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FAF - Q3 2019 First American Financial Corp Earnings Call

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PRESENTATION

Operator

Greetings and welcome to the First American Corporation Third Quarter 2019 Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It's now my pleasure to introduce your host, Craig Barberio. Please go ahead, sir.

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

Good morning, everyone, and welcome to First American's earnings conference call for the third 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 facts. 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 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 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 third quarter results and then discuss our outlook for the remainder of 2019.

We had another strong quarter. Increased transactions across the company's businesses drove revenue growth of 8%. This, coupled with effective expense management and higher investment income, resulted in earnings per share of $1.65, up 23% from last year.

Our title segment delivered a pretax margin of 16.5%; or 16.4%, excluding net realized investment gains. The title segment revenues were up 9% driven by a significant increase in refinance activity as open refinance orders per day increased 105%. I'm also encouraged that our open purchase orders increased 2%, the first growth in open orders since early 2018. Our commercial revenue grew by 9% in the quarter, benefiting from a number of large transactions. Our commercial business continues to operate in an elevated level with broad-based strength across geography and asset classes. Lastly, effective expense management also contributed to our earnings this quarter. Our success ratio was 44%, better than our target ratio of 60%. In addition, we are beginning to see the benefits from title automation efforts that we've recently deployed.

And our Specialty Insurance segment delivered a pretax margin of 8.5% driven by continued revenue and earnings growth in our home warranty business. The segment's loss ratio improved to 60.9%. Home warranty continues to expand its direct-to-consumer business, where the lifetime value of the customer is greater than our traditional real estate channel.

Turning to our outlook. Favorable economic conditions, along with low mortgage rates, continue to support a healthy real estate market. October open order trends are favorable, with purchase orders up 2% and our refinance orders up 115%. In addition, we expect continued solid performance from our commercial business. Although the reduction in the fed fund rate will impact our investment income, given current market conditions, we are optimistic that we will deliver strong financial results in the fourth quarter.

I'd now like to 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 14% compared with last year. This increase reflects a 21% increase in closed orders partially offset by a 6% decrease in the average revenue per order. The average revenue per order decreased to $2,513 due to a shift in the mix of direct title orders to lower-premium refinance transactions. The average revenue per order for each major business line, however, increased during the quarter, with commercial up 9%, purchase up 2% and refinance up 11%. Agent premiums, which are recorded on approximately a 1-quarter lag relative to direct premiums, were up 7%. The agent split was 79.1% of agent premiums.

Information and other revenues totaled $205 million, up 5% compared with last year. The increase was primarily due to growth in real estate transactions that led to higher demand for the company title information products.

Investment income within the Title Insurance and Services segment was $72 million, up 18%. Relative to last year, investment income has benefited from both an increase in average balances and higher short-term interest rates that led to an increase in interest income from the company's investment portfolio and cash balances. Sequentially, investment income was up $1 million despite a 50 basis point decline in the federal funds rate for the 3 months ending September 30. Although the lower federal funds rate did have an adverse effect on average yields, investment income increased sequentially partially due to higher average balances.

Personnel costs were $448 million, up 5% from the prior year. The increase was due to higher incentive compensation, particularly from the increase to our 401(k) match due to better-than-expected financial results. Other operating expenses were $219 million, up 9% from last year. The increase was due to higher production-related costs and $7 million of lease impairments as a result of office consolidation related to a previous acquisition.

The provision for title policy losses and other claims was $51 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 $254 million in the third quarter compared with $207 million in the prior year. Pretax margin was 16.5% compared with 14.6% last year. Excluding the impact of net realized investment gains, pretax margin was 16.4% this quarter compared with 14.1% last year. Net expenses in the corporate segment were $19 million, up $2 million compared with the prior year.

The effective tax rate for the quarter was 23.3%. Moving forward, we expect our tax rate to be around 23.5%, 50 basis points lower than our previous guidance. Cash provided by operations was $311 million, up from $231 million in the third quarter of 2018.

Notes and contracts payable on our balance sheet totaled $728 million as of September 30, which consists of $547 million of senior notes, $160 million on our credit facility, $17 million of trustee notes and $4 million of other notes and obligations. Our debt-to-capital ratio as of September 30 was 18.5%.

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 today is coming from Jack Micenko from SIG.

John Gregory Micenko - *Susquehanna Financial Group, LLLP, Research Division - Deputy Director of Research*

Looking at the personnel cost leverage in the quarter. It looked like there was maybe more of a pronounced step-down improvement. And I guess first question will be is that all volume. Or is there something maybe more permanent going on that's driving that better leverage?

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

I will just say that we've been really focused on managing our costs, and we had an explosion in the refinance orders. And we did pay a lot more in overtime this quarter. We paid more on temps, but I think we feel good about our ability to sort of maintain our kind of employee levels. So I don't think there's any kind of a structural step-down, but I think it's a function of the orders arriving fast and us kind of being diligent on the cost side.

