

Edgar Filing: First American Financial Corp - Form 10-Q

First American Financial Corp  
Form 10-Q  
October 25, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934

For the quarterly period ended September 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-34580

Edgar Filing: First American Financial Corp - Form 10-Q

FIRST AMERICAN FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

26-1911571  
(I.R.S. Employer  
Identification No.)

1 First American Way, Santa Ana, California  
(Address of principal executive offices)

92707-5913  
(Zip Code)

(714) 250-3000

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No 1

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No 1

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act

Large accelerated filer      Accelerated filer

Non-accelerated filer      Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. 1

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes 1 No

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

On October 19, 2018, there were 111,787,641 shares of common stock outstanding.

---

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

INFORMATION INCLUDED IN REPORT

PART I: FINANCIAL INFORMATION

Item 1.	<u>Financial Statements (unaudited)</u>	
	<u>A. Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>	5
	<u>B. Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2018 and 2017</u>	6
	<u>C. Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and 2017</u>	7
	<u>D. Condensed Consolidated Statements of Stockholders' Equity for each of the quarters within the nine months ended September 30, 2018 and 2017</u>	8
	<u>E. Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017</u>	10
	<u>F. Notes to Condensed Consolidated Financial Statements</u>	11
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	36
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	47
Item 4.	<u>Controls and Procedures</u>	47

PART II: OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	48
Item 1A.	<u>Risk Factors</u>	49
Item 6.	<u>Exhibits</u>	56

Items 2 through 5 of Part II have been omitted because they are not applicable with respect to the current reporting period.



THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. THESE FORWARD-LOOKING STATEMENTS CAN BE IDENTIFIED BY THE FACT THAT THEY DO NOT RELATE STRICTLY TO HISTORICAL OR CURRENT FACTS AND MAY CONTAIN THE WORDS “BELIEVE,” “ANTICIPATE,” “EXPECT,” “INTEND,” “PLAN,” “PREDICT,” “ESTIMATE,” “PROJECT,” “WILL BE,” “WILL CONTINUE,” “WILL LIKELY RESU OTHER SIMILAR WORDS AND PHRASES OR FUTURE OR CONDITIONAL VERBS SUCH AS “WILL,” “MAY,” “MIGHT,” “SHOULD,” “WOULD,” OR “COULD.” THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS REGARDING FUTURE OPERATIONS, PERFORMANCE, FINANCIAL CONDITION, PROSPECTS, PLANS AND STRATEGIES. THESE FORWARD-LOOKING STATEMENTS ARE BASED ON CURRENT EXPECTATIONS AND ASSUMPTIONS THAT MAY PROVE TO BE INCORRECT.

RISKS AND UNCERTAINTIES EXIST THAT MAY CAUSE RESULTS TO DIFFER MATERIALLY FROM THOSE SET FORTH IN THESE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE THE ANTICIPATED RESULTS TO DIFFER FROM THOSE DESCRIBED IN THE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION:

- INTEREST RATE FLUCTUATIONS;
- CHANGES IN THE PERFORMANCE OF THE REAL ESTATE MARKETS;
- VOLATILITY IN THE CAPITAL MARKETS;
- UNFAVORABLE ECONOMIC CONDITIONS;
- FAILURES AT FINANCIAL INSTITUTIONS WHERE THE COMPANY DEPOSITS FUNDS;
- CHANGES IN APPLICABLE LAWS AND GOVERNMENT REGULATIONS;
- HEIGHTENED SCRUTINY BY LEGISLATORS AND REGULATORS OF THE COMPANY’S TITLE INSURANCE AND SERVICES SEGMENT AND CERTAIN OTHER OF THE COMPANY’S BUSINESSES;
- USE OF SOCIAL MEDIA BY THE COMPANY AND OTHER PARTIES;
- REGULATION OF TITLE INSURANCE RATES;
- LIMITATIONS ON ACCESS TO PUBLIC RECORDS AND OTHER DATA;
- CHANGES IN RELATIONSHIPS WITH LARGE MORTGAGE LENDERS AND GOVERNMENT-SPONSORED ENTERPRISES;
- CHANGES IN MEASURES OF THE STRENGTH OF THE COMPANY’S TITLE INSURANCE UNDERWRITERS, INCLUDING RATINGS AND STATUTORY CAPITAL AND SURPLUS;
- LOSSES IN THE COMPANY’S INVESTMENT PORTFOLIO;
- MATERIAL VARIANCE BETWEEN ACTUAL AND EXPECTED CLAIMS EXPERIENCE;
- DEFALCATIONS, INCREASED CLAIMS OR OTHER COSTS AND EXPENSES ATTRIBUTABLE TO THE COMPANY’S USE OF TITLE AGENTS;
- ANY INADEQUACY IN THE COMPANY’S RISK MANAGEMENT FRAMEWORK;
- SYSTEMS DAMAGE, FAILURES, INTERRUPTIONS AND INTRUSIONS, OR UNAUTHORIZED DATA DISCLOSURES;
- PROCESS AUTOMATION;
- TECHNOLOGICAL AND OTHER DEVELOPMENTS THAT CHANGE THE WAY REAL ESTATE TRANSACTIONS ARE CONDUCTED AND RELATED DOCUMENTS ARE PROCESSED;
- ERRORS AND FRAUD INVOLVING THE TRANSFER OF FUNDS;
- THE COMPANY’S USE OF A GLOBAL WORKFORCE;
- INABILITY OF THE COMPANY’S SUBSIDIARIES TO PAY DIVIDENDS OR REPAY FUNDS; AND



OTHER FACTORS DESCRIBED IN THIS QUARTERLY REPORT ON FORM 10-Q, INCLUDING UNDER THE CAPTION “RISK FACTORS” IN ITEM 1A OF PART II.

THE FORWARD-LOOKING STATEMENTS SPEAK ONLY AS OF THE DATE THEY ARE MADE. 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.



## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Balance Sheets

(in thousands, except par values)

(unaudited)

	September 30,	December 31,
	2018	2017
<b>Assets</b>		
Cash and cash equivalents	\$2,205,319	\$1,387,226
Accounts and accrued income receivable, net	362,614	311,084
Income taxes receivable	49,031	38,673
<b>Investments:</b>		
Deposits with banks	37,547	41,335
Debt securities, includes pledged securities of \$107,288 and \$108,427	5,529,860	4,752,684
Equity securities	447,749	466,516
Other investments	123,652	117,768
	6,138,808	5,378,303
Secured financings receivable	86,509	—
Property and equipment, net	457,545	439,569
Title plants and other indexes	575,431	568,452
Deferred income taxes	22,803	22,803
Goodwill	1,145,086	1,113,005
Other intangible assets, net	111,647	99,913
Other assets	225,334	214,194
	\$11,380,127	\$9,573,222
<b>Liabilities and Equity</b>		
Deposits	\$4,548,635	\$3,070,566
Accounts payable and accrued liabilities	826,729	793,157
Deferred revenue	255,324	240,822
Reserve for known and incurred but not reported claims	1,026,959	1,028,933
Income taxes payable	5,416	4,602
Deferred income taxes	219,307	219,307
Secured financings payable	86,501	—
Notes and contracts payable	735,258	732,810
	7,704,129	6,090,197
<b>Commitments and contingencies (Note 14)</b>		
<b>Stockholders' equity:</b>		

Edgar Filing: First American Financial Corp - Form 10-Q

Preferred stock, \$0.00001 par value; Authorized—500 shares; Outstanding—none	—	—
Common stock, \$0.00001 par value; Authorized—300,000 shares; Outstanding—111,787 shares and 110,925 shares	1	1
Additional paid-in capital	2,266,830	2,236,351
Retained earnings	1,600,296	1,311,112
Accumulated other comprehensive loss	(192,912 )	(67,509 )
Total stockholders' equity	3,674,215	3,479,955
Noncontrolling interests	1,783	3,070
Total equity	3,675,998	3,483,025
	\$11,380,127	\$9,573,222

See notes to condensed consolidated financial statements.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Statements of Income

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>Revenues</b>				
Direct premiums and escrow fees	\$649,375	\$651,104	\$1,854,835	\$1,819,193
Agent premiums	615,113	629,186	1,701,831	1,757,796
Information and other	198,680	201,819	596,090	586,179
Net investment income	67,874	44,460	167,000	117,109
Net realized investment gains (losses)	11,144	(7,001 )	10,975	10,763
	1,542,186	1,519,568	4,330,731	4,291,040
<b>Expenses</b>				
Personnel costs	449,839	443,992	1,312,455	1,287,570
Premiums retained by agents	485,621	497,911	1,341,808	1,387,608
Other operating expenses	227,670	374,347	675,085	820,540
Provision for policy losses and other claims	122,196	120,349	336,395	333,695
Depreciation and amortization	31,729	36,000	92,534	96,292
Premium taxes	18,774	19,900	51,837	52,527
Interest	10,770	9,107	29,997	26,812
	1,346,599	1,501,606	3,840,111	4,005,044
Income before income taxes	195,587	17,962	490,620	285,996
Income tax expense (benefit)	44,126	(3,224 )	107,896	84,846
Net income	151,461	21,186	382,724	201,150
Less: Net loss attributable to noncontrolling interests	(19 )	(197 )	(123 )	(772 )
Net income attributable to the Company	\$151,480	\$21,383	\$382,847	\$201,922
Net income per share attributable to the Company's				
stockholders (Note 9):				
Basic	\$1.34	\$0.19	\$3.40	\$1.81
Diluted	\$1.34	\$0.19	\$3.38	\$1.80
Cash dividends declared per share	\$0.42	\$0.38	\$1.18	\$1.06
Weighted-average common shares outstanding (Note 9):				
Basic	112,722	111,799	112,541	111,578
Diluted	113,365	112,575	113,213	112,254

See notes to condensed consolidated financial statements.



## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Statements of Comprehensive Income

(in thousands)

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Net income	\$151,461	\$21,186	\$382,724	\$201,150
Other comprehensive income (loss), net of tax:				
Unrealized (losses) gains on securities	(14,662 )	13,929	(73,933 )	52,014
Foreign currency translation adjustment	3,001	11,415	(11,296 )	23,558
Pension benefit adjustment	118	85,891	357	93,061
Total other comprehensive income (loss), net of tax	(11,543 )	111,235	(84,872 )	168,633
Comprehensive income	139,918	132,421	297,852	369,783
Less: Comprehensive loss attributable to noncontrolling interests	(19 )	(192 )	(142 )	(760 )
Comprehensive income attributable to the Company	\$139,937	\$132,613	\$297,994	\$370,543

See notes to condensed consolidated financial statements.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Statements of Stockholders' Equity

(in thousands)

(unaudited)

## First American Financial Corporation Stockholders

	Shares	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Total stockholders' equity	Noncontrolling interests	Total
Balance at December 31, 2017	110,925	\$1	\$2,236,351	\$1,311,112	\$(67,509 )	\$3,479,955	\$3,070	\$3,483,025
Cumulative-effect adjustment (Note 1)	—	—	—	40,550	(40,550 )	—	—	—
Net income (loss) for three months ended March 31, 2018	—	—	—	76,227	—	76,227	(55 )	76,172
Dividends on common shares	—	—	—	(42,330 )	—	(42,330 )	—	(42,330 )
Shares issued in connection with share-based compensation	620	—	(11,759 )	(847 )	—	(12,606 )	—	(12,606 )
Share-based compensation	—	—	19,509	—	—	19,509	—	19,509
Net activity related to noncontrolling interests	—	—	189	—	—	189	(1,090)	(901 )
Other comprehensive loss	—	—	—	—	(50,409 )	(50,409 )	(19 )	(50,428 )
Balance at March 31, 2018	111,545	1	2,244,290	1,384,712	(158,468)	3,470,535	1,906	3,472,441
Net income (loss) for three months ended June 30, 2018	—	—	—	155,140	—	155,140	(49 )	155,091
Dividends on common shares	—	—	—	(42,387 )	—	(42,387 )	—	(42,387 )
Shares issued in connection with share-based compensation	113	—	2,204	(827 )	—	1,377	—	1,377
Share-based compensation	—	—	7,626	—	—	7,626	—	7,626
Net activity related to noncontrolling interests	—	—	133	—	—	133	(158 )	(25 )
Other comprehensive loss	—	—	—	—	(22,901 )	(22,901 )	—	(22,901 )
Balance at June 30, 2018	111,658	1	2,254,253	1,496,638	(181,369)	3,569,523	1,699	3,571,222
Net income (loss) for three months ended September 30, 2018	—	—	—	151,480	—	151,480	(19 )	151,461
Dividends on common shares	—	—	—	(46,912 )	—	(46,912 )	—	(46,912 )
Shares issued in connection with share-based compensation	129	—	5,466	(910 )	—	4,556	—	4,556
Share-based compensation	—	—	7,241	—	—	7,241	—	7,241
Net activity related to noncontrolling interests	—	—	(130 )	—	—	(130 )	103	(27 )
Other comprehensive loss	—	—	—	—	(11,543 )	(11,543 )	—	(11,543 )

Balance at September 30, 2018	111,787	\$1	\$2,266,830	\$1,600,296	\$(192,912)	\$3,674,215	\$1,783	\$3,675,998
-------------------------------	---------	-----	-------------	-------------	-------------	-------------	---------	-------------

See notes to condensed consolidated financial statements.

8

---

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Statements of Stockholders' Equity – (Continued)

(in thousands)

(unaudited)

## First American Financial Corporation Stockholders

	Shares	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Total stockholders' equity	Noncontrolling interests	Total
Balance at December 31, 2016	109,944	\$1	\$2,191,756	\$1,046,822	\$(230,400)	\$3,008,179	\$6,170	\$3,014,349
Net income (loss) for three months ended March 31, 2017	—	—	—	58,282	—	58,282	(213 )	58,069
Dividends on common shares	—	—	—	(37,495 )	—	(37,495 )	—	(37,495 )
Shares issued in connection with share-based compensation	584	—	(5,078 )	(869 )	—	(5,947 )	—	(5,947 )
Share-based compensation	—	—	17,032	—	—	17,032	—	17,032
Net activity related to noncontrolling interests	—	—	—	—	—	—	(841 )	(841 )
Other comprehensive income	—	—	—	—	32,411	32,411	7	32,418
Balance at March 31, 2017	110,528	1	2,203,710	1,066,740	(197,989)	3,072,462	5,123	3,077,585
Net income (loss) for three months ended June 30, 2017	—	—	—	122,257	—	122,257	(362 )	121,895
Dividends on common shares	—	—	—	(37,604 )	—	(37,604 )	—	(37,604 )
Shares issued in connection with share-based compensation	193	—	4,591	(811 )	—	3,780	—	3,780
Share-based compensation	—	—	7,548	—	—	7,548	—	7,548
Net activity related to noncontrolling interests	—	—	—	—	—	—	(26 )	(26 )
Other comprehensive income	—	—	—	—	24,980	24,980	—	24,980
Balance at June 30, 2017	110,721	1	2,215,849	1,150,582	(173,009)	3,193,423	4,735	3,198,158
Net income (loss) for three months ended September 30, 2017	—	—	—	21,383	—	21,383	(197 )	21,186
Dividends on common shares	—	—	—	(42,075 )	—	(42,075 )	—	(42,075 )
Shares issued in connection with share-based compensation	96	—	4,271	(909 )	—	3,362	—	3,362
Share-based compensation	—	—	6,616	—	—	6,616	—	6,616
Net activity related to noncontrolling interests	—	—	(45 )	—	—	(45 )	(40 )	(85 )
Other comprehensive income	—	—	—	—	111,230	111,230	5	111,235
Balance at September 30, 2017	110,817	\$1	\$2,226,691	\$1,128,981	\$(61,779 )	\$3,293,894	\$4,503	\$3,298,397



See notes to condensed consolidated financial statements.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Nine Months Ended	
	September 30, 2018	2017
Cash flows from operating activities:		
Net income	\$382,724	\$201,150
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for policy losses and other claims	336,395	333,695
Depreciation and amortization	92,534	96,292
Amortization of premiums and accretion of discounts on debt securities, net	20,521	25,013
Net realized investment gains	(10,975 )	(10,763 )
Share-based compensation	34,376	31,196
Equity in earnings of affiliates, net	(2,255 )	(4,550 )
Dividends from equity method investments	3,419	9,593
Changes in assets and liabilities excluding effects of acquisitions and noncash transactions:		
Claims paid, including assets acquired, net of recoveries	(333,970 )	(351,397 )
Net change in income tax accounts	12,301	34,462
Increase in accounts and accrued income receivable	(51,150 )	(11,907 )
(Decrease) increase in accounts payable and accrued liabilities	(11,806 )	95,383
Increase in deferred revenue	14,678	20,313
Other, net	(1,931 )	(12,953 )
Cash provided by operating activities	484,861	455,527
Cash flows from investing activities:		
Net cash effect of acquisitions/dispositions	(73,757 )	(82,993 )
Net decrease in deposits with banks	2,462	1,171
Purchases of debt and equity securities	(1,924,260)	(1,276,401)
Proceeds from sales of debt and equity securities	660,548	599,365
Proceeds from maturities of debt securities	429,287	457,334
Net change in other investments	(6,612 )	2,555
Advances under secured financing agreements	(1,537,657)	—
Collections of secured financings receivable	1,520,911	—
Capital expenditures	(87,319 )	(103,064 )
Proceeds from sales of property and equipment	1,670	9,882
Cash used for investing activities	(1,014,727)	(392,151 )
Cash flows from financing activities:		
Net change in deposits	1,478,069	185,948

Edgar Filing: First American Financial Corp - Form 10-Q

Borrowings under secured financing agreements	1,537,593	—
Repayments of secured financings payable	(1,520,855)	—
Repayments of notes and contracts payable	(4,111 )	(4,128 )
Net activity related to noncontrolling interests	(945 )	(964 )
Net (payments) proceeds in connection with share-based compensation plans	(6,673 )	1,195
Payments of cash dividends	(131,629 )	(117,174 )
Cash provided by financing activities	1,351,449	64,877
Effect of exchange rate changes on cash	(3,490 )	7,524
Net increase in cash and cash equivalents	818,093	135,777
Cash and cash equivalents—Beginning of period	1,387,226	1,006,138
Cash and cash equivalents—End of period	\$2,205,319	\$1,141,915
Supplemental information:		
Cash paid during the period for:		
Interest	\$28,030	\$24,619
Premium taxes	\$56,396	\$55,233
Income taxes, less refunds of \$1,047 and \$52,828	\$95,041	\$50,264

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements  
(unaudited)

Note 1 – Basis of Condensed Consolidated Financial Statements

Basis of Presentation

The condensed consolidated financial information included in this report has been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and Article 10 of Securities and Exchange Commission (“SEC”) Regulation S-X. The principles for condensed interim financial information do not require the inclusion of all the information and footnotes required by GAAP for complete financial statements. Therefore, these financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2017. The condensed consolidated financial statements included herein are unaudited; however, in the opinion of management, they contain all normal recurring adjustments necessary for a fair statement of the consolidated results for the interim periods. All material intercompany transactions and balances have been eliminated upon consolidation.

