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First American Financial Corp
Form 10-Q
July 26, 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 June 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

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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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post 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

(Do not check if a smaller reporting company) 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 July 20, 2018, there were 111,658,912 shares of common stock outstanding.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

INFORMATION INCLUDED IN REPORT

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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 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)

| | June 30, | December |
|---|-------------|-------------|
| | 2018 | 31, |
| | 2017 | |
| Assets | | |
| Cash and cash equivalents | \$1,226,510 | \$1,387,226 |
| Accounts and accrued income receivable, net | 348,621 | 311,084 |
| Income taxes receivable | 35,776 | 38,673 |
| Investments: | | |
| Deposits with banks | 40,991 | 41,335 |
| Debt securities, includes pledged securities of \$105,248 and \$108,427 | 5,119,843 | 4,752,684 |
| Equity securities | 438,695 | 466,516 |
| Other investments | 116,582 | 117,768 |
| | 5,716,111 | 5,378,303 |
| Secured financings receivable | 96,148 | — |
| Property and equipment, net | 446,290 | 439,569 |
| Title plants and other indexes | 573,069 | 568,452 |
| Deferred income taxes | 22,803 | 22,803 |
| Goodwill | 1,166,976 | 1,113,005 |
| Other intangible assets, net | 104,258 | 99,913 |
| Other assets | 222,834 | 214,194 |
| | \$9,959,396 | \$9,573,222 |
| Liabilities and Equity | | |
| Deposits | \$3,298,160 | \$3,070,566 |
| Accounts payable and accrued liabilities | 770,660 | 793,157 |
| Deferred revenue | 239,528 | 240,822 |
| Reserve for known and incurred but not reported claims | 1,022,928 | 1,028,933 |
| Income taxes payable | 5,032 | 4,602 |
| Deferred income taxes | 219,307 | 219,307 |
| Secured financings payable | 96,166 | — |
| Notes and contracts payable | 736,393 | 732,810 |
| | 6,388,174 | 6,090,197 |
| Commitments and contingencies (Note 14) | | |
| Stockholders' equity: | | |

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| | | |
|--|-------------|-------------|
| Preferred stock, \$0.00001 par value; Authorized—500 shares; Outstanding—none | — | — |
| Common stock, \$0.00001 par value; Authorized—300,000 shares; Outstanding—111,658 shares and 110,925 shares | 1 | 1 |
| Additional paid-in capital | 2,254,253 | 2,236,351 |
| Retained earnings | 1,496,638 | 1,311,112 |
| Accumulated other comprehensive loss | (181,369) | (67,509) |
| Total stockholders' equity | 3,569,523 | 3,479,955 |
| Noncontrolling interests | 1,699 | 3,070 |
| Total equity | 3,571,222 | 3,483,025 |
| | \$9,959,396 | \$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 June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| Revenues | | | | |
| Direct premiums and escrow fees | \$661,582 | \$641,080 | \$1,205,460 | \$1,168,089 |
| Agent premiums | 559,004 | 554,028 | 1,086,718 | 1,128,610 |
| Information and other | 208,752 | 201,851 | 397,410 | 384,360 |
| Net investment income | 56,334 | 39,609 | 99,126 | 72,649 |
| Net realized investment gains (losses) | 5,485 | 17,861 | (169) | 17,764 |
| | 1,491,157 | 1,454,429 | 2,788,545 | 2,771,472 |
| Expenses | | | | |
| Personnel costs | 448,974 | 436,441 | 862,616 | 843,578 |
| Premiums retained by agents | 439,550 | 435,771 | 856,187 | 889,697 |
| Other operating expenses | 228,935 | 230,791 | 447,415 | 446,193 |
| Provision for policy losses and other claims | 113,619 | 110,958 | 214,199 | 213,346 |
| Depreciation and amortization | 31,058 | 30,145 | 60,805 | 60,292 |
| Premium taxes | 17,049 | 17,179 | 33,063 | 32,627 |
| Interest | 10,004 | 8,990 | 19,227 | 17,705 |
| | 1,289,189 | 1,270,275 | 2,493,512 | 2,503,438 |
| Income before income taxes | 201,968 | 184,154 | 295,033 | 268,034 |
| Income taxes | 46,877 | 62,259 | 63,770 | 88,070 |
| Net income | 155,091 | 121,895 | 231,263 | 179,964 |
| Less: Net loss attributable to noncontrolling interests | (49) | (362) | (104) | (575) |
| Net income attributable to the Company | \$155,140 | \$122,257 | \$231,367 | \$180,539 |
| Net income per share attributable to the Company's | | | | |
| stockholders (Note 9): | | | | |
| Basic | \$1.38 | \$1.10 | \$2.06 | \$1.62 |
| Diluted | \$1.37 | \$1.09 | \$2.05 | \$1.61 |
| Cash dividends declared per share | \$0.38 | \$0.34 | \$0.76 | \$0.68 |
| Weighted-average common shares outstanding (Note 9): | | | | |
| Basic | 112,556 | 111,549 | 112,406 | 111,374 |
| Diluted | 113,117 | 112,199 | 113,093 | 112,026 |

