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Walker & Dunlop, Inc. (WD)

Q2 2015 Earnings Call

CORPORATE PARTICIPANTS

Claire Harvey
Vice President-Investor Relations

Willy Walker
Chairman and Chief Executive Officer

Stephen P. Theobald
Chief Financial Officer & Executive VP

OTHER PARTICIPANTS

Jeffrey D. Adelson
Morgan Stanley & Co. LLC

Jason M. Stewart
Compass Point Research & Trading LLC

Jade J. Rahmani
Keefe, Bruyette & Woods, Inc.

Benjamin Ira Zucker
JMP Securities LLC

Brandon B. Dobell
William Blair & Co. LLC

Charles J. Nabhan
Wells Fargo Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Walker & Dunlop's Second Quarter 2015 Earnings Conference Call and Webcast. Hosting the call today from Walker and 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 11:30 AM Eastern time. The dial in number for the replay is 800-723-0389. The archived call is also available via webcast on the company's website.

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

Thanks, Steve. Good morning, everyone. Thank you for joining the Walker & Dunlop second quarter 2015 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 some of what Willy and Steve will touch on this morning. Please also note that we may reference the non-GAAP financial metrics adjusted EBITDA during the course of this call. Please refer to the earnings release and presentation posted on our website for a reconciliation of this non GAAP financial metrics and any 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, including statements regarding future and financial operating results, involve risks, uncertainties, and contingencies, many of which are beyond the control of Walker and Dunlop and which may cause actual results to differ materially from the anticipated results.

Walker and 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. Now I will turn the call over to Willy.

Willy Walker

Chairman and Chief Executive Officer

Thank you, Claire and good morning everyone. Our financial results this quarter were fantastic on the back of strong loan origination volume, across all product lines. Year-to-date we have originated $7.8 billion in commercial real estate loans, representing 97% growth over the same period last year. Loan origination growth, combined with significant increases in servicing fees and interest income has generated diluted earnings per share of $1.32, for the first half of 2015, equal to 84% of the $1.58 of EPS we delivered for all of last year.

Beyond top and bottom line growth we have generated a 19.3% return on equity year-to-date and our adjusted EBITDA for the first six months has risen 58% to $64.3 million. As you can see on slide three of the investor presentation posted on our website all of these metrics are dramatically up from the first six months of 2014. Although we run our business for annual results, the first two quarters of the year have been incredibly strong and reinforce the strategy and investments we have pursued over the past several years, to create the premier commercial real estate finance company in the United States.

The market for commercial real estate debt remains on track to be larger than the industry predicted on the foundation of strong fundamentals and lower than anticipated interest rates. And we have seen the execution of our strategic growth plan rewarded in this refinancing cycle. Slide four shows that we are seeing year-over-year growth in just about every product we sell. And overall our total loan origination volume grew by 45% over the second quarter of 2014.

This quarter we originated $3.5 billion of loans while our newly acquired investment sales platform closed $319 million in investment sales volume in just 2.5 months, resulting in total transaction volume of $3.8 billion for the second quarter. In Q2 we originated $2.2 billion with the GSEs, or 59% of our total Q2 transaction volumes. We've had a remarkable start to the year with Fannie and Freddie, reflective of the leading market position we have created as one of the largest partners to the agencies.

As you can see on slide five, our year-to-date market share with Fannie Mae is 10.5%, down slightly from 12.4% for all of 2014 and 14.3% with Freddie Mac, up considerably from 10% in 2014. On a combined basis through June 30th, we have originated 12% of the GSE's $48.3 billion of deliveries. The Federal Housing Finance Agency, FHFA established the 2015 score card for Fannie and Freddie's multi-family businesses that was viewed across the industry as very positive. Due to the high volume of financing Fannie and Freddie did in Q1 the FHFA revised the 2015 score card in May to reclassify a significant volume of loans as affordable and therefore not to be counted against the $30 billion market rate lending caps established in the score card.

The expanded exclusion provides much needed liquidity to the multi-family real estate lending market while focusing the GSEs on their core mission of providing financing to work force housing across the country. While no data has been released by the GSEs or FHFA it is our belief that the adjusted definitions will enable each GSE to originate over $40 billion of multi-family loans this year. During the second quarter we saw the GSEs increase pricing in order to slow their pace of business leading to questions about the impact on volumes in the second half of the year.

At this point we expect our Q3 2015 originations with Freddie Mac to be similar to our volume with them in Q3 of last year, or in the range of $1 billion to $1.2 billion, while our originations with Fannie Mae will be down from over $1.1 billion in Q3 of last year to around $600 million to $800 million in this year. There are always deals that can accelerate or delay during a quarter but a month into Q3 we feel good about our Q3 GSE volumes. With FHFA's cap provision behind them the GSEs are back pricing competitively in the market and likely have to a combined $30 billion to $40 billion to lend for the remainder of the year.

Our Q4 pipeline is building nicely and we will continue to leverage our market leading position with the GSEs to have a strong end of the year. Our current expectation is that FHFA will publish the 2016 GSE score card before the end of the year and that it will be similar to the 2015 score card, in establishing lending caps of $30 billion for market rate lending while excluding from the cap small loans, manufactured housing loans and affordable loans. As I stated earlier with these exclusions it is our estimation that Fannie and Freddie will both have the capacity to lend over $40 billion annually.

