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Walker & Dunlop, Inc. (WD)

Q2 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Walker & Dunlop Second Quarter 2014 Earnings Conference Call and Webcast. Hosting the call today from Walker & Dunlop is Willy Walker, Chairman and CEO. He is 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 o'clock AM Eastern Standard Time. The dial-in number for the replay is 1800-839-1198. 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, Leo. Good morning, everyone. Thank you for joining the Walker & Dunlop second quarter 2014 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 our 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 some of what Willy and Steve will touch on this morning.

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

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 include statements regarding future financial operating results that 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 the 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 SEC.

With that, I will turn the call over to Willy.

Willy Walker

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

Thank you, Claire, and thank you, everyone, for joining us this morning. The lending landscape for our business is dramatically different today than it was a year ago. FHFA's 2014 GSE scorecard was released in May and the GSEs multifamily businesses are back. The personnel at Fannie and Freddie are excited and focused on wining business. And Walker & Dunlop size and scale with the GSEs is paying dividends.

Long-term interest rates have backed up ending Q2 at 2.53% and currently at 2.51%. This rally in rates has once again made long-term fixed rate financing exceedingly attractive to borrowers. And even though 2014 commercial loan maturities are down 23% from last year, Walker & Dunlop has competed successfully to originate $4 billion in loans in the first half of 2014, down only 8% from last year.

With the recent launch of our CMBS platform, the continued expansion of our Capital Markets group, the fantastic growth in on-balance sheet lending we have seen, and our leadership position with the GSEs, we feel very well positioned for the rest of 2014, leading into 2015, when there is a 73% increase in commercial loan refinancing volumes.

The GSEs multifamily financing activity dropped dramatically in the first half of 2014 due to several factors. First, both Fannie and Freddie ran hard to hit their lending caps at the end of 2013 and took delivery of every loan they could, providing those spillover activity to start 2014.

Second, GSE refinancing volumes this year are at the lowest point since the financial crisis. Third, the 2014 FHFA scorecard was not released until early May, keeping both Fannie and Freddie in a state of wait and see. This all resulted in Fannie Mae's multifamily origination falling from $15.9 billion in the first six months of 2013 to $8.2 billion for the same period this year, a drop of 48%. Yet, Walker & Dunlop, due to our size, scale and focus on Fannie Mae, saw our Fannie Mae originations fall only 9%.

As a result, our market share with Fannie Mae has grown dramatically, reaching an all-time high of 18% in Q2. Our experience with Freddie Mac is similar. Freddie's multifamily volumes fell 47% from $13.5 billion to $7.1 billion during the first half of 2013 to 2014. Yet, Walker & Dunlop's market share with Freddie Mac expanded from 8.4% for the first half of 2013 to 9.5% this year. We currently have a pipeline of GSE deals that we have not seen since we acquired CWCapital in 2012. And we expect our Freddie volumes in Q3 to exceed our Fannie volumes for the first time ever.

Our HUD origination volumes were down 62% compared to Q2 2013. We've consistently said that HUD volumes are exceedingly hard to predict. So tracking them quarter-on-quarter is not a great indicator of the strength of this business. However, our HUD volumes are down 26% from the first six months of 2013, reflective of the competitive landscape and borrowers' unwillingness to endure the lengthy HUD loan origination process.

Many borrowers would love to lock-in long-term fixed rate financing for 40 years given where interest rates sit today. Yet until HUD improves its processes and timing to rate lock, it will remain a niche product that is difficult to sell when capital is abundant. We have one of the very best HUD origination and underwriting teams in the industry. And we'll remain focused on being one of the very largest and most profitable HUD originators in the country.

As seen on slide six, last year, our Capital Markets team originated $729 million of loans in the second quarter with 81% of those loans being brokered off to life insurance companies, banks and CMBS. This year our Capital Markets team grew their total originations in Q2 by 7% to $783 million. Yet only 70% of those originations were brokered off to life insurance companies, banks and CMBS. The other 30% were originated for Fannie Mae, Freddie Mac and HUD. Loan execution is where Walker & Dunlop earns not only origination fees, but also mortgage servicing rights.

As we outlined when we embarked on the expansion of our Capital Markets business, the strategy is to grow our access to deal flow and, when possible, generate new loan originations for executions where Walker & Dunlop earns origination fees and mortgage servicing rights. Our Capital Markets originations in Q2 show this strategy coming to fruition and also reinforces our previous point about the GSEs increased competitiveness.

Our balance sheet lending, referred to as interim loan program, grew fantastically and provides a needed and highly-strategic financing offering to our clients. We originated $66 million of interim loans for our balance sheet in Q2 or 3% of total origination, up 74% from $38 million a year ago. The pipeline of interim loans is strong as fully leased acquisitions are priced to perfection and borrowers are seeking higher returns by acquiring transitional assets.

