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Walker & Dunlop, Inc. (WD)

Q3 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Walker & Dunlop's Third Quarter 2013 Earnings Conference Call and Webcast. Hosting the call today from Walker & Dunlop is Willy Walker, Chief Executive Officer. He's joined by Steve Theobald, Chief Financial Officer; and Claire Harvey, Vice President of Investor Relations.

Today's call is being recorded and will be available for replay beginning at 10:00 AM Eastern Standard Time. The dial-in number for the replay is 800-723-0528. 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
Vice President-Investor Relations, Walker & Dunlop, Inc.

Thanks, Steve. Good morning, everyone. Thank you for joining the Walker & Dunlop third quarter 2013 earnings call. I have with me this morning our Chairman and CEO, Willy Walker; and our CFO, Steve Theobald.

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 our earnings release and presentation to the Investor Relations section of our website, www.walkerdunlop.com. These slides serve as a reference point for several of what Willy and Steve will touch on this morning. So participants who are interested in following along should pull those up and have them available.

Please also note that we may reference certain non-GAAP financial metrics such as adjusted net income, adjusted earnings per diluted share, adjusted operating margin, adjusted income from operations and adjusted total expenses during the course of this call. Please refer to the earnings release and presentation posted on our website for reconciliations of the GAAP and non-GAAP financial metrics and related explanation.

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.

I will now turn the call over to Willy. Willy?

Willy Walker

Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.

Thank you, Claire. And good morning to everyone joining us on the call today. I'd like to start my comments focusing on what has happened in 2013 from a regulatory and market perspective to give investors in Walker & Dunlop a good sense of what we've experienced and how we've competed in a highly challenging environment.

I will then highlight a number of Walker & Dunlop's recent business development initiatives that have started to benefit our results. I will then turn the call over to Steve to discuss our Q3 financial performance. And I then will finish the call by discussing what we see ahead of us and how Walker & Dunlop will continue to compete and grow going forward.

When the Federal Housing Finance Agency, FHFA, came out in March with their arbitrary 10% reduction to Fannie Mae and Freddie Mac's 2013 multifamily lending volumes, we expressed concern with the regulators' actions but did not think a 10% reduction would dramatically impact the GSEs. We were wrong. As we discussed in our Q2 earnings call, the 10% reduction required the agencies to start allocating capital and picking deals for reasons other than just being great real estate debt investments.

In the midst of Fannie and Freddie trying to determine which deals to do and not do, interest rates shot up over 100 basis points and put securitized lenders such as Fannie and Freddie at a pricing disadvantage to balance sheet lenders who are not selling into an investor community that needed higher spreads in an increasing rate environment. Notwithstanding the turmoil, Walker & Dunlop originated $2.6 billion of loans in Q2, right down the middle of our guidance range. But we didn't do as much business with Fannie Mae as in the past, so margins contracted, as did earnings per share.

Our Q3 origination guidance of $2 billion to $2.5 billion was established in early August, looking at three factors: our active deal pipeline, the competitive landscape, and Fannie and Freddie's comments that they would continue lending throughout the year. As our $1.8 billion of Q3 loan originations indicates, we misread two things: first, balance sheet lenders' desire for commercial real estate loans; and, second, the GSE's dramatic shift in pricing to allow loan origination volumes to get back below their annual limits.

Fannie Mae and Freddie Mac's Q3 loan originations were down 40% over the prior year. Coupled with this pullback by the GSEs, HUD, as we've discussed in our Q2 call, started prioritizing loans in August and eventually ran out of commitment authority in mid September. All of these factors contributed to Walker & Dunlop's quarterly loan origination volumes falling 19% compared to Q3 2012.

Although the regulatory and market shifts this year have been more significant and challenging than anticipated, we've been making significant investments of time, capital, and resources to diversify our business. Our diversification strategy is focused on growing our Capital Markets business to gain access to deal flow, while simultaneously raising third-party capital, as well as lending, using our balance sheet.

In Q3, our Capital Markets business originated $610 million in loans, up 142% over Q3 2012. Our interim lending program originated $101 million of loans for our balance sheet during the quarter, up 657% over the previous year. To put the growth of these new initiatives in perspective, during the first nine months of the year, our Capital Markets and interim lending program have originated $1.8 billion in loans, up over 100% from the first nine months of 2012.