I'd like to now turn the call over to Steve to discuss our financial results and then I will be back with some color on what we're seeing ahead of us. Steve?

Stephen P. Theobald
Chief Financial Officer & Executive VP

Thanks Willy and good morning everyone. I'll begin my remarks by touching on our key operating metrics, beginning with slide six. This quarter we outperformed our targets for each of our key metrics due in large part to the strong loan origination volumes Willy described. We earned diluted EPS of $0.67, up 68% from the prior year, reflecting the significant growth in loan origination volume total revenues and our continued close management of expenses. Diluted EPS this quarter also reflects the full benefit of our recent share repurchase.

We saw a dramatic increase in ROE from 14% in Q2, 2014 to 20% this quarter, well ahead of our low to mid-teens target driven by the combination of the increase in net income and the benefit of the share repurchase. Our operating margin this quarter was 29%, up from 25% in the same quarter last year, bringing our year-to-date operating margin to 30% well above our mid-20% target for the year. The growth in operating margin demonstrates the benefits of scale in our business as we grew revenues year-to-date by 51% while expenses only grew 35%.

Finally adjusted EBITDA grew 38% from Q2 2014 to $28.9 million as a result of significant increases in cash revenues such as origination fees, servicing fees and interest income with only slight offsets from growth in compensation related costs. Our loan origination volume grew to $3.5 billion this quarter, an increase of $1.1 billion or 45% over the second quarter 2014. For the first time in several quarters Fannie Mae was our largest origination partner with just over $1.1 billion of loans followed closely by Freddie Mac with just under $1.1 billion of loans.

Brokered originations were $973 million (sic) [$938.7million] (10:20), which includes $35 million of loans brokered to our conduit. The 60% increase in brokered originations this quarter reflects the continued execution of our capital markets growth strategy and we anticipate brokered volumes will continue to grow as a percentage of our overall loan original volume.

Our interim loan originations were $107 million in Q2 bringing our portfolio to $317 million and producing strong economic returns. Finally our HUD team did an excellent job of originating $150 million of new loans during the quarter. The growth in our loan originations is fantastic. As you can see on slide seven it helped propel increases across all components of our revenues, including 34% growth in mortgage banking gains, 17% growth in servicing fees, 55% growth in warehouse and other interest income and 100% growth in other revenues.

With such significant growth in loan originations it should come as little surprise to see the growth in our gains from mortgage banking activities. What was great to see this quarter was our gain on sale margin rising above 200 basis points, as you can see on slide eight? Let me take a moment to explain. First, the GSEs raised pricing during the second quarter, which had the benefit of increasing our average MSR per Fannie transaction from the first quarter. Second, Fannie Mae was our largest lending partner in Q2 and as Fannie originations are some of our most profitable this had a positive impact on margin.

Finally our average transaction size this quarter was $13.5 million, down considerably from previous quarters and thus earning us higher fees as a percentage of UPB than we do on large loans and portfolios. While we are pleased to be over 200 basis points in gain on sale margin in Q2, going forward we expect the gain on sale margin to return to the level it has been in the last couple of quarters.

We earned $4.3 million of interest income from our agency warehouse financing, up $2 million from the second quarter 2014 as we carried over a significant amount of our Q1 production in the warehouse and maintained a significantly higher average balance during the quarter than we did a year ago. We also earned $2.3 million of interest income from our interim loan portfolio this quarter, an increase of $711,000 over Q2 2014. The original strategy behind that balance sheet lending was to gain access to permanent financing deals that we might not otherwise have won or even seen. As you can see from slide nine that strategy has been very successful based on the amount of mortgage banking gains we have recorded on the loans that we have refinanced out of the portfolio.

And as you can also see we built an annuity stream of interest income that has grown nicely, enabling us to generate double digit returns and with no delinquencies in the portfolio. Over the last 12 months we have originated $15.2 billion in loans, which has not only benefited our financial results but also grown our servicing portfolio by 20% during the same period of time. Our servicing portfolio is now $47.7 billion, up from $39.8 billion a year ago. Most notably we have dramatically grown the size of the portfolio, while maintaining a weighted average servicing fee of 24 basis points and a weighted average loan life of 10 years.

Having an annuity that delivers significant cash flow every year for the next decade provides our shareholders with a valuable asset and our operating platform a consistent source of cash flow and financial flexibility.

Turning to our expenses, as you will see from slide 10, total expenses during the quarter were $81.3 million, an increase of $17 million or 26% over Q2, 2014. Personnel costs, our largest expense were up 35% over last year, largely due to the strength of our loan origination volume and financial performance which increased our commissions and subjected bonus expenses.

Additionally, since the second quarter of 2014 we've added personnel to support our increased deal flow and acquired two businesses in Johnson Capital and Engler Financial Group. Even with all the increased activity and personnel our personnel expense as a percentage of total revenues was 40% identical to Q2, 2014.

We also saw this quarter, an increase of 23% or $4.4 million, in our amortization and depreciation expenses compared to Q2, 2014. The majority of that increase was due to the growth in our servicing portfolio that I've discussed previously. A portion of the increase, approximately $600,000 was the result of the amortization of our pipeline intangible assets from the Engler acquisition. As has been the case for a while now, our loan loss provision expense continues to be de minimus with most of the expense this quarter related to the growth in the interim loan program.

