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FAF.N - Q1 2024 First American Financial Corp Earnings Call

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OVERVIEW:

Company Summary

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

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

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

Terry Ma *Barclays Bank PLC, Research Division - Research Analyst*

PRESENTATION

Operator

Greetings, and welcome to the First American Financial Corporation First Quarter Earnings Conference Call. (Operator Instructions). A brief question-and-answer session will follow the formal presentation. (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) 660-853 or (201) 612-7415 and enter the conference ID 13745815.

And 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 - VP of IR*

Thank you, operator. Good morning, everyone, and welcome to First American's earnings conference call for the first quarter of 2024. 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 yesterday's earnings release and the risk factors discussed on 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 risk and reconciliation to the most directly comparable GAAP financials, please refer to yesterday's earnings release, which is available on our website at www.firstam.com. I will now turn the call over to Ken DeGiorgio.

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

Thank you, Craig. Market conditions in the real estate and mortgage industries continued to be a challenge in the seasonally weak first quarter. Elevated mortgage rates and low, albeit growing inventory levels have caused transaction volumes to remain near historically low levels. During this period, we've maintained our focus on managing operating expenses while continuing to invest in long-term strategic initiatives, such as expanding our title plant assets and building technology solutions to increase efficiency, reduce risk and enhance our customers' experience.

Although our financial results this quarter were a function of the tough mortgage origination market, we have recently started to see signs of a measured recovery. In March, our open resale orders per day were up 5%, and that positive trend has continued so far in April with open resale orders up 2%. Growth in our resale orders so far this year is the first positive change we've seen in this key market since June of 2021.

We are also seeing improvement in our commercial business with open orders up 1% in the first quarter, and we have seen further growth in April with open orders up 5%. Our home warranty segment had another strong quarter, delivering a pretax margin of 19% and is positioned well for future growth.

On our last earnings call, we stated that we expect modest revenue growth this year and that we can achieve title margins similar to what we posted in 2023. After closing the books on the first quarter and looking at the order pipeline in April, our expectations remain unchanged.

I'd like to take a moment to address the recent attention our industry has received from Washington, D.C. This attention is the product of a broader effort, an effort at which all of us at First American wholeheartedly support to make the purchase of a home more affordable. The focus on our industry as part of this effort reveals, however, that as an industry, we need to do a better job educating policymakers and other stakeholders about the critical role title insurance plays in protecting people's investments in their homes, which are the primary vehicle for wealth creation for a majority of Americans.

This role includes not only paying claims when they arise, but also the extensive work we do to correct title defects before the transaction closes. The cost of which is not reflected in our industry's claims rate. This important curative work protects consumers and lenders, among others, from hundreds of billions of dollars of title risk exposure per year. Moreover, title and settlement fees are among the smallest cost components over the life of a mortgage and as a result, are not a barrier to homeownership.

The discussions in Washington are still in early stages, and we believe that ultimately, our industry will be successful in reaffirming the value of title insurance to policymakers. But irrespective, we are uniquely positioned to meet the demands of an evolving market because of our growing leadership in title data, which is fueled by our proprietary data extraction technology, our national closing at platform and deep distribution relationships, our extensive underwriting expertise, our commitment to and continued investment in cutting-edge technology such as Endpoint, our digital settlement platform and automated underwriting for purchase transactions and most importantly, our world-class workforce and culture which recently resulted in our recognition as one of the 100 best companies to work for by Great Place to Work and Fortune Magazine for the ninth consecutive year.

Though we are the leader in the digital transformation of our industry, fundamentally, we are a people business, and it is the quality, talent and dedication of our people that ensure our company's long-term 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 generated earnings of $0.45 per diluted share. Our adjusted earnings per share, which excludes the impact of net investment gains and purchase related amortization, was the same as our GAAP earnings at $0.45 per share, as $0.07 of realized gains were offset by $0.07 of purchase-related amortization.

Turning to our Title segment. Revenue was $1.3 billion, down 2% compared with the same quarter of 2023. Purchase revenue was up 2% during the quarter, driven by a 2% increase in the average revenue per order. Commercial revenue was $143 million, a 4% decline over last year. Though our closed commercial orders fell 4%, the average revenue per order for commercial transactions increased 1%.

Refinance revenue declined 13% relative to last year. With mortgage rates hovering around 7%, they are still at levels materially above what is needed to generate a significant rise in refinance activity. In the Agency business, revenue was $564 million, down 5% from last year. Given the reporting lag in agent revenues of approximately one quarter, these results primarily reflect remittances related to Q4 economic activity.

