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WD - Q1 2012 Walker & Dunlop Inc Earnings Conference Call

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PRESENTATION

Operator

Welcome to Walker & Dunlop's first quarter 2012 earnings conference call and webcast. Hosting the call today from Walker & Dunlop is Willy Walker, Chief Executive Officer. He is joined by Debbie Wilson, Chief Financial Officer, and Claire Harvey, Director of Investor Relations. Today's call is being recorded and will be available for replay beginning at 1.30 PM Eastern time. The dial-in number is 800-677-7085. At this time all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation.

(Operator Instructions)

It is now my pleasure to turn the floor over to Claire Harvey.

Claire Harvey - Walker & Dunlop, Inc. - VP, IR

Thanks Wendy. Good morning everyone and thank you for joining the Walker & Dunlop first quarter 2012 earnings call. Joining me this morning are Willy Walker, our Chairman, President and Chief Executive Officer, and Debbie Wilson, our Executive Vice President and Chief Financial Officer. This call is being webcast live on our website and a recording will be available later this morning. Both our earnings press release and website provide details on accessing the archived call. This morning, we posted the earnings release and a presentation on the Investor Relations section of our website www.walkeranddunlop.com. Both documents provide additional detail on certain topics, which we will refer to during our prepared remarks this morning.

Investors are urged to carefully read the forward-looking statements language in our earnings release. Statements made on this call which are not historical facts may be deemed forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements, including statements regarding future financial operating results involve risks, uncertainties, and contingencies, many of which are beyond the control of Walker & Dunlop and which may cause actual results to differ materially from anticipated results. Walker & Dunlop is under no obligation to update or alter our forward-looking statements, whether as a result of new information, future events or otherwise. We expressly disclaim any obligation to do so. More detailed information about risk factors can be found in our reports on file with the SEC. Now I will turn the call over to Willy.



Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Thank you Claire and thank you everyone for joining us this morning to discuss Walker & Dunlop's first quarter 2012 earnings. We have a successful first quarter that included continued growth in origination volumes and revenues, solid earnings and sustained progress on the Company's stated strategic objectives. I will review our overall performance in Q1 and then turn the call over to Debbie to go into greater detail on our financial performance. I will then conclude our prepared remarks with commentary on the overall market and our growth and strategic initiatives will position the Company well for sustained profitability. We will then open the call to any questions you may have.

Since going public in December of 2010 Walker & Dunlop has originated \$4.7 billion of commercial real estate loans, up from \$3.7 billion in the five quarters prior to going public. That 26% growth in aggregate origination volumes is emblematic of Walker & Dunlop's expertise and growing reputation as one of the top real estate finance companies in the United States. Following the economic downturn Walker & Dunlop expanded rapidly and moved from being the 45th largest commercial real estate lender in the country to the 11th largest by making an excellent acquisition and having access to capital. As banks, life insurance companies and Wall Street conduits have returned to the market Walker & Dunlop has held its own, finishing 2011 as the 13th largest commercial real estate lender in the United States amongst some of the world's largest financial services institutions. First quarter 2012 continued Walker & Dunlop's consistent growth in origination volumes increasing 33% over Q1 2011. This strong origination volume translated into a 19% increase in revenues. Origination volume growth was almost twice revenue growth due to a large percentage of our originations coming from our Capital Markets group where we typically do not book Mortgage Servicing Rights or MSRs.

We're extremely pleased with the almost 200% growth in our Capital Markets business year-on-year as we gained access to new deals and new customers and continue to diversify the sources of capital we use for our lending operations. As we've grown Walker & Dunlop's footprint in terms of people and offices, we have added personnel and administrative costs. At the beginning of 2009 Walker & Dunlop had one office and 90 employees in Bethesda, Maryland. At the beginning of 2012 we had nine offices and almost 200 employees. As we discussed with investors during our Q3 2011 earnings call the cost of adding additional personnel and offices would effect our income statement in 2012. During a quarter with a relatively low origination volumes Q1 is typically the slowest quarter of the year. These additional personnel and operating costs were contributing factors to the reduction in earnings per share by 12% from \$0.31 in Q1 2011 to \$0.27 in Q1 2012. These costs were anticipated and are part of the Company's stated strategic goal of growing our Agency and Capital Markets businesses to originate between \$4.5 billion and \$5.25 billion of commercial loans in 2012.

The amortization of Mortgage Servicing Rights was the other major cost driver in Q1 2012 that impacted profitability. Almost every Fannie Mae and Freddie Mac loan in our servicing portfolio has prepayment protection where if the borrower prepays the loan Walker & Dunlop receives a check for the future servicing payments we would have received. In Q1 2012 however we had a portfolio of loans pay off that did not have prepayment protection and therefore we wrote off of \$636,000 of Mortgage Servicing Rights associated with this portfolio. This was one of a handful of loans in our Fannie and Freddie servicing portfolio without prepayment protection. With regard to strategic initiatives Walker & Dunlop continued to execute on our mission to create the premier real estate finance company in the United States during Q1. As we have stated previously our strategy includes three distinct objectives.

