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FAF - Q1 2012 First American Financial Corporation Earnings
Conference Call

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CORPORATE PARTICIPANTS

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

Dennis Gilmore *First American Financial Corporation - CEO*

Max Valdes *First American Financial Corporation - EVP and CFO*

Mark Seaton *First American Financial Corporation - SVP, Finance*

CONFERENCE CALL PARTICIPANTS

Brett Huff *Stephens Inc. - Analyst*

Jim Ryan *Morningstar - Analyst*

Jim Fowler *Harvest Capital - Analyst*

Eric Beardsley *Barclays Capital - Analyst*

Bose George *Keefe, Bruyette and Woods - Analyst*

PRESENTATION

Operator

Good morning, and thank you for standing by. 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 203-369-0663.

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

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

Good morning, everyone, and thank you for joining us for our first quarter 2012 earnings conference call. Joining us on today's call will be our Chief Executive Officer, Dennis Gilmore; Max Valdes, Executive Vice President and Chief Financial Officer; and Mark Seaton, Senior Vice President of Finance.

At this time, we'd like to remind listeners that management's commentary and responses to your questions may contain forward-looking statements, such as those described on page 4 of today's news release, and other statements that do not relate strictly to historical or current fact.

The 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.

Risk and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements. Factors that could cause the anticipated results to differ from those forward-looking statements described on page 4 are also described on page 4 of the news release.

Management's commentary contains, and responses to your questions may also contain, certain financial measures that are not presented in accordance with Generally Accepted Accounting Principles, including a personnel and other operating expense ratio. The Company is presenting these non-GAAP financial measures, because they provide the Company's management and investors with additional insight into the operational efficiency and performance of the Company relative to earlier periods and relative to the Company's competitors. The Company does not intend for these non-GAAP financial measures to be a substitute for any GAAP financial information.



In the news release that we filed today, which is available on our website, www.firstam.com, the non-GAAP financial measures disclosed in management's commentary are presented with and reconciled to the most directly comparable GAAP financial measures. Investors should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial metrics.

With that said, I'd now like to turn the call over to Dennis Gilmore.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks, Craig. And, good morning and thank you for joining our call. I'll begin with a review of our first quarter highlights. Then, I'll close with a few comments on our outlook for the year.

2012 is off to a good start. Total Company revenues were \$967 million, up 4%, with net income of \$31 million, or \$0.29 per share.

The Title segment generated a pretax margin of 6.8%. Our efficient and scalable cost structure, combined with improved market conditions, enabled us to deliver our best first quarter since 2006.

Closed orders were up 16%, driven by a 36% increase in refinance transactions.

Our Commercial division continued its strong growth, with revenues of \$81 million, up 21%.

While order volumes have improved, we continue to [maintain] tight control on expenses. As a result, the combined ratio of personnel and other operating expenses, the net operating revenue improved to 78% in the quarter, compared to 83% last year.

Our claims provision rate was 7.2% for the quarter, as we continue to operate in an elevated claim environment.

Our Specialty Insurance segment achieved a pretax earnings of \$13 million, for a 17% margin. Segment revenues were up 8%, and our overall loss ratio was 49%.

In April, we completed a new \$600 million revolving credit facility, with improved pricing and terms. A favorable market response enabled us to increase the size of the line. This new facility enhances our flexibility and financial strength of our Company.

Turning to the outlook, first quarter orders were up 31%, the strongest in three years, driven by an increase in refinance activity and a modest but encouraging increase in resale transactions. And, so far in April, open orders per day are running slightly ahead of March. And, we expect HARP 2.0 to generate additional refinance activity.

This increase in open orders combined with a solid commercial pipeline indicates that the closed orders should remain strong throughout the second quarter.

As we've demonstrated in the first quarter, we have been successful in capitalizing on the operating leverage in the business. As the market recovers, we are committed to delivering continued margin improvement.

I'd now like to turn the call over to Max for a more detailed review of our financial results.

Max Valdes - *First American Financial Corporation - EVP and CFO*

Thank you, Dennis. The Company generated total revenues of \$967 million for the quarter, up 4% when compared with the same period of last year.



Net income was \$31.3 million, or \$0.29 per share, compared with a net loss of \$15.3 million, or [\$0.15] per share, for the same period of last year.

