Walker & Dunlop, Inc.
Presenter: William M. Walker, Chairman, President and Chief Executive Officer

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I appreciate Walker & Dunlop coming to present. Willy Walker is the company CEO, and Debbie Wilson, the company CFO, is here as well. We don't have breakout sessions, but there may be a little time for questions afterwards. But I'm eating into your time, so go ahead, Willy.

William M. Walker

Good morning. There's our disclaimer, there, on the front page.

The mission of Walker & Dunlop is to be the premier commercial real estate finance company in the United States. There is a massive opportunity out there as it relates to real estate finance. It's a $3.1 trillion market. If you think that the majority of that is ten-year paper, there are clearly construction loans in there, there's five-year paper, there's seven-year paper, but the great majority of it is ten-year paper. That gives you around a $300 billion a year refinancing opportunity. It's actually closer to $400 billion per year over the next five years, but just taken on average, about $300 billion a year.

Walker & Dunlop did just about $3 billion of lending last year, so we had a one share. As a one share, we were the 11th largest commercial lender in the United States, so you have significant fragmentation in the market, yet at the same time, this massive market that is right in front of us.

We have an established lending platform. We've been in business for 74 years. During that period of time, particularly since we got into the business with Fannie Mae of being a Fannie Mae DUS lender where we take credit risk on the loans that we originate. We've had an exceptional credit history and credit performance of our portfolio.

Finally, I would put forth that a company of our size and scale is heavily dependent on having great people. Every company, obviously, is dependent on great leadership, but there are clearly some businesses that are so big and so scaled with such a deep bench that you might have Mark Hurd leave and in comes somebody else, and they leave and in comes Meg Whitman, and you've got the ability to move that mission forward. In a company of Walker & Dunlop's size, the team that we have assembled and the management team that we have and the people across the country are truly exceptional, and it will be that team that continues to grow the company going forward.

As I mentioned, the market opportunity is massive. It's a $3.1 trillion market. Specifically to multi-family, which is where Walker & Dunlop's core lending activity is today, it's an $840 billion market. I will show you a little bit later what the refinancing volumes are in the core multi-family business over the next ten years to give you a sense of the addressable market specifically in multi-family.

As I mentioned earlier, we're the 11th largest commercial lender in the country. If you look at who we compete with, you can see that the names on that list are some formidable competitors, with Wells Fargo being number one as far as 2010 lead tables are concerned. In our specific niche businesses of FHA, Fannie Mae and Freddie Mac, you can see that we were the second-largest Fannie Mae DUS lender in 2010, the eighth-largest FHA /Ginnie Mae originator in 2010, and the tenth-largest Freddie Mac seller/servicer in 2010. What's been interesting is that Fannie and Freddie, the agencies, during the last three years have grown their annual originations in multi-family at a compound annual growth rate of 11%. The overall market has grown their originations in multi-family at -2% compounded annual growth rate over the last three years. So as the agencies have grown, so has Walker & Dunlop.

Regarding our national lending platform, you can see the red dots on that slide on the left are where we actually have offices. We're in eight major MSAs. The only one I would pull out of that as far as a major MSA is New Orleans. We acquired that office, and we actually like the New Orleans market right now, but it's not a big market. All the rest are in major MSAs.

The blue dots on the slide are correspondents, which are local mortgage banks, form whom we source loans, and you can see on the right-hand side of this slide where our originations are coming from: both our direct channel of having originators in our local offices and the correspondent channel, where it's brokerage firms that are bringing us deal flow. As you can see, in 2007 when CMBS was on fire and we didn't have control of our brokerage network because they were taking the offer from Lehman Brothers or Goldman Sachs at five basis points below our quote or a million dollars of additional proceeds to do a CMBS loan, our direct originations ballooned to over 80%.

As you can see, as the brokerage network has had fewer options on where to take their business, our model has moved back to about 50/50. 50/50 is what we like. We don't pay any of the overhead costs or any of the management costs of keeping our correspondents in business, but when they bring us deal flow, we actually love it. We split the origination fee, then they go back out and do another loan while we take the loan, process it, sell it, and off we go.

