'Fundamentally changed' title insurer primed for housing recovery

By Rodger Nayak

Stewart Information Services Corp. revamped its operating structure during the years following the financial crisis, when falling transaction volumes, collapsing home prices and rising claim rates created strong headwinds for the company.

Many of its peers have also slashed costs, and in the past year, title insurers have shown signs that their crisis-era woes are mostly behind them. Notably, in the second half of 2012, buoyed by a refinance boom and nascent housing recovery, Stewart's stock price gained more than almost any other in the SNL Insurance Index, rising 69.28%.

CEO Matthew Morris told SNL that Stewart is "80% to 85%" finished with the "heavy lifting" of its restructuring. Because of an increase in operating margins, Stewart's bottom line will see greater improvement as the housing market recovers than during past cycles.

The following is an edited, condensed transcript of his conversation with SNL.

SNL Financial: How did the financial crisis impact Stewart?

Matthew Morris: It had a significant effect on us as an industry and as an organization. In order to adapt to the general economic conditions, we had to pull back over 5,000 people. We had to scale down. We had to close hundreds of offices, and really we were in a time of a drastically falling number of transactions, which is our primary source of revenue. In addition to that, the price we charge is dependent on the value of real estate. So while the transactions were falling precipitously, so were our prices. We had price compression and transaction compression, which really affected the industry overall, so we had to undertake a lot of downsizing to adapt to that.

On the positive side, just as the market began to fall, we laid out some pretty aggressive strategies to reorganize and restructure our company that really escalated as the market started falling. A lot of that is moving from simply a parent company, holding company model to more of a leveraged operating model. We undertook an internal consolidation effort in which we consolidated hundreds of legal entities. We consolidated 600 accounting systems. We centralized hundreds of data centers and really created a functional shared services back office with all IT functions, HR functions, finance and accounting functions and procurement functions.

The effort really allowed us not just to reduce our cost but also to change our face to the customer and hopefully become more customer-centric. The company historically was structured more geographically, and as the world got flat and end customers were not as geographically constrained, that model didn't work anymore. So we realigned our management team around our delivery channels.

We tried to leverage the downturn to expedite some pretty fundamental changes in our business model that both align us toward more aggressive sales and customer centricity while also providing a much more flexible and reduced cost structure.

Has Stewart fully dealt with the problems it encountered during the crisis? Are you most of the way there?

I think we are. The trends are all headed in the right direction. There's still some litigation that is somewhat of a hangover. The other issue to point out is that at the same time our revenues were falling precipitously, our claims were increasing precipitously. We were paying claims that were highly elevated due to the crisis but were also off a very high transaction volume, so that really was unsustainable.

Right now, we see our cost structure coming back in line; a lot of changes that we've made have enabled that. We see our claims ratio is trending down, our reserve ratio is trending down. We're starting to see some increase in transaction volume, both from a resale purchase environment as well as obviously the refi market, which has picked up significantly.

One caveat: We as an organization through the restructuring have really focused on service models of delivery, and so we're not as centered on the refi environment. Our percentage of refinance transactions is about half of what the industry's is. This is essentially by design. It's just not a market that we have pursued, and one that we feel will not be around for a long time, so we continue to focus on the purchase market, continue to work on strategies for the commercial market, which we see coming back.

What do you make of the housing recovery so far? What more needs to happen, and what are your expectations for the next year?
The crystal ball is hazy, which you probably get tired of hearing, I would guess. There has been some recovery. We view jobs as the lynchpin of what we need to fully recover. But what we are seeing in several markets is that it's becoming a buyer's market. We have underbuilt for the population we are trying to support, and assuming we have even some job growth, we see a continuing rise in the purchase market. The population is definitely there to support pretty rapid recovery.

Do you see a gap between when the refinance boom ends and when housing purchase activity significantly recovers?

That's hard to judge. In our mind, I think we're going to have an easier time because we're not as exposed to refinance activity as the overall market is. I think we're already seeing mortgage applications starting to fall, not only because rates are rising but also because people that can refi have refi'd. My guess is rates will stay low, the refi trend will slowly move down, and there's going to be a supply issue in housing.

You talked about changes to your organization and improving your cost structure. Do you think this time around, as the housing market rebounds, Stewart will benefit to a greater extent than during past cycles?

The answer is overwhelmingly yes. In Q3, we had 40% incremental margins on the additional revenue, which was really the first time we've had significant margin increase as our revenue increased. In our previous model, you had a lot of duplication so you didn't have higher margins as our revenue was growing. So we're seeing the model definitely pay off, and we'll continue to do so as it grows. There are still some activities that we have to finish as part of the longer strategic plan. But I'd say we're 80% or 85% done with kind of the heavy lifting of redoing the structure and aligning and simplifying the organizations. Some additional cost savings are there, but we've already seen what it can do to the bottom line as revenues increase.

An analyst has mentioned that improving your credit rating to A would be beneficial. How will it boost Stewart's business?

One area where we have not been able to achieve as much as we want is on the commercial side of our business. We have great underwriting staff, we have great resources going for our commercial business, but a lot of the money has moved toward large pension funds and large life insurance companies, where they definitely have policies around ratings. We're BBB+, we're one notch away, but once we move into the A rating, they can fully utilize us, and they have expressed much interest in doing so given the support and expertise we bring to the table.

Not only will that allow us to handle more transactions, but also the amount of retention on each transaction will elevate. In other words, right now when we do a commercial transaction and somebody limits us to $200 million, we need to bring another company in for the rest. With the A rating, we could double that, and essentially a lot of our work is the same. We still have the risk premium that we have to expense, but being able to keep a $400 million policy instead of a $200 million one will definitely help the bottom line and the margins in the commercial space.

A lot of that is dependent on the rating agencies, and they haven't fared extremely well through the financial downturn. They're much quicker to decrease a rating than to increase it. But we have good communication with them. They want to see more of the same is what we're hearing from them. So we have good expectations that we'll get our A back, and that will elevate our commercial business.

Do you think your stock is undervalued?

Always. I think overall we're very pleased with how the stock has performed over the last year, and I get a lot of questions of, was it a one-time hit? But we have fundamentally changed our model. We think there are some more efficiencies to be gained, and on top of that, we think we have a housing recovery. And the flip side of what we talked about on the downturn is true: We will have increasing transactions, which is very helpful, but in addition to that, increasing prices because of the rising value of real estate.