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

Yes. And I would only add, like we mentioned on the second quarter call, we are going to hold our head counts even going into the third quarter, which we effectively have done. As Mark said, we used overtime and temps and other things. And also, and I mentioned in my script too, we're getting some early benefits from a number of automation efforts we're rolling out in the company.

John Gregory Micenko - *Susquehanna Financial Group, LLLP, Research Division - Deputy Director of Research*

Okay. And then on the dividend, the past looks like the third quarter has been when you've maybe taken a look at that a little closer and the ratio has drifted down a bit. Just curious on any updated thoughts around dividend, dividend payout ratio, that sort of thing.

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

Well, the dividends are a key part of our capital management strategy. We've been raising dividend every year for quite a number of years now. And so it's something we discuss regularly with the Board. We expect to pay higher dividends in the future. And so that's something we're looking at and having regular dialogue about, especially the fact that our earnings are so strong this year and the outlook looks good for next year. So I wouldn't really look into anything in particular in the fact that we didn't raise it in August because that's something we're going to evaluate in the future.

Operator

Our next question today is coming from Bose George from KBW.

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

Can we just talk about the increase in the commercial fee profile that was obviously up nicely year-over-year and just kind of ways to think about what happens with that line item?

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

Let me start and then I'll hand it over to Mark on the specific on the ARPO. Again, we had a very strong commercial quarter. Again, I mentioned it in the second quarter. We have some big deals roll from the second into the third, so a little lumpy there, but all in all, a very strong quarter for us in commercial. Pipeline is very strong going into the fourth quarter, and even looking now into '20, we're optimistic in commercial.

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

Yes. I'll just say, I mean, we did close a very large transaction this quarter that skewed the ARPO a little bit. We had a deal that was over $10 million in premium, but even if you were to back that out, we still would have an increase in our ARPO. So we're just seeing a lot of really large transactions come through right now.

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

Okay. That's helpful. And then actually going back to the information and other segment. I think in your prepared remarks you noted that some of it was an increase in orders, but last quarter, there was an increase. And that segment was down a little bit year-over-year, so are there other drivers we should think about and just ways to think about the outlook for the growth in that line item as well?

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

Well, when you look at the growth in info and other in the last -- on an annualized basis, most of the growth is coming from our data business. And so as you know, we sell our title plant information. We sell our property record information and that drove most of the growth. We also did sell more in, I'll just call it, title information product by searches that we provide in connection with the transaction. And so I would expect it would -- the biggest driver is going to be what happens with mortgage originations. But we are seeing higher data sales in that line item, too.

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

And I would only add on that is we're probably getting near bottom on the reduction of default-type products out of that group. So the default business has been falling for us as defaults are very low across the universe right now. And as Mark said, our data businesses are accelerating.

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

Well, okay. And then actually just one more. In your prepared remarks, the $7 million impairment in the office consolidation, did you say that went through the expense this quarter?

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

Yes. Yes, it went through other operating expenses in the title segment, $7 million.

Operator

Our next question today is coming from Mackenzie Aron from Zelman & Associates.

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

I guess I was hoping you could just elaborate a little more on the automation efforts that are helping the margins, maybe if there's anything specific that you can give us a little color on and then also just where in that process. Is it still early innings and something that will continue to be a tailwind?

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

Yes. I'll give you a little bit of insight on that. We really have 2 main points of focus for the company: both digitizing the closing for the title side and automating the title efforts across the board. Specifically on the titling side, we're looking at reduced processing time, increase our efficiency, lower our risk and improve the consumer experience kind of altogether. And in that, we've been aggressively working deploying AI, machine learning across our databases for a number of years actually. We're seeing the benefits right now, early innings, and we're seeing it primarily in our refinance business right now.

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

Okay. Great. And then also kind of switching gears a little bit. But on the acquisition pipeline and whether it's agents or anything on the technology and data side, can you just talk about what you're seeing that could be a tuck-in benefit?

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

Sure. Yes. It's actually been a pretty quiet year for us from an acquisition perspective, but our strategy really hasn't changed. We've got a full pipeline, but we've been pretty selective this year on the acquisition front itself. Like we said before, we're looking for target acquisitions and agents where we want a [tabular marketplace]. We're looking for information companies on the data side to drive greater title automation. And what we have done this year, though, is we've been doing some strategic investments in businesses that are not directly in the title core but complementary to core title. And I anticipate we'll do -- we'll continue to do more of those in '20.

Operator

(Operator Instructions) Our next question is coming from Carter Trent from Stephens.

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

So I know you're pretty heavily exposed to California. Can you talk about the purchase trends you're seeing there? And do you think prices will keep growing in that market like they are? And if so, what kind effect do you think that will have on purchase?

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

Yes. Sure. Let me just answer the question broadly across the country, and then I'll let Mark talk about specifically about California. We're getting progressively more optimistic on purchase. Our purchase orders countrywide were up 2% in the quarter. We're lining up 2% right now in October, really going into more of our seasonal slow time. So clearly, we are becoming more optimistic on purchase as we go into '20. So I think we'll continue to see purchase start probably turn from a headwind to tailwind going into '20. Now specifically on California...

