Doma Third Quarter 2022 Earnings Transcript

C O R P O R A T E P A R T I C I P A N T S

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C O N F E R E N C E C A L L P A R T I C I P A N T S

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Beatriz Bartolome, Head of Investor Relations, Doma
Thank you, operator. Good afternoon everybody and thank you for joining Doma's Third Quarter 2022 Earnings Conference Call.

Earlier today, Doma issued a press release announcing its third quarter results, which is also available at investor.doma.com. Leading today's discussion will be Doma's Founder and Chief Executive Officer, Max Simkoff, and Chief Financial Officer, Mike Smith. Following management's prepared remarks, we will open up the call to questions.

Before we begin, I would like to remind you that our discussion will contain predictions, expectations, forward-looking statements and other information about our business that is based on management's current expectations as of the date of the presentation. Forward-looking statements include, but are not limited to, Doma's expectations or predictions of financial and business performance and conditions and competitive and industry outlook. Forward-looking statements are subject to risks, uncertainties and other factors that could cause our actual results to differ materially from historical results and/or from our forecasts, including those set forth in Doma's Form 8-K filed today.

For more information, please refer to the risks, uncertainties and other factors discussed in Doma's most recently filed annual report on Form 10-K and other SEC filings. All cautionary statements that we make during this call are applicable to any forward-looking statements we make wherever they appear. You should carefully consider the risks and uncertainties and other factors discussed in Doma's SEC filings. Do not place undue reliance on forward-looking statements as Doma is under no obligation and expressly disclaims any responsibility for updating, altering or otherwise revising any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

Additionally, during this conference call, we will also refer to non-GAAP financial measures, including retained premiums and fees, adjusted gross profit, and the other measures described in our earnings release. Our GAAP results and description of our non-GAAP financial measures with a full reconciliation to GAAP can be found in the third quarter 2022 earnings release which has been furnished to the SEC and is available on our investor website.

And with that, I'll turn the call over to Max Simkoff, CEO of Doma.

Max Simkoff, Chief Executive Officer, Doma

Thank you, Bea. Good afternoon everyone and thank you for joining us. The third quarter was pivotal for Doma, and I'm proud of the way our team executed, particularly given the continued challenges of the US housing market. Our financial results have now begun to reflect more tangible benefits of the considerable expense actions we took earlier this year to rightsize our company for the realities of the current real estate cycle. In a short period of time, we have made meaningful strides toward our goal of delivering adjusted EBITDA profitability, and because we understand the importance of delivering sustainable profits irrespective of the length and severity of the current housing market cycle, today we're committing to reaching our Adjusted EBITDA profitability goal even sooner than we had previously stated.

In keeping with previous earnings calls, there are three main themes I'll be focusing on today:

First, there is no mistaking that the US housing market is now headed towards a full-fledged recession, with little hope for sustained relief in the near-term. This dynamic has continued to pressure our results, and as as such we are revising our Adjusted EBITDA guidance for the remainder of this year.

Second, the challenging market we're operating in now creates a unique opportunity for Doma - as we believe we are the only company in our space who is positioned to capitalize on our proven instant underwriting technology and nationally-scaled underwriting platform to deliver better, faster and (yes) cheaper solutions to homeowners who are now facing unprecedented affordability challenges. By staying nimble in response to the highly volatile residential real estate landscape, where customer demand is rapidly shifting towards lower-cost solutions across the value chain, and re-adapting our priorities to remain an industry innovator in this environment, we will better realize our vision of removing the friction, frustration, and expense from home ownership.

Third, despite the adjustment we are making today in relation to the current year, getting to adjusted EBITDA profitability continues to be our top priority across the entire company, and we are now working towards a faster timeline that would enable us to turn profitable sooner than what we had previously communicated as late 2023. I am very pleased with the early returns on the areas of the business that the team addressed first through cost reductions in Q2 and Q3, and which are now already delivering significant improvements in adjusted EBITDA. We believe we can build on this momentum by not only identifying new ways to more quickly roll out our proven instant underwriting capabilities as mentioned earlier, but also by more exhaustively prioritizing profitable execution in our Local division - a topic I'll give more details on in a moment.

I'll now dive into these three themes in more detail. And after that, I will turn the call over to Mike to cover our third quarter financial results and financial outlook.

