.5% of title premiums and escrow fees compared with a loss provision rate of 8.9% in the same quarter of last year.

Pre-tax income for the title insurance services segment was $155 million in the second quarter compared with $85 million in the second quarter of 2014. Pre-tax margin was 12.6% compared with 8.0% last year.

Turning to the specialty insurance segment, total revenues were $98 million, up 7% 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 59.5%, an increase from the 58.5% experienced last year. The increase in the loss ratio was driven by higher weather-related claims in the home warranty business. Pre-tax margin for the segment was 10.8% versus 12.1% in the prior year.

Net expenses in the corporate segment were $24 million in the second quarter, up $4 million relative to the prior year. Most of this increase is related to higher interest expense from our senior notes offering that closed in November 2014.

The effective tax rate for the quarter was 33.9%, which was lower than our normalized tax rate of 36%. A greater mix of insurance versus non-insurance-related income and higher tax-exempt interest in our investment portfolio contributed to the lower tax rate.

In terms of cash flow, cash provided by operations was $233 million versus $150 million in the second quarter of last year. The improvement was primarily due to higher net income and a reduction in working capital. Capital expenditures were $30 million, up from $19 million in the second quarter of last year, due to increases in capitalized software and capitalized title and property-related information.

Turning to capital management, debt on our balance sheet totaled $585 million as of June 30. Our debt consists of $549 million of senior notes, $33 million of trusteed notes, and $3 million of other notes and obligations. Our debt-to-capital ratio as of June 30 was 18%.

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**

Thank you. (Operator Instructions.) Mark Hughes, SunTrust.

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**Mark Hughes** - *SunTrust Robinson Humphrey - Analyst*

The refi you expect to normalize -- it's about 1,500 per day in June -- should it hold steady at 1,500, or will it drop a little bit from here?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

No, at this stage, I think it will hold around that range. It could drop a little; it's really interest rate dependent, though. So we're running around that number, so I think it's a good number for the rest of the year at this stage.

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**Mark Hughes** - *SunTrust Robinson Humphrey - Analyst*

In your revenue per order, the historic relationship between the transaction size and the value of the property versus your revenue -- are you doing better these days in terms of capturing more of that?

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

Well, we're getting -- a couple of things are helping us. One is housing prices nationally rising. That certainly helps our revenue per order. We're also getting more orders in -- I'm sorry -- a higher mix of our business in some of the higher-priced areas like California and Texas. So those are really the key drivers in what's driving the revenue per order for purchase transactions.

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**Mark Hughes** - *SunTrust Robinson Humphrey - Analyst*

Okay. And then the incentive comp -- was there any catch-up in the quarter? Did you over-accrue or catch up from Q1?

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

There was a little bit of a catch-up, just in the sense that we book our bonuses and our 401(k) accrual based on expected earnings for the year. And since our earnings have been really rising better than our expectations, there was a little bit of a catch-up in Q2. But I wouldn't say it was material, though.

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**Mark Hughes** - *SunTrust Robinson Humphrey - Analyst*

Thank you.

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**Operator**

Mark DeVries, Barclays.

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**Mark DeVries** - *Barclays Capital - Analyst*

For the second straight quarter, your commercial revenues have grown at a nearly 30% clip year over year. I know you said you expect that to slow over time, but should this strong growth rate persist through the latter half of the year?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

This is Dennis. We had a very strong commercial quarter again, again with our revenues up 29%. And we've had a number of strong quarters -- actually, a number of strong years at this point. We have a good momentum going into the second half of 2015. I think that momentum will carry us into 2016. But with all that said, it's my expectation that we'll start to see some moderation of commercial growth rates. Now, this is still running at a very elevated marketplace right now.