Recently Adopted Accounting Pronouncements

In May 2017, the Financial Accounting Standards Board (“FASB”) issued updated guidance intended to reduce diversity in practice by clarifying which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company’s condensed consolidated financial statements.

In March 2017, the FASB issued updated guidance intended to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost through the disaggregation of the service cost component from the other components of net benefit cost. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company adopted this change in accounting principle at the beginning of 2018 and applied the change retrospectively to the prior year. As a result, other components of net benefit cost totaling \$155.4 million and \$171.4 million were reclassified from personnel costs to other operating expenses on the condensed consolidated statements of income for the three and nine months ended September 30, 2017, respectively. See Note 10 Employee Benefit Plans for further information on the Company’s net periodic pension costs.

In January 2017, the FASB issued updated guidance to clarify the definition of a business with the objective of providing guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company’s condensed consolidated financial statements.

In November 2016, the FASB issued updated guidance intended to reduce the diversity in practice on presenting restricted cash and restricted cash equivalents in the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In October 2016, the FASB issued updated guidance intended to simplify and improve the accounting for the income tax consequences of intra-entity transfers of assets, other than inventory. The updated guidance, which eliminates the intra-entity transfers exception, requires entities to recognize the income tax consequences of intra-entity transfers of assets, other than inventory, when the transfers occur. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In August 2016, the FASB issued updated guidance intended to eliminate the diversity in practice regarding the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

In January 2016, the FASB issued updated guidance intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. In addition to making other targeted improvements to current guidance, the updated guidance also requires all equity investments, except those accounted for under the equity method of accounting or those that result in consolidation of the investee, to be measured at fair value with changes in the fair value recognized through net income. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017. The Company adopted this guidance at the beginning of 2018 and recognized cumulative net unrealized gains, net of taxes, of \$40.6 million related to its investments in equity securities, previously classified as available-for-sale, through a cumulative-effect adjustment to retained earnings. Changes in the fair values of these investments are reflected in net realized investment gains/losses on the Company's condensed consolidated statements of income. See Note 4 Debt and Equity Securities for further discussion of the Company's investments in equity securities.

In May 2014, the FASB issued updated guidance for recognizing revenue from contracts with customers to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within and across industries, and across capital markets. The new revenue standard contains principles that an entity will apply to determine the measurement of revenue and the timing of recognition. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. Revenue from insurance contracts is not within the scope of this guidance. In August 2015, the FASB issued updated guidance which defers the effective date of this guidance by one year. In 2016, the FASB issued additional updates to the new guidance primarily to clarify, among other things, the implementation guidance related to principal versus agent considerations, identifying performance obligations, accounting for licenses of intellectual property, and to provide narrow-scope improvements and additional practical expedients. In February 2017, the FASB issued an additional update to the new guidance to clarify the scope of derecognition guidance for nonfinancial assets and to provide guidance for partial sales of nonfinancial assets. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017. The Company elected to adopt the new guidance under the modified retrospective approach, which, except for the disclosure requirements, did not have a material impact on its condensed consolidated financial statements. See Note 2 Adoption of Revenue Guidance for further information about the Company's revenues within the scope of the new guidance.

#### Pending Accounting Pronouncements

In August 2018, the FASB issued updated guidance that is intended to reduce potential diversity in practice in accounting for the costs of implementing cloud computing arrangements (i.e., hosting arrangements) that are service contracts. The updated guidance aligns the requirements for capitalizing implementation costs for these arrangements with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software and hosting arrangements that include an internal-use software license. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently assessing the impact of this guidance on its condensed consolidated financial statements.

In August 2018, the FASB issued updated guidance as part of its disclosure framework project intended to improve the effectiveness of disclosures in the notes to the financial statements. The updated guidance eliminates, adds and modifies certain disclosure requirements related to fair value measurements. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. Except for

the disclosure requirements, the Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In January 2017, the FASB issued updated guidance intended to simplify how an entity tests goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Under the updated guidance, an entity will perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and will recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, with the loss recognized limited to the total amount of goodwill allocated to that reporting unit. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

In June 2016, the FASB issued updated guidance intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The updated guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires the consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently assessing the impact of this guidance on its condensed consolidated financial statements.

In February 2016, the FASB issued updated guidance that requires the rights and obligations associated with leasing arrangements be reflected on the balance sheet in order to increase transparency and comparability among organizations. Under the updated guidance, lessees will be required to recognize a right-of-use asset and a liability to make lease payments and disclose key information about leasing arrangements. The updated guidance is required to be adopted using a modified retrospective transition approach. In July 2018, the FASB issued additional updates to the new guidance which allows for the initial application of the guidance at the adoption date and for the recognition of a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. While the Company is currently evaluating the impact the new guidance will have on its condensed consolidated financial statements, the Company expects the adoption of the new guidance will result in a material increase in the assets and liabilities on its condensed consolidated balance sheets and will likely have an insignificant impact on its condensed consolidated statements of income and statements of cash flows.

#### Note 2 – Adoption of Revenue Guidance

The Company's information and other revenues and escrow fees are within the scope of the new accounting guidance related to the recognition of revenue from contracts with customers, which the Company adopted effective January 1, 2018. Under the new guidance, revenue is recognized when control of the promised goods or services is transferred to the customer and in an amount that reflects the consideration the Company expects to be entitled to in exchange for these goods or services. See Note 1 Basis of Condensed Consolidated Financial Statements for further discussion of the new guidance.

For those products and services where the Company's performance obligation is satisfied at a point in time and for which there is no ongoing obligation, revenue is recognized upon delivery. For those products and services where the Company satisfies its performance obligation over time as the product or service is being transferred to the customer, revenue is generally recognized using the output method as the products or services are delivered.

The Company has elected to apply the optional exemptions allowed under the new guidance whereby the Company is not required to disclose either the transaction price allocated to performance obligations that are unsatisfied as of the end of the period or an explanation as to when the Company expects to recognize the related revenue. Such contracts generally include performance obligations that are contingent upon the closing of a real estate transaction or include variable consideration based on order volumes, and have remaining contract terms of generally less than three years. The Company is eligible to apply the optional exemptions to its remaining performance obligations due to 1)



the performance obligation is part of a contract that has an original duration of one year or less, 2) the associated revenue being recognized is based on the Company's right to invoice for the value of the product or service delivered, 3) the associated variable consideration is being allocated entirely to wholly unsatisfied performance obligations or 4) immateriality.

The Company has also elected to apply the practical expedient allowed under the new guidance whereby it can disregard the impact to the transaction price of the effects of a significant financing component for arrangements where the Company expects the period between delivery of the product or service and customer payment to be one year or less. In addition, the Company has elected to apply the practical expedient whereby it can recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period for the asset that the Company otherwise would have recognized is one year or less.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

The Company records a contract asset, and recognizes revenue, upon delivery of certain products related to the closing of a real property transaction where the Company's right to payment is subject to the closing of the real estate transaction. The Company records a contract liability for payments received in advance of revenue recognition for certain products or services. Contract assets and liabilities were not material at September 30, 2018. Revenues recognized during the three and nine months ended September 30, 2018 that were included in contract liabilities at the beginning of the period were not material.

For information about the Company's revenues disaggregated by reportable segment see Note 16 Segment Information.

Note 3 – Escrow Deposits, Like-kind Exchange Deposits and Trust Assets

The Company administers escrow deposits and trust assets as a service to its customers. Escrow deposits totaled \$8.9 billion and \$7.5 billion at September 30, 2018 and December 31, 2017, respectively, of which \$4.4 billion and \$2.9 billion, respectively, were held at the Company's federal savings bank subsidiary, First American Trust, FSB. The escrow deposits held at First American Trust, FSB are temporarily invested in cash and cash equivalents and debt securities, with offsetting liabilities included in deposits in the accompanying condensed consolidated balance sheets. The remaining escrow deposits were held at third-party financial institutions.

Trust assets held or managed by First American Trust, FSB totaled \$3.8 billion and \$3.7 billion at September 30, 2018 and December 31, 2017, respectively. Escrow deposits held at third-party financial institutions and trust assets are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. However, the Company could be held contingently liable for the disposition of these assets.

In conducting its operations, the Company often holds customers' assets in escrow, pending completion of real estate transactions and, as a result, the Company has ongoing programs for realizing economic benefits with various financial institutions. The results from these programs are included in the condensed consolidated financial statements as income or a reduction in expense, as appropriate, based on the nature of the arrangement and benefit received.

The Company facilitates tax-deferred property exchanges for customers pursuant to Section 1031 of the Internal Revenue Code and tax-deferred reverse exchanges pursuant to Revenue Procedure 2000-37. As a facilitator and intermediary, the Company holds the proceeds from sales transactions and takes temporary title to property identified by the customer to be acquired with such proceeds. Upon the completion of each such exchange, the identified property is transferred to the customer or, if the exchange does not take place, an amount equal to the sales proceeds or, in the case of a reverse exchange, title to the property held by the Company is transferred to the customer. Like-kind exchange funds held by the Company totaled \$2.6 billion at September 30, 2018 and December 31, 2017. The like-kind exchange deposits are held at third-party financial institutions and, due to the structure utilized to facilitate these transactions, the proceeds and property are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. All such amounts are placed in deposit accounts insured, up to applicable limits, by the Federal Deposit Insurance Corporation. The Company could be held contingently liable to the customer for the transfers of property, disbursements of proceeds

and the returns on such proceeds.

14

---

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 4 – Debt and Equity Securities

Investments in debt securities, classified as available-for-sale, are as follows:

(in thousands)	Amortized cost	Gross unrealized Gains	Losses	Estimated fair value
September 30, 2018				
U.S. Treasury bonds	\$204,854	\$135	\$(5,033)	\$199,956
Municipal bonds	1,093,531	3,630	(22,973)	1,074,188
Foreign government bonds	156,289	231	(2,518)	154,002
Governmental agency bonds	334,690	284	(8,425)	326,549
Governmental agency mortgage-backed securities	2,786,111	2,422	(49,763)	2,738,770
U.S. corporate debt securities	773,189	2,763	(12,147)	763,805
Foreign corporate debt securities	275,290	1,020	(3,720)	272,590
	\$5,623,954	\$10,485	\$(104,579)	\$5,529,860
December 31, 2017				
U.S. Treasury bonds	\$173,049	\$2,199	\$(1,250)	\$173,998
Municipal bonds	1,031,146	12,185	(7,394)	1,035,937
Foreign government bonds	170,220	489	(1,221)	169,488
Governmental agency bonds	212,731	1,061	(2,322)	211,470
Governmental agency mortgage-backed securities	2,172,377	3,168	(16,588)	2,158,957
U.S. corporate debt securities	734,409	11,768	(2,962)	743,215
Foreign corporate debt securities	256,430	4,145	(956)	259,619
	\$4,750,362	\$35,015	\$(32,693)	\$4,752,684

Sales of debt securities resulted in realized gains of \$0.6 million and \$1.9 million, realized losses of \$3.1 million and \$6.9 million, and proceeds of \$183.1 million and \$525.4 million for the three and nine months ended September 30, 2018, respectively, and realized gains of \$0.9 million and \$3.9 million, realized losses of \$0.4 million and \$4.0 million, and proceeds of \$63.7 million and \$357.7 million for the three and nine months ended September 30, 2017, respectively.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Gross unrealized losses on investments in debt securities are as follows:

	Less than 12 months		12 months or longer		Total	
	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses
(in thousands)						
September 30, 2018						
U.S. Treasury bonds	\$138,105	\$(2,976 )	\$49,131	\$(2,057 )	\$187,236	\$(5,033 )
Municipal bonds	508,857	(7,747 )	296,302	(15,226 )	805,159	(22,973 )
Foreign government bonds	101,286	(1,250 )	33,004	(1,268 )	134,290	(2,518 )
Governmental agency bonds	183,040	(3,260 )	136,979	(5,165 )	320,019	(8,425 )
Governmental agency mortgage-backed securities	1,367,730	(21,748 )	877,474	(28,015 )	2,245,204	(49,763 )
U.S. corporate debt securities	442,049	(7,825 )	86,252	(4,322 )	528,301	(12,147 )
Foreign corporate debt securities	152,560	(2,546 )	39,727	(1,174 )	192,287	(3,720 )
	\$2,893,627	\$(47,352 )	\$1,518,869	\$(57,227 )	\$4,412,496	\$(104,579 )
December 31, 2017						
U.S. Treasury bonds	\$78,605	\$(511 )	\$37,498	\$(739 )	\$116,103	\$(1,250 )
Municipal bonds	279,292	(1,714 )	226,895	(5,680 )	506,187	(7,394 )
Foreign government bonds	98,942	(972 )	6,678	(249 )	105,620	(1,221 )
Governmental agency bonds	55,707	(409 )	93,737	(1,913 )	149,444	(2,322 )
Governmental agency mortgage-backed securities	671,871	(4,868 )	774,959	(11,720 )	1,446,830	(16,588 )
U.S. corporate debt securities	171,817	(1,568 )	60,724	(1,394 )	232,541	(2,962 )
Foreign corporate debt securities	81,525	(821 )	5,697	(135 )	87,222	(956 )
	\$1,437,759	\$(10,863 )	\$1,206,188	\$(21,830 )	\$2,643,947	\$(32,693 )

Based on the Company's review of its debt securities in an unrealized loss position at September 30, 2018, it determined that the losses were primarily the result of changes in interest rates, which were considered to be temporary, rather than a deterioration in credit quality. The Company does not intend to sell and it is not more likely than not that the Company will be required to sell these securities prior to recovering their amortized cost. As such, the Company does not consider these securities to be other-than-temporarily impaired at September 30, 2018.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Investments in debt securities at September 30, 2018, by contractual maturities, are as follows:

(in thousands)	Due in one year or less	Due after	Due after	Due after ten years	Total
		one through five years	five through ten years		
<b>U.S. Treasury bonds</b>					
Amortized cost	\$ 27,440	\$ 63,667	\$ 51,675	\$ 62,072	\$ 204,854
Estimated fair value	\$ 27,200	\$ 62,757	\$ 50,409	\$ 59,590	\$ 199,956
<b>Municipal bonds</b>					
Amortized cost	\$ 84,445	\$ 273,965	\$ 305,452	\$ 429,669	\$ 1,093,531
Estimated fair value	\$ 84,352	\$ 272,119	\$ 300,956	\$ 416,761	\$ 1,074,188
<b>Foreign government bonds</b>					
Amortized cost	\$ 19,036	\$ 109,717	\$ 11,715	\$ 15,821	\$ 156,289
Estimated fair value	\$ 19,002	\$ 108,840	\$ 11,505	\$ 14,655	\$ 154,002
<b>Governmental agency bonds</b>					
Amortized cost	\$ 33,161	\$ 119,472	\$ 127,656	\$ 54,401	\$ 334,690
Estimated fair value	\$ 33,115	\$ 116,611	\$ 125,714	\$ 51,109	\$ 326,549
<b>U.S. corporate debt securities</b>					
Amortized cost	\$ 31,337	\$ 368,851	\$ 329,269	\$ 43,732	\$ 773,189
Estimated fair value	\$ 31,258	\$ 364,834	\$ 324,843	\$ 42,870	\$ 763,805
<b>Foreign corporate debt securities</b>					
Amortized cost	\$ 26,278	\$ 157,324	\$ 83,175	\$ 8,513	\$ 275,290
Estimated fair value	\$ 26,241	\$ 155,799	\$ 82,037	\$ 8,513	\$ 272,590
<b>Total debt securities excluding mortgage-backed securities</b>					
Amortized cost	\$ 221,697	\$ 1,092,996	\$ 908,942	\$ 614,208	\$ 2,837,843
Estimated fair value	\$ 221,168	\$ 1,080,960	\$ 895,464	\$ 593,498	\$ 2,791,090
<b>Total mortgage-backed securities</b>					
Amortized cost					\$ 2,786,111
Estimated fair value					\$ 2,738,770
<b>Total debt securities</b>					
Amortized cost					\$ 5,623,954
Estimated fair value					\$ 5,529,860

Mortgage-backed securities, which include contractual terms to maturity, are not categorized by contractual maturity as borrowers may have the right to call or prepay obligations with, or without, call or prepayment penalties.



FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Investments in equity securities are as follows:

	Cost	Estimated fair value
(in thousands)		
September 30, 2018		
Preferred stocks	\$ 18,616	\$ 18,432
Common stocks	373,543	429,317
	\$392,159	\$447,749
December 31, 2017		
Preferred stocks	\$ 19,233	\$ 18,990
Common stocks	394,439	447,526
	\$413,672	\$466,516

The Company adopted new accounting guidance on January 1, 2018, which requires investments in equity securities with readily determinable fair values to be measured at fair value with changes in fair value recognized through net income. See Note 1 Basis of Condensed Consolidated Financial Statements for further discussion of the new guidance.

Net gains (realized and unrealized) of \$14.2 million and \$16.0 million were recognized for the three and nine months ended September 30, 2018, respectively, as a result of changes in the fair values of equity securities. Included in net gains during the three and nine months ended September 30, 2018, were net unrealized gains of \$14.1 million and \$15.9 million, respectively, related to equity securities still held at September 30, 2018. For the three and nine months ended September 30, 2017, sales of equity securities resulted in realized gains of \$0.7 million and \$17.9 million and realized losses of \$0.3 million and \$2.0 million, respectively.