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 | | Six Months Ended | |
|---|--------------------|-----------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$155,091 | \$121,895 | \$231,263 | \$179,964 |
| Other comprehensive income (loss), net of tax: | | | | |
| Unrealized (losses) gains on securities | (12,475) | 12,634 | (59,271) | 38,085 |
| Foreign currency translation adjustment | (10,545) | 8,709 | (14,297) | 12,143 |
| Pension benefit adjustment | 119 | 3,637 | 239 | 7,170 |
| Total other comprehensive income (loss), net of tax | (22,901) | 24,980 | (73,329) | 57,398 |
| Comprehensive income | 132,190 | 146,875 | 157,934 | 237,362 |
| Less: Comprehensive loss attributable to noncontrolling interests | (49) | (362) | (123) | (568) |
| Comprehensive income attributable to the Company | \$132,239 | \$147,237 | \$158,057 | \$237,930 |

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statement of Stockholders' Equity

(in thousands)

(unaudited)

 First American Financial Corporation Stockholders
 Accumulated

| | Shares | Additional paid-in stock capital | Retained earnings | other comprehensive loss | Total equity | stockholders' 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 six months ended June 30, 2018 | — | — | 231,367 | — | 231,367 | (104) | 231,263 |
| Dividends on common shares | — | — | (84,717) | — | (84,717) | — | (84,717) |
| Shares issued in connection with share-based compensation plans | 733 | (9,555) | (1,674) | — | (11,229) | — | (11,229) |
| Share-based compensation | — | 27,135 | — | — | 27,135 | — | 27,135 |
| Net activity related to noncontrolling interests | — | 322 | — | — | 322 | (1,248) | (926) |
| Other comprehensive loss (Note 13) | — | — | — | (73,310) | (73,310) | (19) | (73,329) |
| Balance at June 30, 2018 | 111,658 | \$ 1 \$2,254,253 | \$1,496,638 | \$(181,369) | \$3,569,523 | \$ 1,699 | \$3,571,222 |

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

| | Six Months Ended | |
|---|------------------|-------------|
| | June 30, 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net income | \$231,263 | \$179,964 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Provision for policy losses and other claims | 214,199 | 213,346 |
| Depreciation and amortization | 60,805 | 60,292 |
| Amortization of premiums and accretion of discounts on debt securities, net | 13,451 | 16,666 |
| Net realized investment losses (gains) | 169 | (17,764) |
| Share-based compensation | 27,135 | 24,580 |
| Equity in earnings of affiliates, net | (708) | (3,447) |
| Dividends from equity method investments | 1,774 | 5,562 |
| Changes in assets and liabilities excluding effects of acquisitions and noncash transactions: | | |
| Claims paid, including assets acquired, net of recoveries | (213,538) | (225,849) |
| Net change in income tax accounts | 20,560 | 104,656 |
| Increase in accounts and accrued income receivable | (36,700) | (18,411) |
| Decrease in accounts payable and accrued liabilities | (59,871) | (92,662) |
| (Decrease) increase in deferred revenue | (1,149) | 2,468 |
| Other, net | (3,290) | (14,797) |
| Cash provided by operating activities | 254,100 | 234,604 |
| Cash flows from investing activities: | | |
| Net cash effect of acquisitions/dispositions | (73,757) | (3,933) |
| Net (increase) decrease in deposits with banks | (757) | 110 |
| Purchases of debt and equity securities | (1,166,788) | (1,029,861) |
| Proceeds from sales of debt and equity securities | 470,670 | 499,526 |
| Proceeds from maturities of debt securities | 282,754 | 276,843 |
| Net change in other investments | 563 | 2,105 |
| Advances under secured financing agreements | (580,162) | — |
| Collections of secured financings receivable | 553,632 | — |
| Capital expenditures | (55,720) | (69,553) |
| Proceeds from sales of property and equipment | 1,624 | 9,013 |
| Cash used for investing activities | (567,941) | (315,750) |
| Cash flows from financing activities: | | |
| Net change in deposits | 227,594 | 318,318 |