To lead things off, it seems clear that the US housing market is entering a recession. The Federal Open Market Committee (FOMC) has delivered four consecutive 75 basis point rate hikes this year (with expectations of further aggressive tightening on the horizon), while stubbornly high inflation, broken global supply chains, and broader geopolitical concerns have all contributed in parallel to effectively double 30-year fixed mortgage rates versus the same time last year. According to Morgan Stanley research, housing affordability is deteriorating at a much faster pace than at any point in the last 30 years. These factors have exerted enormous pressure on even the most mature and profitable franchises operating in real estate. For those companies in the earlier stages of growth, many are unlikely to make it to the other side of a prolonged market downturn of this magnitude. I'll state upfront with conviction that we believe Doma is in a different class from these other young companies, particularly given our proactive approach to implementing a combination of measures to enable our long-term operational and financial success. We are committed to emerging from this housing cycle as a stronger and more steadfast, resilient profitable company.

Our business performance in Q3, which we will continue to frame vs. the prior quarter as we did in Q2, was impacted by the aforementioned macro pressures from a mortgage market that has become extremely challenging for homebuyers. In Q3, we delivered $43 million of retained premium and fees, down 13% sequentially, driven by lower refinance closed orders, which fell by 25% quarter-over-quarter as the mortgage market continues to readjust to the sharply higher interest rate environment. Our purchase closed orders declined 11% sequentially versus Q2, which was directionally expected. As of Q3, purchase orders made up 42% of our direct residential volume and 74% of our direct residential retained premium and fees.

In our Q1 and Q2 earnings calls earlier this year, we discussed the fact that we had formed our own internal mortgage macro forecast for the year that we were going to plan and execute our business by, and which we felt was considerably more conservative than other industry forecasts that were slower or more reluctant to update their numbers. While we've continued to adapt our internal forecast ahead of other industry groups, and have utilized our own independent set of circumstances to model potential outcomes against, no amount of conservatism baked into these forecasts could have predicted the unprecedented pace of contraction in the market that we've now seen. In addition to refinance volumes continuing to decline, the purchase side of the market has also slowed more than anyone expected. Home purchase is now out of reach for many US households given that the 30 year fixed rate has exceeded 7% - a threshold last seen in the early 2000s. Additionally, the rapid pace of interest rate increases in just the past few months has driven cancellation rates higher for pending home purchase transactions - with 17% of all purchase transactions in the month of September being cancelled. This is the highest share of cancellations on record aside from March of 2020.

We expect all of the existing macro factors at play to continue pressuring our ability to generate Retained Premiums and Fees for the remainder of the year. Given these factors, we are revising our adjusted EBITDA guidance for 2022. Mike will provide those details shortly.

While the dynamics of the overall housing market have made things challenging for us and many other companies in our industry, they've made life orders of magnitude more difficult for the individuals across the nation who are now struggling to afford homeownership. The average monthly payment on a conforming mortgage has increased by over 60% vs a year ago, and with the average American homebuyer having just over $5,000 in disposable income - every dollar they pay for value received in the mortgage transaction is now critical. We've also seen increasing calls as of late from several of the largest stakeholders in the housing market (such as Fannie Mae, Freddie Mac, and the FHFA) to find ways of innovating to provide more equitable access to affordable housing. This kind of environment offers a unique opportunity for Doma. We are arguably the only player in our space who has the proven technology and underwriting capabilities to help homeowners close transactions better, faster, and cheaper. Since the day we founded the company, we've also demonstrated that we can be nimble enough to adapt our business to drive value across all types of real estate cycles and market conditions, and the current time is no exception. To best ensure that we seize this opportunity we are in the process of re-adapting our priorities and our business footprint to ensure even more profitable execution of our platform. Toward this end, building on the success we've seen in gaining share in our Enterprise division, we have identified several new potential distribution opportunities to get the power of our instant underwriting deployed across more transactions at scale. In our Local business, we've decided to pause further expansion of the Doma Intelligence platform for purchase transactions to additional branches - so that our team can first conduct an exhaustive review of our national branch footprint and determine what the best configuration should be going forward. As part of the initial review of this footprint, the team recently took actions to begin closing unprofitable branches. As these decisions can attest, the key focus for us right now is to ensure that we have the right pace of investment in place for both our Local and Enterprise businesses enabling both channels to reach profitability earlier in 2023 than we had previously planned.

In summary, our broader near-term priorities are to make sure we're utilizing our scaled underwriting platform with maximum efficiency, and distributing our technology-enabled solution to customers in line with how the market evolves and in the most cost-effective ways.