The composition of the investment portfolio at September 30, 2018, by credit rating, is as follows:

	A- or higher Estimated		BBB+ to BBB- Estimated		Non-Investment Grade Estimated		Total Estimated	
(in thousands, except percentages)	fair value	Percentage	fair value	Percentage	fair value	Percentage	fair value	Percentage
Debt securities:								
U.S. Treasury bonds	\$ 199,956	100.0	\$—	—	\$—	—	\$ 199,956	100.0
Municipal bonds	997,639	92.9	52,149	4.9	24,400	2.2	1,074,188	100.0
Foreign government bonds	125,378	81.4	23,757	15.4	4,867	3.2	154,002	100.0



Edgar Filing: First American Financial Corp - Form 10-Q

Governmental agency bonds	326,549	100.0	—	—	—	—	326,549	100.0
Governmental agency mortgage-backed securities	2,738,770	100.0	—	—	—	—	2,738,770	100.0
U.S. corporate debt securities	303,068	39.7	248,671	32.6	212,066	27.7	763,805	100.0
Foreign corporate debt securities	123,299	45.2	112,708	41.3	36,583	13.5	272,590	100.0
Total debt securities	4,814,659	87.1	437,285	7.9	277,916	5.0	5,529,860	100.0
Preferred stocks	58	0.3	16,017	86.9	2,357	12.8	18,432	100.0
Total	\$4,814,717	86.8	\$453,302	8.2	\$280,273	5.0	\$5,548,292	100.0

As of September 30, 2018, the estimated fair value of total debt securities included \$157.1 million of bank loans, of which \$146.3 million was non-investment grade; \$95.6 million of high yield corporate debt securities, all of which was non-investment grade; and \$86.3 million of emerging market debt securities, of which \$11.6 million was non-investment grade.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

The composition of the debt securities portfolio in an unrealized loss position at September 30, 2018, by credit rating, is as follows:

	A- or higher		BBB+ to BBB-		Non-Investment Grade		Total	
	Estimated		Estimated		Estimated		Estimated	
(in thousands, except percentages)	fair value	Percentage	fair value	Percentage	fair value	Percentage	fair value	Percentage
U.S. Treasury bonds	\$187,236	100.0	\$—	—	\$—	—	\$187,236	100.0
Municipal bonds	757,128	94.0	34,436	4.3	13,595	1.7	805,159	100.0
Foreign government bonds	106,665	79.5	22,758	16.9	4,867	3.6	134,290	100.0
Governmental agency bonds	320,019	100.0	—	—	—	—	320,019	100.0
Governmental agency mortgage-backed securities	2,245,204	100.0	—	—	—	—	2,245,204	100.0
U.S. corporate debt securities	260,752	49.3	193,826	36.7	73,723	14.0	528,301	100.0
Foreign corporate debt securities	82,630	43.0	89,010	46.3	20,647	10.7	192,287	100.0
Total	\$3,959,634	89.7	\$340,030	7.7	\$112,832	2.6	\$4,412,496	100.0

As of September 30, 2018, the estimated fair value of total debt securities in an unrealized loss position included \$28.9 million of bank loans, of which \$28.5 million was non-investment grade; \$60.6 million of high yield corporate debt securities, all of which was non-investment grade; and \$72.9 million of emerging market debt securities, of which \$10.1 million was non-investment grade.

The credit ratings in the above tables reflect published ratings obtained from globally recognized securities rating agencies. If a security was rated differently among the rating agencies, the lowest rating was selected. Governmental agency mortgage-backed securities are not rated by any of the ratings agencies; however, these securities have been included in the above table in the “A- or higher” category because the payments of principal and interest are guaranteed by the governmental agency that issued the security.

#### Note 5 – Goodwill

A summary of the changes in the carrying amount of goodwill, by operating segment, for the nine months ended September 30, 2018, is as follows:

	Title		
	Insurance		
		Specialty	
(in thousands)	and Services	Insurance	Total
Balance at December 31, 2017	\$1,066,240	\$46,765	\$1,113,005
Acquisitions	34,261	—	34,261
Foreign currency translation	(2,180 )	—	(2,180 )
Balance at September 30, 2018	\$1,098,321	\$46,765	\$1,145,086

The Company's four reporting units for purposes of assessing goodwill for impairment are title insurance, home warranty, property and casualty insurance and trust and other services. During the nine months ended September 30, 2018, there were no triggering events that would more likely than not reduce the fair value of any reporting unit below its carrying amount.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 6 – Other Intangible Assets

Other intangible assets consist of the following:

	September 30,	December 31,
(in thousands)	2018	2017
Finite-lived intangible assets:		
Customer relationships	\$ 116,030	\$ 106,086
Noncompete agreements	12,965	11,509
Trademarks	10,016	9,229
Internal-use software licenses	25,779	28,956
Patents	2,840	2,840
	167,630	158,620
Accumulated amortization	(72,867 )	(75,591 )
	94,763	83,029
Indefinite-lived intangible assets:		
Licenses	16,884	16,884
	\$ 111,647	\$ 99,913

Amortization expense for finite-lived intangible assets was \$7.9 million and \$22.0 million for the three and nine months ended September 30, 2018, respectively, and \$7.0 million and \$19.7 million for the three and nine months ended September 30, 2017, respectively.

Estimated amortization expense for finite-lived intangible assets for the next five years is as follows:

Year	(in thousands)
Remainder of 2018	\$ 7,700
2019	\$ 21,707
2020	\$ 13,392
2021	\$ 10,479
2022	\$ 10,030
2023	\$ 9,755



FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 7 – Reserve for Known and Incurred But Not Reported Claims

Activity in the reserve for known and incurred but not reported claims is summarized as follows:

(in thousands)	Nine months ended	
	September 30, 2018	2017
Balance at beginning of period	\$1,028,933	\$1,025,863
Provision related to:		
Current year	328,326	330,342
Prior years	8,069	3,353
	336,395	333,695
Payments, net of recoveries, related to:		
Current year	167,802	165,914
Prior years	166,168	185,483
	333,970	351,397
Other	(4,399 )	13,487
Balance at end of period	\$1,026,959	\$1,021,648

The provision for title insurance losses, expressed as a percentage of title insurance premiums and escrow fees, was 4.0% for the three and nine months ended September 30, 2018 and 2017. The current quarter rate of 4.0% reflects the ultimate loss rate for the current policy year and no change in the loss reserve estimates for prior policy years. The 4.0% rate for the third quarter of 2017 reflected the ultimate loss rate for the 2017 policy year and no change in the loss reserve estimates for prior policy years.

A summary of the Company's loss reserves is as follows:

(in thousands, except percentages)	September 30, 2018		December 31, 2017	
Known title claims	\$81,212	7.9 %	\$83,094	8.1 %
Incurred but not reported claims	881,071	85.8 %	875,724	85.1 %
Total title claims	962,283	93.7 %	958,818	93.2 %
Non-title claims	64,676	6.3 %	70,115	6.8 %
Total loss reserves	\$1,026,959	100.0 %	\$1,028,933	100.0 %

Note 8 – Income Taxes

On December 22, 2017, comprehensive tax reform legislation known as the Tax Cuts and Jobs Act (the “Tax Reform Act”) was signed into law. The Tax Reform Act amended the Internal Revenue Code to reduce U.S. tax rates and modify policies, credits and deductions for individuals and businesses.

Also, on December 22, 2017, the SEC issued Staff Accounting Bulletin No. 118, which provided for a one-year measurement period that allows businesses time to evaluate the financial statement implications of the Tax Reform Act. The measurement period allows businesses to gather the information necessary to prepare and analyze the tax accounting effects of the Tax Reform Act on financial statements issued during the measurement period. The ultimate impact of the Tax Reform Act on the Company’s financial statements may differ, perhaps materially, from the amounts originally estimated due to further refinement of the Company’s calculations, changes in interpretations and assumptions the Company has made, guidance that may be issued by taxing authorities and regulatory bodies, and actions the Company may take as a result of the Tax Reform Act. The Company anticipates completing its tax accounting for the Tax Reform Act during the measurement period, and will record and disclose any adjustments made to its initial estimates during that time frame.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

The Company's effective income tax rates (income tax expense as a percentage of income before income taxes) were 22.6% and 22.0% for the three and nine months ended September 30, 2018, respectively, and -17.9% and 29.7% for the three and nine months ended September 30, 2017, respectively. The Company's effective tax rates differ from the statutory federal rates of 21% and 35% for 2018 and 2017, respectively, due to state and foreign income taxes incurred, as well as permanent differences between financial statement income and amounts reported for income tax purposes, including the recognition of excess tax benefits or tax deficiencies associated with share-based payment transactions through income tax expense. The Company's effective tax rates for 2017 also reflect state tax benefits relating to the termination of the Company's pension plan, as well as the release of reserves relating to tax positions taken on prior year tax returns.

In connection with the Company's June 2010 spin-off from its prior parent, the Company entered into a tax sharing agreement which governs the Company's and its prior parent's respective rights, responsibilities and obligations for certain tax related matters. At September 30, 2018 and December 31, 2017, the Company had a net payable to its prior parent of \$15.5 million and \$15.0 million, respectively, related to tax matters prior to the spin-off. This amount is included in the Company's condensed consolidated balance sheets in accounts payable and accrued liabilities. The increase during the current year was primarily the result of an additional accrual for tax matters prior to the spin-off.

The Company evaluates the realizability of its deferred tax assets by assessing the valuation allowance and makes adjustments to the allowance as necessary. The factors used to assess the likelihood of realization include the Company's forecast of future taxable income and available tax planning strategies that could be implemented to realize the deferred tax assets. The Company's ability or failure to achieve forecasted taxable income in the applicable taxing jurisdictions could affect the ultimate realization of deferred tax assets. Based on actual future operating results in certain jurisdictions, it is possible that the current valuation allowance positions of those jurisdictions could be adjusted in the next 12 months.

As of September 30, 2018 and December 31, 2017, the liability for income taxes associated with uncertain tax positions was \$13.1 million and \$12.8 million, respectively. As of September 30, 2018 and December 31, 2017, the liability could be reduced by \$3.7 million due to offsetting tax benefits associated with the correlative effects of potential adjustments, including timing adjustments and state income taxes. The net amounts of \$9.4 million and \$9.1 million as of September 30, 2018 and December 31, 2017, respectively, if recognized, would favorably affect the Company's effective tax rate.

The Company's continuing practice is to recognize interest and penalties, if any, related to uncertain tax positions in income tax expense. As of September 30, 2018 and December 31, 2017, the Company had accrued \$5.7 million and \$5.3 million, respectively, of interest and penalties (net of tax benefits of \$1.5 million and \$1.4 million, respectively) related to uncertain tax positions.

It is reasonably possible that the amount of the unrecognized benefit with respect to certain of the Company's unrecognized tax positions may significantly decrease within the next 12 months. Any such change may be the result of ongoing audits or the expiration of federal and state statutes of limitations for the assessment of taxes.

The Company, or one of its subsidiaries, files income tax returns in the U.S. federal jurisdiction, various state jurisdictions and various non-U.S. jurisdictions. The primary non-federal jurisdictions are California, Canada, India and the United Kingdom. As of September 30, 2018, the Company had concluded U.S. federal income tax



examinations through 2015 and is generally no longer subject to state and non-U.S. income tax examinations for years prior to 2005.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 9 – Earnings Per Share

The computation of basic and diluted earnings per share is as follows:

(in thousands, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
<b>Numerator</b>				
Net income attributable to the Company	\$151,480	\$21,383	\$382,847	\$201,922
<b>Denominator</b>				
Basic weighted-average shares	112,722	111,799	112,541	111,578
Effect of dilutive employee stock options and restricted stock units (“RSUs”)	643	776	672	676
Diluted weighted-average shares	113,365	112,575	113,213	112,254
<b>Net income per share attributable to the Company’s stockholders</b>				
Basic	\$1.34	\$0.19	\$3.40	\$1.81
Diluted	\$1.34	\$0.19	\$3.38	\$1.80

For the three and nine months ended September 30, 2018, no RSUs had an antidilutive effect on weighted-average diluted common shares outstanding, and for the three and nine months ended September 30, 2017, 1 thousand RSUs and 8 thousand RSUs, respectively, were excluded from the weighted-average diluted common shares outstanding due to their antidilutive effect. No stock options had an antidilutive effect on weighted-average diluted common shares outstanding for either period in the current year or in the prior year.

Note 10 – Employee Benefit Plans

Net periodic cost related to the Company’s defined benefit pension and supplemental benefit plans includes the following components:

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
<b>Expense:</b>				
Service costs	\$130	\$184	\$390	\$551
Interest costs	2,018	2,086	6,054	11,185
Expected return on plan assets	—	—	—	(4,740 )

Edgar Filing: First American Financial Corp - Form 10-Q

Amortization of net actuarial loss	1,205	1,958	3,615	15,792
Amortization of prior service credit	(1,045)	(1,045 )	(3,135)	(3,268 )
Settlement costs	—	152,388	—	152,388
	\$2,308	\$155,571	\$6,924	\$171,908

The Company adopted new accounting guidance which requires the components of net periodic cost, other than the service cost component, to be included in other operating expenses in the Company's condensed consolidated statements of income. The change was applied retrospectively to the prior year, which resulted in a reclass of \$155.4 million and \$171.4 million from personnel costs to other operating expenses for the three and nine months ended September 30, 2017, respectively. For further information about the new guidance see Note 1 Basis of Condensed Consolidated Financial Statements.

Prior year net periodic cost includes costs related to the Company's previously terminated defined benefit pension plans, for which the Company has no remaining obligation.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 11 – Fair Value Measurements

Certain of the Company's assets are carried at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The Company categorizes its assets and liabilities carried at fair value using a three-level hierarchy for fair value measurements that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the Company (observable inputs) and the Company's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The hierarchy for inputs used in determining fair value maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. The hierarchy level assigned to the assets and liabilities is based on management's assessment of the transparency and reliability of the inputs used to estimate the fair values at the measurement date. The three hierarchy levels are defined as follows:

Level 1—Valuations based on unadjusted quoted market prices in active markets for identical assets or liabilities.

Level 2—Valuations based on observable inputs (other than Level 1 prices), such as quoted prices for similar assets or liabilities at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly.

Level 3—Valuations based on inputs that are unobservable and significant to the overall fair value measurement, and involve management judgment.

If the inputs used to measure fair value fall into different levels of the fair value hierarchy, the hierarchy level assigned is based upon the lowest level of input that is significant to the fair value measurement.

Assets measured at fair value on a recurring basis

The valuation techniques and inputs used by the Company to estimate the fair value of assets measured on a recurring basis are summarized as follows:

Debt securities

The fair values of debt securities were based on the market values obtained from independent pricing services that were evaluated using pricing models that vary by asset class and incorporate available trade, bid and other market information and price quotes from well-established, independent broker-dealers. The independent pricing services monitor market indicators, industry and economic events, and for broker-quoted only securities, obtain quotes from market makers or broker-dealers that they recognize to be market participants. The pricing services utilize the market approach in determining the fair values of the debt securities held by the Company. The Company obtains an understanding of the valuation models and assumptions utilized by the services and has controls in place to determine that the values provided represent fair values. The Company's validation procedures include comparing prices received from the pricing services to quotes received from other third party sources for certain securities with market prices that are readily verifiable. If the price comparison results in differences over a predefined threshold, the

Company will assess the reasonableness of the changes relative to prior periods given the prevailing market conditions and assess changes in the issuers' credit worthiness, performance of any underlying collateral and prices of the instrument relative to similar issuances. To date, the Company has not made any material adjustments to the fair value measurements provided by the pricing services.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Typical inputs and assumptions to pricing models used to value the Company's U.S. Treasury bonds, municipal bonds, foreign government bonds, governmental agency bonds, governmental agency mortgage-backed securities and U.S. and foreign corporate debt securities include, but are not limited to, benchmark yields, reported trades, broker-dealer quotes, credit spreads, credit ratings, bond insurance (if applicable), benchmark securities, bids, offers, reference data and industry and economic events. For mortgage-backed securities, inputs and assumptions may also include the structure of issuance, characteristics of the issuer, collateral attributes and prepayment speeds.

Equity securities

The fair values of equity securities, including preferred and common stocks, were based on quoted market prices for identical assets that are readily and regularly available in an active market.

The following tables present the fair values of the Company's assets, measured on a recurring basis, as of September 30, 2018 and December 31, 2017:

(in thousands)	Total	Level 1	Level 2	Level 3
September 30, 2018				
Debt securities:				
U.S. Treasury bonds	\$ 199,956	\$—	\$ 199,956	\$ —
Municipal bonds	1,074,188	—	1,074,188	—
Foreign government bonds	154,002	—	154,002	—
Governmental agency bonds	326,549	—	326,549	—
Governmental agency mortgage-backed securities	2,738,770	—	2,738,770	—
U.S. corporate debt securities	763,805	—	763,805	—
Foreign corporate debt securities	272,590	—	272,590	—
	5,529,860	—	5,529,860	—
Equity securities:				
Preferred stocks	18,432	18,432	—	—
Common stocks	429,317	429,317	—	—
	447,749	447,749	—	—
Total assets	\$5,977,609	\$447,749	\$5,529,860	\$ —

(in thousands)	Total	Level 1	Level 2	Level 3
December 31, 2017				
Debt securities:				
U.S. Treasury bonds	\$ 173,998	\$—	\$ 173,998	\$—
Municipal bonds	1,035,937	—	1,035,937	—
Foreign government bonds	169,488	—	169,488	—
Governmental agency bonds	211,470	—	211,470	—
Governmental agency mortgage-backed securities	2,158,957	—	2,158,957	—

Edgar Filing: First American Financial Corp - Form 10-Q

U.S. corporate debt securities	743,215	—	700,347	42,868
Foreign corporate debt securities	259,619	—	257,953	1,666
	4,752,684	—	4,708,150	44,534
Equity securities:				
Preferred stocks	18,990	18,990	—	—
Common stocks	447,526	447,526	—	—
	466,516	466,516	—	—
Total assets	\$5,219,200	\$466,516	\$4,708,150	\$44,534

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

There were no transfers between Levels 1 and 2 during the three and nine months ended September 30, 2018 and 2017. Transfers into or out of the Level 3 category occur when unobservable inputs become more or less significant to the fair value measurement. The Company's policy is to recognize transfers between levels in the fair value hierarchy at the end of the reporting period.

The following table presents a summary of the changes in the fair values of Level 3 assets for the three months ended September 30, 2018 and 2017:

(in thousands)	September 30, 2018			September 30, 2017		
	U.S. corporate debt	Foreign corporate debt	Total	U.S. corporate debt	Foreign corporate debt	Total
Fair value at beginning of period	\$13,113	\$ 1,601	\$14,714	\$18,128	\$ 1,915	\$20,043
Transfers into Level 3	—	—	—	3,747	573	4,320
Transfers out of Level 3	(10,081)	(1,609 )	(11,690)	(6,788 )	—	(6,788 )
Net realized and unrealized gains (losses):						
Included in earnings	11	—	11	26	(1 )	25
Included in other comprehensive income (loss)	31	11	42	(86 )	(5 )	(91 )
Purchases	—	—	—	901	149	1,050
Sales	(1,280 )	—	(1,280 )	(1,231 )	—	(1,231 )
Settlements	(1,794 )	(3 )	(1,797 )	(2,188 )	(1,758 )	(3,946 )
Fair value at end of period	\$—	\$—	\$—	\$12,509	\$ 873	\$13,382

The following table presents a summary of the changes in the fair values of Level 3 assets for the nine months ended September 30, 2018 and 2017:

(in thousands)	September 30, 2018			September 30, 2017		
	U.S. corporate debt	Foreign corporate debt	Total	U.S. corporate debt	Foreign corporate debt	Total
Fair value at beginning of period	\$42,868	\$ 1,666	\$44,534	\$46,665	\$ 6,268	\$52,933
Transfers into Level 3	—	—	—	377	198	575
Transfers out of Level 3	(25,089)	(788 )	(25,877)	(27,066)	(2,111 )	(29,177)



Edgar Filing: First American Financial Corp - Form 10-Q

Net realized and unrealized gains (losses):

Included in earnings	(194 )	3	(191 )	117	11	128
Included in other comprehensive income (loss)	(156 )	(6 )	(162 )	(460 )	(47 )	(507 )
Purchases	—	—	—	7,994	1,075	9,069
Sales	(8,838 )	(349 )	(9,187 )	(2,824 )	(1,954 )	(4,778 )
Settlements	(8,591 )	(526 )	(9,117 )	(12,294)	(2,567 )	(14,861)
Fair value at end of period	\$—	\$—	\$—	\$12,509	\$ 873	\$13,382

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Financial instruments not measured at fair value

In estimating the fair values of its financial instruments not measured at fair value, the Company used the following methods and assumptions:

Cash and cash equivalents

The carrying amount for cash and cash equivalents approximates fair value due to the short-term maturity of these investments.