We ended the quarter with no loans in our at-risk portfolio 60 days or more delinquent and only three loans remaining for which we are waiting to settle with Fannie Mae. Our continued stellar credit performance is both the product of the point we are in the credit cycle as well as the strength of our fantastic underwriting team.

I'd like to take a few moments to explain the impact of the Engler acquisition on our financials. The overall purchase price was not material and was paid primarily in cash with a small amount of stock. About $1.4 million of the purchase price was allocated to the value of the pipeline of investments sales opportunities that existed at the time the deal closed. On the income statement, investment sales revenues are being included as a component of other revenues. Personnel costs and the other general and administrative costs are presented in their appropriate line items. Since we acquired only 75% of the business you will see for the first time line items on our balance sheet and income statement for non-controlling interest, which represent the equity and pre-tax earnings of the business that continued to be held by the sellers.

In summary, we had a terrific first half of the year, with strong and profitable growth across the board. Our adjusted EBITDA has risen dramatically to $64.3 million for the first half of the year and as seen on slide 11 for the quarter has more than doubled since the same quarter just two years ago. Over the last 18 months the $149 million in EBITDA we generated enabled us to invest in growth initiatives and return capital to shareholders including the repurchase of over 5 million shares of stock, the launch of a new CMBS conduit, the acquisition of two new businesses and growth in our balance sheet lendings.

These investments are all contributing to the bottom line and helping us achieve our 19% year-to-date ROE. We expect to continue to reinvest in the business and deploy capital into these and other areas that we believe offer the best opportunities for superior shareholder return. With that I'd like to turn the call back over to Willy.

Willy Walker

Chairman and Chief Executive Officer

Thanks Steve. We've had the opportunity over the last few months to meet with many investors one-on-one. The recent increase in our stock prices been well received and with our current market position and financial results, we see great growth opportunities ahead. We have rapidly and carefully built one of the largest commercial real-estate lending platforms in the country in anticipation of the huge acquisition and refinancing activities taking place today.

The non-bank multi-family finance market is expected to be greater than $200 billion annually through 2017 and we have established a market leading position with three of the largest providers of capital to the multi-family industry in Fannie Mae, Freddie Mac and HUD. It is clear from the 2015 FHFA scorecard and recent actions to adjust the scorecard that the GSEs multi-family businesses will play a central role in financing workforce multi-family housing for a long time to come.

Beyond multi-family the broader non-bank commercial real-estate market is also expected to be greater than $200 billion annually through 2016. We have grown our brokerage volume 66% year-on-year by hiring great people and acquiring Johnson Capital. We expect to achieve our goal of originating between $3 million and $5 billion of brokered originations this year and we remain committed to growing the brokerage platform going forward.

The expected growth in the commercial real estate market was one of the main reasons for establishing our CMBS partnership with Fortress early last year. Nearly $55 billion of CMBS securitizations have closed year-to-date, on pace to hit the 2015 annual estimate of $110 billion. With growth expected again in CMBS in 2016 and 2017 we took the opportunity in Q2 to increase our ownership interest in the partnership from 20% to 40%. We will start to realize the benefits of our increased ownership interest beginning in the third quarter. A larger investment does increase our capital at risk, however we are currently securitizing assets within 90 days and effectively hedging our risks on those assets.

With a deeper understanding of the credit risks and a larger capital base at Walker & Dunlop we feel very good about increasing our ownership interest in this venture. We also see terrific growth opportunities for our newly established investment sales business. We believe it is a business that aligns nicely with our core lending operations and we see lots of opportunities to pair our expertise in both areas.

Walker & Dunlop investment sales generated $319 million of sales volume this quarter and we anticipate a similar run rate for the final two quarters of the year based on our current pipeline. Perhaps most important is that we see an excellent opportunity for expansion of the business beyond its primary footprint in the Southeast. Since the acquisition we've been in conversations with talented professionals around the country and remain committed to adding a presence in three major MSAs by the beginning of 2016.

Since we currently have offices in most major metro areas we anticipate being able to scale the investment sales business rapidly without adding significant overhead beyond the salaries and costs associated with recruiting those talented professionals. A consistent question from investors and clients alike is where are we in the cycle? Cap rates have compressed significantly, making many question whether prices for commercial real estate assets have gone too high, while record per unit and per square foot prices are clearly signs of a heated market, there is still limited supply of new product across the country. Are there specific markets that currently look over built, for sure, but generally speaking the slow growth recovery has kept new construction at a moderated pace which means a broad glut of new supply is unlikely over the next few years? So then we look at financing and whether the amount of capital exceeding demand is forcing lenders to make overly aggressive loans.

Although the market we operate in is highly competitive we have not yet seen the leverage levels or low debt service coverage levels that appeared in 2006 and 2007 that acted as catalysts to the last downturn. What is clear is that we will see a market downturn sometime and likely due to something nobody sees coming. And when that downturn comes the GSEs and HUD will play their designated roles as counter cyclical providers of capital to the multi-family real estate market. Our scale with Fannie, Freddie and HUD, combined with our almost $48 billion servicing portfolio will provide consistent business and cash flows when the commercial real estate market turns.

And although we have expanded our lending platform to include balance sheet lending, loan brokerage, a CMBS conduit and investment sales, we feel very good about the credit decisions we are making and the highly variable cost nature of these businesses. Walker & Dunlop is growing as fast or faster than most of our competitors in this up cycle but inherent in our business model, are scaled counter cyclical businesses and long term cash flows that perform well throughout cycles.