Our information and other revenues were $217 million, down 2% relative to last year. This decline was primarily due to an increase in the capture rate of title premiums from an affiliated title agent which caused a decline in information and other revenue and a comparable increase to direct premium and escrow fees.

Investment income within the Title Insurance and Services segment was $117 million, down $8 million relative to the prior year due to lower average interest-bearing balances in the company's escrow and tax-deferred property exchange business that were partly offset by higher interest income from the company's warehouse lending business. The provision for policy losses and other claims was $29 million in the first quarter or 3.0% of title premiums in escrow fees, down from the 3.5% loss provision rate in the prior year.

The 3.0% loss rate reflects an ultimate loss rate of 3.75% for the current year with a $7 million release from prior policy years. Over the last several quarters, we have highlighted the margin drag in the title segment related to both endpoint and instant decisioning for purchase transactions. Together, these 2 strategic initiatives reduced our pretax margin in the title segment by 150 basis points this quarter.

Pretax margin in the Title segment was 5.5% or 4.8% on an adjusted basis. These margins reflect a $6.2 million write-off of uncollectible balances impacting the margins by 50 basis points. Total revenue in our home warranty business totaled $105 million, a 1% increase compared with last year. Pretax income in home warranty was $20 million, up 28% from the prior year. The loss ratio in home warranty was 42%, down from 47% in 2023, driven by lower frequency and severity of claims. Adjusted pretax margin in the home warranty segment was 18.8%, up from 15.2% in 2023.

The effective tax rate for the quarter was 19.9%, lower than our normalized rate of 24% due primarily to research and development tax credits recognized during the quarter. In the first quarter, we repurchased 58,600 shares for a total of $3.5 million at an average price of $59.37. Our debt-to-capital ratio as of March 31 was 30.3%. Excluding secured financings payable, our debt-to-capital ratio was 22.5%. Now I would like to turn the call back over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). The first question comes from the line of Bose George with KBW.

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

I wanted to first ask just about investment income. I mean, Mark, you noted the reduction year-over-year was lower escrow and I think on 1031 balances. Can you just dig into some of the drivers of that?

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

Sure, Bose. So one of the things we've seen here as interest rates have risen is that -- more of our customers are electing to earn interest on their escrow per deposits. We have 2 -- I'm simplifying here, but we have 2 basic types of deposits, savings deposits and checking deposits. And more of our customers are electing for savings deposits. And in itself, that should really have an impact on our investment income because one of the advantages that we have is we can monetize savings deposits when a lot of our peers can't because of our bank.

But the second dynamic that's happening in addition to the shift to savings deposits is that more of those savings deposits are going to third-party banks as opposed to our own bank, First American Trust. A lot of it is really the economic reasons because third-party banks will pay a higher rate than First American Trust. And so if we have a higher mix of our deposits at third-party banks, we can earn interest on those.

So when you look at the total mix of deposits that we don't earn interest on today, it's 30%. A year ago, it was 18%. So that's -- that mix shift has been a little bit of a headwind for us for investment. And then the second factor, of course, is just the 1031 businesses, volumes are lower today than they were a year ago.

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

Yes. Great. That's helpful. And just to be clear, is it the commercial customers who have the ability to kind of direct that escrow versus residential? Or how does that work?

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

Everybody has the ability to do it, whether you're a consumer, a large commercial client, you have the ability to request a savings account, but typically commercial customers are the ones that really drive that trend.

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

Okay. Great. And then just in terms of sort of expectations for that investment income line item for the remainder of the year, can you just talk about that?

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

Yes, sure. So -- when we look out the next couple of quarters, we think our investment income in the title segment will be somewhere between $120 million and $125 million per quarter. We'll probably be at the higher end of that range in Q2 and a little bit lower as the year goes on in that range. And that assumes a couple of things.

One, just the normal seasonality of the business. Typically, Q1 is kind of a low point in terms of investment income just because escrow balances are lower there. The second thing is we have -- we talked about these home point balances, and we expect the home point balances to leave somewhere around Q2. So that assumes that home point balances will leave. That's going to be about $20 million of annualized investment income. And by the way, it's also going to be about $20 million of annualized interest expense.

So it sort of washes on a net basis. But if you're just looking at our investment income, it will go down about $5 million a quarter once we lose those balances. And the third thing it assumes is just 2 Fed rate cuts. Now I know I was looking at this morning in markets assuming one Fed rate cut, but we had 2 Fed rate cuts at the end of the year. So when you mix that all together, we think we should be somewhere between 120 and 125 per quarter in the type of segment.