In the Title Insurance and Services segment, total revenues were \$891 million, up 3% compared with the same quarter of last year. Direct premium and escrow fees were up 16%, driven by a 16% increase in our closed orders for the quarter. Agent revenue per order closed increased slightly, to \$1,315, compared to \$1,310 for the same quarter of last year. Agent premiums were down 6%, which is comparable with the 4% decline in direct premiums we experienced in the fourth quarter, reflecting the normal reporting lag in agent revenues of about one quarter.

Information and other revenues total \$155 million, up 3% compared to the same quarter of last year. This increase was driven by higher demand for title plant information, an increased international service revenues, offset in part by reduced demand for default information products. Total investment income for the Title segment was \$15.3 million, down 5% from the same quarter of last year, reflecting higher net realized investment losses compared to last year.

Personnel costs were \$278 million, up \$18.5 million, or 7%, compared with the same quarter of last year. This increase was primarily due to higher incentive-based compensation, increased healthcare-related expenses, and one additional payroll day. During the quarter, we were able to manage the significant increase in order activity without any increase in our total workforce.

Other operating expenses were \$172 million, down \$3.8 million, or 2%, from the same quarter of last year. This decrease was primarily due to lower office-related expenses and professional services, offset in part by higher production-related expenses due to increased order activity.

The combined personnel and other operating expense ratio declined to 78%, from 83% last year, as a result of operating leverage.

Agent retention was 80.2% of agent premiums, compared with 80.0% in the first quarter of 2011. The increase in the agent retention percentage was primarily due to a large commercial deal with a favorable agent split that closed during the first quarter of the prior year.

The provision for title losses was 7.2% of premium and escrow revenue, reflecting an ultimate loss rate of 6.2% for the current policy year and a net increase in the loss reserve estimates for prior policy years, primarily 2007 and 2008.

Pretax income for the Title Insurance and Services segment was \$60.8 million for the first quarter, generating a pretax margin of 6.8%.

Turning to the Specialty Insurance segment, total revenues were \$74 million, up 8% compared with the same quarter of the prior year. The loss ratio was 49%, down from 51% in the prior year, and we generated a pretax margin of 17.3%.

Net expense in our Corporate division was \$22.1 million, up \$1.5 million from the same quarter of the prior year, primarily due to an asset impairment. Going forward, we expect Corporate net expense to be approximately \$20 million per quarter.

With that, I will turn the call over to Mark.

Mark Seaton - First American Financial Corporation - SVP, Finance

Thank you, Max. I will provide a few comments on our liquidity and capital.

Cash used for operations in the first quarter was \$7 million, an improvement of \$44 million relative to the first quarter of last year. It is typical in our business to have the drawdown on cash in the first quarter, due to the seasonality of our operations and the timing of certain cash payments.

Capital expenditures during the quarter were \$18 million, up from \$13 million in the same quarter of last year, due to system and application conversions.



In April, we entered into a new four-year, \$600 million senior secured revolving credit facility. The deal was oversubscribed during syndication, and we exercised our option to increase the size from \$500 million to \$600 million in connection with the closing. This replaces the Company's \$400 million revolving facility that would have matured next year.

Pricing reflects a 75-bps reduction from the prior (technical difficulty). The financial covenants [are] substantially the same, while certain other provisions no longer apply to our ratings, have become less restrictive, or have been removed. In addition, the security will be released if the Company meets certain rating levels.

This facility significantly enhances our liquidity and financial flexibility.

We currently have \$77 million of operating cash and 6 million of our 8.9 million shares of CoreLogic at the holding company. Based on yesterday's closing price, our stake in CoreLogic was valued at \$144 million, \$97 million of which is held at the holding company. In addition, we also have \$400 million available on our new \$600 million line of credit.

Our cash and investment portfolio totaled \$3.3 billion, as of March 31, which includes \$1.4 billion of fiduciary funds. The portfolio is comprised of debt securities of \$2.2 billion, cash and short-term deposits of \$739 million, equity securities of \$218 million, and \$200 million in less-liquid, long-term investments. Overall, we have a high quality portfolio, with just 1% of our debt securities rated below investment grade.

Debt on our balance sheet totaled \$277 million, as of March 31. Our debt consists of \$200 million funded on our credit facility, \$44 million of trust deed notes, and \$33 million of other notes. Our debt-to-capital ratio as of March 31 was 11.7%.

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

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) One moment for the first question. The first question comes from Brett Huff with Stephens Inc. Your line is open.