Lastly, there have been plenty of questions about interest rates, our expectations for rates, and what impact a rising rate environment will have on the growth of our business. We believe we will see one 25 basis points increase between now and the end of the year that will likely flatten the yield curve as foreign capital continues to seek safety in longer term U.S. treasuries.

This scenario would be positive for the long term fixed rate lending products that are some of Walker & Dunlop's most competitive and profitable. It would also mean that some of our customers that capitalized on the short end of the yield curve for the last two years may look to take out their floating rate debt with longer term fixed rate financing.

That said, it is impossible to predict when rates may change and what impact that change will have on the market. Perhaps the simplest answer to the question about interest rates, is that there is a huge amount of maturing debt that needs to be refinanced over the next 30 months and Walker & Dunlop is extremely well positioned to be a major player in that refinancing market.

I cannot be more pleased with financial results we achieved in the first half of the year. The acquisitions and investments we have made are creating the brand, market position and operating leverage that we desired. And we have created a scale platform with some of the industry's most talented professionals, all operating under one common culture of excellence and client service. We just held our annual summer conference for 450 clients, partners and W&D employees and what was most gratifying for me was to hear the tremendous accolades our clients gave our team for their character, capabilities and culture.

We have grown this company dramatically over the past several years and I have never been more excited about our future than I am today. With that I would like to ask the operator to open the line for questions. Thank you for joining us this morning.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] . Our first question is from Cheryl Pate from Morgan Stanley. Your line is open.

Jeffrey D. Adelson
Morgan Stanley & Co. LLC

Q

Hi this is actually Jeff Adelson speaking for Cheryl, how are you?

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Hi Jeff.

Willy Walker
Chairman and Chief Executive Officer

A

Good morning Jeff.

Jeffrey D. Adelson
Morgan Stanley & Co. LLC

Q

Just wanted to touch base really quickly on the net interest income from the warehouse. You saw some good growth there. I was wondering if you could touch a little bit on the sustainability of that going forward.

Willy Walker
Chairman and Chief Executive Officer

A

Yeah so Jeff that tends to fluctuate with volumes, given that the driver of agency warehouse interest income is – the amount of agency business we've done in any particular quarter. So as I mentioned in my remarks in the second quarter not only did we carry over a pretty sizable balance, if you look on the balance sheet at March 31, end of the quarter, we maintained that relatively high balance over the course of Q2.

So the average amount outstanding was higher than it was in the prior year which helped us show that increase in net interest income. And then on the loans held for investment that's obviously a function of the size of the portfolio and we're now at $317 million, at the end of the quarter, which is the high point for the portfolio. And we'll earn obviously a spread off that balance for as long as it's outstanding.

Jeffrey D. Adelson
Morgan Stanley & Co. LLC

Q

Okay great. That's actually all I had thanks.

Operator: Our next question is from Jason Stewart from Compass Point. Your line is open.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Thank you. Good morning and nice quarter. I wanted to ask about some of the market share numbers. I mean we are getting very preliminary data on the amount of affordable lending that the GSEs are doing and wanted to hear your thoughts on how your market share differed between what they are calling at the FHFA the affordable product versus the core cap eligible product?

Willy Walker
Chairman and Chief Executive Officer

A

Jason, we don't have our numbers broken down as it relates to our deliveries year-to-date on what was "affordable and not." But the numbers I have heard are that for the first half of the year, both the agencies were somewhere close to about 30% of their originations being, if you will outside of the cap and not all of that is affordable. That's also small loans and manufactured housing. So I haven't got an updated number recently on it but one was 28% and the other one was somewhere right around there.

So I think about, 30% and there have been since both of them have sort of shifted their focus towards affordable small loans and manufactured to make sure that they maintain capacity in their caps business, I would expect in the back half of the year, those if you will excluded percentages move up from where they were for the first half of the year, when there wasn't quite the focus on that that there was in – that there will be in the second half.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Okay. I think Freddie said 30% yesterday, I don't know, I haven't seen the Fannie number but that would be consistent at least with the Freddie said and I am guessing that some of the smaller balances have never been part of what WD has targeted. Is there anything, any of the small, I think Freddie had a new program out last week, are any of those new programs something that WD is interested in looking at participating in or does it just not make sense from a scale standpoint?

Willy Walker
Chairman and Chief Executive Officer

A

On the affordable side clearly we're – a lot of what the agencies do is workforce housing and so a lot of the deal flow that we've done year-to-date fits into that. The other piece to it is seniors housing, is also at 80% of AMI excluded from the cap and as you know we did a large seniors housing portfolio in Q1 and are very focused in that space. On the small loan side Jason you may remember when we bought CW Capital they had a small loan origination business which we exited in the end of 2013.

We found it exceedingly difficult to originate deal flow outside of the portfolio we acquired in that acquisition. And so we sold off those small loan portfolio, we still have a little bit in our servicing portfolio but we stopped the originations there. We are partnering with some people who are very focused on the small loan space, when we do get small loans because we'd like to be a good partner with the agencies and they are very desirous of that product. But as you said it's not really where our focus is from an origination standpoint, it's not where our client base is. And so specifically to your question right now we're not creating a small loans origination business.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Okay that's perfect. One for you Steve, but thank you for the color on the warehouse line, trying to make sense why that number was higher but could you just can you just give us some color on how will that will carry over and I think if I'm not mistaken this is the first time you've carried a substantial amount. If you could give us the number that you carried over and what the impact on gain on sale if any, I don't know if you fair valued those and it's in the 2Q number or, if it carries over to 3Q.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

I'm not sure. I'm totally following your question, Jason because the warehouse interest income doesn't really have any impact on the gain on sale, because that's pretty much done at that point where we rate-locked the loan so, just from a kind of the way the process works we lock the rate, forward sell the loan simultaneously; we book our revenue at that point. We don't have anything in the warehouse yet because we haven't closed along with the borrower. So it might be a couple of days, it might be a week or so before we actually close that loan and fund it.