In keeping with the third theme of today's call, we will adapt our business footprint and focus while also remaining on a path to adjusted EBITDA profitability. And because we know how important reaching this milestone is, particularly given the structural shift in broader market conditions, we are now committed to reaching adjusted EBITDA profitability on a faster timeline than previously communicated. Today's downward revision to the outlook for 2022 doesn't adversely impact this trajectory. We will look to provide an exact timeline during our fourth quarter earnings call.

We are confident that we can achieve this more ambitious path to profitability because our team has now seen first hand that it can be done after delivering a set of cost reductions in Q2 and Q3 that led to a significant improvement in our adjusted EBITDA versus the second quarter, to the tune of $13 million. While we expect this upward trajectory in adjusted EBITDA to continue in Q4 as the full benefit of those prior cost reductions continue to be realized, our team is confident that by re-prioritizing our focus, as I mentioned earlier, we can deliver on our mission with a leaner cost structure and greater agility as we move into Q1 and Q2 next year. Our goal is to drive significant additional margin benefit for both next year and sustainably over the long term. Similar to our review of the branch network, everything in the business is being evaluated right now with that objective in mind, and we expect that we will have more updates to share on this front during our Q4 earnings call in February.

To sum it up, despite another challenging quarter for the entire housing industry, we believe the strong demand in the current market for better, faster, and cheaper paths to homeownership presents Doma with the unique opportunity to get our instant underwriting solution deployed across more transactions in a more efficient way. We have the technology, the people, and the momentum toward a faster path to EBITDA profitability that will help us do this, while remaining the leading provider who is changing our space for the better.

With that, I will now pass the call over to our CFO, Mike Smith, to provide you with further details on our recent financial performance and an update on our outlook. Mike?

Mike Smith, Chief Financial Officer, Doma
Thank you, Max, and good afternoon, everyone. I will start by recapping our financial results for the third quarter, and then I will dive into the details.

Please refer to our earnings press release filed earlier today and our 10-Q scheduled to be filed later today for full details of the quarter. Unless otherwise specified, all of the third quarter figures cited in my remarks are quarter-over-quarter or sequential comparisons.

Given our intense focus on profitability that Max outlined during his remarks, I'll start there. We made significant expense reductions in the 2nd and 3rd quarters and are already seeing savings realized from these cuts. We expect to see the full benefit of these actions in Q4 this year, and continued improvement on our adjusted gross profit contribution and our adjusted EBITDA.

Our primary measure of unit economics is Adjusted Gross Profit, which was $12 million in the third quarter of 2022, up 7% sequentially. Adjusted Gross Profit as a percentage of RPF was 27% in 3Q22, compared to 22% last quarter.

Adjusted EBITDA, our main profitability measure, improved $13 million in the third quarter to negative $30 million, compared to negative $43 million in Q2. Our quarter-over-quarter improvements in Adjusted Gross Profit and Adjusted EBITDA were driven by the expense actions we took earlier this year to rightsize our cost structure.

We will continue to prioritize our investments in areas that we believe will drive the most long-term value for all of our stakeholders and balance our investments with a focus on profitability and cash generation over growth, as we navigate the current environment.

In terms of our top line performance in 3Q22, we reported revenue on a GAAP basis of $108 million, down 13% quarter-over-quarter. As a reminder, GAAP revenue includes the portion of Third-Party Agent premiums that Doma does not retain, so we focus on Doma's Retained Premiums & Fees - or RPF - which excludes the premium retained by third-party agents. We believe this is a much better representation of Doma's underlying top-line performance. With this in mind, RPF was $43 million in the third quarter, down 13% quarter-over-quarter, driven by lower refinance and purchase closed orders.

As we mentioned on last quarter's call and as you have heard from other companies in the industry, rising mortgage rates have significantly impacted refinance volume for both Doma and other industry participants. Today, mortgage rates are at 7% and are expected to continue to rise until the fed funds rate reaches its apex in this tightening cycle. Accordingly, refinance closed orders were down 25% and purchase closed orders were down 11%.

One other item of note during the third quarter, we recognized a goodwill impairment charge on our Distribution segment of $34 million. The triggering events for this non-cash accounting charge include the sustained declines in Doma's stock price coupled with the current housing and macroeconomic landscape. We do not believe that this goodwill impairment charge impacts our expectations on future profitability or cash generation potential, but rather is a reflection of current economic conditions and our depressed stock price.

