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FAF - Q1 2018 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings. And welcome to First American Financial Corporation First Quarter 2018 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 investors website and for short time, by dialing (877) 660-6853 or (201) 612-7415. And please enter the conference ID number of 13678579. We will now turn the call over to Mr. Craig Barberio, Vice President Investors Relation, to make an introductory statement.

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

Good morning everyone and welcome to our 2018 first quarter 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 relates strictly to historical or current fact. These forward-looking statement 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 that form before forward-looking statement. For more information on this risks and uncertainties, please refer to this morning’s earnings release and the risk factor discuss on our Form 10-K and subsequent at 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 period and relative to the company's competitors. For more details on this non-GAAP financial measures including presentation with and reconciliation to, and most directing comparable GAAP financial measures. Please refer to today’s earnings release which is available on our website at www.firstam.com. I will now turn the call over to Dennis Gilmore.

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

(technical difficulty)

Thank you Craig. Good morning and thank you for joining in our call. Today I'll review our first quarter results, and to discuss our outlook for the remainder of 2018. 2018 is off to strong start, in the first quarter revenue is $1.3 billion but the earning per share of $0.67. This compares to last year revenue is $1.3 billion and earnings of $0.52 per share. Our purchase revenue grew 8% this quarter, driven primarily by a higher fee per file. Our fee per file increase 6% as we continue to benefit from rising home prices.

Our commercial business have a strong start to the year with revenues up 5%. We continue to see strength across most major markets, and I believe 2018 will be another good year for our commercial business. We finance revenue dropped 15% during the quarter as more insurance rates retire.

We reduced our cost structure and our central lender business throughout the second half of 2017, and we will continue to manage costs and align with the refinance activity moving forward.

Overall, our title segment posted a pretax margin of 8.6%, our highest first quarter margin since we begin a standalone public company in 2010. These results were driven by continued strength in the purchase in current commercial markets, disciplined expense management and higher investment income.

In the Specialty Insurance segment, total revenues increased 3% and we earned a pretax margin of 8.7%. Our home warranty business continues to perform well with revenues increasing 8% during the quarter. Our efforts to enhance margin by improving our contracted network and service operations have continued to deliver positive results.

While our property and casualty logistics had higher than expected claim losses due to higher severity, the overall loss ratio for the segment improved to 57%. As we approach the peak of the spring selling season, we remain optimistic about the outlook for 2018.

Given the ongoing economic expansion and current trends in the housing market, we expect future revenue growth in our purchase business.

So far in April, our purchase orders are flat compared to last year. Our commercial business has a healthy pipeline of activity and continues to perform well. Our refinanced business is right sized for the current volume and we continue to benefit from strong investment income.

First American is well positioned in the marketplace with a strong balance sheet and ample financial flexibility to take advantage of strategic growth opportunities.

We are actively investing in digital solutions to enhance our customer experience, and we are focused on growing our core title in settlement business and leveraging our unique asset such as our data, technology and our bank to provide innovative solutions to our customers.

We look forward to our Investor Day on May 18 in New York, where we will provide more detail on our strategy, our operations and our capital management plans.

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 will begin by addressing a new accounting change that will add volatility to our earnings going forward.

Starting this quarter, the change in fair value of equity investments is required to be recognized to net income. Previously changes in fair value were recognized in other comprehensive income on the balance sheet. This change will drive more volatility on GAAP earnings due to market fluctuations was $460 million equity portfolio.

Changes in fair value of these equity investments will be reflected in our net realized investment gain and loss line item on our income statement.

This quarter, we recorded a $7 million loss as a result of this accounting change. We have provided detail of this line item in a table within our earnings release.

Turning to our results, in the Title Insurance and Services segment, direct premium escrow fees were up 3% compared with last year. This increase was driven by a 13% increase in the average revenue per order that was largely offset by a 9% decrease in the number of direct title orders closed. The average revenue per order increased to $2,303, primarily due to a shift in the mix to higher premium purchase in commercial transactions.

The average revenue per order for both purchase and commercial transactions increased 6%.

Agent premiums, which are recorded on approximately one quarter lag, relative to the direct premiums declined 8%, primarily due to a decline in refinance activity. The agent split was 79.0% of agent premiums.

Information and other revenues totaled $186 million, up 3% compared with last year.

Higher revenues from recent acquisitions were partly offset by lower revenues from the company's centralized lender business, largely due to the decline in refinance and foreclosure activity.

