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FAF.N - Q2 2023 First American Financial Corp Earnings Call

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OVERVIEW:

Company reported margin of 12.1%, revenues of $244 million, Pretax income of $14 million.

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

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

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

Soham Jairaj Bhonsle *BTIG, LLC, Research Division - VP & Residential Housing Services Analyst*

PRESENTATION

Operator

Greetings, and welcome to the Second Quarter 2023 First American Financial Corporation Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Craig Barberio, Vice President, Investor Relations. Please go ahead.

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

Good morning, and welcome to First American's Earnings Conference Call for the second quarter of 2023. 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 these 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 performance and performance of the company, operational efficiency, excuse me, 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.

I would now like to turn the call over to Ken DeGiorgio.

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

Thank you, Craig. We posted good results in the second quarter, given the continuing market headwinds, a seasonal uplift in our business, strong growth in net investment income and a continued focus on expense management enabled us to deliver a pretax title margin of 12.1% or 12.6% on an adjusted basis.

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On a consolidated basis, we earned $1.33 per diluted share or $1.35 on an adjusted basis. Demand in our residential purchase business continues to be pressured by affordability issues due to high mortgage rates, along with low inventory that has kept home prices elevated. The purchase market, however, appears to have stabilized, albeit at trough levels.

For the first 3 weeks of July, we are seeing the typical seasonal decline in purchase orders with open orders down 1% compared with June. Refinance open orders remained at trough levels in the second quarter, averaging 350 per day. As I indicated on last quarter's call, the current pool of mortgage loans outstanding would need to see rates drop well below 5% to incentivize a significant uplift in refinance activity, which is highly unlikely in the near future.

The commercial market, which began to deteriorate in the back half of 2022, appears to have stabilized. While commercial revenue was down 39% year-over-year, it was up 20% on a sequential basis, in line with the typical seasonal trend.

Commercial open orders for the first 3 weeks of July were down 26%, consistent with what we experienced in the second quarter. There is still a high degree of uncertainty concerning the commercial market outlook. However, based on the feedback we are still getting from customers, we expect the transaction activity in the second half of the year will be better than the first, which is consistent with normal seasonal patterns.

While our key purchase commercial and refinance markets appear to have troughed, the timing of a recovery in these markets remains unclear. Despite these challenging conditions, our financial discipline and strong balance sheet allow us to continue to invest in strategic initiatives for the long-term benefit of the company as well as return capital to our shareholders.

We continue to make progress at Endpoint, our digital title and settlement company. Our initiative to develop instant title decisioning for purchase transactions remains on track for deployment in 2 markets early next year. We've also made substantial progress at ServiceMac, our subservicing business, which delivered strong revenue growth and its first quarterly profit. And since the market began to deteriorate at the beginning of last year, we have returned $811 million to our shareholders through share repurchases and dividends.

In closing, I am proud that First American has been selected as 1 of just 100 companies to fast companies Best Workplaces for Innovators for 2023. We are the only company in our industry to have ever received this recognition. This accomplishment is a testament to our ongoing commitment to innovation and is a tribute to our people, who in addition to delivering best-in-class customer service enable us to lead the digital transformation of our industry.

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 $1.33 per diluted share or $1.35 on an adjusted basis. Beginning this quarter, we are defining adjusted earnings for the first time to make our results more comparable to our peers. Our adjusted earnings exclude net investment gains and losses, as well as purchase related intangible amortization. These adjustments will also apply to pretax margin. A reconciliation can be found in our press release.

Revenue in our Title segment was $1.5 billion, down 25% compared with the same quarter of 2022. Commercial revenue was $178 million, a 39% decline over last year. Our average revenue per order for commercial transactions declined 12% this quarter to $11,600 due to a combination of lower valuations as prices in the commercial market reset and fewer large transactions. Purchase revenue was down 29% during the quarter, driven by a 30% decrease in the number of orders closed, partially offset by a 1% increase in the average revenue per order.

Refinance revenue declined 59% relative to last year due to the increase in mortgage rates. In the Agency business, revenue was $625 million, down 33% from last year. Given the reporting lag in agent revenues of approximately 1 quarter, these results reflect remittances related to Q1 economic activity. Our information and other revenues were $244 million, down 20% relative to last year. This decline was the result of lower transaction levels across several business units driven by the company's data and property information products and post close and document generation services.

