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EDITED TRANSCRIPT

FAF.N - Q2 2021 First American Financial Corp Earnings Call

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OVERVIEW:

FAF reported 2Q21 results with diluted EPS of $2.72. Co. remains optimistic about 2021 outlook.

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CORPORATE PARTICIPANTS

Craig Barberio First American Financial Corporation - Director of IR

Dennis Joseph Gilmore First American Financial Corporation - CEO & Director

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

CONFERENCE CALL PARTICIPANTS

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

Geoffrey Murray Dunn Dowling & Partners Securities, LLC - Partner

John Robert Campbell Stephens Inc., Research Division - MD

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

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 by entering the conference ID 13721369.

We will now turn the call over to Craig Barberio, Vice President of 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 2021. Joining us today will be our Chief Executive Officer, Dennis Gilmore; and Mark Seaton, Executive Vice President and Chief Financial Officer. Some of the statements made today may contain forward-looking statements that do not relate strictly to historical or current fact. These forward-looking statements speak only as of the date they are made, and the company does not undertake to update 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 information 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 second quarter earnings call. All of our core businesses are producing strong financial results, and we are optimistic that 2021 will be an outstanding year for First American. Today, I will focus my comments on the progress we are making on a number of key strategic initiatives, and Mark will then provide details on our second quarter results.

The process of buying a home is complex and involves multiple parties. First American sits at the center of the transaction coordinating among realtors, lenders and consumers to protect the integrity of the process. As the transactions become increasingly digital, First American is focused on leveraging our unique property data and technology to enhance the customer experience and expect to process more efficient and secure for all parties.

First American's data assets and process expertise provide a unique competitive advantage. Last quarter, we announced our initiative to expand our title plants from 500 to 1,500. By building an additional 1,000 plants, our databases will cover approximately 80% of all real estate transactions.

We've made significant progress since our launch. We are currently at 850 plants and are on track to achieve our goal of 1,500 by the year-end. These additional plants are currently being built on a go-forward basis and will accrue significant benefits to us in the years to come as our historical content becomes deeper and richer.

Due to our patented extraction process, First American is in a unique position to build these plants with a fraction of our historical cost. Plus, we are now capturing virtually every data point on 7.5 million documents per month, up from 5 million last quarter, data that can be leveraged to automate title underwriting decisions in geographic areas that were previously done manually.

In addition to our data leadership, we are focused on developing digital solutions to improve the customer experience. Across the enterprise, we are developing next-generation cloud-based technology to make it even easier for our customers to do business with us.

For example, our direct division recently launched IgniteRE, a platform that provides real estate professionals with enhanced productivity tools and enable them to manage transactions from open to close with buyers, sellers and settlement agents in a secure environment. IgniteRE and ClarityFirst, which we discussed last quarter, are 2 examples of technology investments we've made to strengthen our competitive edge and more will follow.

Both platforms make it easier to work with us and expand our customer relationships. To support our technology initiatives, we acquired 130 product managers, designers and engineers so far this year. These critical hires reflect our commitment to expand our position as the industry-leading innovator.

Turning to our venture strategy. Since 2019, we've invested $260 million in venture-backed companies in the proptech ecosystem. These investments give us insight into high-growth technology companies, most of which have become strategic partners. In addition to providing strategic benefit, they are contributing to profits as well. Venture investments will continue to be a component of our capital allocation strategy.

In closing, I'm confident that 2021 will be another strong year for First American. All of our core divisions are performing well, and we have a healthy pipeline of business heading into the second half of the year. Our balance sheet is strong, and our strategy of focusing on data and technology to enhance the customer experience will continue to succeed.

I'd now like to turn the call over to Mark, who will comment on our second quarter earnings.

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

Thank you, Dennis. We're pleased to report excellent results this quarter. We earned $2.72 per diluted share. Included in this quarter's results were $0.59 of net realized investment gains. Excluding these gains, we earned $2.13 per diluted share.

I'll start with our title business. Revenue in our Title segment was $2.1 billion, up 44% compared with the same quarter of 2020 due to the strength of the purchase in commercial markets. Purchase revenue was up 66% driven by a 43% increase in the number of closed orders, coupled with a 16% increase in the average revenue per order.

Commercial revenue was $223 million, a 104% increase over last year. Large transactions have resumed as we closed 54 transactions in the U.S. with premium greater than $250,000, up from just 12 last year. This year, we expect a record year in our commercial business. Refinance revenue declined 23% relative to last year as the rise in mortgage rates that occurred during the first quarter put pressure on second quarter closings.

