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PRESENTATION

Operator

Greetings and welcome to the First American Financial Corporation First 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 number 13689517.

I'll now turn the call over to Mr. Craig Barberio, Vice President Investor Relations, to make an introductory statement. Please go ahead.

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

Good morning, everyone and welcome to First American's earnings conference call for the first quarter of 2019. 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 these forward-looking statements to reflect circumstances or events that occur after the date these 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 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 insights 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 financials, please refer to this morning'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*

Thanks, Craig. Good morning, and thank you for joining our call. I'll begin with a review of our first quarter results and then discuss our outlook for the remainder of 2019.

First quarter earnings per share were $0.97 or $0.74 excluding net realized investment gains due to an increase in the fair value of our equity securities. The company performed well in the first quarter despite the ongoing challenges in the housing market that began in the second half of last year. While our title segment revenues declined, effective expense management and growth in our investment income drove continued strong earnings and margins. In our title segment, purchase revenues declined 7%, refinance revenues fell 16%, and our commercial revenues declined 3% compared to last year. However, we still delivered a pretax margin of 12.1%. Excluding the impact of net realized investment gains and losses, our pretax margin was 10% this quarter compared with 8.9% last year.

In our Specialty Insurance segment, our home warranty business performed strong, and our property and casualty business continued to experience high client losses. However, we are encouraged that our efforts to improve our P&C business are beginning to gain traction. The segment's overall loss ratio declined modestly to 55% with a pretax margin of 14.6% or 11% excluding net realized investment gains.

Entering the spring selling season, we have become more optimistic about the housing market, given the positive economic backdrop and the recent decline in mortgage rates. We are encouraged by April's open order trend with purchase orders only down 2%, and refinance orders up 29%, which is an improvement in the order trend we've experienced over the past 2 quarters. We now anticipate the [purchasable] market will be a more modest headwind in 2019. In addition, we expect our commercial business will deliver another strong year, and we expect to see year-over-year growth in our investment income for the next 2 quarters.

As 2019 progresses, we will maintain our focus on margin improvement while also investing for the long term through the development of innovative solutions for our customers.

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 7% compared with last year. This decrease reflects a 13% decline in the number of direct title orders closed partially offset by a 7% increase in the average revenue per order. The average revenue per order increased to $2,475 primarily due to an increase in the average fee profile from commercial transactions and a higher residential real estate values.

The average revenue per order for commercial transactions increased 11%, while the average revenue per order for purchase transactions increased 3%. Agent premiums, which are recorded on approximately a 1-quarter lag relative to direct premiums, were down 5%. The agent split was 79.1% of agent premiums. Information and other revenues totaled $170 million, down 9% compared with last year. The decline was primarily due to lower revenues from the company's centralized lender businesses as well as the contractual change for certain customers that resulted in the netting of gross revenues and cost of sales.

Investment income within the Title Insurance and Services segment was $70 million, up 69%. The increase resulted from higher average balances and rising short-term interest rates that drove higher interest income in the company's investment portfolio and cash balances. Higher short-term rates benefit our escrow deposits, operating cash, 1031 Exchange business and our bank, where we held $4.3 billion in cash and debt securities as of March 31.

Personnel costs were $381 million, down 3% from the prior year. The decrease was driven by lower salary and incentive compensation expense. Other operating expenses were $169 million, down 12% from last year. The decline was due to lower production-related costs and the netting of gross revenue and cost of sales, as previously mentioned.

The provision for title policy losses and other claims was $36 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 $142 million in the first quarter compared with $102 million in the prior year. Pretax margin was 12.1% compared with 8.6% last year. Excluding the impact of net realized investment gains and losses, pretax margin was 10.0% this quarter compared with 8.9% last year.

Net expenses in the corporate segment were $18 million, down 6% compared with last year due to higher investment income related to our cash balances and deferred compensation plan. The effective tax rate for the quarter was 22.5%, lower than our normalized tax rate of 24%, due primarily to excess tax benefits associated with the vesting of restricted stock units.

Cash provided by operations was $34 million, down from $43 million in the first quarter of 2018 due to changes in working capital accounts. Notes and contracts payable on our balance sheet totaled $731 million as of March 31, which consists of $547 million of senior notes, $160 million on our credit facility, $18 million of trusteed notes and $6 million of other notes and obligations. Our debt-to-capital ratio as of March 31 was 18.1%.

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 with Barclays.

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

I was hoping to get an update on what you're seeing through April on your open order trends in the commercial business. And also what you're seeing on mix. It does look like while commercial closed orders have been kind of down year-over-year, there's been an offset there on the average fee profile. So are you also seeing a mix shift towards larger transactions in the business you're getting?

