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FAF - Q3 2017 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the First American Financial Corporation third 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 of 13672053.

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

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

Good morning, everyone, and welcome to our 2017 Third Quarter 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.

As always, 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 also 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 this morning's earnings release, which is available on our website at www.firstam.com.

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

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Thanks, Craig. Good morning, and thank you for joining our call. I will review our third quarter results and provide a few comments regarding our outlook for the remainder of 2017.

In the third quarter, our GAAP earnings were $0.19 per share, which include an expense for the pension termination of $0.89 and net realized investment losses of $0.04.

Our Purchase and Commercial business performed well in the third quarter. Purchase revenues were up 10%, driven by a 7% increase in the average fee per order. Our purchase business continues to benefit from growth in transaction activity and from higher real estate values.

Our commercial business had a strong quarter, with revenues up 6% over the last year. With a healthy commercial pipeline heading into the fourth quarter, we expect 2017 to be another good year for this business.

Turning to our Specialty Insurance segment. Revenues grew by 8% with a pretax margin of 5.2%, and our overall loss ratio improved to 65%. Home Warranty had another strong quarter in which it significantly reduced claim losses through improvements in its contractor network and service operation. And to a lesser degree, the business also benefited from favorable weather conditions.

During the third quarter, our Property and Casualty business experienced elevated claim losses due to higher severity and frequency. We also expect the wildfires in California to negatively impact the P&C business in the fourth quarter. We anticipate losses from these fires to continue to develop and we will hit our reinsurance retention limit of $5 million.

Turning to capital management. We spent $87 million on acquisitions during the quarter. We acquired a leading title agency in Nevada that complements our direct operations. In addition, we bought out our majority joint venture partner in a title information company, broadening our geographic footprint to further strengthen our leadership position in title information.

The recent hurricanes and wildfires have caused extreme hardship for many people across the country, including a number of First American employees and customers. Our immediate focus is on helping our impacted employees and providing them with the resources they needed. Throughout these events, I'm proud of how hard our people worked to get operations back up and running and allowing us to quickly resume service to our customer. As a result, we expect the company's financial performance will not be significantly impacted.

We remain optimistic about our Title segment as we head into the fourth quarter. Our purchase business continues to grow with open orders up 5% in October. Our commercial pipeline is strong, our refinance business is right-sized, and our title claims continue to trend favorably. We believe these conditions will enable the company to deliver strong financial results in 2017, and will position us well going into 2018.

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 - CFO and EVP*

Thank you, Dennis. I'll begin by discussing a few unusual items that impacted our earnings this quarter.

We incurred an $0.89 per share expense related to the completion of our pension termination. This quarter, we began realizing an annual benefit of $22 million before tax in our Corporate segment as a result of this termination. We also incurred $0.04 of net realized investment losses.

In addition, we had 3 items that essentially offset each other. These items included $0.07 tax benefit, which was offset by an out-of-period personnel expense of $0.05, and a write off of a title plan asset for $0.03.

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 20% decrease in the number of orders closed, offset by a 24% increase in the average revenue per order. The average revenue per order increased to $2,298 due to a shift in the mix to higher premium purchase and commercial transactions. The average revenue per order for purchase transactions increased 7%, while the average revenue per order for commercial transactions increased 11%.

Agent premiums were up 1%, reflecting the normal reporting lag of agent revenues of approximately one quarter. The agent split was 79.1% of agent premiums.

Information and other revenues totaled $199 million, up 6% compared with last year. The increase was driven by recent acquisitions, which contributed $24 million to revenue this quarter.

Investment income within the Title Insurance and Services segment was $38 million, up $9 million from the third quarter of last year. As we discussed on our call last quarter, our investment income has benefited from higher short-term interest rates. Including in our tax-deferred property exchange business, our floating rate agency mortgage-backed securities portfolio as well as interest on escrow balances.

Personnel costs were $422 million, up 3% from the prior year. This increase was driven by the impact of recent acquisitions as well as an add-up period personnel expense.