We announced earlier this year a strategic alliance with Cushman & Wakefield. Where Cushman & Wakefield are the originators on their investment sales business, specifically to multi-family, they will partner with Walker & Dunlop to be able to bring a client various quotes so that the acquiring party can sit there with Walker & Dunlop and say, 'If I acquire this multi-family asset, what kind of financing could I get from Fannie or Freddie or HUD?' So we're out there actively working with Cushman & Wakefield with their investment sales group to be able to partner and bring in additional deal flow.

If you take a look at our volumes, as far as our growth is concerned, you can see we've had pretty dramatic growth in the past couple of years. Somebody commented earlier this morning that it looked like our originations were sort of flat in 2007, 2008 and 2009, and I responded that flat was quite an accomplishment given what was going on in the real estate financing space during those three years. From that period of time, in 2007, Walker & Dunlop was the 45th-largest commercial real estate lender in the United States. As I mentioned previously, we moved up between that time and 2010 to number 11.

So as the market got hugely displaced and lenders like Lehman Brothers and Washington Mutual didn't appear on lead tables anymore, Walker & Dunlop continued to go forward. You can see we did $3.1 billion last year. We've done $1.8 billion year-to-date through Q2. The guidance we've given for Q3 is between $750 million and $1.1 billion, and if you add to that our guidance we've given for full-year 2011, it gets us to $3.5 billion to $4.25 billion.

One of the things it's important to look at is how we've diversified our originations. If you go back to 2007, you can see that in 2007, we did about 60% of our business with Fannie Mae and 41% of our business with other capital sources. 'Other capital sources' at that time were life insurance companies and CMBS. In 2009, we acquired a business which added to us Freddie Mac as well as HUD. You can see the growth we've seen in our Freddie Mac and HUD businesses, where year-to-date, we're 47% Fannie Mae, 15% Freddie Mac, 20% HUD, and 18% other. CMBS came back quite strong in the first six months of the year, but it has clearly stepped back in the last month or so. There's about $5 billion waiting to get securitized right now. We'll see how that $5 billion gets securitized, or not, and that will really be a very important sign as to whether CMBS is going to have a sustained run or just bops along for couple more years.

As you can see, from a growth standpoint, our loan originations have grown by 11% at a compounded annual growth rate from 2007 to 2010. Total revenue is growing at a CAGR of 25%, and income from operations is growing at a CAGR of 25%. I have to say that, given what the markets went through during that time, that's pretty astounding growth for a company that's focused in our space.

I want to focus for two seconds on our financial performance year-to-date from 2010 to 2011. I'm going to point our two major drivers on the revenue side, two major drivers on the cost side, and then you can see that our income from operations grew from $22 million to $29 million in the first six months of the year, a 29% year-on-year change.

`Before I go to pointing out the major drivers of revenue and expenses, I would point out that a couple of people have gotten a little confused when we report earnings from an EPS standpoint because we converted ourselves from an S-corp to a C-corp. As you can see, in 2010, we paid off taxes at the S-corp. level, so they did not come through in our EPS number. In 2011, we are a C-corp.; therefore, we're paying taxes at the corporate level and when we publish our EPS, everyone is going back and looking at a year ago, but we didn't pay federal taxes a year ago at the corporate level. Just keep that in mind as you look at our releases for Q3 as well as Q4.

If I look at the major drivers from a revenue standpoint, when we originate a loan, we make an origination fee and we also at that time book a mortgage servicing right. So as you can see from the blue part there, 35% of revenues for 2010 were our origination fees, cash. The green part at the bottom our gain attributable to mortgage servicing rights. That green portion, which is 35%, is non-cash. We take the future revenue streams that come off of servicing income, we discount it to the present value, and we book that at the time of origination.