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

Yes, Mark, good morning. This is Mark. I'll start with that. So in terms of the commercial open order counts in April, so far, for the first 17 business days, we're down 11% on an order count basis, and that's relative to the first 17 days in April of 2018. So we are seeing a decline. But as we've talked about in the past, a big driver is the fee profile, and we are seeing a higher mix of larger deals. So even though commercial was down 3% in terms of revenue in the first quarter, we did see a higher mix of higher quality deals that's really driving that fee profile.

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

Okay. So as you think about revenues for this year in commercial, would you expect it to be flattish given kind of the -- what you're seeing both on orders and the average fee profile? Is that the right way to think about it? Or down marginally, kind of, what we -- like what we saw this quarter?

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

Yes, this is Dennis. Yes, I think we're going to see it down slightly. So kind of like we guided last quarter, we think commercial is going to be a very strong year for us. Probably, one of our top 2 or 3 years as an overall year. But we think the revenue will have a little pressure, probably down single digits.

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

Okay. Great. And then expenses were much better than we were modeling for the quarter. Is there anything worth calling out there that you did to kind of manage expenses lower?

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

Well, there's 2 things I'd say. One is, there was nothing really unusual that happened in the quarter, so we didn't get any unusual benefits on the expense line item, right? And as we talked about on the last call, I mean, we were pretty aggressive in managing the cost structure at the end of 2018. And so we actually realized those benefits so far here in the first quarter.

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

Yes. I'd only add to really what Mark just said, we're going into the beginning of '19 a little more pessimistic than we are now. So we were aggressive on our expense ratios in the fourth quarter of '18. Now -- and I'm sure I'll get the question, we're a little more optimistic on the purchase market than we were a few months ago.

Operator

Our next question come from the line of Mackenzie Aron with Zelman and Associates.

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

First question just on the corporate segment, can you just kind of maybe give us an update the way to think about the net drag there, given the accounting changes and the personnel cost?

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

Well, the corporate segment, the way that we think about it, is we just look at the pretax loss there in the corporate segment, which has been very consistent at about $18 million a quarter for quite some time now. There is going to be volatility in investment income because of our deferred compensation plans. So whenever the equity markets rise, because of our deferred comp plan, we're going to have rising investment income. But that's going to be offset by rising personnel costs, too. So those -- there's going to be volatility in those 2 line items, but they're going to net close to 0. And we don't expect much change in terms of our $18 million pretax loss going forward in the corporate segment.

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

Okay. That's helpful. And then on the investment income, I think there was a comment made that you expect the year-over-year growth to continue for the next 2 quarters. Is there anything notable in 4Q '19 that would make that comp more challenging?

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

The thing that would make it more challenging is that we -- that assumes there's not going to be any more Fed increases. Every time the Fed raised, which was 4 times last year, we went and got benefits from our 1031 Exchange business, from our banks, from our escrow deposits. And so assuming the Fed is on hold, we feel like the $70 million investment income run rate in the title segment is a good one. And so when you look at -- sequentially, our investment income didn't rise very much, it rise about $1 million or so. So we feel like we're going to have year-over-year improvement in Q2 and Q3 just because the Fed rates are higher, but once we get to Q4, we'll sort of lap those, and we think our investment income will kind of peter out in terms of year-over-year growth. Again, that assumes that the Fed doesn't change and it also assumes that there's no real change in our balances from where it is today.

Operator

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

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

Congrats on the solid results during the tough volume environment.

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

Thank you.

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

And now that we are seeing the volumes improve a little bit or at least, I guess, be down less, what are you thinking on being able to hold your expense structure here? Are you going to have to hire up for the volume improvement? Or are you kind of staffed where you need to be?

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

We're staffed appropriate for the order volume now. So yes, we're definitely more optimistic going into the spring buying season than we were just a few months ago. And like you mentioned, our order counts in April are so far down 2% [of] purchase, so that's a good sign from what we've seen over the last few quarters. Specifically, regarding headcount, we'll add a limited amount as we go into the spring and summer months, and we'll also back it up with temps and seasonal and overtime. So we're going to watch our expenses real closely going over the next few months.

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

Got it. I mean I think, a key focus here is the margins and the expansion you got in the first quarter. It was 100 bps in the title segment pretax margin improvement year-over-year. And so I'm just trying to get a sense, can we expect margin expansion then for the rest of the year? Just seems like with the volumes are improving a bit and the cost are where they're at. And then also the other OpEx, that declined $22 million year-over-year. Is that sustainable? Is that kind of the new run rate? Just how should we think of that?