Deposits with banks

The fair value of deposits with banks is estimated based on rates currently offered for deposits of similar remaining maturities, where applicable.

Notes receivable, net

The fair value of notes receivable, net is estimated based on current market rates being offered for notes with similar maturities and credit quality.

Secured financings receivable

The carrying amount of secured financings receivable approximates fair value due to the short-term nature of these assets.

Deposits

The carrying values of escrow and other deposit accounts approximate fair value due to the short-term nature of these liabilities.

Secured financings payable

The carrying amount of secured financings payable approximates fair value due to the short-term nature of these liabilities.

Notes and contracts payable

The fair value of notes and contracts payable is estimated based on current rates offered to the Company for debt of similar remaining maturities.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments not measured at fair value as of September 30, 2018 and December 31, 2017:

Edgar Filing: First American Financial Corp - Form 10-Q

(in thousands)	Carrying Amount	Estimated fair value Total	Level 1	Level 2	Level 3
<b>September 30, 2018</b>					
<b>Assets:</b>					
Cash and cash equivalents	\$2,205,319	\$2,205,319	\$2,205,319	\$—	\$—
Deposits with banks	\$37,547	\$37,370	\$4,801	\$32,569	\$—
Notes receivable, net	\$13,410	\$12,416	\$—	\$—	\$12,416
Secured financings receivable	\$86,509	\$86,509	\$—	\$86,509	\$—
<b>Liabilities:</b>					
Deposits	\$4,548,635	\$4,548,635	\$4,548,635	\$—	\$—
Secured financings payable	\$86,501	\$86,501	\$—	\$86,501	\$—
Notes and contracts payable	\$735,258	\$736,806	\$—	\$728,476	\$8,330

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

(in thousands)	Carrying	Estimated fair value			Level
	Amount	Total	Level 1	Level 2	3
December 31, 2017					
Assets:					
Cash and cash equivalents	\$1,387,226	\$1,387,226	\$1,387,226	\$—	\$—
Deposits with banks	\$41,335	\$41,259	\$6,846	\$34,413	\$—
Notes receivable, net	\$7,066	\$6,798	\$—	\$—	\$6,798
Liabilities:					
Deposits	\$3,070,566	\$3,070,566	\$3,070,566	\$—	\$—
Notes and contracts payable	\$732,810	\$755,670	\$—	\$751,827	\$3,843

Note 12 – Share-Based Compensation

The following table presents costs associated with the Company's share-based compensation plans:

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Expense:				
RSUs	\$6,392	\$5,865	\$31,570	\$28,634
Stock options	—	69	—	203
Employee stock purchase plan	849	682	2,806	2,359
	\$7,241	\$6,616	\$34,376	\$31,196

The following table summarizes RSU activity for the nine months ended September 30, 2018:

(in thousands, except weighted-average grant-date fair value)	Shares	Weighted-average
		grant-date fair value
Unvested at December 31, 2017	1,411	\$ 36.66
Granted during 2018	741	\$ 55.65
Vested during 2018	(869 )	\$ 41.34
Forfeited during 2018	(34 )	\$ 44.93

Unvested at September 30, 2018	1,249	\$	44.43
--------------------------------	-------	----	-------

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 13 – Accumulated Other Comprehensive Income (Loss) (“AOCI”)

The following table presents a summary of the changes in each component of AOCI for the nine months ended September 30, 2018:

(in thousands)	Unrealized gains (losses) on securities	Foreign currency translation adjustment	Pension benefit adjustment	Accumulated other comprehensive income (loss)
Balance at December 31, 2017	\$ 36,803	\$ (38,832 )	\$ (65,460 )	\$ (67,489 )
Cumulative-effect adjustment, net of taxes (1)	(40,550 )	—	—	(40,550 )
Change in unrealized gains (losses) on debt securities	(96,416 )	—	—	(96,416 )
Change in foreign currency translation adjustment	—	(11,856 )	—	(11,856 )
Amortization of net actuarial loss	—	—	3,615	3,615
Amortization of prior service credit	—	—	(3,135 )	(3,135 )
Tax effect	22,483	560	(123 )	22,920
Balance at September 30, 2018	\$ (77,680 )	\$ (50,128 )	\$ (65,103 )	\$ (192,911 )
Allocated to the Company	\$ (77,681 )	\$ (50,128 )	\$ (65,103 )	\$ (192,912 )
Allocated to noncontrolling interests	1	—	—	1
Balance at September 30, 2018	\$ (77,680 )	\$ (50,128 )	\$ (65,103 )	\$ (192,911 )

(1) The Company recognized a cumulative-effect adjustment to retained earnings for cumulative net unrealized gains related to its investments in equity securities upon adoption of new accounting guidance on January 1, 2018. See Note 1 Basis of Condensed Consolidated Financial Statements for further discussion of the new guidance.

Edgar Filing: First American Financial Corp - Form 10-Q

The following table presents the other comprehensive income (loss) reclassification adjustments for the three months ended September 30, 2018 and 2017:

	Unrealized gains (losses) on securities	Foreign currency translation adjustment	Pension benefit adjustment	Total other comprehensive income (loss)
(in thousands)				
<b>Three Months Ended September 30, 2018</b>				
Pretax change before reclassifications	\$ (21,879 )	\$ 2,441	\$ —	\$ (19,438 )
Reclassifications out of AOCI	2,522	—	160	2,682
Tax effect	4,695	560	(42 )	5,213
Total other comprehensive income (loss), net of tax	\$ (14,662 )	\$ 3,001	\$ 118	\$ (11,543 )
<b>Three Months Ended September 30, 2017</b>				
Pretax change before reclassifications	\$ 22,833	\$ 11,415	\$ (8,646 )	\$ 25,602
Reclassifications out of AOCI	(928 )	—	153,301	152,373
Tax effect	(7,976 )	—	(58,764 )	(66,740 )
Total other comprehensive income (loss), net of tax	\$ 13,929	\$ 11,415	\$ 85,891	\$ 111,235

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

The following table presents the other comprehensive income (loss) reclassification adjustments for the nine months ended September 30, 2018 and 2017:

(in thousands)	Unrealized	Foreign		Total
	gains (losses) on securities	currency translation adjustment	Pension benefit adjustment	other comprehensive income (loss)
<b>Nine Months Ended September 30, 2018</b>				
Pretax change before reclassifications	\$ (101,173 )	\$ (11,856 )	\$ —	\$ (113,029 )
Reclassifications out of AOCI	4,757	—	480	5,237
Tax effect	22,483	560	(123 )	22,920
<b>Total other comprehensive income (loss), net of tax</b>	<b>\$ (73,933 )</b>	<b>\$ (11,296 )</b>	<b>\$ 357</b>	<b>\$ (84,872 )</b>
<b>Nine Months Ended September 30, 2017</b>				
Pretax change before reclassifications	\$ 95,329	\$ 23,558	\$ (8,646 )	\$ 110,241
Reclassifications out of AOCI	(14,285 )	—	164,912	150,627
Tax effect	(29,030 )	—	(63,205 )	(92,235 )
<b>Total other comprehensive income (loss), net of tax</b>	<b>\$ 52,014</b>	<b>\$ 23,558</b>	<b>\$ 93,061</b>	<b>\$ 168,633</b>

The following table presents the effects of the reclassifications out of AOCI on the respective line items in the condensed consolidated statements of income:

(in thousands)	Amounts reclassified from AOCI				Affected line items
	Three Months Ended		Nine Months Ended		
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017	
Unrealized gains (losses) on securities:					
Net realized gains (losses) on sales of	\$ (2,522)	\$ 928	\$ (4,757)	\$ 14,285	Net realized investment gains (losses)



securities (1)					
Pretax total	\$(2,522)	\$928	\$(4,757)	\$14,285	
Tax effect	\$612	\$(332)	\$1,109	\$(5,778)	
Pension benefit adjustment (2):					
Amortization of net actuarial loss	\$(1,205)	\$(1,958)	\$(3,615)	\$(15,792)	Other operating expenses
Amortization of prior service credit	1,045	1,045	3,135	3,268	Other operating expenses
Settlement costs	—	(152,388)	—	(152,388)	Other operating expenses
Pretax total	\$(160)	\$(153,301)	\$(480)	\$(164,912)	
Tax effect	\$42	\$62,276	\$123	\$66,702	

(1) The current year net realized losses related to sales of debt securities and the prior year net realized gains related to sales of debt and equity securities.

(2) These components of AOCI are components of net periodic cost. See Note 10 Employee Benefit Plans for additional details.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 14 – Litigation and Regulatory Contingencies

The Company and its subsidiaries are parties to a number of non-ordinary course lawsuits. These lawsuits frequently are similar in nature to other lawsuits pending against the Company's competitors.

For those non-ordinary course lawsuits where the Company has determined that a loss is both probable and reasonably estimable, a liability representing the best estimate of the Company's financial exposure based on known facts has been recorded. Actual losses may materially differ from the amounts recorded.

For a substantial majority of these lawsuits, however, it is not possible to assess the probability of loss. Most of these lawsuits are putative class actions which require a plaintiff to satisfy a number of procedural requirements before proceeding to trial. These requirements include, among others, demonstration to a court that the law proscribes in some manner the Company's activities, the making of factual allegations sufficient to suggest that the Company's activities exceeded the limits of the law and a determination by the court—known as class certification—that the law permits a group of individuals to pursue the case together as a class. In certain instances the Company may also be able to compel the plaintiff to arbitrate its claim on an individual basis. If these procedural requirements are not met, either the lawsuit cannot proceed or, as is the case with class certification or compelled arbitration, the plaintiffs lose the financial incentive to proceed with the case (or the amount at issue effectively becomes de minimis). Frequently, a court's determination as to these procedural requirements is subject to appeal to a higher court. As a result of, among other factors, ambiguities and inconsistencies in the myriad laws applicable to the Company's business and the uniqueness of the factual issues presented in any given lawsuit, the Company often cannot determine the probability of loss until a court has finally determined that a plaintiff has satisfied applicable procedural requirements.

Furthermore, because most of these lawsuits are putative class actions, it is often impossible to estimate the possible loss or a range of loss amounts, even where the Company has determined that a loss is reasonably possible. Generally class actions involve a large number of people and the effort to determine which people satisfy the requirements to become plaintiffs—or class members—is often time consuming and burdensome. Moreover, these lawsuits raise complex factual issues which result in uncertainty as to their outcome and, ultimately, make it difficult for the Company to estimate the amount of damages which a plaintiff might successfully prove. In addition, many of the Company's businesses are regulated by various federal, state, local and foreign governmental agencies and are subject to numerous statutory guidelines. These regulations and statutory guidelines often are complex, inconsistent or ambiguous, which results in additional uncertainty as to the outcome of a given lawsuit—including the amount of damages a plaintiff might be afforded—or makes it difficult to analogize experience in one case or jurisdiction to another case or jurisdiction.

Most of the non-ordinary course lawsuits to which the Company and its subsidiaries are parties challenge practices in the Company's title insurance business, though a limited number of cases also pertain to the Company's other businesses. These lawsuits include, among others, cases alleging, among other assertions, that the Company or one of its subsidiaries engaged in improper debt collection practices, improperly charged fees for products and services, participated in the conveyance of illusory property interests, improperly handled property and casualty claims and gave items of value to builders as inducements to refer business in violation of certain laws, such as consumer protection laws and laws generally prohibiting unfair business practices, and certain obligations, including:

-

Edgar Filing: First American Financial Corp - Form 10-Q

Bartine v. First American Title Insurance Company, et al., filed on August 17, 2018 and pending in the United States District Court for the Middle District of Florida,

•Chavez v. First American Specialty Insurance Company, filed on June 29, 2017 and pending in the Superior Court of the State of California, County of Los Angeles,

•Lennen v. First American Financial Corporation, et al., filed on May 19, 2016 and pending in the United States District Court for the Middle District of Florida,

•Tenefufu vs. First American Specialty Insurance Company, filed on June 1, 2017 and pending in the Superior Court of the State of California, County of Sacramento, and

•Wilmot v. First American Financial Corporation, et al., filed on April 20, 2007 and pending in the Superior Court of the State of California, County of Los Angeles.

31

---

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

All of these lawsuits are putative class actions for which a class has not been certified. For the reasons described above, the Company has not yet been able to assess the probability of loss or estimate the possible loss or the range of loss or, where the Company has been able to make an estimate, the Company believes the amount is not material to the condensed consolidated financial statements as a whole.

While some of the lawsuits described above may be material to the Company's operating results in any particular period if an unfavorable outcome results, the Company does not believe that any of these lawsuits will have a material adverse effect on the Company's overall financial condition or liquidity.

The Company also is a party to non-ordinary course lawsuits other than those described above. With respect to these lawsuits, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.

The Company's title insurance, property and casualty insurance, home warranty, banking, thrift, trust and wealth management businesses are regulated by various federal, state and local governmental agencies. Many of the Company's other businesses operate within statutory guidelines. Consequently, the Company may from time to time be subject to examination or investigation by such governmental agencies. Currently, governmental agencies are examining or investigating certain of the Company's operations. These exams or investigations include inquiries into, among other matters, pricing and rate setting practices in the title insurance industry, competition in the title insurance industry, real estate settlement service, customer acquisition and retention practices and agency relationships. With respect to matters where the Company has determined that a loss is both probable and reasonably estimable, the Company has recorded a liability representing its best estimate of the financial exposure based on known facts. While the ultimate disposition of each such exam or investigation is not yet determinable, the Company does not believe that individually or in the aggregate they will have a material adverse effect on the Company's financial condition, results of operations or cash flows. These exams or investigations could, however, result in changes to the Company's business practices which could ultimately have a material adverse impact on the Company's financial condition, results of operations or cash flows.

The Company's Canadian operations provide certain services to lenders which it believes to be exempt from excise tax under applicable Canadian tax laws. However, in October 2014, the Canadian taxing authority provided internal guidance that the services in question should be subject to the excise tax. While discussions with the taxing authority are ongoing, the Company believes that the guidance may result in an assessment. The amount, if any, of such assessment is not currently known, and any such assessment would be subject to negotiation. In the event that the Company disagrees with the ultimate assessment, the Company intends to avail itself of avenues of appeal. While the Company believes it is reasonably likely that the Company would prevail on the merits, a loss associated with the matter is possible. In light of the foregoing, the Company is not currently able to reasonably estimate a loss or range of loss associated with the matter. While such a loss could be material to the Company's operating results in any particular period if an unfavorable outcome results, the Company does not believe that this matter will have a material adverse effect on the Company's overall financial condition or liquidity.

The Company and its subsidiaries also are involved in numerous ongoing routine legal and regulatory proceedings related to their operations. With respect to each of these proceedings, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.



FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Note 15 – Business Combinations

During the nine months ended September 30, 2018, the Company completed acquisitions for an aggregate purchase price of \$77.7 million. For acquisitions in which the Company has not completed its purchase price allocation, preliminary fair value estimates for the assets acquired and liabilities assumed have been recorded. The Company allocates the purchase price of each acquisition to the assets acquired and liabilities assumed using a variety of valuation techniques, including discounted cash flow analysis. These acquisitions have been included in the Company's title insurance and services segment.

Current year acquisitions included the purchase of a small, specialized warehouse lender that provides financing for correspondent mortgage lenders. The business has itself secured warehouse lending facilities with several banking institutions. The mortgage loans are generally sold by the correspondent mortgage lenders to investors within 30 days and more typically in less than 10 days. The assets acquired included secured financings receivable from correspondent mortgage lenders of \$69.6 million and liabilities assumed included secured financings payable of \$69.8 million. The combined capacity for the warehouse lending facilities totals \$123.0 million with one additional warehouse lending facility having no stated capacity. Interest rates for the warehouse lending facilities range from 3.50% to the current prime lending rate as published by The Wall Street Journal. At September 30, 2018, outstanding borrowings under the facilities totaled \$86.5 million.

During the three and nine months ended September 30, 2017, the Company completed acquisitions for an aggregate purchase price of \$87.3 million and \$91.1 million. These acquisitions have been included in the Company's title insurance and services segment.

Note 16 – Segment Information

The Company consists of the following reportable segments and a corporate function:

•The Company's title insurance and services segment issues title insurance policies on residential and commercial property in the United States and offers similar or related products and services internationally. This segment also provides closing and/or escrow services; accommodates tax-deferred exchanges of real estate; provides products, services and solutions involving the use of real property related data designed to mitigate risk or otherwise facilitate real estate transactions; maintains, manages and provides access to title plant records and images; and provides appraisals and other valuation-related products and services, lien release and document custodial services, default-related products and services, evidence of title, warehouse lending, and banking, trust and wealth management services. The Company, through its principal title insurance subsidiary and such subsidiary's affiliates, transacts its title insurance business through a network of direct operations and agents. Through this network, the Company issues policies in the 49 states that permit the issuance of title insurance policies and the District of Columbia. The Company also offers title insurance, closing services and similar or related products and services, either directly or through third parties in other countries, including Canada, the United Kingdom, Australia, South Korea and various other established and emerging markets.

•The Company's specialty insurance segment issues property and casualty insurance policies and sells home warranty products. The property and casualty insurance business provides insurance coverage to residential homeowners and

renters for liability losses and typical hazards such as fire, theft, vandalism and other types of property damage. This business is licensed to issue policies in all 50 states and the District of Columbia and actively issues policies in 47 states. The majority of policy liability is in the western United States, including approximately 62% in California. In certain markets it also offers preferred risk auto insurance to better compete with other carriers offering bundled home and auto insurance. The home warranty business provides residential service contracts that cover residential systems, such as heating and air conditioning systems, and certain appliances against failures that occur as the result of normal usage during the coverage period. This business currently operates in 39 states and the District of Columbia.