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| | | |
|--|-------------|-------------|
| Borrowings under secured financing agreements | 579,871 | — |
| Repayments of secured financings payable | (553,513) | — |
| Repayments of notes and contracts payable | (2,681) | (2,660) |
| Net activity related to noncontrolling interests | (920) | (879) |
| Net payments in connection with share-based compensation plans | (11,229) | (2,167) |
| Cash dividends | (84,717) | (75,099) |
| Cash provided by financing activities | 154,405 | 237,513 |
| Effect of exchange rate changes on cash | (1,280) | 4,259 |
| Net (decrease) increase in cash and cash equivalents | (160,716) | 160,626 |
| Cash and cash equivalents—Beginning of period | 1,387,226 | 1,006,138 |
| Cash and cash equivalents—End of period | \$1,226,510 | \$1,166,764 |
| Supplemental information: | | |
| Cash paid (received) during the period for: | | |
| Interest | \$18,591 | \$16,811 |
| Premium taxes | \$42,840 | \$41,652 |
| Income taxes, less refunds of \$18 and \$51,904 | \$42,456 | \$(16,696) |

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 \$8.0 million and \$16.0 million were reclassified from personnel costs to other operating expenses on the condensed consolidated statements of income for the three and six months ended June 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 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 the new 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 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.

FIRST AMERICAN FINANCIAL CORPORATION
AND SUBSIDIARY COMPANIES

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

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.

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 June 30, 2018. Revenues recognized during the three and six months ended June 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 \$8.7 billion and \$7.5 billion at June 30, 2018 and December 31, 2017, respectively, of which \$3.2 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 \$3.7 billion at June 30, 2018 and December 31, 2017. 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.

FIRST AMERICAN FINANCIAL CORPORATION
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Notes to Condensed Consolidated Financial Statements – (Continued)
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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 \$2.5 billion and \$2.6 billion at June 30, 2018 and December 31, 2017, respectively. 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.

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 |
|--|-------------------|---------------------------|-------------|-------------------------|
| June 30, 2018 | | | | |
| U.S. Treasury bonds | \$172,266 | \$512 | \$(3,058) | \$169,720 |
| Municipal bonds | 1,106,608 | 5,841 | (18,014) | 1,094,435 |
| Foreign government bonds | 148,289 | 305 | (2,674) | 145,920 |
| Governmental agency bonds | 262,355 | 463 | (5,798) | 257,020 |
| Governmental agency mortgage-backed securities | 2,475,714 | 2,985 | (39,449) | 2,439,250 |
| U.S. corporate debt securities | 761,229 | 2,332 | (14,637) | 748,924 |
| Foreign corporate debt securities | 268,118 | 862 | (4,406) | 264,574 |
| | \$5,194,579 | \$13,300 | \$(88,036) | \$5,119,843 |
| 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 |

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| | | | | |
|-----------------------------------|-------------|----------|------------|-------------|
| 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 \$0.7 million and \$1.3 million, realized losses of \$2.6 million and \$3.8 million, and proceeds of \$186.6 million and \$342.3 million for the three and six months ended June 30, 2018, respectively, and realized gains of \$1.3 million and \$2.9 million, realized losses of \$0.3 million and \$3.5 million, and proceeds of \$139.6 million and \$294.0 million for the three and six months ended June 30, 2017, respectively.

FIRST AMERICAN FINANCIAL CORPORATION
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Notes to Condensed Consolidated Financial Statements – (Continued)
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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) | | | | | | |
| June 30, 2018 | | | | | | |
| U.S. Treasury bonds | \$ 111,297 | \$ (1,927) | \$ 34,287 | \$ (1,131) | \$ 145,584 | \$ (3,058) |
| Municipal bonds | 473,525 | (5,656) | 227,275 | (12,358) | 700,800 | (18,014) |
| Foreign government bonds | 72,240 | (1,265) | 35,537 | (1,409) | 107,777 | (2,674) |
| Governmental agency bonds | 118,367 | (2,185) | 116,299 | (3,613) | 234,666 | (5,798) |
| Governmental agency mortgage-backed securities | 1,079,083 | (19,034) | 757,050 | (20,415) | 1,836,133 | (39,449) |
| U.S. corporate debt securities | 511,761 | (11,007) | 60,723 | (3,630) | 572,484 | (14,637) |
| Foreign corporate debt securities | 179,776 | (3,833) | 21,263 | (573) | 201,039 | (4,406) |
| | \$ 2,546,049 | \$ (44,907) | \$ 1,252,434 | \$ (43,129) | \$ 3,798,483 | \$ (88,036) |
| 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 June 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 June 30, 2018.