The first is to be a top five lender with Fannie Mae, Freddie Mac and HUD. We finished 2011 as a top 10 lender with Fannie Mae and Freddie Mac and as the 11th largest HUD lender in the country. We were very pleased to be the second-largest Fannie Mae DUS lender in the country in 2011 and given that Fannie Mae DUS is one of our most profitable lending businesses our client base, national reputation, and servicing portfolio, the vast majority of which comes up for refinancing over the next 10 years, positions us well for future growth and profitability. We will continue to add origination talent and grow our lending operations with Fannie, Freddie and HUD giving their dominant position as providers of capital to multifamily properties. The second strategic initiative is to grow our Capital Markets business to increase Walker & Dunlop's aggregate loan origination volumes and expand our access to capital. During the first quarter we negotiated to have a new team in Fort Lauderdale, Florida join Walker & Dunlop. This team of professionals has extensive client relationships as well as long-standing partnerships with some of the country's largest life insurance companies. Historically this team has originated about 25% of their volume in multifamily properties financed by Fannie Mae and Freddie Mac and the other 75% on other commercial property types such as office, hotels and retail financed by life insurance companies and Wall Street conduits. We are extremely pleased to have this team of professionals join Walker & Dunlop and believe they will add immediate value to our Company. We expect to announce other editions our Capital Markets team over the coming quarters as we continue to build out this business across the country.



The final strategic initiative is adding proprietary capital to Walker & Dunlop. During the first quarter we closed and funded the first interim loan using our balance sheet. 25% of the capital came from us and 75% from a warehouse line. Although our balance sheet is limited in scale, this first transaction demonstrates our ability to create a new product, raise capital to fund that product and effectively sell the product into the market. I would note that the interim loan market is hypercompetitive today with banks borrowing from federal reserve for close to nothing and lending at extremely low interest rates. With that said, given this loan's coupon rate and the leverage we have applied, our equity returns are above our weighted cost of capital. We are also focused on adding additional proprietary capital sources in the form of either investment funds or mortgage REIT. Significant time and effort has been spent on determining whether Walker & Dunlop should build, buy or partner to raise this capital and investors should expect to see development in the coming quarters related to this business strategy. I would now like to turn the call over to Debbie to discuss our financial results in more detail and then I will finish our prepared remarks with some comments on the overall market. Debbie?

Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

Thank you Willy. This was a strong quarter for Walker & Dunlop. We saw significant increases in our origination volumes origination fees and total revenues and made investments to grow our business platform. I would like to spend a few minutes on the key financial results of the quarter and then walk through the life of an MSR as we have received a number of questions on this topic over the past year. Net income for the first quarter of 2012 was \$5.8 million or \$0.27 per share compared to \$6.6 million or \$0.31 per share in the first quarter of 2011, a 12% decrease. The decrease in earnings was largely due to higher personnel and administrative costs, the write off of a large Mortgage Servicing Right and an increase in the provision for risk sharing obligations. Origination volume increased 33% to \$675 million in the first quarter of '12. This growth was driven primarily by the almost 200% increase in Capital Markets volume and included our first interim loan of \$7 million.

Capital Markets was 31% of our total originations during the first quarter and as Willy pointed out, this growth is very much in line with the strategic objective to broaden our brokerage business. Total revenues increased 19% to \$34.4 million and was driven by the growth in originations and servicing income. Origination fees grew 40% in the first quarter and outstripped the 33% growth in originations due to the strong fees earned across all product lines. Gains attributable to Mortgage Servicing Rights were \$9.5 million and flat Q1 to 2011 to '12 due to the comparable GSE and HUD volumes. The servicing portfolio grew 13% to \$16.9 billion and produced \$9.4 million of servicing fee income, up 22% from Q1 of '11. The average servicing fee is now 23 basis points, up 10% from Q1 2011 and the average life of the portfolio has also increased 10% to 8.8 years at March 31, 2012. As we mentioned last quarter other revenues include fees we receive outside of the origination and recurring servicing platform, such as assumption fees, prepayment fees and other miscellaneous fees. During the first quarter of 2012 we received a \$2.5 million fee related to the amendment of a fee arrangement between the Company and a correspondent. You will note that we also received a comparable to \$2.5 million assumption fee during the first quarter of 2011.

I'd like to now focus on expenses. Total expenses were up 37% to \$24.9 million. The increase was driven by higher personnel costs as we continue to invest in the growth of our business and an increase in amortization and depreciation costs. Personnel expense increased 26% reflecting the 16% growth in our employee base from Q1 of '11 to Q1 of '12 as we invested in our sales force and added staff to support our growth. Personnel expense as a percentage of revenue increased to 34% in Q1 2012 from 32% in Q1 of 2011. We anticipated this increase and believe we are effectively managing our overall headcount and costs as we continue to scale our business in 2012.

Amortization and depreciation expense increased 48% or \$2.4 million in the first quarter of '12. I mentioned previously that the servicing revenues grew 22% over Q1 2011, and as the servicing portfolio and associated revenues grow the amortization expense will naturally increase. Approximately \$1.5 million of the additional amortization expense in Q1 of '12 relates to the organic growth of the servicing portfolio. This quarter's amortization expense also includes approximately \$1.1 million of MSR write offs due to loan prepayments. As Willy previously discussed, we receive compensation for lost servicing out almost all Fannie Mae and Freddie Mac loan prepayments. During this quarter however a large atypical Fannie Mae portfolio prepaid for which we did not receive compensation and therefore we wrote off a \$636,000 MSR. We also recognized a \$1.2 million provision for risk sharing obligations which was \$478,000 higher than Q1 of '11.

