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FAF.N - Q4 2022 First American Financial Corp Earnings Call

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OVERVIEW:

Co. reported 4Q22 total revenue of \$1.7b, diluted EPS of \$0.52, diluted EPS excluding net investment losses of \$1.35.

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 & Research Analyst*

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

Mark Douglas Hughes *Truist Securities, Inc., Research Division - MD*

PRESENTATION

Operator

Greetings, and welcome to the First American Financial Corporation Fourth Quarter and Full Year 2022 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 this 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 then for the conference ID 1373-5364. We will now turn the call over to Craig Barberio, Vice President, 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 Fourth Quarter and Full Year 2022 Earnings Conference Call. Joining us today on the 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 at our website at www.firstam.com. I will now turn the call over to our CEO, Ken DeGiorgio.

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

Thank you, Craig. At the very beginning of 2022, many expected the strength of 2021 to continue into the year. Early on, however, we saw that the cycle was turning. As a result, we began to sharpen our focus on expense management. Due in part to these early expense management efforts, the benefit of growth in net investment income and a record-setting year in our commercial business, First American achieved a full year Title segment pretax margin of 10% or nearly 12%, excluding net investment losses on total revenue that declined 9% to \$7.5 billion. Continuing challenging market conditions weighed on our fourth quarter financial results. In the quarter, we generated revenue of \$1.7 billion and earnings per diluted share of \$0.52 or \$1.35 per share, excluding net investment losses.

In our Title segment, we delivered a pretax margin of 7% or 10% excluding net investment losses. The key drivers of these results were our ongoing focus on expense management and continued growth in investment income. Our Specialty Insurance segment also contributed with a pretax margin of 14% or 18% excluding net investment losses.

Turning to our key Title businesses. Refinance has been declining for the past 2 years, so it's now at trough levels. In January, we opened 324 refinance orders per day, down from over 1,100 per day a year ago. Our open purchase orders were down 37% this quarter. Based on our order trends, we are seeing early signs of stabilization with open purchase orders improving from down 40% in November to down 37% in December and down 31% in January. The recent decline in mortgage rates, combined with lower home prices, has led to some improvement in affordability and therefore, demand which makes us cautiously optimistic that the purchase market is in the early stages of recovery.

Our commercial business had a record year in 2022 with revenues up 2%. However, open orders have been meaningfully declining over recent months. Open orders were down 27% in the fourth quarter and this downward trend has continued in January with open orders down 20% compared with last year. While uncertainty remains high, our expectation for our commercial business in 2023 is that it will be another good year, but below 2022's record level. Despite the challenging environment ahead of us, we believe the company is well positioned to emerge even stronger when the current down cycle ends. Our healthy balance sheet allows us to continue to actively pursue capital deployment opportunities, including investing in key strategic initiatives and acquisitions as well as returning capital to shareholders.

We continue to make good progress at Endpoint, our digital title and settlement company and our instant title decisioning initiative for purchase transactions. These investments today will pay out over time by adding efficiency, improving the way customers interact with us and importantly, freeing up our people from process-oriented tasks to further enhance their ability to focus on delivering superior customer service.

On the M&A front, we continue to have the financial flexibility to pursue attractive opportunities that may arise. And during 2022, we returned \$658 million to shareholders through share repurchases and dividends.

In closing, I want to thank our employees for all their hard work and accomplishments in 2022 and for their dedication as we navigated through the sharp downturn in the real estate market. It is their professionalism, talent and customer focus that drives our company's continued success. Now I'd like to turn the call over to Mark for a more detailed discussion of our financial results.

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

Thank you, Ken. This quarter, we earned \$0.52 per diluted share. Included in this quarter's results were \$0.83 of net investment losses. Excluding these losses, we earned \$1.35 per diluted share. Two items contributed to our net investment losses this quarter. First, we realized \$79 million of losses on our fixed income portfolio in connection with our tax planning strategies. Second, we incurred \$46 million of unrealized losses related to our venture portfolio. Revenue in our Title segment was \$1.6 billion, down 29% compared with the same quarter of 2021. The Commercial revenue was \$251 million, a 34% decline over last year. Our escrow balances, which are largely driven by commercial activity totaled \$10 billion at the end of the quarter, down from \$11 billion in the fourth quarter of last year. Purchase revenue was down 30% during the quarter, driven by a 36% decrease in the number of orders closed, partially offset by a 9% increase in the average revenue per order.

Our revenue per order for purchase transactions continue to benefit from recent acquisitions of escrow companies in Southern California. We include escrow revenue from these transactions in the numerator without a corresponding title order in the denominator. Excluding acquisitions, average revenue per order would have been up 1%. Refinance revenue declined 74% relative to last year due to the increase in mortgage rates. In the Agency business, revenue was \$753 million, down 25% from last year. Given the reporting lag in agent revenues of approximately one quarter, these results reflect remits related to Q3 economic activity. Our information and other revenues were \$241 million, down 25% relative to last year. The decline was the result of lower transaction levels across several business units driven by the decline in residential mortgage originations, including the company's data, property information and post-close services. Investment income within the Title Insurance and Services segment was \$132 million, a 169% increase relative to the prior year.