At that point it sits in the warehouse for probably 30 to 45 days before it gets delivered to the investor. So we are really talking about that 45 day period that the loan sits in the warehouse. And because of the strength of our Q1 volumes, we just carried over a huge amount that was both in the warehouse at the end of Q1 as well as deals that subsequent to Q1 closed in the second quarter, which elevated the average balance of our warehouse lines.

So you see this periodically, fourth quarter historically has been a big volume quarter for us. You will see increases in warehouse interest income during those periods. I think typically as you know Q1 is a slower quarter and we generally don't carry that much volume into Q2 but this Q1 was much different.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Okay. So that was part of my – I mean I was getting at how long loans have been in there and 30 to 45 days is pretty typical. So that hasn't changed much.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Right, and then my other point there is if we rate locked a bunch of loans in March they may not have closed until April. So they wouldn't have even been in the warehouse at the end of March but then they're going in, in April and like I said they will be out for a substantial part of the quarter at that point.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Okay, thanks. I'll jump out.

Willy Walker
Chairman and Chief Executive Officer

A

Jason, just one another quick thing because if you are trying to figure out what is held over from one quarter to the next, if you look on our balance sheet, the loans held for sale, that gives you a sense of what's sitting on the warehouse lines as waiting to be delivered. So I just pulled out in front of me at the end of 2014 we had $1.72 billion in loans held for sale and at the end of Q2, so I don't know – I don't have the Q1 number in front of me we had $833 million sitting in loans held for sale.

So that gives you a sense of what's sitting – as Steve actually was saying what's sitting at the end of the quarter that is held for sale and we will continue to carryover that warehouse interest income quarter-to-quarter.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

We were almost $1.3 billion at the end of the first quarter.

Willy Walker
Chairman and Chief Executive Officer

A

Yeah, so there's your delta right now. About $0.5 billion in loans held for sale more at the end of the Q1 than we had at the end of Q2.

Jason M. Stewart
Compass Point Research & Trading LLC

Q

Got it. Thank you very much. Appreciate it.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

You bet.

Operator: Our next question is from Jade Rahmani from KBW. Your line is open. Jade Rahmani your line is open.

Jade J. Rahmani
Keefe, Bruyette & Woods, Inc.

Q

Hi, good morning. Thanks for taking my questions. You gave some color around potential 3Q originations. Wanted to see if you could share any thoughts on 4Q volumes, whether that has the potential to match last year's, given that your volumes in that quarter would be including rate locks for deliveries that would likely take place in 2016?

Willy Walker
Chairman and Chief Executive Officer

A

Right, Jade. I just put forth as we said in the script, the Q4 pipeline is building very nicely. And with the agencies having $30 billion to $40 billion of capacity still for this year and now that the FHFA adjustment is behind us we're getting back to what I'd call a very normal flow of business and as such, I think we'll have a very good end of the year.

We aren't giving guidance on Q4 and we felt that it was important to give people a sense of what Q3 is looking like for the agencies, given there were questions around if you will that five or six week period where Fannie and Freddie sort of hit the brakes as FHFA was trying to figure out what if anything they were going to do.

But the other piece that you are asking about in your question is that the score card works for that year's deliveries, so anything that we rate lock in November and December and even a little bit back into the latter, the back end of October are really 2016 deliveries. So you're delivering into a new score card when you're locking deals at the end of October and clearly for the month of November and December. And so we've only really got another probably three to 3.5 months left of use for the 2015 score card before deliveries and deals that we're underwriting, are going into the 2016 score card.

Jade J. Rahmani
Keefe, Bruyette & Woods, Inc.

Q

And when you look at the year ago fourth quarter would you say that was elevated volumes because the first half was depressed or would you consider that to be more normal?

Willy Walker
Chairman and Chief Executive Officer

A

If you look at our business historically Q4 is the most active quarter and given the way the markets are functioning right now we expect that Q4 will be a normal Q4 which is typically a very strong quarter. I don't want to get out of [indiscernible] (34:42) in trying to predict what Q4 is going to be or to say that Q4 is going to be stronger than the Q1 or the Q2 that we had this year. Q1 and Q2 were record quarters for us but we feel extremely good about our market position with the agencies and more broadly all the businesses that are now, as Steve and I both talked about in the call growing very dramatically.

If you look at our brokerage business, we did $800 some million in the first quarter, we did $900 some million in the second quarter. We're seeing great growth in that business line. Balance sheet lending has grown CMBS is hitting its stride, we've just entered the investment sales business and there's just a lot of business activity going on in the market today and we feel that all of the investments we have made position us very well to take advantage of that.

Jade J. Rahmani
Keefe, Bruyette & Woods, Inc.

Q

In terms of the interim loan origination business do you anticipate any ramp in volumes there?