As you have seen our credit performance continues to be excellent. Losses are a normal part of our business and we expect to incur losses every quarter given the scale of our at-risk servicing portfolio. Over the past year our quarterly losses have averaged \$1.2 million or somewhere between one and three basis points of the at-risk portfolio. At March 31, 2012 the at-risk portfolio totaled \$7.9 billion and our \$1.2 million provision is a two basis points of the portfolio. The operating margin was 28% for Q1 of '12, down 9 percentage points from 37% in Q1 of '11. Primarily due to the



high percentage of Capital Markets originations, investments in people and infrastructure, the write off of a large MSR, and the increase of the provision for risk sharing obligations.

As Willy mentioned we closed our first interim loan during the quarter. This is the first loan to ever appear on our balance sheet as a loan held for investment and not held for sale. Although our interim loan program can fund loans with maturities of up to 24 months, we expect this loan to remain on our balance sheet for less than a year. Net interest income for the loan is included in the net warehouse interest income line item on our income statement. As the total interest income from these loans grow we will expect to either provide separate disclosures or a separate line item for this amount. Investors should expect to see more loans held for investment on our balance sheet and related earnings in our income statement as we continue to grow and create proprietary sources of capital for our lending operations.

I would like to take a few minutes now and explain how MSRs are created and how they flow through the Company's income statement and balance sheet. From time to time during this explanation I will reference slides 14 to 17 in the presentation we posted on our website this morning. Our business is to originate, sell and service commercial mortgages primarily secured by multifamily properties. Servicing commercial loans involves collecting and remitting cash payments, paying tax and insurance bills and monitoring the physical and financial condition of the property. When we close and deliver a Fannie Mae, Freddie Mac or HUD loan we establish a contractual right to receive servicing fees for the remainder of the life of the loan or an MSR. Most loan payments paid by the borrower include a portion for principal reduction, a portion for interest expense, and bundled into the interest expense is the lender servicing fee. In the case of loans we originate for Fannie Mae where Walker & Dunlop shares the default credit risk our servicing fees include consideration for the risk sharing obligation. The contractual right to receive servicing fees for the life of the loan is the same for both commercial and single-family mortgages with two key differences.

The first is duration and the second is servicer compensation in the event of prepayment. Single-family mortgages can be paid off at any time without penalty. Commercial loans on the other hand are protected from opportunistic refinances through a prepayment penalty paid by the borrower. Prepayment penalties compensate the lender or investor for lost interest in the event of a prepayment and are disincentives to prepayment that generally extend the life of commercial loans, making loan duration much more predictable than single family loans. For single family loans, if the loan prepays early, the future servicing fees evaporate and the servicer receives no compensation. To underscore this difference, in the first quarter of 2012 Walker & Dunlop earned \$9.4 million of servicing income, of which 91% was prepayment protected and we would receive our pro rata portion of the penalty paid. The remaining 9% of our servicing fees relate to loans we originated for life insurance companies, banks, conduits and HUD. For these loans, although we would not receive a portion of the prepayment penalty, the borrower would still be obligated to pay the penalty to the investor providing a significant deterrent to prepayment.

Let's walk through an example loan in MSR, see the impact of the MSR on the balance sheet and income statement and then translate the example into our servicing portfolio and MSRs as of December 31, 2011. On slide 14 we have illustrated the contractual servicing fees related to a \$10 million loan with a 10 year term, and 9.5 years of prepayment protection and 23 basis points of annual servicing fee. For this example loan our servicing fees are approximately \$212,000 over the life of the loan. An MSR is created at origination and we record revenue and establish an asset to depreciate over the life of the loan. If the example loan is repaid at the end of the year five the borrower must pay all the outstanding principal plus 4.5 years of remaining interest in servicing fees. Walker & Dunlop would receive those 4.5 years of servicing fees discounted back at the risk-free treasury rate. We use a significantly higher discount rate to establish the value of our MSRs so when most prepayments happen there is a significant step up in value to Walker & Dunlop. Returning to our original example of the \$10 million line, excuse me the \$10 million loan on slide 14, since the loan is open to prepay after 9.5 years we assume for calculation purposes that the loan pays off at the end of year 9, even though we will receive servicing fees for 10 years unless the loan defaults.

In addition we decrease or increase the estimated servicing fees to include the cost of service alone and any interest we will earn on escrows associated with the loan. The assumed cash flows are discounted using an interest rate between 10% and 15%. As you can see on slide 14 the \$212,000 of contractual servicing fees from our example loan are discounted at 12.5% to produce a present value of approximately \$148,000. Slide 15 shows how the present value of the MSR is recorded as income at rate lock, the servicing income is recognized as revenue, and the MSR is amortized over the following 10 years. On slide 16 you will see that a corresponding derivative asset of \$148,000 is established at rate lock and when the loan is sold by Walker & Dunlop the derivative asset is converted to an MSR that is amortized over the life of the loan as shown on slide 15. Slide 17 reflects as of December 31, 2011 the annual contractual servicing revenues in our portfolio by lender type over the next 9 years and then 10 years and beyond. As you can see in the box below the graph the contractual servicing fees due to Walker & Dunlop over the life of the



portfolio total \$308 million without consideration of escrow benefits, servicing costs, prepayments, loan defaults, or future origination activity. In the lower left-hand box we show the amortized book value of those \$300 million plus of cash flows.

Finally in the bottom right box is the estimated value of the MSR assets as determined by an independent valuation firm as of December 31, 2011. From an annual revenue standpoint servicing income will provide us with approximately \$40 million in 2012 and more than \$300 million of contractual servicing fees over the life of the portfolio. At December 31, 2011 we carried the MSR assets on our balance sheet at \$137 million. An independent third-party valued these assets at \$159 million, \$22 million greater than our book value. I am hopeful that this explanation provides investors with additional clarity on MSRs, a very important component of Walker & Dunlop's value. In summary, we had a very good quarter with strong financial performance. The current economic conditions should be positive for our business and we have seen little compression of origination fees while our servicing portfolio continues to grow at double digits on an annual basis. Overall we are well-positioned for 2012 and very pleased with our first-quarter results. With that I turn the call back to Willy.