The corporate function consists primarily of certain financing facilities as well as the corporate services that support the Company's business operations.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

Selected financial information about the Company's operations, by segment, is as follows:

For the three months ended September 30, 2018:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$ 1,413,841	\$ 206,539	\$ 29,978	\$ 28,342
Specialty Insurance	124,179	6,201	1,713	2,403
Corporate	4,461	(17,153 )	38	—
Eliminations	(295 )	—	—	—
	\$ 1,542,186	\$ 195,587	\$ 31,729	\$ 30,745

(in thousands)	Direct premiums and escrow fees	Agent premiums	Information and other	Net investment income	Net realized investment gains (losses)	Total Revenues
Title Insurance and Services	\$ 532,769	\$ 615,113	\$ 195,963	\$ 60,871	\$ 9,125	\$ 1,413,841
Specialty Insurance	116,606	—	2,981	2,573	2,019	124,179
	\$ 649,375	\$ 615,113	\$ 198,944	\$ 63,444	\$ 11,144	\$ 1,538,020

For the three months ended September 30, 2017:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$ 1,397,262	\$ 181,199	\$ 34,363	\$ 33,750
Specialty Insurance	118,481	6,178	1,599	2,015
Corporate	4,108	(169,415)	38	—



Edgar Filing: First American Financial Corp - Form 10-Q

	Eliminations	(283 )	—	—	—	
		\$1,519,568	\$17,962	\$ 36,000	\$ 35,765	
Direct						
	premiums			Net	Net realized	
	and escrow	Agent	Information	investment	investment	Total
(in thousands)	fees	premiums	and other	income	gains (losses)	Revenues
Title Insurance and Services	\$ 538,063	\$ 629,186	\$ 199,271	\$ 37,901	\$ (7,159 )	\$1,397,262
Specialty Insurance	113,041	—	2,814	2,468	158	118,481
	\$ 651,104	\$ 629,186	\$ 202,085	\$ 40,369	\$ (7,001 )	\$1,515,743

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)  
(unaudited)

For the nine months ended September 30, 2018:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$3,968,347	\$518,565	\$ 87,438	\$ 84,296
Specialty Insurance	357,750	26,220	4,981	9,981
Corporate	5,488	(54,165 )	115	—
Eliminations	(854 )	—	—	—
	\$4,330,731	\$490,620	\$ 92,534	\$ 94,277

(in thousands)	Direct premiums and escrow fees	Agent premiums	Information and other	Net investment income	Net realized investment gains (losses)	Total Revenues
Title Insurance and Services	\$1,515,537	\$1,701,831	\$ 588,079	\$ 154,009	\$ 8,891	\$3,968,347
Specialty Insurance	339,298	—	8,807	7,561	2,084	357,750
	\$1,854,835	\$1,701,831	\$ 596,886	\$ 161,570	\$ 10,975	\$4,326,097

For the nine months ended September 30, 2017:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$3,937,119	\$476,746	\$ 91,471	\$ 100,059
Specialty Insurance	343,908	25,779	4,697	5,797
Corporate	10,872	(216,529)	124	—

Edgar Filing: First American Financial Corp - Form 10-Q

Eliminations	(859 )	—	—	—
	\$4,291,040	\$285,996	\$ 96,292	\$ 105,856

Direct

	premiums	and escrow	Agent	Information	Net	Net realized	Total
(in thousands)	fees	premiums	and other	income	investment	investment	Revenues
						gains (losses)	
Title Insurance and Services	\$1,492,258	\$1,757,796	\$ 578,549	\$ 99,181	\$ 9,335		\$3,937,119
Specialty Insurance	326,935	—	8,427	7,118	1,428		343,908
	\$1,819,193	\$1,757,796	\$ 586,976	\$ 106,299	\$ 10,763		\$4,281,027

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. THESE FORWARD-LOOKING STATEMENTS CAN BE IDENTIFIED BY THE FACT THAT THEY DO NOT RELATE STRICTLY TO HISTORICAL OR CURRENT FACTS AND MAY CONTAIN THE WORDS "BELIEVE," "ANTICIPATE," "EXPECT," "INTEND," "PLAN," "PREDICT," "ESTIMATE," "PROJECT," "WILL BE," "WILL CONTINUE," "WILL LIKELY RESU OTHER SIMILAR WORDS AND PHRASES OR FUTURE OR CONDITIONAL VERBS SUCH AS "WILL," "MAY," "MIGHT," "SHOULD," "WOULD," OR "COULD." THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS REGARDING FUTURE OPERATIONS, PERFORMANCE, FINANCIAL CONDITION, PROSPECTS, PLANS AND STRATEGIES. THESE FORWARD-LOOKING STATEMENTS ARE BASED ON CURRENT EXPECTATIONS AND ASSUMPTIONS THAT MAY PROVE TO BE INCORRECT.

RISKS AND UNCERTAINTIES EXIST THAT MAY CAUSE RESULTS TO DIFFER MATERIALLY FROM THOSE SET FORTH IN THESE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE THE ANTICIPATED RESULTS TO DIFFER FROM THOSE DESCRIBED IN THE FORWARD-LOOKING STATEMENTS INCLUDE THE FACTORS SET FORTH ON PAGES 3-4 OF THIS QUARTERLY REPORT. THE FORWARD-LOOKING STATEMENTS SPEAK ONLY AS OF THE DATE THEY ARE MADE. 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.

This Management's Discussion and Analysis contains certain financial measures that are not presented in accordance with U.S. generally accepted accounting principles ("GAAP"), including adjusted information and other revenues, adjusted personnel costs and adjusted other operating expenses, in each case excluding the effects of recent acquisitions. The Company is presenting these non-GAAP financial measures because they provide the Company's management and readers of this Quarterly Report on Form 10-Q with additional insight into the operational performance of the Company relative to earlier periods. The Company does not intend for these non-GAAP financial measures to be a substitute for any GAAP financial information. In this Quarterly Report on Form 10-Q, these non-GAAP financial measures have been presented with, and reconciled to, the most directly comparable GAAP financial measures. Readers of this Quarterly Report on Form 10-Q should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial measures.

#### CRITICAL ACCOUNTING ESTIMATES

There have been no material changes to the Company's critical accounting estimates since the filing of its Annual Report on Form 10-K for the year ended December 31, 2017. A summary of the Company's accounting policies that it considers to be the most dependent on the application of estimates and assumptions can be found in the Management's Discussion and Analysis section of the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

#### Recently Adopted Accounting Pronouncements

In May 2017, the Financial Accounting Standards Board ("FASB") issued updated guidance intended to reduce diversity in practice by clarifying which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In March 2017, the FASB issued updated guidance intended to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost through the disaggregation of the service cost component from the other components of net benefit cost. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company adopted this change in accounting principle at the beginning of 2018 and applied the change retrospectively to the prior year. As a result, other components of net benefit cost totaling \$155.4 million and \$171.4 million were reclassified from personnel costs to other operating expenses on the condensed consolidated statements of income for the three and nine months ended September 30, 2017, respectively. See Note 10 Employee Benefit Plans to the condensed consolidated financial statements for further information on the Company's net periodic pension costs.

In January 2017, the FASB issued updated guidance to clarify the definition of a business with the objective of providing guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In November 2016, the FASB issued updated guidance intended to reduce the diversity in practice on presenting restricted cash and restricted cash equivalents in the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In October 2016, the FASB issued updated guidance intended to simplify and improve the accounting for the income tax consequences of intra-entity transfers of assets, other than inventory. The updated guidance, which eliminates the intra-entity transfers exception, requires entities to recognize the income tax consequences of intra-entity transfers of assets, other than inventory, when the transfers occur. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In August 2016, the FASB issued updated guidance intended to eliminate the diversity in practice regarding the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In January 2016, the FASB issued updated guidance intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. In addition to making other targeted improvements to current guidance, the updated guidance also requires all equity investments, except those accounted for under the equity method of accounting or those that result in consolidation of the investee, to be measured at fair value with changes in the fair value recognized through net income. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017. The Company adopted this guidance at the beginning of 2018 and recognized cumulative net unrealized gains, net of taxes, of \$40.6 million related to its investments in equity securities, previously classified as available-for-sale, through a cumulative-effect adjustment to retained earnings. Changes in the fair values of these investments are reflected in net realized investment gains/losses on the Company's condensed consolidated statements of income. See Note 4 Debt and Equity Securities to the condensed consolidated financial statements for further discussion of the Company's investments in equity securities.

In May 2014, the FASB issued updated guidance for recognizing revenue from contracts with customers to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within and across industries, and across capital markets. The new revenue standard contains principles that an entity will apply to determine the measurement of revenue and the timing of recognition. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. Revenue from insurance contracts is not within the scope of this guidance. In August 2015, the FASB issued updated guidance which defers the effective date of this guidance by one year. In 2016, the FASB issued additional updates to the new guidance primarily to clarify, among other things, the implementation guidance related to principal versus agent considerations, identifying performance obligations, accounting for licenses of intellectual property, and to provide narrow-scope improvements and additional practical expedients. In February 2017, the FASB issued an additional update to the new guidance to clarify the scope of derecognition guidance for nonfinancial assets and to provide guidance for partial sales of nonfinancial assets. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017. The

Company elected to adopt the new guidance under the modified retrospective approach, which, except for the disclosure requirements, did not have a material impact on its condensed consolidated financial statements. See Note 2 Adoption of Revenue Guidance to the condensed consolidated financial statements for further information about the Company's revenues within the scope of the new guidance.

### Pending Accounting Pronouncements

In August 2018, the FASB issued updated guidance that is intended to reduce potential diversity in practice in accounting for the costs of implementing cloud computing arrangements (i.e., hosting arrangements) that are service contracts. The updated guidance aligns the requirements for capitalizing implementation costs for these arrangements with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software and hosting arrangements that include an internal-use software license. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently assessing the impact of this guidance on its condensed consolidated financial statements.

In August 2018, the FASB issued updated guidance as part of its disclosure framework project intended to improve the effectiveness of disclosures in the notes to the financial statements. The updated guidance eliminates, adds and modifies certain disclosure requirements related to fair value measurements. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. Except for the disclosure requirements, the Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In January 2017, the FASB issued updated guidance intended to simplify how an entity tests goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Under the updated guidance, an entity will perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and will recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, with the loss recognized limited to the total amount of goodwill allocated to that reporting unit. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In June 2016, the FASB issued updated guidance intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The updated guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires the consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently assessing the impact of this guidance on its condensed consolidated financial statements.

In February 2016, the FASB issued updated guidance that requires the rights and obligations associated with leasing arrangements be reflected on the balance sheet in order to increase transparency and comparability among organizations. Under the updated guidance, lessees will be required to recognize a right-of-use asset and a liability to make lease payments and disclose key information about leasing arrangements. The updated guidance is required to be adopted using a modified retrospective transition approach. In July 2018, the FASB issued additional updates to the new guidance which allows for the initial application of the guidance at the adoption date and for the recognition of a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. While the Company is currently evaluating the impact the new guidance will have on its condensed consolidated financial statements, the Company expects the adoption of the new guidance will result in a material increase in the assets and liabilities on its condensed consolidated balance sheets and will likely have an insignificant impact on its condensed consolidated statements of income and statements of cash flows.





## Results of Operations

### Summary of Third Quarter

A substantial portion of the revenues for the Company's title insurance and services segment results from the sale and refinancing of residential and commercial real estate. In the Company's specialty insurance segment, revenues associated with the initial year of coverage in both the home warranty and property and casualty operations are impacted by volatility in residential purchase transactions. Traditionally, the greatest volume of real estate activity, particularly residential purchase activity, has occurred in the spring and summer months. However, changes in interest rates, as well as other changes in general economic conditions in the United States and abroad, can cause fluctuations in the traditional pattern of real estate activity.

According to the Mortgage Bankers Association's October 16, 2018 Mortgage Finance Forecast (the "MBA Forecast"), residential mortgage originations in the United States (based on the total dollar value of the transactions) decreased 3.0% in the third quarter of 2018 when compared with the third quarter of 2017. According to the MBA Forecast, the dollar amount of purchase originations increased 8.1% and refinance originations decreased 26.5%. This volume of domestic residential mortgage origination activity contributed to an increase in direct premiums and escrow fees for the Company's direct title operations of 1.1% from domestic residential purchase transactions and a 22.9% decrease in direct premiums and escrow fees from domestic refinance transactions in the third quarter of 2018 when compared with the third quarter of 2017.

During the third quarter of 2018, the level of domestic title orders opened per day by the Company's direct title operations decreased 10.5% when compared with the third quarter of 2017. Residential refinance and purchase opened orders per day decreased 32.0% and 4.2%, respectively, while commercial opened orders per day increased 2.8% when compared to the third quarter of 2017.

The Company adopted new accounting guidance on January 1, 2018, which requires investments in equity securities with readily determinable fair values to be measured at fair value with changes in the fair value recognized through net income. Previously, changes in the fair value were recognized through accumulated other comprehensive loss on the condensed consolidated balance sheets. Beginning in the first quarter of 2018, the Company records changes in the fair values of its equity securities as a component of net realized investment gains (losses) on the condensed consolidated statements of income. See Note 1 Basis of Condensed Consolidated Financial Statements to the condensed consolidated financial statements for further discussion of the new guidance.

On December 22, 2017, comprehensive tax reform legislation known as the Tax Cuts and Jobs Act (the "Tax Reform Act") was signed into law. The Tax Reform Act amended the Internal Revenue Code to reduce U.S. tax rates and modify policies, credits and deductions for individuals and businesses. The changes resulting from the Tax Reform Act are broad and complex and will require additional analysis, but the Company expects that the Tax Reform Act will continue to have an overall favorable impact on its effective tax rate.

In addition, the Company continues to monitor developments in its regulatory environment. Currently, federal officials are discussing various potential changes to laws and regulations that could impact the Company's businesses, including changes to the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the reform of government-sponsored enterprises such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). In addition, the Tax Reform Act included changes that could affect the real estate and mortgage markets, including changes to the mortgage interest deduction, the increase in the standard deduction (which limits the benefit of itemizing and deducting mortgage interest separately) and the limitation of state and local tax deductions, among others. The full extent of the impact of the Tax Reform Act on volumes of real estate transactions and mortgage originations is not currently known. Other changes in these areas,

and more generally in the regulatory environment in which the Company and its customers operate, could similarly impact the volume of mortgage originations in the United States and the Company's competitive position and results of operations.

Edgar Filing: First American Financial Corp - Form 10-Q

Title Insurance and Services

(in thousands, except percentages)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
<b>Revenues</b>								
Direct premiums and escrow fees	\$532,769	\$538,063	\$(5,294)	(1.0)%	\$1,515,537	\$1,492,258	\$23,279	1.6%
Agent premiums	615,113	629,186	(14,073)	(2.2)	1,701,831	1,757,796	(55,965)	(3.2)
Information and other	195,963	199,271	(3,308)	(1.7)	588,079	578,549	9,530	1.6
Net investment income	60,871	37,901	22,970	60.6	154,009	99,181	54,828	55.3
Net realized investment gains (losses)	9,125	(7,159)	16,284	227.5	8,891	9,335	(444)	(4.8)
	1,413,841	1,397,262	16,579	1.2	3,968,347	3,937,119	31,228	0.8
<b>Expenses</b>								
Personnel costs	425,565	421,892	3,673	0.9	1,246,240	1,222,180	24,060	2.0
Premiums retained by agents	485,621	497,911	(12,290)	(2.5)	1,341,808	1,387,608	(45,800)	(3.3)
Other operating expenses	200,932	196,412	4,520	2.3	594,164	579,528	14,636	2.5
Provision for policy losses and other claims	45,916	46,689	(773)	(1.7)	128,700	130,037	(1,337)	(1.0)
Depreciation and amortization	29,978	34,363	(4,385)	(12.8)	87,438	91,471	(4,033)	(4.4)
Premium taxes	16,910	17,871	(961)	(5.4)	46,401	46,973	(572)	(1.2)
Interest	2,380	925	1,455	157.3	5,031	2,576	2,455	95.3
	1,207,302	1,216,063	(8,761)	(0.7)	3,449,782	3,460,373	(10,591)	(0.3)
<b>Income before income taxes</b>	\$206,539	\$181,199	\$25,340	14.0%	\$518,565	\$476,746	\$41,819	8.8%

Edgar Filing: First American Financial Corp - Form 10-Q

Margins 14.6 % 13.0 % 1.6 % 12.3 % 13.1 % 12.1 % 1.0 % 8.3 %

Direct premiums and escrow fees were \$532.8 million and \$1.5 billion for the three and nine months ended September 30, 2018, respectively, a decrease of \$5.3 million, or 1.0%, and an increase of \$23.3 million, or 1.6%, when compared with the respective periods of the prior year. The decrease for the three months ended September 30, 2018 was primarily due to a decrease in domestic title orders closed, partially offset by an increase in the average revenues per order closed. The increase for the nine months ended September 30, 2018 was primarily due to an increase in the average revenues per order closed, partially offset by a decrease in the domestic title orders closed. The average revenues per order closed were \$2,667 and \$2,529 for the three and nine months ended September 30, 2018, respectively, increases of 16.1% and 14.2% when compared with \$2,298 and \$2,215 for the respective periods of the prior year. The increases in average revenues per order closed for the three and nine months ended September 30, 2018 were primarily attributable to higher average revenue per order from commercial transactions, higher residential real estate values, premium and fee increases related to residential purchase transactions, and a shift in the mix of direct revenues from lower premium residential refinance products to higher premium commercial products. The Company's direct title operations closed 184,500 and 554,300 title orders during the three and nine months ended September 30, 2018, respectively, decreases of 13.9% and 10.5% when compared with 214,300 and 619,500 title orders closed during the respective periods of the prior year. Domestic refinance orders closed per day decreased by 31.6% and 23.0%, and domestic residential purchase orders closed per day decreased by 4.5% and 1.3% for the three and nine months ended September 30, 2018, respectively, when compared to the same periods of 2017.

Agent premiums were \$615.1 million and \$1.7 billion for the three and nine months ended September 30, 2018, respectively, decreases of \$14.1 million, or 2.2%, and \$56.0 million, or 3.2%, when compared with the respective periods of the prior year. Agent premiums are recorded when notice of issuance is received from the agent, which is generally when cash payment is received by the Company. As a result, there is generally a delay between the agent's issuance of a title policy and the Company's recognition of agent premiums. Therefore, current quarter agent premiums typically reflect prior quarter mortgage origination activity. The decrease in agent premiums for the three months ended September 30, 2018 is generally consistent with the 3.1% increase in the Company's direct premiums and escrow fees in the second quarter of 2018 as compared with the second quarter of 2017. The decrease in agent premiums for the three months ended September 30, 2018 was also the result of lower volumes in California.

