STEWART INFORMATION SERVICES CORP
Form 10-Q
August 08, 2006

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

or

o **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 001-02658

STEWART INFORMATION SERVICES CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	**74-1677330**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1980 Post Oak Blvd., Houston TX	**77056**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(713) 625-8100**

(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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of August 2, 2006.

Common	17,173,388
Class B Common	1,050,012

FORM 10-Q
QUARTER ENDED JUNE 30, 2006
TABLE OF CONTENTS

As used in this report, we , us , our , the Company and Stewart mean Stewart Information Services Corporation an subsidiaries, unless the context indicates otherwise.

Table of Contents

STEWART INFORMATION SERVICES CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE EARNINGS

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30 2006	JUNE 30 2005	**JUNE 30 2006**	JUNE 30 2005
	($000 omitted)			
Revenues				
Title insurance:				
Direct operations	**276,391**	278,941	**504,209**	491,815
Agency operations	**340,189**	341,500	**621,843**	615,185
Real estate information services	**18,957**	20,688	**38,976**	38,315
Investment income	**8,396**	7,149	**16,933**	13,457
Investment and other gains net	**796**	2,801	**2,191**	3,269
	644,729	651,079	**1,184,152**	1,162,041
Expenses				
Amounts retained by agencies	**274,935**	279,637	**501,811**	503,224
Employee costs	**183,669**	173,873	**362,771**	329,490
Other operating expenses	**107,441**	91,967	**197,245**	172,964
Title losses and related claims	**39,217**	30,213	**64,475**	52,344
Depreciation and amortization	**8,426**	8,244	**17,114**	16,050
Interest	**1,417**	778	**2,847**	1,395
	615,105	584,712	**1,146,263**	1,075,467
Earnings before taxes and minority interests	**29,624**	66,367	**37,889**	86,574
Income taxes	**8,739**	23,543	**10,489**	30,161
Minority interests	**5,175**	5,597	**9,043**	8,520
Net earnings	**15,710**	37,227	**18,357**	47,893
Average number of shares outstanding basic (000)	**18,222**	18,130	**18,203**	18,127
Average number of shares outstanding assuming dilution (000)	**18,310**	18,227	**18,306**	18,226
Earnings per share basic	**0.86**	2.05	**1.01**	2.64
Earnings per share diluted	**0.86**	2.04	**1.00**	2.63

Comprehensive earnings:				
Net earnings	**15,710**	37,227	**18,357**	47,893
Changes in other comprehensive earnings, net of taxes of ($1,259), $2,144, ($2,875) and ($617)	**(2,339)**	3,982	**(5,340)**	(1,145)
Comprehensive earnings	**13,371**	41,209	**13,017**	46,748

See notes to condensed consolidated financial statements.

Table of Contents

STEWART INFORMATION SERVICES CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	JUNE 30 2006	DEC 31 2005
	($000 omitted)	
Assets		
Cash and cash equivalents	**137,880**	134,734
Short-term investments	**147,324**	206,717
Investments statutory reserve funds	**459,072**	449,475
Investments other	**85,058**	85,802
Receivables premiums from agencies	**46,300**	49,397
Receivables other	**53,635**	47,791
Allowance for uncollectible amounts	**(8,537)**	(8,526)
Property and equipment	**93,001**	85,762
Title plants	**67,926**	58,930
Goodwill	**178,844**	155,624
Intangible assets	**14,683**	15,268
Other assets	**85,729**	80,177
	1,360,915	1,361,151
Liabilities		
Notes payable	**91,274**	88,413
Accounts payable and accrued liabilities	**99,772**	125,255
Estimated title losses	**358,748**	346,704
Deferred income taxes	**9,882**	15,784
Minority interests	**19,007**	18,682
	578,683	594,838
Contingent liabilities and commitments		
Stockholders equity		
Common and Class B Common Stock and additional paid-in capital	**148,269**	145,367
Retained earnings	**637,589**	619,232
Accumulated other comprehensive earnings	**288**	5,628
Treasury stock 325,829 shares	**(3,914)**	(3,914)
Total stockholders equity (18,223,400 and 18,154,487 shares outstanding)	**782,232**	766,313
	1,360,915	1,361,151

See notes to condensed consolidated financial statements.

