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FAF - Q4 2017 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to First American Financial Corporation's 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 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 13675613.

We will now turn the call over to Craig Barberio, Vice President, Investor Relations, to make an introductory statement.

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

Thank you, Sherri. Good morning, everyone, and welcome to our 2017 Fourth Quarter and Year-End Earnings Conference Call. Joining us today will be our Chief Executive Officer, Dennis Gilmore; and Mark Seaton, Executive Vice President and Chief Financial Officer.

Some of the statements made today may contain forward-looking statements that do not relate strictly to historical or current facts. These forward-looking statements speak only as of the date they are made, and the company does not undertake to update these forward-looking statements to reflect circumstances or events that occur after the date 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. For more information on these risks and uncertainties, please refer to today's earnings release and the risk factors discussed in our Form 10-K and subsequent SEC filings.

Our presentation today contains certain non-GAAP financial measures that we believe provide additional insight into the operational efficiency and performance of the company relative to earlier periods and relative to the company's competitors. For more details on these non-GAAP financial measures, including presentation with and reconciliation to the most directly comparable GAAP financial measures, please refer to today's earnings release, which is available on our website, www.firstam.com.

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

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

Thanks, Craig. Good morning, and thank you for joining our call. Today I'll review our fourth quarter and full year results, and then I'll discuss our outlook for 2018.

In the fourth quarter, our earnings per share were $1.96. These results include a net benefit of $1.1 per share related to tax reform. Our earnings this quarter benefited from strong healthy fundamentals, disciplined expense management and higher investment income in our cash and investment portfolio.

Our purchase revenue grew 12% this quarter as we continued to benefit from growth in residential real estate market. Closed purchase orders were up 3%, and the ongoing housing inventory shortages across much of the country continued to constrain the market. Our fee profile increased 8% primarily driven by continued home price appreciation. Our commercial business continues to show strength with revenues up 6%. Growth was broad-based, although we did experience some softening in the traditionally strong New York market. Refinance revenue dropped 37% during the quarter as the market continues to adjust to higher mortgage rates. We've aggressively reset the cost structure in our centralized lender business to stabilize this performance. Refinance revenue accounts for 13% of our direct revenue in the fourth quarter, down from 20% a year ago.

Overall, our Title segment posted a pretax margin of 12.2% this quarter. In the Specialty Insurance segment, our home warranty business had a very strong quarter. However, our property and casualty business posted a loss ratio of 108% due to the impact of 2 severe wildfires in California. Over the past 10 years, we've exceeded our $5 million reinsurance retention limit 4 times, 2 of which occurred this past quarter. As a result, this segment's overall loss ratio increased to 63% with a 9.2% pretax margin.

Turning to full year 2017, the company delivered earnings per share of $3.76, a 22% increase over last year. Our return on equity was 13% and our pretax title margin was 12.1%. On the capital management front, we remained active in 2017. We closed acquisitions valued at $91 million, fully funded and terminated our pension plan and raised our dividend by 12%.

Looking forward, we are optimistic about our financial outlook for 2018. We expect continued growth in our purchase business, given the favorable trends in the housing market. We believe our commercial business is poised for another good year, given strong market fundamentals, and residential refinance orders are likely to trend downwards as mortgage rates rise. But we believe we've taken the necessary actions to improve earnings in our essential lender business.

I'm proud of our company's financial performance in 2017. I'm also excited about the strategic initiatives we have under way that will ensure First American remains an industry leader for years to come. Our core business continues to grow, and we are focused on providing innovative solutions for our customers, using First American uniques -- First American's unique assets, including our data, our technology and our bank. We will provide more details about our strategy, our operations and capital management plans at our Investor Day on May 18 in New York.

I'll now turn the call over to Mark for a more detailed review of our financial results.

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Thank you, Dennis. I'll begin by discussing the impact of tax reform on First American followed by a more detailed review of our financial results.