Information and other revenues primarily consist of revenues generated from fees associated with title search and related reports, title and other real property records and images, other non-insured settlement services, and risk mitigation products and services. These revenues generally trend with direct premiums and escrow fees but are typically less volatile since a portion of the revenues are subscription based and do not fluctuate with transaction volumes.

Information and other revenues were \$196.0 million and \$588.1 million for the three and nine months ended September 30, 2018, respectively, a decrease of \$3.3 million, or 1.7%, and an increase of \$9.5 million, or 1.6%, when compared with the respective periods of the prior year. The decrease for the three months ended September 30, 2018 was primarily attributable to the impact of lower overall mortgage origination activity and a decline in foreclosure activity, partially offset by the impact of recent acquisitions. The increase for the nine months ended September 30, 2018 was driven by recent acquisitions. Excluding the \$9.0 million and \$37.1 million impact of new acquisitions for the three and nine months ended September 30, 2018, respectively, information and other revenues decreased \$12.3 million, or 6.2%, and \$27.6 million, or 4.8%, when compared with the respective periods of the prior year. The decreases in information and other revenues for the three and nine months ended September 30, 2018, adjusted for the impact of acquisitions, were primarily due to the impact of lower overall mortgage origination activity and a decline in foreclosure activity.

Net investment income totaled \$60.9 million and \$154.0 million for the three and nine months ended September 30, 2018, respectively, increases of \$23.0 million, or 60.6%, and \$54.8 million, or 55.3%, when compared with the respective periods of the prior year. The increases were primarily attributable to higher average balances and higher short-term interest rates, which drove higher income from the Company's cash and investment portfolio, tax-deferred property exchange business and escrow balances.

Net realized investment gains totaled \$9.1 million and \$8.9 million for the three and nine months ended September 30, 2018, respectively. The net realized gains for the three and nine months ended September 30, 2018 were primarily from an increase in the fair values of equity securities, partially offset by losses from the sales of debt securities. Net realized investment losses totaled \$7.2 million for the three months ended September 30, 2017 and net realized investment gains totaled \$9.3 million for the nine months ended September 30, 2017. Net realized investment losses for the three months ended September 30, 2017 primarily related to a \$6.6 million loss recognized when the Company purchased the remaining equity ownership in an investment in an affiliate during the third quarter of 2017. Net realized investment gains for the nine months ended September 30, 2017 primarily related to sales of equity securities, partially offset by the third quarter loss of \$6.6 million described above.

The title insurance and services segment (primarily direct operations) is labor intensive; accordingly, a major expense component is personnel costs. This expense component is affected by two primary factors: the need to monitor personnel changes to match the level of corresponding or anticipated new orders and the need to provide quality service.

Personnel costs were \$425.6 million and \$1.2 billion for the three and nine months ended September 30, 2018, respectively, increases of \$3.7 million, or 0.9%, and \$24.1 million, or 2.0%, when compared with the respective periods of the prior year. The increases were driven by recent acquisitions. Excluding the \$6.4 million and \$24.8 million impact of new acquisitions for the three and nine months ended September 30, 2018, respectively, personnel costs decreased \$2.7 million, or 0.6%, and \$0.7 million, or 0.1%, when compared with the same periods of the prior year. The decrease for the three months ended September 30, 2018, adjusted for the impact of new acquisitions, was primarily attributable to lower incentive compensation expense, partially offset by higher employee benefit costs. The slight decrease for the nine months ended September 30, 2018, adjusted for the impact of new acquisitions, was primarily attributable to lower incentive compensation expense, overtime expense, severance expense and temporary labor costs, mostly offset by higher salary expense and share-based compensation costs.

Agents retained \$485.6 million and \$1.3 billion of title premiums generated by agency operations for the three and nine months ended September 30, 2018, respectively, which compares with \$497.9 million and \$1.4 billion for the respective periods of the prior year. The percentage of title premiums retained by agents was 78.9% and 78.8% for the three and nine months ended September 30, 2018, respectively, compared to 79.1% and 78.9% for the respective periods of the prior year.

Other operating expenses for the title insurance and services segment were \$200.9 million and \$594.2 million for the three and nine months ended September 30, 2018, respectively, increases of \$4.5 million, or 2.3%, and \$14.6 million, or 2.5%, when compared with the respective periods of the prior year. The increases were driven by recent acquisitions. Excluding the \$4.8 million and \$16.2 million impact of new acquisitions for the three and nine months ended September 30, 2018, respectively, other operating expenses decreased \$0.3 million, or 0.1%, and \$1.6 million, or 0.3%, when compared with the respective periods of the prior year. The slight decreases for the three and nine months ended September 30, 2018, adjusted for the impact of new acquisitions, were primarily attributable to small decreases across a number of expense categories, mostly offset by the recording of a reserve related to a legacy regulatory matter during the third quarter of 2018 and higher software expense and foreign exchange losses. The nine months ended September 30, 2018 were also impacted by lower production related expenses.

The provision for policy losses and other claims, expressed as a percentage of title premiums and escrow fees, was 4.0% for the three and nine months ended September 30, 2018 and 2017. The current quarter rate of 4.0% reflects the ultimate loss rate for the current policy year and no change in the loss reserve estimates for prior policy years. The 4.0% rate for the third quarter of 2017 reflected the ultimate loss rate for the 2017 policy year and no change in the loss reserve estimates for prior policy years.

Depreciation and amortization expense was \$30.0 million and \$87.4 million for the three and nine months ended September 30, 2018, respectively, decreases of \$4.4 million, or 12.8%, and \$4.0 million, or 4.4%, when compared with the respective periods of the prior year. The decreases were primarily attributable to \$4.7 million in out-of-period adjustments recorded in the prior year to fully amortize certain title plant imaging assets that were misclassified as title plant assets and accelerated amortization of internally developed software in the prior year, partially offset by an increase in amortization expense from recent acquisitions.

Premium taxes were \$16.9 million and \$46.4 million for the three and nine months ended September 30, 2018, respectively, decreases of \$1.0 million, or 5.4%, and \$0.6 million, or 1.2%, respectively, compared to \$17.9 million and \$47.0 million for the same periods of the prior year. Premium taxes as a percentage of title insurance premiums and escrow fees were 1.5% and 1.4% for the three and nine months ended September 30, 2018 and 2017, respectively.

The profit margins for the title insurance business reflect the high cost of performing the essential services required before insuring title, whereas the corresponding revenues are subject to regulatory and competitive pricing restraints. Due to the relatively high proportion of fixed costs, title insurance profit margins generally improve as closed order volumes increase. Title insurance profit margins are affected by the composition (residential or commercial) and type (resale, refinancing or new construction) of real estate activity. Title insurance profit margins are also affected by the percentage of title insurance premiums generated by agency operations. Profit margins from direct operations are generally higher than from agency operations due primarily to the large portion of the premium that is retained by the agent. Pretax margins for the three and nine months ended September 30, 2018 were 14.6% and 13.1%, respectively, compared with 13.0% and 12.1% in the respective periods of the prior year.

#### Specialty Insurance

(in thousands, except percentages)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
<b>Revenues</b>								
Direct premiums	\$ 116,606	\$ 113,041	\$ 3,565	3.2 %	\$ 339,298	\$ 326,935	\$ 12,363	3.8 %
Information and other	2,981	2,814	167	5.9	8,807	8,427	380	4.5
Net investment income	2,573	2,468	105	4.3	7,561	7,118	443	6.2
Net realized investment gains	2,019	158	1,861	NM <sup>1</sup>	2,084	1,428	656	45.9
	124,179	118,481	5,698	4.8	357,750	343,908	13,842	4.0
<b>Expenses</b>								
Personnel costs	19,416	18,478	938	5.1	57,234	53,632	3,602	6.7
Other operating expenses	18,705	16,537	2,168	13.1	56,184	50,588	5,596	11.1



Edgar Filing: First American Financial Corp - Form 10-Q

Provision for policy losses and other claims	76,280	73,660	2,620	3.6	207,695	203,658	4,037	2.0
Depreciation and amortization	1,713	1,599	114	7.1	4,981	4,697	284	6.0
Premium taxes	1,864	2,029	(165 )	(8.1 )	5,436	5,554	(118 )	(2.1 )
	117,978	112,303	5,675	5.1	331,530	318,129	13,401	4.2
Income before income taxes	\$6,201	\$6,178	\$23	0.4 %	\$26,220	\$25,779	\$441	1.7 %
Margins	5.0 %	5.2 %	(0.2 )%	(3.8 )%	7.3 %	7.5 %	(0.2 )%	(2.7 )%

(1)Not meaningful

Direct premiums were \$116.6 million and \$339.3 million for the three and nine months ended September 30, 2018, respectively, increases of \$3.6 million, or 3.2%, and \$12.4 million, or 3.8%, when compared with the respective periods of the prior year. The increases were attributable to higher premiums earned in the home warranty business driven by an increase in the average prices charged per home warranty residential service contract and an increase in the number of contracts issued.

Net realized investment gains totaled \$2.0 million and \$2.1 million for the three and nine months ended September 30, 2018, respectively, and were primarily from the increase in the fair values of equity securities, partially offset by losses from the sales of debt securities. Net realized investment gains totaled \$0.2 million and \$1.4 million for the three and nine months ended September 30, 2017, respectively, and were from the sales of debt and equity securities.

Personnel costs and other operating expenses were \$38.1 million and \$113.4 million for the three and nine months ended September 30, 2018, respectively, increases of \$3.1 million, or 8.9%, and \$9.2 million, or 8.8%, when compared with the respective periods of the prior year. The increases were primarily attributable to higher salary expense due to higher average salaries and higher advertising expense, sales tax expense, allocations related to corporate shared services, employee benefit costs and professional services expense.

The provision for home warranty claims, expressed as a percentage of home warranty premiums, was 62.9% and 56.1% for the three and nine months ended September 30, 2018, respectively, compared with 60.1% and 56.1% for the respective periods of the prior year. The increase in the claims rate for the three months ended September 30, 2018 was primarily attributable to an increase in claims severity. The provision for property and casualty claims, expressed as a percentage of property and casualty insurance premiums, was 72.5% and 75.2% for the three and nine months ended September 30, 2018, respectively, compared with 77.8% and 77.3% for the respective periods of the prior year. The decrease in the claims rate for the three months ended September 30, 2018 was primarily attributable to a decline in claims frequency, partially offset by an increase in claims severity.

Premium taxes were \$1.9 million and \$5.4 million for the three and nine months ended September 30, 2018, respectively, compared with \$2.0 million and \$5.6 million for the respective periods of the prior year. Premium taxes as a percentage of specialty insurance segment premiums were 1.6% for the three and nine months ended September 30, 2018, and 1.8% and 1.7% for the three and nine months ended September 30, 2017, respectively.

A large part of the revenues for the specialty insurance businesses are generated by renewals and are not dependent on the level of real estate activity in the year of renewal. With the exception of loss expense, the majority of the expenses for this segment are variable in nature and therefore generally fluctuate consistent with revenue fluctuations. Accordingly, profit margins for this segment (before loss expense) are relatively constant, although as a result of some fixed expenses, profit margins (before loss expense) should nominally improve as premium revenues increase. Pretax margins for the three and nine months ended September 30, 2018 were 5.0% and 7.3%, respectively, compared with 5.2% and 7.5% in the respective periods of the prior year.

#### Corporate

(in thousands, except percentages)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
<b>Revenues</b>								
Net investment income	\$4,461	\$4,108	\$353	8.6	% \$5,488	\$10,872	\$(5,384)	(49.5)%
	4,461	4,108	353	8.6	5,488	10,872	(5,384)	(49.5)
<b>Expenses</b>								
Personnel costs	4,858	3,622	1,236	34.1	8,981	11,758	(2,777)	(23.6)
Other operating expenses	8,297	161,664	(153,367)	(94.9)	25,533	191,221	(165,688)	(86.6)

Depreciation and amortization	38	38	—	—	115	124	(9	)	(7.3	)
Interest	8,421	8,199	222	2.7	25,024	24,298	726		3.0	
	21,614	173,523	(151,909)	(87.5	)	59,653	227,401	(167,748)	(73.8	)

Loss before income

taxes \$(17,153) \$(169,415) \$152,262 89.9 % \$(54,165) \$(216,529) \$162,364 75.0 %

Net investment income totaled \$4.5 million and \$5.5 million for the three and nine months ended September 30, 2018, respectively, compared with \$4.1 million and \$10.9 million for the respective periods of the prior year. The increase in net investment income for the three months ended September 30, 2018 was primarily attributable to higher interest income earned on the Company's cash balances. The decline in net investment income for the nine months ended September 30, 2018 was primarily attributable to lower earnings on investments in the Company's deferred compensation plan when compared to the same period of 2017, partially offset by higher interest income earned on the Company's cash balances.

Corporate personnel costs and other operating expenses were \$13.2 million and \$34.5 million for the three and nine months ended September 30, 2018, respectively, compared with \$165.3 million and \$203.0 million for the respective periods of the prior year. The decreases were primarily attributable to pension settlement costs of \$152.4 million that the Company recognized during the third quarter of 2017 upon completing the termination of its funded defined benefit pension plans.

Interest expense was \$8.4 million and \$25.0 million for the three and nine months ended September 30, 2018, respectively, increases of \$0.2 million, or 2.7%, and \$0.7 million, or 3.0%, when compared with the respective periods of the prior year. The increases were due to an increase in the interest rate on borrowings under the Company's credit facility. Borrowings under the credit facility bear interest at a variable rate, which increased in 2018 when compared to 2017.

#### Eliminations

The Company's inter-segment eliminations were not material for the three and nine months ended September 30, 2018 and 2017.

#### INCOME TAXES

The Company's effective income tax rates (income tax expense as a percentage of income before income taxes) were 22.6% and 22.0% for the three and nine months ended September 30, 2018, respectively, compared with -17.9% and 29.7% for the respective periods of the prior year. The difference in the effective tax rates is primarily due to the reduction in the federal income tax rate from 35% to 21% as a result of the Tax Reform Act, and the effective tax rates for 2017 also reflect state tax benefits relating to the termination of the Company's pension plan, as well as the release of reserves relating to tax positions taken on prior year tax returns.

The Company evaluates the realizability of its deferred tax assets by assessing the valuation allowance and makes adjustments to the allowance as necessary. The factors used to assess the likelihood of realization include the Company's forecast of future taxable income and available tax planning strategies that could be implemented to realize the deferred tax assets. The Company's ability or failure to achieve forecasted taxable income in the applicable taxing jurisdictions could affect the ultimate realization of deferred tax assets. Based on actual future operating results in certain jurisdictions, it is possible that the current valuation allowance positions of those jurisdictions could be adjusted in the next 12 months.

#### NET INCOME AND NET INCOME ATTRIBUTABLE TO THE COMPANY

Net income for the three and nine months ended September 30, 2018 was \$151.5 million and \$382.7 million, respectively, compared with \$21.2 million and \$201.2 million for the respective periods of the prior year. Net income attributable to the Company for the three and nine months ended September 30, 2018 was \$151.5 million, or \$1.34 per diluted share, and \$382.8 million, or \$3.38 per diluted share, respectively, compared with \$21.4 million, or \$0.19 per diluted share, and \$201.9 million, or \$1.80 per diluted share, for the respective periods of the prior year.

#### LIQUIDITY AND CAPITAL RESOURCES

**Cash requirements.** The Company generates cash primarily from the sale of its products and services and investment income. The Company's current cash requirements include operating expenses, taxes, payments of principal and interest on its debt, capital expenditures, dividends on its common stock, and may include business acquisitions and repurchases of its common stock. Management forecasts the cash needs of the holding company and its primary subsidiaries and regularly reviews their short-term and long-term projected sources and uses of funds, as

well as the asset, liability, investment and cash flow assumptions underlying such forecasts. Based on the Company's ability to generate cash flows from operations, its liquid-asset position and amounts available on its revolving credit facility, management believes that its resources are sufficient to satisfy its anticipated operational cash requirements and obligations for at least the next twelve months.

The substantial majority of the Company's business is dependent upon activity in the real estate and mortgage markets, which are cyclical and seasonal. Periods of increasing interest rates and reduced mortgage financing availability generally have an adverse effect on residential real estate activity and therefore typically decrease the Company's revenues. In contrast, periods of declining interest rates and increased mortgage financing availability generally have a positive effect on residential real estate activity, which typically increases the Company's revenues. Residential purchase activity is typically slower in the winter months with increased volumes in the spring and summer months. Residential refinance activity is typically more volatile than purchase activity and is highly impacted by changes in interest rates. Commercial real estate volumes are less sensitive to changes in interest rates, but fluctuate based on local supply and demand conditions for space and mortgage financing availability.

Cash provided by operating activities totaled \$484.9 million and \$455.5 million for the nine months ended September 30, 2018 and 2017, respectively, after claim payments, net of recoveries, of \$334.0 million and \$351.4 million, respectively. The principal nonoperating uses of cash and cash equivalents for the nine months ended September 30, 2018 and 2017 were purchases of debt and equity securities, dividends to common stockholders, capital expenditures, business acquisitions and, for the nine months ended September 30, 2018, advances under secured financing agreements and repayments of secured financings payable. The most significant nonoperating sources of cash and cash equivalents for the nine months ended September 30, 2018 and 2017 were proceeds from the sales and maturities of debt and equity securities and increases in the deposit balances at the Company's banking operations and, for the nine months ended September 30, 2018, borrowings under secured financing agreements and collections of secured financings receivable. The net effect of all activities on total cash and cash equivalents were increases of \$818.1 million and \$135.8 million for the nine months ended September 30, 2018 and 2017, respectively.

The Company continually assesses its capital allocation strategy, including decisions relating to dividends, stock repurchases, capital expenditures, acquisitions and investments. In August 2018, the Company's board of directors approved an increase in the Company's quarterly cash dividend to 42 cents per common share, representing an 11% increase from the prior level of 38 cents per common share. The dividend increase became effective beginning with the September 2018 dividend. Management expects that the Company will continue to pay quarterly cash dividends at or above the current level. The timing, declaration and payment of future dividends, however, falls within the discretion of the Company's board of directors and will depend upon many factors, including the Company's financial condition and earnings, the capital requirements of the Company's businesses, restrictions imposed by applicable law and any other factors the board of directors deems relevant from time to time.