Willy Walker - Walker & Dunlop, Inc. - Chairman, President & CEO

Thank you Debbie. As Debbie just described in detail Walker & Dunlop's Mortgage Servicing Rights are a huge asset to our Company. We still meet with investors on a regular basis who do not understand or appreciate the dramatic difference between commercial MSRs and single-family MSRs. Unlike the single-family world where mortgages can be prepaid without penalty and are therefore highly sensitive to interest rate movements, commercial mortgages are almost all prepayment protected and therefore not nearly as sensitive to interest-rate movements and far more stable. I was asked in the interview last week where the commercial real estate industry would be 25 years from now. I laughed and told the reporter that I have difficulty looking out beyond 3 years much less 25, but that I felt the next 5 years were going to be very strong for the commercial real estate finance industry as \$1.9 trillion of commercial real estate loans come up for refinancing over that period of time. The current sources of capital for commercial real estate include life insurance companies, Wall Street conduits commercial banks, the agencies, HUD, and specialty finance companies such as mortgage REITs and real estate funds.

Each source of capital has its own sweet spot in the market with commercial banks focused on short-term floating rate loans, life insurance companies focused on low leverage loans in major cities generally. Wall Street conduits focused on loans with adequate spread which invariably means some type of structure or additional risk, and specialty finance companies cherry picking their opportunities where the larger sources of capital are not playing. What presents such a huge opportunity for a company like Walker & Dunlop is that Wall Street conduits have not returned to the market in a manner that many had predicted. And without the billions of dollars of capital the conduits supplied to the market in the 2000s there will be a shortfall of capital to commercial real estate in the coming years. Banks will only lend so much money to commercial real estate and with the implementation of Basel III in 2014 it is anyone's guess how commercial bank CFOs will look at commercial real estate loans when MSRs can only account for up to 15% of the Tier 1 capital. Life insurance companies seem to have an insatiable appetite for commercial real estate loans in 2011, a record year, yet they deployed less than \$50 billion of capital. If every life insurance company decided to increase their annual allocation to commercial real estate by 50% it would add \$25 billion of capital to the market. \$25 billion does not move the needle in a \$300 billion to \$500 billion per year market. And although there are plenty of conduits up and running today which supply just under \$30 billion of capital to commercial real estate in 2011, market volatility, pricing and the lack of a robust BP market, make it difficult to see CMBS providing over \$100 billion of capital to commercial real estate anytime soon.

So all of this leaves the door open for companies like Walker & Dunlop. We currently have the track record, the people, the platform and the capital to continue scaling our business in a highly profitable manner over the next several years to meet the massive market demand that will automatically happen due to loan maturities. Accordingly, we are establishing Q2 2012 origination guidance of \$1.1 billion to \$1.4 billion. Q1 2012 was a solid quarter where we grew our top line, absorbed costs we expected to incur as we scale our business and saw continued progress on our strategic plan to grow and diversify Walker & Dunlop's lending activities. With that I'd like to thank you for participating in today's call and open the line to any questions.



QUESTIONS AND ANSWERS

Operator

The floor is now open for questions.

(Operator Instructions)

Bose George, KBW.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Hi, thanks for taking the question. This is Jade Rahmani on for Bose. Last quarter you provided full-year origination guidance of \$4.5 billion to \$5.25 billion. Just want to see if you would care to comment on whether you remain comfortable with that full-year number.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

We do.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Okay great. The expenses as a percentage of revenues were a bit higher than we expected. Wanted to see if any of this was driven by recent hiring where we have not yet seen the full benefit of those revenues.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Yes.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Okay. And then qualitatively could you just described what drives the higher personnel cost ratio when we look at that as a percentage of sales, if that's the lag in revenues or if there is something else that's changed.

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Absolutely. Good morning Jade. It really is, there is two things. One, we are investing in people and growth for which there is a lag of revenues compared to the expenses that are being incurred so you're exactly correct.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Okay so that's the main driving factor of the higher ratio?

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Yes.



Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

I would only add to that Jade, that you also have to look at Q1 is, although we had very significant both volume and revenue growth on the quarter vis-a-vis Q1 2011, if you look at our basically \$1 billion a quarter origination volume when you do a lower volume quarter as we did this quarter. And as I said Q1 is typically our slowest quarter, compensation expense is going to be a higher percentage of revenues.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Okay. So there is negative operating leverage when the revenues decline. The GSE mix of revenues decreased while other increased dramatically. Can you just discuss what drove that?

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

First of all, I would say that nothing has changed as it relates to our core GSE business so nobody should read into that, that Fannie or Freddie and included in that HUD, are any less competitive today or not doing as much business as they were previously. Nothing has changed along those lines. But as we have told investors repeatedly since going public, the real estate capital markets are back if you will, other sources of capital have come back. CMBS is back, banks are back, life insurance companies are back. And as a result our Capital Markets business where we broker loans off to those sources of capital has grown significantly. And as a result of that picked up a larger share in the first quarter of overall origination volumes.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

And does that business have a different seasonality or more lumpiness than the GSE business?