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Investment income within the Title Insurance and Services segment was $142 million, a 105% increase relative to the prior year. In the second quarter, we saw escrow balances increase due to normal seasonality of the business. We also continue to generate higher rates on our balances as the Federal Reserve has hiked 4x this year.

We continue to manage expenses given the decline in transaction activity. Our success ratio was 50%, meaning that our personnel and other operating expenses declined $200 million, and our net operating revenue declined $399 million. The provision for policy losses and other claims was $40 million in the second quarter or 3.5% of title premiums and escrow fees, down from the 4.0% loss provision rate in the prior year. The 3.5% loss rate reflects an ultimate loss rate of 3.8% for the current year with a $3 million release for prior policy years.

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 their life cycle, adversely impact our financial results. We have discussed 3 initiatives: ServiceMac, Endpoint and instant decisioning for purchase transactions which together generated a pretax loss of $15 million this quarter, impacting our pretax title margin by 130 basis points, an improvement from the 150 basis point margin drag in Q1, primarily driven by profitability gains at ServiceMac, which generated a 10% pretax margin this quarter.

Pretax margin in the title segment was 12.1% or 12.6% on an adjusted basis. Total revenue in our home warranty business totaled $106 million, a 4% increase compared with last year. Pretax income in home warranty was $14 million, up 61% from the prior year. The loss ratio in home warranty was 49%, down from 52% in 2022, driven by a lower frequency of claims, partially offset by higher claim severity.

The effective tax rate for the quarter was 23.4%, lower than our normalized rate of 24% due primarily to the mix of income between our insurance and noninsurance businesses since our insurance business generally pays state premium taxes in lieu of income taxes.

In the second quarter, we repurchased 273,000 shares for a total of $15 million at an average price of $56.04. Our debt-to-capital ratio as of June 30 was 29.2%. Excluding secured financings payable, our debt-to-capital ratio was 22.5%. In May, we entered into a new $900 million senior credit facility upsized from our prior $700 million facility. We currently have the entire amount available for liquidity.

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 Bose George with KBW.

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

First, I just wanted to ask about investment income. Can you give us an update on your expectations for investment income? And then can you remind me if there's something unusual in investment income in the second quarter?

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

Bose, thanks for the question. There's nothing really unusual in the second quarter. We've given different assumptions in the past for investment income. But at this point of the year, we're halfway down through the year. We've got a lot more visibility in terms of where balances are. And so in the Title segment, we should be somewhere between $550 million, $560 million of investment income for the full year. We'll have an increase in Q3, and then we're expecting a little bit of a decrease in Q4 just because of some balances that will run off related to ServiceMac, but we're looking at somewhere between $550 million, $560 million right now, full year.

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

Okay. Great. that's helpful. And then actually, with the sale of Home Point to Cooper, when that servicing -- if that does move over to Cooper, how much escrow could that move -- could you lose as that happens? And is there any sort of negative operating leverage while you sort of refill that ServiceMac?

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

Yes, thanks for the question. I mean we're anticipating that about 40% of the loans are going to offboard in September. And to get to the second part of your question on that, we're already making expense reductions associated with that. Now there's a healthy pipeline that we think will replace that. And -- but obviously, the time lines on those aren't quick, but there is a healthy pipeline.

The remaining 60% they could -- they'll probably be there through the end of the year and could extend into next year. It's not exactly clear when the remaining 60% are going to come off. But we're hopeful they will at least be into the next year.

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

Okay. Great. And actually, can you remind me the interest income from the escrow at ServiceMac, does that come through corporate or is that in title?

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

It's in title. But most of it goes through our bank and our bank rolls up to our title segment. So it's in title .

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

Okay. So your guidance the number you gave sort of incorporates all the changes at ServiceMac as well?

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

It does, yet.

Operator

(Operator Instructions) Our next question comes from John Campbell with Stephens Inc.

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

Congrats on a great quarter, but I wanted to touch on the July order data again. I might have missed this, but I think you said that the first 3 weeks commercial orders down 26%. So a little bit better, obviously, than 2Q, but could you maybe rehash on purchase refi and other?

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

So for the first 3 weeks, we're looking at purchase. We're looking down 14% versus prior year. refi. We're looking at about 340 orders a day. That's down 39% from last year.

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

Okay. Very helpful. Yes, go ahead, Ken.

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

No, that's it.