Rising short-term rates are benefiting the interest income we receive on our cash and investment portfolio, escrow balances and tax-deferred property exchange balances. As short-term rates have risen, we expect investment income to continue to be a tailwind for earnings in 2023. On

the expense side, we continue to manage expenses given the decline in transaction activity. Excluding acquisitions, our success ratio was 46%, meaning that our personnel and other operating expenses declined \$232 million, and our net operating revenue declined \$503 million. Though below our long-term target of 60%, we believe our success ratio was a good outcome given the sharp decline in transaction activity and our commitment to continue to fund strategic initiatives.

In addition, we recorded \$17 million of severance expense this quarter. As Ken highlighted, we continue to invest in businesses and innovation initiatives that we believe will positively contribute to our profitability in the long term, but at this point in the life cycle adversely impact our financial results. Last quarter, we discussed 3 initiatives: ServiceMac, Endpoint and instant decisioning for purchase transactions, which together generated a pretax loss of \$21 million this quarter, impacting our pretax title margin by 150 basis points.

Notably, ServiceMac turned EBITDA positive this quarter. Pretax margin in the Title segment was 7.1% or 10.4% excluding net investment losses. Turning to the Specialty Insurance segment. Total revenue in our home warranty business totaled \$108 million, up 4% compared with last year. Pretax income in Home Warranty was \$15 million, down from \$17 million in the prior year. Excluding net investment gains and losses, pretax income was \$21 million, up from \$15 million last year. The loss ratio in home warranty was 47%, down from 52% in 2021, driven in part by a lower frequency of claims. The financial results of our Property and Casualty business are no longer material. The effective tax rate for the quarter was 6.9%. Excluding the impact of our net investment losses, our tax rate would have been 18.0%, less than our normalized tax rate of 24% due primarily to a shift in the mix of earnings to insurance businesses, which generally pay premium tax (inaudible) income tax.

In the fourth quarter, we repurchased 687,850 shares for a total of \$34 million at an average price of \$49.47. For the full year of 2022, we repurchased 7.5 million shares for a total of \$441 million at an average price of \$58.65. Our debt-to-capital ratio as of December 31 was 30.0%. This ratio is impacted by both our accumulated other comprehensive loss and our secured financings payable. Excluding these 2 items, which is more in line with how our banks view the ratio, our debt-to-capital ratio was 22.9%. On February 1, we repaid \$250 million of senior unsecured notes that matured using cash on hand at the holding company. Later in the year, we expect to either draw on our line or issue new senior unsecured notes to replace this debt depending on capital market conditions and other factors.

As of December 31, we recorded accumulated other comprehensive loss of \$868 million. This quarter, we elected to sell fixed income securities, which produced \$79 million of capital loss in connection with our tax planning strategy to offset capital gains we recognized in 2019, '20 and '21. We expect this strategy to ultimately generate \$24 million of cash benefit. Finally, in order to provide additional transparency to investors, we are making 2 enhancements to our disclosures. First, in addition to disclosing purchase and refinance orders, we will break out commercial orders and our monthly disclosures beginning with our January report. Second, in the first quarter, we will move our property and casualty results to our corporate segment and disclose home warranty as a stand-alone reporting segment. 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 question comes from the line of Bose George with KBW.

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

Mark, can you repeat what you said about the severance expense this quarter? And then going forward, do you think we could see more of that? Or do you feel like you've kind of rightsized to the current environment?

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

Bose, so we had \$17 million of severance expense in the fourth quarter. I think heading into the first quarter, we'll have a little bit more severance but not quite to the extent that we had in the fourth quarter.

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

Okay. Great. And then on the tax rate going forward, should we just use kind of the normalized rate? Or did anything kind of change?

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

No, we look at that because if you look over the last couple of years, normalized tax rate has actually been less than 24% because we've gotten discrete benefits here and there. But I think for 2023 and moving forward, somewhere between 23.5% and 24% is our normalized tax rate.

Operator

Our next question comes from the line of Mark DeVries with Barclays.

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

I was hoping to get some color on just the mix of the commercial business in the quarter. You still seem to be benefiting from a pretty large ARPO (inaudible) what's your expectation for that as we get into 2023?

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

I would say we're going to -- we've had obviously a lot of momentum in commercial throughout most of 2022. Fourth quarter was a little bit more challenging for us. Revenue was down 34%. It was still good relative to historical standards. It just wasn't as good as the prior year, which was a record. Looking at '23, I'd say orders are definitely softer now (inaudible) first and second quarter. And we actually think that things will pick up in the second half of the year based off of conversations we're having with our customers. But I think in terms of ARPO, certainly for the next 6 months, we would expect to see a decline in ARPO in commercial just because we're not seeing the same level of larger transactions that we have historically, including last year.