Brett Huff - *Stephens Inc. - Analyst*

Good morning, guys.

Max Valdes - *First American Financial Corporation - EVP and CFO*

Good morning.

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Good morning.

Brett Huff - *Stephens Inc. - Analyst*

One -- first of all, great job on the incremental margins. We were excited about those, and it looks like the operating leverage is looking really good. The one big question we had was in the reserve. We were surprised it was as high as it was. And, I think specifically last year, your in-year, or in-year



policy reserve was something like 5.6%. And, it seems it went up to 6.2%. Is that a conservative view? Should we expect that over the next couple of years? Or, what can you kind of tell us, color wise, on how that'll trend?

Max Valdes - *First American Financial Corporation - EVP and CFO*

Yes, Brett. This is Max. And, it is somewhat conservative. We're being cautious at the beginning of the year. As you know, the whole industry saw some escalated [defaultations] last year. And, we haven't seen any in the first few months of this year, but the year is very new. So, we want to start the year being a little conservative, or cautious. And, then, we'll see how the year plays out.

Brett Huff - *Stephens Inc. - Analyst*

OK. That's helpful. And, as you look forward in terms of, or as you're thinking about paid claims, is your sense that paid claims peaked last year? Will peak this year? Will peak next year? Kind of, where are we in the inflection point? I know that a lot of investors are looking closely at how that will impact cash flow.

Max Valdes - *First American Financial Corporation - EVP and CFO*

Yes, we think they peaked last year, and they'll be coming down this year.

Brett Huff - *Stephens Inc. - Analyst*

OK. And, then, I'm not sure if you, I don't think you said this in your stats, but, Dennis, I think you at least referred to it in terms of a little bit better purchase transactions. Do you guys have a sense of what retail transactions grew year over year over some time period, whatever might be handy, in the last quarter?

Dennis Gilmore - *First American Financial Corporation - CEO*

Oh, sure. Actually, flat right now. We're looking at flat as good. The MBA's forecast is a flat market for year over year. What we actually saw quarter-over-quarter was a 2% increase, and that trend's continued into April, which has, again, slight increase.

Brett Huff - *Stephens Inc. - Analyst*

OK. The quarter-over-quarter, you mean, is that sequential?

Dennis Gilmore - *First American Financial Corporation - CEO*

No, first over first.

Brett Huff - *Stephens Inc. - Analyst*

First over first. OK. So, flat year over year, but -- I'm sorry. I'm confused. Is it flat year over year, for the quarter? Or, 2% higher?

Dennis Gilmore - *First American Financial Corporation - CEO*

Effectively, 2% higher right now.



Brett Huff - *Stephens Inc. - Analyst*

OK. That's what I need. Thank you. And, then, did you see the mix, going forward, have you seen the mix in purchase and refi's switch at all? It sounds like the open orders are tracking close to March for April, so far. Is the mix the same? Or, are we seeing more purchases, yet?

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Brett, this is Mark Seaton. Yes, the mix is, I'll just give it you for the last few months. In January, we had a 68% refi mix, and this is in terms of open orders. In February, it was 65%. March, it was 62%. So, we're kind of trailing down. And, now, it's picked up a little bit in April. April, it's back up to 64%.

Brett Huff - *Stephens Inc. - Analyst*

That's helpful. And, then, last question, Max, I think you mentioned this, and I didn't quite follow. The agent retention, I think, was up just a little bit year over year. Is that right? And, can you just go through that logic again?

Max Valdes - *First American Financial Corporation - EVP and CFO*

Yes. And, Brett, the reason it was up in the first quarter of last year, we had a large deal that closed, a large commercial deal that closed, that had a very favorable agent split. If you pull that deal out from last year, then we're actually, our agent retention percentage is actually slightly down.

Brett Huff - *Stephens Inc. - Analyst*

OK. That's what I wanted to make sure I understood. OK. That's what I needed. Thank you for your time.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you, guys.

Mark Seaton - *First American Financial Corporation - SVP, Finance*

Thank you.

Operator

Our next question comes from Jim Ryan with Morningstar. Your line is open.

Jim Ryan - *Morningstar - Analyst*

Regarding the adverse development on claims from [2007, 2008], could you give a little bit of color on what the nature of the claims are? I mean, how you see them continuing to develop? I mean, kind of confused that they're still happening.