In March 2014, the Company's board of directors approved an increase in the size of the Company's stock repurchase plan from \$150.0 million to \$250.0 million, of which \$182.4 million remained as of September 30, 2018. Purchases may be made from time to time by the Company in the open market at prevailing market prices or in privately negotiated transactions. The Company did not repurchase any shares of its common stock during the nine months ended September 30, 2018 and, as of September 30, 2018, had repurchased and retired 3.2 million shares of its common stock under the current authorization for a total purchase price of \$67.6 million.

**Holding Company.** First American Financial Corporation is a holding company that conducts all of its operations through its subsidiaries. The holding company's current cash requirements include payments of principal and interest on its debt, taxes, payments in connection with employee benefit plans, dividends on its common stock and other expenses. The holding company is dependent upon dividends and other payments from its operating subsidiaries to meet its cash requirements. The Company's target is to maintain a cash balance at the holding company equal to at least twelve months of estimated cash requirements. At certain points in time, the actual cash balance at the holding company may vary from this target due to, among other factors, the timing and amount of cash payments made and dividend payments received. Pursuant to insurance and other regulations under which the Company's insurance subsidiaries operate, the amount of dividends, loans and advances available to the holding company is limited, principally for the protection of policyholders. As of September 30, 2018, under such regulations, the maximum

amount available to the holding company from its insurance subsidiaries for the remainder of 2018, without prior approval from applicable regulators, was dividends of \$230.2 million and loans and advances of \$95.9 million. However, the timing and amount of dividends paid by the Company's insurance subsidiaries to the holding company falls within the discretion of each insurance subsidiary's board of directors and will depend upon many factors, including the level of total statutory capital and surplus required to support minimum financial strength ratings by certain rating agencies. Such restrictions have not had, nor are they expected to have, an impact on the holding company's ability to meet its cash obligations.

The Tax Reform Act amended the Internal Revenue Code to reduce U.S. tax rates and modify policies, credits and deductions for individuals and businesses. While the changes resulting from the Tax Reform Act are broad and complex and will require additional analysis, the Company expects that the Tax Reform Act will continue to have an overall favorable impact on its effective tax rate resulting in less cash required for tax payments in future periods. In addition, the Tax Reform Act moves the U.S. to a partial territorial tax system, which as a result, will reduce the tax costs associated with future distributions of earnings from foreign subsidiaries.

As of September 30, 2018, the holding company's sources of liquidity included \$152.9 million of cash and cash equivalents and \$540.0 million available on the Company's revolving credit facility. Management believes that liquidity at the holding company is sufficient to satisfy anticipated cash requirements and obligations for at least the next twelve months.

**Financing.** The Company maintains a credit agreement with JPMorgan Chase Bank, N.A. in its capacity as administrative agent and the lenders party thereto. The credit agreement is comprised of a \$700.0 million revolving credit facility. Unless terminated earlier, the revolving loan commitments under the credit agreement will terminate on May 14, 2019. The obligations of the Company under the credit agreement are neither secured nor guaranteed. Proceeds under the credit agreement may be used for general corporate purposes. At September 30, 2018, outstanding borrowings under the facility totaled \$160.0 million at an interest rate of 3.87%.

The credit agreement includes an expansion option that permits the Company, subject to satisfaction of certain conditions, to increase the revolving commitments and/or add term loan tranches ("Incremental Term Loans") in an aggregate amount not to exceed \$150.0 million. Incremental Term Loans, if made, may not mature prior to the revolving commitment termination date, provided that amortization may occur prior to such date.

At the Company's election, borrowings under the credit agreement bear interest at either (a) the Alternate Base Rate plus the applicable spread or (b) the Adjusted LIBOR rate plus the applicable spread (in each case as defined in the agreement). The Company may select interest periods of one, two, three or six months or (if agreed to by all lenders) such other number of months for Eurodollar borrowings of loans. The applicable spread varies depending upon the debt rating assigned by Moody's Investor Service, Inc. and/or Standard & Poor's Rating Services. The minimum applicable spread for Alternate Base Rate borrowings is 0.625% and the maximum is 1.00%. The minimum applicable spread for Adjusted LIBOR rate borrowings is 1.625% and the maximum is 2.00%. The rate of interest on Incremental Term Loans will be established at or about the time such loans are made and may differ from the rate of interest on revolving loans.

The credit agreement includes representations and warranties, reporting covenants, affirmative covenants, negative covenants, financial covenants and events of default customary for financings of this type. Upon the occurrence of an event of default the lenders may accelerate the loans. Upon the occurrence of certain insolvency and bankruptcy events of default the loans will automatically accelerate. As of September 30, 2018, the Company was in compliance with the financial covenants under the credit agreement.

In addition to amounts available under its credit facility, certain subsidiaries of the Company are parties to master repurchase agreements which are used as part of the Company's liquidity management activities and to support its risk management activities. In particular, securities loaned or sold under repurchase agreements may be used as short-term funding sources. During the nine months ended September 30, 2018, the Company financed securities for funds received totaling \$10.0 million under these agreements. As of September 30, 2018, no amounts remained outstanding under these agreements.



In addition to being a party to master repurchase agreements, the Company's federal savings bank subsidiary, First American Trust, FSB, maintains a secured line of credit with the Federal Home Loan Bank and federal funds lines of credit with certain correspondent institutions. As of September 30, 2018, no amounts remained outstanding under any of these facilities.

In May 2018, the Company purchased a small, specialized warehouse lender that provides financing for correspondent mortgage lenders. The business has itself secured warehouse lending facilities with several banking institutions. The mortgage loans are generally sold, and the lending facilities are generally repaid, within 30 days and more typically in less than 10 days. The combined capacity for the warehouse lending facilities totals \$123.0 million with one additional warehouse lending facility having no stated capacity. Interest rates for the warehouse lending facilities range from 3.50% to the current prime lending rate as published by The Wall Street Journal. At September 30, 2018, outstanding borrowings under the facilities totaled \$86.5 million.

Notes and contracts payable and secured financings payable as a percentage of total capitalization was 18.6% and 17.4% at September 30, 2018 and December 31, 2017, respectively. Notes and contracts payable as a percentage of total capitalization (excluding secured financings payable) was 16.7% and 17.4% at September 30, 2018 and December 31, 2017, respectively.

**Investment Portfolio.** The Company maintains a high quality, liquid investment portfolio that is primarily held at its insurance and banking subsidiaries. As of September 30, 2018, 93% of the Company's investment portfolio consisted of fixed income securities, of which 64% were United States government-backed or rated AAA and 95% were rated or classified as investment grade. Percentages are based on the estimated fair values of the securities. Credit ratings reflect published ratings obtained from globally recognized securities rating agencies. If a security was rated differently among the rating agencies, the lowest rating was selected. For further information on the credit quality of the Company's investment portfolio at September 30, 2018, see Note 4 Debt and Equity Securities to the condensed consolidated financial statements.

In addition to its debt and equity securities portfolio, the Company maintains certain money-market and other short-term investments.

**Off-balance sheet arrangements.** The Company administers escrow deposits and trust assets as a service to its customers. Escrow deposits totaled \$8.9 billion and \$7.5 billion at September 30, 2018 and December 31, 2017, respectively, of which \$4.4 billion and \$2.9 billion, respectively, were held at First American Trust, FSB. The escrow deposits held at First American Trust, FSB are temporarily invested in cash and cash equivalents and debt securities, with offsetting liabilities included in deposits in the accompanying condensed consolidated balance sheets. The remaining escrow deposits were held at third-party financial institutions.

Trust assets held or managed by First American Trust, FSB totaled \$3.8 billion and \$3.7 billion at September 30, 2018 and December 31, 2017, respectively. Escrow deposits held at third-party financial institutions and trust assets are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. However, the Company could be held contingently liable for the disposition of these assets.

In conducting its operations, the Company often holds customers' assets in escrow, pending completion of real estate transactions and, as a result, the Company has ongoing programs for realizing economic benefits with various financial institutions. The results from these programs are included in the condensed consolidated financial statements as income or a reduction in expense, as appropriate, based on the nature of the arrangement and benefit received.

The Company facilitates tax-deferred property exchanges for customers pursuant to Section 1031 of the Internal Revenue Code and tax-deferred reverse exchanges pursuant to Revenue Procedure 2000-37. As a facilitator and intermediary, the Company holds the proceeds from sales transactions and takes temporary title to property identified by the customer to be acquired with such proceeds. Upon the completion of each such exchange, the identified property is transferred to the customer or, if the exchange does not take place, an amount equal to the sales proceeds or, in the case of a reverse exchange, title to the property held by the Company is transferred to the customer. Like-kind exchange funds held by the Company totaled \$2.6 billion at September 30, 2018 and December 31, 2017. The like-kind exchange deposits are held at third-party financial institutions and, due to the structure utilized to facilitate these transactions, the proceeds and property are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. All such amounts are placed in deposit accounts insured, up to applicable limits, by the Federal Deposit Insurance Corporation. The Company could be held contingently liable to the customer for the transfers of property, disbursements of proceeds and the returns on such proceeds.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The Company's primary exposure to market risk relates to interest rate risk associated with certain financial instruments. Although the Company monitors its risk associated with fluctuations in interest rates, it does not currently use derivative financial instruments on any significant scale to hedge these risks.

There have been no material changes in the Company's market risks since the filing of its Annual Report on Form 10-K for the year ended December 31, 2017.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

The Company's chief executive officer and chief financial officer have concluded that, as of September 30, 2018, the end of the quarterly period covered by this Quarterly Report on Form 10-Q, the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended, were effective, based on the evaluation of these controls and procedures required by Rule 13a-15(b) thereunder.

## Changes in Internal Control Over Financial Reporting

There was no change in the Company's internal control over financial reporting during the quarter ended September 30, 2018, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II: OTHER INFORMATION

### Item 1. Legal Proceedings.

The Company and its subsidiaries are parties to a number of non-ordinary course lawsuits. These lawsuits frequently are similar in nature to other lawsuits pending against the Company's competitors.

For those non-ordinary course lawsuits where the Company has determined that a loss is both probable and reasonably estimable, a liability representing the best estimate of the Company's financial exposure based on known facts has been recorded. Actual losses may materially differ from the amounts recorded.

For a substantial majority of these lawsuits, however, it is not possible to assess the probability of loss. Most of these lawsuits are putative class actions which require a plaintiff to satisfy a number of procedural requirements before proceeding to trial. These requirements include, among others, demonstration to a court that the law proscribes in some manner the Company's activities, the making of factual allegations sufficient to suggest that the Company's activities exceeded the limits of the law and a determination by the court—known as class certification—that the law permits a group of individuals to pursue the case together as a class. In certain instances the Company may also be able to compel the plaintiff to arbitrate its claim on an individual basis. If these procedural requirements are not met, either the lawsuit cannot proceed or, as is the case with class certification or compelled arbitration, the plaintiffs lose the financial incentive to proceed with the case (or the amount at issue effectively becomes *de minimis*). Frequently, a court's determination as to these procedural requirements is subject to appeal to a higher court. As a result of, among other factors, ambiguities and inconsistencies in the myriad laws applicable to the Company's business and the uniqueness of the factual issues presented in any given lawsuit, the Company often cannot determine the probability of loss until a court has finally determined that a plaintiff has satisfied applicable procedural requirements.

Furthermore, because most of these lawsuits are putative class actions, it is often impossible to estimate the possible loss or a range of loss amounts, even where the Company has determined that a loss is reasonably possible. Generally class actions involve a large number of people and the effort to determine which people satisfy the requirements to become plaintiffs—or class members—is often time consuming and burdensome. Moreover, these lawsuits raise complex factual issues which result in uncertainty as to their outcome and, ultimately, make it difficult for the Company to estimate the amount of damages which a plaintiff might successfully prove. In addition, many of the Company's businesses are regulated by various federal, state, local and foreign governmental agencies and are subject to numerous statutory guidelines. These regulations and statutory guidelines often are complex, inconsistent or ambiguous, which results in additional uncertainty as to the outcome of a given lawsuit—including the amount of damages a plaintiff might be afforded—or makes it difficult to analogize experience in one case or jurisdiction to another case or jurisdiction.

Most of the non-ordinary course lawsuits to which the Company and its subsidiaries are parties challenge practices in the Company's title insurance business, though a limited number of cases also pertain to the Company's other businesses. These lawsuits include, among others, cases alleging, among other assertions, that the Company or one of its subsidiaries engaged in improper debt collection practices, improperly charged fees for products and services, participated in the conveyance of illusory property interests, improperly handled property and casualty claims and

Edgar Filing: First American Financial Corp - Form 10-Q

gave items of value to builders as inducements to refer business in violation of certain laws, such as consumer protection laws and laws generally prohibiting unfair business practices, and certain obligations, including:

•Bartine v. First American Title Insurance Company, et al., filed on August 17, 2018 and pending in the United States District Court for the Middle District of Florida,

•Chavez v. First American Specialty Insurance Company, filed on June 29, 2017 and pending in the Superior Court of the State of California, County of Los Angeles,

•Lennen v. First American Financial Corporation, et al., filed on May 19, 2016 and pending in the United States District Court for the Middle District of Florida,

•Tenefufu vs. First American Specialty Insurance Company, filed on June 1, 2017 and pending in the Superior Court of the State of California, County of Sacramento, and

48

---

• *Wilmot v. First American Financial Corporation, et al.*, filed on April 20, 2007 and pending in the Superior Court of the State of California, County of Los Angeles.

All of these lawsuits are putative class actions for which a class has not been certified. For the reasons described above, the Company has not yet been able to assess the probability of loss or estimate the possible loss or the range of loss or, where the Company has been able to make an estimate, the Company believes the amount is not material to the condensed consolidated financial statements as a whole.

While some of the lawsuits described above may be material to the Company's operating results in any particular period if an unfavorable outcome results, the Company does not believe that any of these lawsuits will have a material adverse effect on the Company's overall financial condition or liquidity.

The Company also is a party to non-ordinary course lawsuits other than those described above. With respect to these lawsuits, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.

The Company's title insurance, property and casualty insurance, home warranty, banking, thrift, trust and wealth management businesses are regulated by various federal, state and local governmental agencies. Many of the Company's other businesses operate within statutory guidelines. Consequently, the Company may from time to time be subject to examination or investigation by such governmental agencies. Currently, governmental agencies are examining or investigating certain of the Company's operations. These exams or investigations include inquiries into, among other matters, pricing and rate setting practices in the title insurance industry, competition in the title insurance industry, real estate settlement service, customer acquisition and retention practices and agency relationships. With respect to matters where the Company has determined that a loss is both probable and reasonably estimable, the Company has recorded a liability representing its best estimate of the financial exposure based on known facts. While the ultimate disposition of each such exam or investigation is not yet determinable, the Company does not believe that individually or in the aggregate they will have a material adverse effect on the Company's financial condition, results of operations or cash flows. These exams or investigations could, however, result in changes to the Company's business practices which could ultimately have a material adverse impact on the Company's financial condition, results of operations or cash flows.

The Company and its subsidiaries also are involved in numerous ongoing routine legal and regulatory proceedings related to their operations. With respect to each of these proceedings, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.

#### Item 1A. Risk Factors.

You should carefully consider each of the following risk factors and the other information contained in this Quarterly Report on Form 10-Q. The Company faces risks other than those listed here, including those that are unknown to the Company and others of which the Company may be aware but, at present, considers immaterial. Because of the following factors, as well as other variables affecting the Company's operating results, past financial performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

##### 1. Conditions in the real estate market generally impact the demand for a substantial portion of the Company's products and services and the Company's claims experience

Demand for a substantial portion of the Company's products and services generally decreases as the number of real estate transactions in which its products and services are purchased decreases. The number of real estate transactions in which the Company's products and services are purchased decreases in the following situations, among others:

- when mortgage interest rates are high or rising;
- when the availability of credit, including commercial and residential mortgage funding, is limited; and
- when real estate values are declining.

These circumstances, particularly declining real estate values and the increase in foreclosures that often results therefrom, also tend to adversely impact the Company's title claims experience.

2. Unfavorable economic conditions could adversely affect the Company

Historically, uncertainty and negative trends in general economic conditions in the United States and abroad, including significant tightening of credit markets and a general decline in the value of real property, have created a difficult operating environment for the Company's businesses and other companies in its industries. In addition, the Company holds investments in entities, such as title agencies and settlement service providers, as well as securities in its investment portfolio, which may be negatively impacted by these conditions. The Company also owns a federal savings bank into which it deposits some of its own funds and some funds held in trust for third parties. This bank invests those funds and any realized losses incurred will be reflected in the Company's consolidated results. The likelihood of such losses, which generally would not occur if the Company were to deposit these funds in an unaffiliated entity, increases when economic conditions are unfavorable. Depending upon the ultimate severity and duration of any economic downturn, the resulting effects on the Company could be materially adverse, including a significant reduction in revenues, earnings and cash flows, challenges to the Company's ability to satisfy covenants or otherwise meet its obligations under debt facilities, difficulties in obtaining access to capital, challenges to the Company's ability to pay dividends at currently anticipated levels, deterioration in the value of its investments and increased credit risk from customers and others with obligations to the Company.

3. Failures at financial institutions at which the Company deposits funds could adversely affect the Company

The Company deposits substantial funds in financial institutions. These funds include amounts owned by third parties, such as escrow deposits. Should one or more of the financial institutions at which deposits are maintained fail, there is no guarantee that the Company would recover the funds deposited, whether through Federal Deposit Insurance Corporation coverage or otherwise. In the event of any such failure, the Company also could be held liable for the funds owned by third parties.

4. Changes in government regulation could prohibit or limit the Company's operations, make it more burdensome to conduct such operations or result in decreased demand for the Company's products and services

Many of the Company's businesses, including its title insurance, property and casualty insurance, home warranty, banking, trust and wealth management businesses, are regulated by various federal, state, local and foreign governmental agencies. These and other of the Company's businesses also operate within statutory guidelines. The industry in which the Company operates and the markets into which it sells its products are also regulated and subject to statutory guidelines. Changes in the applicable regulatory environment, statutory guidelines or interpretations of existing regulations or statutes, enhanced governmental oversight or efforts by governmental agencies to cause customers to refrain from using the Company's products or services could prohibit or limit its future operations or make it more burdensome to conduct such operations or result in decreased demand for the Company's products and services or a change in our competitive position. The impact of these changes would be more significant if they involve jurisdictions in which the Company generates a greater portion of its title premiums, such as the states of Arizona, California, Florida, Michigan, New York, Ohio, Pennsylvania and Texas. These changes may compel the Company to reduce its prices, may restrict its ability to implement price increases or acquire assets or businesses, may limit the manner in which the Company conducts its business or otherwise may have a negative impact on its ability to generate revenues, earnings and cash flows.

