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FAF - Q2 2019 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the 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 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 13692064.

We will now 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 earnings conference call for the second 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 the 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 circumstances or events that occur after the date the forward-looking statements are made.

Risks and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements. For more information on these risks and uncertainties, please refer to 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 operable 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

Thank you, Craig. Good morning and thank you for joining our call. I'll begin with a review of our second quarter results and then discuss our outlook for the remainder of 2019. The company delivered outstanding financial results this quarter. Second quarter earnings were $1.64 per share or $1.58 per share, excluding net realized investment gains.

Low interest rates continue to strengthen the purchase market, drive substantial growth in refinance activity and support a healthy commercial market. The title segment delivered a record pretax margin of 17% or 16.5% excluding net realized investment gains. Strong expense management and growth in our investment income drove improvements on our earnings and margins.

The title segment revenues were flat. Our refinance revenues were up 24%. Our purchase revenues declined 2% and the improvements from the recent trends, our commercial revenues were down 2% compared with last year, in line with our expectations.

Our Specialty Insurance segment delivered strong results driven by performance of our home warranty business, which had lower claim losses due to lower claim frequency and severity. The overall segment benefited from a decline in the loss ratio to 56.4%, driving a pretax margin of 12.8% compared with 8.4% last year.

As we previously announced, we have completed our investigation into the consumer impact of our recent information security incident. Though the investigation identified only 32 impacted consumers. We take seriously our responsibility to keep our customers information secure, and we regret the concerns this incidence caused.

Turning to the outlook. The strong economy and lower mortgage rates continue to drive improvement in the market. We are encouraged by July's open order trend. Purchase order were up 4% driven by strength in new home orders. Refinance orders were up 65%, which bodes well for the residential market in the second half of the year. In addition, we expect continued strong performance from our commercial business. Although the anticipated reduction of the Fed funds rate will impact our investment income. Given current market business conditions and the efficiencies of our operations, we expect to deliver strong financial results in the second half of the year.

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 up 1% compared with last year. This increase reflect the 1% increase in the average revenue per order with a number of direct title orders closed flat relative to last year.

The average revenue per order increased to $2,620, primarily due to higher residential real estate values, partially offset by a shift in the mix of direct revenues to lower premium refinance transactions.

The average revenue per order for purchase transactions increased 3%, while the average revenue per order for commercial transactions increased 1%.

Agent premiums, which are recorded on approximately a 1-quarter lag relative to direct premiums, were down 3%. The agent split was 78.9% of agent premiums. Information and other revenues totaled $198 million, down 4% compared with last year. The decline was primarily due to lower revenues from the company's centralized lender businesses and international operations.

Investment income within the Title Insurance and Services segment was $71 million, up 37%. 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.

Short-term rates impact our escrow deposits, operating cash, 1031 Exchange business and our bank, where we held $4.2 billion in cash and debt securities as of June 30.

Personnel costs were $423 million, down 1% from the prior year. The decrease was due to lower salary expense driven by lower average headcount during the quarter. Other operating expenses were $194 million, down 4% from last year. The decline was due to lower production and office-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 loss reserve estimates for prior policy years.

Pretax income for the Title Insurance and Services segment was $233 million in the second quarter compared with $210 million in the prior year. Pretax margin was 17.0% compared with 15.3% last year. Excluding the impact of net realized investment gains and losses, pretax margin was 16.5% this quarter compared with 15.1% last year.

Net expenses in the corporate segment were $19 million, up 7% compared with last year. This quarter, we incurred $1.7 million related to the information security incident. Expenses associated with the incident are recorded in the corporate segment. Although we will incur additional expenses related to this incident, we expect them to be immaterial.

The effective tax rate for the quarter was 18.4%, lower than our normalized rate of 24%, primarily due to the resolution of state tax matters from prior years. Cash provided by operations was $267 million, up from $211 million in the second quarter of 2018.

In April 2019, we entered into a new 5-year, $700 million senior unsecured credit agreement. As of June 30, outstanding borrowings under the facility totaled $160 million. Notes and contracts payable on our balance sheet totaled $730 million as of June 30, which consists of $547 million of senior notes, $160 million on our credit facility, $18 million of trusteed notes and $5 million of other notes and obligations. Our debt-to-capital ratio as of June 30 was 18.4%.

I would now like to turn the call back over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Mark DeVries from Barclays.