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

Yes. Just to give you some numbers. So California is our largest state. And on the purchase side, and this is in the direct business, our revenue was up 2% year-over-year. And on the refinance side, it was up 119%. Obviously, we're getting a lot of refinance volume in California. And then on the agency side, we've actually strategically have been reducing our footprint in California. Our premiums are down about 26% just because we've made some pretty dramatic reductions with the splits. And so we've done that kind of intentionally just to kind of -- because we didn't like the prices it was at. So that's kind of the snapshot on California.

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

Okay. Perfect. That's helpful. And one more on the Specialty Insurance segment. So loss ratios have really improved. Is this more of a -- because of weather benefits in the P&C business or better underwriting in home warranty? And more on home warranty, what's driving the revenue growth there? Is it growing the customer base, better pricing? If you guys can provide some more detail, it would be helpful.

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

Yes. Sure. It just was an overall very good quarter for us in specialty and specifically on home warranty. The third quarter is typically our weakest quarter because of the seasonal claim events going on in the quarter. We had increased claims but lower frequency -- excuse me, lower severity, so we have strong expense management across the board in that business. Also on home warranty, I mentioned in the script we're really, I'll call it, accelerating our efforts to develop greater consumer-direct -- a greater consumer-direct business. We've got a significant one now and we want to grow it in '20 and beyond. When we look at the consumer-direct business, by and large, we think it has a greater lifetime value to the customer than our traditional real estate channel. So to kind of wrap up on home warranty: We just had a very good quarter. We controlled our expenses well, and we're looking to grow our consumer-direct business going forward.

Operator

Our next question is coming from Mark Hughes from SunTrust.

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

Just on that last question, have you given us an update on the mix of consumer-direct versus the real estate channel within the home warranty business?

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

We haven't. What -- our dominant channel there is our real estate channel. So the opportunity for us is to grow the consumer-direct side.

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

Is there any more you can say? You sound very optimistic on commercial. Kind of the big picture, what gives you confidence there?

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

And specifically on commercial?

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

Yes. I'm thinking about kind of 2020.

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

We just look at what we've got going on right now. Our pipelines are full. Because we've really got strength across the markets, across the asset classes. Like I mentioned on the second quarter call, the third quarter call, both calls, we'll always see lumpiness in big deals. But with that said, the pipelines are good going into the fourth quarter. The economy is strong. So I'm not sure '20 will be a record year for us. I just think it's going to be another good year for us in commercial.

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

And then on investment income, Mark, when you take into account the balances and the fed moves and timing and all that, how should we think about the Q4 investment income relative to Q3?

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

Well, last time we had this earnings call, we've talked about the fact that, every time the fed cuts, we expect a $12 million to $15 million decline in investment income on an annualized basis, and we're actually getting the lower end of that range. So our experience has shown that the number is closer to $12 million. The thing that happened in the third quarter is that balances rose and investment income was up $1 million sequentially. And we -- most of our balances are driven by commercial. And so commercial has the seasonally strong quarter in the fourth quarter. So we think that, as we sit here today, balances are going to continue to increase in the fourth quarter. So investment income is likely going to be down a couple million dollars next quarter, but it won't really -- you won't really see this $12 million annualized number until we get into next year.

Operator

Our next question today is coming from Jason Deleeuw from Piper Jaffray.

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

Congrats on a very good quarter.

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

Thank you.

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

A question on the visibility you have on commercial. Can you just remind us how much of visibility, how many months of visibility you have on that pipeline?

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

It's hard to say. That's I would say, of all of our businesses, it's the most difficult to forecast over like a -- call it, a 90-day period simply because, like with purchase and refinance, once we get an order in, we pretty much know when it's going to close. With commercial, we can get an order in, and we just don't know when it's going to close. It can close in 30 days. It can close in 6 months. It can close in a year. So we feel strong about the commercial business because of the orders that we have in the pipeline. But it's really the most difficult business to forecast in the short term.

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

Okay. So -- I mean but you pretty much have good visibility into the end of the year. Is that fair to say as you think about the fourth quarter?

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

Yes. I'll -- this really is the same that Mark said. Pipelines full, we look very strong going into fourth quarter. You just can't predict the closing on some of the big deals that could go into the first quarter or even second quarter. So pipelines full, but it's difficult to predict the exact closing on a transaction.

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

Got it. And then with the FNF-Stewart deal being blocked, has there been any change in the competitive environment that you've noticed?

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

No. It has been and will continue to be business as usual for us. Like we've said on previous calls, we weren't distracted by the deal. We've been very, very focused on our strategy, doing what we think is right for our company and for our customers. And that'll go forward. We'll continue with that strategy going forward. So no change to us.

Operator

Thank you. Ladies and gentlemen, we've reached the end of our question-and-answer session. That also does conclude today's teleconference. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.