Now, turning to our outlook and updated guidance for the full year 2022. As we highlighted in our Q2 earnings call, we believed our retained premiums and fees potential for the full year was at risk, as mortgage volumes for both purchase and refinance were expected to deteriorate further in the second half of 2022 due to a faster-than-expected rise in mortgage rates. We are now guiding to negative ($135) million to negative ($140) million for our full year 2022 adjusted EBITDA.

Importantly, our revised guidance has not impacted our expectations for profitability in 2023. As we previously mentioned, we are now managing the business to get us to adjusted EBITDA profitability on a more accelerated timeline. We will continue to closely watch the trends in open and closed orders and adjust our operations and expense base accordingly. At a time of uncertainty in the industry, we are focusing on what we can control.

I will now pass the call back to Max for closing remarks before we open the call to questions.

Max Simkoff, Chief Executive Officer, Doma
Thanks Mike. I would like to take this opportunity to thank and acknowledge the ongoing contribution of our team who remain committed to our long-term vision to make the experience of buying, selling or owning a home better, faster and more affordable, and to our customers for their continued support.

I will conclude my remarks by reiterating we are laser-focused on reaching adjusted EBITDA profitability even faster than we previously stated. Despite the 2023 housing market outlook having a wide range of potential outcomes, we're confident that the way we've re-balanced our focus keeps us in the driver's seat, and will enable us to emerge stronger and more steadfast on the other side of these challenging market conditions. We look forward to updating everyone on our priorities and progress in Q4.

Operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator
(Operator Instructions) And our first question comes from the line of Matthew Carletti from JMP Securities.

Matthew John Carletti JMP Securities LLC, Research Division - MD & Equity Research Analyst
Max, I was hoping I could follow up on the commentary you had about reaching EBITDA profitability earlier in '23 than previously guided. And you obviously made some conservative statements about kind of the background housing market assumptions. So the question is just kind of, what sort of backdrop of a housing market kind of are you assuming broadly when you kind of make that commitment? And how much does it matter what that backdrop is? Or have you readjusted the business such that there can be some variability in that and you guys have the flexibility to adapt?

Max Simkoff, Chief Executive Officer, Doma
Yes. Great question, and why don't I start with the second part of your question, Matt, which is how much does that backdrop matter. I would say that it largely doesn't matter because we are making good progress, and will continue making good progress on developing the leaner platform and more scalable infrastructure in our business to be able to meet that timeline regardless of the backdrop.

You probably recall, we said earlier this year that we'd formed our own conservative internal forecast for what we thought the market was going to do this year, that was quite a bit more conservative than the other kind of standard industry forecasts. And frankly, despite how conservative we thought we were being with that forecast, it has proved not conservative enough given the further significant upward movement of the 30-year fixed.

What we have learned in the actions that we've taken in the last 2 quarters, which benefit -- you're starting to see now reflected in the adjusted EBITDA numbers this quarter and which we expect you'll see even more so next quarter -- is, we've learned to be leaner and more dynamically and entrepreneurially manage the business. And as I mentioned just a few minutes ago, we also think that we have several potential strategies which we're now evaluating, that would allow us to use our technology at greater scale and perhaps in an even more efficient way than even what we've already achieved and demonstrated in our enterprise channel.

So I'm not prepared to go into too many more specifics on that right now because, again, we're evaluating several strategies to do that. But I think the organization has really demonstrated that their mentality and mindset is prepared to make sure we get to our EBITDA goal, no matter what the market backdrop is.

Matthew John Carletti JMP Securities LLC, Research Division - MD & Equity Research Analyst
My follow-up is going to be along kind of some of those other opportunities, but I think you covered it there. So we'll wait untill next quarter to get some more color.

Operator
(Operator Instructions) And our next question comes from the line of Tom White from D.A. Davidson.

Thomas Cauthorn White D.A. Davidson & Co., Research Division - MD & Senior Research Analyst
I guess maybe just a follow-up on the last one and kind of reconciling the comments about earlier EBITDA profitability with the lowered outlook for this year. It sounds like shutting down some of these local branches is a big piece of that -- maybe the biggest piece. Can you maybe just, at least at this point, talk about how -- what percent of your branches you think you might close? Also curious, what does that mean about those markets kind of long term? Like is it easy to re-enter those, or by exiting, do you kind of seed market share to somebody else that might be difficult to recapture? And then I had a follow-up.