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

Mark, how should we think about expenses in the back half of the year? I know you guys had -- late last year, early this year, been cutting costs and then had this urgent refinance activity that obviously helped the margin this quarter. Should we expect, all of the things being equal, a little bit of pressure on the margins as you need to staff up? Or are you in a good position right now in expense side?

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

Yes. Mark, this is actually Dennis. We did manage our expenses aggressively in the second half. And our headcount's down 8% from the last year. Right now, our staffing levels are up fairly lean relative to our current quarter activities. And we continue to utilize our seasonal workforce very aggressively, by utilizing temps and overtime. So right now with the current order volumes, we do not expect to increase our headcount significantly in the third quarter.

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

Okay. Great. And then are there any kind of residual issues that you need to deal with here from the information security issues that we need to think about?

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

Really -- I put them in 2 buckets. We'll have some small costs roll through in the third quarter, but our intent will not to be to highlight them. We'll actively -- because of the headline nature of what happened, we'll be very actively aggressively defending the lawsuits. We work cooperatively with the regulators. So that will be the tail event.

Operator

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

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

Actually, just wanted to follow up on the sort of the margin outlook really for the back half of the year and for the year. I mean, your historic range, you've talked about 11% to 13%. With the expenses potentially pretty stable in the back half of the year, I mean could you hit the 14% level for the full year?

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

Yes. I probably won't give you the exact number. But we -- I think as you know, we've been very focused on growing our margin over the last 5 years. And we've been successful really regardless of the market outlook. And I think when we entered the second half right now, purchase is going to be less of a headwind, which is good for us. And there's no question, we're benefiting from, we call it, a little bit of a surprise from the refinance and we have a very strong commercial market going forward. So right now, sitting here, we think we can exceed last year's margins in '19.

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

Okay. Great. And then actually just on the other segment, the corporate segment, what's a good run rate for the -- just the expenses out of that segment?

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

Bose, it's Mark. So when you look at -- historically, we've been really consistent at $18 million a quarter. I mean there's not a lot of volatility. This quarter, we were $19 million because, again, we pushed all the cost with the information security into there. So I think somewhere between $18 million and $19 million over the next few quarters is a good assumption.

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

Okay. And then if you just on the Specialty Insurance segment, can you talk about the outlook there, just in terms of the margins?

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

Yes. I think we'll continue to improve there also. We had a very strong second quarter for our home warranty business. But our claims frequency and severity were down there. We did reap a little bit benefit from the weather in the second quarter. Third quarter typically will be another more difficult quarter for that business but I think it will do well. And our P&C continues with this turnaround effort. So I think we'll have another good second half to the year for the Specialty group.

Operator

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

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

Good work on the quarter. Question on the 11% to 13% title pretax margin goal. I know it's a couple of years old. But would you -- when would you update that? Or how are you thinking about that, kind of, when you're thinking about the long-term margin potential of the company? If you could just kind of give us some of your high-level thoughts on that margin range. And when would you consider adjusting that range?

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

Jason, what I would say is when we first developed that range at Investor Day last year, we talked about this 11% to 13% margin in title. But that assumes a mortgage market of 1 4% to 1 8% with about a 25% refi mix. And that's kind of where 2019 is turning out to be. Now we are operating kind of at the high end or even exceeding that level for a couple of reasons. One is investment income has been higher than we thought. And the second thing, I think is commercial has been better than we thought versus when we were back in Investor Day. And so I think we'll kind of wait till the year plays out then we'll consider updating the range, perhaps next year.

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

Okay. And then on the investment income. And looks like we will get a Fed rate cut. What are you expecting in terms of Fed rate cuts and just interest rates and the investment income dollars? Is there any help you can give us in thinking about that going forward?

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

So initially, when the Fed started raising rates, we guided to this $12 million increase in our annualized investment income for every rate increase. And we've actually gotten more like $15 million. And that's what we've guided in the last several quarters just because -- mainly because our balances have risen, right? So we really consistently got $15 million of annualized income every time the Fed has risen. Now the question is what happens when the Fed cuts, which is widely expected. And it's hard to say exactly but we feel like we can beat that $15 million. We don't think it's going to go down quite that much, for a couple of reasons. One is just the strategic nature in which we manage our deposits. And the second one is really in the last 6 months, we've gone to more of a fixed rate strategy in some of our portfolio, specifically the bank and our insurance company. And so we've shifted from floating rate securities to fixed rates, which I think is going to help us. So now as we sit here today, if the Fed cuts, we're expecting somewhere between like a $12 million to $15 million decrease in our investment income. And that assumes the deposit levels are steady, consisting where they are today.