We've generated double-digit equity returns in this program and plan to grow the average outstanding balance of loans to $250 million to $300 million. No deal better illustrates the value of our interim leading program than the $70 million student housing deal we originated in Upstate New York last August. The borrower needed a bridge loan to pay off their construction debt before the property stabilized. Walker & Dunlop won the financing assignment against a strong bank competition, promising flawless execution on the bridge loan and the best permanent financing available.

At the end of June, we structured a $72 million fixed rate takeout loan with Fannie Mae. We differentiate ourselves from the competition by moving quickly to underwrite and structure the interim financing and then executing flawlessly on the permanent loan. Prior to launching our interim loan program, we would not have had the ability to win either the bridge financing or the permanent financing. $142 million of financing later, we are very pleased to have this capability to offer our clients.

Our CMBS platform is up and running. And we're actively quoting deals with our first group of loans totaling $71 million moving towards securitization in Q3. Our objective is to originate $1 billion in conduit loans during the first year, which should happen between now and next June. For the rest of 2014, we expect to do two securitizations totaling $200 million.

Similar to our balance sheet lending, our CMBS venture benefits from the access to deal flow that Walker & Dunlop's origination platform provides. For example, we quoted a three-property multifamily deal in June for execution with the GSEs. The borrower requested more proceeds than an agency loan could provide. So we quoted the deal for our conduit. In the process of quoting the deal for our conduit, the borrower asked us to look at three transitional properties that needed bridge financing.

We closed and funded the three stabilized deals for our conduit and the three transitional deals for our balance sheet at the end of July. A year ago, we would have lost the deal after providing the GSE quotes. Today, due to our new CMBS conduit and scale balance sheet lending operation, we financed these six properties totaling $67 million.

I'll turn the call over to Steve to provide more depth on our financial results to-date and then come back to discuss what we see in the market today and going forward. Steve?

Stephen P. Theobald

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

Thanks, Willy, and good morning, everyone. The second quarter of 2014 marks my fifth quarter as the CFO here at Walker & Dunlop. And I've never been more excited about where our company is today and how we're positioned for tomorrow. Despite the challenges of last year, we have remained focused on creating a platform that is able to meet our customers' borrowing needs, while delivering solid financial results in any competitive environment.

Now happens to be an environment in which our longstanding GSE partners are once again competing aggressively for business. And while this has clear benefits to us today, as can be seen in our Q2 results, it does not change our focus on continuing to invest in broadening our platform and positioning ourselves to take advantage of the $0.5 trillion refinance opportunity that lies ahead.

With that, let me go through our financial results for the quarter in a bit more detail. Net income for the second quarter was $12.9 million or $0.40 per diluted share compared to $14.5 million or $0.42 per diluted share and $0.44 per adjusted diluted share for the second quarter of 2013. Adjusted EBITDA was $20.9 million, a 50% increase from the $14 million we reported for the second quarter of 2013.

Operating margin for the second quarter improved to 25% after being in the high-teens and low-20%s for the last three quarters. As illustrated on slide seven, total originations were $2.4 billion in the second quarter, down 7% from second quarter last year. The second quarter this year was almost the complete opposite of last year. It started quietly and ramped up very quickly with Fannie Mae and Freddie Mac competing heavily for deals.

Our originations with Fannie Mae and Freddie Mac were up 12% over the second quarter last year as both GSEs got progressively more competitive throughout the quarter. For example, Fannie's monthly delivery statistics show their volume increasing throughout the quarter from $1 billion in April to $1.5 billion in May to $2.2 billion in June. We expect both Fannie and Freddie to compete aggressively for business over the remainder of the year.

While our GSE volumes increased this quarter compared to last year's second quarter, our HUD volumes were down 62% year-over-year. While significant, this was not surprising as the second quarter of 2013 was our second largest quarter with HUD ever as we had a number of loans shift from the first quarter last year into the second quarter. Having said that, we're not expecting growth in our HUD business this year as overall HUD industry volumes are down significantly.

Our brokered originations in Q2 were down from the prior year Q2. But, as Willy mentioned, that is a function of agency competitiveness as our Capital Markets team originated significantly more agency volume in the second quarter of this year than they did in the second quarter of 2013.

We had another strong quarter of originations in our interim lending program, which helped us grow the portfolio even with the number of loans paying off. The portfolio ended the quarter at $194 million, up $47 million from the end of June 2013. We did the permanent financing on all of the $58.6 million of loans that we financed out of the portfolio during the quarter.

Turning now to revenues. As you can see from slide eight, total revenues for the quarter were $85.3 million, a 6% decrease from second quarter 2013. The decline in mortgage banking gains from the year ago quarter was partially offset by increased servicing fees, net interest income, and other income.

Mortgage banking gains declined as a result of lower HUD and brokered volumes and from lower margins, particularly gains attributable to mortgage servicing rights, which declined from 111 basis points in Q2 2013 to 95 basis points in Q2 of this year, as shown on slide nine. Servicing fees for our Fannie Mae originations have been under pressure this quarter as credit spreads generally have tightened and Fannie has been aggressively bidding for business. This has been particularly true in larger deals, which typically have lower servicing fee to begin with.