We also announced in Q3 the establishment of our large loan bridge lending program with two large institutional investors. We closed our first loan in this program of $44 million last week. Finally, as we announced yesterday, Walker & Dunlop and Fortress Investment Group are launching a CMBS lending platform that will lend on all commercial real estate property types, starting at the beginning of 2014.

As we head into the refinancing wave of 2015 to 2017, we expect our conduit to be a major provider of capital to commercial real estate. These very significant steps further diversify Walker & Dunlop's lending operations and take advantage of our access to deal flow and deep underwriting and credit capabilities.

Since going public, we have repeatedly mentioned the value of our servicing portfolio and the consistent revenue streams it produces. In Q3, when loan originations fell by 19% and GSE originations fell by over 50%, we grew revenue by 5%, thanks to our Capital Markets business, interim loan program and servicing fees. At the end of September, our servicing portfolio totaled $38.7 billion and generated $23 million in servicing income, up 72% over Q3 2012.

The loan origination business is highly variable as the quarter-to-quarter volumes at Walker & Dunlop and our competition reflect. Behind our origination business, however, is a very valuable, growing servicing portfolio that has had exceedingly low loan losses over time and is expertly managed by Walker & Dunlop's servicing team. As Steve will mention in his remarks, not only is the servicing portfolio hugely valuable today, but it'll continue growing for many years to come and has a very long tail of prepayment protected revenues.

I'd like to turn for a moment to the competitive and regulatory landscape. Competition has always been fierce in our business, whether in the midst of the downturn when all there was to do was agency financing, or more recently as interest rates moved up and balance sheet lenders had a pricing advantage. It is our job to react to competitive market forces and sell our financing in all market environments. But there are several market factors that have made this year particularly challenging.

First, as I previously mentioned, FHFA's 10% reduction made business at Fannie and Freddie anything but usual. Second, interest rates moving up made balance sheet lenders, predominantly banks and life insurance companies, significantly more competitive on pricing. And finally, HUD's inconsistent commitment authority has made our HUD origination volumes erratic. So, does this ever change? With regard to the 10% reduction to Fannie and Freddie, we are hard pressed to think that 2014 loan limits will cause as much turmoil in the GSEs as the 2013 out of the blue reduction did.

With regard to the competitive landscape, it will remain fiercely competitive as balance sheet lenders and CMBS lenders compete for deals. Fannie and Freddie should have somewhere around $50 billion to lend in 2014 and it is our expectation that they remain major forces in the market and compete effectively.

Finally, we see no signs that the federal budget process and partisan bickering will end anytime soon. HUD is a unique financing solution that specific borrowers love for its cheap rates and long loan terms. Although the disruptions to HUD's commitment authority make quarterly volume forecast almost impossible, Walker & Dunlop has a fantastic HUD origination group and we will continue originating as much HUD business as we can.

I want to talk about our year-to-date results and the cost reduction measures we implemented in October. We have originated $6.1 billion in loans this year, resulting in revenues of $234 million, up 54% over the first nine months of 2012. We have made $0.95 per share of adjusted fully diluted earnings. And we accomplished all of this while the regulatory and market conditions could not have been more challenging. We take full responsibility for establishing origination expectations that we have not met, but our business is growing and profitable.

As we mentioned in our earnings release this morning, we implemented a cost reduction plan in October based on our year-to-date origination volumes. My family has managed Walker & Dunlop for 76 years through great times and bad. We've worked exceedingly hard to make this company a fantastic place to work. And I would note that in September, we were named for the second year in a row one of the great small and medium-sized businesses in the United States by the Great Places (sic) [Place] (11:23) to Work Institute and FORTUNE magazine.

We've existed for 76 years and managed successfully through tough times because we are pragmatic about our business and proactive in managing it. Our 2013 expectations were to originate between $10 billion and $12 billion in commercial loans. We'll end the year significantly lower than that range. So we took action in October to lower our expense base.

Steve will discuss the cost savings in more detail in a moment, but I would comment that our executive team did an expert job in managing the very difficult human resource decisions that were part of this cost reduction initiative. It is never easy to cut costs, particularly when reducing the size of your workforce. We are now properly sized for our current origination expectations and are very focused on growing our originations, diversifying our lending activities and continuing to meet our clients' expectations and needs.

With that, I'll turn the call over to Steve to discuss our financial results.