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

Let's separate the questions. I'll start with the margin expansion and then Mark can take the OpEx. Regarding margin expansion, I think, over the last few years, we've grown our margin every year. Obviously, we're going to continue to try to do that. We started off the year a little stronger than we anticipated because of just strong performance and great expense controls. So sitting here now, we've got a more optimistic view on the purchase market, or said differently, we think the purchase will be less of a headwind than we originally thought. We think that we'll have a strong commercial performance again, a good investment income, so all positive. Our long-term target of 11% to 13%, obviously, is still good. And where we are right now, we think we'll be at the upper range of that target.

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

Yes, Jason, in terms of the OpEx, I think the short answer there is the OpEx is down significantly just because our order counts have been down, and about 50% of our operating expenses in the title segment are variable, so that's going to be the big driver. We see orders continue to fall, either on the refi or the purchase side. We'll continue to see savings in OpEx and conversely if they rise, we'll see that rise. So that's where it's going to trend with order counts.

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

Got it. And one last quick one. The refinance revenue per order, that was up a lot year-over-year, what are the factors driving that?

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

There's a couple factors driving it. The first one, our -- so our refi ARPO was up 20% year-over-year and typically, it hasn't changed much over the years. We've seen a big increase in commercial ARPO and the purchase ARPO but not really on the refi side, which -- and we saw that this quarter. So one thing is that we did an acquisition called PCN last year. And with that acquisition, we get escrow-related revenue with no associated orders. So it distorts the refi a little bit. So that -- of the 20% increase in ARPO, about 5% of that was related to this acquisition. So our core refi ARPO was up about 15% year-over-year, which is still higher than what we've seen. Most of that is because we have raised rates in our centralized lender business and so that's all economically driven. There's a little bit of it is because of just higher liability transactions, but most of that 15% is because we raised rates in our centralized refi business.

Operator

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

Carter Andrew Trent - *Stephens Inc., Research Division - Associate*

This is Carter taking the place of John. The information and other segment within the title business, what was the reason for the unusual year-over-year decline there? What was the [required] revenue there? Can you talk about your expectations for growth in that segment going forward?

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

So yes. So info and other, there's a couple of things that has happened. So on an annualized basis, our revenue in info and other was down $16 million in the title business. And $4 million of that because of the fact that we've changed some of the contracts with certain customers. And we used to -- especially in our appraisal business, we used to show the gross revenue and now we've netted it with the cost of the appraisal. So $4 million of the $16 million is because we've netted revenue and expenses. And then of the $12 million, about half of that, $6 million, is related to our centralized lender business. We've still seen declines in our default-related activity. And about $4 million is related to our international operations. So that's really what's driving the decline.

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

And with regards to growth, I think our comps are going to get a little easier in the second half. So I think we will not see the declines we saw here in the first quarter towards the last half of the year.

Carter Andrew Trent - *Stephens Inc., Research Division - Associate*

Okay. Great. Got you. That's helpful. And on the share repos, it looks like the share count declined sequentially. Did you guys repurchase any shares in the quarter?

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

We did a share repurchase in the fourth quarter, when we bought back 425,000 shares and so that's why the share count went down sequentially. In January, in the first week or so of January, we bought back just $2 million worth of shares. So we bought back a few shares, but it was really negligible during the quarter.

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*

I had a question about refi order activity. With the decline in interest rates, you're clearly seeing more signs of life there. In your experience, is there kind of pent-up activity and demand, and say, you get an early rush? Or is this perhaps more sustainable, assuming the interest rates stay relatively low?

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

Yes, this is Dennis. It's probably more sustainable. We ended the quarter with an average about 1,000 orders a day. We're now running refinance base, it's around 1,300 orders per day. So nice uptick, an unexpected uptick, actually. And so I think that trend will continue, but it's really directly associated with rates. So if the rate stays in the current range, I think those ranges -- those order counts will continue. But I would only caution that it's good for us, it's an unexpected pickup in the revenue, but it represents less than 10% of the revenue for the title company. So not going to be a big driver of revenue growth.

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

And then on commercial, not to put too fine a point on it, you said they're down single digits. I wonder if you might care to modify that a little bit, high single, low single, mid-single?

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

No, I think we'll stay with around mid-single digits right now, like I said. And it's really been consistent with what I've been forecasting since late last year. We had a great 2018. It was an overall record for our commercial business. I think commercial will remain very strong for us in 2019. All indicators are that we're going to have another very good year, but I do think it will be down slightly from what we saw in '18.

Operator

Our next questions come from the line of Bose George with KBW.