This quarter's results included next tax benefit of $114 million or $1.01 per share, primarily due to the remeasurement of net deferred tax liabilities as a result of recent tax reform legislation. Moving forward, we expect that our normalized effective tax rate will fall from 34% to 24%. The new rate is higher than the 21% for federal rate primarily due to state taxes and our international operations. In addition, the shift to a territorial tax system will reduce the cost to repatriate cash from our foreign jurisdictions, enhancing our financial flexibility.

In the Title Insurance and Services segment, direct premium and escrow fees were down 1% compared with last year. This decrease was driven by a 19% decrease in the number of orders closed offset by a 23% increase in the average revenue per order. The average revenue per order increased to $2,411 due to a shift in the mix to higher-premium purchase and commercial transactions. The average revenue per order from both purchase and commercial transactions increased 8%.

Agent premiums were down 5% reflecting the normal reporting lag of agent revenues of approximately one quarter. The agent split was 78.9% of agent premiums.

Information and other revenues totaled $187 million, down 1% compared with last year. Higher revenues from recent acquisitions were offset by lower revenues from the company's centralized lender businesses, largely due to the decline in refinance activity. Investment income within the Title Insurance and Services segment was $38 million, up $9 million or 30% from the fourth quarter of last year. Our investment income continues to benefit from higher short-term interest rates, including in our tax-deferred property exchange business, our adjustable rate agency mortgage-backed securities portfolio as well as interest on cash and escrow balances.

Net realized investment losses totaled $2.7 million for the quarter.

Personnel costs were $414 million, down 2% from the prior year. This decrease was primarily driven by lower temporary labor overtime and incentive compensation expenses.

Other operating expenses were $209 million, up 2% from last year. The increase was due to an $8.5 million write-off of uncollectible balances this quarter. The provision for title policy losses and other claims was $45 million, or 4.0% of title premiums and escrow fees compared with a loss provision rate of 5.5% in the same quarter of the prior year. The current quarter rate reflects an ultimate loss rate of 4.0% for the current policy year, with no change in loss reserve estimates for prior policy years.

Pretax income for the Title Insurance and Services segment was $166 million compared with $150 million in the fourth quarter of 2016. Pretax margin was 12.2% compared with 10.8% last year.

Turning to the Specialty Insurance segment. Total revenues were $121 million, up 2% compared with last year. The loss ratio in the Specialty Insurance segment this quarter was 63%, up from 55% in the prior year. Our property and casualty business experienced high claim losses in the quarter due to 2 separate California wildfires, with losses exceeding our $5 million reinsurance retention limit for each event. Pretax margin for this segment was 9.2% compared with 18% in the fourth quarter of last year.

Net expenses in the corporate segment were $17 million. This is the first quarter that we are benefiting from the full run rate savings in the corporate segment from our recent pension termination.

The effective tax rate for the quarter was negative 38.5%. As I noted earlier, we posted a $114 million benefit relating to tax reform this quarter, driving the tax rate well below our normalized rate of 34%.

Debt on our balance sheet totaled $733 million as of December 31. Our debt consists of $546 million of senior notes, $160 million on our credit facility, $23 million of trustee notes and $4 million of other notes and obligations. Our debt-to-capital ratio as of December 31 was 17.4%. We have $540 million remaining on our $700 million revolving credit facility.

In terms of cash flow, cash provided by operations was $177 million, a decline of $61 million relative to last year, primarily due to a $72 million increase in cash taxes paid as a result of low tax payments in the fourth quarter of 2016.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Mackenzie Aron with Zelman & Associates.

Mackenzie Jean Aron - *Zelman & Associates LLC - VP*

First question, just on the tax savings thinking about the incremental cash flow that you will be able to get from the lower effective rate, can you just talk about how you see the priorities for that cash? And if there's potential for buybacks or dividend growth or will most of that be used for further M&A.

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

Yes, this is Dennis. Kind of look at it from a couple different ways. We're going to invest back in our people, so we're going to change or modify our U.S. 401(k) plan a little bit here. That will probably use about $12 million. The rest we'll put back towards either CapEx or M&A if we can get the returns. And then above that, the excess will be returned back to our shareholders.