Our portfolio today is $15.4 billion; of that $15.4 billion, 90% is prepayment protected, so if that loan gets paid off, we get a check for all the future revenue streams, discounted at the treasury rate. We're using a significantly higher discount rate than the treasury rate when we actually put the loans on our books. So, unlike the single family world where prepayment risk is a huge variable and all the single family originators are trying to figure out whether the average duration is three years or four years, in our world, it's all on there. I'll show you in a moment how durable, if you will, our servicing portfolio is.

You can also see, on the left-hand side, how revenues have grown from Q1 of 2008 up to Q2 of 2011. We're essentially making more in a quarter today than we were making in revenues back in 2008. If I go to the components of origination revenues, this is the gain on sale margin. The green dotted line that you can see is the fair value of the MSRs, so that's what we're booking as non-cash. The blue is our origination-related fees.

As you can see, from 2007 until the present, Q2 of 2011, we've seen significant margin expansion. That's because the competitive landscape has not been as fierce as it was previously for origination fees, so we're able to charge a point, a point and a half on our origination fee. Also, as it relates to our servicing fees, we are able to price into our deals, particularly those with Fannie Mae, significant servicing fees. In exchange for that servicing fee, we take the first-loss position on those loans, so if a loan in our Fannie Mae portfolio goes bad, we take 100% of the first 5%, and then we share risk with Fannie Mae back to 20%. Our total exposure to a Fannie Mae loan is capped at 20%. But you can see here as it relates to our origination fees and well as our fair value of the MSRs, they've grown dramatically over the last four years.

Servicing fees have grown as well. You can go back to Q1 of 2008 when, on a quarterly basis, we were earning less than $3 million from servicing fees. That has grown now to more than $8 million in Q2 of 2011, so a significant growth in servicing fees, and as I mentioned a moment ago, all of that is prepayment protected.

So we've taken the portfolio from 2008 to 2011 from $6.9 billion to $14.4 billion. We've taken the average servicing fee in the portfolio from 17 basis points to 22 basis points, as you can see on the upper right. And we've taken the average duration of the portfolio from 7.2 years to 8.1 years. So we've grown this massive servicing portfolio – for us, anyway, as obviously, there are other servicers who have tens and hundreds of billions of dollars of servicing. But for us, to go from $7 billion of servicing to $15.4 billion and be able to grow our servicing fees that are kicking off of that from $3 million a quarter to $8 million a quarter gives us a tremendous annuity stream over the coming years.

On the expense side, one of the things to keep focused on as you look at W&D is that we have a very variable cost structure in the company. Our originators, as they go through the year, they make a very small percentage of origination income when we start at the beginning of the year, and then, as they move into their splits, they start to make more and more of the revenue that we make off of the new loans that they originate. So as the year progresses, you can see how, quarter-to-quarter, personnel expense as a percentage of revenues can spike up or go down. That's all origination-based.

But as you can see on the right-hand side, on an annual basis it gets down to about a 50/50 mix. However, you can see over the past couple of years, as we have basically been originating more with fewer people on an aggregate basis, that the percentage of variable expense has actually gone up. We're getting more out of that same origination force, and as a result of it, they're all getting higher up in their splits, so more is going out in variable than staying on fixed. It also means that we haven't added a lot as far as fixed costs to the company. I was thrilled when we announced second quarter earnings, which showed us at a 41% operating margin after having taken on all the additional expenses of being a public company from an accounting and legal cost standpoint.

The other core piece from an expense standpoint is risk management. We had been really good throughout our history as it relates to losses. You can see our at risk portfolio is now at $7 billion as of June 30, 2011. On the upper right-hand side, you can see our 60-day delinquencies. That's the blue graph, there. 60-day delinquencies peaked at 160 basis points after Q2 of 2010, and as you can see, it has come down dramatically to where we are now at 14 basis points after Q2 of 2011.