Other operating expenses were $196 million, down 1% from last year. An increase of $11 million from recent acquisitions was offset by $12 million in expense reductions, primarily due to lower production related expense from the decline in order volume and lower software, legal and bad debt expense compared with last year.

The provision for title policy losses and other claims was $47 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 $181 million in the third quarter, compared with $189 million in the third quarter of 2016. Pretax margin was 13.0% compared with 13.5% last year.

Turning to the Specialty Insurance segment, total revenues were $118 million, up 8% compared with last year. The loss ratio in the Specialty Insurance segment this quarter was 65%, down from 69% in the prior year. Claims experience improved notably in our Home Warranty business, primarily due to operational improvements, particularly with our contractor network and service operations.

The loss ratio for the Home Warranty business improved 970 basis points to 60% this quarter. Partially offsetting this favorable claims experience are higher claims from our property and casualty business. Pretax margin for this segment was 5.2% compared with 1.6% in the third quarter of last year.

Net expenses in the Corporate segment were $169 million. Included in this amount is $152 million related to the pension termination.

Moving forward, we expect net expenses in the Corporate segment to be approximately $75 million on an annual basis after taking into account the pension savings.

The effective tax rate for the quarter was negative 17.9%. As I noted earlier, we posted an $8 million benefit relating to certain tax items this quarter. This benefit, coupled with low pretax earnings due to the pension termination, caused the negative tax rate this quarter.

On a normalized basis, we expect our tax rate to be closer to 34%.

Debt on our balance sheet totaled $734 million as of September 30. Our debt consists of $546 million of senior notes, $160 million on our credit facility, $24 million of trusteed notes and $4 million of other notes and obligations.

Our debt-to-capital ratio as of September 30 was 18.2%. We have $540 million remaining on our $700 million revolving credit facility.

In terms of cash flow, cash provided by operations was $221 million, a 109% increase relative to last year, primarily due to the [$62] million pension contribution we made last year.

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 comes from the line of Mark DeVries from Barclays.

Mark C. DeVries - *Barclays PLC, Research Division - Director and Senior Research Analyst*

If we back out the -- these nonoperating items in the quarter, we get a pretax margin closer to 14.5%. First of all, does that sound right to you, Mark?

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

Yes, I think that sounds right. If you're backing out the personnel expense in the (inaudible), write-off yes.

Mark C. DeVries - *Barclays PLC, Research Division - Director and Senior Research Analyst*

Okay. I believe at a recent conference, you commented that the 10% to 12% pretax margin target, could be more (inaudible) and have some upside. You've had a couple of quarters now, albeit the seasonally strong ones, but ones well above that kind of target. Interested to get your updated thoughts on that, given these results.

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Yes, Mark, this is Dennis. Yes, we had a very good quarter. And again, like I've said before, the company is very well positioned. Our purchase business is strong. Our commercial is stronger than we thought going into the year. The pretax margin of the 10% to 12% objective, I think is still appropriate. Remember, we're running right now, year-to-date, at about 12.1% right in that range. But going forward, as the market continues to improve, we'll continue to drive our margin higher through increased operating efficiencies. So we're happy where we are right now. We'll look to continue to drive it up as the market continues to improve and we continue to drive greater efficiencies in the business.

Mark C. DeVries - *Barclays PLC, Research Division - Director and Senior Research Analyst*

Okay. I think in your comments, Mark, you indicated that the ARPO was particularly strong because of, I guess, some larger commercial transactions. Is that right? And if so, are you seeing kind of a similar mix in your pipeline right now? Or should we expect a little bit of volatility around that ARPO in the coming quarters?

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

I think a little of both. I mean, there is always volatility around commercial ARPO because, as you know, there are -- there is lumpiness to transactions, but this is a general statement. We have seen higher commercial real estate prices which help our ARPO and we're also just seeing higher quality deals, larger deals that are coming through. So those 2 things are the reason why our ARPO is up this year and why it was up 11% this quarter.

Mark C. DeVries - *Barclays PLC, Research Division - Director and Senior Research Analyst*

Okay. And just one last question from me. It'd be interesting to hear your updated thoughts on, just kind of given what current market expectations are for Fed tightening in the forward curve in general. Mark, what your updated thoughts are? And what the benefits could be from higher rates on your investment income here over the next year?

