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FAF - Q4 2015 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. At this time all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. (Operator Instructions). A copy of today's press release is available on First American's website at www.firstam.com/investor. Please note that this call is being recorded and will be available for replay from the Company's investor website and for a short time by dialing 877-660-6853 or 201-612-7415 and enter the conference ID 13628414.

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

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

Good morning, everyone, and thank you for joining us for our 2015 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 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 may 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 forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

Risk and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements. Factors that could cause the anticipated results to differ from those described in these forward-looking statements are also described on pages 4 and 5 of today's news release.

Management's commentary contains and responses to your questions may also contain certain financial measures that are not presented in accordance with generally accepted accounting principles including personnel and other operating expense ratios and success ratios. The Company is presenting these non-GAAP financial measures that 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 will now turn the call over to Dennis Gilmore.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks, Greg. Good morning and thanks for joining our call. I will begin with a review of 2015 followed by our fourth-quarter highlights and conclude with a few comments regarding our outlook for 2016.

The Company had a strong year in 2015 with EPS rising 22% to $2.62. Each of our key title markets showed strong revenue growth. Purchase revenue was up 11% as the housing market recovery continues. Refinance revenue surged 29% due to a decline in mortgage rates early in the year. Our commercial business had a record year with revenues up 17%.

Throughout 2015, we continued to manage our expenses effectively achieving a success ratio of 56% for the title segment. Our title business posted a 10.2% pretax margin for the year and the Company's return on equity improved to nearly 11%, both in line with our stated objectives.

In 2015, we gained market share in our direct title business and expanded our property record database to be the largest in the industry. We increased the utilization of our data assets throughout the Company and pursued opportunities to use our data to lower our risk profile in our title business. 2015 was a good year for First American.

Turning to the fourth quarter, EPS was $0.74. The quarter's results include $6 million of net realized investment losses which reduced EPS by $0.04. Our commercial business had an all-time record quarter generating $206 million of revenue, up 4% compared to last year. For the quarter, pretax margin on our title business exceeded 10%. We are encouraged by these strong results given that we implemented the new mortgage disclosure rules, TRID, which went into effect in October.

The extensive effort we devoted to TRID including upgrading our systems and training both our people and our customers paid off as we were able to successfully manage through the sweeping process changes that were required. After experiencing some initial delays and closings, by the end of the quarter our direct residential business returned to its typical closing time frames.

Looking forward, we believe that TRID will not have a material impact on our closings and we have a high degree of confidence we are well-positioned for the upcoming spring selling season.

In 2015, we spent $20 million in capital expenditures related to TRID which will impact our amortization expense in 2016 but we do not expect any significant reductions in operating expenses now that TRID has been implemented.

Revenues in our specialty insurance segment grew by 5% during the quarter. However, we experienced higher claim losses in both home warranty and our property and casualty business. Combined with an unfavorable swing in net realized gains and losses, the segment's pretax margin declined to 10%.

Turning to market outlook, despite uncertainties in the economy, we remain optimistic that the housing market will continue to strengthen in 2016. We are well-positioned to capitalize on anticipated growth in the purchase market. We are benefiting from the recent decline in mortgage rates. Our refinance orders per day were 1700 in January and are now running at approximately 2100 per day so far in February. While the increase in refinance orders will provide short-term benefit, it is uncertain how long this level of elevated refinance activity will continue. We believe the commercial market is poised for another strong year in 2016. However, we expect our growth rates to moderate relative to what we experienced last year.

Based on a positive long-term outlook, our Board of Directors recently approved a 4% increase in our common stock dividend to $1.04 per share annually.

In closing, we are proud of what we accomplished in 2015. We believe the Company is well-positioned to capitalize on an ongoing housing recovery and 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 - EVP and CFO*

Thank you, Dennis. Total revenue in the fourth quarter was $1.4 billion, up 8% compared with the fourth quarter of 2014. Net income was $82 million or $0.74 per diluted share. The current quarter results include net realized investment losses of $6 million or $0.04 per diluted share. In addition, investment income in the current quarter includes impairment of investments and affiliates of $2 million which reduced earnings per diluted share by $0.01.

In the title, insurance and services segment, direct premium and escrow fees were up 4% compared with last year. This growth was driven by a 5% increase in the average revenue per order. The average revenue per order increased to $2236 due to an increase in the average revenue per order for purchase transactions as well as a shift in the mix towards commercial transactions.