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

I would say no. It's been pretty consistent. As we have discussed previously, prior to the financial crisis Q1 and Q3 were typically the slower quarters and Q2 and Q4 were typically the strongest, and Q4 was almost always the largest quarter of the year. During the financial crisis that changed where there was nearly no pattern because I believe borrowers were taking capital when they could get it. But as we've now moved out of the financial crisis and we're getting back towards if you will, a more normalized market, I would think we see that pattern getting back into place where Q1 and Q3 are the slower quarters, Q2 is stronger than 1 and 2, and Q4 is again the strongest.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Great. Thanks a lot.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Thank you.

Operator

Will Marks, JMP Securities.



Will Marks - JPM Securities - Analyst

Thank you. Good morning Willy, good morning Debbie. Taking that personnel as a percentage of revenue question a little further, if we assume the growth you are expecting from volumes, should that number improve over last year for the remainder of the year? Do you care to comment?

Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

Sure Will. As you know and look back over our history, personnel expenses have averaged somewhere between 34% and 37% annually over the last few years. Clearly we are making some investments in people but we expect it to be a little bit higher, but we are still comfortable in the 34% to 38% range. Clearly we're very comfortable below 40%, and if you compare that to people that are our peers theirs is just south of 50%. So we do expect it to be slightly higher but we are very comfortable within the 34% to 38% range. But can I also mention that as you know it's highly dependent on quarterly volumes. So I don't want that to get lost in the conversation.

Will Marks - JPM Securities - Analyst

Sure. So it sounds as if we should look at this on a full-year basis and not at the quarter so much.

Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

Right.

Will Marks - JPM Securities - Analyst

And just one other question. It sounds from Willy, your comments, I think we've talked about this in the past that your business is not really reliant on sales transactions on multifamily in particular trading hands. Is that 10% of what's important to you? Do you want to characterize it?

Willy Walker - Walker & Dunlop, Inc. - Chairman, President & CEO

As you know Will, we don't have an investment sales group inside of Walker & Dunlop We do have our partnership with Cushman and Wakefield which I did not mention in my prepared remarks. But as we mentioned in our earnings release, we are starting to see some traction there, and I'm very hopeful that we can give some real numbers on what's come from that partnership in the coming quarters. But we do not rely on that as a significant source of our origination volume. And so as some of our competitors as seeing investment sales volumes sort of fall off in Q1, and as a result the resulting decrease in financing volumes, that is not a significant source of deal flow for us. And so really ours is out there originating loans one-to-one with customers, looking at refinancing opportunities and then clearly we do do financings when properties trade hands, but it's not a key driver of our business.

Will Marks - JPM Securities - Analyst

Okay great. Thanks. That's all for me.

Willy Walker - Walker & Dunlop, Inc. - Chairman, President & CEO

Thanks Will.



Operator

Jason Stewart, Compass Point.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Good morning. Couple questions. One on the MSR expense and the payoff.

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Right.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Could you give us a little bit of detail on the portfolio origination year, anything that you could give us would be great.

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Sure Jason. That transaction was originally about \$550 million. It was originally done prior to 2009. It was renegotiated in 2010. And had some prepayment penalties. It is a highly negotiated transaction that is very atypical to what we normally do in our business and with that atypical transaction came the agreement that we would not share in any of the prepayment penalties. Properties have continued to perform really well and actually better than the expectation of any of those, and so with that the borrower chose to re-leverage the properties, and with that, payoff the loans earlier.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Okay. It would seem like that would be a transaction a lot of borrowers would want to undertake it wasn't for the prepayment penalty. So when you say almost every loan in the portfolio has one, is it -- do you want put a number on it, 99%?

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

It's a great question. We went through -- we've done some due diligence through our portfolio and there is about \$20 million of loans compared to the \$16.9 billion that don't have prepayment protection in the Fannie Mae and Freddie Mac portfolios.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Let me just, sorry Jason, I just I want to jump in on that. The aggregate loan portfolio is \$16.9 billion.

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Right.



Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Of the \$16.9 billion something around \$14 billion is Fannie and Freddie and of the Fannie and Freddie loans 99% of them have prepayment protection on them. As Debbie just said, there are two loans, aggregate UPB of less than \$20 million that don't have prepayment protection on them.

Jason Stewart - *Compass Point Research & Trading - Analyst*

That's immaterial and great detail to provide. Thank you. On the credit side remind me how we should think about a lag or timing between delinquencies to an actual write-off or if there is any -- anything you can give us to help predict when you're going to have some of these very small numbers hit.

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Sure. Two things. One is generally as you know every month we look at delinquencies, and delinquencies are generally the leading indicator of losses. Occasionally, we do look every quarter at our loan portfolio and our allowance and the loans that are in foreclosure or have defaulted to make sure that that number doesn't need to be trued up. So back to the comment, the delinquencies are generally the leading indicator. There are occasionally adjustments. But the provision this month, this quarter was primarily related to one loan that effectively defaulted and went through foreclosure in the period so you don't see the delinquencies at the end of the year -- at the end of the quarter.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Okay. Last question and then I'll get out. On the origination side, the Fort Lauderdale group, do you expect them to start contributing to volume in 2Q, and then I noticed the Cushman and Wakefield you say rate locks in 2Q but not closings, is that correct?

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Both -- the response to both of those, Jason, is yes and yes. The team in Florida is up and going if you will and it's a fantastic team and we're thrilled to have them on board. And as it relates to the Cushman deals that we are working on those would be deals that would rate lock which when we rate lock we recognize revenue for these deals. And so the revenue recognition would be during the quarter, the deals typically close somewhere between 30 and 90 days after we actually rate lock the deal.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Great. Thanks guys.