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

Okay. And then on the Instant title decisioning for purchase, I feel like that's a side of the story that holds a lot of promise for you guys. I know it's very early stage. You guys are also tend to be very conservative in kind of how you roll that out.

But maybe if you could give us some kind of early call-outs from early around the pilots. And then what you might need to see to be comfortable and start to move that into a national expansion efforts? And then also, what the initiative can do for your business over time? Is it more of a share gain kind of revenue driver? Or is it an efficiency gain and margin driver?

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

Yes. I'll start on that, John. I mean, I think what we've seen from sort of our MVP effort that it is -- we're confident that it's ready for rollout. As I've mentioned in my earlier comments, in 2 counties at the beginning of next year. But you're right, it is going to take some time, but I would anticipate that we will have a national rollout probably within the next couple of years, and we'll continue to roll out markets as our development efforts progress.

And I think there's a couple of aspects of the products that will drive results for it. There will be efficiency gains. And again, the precise amount of that remains to be seen and we'll certainly see some efficiency gains in the business. But I think a big part of it is just the improvement in the customer experience, which we think ultimately will drive market share gains.

Customers want to know early if there are title issues that are going to need to be resolved, and we're going to be able to indicate to them initially even before an order is placed, whether or not there's going to be a title issue or whether or not we can issue a commitment.

Operator

(Operator Instructions) Next question comes from Soham Bhonsle with BTIG.

Soham Jairaj Bhonsle - *BTIG, LLC, Research Division - VP & Residential Housing Services Analyst*

Mark, maybe I want to just take a step back and think through title margin sensitivity here more long term. So obviously, you have the investments that should moderate from here, and that should help margins. But as we think about volumes sort of stabilizing and maybe even improving next year, how are you sort of thinking about the lift that you could see right, from that improvement?

Because clearly, you're able to write orders more efficiently today than in years past. And so that makes it sort of hard to look at the past as a precedent here. So if you could just offer any sort of framework on how you're thinking about margins as volumes sort of do end up sort of improving here?

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

Yes. Thanks for the question, Soham. Well, first of all, I'd say that for this year, -- last quarter, we talked about double-digit margins entitled this year, and we stand by that. I mean we feel good about hitting that in a pretty tough economic environment. There's no question about that. When we look at 2024, we expect margins to improve on '24.

Even if volumes are flat, even if volumes are flat because we've got a few tailwinds. You pointed out the strategic investments, they're going to be less of a drag next year. We also have efficiencies that we're bringing out of the business now that will help us next year. And then we'll also have -- depending on what the Fed does, at least some tailwind with investment income next year.

And so even in a flat, let's call it, origination market, we think we can improve margins. The NDA has some pretty aggressive growth for mortgage originations. If that happens, we'll look really good. But even if we get half of that or 1/4 of that growth, we should be even better. So we feel like we'll definitely have margin expansion next year. And then the question is, well, it just depend on how good the market is.

Soham Jairaj Bhonsle - *BTIG, LLC, Research Division - VP & Residential Housing Services Analyst*

Got it. Okay. And then in the second half here, just on the success ratio, so obviously, the seasonality-wise, volume should subside here, but is there any reason outside that, that your success ratios cannot sort of stay flattish. Any other items that we should be thinking about in the back half here?

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

No. I mean there's no extraordinary items to think about. For the first half of the year, we've been at 50%, again, in our title segment. And for the back half of the year, we think we'll be at around 50%. I mean it could be plus or minus a little bit, but 50% is what I would think for the second half and therefore, the full year as well.

Soham Jairaj Bhonsle - *BTIG, LLC, Research Division - VP & Residential Housing Services Analyst*

Got it. And if I could just squeeze 1 in. Ken, I just wanted to touch on commercial here for a second. So it looks like, at least based on the ARPU, there was some mix shift a little bit to the higher -- the larger deals. As you look at your pipeline for the back half, I mean, what's sort of the mix looking like between small and large deals?

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

Well, I think we're anticipating, particularly as you go into the fourth quarter, we're probably anticipating to have some more large deals.

But I think on the ARPO going down, I think it's less about mix and more about price discovery, which we take as a good sign. Obviously, we don't like a CR RPO go down, but we like to see that the price discovery is going on because there's going to -- that implies to us that once that's done, are completely done, there'll be a lot more transaction activity.

Operator

Since there are no further questions, this concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a great day.

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