Willy Walker
Chairman and Chief Executive Officer

A

So we're – it's become a great product for us, Jade. The real thing that we're managing right now is new originations versus pay-offs, and as Steve highlighted in his slide and comments our capture rate of interim loans going to permanent financing has been fantastic, pretty much all of the loans we put on to our balance sheet have turned into permanent financing. So it's a little difficult for us right now given that there are a number of deals that are ready for refinancing to see how – what we have from a pay-off standpoint, new originations but we've given in the past guidance that we were going to build that up to being $250 million to $300 million. We're now at $317 million. So we are little below north of the mark.

But we feel great about that business. We love the credit, it's all multi-family focused so we have the take outs with the agencies or HUD in place and quite honestly one of the most important things there is that that focus on multi-family means that if for whatever reason there is a disruption in the market that counter cyclical role that Fannie and Freddie and HUD play, those loans that are sitting on our balance sheet actually have permanent capital they can go to.

If those were hotels, retail centers or office buildings and the markets were to dislocate, a takeout loan isn't nearly as, if you will visible as it is in the multi-family space and that's one of the reasons we focus just on multi-family lending in that program so far.

Jade J. Rahmani
Keefe, Bruyette & Woods, Inc.

Q

Okay, thanks for that. Just regarding commissions as a percentage of origination fees they totaled around 70% from 63% last year. Clearly the origination volumes have been well ahead. But do you think something in the 70% to 75% range is a reasonable expectation?

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Hey Jade, I think your math might be including the company bonus in that percentage because our commission rates aren't that high. We pay our people well but not at that level. But I guess to get to your question I would expect that commissions as a percentage of our originations will be relatively high, the rest of the year just given how much volume we've done and the fact that it's been broad based across most of our production staff. So they're all into or near the maximum points in their commission splits.

Jade J. Rahmani
Keefe, Bruyette & Woods, Inc.

Q

Great, thanks for taking my questions.

Operator: Our next question is from Ben Zucker from JMP Securities. Your line is open.

Benjamin Ira Zucker
JMP Securities LLC

Q

Hi, good morning, great quarter guys and thanks for taking my question. I was going to ask about the gain on sales margin but you guys did touch on that in pretty good detail. I guess that the loan mix was more favorable and also the fixed versus floating rate weighing and average loan size. Could you explain that other reason that you mentioned that had to do with the GSEs increasing their rates during the quarter and how that translated to a higher gain on sale?

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Sure, Ben happy to do that. So one of the outcomes of an increase in pricing was an increase in the servicing fee, the average servicing fee we receive on our Fannie Mae loans. So I mean basically it was as simple as we got higher average servicing fees in the second quarter than we did in the previous, really three quarters, two quarters. And when we translate that into our gains from mortgage servicing rights it caused an increase in the margin.

Benjamin Ira Zucker
JMP Securities LLC

Q

Okay, I got that that makes sense. Just shifting subjects a little bit, is there any sort of projection from what the investment sales volume will be or can be going forward and I'm looking out more to 2016, because you guys did provide some guidance for the rest of 2015. And I'm not looking for any firm guidance, but just given the recent acquisition and the volumes we saw in this quarter, which seem like a better run-rate than EFG was posting prior to the acquisition. I was just curious where do you think this business could be once it's fully scaled and entered in more markets and property types.

Willy Walker
Chairman and Chief Executive Officer

A

Let's see here.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

I can start it while...

Willy Walker
Chairman and Chief Executive Officer

A

Go ahead, go ahead while I collect my thoughts.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yeah, so that I think it's kind of the un-knowable question, because it's highly dependent on how successful we are at recruiting additional teams and the timing of us bringing those teams on. So as Willy mentioned our goal is to be in three more MSAs by the beginning of next year. If we're successful at doing that, we hopefully have three new teams of folks who are hitting the ground running. It will likely take some period of time for people to rebuild pipelines back up. So you're going to have some delay in that.

So again it's highly dependent on the success of our recruiting efforts, to get a step change from the levels we're at now.

Willy Walker
Chairman and Chief Executive Officer

A

I've collected my thoughts now. So here is the bottom line on it. As you mentioned, the Engler team hit the ground running when they joined Walker & Dunlop. The synergy that we're getting between our financing platform and their investment sales platform is fantastic. And there are many investment sales brokers across the country who are on platforms that do not have the financing strength and market position that Walker & Dunlop does. And therefore we believe that there are plenty of candidates, really good candidates who would jump at the opportunity to be on a combined investment sales financing platform that has the brand and the market position that Walker & Dunlop does.

So we see a great opportunity there. If that turns into three teams at the beginning of 2016 with each are going to do a $1 billion in annual originations you can do your own math. That's the type of teams that we're looking for. But as Steve just said, maybe we get just one person whose is a a great $250 million to $300 million a year originator in Southern California. Okay, great that's a wonderful place to start our Southern California investment sales business, and we'll build from there.

But we see a big opportunity and given the velocity in the market today as far as investment sales, all you have to do is look at some of our competitors and the amount of investments sales volume that they've been benefiting from over the past couple of years and the growth that they have seen, and again I'd put forth, I think we've got a better market position than almost anyone in the multi-family space, and so those investment sales brokers on platforms that don't have that will naturally say hey, that's a great opportunity for me.