Max Valdes - *First American Financial Corporation - EVP and CFO*

Yes, Jim, it's mostly again those troublesome years, 2007 and 2008, and they continue to develop a little bit adversely. Now, what we're encouraged by is the rest of the book. You know, the 2009, 2010, 2011 book is performing really well. So, it's still those two years that are running a little high.

Jim Ryan - *Morningstar - Analyst*

What type of claims would those be? I mean --.

Max Valdes - *First American Financial Corporation - EVP and CFO*

They're mostly lender claims.

Jim Ryan - *Morningstar - Analyst*

Lender claims? OK. Also, regarding the agent split, I'm not specifically referring to the quarter, but what's your idea in terms of the trend on it? How do you view yourself? Do you have a goal in terms of where you'd like to see the agency split end up? Anything along those lines?

Dennis Gilmore - *First American Financial Corporation - CEO*

This is Dennis. We'd like to continue to see it drive down. I think realistically for us, we'll stay in that 80% to 79% range.

Jim Ryan - *Morningstar - Analyst*

OK. All right. Thank you.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

The next question comes from Jim Fowler, Harvest Capital. Your line is open.

Jim Fowler - *Harvest Capital - Analyst*

Good morning. Thanks for taking the question. Could you, for the first quarter, talk about the trends that you're seeing in default title? And, also, can you provide margins on default title, relative to the rest of your business lines?

Dennis Gilmore - *First American Financial Corporation - CEO*

Sure. This is again Dennis. We're encouraged actually on the default right now. With the AG settlements, we think that we'll see some uptick in the default markets. And, we actually saw that in the first quarter slightly. We think that trend will probably continue throughout the rest of the year.



Jim Fowler - *Harvest Capital - Analyst*

And, how does the margin on default specifically relative to --? [Does] it fall within the purchase and refi? Just trying to better --.

Dennis Gilmore - *First American Financial Corporation - CEO*

It's similar to the rest of our business, from a margin perspective.

Jim Fowler - *Harvest Capital - Analyst*

Thank you very much.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

The next question comes from Eric Beardsley of Barclays. Your line is open.

Eric Beardsley - *Barclays Capital - Analyst*

Hi, thanks. You'd mentioned that you hadn't added any staff in the first quarter for volumes. Would you expect to add any later in the year, as you see an increase either from HARP 2.0 or increased purchase activity?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, thanks for the question. We'll just have to see how the orders ultimately develop, but we are very encouraged though by the operating leverage we've seen in the business. So, if we add staff, it will be slight, and we'll just track it to our volumes.

Eric Beardsley - *Barclays Capital - Analyst*

Great. Thanks. And, then, in terms of the Commercial strength, how long would you expect that to continue? And, what type of trends are you seeing there?

Dennis Gilmore - *First American Financial Corporation - CEO*

Actually, it definitely has been one of our bright spots, here. It's been strong for six quarters now, and it's actually turned into more of a broad-based recovery. It's probably a more traditional market, now, buy-sell activity. And, we're planning on, or forecasting for, a strong commercial market all year long, 2012.

Eric Beardsley - *Barclays Capital - Analyst*

All right. Great. Thank you.



Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

(Operator Instructions) The next question comes from Bose George of KBW. Your line is open.

Bose George - *Keefe, Bruyette and Woods - Analyst*

Good morning.

Dennis Gilmore - *First American Financial Corporation - CEO*

Good morning.

Bose George - *Keefe, Bruyette and Woods - Analyst*

I was wondering, do you have visibility on how much of your refi volume is being driven by HARP?

Dennis Gilmore - *First American Financial Corporation - CEO*

Let me just overall answer the HARP question, how we're seeing HARP right now. The first quarter, really no volume for HARP, small at the end of the quarter. What we are though looking for is incremental volume increase through the second, third, and fourth quarters. So, we do know our customers are gearing up for it. So, again, we think we'll see incremental volume increase as we go through the year.

Bose George - *Keefe, Bruyette and Woods - Analyst*

OK. Great. And, then, just, actually, did you buy back any shares during the quarter? I'm just curious what your thoughts are about buybacks, with the shares at their current levels?

Dennis Gilmore - *First American Financial Corporation - CEO*

We did not buy back in the current quarter, and we'll continue to look at appropriate capital deployment as we go forward.

Bose George - *Keefe, Bruyette and Woods - Analyst*

OK. Great. Thanks.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.



Operator

At this time, there are no further questions. 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 203-369-0663. The Company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.

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