Stephen P. Theobald

Chief Financial Officer, Treasurer & Executive VP, Walker & Dunlop, Inc.

Thank you, Willy, and good morning, everyone. I will provide some additional context around our third quarter financial results, discuss the performance of our servicing portfolio in greater depth and explain the details of the cost reductions that Willy mentioned.

Net income for the third quarter was $8.1 million or $0.23 per share. Adjusted net income, which excludes selected expenses relating to the acquisition of CWCapital, was $8.7 million or $0.25 per share. Operating margin for the quarter was 17% and adjusted operating margin was 19%. This compares to adjusted net income of $14.3 million or $0.56 per share and adjusted operating margin of 34% in the third quarter of 2012.

Net income, earnings per share and operating margin on a GAAP basis for the third quarter of 2012 were $7.1 million, $0.28 and 17% respectively. Total origination volume of $1.8 billion was down 19% from Q3 2012 and below our initial guidance of $2 billion to $2.5 billion. As Willy mentioned, this quarter's origination volumes with our core agency partners were negatively impacted by volatility in interest rates, a decline in the market presence of Fannie and Freddie, and a lack of sufficient HUD commitment authority.

On the positive side, we saw great execution and growth from our Capital Markets team. This quarter, brokered originations were the largest part of volume at 35% of total loans originated. We continue to see strong investor demand for commercial real estate. And this, combined with constrained agency originations, likely means that our brokered originations will continue to be a large and growing share of our overall volumes. We expect that our fourth quarter total originations will be between $1.5 billion and $3 billion.

As you will see from the table included in our press release, we have separately disclosed the amount of loans originated through our interim loan program. During the quarter, we originated a total of $101 million of interim loans for our balance sheet and now have a portfolio of $119 million. Because these loans are originated for our own portfolio, they have a profit profile different from our core business.

For these loans, there is no mortgage servicing right and origination fees and costs are deferred and recognized over the life of the loan. Going forward, our revenue will be the net of interest income on the loan, the amortization of deferred origination fees and costs, and the interest expense on the warehouse line used to fund a portion of the loans.

During the quarter, we recognized net interest income of $431,000 on our portfolio. We expect this to grow modestly in the future as we continue to increase the size of the portfolio, providing us another annuity like revenue stream and we believe this business will generate low-to-mid teens returns. As a reminder, we get additional value from these loans with the opportunity to do the permanent takeout financing. Total revenue during the quarter was $73.7 million, a 5% increase over Q3 2012.

Slide five shows the trend in our mortgage banking margins, which were at 257 basis points for the third quarter, up from 245 basis points in the third quarter of 2012. Last quarter, we mentioned that we expected gain on sale margin to average about 245 basis points over the next few quarters, given our business mix and product margins. This quarter, we did slightly better than that as we saw robust origination in servicing fees on all our products.

Our servicing portfolio is now at $38.7 billion. As you can see from slide six, our servicing portfolio is 14% larger than a year ago and continues to grow, adding net loans of $781 million during the third quarter. Our weighted average servicing fee remains at 24 basis points, generating $23 million of revenues during the quarter. Our servicing portfolio more than doubled with the CW acquisition and has grown each quarter since.

We often get questions about whether the servicing portfolio is so large that it will be difficult for us to continue growing it, particularly if Fannie and Freddie volumes continue to be tapped. If you turn to slide seven, we show an example of what our current portfolio looks like over the next seven years based on the end of the yield maintenance period of the underlying loans.

As you can see, the annual runoff is not significant with the highest total in 2020 of $4.2 billion. For context, in only nine months this year, we've already originated $4.3 billion in Fannie, Freddie and HUD loans. The other point on this slide is that the new business we are originating into our servicing portfolio has a higher weighted average servicing rate than the business running off, which will lead to increased average serving fees from the portfolio over the next few years.

As Willy mentioned, we are entering into the CMBS space. This platform will be up and running early in the new year and we expect to originate pools of close to $200 million, which will be contributed to large securitizations being managed by two or three investment in commercial banks. In anticipation of that move, our servicing business was rated by Fitch and S&P, giving us the ability to act as the primary servicer for the loans our venture will contribute to the securitization transactions. For the CMBS venture as a whole, we have a 20% stake and we'll earn origination fees, servicing fees and our profit participation from the JV.