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

It's very helpful. And just the last question on commercial. Your national commercial revenue was down a little bit, your large competitors was up a little bit. Is there anything going out with market share? Or just kind of timing of deals or anything get shifted quarter-to-quarter. Any color on kind of those -- the commercial revenue trends.

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

Yes. We had a very good commercial quarter, actually. We started the year, we actually thought we'd be down a little bit in commercial as we guided to, and we're actually performing better than that. Specifically to the quarter, it was a timing issue. We had -- we did not close a few large deals that will probably spill over into the third quarter. And regarding market share, actually, we think we're picking up market share right now. So overall, very strong fundamentals in commercial. We think we'll have another very good second half to the year.

Operator

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

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

On the other operating expenses, anything on the data capture or processing front that you're getting some incremental efficiencies that are helping to drive that down that maybe more durable or you may see more of it?

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

Mark, we -- I would say that we are getting some benefit on some of the automation that we've put in to some of our processes, specifically on the centralized refi business. I wouldn't say it's material at this point. So when you look at our overall title segment, the cost saving is not significant. But we -- but it's -- we're still early in that and we hope it'll grow over time.

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

And I would only add. The earlier transfers with automation efforts we've rolled out in our central group is good, and it's absolutely helping us deal with the current volume surge. And I think those benefits will grow over time.

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

And then the -- in the Specialty business, the decline in frequency and severity, would you say that was weather, perhaps? Or there's just normal variability? Do you think the underwriting made a difference in the quarter?

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

It's a great question. It's really all of the above. We continue to do a very good job in underwriting. We continue to do a very good job on claims management, and we had some benefit from the relatively mild weather patterns so far in some of our key markets. So it's all of the above.

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

And then finally, the July purchase order are up. And looking at your earlier commentary, last year, I think that you were down 1% through this period. The -- I assume the comparisons just get easier from here, anyway the comment on, kind of, the trajectory of the -- when you reflect on how last year played out on purchase orders?

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

Yes. Thanks for the question. No question. It's getting better for us right now. I think the spring selling season, I would classify it as really in line with our expectations, maybe slightly better, actually. When we started the year, we had actually controlled our cost very aggressively. Thinking we were going to through the resetting of the market. I think that's still happening. But sitting here today, the economy is still very strong for us. I think the housing has really move into a lot more balanced position in our opinion. Early in July, we were up 4%. But a lot of that's being driven by the volatility of new homes. So our new homes are up a lot right now. What's really interesting to us is the resale's up 1% right now so far in July, which is a really good sign. And we're entering the back half with our comps get a lot easier. So all in all, we think actually the purchase will be definitely lesser a headwind going into the second half.

Operator

(Operator Instructions) Our next question comes from the line of Chris Gamaitoni from Compass Point.

Matthew Ward Gaudioso - Compass Point Research & Trading, LLC, Research Division - Associate

This is Matt Gaudioso on for Chris. Just one on centralized lender. You noted lower revenue year-over-year by the spike of refis. Is there anything to call out here? Or could you extend on some commentary?

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

Yes. So our refi business -- well, our centralized lender businesses isn't just originations, which are kind of refi title orders. We also had other businesses in there including default. And default continues to decline. And so it's really just a mix of default versus our origination business.

Operator

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

Mackenzie Jean Aron - Zelman & Associates LLC - VP

Just one question on the capital situation given that the debt to cap is at somewhere at the low end of the 18% to 20% target you all talked about. Can you just talk about how you think about the opportunity right now, whether it's increased dividend or look at buybacks or if there's strategic acquisition opportunities on the table. How you're thinking about capital allocation over the next year or so?

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

Sure. Mackenzie, I'll start with that. First of all, we talk about our target debt to cap of 18% to 20%. And we are at the low end of that range, which is a good comfortable place to be I think at this point in the cycle. At the end of the day, we're trying to invest as much as we can in our core business, either through organic projects that will help build the moat around our business or through M&A. And if we can invest, add adequate returns for our shareholders, organically or through M&A, we'll do that all day long. And to that extent that we can't repay you dividends and occasionally we buyback shares. The dividend is something that's really important to us. We've been raising it very aggressively, really since, probably the last 5 years or even longer. So we want to pay a healthy dividend. It's really important to us. We buyback stocks, occasionally, not frequently, but occasionally. And so those are the -- that's kind of our thought process going forward. But we like the debt to cap where it is right now based on where we are in the cycle.