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Notes to Condensed Consolidated Financial Statements – (Continued)
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Investments in debt securities at June 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 | | |
| U.S. Treasury bonds | | | | | |
| Amortized cost | \$ 31,771 | \$ 48,201 | \$ 40,899 | \$ 51,395 | \$ 172,266 |
| Estimated fair value | \$ 31,647 | \$ 47,291 | \$ 40,044 | \$ 50,738 | \$ 169,720 |
| Municipal bonds | | | | | |
| Amortized cost | \$ 73,033 | \$ 295,362 | \$ 300,483 | \$ 437,730 | \$ 1,106,608 |
| Estimated fair value | \$ 73,044 | \$ 295,138 | \$ 297,958 | \$ 428,295 | \$ 1,094,435 |
| Foreign government bonds | | | | | |
| Amortized cost | \$ 19,550 | \$ 101,513 | \$ 11,382 | \$ 15,844 | \$ 148,289 |
| Estimated fair value | \$ 19,520 | \$ 100,893 | \$ 11,081 | \$ 14,426 | \$ 145,920 |
| Governmental agency bonds | | | | | |
| Amortized cost | \$ 31,852 | \$ 100,514 | \$ 76,537 | \$ 53,452 | \$ 262,355 |
| Estimated fair value | \$ 31,763 | \$ 98,014 | \$ 75,784 | \$ 51,459 | \$ 257,020 |
| U.S. corporate debt securities | | | | | |
| Amortized cost | \$ 21,982 | \$ 356,138 | \$ 311,501 | \$ 71,608 | \$ 761,229 |
| Estimated fair value | \$ 21,951 | \$ 351,759 | \$ 305,639 | \$ 69,575 | \$ 748,924 |
| Foreign corporate debt securities | | | | | |
| Amortized cost | \$ 20,650 | \$ 152,492 | \$ 82,081 | \$ 12,895 | \$ 268,118 |
| Estimated fair value | \$ 20,639 | \$ 151,135 | \$ 80,145 | \$ 12,655 | \$ 264,574 |
| Total debt securities excluding mortgage-backed securities | | | | | |
| Amortized cost | \$ 198,838 | \$ 1,054,220 | \$ 822,883 | \$ 642,924 | \$ 2,718,865 |
| Estimated fair value | \$ 198,564 | \$ 1,044,230 | \$ 810,651 | \$ 627,148 | \$ 2,680,593 |
| Total mortgage-backed securities | | | | | |
| Amortized cost | | | | | \$ 2,475,714 |
| Estimated fair value | | | | | \$ 2,439,250 |
| Total debt securities | | | | | |
| Amortized cost | | | | | \$ 5,194,579 |
| Estimated fair value | | | | | \$ 5,119,843 |

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.

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Notes to Condensed Consolidated Financial Statements – (Continued)
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Investments in equity securities are as follows:

| | Estimated | |
|-------------------|------------|------------|
| (in thousands) | Cost | fair value |
| June 30, 2018 | | |
| Preferred stocks | \$ 18,292 | \$ 17,946 |
| Common stocks | 378,396 | 420,749 |
| | \$ 396,688 | \$ 438,695 |
| 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 of \$7.7 million and \$1.8 million were recognized for the three and six months ended June 30, 2018, respectively, as a result of changes in the fair values of equity securities. Included in net gains during the three and six months ended June 30, 2018, were net unrealized gains of \$5.6 million and \$1.8 million, respectively, related to equity securities still held at June 30, 2018. For the three and six months ended June 30, 2017, sales of equity securities resulted in realized gains of \$15.4 million and \$17.2 million and realized losses of \$1.6 million and \$1.7 million, respectively.

The composition of the investment portfolio at June 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 | \$ 169,720 | 100.0 | \$ — | — | \$ — | — | \$ 169,720 | 100.0 |
| Municipal bonds | 1,011,354 | 92.4 | 59,805 | 5.5 | 23,276 | 2.1 | 1,094,435 | 100.0 |
| Foreign government bonds | 117,244 | 80.3 | 23,596 | 16.2 | 5,080 | 3.5 | 145,920 | 100.0 |

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| | | | | | | | | |
|--|-----------|-------|---------|------|---------|------|-----------|-------|
| Governmental agency bonds | 257,020 | 100.0 | — | — | — | — | 257,020 | 100.0 |
| Governmental agency mortgage-backed securities | 2,439,250 | 100.0 | — | — | — | — | 2,439,250 | 100.0 |
| U.S. corporate debt securities | 301,840 | 40.3 | 245,345 | 32.8 | 201,739 | 26.9 | 748,924 | 100.0 |
| Foreign corporate debt securities | 122,937 | 46.5 | 110,837 | 41.9 | 30,800 | 11.6 | 264,574 | 100.0 |
| Total debt securities | 4,419,365 | 86.3 | 439,583 | 8.6 | 260,895 | 5.1 | 5,119,843 | 100.0 |
| Preferred stocks | 58 | 0.3 | | | | | | |