Investment income within the Title Insurance and Services segment was $41 million, up $15 million from the first quarter of last year.

Our investment income continues to benefit from higher short-term interest rates, including in our cash and investment portfolio, tax-deferred property exchange business and escrow balances. We expect investment income to continue to grow in the second quarter, given the Feb to March rate increase.

Personnel costs were $394 million, up 2% from the prior year. This increase was driven by the impact of the recent acquisitions.

Other operating expenses were $191 million, up 4% from last year. The increase was primarily driven by the impact of recent acquisitions and a net increase in spending across several categories.

The provision for title policy, losses and other claims was $38 million or 4.0% of title premiums and escrow fees, unchanged relative to the prior year.

The current quarter rate reflects an ultimate loss rate of 4.0% for the current policy year, with no change in the loss reserve estimates for prior policy years.

Pretax income for the Title Insurance and Services segment was $102 million in the first quarter compared with $98 million in the first quarter of 2017.

Pretax margin was 8.6% compared with 8.2% last year.

Turning to the Specialty Insurance segment, total revenues were $113 million, up 3% compared with last year. The loss ratio in the Specialty Insurance segment this quarter was 57%, down from 60% in the prior year. Strong results from home warranty benefited from lower claim frequency.

However, the property and casualty business experienced higher than expected claim losses due to the severity.

Pretax margin for the segment was 8.7% compared with 9.1% in the first quarter of last year.

Net expenses in the corporate segment were $19 million, a decline of $5 million due to savings related to the pension termination. The effective tax rate for the quarter was 18.2%. We recorded a $4.7 million benefit related to stock-based compensation.

Excluding this benefit, our tax rate would have been 5.0 percentage points higher or 23.2%.

Debt on our balance sheet totaled $731 million as of March 31.

Our debt consists of $547 million of senior notes, $160 million on our credit facility, $21 million of trustee notes and $3 million of other notes and obligations.

Our debt to capital ratio as of March 31 was 17.4%. Cash provided by operations was $43 million compared to the $6 million 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 is from Jason Deleeuw with Piper Jaffray.

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

It's good to see the strong margins again this first quarter. Is there any help you can kind of give us for the full year in terms of where you think the margins can go? It seems like we're dealing with kind of the worst of the refi declines right now. The purchase grew a little bit here in the first quarter, commercial is a little bit stronger. So we still expect margin expansion as we get through the rest of 2018?

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

Yes, Jason, this is Dennis. Yes, we did have a very good first quarter, and you're right. Refinances are kind of flushing through the system right now. Purchase is strong, commercial strong. So if you note the market performs like we think it will be -- if the market performs like we think it will, we think there is still room for margin expansion in 2018.

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

I know, historically, you've given that target. And I know the Investor Day is coming up, the 10% to 12% target. But I guess, we can get an update on the Investor Day. Is there anything you can kind of help us for this year in terms of thinking about the margins that could, looks like you might be above that range for this year. But any other additional color?

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

Yes, Jason, this is Mark. We are thinking about revising that range in our May Investor Day. So we're kind of thinking about that right now. Last year, we were 12.1%. So obviously, a little bit higher than the high end of the range we posted in. There is room as the purchase market continues to grow. And especially, as investment income continues to grow and that obviously all falls to the bottom line. So between those 2 and just regular operating efficiencies, we feel like there is a little bit more upside than we had last year. But we're going to give more color at our Investor Day next month.

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

Great, thanks. And then, just wondering has there been any change in the marketplace competitively? Or recruitment wise or anything, given the Fidelity Stewart announcement? Just wondering if there'd been any changes that you've noticed?

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

At this stage, no. It's still very early in the process. It's going to be a long process to go through. As it plays out though, we do think there is -- there are opportunities for us and we're going to try to get season.

Operator

Our next question is from Mackenzie Aron with Zelman & Associates.

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

First question, on the agent revenue. It looks like it's been lagging the direct business for the last couple of quarters. So just curious is there more of an exposure to refi there or what might be going on, on the agent side?

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

No, it's really -- it's no different from our direct or our agency business. What we're really seeing is kind of the flushing out of the refinance business. Coming up a really tough comparison if you look from the first quarter of '17. And so, primarily driven by refinance reduction. Secondarily, continue as we mentioned earlier in another call, we continue to reprice some of the Southern California business to achieve a better return. So those are the two big factors.

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

Okay, that's helpful. And then on commercial, can you just give some color on what you're seeing in the pipeline and how we should be thinking about the rest of the year that the business continues to be, you think stronger than people expect them to be resilient?