Looking at our loan originations in Q2, our average deal size has increased fairly significantly from $11.6 million in the second quarter of 2013 to $14.1 million in the second quarter of 2014 as a higher percentage of our GSE loans have been larger than $20 million. In fact, 64% of the loans we originated with Fannie and Freddie this past quarter are over $20 million compared to only 41% in the year ago quarter.

We expect the impact of deal size and competition to continue for the remainder of the year and, therefore, would expect the overall mortgage banking gain margin of 219 basis points earned in both the first and second quarters of this year to be a reasonable estimate for the back half of 2014.

Turning now to slide 10. Our servicing fees increased 7% over the prior year to $24 million. The servicing portfolio grew to $39.8 billion at the end of June, up 5% from the end of 2Q 2013 and, as you may have seen in our press release last week, have since crossed over the $40 billion mark. The weighted average servicing fee held steady at 24 basis points. And we don't expect much deviation from this rate going forward based on both the size and dynamics of our portfolio.

In fact, the weighted average servicing fee of loans added to the portfolio during the quarter was also 24 basis points. I think it's also important to point out that the third-party valuation of our mortgage servicing rights at June 30 was $432 million compared to our net book value of $349 million, indicating a substantial amount of unrecognized value embedded in our financial statements.

Interest and other income, while still a relatively small part of our revenue base, continue to grow and add meaningfully to the bottom line. Interest income nearly doubled in the quarter compared to the prior year as lower borrowing costs on our agency warehouse lines, the significant increase in our on-balance sheet portfolio, and growth in our escrow deposits help generated over $5 million in net interest income during the quarter. Other income increased by $1.5 million year-over-year due entirely to an increase in prepayment fees.

The components of our total expenses are illustrated on slide 11. Total expenses for the quarter were $64.4 million, down 4% from last year, as we continue to benefit from our cost reduction efforts. Compensation and benefit expense was down $3.3 million from the prior year as a result of our reduced head count and lower commission expense.

Overall, personnel expenses were 40% of revenue in the quarter, down from 41% last year. With the exception of interest and amortization expense, all other expense categories were $5.2 million lower year-over-year, a decline of 11%. In addition, our credit performance continues to look great with very low levels of provision expense.

As you can see on slide 12, we ended a second straight quarter with no loans over 60 days delinquent and with a low level of losses as we continue to settle with Fannie Mae on the few remaining problem assets we have left resolved.

Our results generated an improvement in our key return metrics compared to the first quarter as operating margin was at 19% for Q1 compared to 25% this quarter. Annualized ROE during the quarter was at 13.4% compared to 7.2% for Q1.

Perhaps most rewarding was the continued growth in adjusted EBITDA, which, as slide 13 shows, was $20.9 million during the quarter compared to $19.8 million last quarter and only $14 million in the year ago quarter. Growth in our non-origination income and expense management continue to power increases in adjusted EBITDA.

Looking ahead, we have a significant amount of capital available to invest to continue growing and diversifying the company. That capital will be deployed in a variety of manners. For example, we're committed to making an investment of up to $20 million in our CMBS platform. During the second quarter, we began to build a pipeline of potential deals. And subsequent to quarter end, we began putting our capital to work as loans have now been closed and funded.

The next step is to securitize those loans. And we're expecting our first securitization deal to happen this quarter. As Willy mentioned, overall, we would expect the venture to securitize about $200 million in loans during the remainder of 2014, of which we would receive 20% of the benefits through our ownership stake. We're very pleased with our CMBS pipeline and expect to gain momentum on the origination front in the second half of this year. Importantly, we will be well positioned to take advantage of the market opportunity in 2015 when we believe our CMBS platform will add meaningfully to the bottom line.

In addition to investments in our conduit program, we will continue to invest in our interim lending programs, with a goal to grow our on-balance sheet portfolio to between $250 million and $300 million in total outstandings. This would result in another $30 million to $40 million of capital based on the size of the current portfolio at the end of the second quarter. We continue to be pleased with the performance of our current portfolio and have sufficient capital and borrowing capacity to support our client growth.

As we look for other ways to invest for growth, perhaps the most obvious is continuing to bring on new origination talent. We're aggressively recruiting and have a number of potential hires in the pipeline. One benefit of having raised capital through the term loan is that we now have the financial wherewithal to bring on larger teams of originators all at once rather than one at a time accelerating our access to deal flow.

Given the dynamics of the last six quarters, we knew that the first half of this year would be a challenging comparison to the prior year. Having said that, I'm very pleased with our year-to-date results and believe that we have the momentum and the right business model in place for a successful second half of the year.

With that, I'll turn the call back over to Willy.