On the agency side, revenue was a record $905 million, up 51% from last year. Given the reporting lag in agent revenues of approximately 1 quarter, we are experiencing a surge in remittances related to Q1 economic activity. Our information and other revenues were $298 million, up 31% relative to last year.

Revenue growth was primarily due to higher demand for the company's title information products in our data and analytics, commercial and loss mitigation business lines. Investment income within the Title Insurance and Services segment was $47 million, up 10%, primarily due to higher interest income from the company's warehouse lending business and higher average balances in the company's investment portfolio, partially offset by the impact of the decline in short-term interest rates on the company's tax-deferred property exchange and escrow balances. In our Title segment, pretax margin was a record 19.1%. Excluding the impact of net realized investment gains, pretax margin was 16.3%.

Turning to the Specialty Insurance segment. Pretax earnings totaled $20 million, up from $7 million in 2020. Revenue in our home warranty business totaled $108 million, up 10% compared with last year. Pretax income in the home warranty business was $14 million, a decline of 13% in part due to elevated claims expense.

Our property and casualty business generated pretax income of $6 million this quarter. Included in this quarter's results was a $12 million gain on the sale of our agency operations. At the end of the second quarter, our policies-in-force have declined by 22% at the beginning of the year, and we expect a 70% decline by year-end.

The full wind-down of the property and casualty business is on track to be completed in the third quarter of 2022. The effective tax rate for the quarter was 24.0%, in line with our normalized tax rate. Cash flow from operations was $253 million in the second quarter, down from $344 million in the prior year, due primarily to the deferral of estimated tax payments allowed by taxing authorities during the height of the pandemic in 2020.

With respect to the information security incident, as we previously disclosed, we reached a settlement with the SEC for $487,616. The New York Department of Financial Services matter remains ongoing. We continue to believe that it, along with all other matters relating to the incident will be immaterial.

As Dennis mentioned in his remarks, we've invested a total of $260 million in venture-backed companies. This quarter, we recorded a $44 million gain related to our investment in (inaudible), a real estate SaaS company that serves real estate agents, teams and brokers. Our largest investment has been in OfferPad, an iBuyer that is now party to a merger with a SPAC, which recently announced that the value of the aggregate equity consideration to be paid to OfferPad stockholders and option holders will be equal to $2.25 billion. At that valuation, we would expect to book a gain of approximately $237 million on our $85 million equity investment. We expect this merger to close later this year.

Due to the growth of our venture portfolio, we have expanded disclosures in our Form 10-Q, which we expect to file later today. These disclosures will include the cost, unrealized gains and carrying amount of our nonmarketable equity securities as well as information on concentration of these securities.

We remain optimistic about our 2021 outlook. Although refinance orders have declined corresponding to an increase in mortgage rates, the purchase and commercial markets remain strong, our claims experience is favorable and the general improvement in economy is a tailwind to our business.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first questions come from the line of Bose George with KBW.

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

Actually, first, just on the commercial. Mark, can you repeat what you said just on the large transactions? You said 54 transactions with premium greater than I missed the dollar amount and you compared it to last year. Just curious how that compared to 2020. And then just in commercial, I guess, can you just talk about where you're seeing the strength just presumably this is happening without sectors like office coming back?

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

Yes. Bose, why don't I start, this is Dennis. The numbers Mark referenced are of our commercial transaction, large transactions over $250 million were 54 in the quarter, up over 4x from a year ago. But we have to compare -- last year, in 2020, that was the first year -- the first quarter of the pandemic, so probably a tough comparison there.

To your second part of your question, though, is we're up across all geographic areas, almost all product types. Commercial is really strong right now as we mentioned in the scripts, it's likely will be very strong in the rest of the year, probably trending towards a record performance in commercial.

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

Okay. Great. And then can you just remind us what goes through that default and other line for order counts? This was up the last couple of quarters, and I assume that's not being driven by default. So just curious what's the breakout in there.

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

Yes. It's just -- it's a lot of default orders, both for that line item, including loss mitigation. We're doing a lot of loss mitigation work for lenders right now. So it's really default and loss mitigation.

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

Okay. So that is picking up despite the -- because of moratorium?

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

I'm sorry, specific -- well, it's not foreclosure or (inaudible) work right now (inaudible).

Operator

Our next questions come from the line of John Campbell with Stephens.

John Robert Campbell - Stephens Inc., Research Division - MD

Congrats on a solid quarter. So on the extension of the title plants, that's exciting for you guys. I guess the question here is how should we think about just the net effect of those. I think you said 1.5 -- or 1,500 plants over the next several years. Is there a good way to think about that over the next couple of years? Is there a way to kind of frame up the incremental revenue opportunity versus maybe just a potential production cost savings? Anything you can provide there?