Agent premiums were up 14% reflecting the normal reporting lag and agent revenues of approximately one-quarter. The agent split was 79.0% of agent premiums. This quarter to conform to industry practices, we have reclassified certain revenues from direct premium and escrow fees into agent premiums. This reclassification caused our reported agent split to decline by 120 basis points and had no impact to total revenue, net income or earnings per share. Information and other revenues totaled $161 million, down 2% compared with last year driven by a lower demand for the Company's default information products and unfavorable currency translation.

Personnel costs were $381 million, up 10% from the prior year. This increase was primarily due to higher incentive-based compensation relative to last year. Other operating expenses were $180 million, down 3% from last year. This decline was primarily due to higher earnings credits and a reduction in professional services in production-related costs. The ratio of personnel and other operating expenses to net operating revenue was 72.1%.

The provision for title policy losses and other claims was $70 million or 6.5% of title premiums and escrow fees compared with a loss provision rate of 6.6% in the same quarter of the prior year. We expect our loss provision rate in 2016 to decline to between 5% and 6% of title premiums and escrow fees. However, this estimate may change depending on actual claims experience.

During the fourth quarter, our paid claims fell 27% and we expect continued reduction from paid claims this year as older high loss rate policy years become more seasoned.

Pretax income for the title, insurance and services segment was $129 million in the fourth quarter compared with $125 million in the fourth quarter of 2014. Pretax margin was 10.3% compared with 10.8% last year.

Turning to the specialty insurance segment, total revenues of $100 million, up 5% compared with last year. The loss ratio for the segment was 59%, up from 52% in the prior year with higher losses experienced in both home warranty and property and casualty. The increase in the loss ratio in home warranty was primarily due to a return to a more typical seasonal loss rate as compared with an unusually low loss rate last year.

In the property and casualty business, the loss ratio increase was primary due to hail storm events in New Mexico. Pretax margin for this segment was 10.0%.

Net expenses in the corporate segment were $22 million in the fourth quarter, up 14% relative to the prior year driven by higher costs related to Company benefit plans.

The effective tax rate for the quarter was 30%. The tax rate benefited from $5.6 million or $0.05 per diluted share of nonrecurring items largely due to the release of valuation allowances against foreign deferred tax assets.

In terms of cash flow, cash provided by operations was $199 million, a 2% increase from 2014. One of the drivers to our improved cash flow was a decline in paid title claims which declined $18 million this quarter. Capital expenditures were $33 million, unchanged from the fourth quarter of last year.

Debt on our balance sheet totaled $585 million as of December 31. Our debt consists of $549 million of senior notes, $30 million of trustee notes, and $6 million of other notes and obligations. Our debt to capital ratio as of December 31 was 17.5%. We have the entire amount available under our $700 million revolving credit facility.

In January, we repurchased 14,200 shares for $450,000 at an average price of $31.97. These shares were repurchased in accordance with a 10b5-1 trading plan.

Lastly, as Dennis mentioned, our Board of Directors recently approved a 4% increase to our common stock dividend to $1.04 per share annually.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). John Campbell, Stephens.

Unidentified Participant

This is Hayden sitting in for John. So just a quick question on commercial activity. Where do you guys think we are at in the commercial cycle here? And you did mention that you expect those growth rates to slow moderately in 2016. But as just as far as your overall market share, I mean do you kind of expect that to remain flat in a growing environment or do you expect to take share? Kind of walk us through the moving pieces there.

Dennis Gilmore - *First American Financial Corporation - CEO*

A couple of points to that question. The first is what is our outlook on the market? We think we are going to have another very good year in 2016. Our pipelines are very strong, the momentum in the business is strong right now. But as I said, I think the growth rate will start to moderate over what we have experienced over the last few years.

With regards to the share, we have every intent to continue to grow our share and gain share in that marketplace.

Unidentified Participant

Got it. And then on the share repurchase activity, do you guys have the ability or do you intend to maybe take advantage of some of the pullback, maybe be out in the market kind of opportunistically within that share repurchase?

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

It is a possibility. We take it on a day by day basis. So I would just say it is something we are constantly looking at and constantly evaluating. There was one day in January where we did repurchase shares but it is just something that we are continually evaluating.

Unidentified Participant

Got it. And one more real quick if I may. On the expense reclassification associated with the closing protection letters, what are the states that require the splits on those PPO premiums?

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

There's only two states that I am aware of that actually require the splits. I know one of them is North Carolina, I'm not sure about the other one.

Unidentified Participant

Got it. I appreciate the questions.

Operator

Bose George, KBW.

Chas Dyson *- Keefe, Bruyette & Woods - Analyst*

This is actually Chas Dyson on for Bose. I wanted to ask, I know you said that you saw in the direct channel the TRID, you had kind of caught back up by the end of the quarter and not seeing it really having an effect to this point. But on the agent side do you have a sense on how it is affecting the agents in your business? And also is that creating any opportunities to possibly go out and acquire some agent operations that aren't handling it as well?