Table of Contents

STEWART INFORMATION SERVICES CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	SIX MONTHS ENDED	
	JUNE 30 2006	JUNE 30 2005
	($000 omitted)	
Reconciliation of net earnings to cash provided by operating activities:		
Net earnings	**18,357**	47,893
Add (deduct):		
Depreciation and amortization	**17,114**	16,050
Provisions for title losses in excess of payments	**9,320**	18,903
Decrease (increase) in receivables net	**4,551**	(6,098)
Increase in other assets net	**(6,009)**	(1,418)
(Decrease) increase in payables and accrued liabilities net	**(36,424)**	1,648
Minority interests	**9,043**	8,520
Net earnings from equity investees	**(2,559)**	(3,088)
Dividends from equity investees	**2,392**	1,716
Provisions for deferred taxes	**(2,693)**	5,245
Realized investment gains	**(2,191)**	(3,269)
Other net	**1,888**	1,267
Cash provided by operating activities	**12,789**	87,369
Investing activities:		
Proceeds from investments matured and sold	**264,818**	258,053
Purchases of investments	**(209,513)**	(317,699)
Purchases of property and equipment, title plants and real estate net	**(16,977)**	(16,847)
Increases in notes receivable	**(934)**	(926)
Collections on notes receivable	**683**	539
Proceeds from sale of equity investees		7,775
Cash paid for equity investees and related intangibles net		(850)
Cash paid for acquisitions of subsidiaries net (see supplemental information below)	**(35,268)**	(9,403)
Cash provided (used) by investing activities	**2,809**	(79,358)
Financing activities:		
Distributions to minority interests	**(8,638)**	(6,468)
Proceeds from exercise of stock options	**851**	
Proceeds from notes payable	**7,467**	6,592
Payments on notes payable	**(13,951)**	(8,418)
Cash used by financing activities	**(14,271)**	(8,294)
Effects of changes in foreign currency exchange rates	**1,819**	(1,490)
Increase (decrease) in cash and cash equivalents	**3,146**	(1,773)

Cash and cash equivalents at beginning of period	**134,734**	121,383
Cash and cash equivalents at end of period	**137,880**	119,610
Supplemental information:		
Assets acquired:		
Goodwill	**23,206**	20,363
Investments	**13,429**	
Property and equipment	**4,906**	881
Title plants	**8,978**	1,876
Intangible assets	**1,942**	3,033
Other	**86**	473
Liabilities assumed	**(7,219)**	(600)
Debt issued	**(10,060)**	(16,623)
Cash paid for acquisitions of subsidiaries net	**35,268**	9,403

See notes to condensed consolidated financial statements.

Table of Contents

STEWART INFORMATION SERVICES CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1

Interim financial statements. The financial information contained in this report for the three and six month periods ended June 30, 2006 and 2005, and as of June 30, 2006, is unaudited. In the opinion of management, all adjustments necessary for a fair presentation of this information for all unaudited periods, consisting only of normal recurring accruals, have been made. The results of operations for the interim periods are not necessarily indicative of results for a full year. This report should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Certain amounts in the 2005 condensed consolidated financial statements have been reclassified for comparative purposes. Net earnings and stockholders equity, as previously reported, were not affected.

NOTE 2

Stock option plans. The Company combined its two stock option plans into a single plan in April 2005. Effective January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment , using the modified prospective method under which share-based compensation expense is recognized for new share-based awards granted and any outstanding awards that are modified, repurchased or cancelled. All options are granted at the market price of the Company s Common Stock on the date of grant and are immediately exercisable. The Company has no unvested awards.

During the quarter ended June 30, 2006, the Company recognized compensation expense related to options granted of $0.4 million based on a fair value per option of $16.32. Under SFAS No. 123(R), compensation expense is recognized for the fair value of the employees purchase rights, which is estimated using the Black-Scholes Model. The Company assumed a dividend yield of 2.0%, an expected life of seven years, an expected volatility of 35.1% and a risk-free interest rate of 8.0% for the three months ended June 30, 2006.