Total expenses for the quarter were $60.9 million and adjusted total expenses were $59.9 million, up 29% over third quarter 2012. The increase in total expenses was largely due to the increase in amortization and depreciation, which was up 102% or $9.8 million from the third quarter of 2012 and 131% year-to-date. This increase was a result of the acquisition of CWCapital and continued growth in servicing, as well as the impact of mortgage servicing write-offs because of early payoffs and defaults in our HUD portfolio.

HUD loans carry a prepayment deterrent during their yield maintenance term, but we do not share in the prepayment penalty. And while we do not have credit exposure on our HUD loans, a loan that goes into default stops paying servicing fees. And, as a result, we write-off any MSR related to that loan.

The lower rate environment over the last year presented HUD borrowers with a favorable refinancing opportunity. And this, coupled with our larger HUD portfolio, has resulted in an increase in HUD prepayments. This is consistent with what we saw in the first two quarters of the year. In addition to the impact of early payoffs, we wrote-off a $1.5 million MSR on a HUD loan that went into default during the quarter.

Offsetting the increase in amortization and depreciation expense were declines in personnel and tangible amortization and other operating expenses from the third quarter of 2012. Personnel expense was $31.1 million or 42% of total revenues during the quarter compared to $32.2 million and 46% of revenues in the prior year. The year-over-year decline in personnel expenses was driven by lower commissions as well as certain employee-related costs incurred last year related to the closing of the CW acquisition.

As Willy mentioned, we have been taking a hard look at our expenses in light of our lower-than-expected volumes. And in October, we made the decision to reduce our head count by a little more than 50 people. These cuts were across the board with concentrations in two specific areas. First, we made the decision to exit our small loan lending business. This business unit was acquired as part of the CW transaction and it focused on smaller loans to smaller borrowers. As we evaluated the business, we decided it did not fit with our long-term strategy, so we shut it down.

Second, we closed down substantially all of one of our offices. This location was largely a HUD production office tied to one of our producers. That producer retired a short time ago and some of the key staff resigned. We kept a small team in place in that location and spread the remainder of the work being processed by that office to other HUD teams around the country.

In addition to head count reductions, we are looking at various contracts and internal spend categories with the target to reduce expenses starting in 2014. Overall, we expect the reduction in head count and our other cost initiatives to result in annual savings to the company in excess of $7 million.

In the fourth quarter, we expect to take a charge for severance and early lease termination of between $800,000 and $1.2 million. We believe these cost reductions will enable us to deliver operating margins in the mid 20%s over the course of a year, with our current volumes and mix of business, while not sacrificing any ability to grow or meet our customers' demands.

Before I turn the call back to Willy, I want to touch briefly on credit and our balance sheet. From a credit perspective, we continue to see favorable trends in our portfolio. At the end of September, there were two loans totaling $9.1 million in our at risk portfolio that were over 60 days delinquent, unchanged from the end of the second quarter. In addition, we settled up with Fannie Mae on seven loans during the quarter and recognized the loss through a charge-off in our allowance of $3.7 million. These losses were provided for in prior years and had no impact on our earnings during the quarter.

As a reminder, we elect to settle our losses with Fannie when they ultimately resolve the asset rather than at the time of foreclosure, which can result in a significant amount of time between when we provide an allowance for the loan and when we ultimately settle, sometimes three or four years. At this point, we are down to 13 properties that Fannie is still working out. And we expect most, if not all of these, will be resolved with no additional loss to us over the next year or two.

As we discussed on last quarter's earnings call, we have a very solid balance sheet supported by strong cash flows and significant equity capital. To take advantage of our strong financial position, in early October, we announced our intent to pursue an institutional senior secured term loan facility of between $150 million and $200 million to refinance existing debt, fund growth opportunities and for general corporate purposes.

Subsequent to that announcement, we saw the federal government shutdown and our stock price decline with our Q3 originations announcement, creating enough uncertainty in the marketplace that we decided to wait until conditions were more favorable. As markets stabilize, we intend to take another look at moving forward with the secured term loan facility, assuming we find market conditions favorable. As part of the debt raising process, we were rated by S&P and Moody's with ratings of BB- and Ba3 respectively.

In summary, we continue to take steps to position our business for growth and future success. We have built and continue to grow a stable and scalable servicing business. We are managing costs to improve our efficiency and future operating results. And we are raising efficient capital that will allow us to continue our growth and deliver strong shareholder returns over the long run. We are at the beginning stages of the pending maturity wave. And I am confident we are taking the steps necessary to position us to take full advantage of the opportunities the market will provide.