Willy Walker

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

Thank you, Steve. A year ago, when it was evident that our two largest business lines were going to be a challenge to grow, I hit the road and started a concerted effort to help sell Walker & Dunlop's financing solutions, both new and old. I logged over 100,000 miles net with over 100 clients and helped work on billions of dollars in deals. From hundreds of client meetings, I have a pretty good sense of what the market wants and what is making Walker & Dunlop win.

At a time when capital is abundant and deal supply is limited, real estate owners and developers want deal flow. Many of the larger real estate developers have shied away from the acquisitions market and focused on developing new assets, while owner-operators without development capabilities are competing fiercely for stabilized and non-stabilized assets.

REITs are not Walker & Dunlop's target market given their direct access to bank financing for construction loans and unsecured credit facilities. However, private developers of all shapes and sizes come to Walker & Dunlop to secure bank or life insurance company financing for construction loans as well as permanent financing, once a development is complete.

In the stabilized acquisition space, it is a [ph] food fight (22:50) to win deals. And, therefore, certainty of execution and timing from underwriting to rate lock is hugely important. Walker & Dunlop is differentiating itself along these lines with one $72 million deal in Q2 growing from issuing an application to locking the interest rate in 47 hours.

We're also doing more acquisition financing this year, growing the percentage of financing for acquisitions from 20% of total originations during the first six months of 2013 to 28% this year. This data point is extremely rewarding as two of our largest competitors, HFS and CBRE, both have scaled investment sales platforms to tie financing activity with investment sales. Yet, from their recent earnings calls, both saw dramatic reductions in GSE origination volumes.

Two points here. First, W&D's scale and partnership with the GSEs is showing its value every day. And, second, 2014 is showing itself to be a year with high acquisition financing volumes and low refinancing volumes. As we transition towards 2015 when refinancing volumes grow dramatically, W&D's financing expertise will continue to differentiate us from the competition.

The new leadership at FHFA has established a very distinct approach to the conservatorship of the GSEs. Although the scorecard remains in place, the leaders of the GSEs understand the mandate to which they are running there enterprises.

Nobody can predict with certainty what will happen at FHFA or on Capitol Hill. But the regulatory and legislative landscape looked better today for the continued operations of the GSEs than at any point since they went into conservatorship.

For the first time in many years, the GSEs are innovating products to address market needs. For example, they have created an index lock program that allows borrowers to lock to the treasury rate up to 90 days prior to locking in the all-in interest rate on a loan to compete with life insurance companies.

They are offering longer interest-only terms to directly compete with CMBS lenders. And they are allowing us to underwrite assets that are not fully leased to compete with banks and life insurance companies on transitional loans. This innovation has been a clear shift under the new FHFA's scorecard and it is wonderful to see the GSEs back in the market with renewed energy and new products.

In addition, our HUD Capital Markets and the interim lending programs are finding ways to win. Our HUD team is winning by focusing on seniors and affordable housing, two verticals where HUD financing is still competitive in a market with an abundant supply of capital and impatient borrowers.

Our Capital Markets business is differentiating itself based on access to capital and longstanding client relationships. It is also winning business for our GSE, HUD and Proprietary Capital groups, where we control the underwriting process and ultimate credit decision in many cases, adding a degree of certainty to the loan process.

Finally, the growth of our Proprietary Capital group is fantastic and shows the value of our origination platform and underwriting capabilities as we expand into new areas of commercial real estate lending. Between now and the end of the year, we will continue to execute in the markets where we have an established brand and fantastic client relationships to grow our lending volumes.

We expect to originate more loans in the second half of 2014 than we did in the first half. And we believe our bottom line in the second half of the year will show solid year-on-year growth. We're working exceedingly hard to maintain our leadership position as Fannie Mae's largest DUS lender. And we will keep chipping away CBRE's standing as the largest Freddie Mac Seller/Servicer as we continue to gain market share.

We will focus on winning new HUD financings and work with HUD to improve their processes and systems to better compete in these markets. We established a goal of brokering $3 billion to $5 billion in loans per year and are very focused on adding origination talent to our Capital Markets group.

Our CMBS conduit expects to complete two securitizations totaling $200 million before year-end, while establishing a strong reputation in the marketplace before the swell of CMBS refinancings in 2015 and beyond. All of this activity will grow our origination volumes over 2013 and position us extremely well for the future.

We will also continue building out our other lending and brokerage operations to be a broader, more diversified company. Just because the GSEs are back does not mean that we're going to slow down our efforts to continue diversifying and scaling our lending operations.

Over the past 12 months, we originated $8 billion in new loans when our two largest business lines were pulling back. We scaled our on-balance sheet lending program to close to $200 million. We created a brand new conduit from scratch. We grow our servicing portfolio to $40 billion. And we generated $70 million in EBITDA.

Top line growth is paramount to our future success. And we believe we are about to see that. But below the top line is an exceedingly durable, profitable business that is significantly more diverse than it was a year ago and it will be significantly more diverse a year from now.