A summary of the status of the Company s stock option plan follows:

	Shares	Weighted average exercise prices ($)
Exercisable at December 31, 2005	449,634	27.75
Granted	26,000	38.01
Exercised	(42,278)	20.13
Exercisable at June 30, 2006	**433,356**	**29.11**

At June 30, 2006, the weighted average remaining contractual life of options outstanding was 6.2 years and the aggregate intrinsic value was $3.1 million. The aggregate intrinsic value of options exercised during the six months ended June 30, 2006 was $1.2 million. In addition, the Company recognized a tax benefit of $0.3 million related to these exercised options.

Table of Contents

Prior to the adoption of SFAS No. 123(R), the Company applied the intrinsic value method of APB No. 25, Accounting for Stock Issued to Employees , and related Interpretations in accounting for the plans. Accordingly, no stock-based employee compensation expense was reflected in net earnings as all options granted had an exercise price equal to the market value of the Common Stock on the date of grant.

Had compensation expense been determined consistent with SFAS No. 123(R), the fair value of the employees purchase rights would have been estimated using the Black-Scholes Model assuming a dividend yield of 1.1% to 1.2%, an expected life of ten years, an expected volatility of 34.5% to 34.6% and a risk-free interest rate of 5.5% to 6.0% for the three and six months ended June 30, 2005. The effect on the Company s net earnings and earnings per share for the three and six months ended June 30, 2005 would have been reduced to the pro forma amounts below (in thousands of dollars, except per share amounts):

	JUNE 30, 2005	
	THREE MONTHS	SIX MONTHS
Net earnings:		
As reported	37,227	47,893
Stock-based employee compensation determined under the fair value method, net of taxes	(303)	(1,186)
Pro forma	36,924	46,707
Earnings per share:		
Net earnings basic	2.05	2.64
Pro forma basic	2.04	2.58
Net earnings diluted	2.04	2.63
Pro forma diluted	2.03	2.56

NOTE 3

Equity investees. Earnings related to equity investees (in which the Company typically owns 20% through 50% of the equity) were $1.5 million and $2.2 million for the quarters ended June 30, 2006 and 2005, respectively, and $2.6 million and $3.1 million for the six months ended June 30, 2006 and 2005, respectively. These amounts are included in title insurance direct operations in the condensed consolidated statements of earnings and comprehensive earnings.

NOTE 4

Earnings per share. The Company s basic earnings per share was calculated by dividing net earnings by the weighted average number of shares of Common Stock and Class B Common Stock outstanding during the reporting period.

To calculate diluted earnings per share, the number of shares determined above was increased by assuming the issuance of all dilutive shares during the same reporting period. The treasury stock method was used to calculate the additional number of shares. The only potentially dilutive effect on earnings per share for the Company related to its stock option plans. In calculating the effect of the options and determining diluted earnings per share, the average number of shares used in calculating basic earnings per share was increased by 88,000 and 97,000 for the three months ended June 30, 2006 and 2005, respectively, and 103,000 and 99,000 for the six months ended June 30, 2006 and 2005, respectively.

Stock option grants to purchase 133,000 and 67,000 shares were excluded from the computation of diluted earnings per share for the three and six months ended June 30, 2006, respectively. These options were considered anti-dilutive because the exercise prices of the options were greater than the weighted-average market values of the shares for the periods. Stock option grants to purchase 141,000 and 125,000 shares were excluded from the computation of diluted earnings per share for the three and six months ended June 30, 2005, respectively, as these options were considered anti-dilutive.

Table of Contents

NOTE 5

Contingent liabilities and commitments. At June 30, 2006, the Company was contingently liable for guarantees of indebtedness owed primarily to banks and others by certain third parties. The guarantees relate primarily to business expansion and expire no later than 2019. At June 30, 2006, the maximum potential future payments on the guarantees amounted to $7,518,000. Management believes that the related underlying assets and available collateral, primarily corporate stock and title plants, would enable the Company to recover amounts paid under the guarantees. The Company believes no provision for losses is needed because no loss is expected on these guarantees. The Company s accrued liability related to the non-contingent value of third-party guarantees was $333,000 at June 30, 2006.