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

Just wanted to go back to interest income, was curious why it didn't go up in the first quarter. And also, the $15 million annualized expectation, is that still good? And should we just use that off of the kind of the fourth and first quarter run rate and sort of build that in over the course of the year?

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

I -- well, first of all, the $15 million is still a good run rate to use if the Fed were to raise rates. And again, that assumes that balances stay the same. So one of the things that we think about is that our balances are really overweight relative to the commercial business. We used to have this benchmark of -- we get $12 million of annualized investment income every time the Fed raised and now it's more like $15 million because the commercial business is stronger, and we have a lot more deposits now because of the commercial business. So to answer your questions, Bose, yes, $15 million is still a good run rate. But again, that assumes commercial is flat from where it is today. And then just as I mentioned before, looking ahead, we feel like we don't expect much incremental growth in investment income over the next couple of quarters just because the Fed has really been [on par] , so I think $17 million is kind of our expectation now.

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

The -- just in terms of that, the rate -- the increase that the Fed did in December, I was just curious why that didn't sort of benefit the investment income this year?

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

Yes. Well, the biggest -- yes, the biggest reason is just because the balances were down. So on the fourth quarter, it was a really strong commercial quarter, balances were high at that point. And on Q1, we get less transaction activity and so balances were a lot less in the first quarter. So it's really a function of the fact that balances were seasonally low in Q1.

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

Okay. So to the extent balances tick up we could see that benefit in subsequent quarters, even if -- with rates stable?

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

Yes.

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

Okay. And then just -- actually just switching to regulatory, is there anything to update, just seeing out there in the regulatory front that's worth noting?

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

Not really. The market is pretty calm right now.

Operator

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

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

Dennis, I just want to -- just double check, you said refi was 1,300 per day in April?

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

Correct.

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

And with down 2%, purchase is somewhere in the probably 2,200 to 2,300?

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

Correct, yes.

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

Okay. And then in terms of headcount, can you get more specific on the amount of action you took in the fourth quarter and if you're already staffing up now?

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

On the fourth quarter, in the title segment, our headcount was down 400 people in the fourth quarter.

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

And then specifically, Geoff, like how we're thinking about it right now. Again, I would use the term we are more cautiously optimistic on purchase than we were at the beginning of the year. We were very aggressive on headcounts coming into the year. So we are cautious going forward, but we are staffing where we need to with some full time, but we are also using transfer, we're using seasonals and we're using overtime right now.

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

Yes, I guess that what I'm getting at, it sounded like you cut maybe more aggressively than you would if you knew then what you do now. And as you think about Q1, that probably means you had some add back on personnel, maybe add back on bonus accruals, so I'm just trying to think through if there is a little bit of expense catch up for the environment we now find ourselves in as we're thinking about the remainder of the year?

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

No. Not really. Not really.

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

And then last question. Do you look at your margin excluding investment income because if you look at it that way, you're actually losing operating leverage year-over-year, maybe due to mix. And I'm curious, how you think about the opportunity for margins versus '18 if we pull out the NII benefit?

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

We look at our expense ratios as a percentage of net operating revenue, which is a similar method that you were referring to. And yes, we have been losing ground on the expense side, simply because when you look at the last 12 months, refi has been down, purchase has been down, commercial has been down. So we have lost, kind of like our operating margins have come down and that's more than offset by investment income. But yes, margins have come down just because volumes has -- the market's been tough in last 12 months.

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

And Geoff, I think you are aware of this, but we also look at it, not any 1 quarter, but really at trailing 12 months because any 1 quarter can have a little volatility in it. On a trailing 12, we're happy where we are. Also, we're looking at our success ratio, and our success ratio is very strong in the first quarter.

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

Right. So in terms of just looking at, kind of, let's call it, core margin improvement, does it take stability and growth in both purchase and commercial to achieve that? Or can you have a refi environment that more than offsets down a couple of points in commercial and purchase?

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

Kind of -- not a straightforward answer, but it kind of depends. If we get a better commercial -- excuse me, if we get a better purchase market then we expect we'll have the opportunity for margin leverage. So I think the wildcard for us would be is, if we think that the purchase market can be incrementally better than what we thought it would be last quarter. And secondarily, we are going to have some easier comps in the second -- third and fourth quarters on purchase. So I think it will still be a headwind, but I think it's going to be clearly better than we thought it would be at the beginning of the year. But I think the main driver, Geoff, is going to be purchase.

Operator

There are no additional questions at this time and 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 13689517. The company would like to thank you for your participation. This concludes today's conference call. You may now disconnect your lines.