With that, let me turn it back to Willy.

Willy Walker

Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.

Thank you, Steve. Let's look forward to year-end 2013 and what we are planning for in 2014. I will be the first to admit that our crystal ball has been a bit foggy at best for most of 2013. We clearly did not expect the regulatory changes or market conditions that have made this year so challenging. But our team has done a great job of selling and managing through it.

We know that the commercial real estate finance industry has a refinancing boom ahead of it between 2015 and 2017. Hundreds of billions of dollars of commercial mortgages come due in those years and Walker & Dunlop will use its scale, talented origination and underwriting platform and longstanding client relationships to do as much business as possible in what would be a very robust market.

So, what happens in 2014 before the refinancing wave hit? First, we do not know whether FHFA will reduce the GSEs multifamily volumes again. But FHFA continues talking about future reductions and potential lending limits on certain types of multifamily assets.

These comments and actions by FHFA do not make sense as there is widespread support for the GSE's multifamily businesses by both Republicans and Democrats on the Senate Banking Committee, where the most rigorous analysis and debate on the future of the GSEs is taking place. As well, FHFA recently asked for industry input on continued reductions in Fannie and Freddie's multifamily lending businesses. And 91% of respondents said the businesses were sound and should not be further reduced.

And most puzzling, FHFA's own 2013 through 2017 strategic plan calls for four major changes to Fannie and Freddie's lending operations, all of which the GSEs multifamily businesses comply with today. So, even though legislators, industry participants and their own strategic plan don't call for further reductions in Fannie and Freddie's multifamily businesses, the regulator may continue down that path. Similar cuts in 2014 would leave Fannie Mae with $27 billion and Freddie Mac with $23.4 billion to lend in 2014.

With regard to our HUD business, notwithstanding my earlier comments about the dysfunction on Capitol Hill, the current 2014 House and Senate budgets include $30 billion from multifamily and healthcare lending at HUD. So, Fannie, Freddie and HUD are likely to have between $70 billion and $80 billion of capital to lend in 2014. It is our focus and intention to remain one of their largest partners and continue originating great loans on multifamily properties across the country.

Although the regulators are having a significant impact on these businesses in the short-term, it is our sense that GSE's multifamily businesses will survive, whether after being spun out of their mother organizations or inside a new enterprise created by Congress. They already meet FHFA's own strategic plan. They include significant private capital. And they provide liquidity to large and small markets in good and bad times.

So our strategy is to remain a major provider of capital for the multifamily industry, while continuing to grow our Capital Markets group to broaden our access to deal flow and capital sources. We've recently made new hires in Texas and California, two geographies we did not have a Capital Markets presence previously. We outlined last year a goal of growing this business to $3 billion to $5 billion in annual originations. And we are well on our way to doing just that.

But I want to be clear. Our strategy is to expand our Capital Markets groups in conjunction with adding proprietary capital solutions to lend into those new channels. If you look at the financial results of some of the brokerage firms we compete with, they need to do five to six times the aggregate origination volume in loans to produce similar revenues and smaller profits than Walker & Dunlop. In a people-intensive business, why would we ever want to do five to six times the deal flow to produce less profits? We take credit risk and get paid for it.

We have spent decades of time and capital to build a $39 billion servicing portfolio that is close to producing $100 million in annual revenues. We will continue to focus on building our origination, underwriting, asset management, and servicing platform to meet our clients' needs, while maintaining the discipline of our business model.

Yes, the GSEs and HUD have had a challenging year and Walker & Dunlop's origination volumes and revenues have been impacted as a result. But those three capital sources will continue to have massive amounts of capital in 2014. We will continue to diversify our lending operations and we will continue to build our scaled, largely prepayment protected servicing portfolio, to provide our investors with long-term sustainable returns.

With that, I'd like to thank everyone for participating in today's call. And I'll open the line to questions.

QUESTION AND ANSWER SECTION

Operator: Floor is now open for questions. [Operator Instructions] And our first question is from Whitney Stevenson from JMP Securities. Your line is open.

Whitney D. Stevenson
Analyst, JMP Securities LLC
Q

Hi, there, everyone. Good morning. Thank you for taking my questions. I'm wondering if you can talk a little bit about looking ahead to when we get to the bulk of the refinancing wave in 2016 and 2017 about what your goal and mix is from the new lending initiatives you're rolling out.