In the ordinary course of business the Company guarantees the third-party indebtedness of its consolidated subsidiaries. At June 30, 2006, the maximum potential future payments on the guarantees were not more than the notes payable recorded in the condensed consolidated balance sheets. The Company also guarantees the indebtedness related to lease obligations of certain of its consolidated subsidiaries. The maximum future obligations arising from these lease-related guarantees are not more than the Company s future minimum lease payments. In addition, the Company has unused letters of credit amounting to $3,298,000 related primarily to workers compensation coverage.

NOTE 6

Segment information. The Company s two reportable segments are title and real estate information. Selected financial information related to these segments follows:

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30 2006	JUNE 30 2005	**JUNE 30 2006**	JUNE 30 2005
	($000 omitted)			
Revenues:				
Title	**625,772**	630,391	**1,145,176**	1,123,726
REI	**18,957**	20,688	**38,976**	38,315
	644,729	651,079	**1,184,152**	1,162,041
Intersegment revenues:				
Title	**390**	216	**691**	550
REI	**837**	863	**1,938**	1,537
	1,227	1,079	**2,629**	2,087
Depreciation and amortization:				
Title	**7,618**	7,279	**15,481**	14,119
REI	**808**	965	**1,633**	1,931
	8,426	8,244	**17,114**	16,050
Earnings (loss) before taxes and minority interests:				
Title	**29,645**	63,217	**36,409**	82,085
REI	**(21)**	3,150	**1,480**	4,489
	29,624	66,367	**37,889**	86,574

	JUNE 30	DEC 31

	2006	2005
Identifiable assets:		
Title	**1,297,216**	1,302,949
REI	**63,699**	58,202
	1,360,915	1,361,151

Table of Contents

NOTE 7

Regulatory developments. Regulators periodically review title insurance premium rates and may seek reductions in the premium rates charged. The rates charged by title insurance underwriters in several states from which the Company derives a material portion of its revenues are currently under review with proposals to potentially enact significant premium rate decreases. These states include California, Texas, Florida and New York. While the Company cannot predict the outcome of these proposals, to the extent that rate decreases are enacted, the Company s results of operations and financial position will be adversely affected.

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

Management s overview. We reported net earnings of $15.7 million for the three months ended June 30, 2006, compared with net earnings of $37.2 million for the same period in 2005. On a diluted per share basis, net earnings were $0.86 for the second quarter of 2006 compared with net earnings of $2.04 for the second quarter of 2005. Revenues for the quarter decreased 1.0% to $644.7 million from $651.1 million for the same period last year.

The decrease in revenues and transactions handled in the second quarter of 2006 from the same period in 2005 resulted primarily from a reduction in residential closings due to a higher interest rate environment. Mortgage interest rates averaged 6.6% in the second quarter of 2006 compared with 5.7% in the second quarter of 2005. Acquisitions and strong growth in commercial transactions positively impacted revenues in the second quarter of 2006, partially offsetting the decrease in residential activity. Acquisitions increased revenues by $12.1 million for the quarter.

Profits for the second quarter of 2006 versus 2005 were reduced primarily by higher employee costs and other operating costs. Other operating costs increased primarily due to expenses associated with new offices, increased technology development and related security costs and litigation expenses. Employee costs were higher compared with the same period a year ago due to newly opened locations and increased technology-related services. Existing offices reduced employee counts overall by approximately 6% compared to the same period in the prior year. The Company is continually monitoring changes in transaction volume and cyclical developments in the marketplace to manage its current level of business and respond to opportunities with regard to both people and technology.

Critical accounting estimates. Actual results can differ from the accounting estimates we report. However, we believe there is no material risk of a change in our estimates that is likely to have a material impact on our reported financial condition or results of operations for the three and six months ended June 30, 2006 and 2005.