We will continue adding loan originators to all of our business lines by acquiring companies or adding teams of loan originators as we've done periodically over the past several years. As we continue to scale our Capital Markets business, we will aim to start lending on non-multifamily assets using our own capital or with capital we raise from third-parties. We will also continue to add new financing capabilities to our existing offerings such as mezzanine debt and preferred equity to expand our suite of products as the markets evolve and clients' needs change.

If interest rates stay where they are today for the next several years, mezz and preferred equity will not be in high demand. But if rates move as many predict, mezz and preferred equity will be hugely important to meet the refinancing needs of many borrowers. And, as we add these lending capabilities, we will be adding asset management fees and interest income. As we have stated previously, it is our goal to have over 50% of Walker & Dunlop's revenues derived from servicing and asset management fees by the end of 2017.

I am, as always, extremely grateful for all the fantastic work of everyone at Walker & Dunlop. During the challenges of the past year, our team has kept its head down, focused on the task at hand, and done a fantastic job. We continue to win awards for being one of the great places to work, most recently from The Washington Post. And we continue to attract and retain some of the very best professionals in our industry.

Stockholders of W&D owns stock in a fantastic company today that has generated very solid financial returns over the past year in a shrinking refinancing market with significant regulatory changes. The outlook today is very different from a year ago. And those investors who have stuck with us owns stock in a dramatically more scaled and diversified company that has firmly established itself as one of the premier commercial real estate finance companies in the United States.

Thank you all for joining us today. And I'd like to ask the operator to open the call for questions at this time.

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Thank you. Our first question is coming from Bose George of KBW.

Bose George
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Hey, everyone. Good morning. Actually the first question is the outlook for the GSE market share. Obviously, you did an impressive job continuing to grow that. Just curious how you think that could trend.

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

Bose, as you can see from the slides, both the Fannie and Freddie market shares have grown significantly and consistently over the past several years. I honestly – I think we are seeing ours, if you will, standing as the largest Fannie Mae DUS lender and third largest Freddie Mac Seller/Servicer, really position us very, very well with clients.

That scale and expertise and what we're doing for clients is showing its value every single day. So I honestly – I have no idea. I can't project out. But what I would say is, as you probably know, CBRE is the largest Freddie Mac Seller/Servicer and has consistently had over 20% market share. And, as I said in the call, we're going to continue to chip away at Freddie's position as the largest Freddie Seller/Servicer and work hard to maintain our status as largest Fannie Mae DUS lender.

I don't think there is any cap, if you will. But it's a highly competitive market. As you know, there are about 25 DUS lenders and about 25 seller/servicers. And so it's hard for me to say we'll have 18.5% market share or 20% market share or that will fall back to 15%. Quite honestly, don't know. But we feel very good about where we are and how we are competing today to win agency execution.

Bose George
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Great. That makes sense. And then actually I wanted to switch to the comments you guys made on seeing some compression on margins on the larger loans. Just wanted to get an idea of what kind of magnitude that was.

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

A

I mean you gave the actual numbers on what we've seen.

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

A

Right. I think, Bose, on the mortgage servicing rights, I think, most of the compression was from the larger loans. There has been a little bit of compression in the sub $20 million market, but not nearly as much. And then I think the other dynamic of this is generally large loans and particularly really large loans where we don't have full risk sharing have lower servicing rates anyway. And so, to the extent we do more larger dollar, not full risk share, originations, that's going to also cause compression in the mortgage servicing.

Bose George
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Great. Thanks a lot.

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

A

Thank you, Bose.

Operator: Our next question comes from Jason Stewart of Compass Point.

Amy L. DeBone
Analyst, Compass Point Research & Trading LLC

Q

Hi. This is actually Amy DeBone sitting in for Jason. But if you could go back to the servicing fee compression question just one more time and maybe if we can ask it a little bit differently. But, from a ROE perspective for larger deals, does the size of the deal offset the lower fees, once lower costs are factored in?

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

A

So, Amy, I would put forth the following. We're very focused on earning servicing fees on large transactions that, A, are paying us for our risk and, B, paying us for the job we do in servicing the actual loan. And so, as a result of that, we constantly monitor, if you will, when we're getting paid for the risk and when we are not.

I would also say to you that as we look at that, one of the most exciting pieces to it, particularly in Q2, was that we actually this year versus Q2 of last year had the ability to win deals. A year ago, fee compression and whether we were getting paid enough on our servicing fee, quite honestly, was not even a debate, because we weren't winning the deals. The agencies were pulling back and not aggressively pricing to be able to win the deals.

And so, as we get into larger transactions, as Steve outlined on the call, A, we're thrilled to be winning them and, B, we are very much making plenty of money from a servicing standpoint to be paid both for our risk as well as for our cost of servicing the loan. But the entire, if you will, marketplace, not just Walker & Dunlop, but across the lending landscape, everybody is seeing net interest margin come down. And we are not, if you will, outside of that in the sense that to win deals that are having multiple bidders on them, you're having to sharpen your pencils, you're having to win where you can and we are seeing some fee compression on the larger deals.

