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FAF.N - Q1 2022 First American Financial Corp Earnings Call

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**OVERVIEW:**

Co. reported 1Q22 revenue of \$2.0b and diluted EPS of \$0.88.

## CORPORATE PARTICIPANTS

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

**Kenneth David DeGiorgio** *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*

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

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

**Ryan Christopher Gilbert** *BTIG, LLC, Research Division - Director and Homebuilding, Real Estate Tech & Specialty Finance Analyst*

## PRESENTATION

### Operator

Greetings, and welcome to the First American Financial Corporation's first 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](http://www.firstam.com/investor). Please note that this call is being recorded and will be available for replay from the company's investor website for a short time by dialing (877) 660-6853 or (201) 612-7415 and enter a conference ID 13729079.

We will now turn the call over to Mr. Craig Barberio, Vice President, Investor Relations, to make the introductory statement.

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

Good morning, everyone, and welcome to First American's earnings conference call for the first quarter of 2022. Joining us on today's call will be our Chief Executive Officer, Ken DeGiorgio; 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 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](http://www.firstam.com).

I will now turn the call over to our CEO, Ken DeGiorgio.

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### **Kenneth David DeGiorgio** - *First American Financial Corporation - CEO & Director*

Thank you, Craig. Our company delivered good financial results in the first quarter, our seasonally slowest period. Revenue was \$2 billion with earnings of \$0.88 per share, or \$1.17 per share excluding net investment losses.

The market is currently transitioning from record low interest rates to a more normalized environment, and we believe First American will outperform for 2 primary reasons. First, the market is shifting away from refinance transactions towards purchase and commercial transactions, which is where we have a greater market share.

Second, we are the only title company that has a bank which will enable us to capitalize on higher interest rates to a greater extent than our competitors. Based on the forward curve for Fed funds, we expect growth in investment income to add about \$150 million to our annualized pretax income by the end of this year.

In terms of our outlook for the remainder of 2022, we expect transaction levels in the purchase market to continue to be down from last year, given inventory constraints and declining affordability. However, we expect strong housing demand, supported by the strong economy and labor market to continue to drive robust home price appreciation. And together with acquisitions, modest growth in purchase revenue this year. Also, given strong fundamentals in the commercial market, we are confident our commercial business will continue to operate at an elevated level into the second half of the year.

Given the current market transition to a more normalized rate environment, we're sharpening our focus on expense management. We will, however, continue to invest in strategic initiatives that drive our company's operational efficiency and future growth, including through ongoing funding of our title automation and digital closing initiatives and the expansion and enhancement of the data assets that fuel them.

We've been active with share repurchases in response to market conditions that have resulted in our stock being undervalued in recent months. This year, we have repurchased 3.25 million shares for a total of \$210 million at an average price of \$64.64.

I'm also pleased to report that our previously announced acquisition of Mother Lode Holding Company, a title agency with 92 offices across 11 states including the key markets of California, Texas and Arizona, is expected to close in May. We are excited to welcome Mother Lode, which includes 10 highly successful regional brands and over 1,000 talented employees to our company.

In closing, I want to thank our employees for all their hard work and accomplishments. It is their continuous focus on supporting each other, our customers and our communities that for the seventh consecutive year resulted in First American being named to the 100 Best Companies to Work For list by Great Place to Work and Fortune magazine.

Now I'd like to turn the call over to Mark for a more detailed discussion of our financial results.

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

Thank you, Ken. This quarter, we earned \$0.88 per diluted share. Included in this quarter's results were \$0.29 of net investment losses. Excluding these losses, we earned \$1.17 per diluted share.

Revenue on our title segment was \$2 billion, up 8% compared with the same quarter of 2021. Commercial revenue was \$242 million, a 48% increase over last year. We experienced strength across the board in terms of geography, asset class and deal size.

We closed 77 transactions in the U.S. with premium greater than \$250,000, up from 34 transactions last year. Our escrow balances totaled \$15 billion at the end of the quarter, up from \$10 billion at year-end, which indicates a healthy pipeline for commercial activity.