Final thing I'd put in there is that we purposely put that we'll hopefully have three teams by the beginning of 2016. As you know getting people to jump mid-year or towards the end of the year, as they're getting into the high-end of their splits is very difficult. So a lot of our recruiting work right now is focused on getting teams that will come to us at the beginning of 2016, potentially not between now and the end of the year.

Benjamin Ira Zucker
JMP Securities LLC

Q

That makes perfect sense and that's great color, appreciate it. And then lastly, if I could ask one more kind of big picture, I know you also offered some information about the 2016 score card. We've also heard some people talk about the potential for increasing the $30 billion of cap limit and also some who think that the exclusion definitions will be brought in even further to pave the way for more of these affordable housing loans. And I was just wondering, if you guys think that any of these are possibilities or if you kind of think the scorecard will look more similar to 2015 aside from the earlier publication and that's it from me. Thanks guys.

Willy Walker
Chairman and Chief Executive Officer

A

Sure. I'll put a huge disclaimer before I make any statements on this which is I don't know and we don't know and we will see when it comes out. As it relates to market commentary, I think on you first point, as it relates to expanding the caps beyond $30 billion, I personally would be surprised if FHFA does that. I think that they feel comfortable keeping them at $30 billion market rate caps. As it relates to your second point about modifications to the affordable definition, small loan definition or manufactured housing and seniors housing, I would think that there could be some modifications there, and I have heard a number of different areas that they're focusing on potentially broadening some of those definitions.

But I think at this point, I think it – to sort of take what will 2016 look like. I think 2016 will look a lot like 2015 and if 2016 looks a lot like 2015 and the multi-family market is as big or bigger than it is this year, which is what the mortgage bankers association is projecting, it will be another fantastic year for the multi-family market and the agencies will play a very significant role in financing the multi-family asset class in that market.

Benjamin Ira Zucker
JMP Securities LLC

Q

Great. Thanks so much.

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

Brandon B. Dobell
William Blair & Co. LLC

Q

Thanks. Good morning everybody. I want to focus a little bit on the sourcing portfolio, you mentioned you still got the same kind of duration as you had before and obviously the fees have maintained. Deals that are coming into the portfolio versus deals that are moving out or getting paid out, how do you think about the quality, attractiveness those kinds of things of the inverse of the out on the portfolio these days?

Stephen P. Theobald
Chief Financial Officer & Executive VP **A**

So, Brandon I think given the increase we saw in the average fee on the Fannie business in the second quarter, what went into the portfolio had a higher average servicing fee than what came out of the portfolio in Q2. So obviously we feel really good about our ability to sustain that 24 basis point average fee.

Brandon B. Dobell
William Blair & Co. LLC **Q**

Okay. As you think about prepayments and others, the small prepayment income in this quarter, remind us what happened in the back half of last year pre-payment wise, and if you got any visibility on what they may look like the back half of this year?

Stephen P. Theobald
Chief Financial Officer & Executive VP **A**

So, back half of last year, we've recorded I think around $4 million each quarter in prepayment fee income, as I recall. So and I think first quarter was fairly similar, we've done a little bit here in the second quarter. I mean at this point it's really hard to predict. We don't have a lot of visibility into when things are going to prepay unless they're in our pipeline. But given that we've been running at about the same level for four quarters now I would assume it's going to continue at that pace.

Brandon B. Dobell
William Blair & Co. LLC **Q**

Okay, and then Willy you touched on something relative to rate hikes and what it may do to fixed versus floating. How much visibility do you have in your conversations with the customers on when they may start thinking about reacting, what are some of the other drivers that they may look at, to move between the different products, just trying to figure out how much visibility you have on what that fixed versus floating trajectory may look like through the end of this year and probably more importantly for how we start thinking about some of the fee structures for next year?

Willy Walker
Chairman and Chief Executive Officer **A**

Yeah, Brandon, as we've discussed previously in Q1 we saw a lot of floating rate debt going out even as the discussion on an interest rate hike was very much on everyone's mind, which I don't think was – nobody was concerned about interest rate hikes. I think it was more driven by the only way for people to win business was to take the delta, if you will, between the floater versus a fixed rate instrument to be able to buy it and still have positive carry on the deal. And also a lot of funds were buying in Q1 and funds typically, as you know want to buy and sell much quicker and so the lack of the prepayment protection in a floating-rate instrument versus a fixed rate instrument was very attractive.

Brandon B. Dobell
William Blair & Co. LLC **Q**

Okay.

Willy Walker
Chairman and Chief Executive Officer
A

We came through Q2 and our – the percentage of variable versus fixed sort of went back to normal, of course to 75% fixed and 25% variable in Q2. I would put – go back to – I think it's really market driven more than it is interest rate driven. To the extent that everyone has been sitting there waiting to trying read the tea leaves on when we're going to get interest rate hike. I think most people feel as if – I don't want to say fool me once, fool me twice or what have you. But nobody really believes it's going to happen. So I think right now there is a lot of – let's just keep on operating until they actually do it and then we'll react.

Brandon B. Dobell
William Blair & Co. LLC
Q

Okay.

Willy Walker
Chairman and Chief Executive Officer
A

I think one thing we will see happen is that when rates do move, I think you will see a slowdown in the investment sales market for a period of time. I think there will be a repricing of capital and I think buyers will want a repricing of deals commensurate with the shift in interest rates. If you look at what happened on Fannie and Freddie and then pulling back in Q2, the investment sales business also slowed down during that period of time and people waited to see are the agencies going to be there and am I going to get the financing that I thought I was going to get to make this deal work and it took about four to five weeks for the market to kind of get back up and get going.