The other piece of this that's very important is shown on the yellow line on the bottom. Those are our net write-offs. As you can see, net write-offs have stayed basically flat at almost nothing. So we've been very good as it relates to 60-day delinquencies, but what has ended up happening is that, because the majority of this risk is with multi-family and the multi-family market has held up tremendously, even when we foreclose on a property and take it to disposition, there's a market to sell it into. It is not the same for lots of other asset classes in commercial real estate today.

Here are some of the key expense and margin metrics. As I mentioned previously, the variable component of the personnel expense, on an annual basis for 2008, 2009 and 2010, was about 35, 36%. Don't think that, year-to-date, 31 stays there. As we get into the latter half of the year, personnel expense will go up as people get into their splits and our originators take home more of the revenues that we originate, so that trends back up towards normalized numbers of 35, 36%.

You can see on other operating expenses, one of the nice things there is all the costs of going public and we're still managing other operating expenses very, very tightly to get you to total expenses at 59% year-to-date.

Provision for risk-sharing, as you can see, peaked at 6% back in 2010. We're at 4% now, and I think we'll continue to see that number go down.

And then our operating margin, as you can see, bopped up to 41% year-to-date for 2011. Again, because personnel expense will start to come up in the second half of the year, you will see that operating margin come down. I would think that we would get ourselves back to a sort of 33, 34% operating margin by the end of the year given what happens between now and the end of the year from an origination standpoint.

With respect to our go-forward strategy, we've been doing a lot of hiring and we have to retain the people we have. It's a very competitive market. I constantly have people saying to me, 'Can't you go out and hire anybody given the weakness in the economy?' Clearly, in our space, the overall market is not impacting either origination talent or really good underwriters and asset managers, so holding on to the people we have and adding people to the origination platform is very important.

As far as acquiring complementary businesses, we've gone out to look at acquiring new business. The bid-ask in the first six months of the year was pretty wide; that is starting to tighten as the CMBS world has backed away and brokerage companies and originators no longer think that the world is back to 2007, as many of them thought it was going to be.

In regards to diversifying capital sources, we announced an interim loan fund during the third quarter that will help us finance assets that are not ready for permanent financing from Fannie and Freddie and HUD, and we will continue to broaden our sources of capital. Right now, looking at the Fannie / Freddie debate with the fact that our federal government can't even figure out how to fund itself, the idea that they're going to come up with something transformative on Fannie and Freddie I think is a future issue, clearly after the 2012 elections. I was with Ed Haldeman, the CEO of Freddie Mac last week, and his sort of summary of it all is, 'I'd be really surprised if you guys – meaning the six industry CEOs present, including John Pelusi, who will be presenting in about an hour – see impact to your core business until 2015. So the Fannie / Freddie issue is not moving down a glide path right now, if you will.

We've been very fortunate to continue to grow our organic business extremely well. We're very focused in this space, and fortunately, as many of the people we compete with every day have gotten distracted or have pulled back, Walker & Dunlop has been able to continue to move forward.

So what is the opportunity in our core business? I said previously $3.1 trillion, $840 billion in multi-family. Specifically to multi-family, we have between $25 billion and $50 billion a year if multi-family debt, non-bank. So this does not have banks in it, only CMBS, life insurance companies and the agencies. So there's a whole piece where banks don't want to refi the business that's in there, and a lot of the bank financing is actually construction loans and interim loans. So that's a huge opportunity. But in non-bank, you've got between $25 billion and $50 billion a year coming up for refinance over the next five years.

As I said previously, the overall commercial real estate market has, on average, $400 billion of refinancing coming up every year over the next five years. So for us to address our core multi-family market and then to broaden out into new real estate lending, such as retail, hospitality, office and industrial, with the brand, the platform and the track record we have, we're very focused on doing just that.

So that's it.

Moderator

Since we have time for questions, I want to just kick off with a question about your comment essentially restating your guidance of $3.25 billion to $4.25 billion of origination. What has changed in the last couple of months? Has multi-family not changed in terms of origination levels?