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.
A

Whitney, a little tough to, if you will, comment, as it relates to what percentage of all that we like to do. As you know, 2007, there was $230 billion of CMBS loans originated in 2007. The great majority of that will be terming in 2017. The components in 2015, 2016 and 2017 that are the greatest from a refinancing standpoint are those CMBS loans that were done in 2005, 2006 and 2007. So, one of the most exciting parts of our CMBS platform is that many of those loans may or may not be, if you will, agency or Fannie Mae, Freddie Mac type loans or the borrowers actually may or may not be a typical agency borrowers. And so, by launching the CMBS platform, I believe we are going to have a fantastic opportunity to participate in refinancing a solid percentage of those loans that were previously in CMBS pools that will be up for refinancing.

Whitney D. Stevenson
Analyst, JMP Securities LLC
Q

Okay. And then, I think that Steve mentioned the mid-20% margin goal for this year. Is there anything that you're foreseeing in the mix in 2014 that we should think about when looking at a run rate for the margin?

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.
A

I mean I don't think so, Whitney. I'd put forth that you've seen our Capital Markets business grow significantly and be 30% of originations in Q2 and 35% of originations in Q3. But as I hope I was explicit in saying in my comments, the strategy here is to – you've got to get access to the deal flow. And we have done that successfully by hiring new originators in our Capital Markets group and growing that business significantly. But the strategy is to make sure that we're creating proprietary capital sources behind it, so that our revenues and our margins are not that of a pure brokerage firm. And they are the revenues and margins of a lender.

And so as we move down this path, I think we've been very successful at adding the access to originations by growing our Capital Markets business. And, as we have shown in Q3 with the launching of our large loan bridge program with two large intuitional investors and now in Q4 with the announcement of our CMBS platform in early 2014, we are creating those proprietary sources of capital, which should allow us to maintain our margins in that mid 20% range, which Steve talked about.

Whitney D. Stevenson
Analyst, JMP Securities LLC
Q

Okay, great. Thank you.

Operator: Our next question comes from Brandon Dobell from William Blair. Your line is open.

Brandon B. Dobell
Analyst, William Blair & Co. LLC
Q

Thanks. Maybe a quick, I guess, presentation question. When you guys start generating deals out of the CMBS and high yield initiatives, what's the presentation of those going to be on the P&L and the balance sheet? I just want to make sure we have a better idea of how that's going to look, what we're going to see to gauge your progress there?

Stephen P. Theobald
Chief Financial Officer, Treasurer & Executive VP, Walker & Dunlop, Inc.
A

Yeah. Brandon, this is Steve. I'll jump in on that one. I think from the perspective of any loan that our current originators are originating into the CMBS platform, those would roll through our P&L probably largely like a Capital Markets execution would look like.

Brandon B. Dobell
Analyst, William Blair & Co. LLC
Q

Okay.

Stephen P. Theobald
Chief Financial Officer, Treasurer & Executive VP, Walker & Dunlop, Inc.
A

There will be originators that are embedded into the joint venture that are originating directly and only for the JV. The revenue that we earn off that will be our 20% of the profits of the venture and that will likely roll through other income at this point in time.

Brandon B. Dobell
Analyst, William Blair & Co. LLC
Q

Got it. Okay. And then turning to brokered loans, nice progress the last couple quarters in terms of proportionate origination. As we think about the long-term economics of that business, recognizing it's probably going to be a little lower margin than just what the kind of current P&L would look like. But I guess I'm more curious about the service intensity of that business. I.e., can you do good volume without having to have a lot of people, i.e., you kind of upset your personal ratios? And then from a servicing perspective, how do we think about the impact as that part of the portfolio grows on your overall servicing fees, especially as you look out to the next three or four years?

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.
A

So the – Brandon, as you very well know from your coverage of other competitors in this space, the Capital Markets, as we call it, or the brokerage businesses, as others call it, is a lower margin business due to both the fees that you're earning and then also not taking risk on the loans that you originate and then also not booking MSRs and having lower servicing fees.

Brandon B. Dobell
Analyst, William Blair & Co. LLC
Q

Right.

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.