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

Yes, John, let me take a cut at that. It's really worth highlighting the strategic benefits we have with our data and our process component across the company. So you start with -- we've got the largest public record databases now. We've really accelerated the growth there. We've mentioned it before that we've got some very unique patented extraction technology, which allows us to basically capture every field off of document, I mentioned that in my script.

So last quarter, we were extracting 5 million components from the document, this quarter is 7.5 million. So basically, anything on a doc we can take now, and we're building the plant (inaudible) the plants.

So we mentioned earlier -- early last quarter that we're going to run it up to 1,500 plants. We're now 850, we'll be on track to hit 1,500 by the end of the year. And we're building these on a go-forward basis. So they're going to have true benefit for us in the years to come as they become richer and deeper, but we have the technology to point backwards if we need it. So bottom line, it's a little hard to quantify for our analysts right now, but what it will allow us to do is to accelerate our title automation, leverage our data, couple it with our title assets.

John Robert Campbell - Stephens Inc., Research Division - MD

Okay. That's helpful. And then, Dennis, I've got a bigger picture industry question for you, but it just seems like every day, we're seeing a non-bank originator just somebody in the value chain just looking to launch a title offering. And then, of course, you got the iBuyers. It's almost like they have to make that attachment work over time. But to me, it just seems like the end result, if that's all effective, is maybe just a mix shift from direct to agency and not really disintermediation, but I'm just curious about how -- I guess, first, how difficult do you think the attach rates are for those newer players? And then secondly, whether you think that trend is a positive, negative or maybe just a neutral over the long haul?

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

Yes. I'll start on with the ebbs and flows over the years, right? So this is not a new phenomenon for us, and it has that been throughout over the years. Right now, you do have a lot of people entering. So we'll have a -- we'll move from direct to agency. We don't want to fight that at all. We actually try to support it and embrace it. You see that in our venture strategy that although many of these companies are partners for us, so we can deploy title assets or title information to them or data. So either way it goes there. And I think it will continue to ebb and flow probably as the market gets a little more normalized or difficult, maybe it's not as attractive as we go forward. But it's something -- again, at the end of the day, we don't fight, we actually encourage and support no matter how somebody wants to distribute the product.

John Robert Campbell - Stephens Inc., Research Division - MD

Okay. That's helpful. And if I could just squeeze in maybe just one more for Mark here. On the Specialty Insurance segment, once you kind of clear out the P&C contributions you're left with, obviously, just the warranty business. How should we be thinking about that kind of underlying margin going forward?

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

So once you clear out the P&C business, and it's going to take a little bit of time because we're -- the wind down will be complete in the third quarter of next year. But when it left effectively, we're going to just have a home warranty segment. And as we talked about over the years, we're really high on the home warranty business. But when you look at the second quarter, we had an operating margin of 9% (SEE NOTE 1). That excludes investment income. Once you layer on investment income, it's more like 11%, 12%. And Q2 is typically a tough quarter for us, right, because we're getting a lot of claims, a lot of [air conditioners] going out in the second quarter. But through the cycle, through the seasonality of the year, the margins typically are somewhere between the range of 13% to 15% on a normalized basis. And you'll see that again once the segment becomes clean.

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

John, this is Dennis. I would only add you'll see in our disclosures that we broke out the performance of both home warranty and P&C so our investors can get a better sense of what home warranty will look like when we're done wrapping up the P&C business.

Operator

(Operator Instructions) Our next questions come from the line of Mark DeVries with Barclays.

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

I had a follow-up question on the commercial volumes. Those larger transactions tend to be pretty lumpy and episodic. As you look at your pipeline, though, does it look like this is kind of consistent with that kind of lumpiness? Or do you actually see sustained strength as you look out through the end of the year on those larger transactions?

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

Yes, we do see sustained strength. The deals you're really referencing too, I'd reference them to kind of mega deals. But when we talk about the large deals, those are just, if you will, normal large deals and that strength, we think will continue through the rest of the year.

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

Okay. Great. And then on the purchase side, I think Mark highlighted that the fee per file was up about 16% year-over-year, which is actually kind of consistent with home price appreciation but you normally get about half of that. So are you seeing a positive mix benefit here where more of the purchase is also coming from just higher priced markets that's driving your fee up kind of in line with home price appreciation?

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

Yes, we are. And just -- I mean, overall, the market is very strong right now. And on this topic, by the way, we're very optimistic, right, the real demographics are positive for us. We had a very strong spring selling season. I'll say in July right now, we're starting to trend a little more towards, I call it, the seasonal market. We're probably down about 6% on all accounts right now in July.