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**Mark DeVries** - *Barclays Capital - Analyst*

Okay, got it. And you posted very strong margins during the quarter. I think you had guided to 10% to 12%, and it came in above that. I guess what I'm trying to get a sense is how much of that is driven by the outperformance in commercial versus how much might have come from better expense management on your residential side?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

It's definitely both, but we've gotten really good operating leverage in this business, just overall. Our success ratio came in at 47% for the quarter, significantly better than our target of 60%. And when we look at it over a yearly basis, the first half of the year, we're running at 52% to 53% -- again, better than our 60% success ratio. So we're getting leverage across the complete business right now.

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**Mark DeVries** - *Barclays Capital - Analyst*

Okay. But any sense for how much of the margin improvement just came from the better, more favorable mix of commercial in the quarter?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Again, it's a blend from both our residential and our commercial.

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**Mark DeVries** - *Barclays Capital - Analyst*

Okay, all right, thanks.

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**Operator**

Eric Beardsley, Goldman Sachs.

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**Eric Beardsley** - *Goldman Sachs - Analyst*

I was wondering if you could share any data points that you're seeing in July so far in terms of year-over-year growth in purchase orders as well as any trends in commercial.

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Specifically on the commercial -- excuse me -- on the residential side, we are in the normal seasonal decline on our spring buying season right now. I will say again that the spring selling season for us has been very strong. We classified it as healthy for sure. Right now, through the July 20 timeframe, we're up 6% on a year-over-year basis. So strength continues into July.

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**Eric Beardsley** - *Goldman Sachs - Analyst*

Got it. That's on open or closed?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Open.

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**Eric Beardsley** - *Goldman Sachs - Analyst*

Open, okay. Now on the commercial front, in terms of the moderation that -- I guess it's hard to call if and when that happens -- but would you actually expect to start to see year-over-year declines in ARPO or volume, or are you actually expecting it just to level out at current run rates?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Again, it's my expectation that we'll just start to see it probably more level out. At some point, we're going to not see 30-plus percent growth rates on a quarterly basis. So I think we'll start to see the market level out. But again, I've been wrong in that call now for two quarters in a row, so it's a good problem to have. But the market still is very strong.

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**Eric Beardsley** - *Goldman Sachs - Analyst*

Got it. So if we continue to come in at these levels, the margins that you're printing now, where would you see those top out? It seems like you're certainly could do better than that 10% low end that you're targeting.

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Well, just overall, as we laid it out at the Investor Day, we're running the business to try to achieve a 10% to 12% margin throughout the course of the year. We're right on track to achieve that with this current market environment. I will tell you, though, as the market continues to improve, we'll continue to look for better operating leverage on the business.

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**Eric Beardsley** - *Goldman Sachs - Analyst*

And then just lastly, with this -- I'm not sure if this is significantly better than you were expecting on commercial -- but could you deploy any of this incremental earnings into buybacks or increased dividend?

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

Well, yes, that's something we continually look at, and as you know, we've increased the dividend dramatically the last couple of years. Right now, roughly, we're paying about 40% of our earnings through dividends. That's just a rough number. And historically, if you look at the history of First American, it's been about 20%. So we feel very convicted that we should pay a healthy dividend.

And then buyback is something we look at continually. We didn't buy back any stock this quarter, but that's something that we always do look out.

**Eric Beardsley** - *Goldman Sachs - Analyst*

Okay, great, thank you.

**Operator**

Bose George, KBW.

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

Just one more on commercial. During the Investor Day, you had broken out your share in commercial, and you noted that the agent side, you were about 10% below the direct side. Can you just talk about potential growth in that channel over the next, say, 12 to 18 months?

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

Well, it's something we're very focused on. Historically, our commercial agency business just hasn't been an emphasis for us, so we really haven't participated heavily in that market. But we feel like we have advantages, and we feel like we can definitely gain revenue and gain share because we know the customers, and we're starting to penetrate that market more and more. So I think over the next year or two, you'll definitely start to see us increase our commercial agency business.