Mackenzie Jean Aron - *Zelman & Associates LLC - VP*

Okay. Great. And just looking into the pipeline for acquisitions, whether it's further title agents or things on the technology side that you see. Should we be expecting similar opportunities this year?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

Compared to '17, we deployed about $90 million, $91 million last year. We've got a really full pipeline looking -- going into '18 right now. And our strategy is very consistent. First, we're looking to buy title agencies where they make sense to us. And then we'll look to buy some technology plays that help our data and automate the titling process. And then we've got a couple of deals we're looking at that are a little outside the core but very related to title. So again, full pipeline, but like we always are, very disciplined on deployment. So we'll see.

Mackenzie Jean Aron - *Zelman & Associates LLC - VP*

Okay. Perfect. And If I can sneak in one more, just on the comment that New York was soft around commercial, if I heard that correctly. Was there any particular driver there?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

Not really. Just the market has been a little softer over the last couple of quarters. But we're really optimistic on commercial. Had a good year, and we are optimistic going to '18.

Operator

Our next question is from John Campbell with Stephens Inc.

John Robert Campbell - *Stephens Inc., Research Division - VP and Research Analyst*

So if I'm backing up that the onetime loss and then the net realized losses, did you guys do about a 13% margin?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Yes. That's if you back out the realized loss. And we had that $8.5 million write-off of that uncollectible account, you get to about 13%, right.

John Robert Campbell - *Stephens Inc., Research Division - VP and Research Analyst*

Okay. And so -- I mean, you guys kind of comfortably exceeded that 10% to 12% kind of margin goal you've laid out for the year. As I look at 2018, I mean, the investment income left is very clear, you're going to have growth in purchase. That's going to be offset to some extent by lower refis. Assuming commercial can kind of modestly hang in there, is there any reason why shouldn't be above that range again for '18?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

I mean, the short answer there is no. We finished the year at 12.1% for the title segment. And so when we look into '18, assuming we have continued growth in purchase, which is our expectation, and assuming the commercial hangs in there, we think we can incrementally improve the margin because of the benefits we're getting in the portfolio, the operating leverage we get from the market and continued operating efficiencies. So we're hopeful that we can incrementally improve. But it's getting tougher.

John Robert Campbell - *Stephens Inc., Research Division - VP and Research Analyst*

Okay. That's helpful. And then Dennis, I think you mentioned the $12 million of step-up in the 401(k) cost, after the tax saving. Is that something that's going to run through corporate? Is that something we kind of break out rapidly ratably each quarter in corporate? Or is that a onetime expense?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

It's not going to be in the corporate segment. It will be distributed between this title segment and the specialty insurance segment based on employees. And so we would expect roughly a $12 million pretax really in perpetuity. And obviously, 90% to 95% of that would be in the title segment.

John Robert Campbell - *Stephens Inc., Research Division - VP and Research Analyst*

Okay. And then on the investment income, I think we might have talked about, kind of rule of thumb, every 25 bps or so of rate hike equals about $12 million of higher investment income. Are you guys still feel good about that rule of thumb?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Yes. We feel good about that, at least for the time being. I mean, we've shown that we can get that through last year. I mean, last year the Fed raised 3 times. And we're getting pretty close to that in terms of improvement from our investments. And so as the Fed continues to raise, we think that that's still a good benchmark going forward.

John Robert Campbell - *Stephens Inc., Research Division - VP and Research Analyst*

And what's that incremental margin? Last question.

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Well the incremental margin on the $12 million is 100%. And it all falls to the bottom line.

Operator

(Operator Instructions) Our next question is from Bose George with KBW.

Thomas Patrick Mcjoynt-Griffith - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant Analyst*

This is Tom Mcjoynt on for Bose. Just wanted to ask about that $8.5 million uncollectible. That was 100% onetime, right? That's not something you guys would expect to see again?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Yes. I mean, that's clearly onetime. It was an out-of-period adjustment that didn't even relate to the fourth quarter. And we're always going to have stuff that kind of comes up, but that was definitely onetime item, nonrecurring.

