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FAF - Q2 2018 First American Financial Corp Earnings Call

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## CORPORATE PARTICIPANTS

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

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

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

## CONFERENCE CALL PARTICIPANTS

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

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

## PRESENTATION

**Operator**

Greetings, and welcome to First American Financial Corporation Second 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 this call is being recorded and will be available for replay from the company investors' website for a short time, by dialing (877) 660-6853 or (201) 612-7415 and enter a conference ID 168-1408.

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

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

Good morning, everyone, and welcome to First American Second Quarter 2018 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 fact. These 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 circumstance or events that occur after the date the forward-looking statements are made.

Risk and uncertainties exist that may cause these results to differ materially from those set forth in these forward-looking statements.

For more information on these risk and uncertainties, please refer to today's earning release and the risk factor 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 at www.firstam.com.

I will now turn the call over to Dennis Gilmore.

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

Good morning, and thank you for joining our call. Today, I'll review our second quarter results and then discuss our outlook for the remainder of 2018.

We are pleased with our second quarter results. Our earnings per share increased 26% to $1.37. The spring selling season continues to align with our expectations.

Purchase revenues were up 7% this quarter, driven by higher fees profile, as we continue to benefit from rising home prices. Revenues were up 4% this quarter in our commercial business, where we continue to experience healthy demand across most geographic markets.

Refinance revenues dropped 13% during the quarter, as mortgage rates moved higher. However, profit building in our central lender business has significantly improved as a result of previously implemented cost reductions.

Overall, our title segment posted a pretax margin of 15.3%. Favorable market conditions combined with prudent management of our investment portfolio and our bank, discipline in our underwriting processes and efficient management of our cost structure drove our strong results this quarter.

In the Specialty Insurance segment, total revenues increased 4%, and we earned a pretax margin of 8.4%. Our home warranty business continues to perform well, with operating revenues increasing 7% during the quarter.

We continue to see positive results from our ongoing improvements to our contractor network and service operations.

Our property and casualty business had a higher loss ratio due to higher severity. However, the loss ratio for the segment improved modestly to 61%.

During the quarter, we acquired 4 companies for $53 million. The most significant acquisition is PCN, which has a software platform known as Safe Escrow that enables a more efficient, secure closing process.

PCN expands our product offerings to title agents and we anticipate will drive additional deposits to our bank. We also acquired FirstFunding, a small specialized warehouse lender that facilitates financing for correspondent mortgage lenders. Through this acquisition, we will explore ways to further enhance the closing experience for our customers. Lastly, we acquired 2 small title agencies in Florida and New York.

Our outlook for the remainder of 2018 remains positive. Given the ongoing economic expansion, current trends in the housing market, we expect continued revenue growth in our purchase business.

Our commercial business has a healthy pipeline, with open orders up 11% in the quarter. The company will also continue to benefit from strong investment income.

First American is well positioned in the industry and remains committed to deploying capital in a manner that delivers long-term value to our shareholders.

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

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

Thank you, Dennis. In the Title Insurance and Services segment, direct premium and 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 an 8% decrease in the number of direct title orders closed.

The average revenue per order increased to $2,599, primarily due to higher residential real estate values, an increase in the average revenue per commercial owner and a shift in the order mix to higher-premium commercial transactions.

The average revenue per order for purchase transactions increased 7%, while the average revenue per order for commercial transactions increased 8%.

Agent premiums, which are recorded on approximately a 1 quarter lag relative to direct premiums, increased 1%. The agent split was 78.6% of agent premiums.

Information and other revenues totaled $260 million, up 3% compared with last year. Higher revenues from recent acquisitions were partly offset by the impact of lower refinance activity.

Investment income within the Title Insurance and Services segment was $52 million, up 49% from the second quarter of last year. Our investment income continues to benefit from higher short-term interest rates, including in our cash and investments portfolio, tax-deferred property exchange business and escrow balances. We expect investment income to continue to grow in the third quarter given the Fed's June rate increase.

Personnel cost were $427 million, up 3% from the prior year. This increase is primarily driven by the impact of recent acquisitions. Other operating expenses were $202 million, up 1% from last year. The increase was primarily driven by the impact of recent acquisitions, largely offset by a decline in production-related expenses.

The provision for title policy, losses and other claims was $44 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 $210 million in the second quarter compared with $197 million in the second quarter of 2017. Pretax margin was 15.3% compared with 14.8% last year.