A

On the front-end, we'll manage that as we have up until now, which is that that execution doesn't require huge infrastructure. Obviously, it doesn't require underwriters, doesn't require closers and requires far less, if you will, overhead internally to originate a loan. So from the front-end of it, the economics stay pretty consistent, if you will, to where we've been up until now, which is sort of, as the comps to us will show you, sort of, a mid-to-low teen return business.

As it relates to the servicing side of it, you ask a very good question because one of the beauties of our existing servicing portfolio is that because the bulk of it is with two lenders, with Fannie Mae and Freddie Mac, we have standardized documents and standardized servicing requirements on us from those two lenders. When you broaden out the capital sources that you are lending for, you then broaden, if you will, the variability or the discrepancy between various lender servicing standards. And so, it becomes a far more complex operation.

We have been servicing loans for life Insurance companies for decades as well as CMBS lenders for decades. And so, we're pretty expert at that. But you raise a good question which is just the servicing is lower from a revenue standpoint and then it's also higher intensity from a management standpoint. And so, it's very important that you scale with a certain number of lenders. But if you grow that servicing portfolio with every single lender out on the face of the planet, you're going to have a hard time creating the margin you need to.

Brandon B. Dobell
Analyst, William Blair & Co. LLC

Q

Got it. Okay. And then, Willy, just touching on your comments around that $70 billion to $80 billion bucket that could be out there for next year, sounds like you have a pretty decent amount of confidence in the gross numbers. What's your confidence level in how those numbers, I guess match up with what your historical property type strengths have been? i.e., is Fannie going to say we're just not going to originate into that particular geography or properties over a certain dollar amount or something like that that would skew that $70 billion to $80 billion either towards you or away from you in terms of your strength for origination?

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.

A

It's an extremely good question, Brandon, and I wish I knew better how to answer it. I will say this. There are a couple things here. First is, that, as we all know, originators have client bases that go through cycles of refinancing needs. And so, as much as our origination volumes have been off this year, due to a lot of external forces, there's also, if you will, some client mix in there of clients – no way to say that we haven't lost a lot of business because we've lost a ton of business this year. And it has been very hard to lose that business in a year when traditionally we would have won that business if Fannie and Freddie had been more active in the markets. But with that said, first of all, there is the cyclicality of client demand.

The second thing is that the regulator is clearly looking at whether they ought to restrict the agencies in lending in various product types. Most specifically, the discussion inside the regulator right now is should they limit the amount of lending that Fannie and Freddie do on high end assets or as we call them brass and glass. And there are two sides to that. One, we have spoken extensively with both legislators on Capitol Hill, as well as with the regulators saying any time you restrict to one asset class or try and put caps on it, you, generally speaking, distort the market. And that they probably want to allow the agencies to continue to manage their business. And if they want to cap the aggregate volume of business that's better than trying to cap any one type of deal or one type of asset class.

If they were to do that, that is unfortunate because we do have a number of large clients who have large properties that would qualify underneath that type of program. At the same time, some of our competitive firms have much larger lending footprints in places like San Francisco and Manhattan where you do have lots of very, very high end buildings that previously have received financing from Fannie and Freddie. And if there was any cap there, I think that would have a greater impact on their business than ours. Nonetheless, we do have clients who have very large buildings that are, if you will, higher end and it would be a big shame to be shut out of that space.

On affordable housing, manufactured housing, student housing, there really hasn't been a lot of discussion at either the legislative level or at the regulator related to any changes in the way that their agencies lend on those asset classes. The only thing I would say is that it is unlikely that they are allowed to broaden their lending operations into new opportunities or new types of multifamily assets or healthcare assets or anything that they presently today are not lending on.

Brandon B. Dobell
Analyst, William Blair & Co. LLC
Q

Got it. Okay. And then a final one. You mentioned the charge that we had expected in the fourth quarter. Any spillover that you would expect in the first part of 2014, or is it just going to be limited to Q4?

Stephen P. Theobald
Chief Financial Officer, Treasurer & Executive VP, Walker & Dunlop, Inc.
A

It should be limited to Q4, Brandon.

Brandon B. Dobell
Analyst, William Blair & Co. LLC
Q

Okay. I appreciate it. Thanks, guys.

Stephen P. Theobald
Chief Financial Officer, Treasurer & Executive VP, Walker & Dunlop, Inc.
A

Yeah.

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.
A

Thank you.

Operator: [Operator Instructions] Our next question comes from Charles Nabhan from Wells Fargo. Your line is open.