William M. Walker

Multi-family was not being affected by CMBS because CMBS had not gotten down to really putting competitive spreads on the table to compete with the agencies and the life insurance companies, so there's was no competitiveness from CMBS that's been pulled back. It's really more that Fannie and Freddie and a lot of life insurance companies, particularly second tier companies, that were lending on multi-family in the first six months of the year have basically put all their money out to commercial real estate that they want to put out in 2011. So we've some of the smaller life insurance companies pull back.

The New York Lifes and the Met Lifes are very active and still out there, but generally speaking, they're just looking at low leverage deals with Class-A sponsorship in Class-A locations. There are only so many of those trophy assets that the insurance companies are just going to drop rate on and the rest of the flow business is really for Fannie and Freddie. They are both surpassing their budgets on 2011 and feeling like they're getting all of the market share they want.

Moderator

So they hype or the press about, I wouldn't say slower originations, but slower asset sales hasn't hit your core market maybe as much as it sounds like it has from the press?

William M. Walker

Yeah. I guess the other piece to it is that Walker & Dunlop has not relied on investment sales as a big driver of our financing activities. Some of our competitors, like an HFF, use their investment sales to tie the investment sales in with the financing, and that's been a huge source of deal flow for them. Walker & Dunlop has not relied on that, so if did see a downturn in investment sales activity, we're still getting our deal flow through the same channel, if you will, whereas others who have that tie-in have been able to use that tie-in from investment sales into the financing arena. CDRE does it very effectively as well.

Moderator

Right. Any questions out there? OK. I want to follow that up a new area for you on the healthcare side. What have been the changes in that area? Your platform is smaller there versus multi-family, but have you seen any pull-back there?

William M. Walker

I haven't seen any pull-back. I had dinner last week with head of NIC, which is one of the big industry associations focused on healthcare, and he told me that there was record attendance at the NIC conference in Washington last week, their membership was at a record level, and everybody in the healthcare space was all smiles. I put something of a caveat on that in that, you've seen consolidation in the senior care space, many of the big healthcare operators have raised equity capital in the downturn and have been very acquisitive. Reimbursement rates on the Medicare side have gone down significantly, as everybody knows. I think that the big players feel that there's a huge opportunity to continue to grow and the smaller operators are feeling very squeezed.

W&D is very focused on the healthcare space. We are in the process of doing one of the large portfolios in the healthcare space right now and making deliveries to HUD on that portfolio. We feel very good about the growth opportunity in the healthcare space going forward, along with Fannie and Freddie and HUD. Freddie has names 12 seller/servicers as originators for healthcare and Walker & Dunlop is one of them. That just came out two weeks ago.

Moderator

On your announcement that you were putting some of your own capital to work in terms of the newest platform, can you give us an update on the progress of that and where you see it going?

William M. Walker

We've been very active, but that doesn't mean we've gotten tons accomplished just because, as I said previously, the bid-ask was a little wide for us. I think brokerage firms and origination firms, for the first six months of the year, really though that the world was back to 2007 levels, and therefore, their price expectations were jut out of market. It's interesting how August actually reset some of those discussions, and I've had a couple of people call me back and say, 'Hey, maybe we were a little unrealistic in the first six months of the year as far as what valuation should be.

As it relates to broadening our capital sources, we've looked at potentially acquiring fund businesses that would allow us to have another source of capital. If you look at the opportunities for capital out there, you've got the agencies, you've got the banks, you've got the life insurance companies, you've got mortgage REITs, which have been challenged recently. The mortgage REIT bottle is somewhat under some pressure right now. Then, you've got CMBS, which is very much under pressure.

The final one is institutional capital where you go out and raise equity and put it into a First Trust Debt Fund, and the returns that people are getting on First Trust Debt Fund today are meeting institutional investors hurdle rates and it's a very competitive source of capital to put out into commercial real estate. So we had looked to potentially acquire one of those types of companies to add to our platform a proprietary source of capital for other, non-multi-family commercial real estate assets.

Moderator

All right, that's it. Thanks, Willy.

William M. Walker

Thank you all very much.