Dennis Gilmore *- First American Financial Corporation - CEO*

Sure. A couple of points there. Let me again comment on our own direct business. We are very happy with where we are right now, satisfied for our preparation. It has gone well for us. We entered the quarter with a little bit of delays in closings. As the quarter ran through, we caught up on our closings. I still think on the direct side there is room for still increased efficiency for us as we go into the spring buying season.

With regard to the agents, it is probably premature to tell. There are so many agents out there. I am sure many of them have had no trouble and I'm sure some have had trouble with it. Those opportunities will become more clear probably as we go into the spring buying season so we will just see how that plays out.

Chas Dyson *- Keefe, Bruyette & Woods - Analyst*

On the title margin, was there an effect from TRID this quarter that you can quantify and should we see that revert going forward as the delay has narrowed?

Dennis Gilmore *- First American Financial Corporation - CEO*

Not really. We did not bring a lot of excess costs in. We used our own resources for preparation for TRID, both technology training and operations. So I do not think we will see cost reduction associated with TRID going into the spring buying season. What you will see is some residue or some impact from the capital expenditures of TRID. That was $20 million so you will see that impact in 2016 and beyond.

Chas Dyson - *Keefe, Bruyette & Woods - Analyst*

Okay. As then as you guys look out over the next couple of years and see the mortgage market that some forecasters think will be fairly stagnant, do you have any interest at all in consolidating some of the other players in the industry and do you think that it would be feasible from a regulatory perspective?

Dennis Gilmore - *First American Financial Corporation - CEO*

A couple of points. As I said before on consolidation in the industry, I think it is feasible that you could get a consolidation of some combination of the top four underwriters. But it will be completely deal specific. It will be a very difficult deal to be done and there will be heightened scrutiny in it.

Now with regards to acquisitions in the title space for us, specifically we are always looking for tuck in acquisitions in our key states to grow our footprint. If they make sense and they get the necessary return for us.

Chas Dyson - *Keefe, Bruyette & Woods - Analyst*

Okay. Is it fair to say that you could be interested in a large acquisition or it just depends on the fact and circumstances of a deal or it is just not something that you are interested in right now?

Dennis Gilmore - *First American Financial Corporation - CEO*

Again, that would simply depend on the situation.

Chas Dyson - *Keefe, Bruyette & Woods - Analyst*

Okay, that makes sense. Thank you.

Operator

Mark Hughes, SunTrust Robinson Humphrey.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you, good morning. The incentive compensation this quarter, is there a catch up, were there fairly accruals? Did that impact the margin more than you might have expected?

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

Fourth quarter of last year in the title segment, we had kind of a reversal in 401(k) match. Fourth quarter of this year we are booking at basically a higher rate just based on the improved margins of the Company. Net net that is about a $7 million swing from Q4 of last year to Q4 of this year so that is one of the primary drivers.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

And am I right in thinking that probably was an over accrual that you were doing some catch-up or was that $7 million -- or I guess not a $7 million swing -- but would this be the run rate that one might normally expect?

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

I would think the run rate would be a little bit less. I mean our 401(k) match was about $8 million in Q4. I think it would be $1 million or $2 million less than that going forward.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Okay. And then the commercial revenue per order was a little flatter this quarter, it has been volatile. What would you expect on that going forward as a general trend?

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

It is hard to say. I mean typically if you look at our closed orders in commercial, they are flat and what really drives the growth in our commercial revenue and premiums is really the growth in our average fees per file. This year our commercial revenue for the full-year grew 17% over last year. Almost all of that was driven by higher average fees per file. So it is just difficult to say. But as Dennis mentioned before, we do think that will moderate in 2016.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you.

Operator

Kevin Kaczmarek, Zelman & Associates.

Kevin Kaczmarek - *Zelman & Associates - Analyst*

On the open purchase order trends on a monthly basis, it looks like they were negative in December and January. Do you know if there is any particular driver there because I noticed it diverged significantly from mortgage-related metrics like purchased applications showing double-digit growth in both of those months. So can you give us some color on where the weakness is?

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

No, you know, it is funny. We saw something similar in the winter months last year and when you look at the first seven business days in February, our purchase orders are down 2% versus last February. So our growth rates sort of have moderated here in the winter but they did the same thing last year. There is nothing explicitly that we could point to geographically or otherwise that would explain it.

Dennis Gilmore - *First American Financial Corporation - CEO*

Kevin, I would say that we are optimistic going into the spring buying season that we will see continued momentum in purchase growth like we saw in 2015.