Amy L. DeBone Q
Analyst, Compass Point Research & Trading LLC

Okay. So it sounds like lower expenses are factoring into the equation, but at the same time ROEs might be coming down across the industry in general for your competitors as well. Is that a fair conclusion?

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

Well, so, Amy, what you'll see is the following. If you look at the cost reductions that we've put into the platform back in November of 2013, we scaled ourselves down and we are operating with that human resource base that we scaled down to at that time. As origination volumes start to ramp back up, we are watching our hiring very closely. What you will get at some point as origination volumes expand is a place where we get real economies of scale, particularly if we continue to do larger deals that don't require more human resources to underwrite them.

So you're going to get the economies of scale at some point if you continue to do larger deals. The issue with it is that, as with any enterprise that is on a growth trajectory, you're going to have to figure out what that right point is from a staffing standpoint. So if you look at it on a deal by deal basis, you will likely see fee compression, because that $100 million financing is not earning the same servicing fee that it earned two years ago. So, on a deal by deal basis, you will see some compression there. But what we should be able to see and, as you saw in our Q2 numbers, we should be able to get some margin expansion across the platform if we get real economies of scale as origination volumes grow.

Amy L. DeBone Q
Analyst, Compass Point Research & Trading LLC

Okay. Great. Thank you. And just one more follow-up. It looks like for the interim loan portfolio repayment activity picked up this quarter. Did that pick up in repayment activity increased or impact the other income line item at all?

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

So, what I mentioned, Amy, is prepayment fees increased. So if you look at historically repayment experience we've had over the last six quarters, it's been relatively consistent. What's changed is last year a lot of our prepayments were in the HUD portfolio, for which we don't receive a prepayment fee. And this year, the prepayments have been more in the Fannie and Freddie portfolios. And we do receive a fee. And that's – in our case, those fees have offset the impairment in the mortgage servicing right that we have also recognized.

Amy L. DeBone Q
Analyst, Compass Point Research & Trading LLC

Okay. Great. Thanks. I missed that. And then just to get a feel for the – can you give us an idea of what the weighted average life was for the loans that that repaid and then what the average age or weighted average life is for the remaining ones in that portfolio?

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

A

Yeah. So the loans for the – that have been generated in prepayment fees are out of our primary servicing portfolio, not out of the interim loan portfolio. So, in the main servicing portfolio, our $40 billion portfolio, the amount of loans that have paid off early have not impacted the growth in that portfolio, nor has it changed the average servicing fees or weighted average life of those assets. They're still at 10 years and 24 basis points in average fee.

On the ILP loans, we expect actually a fair amount of turnover in that portfolio which is designed to be such because those are generally two year outside three year loans. And our expectation is the average life is only going to be probably 18 months duration. We have designed that portfolio to be able to do the permanent financing on those assets. And we did 100% of the permanent takeout, which means all of the $58 million that paid off the net portfolio in the second quarter we either placed with Fannie, Freddie or HUD.

Amy L. DeBone
Analyst, Compass Point Research & Trading LLC

Q

Okay. Great. Thank you for taking my questions.

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

A

No problem.

Operator: Our next question comes from Brandon Dobell of William Blair.

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

Q

Thanks. Maybe some color on where your, I guess, call it, producer or originator head count stands now either on a year-on-year basis maybe compared to where you finished 2013 at and how should we think about, I guess, the organic growth in that head count for the balance of this year?

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

A

So, Brandon, we're currently at 65. And that's up, I believe, from 61 at the end of 2013.

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

Q

Okay.

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

A

So net four adds. And it's where we are out in the marketplace as are all of our competitors trying to add the very best origination talent. And it's – I think that, as we mentioned in the script, the ability for us to either bring on full teams or acquire firms is something that we've been very focused on and we'll continue to be focused on.

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

Q

That's a good segue into your comment towards the end there really about non-multifamily properties. Maybe a little bit of color on timing and strategy. Is that going to be an organic effort? Is there a particular, I guess, mode of operation you plan to take? Meaning it's a geography you're already really comfortable in multifamily side or do the particular side of clients maybe have assets or money in multiple asset classes, so you can kind of cross-sell your way into dealing with their office or retail properties? And I guess just a little more color on strategy and timing to get into non-multifamily would be helpful.

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

A

Sure. So, Brandon, as you well know, two years ago, before we launched our balance sheet lending program and before we got into the CMBS space, the only risk we took from a lending standpoint was on our Fannie Mae DUS business. And, as much as we took credit risk on that, I believe that many people sat there and said they understand the GSE business. But, as a broad real estate lending platform, they're pretty focused just in the GSE space and they just take risk in the Fannie Mae DUS space.

Two years later, after launching both our balance sheet lending as well as the CMBS platform, we now have a much broader, more diversified platform that is underwriting assets, both for our balance sheet as well as for CMBS execution. I think that opens the opportunity for us to go and raise capital from third-parties or use our balance sheet to lend on non-multi assets.