Title loss reserves

Our most critical accounting estimate is providing for title loss reserves. Our liability for estimated title losses at June 30, 2006 comprises both known claims ($68.5 million) and claims expected to be reported in the future ($290.2 million). The amount of the reserve represents the aggregate future payments, net of recoveries, that we expect to incur on policy and escrow losses and in costs to settle claims.

We base our estimates on reported claims, historical loss experience, title industry averages and the current legal and economic environment. In making estimates, we use moving-average ratios of recent actual policy loss payment experience (net of recoveries) to premium revenues.

Provisions for title losses, as a percentage of title operating revenues, were 5.7% and 4.7% for the six months ended June 30, 2006 and 2005, respectively. Actual loss payment experience, including the impact of large losses, is the primary reason for increases or decreases in our loss provision. A change of 0.5% in this percentage, a reasonably likely scenario based on historical loss experience, would have changed the provision for title losses and pretax earnings by approximately $5.6 million for the six months ended June 30, 2006.

Estimating future loss payments is difficult and our assumptions are subject to the risk of change. Claims, by their very nature, are complex and involve uncertainties as to the dollar amount and timing of individual payments. Our experience has been that most claims against policies and claim payments are made in the first six years after the policy has been issued, although claims are incurred and paid many years later.

Table of Contents

We have consistently followed the same basic method of estimating loss payments for more than ten years. Independent consulting actuaries have reviewed our title loss reserves and found them to be adequate at each year end for more than ten years.

Goodwill and other long-lived assets

Based on our annual evaluation of goodwill as of June 30th, which is completed in the third quarter, and events that may indicate impairment of the value of title plants and other long-lived assets, we estimate and expense any loss in value to our current operations. The process of determining impairment relies on projections of future cash flows, operating results and market conditions. Uncertainties exist in these projections and bear the risk of change related to factors such as interest rates and overall real estate markets. Actual market conditions and operating results may vary materially from our projections. There were no impairment write-offs of goodwill during the six months ended June 30, 2006 and 2005. We use independent appraisers to assist us in determining the fair value of our reporting units and assessing whether an impairment of goodwill exists.

Agency revenues

We recognize revenues on title insurance policies written by independent agencies (agencies) when the policies are reported to us. In addition, where reasonable estimates can be made, we also accrue for revenues on policies issued but not reported until after period end. We believe that reasonable estimates can be made when recent and consistent policy issuance information is available. Our estimates are based on historical reporting patterns and other information about our agencies. We also consider current trends in our direct operations and in the title industry. In this accrual, we are not estimating future transactions. We are estimating revenues on policies that have already been issued but not yet received by us. We have consistently followed the same basic method of estimating unreported policy revenues for more than ten years.

Our accruals for unreported policies from agencies were not material to our total assets or stockholders equity for either of the six months ended June 30, 2006 and 2005. The differences between the amounts our agencies have subsequently reported to us as compared to our estimated accruals are substantially offset by any differences arising from the prior year s accrual and have been immaterial to stockholders equity during each of the three prior years. We believe our process provides the most reliable estimation of the unreported revenues on policies and appropriately reflects the trends in agency policy activity.

Operations. Our business has two main segments: title insurance-related services and real estate information (REI). These segments are closely related due to the nature of their operations and common customers.

Our primary business is title insurance and settlement-related services. We close transactions and issue title policies on homes, commercial properties and other real properties located in all 50 states, the District of Columbia and a number of international markets through more than 9,000 policy-issuing offices and agencies. We also provide post-closing lender services, mortgage default management services, automated county clerk land records, property ownership mapping, geographic information systems, property information reports, flood certificates, document preparation, background checks and expertise in tax-deferred exchanges. Our current levels of international operations are immaterial with respect to our consolidated financial results.

Factors affecting revenues. The principal factors that contribute to increases in our operating revenues for our title and REI segments include:

- declining mortgage interest rates, which usually increase home sales and refinancing transactions;
- rising home prices;
- increasing consumer confidence;