Thomas Patrick Mcjoynt-Griffith - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant Analyst*

Okay. And then in terms of, with the lower tax rates, have you guys had any conversations or have any concerns over getting sort of pressure on to have lower prices from state insurance commissioners?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

No. Obviously, there's been a little noise on that. But we don't think so at this point. We think our rates are appropriate. We think they're reasonable. And we spent a lot of time following all the guidelines in each state. And I guess, you could see longer term, there could be some pressure for lower rates maybe because of tax reform, maybe not. But overall, again, we don't believe tax reforms will result in any wide-spread rate reduction.

Thomas Patrick Mcjoynt-Griffith - *Keefe, Bruyette, & Woods, Inc., Research Division - Assistant Analyst*

Okay. Got it. And just a last one. When we think about the kind of title space, you've got 4 large players. Is it possible to think that 2 of the 4 largest could merge? And what's sort of the process for getting approval any time you guys do an acquisition of another title company? I mean, I presume it's on -- often by a state-by-state basis of getting approvals?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

It is a state-by-state basis. It would be difficult. And I'm just not going to comment on potential consolidation in the industry.

Operator

Our next question is from Jason Deleeuw of Piper Jaffray.

Jason Scott Deleeuw - *Piper Jaffray Companies, Research Division - VP & Senior Research Analyst*

Just wondering on the commercial revenue, it was really strong again this quarter and a little bit better than your peers. So how are we looking heading into 2018? I mean, we're kind of -- I think, expectations been kind of flat. But you just grew at 6% now 2 quarters in a row. Can we expect some growth in commercial in 2018?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

Yes, great question. It was a good quarter, we were up 6% for the quarter and 6% for the year. In the fourth quarter, by the way, there was nothing driving it. There was no onetime big deals or anything like that. We just had strength really broad-based across the market. Our thoughts going into '18 are similar to '17. We'll look for a year similar to '17. So right now we're thinking flattish, maybe down a little. And if we have that, that's a good year for us. Remember, '17 was a very strong year.

Jason Scott Deleeuw - *Piper Jaffray Companies, Research Division - VP & Senior Research Analyst*

Okay. Got it. So it sounds like we should probably just keep going with flattish. On the information and the other revenue, that was a little softer than we thought and -- especially with M&A revenue benefits and it sounds like you're -- it's the centralized refi, there's still a headwind there? Can you just kind of remind us the M&A revenue that annually you're -- that you're expecting? And then, have we lapped the headwind of the centralized refi decline? So is that headwind going to go away?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Well in terms of acquisitions -- well in terms of the information and other revenue in the fourth quarter, it was a little softer. A lot of it was refi-driven because a lot of our noninsurance-related products that are tied to refi are obviously in that line item. When you look at '18, we think that the information and other line items are going to outperform direct and agency, premiums. And a lot of it is because of the acquisitions that we've done in '17, about 2/3 of the revenue that we really purchased or acquired is in the information and other line item. So we're going to get some tailwinds in '18 just by the fact that the acquisition we did in '17.

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

Yes, and to the second part of your question, it just depends on the refinance volumes. Right now, we're pretty stable, running around 1,200 a day. And if we stay around that range, I'm looking for a significant improvement from that -- from the central lender business going into '18 from '17. They worked clearly hard through the last half of '17 to get their cost structure is aligned. So again, it will just depend on where we end up on the volumes, but right now, we feel very good, and we're stabilized at around 1,200 a day.

Jason Scott Deleeuw - *Piper Jaffray Companies, Research Division - VP & Senior Research Analyst*

Okay. And in the prepared comments there was mention of extra cash that you could repatriate now with tax reform. Can you quantify that for us? I mean how much extra is this going to really help you guys just so we have a sense on that?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

It -- we're going through that process now. I'd say, rough numbers, it's not material. Probably $20 million to $40 million. When we look at the dividend that we get from our subsidiaries that go to the holding company. We've never really looked international because obviously the taxes to repatriate were just too punitive. But now we're going to start looking at that closer going forward.

