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FAF - Q3 2018 First American Financial Corp Earnings Call

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

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 this call is being recorded and will be available for replay from the company's investor website and for a short time by dialing (877) 660-6853 or (201) 612-7415 and entering the conference ID 13683867. And now I'll 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*

Good morning, everyone, and welcome to First American's Third 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 after the date the forward-looking statements are made. Risk and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements. For more information on these risks and uncertainties, please refer to this morning'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 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*

Thanks, Craig. Good morning, and thank you for joining our call. I will review our third quarter results and then discuss our outlook. This quarter, we posted earnings of \$1.34 per share on revenues of \$1.5 billion. In our title segment, purchase revenues were up 1% this quarter, driven by higher fee profile.

Revenues were up 5% in our commercial business as we continue to experience healthy demand across the majority of our markets.

Refinance revenue dropped 23% during the quarter and now accounts for just 9% of our direct title revenue. Although rising rates continue to negatively impact our mortgage volumes, the increase in short-term rates helped drive our investment income up 61% relative to last year. The growth in investment income has had a material impact on our earnings throughout 2018. And this trend will continue as the Federal Reserve raises rates. Overall, our title segment posted a pretax margin of 14.6%.

Turning to our Specialty Insurance segment, revenues increased by 5% during the quarter and the segment posted a pretax margin of 5%. Our home warranty business continues to perform well with revenues up 8%, although we experienced higher claim severity largely in line with normal seasonal factors.

The loss ratio for property and casualty business declined this quarter due to lower claim frequency. Overall, the loss ratio for the Specialty Insurance segment was unchanged at 65%.

During the quarter, a number of factors reduced housing affordability, contributing to a well-documented slowdown in the purchase market. In the third quarter, our purchased open orders declined 4%. For the first 3 weeks of October, this trend has continued, with purchase orders down 5% compared to last year. In a response, we continue to make the appropriate adjustments to our cost structure. Heading into the fourth quarter, our commercial pipeline is strong and investment income will continue to rise as a result of the Federal Reserve September rate hike.

Longer term, our continued focus on operating efficiency, combined with rising investment income and a healthy economy will enable us to maintain our strong financial performance. Given our unique assets and commitment to innovation, First American is well positioned and remains focused on 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.

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 down 1% compared with last year. This decrease reflects a 14% decline in the number of direct title orders closed, largely offset by a 16% increase in the average revenue per order.

The average revenue per order increased to \$2,667, primarily due to an increase in the average revenue per commercial order, higher residential real estate values and a shift in the order mix to higher premium purchase and commercial transactions.

The average revenue per order for purchase transactions increased 6% while the average revenue per order for commercial transactions increased 10%. Agent premiums, which are recorded on approximately a 1 quarter lag relative to direct premiums, were down 2%, largely driven by lower volumes in California. The agent split was 78.9% of agent premiums.

Information and other revenues totaled \$196 million, down 2% compared with last year. Declining revenues from lower mortgage origination and foreclosure activity were largely offset by revenues from recent acquisitions. Investment income within the Title Insurance and Services segment was \$61 million, up 61%. Higher average balances and the increase in short-term interest rates drove higher interest income in the company's investment portfolio and cash balances. Higher short-term rates benefit our escrow deposits, operating cash, cash deferred property exchange business and our bank where we held \$4.8 billion in cash and debt securities as of September 30. We expect investment income to continue to grow in the fourth quarter, given the Fed's September rate increase.



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Personnel cost was \$426 million, up 1% from the prior year. This increase is primarily driven by higher personnel costs associated with recent acquisitions and higher employee benefit costs, which was significantly offset by a decline in incentive compensation. Other operating expenses were \$201 million, up 2% from last year. The increase was driven by a \$5.7 million expense related to a legacy regulatory matter. The provision for title policy losses and other claims was \$46 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.

Tax income for the Title Insurance and Services segment was \$207 million in the third quarter compared with \$181 million in the third quarter of 2017. Pretax margin was 14.6% compared with 13.0% last year. Net expenses in the corporate segment were \$17 million, a decline of \$152 million due to an expense related to the completion of the company's pension plan termination in the third quarter of 2017.

The effective tax rate for the quarter was 22.6%, in line with our normalized tax rate of 24%. Cash provided by operations was \$231 million, up 4% compared with last year.

Notes and contracts payable on our balance sheet totaled \$735 million as of September 30, which consists of \$547 million of senior notes, \$160 million on our credit facility, \$20 million of trustee notes and \$8 million of other notes and obligations.

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 Jason Deleeuw with Piper Jaffray.

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

The revenue was down -- the title revenue was down, but the margins were up and helped by the investment income. So can you just help us think about the margins going forward? Can we still get some expansion there even with the slower purchase order volume?

