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FAF - Q2 2012 First American Financial Corporation Earnings
Conference Call

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CORPORATE PARTICIPANTS

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Jim Ryan *Morningstar - Analyst*

John Campbell *Stephens, Inc. - Analyst*

Lee Kaplan *Kestrel Investment - Analyst*

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Geoffrey Dunn *Dowling & Partners - Analyst*

PRESENTATION

Operator

Welcome and thank you for standing by. At this time all participants are in a listen-only mode until the question-and-answer session of today's 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 203-369-1533.

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, IR*

Good morning, everyone, and thank you for joining us for our second 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 four 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. Risks 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 described in the forward-looking statements are also described on page four of today's 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 presenting -- 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 today's news release, 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 measures.

With that, I'll now turn the call over to Dennis Gilmore

Dennis Gilmore - *First American Financial Corporation - CEO*

Thanks, Craig.

Good morning and thank you for joining our call. I'll review the highlights of the second quarter and then I'll provide some comments on our outlook for the third quarter and the full year.

Total revenues for the second quarter were \$1.1 billion, an increase of 18% relative to the second quarter of 2011 and up 13% sequentially. Net income in the current quarter was \$73 million or \$0.68 per share.

In the second quarter we achieved a Title margin of 11.7%, our best result since 2005. Our cost-efficient and scalable operations built over the last several years enabled us to demonstrate excellent operating leverage in the quarter.

Second quarter open orders were up 36% year over year, primarily driven by strong refinance activity. Also, we are encouraged by this year's spring buying season, with resale orders up 4% over the second quarter of last year. In addition, our Commercial division had an outstanding quarter with revenues of \$98 million, up 16% compared to last year.

Our Specialty Insurance segment achieved pretax earnings of \$13 million, revenues were up 11% and the overall loss ratio was 55%.

On Tuesday of this week we sold 4 million shares of CoreLogic stock. We anticipate a gain of approximately \$15 million and will recognize it in the third quarter. Our remaining position of 4.9 million shares must be sold within the next 3 years.

Turning to the outlook, we continue to build on strong second quarter order volumes. Open orders per day in July are running slightly ahead of June, indicating that closed orders will remain strong throughout the third quarter. Given our first half results, we are on track to achieve our objective of an 8% to 10% Title margin for full-year 2012.

At this point, I'd like to take a moment to acknowledge and thank our employees. The past several years have been very challenging for our industry and we would not have been able to deliver this quarter's strong results without our employees' dedication and hard work.

Over this period the organization has relentlessly focused on improving the efficiencies of our operation and dramatically transforming our cost structure. While this process is never done, our emphasis is now on profitable growth in our core business. This will be achieved primarily through organic growth, combined with pursuing select acquisitions.

We are committed to and excited about our mission to be the premier Title and Settlement Service company in the US and in our key markets abroad.

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, CFO*

Thank you, Dennis.

The Company generated total revenues of \$1.1 billion for the quarter, up 18% compared with the same period of last year. Net income was \$73 million or \$0.68 per share, compared with net income of \$32.3 million or \$0.30 per share last year.

In the Title Insurance and Services segment, total revenues were \$1 billion, also up 18% compared with the same quarter of last year. Direct premium and escrow fees were up 27%, driven by a 34% increase in closed orders for the quarter, partially offset by a 5% decline in the average revenue per order. Average revenue per order closed was \$1,466 compared to \$1,549 for the same quarter of last year.

Agent premiums were up 15%, which is comparable with the 16% increase in direct premiums we experienced in the first quarter, reflecting a normal reporting lag in agent revenues of approximately one quarter. In the current quarter, agent retention was unchanged at 80.3% of agent premiums.

Information and other revenues totaled \$167.4 million, up 6% compared to the same quarter of last year. This increase was driven by higher demand for the Company's Data and Information products. Total investment income for the Title segment was \$20.1 million, up 10% from the same quarter of last year, reflecting higher net realized investment gains.

Personnel costs were \$299.3 million, up 11% compared with the same quarter of last year. This increase was primarily due to higher incentive-based compensation driven by improved revenues and profitability.

Other operating expenses were \$189.8 million, up 4% from the same quarter of last year. This increase was primarily due to higher production related expenses and temporary labor in response to the rise in order activity, largely offset by a decline in legal expenses.