Jason Scott Deleeuw - *Piper Jaffray Companies, Research Division - VP & Senior Research Analyst*

Got it. And just one last one. January trends, I think I maybe missed those. What are the trends so far?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

In January, on a year-over-year basis, our purchase orders are about 1,800 a day. And that's up about 2%, 2.5% from the prior year. Refis are running about 1,200 today, which is about flat from the prior year.

Operator

(Operator Instructions) Our next question is from Geoffrey Dunn with Dowling & Partners.

Geoffrey Murray Dunn - *Dowling & Partners Securities, LLC - Partner*

Thanks. My question was asked and answered.

Operator

Our next question is a follow-up from Jason Deleeuw with Piper Jaffray.

Jason Scott Deleeuw - *Piper Jaffray Companies, Research Division - VP & Senior Research Analyst*

Just another one on the agent channel. The revenue was down 5% year-over-year. I know there's the one quarter lag on the reporting. But can you remind us, the -- where it sits right now, the purchase refi revenue mix in the agent channel? I think it's mostly purchase anyway. But can you just kind of help us we can kind of think about how we should grow that in 2018?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Well, 2 things. I mean, first of all, I would say that the purchase refi mix on agency isn't going to be that different than the direct. In the fourth quarter, when we look at open orders, it was about 42% refi. But when we look at the -- our agent revenue was down 5%. Typically, it follows the lag of the activity in the third quarter for direct, which was down 1%. We're down a little bit more than that in the fourth quarter. One of the things we always do is we reevaluate our splits by state and by customer. And one thing we've done in the last couple of quarters is change the splits in Southern California. Our Southern California splits used to be 87-13. We recently moved them to 85-15. And so we've shed a little bit of share there, and that's one of the reasons why our agent revenue kind of underperformed relative to what you might think. But that's a process that we continually evaluate.

Jason Scott Deleeuw - *Piper Jaffray Companies, Research Division - VP & Senior Research Analyst*

Got it. And then there has been acquisitions of agents. Is that still a strategy for First American?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

It is. We have a pretty good pipeline right now, and we're going to continue to look to do some tuck-in agent acquisitions.

Operator

Our next question is from John Campbell with Stephens.

John Robert Campbell - *Stephens Inc., Research Division - VP and Research Analyst*

Wanted to touch on the Specialty Insurance segment one more time. Obviously, 2017 was pretty difficult from a loss ratio standpoint. I know some of that -- obviously, a lot of that is out of your control. But is there a rough idea or a kind of range to think about as far as percent of provision policy claims?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

That's a hard thing. Because you just never know what's going to happen with weather events. Obviously, we had kind of the perfect storm or a series of perfect storms here in the fourth quarter. Historically, when you look at the last few years, our loss ratio in P&C has been somewhere between 60% to 65% the last couple of years, excluding '17. So low to -- low 60s is probably a good where to start with for P&C. But again, we just never really know depending on what the weather conditions are.

John Robert Campbell - *Stephens Inc., Research Division - VP and Research Analyst*

Okay. That's helpful. And then if you assume you get kind of to that normalized range. Obviously, you guys had to fight to do some stuff on the home warranty side. At one point, we're doing kind of mid-teens or low teens margins -- pretax margins in the segment, it's stepped down 100 bps over the last couple of years, each year. Is there a good range that you guys kind of manage to for that business?

Dennis Joseph Gilmore - *First American Financial Corporation - CEO & Director*

I'm not going to give a range, but on the P&C we've had a tough year, there's no question, driven by some severe weather events and just overall, it's been a tough year for our P&C group. So we're very focused on improving its performance. Home warranty, standout performance actually. Very strong quarter-over-quarter from -- on the fourth quarter. We did a lot of work on the home warranty to improve the operations back in '16 and we really saw the benefits of that in '17. So very optimistic on home warranty going to '18 and looking to stabilize the P&C group in '18.

Operator

There are no additional questions at this time. This concludes this morning's call. We 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 13675613. The company would like to thank you for your participation. This concludes today's conference call. You may disconnect.