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

And I'd only add on the deal front. It's been relatively quiet first half of the year for us. But we've actually got a pretty healthy pipeline of deals we're evaluating right now. And our strategy, if just so everybody is clear, is pretty consistent. We're looking to acquire title agencies in key markets. We're looking to buy data and information companies to help the title automation. And we're looking at either acquisitions and minority investments. A little outside of our core but very complementary to title. So good pipeline. And as always, we'll be disciplined on our deployment as long as we can get the returns.

Operator

Our next question comes from the line of John Micenko from SIG.

Soham Jairaj Bhonsle - Susquehanna Financial Group, LLLP, Research Division - Associate

This is actually Soham Bhonsle on for Jack this morning. So my first question was on average revenue per order. The growth there seems to slow a little bit this quarter just given the refi mix. But in your comments you also showed some confidence around commercial volumes going forward. So are you calling for better commercial volumes to maybe offset some of that refi mix impact? How should we sort of think about that dynamic going forward?

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

Well, if you're looking at, kind of, like our title segment's average revenue per order including all the business lines, we expect it to decline next quarter just simply because of the mix of refi versus purchase. Obviously, refi is doing well. We're going to close more refis orders next year and that's going to put some pressure on our refi per order. And then typically, in the fourth quarter, it rises because commercial is a strong quarter usually in the fourth quarter. And so it's -- we think it could rebound in the fourth quarter. We don't -- the way we look at it and manage the business, we don't really look at, kind of, the consolidated fee profile. We break it out purchase, refi and commercial and look at it by individual business lines. And this quarter, our purchase average fee profile was up 3% versus last year mainly just because housing prices have continued to risen. And so I think that was in line with our expectations. Our refinance fee profile was up 15% versus last year, which is up more than it typically is for -- just because, again, housing prices are rising. We've raise rates a little bit. But I think the refi fee profile of 15% has really been a big benefit to us. And finally commercial, the fee profile was flat just because the size of the deals that we're doing in the second quarter were similar to what they were last year. So that's more of how we look at it on a fractured basis.

Soham Jairaj Bhonsle - Susquehanna Financial Group, LLLP, Research Division - Associate

I guess sort of just piggybacking off of that longe-term commercial fee per -- I mean average revenue per order. Sort of where is that trend do you see that, sort of, in the mid-single-digit range or low single digits, where do you, sort of, see that going?

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

You're talking about when you lump purchase, and commercial and refi altogether?

Soham Jairaj Bhonsle - Susquehanna Financial Group, LLLP, Research Division - Associate

Just the commercial side, sorry.

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

I'm sorry. Just commercial. It really all depends on the size of the deals. We're still in a really strong commercial environment. Our fee profile in commercial has consistently been up for probably 6, 7 years now. And so it's been decreasing. If I would say, low single digits is probably somewhat what we already expect.

Operator

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

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

This is Carter on for John. One more quick question on the purchase market. Is there anything to call out from a geographical standpoint or is the volume come pretty broad-based?

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

Thanks for the question. The west I would say it's still probably the trailing central is a little stronger right now. But again, we're looking for a pretty -- definitely less headwinds going into the second half. I think our comps get a lot easier. So I think from a modeling perspective, probably pretty broad-based but the west has still probably got the most pressure.

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

And then real quick on the capital allocation. Is there a specific reason why you prefer paying the dividend over buyback stock? And if you can provide a little more color on the decision-making process behind that?

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

Well, I think the dividend -- I mean we're a strong cash flow generating company and we have a lot of really attractive investment opportunities in our business. But the reality is we generate more cash flow then we have opportunities. And that's why we pay a dividend. It's something we've done, it's something we want to. It's a good discipline to have. As a company, we want to return capital back for our shareholders consistently. And so our primary method is dividend. And that's something we're going to continue to do. I think we -- typically every -- still often when there's dislocations in the market, we repurchase shares and we're always looking for those opportunities. But primarily, we're focused on dividends because we want to return capital on a regular, consistent and quarterly basis.

Operator

That's all the time we have for questions today. 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 13692064.

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