The ratio of personnel and other operating expenses to net operating revenue declined to 73% from 81% last year, reflecting our significant operating leverage.

In the second quarter, the provision for Title losses was 6.6% of premium and escrow revenue, reflecting an ultimate loss rate of 5.9% for the current policy year and a net increase in the loss reserve estimates for prior policy years.

We're encouraged by our Title claims experience in the first half of the year and incurred claims were down \$21 million and paid claims were down \$9 million compared to the same period of last year. We expect this positive trend to continue in the second half of the year as the high loss policy years of 2005 through 2008 become more seasoned. We're also encouraged by the positive results we continue to see from our most recent policy years, 2009 through 2012.

Pretax income for the Title Insurance and Services segment was \$118.4 million for the second quarter, generating a pretax margin of 11.7% compared to \$60.8 million and 7.1% last year.

Turning to the Specialty Insurance segment, total revenues were \$79.6 million, up 11% compared with the same quarter of the prior year. The loss ratio was 55%, compared with 54% last year.

Net realized investment gains increased by \$3 million and, as a result, the second quarter pretax margin was 16.7%, up from 14.5% in the same quarter last year.

Corporate net expense was \$19.4 million, in line with our expectation of \$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 capital and liquidity.

Cash provided by operations in the second quarter was \$112 million, an increase of \$89 million relative to the second quarter of last year.

Capital expenditures during the quarter were \$18 million, up from \$16 million in the same quarter of last year, primarily due to an increase in capitalized software related to the development of customer-facing technologies.

Our cash and investment portfolio totaled \$3.5 billion as of June 30th, which includes \$1.4 billion of fiduciary funds. The portfolio is comprised of debt securities of \$2.1 billion, cash and short-term deposits of \$861 million, equity securities of \$252 million and \$196 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 \$274 million as of June 30th. Our debt consists of \$200 million funded on our credit facility, \$43 million of trust deed notes and \$31 million of other notes. Our debt-to-capital ratio as of June 30th was 11.2%.

On Tuesday we sold 4 million of our 8.9 million shares of CoreLogic, which resulted in proceeds to us of \$90.3 million. This sale generated a realized gain of \$15.2 million, which we will recognize in the third quarter. We will continue our plan of liquidating our remaining 4.9 million shares in CoreLogic within the next three years, as required in connection with our spinoff.

After accounting for the sale of CoreLogic shares, we will have \$134 million of operating cash and 2 million of our remaining 4.9 million shares of CoreLogic at the holding company. Based on yesterday's closing price, our remaining stake in CoreLogic was valued at \$110 million, \$45 million of which is held at the holding company. In addition, we also have \$400 million available on our \$600 million line of credit.

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). Our first question will come from Mark DeVries, Barclays. Go ahead, your line is open.

Mark DeVries - Barclays Capital - Analyst

Yes, thanks. Dennis, could you talk about how you think about managing capacity and expenses in an uncertain environment like this, where industry forecasts are for soft volume, but government and Fed stimulus keeps activity so strong? How are you kind of managing your capacity with that kind of overhang?

Dennis Gilmore - First American Financial Corporation - CEO

Sure. Thanks for the question, Mark. We've been doing it pretty straightforward. We operate -- regardless of the market we're operating in, we look for operating leverage on the business. And so, we're controlling our expenses very closely and we look for growth in our core markets. So, just watching our expenses very closely and, again, looking for operating leverage out of the business.

Mark DeVries - Barclays Capital - Analyst

And what percentage of your expenses would you say are kind of fixed at this point and what percent would be variable?



Dennis Gilmore - *First American Financial Corporation - CEO*

Go ahead, Mark.

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

Hey, Mark, this is Mark. So, if you just looked at our expenses as of the last quarter, I would say about 20% of our personnel costs are variable, which is really our commissions and bonuses and incentive compensation. And if you look at our other operating expense line item, about 50% of that's variable, which is really some of our production costs. And then, of course, our loss provision, our premium tax and our agency retention expenses are 100% variable.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it. What percentage of your open and closed orders were re-fi during the quarter?