Operator

And the next question comes from the line of Terry Ma with Barclays.

Terry Ma - *Barclays Bank PLC, Research Division - Research Analyst*

Can you maybe just speak at a high level about your confidence level in achieving the revenue growth and margin guide? It's a pretty uncertain macro and interest rate outlook.

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

Yes, Terry, thanks for the question. This is Ken. Yes, I mean, listen, we think that the challenging conditions will persist for the year though we think 2024 will be slightly better. And I think we have a high degree of confidence in that. But again, I want to excite it's slightly better. And we look at things like the commercial business, while it was weak in the first quarter, we're seeing open orders, as we mentioned, up 1% in the quarter, up 5% in April so far.

In the commercial business, our ARPO will have the typical seasonal decline, it is up 1% over the prior year, which suggests that maybe the price discovery has concluded or at least well along the way. And I noted that there was an article in the Wall Street Journal earlier this week about Blackstone things that commercial real estate is at bottom. And obviously, they have their finger on the pulse of the commercial real estate market. So that gives us some confidence on the purchase -- on the commercial market.

On the purchase market, affordability will continue to be a challenge with mortgage rates prices, low supply. But we are seeing some green shoots there with, as I've mentioned, open resale orders up 5% in March and 2% so far in April. So again, we're pretty confident that the 2024 will be better than '23, but it isn't going to be meaningfully better.

Terry Ma - *Barclays Bank PLC, Research Division - Research Analyst*

Got it. That's helpful color. And then my second question, just on the margin drag from Endpoint and instant decision. I think you said it was 150 basis points this quarter. I think you guys quoted 130 last quarter. So what drove the delta? And how should we think about that drag kind of evolving throughout the rest of the year?

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

Really what drove the drag was we had a little bit less revenue at Endpoint and a little bit more expenses at both Endpoint and kind of our instant decision for first transactions. We're making a lot of progress with both. Would the drag should be less going forward just because Q1 is typically the lowest revenue? So just the fact that our revenue at the title segment is going to improve from here on out. That's just because of the math is going to reduce the drag from here on out.

Operator

And the next question comes from the line of Soham Bhonsle with BTIG.

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

Mark, I just want to dig a little bit on the margin guide. So if I sort of take what you're implying, right, sort of flattish margins for this year, that would imply margins for every quarter sort of going forward are just, I guess, higher from last year to hit that double-digit margin. So can you just walk us through some of the moving parts? I think you just mentioned some of the drag stuff. But like just a little bit more detail there would be helpful.

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

Yes, sure. So just with our margin outlook, there's a few things going on. I mean, just to reiterate, I mean, we think that the margins will be comparable to last year. It's still early in the year. There's still a lot of things that are moving around.

On the positive side, we've got -- we're off the bottom now. We just talked about this. We've got open orders up and that's going to bode well for later in the year. So we finally feel like after 2 years of having negative growth, we're bumping up off the bottom, and we're going to expect growth in our core businesses of purchasing commercial. We've got tailwinds with respect to the loss rate. We've got tailwinds with respect to a lot of the cost-cutting efforts we did last year and then we got headwinds.

We've got -- we're going to have about $20 million more of depreciation this year because of some of the capital expenditures we've made in the past and some of these projects are going live. So that's going to be a headwind. Some of our benefits and 401(k) matches and things like that kind of get reset. And then we just talked about earlier on the call that we have some headwinds for investment income.

So I think that for the -- I think the second quarter is going to be tough to beat where we were a year ago, but we expect that the margins second half of the year will be kind of better than we had last year. And when you mix that all together, we should be in line with last year.

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

Okay. Got it. And then just on investment income. So you sort of noted noninterest-bearing deposit main moving out of FA-trusted, third-party banks. Should we -- I guess in the guide that you gave the 120, I believe, are you sort of baking in a continuation of that? Or do you sort of see more normalization there after this quarter?

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

Yes. Thanks for that. First of all, they're interest-bearing accounts, they're going to these third parties. I just want to correct that. And -- and in our guide here, we don't -- we assume that 30% mix stayed the same. So that's a risk. I mean if the 30% keeps climbing, I mean that's going to be a risk to our $120 million to $125 million guide. But we also are kind of in the very early stages of coming up of plans to kind of reverse that trend by paying more at the bank. So I think assuming a 30% mix of third-party does a reasonable assumption, but it could go higher, lower depending on what happens in the market.

Operator

(Operator Instructions). Our next question comes from the line of Mark Hughes with Truist Securities.