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

Yes, Jason. This is Dennis. We think our margin objective we set out, the 11% to 13%, is absolutely viable for '19. I think the purchase market's going to go through a little bit of a reset as it's happening right now. But to our benefit, right now will be growth in investment income, growth in our commercial business. So all in all, we think the range we've given is accurate. So -- it's -- we are confident going into '19 right now.

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

Okay. Sounds good. And then the next one. Just on the competitive strategy or how you're thinking about the next year if the Fidelity, Stewart acquisition is approved, is there any change in your thinking competitively that -- or anything that you would do differently if that transaction is approved?

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

No. We'll continue to do what we've been doing. And we continue to actively recruit both direct employees and agents.

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

Got it. And then just the last one. The order volumes for First American, they were a little bit softer than, kind of, the industry trends. Is there any specific factor you can call out as to explain the difference?

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

Yes, I don't actually think that's accurate, by the way. I think we were following industry trends. We were down 4% in the quarter, which is matching our -- and that trend's continued, by the way, into the October timeframe. So we're actually tracking industry trends. We're not losing shares. So I think when you're referencing the competitor, you probably should backup the acquisitions on that side.

Operator

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

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

Just wanted to get your latest thoughts on share buybacks, little volatility in the market, strong balance sheet. How are you looking at that these days?

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

Mark, it's something we're discussing. We're evaluating the buybacks relative to other opportunities we have. We got a real strong capital position, and every day that passes, it just gets stronger and stronger. So given the recent sell-off, buybacks are certainly more attractive now than they've been in some time.

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

And then any -- I think you have suggested the commercial pipeline is strong. Anything -- order flows, any other specifics here at the start of the fourth quarter?

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

No. Other than good third quarter and that strength going into fourth quarter, so we've got a very strong pipeline going into the fourth quarter. And we're also optimistic on commercial heading into '19. We're offered in a very strong economy and, across almost all of our markets, we've got strength.

Operator

Our next question comes from the line of Mark DeVries with Barclays.

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

Staying with the commercial business. The ARPO there was up a fair amount year-over-year. Were you seeing a mix shift towards larger transactions in the quarter? And how does that mix for, kind of, larger versus smaller look in your pipeline?



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

I wouldn't say we saw like a shift in terms of huge deals, like the million-dollar-plus premium deals. We're just -- what we're seeing is -- we're just seeing a lot of just high quality assets trade hands that our national scope that have -- a lot of them have multistate portfolio deals we're doing. So we're just -- we're continuing to see a real broad-based strength in commercial, and we feel like the pipeline's pretty strong heading into the fourth quarter here.

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

Okay. And I think, Dennis kind of answered this. But can you give us an update, sorry if I missed it, on where we stand so far quarter-to-date on both the residential purchase and commercial order accounts?

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

Yes, let me take the residential side. We were down 4% on the quarter on transactions, on purchase orders. That trend's going on, continuing into October. Right now, month-to-date, we're down about 5%. So no real difference from the quarter. I think what's going on right now is the housing market, the purchase market is really -- I'll use the word, resetting, recalibrating and probably moving more towards the sellers market to a balanced market. I think we're looking for '19 to have home price depreciation starting to slow down. We anticipate inventory levels going up, probably time on market going up. Because all in all, I think we're moving probably to a more balanced market. But when we go through the transition, we'll probably be chopping. The other thing too is, just to make sure everybody's clear, we're optimistic going into '19. Let's not forget we're offering in a very strong economy. We've got a wage growth going on, we got a very strong demographics happening, but to our favor right now for housing. So while we're probably going through this resetting, we're optimistic going into '19, especially with spring selling season.

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

Okay. And on the higher ARPO and the residential side. Is that just all home price or are you also seeing a bit of a mix shift towards states with just generally higher prices?

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

Mostly, it's just rising housing prices. We think it might -- over the next several quarters, you'll start to see our purchase ARPO fall a little bit, simply because housing prices are leveling off, and the fact that when we had raised rates a year ago, starts -- some of that is starting to lap. But we're still seeing positive purchase ARPO growth. And it's primarily going to be driven by the rising housing prices, not really mix shift geographically.

Operator

Our next question comes from the line of Mackenzie Aron with Zelman & Associates.

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

Question just on what we're seeing on the agent revenue side being a little bit weaker than the trend in the direct premium and escrows over the last few quarters. I know there were some changes in California a few quarters ago. So just wanted to kind of dig in on what we're seeing there, when those changes should be lapped?



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

It's happening right now. We were down \$14 million, and that's all California. So we continue to reprice California. It was also -- an agent was purchasing in California that impacted us. But we continued to deemphasize California unless we can get the right price points. But I think that, that trend will probably run itself on the course over the next quarter or 2.

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

Okay. That's helpful. And then is there any update you can provide us just M&A opportunities of agents or smaller -- or on the other side of the businesses in terms of the M&A pipeline as well?