Chuck J. Nabhan
Analyst, Wells Fargo Securities LLC
Q

Good morning. Thanks for taking my call. Through your conversations with the GSEs, do you get the sense that they will be reducing some of their originator relationships? And if so, do you anticipate any fallout or opportunity for the company as a result of that dislocation?

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.
A

So, Charles, we'd love to see it. I'm not sure whether we will. There are currently around 25 participants in both the Fannie Mae DUS program and the Freddie Mac Seller/Servicer Program. I've spoken to the leaders of both of those programs saying, isn't it time to focus your time, attention and capital on your largest partners and not have to focus on, if you will, lenders number 20 through 25? They understand the discussion and understand, if you will, the reasons for it, but it's a delicate subject with them. And we're waiting to see if they do anything along those lines or not.

As it relates to their capital and how much they are giving to each lender, one of the things that we were quite concerned with was that they would manage our volumes in 2013 to a 2012 number, minus 10%. And what we have seen actually is that our numbers with Freddie Mac have gone up. Our numbers with Fannie Mae are down through three quarters about 10% from where we were a year ago. But we have been assured by both of them that they are not managing us to any specific number for the year. And so, it's a little difficult for us to tell right now.

The only other thing I would say is that from a competitive positioning standpoint, they have not published any numbers on it, but it is our sense that we are still neck and neck as far as being the largest Fannie Mae DUS lender with one or two other lenders and that we are firmly in the top five with Freddie Mac. And so even though our numbers have gone down and missed our expectations, from a competitive landscape standpoint, our competition has also had similar reductions in their volumes.

Chuck J. Nabhan
Analyst, Wells Fargo Securities LLC

Q

Right. And when we look at your guidance for the fourth quarter of $1.5 billion to $3 billion, that's quite a wide range and I understand there is a bit of uncertainty and you've touched on some of the factors driving that uncertainty. But could you give us a little more color on the factors? I know there's some seasonality in the fourth quarter, but how should we think about that range?

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.

A

So, as I said in the call, we gave guidance on Q3 having looked at our pipeline, looking at the competitive landscape and having heard from the GSEs that they were staying in the markets and would continue to provide capital. And in a very short period of time after making – establishing our Q3 guidance, the market moved on us in a dramatic way. And the agencies really hit the brakes. And, as you well know, we missed our guidance range. And we've been very, very good historically at establishing guidance and being able to meet that guidance.

So, what we have done on this quarter is we've established a guidance range that we are – as you yourself said, it's a wide guidance range and we are going to come in that guidance range. So, it's nothing other than us sitting there, looking at the landscape and saying, we've got a great team, we've got a great pipeline and we are working tirelessly every single day to get as much business done as we possibly can. But the actions by Fannie and Freddie in Q3 and also the competiveness of the marketplace – I will not only say that Fannie and Freddie hit the brakes hard in Q3, which surprised us how hard they hit the brakes, but I would also say as we said in our prepared remarks that the balance sheet lenders, particularly banks and life insurance companies, really got competitive in Q3.

And there seems to be right now an insatiable appetite on the part of balance sheet lenders for not only multifamily loans, but commercial real estate loans across the board. And how long they continue to compete at the levels they are competing at, we're out there every single day and we're seeing the agencies be very competitive day in and day out right now, but it's a highly competitive environment as we said in our prepared statements.

Chuck J. Nabhan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you for taking my call. I appreciate the color.

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.

A

Yeah.

Operator: We have no further questions at this time. I'd like to turn the floor back over to Mr. Willy Walker for any additional or closing remarks.

Willy Walker
Chairman, President and Chief Executive Officer, Walker & Dunlop, Inc.

One thing that somebody just mentioned to me was that in my comment on Fannie and Freddie, we are up from a ranking standpoint on Freddie Mac year-to-date as far as where we believe we are in the rankings, but our aggregate volumes at Freddie Mac are down year-to-date. So, I just didn't want to misspeak there. I obviously did by saying that we're up with Freddie. We're up in the rankings with Freddie, but our aggregate volumes are down.

I would just put forth that Q3 was a quarter in which we worked extremely hard to meet both our internal expectations as well as external expectations. The market was a challenging one. And we are now focused on Q4 and finishing the year very strong and heading into 2014, where we see a lot of opportunity for our company. And so, thank you, everyone, for joining us this morning for the call and have a great day.

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