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

Okay, great. Just switching over to -- in New York, there was, they refinanced the rate cut. I just wanted to get an update on the potential impact of that, and has that gone into effect yet, or is that still kind of being negotiated?

**Dennis Gilmore** - *First American Financial Corp. - CEO*

The reduction in the refinance rate, if I'm not mistaken, is going into effect right now, so it's happening right now. And from our perspective, it really will not make a material difference to us at all. We primarily play in New York in a commercial perspective. We have more (inaudible) the residential footprint.

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

Okay, great, excellent. A quick one on the tax rate. The 36% number -- is that good, going forward?

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

We think of 36% as a good normalized rate. However, for the rest of this year, just in Q3 and Q4, we think it will be more around the 35% range, just because, as I mentioned, we're getting more of a mix of insured versus non-insured income. And we don't really pay -- generally, we don't pay state taxes on insured income. And because of some changes that we've done on the muni side of the investment portfolio, we think those are going to last for at least the rest of the year. So I would say that the tax rate for the rest of the year should be about 35%. But longer term, after that, we think a normalized rate is more closer to 36%.

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

Okay, great, thanks.

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**Operator**

John Campbell, Stephens Inc.

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**John Campbell** - *Stephens Inc. - Analyst*

Congrats on a great quarter.

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Thank you.

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**John Campbell** - *Stephens Inc. - Analyst*

Just back to the title pre-tax margin range, you guys said 10% to 12%. I think, at the end you said you were basing that on a $1.2 trillion market. MBA was out yesterday; I think they revised up to like a $1.35 trillion or so market in 2015. If that plays out, just curious about the sensitivity to you guys. Is there a rule of thumb -- Mark, I don't know if you've done this -- but is there a rule of thumb just for the margin impact for every, call it $100 billion or so, of incremental origination?

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

There's not. We talked about getting a 10% to 12% margin on a full-year basis, excluding any realized gains or losses. And we said that we could do that in somewhere between a $1.2 trillion and a $1.5 trillion. So it's not that sensitive. And that also assumes 35% refi mix, 65% purchase mix. So I think once we get over a $1.5 trillion market, that's when we can start talking about something higher than the 10% to 12% range, but the difference between $1.2 trillion and $1.35 trillion for originations, it's not material to us, really, in terms of our margin target.

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**John Campbell** - *Stephens Inc. - Analyst*

Got it. And then back to commercial, I don't know if you guys have this type of granularity, but can you suss out the refi versus the purchase on the commercial side?

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

You know, we used to track that, and we can. I don't have those numbers here. We used to track commercial refi and commercial purchase, and we have all the data. But really, the price differential between a commercial purchase and a commercial refi, even though there's a difference, it's not nearly as meaningful as on the residential side. So for management purposes, how we manage the business, we don't really look at it that way.

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**John Campbell** - *Stephens Inc. - Analyst*

Got it, got it; that makes sense. And then good job on hitting the success ratio. I think you said 47%. How do you expect that to trend out over the next two quarters? And then is that 60% goal, is that a medium-term type goal, something we should be thinking about for 2016?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Yes, it is. The 60% is a good goal for us over a longer term. And we will be volatile in any one quarter, depending on the magnitude of the change up or down. But we're running strong right now. We're really showing the leverage on this business. Again, half of the year of 2015, we're running at 52% right now, so we're doing very well against our success ratio objectives.

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**John Campbell** - *Stephens Inc. - Analyst*

Excellent. Thanks, guys.

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**Operator**

(Operator Instructions.) Kevin Kaczmarek, Zelman and Associates.

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**Kevin Kaczmarek** - *Zelman & Associates - Analyst*

When you're considering the effects of the October 3 trade implementation, a lot of our industry contacts say there's going to be, I think that the market share winners will include underwriters, direct operations and large agents. And I was wondering, do you guys have a sense of what percentage of your agent order flow is from very small agents? I'm just trying to get a sense of how much market share might be up for grabs.