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

Sure. Yes. We had a -- we actually had a quiet quarter. We were close on a few deals, and were actually [built the part on] -- with the market changing, again, I'm using the term rebalancing, we just didn't think that the prices were valid at the point we were ready to do the deal. So looking forward, I think we'll see better opportunities in '19 as this market goes through this transition. So we've got a lot of excess capital from that perspective. And if the deal makes sense to us and it's the market we'd like to get -- enter, we'll be aggressive.

Operator

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

Carter Trent

This is Carter Trent taking the place of John Campbell. On the residential market, I know we're in a bit of a reset stage currently. But when do you expect a shift to buyer's market as far as timing next year? I know you don't have a crystal ball, but if you had to guess, do you think purchase volumes would be down next year?

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

Hard to call -- hard to make the call right now. I mean, the "resetting" is happening right now. So obviously, the key part of the year for us will be the spring selling season. And again, we're optimistic going into that time frame.

Operator

Our next question comes from the line of Bose George with KBW.

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

Going back to investment income. The math that you've given earlier, the \$12 million of investment income reached 25 basis point raise. Is that still good? Especially as, I mean, you have this one raise in September, maybe several next year. Can you just talk about how that works, whether there's any -- does it diminish as that moves forward?



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

Well, when you look back over the last year. We've obviously gotten a lot more than \$12 million for a few reasons. But going forward, every time the Fed raises 25 basis points, probably more realistic number now is more like \$15 million. And the reason it's higher is just because our balances have risen. When we gave that \$12 million number a year or so ago, we had a lot fewer balances than we do now. So it's more like \$15 million, assuming that our balances remain constant, and we actually are able to get 25 basis point increase on our deposit rate. So I think \$15 million is a more realistic run rate.

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

Okay, great. And then -- actually, just in terms of your cash balance. It looked like that went up meaningfully. Was there some consolidation on to the balance sheet or it was something else happening there?

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

It's really just the timing. We had some very large deposits that just carried over quarter end, large commercial transactions we were closing. And so it looks like we have a lot of cash on the balance sheets, which we did, \$2.2 billion as of September 30. But that's come down even close quarter. So it really has to do with the timing of in and outs.

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

Okay. And then just actually -- going back to the M&A question. Just on the data side. Is there -- are there things you are looking at that could complement what you've done in terms of those acquisitions?

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

There are. There are actually a couple of deals right now we're looking at in the pipeline. So we'll see how they play out. But there are -- we continue to look at data deals.

Operator

(Operator Instructions) Our next question comes from the line of Geoffrey Dunn with Dowling & Partners.

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

I wanted to follow up on the commercial question from before. It seems like a trend we've seen over several quarters has been maybe a bit of a slowdown in closing rates and very strong growth in the ARPO. And so I'm curious if there's a -- just a general composition shift in the marketplace or something else going on. Because it's not unique to First American, but the growth really is being driven by these ARPO numbers versus the closing results. So I was hoping you can maybe expand on that a little bit from an industry standpoint, if anything's really changing in commercial?

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

Well, Geoff, just to maybe go a little bit deeper on there. I mean, we look at kind of the stratification of the size of the deals that we close in commercial. And when you look -- like the large deals we close -- if we're getting \$1 million a premium, that's a very large transaction. We had 4 of those these quarter, a year ago we had 5. So we're not only seeing growth, as I mentioned earlier. What we are seeing though is, when you look at deals in the [\$250,000] to \$1 million range, this quarter, we had 53 of those deals and a year ago, it was 39. So we have seen an increase in, I like I said before, just higher quality transactions, not the mega deals, but a higher frequency of, kind of, the middle-range deals that's driving our ARPO up



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

And what type of a deal is like the [\$250,000] to \$1 million type of range?

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

Just all -- yes, all kinds of commercial properties. I mean, I don't have a great answer for that. But there -- I'd just say the mid-market is continuing to be really strong. We've seen softness in New York, which we've talked about, but a lot of our other offices are doing strong in terms of types of properties, whether it's industrial or hotels or multifamily. Again, we're seeing broad-based strength across all of those asset classes.

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

All right. So this is really kind of mid-mark general -- mid-market general?

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

Yes. Yes.

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

Okay. And then Dennis, I know you typically give just the first 3 weeks of purchase. But I assume -- kind of a similar number overall for the first 3 weeks kind of sequentially down mid-single digit for overall orders?

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

On purchase, yes, we're down 5%. So tracking really is last quarter.

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

But overall, probably, a similar number through a refi of the 2?

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

Refis were running about 800 a day, Jeff.

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

Jeff, we've dropped from about 900 to 800 a day in the quarter. But again, it's kind of volatile right now. I would point out though, Jeff, on refinance, it's right now less than 9% of our direct revenue, but it's not a significant contributor of profitability.

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

That's why I kind of assumed that the overall number is probably similar to the purchase.



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

Obviously, we hope it stabilizes soon, but it is what it is.

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 13683867.

The company would like to thank you for your participation.

This concludes today's conference call. You may now disconnect.

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