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

In the quarter, in the second quarter in terms of open, 55% was re-fi and, on the closed side, 60% was re-fi. So, we're seeing a pickup in the re-fi percentage over the last couple of quarters.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Great, thanks.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

Thank you. Our next question will come from Jim Ryan, Morningstar. Go ahead, your line is open.

Jim Ryan - *Morningstar - Analyst*

Yes, good morning. Good progress on the commercial revenue. I'm wondering if you could give us some kind of an idea of the effect that has on the margins. For example, if commercial continues to rise, is that a driving factor for the margin development? Any thoughts you have on that.

Dennis Gilmore - *First American Financial Corporation - CEO*

Sure. This is Dennis. Commercial's been a very strong performer for us over the last 7 or 8 quarters. And I would actually look to see that the commercial market is more of a normalized market for us now. We do anticipate that the commercial market will remain strong throughout -- at least throughout 2012.

With regards to margin, it does run at a higher incremental margin for the Company, so it's a -- it clearly is a good performer for us.



Jim Ryan - *Morningstar - Analyst*

Okay. And in terms of -- with the increases in revenue, any certain types of deals you're seeing? Is it more workout type transactions or is there any new development going on?

Dennis Gilmore - *First American Financial Corporation - CEO*

Again, I'd classify the market as more of a normalized market right now. No one piece of the market is dominating our order line right now, our order flow.

Jim Ryan - *Morningstar - Analyst*

Okay. Thank you.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

Thank you. (Operator Instructions). Our next question will come from John Campbell, Stephens. Go ahead, your line is open.

John Campbell - *Stephens, Inc. - Analyst*

Hey, guys, it's John Campbell in for Brett Huff. Congrats on a great quarter and thanks for taking my questions.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

John Campbell - *Stephens, Inc. - Analyst*

So, I just wanted to get you guys' thoughts on just the overall re-fi tell; just kind of how far out you guys are seeing that. Are you thinking maybe well into '13 or just kind of where your head's at with that.

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes. Again, this is Dennis. It's very difficult to call how long this will last but, what we are is encouraged right now. Our open orders end of the second quarter into the third are strong. We've actually seen some growth in our refinance transactions going into the third. So, I would predict for the foreseeable future that kind of volume will continue. We'll continue to operate in historical low interest rates. So again, for the foreseeable future, we think the type of order volumes we're seeing out of refinance will continue.

John Campbell - *Stephens, Inc. - Analyst*

Okay, great. And then could you maybe just give us a sense of what percent of that is HARP 2.0 driven re-fi versus just standard rate driven?



Dennis Gilmore - *First American Financial Corporation - CEO*

Yes. Overall, for the overall business, we're probably running in the 15% to 20% range of refinance volumes that are HARP. In our central refinance channels that we deal with our large customers, that would be a higher percentage, though.

John Campbell - *Stephens, Inc. - Analyst*

Okay. And then, just any kind of commentary you guys received or any discussions you've had with some of the big banks, kind of what their -- how much, I guess, in the pipeline they have remaining for HARP 2.0 re-fis?

Dennis Gilmore - *First American Financial Corporation - CEO*

I can't comment on how much they have in their pipeline but, through our discussions with our large customers, all of them are very busy and all of them have very full pipelines right now.

John Campbell - *Stephens, Inc. - Analyst*

Okay. And then just a last question on re-fis. There's been some rumors about a HARP 3.0 program. It looks like the government's kind of targeting the under-water home owners. Have you guys heard anything about this or kind of what's your take on that?

Dennis Gilmore - *First American Financial Corporation - CEO*

We have. And still, I think that's fairly far out in the future right now. And so, I think what we are dealing with, though, is just, again, a very strong refinance market overall.

John Campbell - *Stephens, Inc. - Analyst*

Okay. A last question from me is on the reserves. And nice work keeping a lid on the reserves this quarter. Could you guys just maybe update us and just maybe give us a ballpark of where we are with paid out claims from those bad policy years? I know Max mentioned expectations that it will continue trending down here in the second half, but maybe just give us a sense of where we are with overall payouts. Are we still thinking 7th, 8th inning or just kind of where your head's at there.

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

Yes. Well, John, I think the paid claims are honestly definitely trending down for us. We expect them to keep trending down in the second half of the year. And yes, those sort of problematic policy years are pretty well seasoned now, so we don't expect a lot more from those years.