And also, we think that the purchase market also is starting to stabilize a little more normalized, if you will. The inventories are ticking up a little bit. We're seeing less crazy bidding rules. We probably see less property appreciation in the year and for the next year or so. And all of those trends to us is a positive sign, not a negative. It makes the market more sustainable than normal. So we think it's going to be a really good second half of the year. We think '22 is going to be a good year for purchase too.

Note 1:

Non-GAAP Reconciliation of Home Warranty Operating Margin

Second Quarter 2021	$ in thousands
Total revenues	$107,609
Less: Net investment income	992
Less: Net realized investment gains	3,331
Net operating revenues	$103,286
Pretax income	$ 13,704
Less: Net investment income	992
Less: Net realized investment gains	3,331
Operating profit	$ 9,380
Pretax Margin	12.7%
Less Investment Income impact	0.8%
Less Net realized investment gains impact	2.8%
Operating Margin	9.1%

Totals may not sum due to rounding

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

Okay. Great. And then can you just talk about how much of the strength in revenues in info and other is -- might be more cyclical as opposed to you taking share?

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

Well, it's hard to say because [info] and other as we know, is a collection of businesses. When we look at the biggest drivers of the growth this quarter, the biggest driver was commercial business. So we actually grew info another $15 million just because of commercial business that we did that didn't -- as it's risked attached, with property reports and exchange fees and commercial due diligence and things like that. And so obviously, we've got tailwinds in commercial.

The second biggest driver was loss mitigation in our servicing business. So as we talk about the foreclosure moratoriums are here at least until the end of this month. But lenders are doing a lot of loss mitigation working with the beneficiary of that. So I would say that's somewhat cyclical. And then the third biggest driver was our data and analytics business. And we've just got a lot of momentum on the data analytics business, both because of volumes, but also because we're doing a really good job of licensing our data to different parties and growing that. So it's kind of a mix of things.

Operator

Our next questions come from the line of Geoffrey Dunn with Dowling & Partners.

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

Dennis, I wanted to follow up on your comments initially about working on developing next-gen cloud platforms and hiring a bunch of people to develop cloud and digital efforts. Can you maybe give some more specific examples of areas you're focused on? There's been talk obviously the last couple of quarters, front-end, back-end experiences, all that kind of stuff. And the other question I have is as you develop these modules, do they sit naturally on the [FAST] system? Or is the FAST system something you're also investing in? It's been your kind of core system for years. I'm just curious if that's transitioning along with these other cloud initiatives.

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

Yes. Thanks, Geoff. Well, we just -- we're going to talk a little bit about -- more about these issues just so people know what we're up to. And that's why we mentioned all the developers and engineers we're hiring. I think of the [FAST] system just been a record and ClarityFirst, IgniteRE, others, we've got these type of systems that are going to be the customer interface. They're being built out in every division. We've highlighted just 2 of them for the investors right now. But we're building out new front ends across the enterprise right now to have more enhanced digital experience coming to the next-gen from how we think the digital experience will occur. And we're going to continue to do that, Geoff. So that's why -- that's what we're talking about right now.

We build out Clarity, we build out IgniteRE already, and we've gotten -- again, going across all of our divisions. So that's going to be an ongoing effort. We see the business moving into a digital future, and we believe we're leading that and we're going to continue to lead that effort. So that's how we're thinking about that technology. And I think we talked a lot about the data and how that effort is driving greater innovation for us and greater title automation also.

Operator

Our next questions come from the line of John Campbell with Stephens.

John Robert Campbell - Stephens Inc., Research Division - MD

I think I might have missed this, but could you run through the July to date purchase and refi trends on the resi side?

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

Yes, John, sure. So so far in July, on the purchase side, we're opening about 2,300 purchase orders a day that's opened. And on the refinance side, we're almost at a little bit below 1,700 a day. We -- interesting, in the first week or so with refis, we were about 1,400, 1,500. We have seen a pickup just in the last 2 days with the rates moving. But to answer your question, for the month to date in July, we're almost 1,700.

John Robert Campbell - Stephens Inc., Research Division - MD

Okay. And I don't know if you have the Clarity in the system or if you guys have insights onto the price side, but it looks like that all systems are still a go on price growth. Any kind of sense of what that's looking like in July so far?

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

That's not something we track kind of intra month. So we don't have like a month to date. But there's no question we've got tailwinds in terms of fee per file on the (inaudible) side.

Operator

(Operator Instructions) There are no additional questions at this time. And with that, this does conclude 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 by entering the conference ID 13721369. The company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.