The other piece that I would say from a market color commentary standpoint is that when I go out to meet with clients and we are pitching our Capital Markets execution, the differentiator there is long-term relationships and the capabilities of our finance people in accessing capital, underwriting the deals and finding the appropriate deal for the client. But to be perfectly blunt about it, it is not nearly as compelling a story as when we try and sell our multifamily execution where we are the largest Fannie Mae DUS lender, the third largest Freddie Mac Seller/Servicer and are doing things for our clients that nobody else can do.

And, as a result of that, we are very focused on trying to create similar type of differentiators for other asset classes, so whether that'd be hospitality, office, retail, potentially industrial. Those asset classes as well have huge refinancing volumes in 2015, 2016 and 2017. And as much as we have a very, very established brand reputation and execution capability in multifamily, there's lots of opportunity for us to expand out in other asset classes. So with the combination of the growth in the platform from an underwriting and risk taking on non-multi assets as well as having seen how compelling our positioning is in the multifamily space of controlling the underwriting process, the pricing process and the delivery process, that makes us very keen on creating those other lending executions.

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

Q

Okay. That makes sense. I wanted to touch on, I think it was just one bullet point in one of the slides about the servicing portfolio in the third-party valuation versus the book value – the delta between those two numbers. What's the driver behind that? And as rates move up and down, is there a big impact on how that spread between third-party valuation and book value would look?

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

A

Brandon, there is some impact of interest rates. As you know, because of the prepayment protection in the agency portfolio -

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

Q

Okay.

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

A

There is not as much impact of interest rates. There does tend to be a bigger impact on the HUD portfolio.

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

Q

Okay.

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

A

The actual prepayment history in the HUD portfolio – and the reason being when we book an MSR on those, we're only factoring in the servicing fees during the time in which there is a yield maintenance payment embedded in the loan, which typically on a 35-year HUD loan is going to be 10 years.

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

Q

Okay.

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

A

So, obviously, there is, from a pure prepayment theory perspective, a lot more years of servicing income, coming on those assets. And so those are a little more prone to the valuation on an interest rate perspective. The other, I guess, delta – and this is less about interest rates and quarter-to-quarter movement. But we do service loans for life insurance companies and others that we don't have any MSR recorded for.

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

Q

Okay.

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

A

There is a portion of the fair value that's associated with that servicing as well.

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

Q

Okay. And then final one from me. The increase in the average deal size, I guess, kind of a double-edged sword there. How do we think about that dynamics for the balance of this year? And I guess, maybe the – probably, more importantly, as you think about the increase in refinancing opportunities in 2015, does that larger deal size trends continue? Does the refinancing opportunity have the same impact on average fees? If it's – for these deals, if it's really refinancing, I mean, as opposed to just origination driven? I guess I'm trying to figure out how to think about those two dynamics, refinancing opportunity versus the larger loan size, as you work for this year, but mostly in the next year.

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

A

I honestly wish I had a clear answer for you though. I really do. I would say this that if you look at the deals that we did in Q2, we have, at W&D, a number of, if you will, 10 ton gorilla originators who have very large clients, who've done the majority of their financing with these originators. And with those originators, you get on average larger deal size. What has changed is that many of, what I would deem, our second tier originators have stepped up to start working with larger clients. And those larger clients have confidence in them to work with them on the larger financings.

And so, if you look at the distribution of deal flow in our origination sales force, what you're seeing is that next tier of originators doing larger deals, which is fantastic. It means that they've got client relationships with larger developers, owners, operators and they've got their confidence to get the ability to work on larger transactions. I do not know as I – let's just say that, in my mind, right now, I'm thinking about originator X who has created a new relationship with borrower Y, I don't know what borrower Y's 2015 refinancing volumes look like as it relates to average deal size.

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

Q

Yep.

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

A

But I do believe that since that group of originators has stepped into that type of a client relationship that we're going to continue to see the trend. In other words, we are going to continue to see larger deal size. And, as Steve said, on the quarter-on-quarter, we move from $11 million point some for average deal in Q2 of 2013 up to $14 million point something in Q2 of 2014. That's a pretty significant quarter-on-quarter jump. And on the agency side doing over 60% of our deal flow on $20 million plus deals shows that we're right there on the very biggest and the most competitive deals which we love doing and those borrowers have a lot of deal flow. They control a lot of market share. So us being one of the largest providers, working with the largest operators, that's great.

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

Q

Yeah. That's a bit of a double-edged sword, right? The average deal size goes up, compresses some of the fee metrics you see, but it probably puts you in conversations with a lot broader opportunities, especially given the different capital raising platform you have now as opposed to a couple years ago. So a couple years ago being in those conversations wouldn't have helped that much because you couldn't put them into the interim loan fund or the CMBS conduit or what have you. But it sounds like now that there are the larger deal size, maybe even as big of an issue because it provides more opportunities for you. Is that the way to think about it?