I would think and I'm just projecting here, I would think that the investment sales market has a similar type period when rates move, for people who sit there and say okay how am I feeling about buying this asset at a 4.8% cap or 5.2% cap or 6% cap, given the financing I was going to put on it and just having a 25 basis point increase in rates.

One other piece to the equation that we did touch on is that we do think it will flatten the yield curve as the ten year sort of if you will stays begrudgingly low. There are plenty of economists who think that rates will move in lock step and as the short end of the curve moves the long end of the curve will move similarly. We clearly don't know. But given that the 10 year has been popping around here at sort of 220 bps and up to 240 bps and then recovering back down to 220, it's right now hard for us to see, that drive for 10 year securities, 10 years of U.S. treasuries drawing up as other sovereign debt instruments are yielding people double-digit basis points or low triple-digits of 117 bps or 120 bps versus a 220 bps U.S. treasury.

Until you see some adjustment there on where the global capital markets are for the cost of debt and the yields people are getting, I think we continue to see the 10 year staying – if you will in this band that we've seen it playing around in of 220 bps to 250 bps.

Brandon B. Dobell
William Blair & Co. LLC
Q

Got it. Okay. Steve, as you think about the impact of the increased ownership of the CMBS partnership, I was assuming that would show up in either in other income line or maybe some place else. So I just want to try and understand how big of an impact that shift in ownership is going to be as we think about modeling back half of the year and 2016 versus front half of this year.

Stephen P. Theobald
Chief Financial Officer & Executive VP

A

Yeah, so right now Brandon because we do only own now 40% instead of 20%, it's still we don't have a controlling interest. So we are still accounting for this under the equity method. So it's basically we are picking up the results of the venture through other revenue.

Brandon B. Dobell
William Blair & Co. LLC

Q

Got it. All right, that's it for me. Thanks.

Operator: [Operator Instructions] . Our next question is from Charles Nabhan from Wells Fargo.

Charles J. Nabhan
Wells Fargo Securities LLC

Q

Hey, guys. Most of my questions have been asked. But I wanted to ask about some of the larger P/E driven transactions that you had alluded to during the quarter. I believe Willy you mentioned that Walker was bidding on a couple of deals that may or may not go through GSE execution. So do you have any updates on those transactions?

Willy Walker
Chairman and Chief Executive Officer

A

I'm not sure I mentioned anything on it. You got anything in particular you want to ask me about?

Charles J. Nabhan
Wells Fargo Securities LLC

Q

I believe the comment, I think it occurred at a conference in May was that they were larger deals that may or may not go the GSE execution route, which would obviously have an impact on the caps. So we could take it offline if you don't have anything to add on that.

Willy Walker
Chairman and Chief Executive Officer

A

No, so you may have seen in Commercial Mortgage Alert last week. The Lone Star – the announcement of the Lone Star deal acquiring Home Properties. We didn't do that as you probably saw there Berkadia ended up doing with Freddie. We were in the mix there and didn't win. But there is a significant amount of activity going on right now for larger portfolios. And when people are focused on the larger portfolios they are talking to the largest partners to the agencies. And so in pretty much all of the large deals going on right now people are calling up Berkadia, WD, CBRE and Wells Fargo to say hey we're got a big opportunity you want to work on this with us.

And so, as we saw in Q1 we had two very large portfolio deals that happened in Q1 which pushed our average loan size up. As you see in Q2 we didn't have any large portfolio deals going on at that time. But there is a lot of activity in the market and they're not only on the take private side but just large portfolio deals whether they are publicly traded or privately traded where people are trying to get assets and improve them and get their yields.

Charles J. Nabhan
Wells Fargo Securities LLC

Q

Okay great. And as a follow up I wanted to ask about gain on sale margins within the conduit business. Obviously spreads have widened over the past month, couple of months or so. So I wanted to get an update on what you're seeing from a margin standpoint within that business.

Willy Walker
Chairman and Chief Executive Officer

A

Our margins in Q1 on the conduit were fantastic. But I think that was more a result of both, well it was timing and also the collateral we were contributing. In Q2 margins came down but not, I mean still at a very healthy level. Can I give them what the margin was? So we had a 2.4 point gain on sales margin in the pool that we sold in Q2. And so we budgeted to 2.5 points margin on that. So coming in at 2.4 points was right where we wanted to be. But that was tighter than we had priced previously. And as you well know that the market is very dynamic and it is always coming down to what's the collateral and where is the marketing pricing and obviously more – where did you price the deals when you actually took them down.

So we felt about very good about both Q1 and Q2 as it relates to margin on the conduit. And we look forward to continuing forward with the type of pricing we seen so far.

Charles J. Nabhan
Wells Fargo Securities LLC

Q

Great. Well I appreciate the color guys. Thank you.

Operator: And there are no further questions at this time. I would like to turn the floor back over to Willy Walker for any additional or closing remarks.

Willy Walker
Chairman and Chief Executive Officer

Great I'd just reiterate my thanks to the W&D team for a fantastic quarter, and also to our finance and legal teams for doing what they always do at the end of the quarter which is pull all this together, so we can have a good filing and a good earnings call. So thank you to the team and thank you everyone for joining us this morning. 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.