Purchase revenue was up 10% during the quarter, driven by a 16% increase in the average revenue per order, partially offset by a 5% decline in the number of orders closed. Our purchase orders declined from an unusually strong quarter in Q1 of 2021, which experienced the release of pent-up demand due to the pandemic.

Refinance revenue declined 59% relative to last year due to the increase in mortgage rates. In the agency business, revenue was \$948 million, up 12% from last year. Given the reporting lag in agent revenues of approximately 1 quarter, we experienced growth in remittances related to Q4 economic activity.

Our information and other revenues were \$302 million, up 9% relative to last year. Revenue growth was primarily due to the recently completed acquisition of ServiceMac.

Investment income within the Title Insurance and Services segment was \$53 million, a 23% increase relative to the prior year. The increase was primarily due to higher average invested balances. As the Federal Reserve raises rates, we expect to generate additional investment income from our escrow deposits, cash balances, 1031 exchange deposits and our bank investment portfolio, where we have over \$1 billion of floating rate securities.

On the last earnings call, we estimated, based on current deposit balances, that a 25 basis point increase in the federal funds rate would equate to a \$15 million to \$20 million increase to our annualized investment income in the title segment. We believe this estimate still appropriate and expect to see the benefit of the Fed's March rate hike beginning in the second quarter. Based on the forward curve for the Fed funds rate, we expect our investment income to grow by about \$150 million on an annualized basis by the end of this year. Pretax margin in the title segment was 11%.

Turning to the Specialty Insurance segment. Operating revenue in our home warranty business totaled \$104 million, up 5% compared with last year. Pretax income in home warranty was \$16 million, up from \$13 million in the prior year, primarily due to lower claims activity as the loss rate fell from 54% to 46%.

Our property and casualty business had a pretax loss of \$4 million this quarter. To date, our policies in force have declined by 88% since the beginning of 2021, and we expect the full wind down of the property and casualty business to be completed in the third quarter of this year.

The effective tax rate for the quarter was 24.6%. As a result of recent acquisitions, we expect that our normalized effective tax rate will be 24.5%, slightly higher than the 24% rate we've been using as the benchmark for the last several years since a larger portion of our pretax income is now coming from our noninsurance businesses and is subject to higher state income taxes.

In the first quarter, we repurchased 1.6 million shares for a total of \$108 million at an average price of \$69.04. So far in the second quarter, we repurchased an additional 1.7 million shares for a total of \$102 million at an average price of \$60.54.

As Ken mentioned, in May, we expect to close our acquisition of Mother Lode Holding Company. The purchase price is \$300 million, which represents 5.1x trailing 12-month adjusted EBITDA. Our debt-to-capital ratio as of March 31 was 29.1%, or 23.4% excluding secured financings payable.

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

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question is from Mark DeVries with Barclays.

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

Could you discuss how you're thinking about managing expenses here as the refi volume slows? And how are you thinking about that, particularly relative to kind of the success ratio notion?

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

Yes, a couple of things I say, Mark. First of all, in terms of the success ratio, that's a metric we've been talking about for a long time. And one of the things that we know about the success ratio is it's really relevant when there's significant changes to revenue either up or down.

This quarter, our net operating revenue changed \$50 million on a base of \$2 billion. So it's -- the success ratio is not as relevant when you have small changes to revenue. I think we're going to see that for the rest of this year. As I talked about last quarter, we think our revenue is going to be roughly flat. And so as a result, the success ratio isn't going to be as meaningful.

On the head count side, though, one of the things that I would say is that if we have businesses that are experiencing declining of order volumes, particularly because of refi market, and we're reducing head count in those areas. There's other areas where we're adding. For example, NCS. Our commercial revenue was up 40%. We're adding in commercial. We're adding in endpoint and in ServiceMac with some of these recent acquisitions.