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

A

I think that's exactly right.

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

Q

Okay.

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

A

I think it's exactly it.

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

Q

Okay. Great. I appreciate it. Thanks.

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

A

Thanks, Brandon.

Operator: [Operator Instructions] Our next question is from Jason Weaver, Sterne, Agee.

Jason P. Weaver
Analyst, Sterne, Agee & Leach, Inc.

Q

Hey. Good morning. Thanks for taking the question. I wanted to start off with the HUD lending business. What can you say about any efforts you might have made for aligning that capacity [ph] and overheated that (50:43) business fluctuating and with the large fluctuations in demand.

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

A

Jason, as you can imagine, we work very diligently to do a couple things. One, to make sure that the origination sales force is in focus solely on HUD originations because they do come across originations for Fannie and Freddie and other executions – is point one. Point two is that, from an underwriting standpoint, underwriters on HUD understand how to underwrite HUD loans. They also, in many instances, know how to underwrite Fannie and Freddie loans. And so, there is some, if you will, flex capacity there to move resources from one execution to the other.

The other piece I would put on it is that we didn't talk about it on the call, but we are doing a significant amount of refinancing of our HUD portfolio. HUD has a interest rate reduction program going on right now, where we're refinancing a large portion of our portfolio and making fees on that. We do not count that in our origination volume numbers, but it is adding economics to our HUD team. And that is requiring time, effort and capacity to process those IRRs. And so, as much as our HUD team is off from a volume standpoint, significantly from an actual budget standpoint, it's not off as significantly, just because of the IRR activity.

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

A

And our HUD management team is incented on bottom line performance, not top line volumes. So they are managing the cost structure, in line with both the origination and the refinance opportunity that they're seeing today.

Jason P. Weaver
Analyst, Sterne, Agee & Leach, Inc.

Q

Okay. Thank you. Could you just talk a little bit about how you view the effect on margins from new entrants such as we heard Regions Financial has entered the DUS lending business and I expect a lot of other banks will be doing that as well?

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

A

So, as I said previously, Jason, there are 25 Fannie Mae DUS lenders and 25 Freddie Mac Seller/Servicers. It's always been and always will remain a very competitive market. I would put forth to you that there are only a few competitors, who can really go after the big borrowers and effectively compete for their business. And that really is a group of probably the top five in both Fannie and Freddie. The top five DUS lenders and the top five seller/servicers are our real competition.

That's not to say that there's not some historic relationship with someone – you used the example of Regions Bank. I'm certain that there's somebody who's done lots of construction financing with Regions Bank and has a longstanding relationship with them that sometime in the next couple years will come along and say I want to do my DUS execution with Regions because I have a longstanding relationship with Regions and would like to use them.

But we've seen a lot of very powerful, very big financial services institutions coming to this space and some have been successful and some have not been successful. We feel very well positioned from our track record, relationship with the agencies and access to deal flow to remain one of the very biggest. And it's always going to be a competitive landscape. So if you'd say that that DUS license was retired and went away, it wasn't going to change our world. And if you say that it's been acquired by Regions or anybody else, I don't think it changes our world that much either.

Jason P. Weaver
Analyst, Sterne, Agee & Leach, Inc.

Q

Fair enough. Understood. And one more quick one. Post the release of the scorecard, do you have any new thoughts on what's the previous question last quarter regarding GSE affordable housing targets and the tenant impact on multifamily business industry-wide?

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

A

So affordable is a very important component of the FHFA scorecard. And both Fannie and Freddie have significant affordable housing targets. And, as I think we've mentioned previously, Fannie, from the way that they aggregate deal flow, generally speaking, doesn't have a hard time getting to their affordable targets, whereas Freddie, because of the types of deals they focus on, is always working very hard to make it to their affordable housing targets but, as you know has always made them.

And, so the bottom line there is that we know that the affordable space is a space that both the agencies are focused on. We're doing as much deal flow in that space as we can. I believe that we were the third largest affordable originator for Fannie Mae in 2013. And one of the other ways that Freddie has moved towards affordable is to enter the manufactured housing space. And FHFA has allowed Freddie to get into the manufactured housing space.

We were Fannie Mae's largest manufactured housing originator in 2013. We have a very large client base in manufactured housing. And so the fact that Freddie is now in that space and we were one of the few lenders selected in the pilot program and they have now opened that up to everybody in the manufactured housing space, that's net positive to us, provides us with another capital solution for our manufactured housing clients.

Jason P. Weaver
Analyst, Sterne, Agee & Leach, Inc.

Q

Okay. Thank you for taking my questions.

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

A

Sure.

Operator: And it appears that we have no further questions at this time. I'd be happy to return the conference to Mr. Willy Walker for any concluding comments.

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

Great. Thank you all for joining us today. And we will be talking to many of you in the near future. Thanks. 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.