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

Yes. They're -- I'd say -- and I surprised for us coming off a very strong '17. So kind of some background. Nothing unique in the quarter. We didn't get anything pulled from the fourth quarter, nor did we pull anything in from the second quarter. And it's not driven by a big deal. So there's -- it's just a good strong fundamental book of business right now. And we've got a strong pipeline going into the second quarter. So I'm optimistic on commercial right now.

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

Okay. And then just last one for me. On the P&C losses, what was it again that drove the higher losses this quarter?

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

Yes. We had a favorable frequency, higher severity. And so, we've got a lot of effort going on in our P&C group right now. We continue to modify our underwriting standards. We're tightening our underwriting standards. We're looking to take a little late action where we can and we're looking for better performance out of this group in 2018.

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

Okay. And actually, if I can sneak one in more. On pricing, just curious if post-tax reform you are seeing anything competitively or if there's been anything from the regulatory front that would suggest that maybe regulators are looking at premium rates, given the ROE benefit?

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

We saw a little bit of noise, but I really don't think it certainty. But I don't think that there'll be any significant reaction to us from our pricing standpoint. I mean our rates are adequate, our rates are fair, our rates are delivering an appropriate return for us. And at this stage, I do not see any broad-based issues from the rate perspective from tax reform.

Operator

Our next question is from Mark Hughes with SunTrust.

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

Do you think properly April so far purchase orders flat compared to last year, is that right?

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

That's correct. We started the month very slow, probably some timing for holidays. We've been building all through the month. But right now, we're flat. And looking forward, I'm optimistic. We may see some growth in the transaction volumes. But we're facing -- what we faced over the last year plus, and that is across most of our markets, we've got inventory shortages. So we've got the dynamic of lower transactions, but higher purchase prices which is driving a revenue up are off the level.

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

And then anything you can say in terms of recent daily trend on refinance orders?

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

Stabilizing right now. But obviously, will be dependent on interest rates. Stabilizing around a 1,000 orders per day, and we've adjusted our cost structure accordingly. It's hard to call when we'll hit the trough on the refinance volumes, but we're down to about a 1,000 a day. And by the way, that represents about a little less than 10% of our direct revenue. So we'll start on far or less of a component of our revenue and it has historically been.

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

And then, Mark, could you give us sort of the shorthand on sensitivity to interest rates as the interest rates move up. What does that mean for your investment income or EPS?

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

Well, in the past, we've kind of given a rough benchmark that said that every time the Fed raises rates 25 basis point, we would incur about $12 million annualized benefit to our investment income and that's laid out in the first quarter here when the Fed rate in December, we actually had exactly $3 million more of investment income in the title segment in Q1 than we did in Q4. So I think that's the rough benchmark of what we expect going forward as well.

Operator

(Operator Instructions) Our next question is from John Campbell with Stephens Incorporated.

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

Mark, just might be related to the new accounting changes. But why was the corporate investment revenue negative in the quarter?

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

So we have a deferred comp plan, about $90 million in deferred comp. And changes in the value of the deferred comp plan run through the investment income. But they're exactly offset in mere by a change in personnel costs, right? So you can see a -- we had loss of $1.1 million of investment income, but we also had roughly the same amount as the decrease in personnel expenses. So they really offset each other. But to answer your question, it changes in our deferred comp plan, which really don't have an effect on earnings on the pretax income but it does swing investment income.

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

Okay. And then I want to make sure I get this down correctly. Back to the investment revenue title. So it didn't seem like there's a lot of seasonality there. So there's $41 million or so in the quarter, that's, I guess a sustainable run rate and then you expect a lift base on rates? Right?

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

Yes. Yes, so when the Fed rate in March, we would expect starting in April to have higher investment income. So yes, we would expect incremental higher revenue, reinvestment income in Q2.

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

Okay. And then last one for me. Just updated thoughts on capital allocation and buyback, some in stocks come in a little bit here, any updated thoughts there?

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

No real updated thoughts. You know our strategy has just been consistent. We're always looking at buyback. We obviously haven't done some for a few years but it's something we always evaluate and I'd say the M&A pipeline is fairly robust. So there's a lot of opportunities we're seeing out there in the marketplace. But obviously capital management is something that we're really focused on and hopefully we can make some investment at some point this year.