Max Simkoff, Chief Executive Officer, Doma
Yes. And so let me take a shot at that, and I might ask Mike here to provide some additional detail. I don't think we're going to go into specifics right now on just how many branches we're going to shut down or how many markets we may exit. I would focus on -- the main driver for those decisions is not market share driven, it's profitability driven. And I think that kind of gets to answering the first part of your question, which is, yes, there's significant headway that we can make in getting to our adjusted EBITDA profit target faster by exiting the parts of the business that are the least profitable. And I think the team has started that work, and we're quite confident that we can gain some ground there.

I would also say that, broadly speaking, even with the contraction in the overall mortgage market, we've actually seen a pretty significant number of share gains across different parts of the business in the last quarter. In our enterprise business, for example, we've had a number of larger enterprise accounts materially expand wallet share. We've added new customers. And even in our local business, I mean we've seen a number of markets. In fact, I think in over 1/3 of those local markets that we're in, we actually experienced quarter-over-quarter growth.

So I would say, despite the fact that we're seeing market share gains across a lot of our business, our main focus is making sure that we prioritize primarily against how we get to that adjusted EBITDA target faster, and that's really what's kind of the driving factor behind these decisions.

I guess on the last part of your question, is, exiting those markets, in some cases make it harder to get back into them. I don't think so. But again, it's -- frankly, it's not the biggest driver in how we make those decisions. It's really making sure that we're going to have a profitable platform to scale off of, and that will be around for the long run with a great strategy to grow the business.

Thomas Cauthorn White D.A. Davidson & Co., Research Division - MD & Senior Research Analyst
Maybe just one follow-up. You touched on kind of Fannie and Freddie and some other kind of industry participants in the calls to make housing kind of more affordable. I think earlier this year, Fannie and Freddie changed some rules and can now give lenders, I guess, an option to use like attorney opinion letters instead of traditional title insurance on some loans. I was just curious that kind of -- where that fits into what you're discussing before and what that means for your business?

Max Simkoff, Chief Executive Officer, Doma
Yes. I think the decision that you're referencing -- I think Freddie had -- I'm pretty sure, Freddie had actually been already accepting attorney opinion letters for some time. Fannie announced that they would start also accepting them. And as you probably know, Fannie Mae is the largest purchaser of single-family residential mortgages in the country, and so that was a pretty significant deal. And I think what I would point out about it is, it's a great example of the kinds of things that we're seeing greater urgency and a call to action around, from those industry participants.

The bottom line is that this product as it's traditionally been offered title insurance -- and I would say even broader title [and] closing is a really expensive part of the mortgage process. And as I mentioned few minutes ago, we're now talking about homeownership being completely out of reach for a lot of people. And some of those people becomes out of reach, I mean, literally just because of $1,000 here or there, and we're talking about a product that can cost several thousand dollars as part of the closing process.

So we think there's really great alignment, both amongst the GSEs and the FHFA, and frankly, amongst us alongside the GSEs and the FHFA about wanting to see more affordable and more [expedient] products in the market, and the attorney opinion letter is, I think, a great example of that. And over the coming years, I would expect for there to be a lot more innovation in that area, and we're keenly interested in making sure we're a part of it.

Thomas Cauthorn White D.A. Davidson & Co., Research Division - MD & Senior Research Analyst
One last one I'll flip in, sorry. The comment you made about 1/3 of your local markets seeing growth quarter-over-quarter. I'm just curious, how does that line up with the local markets that had the Doma Intelligence platform rolled out? Like was that a factor in the growth? Or was there something else happening?

Max Simkoff, Chief Executive Officer, Doma
Yes. I think it is actually safe to say now because we've now seen more progress in that part of the business, i.e., where we've rolled out the Doma Intelligence platform to -- in local business. I think it would be fair to say that, that was a part of driving share growth. I would say that because our escrow officers in that part of the business, who are really critical part of making sure that we're successful in building and managing customer relationships, have now really embraced the technology that we've rolled out there. We've now heard from a number of them in this past quarter that it's added

meaningful selling advantage and servicing advantage. So I think it would be fair to say that, that is helping drive some of that growth advantage.

Operator

This does conclude the question-and-answer session as well as today's program. Thank you, ladies and gentlemen, for your participation. You may now disconnect. Good day.