Operator

Brandon Dobell, William Blair.

Brandon Dobell - *William Blair & Company - Analyst*

Thanks. Good morning Willy and Debbie. Want to follow up on the Capital Markets for a second. I guess origination personnel, with addition of the team in Fort Lauderdale, how did that process go relative to your expectations and does that help you or should it help us understand maybe the pace of hiring as we look out the rest of 2012?



Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

The team that we picked up in Fort Lauderdale is an extremely well known team. And they know a lot of people in the industry. So I think that having them join Walker & Dunlop is a wonderful testament to our vision and what we're trying to build out here. I'll leave it to, if you will, others to determine whether that's a net positive to Walker & Dunlop but I believe that it will help our recruiting activities going forward. And as relates to the overall strategy, as you know Brandon, that business, the Capital Markets business is not as profitable as our core lending business. There is nothing in our strategy, as I stated, our core strategy is to continue to grow our lending operations and continue to make both the revenues and the profits that we make off of our core lending business. But as we grow out our brokerage business there is both access to deal flow, there are the economics that come off of that brokerage business and then when we are successful at building out our own proprietary capital sources, feeding those proprietary sources of capital into that brokerage network will not only be wonderful for deal flow and for having proprietary products but it will also maintain some of the economics of our lending business. And so the brokerage business as a standalone strategy is not to morph Walker & Dunlop into a brokerage business. It is to build out a significant brokerage operation that we can then take our own proprietary products and push it through.

Brandon Dobell - *William Blair & Company - Analyst*

All right. Fair enough. Early on in the remarks you guys talked about no fee compression in the Agency business, and maybe a little bit of color around that comment in the context of what sounds like, like you said, more sources of capital back in the business, commercial real estate being back. How does that more sources of capital interplay with the fees and is there something coming down the pipe that a certain level of activity starts to generate fee compression for you guys? Or do you think the status of the GSEs will help protect that? Thanks.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

You want to talk specifically to actual fees quarter-on-quarter, as far as origination fee, and then I'll talk to the more general other sources of capital.

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Absolutely. So Brandon clearly there is more competition and people are back but there really hasn't been, even though we've expected to see, there really has not been any compression. So as we look across all of the businesses we continue to see very strong fees, both from an origination and both when we sell the securities into the market. Clearly, if we do a number of large transactions that can have an effect of fees because large loans generally do have a smaller. But we do continue to have a very strong mix of both small, medium and large transactions at that in many ways combined with the fact of just where the market is, it's allowed us to maintain those origination fees.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Okay. As it relates to specifically multifamily and the overall market for multifamily, the numbers that I have Brandon, are that Fannie did about \$25 billion in 2011, Freddie did about \$20 billion. And so that was \$45 billion which was 55% of the aggregate market. So the aggregate market was somewhere around \$80 billion or \$82 billion for multifamily financing. So I think that first of all there are lots of people who thought that Fannie and Freddie did 90% of the market in 2011. That is not true. They were 55% market share, huge, very significant, but they did not dominate the market as it relates to how they are doing it in the single family world.

The second thing there is that those of the sources of capital that competed for multifamily loans were primarily commercial banks and life insurance companies. And the life insurance companies, when they wanted to win a deal, they just dropped their rate and they won it. And so did that cause some pricing pressure? Yes, but when they saw an asset they wanted, they just went after it, and quite honestly if the all in coupon was at a 4.25, they'd put a bid in there at 4. They could've won the deal at 4.15, but they just took it at 4. So along those lines, life insurance companies went after class A properties in major MSAs, low leverage deals, and then the conduits really didn't compete at all for multifamily in 2011. Will they compete



for multifamily in 2012? Maybe. But as of right now where spreads are for conduits, they are really not price competitive for the life insurance companies and with the agencies.

And so then the final source of capital is commercial banks and clearly they're playing in the interim space, doing transitional properties short-term floating rate deals. But for long-term fixed-rate deals it's really between Fannie and the life insurance companies and as I said in my remarks life insurance companies quite honestly only have so much powder. The life insurance companies did \$11 billion of multifamily in 2011 and that was an all-time record as far as how much capital they put out to multifamily. So, let's just say that the life insurance companies decide they're going to do 50% more this year, so they'll add another \$5 billion or \$6 billion of capital to their multifamily originations. Is that a competitive threat to the agencies? Sure. But all things considered, the agencies still have a very large market share and so far we've not seen pricing impacted.

Brandon Dobell - *William Blair & Company - Analyst*

Okay. And then final one for me, maybe if you could characterize, I'm not sure if pipeline is the right word, but the interim loan business how does the deal flow look now that you've made your first one, you're getting a little more press with the people out there who you'd go to as an opportunity? Or any kind of color on how we should see that business progress through the balance of the year. Thanks.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

I think as the economy recovers, Brandon, there are more and more people looking to be opportunistic and so I guess, first of all, the cookie-cutter I guess five cap rate, multifamily property in a major MSA is basically being dominated by the REITs and the large institutions. And so if you are a, anything but one of those two, you're a real estate developer owner and you want to play in the multifamily space, going after stabilized major MSA assets is really not somewhere where you can compete today. And so as a result of that, people are looking for turnaround opportunities. They're looking for repositioning assets. And those are the types of clients quite honestly that Walker & Dunlop works with. If you look at our traditional client base the large REITs are not customers of Walker & Dunlop's. They work with the large banks so they've got lines of credit, and if they're going to do an agency deal, they'll do it with them. So having an interim product fits perfectly into what our client demands are of looking at, for opportunities to reposition assets. So we feel quite good about the interim pipeline. As you know in comparison to our aggregate business it is -- it's a very small business line to us today, but it does improve the conversation with the clients, it gets us in the door to some clients that we probably would not be able to get into without it. And as we've said, and as Debbie said in her comments, we plan to continue to grow that line of lending to continue to grow our proprietary sources of capital if you will.