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

Okay. Got it. And then just a related question on the investment income. I know there's probably still a little bit more tailwind from a few more Fed hikes. But as the commercial orders trend down, is there a headwind there on investment income from just having kind of lower 1031 exchange balances?

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

There is a headwind. I would say just on investment income, the good news is that when we look at the Fed forward curve, it's actually more favorable now than it was a year ago -- or sorry, last quarter. And so the Fed rate 75 basis points in November and 50 basis points in December, we still haven't gotten the full effect of that, which we will get here in the first quarter. That's the good news. The bad news is balances are falling, and balances are falling for 2 reasons. One is there's just natural seasonality in January, commercial, we typically close a lot of deals at the end of the month and then our escrow balances fall heading into January. So we're seeing a normal seasonal impact to our balances. But we're also, of course, seeing more of a cyclical impact or balances to with commercial down and the purchase market down. So overall, we think investment is going to continue to be a tailwind for us, but certainly balances coming off has hurt us a little bit. I think we've always given this guidance for the last couple

of years of -- we would generate \$15 million to \$20 million of annualized investment income for every rate increase. Now we're probably at the low end of that range given where our balances are.

Operator

Our next question comes from the line of Mark Hughes with Truist.

Mark Douglas Hughes - *Truist Securities, Inc., Research Division - MD*

Yes. Thanks. The ARPO, you talked about this phenomenon where you're helped by the M&A on the residential side would have been 1% otherwise. When do you lap that? And does it go back to the kind of 1%?

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

We'll lap it in the first quarter. So Q4 here is going to be the last quarter that we talked about that Q1 will have a pure kind of year-over-year ARPO for the Southern California escrow issue.

Mark Douglas Hughes - *Truist Securities, Inc., Research Division - MD*

Yes. Okay. And then success ratio still seems pretty good under the circumstances. Would you anticipate the success ratio should improve? It certainly all depends on order trends and a lot of things you can predict. But given what you see on the personnel front, how are you thinking about success ratio?

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

Mark, this is Ken. We think the success ratio will probably improve a little bit. But I'll add, too, is we've always been real conscious about expense management, and that level of consciousness will continue if the -- if the market continues to deteriorate, we're forever conscious on expenses.

Operator

(Operator Instructions)

Our next question comes from the line of John Campbell with Stephens.

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

Happy new year. Just a 2-part question here on the Specialty Insurance segment. Obviously, really good results there. We were thinking that pushed up a bit with the home warranty business kind of rising the surface. But -- you guys were well ahead of us. So the first question is, could you maybe talk to what drove the sequential revenue growth in operating revenues and then why also the (inaudible) from a bigger picture, do you think you've positioned that segment to return to growth this year?

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

Well, I'll give some high-level comments and then Mark can come in on the numbers. But I think, yes, it was a good quarter, considering the pressure in the real estate market and the resulting impact on the real estate channel in our home warranty business. Our claims are still -- the severity is

still high on claims, but the frequency is down. So we think frequency is probably in more normalized levels. I'll note that we've been deploying more resources in our direct-to-consumer business, and we're seeing good results there. And we're also realizing some of the benefits of the price increases we've been making as well as a pretty meaningful pick-up in renewal rates.

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

Yes. The only thing I would add there, John, is at the end of the year, in our home warranty business, we do an annual kind of revenue true-up depending on how the claims patterns came in. And we got -- our revenue true-up in home warranty was \$8 million this quarter. So we did get a benefit of that. And there was about \$2 million of expense associated with that, too, as we true'd up our deferred acquisition costs. So it was about a \$6 million impact to pretax for Home Warranty.

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

Okay. That's helpful. And then I wanted to drill down on the segment earnings. I think that was probably the best segment margin you guys have probably ever had. What's a good margin to think about for the full year, just assuming that we run with -- it sounds like you're not going to have much of an impact of the wind-down of the P&C business moving forward. But maybe just think about what that segment margin looks like and then where you think you can take that maybe over time?

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

Yes. And one thing I'll point out too is that we're also seeing a benefit of the P&C wind-down a year ago, we lost \$8 million in our P&C business on a pretax basis. And this quarter was effectively breakeven. Even in the third quarter, we lost \$9 million. So we're getting that kind of cleared out of our specialty segment. But in terms of like going forward, typically, the Home Warranty margins have been somewhat better than the Title margins. I mean, I would say low double-digit margins is kind of a normalized market for Home Warranty. And they've done a really good job of growing revenue, particularly the direct-to-consumer channel. And so we think the home warranty will grow through the cycle a little bit faster than the overall type of business.

Operator

There are no additional questions at this time. That concludes 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 1373-5364. The company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.

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