5. Scrutiny of the Company's businesses and the industries in which it operates by governmental entities and others could adversely affect the Company

The real estate settlement services industry, an industry in which the Company generates a substantial portion of its revenue and earnings, is subject to continuous scrutiny by regulators, legislators, the media and plaintiffs' attorneys. Though often directed at the industry generally, these groups may also focus their attention directly on the



Company's businesses. In either case, this scrutiny may result in changes which could adversely affect the Company's operations and, therefore, its financial condition and liquidity.

Governmental entities have routinely inquired into certain practices in the real estate settlement services industry to determine whether certain of the Company's businesses or its competitors have violated applicable laws, which include, among others, the insurance codes of the various jurisdictions and the Real Estate Settlement Procedures Act and similar state, federal and foreign laws. The Consumer Financial Protection Bureau ("CFPB"), for example, has actively utilized its regulatory authority over the mortgage and real estate markets by bringing enforcement actions against various participants in the mortgage and settlement industries. Departments of insurance in the various states, the CFPB and other federal regulators and applicable regulators in international jurisdictions, either separately or together, also periodically conduct targeted inquiries into the practices of title insurance companies and other settlement services providers in their respective jurisdictions.

Further, from time to time plaintiffs' lawyers may target the Company and other members of the Company's industry with lawsuits claiming legal violations or other wrongful conduct. These lawsuits may involve large groups of plaintiffs and claims for substantial damages. Any of these types of inquiries or proceedings may result in a finding of a violation of the law or other wrongful conduct and may result in the payment of fines or damages or the imposition of restrictions on the Company's conduct which could impact its operations and financial condition. Moreover, these laws and standards of conduct often are ambiguous and, thus, it may be difficult to ensure compliance. This ambiguity may force the Company to mitigate its risk by settling claims or by ending practices that generate revenues, earnings and cash flows.

6. The use of social media by the Company and other parties could result in damage to the Company's reputation or otherwise adversely affect the Company

The Company increasingly utilizes social media to communicate with current and potential customers and employees, as well as other individuals interested in the Company. Information delivered by the Company, or by third parties about the Company, via social media can be easily accessed and rapidly disseminated, and could result in reputational harm, decreased customer loyalty or other issues that could diminish the value of the Company's brand or result in significant liability.

7. Regulation of title insurance rates could adversely affect the Company

Title insurance rates are subject to extensive regulation, which varies from state to state. In many states the approval of the applicable state insurance regulator is required prior to implementing a rate change. This regulation could hinder the Company's ability to promptly adapt to changing market dynamics through price adjustments, which could adversely affect its results of operations, particularly in a rapidly declining market.

8. Changes in certain laws and regulations, and in the regulatory environment in which the Company operates, could adversely affect the Company

Federal officials are currently discussing various potential changes to laws and regulations that could impact the Company's businesses, including changes to the Dodd-Frank Wall Street Reform and Consumer Protection Act and the reform of government-sponsored enterprises such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Changes in these areas, and more generally in the regulatory environment in which the Company and its customers operate, could adversely impact the volume of mortgage originations in the United States and the Company's competitive position and results of operations.

9. The Company may find it difficult to acquire necessary data

Certain data used and supplied by the Company are subject to regulation by various federal, state and local regulatory authorities. Compliance with existing federal, state and local laws and regulations with respect to such data has not had a material adverse effect on the Company's results of operations to date. Nonetheless, federal, state and local laws and regulations in the United States designed to protect the public from the misuse of personal information in the marketplace and adverse publicity or potential litigation concerning the commercial use of such information may affect the Company's operations and could result in substantial regulatory compliance expense, litigation expense and a loss of revenue. The suppliers of data to the Company face similar burdens. As a result of these and other factors, the Company may find it financially burdensome to acquire necessary data.

10. Changes in the Company's relationships with large mortgage lenders or government-sponsored enterprises could adversely affect the Company

The mortgage market in the United States is concentrated. Due to the consolidated nature of the industry, the Company derives a significant percentage of its revenues from a relatively small base of lenders, and their borrowers, which enhances the negotiating power of these lenders with respect to the pricing and the terms on which they purchase the Company's products and other matters. Similarly, government-sponsored enterprises, because of their significant role in the mortgage process, have significant influence over the Company and other service providers. These circumstances could adversely affect the Company's revenues and profitability. Changes in the Company's relationship with any of these lenders or government-sponsored enterprises, the loss of all or a portion of the business the Company derives from these parties, any refusal of these parties to accept the Company's products and services, the modification of the government-sponsored enterprises' requirement for title insurance in connection with mortgages they purchase or the use of alternatives to the Company's products and services, could have a material adverse effect on the Company.

11. A downgrade by ratings agencies, reductions in statutory capital and surplus maintained by the Company's title insurance underwriters or a deterioration in other measures of financial strength could adversely affect the Company

Certain of the Company's customers use measurements of the financial strength of the Company's title insurance underwriters, including, among others, ratings provided by ratings agencies and levels of statutory capital and surplus maintained by those underwriters, in determining the amount of a policy they will accept and the amount of reinsurance required. Each of the major ratings agencies currently rates the Company's title insurance operations. The Company's principal title insurance underwriter's financial strength ratings are "A2" by Moody's Investor Services, Inc., "A" by Fitch Ratings, Inc., "A-" by Standard & Poor's Ratings Services and "A" by A.M. Best Company, Inc. These ratings provide the agencies' perspectives on the financial strength, operating performance and cash generating ability of those operations. These agencies continually review these ratings and the ratings are subject to change. Statutory capital and surplus, or the amount by which statutory assets exceed statutory liabilities, is also a measure of financial strength. The Company's principal title insurance underwriter maintained \$1.2 billion of total statutory capital and surplus as of December 31, 2017. Accordingly, if the ratings or statutory capital and surplus of these title insurance underwriters are reduced from their current levels, or if there is a deterioration in other measures of financial strength, the Company's results of operations, competitive position and liquidity could be adversely affected.

12. The Company's investment portfolio is subject to certain risks and could experience losses

The Company maintains a substantial investment portfolio, primarily consisting of fixed income debt securities. The investment portfolio also includes adjustable-rate debt securities, common and preferred stock, as well as money-market and other short-term investments. Securities in the Company's investment portfolio are subject to certain economic and financial market risks, such as credit risk, interest rate (including call, prepayment and extension) risk and/or liquidity risk. The risk of loss associated with the portfolio is increased during periods of instability in credit markets and economic conditions. Debt and equity securities are carried at fair value on the Company's balance sheet. Changes in the fair value of debt securities is recorded as a component of accumulated other comprehensive loss on the balance sheet. For debt securities in an unrealized loss position, where the loss is deemed to be other-than-temporary, the Company records the loss in earnings. Starting in 2018, changes in the fair value of equity securities are recognized in earnings. Changes in the fair value of securities in the Company's investment portfolio could have a material adverse effect on the Company's results of operations, statutory surplus, financial condition and cash flow.

13. Actual claims experience could materially vary from the expected claims experience reflected in the Company's reserve for incurred but not reported claims

The Company maintains a reserve for incurred but not reported ("IBNR") claims pertaining to its title, escrow and other insurance and guarantee products. The majority of this reserve pertains to title insurance policies, which are long-duration contracts with the majority of the claims reported within the first few years following the issuance of the policy. Generally, 70% to 80% of claim amounts become known in the first six years of the policy life, and the majority of IBNR reserves relate to the six most recent policy years. Changes in expected ultimate losses and corresponding loss rates for recent policy years are considered likely and could result in a material adjustment to the IBNR reserves. Based on historical experience, management believes a 50 basis point change to the loss rates for recent policy years, positive or negative, is reasonably likely given the long duration nature of a title insurance policy. For example, if the expected ultimate losses for each of the last six policy years increased or decreased by 50 basis points, the resulting impact on the Company's IBNR reserve would be an increase or decrease, as the case may be, of \$121.7 million. A material change in expected ultimate losses and corresponding loss rates for older policy years is also possible, particularly for policy years with loss ratios exceeding historical norms. The estimates made by management in determining the appropriate level of IBNR reserves could ultimately prove to be materially different from actual claims experience.

14. The issuance of the Company's title insurance policies and related activities by title agents, which operate with substantial independence from the Company, could adversely affect the Company

The Company's title insurance subsidiaries issue a significant portion of their policies through title agents that operate with a substantial degree of independence from the Company. While these title agents are subject to certain contractual limitations that are designed to limit the Company's risk with respect to their activities, there is no guarantee that the agents will fulfill their contractual obligations to the Company. In addition, regulators are increasingly seeking to hold the Company responsible for the actions of these title agents and, under certain circumstances, the Company may be held liable directly to third parties for actions (including defalcations) or omissions of these agents. Case law in certain states also suggests that the Company is liable for the actions or omissions of its agents in those states, regardless of contractual limitations. As a result, the Company's use of title agents could result in increased claims on the Company's policies issued through agents and an increase in other costs and expenses.

52

---

15. The Company's risk management framework could prove inadequate, which could adversely affect the Company

The Company's risk management framework is designed to identify, monitor and mitigate risks that could have a negative impact on the Company's financial condition or reputation. This framework includes departments or groups dedicated to enterprise risk management, information security, disaster recovery and other information technology-related risks, business continuity, legal and compliance, compensation structures and other human resources matters, vendor management and internal audit, among others. While many of the processes overseen by these departments function at the enterprise level, many also function through, or rely to a certain degree upon, risk mitigation efforts in local operating groups. Similarly, with respect to the risks the Company assumes in the ordinary course of its business through the issuance of title insurance policies and the provision of related products and services, the Company employs localized as well as centralized risk mitigation efforts. These efforts include the implementation of underwriting policies and procedures and other mechanisms for assessing risk. Underwriting title insurance policies and making other risk-assumption decisions frequently involves a substantial degree of individual judgment and, accordingly, underwriters are maintained at the regional, divisional and corporate levels with varying degrees of underwriting authority. These individuals may be encouraged by customers or others to assume risks or to expeditiously make risk determinations. If the Company's risk mitigation efforts prove inadequate, the Company could be adversely affected.

16. Systems damage, failures, interruptions and intrusions, and unauthorized data disclosures may disrupt the Company's business, harm the Company's reputation, result in material claims for damages or otherwise adversely affect the Company

The Company uses computer systems and other technologies (collectively referred to as "systems"), some of which it owns and manages and some of which are owned and/or managed by third parties, including providers of distributed computing infrastructure platforms commonly known as the "cloud." The Company and its agents, suppliers, service providers, and customers use these systems to receive, process, store and transmit business information, including highly sensitive non-public personal information as well as data from suppliers and other information upon which the Company's business relies. The Company also uses these systems to manage substantial cash, investment assets, bank deposits, trust assets and escrow account balances on behalf of itself and its customers, among other activities. Many of the Company's products, services and solutions involving the use of real property related data are fully reliant on these systems and are only available electronically. Accordingly, for a variety of reasons, the integrity of these systems and the protection of the information that resides thereon are critically important to the Company's successful operation.

These systems have been subject to, and are likely to continue to be the target of, computer viruses, cyber attacks, phishing attacks and other malicious activity. These attacks have increased in frequency and sophistication in recent years. Further, certain other potential causes of system damage or other negative system-related events are wholly or partially beyond the Company's control, such as natural disasters, vendor failures to satisfy service level requirements and power or telecommunications failures. These incidents, regardless of their underlying causes, could expose the Company to system-related damages, failures, interruptions, and other negative events or could otherwise disrupt the Company's business and could also result in the loss or unauthorized release, gathering, monitoring or destruction of confidential, proprietary and other information pertaining to the Company, its customers, employees, agents or suppliers.

Certain laws and contracts the Company has entered into require it to notify various parties, including consumers or customers, in the event of certain actual or potential data breaches or systems failures. These notifications can result, among other things, in the loss of customers, lawsuits, adverse publicity, diversion of management's time and energy, the attention of regulatory authorities, fines and disruptions in sales. Further, the Company's financial institution customers have obligations to safeguard their systems and sensitive information and the Company may be bound

contractually and/or by regulation to comply with the same requirements. If the Company fails to comply with applicable regulations and contractual requirements, it could be exposed to lawsuits, governmental proceedings or the imposition of fines, among other consequences.

Accordingly, any inability to prevent or adequately respond to the issues described above could disrupt the Company's business, inhibit its ability to retain existing customers or attract new customers and/or result in financial losses, litigation, increased costs or other adverse consequences that could be material to the Company.

17. The Company's increased automation of processes could result in increased title claims or otherwise adversely affect the Company

In an effort to speed the delivery of its products, increase efficiency, improve quality and decrease risk, the Company and its agents increasingly are employing computer systems and algorithms to automate various processes, including certain processes related to the search and examination of information in connection with the issuance of title insurance policies. Risks from process automation include those associated with potential defects in the design and development of the algorithms or other technologies used to automate the process, misapplication of those technologies and the reliance on data that may prove inadequate. As a result of these risks the Company could experience increased claims, reputational damage or other adverse effects, which could be material to the Company.

18. Technological and other developments could change the way real estate transactions are conducted and related documents are processed in a manner that adversely affects the Company

Significant efforts are being made to transform through technology and other methods the manner in which real estate transactions are conducted, including the method for verifying the identities of the parties to a transaction; the process by which instruments and other documents are prepared, delivered, executed, authenticated and registered; the method by which collateral is valued and the interest in collateral is secured; and the process to protect the security of the transaction. Efforts are also being made to disrupt the traditional real estate brokerage model. These efforts, and the manner in which the Company, its agents and other industry participants respond to them, could require significant additional investment by the Company, could lead to a reduction in market share or profitability or could otherwise have an adverse effect on the Company.

19. Errors and fraud involving the transfer of funds may adversely affect the Company

The Company relies on its systems, employees and domestic and international banks to transfer its own funds and the funds of third parties. These transfers are susceptible to user input error, fraud, system interruptions, incorrect processing and similar errors that could result in lost funds or delayed transactions. The Company's email and computer systems and systems used by its agents, customers and other parties involved in a transaction have been subject to, and are likely to continue to be the target of, fraudulent attacks, including attempts to cause the Company or its agents to improperly transfer funds. These attacks have increased in frequency and sophistication in recent years. Funds transferred to a fraudulent recipient are often not recoverable. In certain instances the Company may be liable for those unrecovered funds. The controls and procedures used by the Company to prevent transfer errors and fraud may prove inadequate, resulting in financial losses, reputational harm, loss of customers or other adverse consequences which could be material to the Company.

20. The Company's use of a global workforce involves risks that could adversely affect the Company

The Company utilizes lower cost labor in countries such as India and the Philippines, among others. These countries are subject to relatively high degrees of political and social instability and may lack the infrastructure to withstand natural disasters. Such disruptions could decrease efficiency and increase the Company's costs. Weakness of the United States dollar in relation to the currencies used in these countries may also reduce the savings achievable through this strategy. Furthermore, the practice of utilizing labor based in other countries is subject to heightened scrutiny in the United States and, as a result, the Company could face pressure to decrease its use of labor based outside the United States. Laws or regulations that require the Company to use labor based in the United States or effectively increase the cost of the Company's labor costs abroad also could be enacted. The Company may not be able to pass on these increased costs to its customers.



21. As a holding company, the Company depends on distributions from its subsidiaries, and if distributions from its subsidiaries are materially impaired, the Company's ability to declare and pay dividends may be adversely affected; in addition, insurance and other regulations limit the amount of dividends, loans and advances available from the Company's insurance subsidiaries

The Company is a holding company whose primary assets are investments in its operating subsidiaries. The Company's ability to pay dividends is dependent on the ability of its subsidiaries to pay dividends or repay funds. If the Company's operating subsidiaries are not able to pay dividends or repay funds, the Company may not be able to fulfill parent company obligations and/or declare and pay dividends to its stockholders. Moreover, pursuant to insurance and other regulations under which the Company's insurance subsidiaries operate, the amount of dividends, loans and advances available is limited. As of September 30, 2018, under such regulations, the maximum amount available in 2018 from these insurance subsidiaries, without prior approval from applicable regulators, was dividends of \$230.2 million and loans and advances of \$95.9 million.

22. Certain provisions of the Company's bylaws and certificate of incorporation may reduce the likelihood of any unsolicited acquisition proposal or potential change of control that the Company's stockholders might consider favorable

The Company's bylaws and certificate of incorporation contain provisions that could be considered "anti-takeover" provisions because they make it harder for a third-party to acquire the Company without the consent of the Company's incumbent board of directors. Under these provisions:

- election of the Company's board of directors is staggered such that only one-third of the directors are elected by the stockholders each year and the directors serve three year terms prior to reelection;
- stockholders may not remove directors without cause, change the size of the board of directors or, except as may be provided for in the terms of preferred stock the Company issues in the future, fill vacancies on the board of directors;
- stockholders may act only at stockholder meetings and not by written consent;
- stockholders must comply with advance notice provisions for nominating directors or presenting other proposals at stockholder meetings; and
- the Company's board of directors may without stockholder approval issue preferred shares and determine their rights and terms, including voting rights, or adopt a stockholder rights plan.

While the Company believes that they are appropriate, these provisions, which may only be amended by the affirmative vote of the holders of approximately 67% of the Company's issued voting shares, could have the effect of discouraging an unsolicited acquisition proposal or delaying, deferring or preventing a change of control transaction that might involve a premium price or otherwise be considered favorably by the Company's stockholders.

## Item 6. Exhibits.

Each management contract or compensatory plan or arrangement in which any director or named executive officer of First American Financial Corporation, as defined by Item 402(a)(3) of Regulation S-K (17 C.F.R. §229.402(a)(3)), participates that is included among the exhibits listed on the Exhibit Index is identified on the Exhibit Index by an asterisk (\*).

Exhibit No.	Description	Location
3.1	<u>Amended and Restated Certificate of Incorporation of First American Financial Corporation dated May 28, 2010.</u>	Incorporated by reference herein to Exhibit 3.1 to the Current Report on Form 8-K filed June 1, 2010.
3.2	<u>Bylaws of First American Financial Corporation, effective as of August 16, 2017.</u>	Incorporated by reference herein to Exhibit 3.1 to the Current Report on Form 8-K filed August 22, 2017.
31(a)	<u>Certification by Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.</u>	Attached.
31(b)	<u>Certification by Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.</u>	Attached.
32(a)	<u>Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350.</u>	Attached.
32(b)	<u>Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.</u>	Attached.
101.INS	XBRL Instance Document.	Attached.
101.SCH	XBRL Taxonomy Extension Schema Document.	Attached.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	Attached.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	Attached.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	Attached.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	Attached.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FIRST AMERICAN FINANCIAL CORPORATION

(Registrant)

By /s/ Dennis J. Gilmore  
Dennis J. Gilmore  
Chief Executive Officer

(Principal Executive Officer)

By /s/ Mark E. Seaton  
Mark E. Seaton  
Chief Financial Officer

(Principal Financial Officer)

Date: October 25, 2018