Brandon Dobell - *William Blair & Company - Analyst*

Okay. Great. Thanks.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Thank you.

Operator

Mike Widner, Stifel Nicolas.

Mike Widner - *Stifel Nicolaus - Analyst*

Good morning guys. I think most of my questions have been asked. Just wanted to go back to the personnel expense line item. Maybe just go back to a couple things, I think Debbie you said, and Willy, you alluded to as well, 34% in the first quarter, it is kind of in the historic range. But then you



alluded to kind of expecting for the year a range more like 34% to 38% which suggests successive quarters being more likely higher rather than lower. And at the same time you kind of indicated that the expenses this quarter did reflect bringing on some new personnel. Just wondering if you could help reconcile those. As those people get ramped up can we expect any sort of positive leverage or is it really you expect them to kind of go the other way.

Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

A couple of things. One if you actually look back on the quarters that are disclosed, personnel expenses actually ranged, annually we talked about in the 34% to 37% or 38%, but quarterly it's gone anywhere from 26% to 47%, right?

Mike Widner - Stifel Nicolaus - Analyst

Right.

Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

That's clearly transactional on where people are split. As you remember expenses go up throughout the year so -- because people get it higher into their splits. So I actually think, if you think about the quarter, it's really three things. One, we actually brought on some people and there is a lag between bringing them on and production. Number one. Second of all volume. Volume has a big impact because we did less than \$1 billion, and as you know, our platform really kind of hums when it hits \$1 billion and greater. So there's the fact that we bought them on, the fact of lower volumes, and then it's always impacted by the time of year of splits. So we do think it's going to be a little bit higher, but it's also going to be highly impacted by volumes on a quarter and annual basis.

Mike Widner - Stifel Nicolaus - Analyst

So on the splits, I guess for some reason I was under the impression that more hit on the origination related fees and the origination margin more than on the personnel expense line, I guess it actually hits both?

Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

All of the commissions that we pay run through the personnel expense line, so they are impacted by that. So to the extent as the year goes on we've talked about how personnel expense can be affected by the origination volumes and associated fees.

Mike Widner - Stifel Nicolaus - Analyst

Got you. Okay. I think that make sense to me and I'm just looking out, as far, the other question I had, but I think you guys answered it, was on the delinquencies. Basically that the loan that you charged off rolled completely through, so as I look at the 60 day delinquencies, you're kind of at a relatively low mark compared to where you've been on average over the last couple of years.

Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

Right. It is because there is -- I think it is one loan sitting in 60 day delinquencies.



Mike Widner - *Stifel Nicolaus - Analyst*

Okay. And that's probably as good indication as we can have as to what we should expect for increasing provisions or additional provisions?

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Right. And the delinquencies are highly impacted by what states they are in. But we mentioned that we expect kind of the average over the last quarters, which has been about \$1 million to a quarter, in between 1 and 3 basis points of the portfolio. So there is going to be losses in the portfolio.

Mike Widner - *Stifel Nicolaus - Analyst*

Got you. That's all for me. Thanks. Thanks for the answers.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Thanks Mike.

Operator

Jim Fowler, Harvest Capital.

Jim Fowler - *Harvest Capital - Analyst*

Good morning Willy and Debbie and Claire. Couple of questions, I've been going between a couple calls so I apologize if these have been answered. The \$2.9 billion of servicing that isn't GSE, could you discuss just a bit the prepayment penalty coverage on that portion of the servicing portfolio?

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Sure. There are two things. First of all, all of -- let's separate between whether their borrower has prepayment protection and whether or not we get a check. So if you look at March 31, the \$16.9 billion, there is \$1.5 billion in Fannie Mae HUD and \$1.9 billion in other. So \$3.5 billion or so for which there is prepayment protection on the loans but for which we will not receive a check. That's the real difference. So if you think about it, I can run a percentage, but for the vast majority, for about 80% of the UPB that's out there, and a higher percentage of our MSR's we will receive a check for, if the loan prepays early, which is primarily almost all of the Fannie Mae and Freddie Mac loans with the exception of the \$20 million that we talked about before. Remember we don't set up an MSR for the servicing of the other loans, the \$1.9 the billion that's out there, so our MSR's relate solely to Fannie, Freddie and HUD. And of those three categories, the \$1.5 billion in HUD we don't receive a check if it pays off early.

Jim Fowler - *Harvest Capital - Analyst*

Thank you very much. Willy, on the conduit it and all of the lending in the quarter that's comprised by the other category could you talk for a minute on the economics of that channel. By that I mean the fees that we should assume that you receive from the borrower and are there any fees that you are paid by the party to whom you place the loan?

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

So Jim, on an origination fee standpoint, your origination fee will be anywhere between 50 basis points and 100 basis points of the loan. And that's a negotiated price. And as Debbie said previously, deal size has a lot to do with that. The larger the deal you're going to get down closer to a 50

basis point fee. Smaller deal, you're going to be up closer to 100 basis point fee. And then depending on we are working with, if we're a correspondent to a life insurance company, typically we will make a servicing fee going forward. As Debbie said we do not book Mortgage Servicing Right when we put that servicing onto our balance sheet, we don't put anything on our balance sheet. All we do is earn anywhere between 2 and 10 basis points depending on who it is and what we do for them in servicing of that loan. That servicing contract is cancelable with 60 days notice so it can go away just as quickly as it comes if you will. But it's a nice source of revenue that comes in to us for the loans that we do with life insurance companies.