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

I would say, Kevin, generally speaking, it's the 80/20 rule. We've got about 6,500 agents in the Company, and 80% of revenue comes from the top 20% of the agents. So it's definitely heavily concentrated for the bigger agents.

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**Kevin Kaczmarek** - *Zelman & Associates - Analyst*

Okay. And sorry, one more question on the commercial. At this strength, it's hard not to wonder about it. But can you talk about where you're seeing the strength now? Like were there any big transactions in the quarter, like did the GE commercial property sale have any effect if you were involved there? Can you give us some color on the drivers, such as their geographies or maybe private equity buyers that are driving a lot of this strength this year?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

It really is broad-based. It goes across all of our geos and across all our market segments. Clearly, we had some large transactions in the quarter, but we just, our overall number of transactions increased, and the size of those transactions increased. So, again, broad-based strength across all our segments.

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**Kevin Kaczmarek** - *Zelman & Associates - Analyst*

Okay, great. Thank you.

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**Operator**

Jason Deeleuw, Piper Jaffray.

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

I'm just wondering, the visibility you guys have for commercial activity as we go into the second half of this year. What is the lag in terms of the openings versus the closings for commercial? Is it similar to residential, or is there a different than -- can you just give us the sense for the type of visibility, how you guys get visibility into commercial activity going forward?

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

The visibility is very difficult. Like on the origination purchase side, we know that a transaction is going to close, for the most part, 60 days after it opens. On the residential refinance side, we know it's going to close 50 days after. The commercial side, it's really all over the board. We can open up an order and close it two weeks later; we can open up an order and close it 12 months later. So that's what makes forecasting the business very tricky. So we feel like we have a healthy pipeline of orders that we did, but it's very difficult to tell which quarter they're going to actually close in.

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

Got it. And then, Dennis, I was wondering. I was hoping to get your thoughts here on the sustainability that the residential home purchase market brings. What are you looking at? What metrics are you looking at to give you confidence that we can sustain?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

Really, we look at just a tremendous amount of data. And personally, I feel better right now about the overall commercial market than I've probably felt in five years. We had good growth off of 2014; the transaction volumes are up 6%; our offers continue to increase. And break it down, we're seeing it broad-based almost across all regions of the country. The only thing I would probably be a little worried about is the growth in the purchase price itself, which probably is really an indication that we've got more supply constraint than demand constraint. So just overall, very satisfied with the spring market. And I think that momentum, and my optimism, will continue going into 2016.

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

And then how much do you think the higher interest rates in the last couple of months has -- do you think that's impacted purchase activity? Do you think it maybe pulled forward some activity or maybe not? Or have you seen any fall-off in activity from higher rates that you're hearing about?

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**Dennis Gilmore** - *First American Financial Corp. - CEO*

No, we have not. And it's difficult to have that one-for-one correlation. But my own assumption is that interest rates are important in the purchase market, but not near as important as they are in the residential -- excuse me, in the refinance market. Refinance, direct correlation of rising rates, drop in our volumes. We do not see that tight of correlation in the purchase market.

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

And then on the capital structure, about 18% -- that's the cap ratio right now. You're generating excess capital. That ratio is probably going to continue to trend down, maybe a turn a year by our estimates, it looks like. So what is too low of a level for your debt ratio? When would you -- I mean, how are you thinking about that, going forward?

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

Well, our sweet spot is 18% to 20%, and we're at the low end of that range right now, so we're very comfortable with where we are. In the past, I think the lowest we've been in the last five years is about 12%. And once we get to 12%, we feel like that's low. And even 12% to 15%, I'd say, once we get to that range, we start thinking about ways to bring the debt-to-cap up. But we have a ways before we get to that level.

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

All right, thank you very much, and great quarter.

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**Operator**

That concludes this morning's call. We'd like to remind listeners that today's call will be available for replay on the Company's website or by dialing 877-660-6853 or 201-612-7415, and enter the conference ID 13614230.

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

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