Net expenses in the corporate segment were $18 million, a decline of $5 million due to savings related to the pension termination. The effective tax rate for the quarter was 23.2%, in line with our normalized tax rate of 24%. Cash provided by operations was $211 million compared with $229 million last year.

Notes and contracts payable on our balance sheet totaled $736 million as of June 30, which consists of $547 million of senior notes, $160 million on our credit facility, $21 million of trustee notes and $8 million of other notes and obligations.

In addition to these notes and contracts payable, we also have $96 million of secured financings payable related to our FirstFunding acquisition. These liabilities are offset by $96 million of secured financings receivable, which are loans to correspondent mortgage lenders that are secured by mortgages. These new offsetting line items on our balance sheet will be reflected in our 10-Q.

As Dennis mentioned, we acquired 4 companies this quarter for an initial cash consideration of $53 million.

In 2017, the aggregate revenues for these businesses were $39 million, and the aggregate pretax earnings were $8 million.

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 Mark Hughes with SunTrust.

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

Can you talk a little bit more about that commercial order growth, up 11%. Is -- was that fairly even throughout the quarter and has that persisted into July?

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

Yes. Mark, this is Mark. Yes, commercial we're seeing a big pickup in orders, as you said, 11%. I would say it was pretty evenly distributed throughout the quarter. So far in July, our commercial orders are actually down, about 5% year-over-year. But as you know, commercial orders are kind of lumpy, and -- but we see a pretty good pipeline heading into the second half of the year here.

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

And since you touched on it, on purchase orders how do they look in July?

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

July purchase orders. In terms of year-over-year are down about 1.5% so far this month.

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

And then refi?

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

That's relative to last year. And then refi is -- so far in July, it's down about 13% versus last year, about 13% versus last month.

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

Mark, this is Dennis. I would only add on the purchase -- excuse me -- is that we're running down about 1% as far July. But our resale is about flat, and our new homes are down a little more. New homes are always lumpy too. So we're pretty optimistic going into the second half on the purchase business right now.

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

Then final question. The impact on investment income from the June rate hike, what is the -- how should we look at that?

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

Well, we've talked about the fact that we get about $12 million annualized every time the Fed raises 25 basis points, so they raised in June. We should get a little bit better than that here in the third quarter in terms of an annual benefit, and so that should be flowing through in Q3 here. So we're pretty pleased with how our investment income has been progressing. We've been talking for quite some time now about how -- when rates rise, we're going to do better in that environment. And one of the reasons is because we have a bank and it's a very strategic asset for us, and we're seeing the benefits of the bank, and we think it'll continue into the third quarter.

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**Operator**

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

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

Just on the investment income, can you just remind us, Mark, was there anything that changed with the accounting change that happened last quarter that flowed through this quarter?

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

There's nothing -- everything that happened with the accounting change was sort of the mark to market on equities. That all flow through net realized gains. And so when you look at the title segment, the $52 million of investment income we have in the title segment is -- I would say there's nothing really onetime in there at all. Everything that is onetime goes through net gains. The only exception I would say to that is that we did -- as Dennis mentioned, we did an acquisition called FirstFunding that closed this quarter. We had about $1 million of investment income that flowed through Q2 that wasn't there in Q1. So that was the only thing I would point out.

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

Okay, perfect. And then just on the acquisitions this quarter, the $39 million revenue. Rough split between how that'll flow through on direct versus information and other, can you give us some sense of how that'll break out?

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

So roughly, it'll be about 12% or so in investment income. And the other 88% is basically half in info and other and half in direct premiums and escrow fees. That's the rough breakout.

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

Okay, perfect. And then just as you look out the rest of the year and into next year for the M&A pipeline, is there -- are there further opportunities that you guys would be looking at?

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

Yes. Our pipeline is pretty full right now. We're looking, as we always do, adding in title opportunities in our key states. So if there are opportunities, you'll see more of those in the second half of the year.

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**Operator**

Our next question is from Bose George with KBW.

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

Just in -- on the commercial side, just given the strength of the fee profile growth, were there any large deals this quarter that kind of pushed those numbers up?

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

No. Just an overall strong quarter for us.

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

Okay, great. And then in terms of the margin expectation, just given the strength this quarter, do you think 2018 you could come in above that 11% to 13% that you guys have guided to?

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

Well, I think that the guidance we gave at the Investor Day is still accurate, 11%, 13%. But year-to-date, we're running at 12%. So clearly, I think we'll be at the higher end of that range for the rest of the year.