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

Okay, and if I could maybe squeeze in one more. I do think this is important. Going back to the question around the premium rates for the industry, I mean obviously, I guess as MGIC or the mortgage insurance guys cutting some rates. I know that drove some concern with investors. Dennis, I guess best you can, could you maybe just give us an idea why you think that title premiums might or might not be at risk or any kind of color you can provide there?

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

Again, like I said, I think our returns are appropriate. And I think our rates are appropriate and we follow all the guidelines. I just don't see a lot of pressure here. Now I can't predict the future here, but we think the rates are appropriate where they are right now.

Operator

Our next question is from Bose George with KBW.

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

Actually the only one I had was just a clarification on the investment income question earlier. So with that -- going forward with that deferred comp piece not being there, the -- does the corporate segment just, the investment income there, sort of goes back up by the -- that $4-plus million and then everything else just stay the same incorporate, is that right?

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

Yes, yes. I think, that's correct. Yes, our run rate of a pretax loss incorporate is about $19 million. And so, if investment income goes back up to plus $2 million or $3 million, our personnel cost would go up $2 million to $3 million and would be -- it would be around -- same thing around $19 million of the loss incorporate roughly.

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

Okay. The -- but then when you think about the investment income on a cumulative basis, it's still -- I guess what I'm trying to understand is since this quarter, the investment income was impacted by the deferred comp issue. But it was there basically just an offset on the expense side that sort of reduced the bottom line impact or offset the bottom line impact?

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

Yes. It was completely offset by a reduction in personnel expenses in -- completely offset. So the benefits that we talk about for our portfolio and our 10/31 exchange with this, substantially all of that benefit is in the title segment. You're not going to really see in the corp. Corp is -- what the investment income is in corp, is really changes in our deferred comp plan, has to run-through investment income.

Operator

(Operator Instructions) Our next question is from Mark DeVries with Barclays.

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

Mark, you just commented on how the M&A pipeline was relatively robust. Can you just give us a little bit color on what -- where the strength is? Where you're seeing the most opportunities? Is it in agents or kind of nontitle businesses?

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

Yes, I'll start with that one. So I said both. So we always look at the title-related companies. And we are -- we have -- I would say some of those businesses that are in the pipeline that we've been looking at for quite some time, there's also a different category, which is just other products and services, they're not really title rated but are certainly tied to our core business. So it really enhanced the strength of our core business. And so, we're looking at some companies that are not title and settlement related, but are certainly very strategic to what we're thinking about. So these are really opportunistic transactions. Sometimes, we'll spend a lot of money on M&A in one year and sometimes we won't. But so far, what we're seeing right now is the fairly healthy pipeline for M&A deals just early in the year.

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

Okay. So given the shape of that pipeline, you might anticipate spending more capital this year on that versus returning to shareholders?

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

Well, that's hard to say. When we talk about returning to shareholders, we returned about $160 million or so through the dividend, based on our current run rate. So whether we get that much, it's hard to say at this point.

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

This is Dennis. It's always going to be the lumpy here for acquisition. But just kind of follow up what Mark said. In the first quarter, we had a few deals with a small title agency up in the (inaudible) with Russell brought in the Bank of America late in the lease business, relatively small from our perspective. We continue to look for acquisitions in the title space to tuck-in acquisitions there. We've got a number of those we're looking at. We're looking at information companies to help the title automation and like Mark said, looking at a couple of deals that are outside the core title but very complementary of the core title. And so we're hoping to close some of these over the next couple of quarters.

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

Okay. Got it. And then, looks like the paid claims -- at least title claims were down pretty meaningfully this quarter, anything driving that? And unrelated question, I think on just the provision rate. I think Mark, when last time you commented on it, I recall you said that, that was probably, at least this is likely to go up from here as it was to go down, any changes on that for you?

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

First of all, on the loss rate, I think that's probably still our view. We feel very comfortable looking at 4.0% this year, based on what we're seeing. Our claims are coming in sort of the in line, if not little bit better than our expectations. But I think we're very comfortable with 4.0% as we see here now. In terms of paid claim to claims following, there's always a little bit of a seasonality with paid claims in the first quarter. Usually, it's a little bit higher in Q4 as we try to close out some of the deals in Q1, it's always a little bit low in terms of pays. But there's nothing other than that, that I would point to. I think our paid claims are starting to kind of bottom out though. I think when you look at what we expect for 2018 versus '17, it's going to be roughly the same in terms of pays.

Operator

There are no additional questions at this time. 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 number of 13678579. The company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.