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

Well, if you look back, what's happened. I mean, over the last year, we've -- at least in the Title segment, we've got $9 million more of investment income than we did a year ago. So that's $36 million on an annualized basis. So we've got $36 million more of annualized investment income, because of -- some of it is because of higher balances, but a lot of it, I would say, most of it is rate driven. And so if the Fed continues to tighten, we're going to continue to see that benefit. So over the last year, for every time the Fed raises 25 basis points, just a high level, we get about $12 million more of investment income on an annualized basis. So that's something what we're certainly seeing the benefit of.

Operator

Our next question comes from the line of John Campbell from Stephens.

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

Just back to the margin. As I think about next year, I mean, if we hold commercial kind of roughly flattish, and I know there's a lot of moving parts there. But is there any reason, I mean, especially considering your comments just in, Mark, about investment income maybe lifting a little bit more next year? Is there any reason why you wouldn't see margin expansion out of that title business next year?

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Well, it's really going to depend on 2 things, right? It depends on how the market performs from commercial and we're optimistic on commercial right now. Going to the range of '17 into '18, and it will depend on the purchase market. But if those 2 hold and continue to expand like we think, we think they will, we'll continue to drive efficiencies and we'll continue to try to see better margins in the business. But I think we should come back to where we are right now, and here we're running right at the upper end of our range -- 10% to 12% around, right at 12% right now. So we're encouraged by where we are in the business and we're encouraged looking forward.

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

And Mark, I think I heard you say the $75 million of expected annual expense in Corporate. Is there any really seasonality to that line? Or is it spread evenly throughout the quarters?

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

It's spread very evenly throughout the quarter. No seasonality.

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

Okay. And then a last one from me. Can you talk to some of the acquisitions and maybe give us an idea, kind of size up the revenue run rate from those acquisitions?

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

So yes. It was an active quarter for us. We closed $87 million worth of acquisitions. And I guess what I would say is, the deals were -- on a -- when you aggregate them together, we had about $60 million of annualized revenue and about 2/3 of that was -- will flow through our information and other line item, and about 1/3 will go through direct premiums. And the margins are at least as high as they are in our overall Title segment.

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

Okay, got it. And to make sure I understand that, you said $87 million is what you're running up to, to-date and $60 million was the run rate in the quarter? Is that what it is?

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

No, I'm sorry. The $87 million was the cash outlay for (inaudible) quarter.

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

Got it.

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

Yes. The $60 million of the annualized revenue run rate.

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

And 2/3 of that is in info and other, and then 1/3 is in direct.

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

That's right.

Operator

Our next question comes from the line of Mark Hughes with SunTrust.

Mark Douglas Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

The information and other, when you think about it on an organic basis, what kind of a run rate growth should we expect in that?

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Well, that one is a little difficult to -- there's different drivers in there. So we have default revenues in there. We have refinance revenue, we have purchase revenue, we have our -- a lot of our international operations revenue run through there. So I would say, there's multiple different drivers. However, I would think that the info and other line item would increase at least as fast as our direct premium and escrow line item, particularly in light of the fact that some of these acquisitions we're doing will increase the info and other rate line item.

Mark Douglas Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

And then -- what is the run rate for refi-es in October? If you might share that.

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

We're -- I was going to say we're running right around 1,300 open orders a day. We've stabilized now over the last few months. And also, we've got -- we've adjusted our cost structure to that current level.

Mark Douglas Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

And then your M&A, this is a pretty robust quarter. Is that -- having done some of the capital management or taken some of the steps, destacking? Is -- and I think your comments on the share repurchase doesn't seem like that's a near-term focus, should we anticipate elevated level of M&A in coming quarters?