John Campbell - *Stephens, Inc. - Analyst*

Okay, great. That's all for me. Thanks, guys.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

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

Thanks, John.

Operator

Thank you. Our next question is from Lee Kaplan, Kestrel Investment. Go ahead, your line is open.

Lee Kaplan - *Kestrel Investment - Analyst*

Good morning. Thank you for taking my question. Can you tell me your thoughts on allocation of capital, since you guys seem to have right-sized the Company and turned the corner?

Dennis Gilmore - *First American Financial Corporation - CEO*

Sure. This is Dennis. I mean, our overall perspective on capital management, when we spun the Company, we came out decidedly conservative from a capital perspective. We were operating in a very volatile market at that point. And we were looking for improvement in not only our operating metric, the pretax metric of the business, but our cash flow.

As we sit here today, we're encouraged, really, on all fronts. We're seeing the markets start to see some improvement. We are satisfied and going in the right direction in our operating metrics on the business across the board.

The thing from a shareholder perspective is we look forward to the foreseeable future, 2013 and beyond. I think our shareholders should anticipate a little bit more active capital management from us.

Lee Kaplan - *Kestrel Investment - Analyst*

And then, do you have any thoughts on using the proceeds of the CoreLogic sales?

Dennis Gilmore - *First American Financial Corporation - CEO*

The same -- basic same answer again. I think as we look forward into '13 and beyond, you'll see more of an active capital management from us.

Lee Kaplan - *Kestrel Investment - Analyst*

Thank you.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

Thank you. Our next question will come from Bose George, KBW. Go ahead, your line is open.



Bose George - Keefe, Bruyette & Woods - Analyst

Good morning. Can you give us an update on what happens next with the Edwards case? Just any thoughts there?

Dennis Gilmore - First American Financial Corporation - CEO

Sure. This is Dennis. Really, we just go back to where we were. We will go back and defend the case at the trial court level and we think we have strong defenses and we plan to very vigorously defend our position.

Bose George - Keefe, Bruyette & Woods - Analyst

So, the case was -- the first time around it wasn't heard on the merits, so this -- what's going to now, the case will just be heard on the merits now?

Dennis Gilmore - First American Financial Corporation - CEO

Exactly. And we plan to aggressively defend.

Bose George - Keefe, Bruyette & Woods - Analyst

Great. Thank you.

Operator

Thank you. Our next question is from Geoffrey Dunn, Dowling & Partners. Go ahead, your line is open.

Geoffrey Dunn - Dowling & Partners - Analyst

Thank you. Dennis, I want to come back on capital. That's probably no surprise. I'd like to get a better idea of how you are approaching the priorities for the redeployment of capital. Obviously, I think your subsidiary has probably some access there. Your balance sheet's under levered. And we can look at both buying back stock below book value, as well as a dividend payout. So, can you just expand a little bit more on how you think about how you're going to approach this and what steps we should be watching for to judge the capital activity?

Dennis Gilmore - First American Financial Corporation - CEO

Sure, Geoff. Again, as we look forward into '13 and beyond, we will look for all opportunities, obviously, to deploy the capital, what we think is right for the business. I would tell you, though, that we continue to -- we are a dividend-paying stock and that's going to be one of the key things we're going to look at as we move forward.

Geoffrey Dunn - Dowling & Partners - Analyst

Is there any commentary about desire to be buying back stock this year below book?



Dennis Gilmore - *First American Financial Corporation - CEO*

Again, Geoff, I'm not going to comment specifically on how we're going to approach it for the next quarter or so, but we're going to look at all opportunities.

Geoffrey Dunn - *Dowling & Partners - Analyst*

Okay, then let me ask you a different way. When you do come up with a capital management plan, is that something you're going to be able to outline to us or is it something that's going to be a quarter to quarter -- we watch for what you do?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, we'll give the shareholders more guidance on what our strategy's going to be as we start to roll it out.

Geoffrey Dunn - *Dowling & Partners - Analyst*

Okay. Thanks.

Dennis Gilmore - *First American Financial Corporation - CEO*

Thank you.

Operator

Thank you. 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 203-369-1533. The Company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.

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