And then on the conduit side. Sometimes conduits will give you servicing and you will serve as the loan as a sub-servicer, not a master service or a primary servicer but as a sub-servicer. And then sometimes they will pay you a fee in lieu of that servicing. Fees in lieu of servicing were very big back in 2005, '06 and '07. They are coming back a little bit but not much and so when we are doing loans with conduits generally speaking today we are taking that servicing fee that comes along with originating that loan for them.

Jim Fowler - *Harvest Capital - Analyst*

And would that conduit sub-servicing fee be similar 2 to 10 basis points or --

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

I would go back to the same range I put before, between 2 and 10.

Jim Fowler - *Harvest Capital - Analyst*

Yes. Good. Just a niche. Credit continues to be superb of course but I'm just wondering in the quarter there was a tiny bit of bleed in the provision. Do you have a targeted provision level as you grow the portfolio that we can just model along here?

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

I think the numbers that Debbie gave as it relates to kind of looking at \$1 million of losses per quarter over the last four or five quarters, what'd you use as your --

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Five.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Past four quarters.

Debbie Wilson - *Walker & Dunlop, Inc. - EVP, CFO & Treasurer*

Four quarters.



Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

Is probably a pretty good number for a stable economic environment. I think that the one thing that we've seen a lot of Jim is that the defaults in the portfolio are not geographically specific. They are not asset specific. They are borrower specific. And they are borrowers who got into trouble on doing a deal somewhere and they got -- they haven't learned how to manage the asset properly, but it's uncanny how they are truly, truly borrower specific. And given the scale of our portfolio, our portfolio presently has over 1800 assets in it, there is going to be some borrower who has not done a good job of doing their job in our portfolio, just given the scale. And so I think that as you look at the loan losses they are -- we clearly are not immune to the overall economic conditions. We are not immune to potentially lending money to people that we wish we hadn't lent money to. And we are clearly not immune to making mistakes as it relates to some deal and how we've actually underwritten it.

But given the way that we have, if you will, attacked our underwriting for the last 23 years since we've been a lender with Fannie Mae and taken the credit risk that we do, I think our track record shows that we are extremely conservative, we are extremely good at assessing the risk, and we're extremely good at doing our diligence on borrowers. But just, if you will, the law of averages is going to have some problems somewhere in the portfolio on a quarterly basis and to your point of what is your target, it's hard because we're growing so fast to be honest with you. If I said \$1.2 million is sort of the quarterly target, that sounds great, but if we are successful, which I expect we will be on hitting our annual origination targets of \$4.5 billion to \$5.25 billion and you have limited runoff in the portfolio, what's that number when we get ourselves to an \$18 billion, \$19 billion, \$20 billion portfolio. So we feel very good at sort of, right now as Debbie said, the loss on the quarter were 2 basis points of the at-risk portfolio. We've been between 1 and 3 basis points. So if you're going to model out, I don't think that you would go much beyond what our historic average has been of 1 to 3 basis points and we feel very good about both the overall macroeconomic conditions and the way we've gone about originating and underwriting our business to stay in that range.

Jim Fowler - *Harvest Capital - Analyst*

Last question and sorry it's just a dumb question. In the multifamily is it similar to residential where you have a trustee process in some states and a traditional process in other states, and if that is the case how is your portfolio aligned just broadly in terms of percentage allocation of those two processes?

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

I don't know the answer to your question. We have our portfolio broken down by state obviously. We do not have it broken out of judicial states and non-judicial states and what have you there. There are -- but we could -- I have no idea. That's a cut we could do Jim at some point.

Jim Fowler - *Harvest Capital - Analyst*

Your level of delinquency.

Willy Walker - *Walker & Dunlop, Inc. - Chairman, President & CEO*

The bottom line on it Jim is that with the few delinquencies that we've had, whether we are in a judicial state that's going to take us two years to work it out or a non where we can work through the loan in six months, it's, as you know, we take the provision for loss sharing at the time that we know that the loan has gone -- is going to go into default. And then we work that process out and that runs through, once we settle up on the loan anywhere between 6 and 24 months later. But you've sort of, if you will, taken a hit on the P&L, you all will see the hit the moment we identify the loan. And so there's nothing here where we are going to have a whole lot of capital tracked if you will of having a lot of exposure to judicial states given our historic loan losses and the diversity of our portfolio across the country.



Debbie Wilson - Walker & Dunlop, Inc. - EVP, CFO & Treasurer

Right.

Jim Fowler - Harvest Capital - Analyst

Thanks and look forward to seeing you all next week.

Willy Walker - Walker & Dunlop, Inc. - Chairman, President & CEO

Great. Thank you.

Operator

We have no further questions. I like to turn the call back to Willy Walker for closing remarks.

Willy Walker - Walker & Dunlop, Inc. - Chairman, President & CEO

Great. Thank you all very much for participating in this morning's call and for your questions and I know we're having follow-up calls with a number of the analysts. We look forward to talking with you then. I wish everyone a very nice day. Thank you.

Operator

Thank you. This does conclude today's conference call. Please disconnect your lines at this time and have a wonderful day.

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