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

More detail you can discuss on the potential regulatory changes if buyers are not required to purchase the title insurance, but it's bundled in with the mortgage. How do you view that as a competitive evolution in the business?

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

Yes. And I assume you're talking about, Mark, the CFPB request for information for prohibiting lenders from passing through the cost of title. I mean -- this has been -- this was tried before by HUD and it didn't get off the ground. I think probably a big reason for that, and I think it will be a big reason for why I probably won't get off the ground this time around either is the lack of transparency.

So I think policymakers prefer that borrowers know exactly what they're paying for because ultimately, borrowers will still pay for lenders, title insurance policies. It will just be wrapped up into the interest rate or loan level price adjustments or what have you. So I don't think ultimately it will take off. But if it does, I think the value proposition of Title Insurance to lenders is well established. And I think, again, we have to keep a close eye on developments, but I don't think it will ultimately have a significant impact on the lender side of our business or the industry for that matter.

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

The commercial ARPO, you suggested that was an indication that price discovery is progressing. Was there -- is there a mix shift to part of that bigger deals started happening because of the price discovery? Is that the idea?

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

Yes. The bigger deals are always a component that we look at. We had 4 what we call mega deals with premium over $1 million in the most recent quarter. So that always has an effect on the commercial ARPU.

But as a general statement, we think that after -- again, after seeing declines in commercial ARPO for several quarters now. It's finally leveled off, which is a good sign. It kind of mirrors the bottoming we've seen on the residential side.

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

Yes. And then purchase ARPO, this wasn't much movement, but last quarter it was up 4%. This quarter, up to any detail on that? Was that just a geographic mix shift? What do you see there?

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

It's kind of what we think. I mean there's 2 things to drive it. One is housing prices. Housing prices are still rising. I think given the fact that where housing prices are, the increase in housing prices, we would expect kind of a 2% fee per file. The other thing that can drive it, depending on the quarter was just the mix. I mean if we get a lot more business in California, which has a higher fee per file, that could that could drive things. But really, it's more a function of where housing prices are.

Operator

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

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

Just back to the transition of the home point loans. It sounds like you're expecting some of that offboarding to take place in 2Q. I guess, first, will that be the bulk of it? And then secondly, can you maybe talk to the off-boarding fees, maybe the size and timing of those?

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

Yes. Thanks, John. So we're going to -- today, we've got roughly about $380 million of deposits, give or take, I mean changes by the day. And we think $50 million will leave around May 1 and $330 million will leave on July 1. And at that point, we won't have any more of the home point loans. And as I mentioned earlier, when we lose those deposits at our bank, we'll lose $20 million on an annualized basis of investment income because we're really just turning Fed funds. And we're also paying out Fed funds. So we'll lose about $20 million of annualized expense as well.

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

Okay. And then are there fees associated with that off-boarding that are paid to you?

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

There are deboarding fees, I would say they're pretty de minimis, though, I mean, less than $1 million. So they're already boarding fees, but it's not -- it won't be material.

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

Okay. That's helpful. And then from a CapEx standpoint, last quarter, Mark, I think you mentioned expecting $30 million or so of relief just from the wind down of some software projects. Obviously, that's been ramped and you expect higher depreciation from here. But just from a overall CapEx standpoint, kind of what you're expecting for this year? And maybe if you got visibility next year, what that looks like for next year?

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

So we think our CapEx has peaked. Last year, we were $260 million of CapEx. We think CapEx will be down somewhere between 15% and 20% this year. And a lot of that has to do with some of these big initiatives you're never done, but the sort of the pig has been pushed through the python, if you will, and we're kind of over the hump. And also, we're doing things a lot more efficiently now.

We found that just hiring great tech talent, great engineers. It's just a better way to build products as opposed to going to third parties where you're paying more and not quite getting the same value. So that's been a big initiative for us, and it's we're seeing early signs of success. So we feel really good about the direction of where we're going from a tech perspective. And not only is that going to help us from a performance in terms of building products, but it's also going to have the effect of saving dollars, particular CapEx dollars. So 15% to 20% decline this year. And that's with still making all the strategic investments that we feel like we need to make.

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

Okay. That's helpful. And if I could squeeze in one more. I think I might have missed this, but did you comment on the April refi month-to-date orders?

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

The April refi orders are -- we're running at about 371 per day, and it's about the same as where it was last year and about 6% over last month.

Operator

(Operator Instructions). There are no additional questions. That also concludes this morning's call. We'd like to remind listeners that today's call will be available for replay on the company's website or by dialing (877) 660-6853 or (201) 612-7415 and enter the conference ID number 1345815.

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