And so there's kind of 2 things going on. We're reducing in areas that are kind of order dependent, we're adding in areas that are growing. So we have to kind of balance that as we go forward.

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

Got it. And then second question. I was happy to see the share repurchase activity. Could you just talk more about kind of your appetite to do more of that should the shares continue to kind of trade near these levels?

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**Kenneth David DeGiorgio** - First American Financial Corporation - CEO & Director

Mark, this is Ken. Thanks for the question. Yes. I mean it's -- as we noted, I mean we repurchased 3.25 million shares already. And we've gotten more aggressive recently. But as we've said in the past, we're going to evaluate share repurchases going forward compared to other capital deployment opportunities, be it M&A, investing back in the business in innovation and technology, dividends in our venture capital portfolio. But I will say if the current environment persists, we expect to be active in repurchase market.

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

Okay. Great. I'll just squeeze in 1 related follow-up on that. I think private market valuations have, obviously, come off a fair amount in the fintech space. Are you seeing more opportunity to put capital work in kind of the mortgage tech space? Or are companies reluctant to kind of sell at these valuations right now?

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**Kenneth David DeGiorgio** - First American Financial Corporation - CEO & Director

I mean interestingly, we're not seeing the private values come off as much as you might be seeing in the publicly traded market. But we don't see a ton of attractive opportunities. I think we're getting -- we've always been disciplined about investing in the venture space. And I think our -- the hurdles are probably getting a little higher. I think -- as we've mentioned in the past, we've got 2 hurdles, 1 strategic and 1 financial. And both of those hurdles are probably getting a little higher in the current environment.

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**Operator**

Our next question is from Bose George with KBW.

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

Actually, first, just the comment about premiums or revenues being flat. I assume that includes the accretion from Mother Lode?

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

That's right, Bose. That's right. We're going to expect to close Mother Lode here in May. And so when I say revenue is flat, that assumes acquisitions. And the biggest one is Mother Lode. So that does include that.

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

Okay. Great. And then just 1 more on the expenses. Were there anything sort of onetime? I mean you referred to the incentive comp in the release. Like is there anything that sort of elevated it? Or should we just think of this as fairly normalized?

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

Yes. I wouldn't say there was anything that was unusual. I mean the one thing I would point out is that we had \$12 million higher RSU expense in the title segment than we did a year ago. We're not allowed to sort of accrue our restricted stock units.

Last year was a good year for bonuses because it was a record year. And so we booked a lot of that in the first quarter. So our first quarter RSU expense was \$12 million higher than last year. But that's an entry we do every first quarter, just higher this year. There was nothing unusual other than I would say that.

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

Okay. Great. And then can you just give us an update on purchase order trends in April?

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

Yes. So through the first 19 business days in April, our purchase orders are 2,100 a day, it's down about 10% from a year ago. Refis are about 700 a day, that's down about 60% from a year ago. And our commercial transactions are -- these are all opens, I'm talking about. Commercial is about 600 today, and that's kind of where we were the last year.

**Operator**

(Operator Instructions) Our next question is from Ryan Gilbert with BTIG.

**Ryan Christopher Gilbert** - *BTIG, LLC, Research Division - Director and Homebuilding, Real Estate Tech & Specialty Finance Analyst*

I wanted to ask about pretax margin in the title business. And I know that typically, we see a sequential improvement from 1Q to 2Q as volume picks up. And I'm wondering if we should expect to see that again in 2022 or if there's -- the headwinds on orders are going to affect that at all?

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

No. I think we're -- Q1, based on what we see today, is definitely going to be the seasonally slowest period. So margins are just going to increase from here on out. And one thing that we mentioned on the remarks that I'll just point out again is that as the Fed raises rates, I mean we're going to get \$15 million to \$20 million of annualized investment income. And we saw that in March. As soon as the Fed raised in March, all of our banks -- almost all of our banks increased their rates.

And so we're going to start to see a big benefit of investment income here, particularly as we get to the second half of the year. But even if you excluded that, we would still have higher margins in the latter quarters than we did in Q1. There's no question about that.