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

Okay, great. And then actually, the -- in terms of the acquisition that you did, the 9 -- I think it was $9 million of earnings, is that an after-tax earnings number?

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

That's a pretax number, Bose. Pretax.

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

Pretax. Okay. And then just one last one. When you think about capital use, clearly you're generating a lot of free cash, the -- apart from the dividend, is -- should we think about most of that cash being used not towards these acquisitions since buybacks are at the moment, I guess, not on the table?

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

I think our strategy is going to be the same. We're going to continue to invest in the business through CapEx like we have been. But we're probably at about the level we want to be right now. We'll continue to look for the acquisition opportunities. On that front, we'll only deploy if we think we can get the returns we expect, and then we'll continue to look at the dividends, and we'll consider share buybacks too if appropriate going forward. So our strategy really hasn't changed going forward.

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**Operator**

Our next question is from John Campbell with Stephens Incorporated.

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

Yes, just on the acquisitions, can you provide just a little more color on the kind of margins that you guys are expecting from each and kind of the time line of when you expect contributions from those acquisitions?

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

Yes. Sure. So we talked about how -- at least last year, when you look at the acquisitions that we did, on a aggregate basis, they did about $39 million of revenue and $8 million of pretax earnings. So that's about a 20% margin collectively. It's not going to change our overall margin materially, but they are somewhat accretive to our title segment margins. And I would just say that with these -- there's not a whole lot of cost synergies. These are just more very strategic acquisitions that are going to allow us to improve the closing experience for our customers and do some other things. So they're -- we're really excited about.

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

Minimum integrations. We'll see the benefits by the fourth quarter.

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**Operator**

Our next question is from Geoffrey Dunn with Dowling & Partners.

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

Mark, you've been very clear about the benefit you get on investment income from rate increases. But I certainly didn't foresee the jump that you had this quarter. Is there any way you can break out or break apart your NII a little bit to give a little bit more clarity into the biggest moving parts? So I don't know if you can give some sort of breakdown and how it compares year-over-year to show us what the biggest moving components are?

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

Yes. I can do -- I can give you some more information on that, Geoff. So the first thing I'd say -- a couple of things. The investment income that we had this quarter surprised us a little bit. It was higher than our expectations. It's very broad based. So we're getting higher investment income from our investment portfolio, from our bank, from our escrow deposits, from 1031 Exchange, from operating cash. It's really broad based. When you break out the $10 million change sequentially, again, $1 million of it came from the FirstFunding acquisition. About $5 million of it was because of rates, just the fact that when the Fed raised in April we're going to make $5 million more based off of our deposits. And then the other $4 million, sequentially, is just because we've had higher balances. And I think that's where we're probably exceeding our expectations. We've had higher balances because commercial has done better, and we have higher commercial deposits. We've put a little bit more cash in our investment portfolio, so our balances are also higher. And that's, I think, one of the reasons why we're sort of exceeding our expectations there on the investment income this quarter.

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

How about...

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

But I would say that we think it's sustainable though. We expect it to continue to grow in the back half of the year.

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

What about specifically in 1031? Is that showing a big jump as well over the last couple of quarters?

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

I would say that the jump in 1031 is consistent with the jump that we're getting in cash and escrow. So I wouldn't say it's outsized. I mean, it's certainly up. When you look at investment income in our 1031 business, this quarter was about $8 million. And in Q1, it was about $6.2 million. So we're getting about a $1.8 million sequential benefit, but that's out of $10 million, right? So that's just one bucket out of several. So again, it's real broad based.

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

Okay. And then -- so I guess when you look at the third quarter, you're seeing the rate increase in June that you saw in April, I guess everything else held equal, it seems like it's more than a $12 million annualized bump here. Given everything you discussed, what's the prospect of this being $60 million next quarter versus $55 million? I'm not sure I quite understand the full driver here?

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

Yes. $60 million seems like a stretch. I think when we look at next quarter we're fully going to get the benefit from the rate increase. It's unclear what's going to happen with the level of deposits. I would say that we're sort of exceeding our expectations in terms of the economics that we're getting for every time the Fed does increase rates. So we might do a little bit better than $12 million, but not -- I think that the sequential change we got this quarter is not to be expected going forward. It's going to be closer to $12 million than we got this quarter.

**Operator**

(Operator Instructions) Our next question is from Jason Deleeuw with Piper Jaffray.