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

I -- it'll definitely be lumpy. But our strategy stays the same. We're continuing to look for -- title opportunities, primarily agents will want to build out our direct footprints. We're looking to continue to build out our information businesses and how it relates to title automation. So a lot of focus there. We continue to look for data -- excuse me, for mortgage products to expand on mortgage offerings. I guess the only thing we've really seen change over the last couple of months is, we've seen quite a few new opportunities that are slightly outside of the core title but very complementary to core, and we're taking a look at some of those. But they're not significant in size.

Operator

Our next question comes from the line of Jason Deleeuw with Piper Jaffray.

Eric Michael Robinson - *Piper Jaffray Companies, Research Division - Research Analyst*

You've got Eric Robinson on here for Jason. A lot of my questions have been asked. But I guess, if I could just touch on related to the data and technology initiatives you guys have been focusing on recently, would you mind just going into a little more detail regarding your recent API initiatives and other technology initiatives that are used -- that are going to be used to support the digital origination process?

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Sure. We continue to focus in on building out our respective public record databases and we continue to look for acquisitions that augment that strategy and that's one of the deals we did this past quarter. And bottom line, over the long term, we look to continue to try to drive automation in the titling process and drive efficiencies in the digital closing. So a lot of energy there from both organic and from acquisitions' perspective, and there will be in the future, where we think this is a big market opportunity for us.

Eric Michael Robinson - *Piper Jaffray Companies, Research Division - Research Analyst*

Got it. And then, I guess, just to touch again on the open purchase orders here in October, did I hear it right? Was it -- was purchase 5% thus far in October?

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Correct. We're running at about 5% above last year.

Operator

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

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Could I just follow up on the acquisition questions? The level of acquisitions this quarter is obviously pretty strong. I mean, would you characterize that as kind of opportunistic? Or are just you're seeing more out there so we could just see this as being a bigger use of capital going forward?

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Probably a little of both. I think if we are opportunistic this quarter and it will always be lumpy. But we are seeing a lot of viable deals now in those spaces I've mentioned before. So -- again, I think, we'll continue to focus on it. But at the end of the day, nothing is changing for us. We won't deploy unless we can get the returns that we expect.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay, great. And then -- if you just -- switching to your earlier comments about the wildfires -- wildfire impact. The -- just given the reinsurance, so that number is essentially capped at $5 million, the potential losses for you guys.

Dennis J. Gilmore - *First American Financial Corporation - CEO & Director*

Yes, yes. So we're going to have losses that will exceed our $5 million retention. So we're basically capped at $5 million. We will have to pay a reinstatement fee as well to reinstate our reinsurance, but that's going to be roughly $1 million, we don't know exactly. But our losses are capped.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. And then actually one on the one-time expenses you guys had. The things like the out-of-period personnel expense. Should we think of them as really one-time? Or do they -- are they periodic adjustments like that, that happen?

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

Well, in the case of the personnel expense, it was a real expense that the company incurred, it just wasn't in the current quarter. And so it was -- when you're looking at the third quarter operating results, I would exclude it. But when you're -- they're going to occur from time to time. In case of the title plan, it was different in the sense that we went through an effort to reconcile all the title plans on our books and we briefly effectively found that there was $5 million that was -- there was booked in title plans that really shouldn't have been and so we wrote that off. That was truly a one-time thing. So it's kind of a mix there.

Operator

Our next question comes from the line of Geoffrey Dunn from Dowling & Partners.

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

Mark, I just want to follow up on that wildfire question. Out of my element on this, but as I understand, (inaudible) has declared those as 3 events? How does your reinsurance cover work? Is it an event-based thing where you might have 3 $5 million max hits? Or is it all-encompassing somehow? I'm not sure if I'm asking that correctly, but can you address that concept?

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

Well, at the end of the day, Geoff, the way that we've understood it is, it's really one event for the claims that we have, the property that we have. So we only -- we don't expect this to be more than a $5 million hit at the end of the day. Because there were multiple different events, but as long as they're within 240 hours of each other, we can kind of consolidate them into 1 event.

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

Okay. Actually one follow-up I got on right as you were talking about Corporate. What were you saying about where you expect the Corporate run rate expense to be going forward?

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

$75 million.

Operator

There are no further questions at this time. This does conclude 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 of 13672053.

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