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Kevin Kaczmarek - *Zelman & Associates - Analyst*

Okay. All of my other questions have been answered.

Operator

Jeremy Campbell, Barclays.

Jeff Harlib - *Barclays Capital - Anayst*

Hey, guys, it is actually Jeff Harlib in for Jeremy today. If commercial remains strong and we do get a mini refi wave from the present downward move in interest rates, what types of margins could we expect for 2016?

Dennis Gilmore - *First American Financial Corporation - CEO*

Pretty happy with where we are right now. We've got a 10.2 for the year, right in line with what we expected and that is based on the current market environment. So kind of how we look at it, if the market improves from a purchase perspective and commercial continues to grow and we get the benefit from refinance, we are going to look for continued operating leverage in this business so we will continue to drive improved operating leverage going forward if the markets continue to improve.

Jeff Harlib - *Barclays Capital - Anayst*

Great, thanks.

Operator

Jason Deleeuw, Piper Jaffray.

Eric Robinson - *Piper Jaffray - Analyst*

You've got Eric Robinson on for Jason here. Just looking at the agency operations for the quarter and recognizing the quarter lag recognized in net revenue, would you expect any kind of TRID impact going into the first quarter of 2016 from the agency side?

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

You know, typically the agent business lagged our direct business by about a quarter. I mean it is not perfect but that is kind of a rule of thumb. The direct business in Q4 we thought there was going to be an impact, there really wasn't an impact because of TRID. It sort of caught up by the end of the quarter as we mentioned in our remarks. So looking in Q1, we wouldn't expect a material impact because of that lag on our agency revenue in Q1 because of TRID.

Eric Robinson - *Piper Jaffray - Analyst*

Okay, thanks. And then just on commercial activity, are you guys seeing most of that activity on like purchase activity or is that more refi for commercial?

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

It is a combination. I mean refi and commercial there is a lot more refi in commercial than there is in residential simply because you have got the five- and seven-year loan. You don't have 30-year mortgages out there. So we get paid about the same though for a purchase in a refi so the nature of the transaction on the commercial side whether it is a purchase or refi, it is not as important to us as it is on the residential side where we get paid more than twice as much for a purchase than refi. And so for a while we used to track purchase and refi commercial orders and then we just stopped doing that because the refi wasn't a significant driver so I wouldn't say it is a material measure for us.

Eric Robinson - *Piper Jaffray - Analyst*

Got it. And then just one more here. What are you guys seeing as far as residential trends in some of these energy specific markets? Are you noting any more weakness there or are things still pretty strong?

Dennis Gilmore - *First American Financial Corporation - CEO*

I think what we are going to see in 2016, we have started to see it already and that is weakness in the Houston market, both in residential and commercial and that is the primary residential market that we think we will see weakness from the energy issue.

Eric Robinson - *Piper Jaffray - Analyst*

Got it, got it. That is all I have for you. Thank you.

Operator

Bose George, KBW.

Chas Dyson - *Keefe, Bruyette & Woods - Analyst*

This is Chas Dyson on again. I just want to ask about the information revenue line and the title segment. I know you guys have called out that the default information is a drag on that line. But I was wondering if you could give us some color around kind of mixing that and talking about how much of a drag that is versus some of the growth aspects in the rest of the business and also the demand you are seeing on some of the mortgage and database solutions in the pipeline?

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

Sure, on inflow and other, there is a few positives and a few negatives that really drove that. On the positive side, we sell a lot of search products and uninsured products just in connection with the settlement process. That business was up 11%, very similar to the growth trend that we saw on our premiums. Our data businesses within info and other were also up 5% so those are the positive.

On the negative side, we talked about the fact that our default business continued to decline. It was down 21% and also our international business we suffered I guess from foreign currency translation adjustments. So our international business on a constant currency basis was basically flat but because the US dollar strengthened so much during the period, our international revenue in that line item was actually down 10%.

So those are some things that were -- there are ups and downs but overall the info and other was down 2% for the quarter.

Chas Dyson - *Keefe, Bruyette & Woods - Analyst*

And do you feel pretty comfortable with the product suite there or do you think about taking some of those products off-line as it looked like they may not have come back for a number of years?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, we are comfortable with the product suite and I think the trends will continue, we will continue to see softness in the default offerings and I think we will continue to see opportunities for growth in the information products and some of the data products. And I think the commercial trends will continue. So again, feel comfortable with them and I think the trends will continue into 2016.

Unidentified Participant

Okay, thank you very much.

Operator

There are no additional questions at this time. That will conclude this morning's call. I 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 or 201-612-7415 and enter the conference ID of 13628414.

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