**Ryan Christopher Gilbert** - BTIG, LLC, Research Division - Director and Homebuilding, Real Estate Tech & Specialty Finance Analyst

Okay. Got it. Second question for me is on actually the agency margin. It looked like it came down around 60 basis points in 1Q '22 from 1Q '21. Is there anything to call out there? And then as we think about adding Mother Lode to the business, does that impact the -- your overall agency percentage of the business?

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

In terms of this blip, I think, is what you're talking about the agency margins, it's really just a function more of geographies. Typically, as you know -- I mean we have better splits on the East Coast than the West Coast. And so it's really just a function of geography more than anything else.

I think in terms of the Mother Lode acquisition, it's an agent today. Once we acquire it, it will be a direct operation. So it really won't have an effect on our agency revenues. It will basically flip to direct revenue once we close it.

**Operator**

Our next question is from John Campbell with Stephens Inc.

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

Back to your comments around the purchase rev being up this year. I mean, obviously, Mother Lode, the acquired orders are going to help there. So I guess first is, are you assuming organically purchase rev down on the year?

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

Yes. So organically, excluding acquisitions, when we look at our purchase revenue, it will be down slightly, 2%, 3%, something like that based on what we're seeing today. We, obviously, have the situation where orders are falling, but we're getting a big benefit in the average fee per file. On an organic basis, I think we're a little bit less than flat. I think once you layer in the acquisitions, we'll be high single digits on purchase revenue.

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

Okay. And then I don't want to put too fine of a point on it. I know there's a lot of moving pieces here, but any -- what's your rough sense for how much units are down on the year relative to price on an organic standpoint?

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

Can you -- I don't think I understood your question, John. Can you explain that again?

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

Well, if you're thinking about purchase revenue, it's just a matter of the number of orders times price, HPA. And so just curious about how you're thinking about the decline in orders -- purchase orders versus upside to price.

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

Well, okay, I got you. So, so far, I would say, on the year, we're going to be -- I mean when you look at the first 4 months of the year, we're down high single digits in terms of orders. And we think it might get a little bit better than that, but I think high single-digit decline is probably a reasonable assumption in terms of orders, again, on an organic basis. On an HPA, I think we should be 7% to 8% up something like that.

One of the things that's happened is in the first quarter, our fee per file was up 16%. Half of that is really because of the fact that we bought some independent escrow companies in Southern California and there's revenue but not any orders attached to them. Organically, we're seeing about an 8% increase in HPA. And so they're roughly going to wash out, if that makes sense, some of the orders in HPA.

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

That makes sense. And then, I guess, a decade ago, it was -- the rule of thumb was always like purchase was 2x the revenue per order of a refi. It seems like that's going way the other way. So I don't -- is it 3, 3.5x now? What's a good way to think of that?

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

I'd say, generally speaking, it's about 2.5x. You're right. It used to be 2x, but because housing prices have increased and several years ago, we were taking rate. Now the rule of thumb is 2.5x.

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

Okay. Last one for me. The expected funding mix for the Mother Lode acquisition, just how much dry powder you have cash-wise, holding company and what you expect debt wise?

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

So as of March, we had \$813 million cash at the holding company. So the Mother Lode acquisition is \$300 million. We can obviously fund that without taking on additional debt. And we've repurchased about \$100 million of stock in April. So really kind of on a pro forma basis, we're about \$400 million. It's a very comfortable place to be.

I mean one thing that we feel good about is we did the debt deal last year, where we raised \$650 million at a 2.9% rate. And that's turning out to be a pretty good deal in hindsight. So effectively, what we did is we pre-borrowed for the Mother Lode deal. So we're just going to fund it with cash on hand.

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**Operator**

There are no additional questions at this time. That will conclude this morning's call. We would like to remind listeners that today's call will be available for replay on the company's website or by dialing (877) 660-6853 or (201) 612-7415 and enter the conference ID number 13729079.

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

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