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

You've got Eric Robinson on the line. I just wanted to dive into the purchase orders a little more, the ARPO there and the revenue [for]. Do you guys think that the 7% increase there is sustainable relative to home price appreciation trends right now? Or how do you guys feel about that?

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

If home price appreciation continues at the click it's been, I think it is sustainable. But we're starting to see, for the first time in probably 2, 3 years, some increases in some key markets on inventory increases. So if we start to see the inventory out there start to normalize, I think that what we'll end up seeing, maybe early '19, we'll see more transaction volumes, a little less price appreciation. But again, that's our view on the market. But it really would be driven by the inventory issues, sequentially.

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

What's -- could you dive into some of those markets a little more? Where is (inaudible)?

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

It's actually some of the hotter markets right now. So we're seeing some inventory increases in Seattle and Portland, in Denver [is up], but they're small. So it's just the very first beginning signs of some of inventory increases. So, obviously we're watching it closely. I mean overall though we would prefer a market with a little less price appreciation and more transactions. I think that would be a more normalized market, which would be -- an actually a healthier, better market for us. So again, we don't control that, but we'll see how it plays out.

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

Got you. And then just in terms of some of the acquisitions that you made this past quarter and the ones related to improving the closing experience, what pain points do you see your customer see that you think FAF can help improve on that closing experience?

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

Well, overall we're very focused on advancing the closing experience, driving it through additional closing experience. But specifically, the largest acquisition we did was PCN, and PCN provides a number of products and services to agents to improve closing experience. One specific product is called Safe Escrow. And it really aligns with our strategy we talked about at the Investor Day, and that is our key strategy is to help do disbursements for our agents, which allows our agents to have fewer wire fraud risks, allows us to be more efficient operating with the agent and drive additional deposits for the bank. And that software platform, Safe Escrow, aligns with that strategy, so we're excited about that opportunity.

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

Got you. Cool. And then just on the commercial side of things. I know you mentioned that strength has been broad based. I guess just in terms of regions and then from size of deal is there -- are you seeing stronger deals like, say, into the $5 million category? Or where you seeing the strength in (inaudible) essentially from (inaudible)?

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

Really seeing strength across pretty much the whole market. So it's not driven by large deals. There's no -- there's nothing unique about the deals right now. As Mark mentioned earlier, we're encouraged by our orders being up 11% in the quarter. Starting the third quarter a little soft on orders but, again, lumpy always. The other thing I'd say is the only markets we're seeing -- only significant slowdown has been New York, and that's been ongoing now for a number of quarters. So again, we're optimistic going in the second half on commercial.

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**Operator**

Our next question is from Mark DeVries with Barclays.

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

First question for Dennis. Dennis, how much more room do you see to improve the margins in home warranty?

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

Specifically, home warranty. I think the business will continue to get better. We continue to invest in that business pretty aggressively on the technology front to just improve our claims handling experience and our customer experience, so a lot of investment going on there. I do think that the margins will continue to improve on that. But again, just everybody is aware, that business can be a little lumpy depending on weather, environments during the summer. So has a little different cyclically than our title business. Optimistic about the business. So we like its trends. We like its growth curve, and we like its performance.

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

Okay. But any sense of just like range of magnitude of how much more upside you see in the margin?

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

We typically don't break that out. But I do think there's upside in that business.

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

Okay, got it. And then finally for Mark. Could you just discuss your expected IRRs on these acquisitions you've been doing and how those compared to buybacks here?

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

Yes. I mean every time we're looking at acquisition we want at least a 12% to 15% IRR. I would say with these we think we can get that. And that's assuming really no revenue synergies at all. So we feel like they're going to be really good investments on a stand-alone basis. They're immediately accretive to the P&L. And there's also optionality on the upside. So we feel like they're going to be definitely a good use of capital and very aligned to our strategic vision.

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

Okay. And how does that compare to how you evaluate buybacks here in terms of the IRR?

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

I would say they're more attractive just because we can enhance the products that we offer our customers which, obviously we can't in the buyback. These are very strategic. It's going to allow us to take more deposits in the bank, derisk the transaction. So we'd always rather invest to grow our business, assuming the IRRs are the same, and that's kind of what we did here.

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**Operator**

We have a follow-up question by Bose George with KBW.

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

Just wanted to ask about the regulatory front. Had there been anything that you've heard from state regulators, just anything on the pricing front that's different?

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

No. No change. No issues.

**Operator**

Ladies and gentlemen, there are no additional questions at this time. That 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 13681408. The company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.